QBE Insurance 22/08/2017 **FAT-AUS-836**

QBE AUD $10.94 Spec. **HIGH** B

A few times bitten, and now very shy

Investor reaction to full year results from QBE Insurance (ASX, QBE) last week was far from positive, despite the company posting a 30 percent increase in net profit to US$345 million. The insurer saw a strong underwriting performance in North America and Australasia, which offset a rise in claims in emerging markets. The company recorded an underwriting profit for the period of US$154 million, up strongly from US$54 million last year.

The market though focussed on the 'bad' however and the problems QBE has had in emerging markets with rising claims. The emerging markets insurance division reported a combined operating ratio (claims and expenses as a percentage of net earned premiums) of 110.8 percent, which means that the unit is losing money. Rationalisation is therefore probably on the cards. While ruling out a sale, QBE is taking action, and is reverting to two separately managed divisions in the Asia-Pacific region and Latin America. A review is underway, and the EM CEO is stepping down.

The market though may have missed the point here in our view, with remedial action being taken and given core divisions elsewhere were performing well. Premiums are also seeing some upward pressure. The problem however, seems to be more that the market has been bitten by bad news before and now seems conditioned to expect more of the same.

The yield curve has also flattened recently, which will temper enthusiasm that investment income is set to rise. We still see this as occurring, with inflation coming through the system, although this may be a 2018 story.

That said, with other divisions (EM aside) performing well and premium income tracking higher we believe that the market reaction to last week's results has been overly harsh. Particularly considering the shares are undervalued versus the peer group, selling on a price to book ratio of just 1.2, which is almost a 50 percent discount to the sector. An earnings multiple of 13 times for FY18 and 4 percent dividend yield also adds further allure.

We therefore retain our conviction buy on QBE for Members without exposure, and particularly at current levels. A medium to long-term investment horizon is though essential.

First half results

Looking at QBE's first half results, the headline numbers were actually solid in our view, with cash profit after tax rising 30 percent to US$374 million. Statutory 2017 interim net profit of US$345 million was also up 30 percent as the overall combined operating ratio (COR) improved to 97.5 percent from 99.0 percent in the prior period. The adjusted COR came in at 95.3 percent, and is in line with management's revised target range of 94.5 to 96.0 percent.

Driving the underwriting performance was premium increases at the Australian business, and a solid performance in the US. Gross written premiums rose 3 percent, while net earned premiums were up 6 percent. This also supports our view that the global premium cycle is turning upwards.

Ongoing cost reduction initiatives contributed to a 0.9 percent improvement in the company's expense ratio. The result also included a sixth consecutive half of positive prior year accident claims development of US$107 million, lower than the US$196 million in the prior period.

Higher investment income also boosted the bottom line, and the company declared an interim dividend of A22 cents a share (franked at 30 percent) and payable on September 29.

1H17 FINANCIAL RESULTS SUMMARY

For the half year ended 30 June		1H16[1,2]	1H17[1,3]	Change
GWP	$M	7,892	8,044	↑ 3%[4]
NEP	$M	5,791	6,045	↑ 6%[4]
COR	%	99.1	94.9	↓ 4.2ppt
COR (ex discount rate)	%	94.5	95.3	↑ 0.8ppt
Insurance profit	$M	324	562	↑ 73%
Insurance profit to NEP	%	5.6	9.3	↑ 3.7ppt
Net profit after income tax	$M	263	464	↑ 76%
Cash profit after tax	$M	287	374[5]	↑ 30%
ROE	%	5.1	8.8	↑ 3.7ppt
Dividend per share	AU cents	21.0	22.0	↑ 5%

1. Excludes M&LS fronting (refer page 11 of HY17 report for details)
2. Excludes transactions to reinsure UK long-tail liabilities (refer page 11 of HY17 report for details)
3. Excludes a $156M one-off adverse impact on the Group's underwriting result due to the Ogden decision in the UK (refer page 11 of HY17 report for details)
4. Constant currency basis
5. *Includes* the $156M adverse impact on the Group's underwriting result due to the Ogden decision in the UK

Source: QBE results presentation

QBE's biggest three divisions by revenue are North America, Europe and Australasia, and each delivered an encouraging performance.

The COR at the North American unit improved significantly to a profitable 98.2 percent, versus 100.5 percent in the prior period. A turnaround plan, and non-core asset sales, helped with gross written premiums up 4 percent on an underlying basis. Insurance profits came in at US$71 million.

In Europe, the insurer's business also delivered a solid underwriting result, with a first half COR of 91.3 percent. Notably, this was achieved despite a challenging and competitive trading environment. Insurance profits came in at some US$231 million.

