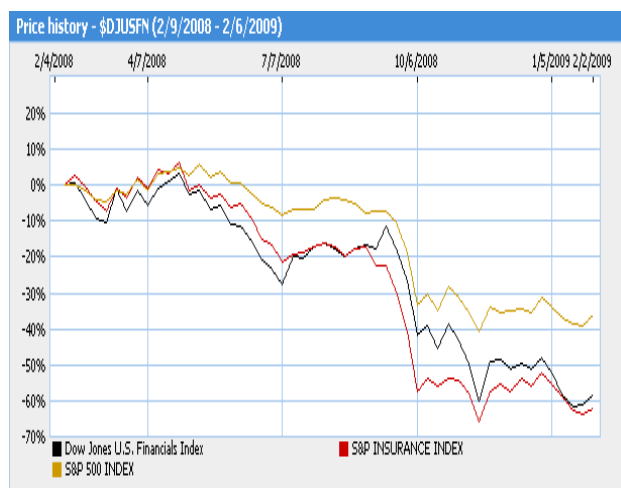




Property and Casualty Insurance (Non-Life)

Anil Ramchandani

anil-ramchandani@uiowa.edu



Key Index Statistics – Property & Casualty

Net Profit Margin (mrq)	5.68
Return on Equity	5.71
Total Debt/Equity	0.26
Payout Ratio	17%
P/E Ratio	11.3
Price/Sales	1.02
Price/Book	1.03

Major Players by Market Cap (B)

BERKSHIRE HATHAWAY	140.05
ALLIANZ ADR	38.81
TRAVELERS COMPANIES Inc	23.97
CHUBB CORP	12.76
ACE Ltd	11.33
ALLSTATE	8.34
LOEWS	8.23
PROGRESSIVE	7.49
FAIRFAX FINANCIAL HOLDING	4.46

INVESTMENT THESIS

Fundamental Outlook on Property & Casualty (P&C) insurance industry remains between neutral to positive because the premium rates are expected to become firm after huge investment losses.

- (+) We expect that generation of excess capital, in addition to low stock prices, would result in huge share repurchases in the future.
- (+) We believe that this excess capital can also lead to acquisitions and industry consolidation. Industry consolidation would increase the economic profits of the participants of the industry and reduce competitive pressures.
- (+) Fed funds rate cuts since September 2007 have steepened the yield curve. This will help in improving investment spreads for P & C insurers and other companies which have spread based products.
- (+) Companies with International operations will have an edge and would enjoy diversification benefits. This means that companies would be unlikely to suffer a huge loss from a single catastrophic event
- (-) However, in a declining rate environment, insurance companies will run the risk of reinvesting proceeds from matured investments at lower yields, reducing margin.
- (-) Exposure is expected to decline because of the current economic environment. For example, a trucking company which had a fleet of 5 trucks would downsize its fleet to 3 due to current economic environment. This would lead to a reduction in business growth and arguably business shrinking.
- (-) The industry was leveraging its capital at less than 1:1 against a historical average of 2:1. This excess capital (or underwriting capacity) of approximately \$250 billion has been eroded to an extent by heavy catastrophes and investment losses. This will exert upward pressure on premium sales.

EXECUTIVE SUMMARY

The US insurance industry was hit hard by the dramatic collapse in equity markets in the second half of 2008. The US property and casualty insurance sector, which accounts for 53.4% of the United States insurance market’s value, saw net income after taxes fall 57.4% to US\$13.9 billion in the first half of 2008, as underwriting and investments fell.

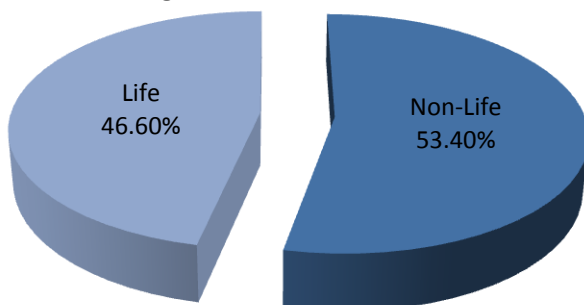
Sharply slower investment income growth, accompanied by the continued slowing of business fundamentals and rising policy surrenders significantly impacted property and casualty insurers in 2008.

