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QBE Insurance Group (QBE)

Forged in the fires of adversity

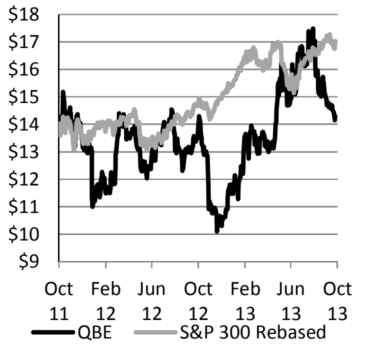
Recommendation
Buy (Initiation)
Price
$14.29
Target (12 months)
$17.10 (Initiation)

Expected Return	
Capital growth	**19.7%**
Dividend yield	**3.6%**
Total expected return	**23.3%**
Company Data & Ratios	
Enterprise value	**n/m**
Market cap	**$17,532m**
Issued capital	**1,227m**
Free float	**100%**
Avg. daily val. (52wk)	**$87.4m**
12 month price range	**$10.02 - $17.53**
GICS sector	**Insurance**

Price Performance

	(1m)	(3m)	(12m)
Price (A$)	15.73	16.56	13.52
Absolute (%)	-9.15	-13.71	5.70
Rel market (%)	-10.05	-22.46	-10.41

Absolute Price



SOURCE: IRESS

Size and security

QBE is a top 20 global player in the insurance and reinsurance space with operations in all key markets. Headquartered in Sydney, QBE employs more than 17,000 people in 48 countries (Europe, North America, Australia and New Zealand, and Asia Pacific being the core geographies). The underlying business strategy is to act as a lead underwriter in selected business segments. Core to QBE's risk management is its diversification strategy along product and geographic lines.

Right place, right time

This is a case of QBE being in the right place at the right time. The insurance cycle appears to be turning with rising rates (e.g. in the US), new supply of reinsurance capital from institutional investors placing downward pressure on renewal rates and a rebound in markets to further strengthen insurance profit. 2013 is also considered a transition year with management focused on rationalising support functions (minimum sustainable benefits of US$250m by 2015 or 11% of current year underwriting costs) and enhancing productivity in recent acquisitions to maximise ROE. Finally, QBE remains an interest rate and currency normalisation play and should outperform in a rising rate environment (given strong correlation to the US risk free rate and US$).

Strong earnings growth profile

In addition to being a defensive stock with global scale, we expect double digit earnings growth in the medium term from resumption of premium growth from 2014, productivity and efficiency gains, and improving investment returns on its float.

Initiating coverage with a $17.10 price target and Buy rating

We initiate coverage on QBE Insurance Group (QBE) with a Buy rating and $17.10 price target. The latter is based on a blend of four valuation methodologies weighted as follows: DCF (35% weight); float plus equity valuation (35% weight); normalised Price/Book (15%); and Sum of Parts – Geographic (15%).

Earnings Forecast

Year end December	2012	2013e	2014e	2015e
NPAT (reported) (US$m)	761	1,050	1,386	1,655
NPAT (adjusted) (US$m)	1,042	1,298	1,652	1,919
EPS (reported) (US$cps)	65	87	113	133
EPS (reported) growth - US$ terms (%)	0%	34%	30%	18%
EPS (reported) (A$cps)	63	91	125	156
PER (x)	22.5	15.7	11.4	9.1
P/Book (x)	1.6	1.4	1.3	1.1
P/NTA (x)	3.4	2.8	2.3	1.8
Dividend (A$cps)	50	51	65	81
Yield (%)	3.5%	3.6%	4.6%	5.7%
ROE (%)	6.9%	9.3%	11.5%	12.6%
Insurance margin (%)	8.0%	11.7%	14.1%	15.6%
Franking (%)	32.0%	100.0%	100.0%	100.0%

SOURCE: BELL POTTER SECURITIES ESTIMATES

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Executive summary

Size and security

We initiate coverage on QBE Insurance Group (QBE) with a Buy rating and $17.10 price target. The insurer is a top 20 global player in the insurance and reinsurance space with operations in all key markets. Headquartered in Sydney, the Group employs more than 17,000 people in 48 countries (Europe, North America, Australia and New Zealand, and Asia Pacific being the core geographies). The underlying business strategy is to act as a lead underwriter in selected business segments. Core to QBE's risk management is its diversification strategy along product and geographic lines.

QBE's roots can be traced back to 1886 when James Burns and Robert Philp established The North Queensland Insurance Company (QI). In 1921, Burns founded Bankers' and Traders' Insurance Company (B&T) with QI being the largest shareholder followed by the owners' trading firm Burns Philp. In 1959, QI and B&T each acquired 40% of The Equitable Probate and General Insurance Company with Burns Philp taking the residual shareholding. QI and B&T then merged in 1973 to form the present day QBE.

Positives from a bank analyst's perspective

The insurance cycle is turning – Assessment of underwriting profit trends suggests the cycle may have bottomed with 2013 being regarded as a transition year. The average rate increase was 5% in 1H13 and QBE expects further rises in 2H13 (including 4-5% in the US market). The traditional insurance market typically assumes very little underwriting profit over the long term and relies on investment income on the float to sustain insurance profit. Since 2001, QBE has managed to turn in sufficient underwriting profits despite various catastrophe (CAT) events as well as decent investment returns. With US risk free rates and investment markets set to rebound, we see significant value upside in the next few years. We are also past the mid-point of the traditional Atlantic June-November hurricane season and with the recent Tropical Storm Karen having weakened from wind shear.

QBE is focused on risk management to maximise returns – Banks and insurers rely on liquidity and interest rate risk management. The former allows the entities to meet obligations as they become due while the latter serves to minimise earnings and mark-to-market volatility. QBE's consistency in managing these risks as depicted by steady returns is seen as a major competitive advantage. Managing operational risk is another facet and this involves the diversification concept (i.e. the larger the sample, the higher the probability that the actual loss will be close to the expected loss – with each loss being small enough to only affect a small fraction of the pool at the same time). In this respect, QBE's global scale offers sufficient insurance risk diversification that can also be construed as providing a large and uncorrelated number of small bets. Capital management aligns with risk management and QBE's reinsurance captive Equator Re provides global risk management to all operating divisions through the efficient allocation of capital for reinsurance purposes as well as cheaper overall reinsurance given its global scale.

QBE is an interest rate and currency normalisation play – Like the banks, QBE is a rate sensitive stock. While the insurer was one of the biggest losers in terms of net worth in the past five years during a downward rate environment, it is now on track to recoup these losses as the US risk free rate (e.g. using the 10-year Government bond yield) is set to increase in an improving economy. The current setting is favourable to both banks and insurers as they tend to outperform in a rising rate environment. QBE is also a US$ normalisation play given strong links to interest rates. The high correlation to the US risk free rate and the A$/US$ cross rate became effective when North American contributions surpassed 30% of Group Gross Earned Premiums (GEP). The correlation is set to continue as the proportion of US GEP increases again following resolution of the challenges in the past few years.

QBE has significant productivity upside – QBE announced its Global Operational Transformation Program in July that will drive process simplification (reducing rework), standardisation (driving scale economies) and continuous improvement. Implementation and restructuring costs are estimated at US$310m over the three years to 2015 while annual run-rate benefits from rationalising the back office (Finance, HR, Claims, Operations, IT and Procurement) are expected to be at least US$250m by 2015 (11% of 2013 expected underwriting expenses). In particular, we see upside coming from the domestic operations where QBE trails IAG and SUN in terms of acquisition and underwriting expenses (most likely due to smaller relative scale). We see an opportunity for QBE to rationalise its operations and lower the expense ratio to peer group levels (much like what SUN did in the last few years, expediting its claims functions and rationalising the back office). Finally, we see further upside in QBEANZ's Lenders' Mortgage Insurance operations, second only to Genworth in terms of market share and now highly leveraged to rising premiums from the inevitable east coast housing recovery.

QBE is now focused on increasing return on recent acquisitions – QBE has traditionally been an acquisitive company, having completed 135 transactions since 1982 including 38 since 1998 but accompanied by falling ROE since 2006. While the bottom line has certainly been impacted by CAT claims, we are also of the view that the Return on Incremental Capital remains below the cost of equity. The fact that there has been no major acquisition since last year suggests QBE has finally recognised the need to work through its current portfolio of assets, i.e. to increase productivity and raise Group ROE.

QBE is well placed to capitalise on the "free" float – We believe QBE's float is a major advantage in sustaining earnings growth. An insurer collects premiums upfront and pays claims later, and in the process "floats" or invests the proceeds and keeps 100% of the returns. This is similar to the bank's free funds where customers pay the institutions (via forgone interest) for holding their money. QBE has a significant float component and better relative float margin and should continue to derive volume and rate benefits (based on rising rates and compounding returns) sufficient to sustain earnings growth. We believe the market has not fully appreciated the true value of the float. As "notional debt", the cost has been negative for QBE since 2002. QBE's margin trends based on insurance profit (underwriting profit plus investment return) again support our view that the insurance cycle has bottomed. Float as a percentage of shareholders' equity is 162% for QBE and compares favourably with the average of 118% for leading US Property & Casualty (P&C) insurers.

Further margin upside from reinsurance – We expect the new supply of capital into reinsurance from non-traditional institutional investors (US$10bn in the last 18 months according to Guy Carpenter estimates) to continue to exert downward pressure on renewal rates (e.g. recent US experience is for double-digit rate reductions during 2013 mid-year renewals), thus making risk transfer even more efficient. With these investors chasing higher yields and low correlations, total capital from this source has increased to US$45bn (or 14% of global property CAT limits purchased). The trend is expected to continue into 1 January 2014 and this is another positive for QBE in preserving underlying margins.

Sponsorship of the Sydney Swans – Finally, QBE and the Sydney Swans celebrated 27 years of partnership this year, being the second largest and longest club program in Australian sport. The commitment is reflective of QBE's business philosophy in creating long-term partnerships through the highs and the lows and providing financial support when required and sharing in the important achievements and milestones.

Forged in the fires of adversity

Size and security

We initiate coverage on QBE Insurance Group (QBE) with a Buy rating and $17.10 price target.

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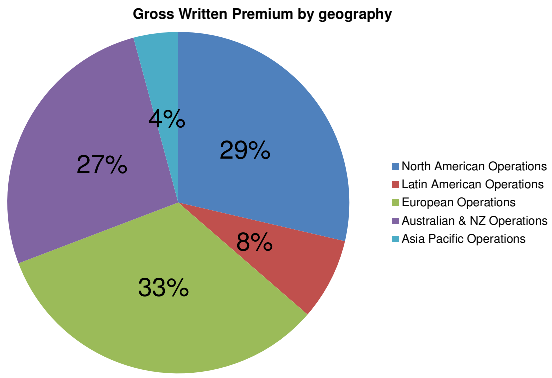
QBE's head office is in Sydney and the company employs more than 17,000 people in 48 countries. The underlying business strategy is to maintain operations in all key insurance markets and act as a lead underwriter in selected lines of business. Core to QBE's risk management is its diversification strategy along product and geographic lines.

QBE's main geographic segments (ranked by Gross Written Premium or GWP) are briefly described below together with their respective outlooks for 2013.

Figure 1 – Gross Written Premium by geography (1H13)



SOURCE: COMPANY DATA

QBE European Operations (QBEEO)

QBE European Operations (QBEEO) is a wholesale insurer and reinsurer specialist in London Market (including Lloyd's, being the 3rd largest underwriter) and UK and European commercial lines business providing diversification to the Group. Market share of P&C GWP by region is estimated as follows and suggests sufficient scale in the markets that matter: Western Europe 0.25%; Central and Eastern Europe 1.2%; UK National 5.0%; London Market ex-Lloyd's 6.0%; and Lloyd's 6.0%.

Lloyd's is the world's specialist insurance and reinsurance market where members join together as syndicates to insure policyholder risks. Syndicates work by subscription where business is conducted between brokers and underwriters and with more than one syndicate taking a share of the same risk. They operate on an ongoing basis and tailor insurance solutions to specific risks, covering either all or a portion of that risk. The main risks covered include casualty, property, marine, energy, motor, aviation and reinsurance.

While Lloyd's is not a company, there is also the Corporation of Lloyd's which oversees the market and provides corporate governance and compliance functions. There are currently 57 managing agents and 87 syndicates. A managing agent is a company set up to manage one or more syndicates on behalf of the members who provide capital. The managing agent employs underwriting staff and handles daily administration of the syndicate. Members include major insurance groups (that provide the bulk of the capital), listed companies, private equity funds as well as individuals. We estimate there are 1,200-1,300 corporate members and 700-800 individual names at present.

