June 2017

Twelve Capital Research Spotlight – Insurance Relative Value

A decade on from the start of the global financial crises, this publication reflects on; 1. How the equity and credit of the insurance sector has traded in the period, 2. How the equity and credit valuations currently stand relative to other opportunities, and 3. How the insurance company fundamentals have changed in that time period.

Twelve believes both the equity and credit of the Insurance sector is currently offering highly attractive returns, particularly on a relative basis compared with other sectors. The relative attractions are further enhanced when taking into account the stronger fundamentals of the businesses. Twelve highlights 10 reasons that insurance companies are now more robust investible securities than 10 years ago.

Insurance sector still attractive, particularly on a relative basis

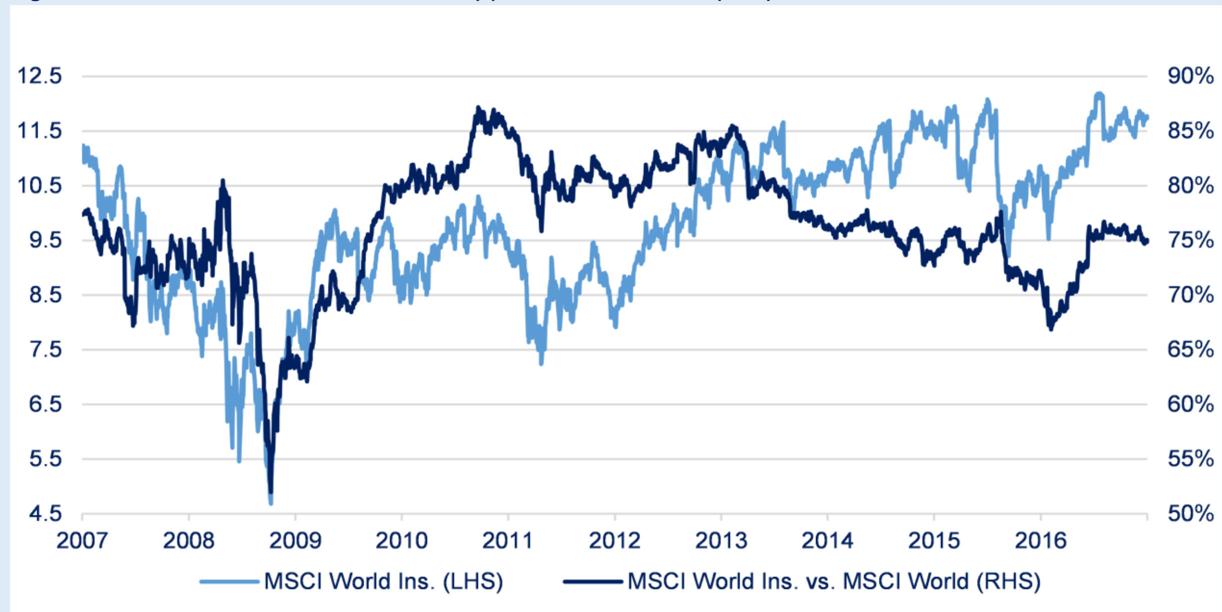
Both insurance equity and subordinated debt have performed strongly over the decade, fully digesting the global financial crises and returning enviable investor returns. Twelve believes the sector still offers attractions, particularly when considered relative to the wider market.

Equity: P/E multiple relative to wider market shows opportunity

The absolute P/E of the sector is now trading marginally above where it was 10 years ago at 11.5x, recovering strongly from the nadir of 2008/9 of c.5x.

However, despite the material improvements to the fundamentals of these businesses, the discount to the wider market remains broadly the same at 25%. This is shown on the dark blue line in figure 1. While Twelve does not anticipate the discount to fully close given the sector's lower growth and complexity discount, Twelve views the extent of the current discount to be too rich. As a result, Twelve expects the insurance sector to perform strongly on a relative basis.

Figure 1: MSCI World Insurance P/E absolute (x) and relative to MSCI (RHS)



