![BELL POTTER]

7 August 2020

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Insurance Australia Group (IAG)

In the twilight zone

Recommendation
Hold (unchanged)
Price
$5.03
Target (12 months)
$5.60 (previously $5.85)

GICS Sector

Insurance

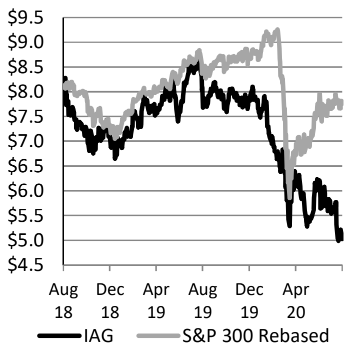
Expected Return	
Capital growth	**11.3%**
Dividend yield	**3.4%**
Total expected return	**14.7%**

Company Data & Ratios	
Enterprise value	**n/m**
Market cap	**$11,625m**
Issued capital	**2,311m**
Free float	**100%**
Avg. daily val. (52wk)	**$53.5m**
12 month price range	**$4.97 - $8.25**

Price Performance

	(1m)	(3m)	(12m)
Price (A$)	5.80	5.48	8.31
Absolute (%)	-13.36	-8.30	-39.53
Rel market (%)	-13.14	-21.20	-30.02

Absolute Price



SOURCE: IRESS

FY20: $279m cash NPAT, no final ordinary dividend

IAG pre-released its FY20 result in a trading update on 24 July. There were thus few surprises in today's disclosures that featured: (1) 1.1% GWP growth adversely impacted by FY19 business exit, lower CTP pricing and modestly negative COVID-19 impact; (2) reserve strengthening in Australian commercial long tail classes; (3) 16.0% underlying margin with the half year decline due to higher reinsurance costs, lower investment returns and some Australian commercial long tail portfolio performance deterioration; (4) cash NPAT of $279m; and (5) cancellation of the FY20 final dividend. Given "heightened uncertainty" in claim development arising from uncertain economic and operating conditions, IAG has guided to "negligible prior period reserve movement" in FY21 and zero reserve releases in the foreseeable future.

Price target lowered to $5.60, Hold rating unchanged

We have lowered medium term GWP growth expectations by 1% given ongoing COVID-19 impacts and have increased claims by 1% as we head into a possible La Niña event (greater incidence of storms, floods, hail, tornado and cyclones). Net of better investment outcomes, changes to our cash NPAT forecasts are: FY21 nil; FY22 -3%; FY23 -5%; and FY24 -5%. IAG's valuation/price target is thus lowered by ~5% to $5.60 and its Hold rating is unchanged. Our conservatism also appears justified given the upcoming test case involving the Insurance Council of Australia and the Australian Financial Complaints Authority in respect of the application of infectious diseases cover within business interruption policies. The test case will seek a court decision on whether a reference to a quarantinable disease under the Australian Quarantine Act 1908 should be construed as a reference to a listed human disease under the Biosecurity Act 2015 in various SME policies containing business interruption cover (as the former Act was repealed/replaced by the latter Act). At the end of the day, this is all about ambiguous policy wordings that could invalidate any exclusion clause.

Earnings Forecast

Year end 30 June	2020	2021e	2022e	2023e
NPAT (reported) (A$m)	435	738	793	845
NPAT (cash) (A$m)	279	774	829	881
EPS (cash) (A¢ps)	12	34	36	38
EPS (cash) growth (%)	-70%	177%	7%	6%
PER (x)	41.5	15.0	14.0	13.2
P/Book (x)	1.8	1.7	1.6	1.5
P/NTA (x)	3.6	3.1	2.8	2.6
Dividend (A¢ps)	10	17	20	23
Yield (%)	2.0%	3.4%	4.0%	4.6%
ROE (cash) (%)	4.6%	11.7%	11.9%	12.0%
Insurance margin (reported) (%)	10.1%	13.7%	14.2%	14.7%
Franking (%)	35.0%	50.0%	60.0%	70.0%

SOURCE: BELL POTTER SECURITIES ESTIMATES

In the twilight zone

FY20: $279m cash NPAT, no final ordinary dividend

IAG pre-released its FY20 result in a trading update on 24 July. As such, there were few surprises in today's disclosures that included the following key items:

1. 1.1% GWP growth vs. 3.1% in FY19, in line with "low single-digit" guidance and adversely impacted by FY19 business exit, lower CTP pricing and a modestly negative COVID-19 impact;
2. 10.1% insurance margin vs. 16.9% in FY19, lower than guidance of 12.5-14.5% due to adverse natural perils (-70bp), prior period reserving (-120bp) from adverse development in Australian long tail reserves and credit spread factors (-70bp) helped in a way by broadly neutral COVID-19 impacts;
3. 16.0% underlying margin comprising 16.9% in 1H20 and 15.1% in 2H20, with the 2H20 decline impacted by higher reinsurance costs, lower investment returns and some Australian commercial long tail portfolio performance deterioration;
4. $23m pre-tax loss from its fee-based business vs. $9m loss in FY19;
5. $181m pre-tax loss on shareholders' funds income, better than April guidance of $280m loss but lower than $227m profit in FY19;
6. $246m pre-tax customer refund provision for multi-year pricing issues (e.g. where discounts were not applied in full in Australia) vs. $150m in 1H20, included in the net corporate expense line;
7. $326m after tax profit on the sale of IAG's 26% interest in SBI General Insurance Company, with the bulk of this profit reflected in the net corporate expense line; and
8. No final dividend with the top end of its 60-80% target cash payout already delivered when the 10¢ interim dividend was paid in March.

