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A CONVENIENT EXIT OR AN ALTERNATIVE WAY FORWARD?

Helios Underwriting plc (Helios) was a sponsor of the ALM's 2021 autumn conference. Many of the attendees joined a lunchtime discussion session to hear more about Helios. The following article by Helios details their proposal for those Members of Lloyd's (Members) who may be either looking to cease trading at Lloyd's or are looking at investing in Lloyd's via a different route.

HELIOS UNDERWRITING

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Introduction and background

The past few years have undoubtedly been difficult for Members who have had to contend with deteriorating trading conditions from 2013 onwards, and a series of losses between 2017 and 2020. Although rates have been increasing in many classes since 2018, 2021 has just been hit by several large losses. Natural catastrophe losses in 2021 have produced more than $100 billion of insured losses and there has been much talk of "unforeseeable" losses associated with cyber risks and the effects of climate change.

Members have also had to deal with increased regulatory pressure and the rising costs associated with trading as a Member at Lloyd's. The high burden of costs associated with membership (including managing agency fees, members' agents' fees, profit commissions, administrative service company charges, as well as Lloyd's Members' Services' ("MSU") charges) have all exacerbated the impact of the recent years' losses on many Members, and in particular those underwriting smaller levels of premium. Members now need to earn a larger profit from underwriting to simply break-even, let alone produce a good pre-tax profit. In addition, Members trading in a NameCo face the prospect of UK Corporation Tax increasing from 19% to 25% in April 2023. With fewer syndicates available, as well as increasing auction prices for some of the better performing ones, it has become harder for Members to increase their capacity to maximise the opportunities presented by the hardening market.

The combination of these factors has led some Members to reconsider their underwriting options. These have included continuing to trade as a Member, selling their capacity through the auction system and resigning from Lloyd's (in the case of unlimited liability Members), or selling their NameCo or Limited Liability Partnership ("LLP"). NameCos and LLPs, collectively known as limited liability vehicles ("LLVs"), have limited options to conclude an exit; including a sale to other current Members of Lloyd's, to new potential Members wishing to join the market, or to a company such as Helios Underwriting with our tremendous knowledge and market experience.

What is Helios?

Helios is an AIM-listed company that produces an income-generating investment for its shareholders from its Lloyd's activities. Helios runs a spread portfolio of its own and can buy Members' LLVs outright, allowing a Member to exit from Lloyd's instantly. It also offers owners of LLVs an alternative way of investing at Lloyd's by taking Helios shares as an alternative to cash for all or part of the consideration. Becoming a shareholder in Helios provides the former Member an investment in an AIM quoted, dividend-paying company that runs a volatility-managed and diverse portfolio of Lloyd's syndicates, with far fewer of the costs and regulatory burdens associated with being a trading Member of Lloyd's.

Helios generates returns by the growth of capital value and the payment of a regular and growing dividend income to its shareholders. In addition to running its own underwriting portfolio, Helios acquires LLVs from existing Members to increase the size of its trading portfolio of capacity with an emphasis on freehold capacity. To date, Helios has acquired 71 companies which had a total underwriting capacity of over £100 million. Helios makes tactical use of reinsurance to enhance the pace of the portfolio's growth and to reduce volatility and risk.

Our history

Helios began trading in 2008 with a capacity of £8 million. Nigel Hanbury, the former Chief Executive Officer (CEO) and then Chairman of Hampden Agencies Limited, was appointed CEO of Helios in late 2012. Helios's Chief Financial Officer, Arthur Manners, was appointed in 2015. He had worked for the Beazley Group plc from 1993 to 2009 as Finance Director, and latterly as Company Secretary. Since 2013 the Helios management team has increased the company's underwriting capacity up to £232.7 million for 2022. Helios has built a Non-Executive Board with participation from (re)insurer expertise, banking and industry.

