HARDMAN & CO.

# CHESNARA PLC

## Good 2023 results set platform for future progress

**Chesnara has announced its 2023 results. Positive returns from equity markets and gains from acquisitions in the first half were somewhat offset by adverse changes to operating assumptions in the second. Economic Value profit of £59.1m marked a good turnaround from a loss of £85.1m in 2022. Economic Value of £524.7m was 2% higher than a year ago, reflecting the dividend payment and forex effects. The final dividend of 15.61p brought the full year up to 23.97p, a 3% increase over the previous year. Cash generation was good with base cash generation of £32.6m and commercial cash generation of £53.0m.**

- **Acquisitions:** There was little incremental news on acquisitions, with the main item being the completion of the Part VII transfer of CASLP. Chesnara has been active in seeking deals, and it should be reassuring to investors that several have been rejected, as management wishes only to do the right deals.
- **Estimates:** A couple of operating lines were worse than expected, which has led to a downgrade to our estimates. The adjustments to new business and operating experiences/assumptions have led to downgrades of our 2024E EPS, to 33.8p from 38.6p. We have introduced 2025E EPS of 34.6p.
- **Valuation:** With a price at approximately 80% of its forecast Economic Value, Chesnara seems undervalued. A prospective dividend yield of 8.8%, with good prospects of continued growth, also suggests 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) | 2020 | 2021 | 2022 | 2023 | 2024E | 2025E |
|---|---|---|---|---|---|---|
| Operating earnings | -66.1 | -58.8 | -26.8 | -7.7 | 11.5 | 11.5 |
| Economic earnings | 22.9 | 109.6 | -109.1 | 42.9 | 46.6 | 48.0 |
| Economic Value earnings | -37.6 | 57.8 | -85.1 | 59.1 | 50.8 | 52.0 |
| Economic Value/share (p) | 424 | 416 | 340 | 349 | 358 | 368 |
| Base cash generation | 28 | 20 | 83 | 33 | 42 | 41 |
| EPS (p) | -25.1 | 38.5 | -56.6 | 39.3 | 33.8 | 34.6 |
| Dividend (p) | 21.94 | 22.60 | 23.28 | 23.97 | 24.69 | 25.43 |
| Price/Economic Value (x) | 0.66 | 0.67 | 0.82 | 0.80 | 0.78 | 0.76 |
| Yield | 7.9% | 8.1% | 8.3% | 8.6% | 8.8% | 9.1% |

*Source: Hardman & Co Research*

### Life assurance

*Source: LSEG*

### Market data

| | |
|---|---|
| EPIC/TKR | **CSN** |
| Price (p) | **279.0** |
| 12m high (p) | 307.0 |
| 12m low (p) | 243.0 |
| Shares (m) | 150.8 |
| Mkt cap (£m) | 420.9 |
| Economic Value (£m) | 524.7 |
| Country of listing | UK |
| 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 |

+44 (0)1772 972 050
www.chesnara.co.uk

### Key shareholders

| | |
|---|---|
| Columbia Threadneedle | 11.8% |
| Abrdn | 10.9% |
| Hargreaves Lansdowne | 7.5% |
| Interactive Investor | 7.3% |
| M&G | 6.5% |
| Canaccord Genuity | 3.8% |
| Rotal London | 3.7% |
| Janus Henderson | 3.6% |

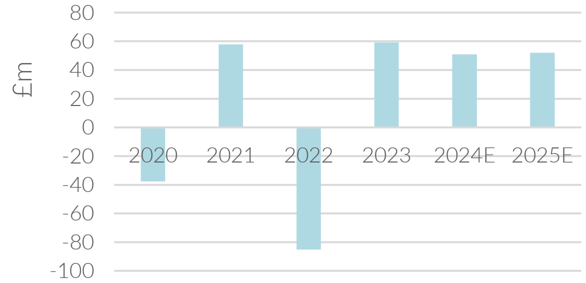
### Diary

| | |
|---|---|
| 14 May | AGM |
| 28 May | Final dividend paid |
| 30 Jun | Half-year-end |

### Analyst

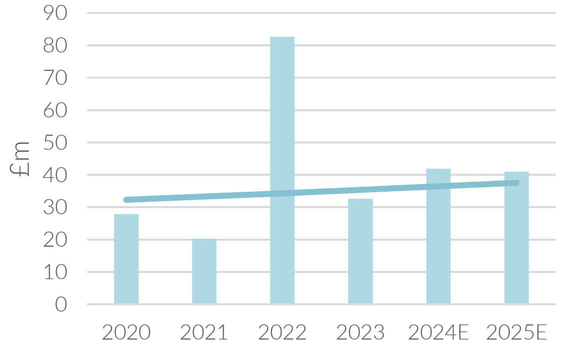
Brian Moretta bm@hardmanandco.com

## Economic Value earnings



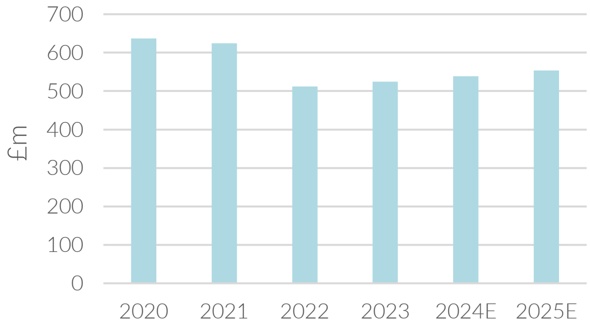

- Volatility for investment assets in 2020 and 2022
- Also affected by operational challenges
- Forecasts are based on normalised assumptions
- Gains from acquisitions in 2023 of £28.4m