Table 1 – Group P&L

Appendix – Group results

GROUP RESULTS	1H19 A$m	2H19 A$m	1H20 A$m	2H20 A$m	FY19 A$m	FY20 A$m
Gross written premium	**5,881**	**6,124**	**5,962**	**6,173**	**12,005**	**12,135**
Gross earned premium	5,984	5,958	6,105	6,059	11,942	12,164
Reinsurance expense	(2,373)	(2,331)	(2,396)	(2,405)	(4,704)	(4,801)
Net earned premium	**3,611**	**3,627**	**3,709**	**3,654**	**7,238**	**7,363**
Net claims expense	(2,358)	(2,261)	(2,433)	(2,577)	(4,619)	(5,010)
Commission expense	(324)	(351)	(337)	(336)	(675)	(673)
Underwriting expense	(535)	(506)	(519)	(565)	(1,041)	(1,084)
Underwriting profit	**394**	**509**	**420**	**176**	**903**	**596**
Investment income on technical reserves	102	219	81	64	321	145
Insurance profit	**496**	**728**	**501**	**240**	**1,224**	**741**
Net corporate expense	5	(9)	(152)	213	(4)	61
Interest	(48)	(46)	(54)	(38)	(94)	(92)
Profit/(loss) from fee-based business	5	(14)	(2)	(21)	(9)	(23)
Share of profit from associates	19	26	29	30	45	59
Investment income on shareholders' funds	(7)	234	50	(231)	227	(181)
Profit before income tax and amortisation	**470**	**919**	**372**	**193**	**1,389**	**565**
Income tax expense	(123)	(240)	(90)	53	(363)	(37)
Profit after income tax (before amortisation)	**347**	**679**	**282**	**246**	**1,026**	**528**
Non-controlling interests	(25)	(73)	20	(79)	(98)	(59)
Profit after income tax and non-controlling interests (before amortisation)	**322**	**606**	**302**	**167**	**928**	**469**
Amortisation and impairment	(29)	(28)	(15)	(15)	(57)	(30)
Profit attributable to IAG shareholders from continuing operations	**293**	**578**	**287**	**152**	**871**	**439**
Net profit/(loss) after tax from discontinued operations	207	(2)	(4)	-	205	(4)
Profit attributable to IAG shareholders	**500**	**576**	**283**	**152**	**1,076**	**435**

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SOURCE: COMPANY DATA

Table 2 – Group KPIs

Appendix – Group ratios and key metrics

Insurance Ratios - Continuing Business	1H19	2H19	1H20	2H20	FY19	FY20
Loss ratio	65.3%	62.3%	65.6%	70.5%	63.8%	68.0%
Immunised loss ratio	64.6%	59.5%	65.6%	68.6%	62.0%	67.1%
Expense ratio	23.8%	23.7%	23.1%	24.7%	23.7%	23.8%
Commission ratio	9.0%	9.7%	9.1%	9.2%	9.3%	9.1%
Administration ratio	14.8%	14.0%	14.0%	15.5%	14.4%	14.7%
Combined ratio	89.1%	86.0%	88.7%	95.2%	87.5%	91.8%
Immunised combined ratio	88.4%	83.2%	88.7%	93.3%	85.7%	90.9%
Reported insurance margin	**13.7%**	**20.1%**	**13.5%**	**6.6%**	**16.9%**	**10.1%**
Underlying insurance margin	**16.2%**	**16.9%**	**16.9%**	**15.1%**	**16.6%**	**16.0%**
Key Financial Metrics (Total Operations)	**1H19**	**2H19**	**1H20**	**2H20**	**FY19**	**FY20**
Cash earnings ($m)	319	612	380	(101)	931	279
Reported ROE (average equity) (% pa)	15.4%	18.4%	9.0%	5.0%	16.7%	7.0%
Cash ROE (average equity) (% pa)	**9.8%**	**19.6%**	**12.1%**	**(3.3%)**	**14.4%**	**4.5%**
Basic EPS (cents)	21.31	24.99	12.28	6.60	46.26	18.87
Diluted EPS (cents)	20.48	24.16	12.16	6.38	44.58	18.49
Cash EPS (cents)	13.60	26.56	16.49	(4.37)	40.04	12.12
Diluted cash EPS (cents)	**13.40**	**25.63**	**15.98**	**(4.37)**	**38.83**	**12.12**
DPS (cents)	**12.00**	**20.00**	**10.00**	**-**	**32.00**	**10.00**
Probability of adequacy	90%	90%	90%	90%	90%	90%
CET1 multiple	**1.18**	**1.31**	**1.15**	**1.23**	**1.31**	**1.23**
PCA multiple	2.00	2.12	1.80	1.97	2.12	1.97

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SOURCE: COMPANY DATA

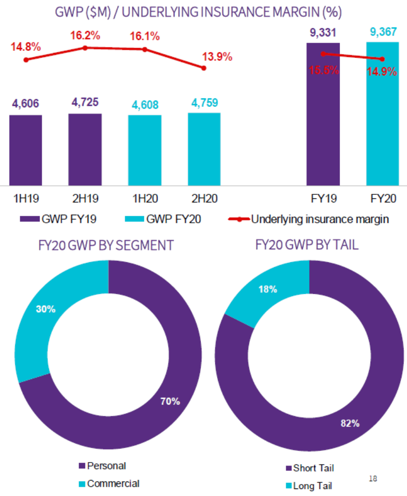
To recap, IAG has provided $100m for potential COVID-19 claim costs. These sit within a wide range and probability weighted to cover business interruption, landlords', other classes as well as the impact of a prolonged economic downturn on long tail claims. The ultimate outcome and adequacy of provisions remain "highly uncertain" at this point in time.