In Austrasia, the COR came in at 92.2 percent, down from 93.9 percent, underpinned by premium increases and tight underwriting discipline. Insurance profits in Australia of US$209 million were driver by premium rises of more than 5 percent.

1H17	North America	Europe[1]	Australia & New Zealand	Emerging Markets	Equator Re	Group[1,2]
GWP ($M)	2,803	2,393	2,007	857	1,375	8,044
GEP ($M)	2,187	1,915	2,024	804	798	6,909
NEP ($M)	1,712	1,532	1,705	679	419	6,045
Net claims ratio (%)	66.8	53.3	63.6	64.9	68.7	62.7
Net commission ratio (%)	15.5	19.3	15.0	23.9	9.8	17.0
Expense ratio (%)	16.0	16.1	13.9	22.1	2.1	15.2
COR (%)	98.3	88.7	92.5	110.9	80.6	94.9
COR (%) ex discount rate	**98.2**	**91.3**	**92.2**	**110.8**	**79.9**	**95.3**
1H16						
COR (%) ex discount rate	100.5	[3]88.3	93.9	99.5	63.5	[3]94.5
COR (%)	104.0	[3]98.6	95.9	99.5	70.1	[3]99.1

1. Excludes $156M one-off adverse impact on the Group's underwriting result due to the Ogden decision in the UK (refer page 11 of HY17 report for details)
2. Excludes M&LS fronting (refer page 11 of HY17 report for details)
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Source: QBE results presentation

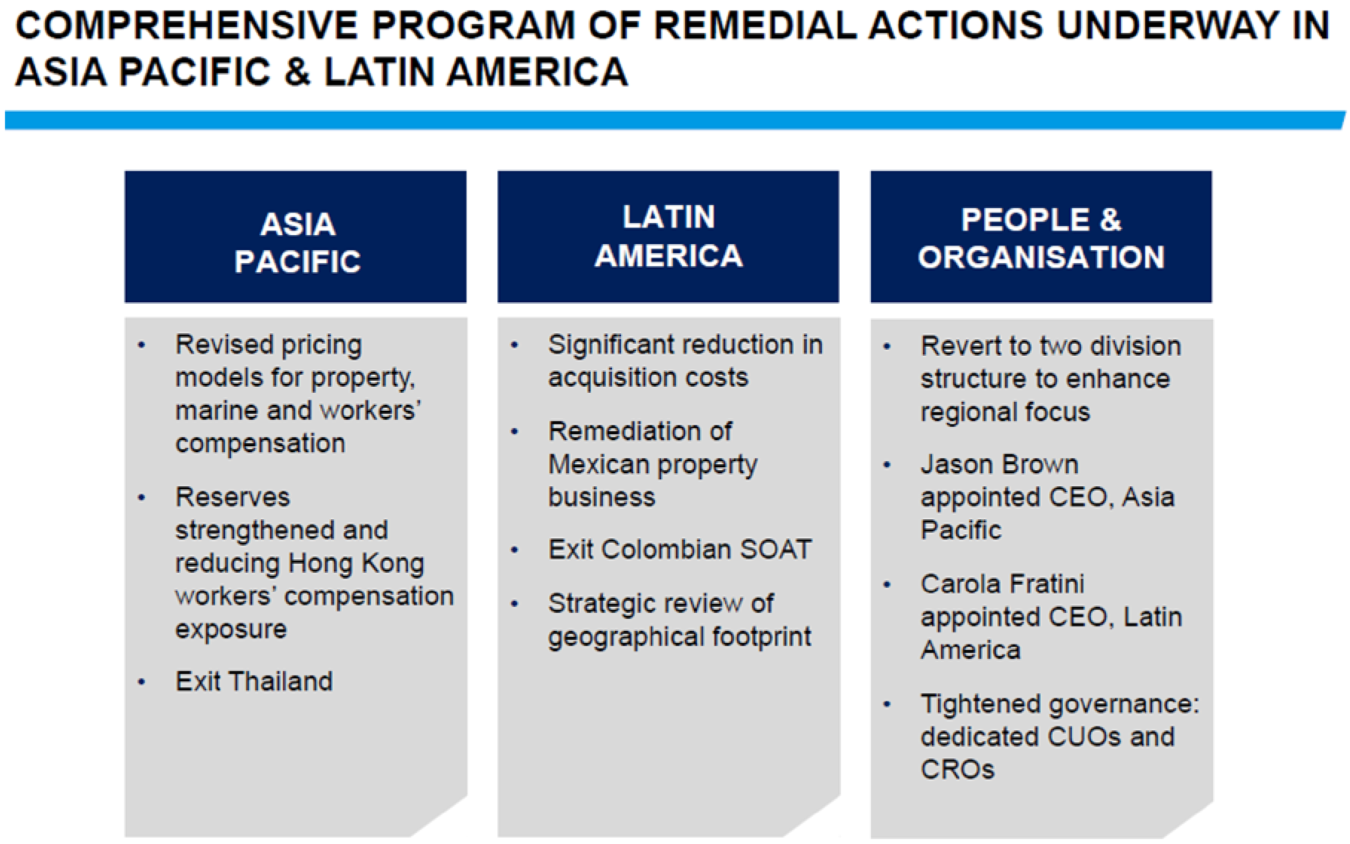
So businesses which account for around 90 percent of revenue performed well, yet all the attention it seems was on the emerging markets unit, which was the catalyst for an earnings downgrade delivered in June.