## Base cash generation and dividends paid (line)



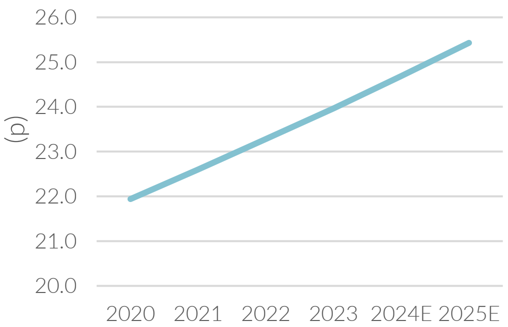

- 2020 affected by Scildon, 2021 by a challenging Swedish market
- Symmetric adjustment smooths effect of markets on cash
- 2023 cash boosted by Risk Margin reduction in UK
- More normal conditions should keep cash generation to comfortable levels

## Economic Value




- Volatility for investment assets in recent years
- Also affected by operational challenges
- Forecasts are based on normalised assumptions
- Gain from acquisitions of £28.4m in 2023

## 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*

# Results commentary

The headline figures for FY'23 continued the positive results shown at the half-year, with a much-improved performance over 2022, albeit the second half of the year was not as strong as the first. Good returns from equity markets plus the benefits from acquisitions were the strongest drivers, with an offset from operating assumption changes. Economic Value earnings of £59.1m were behind our forecasts, but still a great improvement on the loss of £85.1m in 2022. Economic Value rose 2% to £524.7m, as at 31 December 2023. Within these figures, acquisitions provided a gain of £28.4m, offset by forex changes and, for the balance sheet, payment of the dividend.

Cash generation, at £32.5m, was solid, albeit somewhat down from £82.7m in 2022. The symmetric adjustment was the biggest swing factor, with good equity returns leading to it reducing cash generation in 2023, the opposite of 2022. Commercial cash generation (which excludes this) was £53.0m, an increase on 2022's £46.6m.

As expected, the final dividend of 15.61p is a 3% increase over the 2022 figure, giving a total for the year of 23.97p.

As noted at the time of the interims, 2023 saw the introduction of IFRS17. We will continue to focus on Economic Value and the cash generation as better measures of the true value within Chesnara. However, there is now greater consistency between IFRS and Economic Value and we will refer to some items.

## Earnings and operations

**Economic Value earnings**

| Year-end Dec (£m) | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|---|
| Expected movement | -0.4 | 0.3 | -1.7 | -1.3 | 14.9 |
| New business | 7.8 | 3.7 | 2.4 | 8 | 4.4 |
| Operating experience variances | -6.8 | -22.0 | -19.2 | -20.7 | 0.8 |
| Operating assumption changes | 3.8 | -35.8 | -13.9 | -14.5 | -27.8 |
| Other operating variances | -0.3 | 3.9 | -0.2 | 1.7 | 0.0 |
| Total u/l operating earnings | 4.1 | -49.9 | -32.6 | -26.8 | -7.7 |
| Material other operating items | 1.5 | -16.2 | -26.2 | | 0 |
| Total operating earnings | 5.6 | -66.1 | -58.8 | -26.8 | -7.7 |
| Economic experience variances | 143.1 | 45.7 | 79.5 | | |
| Economic assumption changes | -22.0 | -22.8 | 30.1 | | |
| Total economic earnings | 121.1 | 22.9 | 109.6 | -109.1 | 42.9 |
| Other non-operating variances | -5.2 | -2.8 | 4.5 | -2.6 | -11.9 |
| Risk margin movement | -7.0 | 4.7 | 10.8 | 20.4 | 1.1 |
| Tax | -10.5 | 3.7 | -8.2 | 12.0 | 6.3 |
| Gain on acquisition | | | | 21 | 28.4 |
| **Economic Value earnings** | **104.0** | **-37.6** | **57.8** | **-85.1** | **59.1** |
| EPS (p) | 69.3 | -25.1 | 38.5 | -56.6 | 39.3 |

*Source: Hardman & Co Research*

From this, we can see that there is an improvement across several lines of the P&L, not just the economic earnings. We note that the expected movement is the unwind of the discount rate, which higher interest rates have increased substantially.

### Operating movements

After a period of struggling with operating experiences that were somewhat worse than assumed (as we previously noted, much of which were for reasons outside Chesnara's control), 2023 saw a much-improved result. Indeed, the net result for variances was very slightly positive, although this covers a wide range of moving parts. Unfortunately, this was offset by changes in assumptions going forward. The net result was still a £7.7m loss on operating earnings, albeit this is much reduced compared with the three preceding years.

### *Lapses*

This has been the biggest area of concern in operations for the past few years, particularly in Sweden where legislative changes have made it easier to make transfers in the pensions market. The market was also temporarily distorted by a competitor with unrealistic pricing, which has now reverted to something more rational.

While the most recent legislation changes have affected Movestic's existing business less than its competitors, and it has executed some retention initiatives, lapses still came in higher than expected, albeit the strain is less than in previous years. While assumptions continue to be strengthened, it looks like it may take some time for this market to settle down. Competition is leading to ongoing fee pressure too.

Elsewhere, we saw better results. While Waard had a weak first-half, it finished the year with better-than-expected lapses. This was aided by reigniting premiums in Conservatrix. As it was previously part of an insolvent company, ongoing premiums were restricted. Waard has managed to get some clients to restart premiums, creating additional synergies. Hopefully, there may be some more of that to come.

The UK also saw a positive lapse experience, leading to higher fee income than expected.