QBEEO manages its Lloyd's activities through QBE Underwriting Limited (QUL), one of the managing agents at Lloyd's. QBEEO is differentiated from its Lloyd's peers by high casualty specialism and lower reinsurance volatility. QUL manages QBE Casualty Syndicate 386 and umbrella QBE Syndicate 2999.

Syndicate 386 is a specialist non-marine liability insurer covering property, casualty (professional, employers', public and product liability) and motor. 2012 GWP was GBP444m (unchanged due to competition) and the syndicate reported NPAT of GBP102m including a 43.7% claims ratio (27.2% in 2011) and 82.7% combined ratio (67.3% in 2011). We expect the market to remain soft throughout 2013.

Syndicate 2999 is an umbrella syndicate comprising four sub-syndicates (566, 1036, 1886 and 5555). Classes of business include reinsurance, marine, non-marine and aviation. In 2012, Syndicate 2999 reported GWP of GBP1,155m (+3%) and NPAT of GBP118m (loss in 2011) including a 54.1% claims ratio (72.7% in 2011) and 89.3% combined ratio (104.6% in 2011) despite competition, Superstorm Sandy and the Concordia grounding. However, QBEEO also expects the market to be soft in 2013.

In addition to Lloyd's, QBEEO operates from 10 UK regional centres and 19 European countries (Belgium, Bulgaria, Czech Republic, Denmark, Estonia, France, Germany, Hungary, Italy, Norway, Romania, Slovakia, Spain, Sweden, Switzerland and Ukraine) through specialist business insurer QBE Insurance (Europe) (professional indemnity, financial and credit, bloodstock, liability, motor and property facultative – i.e. covering specific risks).

QBEEO reported US$3.1bn GWP (33% of Group), US$1.7bn NEP (24% of Group) and US$88m NPAT (18% of Group) in 1H13 (see table below). Premium income increased 13% helped by the acquisition of Brit UK Regional and modest organic growth in property casualty and motor (average rate rise 2%). The claims ratio fell slightly from 64.1% to 63.0% despite floods in Europe, Canada and Argentina using up the half-year allowance. The margin contraction from 11.2% to 6.1% was largely due to lower investment returns while the combined ratio was stable at 95-96%.

The 2013 divisional outlook is for slightly lower GWP of US$4.9bn (2012 US$5.1bn), taking into account nominal rate increases and no planned acquisitions, plus marginally higher NEP of US$3.4bn.

Table 1 – European Operations underwriting result

FOR THE HALF YEAR ENDED 30 JUNE		2013	2012	2011	2010	2009
Gross written premium	US$M	**3,103**	2,748	2,824	2,412	2,228
Gross earned premium	US$M	**2,480**	2,267	2,242	1,935	1,802
Net earned premium	US$M	**1,731**	1,557	1,529	1,227	1,189
Net incurred claims	US$M	**1,091**	998	1,013	715	746
Net commission	US$M	**323**	273	257	191	200
Expenses	US$M	**243**	209	189	179	123
Underwriting result	US$M	**74**	77	70	142	120
Claims ratio	%	**63.0**	64.1	66.2	58.2	62.8
Commission ratio	%	**18.7**	17.5	16.8	15.6	16.8
Expense ratio	%	**14.0**	13.4	12.4	14.6	10.3
Combined operating ratio	%	**95.7**	95.0	95.4	88.4	89.9
Insurance profit margin	%	**6.1**	11.2	13.0	18.3	18.0

SOURCE: COMPANY DATA

QBE North America (QBENA)

QBENA was established in 1991 and its head office is in New York. It has a 1.5% share of the US property and casualty (P&C) insurance market and focuses on specialist and SME sectors targeting selected commercial, personal and agricultural risks. The front line business is conducted on a regional basis through three subsidiaries.

1. **Financial Partner Services (FPS, formerly QBE FIRST)** – Based in Atlanta, Georgia, FPS largely provides mortgage and auto lender-placed insurance (LPI), auto risk mitigation (collateral protection insurance), property tax products (tax servicing solutions) as well as escrow administration and consumer insurance (homeowners). FPS has relationships with 18 of the top 25 US homebuilders and two of the largest US financial institutions responsible for ~50% of new mortgage originations. The LPI market share is estimated at 33% based on loans serviced.
2. **QBE NAU Country** – NAU is based in Ramsey, Minnesota and is the third largest underwriter and manager of multi-peril crop insurance (MPCI) in the US with ~15% market share (with hail insurance being a small component). NAU covers 84 different crops (52m acres, 93,000 policies) and the business is largely written in the Midwest and California. Note that MPCI is a US Government sponsored program within the US Department of Agriculture and is managed by the Federal Crop Insurance Corporation. While the government sets the rates, assigned risk allows NAU to cede poor policies/crop/counties to the government (that also takes all exposures over the 500% loss ratio threshold). Despite being susceptible to adverse weather extremes, the purchase of stop loss in commercial markets enables NAU to limit its probable exposures to net combined ratio of ~103%.
3. **QBE Farmers Union Insurance** – Based in Denver, Colorado, Farmers Union was established in 1945 and services clients in nine Midwestern and Rocky Mountain states through 400 local agents. Business lines include auto, home (homeowners and renters), farm and business (including telecommunications insurance across 38 states and DC).

Intermediary distribution is through four channels: Regional (315 exclusive and 1,440 independent agents licenced in all states including DC with a balanced commercial, personal, agricultural book); Program (64 partners and independent agents specialising in SME); Major Brokers; and Specialty (trade credit, aviation and professional indemnity).

QBENA reported US$2.7bn GWP (29% of Group), US$1.3bn NEP (18% of Group) and net loss after tax of US$87m in 1H13 (Table 2, next page). GWP was down 16% despite a hardening premium pricing cycle (average rate rise 7%). This was due to pressure from reduced FPS LPI volumes and pricing, lower crop commodity prices (including delayed planting), ongoing remediation of the P&C book (some deterioration in retention from rate rises) and reallocation of some reinsurance premium to QBEEO as part of the establishment of QBE Re (see later section). Claims improved given favourable weather patterns including normal seasonal trends in crop claims activity.

The 2013 divisional outlook is for GWP of US$5.9bn (2012 US$6.6bn), US$3.0bn NEP (2012 US$3.5bn) and average to slightly-above-average margin (6.9% in 1H13).

Not surprisingly, QBE claims are impacted by weather extremes and in particular droughts and hurricanes. The latest drought outlook over the next three months issued by the National Oceanic and Atmospheric Administration (NOAA) suggests enhanced odds of below average precipitation that would promote drought expansion into the Northwest in western Texas, and ongoing drought in California and the northern intermountain West.

On the other hand, the latest hurricane outlook calls for an active/extremely active season in 2013. This is predicated upon ongoing atmospheric climate patterns responsible for higher Atlantic hurricane activity since 1995, warmer water temperatures in the tropical

Atlantic Ocean and Caribbean Sea, and an absence of El Nino to suppress hurricane formation.

The six-month Atlantic hurricane season begins on 1 June and NOAA had forecast a 70% probability of 13-20 named storms becoming 7-11 hurricanes including 3-6 major ones (Category 3,4 and 5). This compares with the seasonal average of 12 named storms and six hurricanes including three major ones. However, we are now past the mid-point and activity during September was near normal in terms of the number of storms and hurricanes and below normal in terms of activity duration and strength. Simply put, there have been no major hurricanes so far and also with the recent Tropical Storm Karen having been disrupted by wind shear. We note the NOAA's outlook is not a landfall forecast and that is what causes real damage to the sector.

Table 2 – North America underwriting result

FOR THE HALF YEAR ENDED 30 JUNE		2013	2012	2011	2010	2009
Gross written premium	US$M	**2,703**	3,228	3,144	2,119	1,904
Gross earned premium	US$M	**2,536**	3,053	2,770	1,852	1,745
Net earned premium	US$M	**1,286**	1,609	1,572	1,110	1,089
Net incurred claims	US$M	**739**	1,023	941	654	645
Net commission	US$M	**85**	117	151	124	154
Expenses	US$M	**391**	377	296	229	131
Underwriting result	US$M	**71**	92	184	103	159
Claims ratio	%	**57.5**	63.6	59.9	58.9	59.3
Commission ratio	%	**6.6**	7.3	9.6	11.2	14.1
Expense ratio	%	**30.4**	23.4	18.8	20.6	12.0
Combined operating ratio	%	**94.5**	94.3	88.3	90.7	85.4
Insurance profit margin	%	**6.9**	8.0	16.8	14.0	18.9

SOURCE: COMPANY DATA

QBE Australia and New Zealand (QBEANZ)

QBEANZ is largely an intermediary business servicing insurance brokers, authorised representatives, CTP agents, etc. who provide insurance solutions to individuals, families and businesses (SME to high end corporates). The division is split as follows:

1. **Intermediary Distribution** – Products include accident and health, aviation, builders warranty, commercial motor and packages, CTP, engineering, farm, home, liability, marine, professional liability, property, surety (APRA approved alternative to bank guarantees), trade credit (insolvency and bad debts) and workers' compensation.
2. **Corporate Partners and Specialty** – This is based on long term relationships with selected intermediaries such as specialist underwriting agencies, financial institutions, motorcycle dealers and travel agents. Products include car, CTP, home, landlords, commercial packages, farm and workers' compensation.
3. **Credit and Surety** – This is a specialist risk area for insurance brokers, banks, trade financiers and accountants.
4. **Lenders' Mortgage Insurance (LMI)** – This provides against borrower default in respect of > 80% LVR full doc loans and 60-80% LVR low doc loans. There are currently 645,000 insured loans (~35% market share and second largest after Genworth with ~50% market share) with an average loan size of under A$300,000. Clients include banks, building societies, credit unions and non-bank lenders.
5. **Elders Insurance** – Acquired in 2009, products include farm, business, home/motor/boat, landlords and commercial motor.

Strategic partners include Steadfast (400+ offices, annual GWP > A$2.5bn), Austbrokers (annual GWP > A$1.2bn), Insurance Advisernet Australia (GWP under management A$1.6bn) and IBNA (annual GWP > A$1bn). We estimate QBE's share of Australian NEP is around 13% and compares with 31% each for IAG and SUN. QBE's NSW CTP market share is estimated at 17% and this compares with 38% for IAG and 21% for SUN.

QBEANZ reported US$2.5bn GWP (27% of Group, average rate rise 6.5%), US$2.1bn NEP (28% of Group) and US$278m NPAT (58% of Group and skewed by the QBENA loss) in 1H13 (Table 3). Due to rate rises and portfolio remediation, the claims ratio improved from 61.8% to 59.3% although the margin fell from 18.5% to 17.3% from lower investment returns (noting the combined ratio improved by 1.5% to 89.9%). While industry CAT losses were higher on a yearly basis, QBEANZ has repositioned its book away from CAT-prone areas such as in QLD and Melbourne – thus the better claims ratio compared with the sector.

The 2013 divisional outlook is for forecast GWP of US$4.8bn (2012 US$5.0bn), NEP of US$4.0bn (2012 US$4.1bn) and improved profitability in 2H13.

Table 3 – Australia and NZ underwriting result

FOR THE HALF YEAR ENDED 30 JUNE		2013	2012	2011	2010	2009
Gross written premium	US$M	**2,507**	2,470	2,360	1,891	1,215
Gross earned premium	US$M	**2,392**	2,348	2,214	1,900	1,154
Net earned premium	US$M	**2,077**	2,027	1,815	1,558	951
Net incurred claims	US$M	**1,231**	1,252	1,329	978	556
Net commission	US$M	**314**	266	229	160	111
Expenses	US$M	**322**	335	315	261	171
Underwriting result	US$M	**210**	174	(58)	159	113
Claims ratio	%	**59.3**	61.8	73.2	62.7	58.4
Commission ratio	%	**15.1**	13.1	12.6	10.3	11.7
Expense ratio	%	**15.5**	16.5	17.4	16.8	18.0
Combined operating ratio	%	**89.9**	91.4	103.2	89.8	88.1
Insurance profit margin	%	**17.3**	18.5	5.6	16.2	22.0

SOURCE: COMPANY DATA

QBE Latin America (QBELA)

QBE writes all lines of P&C insurance in seven countries in Latin America: Argentina; Brazil; Colombia; Mexico; Ecuador; Chile; and Puerto Rico.

QBELA reported US$0.7bn GWP (8% of Group), US$0.6bn NEP (8% of Group) and NPAT of US$41m in 1H13 (9% of Group) (see table below). While GWP increased 43% mainly through the acquisition of HSBC Argentina and Optima Insurance in Puerto Rico, organic GWP growth was a respectable 7%. Claims were roughly unchanged while commissions and expenses increased in line with the above acquisitions.

The 2013 divisional outlook is for GWP of US$1.5bn (2012 US$1.2bn) based on acquisition contributions and similar growth in NEP to US$1.3bn (2012 US$1.0bn). Argentina, Colombia and Ecuador are the largest markets with 87% of expected GWP.

