

US P&C Insurance: Equity Valuations

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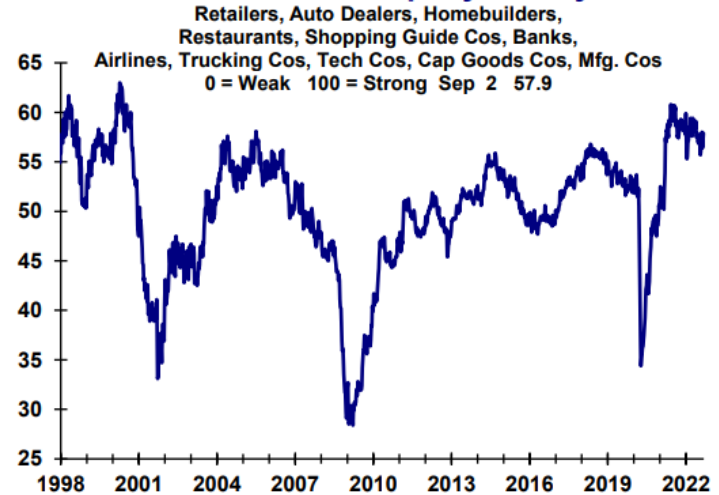
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Macro Environment: Slower Growth, Possible Recession

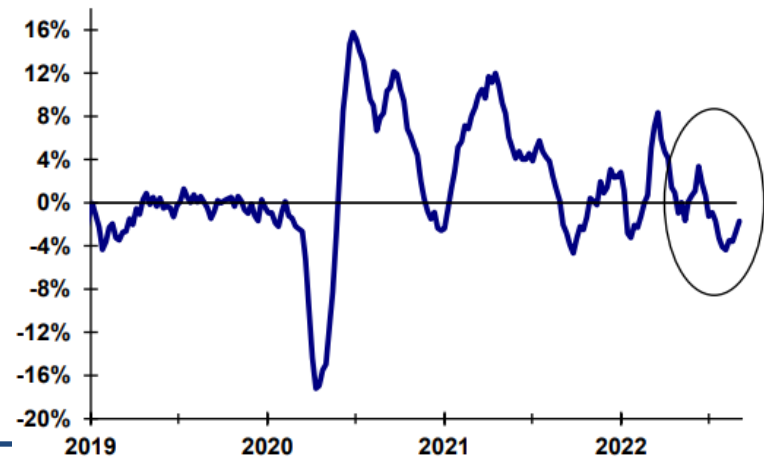
- **EISI Expects REAL GDP DECLARATION** from +5.5% in '21 to 0.4% in '22 & +1% in '23
- **The market is assuming something worse**
- EVRISI Company Surveys are still strong, but have come down recently from 2021
- Inflation surged this year because M2 surged +30% last year & related supply chain disruptions (i.e. new auto production)
- **Fed is hiking to get inflation under control, potentially at the expense of economic growth**
- **Inverted yield curves signal recession fears**

Evercore ISI Company Surveys



Evercore ISI Company Surveys Diffusion Index

8 Wk. Avg. Sep 2 -1.7%



Evercore ISI U.S. Economic Outlook

Evercore ISI U.S. Outlook

	2021	2022 f	2023 f
Real GDP*	+5.5%	+0.4%	+1.0%
GDP Price Deflator*	+5.9%	+5.7%	+4.0%
Nominal GDP*	+11.8%	+6.1%	+5.0%
S&P Earnings*	\$218	\$230	\$238
Unemployment Rate*	3.9%	4.0%	4.2%

