QuotedData

Update | Investment companies

13 February 2018

Blue Capital Alternative Income Fund Limited

Wind-blown, but still standing

Blue Capital Alternative Income's (BCAI's) net asset value declined by 24.8% during 2017 (including dividends). BCAI's manager says that the 2017 Atlantic hurricane season, which accounts for most of the fall, was perhaps a one in 33-year event and that BCAI's losses are in line with its internal projections for such a scenario. BCAI now has less capital to deploy although, with insured losses estimated by Munich Re at $135bn globally, this also applies to other reinsurers. This has resulted in increased rates (prices) for the January 2018 reinsurance contract renewal season and the manager projects an 8%-13% return for 2018.

LIBOR+8% target returns

BCAI aims to offer investors target returns of LIBOR+8% by investing in a broad range of reinsurance risk diversified by risk type, geography and peril. It currently invests in just over 1,400 different contracts from a variety of customers. No one relationship currently supplies more than 36% of invested assets for the portfolio.

US-dollar returns

The reinsurance industry is a largely US-dollar denominated one, so the fund's returns are thus in US-dollars and therefore can be affected by the GBP/USD exchange rate for UK-based investors. Sterling investors do face a currency risk, therefore. The fund's expenses are dollar denominated.

Period ended	Share price total return (%)	NAV total return (%)	1-month US$ LIBOR +8% (%)
31/12/13	12.2	11.9	8.2
31/12/14	3.7	8.8	8.2
31/12/15	3.6	9.8	8.2
31/12/16	(1.9)	8.3	8.5
31/12/17	(20.6)	(24.8)	9.1

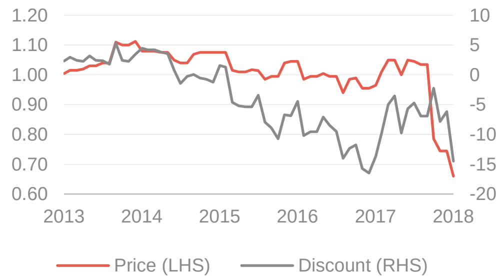
Source: Morningstar, Marten & Co

Sector	Specialist-reinsurance
Ticker	BCAI LN
Base currency	USD
Price	0.66
NAV	0.7939*
Premium/(discount)	(16.7%)
Yield	10.8%

* last published as at 31 December 2017.

Share price and discount

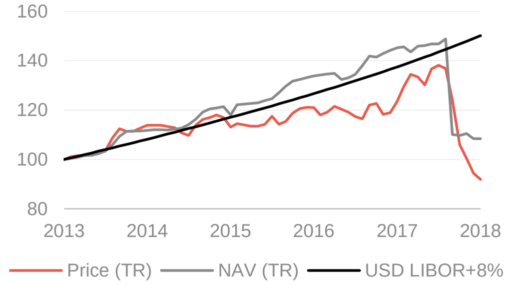
Time period 31/01/13 to 31/01/18



Source: Morningstar, Marten & Co

Performance over five years

Time period 31/01/13 to 31/01/18



Source: Morningstar, Marten & Co

Domicile	Bermuda
Inception date	6 December 2012
Manager	Blue Capital
Market cap (USDm)	115.8m
Shares outstanding	175.4m
Daily vol. (1-yr. avg.)	169.2k shares
Net gearing	Nil

Click here for QuotedData's initiation note

Introduction

Please see the appendix at the end of QuotedData's May 2017 initiation note for some background information on the reinsurance industry

The share price has experienced a savage decline

Since QuotedData last published on BCAI in May 2017, BCAI's share price has experienced a savage decline due to the string of insurance industry catastrophe loss events in 2017. The manager tells us that the losses in BCAI's portfolio are in-line with the internal projections for events of this magnitude. The good news is that this should remove substantial capital from the insurance market and in the manager's view this ought to lead to significant rate increases for 2018. A competitor fund has already raised fresh capital to take advantage of this situation. BCAI's board has resolved not to implement the tender offer that it had been considering (to address its discount), believing that the opportunity presented by increased rates in 2018 justifies retaining as much capital as possible within the business.