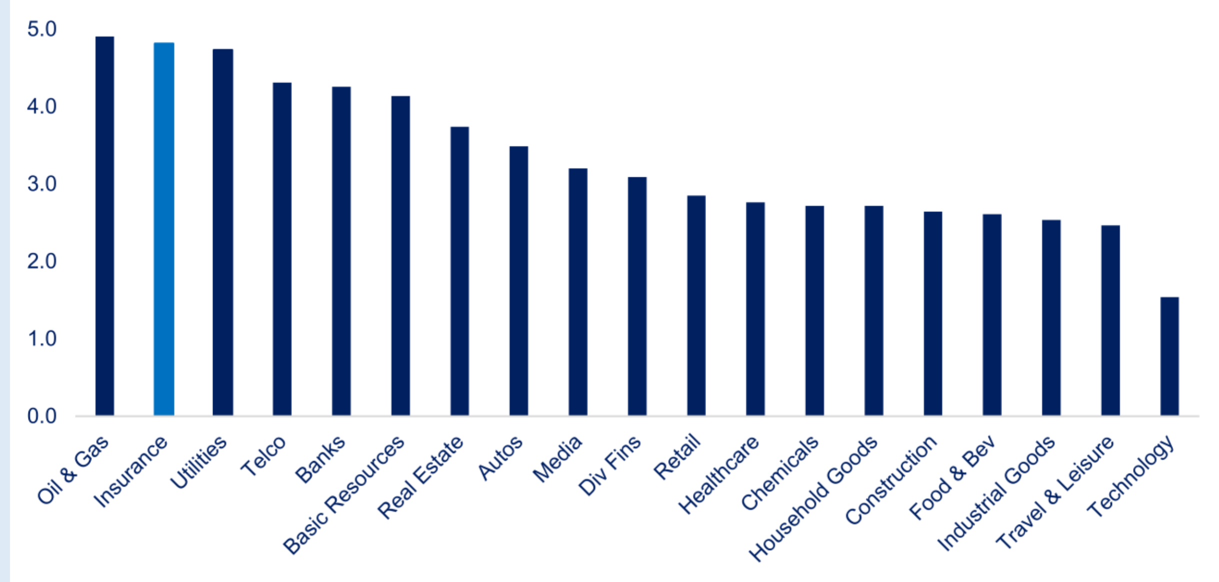
Source: Bloomberg as at 31 May 2017. The MSCI World Insurance Index is an Index focused at measuring the equity performance of the c.80 largest listed global insurance companies weighted by free-float of market capitalization.

Equity: Dividend yield attraction remains

In our view, a high and robust dividend yield acts as an attractive starting point for an equity investment.

The European insurance sector's dividend yield remains highly attractive, with the 4.8% 2017E dividend yield making it the second highest yielding sector in Europe (see figure 2). The higher quality and less volatile earnings, together with the stronger capital positions provides great comfort that these dividends will be paid. In fact, Twelve expect the sector to exceed this when including capital actions such as special dividends and share buybacks.

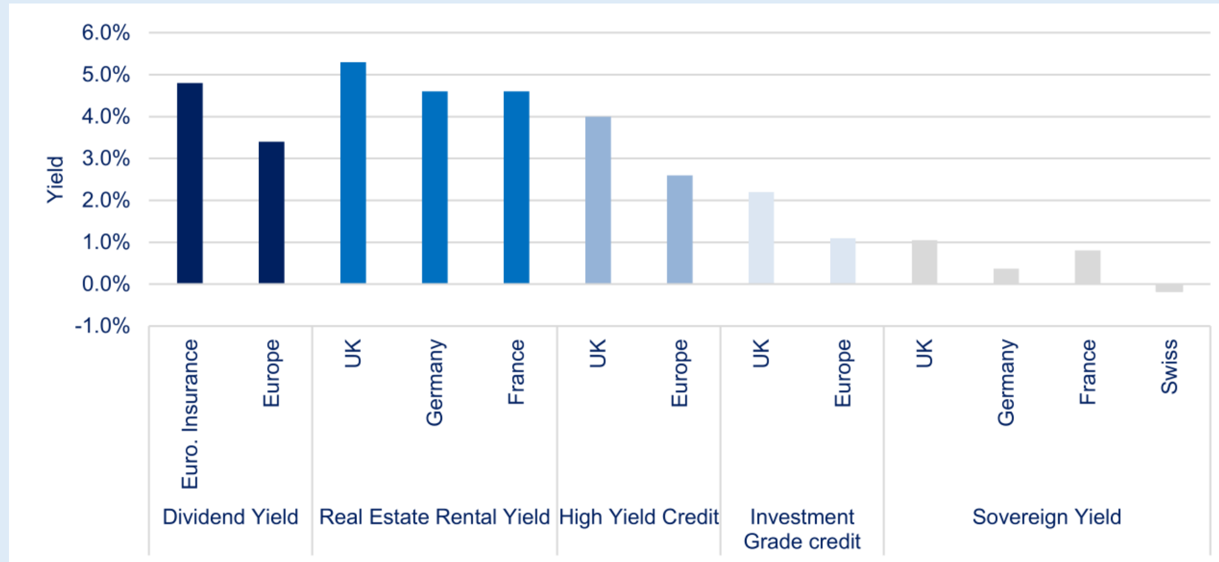
Figure 2: Insurance sector offering the second highest dividend yield in Europe (%)



Source: Bloomberg as at 31 May 2017.