Australian GWP increased by 0.4% pcp to $9.37bn (2H20 GWP +0.7% to $4.76bn). In addition to FY19 business exit and lower CTP pricing effects, Australian GWP growth in 2H20 was impacted by ~$60m from lower pandemic-related new business volumes. Rate-driven growth in short-tail personal lines of 3.2% benefited from volume growth in VIC (although this is likely to slow down in 1H21), better customer retention and rate increases that kept pace with claims inflation. GWP growth in commercial lines was 2.9% lower and was linked to lower volumes between March and May 2020, and this was despite an average rate increase of more than 5% in the SME space. While this rate of reduction improved in 2H20 to -1.4%, operating conditions in commercial long tail portfolios will likely remain challenging heading into FY21 (despite expected rate increases of ~5.5%).

Table 3 – Australia

Appendix – Australia

AUSTRALIA RESULTS	1H19 A$m	2H19 A$m	1H20 A$m	2H20 A$m	FY19 A$m	FY20 A$m
Gross written premium	**4,606**	**4,725**	**4,608**	**4,759**	**9,331**	**9,367**
Gross earned premium	4,698	4,625	4,739	4,677	9,323	9,416
Reinsurance expense	(1,864)	(1,807)	(1,859)	(1,835)	(3,671)	(3,694)
Net earned premium	**2,834**	**2,818**	**2,880**	**2,842**	**5,652**	**5,722**
Net claims expense	(1,943)	(1,821)	(1,940)	(2,141)	(3,764)	(4,081)
Commission expense	(239)	(251)	(245)	(242)	(490)	(487)
Underwriting expense	(437)	(401)	(420)	(440)	(838)	(860)
Underwriting profit	**215**	**345**	**275**	**19**	**560**	**294**
Investment income on technical reserves	89	193	74	52	282	126
Insurance profit	**304**	**538**	**349**	**71**	**842**	**420**
Profit/(loss) from fee-based business	9	(10)	6	(17)	(1)	(11)
Share of profit/(loss) from associates	1	1	-	(1)	2	(1)
Total divisional result	**314**	**529**	**355**	**53**	**843**	**408**
Insurance Ratios	**1H19**	**2H19**	**1H20**	**2H20**	**FY19**	**FY20**
Loss ratio	68.6%	64.6%	67.4%	75.3%	66.6%	71.3%
Immunised loss ratio	67.8%	61.0%	67.3%	72.9%	64.4%	70.1%
Expense ratio	23.8%	23.1%	23.1%	24.0%	23.5%	23.5%
Commission ratio	8.4%	8.9%	8.5%	8.5%	8.7%	8.5%
Administration ratio	15.4%	14.2%	14.6%	15.5%	14.8%	15.0%
Combined ratio	92.4%	87.7%	90.5%	99.3%	90.1%	94.8%
Immunised combined ratio	91.6%	84.1%	90.4%	96.9%	87.9%	93.6%
Reported insurance margin	10.7%	19.1%	12.1%	2.5%	14.9%	7.3%
Underlying insurance margin	14.8%	16.2%	16.1%	13.9%	15.5%	14.9%



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SOURCE: COMPANY DATA

The decline in the Australian underlying margin to 13.9% in 2H20 (vs. 16.1% in 1H20, 19.1% in 2H19 and 14.8% in 1H19) reflected a small net negative COVID-19 impact (largely potential pandemic claims – in terms of travel, landlord's, a bit of business interruption, etc. – and higher quarantine-related operating costs) that more than offset a significant motor frequency benefit of $100m (especially in April and May) as well as poorer commercial long tail contributions and lower running yield on technical reserves. The material decline in its reported margin to only 2.5% in 2H20 (vs. 12.1% in 1H20, 16.2% in 2H19 and 10.7% in 1H19) reflected reserve strengthening, higher peril costs and adverse credit spread effects.

Australian divisional profit decreased by 52% pcp to $408m (2H20 was $53m vs. $529m in 2H19), mainly impacted by higher net claims expense (+8% pcp to $4.08bn, 2H20 was $2.14bn vs. $1.82bn in 2H19) and lower investment income on technical reserves (-55% pcp to $126m, 2H20 was $52m vs. $193m in 2H19).

New Zealand was the better performer in FY20 with GWP growth of ~4% to $2.75bn (2H20 $1.41bn vs. $1.39bn in 2H19) mainly due to strong business growth in excess of 5% (higher volumes in all key commercial classes and higher rates in property and liability) and slightly favourable FX translation offsetting flat consumer GWP (although slightly positive in underlying terms excluding EQC changes). COVID-19 GWP impact of ~$20m was modest.

Adding to overall New Zealand operating resilience was an underlying margin remaining in the high teens (18.3% in 2H20 vs. 18.9% in 1H20, 18.9% in 2H19 and 20.0% in 1H19) and only slightly off due to higher reinsurance costs. The improvement in its reported margin to 21.5% in 2H20 (vs. 18.9% in 1H20, 24.4% in 2H19 and 24.9% in 1H19) reflected a better claims outcome.

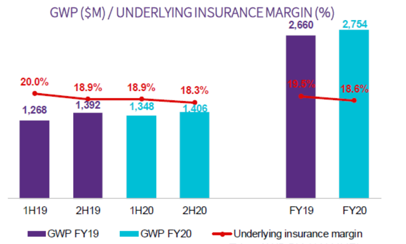
Including favourable FX effects, New Zealand divisional profit decreased by 15% pcp to $330m (2H20 was $174m vs. $197m in 2H19), mainly impacted by higher net claims expense (+9% pcp to $919m, 2H20 was $434m vs. $435m in 2H19) and lower investment income on technical reserves (-47% pcp to $19m, 2H20 was $13m vs. $27m in 2H19).