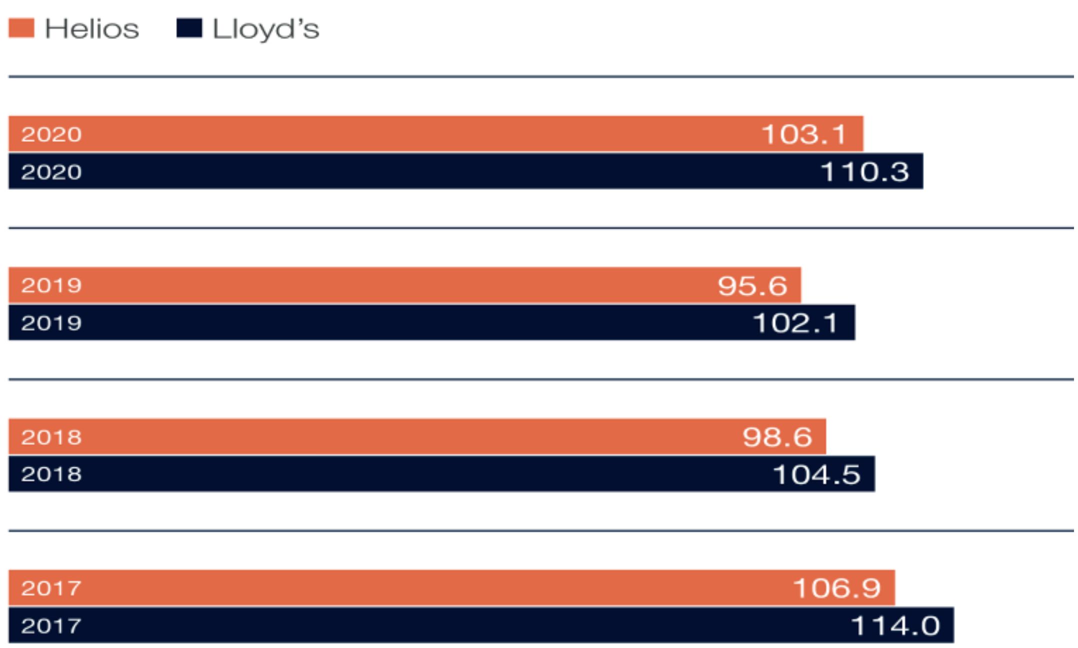
Helios has a history of outperformance

Helios has outperformed Lloyd's by a healthy margin. The quality of its portfolio was demonstrated in 2020 when Helios reported a combined ratio of 103.1% whilst Lloyd's reported its fourth consecutive year of loss and a combined ratio of 110.3%. Over the past four years, Helios' combined ratio has outperformed that of Lloyd's by 6.7 percentage points a year, with an average combined ratio of 101.0% compared to one of 107.7% for the overall Lloyd's market (see Figure 1).

Helios' current syndicate participations should enable outperformance to continue given the market discipline and pricing correction we are currently witnessing. Not only does Helios have superior access to talent and capital deployment opportunities, but the diversification of our portfolio coupled with protection mechanisms serves to enhance our return prospects.

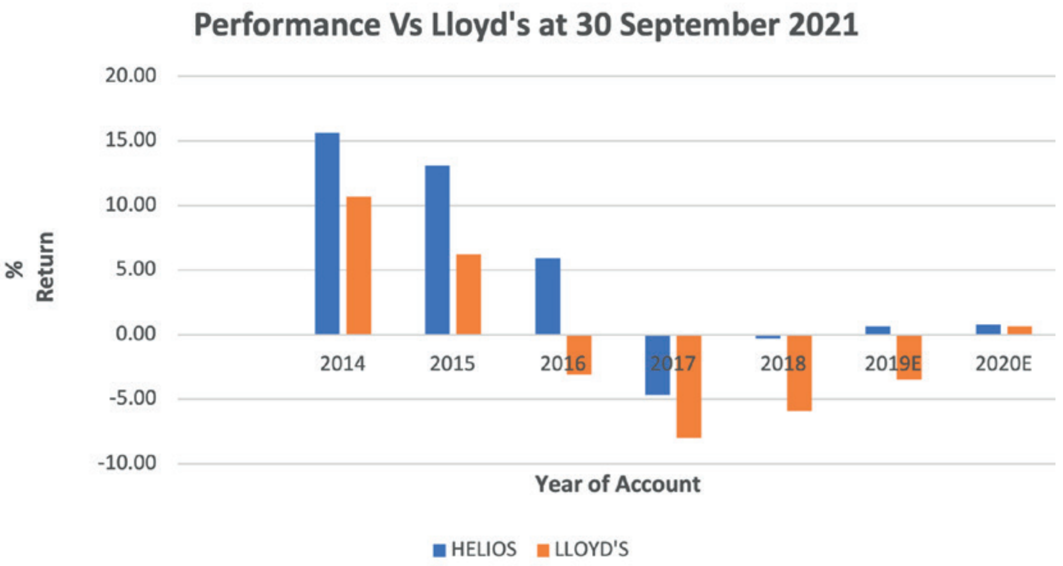
With the closure of the 2018 year of account, Helios' portfolio has outperformed Lloyd's for its 10th successive three-year of account result. Helios reported a loss of 0.3% of capacity for its portfolio compared to Lloyd's average result of a loss of 5.9% of capacity. The Helios 2018 account improved by 3.3 percentage points from the estimate issued at Q4 of 2019 and also benefited from prior year releases. Figure 2 shows the returns on capacity and forecasts for the 2019 and 2020 years of account for Helios' portfolio compared to Lloyd's

Figure 1: Helios combined ratio (%) compared with Lloyd's 2017 to 2020



SOURCE: HELIOS UNDERWRITING PLC – ANNUAL REPORT AND FINANCIAL STATEMENTS 2020

Figure 2: Helios' year of account results compared to Lloyd's between 2014 and 2020



SOURCE: HELIOS UNDERWRITING PLC – COMPANY WEBSITE

for the period from 2014 to 2018, and demonstrates Helios' consistent outperformance.