Perspective - 2017, an exceptional hurricane season

BCAI has seen NAV total return including dividends fall by 24.8% during 2017

BCAI has seen NAV total return including dividends fall by 24.8% during 2017. BCAI invests in catastrophe reinsurance linked securities that protect highly regulated insurance companies against natural catastrophes. The fall in the NAV reflects the active 2017 hurricane season in particular, plus smaller events such as the earthquakes in Mexico and wildfires in California. The NAV hit includes all the hurricanes in 2017. The hurricane season begins on 1 June every year and officially ends on 30 November.

2017 has not been a typical year for catastrophe events; it is the fifth most active season since records began in 1851

It is now possible to offer some perspective on the level of storm activity seen during 2017. In a typical North Atlantic year, there are 12 named storms and six hurricanes (three of these will be major hurricanes, i.e. category 3 or higher). In 2017, there were 17 named storms, making 2017 the fifth most active season since records began in 1851. The year saw the highest number of major storms since 2005; that year saw Hurricanes Dennis, Emily, Katrina, Rita and Wilma. Further perspective may be gained from considering that 2017 was one of only six hurricane seasons to witness multiple Category 5 hurricanes. In addition, 2017 is only the second hurricane season (after 2007) to see two Category 5 hurricanes make landfall. In total there were 10 hurricanes, six of which have been categorised as major hurricanes. It has thus been an unusually active hurricane season.

The three largest hurricanes (Harvey, Irma and Maria) could have an economic cost of US$300bn. The insurance industry loss from the three hurricanes is currently estimated by Munich Re at $92bn.

Hurricane Harvey

Harvey caused the biggest ever USA auto loss

Hurricane Harvey had recorded wind speeds of 130mph. It caused 83 fatalities and the largest auto loss in US history, as well as the wettest tropical cyclone on record. The insured loss estimates are in the range of US$25-35bn according to catastrophe risk modelling company, RMS. This hurricane made landfall in the USA on three separate occasions over a period of six days. As an example of its impact, it produced two feet of water across one third of Houston in 24 hours (source: CNN). Many industry sources place the economic (rather than the insured) loss at over US$100bn. This would make it the costliest US hurricane in history. The important point of perspective to note is that both the insured and the economic loss from this hurricane will be one of the largest ever recorded.

Hurricane Irma

Hurricane Irma has a broad spread of loss estimates as many claims are only likely to emerge once the clearing up process gets properly underway

Hurricane Irma produced winds of up to 185 mph, caused 84 deaths and, at the time of writing, is viewed as the largest Caribbean insurance loss in history. BCAI believes the insured loss for the industry is in the region of US$35-55bn. This is in line with risk modelling company, AIR Worldwide's initial estimate of US$15-50bn. The reason for the broad spread of loss estimates because many claims are only likely to emerge once the clearing up process gets properly underway. To offer some perspective on the ferocity of this storm, only Hurricane Allen in 1980 produced stronger wind speeds (190 mph).

Hurricane Maria

Hurricane Maria saw nearly as high wind speeds (175 mph) and BCAI believes the insured loss could reach US$50bn. This hurricane devastated Puerto Rico and the economic loss seems likely to be multiples of the insured event as historically much of the territory has not been insured.

Other losses – California wildfires and Mexico earthquake

There have also been catastrophe losses outside of the Atlantic region

While the Atlantic hurricane season has been extremely active this year, there have also been a number of catastrophe losses in other places. California has been hit by wildfires with the current cost to insurers estimated at US$8bn. Mexico has also been hit by two serious earthquakes.

Recapitalise to take advantage of improving rates

Industry wide losses are being seen

In an attempt to place these events in perspective, the world's two largest reinsurers, Munich Re and Swiss Re, posted nine-month losses at the group level due to the exceptional nature of the natural catastrophe losses in the market. Munich Re posted a nine-month 2017 group loss of €146m while Swiss Re suffered a US$468m deficit at group level. Munich Re estimates that losses emanating from hurricanes Harvey, Irma and Maria will cost it €2.7bn while Swiss Re expects a net loss of US$3.6bn from these events. The latter also has a large exposure to the recent Mexico earthquakes.

Such exceptional events improve the supply/demand balance in favour of reinsurers

Events such as these improve the supply/demand balance in favour of reinsurers. On the supply side, capital is removed due to losses while some additional money from more transient sources, such as hedge funds and the like, may also exit as investors become more cognisant of the risks. On the demand side, purchasers of reinsurance are also more aware of the need for cover. The combination of these effects should drive up reinsurance rates and more experienced players will look to raise fresh capital to take advantage of the improved pricing environment and rebuild their balance sheets.