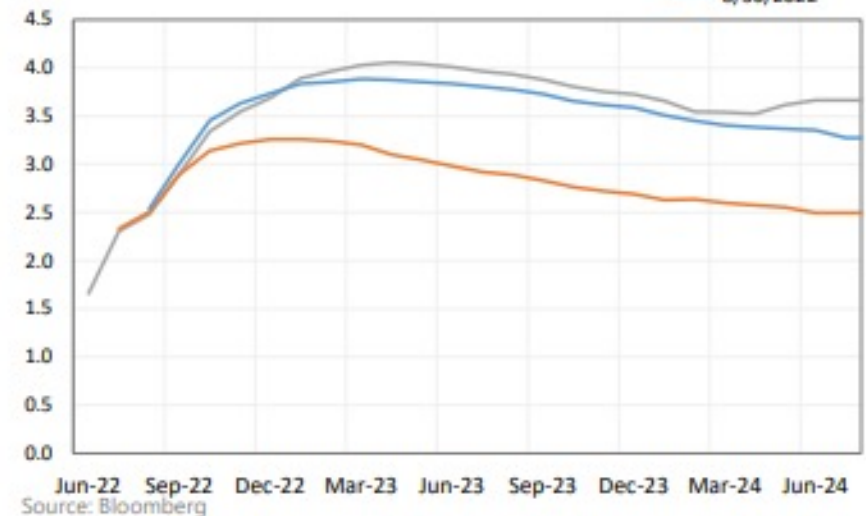
*End of year

FED Rate Hikes: Fighting Inflation

- Fed Chair Powell Jackson Hole speech more hawkish than expected; said the Fed “must keep at it until the job is done” and that rates will need to go “sufficiently restrictive” and likely stay there “for some time”
 - Despite some pivot optimism, the duration of restrictive policy appears like it will be longer than mkt expected
- Following the Jackson Hole, the market is pricing in a 75bps FF hike in Sept & 3.5% FF by YE22
- Rate hikes have resulted in fears of a recession & stocks have priced this in

Fed Funds Rate Expectations

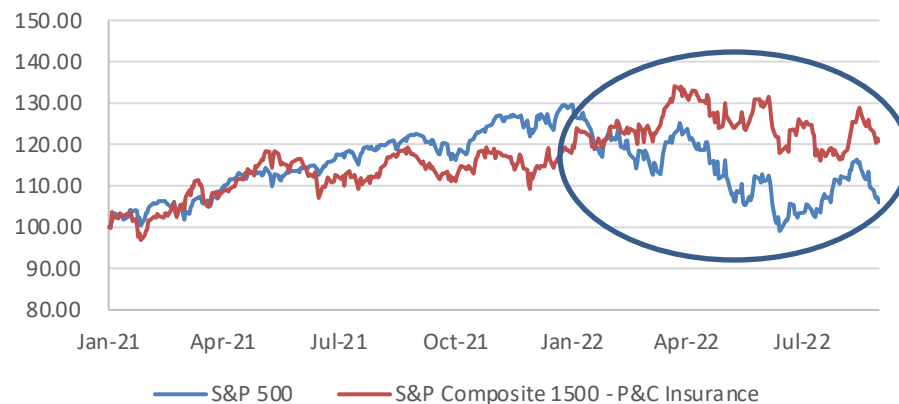
(percent, 1M fed funds futures rates)



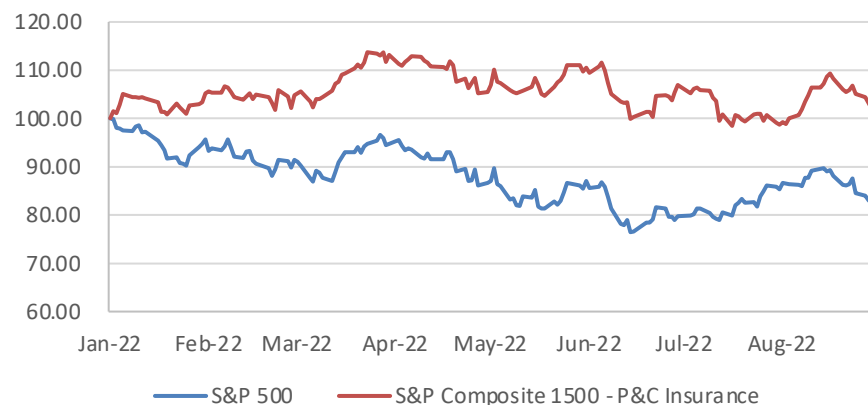
Equity Market Performance

- **P&C Index has Outperformed the S&P 500 in 2022**
- P&C Index is up over +2% compared to close to -20% drop in the S&P 500
- **Defensive Nature is attractive:** Personal Lines stocks tend to outperform during a Recession due to lower auto frequency; Lower economic activity usually translates to lower claims on commercial lines
- One of the only sectors in the S&P 500 with upward EPS estimate revisions due to improvements both in underwriting and NII
- NII est revision upwards: Inflation and Rate Hikes has led to NMY significantly higher than portfolio yields
- Underlying Margin Improvement expected in 2022/23 in CMLs driven by Pricing Tailwinds