However, survivors of this economic downturn would see a benign environment in future5z

INDUSTRY DESCRIPTION

The insurance market consists of the non-life insurance sector and the life insurance sector. The value of the market is shown in terms of gross premium incomes. The life insurance sector consists of mortality protection and annuity. The non-life insurance sector consists of accident and health, and property and casualty insurance segments.

Market segmentation: Life V/s Non-Life



Source: Datamonitor Industry Profile

Lines of insurance	2003		2006		2007	
	Direct premiums written (1)	(%)	Direct premiums written (1)	(%)	Direct premiums written (1)	(%)
Annuities						
Total	\$278,993.5	51.6	\$310,579.2	50.1	\$327,635.1	49.1
Life						
Total	\$140,770.8	26.1	\$166,245.3	26.8	\$184,215.0	27.6
Accident and health						
Total	\$120,576.8	22.3	\$142,863.4	23.1	\$154,840.0	23.2
All other lines	0.0	(2)	0.1	(2)	0.4	(2)
Total, all lines	\$540,341.2	100	\$619,688.0	100	\$666,690.5	100

Source: Datamonitor Industry profile and S&P Industry Report

Insurance is the fifth largest industry in the US, accounting for 29.5% of global premium income of US\$4.06 trillion in 2007, according to reinsurer Swiss Re. There are nearly 4,000 insurance companies in the US offering personal and commercial product lines, including basic life/ health and property/casualty protection, as well as a long list of other coverage ranging from automobile and reinsurance.

The 20 largest life insurance companies accounted for nearly 73% of the industry’s total admitted assets as of year-end 2006. In addition, according to A.M. Best Co., the 10 largest life insurance groups accounted for more than 51% of the industry’s admitted assets as of year-end 2007. The country’s three largest insurance groups — MetLife Inc., Prudential Financial Inc., and American International Group Inc. (AIG) — accounted for more than 24% of total admitted assets. With AIG’s recent demise, we would expect either Hartford Life Group or Manulife Financial Corp. to become the life insurer with the most admitted assets going forward.

In the life insurance sector, traditional life coverage is no longer the primary business of many players. The emphasis has shifted to the underwriting of annuities products, driven by an ageing population and reductions in state social security benefits. The Insurance Information Institute (III) reports that traditional products such as universal life and term life for individuals, as well as group life, remain an important part of the insurance business, as does disability income and health insurance.

The credit market turmoil badly wounded the life and health insurance sector, which had significant investments in corporate equities. The National Association of Insurance Commissioners (NAIC) reported that the realized capital loss incurred by the life and health sector totaled US\$14.8 billion in the first half of 2008. This loss, compared to a US\$2.4 billion realized investment gain in the same period a year earlier, included losses both from the sale of investments and write-downs of badly impaired securities.

The intensely competitive US P&C insurance market is fragmented, with the ten largest P&C insurers controlling nearly 49% of the sector’s total premiums (shown in ‘Markets and Competition’ section of the report), according to the Insurance Services Office (ISO). Premium rates have fallen, as insurance companies compete vigorously for market share. However, due to a significant rise in the combined ratio of companies (average of combined ratio of the companies has risen to 102.1), we believe that rates may not soften further. Measured by premiums written, auto insurance is the largest P&C product line,

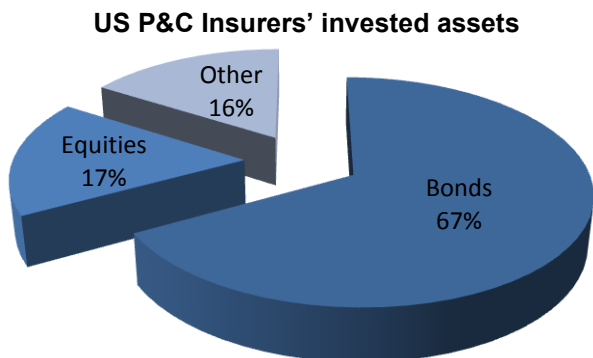
accounting for about one third of total P&C premiums. However, due to a significant fall in auto sales, we believe that auto insurance may lose its share of premiums earned in 2009.