Insight

Hurricane Harvey might be the most expensive storm ever

In terms of the cost of 2017, as a hurricane season, BCAI's view is supported by Statista (an online statistics and market research portal). Statista believes that Hurricane Harvey is the most expensive US storm in total cost (rather than just insured loss) terms ever at US$190bn. The next nearest was Hurricane Katrina in 2005 at US$125bn. Interestingly, in third place is another 2017 event, Hurricane Irma at US$100bn. The Statista list then falls off sharply with 2012's 'super storm' Sandy costing a 'mere' US$65bn, the Northridge earthquake in California in 1994 costing US$40bn, 2008's Hurricane Ike costing US$30bn and Hurricane Andrew (1992) coming in at US$27bn.

The 2017 hurricane season was thus one of the most severe and expensive in recent history.

Manager's view

BCAI's 2017 losses are in line with its expectations

BCAI's losses are in line with its models

According to data from Blue Capital, BCAI's annual NAV total return has exceeded 8% in four of the five years to December 2017. The same data set says that 90% of the 60 months to 31 December 2017 have generated positive NAV total returns. The September 2017 NAV hit of 26% reflected two category four hurricanes hitting the USA and the Caribbean as well as two earthquakes in Mexico. Given this level of activity, BCAI believes that the actual losses were within modelled expectations.

NAV includes all hurricanes to date

BCAI's 2017 losses to date are within what the manager expected given the industry wide losses and their size. Management is of the view that the insurance market is likely to bear losses of approximately US$150bn globally for the hurricane season and placing this in perspective means that the estimated chances of such a large loss were calculated at between 3-7%. It believes that its losses from Hurricane Harvey will amount to US$4.8m, while Hurricane Irma will cost it US$42.4m and Hurricane Maria will impact by US$6.5m.

Once a reinsurance contract has paid claims totalling the cover originally purchased, the contract is considered to have been discharged. It is common practice for reinsurance contracts to have provisions that enable the buyer to reinstate the original, pre-claim, cover for an additional premium. This means that some reinsurance contracts could pay two (or more) total losses in a year. Given the very active nature of this year's hurricane season, it is likely that some reinsurance was reinstated and these contracts paid out on more than one event. This kind of loss is estimated to have cost BCAI US$9.3m, as contracts covering multiple events triggered loss thresholds. In addition, there are some US$7.4m of estimated losses from smaller events and other, attritional losses. Estimates of the losses from all of the hurricanes have been included in BCAI's published NAVs since 31 October 2017.

While the majority of the remaining NAV is available for the 2018 reinsurance contract renewal season, loss provisions are amplified by buffer that has to be held back in accordance with the contract, meaning that a further 11.8% of the NAV (US$16.5m) is not currently available to write new business. The company does expect this provision to unwind during 2018 and 2019. This means that BCAI's portfolio at 1 January 2018, at US$119.7m, is 34.8% less than its value of US$183.5m, as at 1 January 2017.

As at 1 June 2017 BCAI's largest modelled Probable Maximum Loss (PML) as a percentage of NAV was Florida hurricane at 33.9% with a US mid Atlantic hurricane estimate at 6.7%. It can thus be seen that this broadly accords with the estimated out turn of events from 2017's exceptional hurricane season.

The 2017 hurricane season has probably provided the market with additional incentives to buy reinsurance.