Table 4 – Latin America underwriting result

FOR THE HALF YEAR ENDED 30 JUNE		2013	2012	2011	2010	2009
Gross written premium	US$M	**733**	512	380	223	161
Gross earned premium	US$M	**694**	493	384	221	156
Net earned premium	US$M	**622**	422	302	189	142
Net incurred claims	US$M	**368**	235	172	110	85
Net commission	US$M	**133**	90	62	45	35
Expenses	US$M	**90**	66	44	20	16
Underwriting result	US$M	**31**	31	24	14	6
Claims ratio	%	**59.1**	55.8	57.0	58.2	59.9
Commission ratio	%	**21.4**	21.3	20.5	23.8	24.6
Expense ratio	%	**14.5**	15.6	14.6	10.6	11.3
Combined operating ratio	%	**95.0**	92.7	92.1	92.6	95.8
Insurance profit margin	%	**10.6**	14.0	12.9	9.0	13.4

SOURCE: COMPANY DATA

QBE Asia Pacific (QBEAP)

QBEAP is a specialist underwriter with its main focus in SE Asia (Hong Kong, Singapore, Malaysia and Indonesia):

1. **Hong Kong** – This operates through QBE Hongkong and Shanghai Insurance, a JV between QBE and China Construction Bank, and provides specialist insurance solutions (e.g. professional liability, marine and trade credit) and traditional products (e.g. commercial and domestic property, general liability, accident and health and motor) for intermediaries and clients in the Hong Kong market.
2. **Singapore** – The intermediary business has been in operation for over a 100 years and provides personal (e.g. accident & health, domestic property and travel) and business products (e.g. business packages, engineering and construction, general liability, accident, motor, marine, professional liability and property).
3. **Malaysia** – This focuses on business clients (SME to corporates) and classes are largely specialist in nature including Trade Credit insurance.
4. **Indonesia** – Operations are conducted through a JV with PT Pool Advista Indonesia (consulting and investment management services) providing specialist insurance solutions (e.g. business packages, domestic home and fire, engineering and construction, general liability, accident, motor, marine, professional liability and property) via intermediaries to business, professionals and families.

Other geographies covered include India, Macau, Mainland China, Philippines, Thailand, Vietnam and the Pacific Islands.

QBEAP reported US$400m GWP (4% of Group), US$244m NEP (3% of Group) and US$26m NPAT (5% of Group, again skewed by the QBENA loss) in 1H13 (see table below). Premium income increased 51% from strong performances in Hong Kong (including the Hang Seng Insurance acquisition), Malaysia, Philippines, Thailand and Singapore. Claims experience normalised after a very difficult prior period that included significant reinsurance reinstatement costs (that depressed 1H12 NEP).

The 2013 divisional outlook is for GWP of US$730m (Asia 84% and Pacific 16%, 2012 US$578m) and NEP of US$510m (2012 US$415m). We note the non-life insurance GWP pool in Asia is estimated at US$220bn and represents 20% of the global market, while compounded annual GWP growth is estimated at 8% over the next decade.

Table 5 – Asia Pacific underwriting result

FOR THE HALF YEAR ENDED 30 JUNE		2013	2012	2011	2010	2009
Gross written premium	US$M	**400**	265	234	216	196
Gross earned premium	US$M	**311**	243	224	202	182
Net earned premium	US$M	**244**	182	183	150	135
Net incurred claims	US$M	**109**	85	74	74	62
Net commission	US$M	**52**	41	35	31	29
Expenses	US$M	**46**	40	37	33	26
Underwriting result	US$M	**37**	16	37	12	18
Claims ratio	%	**44.6**	46.7	40.5	49.3	45.9
Commission ratio	%	**21.3**	22.5	19.1	20.7	21.5
Expense ratio	%	**18.9**	22.0	20.2	22.0	19.3
Combined operating ratio	%	**84.8**	91.2	79.8	92.0	86.7
Insurance profit margin	%	**16.4**	10.4	25.7	14.0	15.6

SOURCE: COMPANY DATA

Group Reinsurance

Group Reinsurance is carried out by QBE Re (established in 2012). The division brings together the Group's global reinsurance capabilities and is involved in three activities: Aggregate management and CAT modelling; managing reinsurance covers; and risk pooling for Group operating units through Equator Re, QBE's reinsurance captive. This Bermuda-based captive provides centralised management of excess of loss, proportional reinsurance protection to all operating divisions and additional underwriting capacity, and also reduces Group dependency on external reinsurance markets. Optimising the level of capital held within the divisions (much like Group treasury within the banks) further enables Equator Re to maximise Group capital efficiency.

Pre-eliminations, Equator reported US$1.5bn GWP, US$1.4bn NEP (19% of Group) and US$131m NPAT (27% of Group) in 1H13. The 2013 divisional outlook is for GWP of US$3.3bn (2012 US$3.7bn) and NEP of US$3.1bn (2012 US$3.4bn).

Table 6 – Equator underwriting result

FOR THE HALF YEAR ENDED 30 JUNE		2013	2012	2011	2010	2009
North American Operations	US$M	**914**	1,137	875	576	526
Latin American Operations	US$M	**23**	9	17	18	-
European Operations	£M	**403**	374	395	347	353
Australian & New Zealand Operations	A$M	**230**	261	388	178	163
Asia Pacific Operations	US$M	**97**	88	86	75	48

Underwriting result

FOR THE HALF YEAR ENDED 30 JUNE		2013	2012	2011	2010	2009
Gross written premium	US$M	**1,889**	2,093	2,021	1,359	1,216
Gross earned premium	US$M	**1,533**	1,682	1,545	1,032	893
Net earned premium	US$M	**1,373**	1,562	1,377	1,006	873
Net incurred claims	US$M	**821**	935	941	605	566
Net commission	US$M	**395**	448	335	250	215
Expenses	US$M	**50**	47	67	39	38
Underwriting result	US$M	**107**	132	34	112	54
Claims ratio	%	**59.8**	59.8	68.3	60.1	64.8
Commission ratio	%	**28.8**	28.7	24.3	24.9	24.6
Expense ratio	%	**3.6**	3.0	4.9	3.9	4.4
Combined operating ratio	%	**92.2**	91.5	97.5	88.9	93.8
Insurance profit margin	%	**9.5**	12.9	8.1	15.6	11.1

SOURCE: COMPANY DATA

Following global catastrophes in 2010 and 2011, retentions on divisional and per risk programs were increased and additional reinsurance covers purchased. While higher divisional risk retentions increase the exposure in these divisions (to facilitate risk pricing), the net effect at Group level is nil as the captive's exposure is reduced.

The worldwide CAT reinsurance structure includes a worldwide main cover US$1.3bn xs US$200m, additional Australian/NZ main cover US$3bn xs US$1.5bn (compares with IAG's A$4.5bn xs A$250m and SUN's A$5.8bn xs A$250m), QBE FPS cover US$700m xs US$200m and group aggregate cover US$400m xs US$800m (US$5m deductible).

In addition, the worldwide risk cover includes US$800m cover for non-CAT events (xs US$200m, with Equator Re providing retention protection) and group aggregate risk cover against volatile claims frequency of US$200m (xs US$400m) – the latter 81% placed so the maximum recovery is US$162m.

QBE's Maximum Event Retention (MER the largest loss to which the Group will be exposed) is estimated at $600m (4% of 2013e NEP).

Reinsurance broking specialist Guy Carpenter's mid-year Market Overview (September 2013) suggests the new supply of capital into reinsurance from institutional investors (US$10bn in the last 18 months) should continue to exert downward pressure on pricing (US experiencing double-digit rate reductions during 2013 mid-year renewals) thus making risk transfer even more efficient. With investors chasing higher yields and low correlations, total capital has increased to US$45bn (or 14% of global property CAT limits purchased). Guy Carpenter expects the trend to continue into 1 January 2014 and this remains a positive for QBE in preserving underlying margins.

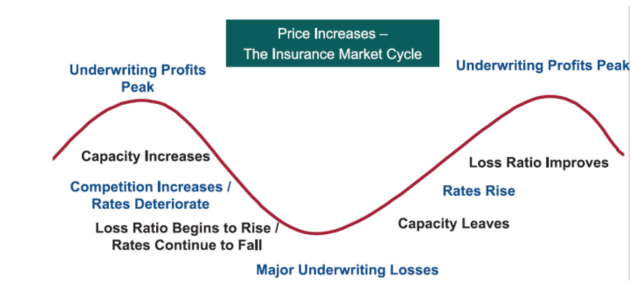
Financials and outlook

Cycle turning

The insurance cycle is illustrated in Figure 2. While QBE has not suffered major underwriting losses since 2001, the red bars in Figure 3 suggest the cycle may have bottomed with 2013 also regarded as a transition year. The average rate increase was 5% in 1H13 and QBE expects further rises in 2H13 (including 4-5% in the US market).

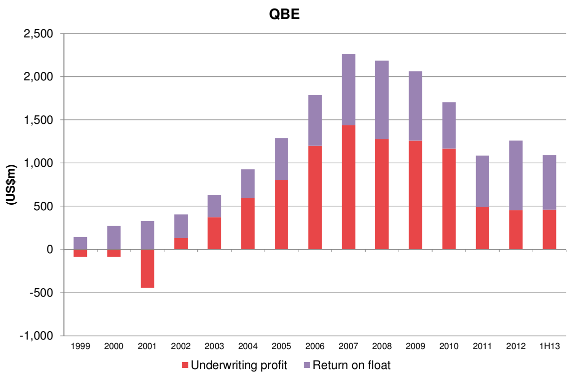
The traditional insurance market typically assumes very little underwriting profit over the long term and relies on investment income on float money (or free funds – discussed in a later section) to sustain the insurance profit. Since 2001, QBE has managed to turn in decent underwriting profits despite various CAT events on top of some sizeable investment returns. With the cycle including US rates and investment markets set to rebound (more on this later), we see some significant value upside over the next few years.

Figure 2 – Insurance cycle



SOURCE: IAG, ORD MINNETT, DELOITTE TOUCHE

Figure 3 – Cycle appears to have bottomed in 1H13 for QBE



SOURCE: COMPANY DATA

Table 7 illustrates QBE's six-monthly performance trends. While premium growth is expected to be impacted by slower QBENA and adverse FX movements on non-US operations, overall expenses remain under control – for example, attritional claims are stable at around 60% of NEP despite some large risk claims severity while efficiency gains were evident in acquisition and underwriting. More importantly, the underwriting profit remains on a positive trajectory and is also on track to approach some of the highs in 2008 (likewise the insurance profit) while ROE is trending in the right direction once again and approaching the cost of equity.

Table 7 – 6m comps

Y/e December 31 (US$m from 2009)	1H08	2H08	1H09	2H09	1H10	2H10	1H11	2H11	1H12	2H12	1H13	2H13e
QBE Group												
Growth in GWP	-	-	22%	-2%	-15%	6%	30%	38%	3%	-2%	2%	-8%
Gross unearned premium movement	-	-	46%	57%	-20%	-1%	48%	16%	-26%	13%	26%	-79%
Growth in NEP	-	-	21%	0%	-15%	3%	29%	40%	9%	-2%	0%	-11%
Growth in reinsurance expense	-	-	10%	8%	-7%	21%	21%	19%	-1%	5%	3%	-24%
Loss ratio (net claims expense / NEP)	55%	60%	61%	60%	60%	60%	66%	70%	62%	70%	59%	61%
Expense ratio (expense / NEP)	31%	31%	29%	30%	30%	30%	30%	28%	31%	31%	33%	30%
- Commission ratio	17%	17%	17%	15%	15%	16%	16%	14%	17%	16%	18%	15%
- Underwriting ratio	14%	13%	12%	15%	15%	14%	14%	14%	15%	15%	16%	15%
Combined ratio	86%	91%	89%	90%	90%	90%	96%	98%	93%	101%	93%	90%
Return on technical reserves	-	-	5%	5%	4%	3%	6%	1%	5%	4%	3%	2%
Insurance margin	22%	18%	17%	17%	16%	14%	11%	4%	13%	4%	11%	13%
Underwriting profit	727	548	664	598	542	626	291	203	522	-69	530	716
Insurance profit	1,116	1,067	1,080	984	822	881	762	323	958	304	790	940
Return on equity	-	20%	19%	19%	9%	17%	13%	1%	14%	0%	8%	10%
PCA multiple (x) (target 1.5-1.8x)	2.40	1.71	1.66	1.61	1.59	1.62	1.68	1.51	1.54	1.57	1.61	1.64

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Comps indicate value upside from further efficiencies

We assess QBEANZ against domestic peers IAG and SUN in Table 8. QBEANZ's performance has been impacted by currency translation, i.e. weaker A$ in 2H13. However, its loss ratio is better than those of IAG and SUN and this is likely due to a smaller domestic footprint (QBE's share of Australian NEP is around 13% vs. 31% each for IAG and SUN; QBE's NSW CTP market share is ~17% vs. IAG's 38% and SUN's 21%). The advantage is somewhat eroded by higher reinsurance, acquisition and underwriting expenses most likely due to smaller relative scale. While QBEANZ's combined ratio exceeded 100%, we see an opportunity to rationalise its operations and lower the expense ratio to peer group levels (much like what SUN did in the last few years, expediting its claims functions and rationalising the back office). We also see further upside in QBEANZ's LMI operations (2012 insurance margin 66%), now highly leveraged to rising premiums from the likely east coast housing recovery.

