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ValueLine: Why I like QBE

By Roger Montgomery

PORTFOLIO POINT: There are many insurance stocks on the ASX but only one is attractively priced.

Who would buy insurance stocks just now? What with the increasing frequency of catastrophic events, a highly competitive marketplace and impenetrable financial results you could be forgiven for wondering what could be attractive about investing in insurance.

Well, the world's greatest living investor, Warren Buffett, can see the attraction. His Berkshire Hathaway is a major shareholder in General Re and Geico.

No surprise then that while uninitiated shareholders run for cover every time they hear of another earthquake, a select group know that the best-run insurers have more money at their disposal than many fund managers and consistently deliver profits.

Indeed some insurers are so well protected against events such as freak storms that sometimes they even make money out of them.

A well-run insurance company can be one of the truly great businesses to own and, as I explain today, with the right tools and a bit of homework you should be able to identify the insurance business that completes your portfolio.

In Australia the three major general insurance companies are QBE Insurance (QBE), IAG Insurance (IAG) and Suncorp (SUN). (These are distinct from life insurance specialists who insure your family in the event of your death.)

How they're performing: Suncorp, QBE and IAG

QBE has been regarded as the premier listed insurance company for many years. Led by long-term chief executive Frank O'Halloran, the company has been one of the few in Australia to successfully execute a growth-by-acquisition strategy. More recently it has been sold down after results came in at the lower end of its guidance; QBE closed yesterday at $21.03 and is on a price/earnings (P/E) multiple of 10.8 times.

IAG, on the other hand, trading at $3.99 on a P/E of 16.7 times, has been something of a disappointment to shareholders, especially after it rejected a takeover bid from QBE at $5.14 a share in 2008 and later returned to the market for a capital raising.

Insurance terminology

The jargon used in reporting is unique, which is why so many people have trouble assessing insurers. This won't take long and is well worth it, so stay with me.

Gross written premium is the amount of money that an insurer has received over a year for insurance protection. Sometimes insurance companies use gross earned premium as well, which makes adjustment for policies that commenced at a time other than the beginning of the financial year.

The net earned premium is the gross written premium with the cost of reinsurance deducted. Reinsurance is where the insurer spreads risk among other institutions, much like when a bookie lays off an especially large bet on other bookies.

The net earned premium less claims and expenses will give you the underwriting result we referred to earlier. Importantly this has not yet accounted for the returns from investing the float, which is added to the underwriting result and becomes the insurance result. The insurance result is the bottom line.

The two ratios you need to take notice of are the loss ratio and the expense ratio. The loss ratio is simply a function of the amount paid out in claims compared to the net earned premium, a measure of profitability. The expense ratio, calculated by dividing operating expenses by premium income, is another measure of profitability.

Unlike QBE, IAG's acquisition strategy has been far less successful; triggering the replacement in 2007 of chief executive Michael Hawker with Mike Wilkins, which was a popular move among my investment peers.

Suncorp, currently trading at $8.63 and on a P/E of 25 times, is a little different. It's a mix of regional banking assets and an insurance business: in other words, an unfashionable conglomerate. Suncorp has had particular trouble integrating its acquisition of Promina, made back in 2007, which diluted equity per share and returns on equity. Newly minted chief executive Patrick Snowball has begun a strategy of selling non-core assets and refocusing the business.

How to value insurers

Insurance companies make money two ways. The first is exactly as you might think: by writing policies, collecting premiums and paying claims. Very easy to explain, not so easy to perfect.

An insurance business books a profit from these activities when claims and operating expenses are deducted from the premiums. This is also known as the underwriting profit. Margins from this side of the business can be quite skinny if the company is run poorly because for every AAA lifetime rated driver that has never made a claim there will be a hailstorm that wreaks $400 million worth of damage in just a few hours. But if the operator can get this business right, the premiums that the company collects and invests in various markets, can cost them nothing.

And it's the proceeds from investing these premiums that constitutes the second revenue stream for insurers. Warren Buffett explained how this works rather eloquently in most recent letter to shareholders earlier this month.

"This collect-now, pay-later model leaves us holding large sums – money we call 'float' – that will eventually go to others. Meanwhile, we get to invest this float for Berkshire's benefit. Though individual policies and claims come and go, the amount of float we hold remains remarkably stable in relation to premium volume. Consequently, as our business grows, so does our float."

What this means is that if an insurance business can make an underwriting profit then not only is the cost of the float free, but the company gets paid for holding it while also receiving the proceeds from investing the float at the same time.

This is what makes the insurance business so attractive and why the competition among insurers is so intense at times that many businesses are prepared to maintain underwriting losses just to secure the returns from the float. According to the Australian Prudential Regulation Authority (APRA), the industry as a whole maintained an underwriting loss from 1995 to 2002.

Another aspect of the insurance business that is poorly understood is reinsurance. This is where the business covers itself by taking out another policy with a third party to cover any unforseen claims. IAG and Suncorp have announced in recent days that their exposures to the recent hail storms in Victoria were limited to $135 million and $200 million respectively. QBE has yet to make a statement.

What is more interesting is that reinsurance can also deliver windfall payments to insurance companies. Suncorp's claims from floods in southeast Queensland are expected to rise in coming weeks; if those claims and the ones from hail storms rise above $250 million in total, Suncorp will be eligible for a bonus reinsurance payment of $335 million.