INDUSTRY TRENDS

UNDERWRITING and INVESTMENT LOSSES

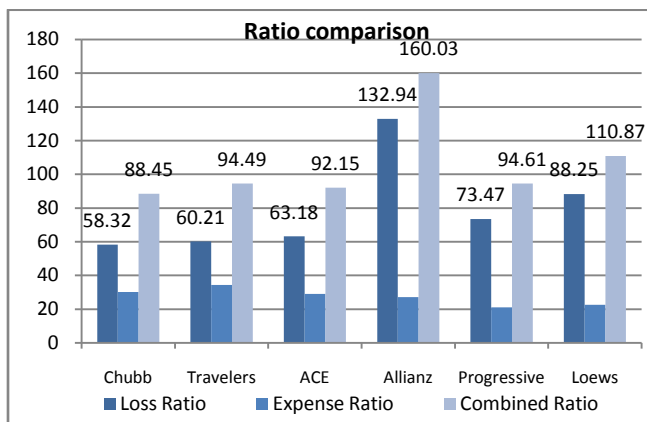
The combination of deteriorating underwriting and investment results that plagued many insurers during most of 2008 could ultimately lead to a firming of premium rates for most lines of coverage, as these losses have removed the so-called “excess” underwriting capacity from the marketplace. However, the impact of these pricing gain (or stabilization) will not emerge until 2009. This means that companies which would survive this downturn would play in a higher rates and fewer competitors environment.

It is particularly positive for companies which have a lower combined ratio in the industry. Any such firming up of rates would give them some additional margin. The list of companies and their combined ratio has been shown in the graph below.



Source: S&P Report on P&C Industry

Insurance Services Office (ISO) and Property Casualty Insurers Association of America (PCI) reported that the P&C sector's investment gains had slipped by 18.4% or US\$5.6 billion to US\$25.8 billion, from US\$30.3 billion in the first half of 2007. Investment gains consist primarily of interest earned from the sector's bond portfolio, as well as realized capital gains and losses from investments, especially stocks. Contributing to the decline was a US\$1.1 billion realized capital loss, compared with a US\$10.4 billion gain in the first half of 2007. Investment Incomes would most likely fall due to a fall in bond yields.



Source: Bloomberg.com

US P&C Insurance First Half 2008 Financial Results

	US\$ Billions
Net Earned Premiums	217.7
Incurred Losses	162.4
Expenses	60.2
Policyholder Dividends	0.7
Net Underwriting Gain (Loss)	-5.6
Investment Income	25.8
Other Items	0.2
Pre-Tax Operating Gain	20.4
Realized Capital Gains (Losses)	-1.1
Pre-Tax Income	19.3
Taxes	5.4
Net Income After Tax	13.9
Surplus (End of Period)	505
Combined Ratio	102.1**

** Includes mortgage and financial guarantee insurers
Source: Insurance Information Institute, based on figures from the Insurance Services Office and the Property Casualty Insurers Association of America

In addition to the ongoing capital markets pressures, insurers have also had the additional (and continuing) challenge of dealing with catastrophe losses. After a lull in 2006 and 2007 following record losses in 2005, catastrophes once again ticked upward in 2008. Forecasters are also calling for an active hurricane season in 2009, citing “above average” activity in the Atlantic.¹ Companies with international operations would be least likely to be affected from a single catastrophe.