What can Helios offer its shareholders?

Is Helios just a convenient way to exit the market? Helios believes it is in a strong position to be able to offer shareholders a compelling package of trading features. First, shareholders are not subject to the same direct costs, regulatory and administrative burdens as Members of Lloyd's. The Helios business model aims to facilitate profitable growth on two fronts: first, its underwriting portfolio in producing good underwriting returns over the next few years, particularly as the losses of recent years (including those in 2021) should ensure that market conditions remain strong for the medium-term; and secondly, the company has the ability to acquire more LLVs and increase its size and NAV.

1. A top-performing portfolio of syndicates

Helios has a strong underwriting portfolio, which has been consistently focussed on some of the best syndicates trading at Lloyd's. Helios, in association with its Lloyd's adviser, Hampden Agencies, curates this portfolio on an annual basis. Its tactical management of its portfolio considers likely market conditions for the coming year and the re-balancing that is needed as newly acquired LLVs are added. In just the same way as a trading Member of Lloyd's, Helios was offered pre-emptions, which amounted to £10.7 million for 2021 and £6.1 million for 2022. Helios buys and sells capacity in the auctions to optimise its portfolio each year.

We believe that the five syndicates most supported by third party capital members as a whole in 2022 are 510 (TMK), 623 (Beazley), 33 (Hiscox), 609 (Atrium), 5886 (Blenheim), which is similar to 2021. Since 2020, Helios has increased its holdings in syndicates 4242 (Beat) and 2010 (Lancashire) and these have become two of its seven most supported syndicates. This illustrates how the Helios portfolio may be subject to a greater degree of potential change than that of the average Member as the company continues to acquire more LLVs in the future, and each of these will have its own portfolio. Further, Helios shapes its underwriting to deal not only with the prevailing market conditions and pre-emptions but also the influx of capacity from newly acquired LLVs each year.

2. Helios' use of reinsurance protection

The second reason that Helios has outperformed Lloyd's in recent years has been its good tactical use of quota share and stop loss reinsurance. These reinsurance arrangements have mitigated its exposure to market losses and assisted in the financing of underwriting capital. Helios' relative size has allowed it access to quota share reinsurance deals that may not be available to all third party capital Members of Lloyd's. As market conditions have improved, Helios reduced the proportion of its book of business that it ceded to its quota share reinsurers and retained more risk. For 2022, Helios is retaining £172 million of its capacity as compared to only £63 million in 2021.

Figure 3: Breakdown of Helios' portfolio for 2022

Top seven holdings by Managing Agent (January 2022)

Syndicate	Managing agent	Capacity £M	Helios portfolio % of total
510	Tokio Marine Kiln	32.3	13.9
5886	Blenheim Underwriting	22.5	9.7
623	Beazley Furlonge	21.6	9.3
33	Hiscox Syndicates	13.8	5.9
609	Atrium Underwriters	12.1	5.2
4242	Beat/Asta Managing Agency	12.6	5.4
2010	Lancashire	10.1	4.4
Subtotal		125.0	53.8
Other		107.7	46.2
Total Helios portfolio		232.7	100.0

SOURCE: HELIOS UNDERWRITING PLC

A component of mitigating the impact of losses on the Helios portfolio has been the use of stop loss reinsurance. For 2022, Helios purchases stop loss reinsurance for its retained capacity of £172 m with an indemnity of 10% of its share of the capacity; a claim can be made if the loss for the year of account at 36 months exceeds 107.5% of capacity, with provision for funding solvency deficits as they arise.

3.Helios has potential to grow its business dramatically

Helios is a growing business and its underwriting portfolio can increase through pre-emptions and the extra capacity from LLVs it acquires. Helios' portfolio grew from £110 million to £232 million between 2021 and 2022. Helios' strategy of purchasing LLVs from Members sets it apart from many other Lloyd's investment ventures. Helios acquired a further 28 vehicles in 2021 with capacity of £35 million.

Many of the underlying issues referred to here are not going to disappear any time soon, and for those for whom continued membership of Lloyd's is no longer attractive Helios could provide a valuable service. Helios offers three sale options with consideration being offered in cash, shares or a combination of cash and shares.

