CHESNARA PLC

Nice little acquisition

Chesnara has announced its first acquisition of 2023. It is buying the onshore protection business from Canada Life's UK business. This consists of 47,000 term assurance and critical illness policies. Chesnara is paying £9m for the policies, and expects the Economic Value to be £16m – so this is a bit smaller than some of its more recent deals. The uplift of £7m increases Economic Value by ca.1.4%. Cash generation will be improved by ca.£16m over the next five years. This benefit is relatively front-end-loaded; so there will be a smaller cashflow benefit beyond the five years. This will have an almost neutral effect on the Solvency II ratio.

- **UK administration:** Chesnara has also announced a strategic partnership with SS&C Technologies for the administration of its UK operations. SS&C is an established provider of technology and administration services. Chesnara expects it to help with both ongoing administration and future M&A.

- **Estimates:** The Canada Life deal has led to small upgrades to our figures. We have increased our Economic Value earnings estimates by 1%. Cash generation sees a stronger effect, with our estimate increased by 8% for 2023 and 7% for 2024. Our 2023 and 2024 Economic Value per share estimates are also 3% higher.

- **Valuation:** With a price at under 80% of its forecast Economic Value, Chesnara seems undervalued. A prospective dividend yield of 8.4%, with good prospects of continued growth, also suggest an undervalued stock.

- **Risks:** Ultimately, the company remains tied to movements in financial markets and adverse developments in operational areas. Having just come through a testing period for the latter, in particular, we can see how well Chesnara can manage these challenges.

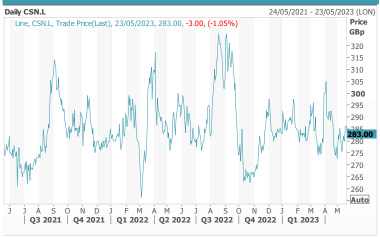
- **Investment summary:** Chesnara has three pillars for delivering value, under a responsible risk-based management. A close analysis reveals that there is substance underlying these aims. In our opinion, the discount to Economic Value looks wider than it should, and the yield appears high for a dividend that is both secure and growing.

Financial summary and valuation

Year-end Dec (£m)	2019	2020	2021	2022	2023E	2024E
Operating earnings	5.6	-66.1	-58.8	-26.8	0.9	1.5
Economic earnings	121.1	22.9	109.6	-109.1	43.4	44.7
Economic Value earnings	104.0	-37.6	57.8	-106.1	45.2	47.1
Economic Value/share (p)	446	424	416	340	370	377
Base cash generation	37	28	20	83	55	52
EPS (p)	69.3	-25.1	38.5	-70.6	30.0	31.3
DPS (p)	21.30	21.94	22.60	23.28	23.98	24.70
Price/Economic Value (x)	0.64	0.67	0.69	0.84	0.77	0.76
Dividend yield	7.4%	7.7%	7.9%	8.1%	8.4%	8.6%

Source: Hardman & Co Research

Life assurance



Source: Refinitiv

Market data

EPIC/TKR	**CSN**
Price (p)	**286.0**
12m high (p)	334.4
12m low (p)	259.0
Shares (m)	150.4
Mkt cap (£m)	430.1
Economic Value (£m)	511.7
Country of listing	UK
Reporting currency	GBP
Market	London

Description

Chesnara primarily manages and acquires closed life assurance books in the UK, Sweden and the Netherlands.

Company information

CEO	Steve Murray
CFO	David Rimmington
Chairman	Luke Savage

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www.chesnara.co.uk

Key shareholders

abrdn	12.8%
Columbia Threadneedle	12.1%
M&G	6.4%
Interactive Investor	6.2%
Hargreaves Lansdowne	6.1%
Canaccord Genuity	5.7%
Janus Henderson	3.5%
Royal London	3.0%

