

# Cliff edge or knife edge?

Insurance sector

July 2010



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# Insurance

## Cliff edge or knife edge?

This report covers the 10 specialist underwriters ('the Lloyd's insurers') quoted in the UK. The very nature of their business, particularly in areas like catastrophe reinsurance, is inevitably volatile and it is also cyclical, although maybe less so than in the past. The cycle is in a softening phase which combined with persistently low investment returns has the potential to drastically reduce sector profitability. However, paradoxically, in this sector a lot of pain is good, reducing capital and instilling greater discipline in pricing. In this environment we expect near-term profitability to be much weaker than in recent years, but to remain solidly positive in the absence of a major industry loss event. This is why we think the sector is on a knife edge and not at the edge of the cliff.

### Softer pricing

High levels of capital in the industry suggest more widespread pricing weakness from here, but there is evidence that the cycle is now more muted.

### Low investment returns are biting

Persistently low investment returns are having a material impact on sector profitability.

### Much is discounted in valuations

We think the sector offers a combination of attractive fundamental value but poor immediate prospects and further downwards adjustment in the market's consensus expectations. In our view, it is too early to be generally positive on the sector, but a major loss event could change the situation quickly. The sector is also relatively uncorrelated with the broader equity market which may influence investor decision making.

### One sector, very different businesses

The companies covered by this report are very different, in terms of scale, geographical reach, the types of insurance they write, and business structures. In the Company Profile section we consider what actions management can take to mitigate the weaker pricing and investment environment.

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#### Companies in this report

Amlin  
Beazley  
Brit Insurance Holdings  
Catlin Group  
Chaucer Holdings  
Hardy Underwriting Bermuda  
Hiscox  
Lancashire Holdings  
Novae Group  
Omega Insurance Holdings

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## Investment summary: Cliff edge or knife edge?

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### Soft cycle

The rate cycle has been unusually firm for some time, particularly in US catastrophe reinsurance, suggesting that widespread use of disciplined pricing models has reduced cyclicality. High levels of capital in the industry suggest more widespread pricing weakness to come. We are wary of further recession related losses emerging and that reserve releases from good years are masking recent weaker recent trends in some areas of casualty insurance.

### Low investment returns

The sharp decline in investment returns will be fully felt this year, having been masked by recovering asset values and narrowing corporate bond spreads last year. We estimate that lower investment returns negatively impact the pre-tax return on equity (ROE) of the sector by around 9%.

### Fundamental value

We estimate that the insurance sector is trading at an average 0.95x 2010 net tangible assets (NTA), not far off major historical lows. We do not think that sector profitability is going 'over the cliff' with significant premium rate weakness, low investment returns and emerging reserve inadequacy combining to create value destroying losses. Rather, we expect these influences to be more muted, lowering profitability from very high levels to acceptable levels for a weak point in the cycle. This leaves the sector on a 'knife edge'; profitability could easily become weaker than we envisage, but a major industry loss event could quickly turn pricing.

### Diverse sector

We consider that scale and diversification offer attractive benefits for capital efficiency and sustainable returns. Amlin, Hiscox, and Catlin stand out in this regard. Lancashire is more focused and nimble and combines successful risk selection with very active capital management to generate strong returns. For others, the market environment may slow development, but we consider what each company is likely to do to maximise returns. We expect capital management benefits at Novae and maybe Omega. Brit is focused on underwriting improvement. We think the market too harsh on Hardy's loss experience this year.

## First half results

### Exhibit 1: Investment gearing

	Total return %				Total return relative to FTSE All Share			
	1 month	3 months	6 months	12 months	1 month	3 months	6 months	12 months
Amlin	8.9	8.3	11.6	39.5	10.5	17.4	11.2	14.6
Beazley	(1.1)	6.0	17.3	22.9	0.3	15.0	16.9	0.9
Brit	(4.8)	17.6	23.1	19.8	(3.3)	27.5	22.7	(1.6)
Catlin	3.8	2.8	19.5	31.3	5.3	11.5	19.1	7.8
Chaucer	7.0	(5.0)	3.7	14.3	8.6	3.0	3.3	(6.1)
Hardy	(2.2)	(15.3)	(12.9)	(10.1)	(0.7)	(8.2)	(13.2)	(26.2)
Hiscox	(0.9)	1.4	8.4	23.1	0.5	9.9	8.0	1.1
Lancashire	7.2	12.1	22.5	48.9	8.8	21.6	22.1	22.3
Novae	2.9	2.9	5.0	(1.7)	4.4	11.6	4.6	(19.2)
Omega	(3.0)	(7.1)	(14.0)	(17.0)	(1.5)	0.7	(14.3)	(31.9)
FTSE All Share	(1.5)	(7.8)	0.4	21.8	N/A	N/A	N/A	N/A

Source: Company data, Edison Investment Research

### Good first half share price performance

The sector has performed well in to date in 2010. A lack of correlation with the wider equity market continues and the early June approach to Brit Insurance by Apollo was helpful.

### Despite heavy catastrophe losses

The first half of this year has seen a record amount of catastrophe loss, which is generally skewed towards the second half of the year covering the US windstorm season. The Chilean earthquake, Deepwater Horizon, and European windstorm Xynthia are among a large number of losses amounting to US\$22bn according to Munich Re.

### The first half will reflect better pricing and the sovereign debt rally

Premium rate declines have been modest overall in H1, perhaps 0-0.5% overall, but reported results will be helped by business written last year at better rates (a typical 12 month policy written in mid-2009 will still be 'earning' in H110). The first half rally in better quality sovereign debt will support investment earnings (on a mark-to-market basis), but will only make future investment returns more difficult.

### Exhibit 2: Results calendar

Company	Date
Beazley	23 July
Brit Insurance	28 July
Lancashire	05 August
Novae	05 August
Hardy	05 August
Catlin	06 August
Amlin	23 August
Hiscox	23 August
Chaucer	26 August
Omega	31 August

Source: Company data, Edison Investment Research

## The insurance cycle

Insurance pricing tends to follow an eight year cycle driven mainly by capital availability. The past few years have unusually seen overall pricing sustained at a high level with catastrophe lines still priced at very attractive near-peak levels. Casualty insurance has seen a much weaker trend. We do not believe the cycle dead, although more widespread use of sophisticated risk modelling and pricing has introduced a greater discipline. With the industry well capitalised we see a real risk of pricing weakening in high margin areas such as catastrophe reinsurance before the overdue recovery in casualty emerges. But the paradox of this sector is that pain, or rather a lot of pain, is good, turning prices and leading share prices. A major loss event (US\$40bn or so) could alter the situation very quickly.

### The classical cycle

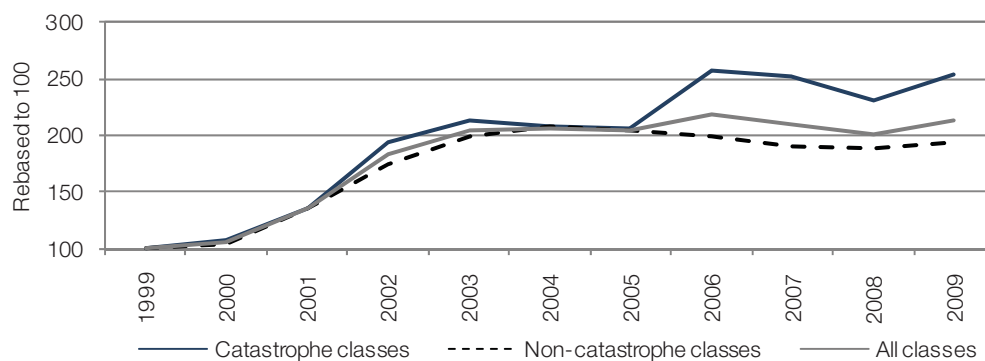
Insurance pricing is cyclical, most commonly driven by changes in 'supply' which is closely linked to the amount of available capital in the industry. Cycles in pricing have tended to last around eight years, measured from peak to peak, but can be very variable. Periods of improving pricing and terms and conditions have tended to follow significant catastrophic loss events or large investment losses that have the effect of reducing industry capital resources. But eventually better pricing, often combined with a period of benign claims experience and/or strong investment returns, force a peak in the market. At this point existing insurers with ample capital, often joined by new entrants attracted by strong industry returns, once again begin to accept lower pricing and more generous terms and conditions.

### Where we are in the cycle now

In reality the picture is more complicated than the simple description above with a multitude of different types and classes of insurance each reacting to specific circumstances and conditions. In overall terms the current cycle has been unusual with rates staying at or near peak levels for about seven years. Reinsurance and most property classes have remained strong over this period, particularly catastrophe exposed lines. Casualty insurance has generally weakened.

#### Exhibit 3: Premium rate development

Note: Catlin specific data.



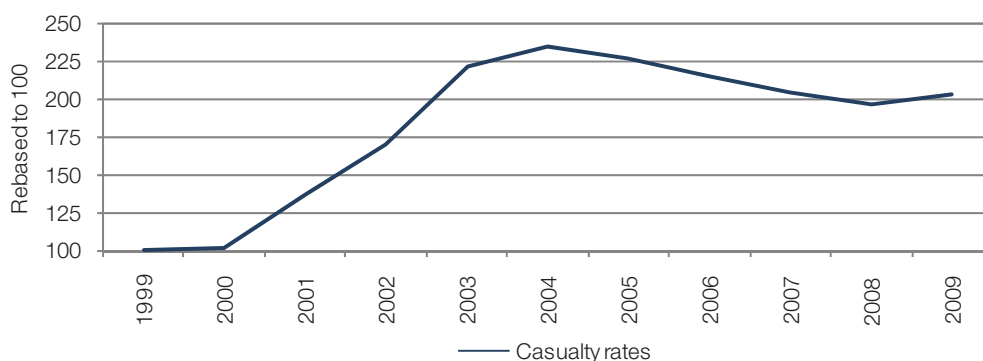
Source: Catlin Group Limited

## Casualty insurance near an upturn?

Casualty insurance pricing peaked in around 2004 and has generally declined since. Given the longer tail nature of the business, which sees the insurer holding reserves for a longer period (around five years on average) before finally settling a claim, the decline in investment returns on these reserves has been hard felt. There were hopes of this in 2009 following exceptionally weak investment returns in 2008, but it has really only been seen in areas such as credit insurance and financial institutions where large losses have been recognised.

### Exhibit 4: Casualty insurance premium rate development

Note: Catlin specific data.



Source: Catlin Group Limited

Part of the explanation for the lack of rate improvement is that losses related to the credit crisis and ensuing recession have to date been more muted than many, including us, expected. Casualty insurance covers risks such as corporate failure, corporate negligence and fraud, all of which are more prevalent in recession. We think it very likely that there is more to emerge, which, combined with weak pricing over several years, persistent low investment returns, and the inevitable decline in reserve releases from earlier, better priced years, all suggest that conditions are ripe for a turn. Predicting the point of this turn is difficult. It is entirely possible that insurers will need to suffer more pain, reduced returns and capital losses than we have factored in for this to happen.

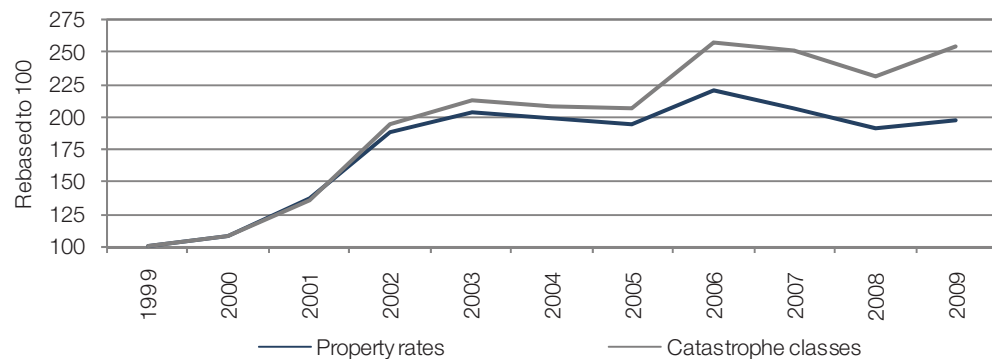
### Property rates have been firm, catastrophe rates supported by losses

Most property classes and particularly catastrophe exposed insurance and reinsurance has remained firm over several years. Very large losses in the 2005 US windstorm season gave a fillip to pricing just as it was beginning to show signs of softening and the pattern repeated last year following Hurricane Ike and Gulf of Mexico energy losses in 2008. 2009 saw a favourable combination of increased pricing and an unusually benign year for losses, particularly natural catastrophe losses, helping to boost industry capital.



**Exhibit 5: Property and catastrophe exposed classes, premium development**

Note: Catlin specific data; catastrophe includes property and casualty.



Source: Catlin Group Limited

The first half of this year saw a heavy burden of natural catastrophe losses for the industry, US\$22bn according to Munich Re, which is as much as the whole of last year despite the first half of the year generally seeing lower levels of loss than the second. The pricing of energy risks has responded strongly to the Horizon Deepwater disaster in the Gulf of Mexico, but the Chilean earthquake has had a limited impact on international (non-US) catastrophe pricing. More widely, the industry has had to suffer the losses without a general shift in pricing. This is not particularly surprising given a healthy level of capital in the industry and pricing still at very attractive levels. US property pricing in particular and catastrophe insurance has shown some weakening, which, absent further material losses for the industry, seems likely to continue.

The US Atlantic hurricane season is under way (it runs from the beginning of June to the end of November) and many weather watchers expect it to be more active than last year. Most observers think an industry loss of US\$40bn or so is needed to restore balance, on a par with the major storm losses of the past decade, but significantly less than Hurricane Katrina in 2005.

**Cycle abolished?**

The author has long been sceptical of claims of 'paradigm shift' or 'this time it is different' across a number of industries, but there is a sound case to be made for the argument that the unusual flatness of the current cycle is at least partly explained by the widespread use of sophisticated risk aggregation and price modelling techniques that have become commonplace in recent years. The models themselves are unlikely to be 'right' about the eventual outcomes and interconnections of major loss events, but as they are widely used across the industry there is far less chance of the insurance companies themselves and the market as a whole behaving irrationally in its approach to risk and pricing. However, with rates still near highs in catastrophe exposed lines, margins are high and there is no reason why they should not rationally fall so long as capital is available. We do not believe in the death of the cycle, but we are very hopeful that its amplitude has decreased.

## Industry capital

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The cycle in insurance pricing is significantly determined by the amount of available capital in the industry – in fixing prices ‘supply’ is more variable than ‘demand’. There has been much volatility in industry capital over the past two years. According to the industry information provider ISO, the level of capital in the US industry fell by 15% between June of 2008 and March of 2009 under the twin-pronged assault of catastrophe insurance losses and financial asset impairments. This was a level not seen since the end of 2005. The subsequent rally in financial assets and an unusually benign year for catastrophe losses in 2009 saw capital quickly rebuild to around peak levels. Unusually large claims activity in the first half of this year has only really prevented capital from building further.

This is the main reason that we expect more generalised pressure on premium rates as the year progresses in the absence of a ‘market moving’ loss event that we think would need to be of the order of US\$40bn, on a par with the major storm losses of the past decade, but significantly less than Hurricane Katrina in 2005.

We do not expect the advent of the new European insurance capital regime, Solvency II, in 2012 to have any material impact on overall industry capital requirements, but we would expect companies to be cautious ahead of the event and maintain somewhat higher levels of capital. We believe there is room to offset an increase in regulatory capital requirements within the existing Lloyd’s prudential uplift that it applies to members.

## Investment earnings

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The sharp fall in investment returns apparent since the onset of the financial crisis shows no sign of reversing and has material implications for the return on net tangible assets (RONTA). The issue was masked to some extent in 2009 as asset values rebounded and corporate bond spreads tightened. But 2010 sees low rates really start to bite and any thought of a quick turnaround seems speculative. The ratio of investments to NTA varies by company, but is on average around three times. Companies with a larger share of longer tail business such as casualty insurance will see a higher level, as will companies with leaner balance sheets and relatively lower levels of tangible equity.

Investment portfolios are dominated by high short-duration cash and fixed income, including higher quality corporate bonds. Some do also contain selected exposure to riskier assets such as equities, asset-backed securities and hedge funds, and even though the weightings are relatively small it can have quite a significant impact on overall returns.

**Exhibit 6: Investment gearing**

Note: Financial investments and cash divided by net tangible assets.

As at December 2009	Investments/NTA
Amlin	2.8
Beazley	4.1
Brit	4.3
Catlin	3.7
Chaucer	4.7
Hardy	2.1
Hiscox	2.5
Lancashire	1.7
Novae	3.4
Omega	1.3
<b>Average</b>	<b>3.1</b>

Source: Company data, Edison Investment Research

Before the financial crisis, risk-free returns were around 5% compared with near zero today. Even if the return can be increased to, say, 2% by adopting a blend of short dated government debt and cash on the one hand and higher yielding corporate debt on the other, the difference is material. The decline of 3% represents an average drop in pre-tax RONTA of around 9%.

The companies are relatively constrained in their ability to vary their investment stance and in theory it does not create shareholder value to do so as higher returns are largely reflecting higher risk. Investment portfolios need to be sufficiently liquid so that claims can be met as they become due. As far as possible liabilities need to be matched by assets of similar duration and currency denomination so as to avoid unwanted volatility in results. Above all, the companies want to protect their capital bases from unwanted volatility in asset values.

Traditionally, periods of weak investment performance have been associated with better insurance pricing as the industry seeks to maintain returns. But currently the industry is having to live with low investment returns even as ample available capital starts to weigh more generally on insurance pricing. If there is no movement in interest rates through 2011 then there would be some downside risk to our investment return assumptions for companies adopting a very risk averse investment stance. In Exhibit 13 we show the sensitivity in RONTA for different assumptions.

## Dividends

We expect modest growth in dividends per share across the sector given our outlook of reduced levels of profitability. In Exhibit 7 we exclude Lancashire and Omega from our calculation of the average change in DPS. Lancashire prefers to use special dividends and share buy-backs to manage its capital base, but is introducing regular dividends from a low starting base. Omega pays out around 70% of earnings and as we expect these to be lower in 2010 we also expect a lower dividend. However, we see Omega as having a strong capital position and would not rule out some other form of capital return if it finds insufficient opportunities to grow premiums.

### Exhibit 7: Dividend cover and dividend growth

Note: Dividend cover is normalised EPS divided by DPS; average change in DPS excludes Lancashire and Omega.