TERRORISM

The attacks on the Taj Mahal Hotel and other sites in Mumbai, India, in late November 2008 served to reinforce the notion that terrorism remains a huge threat to property and casualty insurers. Initial estimates from the terrorist attacks peg the insured losses at \$600

¹ Forecast given by Colorado state university (Check reference 1 for website)



million in India, with experts saying this event will likely cause a sharp spike in terrorism coverage. For risks such as acts of terrorism — for which affordable and available coverage is difficult to find — federal support has been instrumental in addressing market dislocations. The Terrorism Risk Insurance Act (TRIA) is the federal terrorism backstop insurance program that was enacted in 2002 in the aftermath of the September 11 terrorist attacks and renewed in 2005. Congress passed another iteration of TRIA in late 2007, with the next expiration scheduled for 2014. Under this act, a company is liable to pay till the deductible level assigned to it. For most of the companies this limit is kept at \$1 billion. For any loss caused by an act of terrorism which is between \$1 and \$100 billion, TRIA would pay for 85% of the losses and affected companies would be liable only for 15% of the losses. Nevertheless, the industry still faces significant coverage gaps for nuclear, biological, and chemical attacks.

ACQUISITIONS

Growing competitive and financial pressures are eroding the ability of some US insurance companies to survive independently, while the declining value of the US dollar has made US insurers an attractive target for international players. In future, large M&A activities may be initiated by firms which are based abroad. Recently on March 2nd, United Insurance Holdings Corp. sent a letter of intent to acquire all of the assets and some of the liabilities of Coral Enterprises LLC². Other companies such as HCC Insurance, State automobile mutual, ACE Ltd., Unitrin, Trinity Universal and Hanover Insurance have recently completed their acquisitions. Such acquisitions would consolidate the industry and we would be able to see that the majority of the industry's market share would be in the hand of few big players.

MARKETS AND COMPETITION

For risk-averse investors, apart from savings, there is no close substitute for insurance. The demand for insurance products remains inelastic, especially in the regions which are susceptible to natural catastrophes and terrorism.

Insurance markets are very competitive due to low entry barriers. Moreover, as majority of the market share is controlled by small number of big firms, the new entrants may find it difficult to place their feet in the market and gain some market share. Their problems have been further complicated because of the current

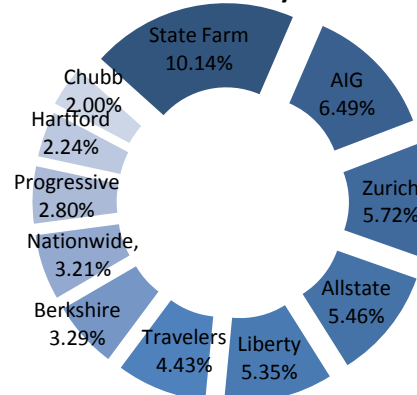
financial crisis since customers would be vary to not to get an insurance from companies which may not exist in near future.

Hence, the insurance industry is going through a phase of consolidation. Consolidation is also being seen as a way to compete against the giants. Companies are also viewing M&A activities as a tool to fight against reducing revenue growth by achieving economies of scale, economies of scope and cost complementarity.

For example, Lincoln National Corp. and Jefferson-Pilot Corp. struck a merger deal worth \$7.6 billion in October 2005. The deal, completed on April 3, 2006, created the fourth largest US life insurer, with \$151.3 billion in assets and allows the combined company to better compete with larger rivals such as MetLife Inc., Manulife Financial Corp., and Prudential Financial Inc. Although there have been no reports or a rumor suggesting that some other company is planning to acquire Chubb, we believe that Chubb's growth potential, its conservative investment strategy, its ability to maintain higher premiums and retain clients, and its strong balance sheet would be attractive for other insurers. Other companies may try to acquire Chubb.

Industry's major players and their market shares have been shown below.

Domestic P&C Industry Market Share



Source: www.naic.org (March 6th, 2009)

We believe that due to a steep decline in investment income and a similar rise in unrealized losses on investments, Insurer's considerable amount of capital may be locked and cannot be reinvested.

Therefore, competitors that are experiencing financial difficulties may offer products at prices and on terms that are not consistent with Industry's economic standards in an effort to maintain their business and get access to capital³. This may expose many of the companies of this industry to risks which will prove harmful to themselves in the long run.