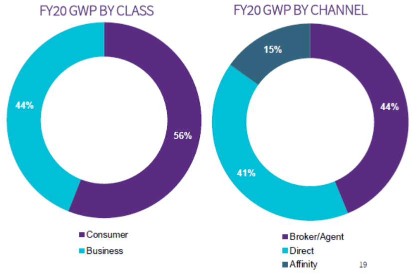
Table 4 – New Zealand

Appendix – New Zealand

NEW ZEALAND RESULTS	1H19 A$m	2H19 A$m	1H20 A$m	2H20 A$m	FY19 A$m	FY20 A$m
Gross written premium	**1,268**	**1,392**	**1,348**	**1,406**	**2,660**	**2,754**
Gross earned premium	1,277	1,327	1,357	1,376	2,604	2,733
Reinsurance expense	(503)	(520)	(533)	(565)	(1,023)	(1,098)
Net earned premium	**774**	**807**	**824**	**811**	**1,581**	**1,635**
Net claims expense	(411)	(435)	(485)	(434)	(846)	(919)
Commission expense	(81)	(98)	(90)	(92)	(179)	(182)
Underwriting expense	(98)	(104)	(99)	(124)	(202)	(223)
Underwriting profit	**184**	**170**	**150**	**161**	**354**	**311**
Investment income on technical reserves	9	27	6	13	36	19
Insurance profit	**193**	**197**	**156**	**174**	**390**	**330**

Insurance Ratios	1H19	2H19	1H20	2H20	FY19	FY20
Loss ratio	53.1%	53.9%	58.9%	53.5%	53.5%	56.2%
Immunised loss ratio	52.7%	53.5%	59.0%	53.0%	53.1%	56.0%
Expense ratio	23.2%	25.0%	22.9%	26.6%	24.1%	24.7%
Commission ratio	10.5%	12.1%	10.9%	11.3%	11.3%	11.1%
Administration ratio	12.7%	12.9%	12.0%	15.3%	12.8%	13.6%
Combined ratio	76.3%	78.9%	81.8%	80.1%	77.6%	80.9%
Immunised combined ratio	75.9%	78.5%	81.9%	79.6%	77.2%	80.7%
Reported insurance margin	24.9%	24.4%	18.9%	21.5%	24.7%	20.2%
Underlying insurance margin	20.0%	18.9%	18.9%	18.3%	19.5%	18.6%





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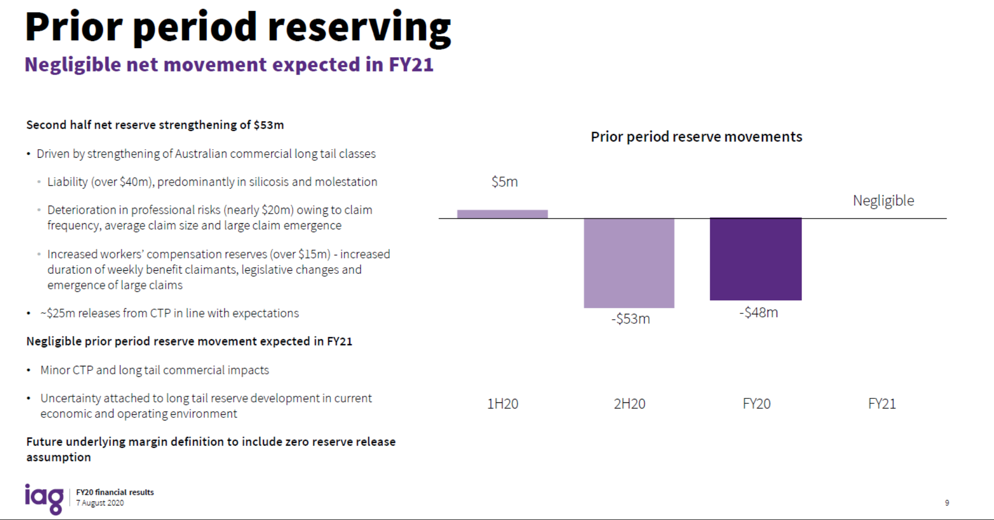
SOURCE: COMPANY DATA

The $53m reserve strengthening in 2H20 (vs. reserve release guidance of 1% NEP and first time since FY08) is due to stronger claim development across Australian long tail classes (>$40m liability largely in the areas of silicosis and molestation, ~$20m professional risk and >$15m workers' compensation net of CTP releases of ~$25m). There remains "heightened uncertainty" in claim development arising from uncertain economic and operating conditions, and IAG has guided to "negligible prior period reserve movement" in FY21. IAG has also guided to zero reserve releases in the foreseeable future when it comes to calculating the underlying margin.

Figure 1 – Don't expect reserve releases any time soon



SOURCE: COMPANY DATA

IAG has increased its gross allowance by ~2.5% to $975m. Post-quota share, this would be ~2.7% higher at $658m. It has also transitioned to a financial year basis (i.e. 12 months to 30 June 2021) for aggregate cover (FY21: $350m cover for qualifying events over $400m) to avoid renewal during the peak period of CAT activity (i.e. the summer months). There is a stop-loss protection with $67m cover for retained events over $742m. For the rest of calendar year 2020, IAG's MER is only $41m post-quota share and $290m cover remains available under its FY20 aggregate program.

