Insurance Australia Group: how fears could be overplayed

Our weekly view on Australian Equities

24 June 2021

Insurance sector earnings recovery

The insurance sector has been hit hard since early 2020, underperforming the market by almost 25%. A combination of stock and industry concerns, against a difficult claims environment, has weighed on equity prices. Two-thirds of major players in 2020 were forced to raise common equity capital in response.

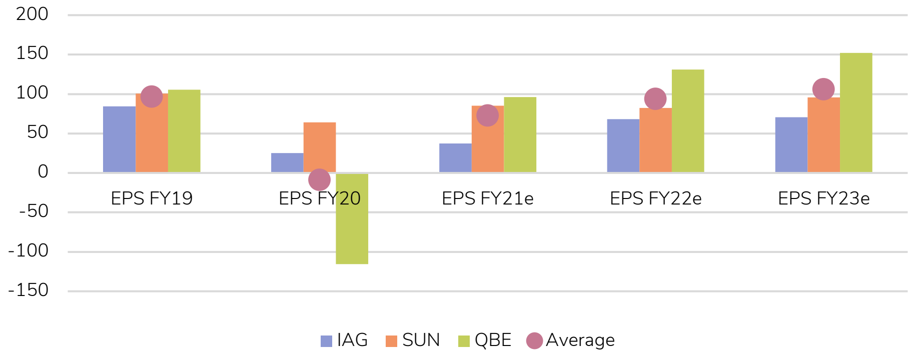
QBE Insurance (QBE) and Suncorp (SUN) share prices have shown signs of outperformance in 2021. Investors are beginning to think the worst is over. The underlying insurance businesses are showing earnings resilience to COVID-19 disruptions, and the early benefits of policy re-pricing that is going on across the industry.

In our view, Insurance Australia Group (IAG) (recently added to the Wilsons Australian Equity Focus List), the highest quality of the local insurers with a sector-leading return on capital profile, has seen its share price materially lag against the recovery of its peers.

Investor attention on IAG remains acutely focused on the potential for a $2bn claims problem emerging with Business Interruption (BI) insurance. Our work suggests that IAG may have overprovisioned for this issue, potentially by a factor over 2x.

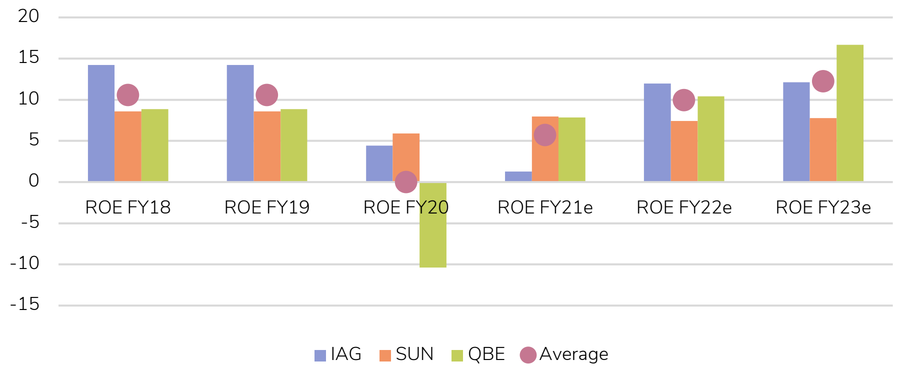
While it will likely take several months to know for sure if our view holds, the potential for a material re-rating of the IAG share price remains. We see similarities between how IAG is being priced today and how the large banks were valued in the depths of COVID.

Exhibit 1: The insurance sector fell into losses in FY20, strong earnings growth is expected over the next 12 months



Source: Refinitiv, Wilsons.

Exhibit 2: The prospects for an improvement in sector return on equity look encouraging



Source: Refinitiv, Wilsons. EPS rebased to 100 for FY18.

Cyclically low insurance sector earnings

Insurance sector earnings pre-COVID were not anything to write home about, with choppy, low single-digit earnings growth (at best) the norm.

Low inflation and low-interest rates made it difficult to put through premium increases, and global capital markets awash with liquidity kept costs of capital low for all players. Alongside this, the threat of new entrants was ever-present.

Management teams and strategy execution in the years leading into COVID were probably best described as mixed. All three main players have refreshed their management teams in the last 24 months. The result of all this was it proved pretty difficult to lift insurance margins across the sector in the years leading into COVID.

The hit from COVID now leaves sector earnings at trough cycle levels. ROE across the industry also looks to have troughed. With the prospect of stronger execution at a company level, we think the outlook for a cyclical recovery in earnings is improving.

COVID-19 exacerbated insurance sector earning pressure

Earnings of all three leading insurance companies came under pressure in FY20. QBE slipped into losses – due to underwriting errors and material COVID provisions. The most significant contributor to the fall in earnings across the industry was not direct COVID costs but provisions booked against potential COVID related claims.