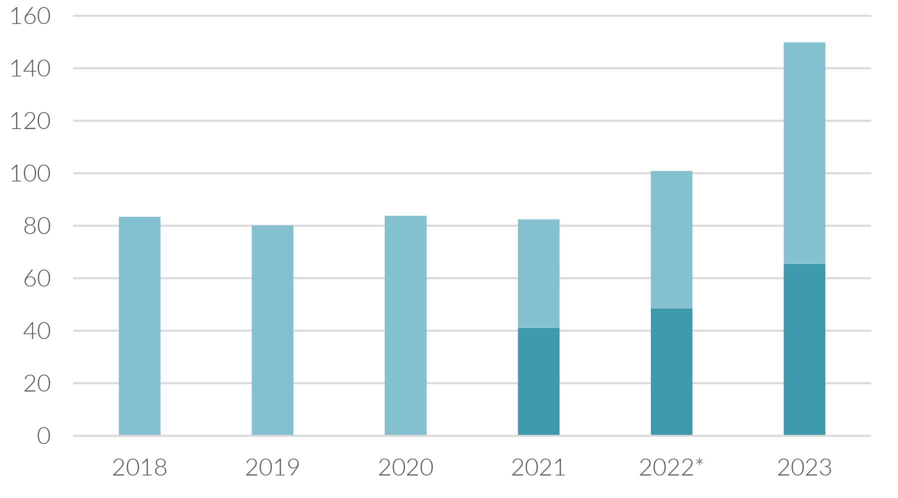
### *Mortality*

Mortality got very little attention in the statement, suggesting it has largely been in line with expectations. However, there has been some strengthening of assumptions in Scildon.

### *Expenses*

Our expense analysis is somewhat complicated by the introduction of IFRS17. This affects the expense calculation shown in the accounts. While we have been supplied with restated 2022 figures, those for prior years remain on the old accounting basis.

**IFRS expenses (£m) (first half highlighted 2021-23)**




**2022 figures are restated for IFRS17, prior years on the original accounting basis.*
*Source: Chesnara, Hardman & Co Research*

There was a significant increase in expenses in 2023. The largest factor has been the acquisitions, with Sanlam in particular being significant. However, a full year from Robein Leven and adding Conservatrix and Canada Life have also had an effect. While synergies should lead to lower unit costs, the absolute level is higher.

Underpinning a rise in ongoing costs has been inflation-matching pay rises, something that should have less impact going forward, now that inflation is lower. There has also been an increase in central costs. Some of this, such as the larger M&A team, will be ongoing while the implementation costs of IFRS17 are one-off (albeit costs of different regulatory changes recur).

In early 2023, Chesnara announced a new partnership with SS&C to manage its UK operations. The migration across of its existing book of business is now ongoing, with CASLP to follow afterwards now that the Part VII transfer is complete. Preparations are also under way for integrating Canada Life, albeit that is likely to be in 2025. This should all bring lower unit costs, while giving an improved platform for future acquisitions.

Within Waard, the Conservatrix acquisition was integrated in the first half and the second half saw some improvements from synergies. The non-unit-linked business has moved to a single custodian. As well as improving costs, it should allow better sustainability tracking. It has also digitalised its consumer portal for launch this year.

The IT upgrade in Scildon has continued, producing cost efficiencies in line with expectations.

### *Management changes*

As noted at the time of the interim results, there were several changes in leadership in the divisions. While Movestic initially announced Sara Lindberg as an interim appointment, that has now been made permanent.

At last year's AGM, the long-standing Group FD, David Rimmington, announced that he would not be seeking re-election. He will be replaced by Tom Howard, who comes from Aviva and will take the post of Group Chief Financial Officer with effect from 1 May, subject to regulatory approvals.

## Economic movements

Positive equity markets led to economic earnings being much improved, at £42.9m, compared with the loss of £109m in 2022. These were almost exactly in line with our (normalised) forecast of £43.4m.

### *Equities*

Equity markets rose in all three of Chesnara's countries. As at the interims, the biggest effect was in Sweden, where the OMX increased by 15.6% in 2023. With the Swedish business also having the largest exposure to equities, this helped offset some of the fee pressure noted above.

While the UK is the next most exposed, a FTSE All-Share return of 3.7% over the year was effectively in line with gilt yields and contributed little to earnings. In the Netherlands, the AEX rose 13.4%, albeit the net exposure is lower.

### *Interest rates*

Although bond yields, generally, rose in the first half of 2023, they fell back in the second half and finished lower. In the UK, the 10-year gilt yield was only slightly lower, at 3.6%, having started the year at 3.8% and risen above 4.4% at the half-year. Bond yields in the Netherlands showed a similar pattern, with the 10-year Euro swap yield falling to 2.5% from 3.2%, having risen during the year.

Credit spreads showed a more mixed pattern. In the UK, AA credit spreads narrowed sharply in the second half to 0.71%, having started the year at 1.04%. In contrast, European AA credit spreads widened over both the first and second halves, rising from 0.29% to 0.63%.

The net effect was that both the UK and Sweden had strong positive results from economic earnings, while the Netherlands, which is much more exposed to bonds and mortgages, experienced some small losses. The latter had several moving parts.

### *Fund returns*

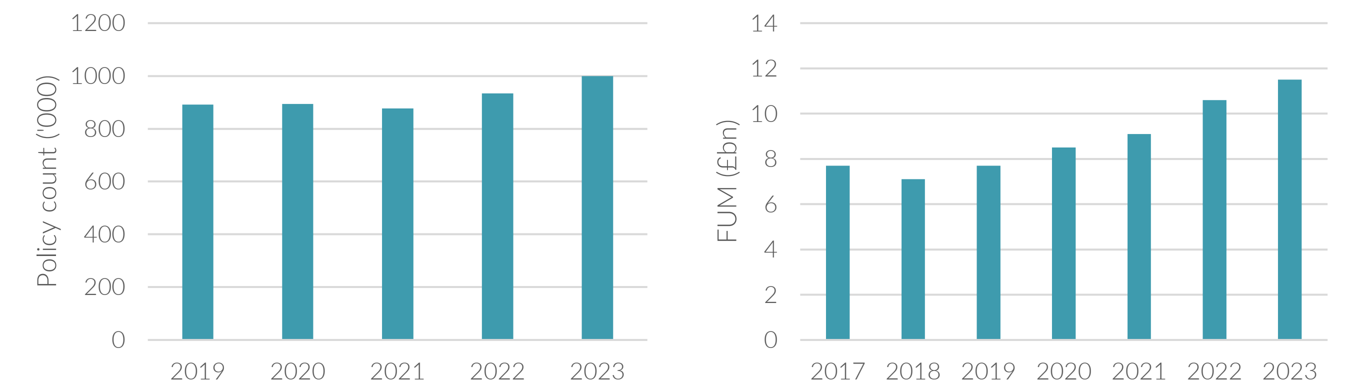
In 2023, UK investors saw some underperformance from their funds relative to benchmarks, albeit mostly by less than 1ppt. However, this represents a good recovery from the position at the half-year. Having mostly outperformed in the past few years, long-term performance remains good.