	Dividend cover (e)			Change in DPS		
	2010e	2011e	2012e	2010e	2011e	2012e
Amlin	1.9	2.3	2.3	5%	5%	5%
Beazley	1.9	2.2	2.1	7%	7%	10%
Brit	1.2	1.9	2.4	0%	0%	0%
Catlin	1.4	2.1	2.2	0%	0%	5%
Chaucer	0.8	1.5	1.6	0%	0%	0%
Hardy	1.1	2.6	2.7	9%	3%	3%
Hiscox	1.9	2.4	2.4	10%	9%	8%
Lancashire	5.8	5.9	5.2	200%	33%	25%
Novae	2.2	2.7	3.5	9%	4%	4%
Omega	1.5	1.4	1.4	(46%)	67%	12%
<b>Average (see note)</b>	<b>2.0</b>	<b>2.5</b>	<b>2.6</b>	<b>5%</b>	<b>4%</b>	<b>4%</b>

Source: Edison Investment Research estimates

We see dividend payments as generally soundly based. On our forecasts, the level of dividend cover is generally increasing through the next couple of years as companies look towards the still uncertain capital impacts of Solvency II.

### High sensitivity to US dollar

Movements in FX rates, particularly the US dollar exchange rate, have a significant impact on reported results. We estimate that on average two-thirds of premium is written in US dollars and a number of companies have significant non-sterling net assets holdings in overseas currencies to support overseas businesses.

Hiscox, Lancashire and Omega report their results in US dollars and Beazley is switching for this year. For those companies reporting in sterling the impacts are greatest. By and large the companies attempt to match the profit and loss account impacts as far as possible, but International Financial Reporting Standards (IFRS) has introduced some artificial volatility into reported numbers ("the effect of foreign exchange on non-monetary items") which evens out over time. The market rightly looks through this IFRS noise.

The first half has seen the US dollar strengthen against sterling (from 1.61 at year end to 1.50), which should see generally positive translation gains in profit and loss accounts, positive IFRS impacts to be ignored, and a positive revaluation impact on net assets.

## Company strategies

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The insurance companies featured in this report are the specialist insurance/reinsurance underwriters quoted in London. With the exception of Lancashire, all of these businesses have their origins and continue to operate within the Lloyd's insurance market, but there is a tremendous variation in terms of insurance portfolio mix, geographic diversity and business domicile, scale of operation and market capitalisation. We believe that the larger capitalised companies, Amlin, Hiscox, Catlin, enjoy benefits of scale, capital efficient diversification, and more wide-ranging growth opportunities.

### Lloyd's

The Lloyd's market offers participants a number of advantages, but most obviously in terms of lower capital requirements than would be possible on a standalone basis due to support from Lloyd's own balance sheet. The subscription nature of the market has proven popular with insurance buyers and participants are able to trade under Lloyd's worldwide network of licences. However, Lloyd's is a wholesale market which tends to be more price sensitive and cyclical. Portfolio diversification is most certainly available across the wide range of insurance classes written in the market, but diminishes with size as more of the same type of risk is added. Although the market has been very successful in recent years, it has itself gone through periodic crisis. A common thread in company strategies is to seek insurance risks that would not normally find their way to London to support growth and risk diversification.

### Business diversification

We consider that scale and diversification offers attractive benefits for capital efficiency and sustainable returns. Amlin, Hiscox and Catlin in particular stand out for their scale and diversification away from their Lloyd's market origins; others are not far behind. Lancashire is the exception. As a fairly recent Bermuda start-up it does not operate within Lloyd's, is more narrowly focused on short tail, low frequency, high impact losses, and combines successful risk selection with very active capital management to generate strong returns.

Diversification of insurance risks is capital efficient; two uncorrelated risks do not require as much capital as two that are correlated. A strong base of relatively predictable, low volatility business can be used to counter-balance the writing of high margin, highly volatile catastrophe risks.

Diversification generally increases RONTA and offers more opportunities to grow. Of course this assumes successful diversification; it is not without risk to enter new markets.

International reach can be gained by opening overseas offices to 'bind' business on behalf of the Lloyd's underwriting platform. This is cheaper than establishing separately capitalised overseas insurance companies. It would take at least US\$500m to establish a stand-alone Bermudan reinsurance business, for example. Hardy, Chaucer, and Novae rely on their capital efficient Lloyd's platforms to support their business sourced outside of the London market.

### M&A

The Apollo approach to Brit Insurance has rekindled interest in sector M&A, although in reality that approach appears a more straightforward portfolio investment.

M&A is not as obviously value creating in this sector as some others and generally requires more than simple consolidation benefits. A combined ratio at or about 90% of premiums is not uncommon. Of this, say 60% of premiums go out of the door in claims costs and in M&A this is unlikely to change materially. Of the 30% of premiums that are lost to expenses, perhaps 20% is paid to brokers in commissions and only around 10% is actual addressable cost. Moreover, where there is overlap in the brokers or end customers, two and two often ends up being less than four as business is redirected.

However, the smaller the companies involved, the greater is the weight of fixed overhead cost that could be reduced. There may be capital efficiencies in combination. Novae's approach to Chaucer early last year when the latter was weakened by investment losses would have put under-used capital at Novae to work. Greater scale in underwriting makes portfolio diversification more efficient – a wider mix of risks can be achieved without being spread too thinly. Some companies may have realised tax efficiencies by re-domiciling to lower tax jurisdictions and M&A may be a way of accessing this.

We think that some of the smaller companies in this report would achieve some of these benefits in M&A, but finding willing buyers and willing sellers in the current market and with low valuations across the sector is far from easy. We do not see any company willing to sell at less than book value.

While the new capital regime Solvency II will not make a material difference to the companies in this report in our view, it certainly raises the costs for smaller companies and may hasten more consolidation. Stronger companies may see M&A as a safer route to grow than organic expansion in a weak market. We think that there are still a small number of Bermudan insurance operations that would like to diversify and who would find a Lloyd's presence attractive.

## Valuation

We believe that the sector combines strong fundamental value with a high degree of uncertainty and a toughening trading environment. With premium rates softening we think it too early to anticipate this fundamental value being materially recognised by the market. We consider that around 1.0x NTA feels about right for the sector in current market conditions and for the sector to track NTA growth. The larger capitalisation stocks are the more likely beneficiaries on the whole.

### Exhibit 8: Key valuation statistics

Note: RONTA is normalised after tax return on start year net tangible assets; EPS is normalised. Prices as at 21 July 2010.

	Share price (p)	RONTA			P/NTA			P/E			Yield 2010
		2010	2011	2012	2010	2011	2012	2010	2011	2012	
Amlin	425	14.2%	15.8%	15.1%	1.31	1.21	1.11	10.4	8.4	8.1	4.9%
Beazley	121	14.9%	14.4%	13.2%	1.04	0.96	0.89	7.6	7.5	7.6	6.0%
Brit	900	7.1%	10.9%	12.8%	0.84	0.79	0.73	12.1	7.7	6.2	6.7%
Catlin	381	9.8%	14.4%	14.8%	0.95	0.89	0.82	10.4	6.9	6.2	6.9%
Chaucer	46	6.0%	11.0%	11.2%	0.87	0.87	0.83	14.1	8.1	7.8	8.7%
Hardy	236	6.0%	14.5%	14.3%	0.88	0.81	0.74	14.8	6.1	5.6	6.1%
Hiscox	349	11.7%	14.2%	14.0%	1.09	0.99	0.91	10.9	7.9	7.3	4.7%
Lancashire	536	11.9%	14.8%	14.5%	1.05	0.94	0.85	9.4	6.9	6.3	1.8%
Novae	319	6.4%	8.5%	11.3%	0.80	0.76	0.70	12.1	9.3	7.1	3.8%
Omega	99	5.8%	8.8%	9.4%	0.82	0.78	0.76	14.6	9.8	8.8	4.4%
<b>Sector average</b>		<b>9.4%</b>	<b>12.7%</b>	<b>13.1%</b>	<b>0.97</b>	<b>0.90</b>	<b>0.84</b>	<b>11.7</b>	<b>7.9</b>	<b>7.1</b>	<b>5.4%</b>

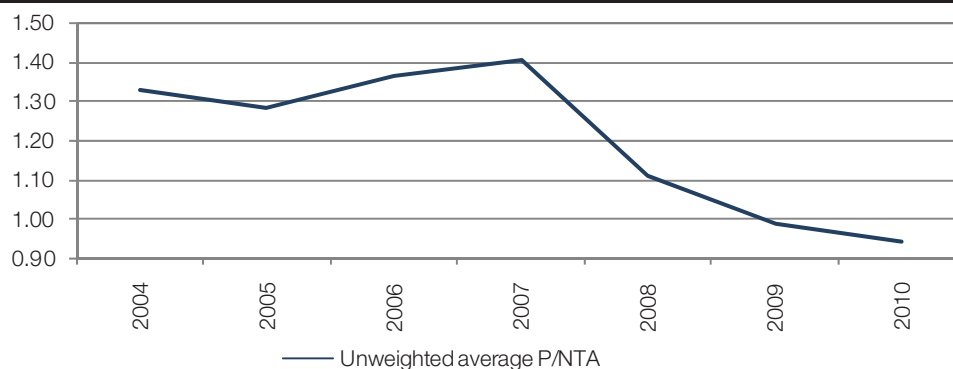
Source: Company data, Edison Investment Research estimates

### Sector P/NTA not far from historic lows

We estimate the sector to be on an average 0.95x price/net tangible assets (P/NTA). This is not far off the historic lows seen at the end of the last major insurance down-cycle in 2000 and immediately after the loss of the World Trade Centre in 2002, at around 0.80x.

### Exhibit 9: Sector average P/NTA (not market capitalisation weighted)

Note: We use year end NTA and average share prices during the year



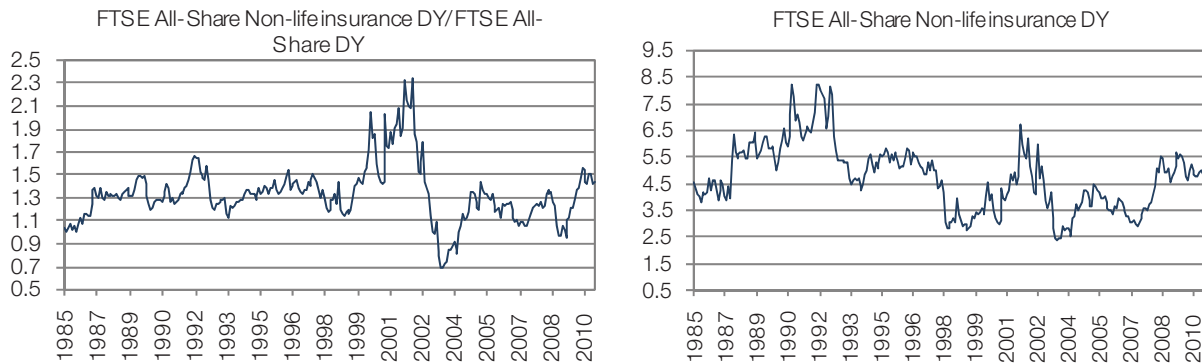
Source: Company, Edison Investment Research

A difference with the past is the combination of a weaker pricing environment with weak investment returns, rather than the more traditional situation where low investment returns/losses spur higher pricing and vice versa. The difference is that industry has ample capital. We nonetheless anticipate a flatter pricing cycle than in the past and for RONTA to remain healthily positive. A more sustained and sharper downtrend in pricing than we envisage or more significant loss experience would obviously generate lower returns than the average of c 13% we forecast for the next couple of years (an unusually large number of H1 catastrophe losses depress returns this year). We think a

major industry loss of around US\$40bn or so would have a positive impact on insurance rates, whereas a string of smaller losses is more likely to depress RONTA without doing so.

## Yield support

**Exhibit 10: Sector dividend yield and yield relative to market**



Source: Company data, Edison Investment Research

We estimate that the sector is trading on a prospective (2010) dividend yield of 5.5%. We expect modest dividend growth over the next couple of years, but on our forecast RONTA dividend cover is generally healthy.

We consider yield to be a healthy support to the sector, but not a reason to be more immediately positive about sector performance.

## Valuation methodology

The most common approach to sector valuation is to compare RONTA with the share price multiple of tangible assets per share. The higher RONTA, the higher should be the P/NTA. Price earnings ratios are also used, but in reality both are the same. P/NTA divided by RONTA is just another way of expressing P/return or P/E.

While it is the case that higher RONTA stocks have been rewarded with a higher P/NTA, much to the frustration of their managements at times the differential has not given much credit for the sustainability of superior returns.

If RONTA is 15% and net assets grow 3% per annum in support of premium growth while sustaining the 15% RONTA, then the maths says an investor with a hurdle rate of return of 10% could rationally pay 1.71x NTA. However, we do not think they will anytime soon; the key word is 'sustainably'.

What is the sustainable return? This is a cyclical industry with volatile returns that are difficult to predict. A bird in the hand is generally thought to be worth two in the bush in this sector, and there is a tendency for share prices to follow NTA growth rather than predict too far out. The other factor is that growth in the industry has often been less than successful, being associated with unexpected losses. And in an industry where the true 'cost of sales' (claims costs) is not known until sometime after the business has been written and booked, the real profitability of business written today is yet to be proven.



## Our share price performance expectation

Taking a 'static' valuation with no adjustment for potential reinvestment and growth, the implied investor hurdle rate/cost of equity is 14% across the sector. This is very high and indicates the fundamental value in the sector. But equity market are known to hate uncertainty and nothing is more uncertain than insurance; it is the very nature of the business.

### Exhibit 11: Implied COE (2011)

Note: Implied COE derived from expected 2011 RONTA and P/NTA.

Company	COE (2011)
Amlin	13.1%
Beazley	15.0%
Brit	13.7%
Catlin	16.3%
Chaucer	12.7%
Hardy	17.9%
Hiscox	14.3%
Lancashire	15.7%
Novae	11.2%
Omega	11.2%
<b>Sector average</b>	<b>14.1%</b>

Source: Company data, Edison Investment Research

If the sector were to trade at 1.0x 2011 NTA, a reasonable aspiration, then the 2011 sector implied COE is 13.5% on our numbers. If we continue to ignore growth and apply this COE uniformly across the sector then the following pattern emerges.

### Exhibit 12: Implied share price at standard COE (2011)

Note: We use year end NTA and average share prices during the year.

	Share price (p)	Implied price (p)	Upside/downside
Amlin	425	413	(2.9%)
Beazley	121	134	11.0%
Brit	900	916	1.7%
Catlin	381	459	20.4%
Chaucer	46	43	(6.2%)
Hardy	236	313	32.8%
Hiscox	349	371	6.3%
Lancashire	536	624	16.5%
Novae	319	264	(17.4%)
Omega	99	82	(17.3%)

Source: Company data, Edison Investment Research

**We would not for a moment claim this to be any sort of indicator of likely share price performance, but it does help to identify what is implied by the current share price.** In relative terms, **Amlin** and **Hiscox** have been rewarded for higher returns but arguably not for the sustainability of returns and superior growth options. We think **Beazley's** share price reflects lingering concern over the sustainability of returns in its casualty business. **Brit's** share price has been given a boost from the Apollo approach and our 2011 forecasts do not fully reflect its focus on improving underwriting. **Catlin** and **Hardy** appear to reflect concerns about the underwriting quality of recent growth. **Chaucer** is very heavily impacted by low investment returns and has few obvious ways to significantly boost returns in the current environment. **Lancashire** looks set to maintain strong returns, but the market may be concerned that it will struggle to find attractive business in a weaker

market. For **Novae** and **Omega** the market is rightly recognising that both have capital inefficiencies to work through.

Overall we think the larger capitalisation stocks, Amlin, Hiscox and Catlin, would benefit most from the sector moving to and tracking NTA growth, the valuation gap with the smaller underwriters perhaps widening. We also think that Lancashire is likely to maintain strong returns, but we are less sure whether it will be able to maintain the same premium base. Among the smaller capitalisation stocks we think that Hardy has been heavily punished for its H1 loss exposures and that sentiment should improve with a successful navigation of the US windstorm season relative to more US-focused peers.

## Sensitivity to changes in combined ratios and investment returns

We are expecting a relatively shallow down-cycle in premium rates, but the outturn could be worse than we allow for. Moreover, even small annual changes in premium rates would have a material impact if sustained over a longer period (a 10% cumulative rate decline starting from a 90% Combined Ratio would eradicate underwriting profits if no action were taken). In Exhibit 13 we show the impact on forecast 2011 RONTA for different Combined Ratios.

In addition, if there is no change in available investment returns through 2011 there would be downside risk to our forecast investment earnings for companies adopting a very low risk investment stance. We show the sensitivity of RONTA to alternative investment return assumptions. We also show forecast 2011 dividends as a percentage of RONTA as an indication of dividend cover under a weaker than forecast scenario.

### Exhibit 13: Sensitivity to changes in underwriting profitability and investment returns.

Note: COR is combined ratio including group expense.

	RONTA	COR	Impact of change in COR			Inv. Return	Impact of change in investment return			Dividend as % NTA
	2011e	2011e	1%	2%	3%	2011e	-50bp	-75bp	-100bp	2011e
Amlin	15.8%	83.1%	15.0%	14.3%	13.5%	2.0%	14.7%	14.2%	13.6%	6.2%
Beazley	14.4%	93.8%	13.1%	11.8%	10.5%	1.5%	12.9%	12.2%	11.4%	6.1%
Brit	10.9%	97.1%	9.5%	8.2%	6.8%	2.0%	9.1%	8.2%	7.3%	5.3%
Catlin	14.4%	91.7%	13.1%	11.9%	10.6%	2.0%	12.9%	12.1%	11.4%	6.1%
Chaucer	11.0%	99.5%	9.4%	7.8%	6.3%	1.5%	9.2%	8.3%	7.5%	7.1%
Hardy	14.5%	91.6%	13.2%	11.8%	10.5%	1.5%	13.5%	13.1%	12.6%	5.1%
Hiscox	14.2%	90.6%	13.4%	12.6%	11.8%	2.5%	13.4%	12.9%	12.5%	5.1%
Lancashire	14.8%	72.6%	14.5%	14.1%	13.7%	2.5%	14.1%	13.7%	13.3%	2.1%
Novae	8.5%	95.6%	7.2%	5.9%	4.7%	1.5%	7.0%	6.2%	5.5%	3.0%
Omega	8.8%	94.5%	8.2%	7.6%	7.1%	2.0%	8.1%	7.8%	7.4%	5.8%
<b>Sector av.</b>	<b>12.7%</b>	<b>91.0%</b>	<b>11.7%</b>	<b>10.6%</b>	<b>9.6%</b>	<b>1.9%</b>	<b>11.5%</b>	<b>10.9%</b>	<b>10.2%</b>	<b>5.2%</b>

Source: Company data, Edison Investment Research

Those companies enjoying better margins are relatively less impacted by a rate reduction applied uniformly across the sector. The level of equity gearing (GWP/NTA) also has an impact. Exhibit 13 supports our expectation that the larger, more diversified companies in the sector will in general perform best.

## Company profiles

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# Amlin

26 July 2010

## Investment summary: Class act continues

We find Amlin's product and geographic diversity highly attractive, but the cornerstone to the success of its strategy has been superior underwriting performance. This has allowed Amlin to produce strong returns on equity, despite operating with a well capitalised balance sheet. This in turn has given Amlin the flexibility to make acquisitions, fund organic growth and operate with a slightly more aggressive investment portfolio. A high weighting to high margin catastrophe-exposed business is undoubtedly a contributing factor, and we anticipate a weakening from highly attractive levels. However, we still look for an attractive mid-teens RONTA, which fundamentally supports a higher valuation.