² <http://www.bizjournals.com/tampabay/stories/2009/03/02/daily12.html>

³ Travelers 10-K Report



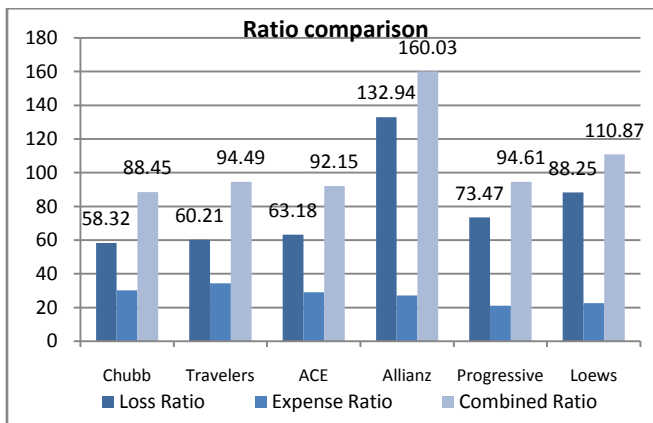
COMPARATIVE ANALYSIS

Among the major players of the property & casualty insurance industry, Travelers and Chubb Corp are the strongest players. These two companies have been producing highest return on assets and equity and have the highest Net profit margin amongst their peers.

Symbol	Company Name	Mkt Cap (Billions)	ROA	ROE	NPM
Property & Casualty					
BRK.A	Berkshire Hathaway	140.05	3	6.52	7.48
AZ	Allianz ADR	38.81	0.5	11.12	5.41
TRV	Travelers Companies Inc	23.97	2.6	11.29	11.95
TKOMY	Tokio Marine Holdings ADR	20.94	0.6	3.65	
CB	Chubb Corp	14.84	4	14.7	14.98
ACE	ACE Ltd	14.61	1.7	7.54	8.78
ALL	Allstate Corp	11.67	-1.2	-9.74	-5.71
L	Loews Corp	10.41			4.38
PGR	Progressive Corp	8.64	0	0.14	0.05
FFH	Fairfax Financial Holdings Ltd	6.16	7.2	41.53	24.61

Source: Moneycentral MSN (www.moneycentral.msn.com)

Generally, net profit margins, return on assets and return on equity of companies consolidate as a firm grows. However, we foresee Chubb maintaining its superior profit margin over next 4-5 years. Our belief is on the back of the company's ability to keep loss ratio and combined ratio under check and its ability to generate superior revenues/employee as shown below.

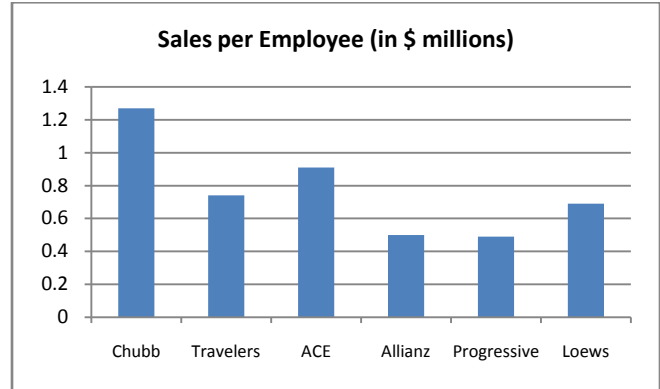


Source: Bloomberg.com

As we can see in the graph above, Chubb has the lowest Loss ratio and combined ratio among its peers in the Property & Casualty industry. This means that Chubb's primary underwriting business is more profitable than its peers. This could be because of their

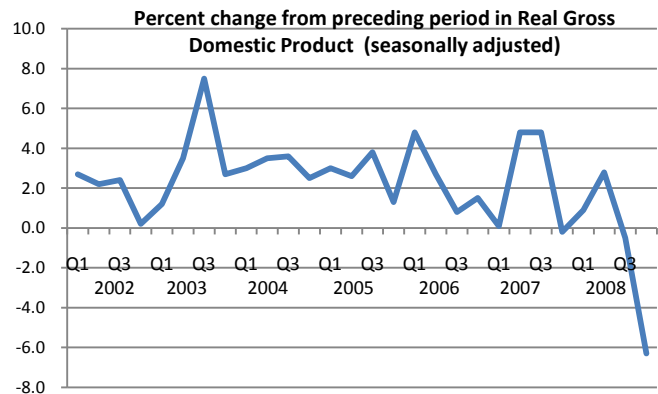
conservative approach and risk aversion, which means that they may be charging higher premiums to ensure that they are not under insured.