P&C Index Outperforming S&P 500 in 2022
(1/1/21 Index to 100)



YTD - P&C Index +2% vs S&P -18%
(1/1/22 Index to 100)

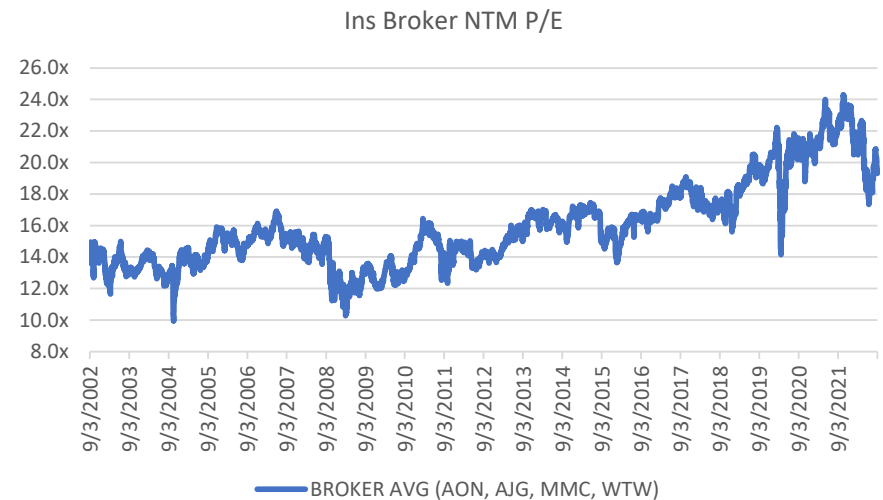
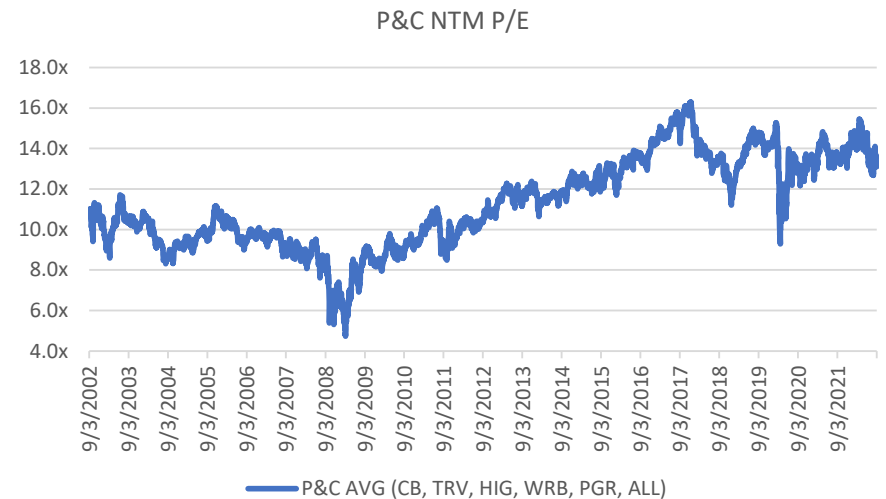


Drivers of P/E and P/BV Multiples

- Macro & Industry
 - Interest rates
 - Equity risk premium (i.e. market multiples)
 - P&C sector - cyclical changes in profitability (i.e. under-earning ahead of a hard cycle or over earning ahead of a soft cycle)
 - Pricing cycle
 - Regulation
- Company-Specific items
 - Consistent reserve conservatism/issues results in premium/discounted valuations
 - Mgmt quality
 - Organic Growth in revenues (particularly at brokers) – usually biggest determinants
 - Direction of margins (multiples higher if margins improving, lower if deteriorating)
 - EPS and BVPS growth rates