The sector's dividend yield is also attractive when considered with other asset class yields. Figure 3 shows that the European dividend yield compares favourable with many other asset classes generally used for yield investment. At a time where yield across asset classes is so scarce, the value of a high dividend yield has never been higher in Twelve's view.

Figure 3: European Insurance dividend yield attractive relative to other asset classes



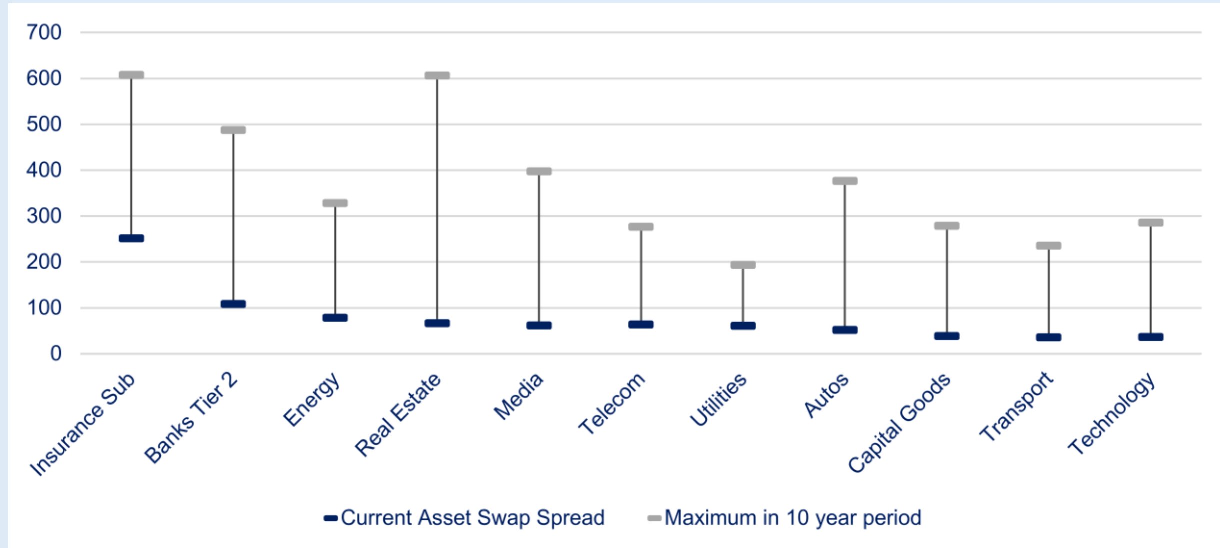
Source: Bloomberg, J.P. Morgan as at 24 May 2017.

Credit: Spread compression, but highly attractive on a relative basis

Credit spreads have had a bumpy journey over the decade. Having traded at historically tight levels 10 years ago, the sector, and nor the wider market, have yet to return to such levels. However, there has certainly been major compression relative to the widest trading levels experienced in 2009.

Figure 4 ranks all of the major European sectors current asset swap spreads in order of current levels. With insurance being on the far left, it shows it is currently the highest yielding sector. This is despite it tightening c.350bps from its widest levels.

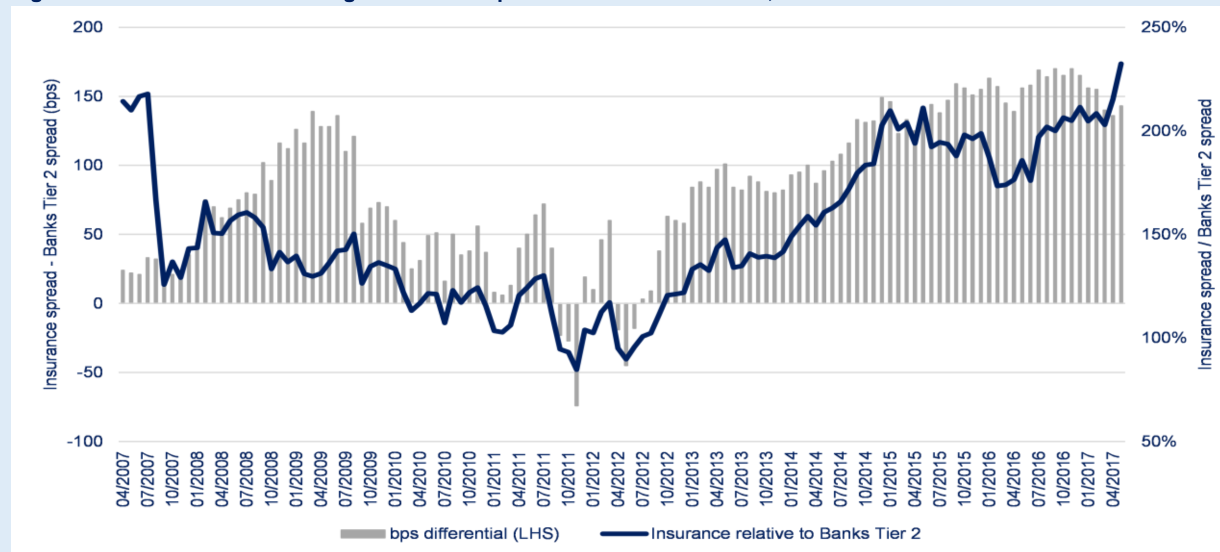
Figure 4: Asset swap spreads of sectors over 10 years (bps) ranked highest to lowest on current levels