Chubb has the most productive employees among its peers as on an average each employee of Chubb contributes \$1.27 million to sales.



Source: Bloomberg.com

ECONOMIC OUTLOOK



Seasonally adjusted real gross domestic product

Source: Using data from the website of Bureau of economic analysis

A slowdown in economy would directly put pressure upon the number of policies sold by P&C Insurers and the number of policy surrenders. GDP contracted by 6.3% in the 4th Quarter of 2008. Such economy forced businesses to reduce the number of vehicles that they were using, sell their commercial properties and lay-off employees. This resulted in a reduction of premiums paid on policies related to Workers' compensation, commercial multi-peril and properties.

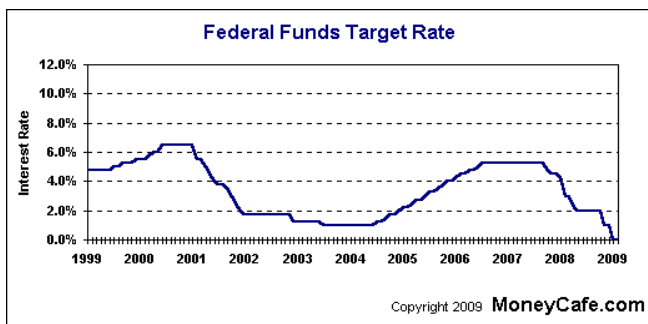
Contracting GDP and economic activity have spurred the unemployment rate. As of March 2009, unemployment rate increased to 8.5% and is expected to peak out at 9.7% within the next 6 months as per the consensus of Henry fund analysts.



Rising unemployment may increase the number of defaults in premium payment and thus bring uncertainty to financial results of the P&C Insurers. However, there may be a steep rise in demand for unemployment insurance policies.



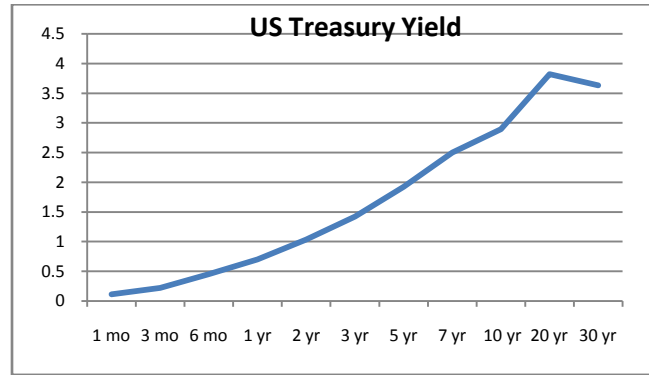
Dramatic fall in housing prices and a deflationary environment would have a negative impact on the industry. If the price of the house falls below the present value of the principal and interest paid by the owner of the house then he may default on such property and surrender his insurance policy. In addition, if the property prices fall below the price for which it has been insured then the owner would have an incentive to destruct his own house and claim the insurance amount. As seen in the graph above, home prices have fallen by 30% from their peak prices. This can be noticed from the fact that Loss ratio of companies has increased in 2008. However, lower prices of houses have lead to an increase in sales and as a result loss ratio may improve in future. We believe that Home sales would improve this year.



Source: Moneycafe.com

On December 16, 2008, the Federal Reserve set the target for fed funds rate to a historical low of 0.00 – 0.25%.

Such a free fall in federal funds rate has pushed short-term yields on US treasuries to almost 0 and has steepened the yield curve.



Source: US Treasury (www.ustreas.gov)

Due to such a rapid fall in federal funds target rates and lower yields on short-term bonds, the insurance prices may rise as now each premium dollar would generate less investment income, especially on short-term fixed income securities. Therefore, most companies would likely increase their premium rates in order to remain profitable. This premium growth would result in an increase in revenues. However, a competitive environment may not allow companies to increase premium rates significantly.