The unit posted a US$48 million loss due to a claims blowout, with the COR deteriorating to 110.8 percent from 99.5 percent in the prior period. There was a material increase in the current year accident claims ratio across numerous portfolios and regions, in both Asia Pacific and Latin America, coupled with adverse prior year accident claims development, primarily in Hong Kong workers' compensation.

CEO Jon Neal said that the result was 'extremely disappointing' and that "We've got to eliminate surprises from the market" Certainly no truer word has been spoken with respect to QBE by management (although a 'positive' surprise would be nice), but there is a plan to get the EM unit back on track.

The Emerging markets unit's Chief Exec David Fried has taken his share of the blame, and is stepping down. And to improve regional focus, the division is reverting to two separately managed divisions in Asia Pacific and Latin America. Jason Brown (currently Group Chief Risk Officer) and Carola Fratini (currently CEO of Argentina) have been appointed as the new CEOs of Asia Pacific and Latin America respectively.

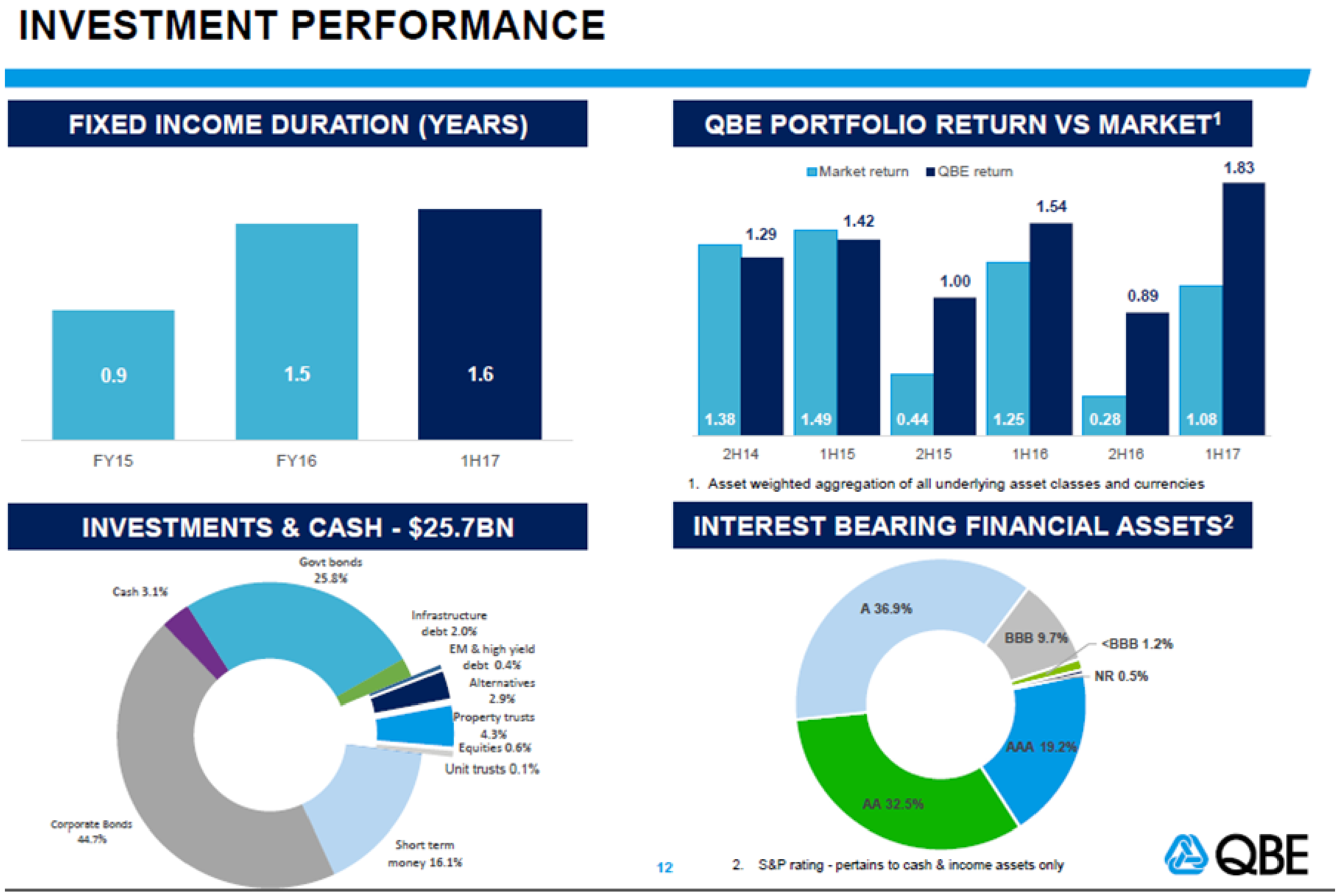
The company has also undertaken a review to determine the remediation activities needed to improve the underwriting performance in the second half of 2017 and beyond. Tighter underwriting discipline and control, while costs are being taken out, better reinsurance protections are being considered, and improved pricing models are being introduced. Asset sales and country exits are also being looked at.



