Sector View

Insurance

Top Pick Q2 2016: AXA

	1 M	3 M	6 M	31/12/15
Insurance	2.3%	-13.3%	-2.0%	-13.6%
DJ Stoxx 600	1.1%	-8.1%	-1.9%	-8.4%

*Stoxx Sector Indices

Companies covered

AEGON		**NEUTRAL vs. BUY**	**EUR6 vs. 6.4**
Last Price	EUR4.915	*Market Cap.*	EUR10,553m
ALLIANZ		**BUY**	**EUR180 vs.195**
Last Price	EUR142.6	*Market Cap.*	*EUR65,168m*
AXA		**BUY**	**EUR29 vs.31**
Last Price	EUR20.64	*Market Cap.*	*EUR50,109m*
CNP ASSURANCES		**NEUTRAL**	**EUR15**
Last Price	EUR13.345	*Market Cap.*	*EUR9,163m*
COFACE		**NEUTRAL**	**EUR10 vs.10.5**
Last Price	EUR7.114	*Market Cap.*	*EUR1,127m*
EULER HERMES		**BUY**	**EUR96 vs. 100**
Last Price	EUR79.25	*Market Cap.*	*EUR3,593m*
HANNOVER RE		**SELL**	**EUR110 vs.107**
Last Price	EUR100.8	*Market Cap.*	*EUR12,156m*
MUNICH RE		**SELL**	**EUR185 vs.200**
Last Price	EUR176.65	*Market Cap.*	*EUR29,473m*
SCOR		**BUY**	**EUR38 vs. 38.5**
Last Price	EUR30.7	*Market Cap.*	*EUR5,914m*
SWISS RE		**NEUTRAL**	**CHF100 vs.110**
Last Price	CHF88.35	*Market Cap.*	*CHF32,752m*
ZURICH INSURANCE GROUP		**NEUTRAL**	**CHF270 vs. 295**
Last Price	CHF220.9	*Market Cap.*	*CHF33,231m*

LOOKING BACK AT Q1 2016

Excluding Aegon and Zurich, Q4/FY 2015 numbers were in line or ahead of expectations. Operating performances were strong again, driven by underwriting results in most business lines (pricing discipline in primary insurance, lower-than-budgeted natcats, an ongoing shift from traditional life towards unit-linked and protection products) and some capital gains (although most companies continue to suffer ongoing pressure on recurring RoIs).

Most companies passed the Solvency II test with flying colours. As expected, the winners were companies with very diversified business models. We would especially mention AXA (205%), Allianz (200%) and the reinsurers (Hannover Re 246%, Munich Re 302%, Scor 211%, Swiss Re 205%). We had one positive surprise with CNP (192% vs. c. 180% expected) and one negative one with Euler Hermes (173% vs. c. 190% expected).

We continued to witness a degree of volatility on the financial markets, driven by i/ oil price weakness and its implications/consequences, ii/ the global economic slowdown, and iii/ political issues. Interest rates fell sharply (10Y Euro rate at 0.61% at end-March vs. 1.07% at end-December, 10Y US rate at 1.78% vs. 2.27%). Corporate spreads rose a little overall (iTraxx Main down 4bps and iTraxx Senior Financials up 14bps). Equity markets were more under pressure (DJ Stoxx50 down 10%).

Considering the structure of insurers' investment portfolios, these movements are globally positive for asset valuations, pushing insurers' NAVs up further. Note that the stress we experienced in some corporate spreads until mid-February has also allowed companies to invest in more satisfactory conditions. Yet the Q1 environment was clearly negative from a Solvency II perspective, with the margin probably down at end-March vs. end-December.

We see this as one key item justifying the underperformance of the sector in Q1 (-13.1% vs. -7.7% for the Stoxx600), with growing fears that dividends might be at risk if solvency margins fall below optimal areas due to lower interest rates. The other item justifying the sector's underperformance is the growing stress on corporate defaults, fuelled by issues in the oil sector and the global economic slowdown. We believe these fears have been overplayed: the sensitivity of Solvency II margins to interest rates is not new, and investors' fears clearly underestimate management actions over time, while bond portfolios are of high quality (mainly OECD govies and investment grade corporates). Yet in this context, reinsurers performed better than most primary insurers.

