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esure Group 16/08/2018 **FAT-UK-746**

ESUR GBP £2.77 Spec. **MED.** **SH**

Fat Prophets take some Profits

Shares in online direct insurer, esure Group (LSE.ESUR) have surged in the last couple of days after the company received a takeover offer from Bain Capital for a whopping 37% premium to last Friday's closing price. Along with the announcement on the deal, the company also reported a 15.6% drop in after tax profit, with the bottom line impacted by claims related to extreme winter weather conditions earlier in the year. In the meantime, we recommend Members take profits with a Sell Half rating on the shares.

What's New?

The most salient development since our last coverage last July (FAT-UK-741), in our view, and also garnered full attention from the media, was a takeover offer by Bain Capital, a leading private equity firm with circa $95 billion in Assets Under Management (AUM) announced Monday 13 August 2018. This was also briefly covered in our Mid-Week Alert.

In the offer, Bain Capital, through its subsidiary Blue (BC) Bidco Ltd (Bidco), to acquire the entire company for approximately £1.207 billion, on a fully diluted basis or £2.80 per share, which is a 37% premium to last Friday's closing price of £2.04.

The latest development here was the announcement prior to the market open Tuesday (14 August) that the Board has reached an agreement with Bain Capital to recommend to Shareholders to accept the offer in the upcoming General Meeting sometime in early October 2018.

The Board has reached a unanimous agreement to back the deal following a review of the Independent Directors (Mr Darren Orgden & Mr Martin Pike) of the terms as well as the backing of the Chairman, Sir Peter Wood and the second largest shareholder, Toscafund, a London-based hedge fund. In theory, this accounts for 48.027% of the vote split with Sir Wood (~30.69%) with the largest count, Toscafund (~17.01%) and the other Independent Directors (0.327%).

However, Members should note that this development does not necessarily mean the deal will go through since its still subject to the standard regulatory approval and a 75% majority support from the shareholders in the upcoming General Meeting. That said, if the agreement is accepted and the deal pushes through, it is expected to be completed in the 4Q18 according to the filing.

In addition to that, there is a key detail with Sir Wood not entitled to cast his vote considering his arrangement with Bain Capital that he is to be retained as Chairman and that he will rebuy a minority 4.26% stake.

The Managing Director and co-head of Bain Capital Europe, Robin Marshall, commented on this saying "Sir Peter Wood is a towering figure in the industry and we would be delighted to be able to take the company that he and his team have built to the next level. **We are excited that he will remain a minority shareholder in the company and also grateful that he will remain as chairman to facilitate a smooth transition to private ownership**."

Though, in all likelihood, we expect this deal to push through considering the attractiveness of the offer. However, we cannot discount a possibility of a rival competing bid as the deal currently values the company at circa 12.9 times forward consensus estimates, putting it only slightly over the Median Sector value of 11.8 times, and given the strength of the company's offerings relative to its peers and its pace of growth.

That said, considering the fact that the company (and sector) is currently in the downcycle phase for premium rates, we do recognise that the offer price is generous – relative to the recent prices – and this captures a significant portion of benefits from a sector upcycle view. **Accordingly, we recommend that Members lock in some profits now and sell half their holdings in esure (LSE.ESUR).**

Along with the announcement on the deal, esure also announced its results for the first half (1H18) of the year, which we also briefly review below:

1H18 Results Review

Starting from the top and 1H18 revenues maintained its momentum with GWP up some 12.0% year-on-year to £440.3 million and well on track (~49.6%) to achieve FY18 consensus estimate of £880.6 million. The company also reported solid growth in its Motor Insurance customer base, which increased 13.3% year-on-year, or addition some 232,000 to have in-force polices numbering 1.972 million.

Going forward there might be some bumps in the road in the near to medium term given the weaker prospects from the housing market (which we have noted in our property reports), implying continued weakness in the Home Insurance segment, though the Motor segment is likely to continue to have a positive year from the ongoing reforms.