Despite the above impacts, capital levels remain very strong with CET1 ratio of 1.23x (vs. the 0.9-1.1x target) and PCA multiple of 1.97x (vs. the 1.4-1.6x target) and these are largely due to the disposal of the SBI interest and a reduction in growth asset exposure. While IAG has reaffirmed its 60-80% dividend payout policy (based on cash earnings that include amortisation and impairment of acquired identifiable intangibles and exclude unusual items).

Price target lowered to $5.60, Hold rating unchanged

We have lowered medium term GWP growth expectations by 1% (given ongoing COVID-19 impacts on personal and commercial volumes) and have increased projected claims by 1% as we head into a possible La Niña event at the end of the calendar year (that tends to be associated with greater incidence of storms, floods, hail, tornado and cyclones). Net of better investment outcomes, changes to our cash NPAT forecasts are: FY21 nil; FY22 -3%; FY23 -5%; and FY24 -5% (Table 7, next page). IAG's valuation/price target is thus lowered by ~5% to $5.60 and its Hold rating is unchanged.

Table 5 – Composite valuation

Composite Valuation	Value ($m)	Per share	Weighting	Composite value per share
DCF	12,502	$5.41	40%	$2.16
Float plus equity valuation	8,965	$3.88	20%	$0.78
ROE (sustainable)	11,981	$5.18	20%	$1.04
Sum-of-Parts	10,141	$4.39	20%	$0.88
Surplus capital (plus 50% of AmGeneral)	1,670	$0.72		$0.72
Total				**$5.58**

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Table 6 – SOP valuation

SOP	FY22e NPAT	Pros. PE (times)	Value ($m)	Per share
Australia	457	12.5	5,715	$2.47
New Zealand	283	12.5	3,539	$1.53
United Kingdom	0	0.0	0	$0.00
Asia	28	10.0	280	$0.12
Other	61	10.0	608	$0.26
Total	**829**	**12.2**	**10,141**	**$4.39**

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Our conservatism also appears justified given the upcoming test case involving the Insurance Council of Australia and the Australian Financial Complaints Authority in respect of the application of infectious diseases cover within business interruption policies. The test case will seek a court decision on whether a reference to a quarantinable disease under the Australian Quarantine Act 1908 should be construed as a reference to a listed human disease under the Biosecurity Act 2015 in various SME policies containing business interruption cover (as the former Act was repealed/replaced by the latter Act).

At the end of the day, this is all about ambiguous policy wordings that could invalidate any exclusion clause.

Table 7 – Estimate changes

Insurance Australia Group	FY21e			FY22e			FY23e			FY24e		
Y/e June 30 ($m)	Current	Previous	Change	Current	Previous	Change	Current	Previous	Change	Current	Previous	Change
Gross written premium (GWP)	12,142	12,205	-1%	12,293	12,318	0%	12,417	12,468	0%	12,603	12,655	0%
Less: Gross unearned premium	29	-26	-191%	29	-28	-197%	29	-28	-198%	29	-29	-198%
Less: Reinsurance expense	-4,825	-4,779	-1%	-4,885	-4,822	-1%	-4,934	-4,881	-1%	-5,008	-4,955	-1%
Net earned premium (NEP)	7,346	7,400	-1%	7,436	7,467	0%	7,511	7,559	-1%	7,624	7,672	-1%
Gross claims expense	-4,772	-4,798	1%	-4,827	-4,841	0%	-4,875	-4,899	0%	-4,948	-4,972	0%
Reserve release	0	70	-100%	0	70	-100%	0	70	-100%	0	70	-100%
Net claims expense	-4,772	-4,729	-1%	-4,827	-4,772	-1%	-4,875	-4,829	-1%	-4,948	-4,902	-1%
Commission expense	-663	-662	0%	-671	-667	-1%	-676	-674	0%	-684	-682	0%
Underwriting expense	-1,020	-1,018	0%	-1,024	-1,020	0%	-1,027	-1,025	0%	-1,035	-1,032	0%
Underwriting profit	**891**	**990**	**-10%**	**915**	**1,009**	**-9%**	**933**	**1,032**	**-10%**	**957**	**1,055**	**-9%**
Investment income on tech. reserves	118	65	80%	143	113	26%	167	161	4%	194	212	-9%
Insurance profit	**1,009**	**1,055**	**-4%**	**1,058**	**1,122**	**-6%**	**1,101**	**1,193**	**-8%**	**1,151**	**1,267**	**-9%**
Other	0	0		0	0		0	0		0	0	
Associates	40	40		40	40		40	40		40	40	
Total divisional result	1,049	1,095	-4%	1,098	1,162	-6%	1,141	1,233	-7%	1,191	1,307	-9%
Net corporate expense	-8	-8	n/m	-8	-8	n/m	-8	-8	n/m	-8	-8	n/m
Interest	-61	-76	-20%	-61	-76	-20%	-61	-76	-20%	-61	-76	-20%
Investment income - s'holders' funds	87	56	57%	111	98	13%	136	124	10%	163	127	29%
Other	-4	-4		-4	-4		-4	-4		-4	-4	
Profit before tax and amortisation	1,063	1,063	0%	1,136	1,172	-3%	1,204	1,269	-5%	1,281	1,346	-5%
Income tax expense	-255	-255	0%	-273	-281	3%	-289	-304	5%	-307	-323	5%
Minority interest	-40	-40	0%	-40	-40	0%	-40	-40	0%	-40	-40	0%
Profit after tax b4 amortisation	**768**	**768**	**0%**	**823**	**851**	**-3%**	**875**	**924**	**-5%**	**933**	**983**	**-5%**
NPAT (cash basis)	**774**	**774**	**0%**	**829**	**857**	**-3%**	**881**	**930**	**-5%**	**939**	**989**	**-5%**
DPS (cps)	17	22	-23%	20	25	-20%	23	27	-15%	26	29	-10%
EPS (cash basis) (cps)	34	33	0%	36	37	-3%	38	40	-5%	41	43	-5%
ROE	11.7%	12.0%	-0.3%	11.9%	12.7%	-0.8%	12.0%	13.2%	-1.2%	12.2%	13.5%	-1.2%
Effective tax rate	**24.0%**	**24.0%**	**0.0%**	**24.0%**	**24.0%**	**0.0%**	**24.0%**	**24.0%**	**0.0%**	**24.0%**	**24.0%**	**0.0%**
Loss ratio	65.0%	63.9%	-1.1%	64.9%	63.9%	-1.0%	64.9%	63.9%	-1.0%	64.9%	63.9%	-1.0%
COR	87.9%	86.6%	-1.2%	87.7%	86.5%	-1.2%	87.6%	86.4%	-1.2%	87.5%	86.2%	-1.2%
Insurance margin	**13.7%**	**14.3%**	**-0.5%**	**14.2%**	**15.0%**	**-0.8%**	**14.7%**	**15.8%**	**-1.1%**	**15.1%**	**16.5%**	**-1.4%**
GWP growth	0.1%	0.6%	-0.5%	1.2%	0.9%	0.3%	1.0%	1.2%	-0.2%	1.5%	1.5%	0.0%
Reserve release as % of NEP	0.0%	0.9%	-0.9%	0.0%	0.9%	-0.9%	0.0%	0.9%	-0.9%	0.0%	0.9%	-0.9%