Estimates for BI insurance claims drove most of the increase in provisions. Primarily taken out by SMEs businesses, BI provides cover for lost earnings when unexpected external events impact the ability of a business to operate.

Why IAG is most exposed

Of the three local insurance companies, IAG is the most exposed to BI. Relative to both QBE and SUN, IAG policy wording was more open to interpretation for coverage of pandemic risks. As a result, IAG is potentially more vulnerable to an adverse ruling from the courts forcing the industry to pay out BI policy claims. The insurance industry is fighting the 5-0 NSW Court of Appeal decision (November 2020) that a pandemic is an insurable event. The first hearing in the High Court is scheduled for later this week.

IAG, as of February this year, had ~76,000 policies that cover BI, which is high relative to peers. However, only 500 policies had been claimed by February. In 1H21, IAG booked a net provision of just over $A1.1bn against potential claims under BI. We estimate the gross provision is >$A2.0bn for BI before reinsurance takes effect for IAG. In response to this earnings risk, the IAG share price has fallen from >$8.50 to ~$5.00.

IAG's market capitalisation has dropped by over $8bn, or x4 the size of the potential issue. This is despite the earnings contribution from BI being relatively insignificant against IAG's core business of home and motor insurance. Much like the banking sector in 2018-2019 with the Royal Commission – a high level of uncertainty has resulted in a large discount to fair value in IAG.

Exhibit 3: IAG share price has fallen >30% primarily due to BI risks

Source: Refinitiv, Wilsons.

IAG business interruption provision could be significantly overstated

The IAG share price is likely to tread water until clarity on BI is cleared up by the court process. We think there is potential that IAG has over provided. While we don't have claims data yet in Australia to run any meaningful numbers, the UK insurers have begun paying out on BI after the UK courts ruled, in late 2020, that the pandemic was an insurable event.

It is worth noting that in the UK, COVID lockdowns have stretched for almost 190 days versus a shorter period domestically, just ~70 days across Australia ex-Melbourne (~190 days for Melbourne). Notwithstanding the potential differences in policy coverage, thresholds and claims propensity, the UK data provides a valuable reference point for the appropriateness of IAG's provision.

Of the 37k industry claims (a further potential 9k claims are still being considered), the UK average payout currently sits at $A54k. If the same dollar level held for IAG against the 500 claims received to date, that would equate to a claim cost of ~$A30m, relative to $2bn gross provisions.

There remains a risk that the number of claims is dramatically higher – more time has passed for policyholders to claim and recent lockdowns, particularly in Victoria. As Exhibit 3 shows, even if we increase the claim numbers by 13x to 6,500 and lift the average claim size 2x to $A100k, that would imply a total potential claim cost for IAG of ~$A650m or just over a quarter of the gross provision.

IAG sensitivity to BI growth in claim numbers and size

IAG would need to have 37k claims (half of all BI policies) at the UK average payout of $A54k to consume the entire $A2bn of gross provisions – this seems unlikely, especially as the lockdown in Australia has been less severe than the UK and the majority of businesses have remained open. Simply put, we think IAG has likely overprovisioned for the abundance of caution.

When will we better understand IAG's BI materiality?

With the courts now involved in determining the extent to which the insurance industry will need to payout on BI, the timing is ultimately uncertain.

The High Court begins an appeal hearing on 25 June, while the Federal Court in September is due to hear a second test case. During August, we have IAG's FY21 results that should give an update on the BI situation. We may not have a final resolution until CY22.

Ultimately, we think that the insurance industry will need to payout on BI, IAG included. With IAG in our view appearing to hold a more than adequate level of provision coverage, we think the resolution of this issue will lead to a material relief rally in the stock price.

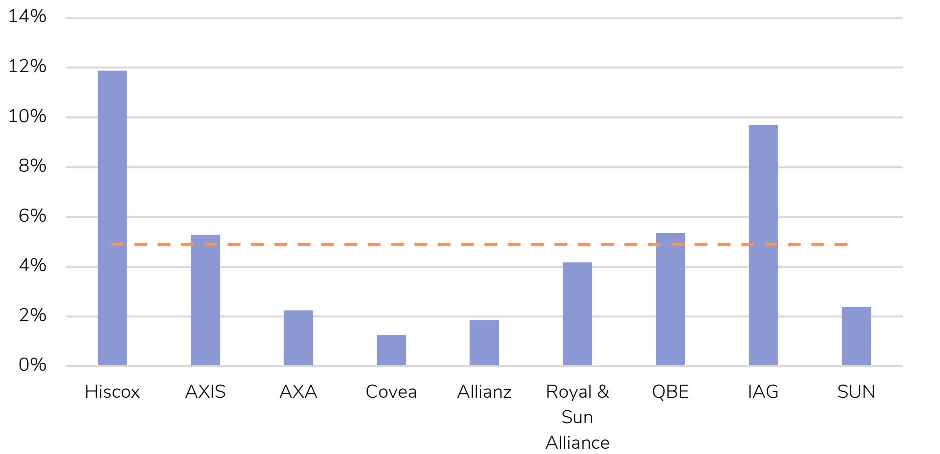
If we adjust for COVID losses and provisions (no benefit of potential write-back), IAG is trading on ~13x PER FY22 – a significant discount to its historical multiple of ~15x over