NEW ESTIMATES, RECOMMENDATIONS AND FAIR VALUES

We take this opportunity to update our earnings forecasts for 2016-2017. On average, both our operating profit and net income sequences are revised downwards by 2%. Overall company commitments for active cash flows / shareholders' equity base management allow companies to keep decent ROEs (c. 10% on average), slightly above our cost of equity (9.4% on average).

We release new fair values, which are based on our new 2016 estimates and include new BG valuation criteria (risk-free rate 1.6% vs. 2.0%, equity risk premium 7.0% vs. 6.4%). As a consequence, most fair values have been revised downwards.

We also take this opportunity to downgrade our recommendation on Aegon from Buy to Reduce, in view of the still below-standard quality of fundamentals and the dismal environment in both the USD and US rates.

EUR	Fair value		Theoretical	Recommendation	
	New	Old	upside (%)	New	Old
Aegon	6.0	6.4	30%	Neutral	Buy
Allianz	180	195	31%	Buy	Buy
AXA	29.0	31.0	43%	Buy	Buy
CNP	15.0	15.0	9%	Neutral	Neutral
Zurich (CHF)	270	295	36%	Neutral	Neutral
Hannover Re	110	107	10%	Sell	Sell
Munich Re	185	200	6%	Sell	Sell
Scor	38.0	38.5	24%	Buy	Buy
Swiss Re (CHF)	100	110	15%	Neutral	Neutral
Coface	9.5	10.5	31%	Neutral	Neutral
Euler Hermes	96	100	22%	Buy	Buy

Source: Bryan Garnier & Co. ests.

WHAT WE EXPECT IN Q2 2016

Geopolitical/economic uncertainties remain high at the beginning of Q2 2016 and should continue to generate some volatility on the financial markets. However:

Both the FED and the ECB actions continue to create a fairly safe environment for bonds investors like insurance companies. Bonds usually represent 75% of total investments for insurance companies, with the bulk of it invested in OECD govies and investment grade corporate bonds. And the ECB has just extended its QE programme to non-financial investment grade corporate bonds, meaning that it can now act on c. 70% of bond instruments held by typical European insurers. This is good news from a default risk perspective, which is key from an economic standpoint, and remember that lower credit spreads are positive under Solvency II. True, the pressure on ROIs and investment income should remain. Should rates and spreads stay where they currently are, our calculations show that a theoretical 5-year investment portfolio made up of govies (40% Euro, 10% US) and corporate bonds (25% investment grade, 5% high yield, 20% financials) would generate a 3.3% return in 2016 vs. 3.8% in 2015 and 4.3% in 2014. Nothing new here, and active management of the investment portfolio and some kind of diversification should help mitigate this trend.

Insurance companies are due to report Q1 2016 numbers in late April and in May and these should be strong again, driven by the ongoing focus on underwriting results (primary P&C and Life + reinsurance), persistantly low natcats and insurers' ability to pass lower interest rates on to customers (traditional life). As we already said, solvency margins should be down vs. end-December, yet still comfortably within optimal areas.

As a consequence, insurers will not deviate from current strategies, i.e. focusing on underwriting profitability through better risk management and cost control, price discipline, a more favourable product-mix in Life/Protection, a prolonged focus on capital allocation and cash flow management. This strategy should help protect overall profitability in the low interest rate environment and higher-than-average shareholders' returns.

Based on these items, we continue to use a 'risk-on' sector beta, i.e. 1.1 (vs. 1.35 for the 'risk-neutral' mode and 1.6 for the 'risk-off' mode) in our models.

CONCLUSIONS AND TOP PICKS

We believe the insurance sector will continue to show strong fundamentals/earnings quality, and that investors will gradually learn how to deal with the new Solvency II environment, which should be positive for multiples.

We continue to favour diversified primary insurers vs. reinsurers, which are exposed to potential back-to-normal natcats levels. As for Q2, we continue to strongly support the AXA investment case (Buy, FV EUR29 vs. EUR31), considering: i/ the company's convincing transformational journey strategy over the last few years, ii/ the recurring quality of earnings over the last half year periods (pricing power, combined ratio, new business margin, solvency,…), iii/ managements' efforts to address shareholder returns (pay-out ratio revised upwards to 45-55%), iv/ a prolonged 10-15% discount to peers like Allianz and Zurich, and v/ the prospect of the new 2020 strategic plan, which should bring a balance between continuity (focus on underwriting profitability and capital management) and adaptation to the digital transformation. Q1 2016 sales/solvency will be reported on 3th May. Investor Day on 21st June.

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