Diary

26 May	Final dividend paid
21 Sep	Interim results

Analyst

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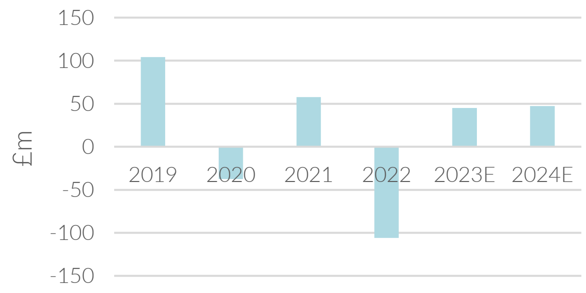
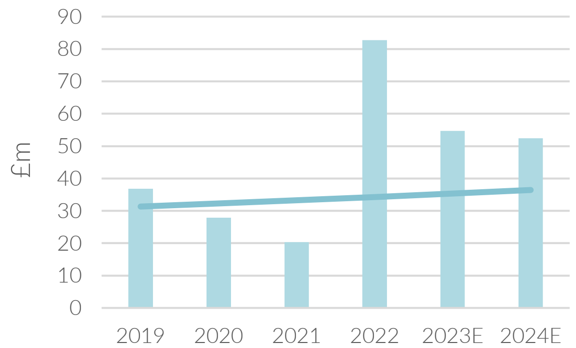
Economic Value earnings



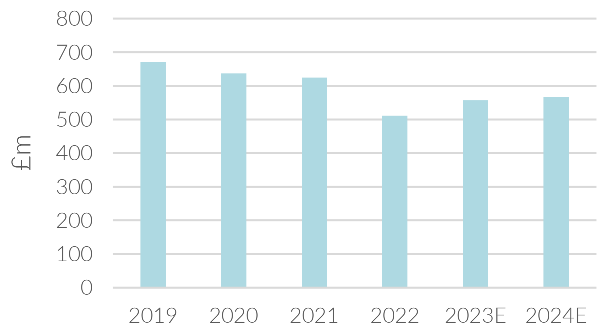
- Volatility for investment assets in recent years and 2022
- Also affected by operational challenges
- Forecasts based on normalised assumptions
- Expected gains of £21m from Conservatrix and £7m from Canada Life in 2023

Base cash generation and dividends paid (line)



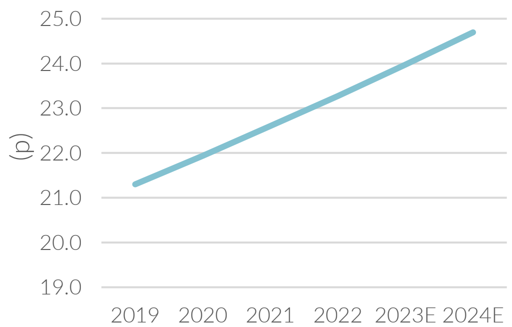
- 2020 affected by Scildon, and 2021 by a challenging Swedish market
- Symmetric adjustment smooths effect of markets on cash
- 2022 cash boosted by currency hedge
- Expected removal of headwinds should restore cash generation to comfortable levels

Economic Value



- Volatility for investment assets in recent years
- Also affected by operational challenges
- Forecasts based on normalised assumptions
- Gain from Sanlam and Robein Leven of £21m in 2022

Dividend per share



- Chesnara has been a consistent dividend payer for more than a decade and a half
- We forecast continued steady growth of 3% p.a.

Source: Company data, Hardman & Co Research

Commentary

Canada Life deal

It is almost a year since Chesnara's last new acquisition announcement. This clearly fits in with the company's strategy. In the UK, Canada Life has probably been more successful in its offshore business – so it shouldn't be a surprise that some of its onshore operations are small and seen as non-core.

This is a small acquisition for Chesnara. The policies are straightforward, and adding them to its systems should not preclude further acquisitions in the near term. Technically, the arrangement is through a reinsurance arrangement until the court can approve a Part VII transfer, which will probably take place in 2024. The latter is mostly procedural, but timing does depend on the UK court system. The net economic effect is that Chesnara will get the full benefit from 31 December 2022.

With an Economic Value of £16m and expected cash generation of ca.£16m in the first five years, it is clear that, from this perspective, the book is somewhat front-end-loaded. Although Canada Life only closed this line to new business in November 2022, this suggests that there have been few new policies in recent times.

Given the relatively small scale and short-term nature of the book, it would be a surprise if the effect on the Solvency II ratio were not the "broadly neutral" indicated in the announcement.

SS&C Technologies partnership

Although this announcement will mean some significant changes in how the UK operations are run, the effect from an investor perspective is limited. Chesnara continues to endeavour to run its operations efficiently, and this requires periodic system reviews and updates.

From Chesnara's perspective, the main benefit seems to be greater flexibility when it comes to M&A. There should be some benefit to unit costs in the long run, but we are not making any allowance for that in our forecasts, and we implicitly expect Chesnara to bring down unit costs in due course.