In a period of declining interest rates, growth in net investment income — an important revenue source for a property & casualty insurer — will slow, as yields on insurers' bond portfolios slide. However, lower interest rates also increase the value of the underlying assets (usually fixed-income securities) that produce the investment income. Fed Funds rate are likely to remain in this range for at least next 2-3 quarters.

Companies in this sector have invested most of their assets in short-term bonds (67%). Remaining assets have been invested in equities (17%) and other alternative investments (16%).

Companies with international operations will be negatively impacted by any further revaluation of dollar as it would reduce the underlying value of these assets in dollar terms and thus affect company's profits. With the strengthening of the dollar, companies would have to pay more dollars to settle claims made in other countries. However, it is unlikely that such an appreciation would happen considering the deficits US Government is running in and the huge debt which has been issued by US treasury in the last 6 months. This may lead to hyper-inflation and devaluation of dollar over next 2 years which is positive for companies with international operations. Reduced consumer spending may help dollar in gathering some strength against other currencies.



CATALYSTS FOR GROWTH**REVIVAL OF MARKETS**

Revival of capital markets would not only reduce the unrealized investment losses held by insurance companies but it would also help in building up consumer confidence in the US financial system. It is important for customers to feel confident about the insurance company they are investing in.

INTERNATIONAL EXPANSION

International expansion would help diversifying the industry risk across the globe and a slowdown/recession in developed countries would be partially offset by developing economies. Since 40% of the population resides in just 2 developing countries i.e. India and China, an expansion in Asia-Pacific region may help companies in achieving economies of scale.

INDUSTRY CONSOLIDATION

Such extreme economic environment would lead to industry consolidation which can be helpful for players with high credit ratings as most policy holders are seeking insurers with high credit ratings. Companies with high credit ratings would be able to raise capital at a comparatively cheaper rate than their competitors with lower credit ratings. Therefore, we expect that companies with higher credit ratings will outperform the industry.

DEVALUATION OF DOLLAR

For companies which generate a considerable amount of their revenues from international operations, a fall in the value of dollar would prove to be slightly beneficial. This would increase the premiums earned in terms of dollar. However, on the flip side, an increase in claims would mean that now these companies would have to pay more dollars to settle claims.

INVESTMENT POSITIVES

- Net written premiums are expected to rise by approximately 4-5% for P&C Insurers.
- The survivors of this downturn would get an opportunity to flourish in an environment with higher rates and fewer competitors.
- Companies with lower combined ratio and higher credit ratings would flourish in future due to their ability to compete any fall in premium rates and profit from any increase in the rates.
- Increased M&A activity would help consolidation in the industry and reduce competitive pressures.

- The current environment of steeper yield curve may help in improving investment spreads for P & C insurers and other companies which have spread based products.
- Companies with International operations will have an edge and would enjoy geographical diversification benefits. This means that companies would be unlikely to suffer a huge loss from a single catastrophic event.
- With homeowners' defaults rising, mortgage insurers have found themselves overwhelmed by claims. In May 2008, defaults on privately insured mortgages jumped 48% from a year earlier, according to industry group Mortgage Insurance Companies of America. So, the market has taken a lot of negative news into account and current prices reflect the same.

INVESTMENT NEGATIVES

- Net Investment income is expected to shrink as a percentage of revenues in 2009 due to Fed rate cuts and management's guidance of 2.4% return on non-fixed income assets.
- Exposure is expected to decline because of the current economic environment. For example, a trucking company which had a fleet of 5 trucks would downsize its fleet to 3 due to current economic environment. This would lead to a reduction in business growth and arguably business shrinking.
- Forecasts suggest that 2009 would be an active hurricane season and above average activity is expected in the Atlantic Ocean.¹ P&C Insurers may suffer a huge loss proportionate to damage caused to the properties because of these catastrophes.
- In a declining rate environment, insurance companies run the risk of reinvesting proceeds from matured investments at lower yields, reducing margin.

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