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Insurance Australia Group

Company description

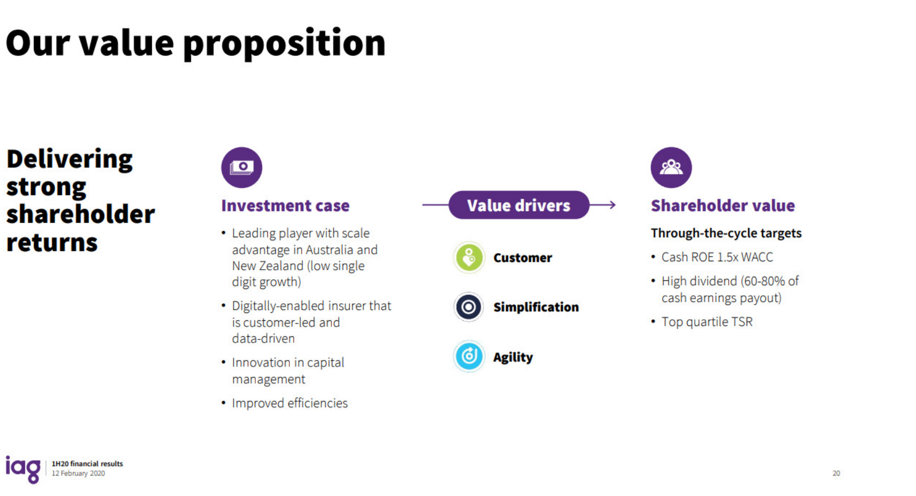
IAG is the parent company of a general insurance group with operations in Australia and New Zealand. Its businesses underwrite over $12bn GWP per annum, selling insurance under many leading brands, including NRMA Insurance, CGU, SGIO, SGIC, Swann Insurance, WFI and Lumley Insurance. While IAG's direct heritage dates back to 1925 when the National Roads and Motorists' Association (NRMA) started providing insurance to its members in NSW and the ACT through the CGU business, the insurer has been providing insurance services in Australia for almost 160 years. IAG has key relationships with Berkshire Hathaway, NRMA, RACV, Coles and AmBank.

Investment strategy

Our current rating reflects the following:

- Strategic relationship with Berkshire Hathaway (3.7% strategic investment plus 10-year 20% quota share);
- Additional 12.5% whole-of-account quota share with Munich Re (on top of 30% CTP quota share), Swiss Re and Hannover Re;
- Almost a third of the business now immunised from earnings volatility;
- Scale (as part of an Australian insurance duopoly in an underinsured market);
- Relative size of its float that is leveraged to equity market rebound;
- Above peer average margin and ROE; and
- Strong capital position.

Figure 2 – Sustainable ROE at least 13-14% based on 9-10% WACC



SOURCE: COMPANY DATA

Board and management

Elizabeth Bryan (Chairman) – Elizabeth was appointed Chairman in March 2016 and is currently chairman of Insurance Manufacturers Australia Pty Limited and Virgin Australia Group.

Peter Harmer (Managing Director and CEO) – Appointed to the current role in November 2015, Peter was previously Chief Executive of IAG Labs division (digital and innovation) and Chief Digital Officer and prior to that was Chief Executive of the Commercial Insurance division. Before joining IAG, he was CEO of Aon Limited UK and spent seven years as CEO of Aon's Australian operations. Peter has over 35 years' experience in the insurance industry including senior roles in underwriting, reinsurance broking and commercial insurance broking.

Valuation

The price target is closely aligned to the composite valuation as follows.

Table 8 – Composite valuation

Composite Valuation	Value ($m)	Per share	Weighting	Composite value per share
DCF	12,502	$5.41	40%	$2.16
Float plus equity valuation	8,965	$3.88	20%	$0.78
ROE (sustainable)	11,981	$5.18	20%	$1.04
Sum-of-Parts	10,141	$4.39	20%	$0.88
Surplus capital (plus 50% of AmGeneral)	1,670	$0.72		$0.72
Total				**$5.58**

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Table 9 – SOP valuation

SOP	FY22e NPAT	Pros. PE (times)	Value ($m)	Per share
Australia	457	12.5	5,715	$2.47
New Zealand	283	12.5	3,539	$1.53
United Kingdom	0	0.0	0	$0.00
Asia	28	10.0	280	$0.12
Other	61	10.0	608	$0.26
Total	**829**	**12.2**	**10,141**	**$4.39**

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

SWOT analysis

Strengths

1. Berkshire Hathaway as a strategic investor;
2. General insurance scale and iconic brands (brand loyalty); and
3. Capital efficiency.