### Highly diverse

We find Amlin's product and geographic diversity highly attractive. Diversity brings capital benefits and a wider range of opportunities for development regardless of market conditions.

### Strong underwriting the cornerstone

Strong underwriting is the cornerstone of Amlin's success. Low loss ratios can be partly explained by Amlin's heavy catastrophe exposure, but even here it has shown itself adept at managing risk. Outside of catastrophe lines, we feel Amlin has built a book of above-average quality. Strong underwriting is the main factor behind a sector-beating ROE, averaging 29% per year over the past five years, despite running with a well-capitalised balance sheet. This, in turn, has allowed Amlin to run a higher risk/higher return investment portfolio, make acquisitions (Fortis Corporate Insurance in 2009), and fund organic growth. Moderate debt gearing further supports returns. Shareholders can take comfort that even a major loss event would be unlikely to interrupt business development or dividends, or call for equity support.

### Valuation: Fundamentally undervalued

Amlin's business model has a track record of producing sustained value creating growth. Fundamentally the shares are worth more. If sustained, a 15% ROE, 10% COE, and 3% growth would argue for 1.7x NTA. Alas we see little prospect of investors pricing this in the shares in such an uncertain sector, particularly amid a challenging insurance and investment market.

#### Exhibit 14: Valuation

Note: PBT normalised; EPS normalised and fully diluted; COR inc. group overhead.

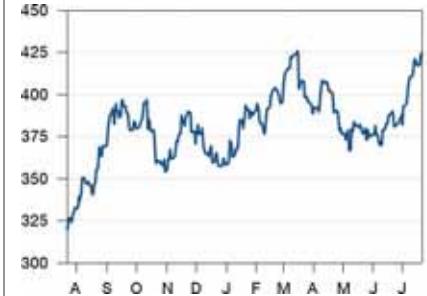
Year end December	GWP £m	COR %	PBT £m	EPS (p)	DPS (p)	NTA (p)	RONTA %	P/E	P/NTA	Yield
2009	1,544	71.0%	538	98.2	20.0	290	44.1%	4.3	1.47	4.7%
2010e	1,845	86.1%	255	40.7	21.0	324	14.2%	10.4	1.31	4.9%
2011e	1,901	83.1%	316	50.5	22.0	353	15.8%	8.4	1.21	5.2%
2012e	2,107	83.7%	329	52.6	23.0	383	15.1%	8.1	1.11	5.4%

Source: Amlin, Edison Investment Research

Price\* 425p  
Market Cap £2.1bn

\*Price as at 21 July 2010

#### Share price graph



#### Share details

Code AML  
Listing Full  
Sector Non-life insurance  
Shares in issue 502.1m

#### Business

Amlin is an international insurer/reinsurer domiciled in London. It focuses on providing commercial insurance and reinsurance, operating in the UK, within Lloyd's, Continental Europe and Bermuda.

#### Bull

- Highly diversified
- Strong underwriting
- Strong RONTA

#### Bear

- Vulnerable to catastrophe rate weakness
- General pricing weakness
- Low investment returns

## Investment summary: Class act continues

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### Highly diverse

We view Amlin's diversity as a strength. Through Lloyd's it writes a wide range of specialist insurance and reinsurance risks. Amlin UK and Amlin France provide commercial insurance to SME customers in their respective countries. Last year's acquisition from Fortis, which has been re-named Amlin Corporate Insurance (ACI), focuses on commercial insurance for medium-sized corporates in Belgium and the Netherlands, with a particular strength in marine insurance that complements Amlin's business written through Lloyd's. In Bermuda, Amlin writes predominantly catastrophe reinsurance. Diversity brings capital efficiency, flexibility and growth opportunities.

### Underwriting key

We believe that Amlin's low claims/loss ratios are the result of having built a high-quality non-catastrophe book of business, as well as the overall portfolio containing a relatively high share of high margin catastrophe risks. Amlin has proven to be adept at managing catastrophe risk. As well as clever use of reinsurance, its strategy has been to write a smaller share of a wider spread of risks rather than a large share of fewer risks. If, as we anticipate, catastrophe insurance rates ease from strong levels, some of this mix advantage may be temporarily lost.

Historically, Amlin's Lloyd's business has produced a stronger underwriting result than the Lloyd's market as a whole in weak markets, which provides some evidence of its disciplined approach.

### Strong balance sheet

Rather than seeking to optimise returns through running a lean balance sheet, Amlin has used capital strength to its advantage, supporting flexibility and growth. Superior underwriting and investment returns have nonetheless delivered strong returns on capital. Tangible equity plus debt exceeded Amlin's economic capital requirement by £400m, or 30%, at the end of 2009 with debt a moderate 22% of NTA. This gives considerable protection against any major loss event and investors need have little fear of dividend cuts or capital calls.

### Further acquisitions likely

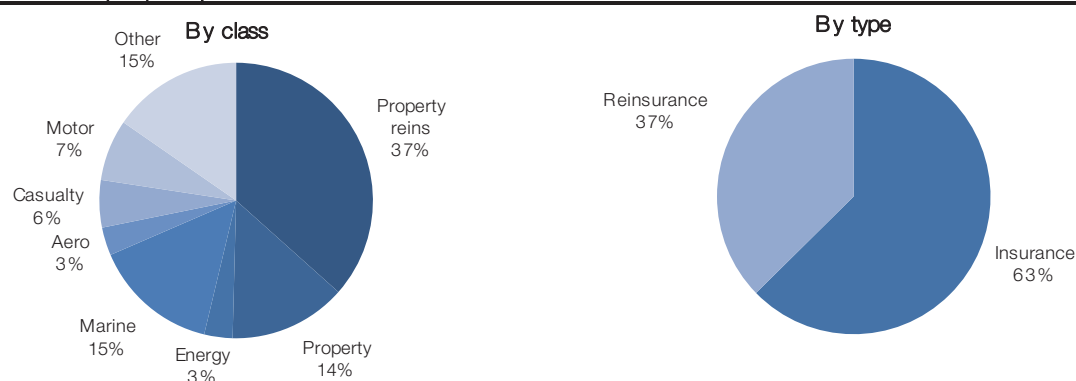
We expect Amlin to use its balance sheet to support growth through further targeted acquisitions. The early indications are that ACI is integrating successfully and that Amlin's re-underwriting of unprofitable, particularly marine, risks is going well. Solvency II may provide opportunities among smaller, weaker competitors.

### UK commercial is overdue a recovery

Amlin UK represents 10% of premium. UK commercial insurance is highly competitive and suffering low margins, and is overdue a recovery. We have built some moderate improvement into our forecasts but feel this could easily be exceeded on past experience of market recoveries.

### Conclusion

Amlin operates a highly successful business model that we think capable of maintaining very attractive returns, albeit substantially below the exceptional average 29% ROE of the past five years. If sustainable, growth with value creating returns does not make the stock expensive, despite the highest P/RONTA in the sector. However, we do not believe that investors are yet willing to pay for growth in an uncertain sector.

**Exhibit 15: GWP split (2009)**

Source: Amlin, Edison Investment Research

**Exhibit 16: Financials**

Year end 31 December	2008	2009	2010e	2011e	2012e	H110e
£m	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
Gross written premium	1,034.0	1,543.9	1,845.0	1,901.0	2,106.6	1,201.9
Net premium revenue	913.5	1,317.3	1,510.8	1,676.3	1,778.7	756.6
Investment return	18.0	207.5	108.0	95.0	102.2	60.0
Other income	2.7	10.1	10.0	10.0	10.0	5.0
<b>Total Revenue</b>	<b>934.2</b>	<b>1,534.9</b>	<b>1,628.8</b>	<b>1,781.3</b>	<b>1,890.9</b>	<b>821.6</b>
Net claims cost	(500.7)	(564.2)	(869.3)	(916.3)	(980.1)	(444.4)
Other expenses	(290.7)	(438.6)	(481.6)	(526.4)	(558.9)	(228.9)
FX	0.0	0.0	0.0	0.0	0.0	0.0
<b>Operating Profit</b>	<b>142.8</b>	<b>532.1</b>	<b>277.8</b>	<b>338.6</b>	<b>351.9</b>	<b>148.3</b>
Financing costs	(21.2)	(23.0)	(23.0)	(23.0)	(23.0)	(10.7)
<b>Profit Before Tax as reported</b>	<b>121.6</b>	<b>509.1</b>	<b>254.8</b>	<b>315.6</b>	<b>328.9</b>	<b>137.6</b>
Impact of FX on non-monetary items	58.1	(29.0)	0.0	0.0	0.0	0.0
<b>Profit Before Tax (norm)</b>	<b>63.5</b>	<b>538.1</b>	<b>254.8</b>	<b>315.6</b>	<b>328.9</b>	<b>137.6</b>
Tax	(41.2)	(54.3)	(51.0)	(63.1)	(65.8)	(27.5)
Minorities	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	0.0
<b>Profit After Tax (norm)</b>	<b>41.9</b>	<b>480.6</b>	<b>203.8</b>	<b>252.4</b>	<b>263.0</b>	<b>110.1</b>
<b>Profit After Tax as reported</b>	<b>80.3</b>	<b>454.7</b>	<b>203.8</b>	<b>252.4</b>	<b>263.0</b>	<b>110.1</b>
Average Number of Shares Exc Own Shares (m)	471.2	483.1	493.9	493.9	493.9	493.9
<b>EPS - normalised (p)</b>	<b>8.9</b>	<b>99.5</b>	<b>41.3</b>	<b>51.1</b>	<b>53.3</b>	<b>22.3</b>
<b>EPS - as reported (p)</b>	<b>17.0</b>	<b>94.1</b>	<b>41.3</b>	<b>51.1</b>	<b>53.3</b>	<b>22.3</b>
<b>EPS - normalised and fully diluted (p)</b>	<b>8.8</b>	<b>98.2</b>	<b>40.7</b>	<b>50.5</b>	<b>52.6</b>	<b>22.0</b>
Dividend per share (p)	17.0	20.0	21.0	22.0	23.0	7.0
Dividend cover	0.5	4.9	1.9	2.3	2.3	3.1
NAV per share	259.5	322.6	356.5	385.6	415.8	344.0
ROE	4.0%	38.3%	12.8%	14.3%	13.8%	13.8%
Net tangible assets per share	236.0	289.6	323.5	352.6	382.9	311.0
RONTA	4.4%	44.1%	14.2%	15.8%	15.1%	15.4%
Loss ratio	0.0%	42.0%	57.5%	54.7%	55.1%	58.7%
Expense ratio (inc Group overhead)	0.0%	29.0%	28.6%	28.4%	28.6%	28.9%
Combined ratio	81.0%	71.0%	86.1%	83.1%	83.7%	87.7%
Reported COR	75.7%	72.2%	86.1%	83.1%	83.7%	87.7%
Investment return	0.6%	6.0%	2.5%	2.0%	2.0%	3.1%
NTA/GWP	107.0%	92.6%	86.6%	91.6%	89.8%	n.m.
Debt/NTA	26.8%	22.1%	19.8%	18.2%	16.7%	n.m.

Source: Amlin, Edison Investment Research

26 July 2010

## Investment summary: Strong record

Beazley has enjoyed an unbroken record of underwriting profitability since its formation in 1986, and has also enjoyed strong growth. A relatively heavy weighting to medium-tail casualty insurance with greater risk from a weaker rating environment and claims inflation is worthy of inspection. However, the exposure is to less risky areas and appears well reserved. More recently, growth has focused on better priced short-tail risks in property and reinsurance. A useful US business has been built through organic growth and acquisition, giving Beazley access to a wider range of complementary risks that would not otherwise be available in Lloyd's. The balance sheet is strong and Beazley has been buying back shares. Despite weak investment returns the strong underwriting, an above-average level of debt gearing and tax efficiencies support an attractive RONTA.

### Unbroken profit record

Beazley's track record of unbroken underwriting profits at Lloyd's is unusually strong and gives comfort that it has the skill to manage portfolio returns across the cycle. This is a useful advantage in current market conditions.

### Building a meaningful US business

Beazley has been building a meaningful US presence in recent years, which received a boost with the acquisition of First State last year. Locally-written US business represented 20% of the group total in Q1. The business that Beazley writes is complementary to its existing know-how, but would not normally find its way to the London market.

### Large casualty portfolio

Beazley's strong niche in "claims made" professional indemnity insurance accounts for most of its larger-than-average casualty exposure. Pricing has been weak for some time and the medium-tail nature of the business exposes it to claims inflation. We believe some caution is justified, but we also understand Beazley has avoided the riskier areas and taken a conservative reserving approach, with earlier years now throwing off material reserve releases.

### Valuation: Outperformance to continue

We see profitability falling but low top-line growth could support capital return not factored in and maintain RONTA at around 15%. Supported by sustainable dividend growth the share are fundamentally undervalued despite an above sector-average P/NTA.

#### Exhibit 17: Valuation

Note: PBT normalised; EPS normalised and fully diluted; COR inc. group overhead.

Year end December	GWP US\$m	COR %	PBT US\$m	EPS (US\$c)	DPS (US\$c)	NTA (US\$c)	RONTA %	P/E	P/NTA	Yield
2009	1,751.3	90.5%	227.5	40.2	11.0	169.8	28.4%	4.6	1.09	6.0%
2010e	1,779.4	91.8%	154.9	24.3	11.0	177.9	14.9%	7.6	1.04	6.0%
2011e	1,764.5	93.8%	159.9	24.5	11.7	192.4	14.4%	7.5	0.96	6.3%
2012e	1,852.8	93.8%	157.3	24.3	12.4	206.1	13.2%	7.6	0.89	6.7%

Source: Beazley, Edison Investment Research

Price\* 121p  
Market Cap £646m

\*Price as at 21 July 2010

#### Share price graph



#### Share details

Code BEZ  
Listing Full  
Sector Non-life insurance  
Shares in issue 533.8m

#### Business

Beazley is an international insurer/reinsurer group, tax resident in the Republic of Ireland. It underwrites a broad range of business with an above average casualty share. It underwrites through Lloyd's and Beazley Insurance Company in the US.

#### Bull

- Strong underwriting record
- Building US presence
- Tax efficient

#### Bear

- Casualty risk
- Pricing weakness
- Low investment returns

## Investment summary: Strong record

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### **Strong cross cycle underwriting**

With its unbroken track record of underwriting profits at Lloyd's, Beazley has proven itself adept at growing the business and maintaining across the cycle underwriting discipline. With pricing in Beazley's core Speciality Lines remaining weak, despite showing signs of claims inflation and despite the exceptionally low contribution from investment earnings, this is very important.

For the past four years, Beazley has reported a combined ratio of 90% (89% in H110) and has benefitted from regular reserve releases, especially in Specialty Lines where conservatively reserved business written in earlier years is maturing.

### **Sizeable US business**

Beazley's US business is now very material within the group and represents a useful diversification from the more wholesale Lloyd's business. We expect locally-written US premiums to represent around 20% of the group total this year. The business that Beazley writes draws on its existing capabilities, but would not otherwise find its way to the London market. The attractively priced acquisition of First State last year, a business well known to Beazley, gave the business a material boost at a time when weak pricing in the market constrained Beazley's desire for strong organic growth.

### **Efficient balance sheet and corporate structure**

Beazley has reorganised under a parent company resident in the Republic of Ireland. We anticipate an effective tax rate of c 18% versus a normal 28% in the UK, although the rate will vary with the geographical spread of profits. Debt as a percentage of tangible equity at 30% is ahead of the sector average but comfortable. Given uncertainty around Solvency II and an increased appetite for shorter-tail property and reinsurance risks, we would expect Beazley to maintain a strong capital buffer for now. It has been repurchasing a small number of shares, but we estimate could support a higher RONTA than we forecast with more substantial capital return measures in the absence of growth opportunities.

### **Casualty risk**

In Beazley's larger than average-sized Casualty book, claims generally have to be notified during the period of the policy but it can take up to five years to establish the final cost of claims with clarity. During this period there is a material risk of claims cost inflation. Beazley has a policy of reserving conservatively upfront and is seeing meaningful releases from business written in earlier years but there can be no certainty that business written in recent years, in a weak pricing environment susceptible to recession-driven claims activity, will produce the same result.

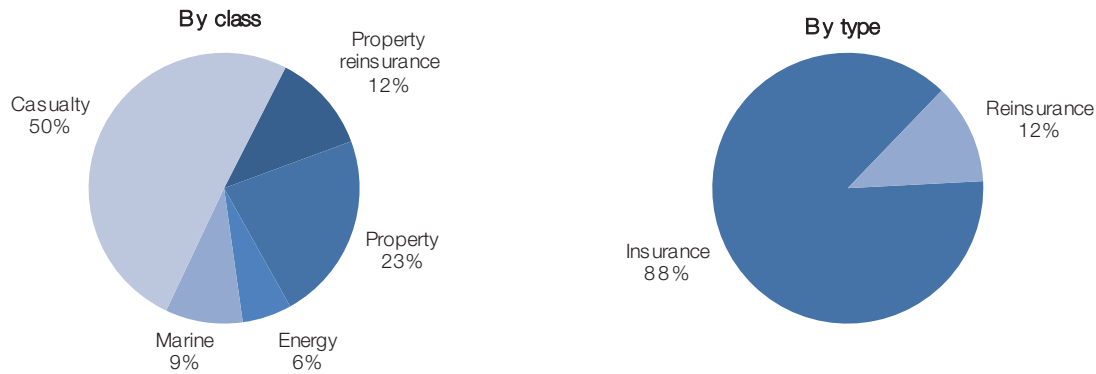
However, management believes it has continued to reserve conservatively and that a significant prudential margin exists in claims reserves. Moreover, the detail of its exposures suggests that Beazley has avoided the greatest risks in areas such as financial institutions insurance going into the credit crisis.

### **Conclusion**

A strong underwriting track record, tax efficiency and debt gearing all contribute to an above-average RONTA. We see pressure on returns from the market environment and persistent low investment returns, and consider caution over casualty risk to be only sensible, but we find the shares fundamentally undervalued on our anticipated mid-teens RONTA.