Table 8 – Domestic comps

General Insurance	IAG			SUN			QBE Group			QBE Australia/NZ		
	2012	2013	pcp	2012	2013	pcp	2012	1H13 ann.	pcp	2012	1H13 ann.	pcp
P&L ($m) (US$m for QBE)												
Gross written premium (GWP)	8,495	9,498	12%	7,955	8,589	8%	18,434	18,657	1%	4,987	5,024	1%
Less: Gross unearned premium	-449	-363		-371	-265		-93	-307		-193	-186	
Less: Outwards reinsurance expense	-700	-817	-14%	-780	-1,026	-24%	-2,543	-2,578	-1%	-671	-665	1%
Net earned premium (NEP)	7,346	8,318	13%	6,804	7,298	7%	15,798	15,772	0%	4,123	4,173	1%
Net incurred claims	-5,421	-4,982	9%	-5,396	-4,919	10%	-10,428	-10,259	2%	-2,487	-2,466	1%
Acquisition expenses	-604	-695	-13%	-903	-936	-4%	-2,560	-2,627	-3%	-557	-605	-8%
Other underwriting expenses	-1,390	-1,483	-6%	-712	-817	-13%	-2,357	-2,425	-3%	-691	-678	2%
Underwriting profit	**-69**	**1,158**	**Large**	**-207**	**626**	**-402%**	**453**	**461**	**2%**	**388**	**424**	**9%**
Inv. income - insurance funds	914	270	-70%	718	333	-54%	809	633	-22%	-	-	-
Insurance profit	**845**	**1,428**	**69%**	**511**	**959**	**88%**	**1,262**	**1,094**	**-13%**	-	-	-
JV and other	-46	-32		22	35		3	0		-	-	
Inv. income - s'holders' funds	89	347		203	288		407	294		-	-	
Capital funding	-97	-95		-66	-33		-324	-326		-	-	
Contribution before tax & amortisation	**791**	**1,648**	**108%**	**670**	**1,249**	**86%**	**1,348**	**1,062**	**-21%**	**-**	**-**	**-**
Reserve release	195	212		166	105		568	466		-	-	
Reserve release as % of NEP	2.7%	2.5%		2.4%	1.4%		3.6%	3.0%		-	-	
Loss ratio	74%	60%		79%	67%		66%	65%		60%	59%	
Reinsurance expense as % of GWP	8.2%	8.6%		9.8%	11.9%		13.8%	13.8%		13.5%	13.2%	
Commission ratio	8%	8%		13%	13%		16%	17%		14%	14%	
Underwriting ratio	19%	18%		10%	11%		15%	15%		17%	16%	
Combined ratio	101%	86%		103%	91%		97%	97%		104%	103%	
Insurance margin	11.5%	17.2%		7.5%	13.1%		8.0%	6.9%		-	-	
Underlying insurance margin	**12.0%**	**12.5%**		**12.1%**	**13.5%**		**11.8%**	**12.1%**		**-**	**-**	
Guidance (next 6-12 months)												
GWP growth	5-7% (GWP)			PI 6-8%, CI 3-4% over system			-3.4% (based on 4-5% rate rise)			-3.7%		
Combined ratio	-			-			92.0%			-		
Underlying insurance margin	12.5-14.5%			=>12%			11%			-		
Dividend payout	50-70% of cash earnings			60-80% cash earnings			<=50% cash earnings			-		
CET1 benchmark (x)	0.9-1.1x			1.1x			-			-		
PCA benchmark (x)	1.4-1.6x			-			1.5-1.8x			-		
Capital Adequacy ($m) (US$m for QBE)												
CET1	2,751	2,798	2%	2,905	3,514	21%	6,341	6,679	5%	-	-	
Total regulatory capital	3,668	4,262	16%	3,669	4,157	13%	8,888	9,123	3%	-	-	
Prescribed Capital Amount (PCA)	2,531	2,558	1%	2,277	2,123	-7%	5,663	5,664	0%	-	-	
CET1 multiple (x)	**1.09**	**1.09**	**0.01**	**1.28**	**1.66**	**0.38**	**1.12**	**1.18**	**0.06**	**-**	**-**	
PCA multiple (x)	**1.45**	**1.67**		**1.61**	**1.96**		**1.57**	**1.61**		**-**	**-**	
Investment Income ($m) (US$m for QBE)												
Combined investment composition												
- Cash & Fixed Interest	88.2%	85.7%		93.8%	94.5%		99.5%	99.1%		-	-	
- Equities	5.8%	7.6%		5.6%	5.5%		0.4%	0.5%		-	-	
- Property & alternatives	6.0%	6.7%		0.6%	0.0%		0.1%	0.4%		-	-	
Gross yield - policyholders' funds	9.7%	2.9%		8.3%	3.7%		4.2%	2.2%		-	-	
Gross yield - shareholders' funds	2.5%	8.3%		6.7%	8.6%		4.4%	2.8%		-	-	

SOURCE: COMPANY DATA

Comps relative to selected major offshore P&C companies are shown in the table below. While QBE's reserve releases are much lower, the loss ratio is more favourable and we suspect this is due to better reinsurance arrangements that capitalise on its global scale. However, the expense ratio implies there are still inefficiencies and this explains the current push to streamline operations. The cost of the recently announced operational transformation program is 1% of NEP and this is expected to deliver in excess of pre-tax cost benefits of US$250m p.a. by 2015.

Table 9 – Selected offshore comps

General Insurance	QBE	IAG	SUN	ACE	Allianz (P&C)	Aviva (P&C)	Berkshire Insurance	RSA	Progressive	Travelers (P&C)	Zurich
	1H13	1H13	1H13	1H13	1H13	1H13	1H13	1H13	1H13	1H13	1H13
P&L (local currency m)											
Gross written premium (GWP)	9,446	4,905	4,364	10,993	25,951	4,898	-	5,208	-	12,435	19,770
Less: Gross unearned premium	-1,033	-264	-139	-549	-2,829	-89	-	-354	-	-301	-
Less: Outwards reinsurance expense	-1,080	-418	-528	-2,804	-2,431	-349	-	-556	-	-1,014	-
Net earned premium (NEP)	7,333	4,223	3,697	7,640	20,691	4,460	20,736	4,298	8,456	11,120	14,464
Net incurred claims	-4,359	-2,546	-2,614	-4,417	-13,797	-2,893	-	-2,831	-6,103	-6,560	-9,914
Acquisition and underwriting expenses	-2,444	-1,133	-871	-2,357	-5,885	-1,456	-	-1,348	-1,890	-3,607	-3,910
Underwriting profit	**530**	**544**	**212**	**866**	**1,009**	**111**	**2,215**	**119**	**464**	**953**	**640**
Total investment income	394	215	206	1,375	1,547	125	2,531	275	416	-	1,127
Contribution before tax	**924**	**759**	**418**	**2,241**	**2,556**	**236**	**4,746**	**394**	**880**	**-**	**1,767**
Reserve release	163	122	105	288	692	136	n/a	142	n/a	n/a	n/a
Reserve release as % of NEP	2.2%	2.9%	2.8%	3.8%	3.3%	3.0%	n/a	3.3%	n/a	n/a	n/a
Loss ratio	59%	60%	71%	58%	67%	65%	n/a	66%	72%	59%	69%
Reinsurance expense as % of GWP	11%	9%	12%	26%	9%	7%	n/a	11%	n/a	8%	n/a
Expense ratio	33%	27%	24%	31%	28%	33%	n/a	31%	22%	32%	27%
Combined ratio	93%	87%	94%	89%	95%	98%	n/a	97%	95%	91%	96%
Underwriting profit as % of NEP	7.2%	12.9%	5.7%	11.3%	4.9%	2.5%	10.7%	2.8%	5.5%	8.6%	4.4%

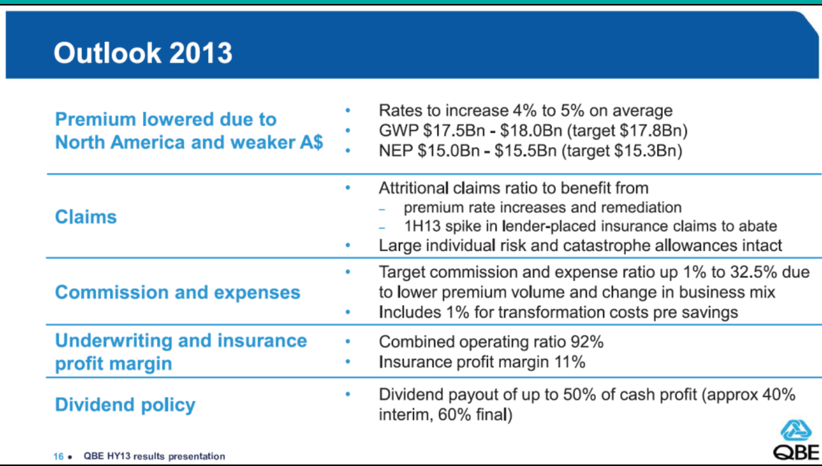
SOURCE: COMPANY DATA

2013 outlook

After a prolonged period of growth via acquisitions, QBE is evolving from a regionally-focused multinational business to a fully integrated global insurer with scale.

The outlook for 2013 is for 5% higher premium rates on average and in excess of incremental cost of claims inflation largely in Australia, NZ and North America. The CAT allowance was 8.5% of NEP in 1H13 (~$625m) and is expected to be 12.3% in 2H13 (~$925m), bringing the total CAT allowance for the year to 10.5%. Transformation of the business over time should result in a combined operating ratio of 90% or better while the target dividend payout ratio is up to 50% of cash earnings (roughly 40% interim, 60% final).

Figure 4 – Outlook statement



SOURCE: COMPANY DATA

Right place, right time

We believe there is value in initiating coverage on QBE from a bank analyst's perspective. In our view, QBE has a lot in common with the banks (in terms of risk management and the drive for capital efficiency) and we list below the positives that would drive earnings growth and sustain long term shareholder value creation.

Continuous focus on risk management and capital efficiency

Asset and liability management (ALM) focuses on liquidity risk and interest rate risk and is a common market risk management tool among banks and insurers. Liquidity risk management allows these entities to meet obligations as they become due while optimal interest rate risk management (IRRM) is designed to reduce earnings volatility. Effective IRRM also involves managing the duration of assets and liabilities. General insurers are traditionally long liabilities/short assets while banks are traditionally long assets/short liabilities, and the common objective is to ensure as little mismatch as possible in the respective durations to minimise mark-to-market volatility. The requirement to at least preserve underwriting and banking margins suggests there is the ongoing requirement to maximise returns on float (technical reserves for QBE or free funds for banks). QBE's historical consistency in managing its float (Table 7, page 12) is a major competitive advantage and the concept will be discussed in a later section.

Operational risk management is another facet and this involves the diversification concept (i.e. the law of large numbers). The larger the sample, the higher the probability that the actual loss will be close to the expected loss – with each loss being small enough to only affect a small fraction of the pool at the same time. In other words, a sufficient number have to be insured to get the benefit of the law of large numbers. In this respect, QBE's global scale offers sufficient insurance risk diversification that can also be construed as providing a large and uncorrelated number of small bets. Capital management aligns with risk management and is a further competitive advantage. Much like the banks' treasury functions, QBE's reinsurance captive Equator Re provides global risk management to all operating divisions through the efficient allocation of capital for reinsurance purposes as well as cheaper overall reinsurance given its global scale.