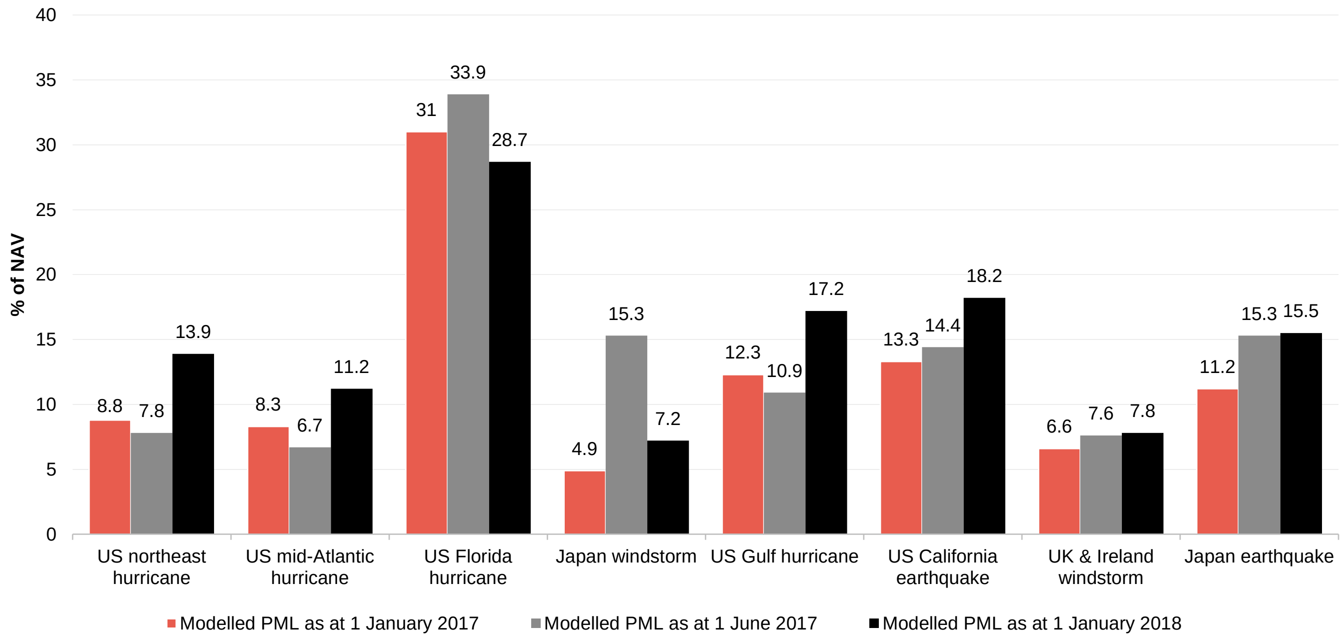
Recovery potential and changing exposures

A more focused, concentrated portfolio is expected in 2018

A combination of increased rates in the market and BCAI's reduced capacity has enabled it to be even more selective in the business it writes than in previous years. As discussed below, the business it is writing should all be better priced than 2017's business. This sharper focus has the potential to enhance future returns in the absence of catastrophe or other large losses.

So far, BCAI has not elected to follow its peers down the fundraising route. The manager says that it is allocating its remaining capital to those risks that it believes offer the best risk/reward outcomes. Figure 1 provides an illustration of how BCAI's modelled PML at 1 January 2018 compares against its PMLs at 1 January 2017 and 1 June 2017. US Florida hurricane still has the highest PML, 28.7% of NAV as at 1 January 2018, but this is down from 33.9% at 1 June 2017. In contrast, all the other types have seen their 1 January 2018 PMLs have increase in comparison with 1 June 2017 values (excluding Japanese windstorm).

Figure 1: BCAI Modelled Probable Maximum Loss as a percentage of NAV as at 1 January 2017, 1 June 2017 and 1 January 2018*



Source: Blue Capital Alternative Income *Note: Modelled Probable Maximum Losses (PML's) are 1 in 100-year event modelled loss, except for earthquake which is 1 in 250-year event modelled loss.

Impact on rates and expected returns

Rates are expected to harden

BCAI anticipated that reinsurance rates would rise in loss affected areas and expected double digit rate rises for those contracts renewing at 1 January 2018. It also believed that rates were likely to rise in unaffected areas by up to high single digit percentages. Reflecting this view, the manager issued some guidance on its projected returns for 2018 on 21 November 2017. The manager models these by looking at the probability of a range of outcomes. Their models suggested that, under a median (centre of the range) loss environment, the manager projected returns of 15.0%, while under a mean (average of the range) loss environment it projected returns at 10.0%.

From the 5 February 2018 update that BCAI provided on the January 2018 renewal season, it would appear that the company's view on hardening rates was correct. In the update, Mike McGuire (CEO of Blue Capital Management) said, "Following the significant industry losses experienced in 2017, we are pleased to report improved market conditions during the January renewal period. On average, loss affected business benefited from renewing premium rate increases of 15%-20% while non-loss affected agreements benefited from rate increases of 3-5% (in each case compared to 2017 and net of expenses)."

BCAI has, for illustrative purposes, provided a portfolio return summary. This is illustrated in Figure 2 below and is derived from BCAI's modelled portfolio as at 1 January 2018.