## Exhibit 18: GWP split (2009)



Source: Beazley, Edison Investment Research

## Exhibit 19: Financials

Year end 31 December	2009	2010e	2011e	2012e	H110	H210e
US\$m	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
Gross written premium	1,751.3	1,779.4	1,764.5	1,852.8	940.6	838.8
Net premium revenue	1,313.6	1,380.0	1,428.6	1,469.8	678.2	701.8
Investment return	88.1	26.5	53.3	52.2	8.5	18.0
Other income	19.6	26.9	25.0	20.0	14.9	12.0
<b>Total Revenue</b>	<b>1,421.3</b>	<b>1,433.3</b>	<b>1,506.9</b>	<b>1,542.0</b>	<b>701.6</b>	<b>731.7</b>
Net claims cost	(742.6)	(795.7)	(844.5)	(867.9)	(377.2)	(418.5)
Other expenses	(472.4)	(473.3)	(496.0)	(510.3)	(229.8)	(243.5)
FX	(34.4)	(6.1)	0.0	0.0	(6.1)	0.0
<b>Operating Profit</b>	<b>171.9</b>	<b>158.2</b>	<b>166.4</b>	<b>163.8</b>	<b>88.5</b>	<b>69.7</b>
Financing costs	(13.8)	(13.4)	(6.5)	(6.5)	(6.7)	(6.7)
Extraordinary	0.0	33.7	0.0	0.0	33.7	0.0
<b>Profit Before Tax as reported</b>	<b>158.1</b>	<b>178.5</b>	<b>159.9</b>	<b>157.3</b>	<b>115.5</b>	<b>63.0</b>
Impact of FX on non-monetary items	(69.4)	(10.1)	0.0	0.0	(10.1)	0.0
<b>Profit Before Tax (norm)</b>	<b>227.5</b>	<b>154.9</b>	<b>159.9</b>	<b>157.3</b>	<b>91.9</b>	<b>63.0</b>
Tax	(19.3)	(27.1)	(28.8)	(28.3)	(17.6)	(9.5)
<b>Profit After Tax (norm)</b>	<b>199.7</b>	<b>131.5</b>	<b>132.1</b>	<b>131.0</b>	<b>77.9</b>	<b>53.6</b>
<b>Profit After Tax as reported</b>	<b>138.8</b>	<b>151.5</b>	<b>131.1</b>	<b>129.0</b>	<b>97.9</b>	<b>53.6</b>
Average Number of Shares Exc Own Shares (m)	479.5	518.3	517.1	517.1	519.6	517.1
<b>EPS - normalised (US\$c)</b>	<b>41.7</b>	<b>25.4</b>	<b>25.5</b>	<b>25.3</b>	<b>15.0</b>	<b>10.4</b>
<b>EPS - as reported (US\$c)</b>	<b>28.9</b>	<b>29.2</b>	<b>25.5</b>	<b>25.3</b>	<b>18.8</b>	<b>10.4</b>
<b>EPS - normalised and fully diluted (US\$c)</b>	<b>40.2</b>	<b>24.3</b>	<b>24.5</b>	<b>24.3</b>	<b>14.4</b>	<b>9.9</b>
Dividend per share (US\$c)	11.0	11.0	11.7	12.4	3.6	7.4
Dividend cover	3.7	2.2	2.1	2.0	4.0	1.3
NAV per share	191.7	199.4	213.9	227.6	192.7	199.4
ROE	24.6%	13.2%	12.8%	11.8%	15.6%	10.8%
Net tangible assets per share	169.8	177.9	192.4	206.1	171.1	177.9
RONTA	28.4%	14.9%	14.4%	13.2%	17.6%	12.1%
Loss ratio	55.1%	57.2%	59.1%	59.1%	54.7%	59.6%
Expense ratio (inc Group overhead)	35.4%	34.6%	34.7%	34.7%	34.5%	34.7%
Combined ratio	90.5%	91.8%	93.8%	93.8%	89.2%	94.3%
Reported COR	90.5%	91.8%	93.8%	93.8%	89.2%	94.3%
Investment return	2.7%	0.7%	1.5%	1.5%	0.5%	1.0%
NTA/GWP	50.4%	51.7%	56.4%	57.5%	n.m	n.m
Debt/NTA	31.5%	29.5%	27.2%	25.4%	30.6%	29.5%

Source: Beazley, Edison Investment Research

# Brit Insurance Holdings

26 July 2010

## Investment summary: Work in progress

Brit Insurance has produced returns on capital below the sector average which can largely be attributed to underwriting performance. Management is addressing the issue vigorously with substantial repositioning of the portfolio, and we believe credit crisis liability exposures have been well reserved. Significant UK commercial insurance exposure would clearly benefit from an overdue improvement in pricing and profitability. The recent acquisition approach from Apollo at 1050p per share is a vote of confidence that management is taking the right steps to improve returns against a difficult industry backdrop.

### Focus on underwriting improvement

Brit Insurance has appeared somewhat slow-footed in taking advantage of market opportunities, such as the strong catastrophe reinsurance market of recent years. Until recently, Global Markets has persevered with insufficiently profitable lines of business and had above-average exposure to credit crisis losses. Management is aggressively repositioning the portfolio within Global Markets.

### UK commercial business overdue a turn

Brit UK, which writes SME commercial insurance, has been struggling against intense competition and weak margins. However, it has been building a useful infrastructure, and is well placed to benefit from an eventual turn in pricing.

### Capital concerns allayed

In our view, the group is adequately but not excessively capitalised. First-time additional disclosure with the 2009 results should help to allay fears that it would struggle to maintain its planned growth after a major loss event.

### Apollo approach

Brit Insurance received an initial approach from private equity firm Apollo Management proposing a bid at 1000p per share, later increased to 1050p. Management rejected the offer as being too low but remains open to discussion.

### Valuation: Outperformance to continue

A difficult market environment and low investment returns mask the underlying improvement in the group's performance. The RONTA would argue for a higher valuation but recent speculation has closed the gap with peers.

#### Exhibit 20: Valuation

Note: PBT normalised; EPS normalised and fully diluted; COR inc. group overhead.

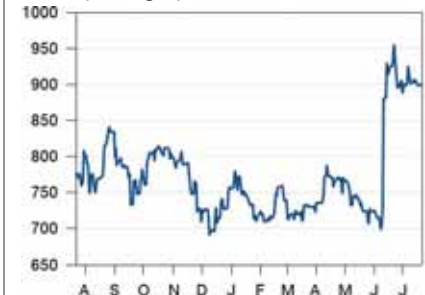
Year end December	GWP £m	COR %	PBT £m	EPS (p)	DPS (p)	NTA (p)	RONTA %	P/E	P/NTA	Yield
2009	1,394.6	96.7%	167.1	162.5	60.0	1,052.0	16.3%	5.5	0.86	6.7%
2010e	1,574.2	101.0%	71.7	74.2	60.0	1,072.9	7.1%	12.1	0.84	6.7%
2011e	1,624.3	97.1%	105.0	116.8	60.0	1,135.3	10.9%	7.7	0.79	6.7%
2012e	1,733.0	95.8%	130.2	144.8	60.0	1,225.6	12.8%	6.2	0.73	6.7%

Source: Brit, Edison Investment Research

Price\* 900p  
Market Cap £707m

\*Price as at 21 July 2010

#### Share price graph



#### Share details

Code BRE  
Listing Full  
Sector Non-life insurance  
Shares in issue 78.5m

#### Business

Brit Insurance is a Netherlands domiciled general insurance and reinsurance group specialising in commercial insurance. It is organised into three business units – Brit Global Markets, Brit Reinsurance and Brit UK – and underwrites through the Brit Syndicate in Lloyd's and Brit Insurance Ltd.

#### Bull

- Diversified portfolio
- Well positioned for UK recovery
- Tax efficient

#### Bear

- Weak historic underwriting
- Pricing weakness
- Low investment returns

## Investment summary: Work in progress

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### **Management focused on improvement**

Brit Insurance is working hard to close the gap in its returns versus better-performing peers in the sector. The focus is on improving underwriting performance. In our opinion, underwriting performance has suffered both from being slow to take advantage of market opportunities and from persevering for too long with business lines that were insufficiently profitable. Brit Global Markets has been actively restructuring its portfolio, exiting underperforming lines such as US medical malpractice. Financial institutions insurance has been repositioned away from the large investment banks and mortgage brokers, focusing more on financial crime rather than liability. More recently, the group has increased its catastrophe exposure to near the limit of its risk appetite take advantage of the better pricing currently available, although on a group basis it is not as high as some peers.

Brit UK, a significant 27% of total premiums, has been building a strong regional broker network that leaves it well placed to benefit from an eventual turn in the market. We have factored in a gradual improvement from 2011.

We estimate that every 1% improvement in the group combined ratio lifts RONTA by 1.3%.

### **Recessionary claims exposure**

We are satisfied that credit crisis claims on its financial institutions book are adequately reserved. However, we are wary about the risk of further recession related claims emerging across the industry and note the above average exposure of Global Markets to professional risks.

### **Efficient balance sheet and corporate structure**

We consider Brit Insurance to be adequately capitalised but not excessively so or requiring attention. This remains the case on our estimates despite pressure on returns, as we do not anticipate any material growth in premiums between now and 2012. RONTA is further supported by a relatively high level of gearing within the balance sheet. The re-domicile to the Netherlands is tax efficient and we anticipate the tax rate dropping to roughly half of the UK basic rate.

### **Unlikely acquirer**

Brit Insurance looked at possible acquisitions earlier last year, including Chaucer. We view the Chaucer approach as opportunistic given its problems at the time, but it would have given access to Chaucer's strong underwriting capability. Underwriting is being addressed internally and we do not expect the group to be an acquirer.

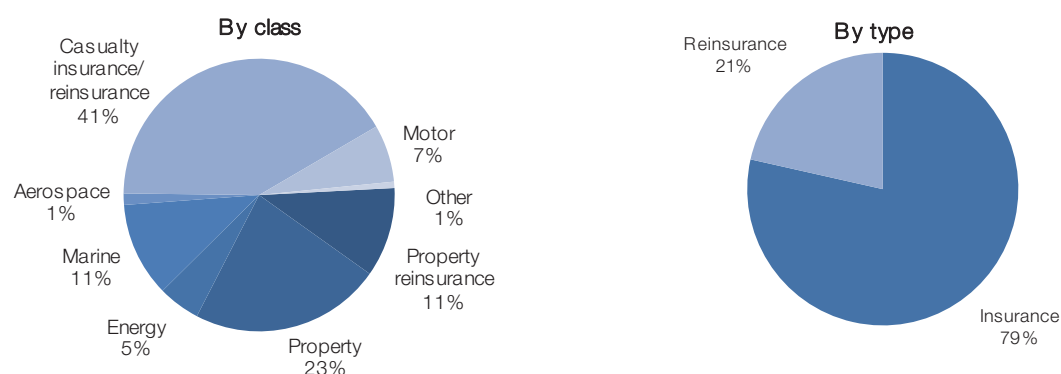
### **Apollo approaches**

Apollo's increased indicative offer of 1050p was not far off our expected end-year NTA and would have removed much uncertainty about near-term trading. Clearly if management initiatives are successful, then greater value will be realised over time. It seems logical to assume Apollo shares this view.

### **Conclusion**

We see the group as swimming somewhat against the tide as it seeks to improve returns, gaining no support from the market or investment returns. However, we do anticipate an improvement in returns as a result of the steps being taken and see fundamental upside in the shares.

## Exhibit 21: GWP split (2009)



Source: Brit, Edison Investment Research

## Exhibit 22: Financials

Year end 31 December	2008	2009	2010e	2011e	2012e	H110e
£m	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
Gross written premium	1,394.6	1,696.4	1,574.2	1,624.3	1,733.0	868.5
Net premium revenue	1,101.8	1,463.9	1,410.3	1,395.7	1,469.9	705.2
Investment return	(11.7)	133.3	68.5	74.0	77.8	38.8
Other income	5.1	3.3	(0.5)	1.0	1.0	(0.3)
<b>Total Revenue</b>	<b>1,095.2</b>	<b>1,600.5</b>	<b>1,478.3</b>	<b>1,470.8</b>	<b>1,548.7</b>	<b>743.7</b>
Net claims cost	(727.6)	(930.7)	(931.2)	(873.5)	(902.5)	(486.7)
Other expenses	(396.5)	(508.5)	(493.3)	(481.6)	(505.4)	(232.7)
FX	124.0	(33.4)	28.7	0.0	0.0	28.7
<b>Operating Profit</b>	<b>95.1</b>	<b>127.9</b>	<b>82.4</b>	<b>115.7</b>	<b>140.8</b>	<b>52.9</b>
Financing costs	(5.9)	(11.5)	(10.7)	(10.7)	(10.7)	(5.3)
<b>Profit Before Tax as reported</b>	<b>89.2</b>	<b>116.4</b>	<b>71.7</b>	<b>105.0</b>	<b>130.2</b>	<b>47.6</b>
Impact of FX on non-monetary items	49.6	(54.9)	0.0	0.0	0.0	0.0
<b>Profit Before Tax (norm)</b>	<b>39.6</b>	<b>171.3</b>	<b>71.7</b>	<b>105.0</b>	<b>130.2</b>	<b>47.6</b>
Tax	(22.6)	(28.9)	(14.3)	(14.7)	(18.2)	(9.5)
<b>Profit After Tax (norm)</b>	<b>26.2</b>	<b>125.6</b>	<b>57.4</b>	<b>90.3</b>	<b>111.9</b>	<b>38.1</b>
<b>Profit After Tax as reported</b>	<b>66.6</b>	<b>87.5</b>	<b>57.4</b>	<b>90.3</b>	<b>111.9</b>	<b>38.1</b>
Average Number of Shares Exc. Own shares (m)	77.3	77.3	77.3	77.3	77.3	77.3
<b>EPS - normalised (p)</b>	<b>33.9</b>	<b>162.5</b>	<b>74.2</b>	<b>116.8</b>	<b>144.8</b>	<b>49.2</b>
<b>EPS - as reported (p)</b>	<b>86.2</b>	<b>113.2</b>	<b>74.2</b>	<b>116.8</b>	<b>144.8</b>	<b>49.2</b>
<b>EPS - normalised and fully diluted (p)</b>	<b>33.9</b>	<b>162.5</b>	<b>74.2</b>	<b>116.8</b>	<b>144.8</b>	<b>49.2</b>
Dividend per share (p)	60.0	60.0	60.0	60.0	60.0	30.0
Dividend cover	0.6	2.7	1.2	1.9	2.4	1.6
NAV per share	1,099.2	1,156.8	1,178.0	1,240.3	1,330.7	1,183.0
ROE	3.1%	14.8%	6.4%	9.9%	11.7%	8.5%
Net tangible assets per share	992.8	1,052.0	1,072.9	1,135.3	1,225.6	1,078.0
RONTA	3.4%	16.3%	7.1%	10.9%	12.8%	9.4%
Loss ratio	63.5%	62.2%	66.0%	62.6%	61.4%	69.0%
Expense ratio (inc Group overhead)	35.4%	34.5%	35.0%	34.5%	34.4%	33.0%
Combined ratio	98.9%	96.7%	101.0%	97.1%	95.8%	102.0%
Reported COR	96.4%	94.0%	98.5%	94.6%	93.4%	102.0%
Investment return	0.0%	4.2%	2.0%	2.0%	2.0%	2.3%
NTA/GWP	84.2%	79.1%	49.0%	45.3%	43.3%	n.m
Debt/NTA	37.6%	30.1%	32.1%	30.2%	27.5%	n.m

Source: Brit, Edison Investment Research

26 July 2010

## Investment summary: Investments yield

Catlin has been investing heavily in international underwriting hubs, diversifying out of the wholesale London market, which is beginning to show meaningful results. While the Catlin Syndicate remains the largest in Lloyd's, the international hubs now contribute c 40% of group premiums and profits. We anticipate this business being more resilient in a weak market and offers continued opportunities for growth such that the contribution share that looks set to climb further. We see this diversification as highly attractive in a sector context with RONTA, as Catlin is further supported by tax efficiencies accruing from the Bermudan domicile and a higher-than-average level of debt (including preferred shares) within an overall solidly capitalised balance sheet.

### Successful diversification

Catlin's efforts to build a diversified international business to complement the more wholesale (and hence more cyclical) Lloyd's market business are clearly paying off. We see this diversification as highly attractive, offering growth opportunities and greater resilience in a weak market. The hubs have been growing strongly with each producing a positive profit contribution in 2009 for the first time. We are naturally cautious about the risks of fast growth but take comfort in Catlin's underwriting record and processes and the fact that the hubs are in "build up".

### Capital and tax efficiency

We consider Catlin's capital position to be solid, but not excessive or requiring strict management. Ordinary shareholder's equity is supported by an above-average level of debt including preference capital. We anticipate the premium growth over the next couple of years will use retained earnings and maintain this efficiency, so we do not expect material dividend growth. The Bermudan domicile affords Catlin tax efficiencies that further support RONTA.

### Valuation: Robust returns

We see Catlin's business and capital structure as able to support continued returns at or near the top of the sector, despite an expected weaker market and continued low investment returns. A mid-teen RONTA should support a premium P/NTA. However, we expect consensus earnings for CGL and the sector to fall further and cannot identify any obvious immediate catalyst for a re-rating.

#### Exhibit 23: Valuation

Note: PBT normalised; EPS normalised and fully diluted.

Year end December	GWP US\$m	COR %	PBT US\$m	EPS (US\$c)	DPS (US\$c)	NTA (US\$c)	RONTA %	P/E	P/NTA	Yield
2009	3,715	93.1%	603	147.2	40.0	590	34.5%	3.9	0.98	6.9%
2010e	3,921	94.4%	309	56.0	40.0	608	9.8%	10.4	0.95	6.9%
2011e	4,016	91.7%	412	84.5	40.0	656	14.4%	6.9	0.89	6.9%
2012e	4,413	91.4%	452	93.9	42.0	711	14.8%	6.2	0.82	7.2%

Source: Catlin, Edison Investment Research

Price\* 381p  
Market Cap £1.4bn

\*Price as at 21 July 2010

#### Share price graph



#### Share details

Code CGL  
Listing Full  
Sector Non-life insurance  
Shares in issue 358.9m

#### Business

Catlin Group is an international specialist insurer/reinsurer domiciled in Bermuda. It operates six underwriting hubs, in London, Bermuda, US, Asia Pacific, Europe and Canada. The London hub includes the large Catlin Syndicate at Lloyd's as well as Catlin Insurance (UK).

#### Bull

- Successful diversification
- Efficient balance sheet
- Tax efficiencies

#### Bear

- Pricing weakness
- Low investment returns

## Investment summary: Investments yield

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### Successful diversification

Catlin has remained among the largest underwriters in the Lloyd's market. Over many years it has invested in building a set of international businesses that now represent c 40% of premiums and underwriting profits, and are now driving group growth. The group operates six underwriting hubs in London, Bermuda, US, Asia Pacific, Europe and Canada. As a result, Catlin has a highly diversified premium base across insurance classes as well as geographies. This diversity is capital efficient and the lower dependence on the wholesale Lloyd's market should be more resilient and less cyclical, while offering continued growth opportunities.

We expect continued growth from the international business over the next couple of years, despite our assumption of a weaker overall market. We also expect the contribution share to climb further.

GWP in the international hubs grew 36% in 2009 after 33% in 2008. We are generally wary of the risks to underwriting quality from strong growth but take comfort from Catlin's strong underwriting culture and process as well as recognising that these businesses are still at a relatively early stage of development.