Interest rate and currency normalisation play

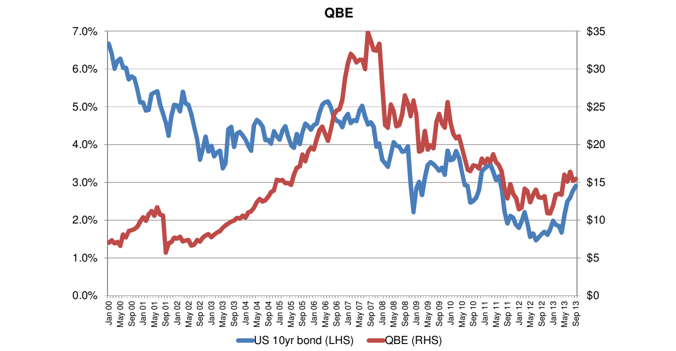
Like the banks, QBE is a rate sensitive stock. While the insurer was one of the biggest losers in terms of net worth in the past five years during a downward rate environment, it is now on track to recoup these losses as the US risk free rate (e.g. using the 10-year Government bond yield) is set to increase in an improving economy. In a way, the current setting also appears very similar to those of the banks given they tend to do better in a rising rate environment. QBE is thus viewed as a classic interest rate normalisation play.

The loss in notional net worth in the downward rate environment arose from the fact that the insurer's investment assets are largely short term in duration (around six months in maturity and relatively insensitive to movements in the US risk free rate) while claims liabilities are roughly 2.8 years in duration and increased by around US$1.2bn as the risk free rate declined over the past five years. Consistent with the trend reversal, it is estimated that every 1% increase in the risk free rate would lead to around US$478m pre-tax benefit in QBE's net worth (i.e. through lower resulting claims liabilities).

It appears inescapable that QBE would also be a US$ normalisation play as well given the strong links to interest rates. The high correlation to the US risk free rate and the A$/US$ cross rate is illustrated in the four charts on the next page. This has also become increasingly evident when North American contributions surpassed 30% of Group Gross

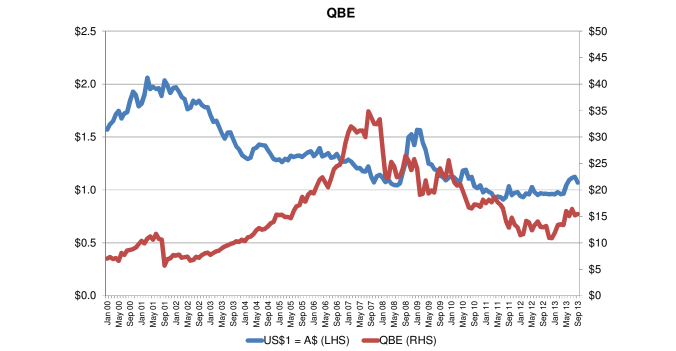
Earned Premiums (GEP). The correlation is set to continue as the proportion of US GEP increases again following resolution of the challenges in the past few years.

Figure 5 – Close correlation post 2007 with the risk free rate...



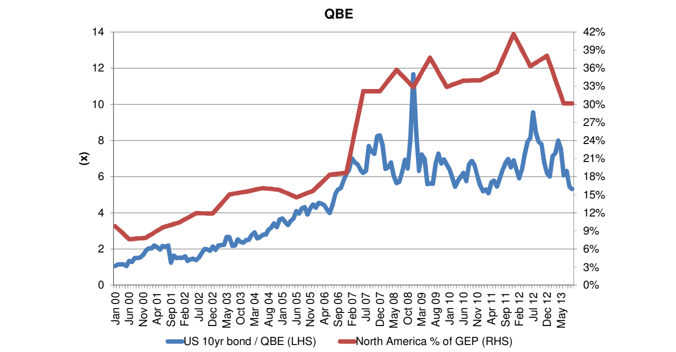
SOURCE: COMPANY DATA, BLOOMBERG

Figure 6 – ...and the US$



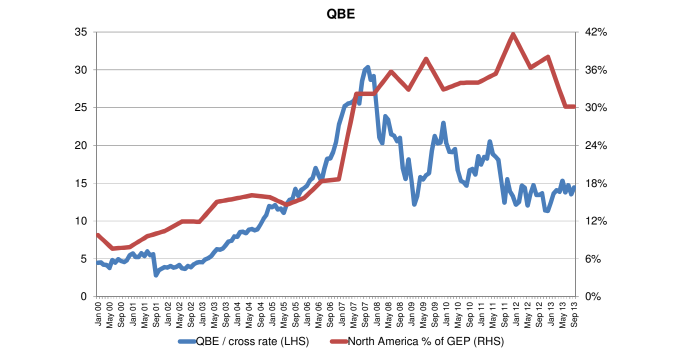
SOURCE: COMPANY DATA, BLOOMBERG

Figure 7 – The correlation intensified...



SOURCE: COMPANY DATA, BLOOMBERG

Figure 8 – ...with higher North American contributions

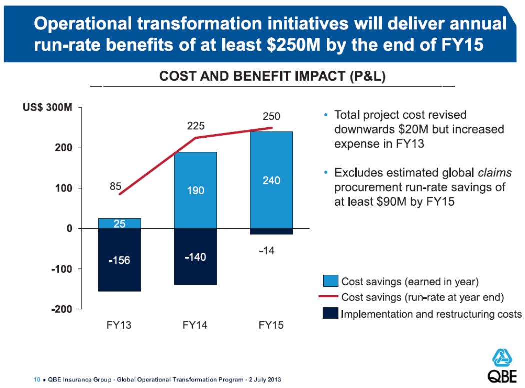


SOURCE: COMPANY DATA, BLOOMBERG

Productivity upside in the pipeline

QBE announced its Global Operational Transformation Program in July. This revolves around its Group Shared Services Centre (GSSC) that will drive process simplification (reducing rework), standardisation (driving scale economies) and continuous improvement. Implementation and restructuring costs are estimated at US$310m over the three years to 2015 while annual run-rate benefits from rationalising the back office (Finance, HR, Claims, Operations, IT and Procurement) are expected to be at least US$250m by 2015 (saving a minimum 11% of 2013 forecast underwriting expenses).

Figure 9 – Minimum rationalisation benefits US$250m by 2015



SOURCE: COMPANY DATA

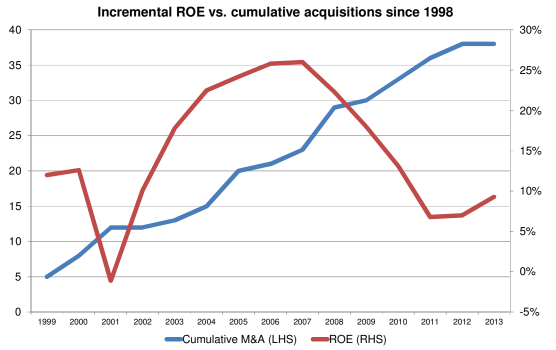
QBE has traditionally been an acquisitive company, having completed 135 transactions since 1982 including 38 since 1998. Table 10 highlights specific acquisitions in the latter period but also the fact that Group ROE has been steadily falling since 2006. While the bottom line has certainly been impacted by CAT claims, we are also of the view that the Return on Incremental Capital (ROIC) on the transactions has fallen in tandem and is now below the cost of equity (Figure 10). The fact that there has been no major acquisition since last year suggests QBE has finally recognised the urgent need to work its current portfolio of assets, i.e. increase productivity to raise Group ROE.

Table 10 – M&A track record since 1998

Acquisitions since 1998		#	ROE	NPAT	Average equity	ROIC
General Accident PNG	1998	1	14%	78	561	14%
Iron Trades Insurance UK; Slovakia; ASITO Moldova; TII	1999	4	12%	73	608	-11%
ING Singapore; Limit PLC; Macedonian Insurance	2000	3	13%	99	786	9%
Aviation agency; MBf Malaysia; HIH; LatAm	2001	4	-1%	-13	1,182	-15%
	2002	0	10%	151	1,495	8%
Ensign UK	2003	1	18%	370	2,079	19%
Zurich Singapore; MM	2004	2	23%	634	2,818	25%
British Marine; Minibus Plus UK; National Farmers US; Colombian GI Central de Seguros; Euro agency	2005	5	24%	832	3,438	26%
Praetorian US	2006	1	26%	1,121	4,345	28%
Winterthur US; Seguros Cumbre Mexico	2007	2	26%	1,612	6,200	27%
ZC Sterling US; PMI Asia; 1 x US agency; 2 x Euro agencies; North Pointe US	2008	6	22%	1,558	6,987	23%
Elders	2009	1	18%	1,532	8,511	18%
Renaissance Re US; Secura NV Belgium; NAU Country US	2010	3	13%	1,278	9,756	13%
Balboa Insurance US; CUNA Australia; Ren RE US	2011	3	7%	704	10,353	6%
Hang Seng HK; HSBC Argentina	2012	2	7%	761	10,871	7%
	2013	0	9%	1,050	11,319	9%

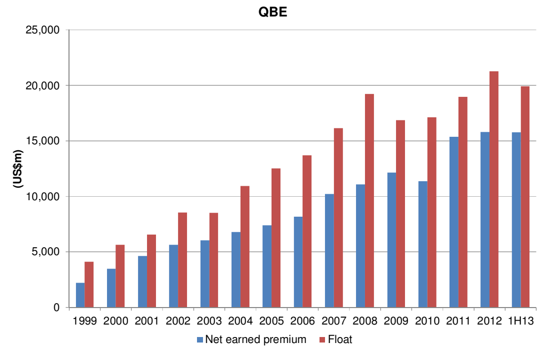
SOURCE: COMPANY DATA

Figure 10 – End of aggressive M&A should improve ROE



SOURCE: COMPANY DATA

Figure 11 – QBE's float advantage



SOURCE: COMPANY DATA

Capitalising on the "free" float

We believe QBE's float is a major advantage in sustaining earnings growth (Figure 11). An insurer collects premiums upfront and pays claims later (and much later for long tail liabilities that are subject to drawn-out litigation), and in the process "floats" or invests the proceeds and keeps 100% of the returns. The float (or technical reserves) is similar to bank's free funds (e.g. non-interest bearing debt) where customers pay the institutions (via forgone interest) for holding their money (i.e. Other People's Money).

While the banks' free funds are typically 6-10% of interest earning assets, QBE derives a much larger benefit comprising more than 80% component in investment assets. QBE's float is essentially perpetual interest free debt. This has historically funded M&A deals and should be valued as equity instead of a liability. QBE has a significant float component and better float margin and should continue to derive volume and rate benefits (based on rising rates and compounding returns) sufficient to sustain earnings growth. We believe the market has not fully appreciated the true value of the float.

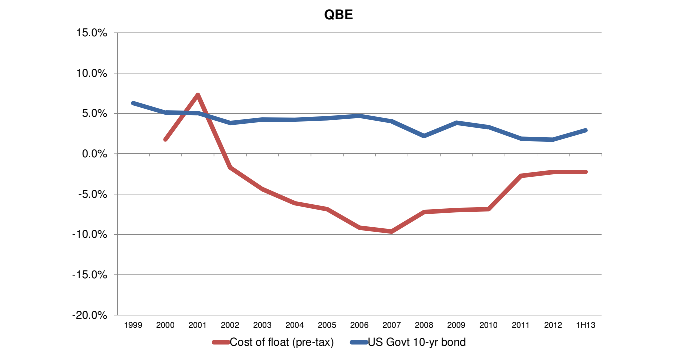
The free fund effect increases in value in a rising rate environment. With rate rises to increase future float especially in North America, the benefit is set to increase even more for QBE through compounding. We see QBE as a "low risk bank" where customers pay the company for holding their money and for a very long duration.

In relation to M&A and using Berkshire as an example, this concept also explains why the US conglomerate is able to consistently expand its operations. While there could be a premium involved for equity, Berkshire continues to benefit from the float that adds to interest-free debt funding. The float is on average double that of shareholders' equity and as good as equity given the perpetual nature of such interest free debt. As a result, paying 1.5 times book value in the usual sense ends up like paying 0.5 times float – value accretive from day one. The float generates a return that would also offset part of the cost of equity and boost valuation.

As suggested earlier, the cost of providing insurance (i.e. the cost of the float) is typically the underwriting loss (combined ratio >100%) and insurers largely rely on investment returns to create value for shareholders. Put another way, an underwriting profit or breakeven is traditionally regarded as a bonus. As can be seen in Figure 3 earlier, there are more years of underwriting profits than losses – meaning the cost of the float or "notional debt" is negative for most years.

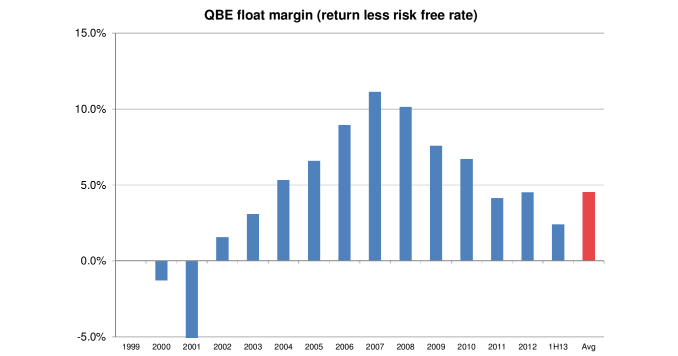
Figure 12 highlights the insurance float's notional funding advantage. As "notional debt", the cost has been negative for QBE since 2002 (imagine the bank paying you to take out a loan). This implies QBE is also a better credit risk than the US Government. The margin based on insurance profit (underwriting profit plus investment return) in Figure 13 again supports our view that the insurance cycle has bottomed for QBE. Float as a percentage of shareholders' equity is 162% for QBE and compares favourably with the average of 118% for the leading US P&C insurers.