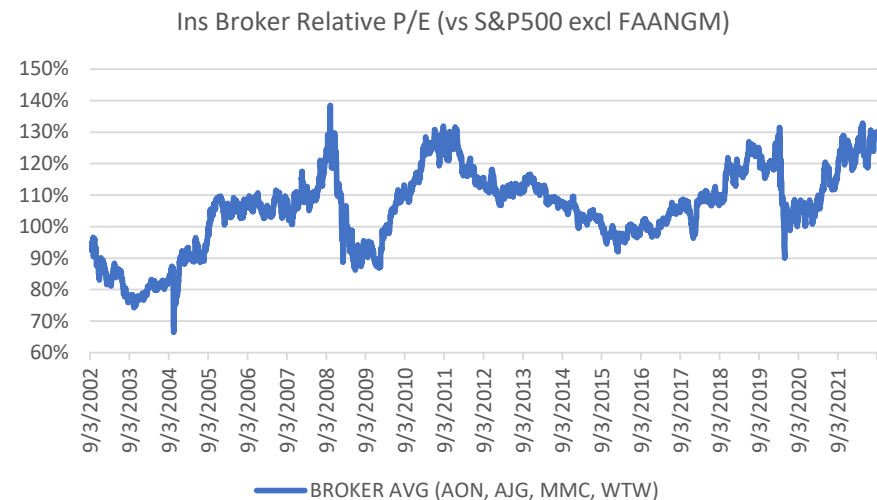
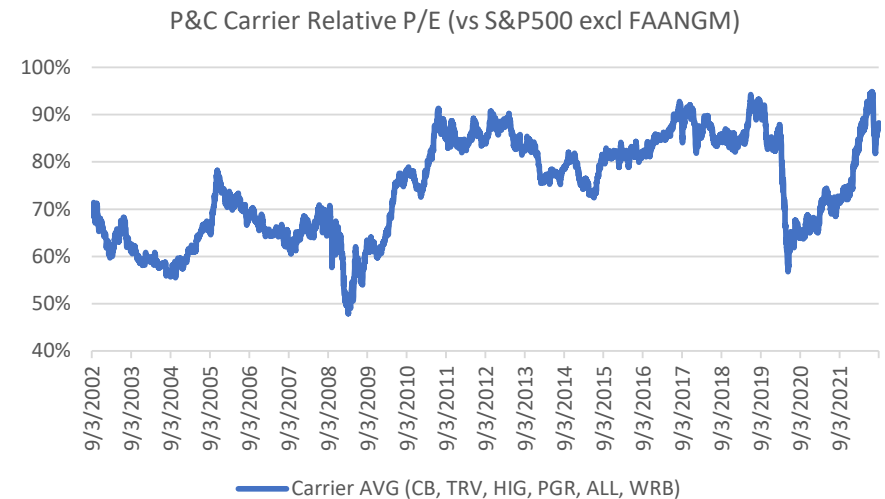
P&C Insurance Industry P/E's Over Time

- P&C carrier P/E Ratios re-rated higher after the GFC
 - partly due to market re-rating but also due to a low inflation environment
- Brokers experienced significant re-rating
 - exemplified enhanced benefits from scale, more stable organic revenue growth (despite soft commercial P&C pricing from '14-18) and consistent margin expansion & EPS growth



P&C Insurance Industry Relative P/Es Over Time

- P&C carrier P/E Ratios trade at a ~10% discount to the market; but have re-rated vs ~20-25% historic discount
 - P&C carriers have benefited from upward EPS estimate revisions from NII, increasing their relative attractiveness
- Brokers trade at a 30% premium to the S&P500, close to all time highs & historic 5-15% premium
 - Have proven to be more resilient businesses and have been consistently growing EPS in the ~10-15% range