4. What is the tax treatment when a Member sells an LLV to Helios?

The tax implications of any sale to Helios need to be considered carefully by a potential vendor and will vary on whether the Member is disposing of shares in their NameCo or an interest in an LLP and then, which of three sale options is chosen. The following three examples illustrate the different tax treatments applicable to each of the three different transaction routes open to Members.

- ***Selling for cash***
  In the case of the NameCo and the LLP, the gain arising on the disposal of shares in a NameCo or the LLP interest will be subject to Capital Gains Tax ("CGT") at 10% for basic rate taxpayers and 20% for higher rate taxpayers. Provided the conditions of Business Asset Disposal Relief ("BADR") have been satisfied the gain will be subject to CGT at 10% up to the Lifetime Limit of £1 million. However, from an IHT perspective, in the case of both a NameCo and an LLP, the cash received from the disposal of shares in a NameCo or the LLP interest would not qualify for business property relief ("BPR").

- ***Selling in exchange for shares in Helios***
  If shares in a NameCo are exchanged for shares in Helios, there is no disposal for CGT purposes and the original base cost of the NameCo shares will become the base cost of the shares in Helios. With an LLP, however, the situation is different; there are no share-for-share provisions, and this means that a capital gain would arise as it would for a direct disposal of the interest in the LLP for cash.

  Shares held in Helios are considered to be unquoted for BPR purposes and are eligible to qualify for BPR, and provided the shares in the NameCo or the LLP interest have been held for at least two years prior to exchange for Helios shares, will be eligible to qualify from the day of exchange. HMRC presently allows the total ownership period to be aggregated when business property is replaced with new business property.

- ***Selling in exchange for a combination of shares and cash***
  In this instance, the NameCo and the LLP are treated differently. Where a combination of Helios shares and cash is received as a consideration for the disposal of NameCo shares, a part disposal arises for CGT purposes. A capital gain will arise in respect of the cash element, but the share-for-share exchange exemption will apply to the consideration received in the form of Helios shares. In the case of an LLP, there are no similar share-for-share provisions, so for CGT purposes a capital gain would arise and all the consideration would be treated as if it were a direct disposal for cash. Any cash consideration received would not be eligible for BPR.

Any Member considering a sale to Helios needs to take specific and independent tax advice before making any decision and commitment to sell to Helios.

5. Helios' potential to offer access to different syndicates

A consistent problem for Members has been the lack of access to new, quality syndicates. There are now only 19 syndicates on which members have freehold capacity, and which have any easily ascertained "value" in their auction strike price.

As Helios is writing a significantly larger capacity (£232 million for 2022) than any individual Member this size not only gives it operational and cost-efficiencies, it gives it leverage when dealing directly with managing agents. Helios can seek access to. Helios believes that it is well placed to persuade the managing agents of some first and second quartile syndicates that are not currently available to Members to see the advantage of the larger third party capital line that Helios can offer.

6. The dividend policy

A key attraction of any (re)insurance company share for potential investors is whether the company can pay a reliable dividend income and whether this can be increased over the course of time. Whilst in 2019 COVID uncertainties meant that no dividend was paid, in its 2020 Annual Report and financial statement, the company stated that it was "implementing a new dividend policy where it intends to pay a sustainable annual ordinary dividend, of 3p per share, which would be supplemented by special dividends from time to time. The Board continues to recognise the importance of income returns to shareholders." A positive statement for shareholders, and a commitment to a stable dividend payment policy, with the potential to be augmented by the payment of "special" dividends on a periodic basis.

Conclusion

Helios offers some different and potentially attractive options to LLV owners thinking of ceasing underwriting as trading Members of Lloyd's. The three "sale-options" for LLVs may afford a Member an immediate and tax efficient exit from the market. The company can offer potential shareholders something different from being a trading Member of Lloyd's: "an alternative way forward" as a shareholder in Helios allowing the Member to continue to have a Lloyd's investment after the sale of their LLV and gain exposure to a portfolio of Lloyd's syndicates in an AIM quoted company.

Helios' structure means it can produce an income generating investment from its Lloyd's underwriting capacity and generate potential returns from the growth of capital value. It is committed to pay regular and special dividends to its shareholders.

Aside from having a strong underwriting portfolio, heavily focussed on top quartile Lloyd's syndicates, Helios' selective use of reinsurance has, and will continue to mitigate the company's exposure to excessive loss. Most importantly, Helios has a potential for substantial growth as its portfolio of syndicates pre-empts, and as it acquires more LLVs; and its additional capacity may attract new syndicates to its portfolio. Helios believes it offers an attractive alternative to Members wishing to cease trading at Lloyd's.

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