Below we look at the breakdown of performance across the company's two operating segments:

	Motor		**Home**	
	1H 2018	**1H 2017**	**1H 2018**	**1H 2017**
Gross written premiums (£m)	**398.4**	351.3	**41.9**	42.0
In-force policies (thousands)	**1.972**	1.740	**477**	518
Combined operating ratio (%)	**97.6**	95.3	**130.1**	104.9
Loss ratio (%)	75.7	72.6	87.5	61.6
Expense ratio (%)	21.9	22.7	42.6	43.3
Trading (loss) / profit (£m)	**49.5**	48.1	**(7.3)**	3.4
Underwriting (£m)	8.2	12.8	(11.8)	(2.0)
Non-underwritten additional services (£m)	38.3	30.0	4.2	4.8
Investments (£m)	3.0	5.3	0.3	0.6

Source: 14 August 2018 Company Filing

Starting with the largest contributor, the **Motor Segment**, and GWP increased 13.4% to £398.4 million. The company saw significant footprint expansion with many motorists switching to esure given its relatively cheaper offerings. As noted above, the segment saw in-force policy growth of circa 232,000.

Unfavourable weather conditions, on the other hand, saw an impact to underwriting profit with higher claims (Loss Ratio) this time around, though through solid cost control and cross-selling of non-underwritten services more than offset these headwinds, leading to a slight **2.9% year-on-year growth in trading profit growth to £49.5 million**.

Moving on to the **Home Insurance** unit, the aforementioned unfavourable weather conditions, which began in February (“Beast from the East”), and flash flooding in May combined with a soft property market lead to declines in both in-force policies (-7.9% yoy) and GWP (-£100k). The lower sale volumes also resulted in fewer cross-selling opportunities resulting in lower non-underwritten services revenue (-12.5%) of £4.2 million.

The unfavourable weather conditions also resulted in substantial losses from higher claims with the loss ratio up 25.9 percentage points to 87.5% and more than offsetting the marginal gains from cost cutting efforts. All in all, the segment posted a trading loss of £7.3 million compared to last year’s £3.4 million profit.

The graphic below shows the group level metrics:

Group

	1H 2018	1H 2017
Gross written premiums (£m)	**440.3**	393.3
In-force policies (millions)	**2.449**	2.258
Trading profit (£m)	42.2	51.5
Profit before tax (£m)	**36.1**	45.1
Earnings per share (pence)	7.4	8.7
Dividend per share (pence)	**-**	4.1
Combined operating ratio (%)	**100.9**	96.6
Loss ratio (%)	76.9	71.2
Expense ratio (%)	24.0	25.4
Investment return – gross (%)	**0.6**	0.9
Solvency coverage (%)	**154**	157