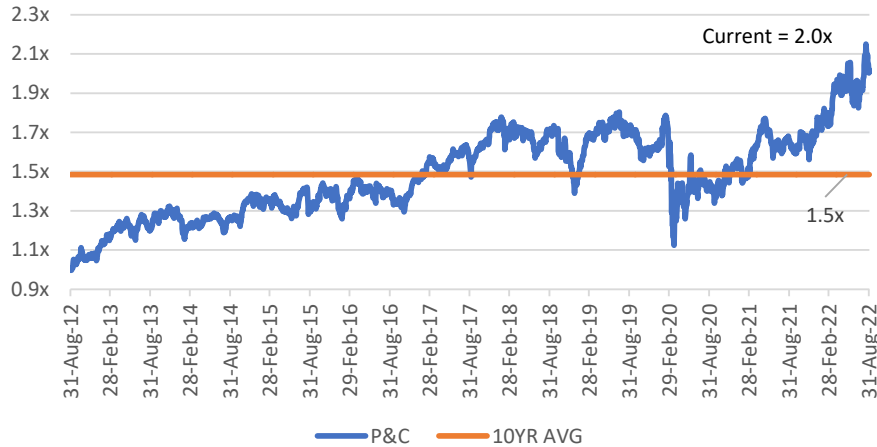


P&C Insurance Carrier P/BVs

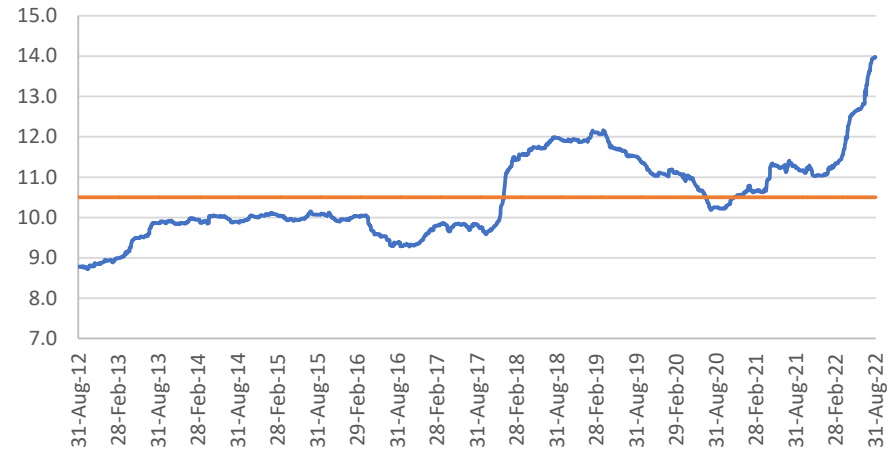
- P/BVs are close to a 10yr high but estimated ROEs are also much higher
 - Driven by both underwriting improvements and net investment income from higher interest rates
- TBVPS incl Dividends is gold standard/biggest driver of shareholder value creation
 - Consistently high TBVPS growth results in higher valuations & TSR
- Gordon growth model is a key input
 - $P/BV = (ROE-g)/(K_e-g)$