Figure 12 – QBE's negative funding cost



SOURCE: COMPANY DATA

Figure 13 – Bottom of the insurance cycle pending



SOURCE: COMPANY DATA

Valuation

We believe QBE is significantly undervalued given the size of its float. To back this assertion, we explore an additional valuation methodology based on the value of float plus equity for its most comparable peers. While there is a wide range of valuations (Table 11), there are companies that are consistently priced at closer to 1x float plus equity value (e.g. Berkshire and Progressive Corp).

QBE's ratio also remains at the bottom of the sector range and we believe there is an element of mispricing given its substantial float and improving underlying fundamentals such as rising rates, lower reinsurance costs and productivity and efficiency gains by 2015.

Table 11 – GI comps 1

(respective currency, m)	Shareholders' equity	Float (technical reserves)	Total	Market cap	Mkt cap / SHF + float	Float as % of SHF and Float	2014e ROE
QBE (1H13)	**11,210**	**18,155**	**29,365**	**17,532**	**0.60**	**62%**	**12%**
IAG (2013)	4,988	9,389	14,377	12,121	0.84	65%	20%
SUN (2013)	13,983	9,097	23,080	16,443	0.71	39%	9%
Offshore majors							
ACE (2Q13) (ACE.US)	27,295	26,413	53,708	32,005	0.60	49%	9%
Berkshire Hathaway (2Q13) (BRK/A.US)	204,988	75,000	279,988	285,451	1.02	27%	7%
Chubb (2Q13 plus estimates) (CB.US)	15,523	24,655	40,178	23,037	0.57	61%	10%
Progressive Corp (2Q13) (PGR.US)	6,524	8,498	15,022	16,044	1.07	57%	15%
Travelers (2Q13) (TRV.US)	24,890	42,307	67,197	31,618	0.47	63%	11%
Average offshore majors					**0.75**	**51%**	**10%**

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES; 2014E ROE BASED ON BP FORECASTS FOR QBE, IAG AND SUN

The $17.10 price target is based on a composite valuation as follows:

- DCF value of $16.18 per share (comprising 12.8% cost of equity and 3.25% terminal growth rate; 35% weight) including surplus capital;
- Float plus equity valuation of $19.05 per share based on 0.75x multiple of shareholders' equity and float (35% weight);
- Normalised Price/Book valuation (at least 12% ROE) of $14.87 per share (15% weight); and
- Sum-of-Parts valuation of $16.40 (15% weight).

The international comps table is found on the next page. While it highlights QBE trading in line with its global peers, the table also suggests the Price/Book upside would be significant with an improving ROE outlook underpinned by productivity/efficiency gains and rising float returns.

Table 12 – Composite valuation

Composite Valuation	Value ($m)	Per share	Weighting	Composite value per share
DCF (plus XS capital)	19,853	$16.18	35%	$5.66
Float plus equity valuation	23,376	$19.05	35%	$6.67
ROE (sustainable)	18,248	$14.87	15%	$2.23
Sum-of-Parts	20,115	$16.40	15%	$2.46
Total				**$17.02**

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Table 13 – SOP valuation

SOP	2015e NPAT	Pros. PE (times)	Value ($m)	Per share
North American Operations	552	12.5	6,898	$5.62
Latin American Operations	210	10.0	2,101	$1.71
European Operations	147	12.0	1,761	$1.44
Australian & NZ Operations	636	12.5	7,954	$6.48
Asia Pacific Operations	119	12.5	1,492	$1.22
Other	-9	10.0	-90	-$0.07
Total	**1,655**	**12.2**	**20,115**	**$16.40**

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Table 14 – GI comps 2

		Mkt cap	PE		PB		ROE		Yield		NPAT ($m)	
(local currency)	Ticker	($bn)	2013e	2014e	2013e	2014e	2013e	2014e	2013e	2014e	2013e	2014e
Australia *												
IAG	IAG.AU	12	12.4	11.5	2.3	2.2	19%	20%	5.4%	5.7%	987	1,063
QBE	QBE.AU	18	11.9	10.1	1.3	1.2	12%	13%	4.2%	5.0%	1,438	1,694
SUNCORP	SUN.AU	16	11.8	10.9	1.1	1.1	10%	10%	6.5%	6.6%	1,396	1,505
Average			**12.0**	**10.8**	**1.6**	**1.5**	**14%**	**14%**	**5.4%**	**5.8%**		
US/CA Majors *												
ACE	ACE	32	11.2	10.9	1.0	1.0	10%	9%	2.2%	2.3%	2,881	2,973
AFLAC	AFL	30	9.9	9.2	1.8	1.7	19%	19%	2.4%	2.6%	2,970	3,133
ALLSTATE	ALL	24	10.1	9.2	1.1	1.1	12%	12%	2.0%	2.2%	2,287	2,386
BERKSHIRE HATHAWAY	BRK/A	285	17.9	-	1.0	-	7%	-	-	-	15,912	-
CHUBB	CB	23	12.3	11.7	1.3	1.3	11%	10%	2.0%	2.1%	1,798	1,830
PROGRESSIVE	PGR	16	16.2	15.3	2.2	2.0	14%	15%	1.7%	1.9%	981	1,008
PRUDENTIAL	PRU	37	8.8	8.2	1.0	0.9	14%	13%	2.3%	2.6%	4,200	4,481
TRAVELERS	TRV	32	10.6	10.3	1.1	1.1	11%	11%	2.5%	2.6%	2,923	2,967
Average			**12.1**	**10.7**	**1.3**	**1.3**	**12%**	**13%**	**2.2%**	**2.3%**		
Europe Major *												
AVIVA	AV/	13	9.1	8.3	1.2	1.1	15%	15%	3.7%	4.0%	1,371	1,520
LEGAL & GENERAL	LGEN	12	11.7	10.8	1.9	1.7	16%	16%	5.2%	5.8%	982	1,039
PRUDENTIAL	PRU	30	12.4	11.1	2.4	2.1	19%	20%	2.9%	3.1%	2,375	2,724
ALLIANZ	ALV	54	8.9	8.5	1.0	0.9	11%	11%	4.5%	4.7%	6,004	6,249
MUENCHENER	MUV2	26	8.6	8.3	0.9	0.9	11%	10%	5.1%	5.3%	2,954	2,959
ASSICURAZIONI	G	26	11.1	10.0	1.1	1.1	11%	11%	3.1%	3.8%	2,232	2,501
AXA	CS	44	8.4	7.9	0.8	0.8	9%	10%	4.7%	5.0%	5,218	5,581
SAMPO	SAMAS	19	12.6	11.9	1.6	1.6	13%	13%	4.9%	5.4%	1,471	1,536
SWISS RE	SREN	28	9.8	9.1	0.9	0.9	10%	10%	5.7%	5.6%	3,057	3,231
ZURICH	ZURN	35	9.0	8.7	1.1	1.1	12%	12%	7.0%	7.0%	4,371	4,476
Average			**10.2**	**9.4**	**1.3**	**1.2**	**13%**	**13%**	**4.7%**	**5.0%**		
Asia Major*												
TOKIO MARINE	8766	2,409	12.8	11.9	0.9	0.8	7%	7%	2.1%	2.2%	188,280	206,804
PING AN	2,298	407	11.1	9.7	1.7	1.4	16%	16%	1.5%	1.7%	32,672	37,364
Average			**11.4**	**10.3**	**1.3**	**1.1**	**12%**	**12%**	**2.7%**	**3.0%**		

* Consensus (Bloomberg)

SOURCE: BLOOMBERG

Assumptions

Table 15 – QBE European Operations

Y/e December 31 (US$m from 2009)	2008	2009	2010	2011	2012	2013e	2014e	2015e	2016e	2017e
European Operations										
Growth in GWP	-	2%	-18%	16%	5%	-3%	0%	3%	5%	5%
Gross unearned premium movement	5%	2%	4%	4%	4%	5%	5%	5%	5%	5%
Outwards reinsurance / GWP	30%	34%	34%	31%	30%	24%	24%	24%	24%	24%
Loss ratio (net claims expense / NEP)	54%	62%	58%	65%	62%	66%	70%	70%	70%	70%
Expense ratio (expense / NEP)	31%	30%	33%	30%	32%	31%	30%	30%	30%	29%
- Commission ratio	17%	17%	17%	17%	17%	18%	17%	17%	17%	17%
- Underwriting ratio	15%	13%	16%	13%	15%	14%	13%	13%	13%	13%
Return on technical reserves	6%	5%	3%	4%	3%	2%	3%	3%	3%	3%
Growth in NEP	-	0%	-20%	21%	6%	5%	0%	3%	5%	5%
Insurance margin	25%	16%	15%	9%	10%	4%	4%	5%	5%	5%
Underwriting profit	470	282	246	143	179	81	32	30	27	27
Insurance profit	822	508	376	298	327	155	153	168	176	184

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Table 16 – QBE North America

Y/e December 31 (US$m from 2009)	2008	2009	2010	2011	2012	2013e	2014e	2015e	2016e	2017e
North American Operations										
Growth in GWP	-	15%	0%	46%	-13%	-10%	0%	3%	4%	4%
Gross unearned premium movement	-3%	2%	1%	1%	-6%	5%	4%	4%	4%	4%
Outwards reinsurance / GWP	33%	35%	41%	45%	53%	43%	40%	40%	40%	40%
Loss ratio (net claims expense / NEP)	60%	61%	62%	65%	78%	57%	57%	57%	57%	57%
Expense ratio (expense / NEP)	33%	28%	28%	25%	29%	32%	28%	26%	25%	24%
- Commission ratio	19%	14%	12%	7%	6%	6%	6%	5%	5%	5%
- Underwriting ratio	14%	14%	17%	19%	23%	26%	22%	21%	20%	19%
Return on technical reserves	3%	3%	1%	1%	1%	1%	2%	2%	2%	2%
Growth in NEP	-	5%	-7%	34%	-13%	-11%	8%	3%	4%	4%
Insurance margin	12%	15%	14%	11%	-5%	13%	19%	22%	24%	25%
Underwriting profit	198	335	309	378	-237	319	505	605	666	733
Insurance profit	358	479	412	440	-170	413	652	772	846	921

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Table 17 – QBE Australia and New Zealand

Y/e December 31 (US$m from 2009)	2008	2009	2010	2011	2012	2013e	2014e	2015e	2016e	2017e
Australian & NZ Operations										
Growth in GWP	-	20%	6%	21%	11%	-4%	2%	4%	5%	5%
Gross unearned premium movement	4%	5%	0%	3%	4%	4%	3%	3%	3%	3%
Outwards reinsurance / GWP	15%	17%	19%	13%	13%	13%	13%	13%	13%	13%
Loss ratio (net claims expense / NEP)	63%	61%	61%	69%	60%	59%	59%	59%	59%	59%
Expense ratio (expense / NEP)	28%	28%	28%	30%	30%	30%	28%	26%	26%	25%
- Commission ratio	12%	11%	10%	13%	14%	15%	13%	12%	12%	12%
- Underwriting ratio	16%	17%	18%	17%	17%	15%	15%	14%	14%	13%
Return on technical reserves	7%	6%	4%	5%	7%	4%	2%	3%	3%	3%
Growth in NEP	-	16%	10%	24%	9%	-3%	3%	4%	5%	5%
Insurance margin	21%	21%	17%	6%	19%	16%	16%	18%	19%	19%
Underwriting profit	221	303	329	25	388	436	547	633	688	746
Insurance profit	494	587	516	243	779	638	667	771	838	903

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Table 18 – QBE Latin America

Y/e December 31 (US$m from 2009)	2008	2009	2010	2011	2012	2013e	2014e	2015e	2016e	2017e
Latin American Operations										
Growth in GWP				-	59%	26%	12%	10%	10%	8%
Gross unearned premium movement				2%	4%	4%	4%	4%	4%	4%
Outwards reinsurance / GWP				17%	12%	10%	10%	10%	10%	10%
Loss ratio (net claims expense / NEP)				57%	56%	59%	59%	57%	57%	57%
Expense ratio (expense / NEP)				33%	39%	34%	31%	30%	30%	30%
- Commission ratio				19%	22%	20%	18%	17%	17%	17%
- Underwriting ratio				14%	17%	14%	13%	13%	13%	13%
Return on technical reserves				5%	4%	3%	2%	2%	3%	3%
Growth in NEP				-	64%	30%	13%	10%	10%	8%
Insurance margin				16%	12%	11%	13%	16%	16%	16%
Underwriting profit				64	54	86	147	214	236	253
Insurance profit				101	121	140	190	266	295	317