### Efficient structure

Shareholder returns are further enhanced by Catlin's efficient balance sheet structure and tax-efficient Bermuda domicile. During 2009, the group raised \$289m on new capital and entered this year with a healthy surplus of 19% over its economic capital requirement. This gives it the ability to withstand a major loss event and still be able to participate in the stronger market that may be expected to follow. Given the lower RONTA that we expect over the next couple of years, combined with expected international premium growth, this position looks entirely adequate but not excessive.

Additionally, returns to ordinary equity are enhanced by an above-average amount of debt funding, largely represented by non-cumulative perpetual preferred capital.

Catlin seeks to maximise the amount of capital held in Bermuda, which is both tax efficient and gives it increased flexibility to use that capital around the group. As well as third-party business, Bermuda also provides intra-group reinsurance. The resulting group tax rate is kept relatively low (we estimate c 15% on balance) but also volatile, depending on where the profits are actually generated. A heavy catastrophe loss year such as 2008 will generally see more profit generated in higher tax jurisdictions.

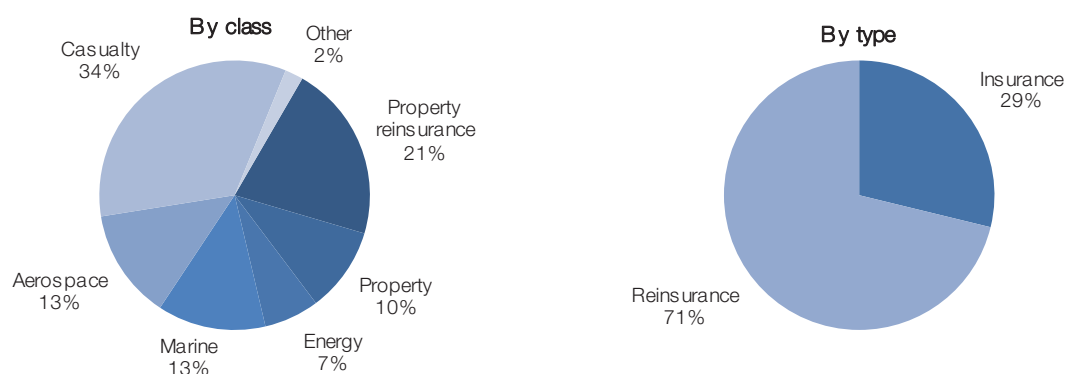
### De-risked investment portfolio

Catlin suffered heavy investment losses in 2008 on its hedge fund and fund-of-fund investments. 2009 saw a welcome bounce but the portfolio has now been substantially de-risked. This will inevitably mean a significant drop in investment return but gives Catlin flexibility to take advantage of opportunities that may arise.

### Conclusion

Catlin is not immune from the pressures currently facing the sector but its product and geographic diversity, record of disciplined underwriting, and efficient structure all combine to suggest a continuation of returns at the top of the peer group.

## Exhibit 24: GWP split (2009)



Source: Catlin, Edison Investment Research

## Exhibit 25: Financials

Year end 31 December US\$m	2008	2009	2010e	2011e	2012e	H110e
	US GAAP	US GAAP	US GAAP	US GAAP	US GAAP	US GAAP
Gross written premium	3,437.0	3,715.0	3,920.9	4,016.1	4,412.8	2,321.2
Net premium revenue	2,596.0	2,918.0	3,267.9	3,384.7	3,621.6	1,476.3
Investment return	(104.0)	383.0	141.1	148.0	156.7	92.5
Other income	15.0	4.0	0.0	0.0	0.0	0.0
<b>Total Revenue</b>	<b>2,507.0</b>	<b>3,305.0</b>	<b>3,409.0</b>	<b>3,532.7</b>	<b>3,778.2</b>	<b>1,568.8</b>
Net claims cost	(1,632.0)	(1,681.8)	(2,022.6)	(2,004.6)	(2,146.5)	(957.2)
Other expenses	(849.0)	(1,034.2)	(1,061.4)	(1,099.8)	(1,163.4)	(499.6)
FX	(21.0)	30.0	0.0	0.0	0.0	0.0
<b>Operating Profit</b>	<b>5.0</b>	<b>619.0</b>	<b>324.9</b>	<b>428.3</b>	<b>468.4</b>	<b>112.0</b>
Impact of FX on non-monetary items	0.0	1.0	2.0	3.0	4.0	0.0
Financing costs	(18.0)	(16.0)	(16.0)	(16.0)	(16.0)	(8.0)
<b>Profit Before Tax (norm)</b>	<b>(13.0)</b>	<b>603.0</b>	<b>308.9</b>	<b>412.3</b>	<b>452.4</b>	<b>104.0</b>
<b>Profit Before Tax as reported</b>	<b>(13.0)</b>	<b>604.0</b>	<b>310.9</b>	<b>415.3</b>	<b>456.4</b>	<b>104.0</b>
Tax	10.0	(50.0)	(61.8)	(61.8)	(67.9)	(15.6)
Preference dividend	(44.0)	(44.0)	(44.0)	(44.0)	(44.0)	(22.0)
<b>Attributable Profit After Tax (norm)</b>	<b>(47.0)</b>	<b>509.0</b>	<b>203.1</b>	<b>306.5</b>	<b>340.5</b>	<b>66.4</b>
<b>Attributable Profit After Tax as reported</b>	<b>(47.0)</b>	<b>510.0</b>	<b>205.1</b>	<b>309.5</b>	<b>344.5</b>	<b>66.4</b>
Average Number of Shares Exc. Own Shares (m)	286.0	333.7	350.1	350.1	350.1	350.1
<b>EPS - normalised (US\$c)</b>	<b>(16.4)</b>	<b>152.5</b>	<b>58.0</b>	<b>87.5</b>	<b>97.3</b>	<b>19.0</b>
<b>EPS - as reported (US\$c)</b>	<b>(16.4)</b>	<b>152.5</b>	<b>58.0</b>	<b>87.5</b>	<b>97.3</b>	<b>19.0</b>
<b>EPS - normalised and fully diluted (US\$c)</b>	<b>(16.4)</b>	<b>147.2</b>	<b>56.0</b>	<b>84.5</b>	<b>93.9</b>	<b>18.3</b>
Dividend per share (US\$c)	37.9	40.0	40.0	40.0	42.0	19.0
Dividend cover	(0.4)	3.7	1.4	2.1	2.2	1.0
NAV per share (US\$c)	661.0	768.0	766.5	812.9	866.8	752.5
ROE	(1.9%)	24.3%	7.6%	11.1%	11.7%	4.9%
Net tangible assets per share (US\$c)	463.0	590.0	608.1	655.6	710.9	593.7
RONTA	(2.5%)	34.5%	9.8%	14.4%	14.8%	6.4%
Loss ratio	62.9%	57.6%	61.9%	59.2%	59.3%	64.8%
Expense ratio (inc Group overhead)	32.7%	35.4%	32.5%	32.5%	32.1%	33.8%
Combined ratio	95.6%	93.1%	94.4%	91.7%	91.4%	98.7%
Reported COR	94.9%	89.1%	0.0%	0.0%	0.0%	n.a
Investment return	(1.4%)	5.8%	2.0%	2.0%	2.0%	2.7%
NTA/GWP	38.3%	55.6%	54.3%	57.2%	56.4%	n.m
Debt/NTA	52.3%	33.3%	32.3%	29.9%	27.6%	n.m

Source: Catlin, Edison Investment Research

# Chaucer Holdings

26 July 2010

## Investment summary: Running hard

The diversification benefits to capital requirement from Chaucer's large motor insurance book enable it to run a lean balance sheet relative to premiums written. Although Chaucer has a strong track record of underwriting, returns have been depressed by weak underwriting conditions in motor, low investment returns (which impact Chaucer more than most), and a lack of scale. Although motor rates are now improving strongly, and some other classes are responding to recent loss events, it is difficult to see a meaningful improvement in returns under current market conditions.

### Diversification benefit?

The diversification benefits from Chaucer's motor book enable it to write more premium per pound of capital than otherwise would be the case. This improves return on capital and also allows Chaucer greater scale efficiency. However, the benefit is less obvious when the motor market is generating large underwriting losses as it had been. Chaucer is aggressively raising rates to restore profitability.

### High investment gearing

The relatively longer-tail nature of Chaucer's underwriting portfolio combined with its lean balance sheet structure generates a high ratio of investment assets to net tangible assets, 3.7x at year end. As a result, Chaucer is hurt more than most by low investment returns, particularly given a more cautious investment stance after 2008 losses.

### Limited room for manoeuvre

We do not expect Chaucer's new management team to sit idle in the face of current challenging conditions, and we anticipate an update on strategy later in the year. In addition to restoring pricing in motor, we expect Chaucer to reposition the business closer to the customer. Chaucer also aims to bolster certain liability classes with some strong hires. However, we do not see any obvious levers that management can pull to significantly improve returns in current conditions.

### Valuation: Returns constrained

If Chaucer can achieve our forecast RONTA of c 11% the P/NTA of c 0.8x is too low, although not obviously so versus peers. Understandably the rating reflects concerns about capital gearing, shareholder gearing to reserve risks, and low dividend cover.

Price\* 46p

Market Cap £252m

\*Price as at 21 July 2010

Share price graph



Share details

Code CHU  
 Listing Full  
 Sector Non-life insurance  
 Shares in issue 548.1m

Business

Chaucer Holdings is a UK domiciled diversified insurance group, underwriting at Lloyd's. It underwrites a broad range of insurance risks but is atypical in that it writes a significant amount (20%) of motor.

Bull

- Good underwriting track record
- Improving motor conditions
- Attractive nuclear u/w niche

Bear

- High impact from low investment returns
- Low capital generation
- Lloyd's dependency

### Exhibit 26: Valuation

Note: PBT normalised; EPS normalised and fully diluted

Year end December	GWP £m	COR %	PBT £m	EPS (p)	DPS (p)	NTA (p)	RONTA %	P/E	P/NTA	Yield
2009	796.3	101.4%	75.3	10.4	4.0	55.5	19.8%	4.4	0.83	8.7%
2010e	813.7	98.4%	23.8	3.3	4.0	53.0	6.0%	14.1	0.87	8.7%
2011e	813.7	95.5%	42.6	5.7	4.0	53.2	11.0%	8.1	0.87	8.7%
2012e	894.4	95.3%	45.0	5.9	4.0	55.1	11.2%	7.8	0.83	8.7%

Source: Chaucer, Edison Investment Research



## Investment summary: Running hard

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### **Clear business model**

Chaucer has a clearly defined strategy for generating returns to shareholders. A diversified underwriting portfolio, particularly the large motor book, helps to minimise the amount of capital Chaucer needs to hold. A strong underwriting track record enhances the return on that capital. The "Turnkey Solutions Division", effectively the management of Lloyd's capacity for third-party interests, generates incomes and defrays cost. The nuclear insurance book is an attractive niche. Relative to the capital base, Chaucer also has a large investment portfolio that would normally add substantially to overall return, although at current levels of investment return this is greatly reduced.

Our assumption of continued low investment returns, combined with Chaucer's relative lack of scale compared with the spread of its underwriting interests, are the main factors constraining RONTA over the next couple of years despite re-pricing of the motor book. We note that Chaucer is also relatively underweight in areas such as catastrophe reinsurance where pricing has been strong, and we ascribe this to the group's risk appetite which in turn will be partly driven by the lean capital base.

### **Not standing still**

Chaucer finds itself with a new senior management line up following a turbulent 2008/9, which saw large losses on the investment portfolio and a capital raising amidst M&A approaches from Novae and Brit. We believe that management is working hard on executing the business model and will have more to say about strategy later in the year. A recent initiative is the hiring of a very experienced and respected team to begin writing international liability if rates eventually begin to turn as Chaucer expects. On private motor we expect rapid development of Chaucer Direct, enabling it to get closer to the customer, improve retention, and market ancillary products in a way that is not possible with the existing broker led business.

Given the existing lean balance sheet and dependence on the Lloyd's market, we do not see any significant levers that management can pull to significantly improve returns under current market conditions. Re-domicile to a lower tax jurisdiction is an option but it is not as obvious a choice as it may seem as it may have a significant impact on near-term cash-flows.

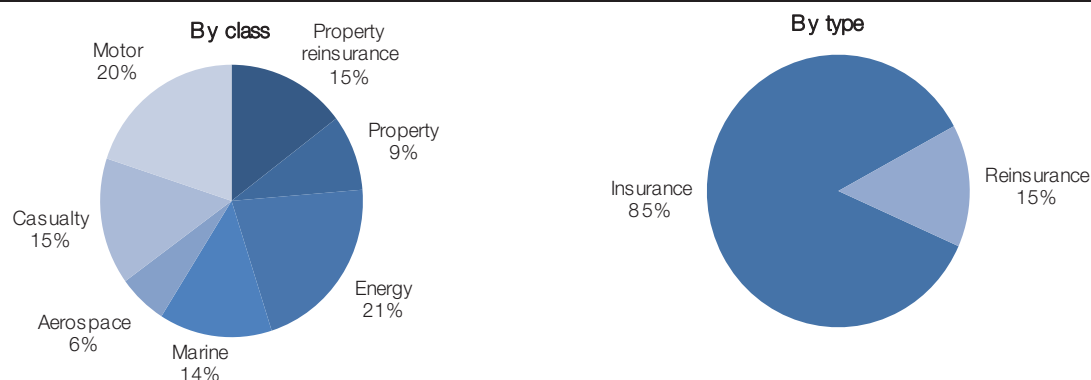
### **Some shareholder uncertainty**

During 2009 Pamplona Investment Holdings acquired 9.99% of Chaucer and declared its intention to buy up to 29.9%. It has been seeking regulatory approval from the FSA for the increased stake but no announcement has been forthcoming. Various press reports have suggested that the FSA has declined approval but we await confirmation and any indication from Pamplona of its future intentions.

### **Conclusion**

Chaucer has a clearly articulated strategy for producing returns on shareholder capital built around strong underwriting and a lean balance sheet structure. However, we see no obvious ways of significantly boosting returns above a solid low double-digit RONTA in the conditions that we anticipate over the next couple of years. Our forecast dividend cover is relatively low but barring unexpected earnings shocks or unanticipated growth opportunities we see it as sustainable.

Exhibit 27: GWP split (2009)



Source: Chaucer, Edison Investment Research

Exhibit 28: Financials

Year end 31 December	2008	2009	2010e	2011e	2012e	H110e
£m	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
Gross written premium	741.0	796.3	813.7	813.7	894.4	502.8
Net premium revenue	547.2	606.3	630.7	624.9	644.5	315.4
Investment return	(71.0)	53.3	34.2	35.1	35.1	20.0
Other income	9.2	11.2	8.5	8.5	8.5	5.6
<b>Total Revenue</b>	<b>485.4</b>	<b>670.8</b>	<b>673.5</b>	<b>668.5</b>	<b>688.0</b>	<b>341.0</b>
Net claims cost	(364.4)	(389.7)	(428.2)	(406.2)	(417.3)	(209.1)
Other expenses	(151.0)	(235.0)	(217.4)	(215.6)	(221.6)	(119.3)
FX	0.0	0.0	0.0	0.0	0.0	0.0
<b>Operating Profit</b>	<b>(30.0)</b>	<b>46.1</b>	<b>27.9</b>	<b>46.7</b>	<b>49.1</b>	<b>12.6</b>
Financing costs	(4.0)	(4.1)	(4.1)	(4.1)	(4.1)	(2.1)
Exceptional	7.8	0	0	0	0	0
<b>Profit Before Tax as reported</b>	<b>(26.2)</b>	<b>42.0</b>	<b>23.8</b>	<b>42.6</b>	<b>45.0</b>	<b>10.5</b>
Impact of FX on non-monetary items	33.3	(33.3)	0.0	0.0	0.0	0.0
<b>Profit Before Tax (norm)</b>	<b>(67.3)</b>	<b>75.3</b>	<b>23.8</b>	<b>42.6</b>	<b>45.0</b>	<b>10.5</b>
Tax	7.3	(13.9)	(6.7)	(11.9)	(12.6)	(2.9)
Minorities	(0.1)	0.0	0.0	0.0	0.0	0.0
<b>Profit After Tax (norm)</b>	<b>(48.6)</b>	<b>50.3</b>	<b>17.1</b>	<b>30.7</b>	<b>32.4</b>	<b>7.6</b>
<b>Profit After Tax as reported</b>	<b>(19.0)</b>	<b>28.1</b>	<b>17.1</b>	<b>30.7</b>	<b>32.4</b>	<b>7.6</b>
Average Number of Shares Exc. Own Shares (m)	317.3	480.4	520.6	535.6	543.1	520.6
<b>EPS - normalised (p)</b>	<b>(15.3)</b>	<b>10.5</b>	<b>3.3</b>	<b>5.7</b>	<b>6.0</b>	<b>1.5</b>
<b>EPS - as reported (p)</b>	<b>(6.0)</b>	<b>5.8</b>	<b>3.3</b>	<b>5.7</b>	<b>6.0</b>	<b>1.5</b>
<b>EPS - normalised and fully diluted (p)</b>	<b>(14.9)</b>	<b>10.4</b>	<b>3.3</b>	<b>5.7</b>	<b>5.9</b>	<b>1.4</b>
Dividend per share (p)	5.5	4.0	4.0	4.0	4.0	1.3
Dividend cover	(2.7)	2.6	0.8	1.4	1.5	1.1
NAV per share	72.9	61.7	59.1	59.1	61.0	58.6
ROE	(17.2%)	17.6%	5.4%	9.8%	10.1%	4.8%
Net tangible assets per share	62.5	55.5	53.0	53.2	55.1	52.6
RONTA	(19.4%)	19.8%	6.0%	11.0%	11.2%	5.3%
Loss ratio	66.6%	64.3%	67.9%	65.0%	64.8%	68.5%
Expense ratio (inc Group overhead)	35.6%	37.1%	34.5%	34.5%	34.4%	28.2%
Combined ratio	102.2%	101.4%	102.4%	99.5%	99.1%	96.7%
Reported COR	93.9%	93.2%	98.4%	95.5%	95.3%	97.2%
Investment return	(6.8%)	1.7%	1.5%	1.5%	1.5%	1.5%
NTA/GWP	26.1%	35.7%	34.4%	35.5%	33.5%	n.m
Debt/NTA	23.3%	14.2%	14.4%	14.0%	13.5%	n.m

Source: Chaucer, Edison Investment Research

# Hardy Underwriting Bermuda

26 July 2010

## Investment summary: Changing risk profile

Since 2007 Hardy has been undertaking an ambitious development programme, aiming to roughly double the size of the business by 2012 through diversification of the underwriting portfolio and a greater international presence, supported by its capital efficient Lloyd's platform. Given the weak rating trend in its traditional business lines, the significant expansion of property insurance and reinsurance was well timed. However, the size of Chilean earthquake losses this year, the largest relative to equity among the companies in this report, has damaged investor sentiment and refocused attention on whether recent growth will have impaired a strong underwriting track record. We think the atypical skew of Hardy's property reinsurance towards international and away from US risks largely explains the scale of the loss and expect investor confidence to rebuild slowly.