Source: Bloomberg, Bank of America Merrill Lynch as at 31 May 2017.

Figure 5 shows the sectors yield relative to Banks Tier 2 debt. The grey bars show the insurance subordinated debt spread in excess of Banks Tier 2, so currently c.150bps. This in itself is one of the highest levels over the past 10 years. The blue line reflects the relative insurance spread to banks as a percentage. At 230% currently, the European insurance sector is trading at relative lows to the European banks sector in credit. This is a major opportunity in our view for investment on a relative basis.

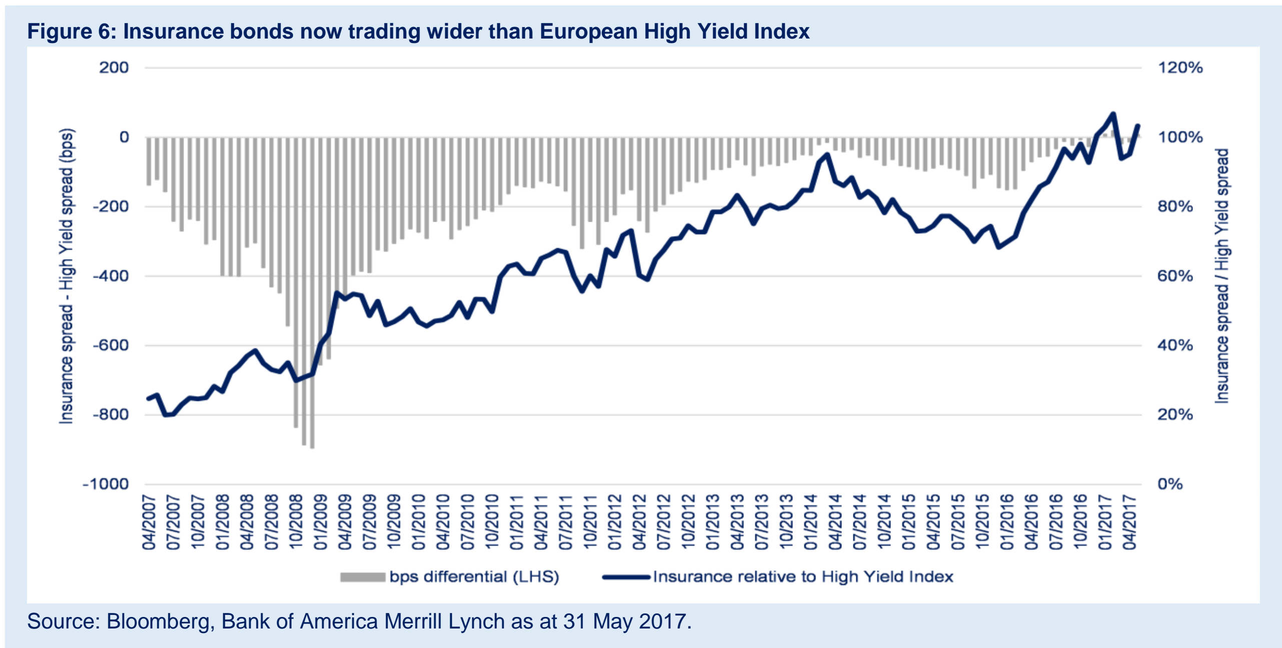
Figure 5: Insurance bonds trading close to 150bps wider than Banks Tier 2, close to widest levels



Source: Bloomberg, Bank of America Merrill Lynch as at 31 May 2017.