Exhibit 4: IAG sensitivity to growth in both claim numbers and size ($Am)

		Number of claims ('000)						
		500	**1,500**	**2,500**	**3,500**	**4,500**	**5,500**	**6,500**
$A value of claims	**40,000**	20	60	100	140	180	220	260
	50,000	25	75	125	175	225	275	325
	60,000	30	90	150	210	270	330	390
	70,000	35	105	175	245	315	385	455
	80,000	40	120	200	280	360	440	520
	90,000	45	135	225	315	405	495	585
	100,000	50	150	250	350	450	550	650

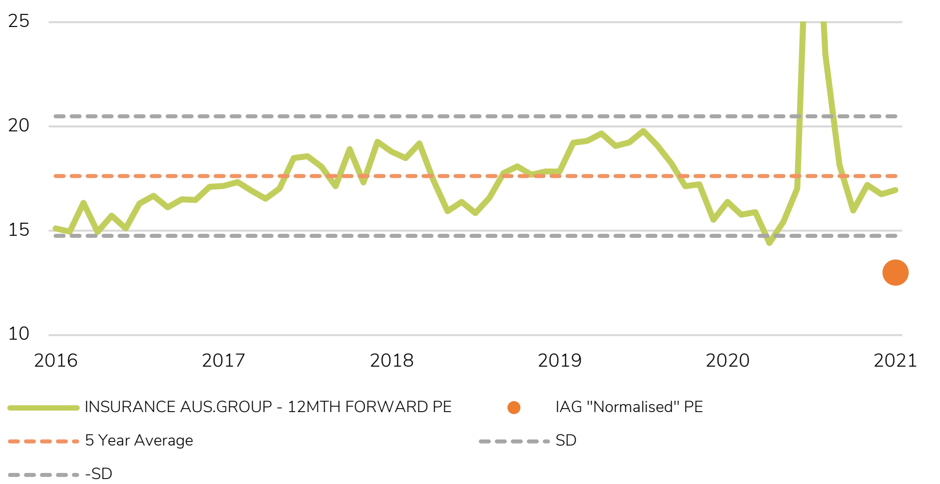
Source: FCA, Wilsons. UK average BI payout currently sits at $A54k as of June 14, 2021.

Exhibit 5: Provisioning levels relative to gross written premium suggest IAG is well covered



Source: Company Data, FCA, Wilsons. 8 largest UK insurers ex MS Amlin where data is not available. GWP is FY20a.

Exhibit 6: IAG is trading at a 26% discount to historical 12-month forward PE multiple



Source: Refinitiv, Wilsons

Our view on financials within the Focus List

We recently lifted the Focus List's weight to Financials, taking it to 1.1x overweight. Within the sector, we are 1.2x overweight the big four banks, 2.0x overweight insurance and underweight non-bank financials. See report.

The recent addition of IAG to the Focus List (3% weighting, 5x index weight) provides a similar set-up to that of the banks, when we moved overweight in 3QCY20. Unloved and having raised capital for an issue that is difficult to quantify, uncertainty levels remain high. The resulting valuation discount has created an opportunity for investors.

Ultimately, IAG is a high-quality business with a strong market position and sound management. The prospects of hardening insurance premiums, and a more normal claims environment going forward, looks particularly interesting.

Excluding any provision write back, IAG offers ~5% NPAT CAGR over the next three years according to consensus. This premised on premium growth of just 2.5%, which appears conservative against the industry backdrop of firming home and motor premiums. The potential for a refocused IAG (ex BI issues) to address recent market share underperformance also provides upside.

A positive outcome of BI has the potential to leave IAG with ~$A1bn in surplus capital. A share buy-back at current prices would be ~10% accretive to earnings. A special dividend of ~40cps is possible, less likely scenario given the lack of surplus franking credits in our view.

Both QBE and SUN offer earnings recovery exposure. QBE is offering exposure to the global insurance cycle and the ongoing refocusing of the company into less risky areas of the insurance. Ultimately, we think IAG is a higher quality asset – earnings are largely derived from duopoly market structure vs. QBE, which is competing in a more crowded global market where returns tend to be more at risk of being competed away.

Presently, SUN is an asset restructuring story under a refreshed management team. Share price performance we think from here is heavily dependent on a potential spin-off of the banking assets – something we think could create additional shareholder value.

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