### Clear vision

Hardy showed a clear vision for the need to grow and diversify the business, as well as the opportunities this would afford. Hardy's traditional insurance classes have been weak and the expansion of property exposure well timed. Sourcing of business has been diversified through the opening of Hardy Bermuda and the launch of Middle East joint venture HAIM, and a Singapore office opens later in the year. Lacking the scale to establish separately capitalised insurance companies, Hardy uses its capital efficient Lloyd's platform to support growth. The Bermudan domicile has created tax efficiency.

### Good underwriting record

Hardy has enjoyed a strong underwriting track record. However, strong growth in the insurance industry, especially into new lines and territories, has often proven to be risky. The scale of Chilean earthquake losses and significant exceptional Australian hailstorm losses this year has given focus to these concerns.

### Valuation: Solid low cycle return

We believe forward RONTA of c 15% and a P/NTA of c 0.8x partly reflects investor concern about the maintenance of underwriting quality in Hardy's recent strong expansion. We think some caution understandable but the losses this year largely reflect the non-US focus of Hardy's book. A favourable performance in the H2 US windstorm season would help to rebuild sentiment.

#### Exhibit 29: Valuation

Note: PBT normalised; EPS normalised and fully diluted.

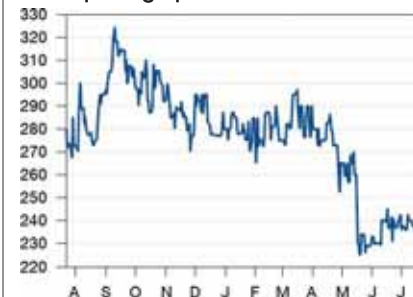
Year end December	GWP £m	COR %	PBT £m	EPS (p)	DPS (p)	NTA (p)	RONTA %	P/E	P/NTA	Yield
2009	242.0	84.6%	30.5	55.8	13.3	266.2	23.0%	4.2	0.89	5.6%
2010e	295.0	97.1%	9.6	15.9	14.5	268.1	6.0%	14.8	0.88	6.1%
2011e	309.8	91.6%	23.4	38.8	15.0	292.2	14.5%	6.1	0.81	6.4%
2012e	325.2	91.5%	25.3	41.9	15.5	318.7	14.3%	5.6	0.74	6.6%

Source: Hardy, Edison Investment Research

Price\* 236p  
Market Cap £123m

\*Price as at 21 July 2010

#### Share price graph



#### Share details

Code HDU  
Listing Full  
Sector Non-life insurance  
Shares in issue 52.3m

#### Business

Hardy Underwriting Bermuda is a specialist insurer/reinsurer operating in London and Bermuda, where the company is domiciled. It writes mainly shorter tail risks across a broad range of classes with recent strong growth in property insurance and reinsurance.

#### Bull

- Strong underwriting record
- Growing international platform
- Low tax domicile

#### Bear

- Uncertain risk from growth
- Premium rate weakness
- Low investment returns

## Investment summary: Changing risk profile

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### Strong vision

In our opinion Hardy's management has showed vision in developing the business. It enjoyed a good record of underwriting in its traditional lines of aviation, marine, specialty lines and, to a lesser extent, US property catastrophe treaty but was lacking in scale and completely dependent on the Lloyd's market. Growth has come largely from direct and facultative property insurance and a greatly expanded property treaty portfolio, particularly international. These lines have seen strong pricing in contrast to continued weakness across the traditional book. Hardy Bermuda opened last year to write property insurance and reinsurance that would not otherwise be available to Hardy in the Lloyd's market. Similarly, the Middle East joint venture, HAIM, diversifies the business available to Hardy and an office in Singapore opens later this year. Lacking the balance sheet to support separately capitalised business, Hardy makes use of its capital efficient Lloyd's platform. Domicile in Bermuda has yielded tax efficiencies.

### Changing risk profile

The growth in reinsurance, particularly catastrophe risks, has occurred in a strong pricing environment but is by nature more volatile. The relative size of Hardy's Chilean earthquake losses (and to a lesser extent Australian hailstorm losses) has unnerved investors and given focus to concerns that strong growth may impair underwriting quality. In our opinion the size of these losses largely reflects the fact that 70% of Hardy's property reinsurance exposure is International (rather than US), twice as large as Lloyd's market as a whole. It is overweight in Chile and Australia. The expanded property treaty reinsurance book has hitherto performed well, generating a underwriting profit in 2008, a year of large US windstorm loss to the industry.

### Scale is necessary

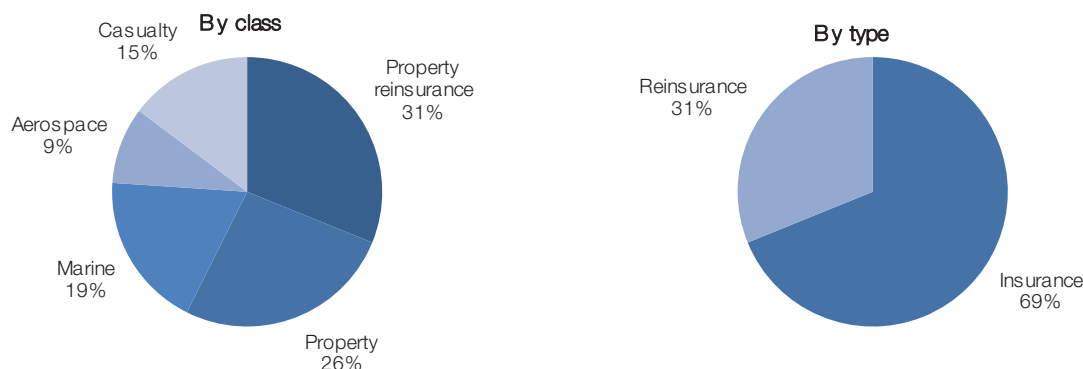
In general the size of premiums written in Hardy's traditional portfolio is smaller than the Group average but high margin. Scale is not a pressing issue. But the reinsurance business requires larger premium sizes to satisfy customers and brokers and a larger premium base to support international offices and effective risk modelling capabilities in particular. For this reason we expect Hardy to seek further balanced expansion.

### Growth may slow for now

With most insurance classes showing weak pricing trends and reinsurance prices showing signs of having peaked, we expect growth at Hardy to slow from the recent rapid pace through 2011/12. If market conditions are right, however, we would expect Hardy to take advantage, perhaps looking to use third-party capital to manage shareholder risk exposure and to support own capital where growth is held back by unwelcome developments this year.

### Conclusion

Hardy has a strong track record of underwriting but rapid development inevitably raises concerns about the management of risk. Experience this year has given focus to those concerns, although we think the structure of Hardy's risk exposure explains much of the difference versus peers. A more active US windstorm season, with Hardy performing well versus peers would see investor confidence begin to recover we think.

**Exhibit 30: GWP split (2010e)**

Source: Hardy, Edison Investment Research

**Exhibit 31: Financials**

Year end 31 December	2008	2009	2010e	2011e	2012e	H110e
£m	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
Gross written premium	172.8	242.0	295.0	309.8	325.2	175.0
Net premium revenue	120.8	176.6	207.8	232.8	244.5	103.4
Investment return	7.8	5.6	4.6	5.1	5.5	2.3
Other income	0.3	0.3	0.5	0.5	0.5	0.3
<b>Total Revenue</b>	<b>128.9</b>	<b>182.6</b>	<b>212.9</b>	<b>238.4</b>	<b>250.5</b>	<b>106.0</b>
Net claims cost	(69.6)	(83.2)	(120.2)	(123.6)	(130.0)	(67.5)
Other expenses	(53.1)	(71.1)	(81.5)	(89.7)	(93.6)	(39.1)
FX	9.2	3.7	0.0	0.0	0.0	0.0
<b>Operating Profit</b>	<b>15.3</b>	<b>32.1</b>	<b>11.2</b>	<b>25.0</b>	<b>26.9</b>	<b>(0.6)</b>
Impact of FX on non-monetary items	9.5	(10.4)	0.0	0.0	0.0	0.0
Financing costs	(1.7)	(1.6)	(1.6)	(1.6)	(1.6)	(0.8)
<b>Profit Before Tax (norm)</b>	<b>13.6</b>	<b>30.5</b>	<b>9.6</b>	<b>23.4</b>	<b>25.3</b>	<b>(1.4)</b>
<b>Profit Before Tax as reported</b>	<b>23.1</b>	<b>20.1</b>	<b>9.6</b>	<b>23.4</b>	<b>25.3</b>	<b>(1.4)</b>
Tax	(3.6)	(2.7)	(1.4)	(3.5)	(3.8)	0.2
<b>Profit After Tax (norm)</b>	<b>11.5</b>	<b>26.4</b>	<b>8.2</b>	<b>19.9</b>	<b>21.5</b>	<b>(1.2)</b>
<b>Profit After Tax as reported</b>	<b>19.5</b>	<b>17.4</b>	<b>8.2</b>	<b>19.9</b>	<b>21.5</b>	<b>(1.2)</b>
Average Number of Shares Exc. Own Shares (m)	35.2	47.4	51.3	51.3	51.3	51.3
<b>EPS - normalised (p)</b>	<b>32.7</b>	<b>55.8</b>	<b>15.9</b>	<b>38.8</b>	<b>41.9</b>	<b>(2.4)</b>
<b>EPS - as reported (p)</b>	<b>55.4</b>	<b>36.8</b>	<b>15.9</b>	<b>38.8</b>	<b>41.9</b>	<b>(2.4)</b>
<b>EPS - normalised and fully diluted (p)</b>	<b>32.7</b>	<b>55.8</b>	<b>15.9</b>	<b>38.8</b>	<b>41.9</b>	<b>(2.4)</b>
Dividend per share (p)	12.1	13.3	14.5	15.0	15.5	4.4
Dividend cover	2.7	4.2	1.1	2.6	2.7	(0.5)
NAV per share	289.5	296.4	298.3	322.4	349.0	284.5
ROE	13.5%	20.3%	5.4%	13.0%	13.0%	(1.6%)
Net tangible assets per share	245.4	266.2	268.1	292.2	318.7	254.3
RONTA	16.5%	23.0%	6.0%	14.5%	14.3%	(1.8%)
Loss ratio	56.3%	45.1%	57.8%	53.1%	53.2%	65.3%
Expense ratio (inc Group overhead)	43.5%	39.4%	39.2%	38.5%	38.3%	37.8%
Combined ratio	99.9%	84.6%	97.1%	91.6%	91.5%	103.1%
Reported COR	92.8%	80.6%	90.8%	86.1%	86.1%	96.8%
Investment return	5.2%	1.7%	1.5%	1.5%	1.5%	1.5%
NTA/GWP	49.9%	56.4%	46.6%	48.4%	50.3%	n.m
Debt/NTA	23.5%	13.3%	13.2%	12.1%	11.1%	n.m

Source: Hardy, Edison Investment Research

# Hiscox

26 July 2010

## Investment summary: Belle whatever the weather

Hiscox has executed well on its strategy to build out its specialist 'retail' international insurance business as a balance to the better margined, but more volatile, catastrophe-exposed lines. We see continued good growth prospects from the retail business, which gives Hiscox the flexibility to rein back on the catastrophe reinsurance business if pricing falls back from its elevated level. Combined with a slightly greater appetite for risk in its investment portfolio we expect continued above sector returns and a progressive dividend policy.

### Retail business drives growth

We expect continued growth from the more retail-focused business in the UK & Europe, and the US which have plenty of headroom to grow in chosen markets, while producing a relatively stable underwriting performance. The group contains some strong and highly resilient niches in areas such as 'Kidnap and Ransom' and 'Fine Art'.

### Retail supports catastrophe business

The growing and relatively dependable base of earnings in the retail business has allowed Hiscox to grow higher margin but more volatile business, such as property catastrophe reinsurance, while maintaining balance within the overall portfolio. Hiscox has been relatively nimble, taking advantage of strong rates to increase exposure as far as it feels comfortable. If rates continue to soften from here, the growing retail business gives Hiscox the flexibility to rein back exposure.

### Solid capital position

Hiscox has increased the capital held in business while returns are more dependent on volatile underwriting performance with investment returns low. Nonetheless, we see room for progressive dividend growth and more substantive capital measures if reinsurance exposure is reduced over the next year or so.

### Valuation: Outperformance to continue

Barring unexpected 'outsized' losses, we think Hiscox is capable of sustaining a 15% RONTA despite a weaker market and low investment returns. This supports a significantly higher valuation in absolute terms and a continued premium to sector. However, we expect consensus earnings for HSX and the sector to fall further and cannot identify a Hiscox-specific catalyst for a re-rating at this time.

#### Exhibit 32: Valuation

Note: PBT normalised; EPS normalised and fully diluted.

Year-end December	GWP £m	COR %	PBT £m	EPS (p)	DPS (p)	NTA (p)	RONTA %	P/E	P/NTA	Yield
2009	1,435	81.6%	374	84.3	15.0	285.7	36.3%	4.1	1.22	4.3%
2010e	1,519	94.2%	147	32.0	16.5	321.2	11.7%	10.9	1.09	4.7%
2011e	1,585	90.6%	202	44.0	18.0	351.8	14.2%	7.9	0.99	5.2%
2012e	1,759	90.6%	218	47.5	19.5	383.1	14.0%	7.3	0.91	5.6%

Source: Hiscox, Edison Investment Research

Price\* 349p  
Market Cap £1.4bn

\*Price as at 21 July 2010

#### Share price graph



#### Share details

Code HSX  
Listing Full  
Sector Non-life insurance  
Shares in issue 403.1m

#### Business

Hiscox is an international specialist insurer/reinsurer domiciled in Bermuda. Its strategy is to balance more volatile catastrophe-exposed business with less volatile local specialty insurance.

#### Bull

- Well balanced portfolio
- Organic growth in retail
- Solid balance sheet

#### Bear

- Pricing weakness
- Low investment returns

## Investment summary: Belle whatever the weather

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### **Well balanced portfolio**

The more retail-focused specialist insurance activities accounted for 46% of GWP in 2009. The business is predominantly in the UK & Europe division and the US within the International division. Areas such as 'Kidnap & Ransom' and 'Fine Art' are specialist niches that generate good returns and are generally less competitive.

We expect continued growth and would also anticipate improving operational efficiency as the businesses increase in scale.

However, for the group, the importance of retail goes beyond building strong businesses. These businesses provide the stable counter-balance to the higher-margin, more-volatile parts of the portfolio, particularly property catastrophe. Hiscox has taken full advantage of strong reinsurance pricing to increase its exposure to the maximum level at which it is comfortable with risk. At 31%, it is high in a sector context, although Hiscox is making use of third-party capital to limit its own balance sheet exposure. If elevated reinsurance pricing shows weakness from here, then the growing retail business gives Hiscox the flexibility to pare back its exposure.

### **Strong reserve releases**

Reserve releases have made an important contribution to earnings over the past couple of years. In 2009 £139m was released, benefitting the combined ratio by 13%. We think this reflects a combination of strong upfront reserving, the run-off of longer-tail classes written profitably in the 2002/04 period, and some large claims settlements. We would expect some tailing off but a continued strong contribution based on initial strong reserving.

### **Slightly more aggressive investment stance**

Hiscox runs a slightly more aggressive investment portfolio than peers, with 41% of the portfolio in a mixture of corporate bonds, equities, and ABS/MBS. After suffering investment losses in 2008, it held its nerve and enjoyed a 7.2% return in 2009. Now that risk spreads have narrowed, it will not repeat that performance but would hope benefit slightly versus peers with more government bond focused portfolios.

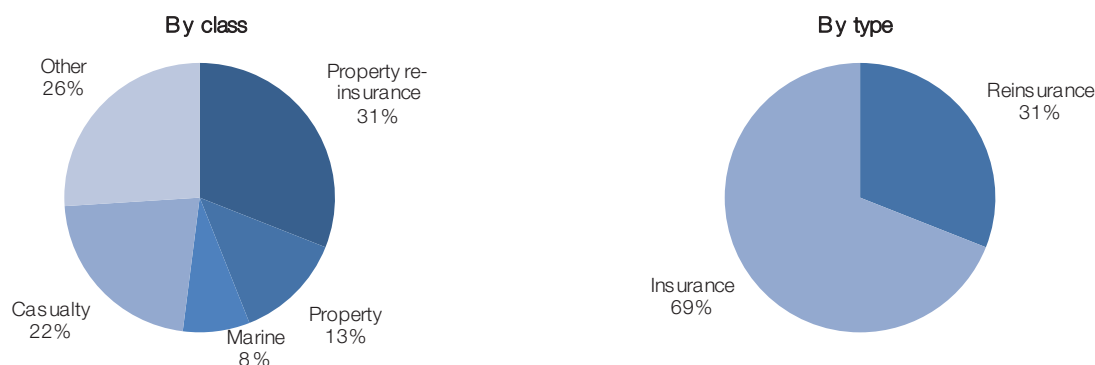
### **Lower investment returns mean more capital to support risk**

Hiscox has increased the capital held in the business. It makes the point that lower (dependable) investment returns require more capital to be held to cover volatile insurance risk. It may also be factoring in catastrophe exposure and the maximum of its risk tolerance, continued growth in retail, Solvency II uncertainty, and debt renegotiation in 2013.

We do not expect any significant moves on the capital front, although we do expect continued growth in the dividend. If Hiscox finds itself reducing exposure to catastrophe business as a result of weaker pricing, then we think this could change, especially if the shares are trading at a discount to NTA.

### **Conclusion**

We believe Hiscox will continue to show above-average returns mainly as a result of its well managed, geographically diversified, and well balanced book of business. However, low investment returns and a weaker pricing environment will be a drag for the foreseeable future.