Meanwhile, Swedish investors averaged a return of 11.8%, While this was a weaker second half, it was still positive and driven by the good equity market returns.

## Operational KPIs

The alternative KPIs show the general improvement in Chesnara's operations over the past few years. Although new business and market movements contribute to changes, recently, acquisitions have been the biggest drivers. In 2023, the completion of Conservatrix and Canada Life were positive contributors, as were the positive equity market movements. With 85% of liabilities being unit-linked, we regard FUM as being the more significant as increases directly improve fee income.

Policy count and funds under management



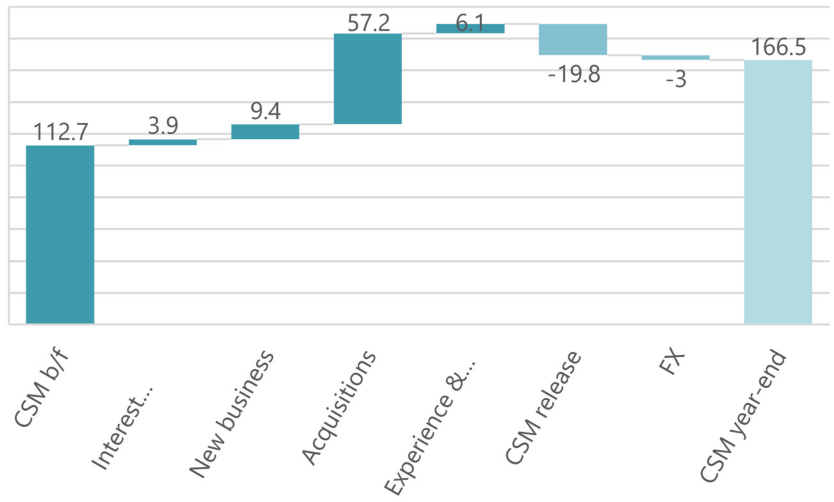

*Source: Hardman & Co Research*

## CSM

As we noted at the time of the interims, IFRS17 has introduced the contractual service margin (CSM). While it is incomplete (it only applies to the 42% of Chesnara's liabilities that are classified as insurance), it still has some value to investors. Although the calculations are not as prescribed as for Solvency II, Chesnara hopes that, in time, there may be some convergence, which might simplify reporting.

The breakdown gives some further insight into value creation within Chesnara over the past year. As might be expected, acquisitions were the most significant addition to the CSM, way more than new business. The CSM release is from the run-off of existing business. The same patterns would be reflected in the investment business if it were included here, albeit the absolute values would change significantly.

CSM movement in 2023




*Source: Chesnara, Hardman & Co Research*

# Acquisitions

Although Chesnara has made progress on three transactions in 2023, the news on Conservatrix and Canada Life was as previously announced. The main incremental news is the completion of the Part VII transfer of CASLP (formerly Sanlam). This court approval is the final step required in the UK before life companies can merge. This will allow full integration of CASLP into Countrywide, allowing realisation of operating and capital synergies.

Acquisitions in 2023

| | Conservatrix | Canada Life |
|---|---|---|
| Discount | 34% | 44% |
| Day 1 Economic Value gain | £22m | £7m |
| Steady state annual cash | £4m | £3m |
| Integration status | Complete | On track |

*Source: Hardman & Co Research*

The integration of Conservatrix into Waard was complete at the time of the half-year announcement and the benefits are reflected in the 2023 figures. The Canada Life transaction was initially enacted through a reinsurance agreement, which took effect from 1 January. While the Part VII transfer is not expected until 2025, which will prevent full integration until then, the book has effectively been part of Chesnara for the whole of 2023 too.

### *Prospects*

When Chesnara raised its Tier II debt, in early 2022, we were optimistic that it could be deployed into acquisitions in a reasonably short timescale. While there has been progress, the pace has perhaps been slower than we had hoped for.

This is not for the lack of trying. Chesnara has built up its M&A team and has been active in the market for deals. However, it has seen several potential acquisitions fall through for various reasons:

- other bidders offered more money;

- items were revealed during diligence that would affect the purchase price, but a suitable valuation adjustment could not be agreed; or
- items were revealed during diligence that would make the transaction undesirable.

Although we are disappointed in deals falling through, we find this reassuring: while Chesnara's management is keen to make further acquisitions, it is not willing to override value considerations for the sake of demonstrating progress.

As Chesnara's presentation demonstrates, there is an active European M&A market and there have been several transactions executed in the past year. We have spoken before about the underlying impetus for sellers: renewed focus on core businesses, a need to manage capital effectively and steadily increasing regulatory burdens, which disproportionately affect subscale businesses. These all remain in place. We might also add a more stable economic environment: valuations can be sensitive to interest rate movements, so greater steadiness in those may be helpful.

Over the past year, Chesnara has increased the available internal resources and is open to larger deals than it was 12 months ago. Between cash on the balance sheet and its existing credit facilities, it has over £200m available for a deal today.

