multiplicitypartners

MULTIPLICITY PERSPECTIVES

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ILS SIDE POCKETS – CONSIDER YOUR LIQUIDITY OPTIONS

As a secondary buyer of illiquid funds, in particular across niche strategies, we observed a strong surge of investor interest to exit insurance-linked securities (ILS) funds through secondary sales. Over the past few years, large amounts of capital have been locked up in side pockets of ILS funds. By acquiring ILS side pockets from investors, Multiplicity helps investors to redeploy capital more profitably elsewhere and get a fast and clean exit from legacy investments.

Why would anyone sell ILS funds?

Having substantial amounts of locked up cash causes a material dilution of investors‘ performance. We also see investors that remain committed to ILS considering an occasional sale of their ILS side pockets, so that they can reinvest the capital into new deals, e.g. to be ready for the 1/1 renewal season. Having money blocked up in side pockets can be costly in a hard market.

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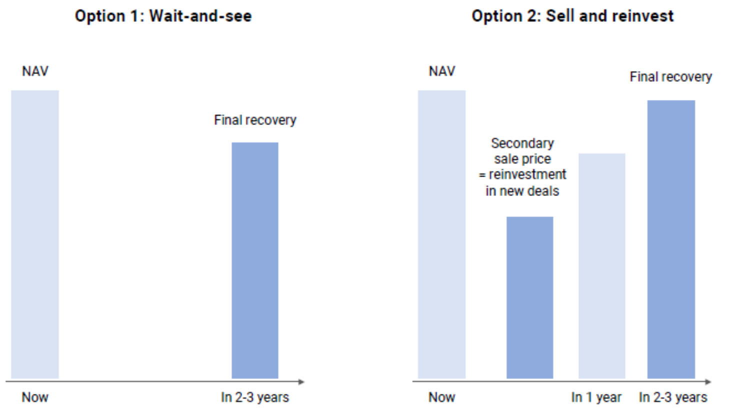

Figure 1: Illustrative value development; source: Multiplicity Partners

Addressing the trapped money

Many ILS funds have created side pockets to segregate losses, or potential losses, from non-impacted assets. This is a valuable instrument to treat investors fairly in open-end funds. Due to the valuation issues, we would otherwise see major conflicts arising between investors that redeem, stay or subscribe. In essence, the capital attributed to side pockets is collateral that is blocked in a trust account and cannot be redeployed. We estimate that around USD 10 billion of the USD 100 billion ILS market capital is currently trapped in side pockets or similar structures.

For ILS fund investors looking for a clean and quick exit, we can provide innovative and effective liquidity solutions. To this end, we recently started to expand our ILS capabilities by establishing a close network of seasoned insurance underwriters to assess and execute more complex ILS transactions.

How to underwrite side pockets

Loss creep is the material risk in side pocket valuations and hence the focus in our underwriting

The key issue to watch is the so-called loss creep. Loss creep refers to (additional) loss estimates or (late) reported losses from a previous natural catastrophe that result in an adverse development of the insurance claims. This has been the source of many negative surprises in recent years. Figure 2 shows a few examples of the loss creep issue.

An interesting analysis by Guy Carpenter shows how claims estimates for major catastrophes were “creeping” up substantially over several quarters after the event.

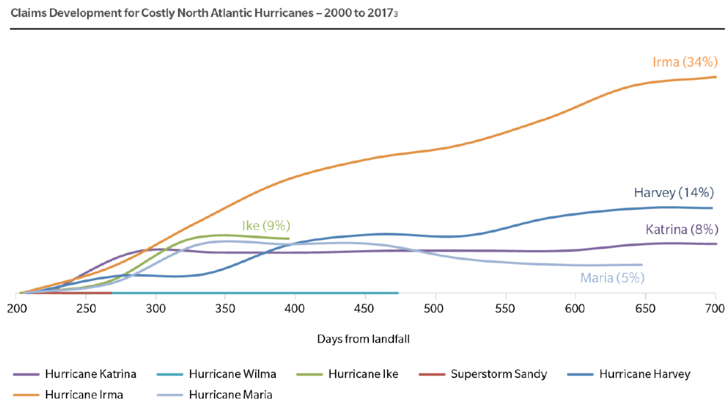

Figure 2: Claims development of costly hurricanes; sources: Guy Carpenter, PCS

Significant differences in the treatment of loss reserves across ILS managers lead to a very different pricing of ILS side pockets in the secondary market

The obvious question for an investor is: how much of these future loss increases are already anticipated in the loss reserves of an ILS vehicle? We see significant differences in the treatment of loss reserves across ILS managers, leading to a very different pricing of ILS side pockets in the secondary market.