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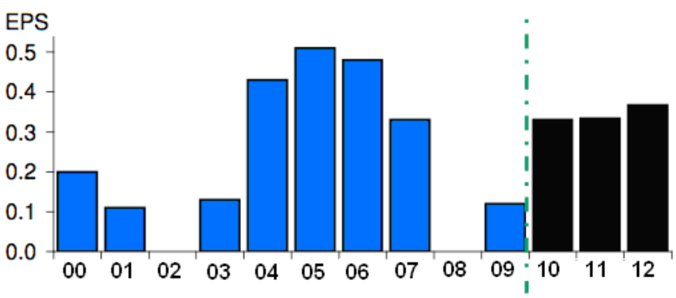
Now that you understand how an insurance company works, it's worth considering whether any are worth buying right now.

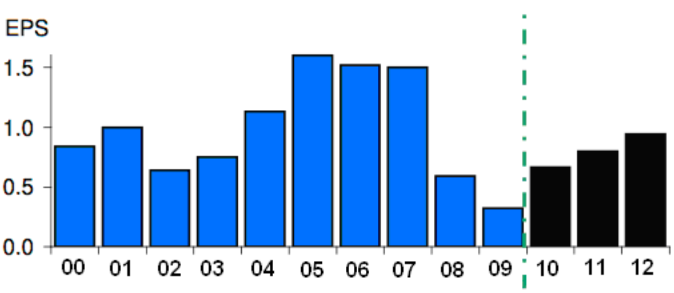
A glance at the earnings profiles of Suncorp, IAG and QBE reveals the demonstrated track record of QBE to be the most desirable with the forecasts for all three reflecting the sanguine view of analysts.

Keep in mind, however, that analysts are notoriously poor at predicting change and because IAG and Suncorp's earnings profilse are strongly correlated to stockmarkets the analysts' forecasts need to be seen as a prediction notwithstanding a stockmarket shock.

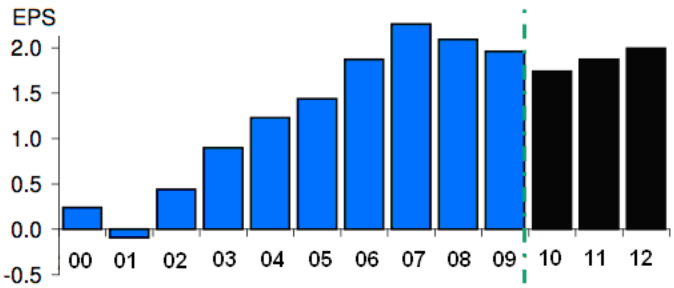
IAG earnings profile



Suncorp earnings profile



QBE earnings profile



And while first prize is a company whose earnings are expected to be meaningfully higher in the future, it is return on equity (ROE) that drives valuations. On that score, QBE again tops its peers with forecast ROE of 16.9% in 2010, 17.3% in 2011 and 17.4% in 2012. The latest JP Morgan Deloitte report also ranks QBE the most highly regarded insurer in the country by intermediaries, ahead of its rivals.

IAG ranks second in terms of return on equity with 14.2% in 2010, 13.5% in 2011 and 14.1% in 2010. Suncorp brings up the rear with 6.2% in 2010, 7.3% in 2011 and 8.3% and 2012 – as I mentioned earlier – the kinds of returns you might expect from term deposit with far less risk.

It is perhaps worth singling out QBE again because it's the one company in this group trading close to its intrinsic value of $19.83. Suncorp, on the other hand, is worth $4.86, significantly below its current price of $8.57 and a lower valuation than in the past thanks to a reduction in equity due to dividends exceeding earnings and dilutive capital raisings, including a $7 billion issue of shares in 2007 to fund the "merger" with Promina, and another $2 billion between 2007 and 2009. IAG's intrinsic value is 80¢, 20% below its price of $3.96.

In addition to preferring a business at a discount to intrinsic value, I also want a business where the value is rising at an attractive clip. On that score, of IAG's 10% growth over two years, QBE's 19% and Suncorp's 60%, only Suncorp is demonstrating potential. Unfortunately, even in 2012, the intrinsic value of Suncorp will still be below the current price.

Insurance companies head to head

Company	Year high	Year low	Div yield	P/E	Mar 16 close
Suncorp	$9.59	$5.35	4.06%	25	$8.63
IAG	$4.21	$3.28	3.60%	16.7	$3.99
QBE	$25.70	$18.35	6.09%	10.8	$21.03

Insurance companies are a curiosity from a financial statement perspective and, as of today, that's all they should be from an investment perspective too.

With a gun to my head and forced to make a decision, I would bet with Frank O'Halloran at QBE every time and QBE's proximity to intrinsic value is, relatively speaking, the most attractive of the three. In my opinion, this is due to the "disappointing" results mentioned earlier and in part to negative sentiment surrounding its exposure to the US dollar. Of course sentiment can change in the blink of an eye: witness CSL's recent approval with analysts who now look past its US dollar exposure to the "wonderful" business performance underneath.

ValueLine is not forced to make investments in any business unless all the boxes are ticked and so with regards to insurers I'll wait for a bigger discount to intrinsic value to emerge before committing myself. ◆

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