To this, it could raise further debt or equity. While Chesnara is comfortable with its current debt level, a larger company post-acquisition could afford more debt in absolute terms. Chesnara is also willing to increase debt levels if there is a path to reducing them reasonably quickly. For example, there may be capital synergies that can be released once an acquisition is complete.

Using equity is something management has also mentioned increasingly over the past year. At its most simple, while the share price is at a discount to Economic Value, Chesnara's acquisitions have often been at larger discounts. Even if that isn't achieved, then the value of synergies can still lead to value enhancement. There seems to have been some early-stage discussions with possible strategic partners around funding equity issues. Given that this has been disclosed, we can presume that there is some interest. Although we don't know the size of appetite, which will also depend on the terms of any deal, this would suggest that deals significantly larger than £200m could be possible.

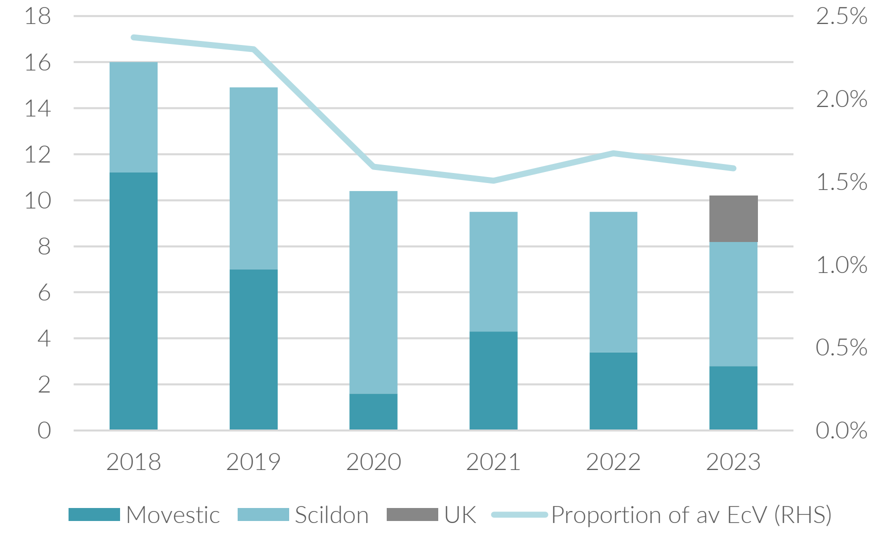
At the interim results, management expressed greater openness to transactions in Sweden. However, deeper inspection suggests that is not as promising as it initially appeared. We have previously noted that Sweden has been a challenging market, which seems to be getting better, and potential vendors may be waiting for that improvement to be realised. Nevertheless, there is still plenty of activity in the UK and Netherlands and it seems likely that, for now, any transactions will most likely be in those markets.

## New business

Possibly the only real disappointment in the 2023 results was in new business. While the first half produced some promising results for the existing businesses, this momentum did not continue into the second half of the year. In Movestic in particular, we had forecast a bounce-back from the difficult markets in 2021 and 2022, which did not quite materialise as we hoped.

While, overall, new business was up 7% to £10.2m, £2.0m of this came from the addition of Sanlam, and both Movestic and Scildon were down YoY.

Chesnara's value of new business (£m)




*Source: Chesnara, Hardman & Co Research*

The position in Sweden is somewhat complex. There are some positive signs, with unit-linked volumes increasing 15% compared with 2022 and there was a small market share increase. However, margin and cost pressure affected the value of this new business, with salary increases particularly strong. The custodian business, which had recently been a strength for Movestic, was also down.

As noted above, the legislative changes over the past few years have had a strong effect on the market. For now, brokers remain more focused on churning/switching existing business than on generating new business. Given that background, we have to be more sanguine about the prospects for meaningful improvement than we were before.

While the value of new business also fell in Scildon, this was again due to reduced margins, with both premiums (Annual Premium Equivalent) and policy count increasing. Market share was a touch lower than 12 months ago but not meaningfully so. The focus on term assurance means that new business prospects remain tied to the housing market. This remains subdued and we don't expect a meaningful improvement in 2024.

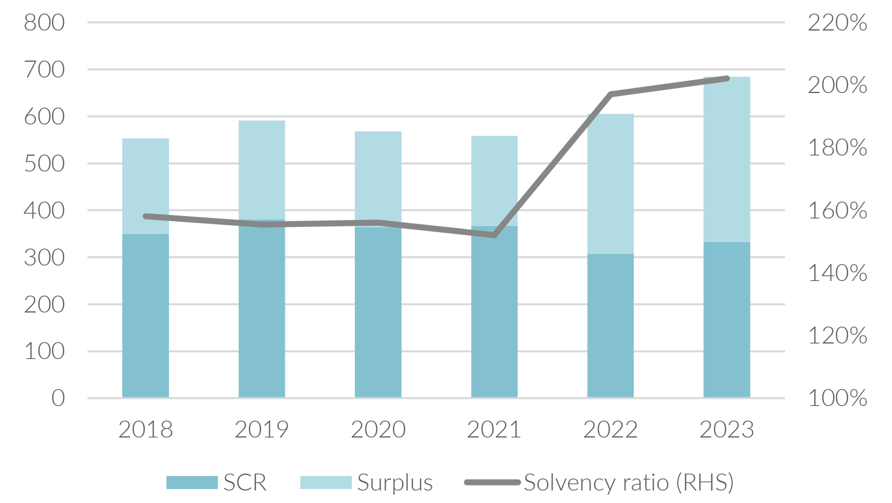
# Capital and cash generation

Risk assets can have a complex effect on solvency ratios. While price rises or declines affect assets, the corresponding value changes of liabilities means the risks to be covered are also impacted. Within Solvency II, the Symmetric Adjustment is a countercyclical measure to smooth out changes: in times of good returns, some of the return is effectively set aside, to be released when returns are weaker. The positive returns on risk assets in 2023 meant that some return was set aside.