Forecasts

Recall that our forecasts are on a normalised basis. The structure of the Canada Life deal means that there will be benefits from FY'23. As indicated, we have made no adjustments for the SS&C partnership. We have assumed the following:

- Economic earnings will increase in line with the increase in Economic Value, i.e. +1%.
- We have added £16m to the Economic Value in 2023E, with a £7m gain.
- We have increased our cashflow estimates for the UK by £4m for 2023 and £3.6m for 2024. These are more significant than for the earnings, adding 8% to the 2023 estimated cashflow and 7% to 2024.

Economic Value earnings						
Year-end Dec (£m)	**2019**	**2020**	**2021**	**2022**	**2023E**	**2024E**
Expected movement	-0.4	0.3	-1.7	-1.3	0.0	0.0
New business	7.8	3.7	2.4	8.0	8.8	9.7
Operating experience variances	-6.8	-22.0	-19.2	-20.7	-7.9	-8.2
Operating assumption changes	3.8	-35.8	-13.9	-14.5	0.3	0.3
Other operating variances	-0.3	3.9	-0.2	1.7	-0.3	-0.3
Total u/l operating earnings	4.1	-49.9	-32.6	-26.8	0.9	1.5
Material other operating items	1.5	-16.2	-26.2	0.0	0.0	0.0
Total operating earnings	5.6	-66.1	-58.8	-26.8	0.9	1.5
Economic experience variances	143.1	45.7	79.5	0.0	41.1	42.3
Economic assumption changes	-22.0	-22.8	30.1	0.0	2.3	2.3
Total economic earnings	121.1	22.9	109.6	-109.1	43.4	44.7
Other non-operating variances	-5.2	-2.8	4.5	-2.6	3.6	3.7
Risk margin movement	-7.0	4.7	10.8	20.4	2.4	2.4
Tax	-10.5	3.7	-8.2	12.0	-5.0	-5.2
Economic Value earnings	**104.0**	**-37.6**	**57.8**	**-106.1**	**45.2**	**47.1**
Gain on acquisition	0.0	0.0	0.0	21.0	28.0	0.0
EPS (p)	69.3	-25.1	38.5	-70.6	30.0	31.3
DPS (p)	21.30	21.94	22.60	23.28	23.98	24.70

Source: Hardman & Co Research

While the normalised basis is our core expectation, in practice, results will rarely match the average. To give some idea of sensitivity, the following table gives estimates with two adjustments:

- annual equity returns of 3.5%, instead of 7%; and
- no returns from credit spreads, i.e. credit losses match the gain from the spread.

Investors can easily imply the effect of different assumptions from these. We note, however, that the first couple of months of the second half have been noticeably less volatile.

Sensitivity to economic assumptions				
£m	**2021**	**2022E**	**2023E**	**2024E**
Normalised Economic Value earnings	57.8	-106.1	45.2	47.1
Half equity returns			26.5	27.1
Reduction			-41%	-42%
No credit spreads			31.4	32.1
Reduction			-31%	-32%

Source: Hardman & Co Research

Given the market changes, our forecasts for group Economic Value have increased in line with the extra earnings and gain in 2024. Our 2023 and 2024 estimates for Economic Value per share have increased by 3%, to 370p and 377p per share, respectively.

The changes to the cashflow improve expected dividend cover for 2023 from 1.4x to 1.5x.

Key balance sheet and cash generation						
Year-end Dec (£m)	2019	2020	2021	2022	2023E	2024E
Borrowings	88.2	67.0	47.2	212.0	212.0	212.0
Economic Value	670.0	636.8	624.2	511.7	556.5	567.2
Economic Value/share (p)	446	424	416	340	370	377
Base cash generation						
UK	33.6	29.5	27.4	40.8	33.7	30.3
Movestic	-6.2	12.4	-14.4	16.1	13.0	13.7
Waard	0.8	4.1	2.9	8.4	12.8	13.5
Scildon	22.6	-22.3	15.2	-3.4	5.4	5.6
Group	-14.0	4.1	-10.8	20.8	-10.2	-10.6
Total	36.8	27.8	20.3	82.7	54.7	52.4
Dividends paid	-31.3	-32.3	-33.3	-34.3	-35.4	-36.4
Dividend cash cover (x)	1.2	0.9	0.6	2.4	1.5	1.4

Source: Hardman & Co Research

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