Source: 14 August 2018 Company Filing

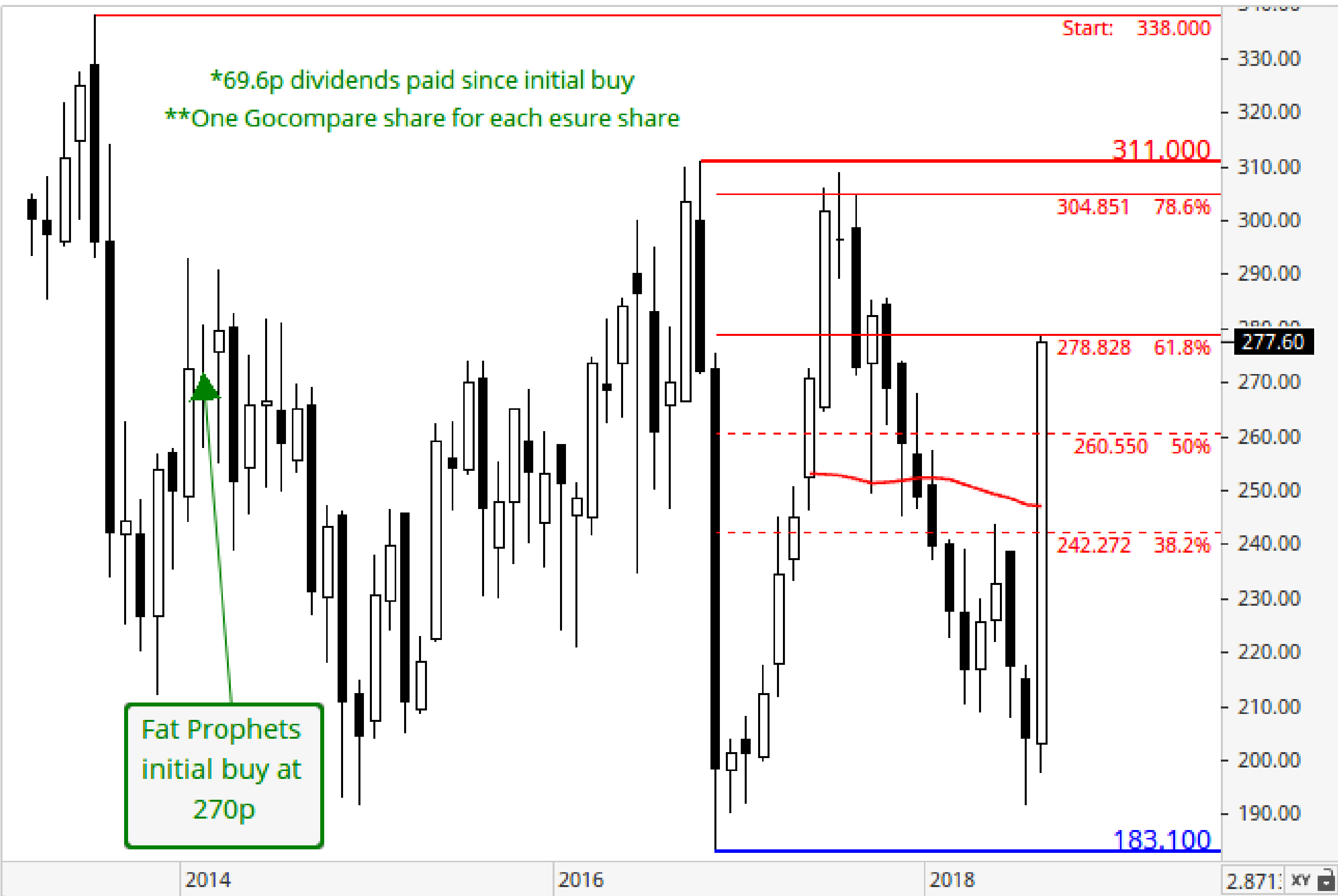
Moving back to the group level and on the cost side, the higher claims in both segments more than offset improvements in cost management and resulted in the **Combined Ratio worsening by 4.3 percentage points year-on-year to 100.9%**, implying losses on in underwriting.

The saving grace was the fact that the company generated extra revenues from commissions and policy fees (other income) for cross-selling and growth offsetting the underwriting loss. This contributed some £23.4 million while investment income and instalment interest income also pitched in circa £30.7 million allowing the group to realise trading profit of £42.2 million, though lower year-on-year by 18.1%.

All in all, group level net profit after tax fell 15.6% to £30.8 million. This equates to EPS decline of 14.9% year-on-year to 7.4p (1H17: 8.7p). Going forward, we expect the Combined Ratio to improve provided weather conditions normalise while the Motor Insurance business continues its growth trajectory.

In light of the Takeover Offer, the Board has advised that there won't be an Interim Dividend.

Esure Group PLC - ESUR (LSE) - 1 Month CandleStick Chart - GBP



Summary

We believe that the takeover offer by Bain Capital is quite generous considering the fact that the company is currently in the downcycle phase for its premiums, and with respect to esure's recent share price. The offer price also captures a significant portion of the benefits from a sector upcycle in our view.

Esure Group PLC - ESUR (LSE) - 1 Day CandleStick Chart - GBP

esure is currently trading on approximately 12.9 times forecast FY19 earnings, with a projected dividend yield of 3.4%.

Given the recent offer, **we recommend that Members lock in some profits now and sell half their holdings in esure (LSE.ESUR).**

STV Group, Sylvania Platinum, Tata Motors, Tencent, Tertiary Minerals, Teva Pharamaceutical, Toyota Motor, Tullow Oil, Unilever, Vedanta Resources, Vodafone, Walt Disney, Zillow.

Snapshot ESUR

esure Group

Latest Closing Price: £2.774

Market Capitalisation:£1.18b

	FY1	FY2
Price to Earnings	12.9	9.9
Dividend Yield (%)	3.9	6.9
Price to Book	3.4	2.6
Return on Equity (%)	-	28.4