An even more compelling data set in Twelve's view is how the European insurance subordinated debt spreads have traded relative to European High Yield. Figure 6 shows that European insurance bonds are now trading wider than European High Yield. Given the relative default rate of High Yield, this is too harsh on European Insurance bonds.

Figure 6: Insurance bonds now trading wider than European High Yield Index



Source: Bloomberg, Bank of America Merrill Lynch as at 31 May 2017.

10 reasons insurers are more investible than 10 years ago.

Having highlighted the relative valuation attractions of the insurance sector, the fundamentals have to be taken into account. During the financial crises, it was largely 'investment/banking' divisions that created issues for insurance businesses, not traditional insurance; AIG and ING being two examples of this. Contagion was the primary driver that led the equities and credits of the insurance sector lower, as opposed to the fundamentals. Despite this, the sector has learned many lessons from the global financial crises, and taken action.

Twelve highlights 10 reasons insurers are now more robust investible securities than 10 years ago;

1. **Lower risk investment portfolios.** This is best reflected in the European insurers' reduction in equities within the investment portfolios; reducing from 19% to 5% in the decade. This has largely been replaced with fixed income securities. While there has been some minor creep in credit quality of the investment books as yield has become more scarce, this is more than compensated by the equity reduction.

2. **Higher quality earnings**. Non-life insurers are now more focused on margin over volume. Life insurers have reduced spread earnings and increased higher quality fee income. Investment return dependence has reduced in both.

3. **Improved disclosure across many areas:**
a. **Capital.** Solvency II has been somewhat of a leveller. It has enhanced disclosures and enabled more granular analyst oversight, even at a subsidiary level. This is still improving as the current SCFR disclosures are proving.

b. **Earnings/Capital sensitivity.** New accounting rules, coupled with Solvency II requirements has led to enhanced sensitivity disclosure to both macro and company specific scenarios. This has increased transparency and understanding of the businesses. As a consequence, management teams have taken action to reduce sensitivities.

c. **Investments.** The financial crises heightened risk awareness around a number of investment asset classes. Analysts and investors are now more acutely aware of key investment risks and therefore demand greater disclosure.

d. **Reserves.** Insurance reserves, i.e. estimated final cost of claims yet to be settled, are inherently complex. But disclosure has improved over the years; with many companies now disclosing detail across individual lines of business, not just at the group level. This is still complex, but improved.

4. **Solvency II ratios are strong, highlighting capital strength.** The implementation of Solvency

II in itself is progress. In addition, capital positions are strong across the sector. Twelve estimates the listed insurance sector has an average Solvency II ratio in the region of 175%.

5. **Lower debt leverage.** The sector has reduced the level of debt supporting capital requirements. A greater focus is being placed on quality of capital by the market, which will become an increasingly important influential component of valuations. Solvency II has been a driver of this.

6. **Stronger capital management.** There is now a greater focus on Return on Equity. As a result, companies are now no longer solely focused on the numerator, but also on the denominator in the Return on Equity calculation. This has resulted in increased normal dividends, sizeable special dividends and share buyback programmes.

7. **Improved earnings resilience.** Many of the management actions have resulted in a reduction in earnings volatility; more fee income, reduced risk in investment portfolios, lower debt leverage etc. As a result, the companies have become more reliable in our view. This is evidenced by the earnings resilience the sector has shown in terms of sell-side analyst expectations at the start of the year to what the company actually achieve. Over the past five years, the sector has been far more resilient to the wider market. Essentially, while at the beginning of the year the wider market promises higher growth, this is not always achieved. The insurance sector tends to deliver on its lower growth forecast.

8. **Cash flow transparency.** There has been a notable improvement in management focus on cash. This has helped to support the sectors dividend yield attractions.

9. **Improved quality of management teams.** Twelve believes Insurance companies are well run businesses. This view is highly subjective and difficult to quantify, however, Twelve believes the current crop of insurance management may be the best for (at least) a generation. Businesses are focused on driving more value for less spend; weaknesses are being acknowledged and addressed; cash is king; and destructive M&A has generally been an absent theme.

10. **Stronger Corporate Governance.** This is largely a market wide theme rather than simply insurance companies. However, board level expertise, coupled with greater scrutiny by external stakeholders, has enhanced corporate governance in the sector in our view.

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About Twelve Capital

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Twelve's investment expertise covers the entire insurance balance sheet, including Insurance Bonds, Insurance Private Debt, Catastrophe Bonds, Private Insurance-Linked Securities and Insurance Equity. It also composes portfolios of its Best Ideas. Its capital solutions are drawing the world of insurance and reinsurance into a closer, more productive relationship with capital markets.
The firm was founded in October 2010 and is majority-owned by its employees. It has offices in Zurich and London.

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