**Exhibit 33: GWP split (2009)**

Source: Hiscox, Edison Investment Research

**Exhibit 34: Financials**

Year end 31 December	2008	2009	2010e	2011e	2012e	H110e
£m	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
Gross written premium	1,147.4	1,435.4	1,519.5	1,584.7	1,758.7	959.1
Net premium revenue	928.1	1,098.1	1,191.5	1,253.2	1,365.2	595.7
Investment return	(80.6)	183.2	62.8	68.2	73.8	40.0
Other income	20.1	19.6	19.4	19.4	19.4	8.1
<b>Total Revenue</b>	<b>867.6</b>	<b>1,300.9</b>	<b>1,273.7</b>	<b>1,340.8</b>	<b>1,458.4</b>	<b>643.8</b>
Net claims cost	(479.4)	(463.2)	(627.8)	(618.9)	(680.7)	(338.3)
Other expenses	(387.6)	(486.2)	(494.7)	(516.1)	(555.6)	(243.3)
FX	73.7	27.6	0.0	0.0	0.0	0.0
<b>Operating Profit (pre impact of FX on non-monetary items)</b>	<b>74.2</b>	<b>379.1</b>	<b>151.2</b>	<b>205.9</b>	<b>222.1</b>	<b>62.2</b>
Impact of FX on non-monetary items	36.1	(53.2)	0.0	0.0	0.0	0.0
Financing costs	(5.2)	(5.3)	(4.3)	(4.3)	(4.3)	(2.6)
<b>Profit Before Tax (norm)</b>	<b>69.1</b>	<b>373.8</b>	<b>146.9</b>	<b>201.6</b>	<b>217.8</b>	<b>59.6</b>
<b>Profit Before Tax as reported</b>	<b>105.2</b>	<b>320.6</b>	<b>146.9</b>	<b>201.6</b>	<b>217.8</b>	<b>59.6</b>
Tax	(34.4)	(40.1)	(22.0)	(30.2)	(32.7)	(14.9)
<b>Profit After Tax (norm)</b>	<b>46.5</b>	<b>327.0</b>	<b>124.9</b>	<b>171.4</b>	<b>185.2</b>	<b>44.7</b>
<b>Profit After Tax as reported</b>	<b>70.8</b>	<b>280.5</b>	<b>124.9</b>	<b>171.4</b>	<b>185.2</b>	<b>44.7</b>
Average Number of Shares Exc. Own Shares (m)	377.5	372.8	374.8	374.8	374.8	374.8
<b>EPS - normalised (p)</b>	<b>12.3</b>	<b>87.7</b>	<b>33.3</b>	<b>45.7</b>	<b>49.4</b>	<b>11.9</b>
<b>EPS - as reported (p)</b>	<b>18.8</b>	<b>75.2</b>	<b>33.3</b>	<b>45.7</b>	<b>49.4</b>	<b>11.9</b>
<b>EPS - normalised and fully diluted (p)</b>	<b>11.9</b>	<b>84.3</b>	<b>32.0</b>	<b>44.0</b>	<b>47.5</b>	<b>11.5</b>
Dividend per share (p)	12.8	15.0	16.5	18.0	19.5	5.0
Dividend cover	0.9	5.6	1.9	2.4	2.4	2.3
NAV per share	258.1	299.2	334.7	365.2	396.6	312.7
ROE	5.6%	34.4%	11.1%	13.7%	13.5%	8.0%
Net tangible assets per share	244.9	285.7	321.2	351.8	383.1	299.3
RONTA	6.0%	36.3%	11.7%	14.2%	14.0%	8.3%
Loss ratio	51.7%	42.2%	52.7%	49.4%	49.9%	56.8%
Expense ratio (inc Group overhead)	45.7%	39.4%	41.5%	41.2%	40.7%	40.8%
Combined ratio	97.3%	81.6%	94.2%	90.6%	90.6%	97.6%
Reported COR	75.3%	86.0%	93.4%	89.8%	89.8%	96.8%
Investment return	(1.3%)	7.2%	2.5%	2.5%	2.5%	1.5%
NTA/GWP	78.7%	74.6%	79.2%	83.2%	81.7%	n.m
Debt/NTA	15.9%	12.9%	11.5%	10.5%	9.6%	n.m

Source: Hiscox, Edison Investment Research



# Lancashire Holdings

26 July 2010

## Investment summary: Staying nimble

Lancashire's business model differs quite considerably from that of the peers featured elsewhere in this report. It is extremely focused on ROE/RONTA and highly selective in the generally short-tail, low probability but high severity risks that it accepts. It has no premium targets but operates nimbly as market conditions allow, adjusting the capital base quite aggressively to manage returns. To date, it has successfully executed on this strategy with a 19% compound annual growth in book value adjusted for dividends since inception.

### Highly flexible

We have highlighted elsewhere in this report how premium growth targets can often become a source of disappointment as underwriting quality suffers. Lancashire has no premium targets, making forward estimates unusually testing. It is highly selective and opportunistic about the risks it writes, preferring to aggressively manage the capital base to support returns. It is supported in this by a relatively simple business structure with relatively low overheads for the small size of premium.

### Strong shareholder returns despite low dividend

Lancashire favours special dividend payments and share buy-backs over ordinary dividends so as to maximise flexibility. These have been significant, yet Lancashire maintains a very strong balance sheet, so that it can withstand a major loss event but still be sufficiently capitalised to take advantage of the likely rate increases to follow.

### Low investment gearing

The short-tail nature of the portfolio and age of the business combined with a strong capital base means that returns are more than averagely driven by underwriting, an advantage while investment returns are low.

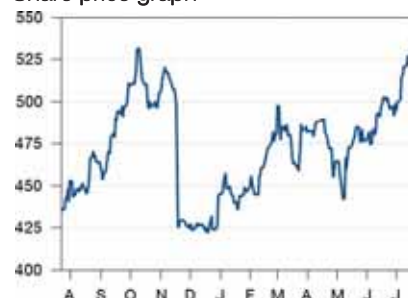
### Valuation: Strong but volatile returns

If Lancashire can nimbly find opportunities in a generally weak market then past performance and our best guesses suggest the shares are clearly undervalued, supported by continuing buy-backs. With debt/NTA at just 10% there is also room to introduce more gearing into the portfolio or take advantage of market opportunities if they arise.

Price\* 536p  
Market Cap £931m

\*Price as at 21 July 2010

#### Share price graph



#### Share details

Code LRE  
Listing Full  
Sector Non-life insurance  
Shares in issue 173.6m

#### Business

Lancashire Holdings is a Bermuda domiciled specialist insurer/reinsurer formed in 2005. It writes mainly short tail business with a particular focus on low incidence but high severity risks. Unlike peers featured in this report it does not operate within Lloyd's.

#### Bull

- Strong underwriting process
- Very returns focused
- Strong balance sheet

#### Bear

- Volatility of returns in chosen markets
- Premium rate weakness
- Bermuda dependence

#### Exhibit 35: Valuation

Note: PBT normalised; EPS normalised and fully diluted; NTA adjusted for outstanding warrants and options.

Year end December	GWP US\$m	COR %	PBT US\$m	EPS (US\$c)	DPS (US\$c)	NTA (US\$c)	RONTA %	P/E	P/NTA	Yield
2009	628	47.4%	389	205.2	5.0	741	30.5%	4.0	1.10	0.6%
2010e	627	81.1%	158	86.5	15.0	780	11.9%	9.4	1.05	1.8%
2011e	629	72.6%	211	117.9	20.0	867	14.8%	6.9	0.94	2.4%
2012e	681	71.3%	233	129.9	25.0	960	14.5%	6.3	0.85	3.1%

Source: Lancashire, Edison Investment Research

## Investment summary: Staying nimble

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### Highly flexible

Lancashire looks for short-tail risks with a low probability of loss occurring but a high severity of loss if it does. Such business tends to be high margin but volatile. The underwriting process is distinctive and aided by the size and organisational simplicity of the business. Every risk comes before the daily underwriting conference call where it is scrutinised by senior management, fellow underwriters and actuaries. Lancashire has shown that if it cannot get the business it wants at the right price then it is prepared to shrink the premium base and aggressively manage capital to maximise ROE/RONTA. In 2009 gross written premium fell by 2% but 11% when adjusted for a 9% average premium rate increase. A relatively simple business structure contributes towards a relatively low cost ratio for the size of premiums. So far, the results are very good, with a compound growth in net tangible assets per share, adjusted for dividends, of 19%.

### Significant capital returns

To maximise flexibility over management of the capital base, Lancashire prefers to use special dividends and share buy-backs rather than committing to larger regular dividends. Special dividends of \$240m and \$263m were paid in 2007 and 2009. We estimate that c \$275m of shares will have been repurchased up to June 2010, with c \$75m of the current buy-back facility still being executed. Our forecast assumes a \$50m repurchase during the second half of this year at a slight discount to tangible net assets per share (adjusted for outstanding warrants and options).

### Balance sheet remains strong

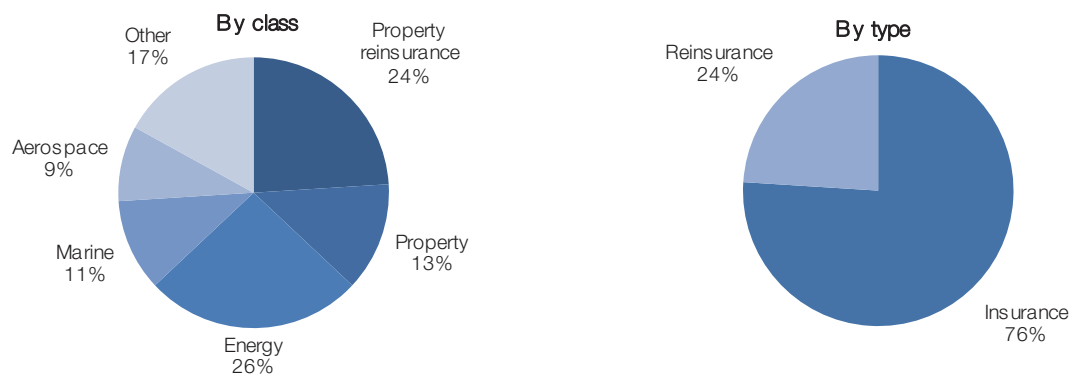
Despite the capital returns, Lancashire's balance sheet remains strong. The ratio of net tangible assets to gross written premium is a high 220%, although this partly reflects the youthfulness of the company and its mix of business. Debt/NTA is just 10%. A better way to look at it is to say that Lancashire has a risk tolerance of c 25% of NTA or c \$350m, which combined with accrued 'normal' profits would mean it could withstand a large one in 100-year event and still have available capital to take advantage of the hardening in rates that could be expected to follow.

### Will there be opportunities in a weak market?

It is not possible for investors or indeed for Lancashire itself to know whether there will be continued opportunities to deploy capital in weaker market conditions. Recent experience is positive. A significantly increased amount of property catastrophe insurance was written early in the year to take advantage of still strong rates, expected to progressively weaken. We would anticipate that Lancashire has significantly increased both volume and pricing in its energy business following the Deepwater Horizon disaster. Increased demand for cover and tighter regulation of the off-shore industry should be positive in future. However, other classes are not as favourable and Lancashire's exposure is shrinking.

### Conclusion

Making forward estimates for Lancashire is especially difficult given its disciplined but opportunistic approach to underwriting and the inevitable volatility of results, but we foresee continued healthy returns, if less spectacular than recent years. This discipline may be seen as a 'lack of growth' by some investors but we would not share this concern.

**Exhibit 36: GWP split (2009)**

Source: Lancashire, Edison Investment Research

**Exhibit 37: Financials**

Year end 31 December	2008	2009	2010e	2011e	2012e	H110e
US\$m	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
Gross written premium	638.1	627.8	626.8	629.3	680.8	396.8
Net premium revenue	607.3	594.7	576.8	578.0	607.4	299.9
Investment return	47.8	80.1	58.7	61.9	67.8	35.2
Other income	0.0	0.0	0.0	0.0	0.0	0.0
<b>Total Revenue</b>	<b>655.1</b>	<b>674.8</b>	<b>635.5</b>	<b>639.9</b>	<b>675.2</b>	<b>335.2</b>
Net claims cost	(375.5)	(98.7)	(298.1)	(248.3)	(253.3)	(195.0)
Other expenses	(159.5)	(182.9)	(170.0)	(171.3)	(180.0)	(85.0)
FX	(8.5)	3.4	0.0	0.0	0.0	0.0
<b>Operating Profit</b>	<b>111.6</b>	<b>396.6</b>	<b>167.5</b>	<b>220.3</b>	<b>242.0</b>	<b>55.2</b>
Financing costs	(14.0)	(8.1)	(9.1)	(9.1)	(9.1)	(3.6)
<b>Profit Before Tax as reported</b>	<b>97.6</b>	<b>388.5</b>	<b>158.4</b>	<b>211.2</b>	<b>232.9</b>	<b>51.6</b>
Impact of FX on non-monetary items	0.0	0.0	0.0	0.0	0.0	0.0
<b>Profit Before Tax (norm)</b>	<b>97.6</b>	<b>388.5</b>	<b>158.4</b>	<b>211.2</b>	<b>232.9</b>	<b>51.6</b>
Tax	(0.1)	(3.1)	(7.9)	(10.6)	(11.6)	(2.6)
<b>Profit After Tax (norm)</b>	<b>97.5</b>	<b>385.4</b>	<b>150.5</b>	<b>200.7</b>	<b>221.2</b>	<b>49.0</b>
<b>Profit After Tax as reported</b>	<b>97.5</b>	<b>385.4</b>	<b>150.5</b>	<b>200.7</b>	<b>221.2</b>	<b>49.0</b>
Average Number of Shares Exc. Own Shares (m)	177.5	172.7	160.1	156.6	156.6	163.5
<b>EPS - normalised (\$c)</b>	<b>54.9</b>	<b>223.1</b>	<b>94.0</b>	<b>128.1</b>	<b>141.3</b>	<b>29.9</b>
<b>EPS - as reported (\$c)</b>	<b>54.9</b>	<b>223.1</b>	<b>94.0</b>	<b>128.1</b>	<b>141.3</b>	<b>29.9</b>
<b>EPS - normalised and fully diluted (\$c)</b>	<b>52.9</b>	<b>205.2</b>	<b>86.5</b>	<b>117.9</b>	<b>129.9</b>	<b>27.5</b>
Dividend per share (\$c)	0.0	5.0	15.0	20.0	25.0	10.0
Dividend cover	n.m.	41.0	5.8	5.9	5.2	2.8
NAV per share (\$c)	736.30	808.88	864.44	973.86	1,092.04	836.25
ROE	8.2%	30.5%	11.9%	14.8%	14.5%	7.2%
Net tangible assets per share (\$c)	736.30	808.88	864.44	973.86	1,092.04	836.25
RONTA	8.2%	30.5%	11.9%	14.8%	14.5%	7.2%
Loss ratio	61.8%	16.6%	51.7%	43.0%	41.7%	65.0%
Expense ratio (inc Group overhead)	26.3%	30.8%	29.5%	29.6%	29.6%	28.3%
Combined ratio	88.1%	47.4%	81.1%	72.6%	71.3%	93.3%
Reported COR	86.3%	44.6%	77.7%	69.0%	67.7%	91.0%
Investment return	3.0%	2.6%	2.5%	2.5%	2.5%	0.0%
NTA/GWP	199.5%	219.6%	216.0%	242.3%	251.2%	n.m
Debt/NTA	10.3%	9.5%	9.7%	8.6%	7.7%	n.m

Source: Lancashire, Edison Investment Research

# Novae Group

26 July 2010

## Investment summary: Time to grow?

With legacy underwriting issues largely dealt with, management can now focus on improving a below-sector ROE that has contributed to underperformance in recent years. Re-organising the business structure to unlock under-used capital produces a fairly predictable benefit and we expect a return of capital later this year. However, working the remaining capital harder and continuing to diversify exposure into better priced areas of the market carries significant execution risk. If successful, the strategy offers the reward of significantly better returns and an improved absolute and relative rating, but we would expect the market to remain cautious until evidence of success emerges.

### Reorganisation and capital return

Novae is moving to unlock £60m of under-used capital in its NICL subsidiary. Subject to court approval we anticipate £30m (c 40p per share) being returned to investors later in the year. No tax is likely to be paid through 2012 (though charged to the P&L), but beyond that, re-domicile to a lower tax jurisdiction is under review.

### Diversified growth

We also expect it to seek capital and operational efficiency through growth. Novae's traditional casualty lines have experienced a muted rating environment and suffered the effects of lowered investment returns on typically longer held reserves. We anticipate further capital efficient diversification of risk and growth in property and reinsurance where rates have been stronger.

### Open to M&A

Novae's approach to Chaucer last year is evidence of its willingness to grow value through M&A. However, the low share rating poses a challenge.

### Valuation: Increasing return and risk

We anticipate growth in GWP despite the weak market outlook. The improved RONTA is largely the result of diversified premium growth without a commensurate rise in capital requirement and with no deterioration in underwriting ratios. We note that a 1% shift in expected combined ratio impacts RONTA by 1.1% and NTA by 2.7%. It is also the case that a 1% increase in investment yield would lift RONTA by a similar amount. If strategy is successfully implemented the shares appear undervalued with a 2012 RONTA of 11.3% (taxed at full the UK rate) for a P/NTA of 0.67x.

#### Exhibit 38: Valuation

Note: PBT normalised; EPS normalised and fully diluted.

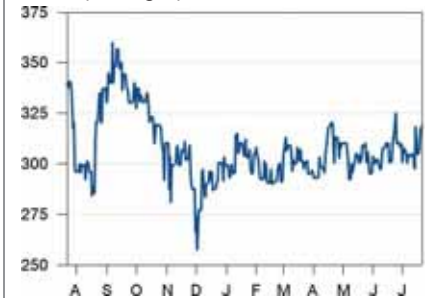
Year end December	GWP £m	COR %	PBT £m	EPS (p)	DPS (p)	NTA (p)	RONTA %	P/E	P/NTA	Yield
2009	384	104.9%	17.7	20.2	11.0	423	5.3%	15.8	0.75	3.4%
2010e	582	96.3%	26.7	26.3	12.0	397	6.4%	12.1	0.80	3.8%
2011e	669	95.6%	34.7	34.1	12.5	419	8.5%	9.3	0.76	3.9%
2012e	736	94.4%	46.0	45.2	13.0	453	11.3%	7.1	0.70	4.1%

Source: Novae, Edison Investment Research

Price\* 319p  
Market Cap £234m

\*Price as at 21 July 2010

#### Share price graph



#### Share details

Code NVA  
Listing Full  
Sector Non-life insurance  
Shares in issue 73.2m

#### Business

Novae Group is a London-based specialist insurer/reinsurer that will soon operate entirely through Lloyd's. Business is split between Speciality, Property, Liability, and Aviation & Marine with casualty business representing c 54% of 2009 GWP.

#### Bull

- Able management team
- Clear focus on returns
- Expected capital return

#### Bear

- Greater exposure to recession led claims
- Execution risk to growth
- High dependence on Lloyd's

## Investment summary: Time to grow?

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### **Legacy issues near an end**

Novae's able management team has spent the past few years dealing with the legacy of poor underwriting from the early 2000s. The impact on Novae has gone beyond the pure financial by slowing management in its plans to develop the business by increasing scale and diversifying its traditional business sourced in the Lloyd's market. Remaining legacy claims of just £101m are running according to plan but consume £40m of capital with no material return. A transaction to exit this business entirely, even at a discount, would be beneficial to group returns and would reduce volatility.

### **Capital reorganisation a start....**

Novae has transferred the underwriting of small commercial risks in the UK from NICL to its Lloyd's syndicate in a move that will free £60m of under-used capital, subject to court approval, and improve cost efficiency. We forecast a £30m return of capital towards the end of the year, which lifts our expected 2011 RONTA by 40bps. Re-domicile to a lower tax jurisdiction is a possibility when tax becomes payable, likely after 2012.

An upwards move in investment returns would be make a material difference to Novae given its high level of investments relative to equity as a result of its traditional casualty focus, but cannot be relied on. A 1% upwards shift in returns would add 2.8% to our forecast RONTA.