P&C Insurance Carrier P/BVs

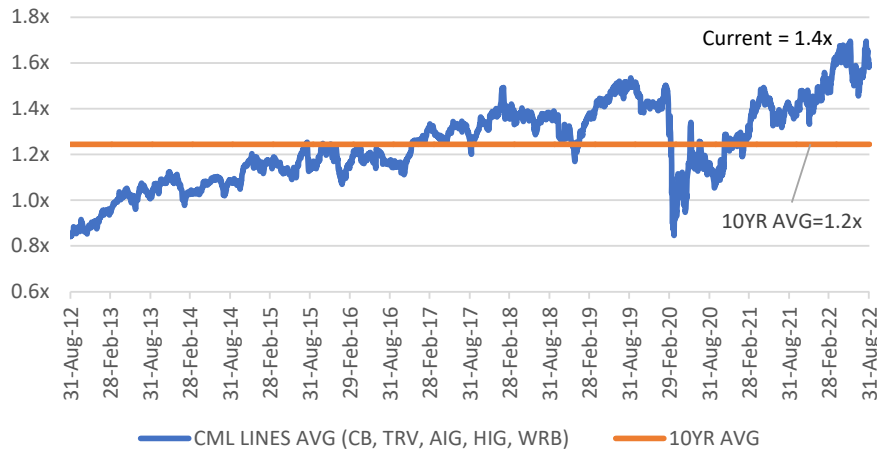
P&C Carrier P/BV



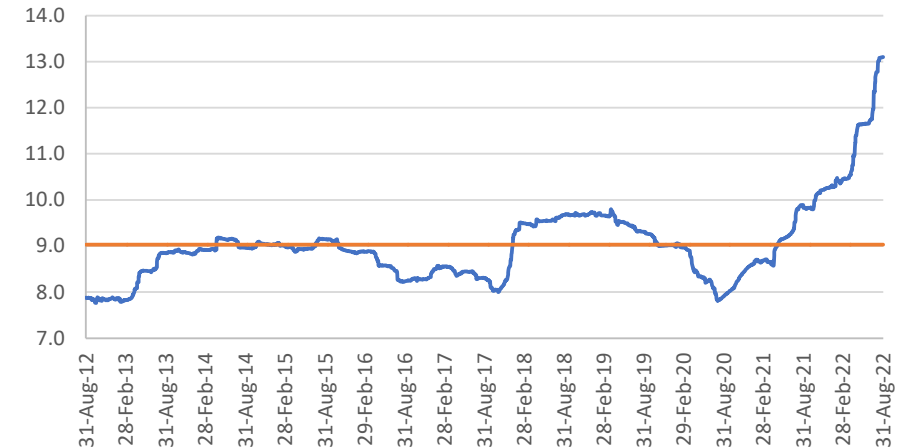
P&C Carrier EST ROE



CML Lines P/BV over 10yrs



Commercial Lines EST ROE



Thinking About Valuation

- Investors need to be cognizant of valuation - just buying a great business already at a full valuation without any other forms of differentiation isn't usually a winning formula
- Changes in valuations are based on investors coming to the realization that the franchise is worth more (or less) than before
 - Can be driven by the emergence or removal of a tail risk, or entering a new market with more growth opportunities
- We think it is harder to predict multiple expansion or deterioration and view a thesis based on multiple expansion as generally lower quality (unless we have a smoking gun on P&C reserves) compared to one based on EPS beats
- We like to use upside to earnings estimates as a better/higher visibility source of alpha (if street consensus EPS estimates are 10% too low the stock should go up 10% once the market realizes this & holding the P/E or P/BV constant)

Valuation Principles

- Ultimately investors are valuing stocks based on a discounted cash flow basis or greater fool theory
 - It is important to know which one you are using
- All valuation should boil down to a Discounted cash flow model
 - Project future cashflows into the future
 - Discount cashflows to the present day at the company's cost of capital
- In financials, investors typically use the Dividend Discount Model (DDM) which is heavily reliant on the Gordon Growth Model ($\text{Value} = D1 / (K_e - g)$); values a dividend like a perpetuity
 - $D1$ = Dividend received in yr 1
 - g = growth rate of future dividends
 - K_e = cost of equity
 - $g = \text{ROE} * (1 - \text{payout ratio}) \rightarrow$ how much does a company need to reinvest to grow at a certain rate?
 - Therefore, $\text{ROE} = g / (1 - \text{Payout})$
- DDM Valuation needs to be gut-checked w/ resulting P/E or P/BV
- In practice, the DDM has many simplifying assumptions so can't be taken as absolute truth
- Alternatively, investors use P/E and P/BV to value balance sheet financial stocks and P/E, EV/EBITDA and P/FCF for the insurance brokers
- We use P/E multiples as it limits some implicit risk in estimating all the variables in a DDM

Closing Thoughts

- Prevailing Valuations say a lot about the market's view of the state of a business/industry
- However, passive investments can exacerbate share price moves and create opportunities
- Important to understand how various valuation metrics are connected
- Alternative metrics can also be useful (i.e. Market Value/PIF or EV/EBITDA relative to Organic Revenue Growth)

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Buy- Return 10% to 20%

Neutral - Return 0% to 10%

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Coverage Universe			Investment Banking Services Past 12 Months		
Ratings	Count	Pct.	Ratings	Count	Pct.
Buy	541	62	Buy	106	20
Hold	295	34	Hold	27	9
Sell	14	2	Sell	0	0
Coverage Suspended	13	1	Coverage Suspended	3	23
Rating Suspended	11	1	Rating Suspended	6	55

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