Weaknesses

1. Sub-scale in Asia (being addressed in the current strategic review).

Opportunities

1. Market power/efficiency gains to underpin growth in Core Australasian markets; and
2. Release of surplus capital from sale of Asian investments.

Threats

1. Significant east coast and New Zealand CAT/claims events;
2. Reduced investment income from widening credit spreads;
3. Increased competition from new on-line players and retailers (e.g. Auto & General, Youi, Aldi, Woolworths, Coles, etc.); and
4. Government interference over pricing and FNQ insurance coverage.

Insurance Australia Group

as at 7 August 2020

Recommendation	Hold
Price	$5.03
Target (12 months)	$5.60

Table 10 – Financial summary

Insurance Australia Group		Share Price (A$)	5.03
As at	7-Aug-20	Market Cap (A$M)	11,625

PROFIT AND LOSS					
Y/e June 30 ($m)	**2019**	**2020**	**2021e**	**2022e**	**2023e**
General Insurance					
Gross written premium (GWP)	**12,005**	**12,135**	**12,142**	**12,293**	**12,417**
Less: Gross unearned premium	-63	29	29	29	29
Less: Reinsurance expense	-4,704	-4,801	-4,825	-4,885	-4,934
Net earned premium (NEP)	**7,238**	**7,363**	**7,346**	**7,436**	**7,511**
Gross claims expense	-4,745	-4,962	-4,772	-4,827	-4,875
Reserve release	126	-48	0	0	0
Net claims expense	-4,619	-5,010	-4,772	-4,827	-4,875
Commission expense	-675	-673	-663	-671	-676
Underwriting expense	-1,041	-1,084	-1,020	-1,024	-1,027
Underwriting profit	**903**	**596**	**891**	**915**	**933**
Investment income on tech. reserves	321	145	118	143	167
Insurance profit	**1,224**	**741**	**1,009**	**1,058**	**1,101**
Other	0	0	0	0	0
Associates	45	59	40	40	40
Total divisional result	1,269	800	1,049	1,098	1,141
Net corporate expense	-4	61	-8	-8	-8
Interest	-94	-92	-61	-61	-61
Investment income - s'holders' funds	227	-181	87	111	136
Other	-9	-23	-4	-4	-4
Profit before tax and amortisation	**1,389**	**565**	**1,063**	**1,136**	**1,204**
Income tax expense	-363	-37	-255	-273	-289
Discontinued operations (after tax)	205	-4	0	0	0
Minority interest	-98	-59	-40	-40	-40
Profit after tax b4 amortisation	**1,133**	**465**	**768**	**823**	**875**
Amortisation and impairment	-57	-30	-30	-30	-30
Profit/(loss) attrib. to shareholders	**1,076**	**435**	**738**	**793**	**845**

CASHFLOW					
Y/e June 30 ($m)	**2019**	**2020**	**2021e**	**2022e**	**2023e**
Profit/(loss) attrib. to shareholders	1,076	435	738	793	845
Increase in investments	323	584	-896	-438	-416
Increase in premium receivable	-195	21	6	-47	-42
Increase in other assets	357	-1,110	362	-88	-80
Investing cashflow	**485**	**-505**	**-528**	**-573**	**-538**
Increase in unearned premium	117	-58	-10	78	71
Increase in interest bearing liabilities	120	-554	0	0	0
Ordinary equity raised	0	0	0	0	0
Other	-1,708	549	-200	-298	-378
Financing cashflow	**-1,471**	**-63**	**-210**	**-220**	**-307**
Net change in cash	90	-133	0	0	0
Cash at end of period	**538**	**405**	**405**	**405**	**405**

BALANCE SHEET					
Y/e June 30 ($m)	**2019**	**2020**	**2021e**	**2022e**	**2023e**
Cash and cash equivalents	538	405	405	405	405
Investments	10,684	10,100	10,996	11,435	11,850
Premium receivable	3,784	3,763	3,757	3,804	3,846
Trade and other receivables	386	656	656	656	656
Reinsurance and other recoveries	5,779	6,069	6,067	6,141	6,209
DAC and DRE	3,451	3,501	3,141	3,154	3,166
Intangible assets and goodwill	3,098	3,134	3,134	3,134	3,134
Other assets	1,566	2,066	2,066	2,066	2,066
Total assets	**29,286**	**29,694**	**30,222**	**30,795**	**31,333**
Outstanding claims	10,296	10,584	10,580	10,710	10,829
Unearned premium	6,334	6,276	6,266	6,344	6,415
Interest bearing liabilities	2,080	1,526	1,526	1,526	1,526
Other liabilities	3,866	4,954	4,954	4,954	4,954
Total liabilities	**22,576**	**23,340**	**23,326**	**23,534**	**23,723**
Ordinary share capital	6,617	6,617	6,617	6,617	6,617
Treasury shares held in trust	-48	-49	-49	-49	-49
Reserves	46	30	30	30	30
Retained profits	-211	-521	21	386	734
Minority interests	306	277	277	277	277
Total shareholders' equity	**6,710**	**6,354**	**6,896**	**7,261**	**7,609**
Total sh. equity & liabs.	**29,286**	**29,694**	**30,222**	**30,795**	**31,333**
WANOS - statutory (m)	**2,326**	**2,305**	**2,311**	**2,311**	**2,311**
WANOS - cash (m)	**2,326**	**2,305**	**2,311**	**2,311**	**2,311**
Reserve release as % of NEP	**1.7%**	**-0.7%**	**0.0%**	**0.0%**	**0.0%**
Reinsurance expense as % of GEP	**39.4%**	**39.5%**	**39.6%**	**39.6%**	**39.6%**
Effective tax rate	**26%**	**7%**	**24%**	**24%**	**24%**
Underlying margin	**16.6%**	**16.0%**	**14.7%**	**15.2%**	**15.7%**
Gross operating costs	**2,247**	**2,290**	**2,226**	**2,230**	**2,233**