While we acknowledge there are many different ways to assess ILS positions within the main vehicle or a side pocket, there are some aspects of good practice in this context.

1. The ILS manager (from who's fund the side pocket emanated) has a systematic process in place which is applied to (i) put a position into a side pocket and (ii) to value the position in the side pocket, among which:
   - event assessment
   - per position assessment
   - per position drill down (e.g. events contributing to aggregate XL position)

2. A third-party valuation (TPV) exists, forming the basis of the side pocket NAV

3. The TPV shows detailed per deal valuation and gap analysis (vs. manager valuation)

4. Application of different actuarial extrapolation methods for the ultimate loss per position

5. Manager underwriting style:
   - complexity of treaties (e.g. aggregate, top and drop, cascading)
   - applies strict coverage language
   - uses buffer loss tables (preferred) or collateral release language consistently

The assessment of these and other points will give an indication of the price a buyer is willing to offer. Obviously, the more transparency (e.g. access to contract language) we will be given, the more accurate the buyer's assessment and typically, the better the price.

What liquidity solutions can we offer

In the past, we mainly dealt with individual ILS investors that were looking to dispose the ILS side pockets to us. More recently, we engaged with ILS fund managers to provide a tender offer to all investors or to acquire the underlying trust units that would allow the manager to liquidate a side pocket.

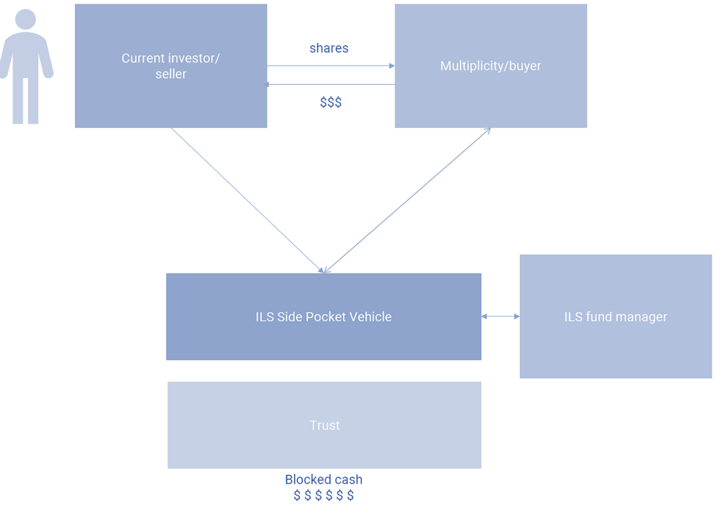

Figure 3: sale of fund shares in a bilateral transaction

In the most straightforward transactions, we engage with a single seller and buy the side pocket shares against cash. The potential recovery or adverse claim development remains with the buyer. As an optional feature, we can offer earn-out clauses so that the seller can keep some of the future upside.

Would you like to receive a quick indicative pricing for your asset? Or share your views on this article? Please write to Andres today at ah@mpag.com, or call him at +41 44 500 4555.

Andres is a Partner of Multiplicity Partners and the Portfolio Manager of the LTO Funds. He has 20 years of experience in alternative investments, distressed investing and portfolio management.
Before joining Multiplicity in 2012, he held various investment roles with the alternative asset managers Horizon21 and Man/RMF. Andres holds a MSc in Mathematics from the University of Zurich and is a CFA and CAIA Charterholder.

ABOUT MULTIPLICITY PARTNERS

Multiplicity Partners is an investment firm specialised in providing liquidity solutions to holders of private market funds and distressed assets. The firm also offers a range of advisory and governance services across alternative assets.

Multiplicity Partners has been an active participant in the secondary market for fund interests and distressed assets since 2010. The team has successfully completed more than a hundred transactions across a wide range of illiquid and complex financial assets. Each partner contributes more than 15 years of relevant experience, giving us the collective capabilities to effectively identify, analyse and execute attractive investment opportunities in hard-to-value assets. Multiplicity Partners was founded in 2010 and is based in Zurich, Switzerland.

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