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Table 19 – QBE Asia Pacific

Y/e December 31 (US$m from 2009)	2008	2009	2010	2011	2012	2013e	2014e	2015e	2016e	2017e
Asia Pacific Operations										
Growth in GWP	-	7%	-15%	13%	-15%	26%	5%	6%	6%	6%
Gross unearned premium movement	5%	5%	2%	4%	6%	14%	5%	5%	5%	5%
Outwards reinsurance / GWP	26%	28%	28%	31%	22%	16%	14%	14%	14%	14%
Loss ratio (net claims expense / NEP)	41%	47%	46%	47%	42%	45%	40%	40%	40%	40%
Expense ratio (expense / NEP)	42%	42%	41%	45%	43%	39%	38%	38%	38%	38%
- Commission ratio	21%	21%	20%	23%	23%	21%	20%	20%	20%	20%
- Underwriting ratio	21%	21%	21%	23%	21%	18%	18%	18%	18%	18%
Return on technical reserves	4%	2%	3%	3%	1%	2%	3%	3%	3%	3%
Growth in NEP	-	6%	-12%	5%	-6%	23%	21%	6%	6%	6%
Insurance margin	25%	15%	18%	13%	16%	18%	25%	25%	25%	25%
Underwriting profit	77	57	56	35	59	83	136	145	153	162
Insurance profit	112	71	77	59	66	94	155	167	177	188

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Table 20 – QBE Equator Re

Y/e December 31 (US$m from 2009)	2008	2009	2010	2011	2012	2013e	2014e	2015e	2016e	2017e
Equator Re										
Growth in GWP	-	0%	0%	0%	0%	0%	0%	0%	0%	0%
Gross unearned premium movement	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Growth in reinsurance expense	0%	32%	-4%	45%	2%	-30%	-3%	0%	0%	0%
Loss ratio (net claims expense / NEP)	57%	59%	61%	78%	70%	60%	60%	60%	60%	60%
Expense ratio (expense / NEP)	27%	29%	29%	27%	29%	30%	27%	27%	26%	25%
- Commission ratio	21%	24%	25%	23%	26%	27%	24%	24%	23%	22%
- Underwriting ratio	6%	5%	4%	3%	3%	3%	3%	3%	3%	3%
Return on technical reserves	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Growth in NEP	-	26%	-4%	46%	1%	-30%	-3%	0%	0%	0%
Insurance margin	21%	17%	14%	-2%	4%	12%	15%	15%	16%	17%
Underwriting profit	309	285	228	-151	10	241	306	306	329	352
Insurance profit	397	419	322	-56	139	289	354	354	377	400

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Table 21 – QBE Group outcomes

Y/e December 31 (US$m from 2009)	2008	2009	2010	2011	2012	2013e	2014e	2015e	2016e	2017e
QBE Group										
Growth in GWP	-	10%	-6%	34%	1%	-3%	2%	4%	5%	5%
Gross unearned premium movement	-	32%	-48%	136%	-80%	846%	-22%	4%	5%	5%
Growth in NEP	-	10%	-6%	35%	3%	-6%	4%	4%	5%	5%
Growth in reinsurance expense	-	9%	8%	20%	2%	-13%	-3%	7%	9%	9%
Loss ratio (net claims expense / NEP)	58%	60%	60%	68%	66%	60%	61%	60%	60%	60%
Expense ratio (expense / NEP)	31%	29%	30%	29%	31%	31%	29%	28%	27%	27%
- Commission ratio	17%	16%	15%	15%	16%	16%	15%	14%	14%	14%
- Underwriting ratio	14%	13%	14%	14%	15%	15%	14%	14%	13%	13%
Combined ratio	89%	90%	90%	97%	97%	92%	89%	88%	87%	87%
Return on technical reserves	-	5%	3%	3%	4%	3%	3%	3%	3%	3%
Insurance margin	20%	17%	15%	7%	8%	12%	14%	16%	16%	17%
Underwriting profit	1,275	1,262	1,168	494	453	1,246	1,674	1,934	2,098	2,274
Insurance profit	2,183	2,064	1,703	1,085	1,262	1,730	2,172	2,498	2,709	2,913
Return on equity	20%	19%	13%	7%	7%	9%	12%	13%	13%	13%
PCA multiple (x) (target 1.5-1.8x)	1.71	1.61	1.62	1.51	1.57	1.64	1.79	1.91	2.02	2.13

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Table 22 – Reserves

Y/e December 31 (US$m from 2009)	2008	2009	2010	2011	2012	2013e	2014e	2015e	2016e	2017e
Reserves										
Net outstanding claims liability (claims reserve)	16,161	14,350	15,017	16,984	18,412	17,713	17,962	18,627	19,507	20,406
Reinsurance and other recoveries	5,043	3,683	3,219	3,693	4,377	3,542	3,592	3,725	3,900	4,080
Gross outstanding claims liability on balance sheet	**21,204**	**18,033**	**18,236**	**20,677**	**22,789**	**21,254**	**21,553**	**22,352**	**23,407**	**24,486**
Net Central Estimate	14,962	13,216	13,747	15,783	17,079	16,362	16,592	17,207	18,019	18,850
Risk Margin	1,199	1,134	1,270	1,201	1,333	1,351	1,370	1,421	1,488	1,556
Net outstanding claims liability (claims reserve)	**16,161**	**14,350**	**15,017**	**16,984**	**18,412**	**17,713**	**17,962**	**18,627**	**19,507**	**20,406**
Net Central Estimate	93%	92%	92%	93%	93%	92%	92%	92%	92%	92%
Risk Margin	7%	8%	8%	7%	7%	8%	8%	8%	8%	8%
Net outstanding claims liability (claims reserve)	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**
Net Central Estimate / NEP	135%	109%	121%	103%	108%	110%	108%	108%	108%	108%
Reinsurance and other recoveries / claims reserve	31%	26%	21%	22%	24%	20%	20%	20%	20%	20%

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Operations fact sheet

Summary of operations

Europe:

- Wholesale insurer and reinsurer specialist
- 3rd largest underwriter in London Market including Lloyd's
- Regional GWP market share: Western Europe 0.25%; Central and Eastern Europe 1.2%; UK National 5.0%; London Market ex-Lloyd's 6.0%; and Lloyd's 6.0%
- Lloyd's syndicates 386 (specialist non-marine liability insurer covering property, casualty (professional, employers', public and product liability) and motor) and 2999 (umbrella syndicate comprising four sub-syndicates 566, 1036, 1886 and 5555, with classes of business including reinsurance, marine, non-marine and aviation)
- Operates from 10 UK regional centres and 19 European countries (Belgium, Bulgaria, Czech Republic, Denmark, Estonia, France, Germany, Hungary, Italy, Norway, Romania, Slovakia, Spain, Sweden, Switzerland and Ukraine) through specialist business insurer QBE Insurance (Europe) (professional indemnity, financial and credit, bloodstock, liability, motor and property facultative – i.e. specific risks).

North America:

- 1.5% share of US P&C market
- Focuses on specialist and SME sectors targeting selected commercial, personal and agricultural risks
- Three subsidiaries:
  - Financial Partner Services – Provides mortgage and auto lender-placed insurance (LPI), auto risk mitigation (collateral protection insurance), property tax products (tax servicing solutions) as well as escrow administration and consumer insurance (homeowners); LPI market share is estimated at 33% based on loans serviced
  - QBE NAU Country – Third largest underwriter and manager of multi-peril crop insurance (MPCI) in the US with ~15% market share; covers 84 different crops (52m acres, 93,000 policies) and the business is largely written in the Midwest and California with stop loss limiting probable exposures to net combined ratio of ~103%
  - QBE Farmers Union Insurance –Business lines include auto, home (homeowners and renters), farm and business (including telecommunications insurance across 38 states and DC).

Australia and New Zealand:

- Largely an intermediary business servicing insurance brokers, authorised representatives, CTP agents
- Four components:
  - Intermediary Distribution – Accident and health, aviation, builders warranty, commercial motor and packages, CTP, engineering, farm, home, liability, marine, professional liability, property, surety, trade credit and workers' compensation
  - Corporate Partners and Specialty – Car, CTP, home, landlords, commercial packages, farm and workers' compensation

  - Credit and Surety – Specialist risk area for insurance brokers, banks, trade financiers and accountants
  - Lenders' Mortgage Insurance (LMI) – Provides against borrower default in respect of > 80% LVR full doc loans and 60-80% LVR low doc loans; currently 645,000 insured loans (~35% market share and second largest after Genworth with ~50% market share) with an average loan size of under A$300,000
  - Elders Insurance – Products include farm, business, home/motor/boat, landlords and commercial motor.
- Strategic partners include Steadfast (400+ offices, annual GWP > A$2.5bn), Austbrokers (annual GWP > A$1.2bn), Insurance Advisernet Australia (GWP under management A$1.6bn) and IBNA (annual GWP > A$1bn)
- Share of Australian NEP is around 13% and compares with 31% each for IAG and SUN
- NSW CTP market share is estimated at 17% and this compares with 38% for IAG and 21% for SUN.

Latin America:

- Writes all lines of P&C insurance in seven countries in Latin America: Argentina; Brazil; Colombia; Mexico; Ecuador; Chile; and Puerto Rico.

Asia Pacific:

- Specialist underwriter with its main focus in SE Asia:
  - Hong Kong – Operates through a JV between QBE and China Construction Bank and provides specialist insurance solutions and traditional products for intermediaries and clients in the Hong Kong market
  - Singapore – Provides personal and business products
  - Malaysia – Focuses on business clients and classes are largely specialist in nature including Trade Credit insurance
  - Indonesia – Operations conducted through a JV with PT Pool Advista Indonesia (consulting and investment management services) providing specialist insurance solutions via intermediaries to business, professionals and families.

Group Reinsurance:

- Carried out by QBE Re
- Brings together the Group's global reinsurance capabilities and is involved in three activities:
  - Aggregate management and CAT modelling
  - Managing reinsurance covers
  - Risk pooling for Group operating units through Equator Re, QBE's reinsurance captive; the Bermuda-based captive provides centralised management of excess of loss, proportional reinsurance protection to all operating divisions and additional underwriting capacity, and also reduces Group dependency on external reinsurance markets.

QBE profile

Company description

QBE's roots can be traced back to 1886 when James Burns and Robert Philp established The North Queensland Insurance Company (QI). In 1921, Burns founded Bankers' and Traders' Insurance Company (B&T) with QI being the largest shareholder followed by the owners' trading firm Burns Philp. In 1959, QI and B&T each acquired 40% of The Equitable Probate and General Insurance Company with Burns Philp taking the residual shareholding. QI and B&T then merged in 1973 to form the present day QBE.

QBE's head office is in Sydney and the company employs more than 17,000 people in 48 countries. The underlying business strategy is to maintain operations in all key insurance markets and act as a lead underwriter in selected lines of business. Core to QBE's risk management is its diversification strategy along product and geographic lines.

Investment strategy

Our Buy rating reflects:

1. QBE's focus on continuous risk management under the new leadership to maximise ROE;
2. QBE as an interest rate and currency normalisation play;
3. Productivity upside over the next few years; and
4. Value upside given the significance of the insurer's float in a rising rate environment.

Board and management

Belinda Hutchinson AM (Chairman) – Appointed director in September 1997 and Chairman in July 2010, Ms Hutchinson is a member of the Funding, Audit, Risk and Capital, Investment and Remuneration committees. She is also a director of AGL Energy Limited and St Vincent's Health Australia, and Chancellor of the University of Sydney.

John Neal (Group CEO) – Mr Neal joined QBE in 2003 and was appointed to the current role in August 2012. Prior to this, he was CEO of Global Underwriting Operations and also held several leadership positions in QBE Europe including Chief Underwriting Officer. Mr Neal has over 25 years' experience in the industry and was CEO of Ensign (Lloyd's managing agent) before joining QBE. QBE acquired Ensign in 2003.

Neil Drabsch (Group CFO) – Appointed to the role in 1994, Mr Drabsch joined QBE in 1991 and was previously Group Company Secretary. He is a chartered accountant and has 46 years' experience in insurance and reinsurance management as well as finance and accounting.

Steven Burns (Group CFO designate) – Mr Burns is currently CEO of QBE Europe (appointed 2004) and will succeed Neil Drabsch as Group CFO in February 2014. He is a qualified chartered accountant and was previously the finance and managing director of Limit and its antecedent companies for 14 years. Limit was acquired by QBE in 2000.