Figure 2: BCAI portfolio return summary*

Heading	2018 portfolio	January 2017 portfolio
Expected return range**	8-13%	6-10%
Probability of:		
Mean or greater return	67%	71%
Breakeven or greater return	85%	80%
Loss to NAV greater than 5%	9%	14%
Loss to NAV greater than 10%	6%	10%
Loss to NAV greater than 15%	4%	7%
Loss to NAV greater than 25%	2%	3%
Loss to NAV greater than 35%	1%	2%

Source: Blue Capital Alternative Income *Note: The projections are derived by reference to BCAI's modelled portfolio as at 1 January 2018. BCAI says that the projections do not take into account actual costs, expenses or other factors which are not attributable to the portfolio. As such, the portfolio return summary should not in any way be construed as forecasting the company's actual returns should no losses occur or otherwise. **Note: The expected return range is the net aggregate return distribution between a mean and median catastrophe year.

Fund performance

Please visit QuotedData.com for an up-to-date comparison of BCAI and its insurance and reinsurance peers

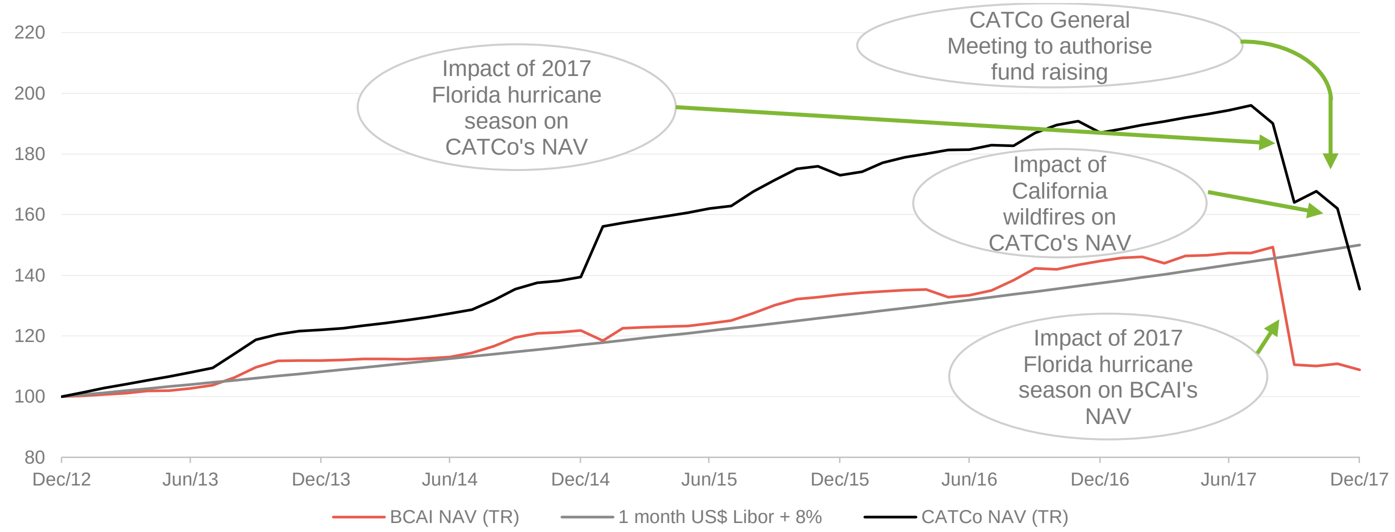
Figure 3 below illustrates BCAI's fund performance. This reflects the severity of the 2017 hurricane season. The manager says that with around 1,500 different positions in the BCAI portfolio in 2017, communicating in a meaningful way with the market, on the ultimate loss situation as well as the outlook, has been impossible. The scale and complexity of the losses means that dialogue has only recently been possible.

It can be seen from Figure 3 that BCAI delivered on its aim of LIBOR +8% until the 2017 hurricane season. There is one other closed end fund in a broadly similar market to BCAI called CATCo Reinsurance Opportunities Fund (CATCo). CATCo outperformed BCAI prior to the 2017 hurricane season. In the immediate aftermath, BCAI seemed to be hit harder than CATCo but, as can be seen in Figure 3 below, CATCo's NAV took another hit (which was not announced until 19 January 2018, after its $546m C share issue). Comparing both companies' NAV total returns between 31 August 2017 and 31 December 2017, BCAI shows a decline of 25.6% and CATCo shows a decline of 28.7%. CATCo's decline from peak to trough is higher (around 31%) as its NAV was on a declining trend immediately prior to the 31 August 2017 announcement.