Source: QBE results presentation

We believe that management are delivering a credible response to underperforming EM division, but the wider point is that it accounts for less than 10 percent of the revenue pie. We think the market was more disappointed, yet again, by another 'negative surprise' and irrespective of the quantum. Notably some brokers have now moved to a Sell on the stock, and have appear to have lost faith, despite the clear value at current levels. Is this exiting at the bottom? Time will tell.

While the various earnings warnings over the years have been frustrating, we believe there is much to be positive about with QBE. Core divisions which account for the lion's share of earnings are performing well, and premiums are tracking higher. The company's investment performance has also been rising consistently (3.6 percent in the half) as shown below, and this will have much further to play out as interest rates rise.



Source: QBE results presentation

Cash generation and the company's balance sheet (the debt to equity ratio is 32.8 percent) remain strong. Management also expect to activate a A$1 billion three-year cumulative on-market share buyback during the second half of 2017. This should also help underpin some support for the stock and is a savvy move in our view.

From an outlook perspective management is expecting modest premium growth and a COR towards the upper end of 94.5 to 96.0 percent. We wouldn't be surprised if there is some low bar setting here given previous issues. We also think that premium growth could well be stronger as the cycle turns upwards further.

Turning to the charts, on the daily, the bearish moving average crossover present (where the 50-day moving average red line crosses below the 200-day moving average green line) is indicative of medium-term momentum to the downside. Positively, from a relative strength (RSI) perspective, this indicator has declined into oversold territory, which is suggestive of an exhaustion in short-term selling pressure. In order for the short-term technical landscape to improve, a sustained break above the 200-day moving average (green line) of $12.31 is required. Should this occur, then momentum would once again shift in favour of the bull-camp.

With reference to the monthly chart, resistance was respected at the 50% Fibonacci retracement of $13.14 in May. This has resulted in momentum to have rotated south. Should the bears remain in control over the near-term, then a zone of support is evident between $9.23 and the psychologically significant $10.00 round number. This price range has been tested on a number of occasions since 2012, and it is likely that the longer term bulls would once again defend this support zone (should it be tested).

Summary

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The market though focussed on the ‘bad’ however and the problems QBE has had in emerging markets with rising claims. The market though may have missed the point here in our view, with the unit accounting for less than 10 percent of revenue, remedial action being taken and given core divisions elsewhere were performing well. Premiums are also seeing some upward pressure, and we expect investment income to continue following suit over the medium-term.

We believe that the market reaction to last week’s results has been overly harsh. Particularly considering the shares are undervalued versus the peer group, selling on a price to book ratio of just 1.2 times, an earnings multiple of 13 times for FY18 and with a 4 percent dividend yield.

We therefore retain our conviction buy on QBE for Members without exposure, and particularly at current levels. A medium to long-term investment horizon is though essential.

Disclosure: QBE Insurance is held in the Fat Prophets Global Contrarian Fund, the Global Opportunities and Australian Concentrated Share portfolios.

Snapshot QBE

QBE Insurance

Latest Closing Price: $10.94

QBE Insurance Group Limited is an insurance company which underwrites most forms of commercial and industrial insurance policies, as well as individual policies. QBE also manages Lloyds syndicates and provides investment management services. The Company provides its services both domestically and internationally.

Market Capitalisation:$14.75b

	FY1	FY2
Price to Earnings	17.4	13.5
Dividend Yield (%)	4.0	4.7
Price to Book	1.24	1.20
Return on Equity (%)	7.00	8.52