SWOT analysis

Strengths

1. Global insurer with top line diversification benefits;
2. Risk management; and

3. Economies of scale in underwriting and reinsurance.

Weaknesses

1. Exposure to hurricane-prone geographies; and
2. Declining Return on Incremental Capital from acquisitions, although we understand this is being addressed.

Opportunities

1. Market power/efficiency gains to underpin growth in Core Australasian markets; and
2. Release of surplus capital in due course.

Threats

1. Significant CAT/claims events;
2. Acquisition and execution risks;
3. Reduced investment income from widening credit spreads; and
4. Increased competition from new on-line players and retailers (e.g. WOW, WES).

Major shareholders – top 20 (source: Thomson)

1. Aberdeen Asset Management (Asia) Ltd. (12.13%)
2. First State Investments (UK) Ltd. (5.78%)
3. Colonial First State Global Asset Management (Core) (3.18%)
4. MLC Investment Management Ltd. (2.13%)
5. Franklin Advisers, Inc. (1.25%)
6. The Vanguard Group, Inc. (1.04%)
7. BlackRock Institutional Trust Company, N.A. (0.87%)
8. Aberdeen Asset Management (Edinburgh) (0.71%)
9. Matthews International Capital Management, LLC. (0.66%)
10. AMP Capital Investors Limited (0.64%)
11. Norges Bank Investment Management (0.62%)
12. GMO LLC (0.60%)
13. Australian Foundation Investment Company Ltd. (0.58%)
14. First State Investments (HK) Ltd. (0.51%)
15. MFS Investment Management (0.43%)
16. BlackRock Investment Management, LLC (0.41%)
17. British Columbia Investment Management Corp. (0.37%)
18. T Rowe Price International (UK) Ltd. (0.29%)
19. TIAA-CREF (0.24%)
20. Ausbil Dexia Ltd. (0.24%)

QBE Insurance Group
as at 15 October 2013

Recommendation	Buy
Price	$14.29
Target (12 months)	$17.10

Table 23 - Financial summary

QBE Insurance Group		**Share Price (A$)**	**14.29**
As at	15-Oct-13	**Market Cap (A$M)**	**17,532**

PROFIT AND LOSS

Y/e December 31 (US$m from 2009)	2011	2012	2013e	2014e	2015e
General Insurance					
Gross written premium (GWP)	18,305	18,434	17,931	18,248	18,988
Less: Gross unearned premium	-465	-93	-880	-684	-711
Less: Reinsurance expense	-2,481	-2,543	-2,214	-2,141	-2,296
Net earned premium (NEP)	**15,359**	**15,798**	**14,837**	**15,423**	**15,981**
Gross claims expense	-10,973	-10,996	-9,135	-9,432	-9,699
Reserve release	507	568	213	100	100
Net claims expense	-10,466	-10,428	-8,922	-9,332	-9,599
Commission expense	-2,291	-2,560	-2,412	-2,249	-2,251
Underwriting expense	-2,108	-2,357	-2,258	-2,169	-2,198
Underwriting profit	**494**	**453**	**1,246**	**1,674**	**1,934**
Investment income on tech. reserves	591	809	484	498	564
Insurance profit	**1,085**	**1,262**	**1,730**	**2,172**	**2,498**
Other	0	0	0	0	0
Associates	6	3	0	0	0
Total divisional result	1,091	1,265	1,730	2,172	2,498
Amortisation and impairment	-133	-407	-342	-342	-342
Interest	-275	-324	-316	-295	-295
Investment income - s'holders' funds	185	407	246	257	305
Other	0	0	0	0	0
Profit before income tax	**868**	**941**	**1,318**	**1,792**	**2,165**
Income tax expense	-149	-161	-256	-394	-498
Discontinued operations (after tax)					
Minority interest	-15	-19	-12	-12	-12
Profit after income tax	**704**	**761**	**1,050**	**1,386**	**1,655**
Amortisation and impairment	87	281	248	267	263
Cash profit after income tax	**791**	**1,042**	**1,298**	**1,652**	**1,919**

CASHFLOW

Y/e December 31 (US$m from 2009)	2011	2012	2013e	2014e	2015e
Cash profit after income tax	791	1,042	1,298	1,652	1,919
Increase in investments	-2,925	-2,987	826	-403	-1,077
Increase in premium receivable	-1,499	-89	384	-84	-188
Increase in other assets	344	-378	-246	-3	-174
Investing cashflow	**-4,080**	**-3,454**	**963**	**-490**	**-1,438**
Increase in unearned premium	1,281	490	-453	152	340
Increase in interest bearing liabilities	1,467	144	-184	0	0
Equity raised	966	1,064	-795	222	268
Other	-634	1,282	-1,114	-614	-245
Financing cashflow	**3,080**	**2,980**	**-2,546**	**-240**	**364**
Net change in cash	-209	568	-285	922	844
Cash at end of period	**1,457**	**2,025**	**1,740**	**2,663**	**3,507**

BALANCE SHEET

Y/e December 31 (US$m from 2009)	2011	2012	2013e	2014e	2015e
Cash and cash equivalents	1,457	2,025	1,740	2,663	3,507
Investments	26,508	29,495	28,669	29,073	30,149
Premium receivable	4,778	4,867	4,483	4,567	4,756
Trade and other receivables	736	365	760	760	760
Reinsurance and other recoveries	3,693	4,377	3,542	3,592	3,725
DAC and DRE	2,432	2,606	3,114	3,067	3,107
Intangible assets and goodwill	6,065	6,068	5,614	5,614	5,614
Other assets	1,068	959	1,138	1,138	1,138
Total assets	**46,737**	**50,762**	**49,060**	**50,473**	**52,755**
Outstanding claims	20,677	22,789	21,254	21,553	22,352
Unearned premium	8,069	8,559	8,106	8,258	8,598
Interest bearing liabilities	4,802	4,946	4,762	4,762	4,762
Other liabilities	2,751	3,051	3,317	3,317	3,317
Total liabilities	**36,299**	**39,345**	**37,439**	**37,890**	**39,029**
Ordinary share capital	8,939	10,002	9,208	9,431	9,699
Treasury shares held in trust	-2	-1	-2	-2	-2
Reserves & other	-1,644	-1,725	-1,531	-1,531	-1,531
Retained profits	3,093	3,082	3,899	4,638	5,514
Minority interests	52	59	47	47	47
Total shareholders' equity	**10,438**	**11,417**	**11,621**	**12,583**	**13,726**
Total sh. equity & liabs.	**46,737**	**50,762**	**49,060**	**50,473**	**52,755**
WANOS - statutory (m)	**1,084**	**1,169**	**1,207**	**1,228**	**1,245**
WANOS - cash (m)	**1,084**	**1,169**	**1,207**	**1,228**	**1,245**
Reserve release as % of NEP	3.3%	3.6%	1.4%	0.6%	0.6%
Reinsurance as % of GWP	13.6%	13.8%	12.3%	11.7%	12.1%
Debt to equity (target <45%)	46%	43%	41%	38%	35%
Cross rate (A$1.00 = US$)	$1.06	$1.03	$0.96	$0.90	$0.85

VALUATION DATA

Y/e December 31 (US$m from 2009)	2011	2012	2013e	2014e	2015e
NPAT (reported)	704	761	1,050	1,386	1,655
EPS (statutory basis) (US cps)	65	65	87	113	133
- Growth	-47%	0%	34%	30%	18%
EPS (cash basis) (US cps)	73	89	108	135	154
- Growth	-43%	22%	21%	25%	15%
P / E ratio (times)	23.4	22.5	15.7	11.4	9.1
P / Book ratio (times)	1.8	1.6	1.4	1.3	1.1
P / NTA ratio (times)	4.3	3.4	2.8	2.3	1.8
Net DPS (A cps)	87	50	51	65	81
Yield	6.1%	3.5%	3.6%	4.6%	5.7%
Franking	14%	32%	100%	100%	100%
Payout (cash)	127%	58%	45%	44%	45%
Effective tax rate	17%	17%	19%	22%	23%

CAPITAL ADEQUACY

Y/e December 31 (US$m from 2009)	2011	2012	2013e	2014e	2015e
Tier 1 capital	5,284	6,657	7,374	8,336	9,479
Tier 2 capital	2,218	2,231	2,160	2,160	2,160
Total capital base	7,502	8,888	9,534	10,496	11,639
Total PCA	4,968	5,663	5,796	5,878	6,095
PCA multiple (x) (target 1.5-1.8x)	1.51	1.57	1.64	1.79	1.91
CET1 / PCA (>60%)	0%	112%	122%	137%	151%
Notional surplus capital (> 1.8x PCA)	**-1,440**	**-1,305**	**-899**	**-84**	**668**
- Per share (US cps)	**-117**	**-106**	**-73**	**-7**	**54**

PROFITABILITY RATIOS

Y/e June 30	2011	2012	2013e	2014e	2015e
Return on assets	1.6%	1.6%	2.1%	2.7%	3.1%
Return on equity	**6.5%**	**6.9%**	**9.3%**	**11.5%**	**12.6%**
Growth in GWP	34.3%	0.7%	-2.7%	1.8%	4.1%
Growth in NEP	35.2%	2.9%	-6.1%	4.0%	3.6%
Loss ratio	68.1%	66.0%	60.1%	60.5%	60.1%
Expense ratio	28.6%	31.1%	31.5%	28.6%	27.8%
- Commission ratio	14.9%	16.2%	16.3%	14.6%	14.1%
- Underwriting ratio	13.7%	14.9%	15.2%	14.1%	13.8%
Combined ratio	**96.8%**	**97.1%**	**91.6%**	**89.1%**	**87.9%**
Insurance margin	**7.1%**	**8.0%**	**11.7%**	**14.1%**	**15.6%**

RESERVES

Y/e December 31 (US$m from 2009)	2011	2012	2013e	2014e	2015e
Net Central Estimate	15,783	17,079	16,362	16,592	17,207
Risk Margin	1,201	1,333	1,351	1,370	1,421
Net outstanding claims liability (claims reserve)	**16,984**	**18,412**	**17,713**	**17,962**	**18,627**
Unearned premium	8,069	8,559	8,106	8,258	8,598
Less: DAC	-2,432	-2,606	-3,114	-3,067	-3,107
Less: Insurance receivables	-4,778	-4,867	-4,483	-4,567	-4,756
Technical reserves	**17,843**	**19,498**	**18,221**	**18,586**	**19,363**

DIVISIONAL

Y/e December 31 (US$m from 2009)	2011	2012	2013e	2014e	2015e
Gross written premium (GWP)					
North American Operations	7,529	6,569	5,944	5,944	6,122
Latin American Operations	768	1,223	1,544	1,729	1,902
European Operations	4,828	5,077	4,943	4,943	5,091
Australian & NZ Operations	4,486	4,987	4,772	4,868	5,062
Asia Pacific Operations	680	578	729	765	811
Equator Re & Other	14	0	0	0	0
Gross written premium (GWP)					
North American Operations	41%	36%	33%	33%	32%
Latin American Operations	4%	7%	9%	9%	10%
European Operations	26%	28%	28%	27%	27%
Australian & NZ Operations	25%	27%	27%	27%	27%
Asia Pacific Operations	4%	3%	4%	4%	4%
Equator Re & Other	0%	0%	0%	0%	0%
Insurance profit					
North American Operations	440	-170	413	652	772
Latin American Operations	101	121	140	190	266
European Operations	298	327	155	153	168
Australian & NZ Operations	243	779	638	667	771
Asia Pacific Operations	59	66	94	155	167
Equator Re & Other	-56	139	289	354	354
Insurance profit					
North American Operations	41%	-13%	24%	30%	31%
Latin American Operations	9%	10%	8%	9%	11%
European Operations	27%	26%	9%	7%	7%
Australian & NZ Operations	22%	62%	37%	31%	31%
Asia Pacific Operations	5%	5%	5%	7%	7%
Equator Re & Other	-5%	11%	17%	16%	14%
EPS (reported basis) (A cps)	**61**	**63**	**91**	**125**	**156**

SOURCE: BELL POTTER SECURITIES ESTIMATES

Recommendation structure

Buy: Expect >15% total return on a 12 month view. For stocks regarded as 'Speculative' a return of >30% is expected.

Hold: Expect total return between -5% and 15% on a 12 month view

Sell: Expect <-5% total return on a 12 month view

Speculative Investments are either start-up enterprises with nil or only prospective operations or recently commenced operations with only forecast cash flows, or companies that have commenced operations or have been in operation for some time but have only forecast cash flows and/or a stressed balance sheet.

Such investments may carry an exceptionally high level of capital risk and volatility of returns.

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ANALYST CERTIFICATION

Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers and were prepared in an independent manner, including with respect to Bell Potter, and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.TS Lim owns 11 shares in QBE.