### **... but we also expect diversified growth**

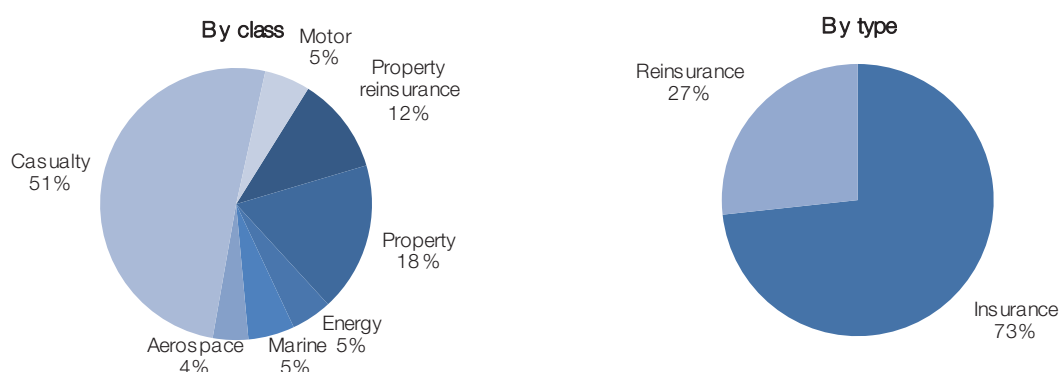
We also expect management to seek further growth in the premium base, particularly in better priced areas of the market such as reinsurance. The establishment of Novae Re is an important step in this direction. Novae remains heavily weighted towards longer-tail casualty risks and diversification towards shorter tail property and reinsurance risks is capital efficient while continuing to spread overhead costs, both of which will improve returns if successfully implemented. With less benefit from investment income on long-tail reserves, such business would be expected to produce a stronger underwriting return, which would mitigate the impact of further recession related casualty losses.

### **Growth brings risk**

The key challenge in growing, in new areas, in a weak market is to maintain underwriting quality. Even successful growth in the direction we anticipate would be expected to bring greater volatility in underwriting. However, we do not expect Novae to blindly chase premium as evidenced by the discipline shown at NICL, despite the drag of un-used capital. If conditions allow we think growth could exceed our forecast but pricing is insufficient we would expect management to settle on a lower level of premium. Additionally we see the risk of further recession led claims development on Novae's casualty book as a further risk.

### **Conclusion**

We believe Novae has a clear understanding of the challenges that it still faces, particularly around scale and capital efficiency. Successfully addressing these issues will improve returns and support valuation. If combined with better investment returns and tax efficiencies we see considerable upside. The prospect of a capital return and potential final exit from the legacy portfolio offer potential points of cheer along the way.

**Exhibit 39: GWP split (2009)**

Source: Novae, Edison Investment Research

**Exhibit 40: Financials**

Year end 31 December	2008	2009	2010e	2011e	2012e	H110e
<b>£m</b>	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
Gross written premium	349.0	384.1	582.0	669.3	736.2	333.8
Net premium revenue	258.4	303.6	418.6	533.5	596.8	207.5
Investment return	50.0	31.0	19.1	18.8	20.0	9.5
Other income	1.8	1.1	1.0	1.0	1.0	0.5
<b>Total Revenue</b>	<b>310.2</b>	<b>335.7</b>	<b>438.7</b>	<b>553.3</b>	<b>617.8</b>	<b>217.6</b>
Net claims cost	(166.9)	(194.7)	(247.0)	(322.8)	(364.0)	(124.1)
Other expenses	(115.8)	(123.7)	(156.3)	(187.1)	(199.1)	(78.4)
FX	9.4	1.4	0.0	0.0	0.0	0.0
<b>Operating Profit</b>	<b>36.9</b>	<b>18.7</b>	<b>35.4</b>	<b>43.4</b>	<b>54.7</b>	<b>15.1</b>
Financing costs	(9.6)	(1.0)	(8.7)	(8.7)	(8.7)	(4.4)
<b>Profit Before Tax (norm)</b>	<b>27.3</b>	<b>17.7</b>	<b>26.7</b>	<b>34.7</b>	<b>46.0</b>	<b>10.8</b>
Impact of FX on non-monetary items	12.9	(13.5)	0.0	0.0	0.0	0.0
<b>Profit Before Tax as reported</b>	<b>40.2</b>	<b>4.2</b>	<b>26.7</b>	<b>34.7</b>	<b>46.0</b>	<b>10.8</b>
Tax	(3.1)	22.2	(7.5)	(9.7)	(12.9)	(3.0)
<b>Profit After Tax (norm)</b>	<b>27.3</b>	<b>14.8</b>	<b>19.2</b>	<b>25.0</b>	<b>33.1</b>	<b>7.8</b>
<b>Profit After Tax as reported</b>	<b>37.1</b>	<b>26.4</b>	<b>19.2</b>	<b>25.0</b>	<b>33.1</b>	<b>7.8</b>
Average Number of Shares Outstanding (m)	71.7	71.8	71.9	71.9	71.9	71.9
<b>EPS - normalised (p)</b>	<b>38.1</b>	<b>20.6</b>	<b>26.7</b>	<b>34.8</b>	<b>46.0</b>	<b>10.8</b>
<b>EPS - as reported (p)</b>	<b>51.7</b>	<b>36.8</b>	<b>26.7</b>	<b>34.8</b>	<b>46.0</b>	<b>10.8</b>
<b>EPS - normalised and fully diluted (p)</b>	<b>37.0</b>	<b>20.2</b>	<b>26.3</b>	<b>34.1</b>	<b>45.2</b>	<b>10.6</b>
Dividend per share (p)	10.0	11.0	12.0	12.5	13.0	3.3
Dividend cover	3.7	1.8	2.2	2.7	3.5	3.2
NAV per share	419.9	436.2	410.2	432.9	466.4	439.0
ROE	10.1%	4.9%	6.1%	8.5%	10.6%	4.9%
Net tangible assets per share	410.8	422.7	396.7	419.4	453.0	425.5
RONTA	10.4%	5.3%	6.4%	8.5%	11.3%	5.1%
Loss ratio	64.6%	64.1%	59.0%	60.5%	61.0%	59.8%
Expense ratio (inc Group overhead)	44.8%	40.7%	37.3%	35.1%	33.4%	37.8%
Combined ratio	109.4%	104.9%	96.3%	95.6%	94.4%	97.6%
Reported COR	100.5%	99.2%	92.0%	92.0%	91.0%	93.3%
Investment return	5.1%	3.0%	1.7%	1.5%	1.5%	1.8%
NTA/GWP	84.2%	79.1%	49.0%	45.1%	44.2%	n.m
Debt/NTA	37.6%	30.1%	32.1%	30.3%	28.1%	n.m

Source: Novae, Edison Investment Research

# Omega Insurance Holdings

26 July 2010

## Investment summary: Growing pains

Omega is well advanced in building out a multiple platform international insurance/reinsurance company from its roots of successfully managing Lloyd's syndicate 958. Following a very public row with key shareholders, it now finds itself with a new CEO, new Chairman, and new line-up of NEDs. We do not expect any major change of strategic direction; nor do we consider the dispute to indicate any financial problems. However, with the rating environment weakening and persistent low investment returns, we would expect a greater focus on capital management to support returns. Omega stands well placed to take advantage of any turnaround in rates.

### Shareholder dispute

Soon after the departure of one of its founders and former Chief Underwriting Officer late last year, Omega found itself in a very public dispute with important shareholders, which left it with a new board line-up and new CEO. We do not believe that this signals any wider financial issues at Omega and we do not expect any major shift in strategy.

### Excellent underwriting history

Omega's roots lie in the management of Lloyd's Syndicate 958, which has enjoyed an unbroken record of profit since it started in 1980. From 2005 onwards Omega has set about building a wholly-owned insurance capability, mainly in Bermuda and the US, to capitalise on this expertise. It seeks to write similar and complementary business to Syndicate 958 that would not normally find its way to London.

### Newer operations are a capital drag for now

The capital requirement for Omega's new operations is driven by the rating agencies and is higher than that for a more mature operation. We calculate end-2010 TNAV at 120% of GWP, high relative to peers. For the next couple of years this will act as a drag on returns, compounding the effects of low investment returns and weaker rates. For this reason we expect management to focus more on capital management, perhaps introducing some gearing into the balance sheet.

### Valuation: Solid low cycle return

We see returns constrained by low investment returns and inevitable capital and operating inefficiencies at the new operations. However, if the market environment does not facilitate growth, we expect capital measures that could improve returns by up 1% on our forecast. Meanwhile the balance sheet supports a strong though variable dividend (pay-out ratio c 70%).

#### Exhibit 41: Valuation

Note: PBT normalised, EPS normalised and fully diluted.

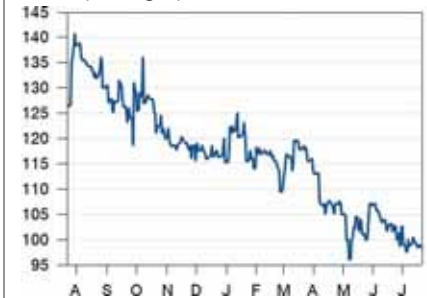
Year end	GWP	COR	PBT	EPS	DPS	NTA	RONTA	P/E	P/NTA	Yield
December	\$m	%	\$m	(\$c)	(\$c)	(\$)	%			
2009	265.8	90.7%	50.7	19.2	12.5	1.86	11.6%	7.8	0.81	8.3%
2010e	371.8	98.6%	30.9	10.3	6.7	1.83	5.8%	14.6	0.82	4.4%
2011e	370.4	94.5%	44.4	15.3	11.2	1.92	8.8%	9.8	0.78	7.4%
2012e	425.9	93.7%	49.8	17.2	12.6	1.99	9.4%	8.8	0.76	8.4%

Source: Omega, Edison Investment Research

Price\* 99p  
Market Cap £241m

\*Price as at 21 July 2010

#### Share price graph



#### Share details

Code OIH  
Listing Full  
Sector Non-life insurance  
Shares in issue 243.5m

#### Business

Omega Insurance Holdings is domiciled in Bermuda and listed on the LSE. It is an international insurer/reinsurer with a focus on short tail, property oriented classes.

#### Bull

- Excellent underwriting record
- Debt free balance sheet
- Multi-platform growth

#### Bear

- Capital drag of new operations
- Rate weakness
- Low investment returns

## Investment summary: Growing pains

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### **Strong pedigree**

Omega's origins are as the managing agent for Lloyd's Syndicate 958. The Syndicate has enjoyed an unusually strong track record of unbroken profitability since it began underwriting in 1980. In 2005 Omega set about building a multi-platform insurance company, floating on AIM and launching Omega Specialty, the group's Bermudan reinsurance company. In 2006 the group re-domiciled to Bermuda and launched Omega US, which commenced underwriting in 2008. In 2009 Omega was admitted to main list of the LSE. Also in 2009, the group increased its ownership of capacity in Syndicate 958 from 16.4% to 38.8% which, together with a quota share written by Omega Specialty on behalf of the Syndicate, gives Omega an effective 51% interest.

The Syndicate writes a broad spread of property and casualty business. Omega Specialty is mainly a property catastrophe reinsurer as well as reinsuring much of the group's interest in Omega US and the Syndicate. Omega US is a property and casualty insurer focusing mainly on US SME.

### **Newer operations take some time**

The effective capital requirement for Omega Specialty and Omega US is set by the rating agencies, which require more capital to be held by a new operation for any given credit rating. The issue largely relates to Omega Specialty and we believe this may be relaxed after 2012. Meanwhile the additional capital requirement acts as a drag on returns.

Early in 2009 Omega raised \$178m to take advantage of an expected hardening in rates, which proved to be short lived in a benign year for catastrophe losses. The acquisition of capacity in Syndicate 958 consumed \$71m in consideration and capital support but, despite the continued development of the group, it still entered 2010 with \$56m of capital surplus. While we expect continued growth in Omega US, we think it will be difficult to put this capital to work without a reversal of weakening rates.

### **Expect capital measures**

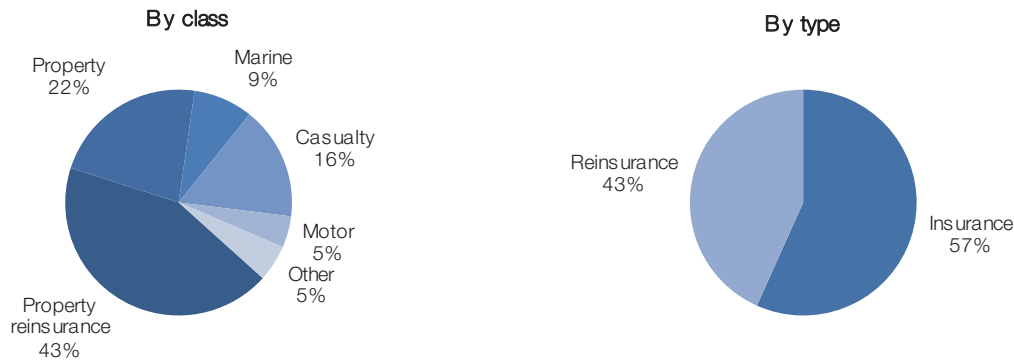
It is too early to know what measures Omega may decide to take. A heavy loss hurricane season could have a major impact on market pricing and capital levels and give Omega the opportunity to deploy capital in the market. But if that fails to materialise, we would expect management to seek to mitigate the impact of weaker pricing, lower premium growth and low investment returns on RONTA. By way of illustration, we calculate that a return of \$25m of surplus capital plus a further \$50m of equity, replaced with debt capital (debt/TNAV 14%) would boost RONTA by 1% relative to our current forecast.

### **Conclusion**

Omega is well advanced in building out the business, but a combination of young operations, weaker market and low investment returns are all a drag on returns for now. However, in the absence of a market hardening, we do think there are measures that management can take to support returns from a position of balance sheet strength. Meanwhile the strength of the balance sheet supports a continuation of the high pay-out ratio.



## Exhibit 42: GWP split (2009)



Source: Omega, Edison Investment Research

## Exhibit 43: Financials

Year end 31 December	2008	2009	2010e	2011e	2012e	H110e
US\$m	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
Gross written premium	265.4	265.8	371.8	370.4	425.9	259.5
Net premium revenue	215.7	195.5	261.0	295.0	321.2	107.0
Investment return	21.8	16.3	12.9	14.1	15.1	7.7
Other income	23.7	16.4	14.2	14.1	14.4	7.1
<b>Total Revenue</b>	<b>261.2</b>	<b>228.2</b>	<b>288.1</b>	<b>323.2</b>	<b>350.7</b>	<b>121.8</b>
Net claims cost	(163.9)	(96.3)	(159.9)	(172.3)	(187.6)	(74.6)
Other expenses	(72.7)	(81.0)	(97.4)	(106.5)	(113.2)	(39.5)
FX	3.9	(.2)	0.0	0.0	0.0	0.0
<b>Operating Profit (pre impact of FX on non-monetary items)</b>	<b>28.5</b>	<b>50.7</b>	<b>30.9</b>	<b>44.4</b>	<b>49.8</b>	<b>7.7</b>
Impact of FX on non-monetary items	0.0	0.0	0.0	0.0	0.0	0.0
Exceptional items	0.0	(3.6)	(2.9)	0.0	0.0	(2.9)
Financing costs	(0.2)	(0.1)	0.0	0.0	0.0	0.0
<b>Profit Before Tax (norm)</b>	<b>28.2</b>	<b>50.7</b>	<b>30.9</b>	<b>44.4</b>	<b>49.8</b>	<b>7.7</b>
<b>Profit Before Tax as reported</b>	<b>28.2</b>	<b>47.1</b>	<b>28.0</b>	<b>44.4</b>	<b>49.8</b>	<b>4.8</b>
Tax	(6.0)	(3.4)	(4.6)	(5.3)	(6.0)	(1.2)
<b>Profit After Tax (norm)</b>	<b>22.2</b>	<b>47.2</b>	<b>26.2</b>	<b>39.0</b>	<b>43.9</b>	<b>6.5</b>
<b>Profit After Tax as reported</b>	<b>22.2</b>	<b>43.6</b>	<b>23.3</b>	<b>39.0</b>	<b>43.9</b>	<b>3.6</b>
Average Number of Shares Outstanding (m)	147.5	234.8	243.5	243.5	243.5	243.5
<b>EPS - normalised (\$c)</b>	<b>15.1</b>	<b>20.1</b>	<b>10.8</b>	<b>16.0</b>	<b>18.0</b>	<b>2.7</b>
<b>EPS - as reported (\$c)</b>	<b>15.1</b>	<b>18.6</b>	<b>9.6</b>	<b>16.0</b>	<b>18.0</b>	<b>1.5</b>
<b>EPS - normalised and fully diluted (\$c)</b>	<b>14.1</b>	<b>19.2</b>	<b>10.3</b>	<b>15.3</b>	<b>17.2</b>	<b>2.6</b>
Dividend per share (\$c)	11.3	12.5	6.7	11.2	12.6	6.0
Dividend cover	1.2	1.5	1.5	1.4	1.4	0.4
NAV per share (\$)	1.92	2.04	2.01	2.10	2.17	1.99
ROE	7.2%	10.5%	5.3%	8.0%	8.6%	2.6%
Net tangible assets per share (\$)	1.90	1.86	1.83	1.92	1.99	1.82
RONTA	7.3%	11.6%	5.8%	8.8%	9.4%	2.9%
Loss ratio	76.0%	49.3%	61.3%	58.4%	58.4%	69.8%
Expense ratio (inc Group overhead)	33.7%	41.4%	37.3%	36.1%	35.3%	37.3%
Combined ratio	109.7%	90.7%	98.6%	94.5%	93.7%	101.0%
Reported COR	101.4%	81.3%	91.5%	88.3%	88.0%	100.1%
Investment return	5.8%	2.8%	2.0%	2.0%	2.0%	2.5%
NTA/GWP	106.0%	170.4%	119.9%	126.5%	113.9%	n.m
Debt/NTA	0.0%	0.0%	0.0%	0.0%	0.0%	n.m

Source: Omega, Edison Investment Research

## Glossary of terms

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### Exhibit 44: Glossary

Casualty insurance	Covers the insured against third-party claims or, in the case of employers' liability insurance, claims by employees.
Catastrophe reinsurance	Is a form of reinsurance that indemnifies the buyer against losses (in excess of a stated sum) arising from a single catastrophic event or series of events.
Claims made policies	Only pay claims that are made during a specified period, normally the term of the policy. But it can still take several years for the claim to be finalised and settled.
Liability insurance	Is another term for casualty insurance.
Long-tail risk	Refers to insurance where claims may be made many years after the period of insurance has expired. Casualty insurance is a good example of long-tail business unless it is written on a 'claims made basis'.
Reinsurance	Is insurance purchase by an insurance company from another reinsurer. In reality it is perfectly normal for companies to underwrite both insurance and reinsurance business.
Short-tail risk	Refers to insurance where claims are usually made during the term of the policy, or shortly afterwards. Property insurance is a good example of short tail business.

Source: Edison Investment Research

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