While IFRS17 does not affect solvency or Economic Value, it does affect the accounting balance sheet. As of December 2023, the increased IFRS equity was £385m, plus a CSM of £113m. This decreased to £360m at the year-end, plus the CSM of £166m. This has an effect on the leverage ratio, which reduced from 37.6% under the old basis at the year-end, to restated value of 30.3%. By the 2023 year-end, this had reduced to 29.2% at the half-year. After some initial uncertainty, it seems rating agencies are comfortable with this new calculation basis.

## Solvency

Group Solvency II metrics




*Source: Chesnara, Hardman & Co Research*

In 2023, both the Solvency Capital Requirement (SCR) and the surplus increased, the former by 8% to £333m and the latter by 18% to £351m. Both of these are 2% larger than at the half-year. This differential boosted the solvency ratio to 205%, well above Chesnara's target range of 140%-160%.

The growth in the SCR was due to the increase in equity markets, increasing the risk capital required to back the company, and the acquisitions, which brought additional market and life underwriting requirements.

The 1H saw a large benefit to surplus from the reduction of restrictions on the tier 2 debt, while in 2H there was a further mark-to-market benefit. Chesnara also took two actions that improved the surplus:

- It slightly expanded the forex hedge (which contributed positively to the 2023 results).

- It took out reinsurance against a mass lapse in the UK business. We understand that this is low-cost and the capital benefit from reducing the mass lapse risk greatly outweighs the addition for reinsurance risk.

Three of the divisions contributed positively to the improvement in surplus, with Movestic being the exception. The UK was the largest contributor, with Waard also being meaningful. Both Scildon and Movestic were relatively small. Exchange rates had a negative impact of £6.2m, with some offset from the hedge.

## Cash generation

Cash generation in Chesnara is the net change in available surplus. Cash, and the dividend, at the group level, is funded from dividends from the individual divisions. These are generally paid annually, and those for 2023 will most likely be paid to the group in 1H'24.

**Group cash generation breakdown**

| £m | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|---|---|
| Base cash generation | | | | | | |
| UK | 55.8 | 33.6 | 29.5 | 27.4 | 40.8 | 45.0 |
| Sweden | 18.1 | -6.2 | 12.4 | -14.4 | 16.1 | -7.0 |
| Waard | 7.8 | 0.8 | 4.1 | 2.9 | 8.4 | 15.3 |
| Scildon | -17.7 | 22.6 | -22.3 | 15.2 | -3.4 | -3.1 |
| Group | -16.2 | -14 | 4.1 | -10.8 | 20.8 | -17.6 |
| **Total cash generation** | **47.8** | **36.8** | **27.8** | **20.3** | **82.7** | **32.6** |
| Internal dividends | | | | | | |
| UK | 32.0 | 32.0 | 33.5 | 27.5 | 56.0 | 35.0 |
| Sweden | 2.9 | 6.2 | 10.2 | 0.0 | 12.0 | 7.8 |
| Waard | 12.9 | 4.9 | 4.0 | 6.1 | 5.3 | 6.9 |
| Scildon | 21.7 | 7.0 | 0.0 | 5.0 | 0.0 | 0.0 |
| **Total dividends from subsidiaries** | **69.5** | **50.1** | **47.7** | **38.6** | **73.3** | **49.7** |
| **Dividends paid to shareholders** | **30.4** | **31.3** | **32.3** | **33.3** | **34.3** | **35.4** |
| Cash cover (x) | 1.6 | 1.2 | 0.9 | 0.6 | 2.4 | 0.9x |
| Internal dividend cover (x) | 2.3 | 1.6 | 1.5 | 1.2 | 2.1 | 1.4x |

*Source: Chesnara, Hardman & Co Research*

Base cash generation was solid for the year at £32.6m, slightly less than the cost of dividend. The strongest contributor was again the UK, with Waard also making a much stronger contribution. Central group activities were the largest negative.

Within the UK, there were a couple of one-offs, with the reduction in the Risk Margin and synergies from the Part VII transfer of CASLP. Positive markets also helped, somewhat offset by a strengthening of expense assumptions. Meanwhile, Waard saw a positive benefit from improved expense assumptions as economy of scale benefits from the recent acquisitions come through, although this year's actual expenses were worse than assumed. It also benefitted from interest rate movements.

In Movestic, equity markets were a strong driver, albeit offset by the symmetric adjustment. However, worse-than-expected lapses, fee pressure and new business strain made it a new cash consumer. Broadly, Scildon benefited operationally but was offset by economic movements. Although it grew, capital requirements grew faster with some temporary tax impacts adding £10m to its SCR. Group costs were discussed above, including some one-offs.

With positive equity markets in particular, the symmetric adjustment reduced the cash generation in all the divisions, with a net addition of £13.1m. With the significant tax adjustment in Scildon, commercial cash generation of £53.0m was more than £20m higher than base, and 14% more than in 2022.

Looking at cash prospects going forward, 2024 may be a simpler year. There will be little effect from acquisitions: Canada Life will complete in 2025 and any new acquisition would have to be announced soon to complete this year. Having seen changes to LIBOR, the cost of IFRS17 and changes to the Risk Margin, the regulatory front looks quieter too. We note that EIOPA has expressed an intention to have another look at Solvency II, but we do not expect wholesale changes, and these will take some time to produce, let alone implement.

## Dividend cover

Internal dividends from the divisions of £49.7m is somewhat lower than last year, but is still 1.4x the total group dividend to shareholders. Although base cash generation was slightly under the latter, the commercial cash is 1.5x the cost of dividend. Chesnara seems well placed to continue steady dividend growth in the future.

# Prospects

## Operations

A positive start by equity markets in 2024 is helpful, but, unless we see announcements on acquisitions, it looks like being more of a "business-as-usual" year than we have seen recently.