VALUATION DATA					
Y/e June 30 ($m)	**2019**	**2020**	**2021e**	**2022e**	**2023e**
NPAT (cash basis)	**931**	**279**	**774**	**829**	**881**
EPS (statutory basis) (cps)	46	19	32	34	37
- Growth	18%	-59%	69%	7%	7%
EPS (cash basis) (cps)	40	12	34	36	38
- Growth	-9%	-70%	177%	7%	6%
P / E ratio (times)	12.6	41.5	15.0	14.0	13.2
P / Book ratio (times)	1.7	1.8	1.7	1.6	1.5
P / NTA ratio (times)	3.2	3.6	3.1	2.8	2.6
Net DPS (cps)	32	10	17	20	23
Yield	6.4%	2.0%	3.4%	4.0%	4.6%
Franking	85%	35%	50%	60%	70%
Payout (cash) (target 60-80%)	80%	83%	51%	56%	60%
Effective tax rate	26%	7%	24%	24%	24%

CAPITAL ADEQUACY					
Y/e June 30 ($m)	**2019**	**2020**	**2021e**	**2022e**	**2023e**
CET1 capital	3,082	2,567	3,085	3,456	3,809
Total Tier 1 capital	3,651	2,971	3,489	3,860	4,213
Total capital base	4,981	4,098	4,616	4,987	5,340
CET1 multiple (x) (target 0.9-1.1x)	**1.31**	**1.23**	**1.48**	**1.65**	**1.81**
PCA multiple (x) (target 1.4-1.6x)	**2.12**	**1.97**	**2.22**	**2.38**	**2.54**
Not'l surplus capital (CET1 based >1.0x)	728	485	1,003	1,362	1,704
- Per share (cps)	32	21	43	59	74
Not'l surplus capital (PCA based >1.6x)	1,215	767	1,285	1,636	1,972
- Per share (cps)	53	33	56	71	85

PROFITABILITY RATIOS					
Y/e June 30	**2019**	**2020**	**2021e**	**2022e**	**2023e**
Return on assets	3.2%	1.0%	2.6%	2.7%	2.8%
Return on equity	**14.5%**	**4.6%**	**11.7%**	**11.9%**	**12.0%**
Growth in GWP	3.1%	1.1%	0.1%	1.2%	1.0%
Growth in NEP	-5.6%	1.7%	-0.2%	1.2%	1.0%
Loss ratio	63.8%	68.0%	65.0%	64.9%	64.9%
Expense ratio	23.7%	23.9%	22.9%	22.8%	22.7%
- Commission ratio	9.3%	9.1%	9.0%	9.0%	9.0%
- Administration ratio	14.4%	14.7%	13.9%	13.8%	13.7%
Combined ratio	**87.5%**	**91.9%**	**87.9%**	**87.7%**	**87.6%**
Insurance margin	**16.9%**	**10.1%**	**13.7%**	**14.2%**	**14.7%**

RESERVES					
Y/e June 30 ($m)	**2019**	**2020**	**2021e**	**2022e**	**2023e**
Net Central Estimate	3,799	3,778	3,777	3,823	3,865
Risk Margin	718	737	737	746	754
Net outstanding claims liability (claims reserve)	**4,517**	**4,515**	**4,513**	**4,569**	**4,619**
Unearned premium	6,334	6,276	6,266	6,344	6,415
Less: DAC & other	-1,067	-1,239	-1,112	-1,116	-1,120
Less: Insurance receivables	-3,784	-3,763	-3,757	-3,804	-3,846
Technical reserves	**6,000**	**5,789**	**5,911**	**5,993**	**6,068**

DIVISIONAL					
Y/e June 30 ($m)	**2019**	**2020**	**2021e**	**2022e**	**2023e**
Gross written premium (GWP)					
Australia	9,331	9,367	9,414	9,484	9,579
New Zealand	2,660	2,754	2,728	2,808	2,837
United Kingdom	0	0	0	0	0
Asia	0	0	0	0	0
Other	14	14	0	0	0
Gross written premium (GWP)					
Australia	78%	77%	78%	77%	77%
New Zealand	22%	23%	22%	23%	23%
United Kingdom	0%	0%	0%	0%	0%
Asia	0%	0%	0%	0%	0%
Other	0%	0%	0%	0%	0%
Insurance profit					
Australia	842	420	620	653	689
New Zealand	390	330	390	404	412
United Kingdom	0	0	0	0	0
Asia	0	0	0	0	0
Other	-8	-9	0	0	0
Insurance profit					
Australia	69%	57%	61%	62%	63%
New Zealand	32%	45%	39%	38%	37%
United Kingdom	0%	0%	0%	0%	0%
Asia	0%	0%	0%	0%	0%
Other	-1%	-1%	0%	0%	0%

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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T S Lim, authoring analyst, holds a long position in IAG.

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