In its announcements, CATCo attributes the first major move downwards primarily to Florida hurricanes (see announcement on 17 October in relation to end September NAV) and the second primarily to the California Wildfires (see announcement on 19 January 2018 in relation to end of December NAV). It should be noted that these losses impact on CATCo's ordinary shares and not the C shares that it issued at the end of 2017. Fortunately for the C shares, these are in a separate pool, although investors would have made their commitments in the absence of the knowledge of the second major move down in the NAV for the ordinary shares. The necessary approvals for the

C share issue were received at an EGM on 7 November 2017 and dealings commenced on 12 December 2017.

Figure 3: BCAI NAV total return versus benchmark and CATCO NAV total return over five years



Source: Morningstar, Marten & Co

BCAI's modelled Probable Maximum Loss (PML) from a major Florida hurricane (a one in 100-year event) was 33.9% as a percentage of 1 June 2017 NAV; this data was published in October 2017 based on mid-year data and is illustrated in Figure 2 on page 6. By contrast, looking at CATCo's end November 2017 Factsheet, it says that its modelled net portfolio return for Florida hurricanes as a worst case single event (not directly comparable with Probable Maximum Loss, but the most relevant data available) is negative 10%.

The reason BCAI chose to have its largest exposure in Florida is that it believed this market was the most profitably priced.

Outlook

Rate increases are likely to be sustained throughout 2018

BCAI's manager announced on 5 February 2018 that, following the significant industry losses experienced in 2017, it has seen improved market conditions during the January renewal period. Specifically, it says that, "On average, loss affected business benefited from renewing premium rate increases of 15%-20% while non-loss affected agreements benefited from rate increases of 3-5% (in each case compared to 2017 and net of expenses)".

The manager believes that rates may continue to rise over the early part of 2018 as insurers calculate the true extent of their 2017 losses. As such, it also appears likely that rate increases that occur in January will also be sustained in the April and June renewals. However, the most important renewal season for setting the tone of the rating environment remains 1 January. The increased focus that recent losses impose on the portfolio of business written for 2018 ought to enhance returns on capital deployed.

Having deployed its capital in the January renewal season, the underwriting risk capital available for renewals later in the year is likely to be a little thinner than has been normal in recent years. This should enable a more robust rating environment to be sustained during the year.

BCAI is likely to have a more concentrated portfolio for 2018

In 2018, BCAI's portfolio is likely to be more concentrated than 2017's due to the combination of higher rates and less capital to deploy. This will enable it to focus on the renewals offering the best risk profile to rate combination. It seems likely that its original focus on key clients will be sharpened. Given that BCAI has less capital for the 2018 year, the portfolio will be different. As mentioned on page 6, the manager has provided guidance of an 8%-13% return between a mean and median catastrophe year.

Sompo should help recovery

Blue Capital's existing expertise in the market is enhanced by the relationship with Sompo International. The latter is likely to be a key help in accessing business on a global basis as well as being able to access the expertise of staff and distribution across the world.

Fund profile

More information on BCAI can be found at the manager's website:

www.bluecapital.bm

Established in 2012, BCAI is quoted in Bermuda and London on the main market as an investment company investing in catastrophe reinsurance. The fund typically invests in over 1,400 reinsurance contracts sourced from a variety of providers. Furthermore, management focuses on smaller insurers that have to rely on significant amounts of reinsurance for regulatory reasons. This provides a number of advantages with the main ones being that these entities tend to accept higher prices and be more loyal to capital suppliers such as BCAI.

Previous publications

QuotedData published an initiation note on BCAI – ***Uncorrelated yield opportunity*** – on 31 May 2017. This explains in some detail the workings of the fund, the background of the manager, the investment philosophy and approach that drives risk selection, fees, dividend policy, capital structure and the board. It also includes a comprehensive overview introduction to the reinsurance industry. The contents pages from this initiation note are included below.

Uncorrelated yield opportunity – 31 May 2017

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QuotedData

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IMPORTANT INFORMATION

available information. This note is not directed