Operationally, there is the ongoing transfer of UK business to the SS&C platform. In the UK, Scildon's IT upgrade should complete, while Waard will see some further investment in its platform. The latter illustrates a point we have made before that, while IT upgrades are individually one-offs, there are always more improvements that can be made. With inflation coming down, we are hopeful that costs will be closer to assumed levels in 2024. However, inflation is still above previous levels and can affect costs with lags. We would not be surprised by further overruns, but at a lower level than in 2023.

Economically, the UK business is changing its asset mix for non-linked business. This is to increase bond exposure post the Canada Life deal (term assurance reserves, typically, are invested in bonds). While this is large enough to be commented on, we don't believe it materially affects future prospects.

## Acquisitions

As we discussed above, we can't say when we will see any further announcements on acquisitions, although management continues to talk positively about prospects. We note that completion, typically, takes several months. An announcement now may not meaningfully affect the 2024 results and benefits would only be seen in 2025.

# Forecasts

In our earnings forecasts, we were slightly behind on the expected movement, while new business and operating assumption changes were both significantly behind our expectations. We have upgraded the figures for the first of these in line with 2023.

For new business, we have downgraded our expectations. We are less optimistic on the prospects of a strong recovery in Movestic and Scildon. Accordingly, we have reset the baseline and reduced growth for the next two years to 5% p.a. We have also slightly downgraded future operating assumption changes, albeit we believe a more benign environment will mitigate further negative results.

Our forecasts are on a normalised basis, economically. The adjustments to new business and operating experiences/assumptions have led to downgrades of our 2024E EPS, to 33.8p from 38.6p. We have introduced 2025E EPS of 34.6p.

We have kept our forecast dividend growth rate forecast unchanged, at 3% p.a. There is an ongoing discussion about whether this is the correct rate, noting near-term changes would not be hugely expensive. Lower inflation has reduced some of the pressure for larger increases, although, on the other hand, we note that Chesnara's cash resources continue to grow. The pace and scale of acquisitions is material too: management would rather deploy cash into value enhancing deals.

**Economic Value earnings**

| Year-end Dec (£m) | 2020 | 2021 | 2022 | 2023 | 2024E | 2025E |
|---|---|---|---|---|---|---|
| Expected movement | 0.3 | -1.7 | -1.3 | 14.9 | 14.9 | 14.9 |
| New business | 3.7 | 2.4 | 8.0 | 4.40 | 4.62 | 4.85 |
| Operating experience variances | -22.0 | -19.2 | -20.7 | 0.8 | -3.00 | -3.09 |
| Operating assumption changes | -35.8 | -13.9 | -14.5 | -27.8 | -5.00 | -5.15 |
| Other operating variances | 3.9 | -0.2 | 1.7 | | | |
| Total u/l operating earnings | -49.9 | -32.6 | -26.8 | -7.7 | 11.5 | 11.5 |
| Material other operating items | -16.2 | -26.2 | 0.0 | | | |
| Total operating earnings | -66.1 | -58.8 | -26.8 | -7.70 | 11.52 | 11.51 |
| Economic experience variances | 45.7 | 79.5 | 0.0 | 43.0 | 44.2 | 45.6 |
| Economic assumption changes | -22.8 | 30.1 | 0.0 | 2.3 | 2.3 | 2.4 |
| Total economic earnings | 22.9 | 109.6 | -109.1 | 42.9 | 46.6 | 48.0 |
| Other non-operating variances | -2.8 | 4.5 | -2.6 | -11.9 | -2.76 | -2.84 |
| Risk margin movement | 4.7 | 10.8 | 20.4 | 1.1 | 1.13 | 1.17 |
| Tax | 3.7 | -8.2 | 12.0 | 6.3 | -5.6 | -5.8 |
| Gain on acquisition | 0.0 | 0.0 | 21.0 | 28.4 | 0 | 0 |
| **Economic Value earnings** | **-37.6** | **57.8** | **-85.1** | **59.1** | **50.8** | **52.0** |
| EPS (p) | -25.1 | 38.5 | -56.6 | 39.3 | 33.8 | 34.6 |
| DPS (p) | 21.94 | 22.60 | 23.28 | 23.97 | 24.69 | 25.43 |

*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.

**Sensitivity to economic assumptions**

| £m | 2022 | 2023 | 2024E | 2025E |
|---|---|---|---|---|
| Normalised Economic Value earnings | -85.1 | 59.1 | 50.8 | 52.0 |
| Half equity returns | | | 25.8 | 31.1 |
| Reduction | | | -49% | -40% |
| No credit spreads | | | 31.1 | 36.6 |
| Reduction | | | -39% | -30% |

*Source: Hardman & Co Research*

With 2023 earnings a little lower than expected, the 2023 year-end Economic Value was a little behind our forecast. This brings our 2024E down to £539.1m and we introduce a 2025E of £553.6m.

For cashflow estimates, we have tweaked the European figures again and returned the UK to a decline in 2025 as the book starts to run off after the boost from acquisitions. Dividend cover remains comfortable, especially as there are likely to be acquisitions on this period that should improve cashflow.

**Key balance sheet and cash generation**

| Year-end Dec (£m) | 2020 | 2021 | 2022 | 2023 | 2024E | 2025E |
|---|---|---|---|---|---|---|
| Borrowings | 67.0 | 47.2 | 212.0 | 207.9 | 207.9 | 207.9 |
| Economic Value | 636.8 | 624.2 | 511.7 | 524.7 | 539.1 | 553.6 |
| Economic Value/share (p) | 424 | 416 | 340 | 349 | 358 | 368 |
| | | | | | | |
| Base cash generation | | | | | | |
| UK | 29.5 | 27.4 | 40.8 | 45.0 | 36.0 | 34.2 |
| Movestic | 12.4 | -14.4 | 16.1 | -7.0 | 9.1 | 10.0 |
| Waard | 4.1 | 2.9 | 8.4 | 15.3 | 6.3 | 6.6 |
| Scildon | -22.3 | 15.2 | -3.4 | -3.1 | 1.0 | 1.0 |
| Group | 4.1 | -10.8 | 20.8 | -17.6 | -10.6 | -10.9 |
| Total | 27.8 | 20.3 | 82.7 | 32.6 | 41.9 | 41.0 |
| Dividends paid | -32.3 | -33.3 | -34.3 | -35.4 | -36.4 | -37.5 |
| Dividend cash cover (x) | 0.9 | 0.6 | 2.4 | 0.9 | 1.1 | 1.1 |

*Source: Hardman & Co Research*

# Disclaimer

*Hardman & Co provides professional independent research services and all information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable. However, no guarantee, warranty or representation, express or implied, can be given by Hardman & Co as to the accuracy, adequacy or completeness of the information contained in this research and they are not responsible for any errors or omissions or results obtained from use of such information. Neither Hardman & Co, nor any affiliates, officers, directors or employees accept any liability or responsibility in respect of the information which is subject to change without notice and may only be correct at the stated date of their issue, except in the case of gross negligence, fraud or wilful misconduct. In no event will Hardman & Co, its affiliates or any such parties be liable to you for any direct, special, indirect, consequential, incidental damages or any other damages of any kind even if Hardman & Co has been advised of the possibility thereof.*

*This research has been prepared purely for information purposes, and nothing in this report should be construed as an offer, or the solicitation of an offer, to buy or sell any security, product, service or investment. The research reflects the objective views of the analyst(s) named on the front page and does not constitute investment advice. However, the companies or legal entities covered in this research may pay us a fixed fee in order for this research to be made available. A full list of companies or legal entities that have paid us for coverage within the past 12 months can be viewed at http://www.hardmanandco.com/legals/research-disclosures. Hardman may provide other investment banking services to the companies or legal entities mentioned in this report.*

*Hardman & Co has a personal dealing policy which restricts staff and consultants' dealing in shares, bonds or other related instruments of companies or legal entities which pay Hardman & Co for any services, including research. No Hardman & Co staff, consultants or officers are employed or engaged by the companies or legal entities covered by this document in any capacity other than through Hardman & Co.*

*Hardman & Co does not buy or sell shares, either for their own account or for other parties and neither do they undertake investment business. We may provide investment banking services to corporate clients. Hardman & Co does not make recommendations. Accordingly, they do not publish records of their past recommendations. Where a Fair Value price is given in a research note, such as a DCF or peer comparison, this is the theoretical result of a study of a range of possible outcomes, and not a forecast of a likely share price. Hardman & Co may publish further notes on these securities, companies and legal entities but has no scheduled commitment and may cease to follow these securities, companies and legal entities without notice.*

*The information provided in this document is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject Hardman & Co or its affiliates to any registration requirement within such jurisdiction or country.*

*Some or all alternative investments may not be suitable for certain investors. Investments in small and mid-cap corporations and foreign entities are speculative and involve a high degree of risk. An investor could lose all or a substantial amount of his or her investment. Investments may be leveraged and performance may be volatile; they may have high fees and expenses that reduce returns. Securities or legal entities mentioned in this document may not be suitable or appropriate for all investors. Where this document refers to a particular tax treatment, the tax treatment will depend on each investor's particular circumstances and may be subject to future change. Each investor's particular needs, investment objectives and financial situation were not taken into account in the preparation of this document and the material contained herein. Each investor must make his or her own independent decisions and obtain their own independent advice regarding any information, projects, securities, tax treatment or financial instruments mentioned herein. The fact that Hardman & Co has made available through this document various information constitutes neither a recommendation to enter into a particular transaction nor a representation that any financial instrument is suitable or appropriate for you. Each investor should consider whether an investment strategy of the purchase or sale of any product or security is appropriate for them in the light of their investment needs, objectives and financial circumstances.*

*This document constitutes a 'financial promotion' for the purposes of section 21 Financial Services and Markets Act 2000 (United Kingdom) ('FSMA') and accordingly has been approved by Capital Markets Strategy Ltd which is authorised and regulated by the Financial Conduct Authority (FCA).*



*(Disclaimer Version 8 – Effective from August 2018)*

# Status of Hardman & Co's research under MiFID II

*Some professional investors, who are subject to the new MiFID II rules from 3rd January 2018, may be unclear about the status of Hardman & Co research and, specifically, whether it can be accepted without a commercial arrangement. Hardman & Co's research is paid for by the companies, legal entities and issuers about which we write and, as such, falls within the scope of 'minor non-monetary benefits', as defined in the Markets in Financial Instruments Directive II.*

*In particular, Article 12(3) of the Directive states: 'The following benefits shall qualify as acceptable minor non-monetary benefits only if they are: (b) 'written material from a third party that is commissioned and paid for by a corporate issuer or potential issuer to promote a new issuance by the company, or where the third party firm is contractually engaged and paid by the issuer to produce such material on an ongoing basis, provided that the relationship is clearly disclosed in the material and that the material is made available at the same time to any investment firms wishing to receive it or to the general public…'*

*The fact that Hardman & Co is commissioned to write the research is disclosed in the disclaimer, and the research is widely available.*

*The full detail is on page 26 of the full directive, which can be accessed here: https://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-2031-EN-F1-1.PDF*

*In addition, it should be noted that MiFID II's main aim is to ensure transparency in the relationship between fund managers and brokers/suppliers, and eliminate what is termed 'inducement', whereby free research is provided to fund managers to encourage them to deal with the broker. Hardman & Co is not inducing the reader of our research to trade through us, since we do not deal in any security or legal entity.*

research@hardmanandco.com

9 Bonhill Street
London
EC2A 4DJ

www.hardmanandco.com