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13 December 2013

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The Admiral Group

We have identified Admiral Group plc as a potentially interesting company to invest in for the High Street equity mandate, and we held a call with the company's investor relations (IR) on Tuesday to discuss the business.

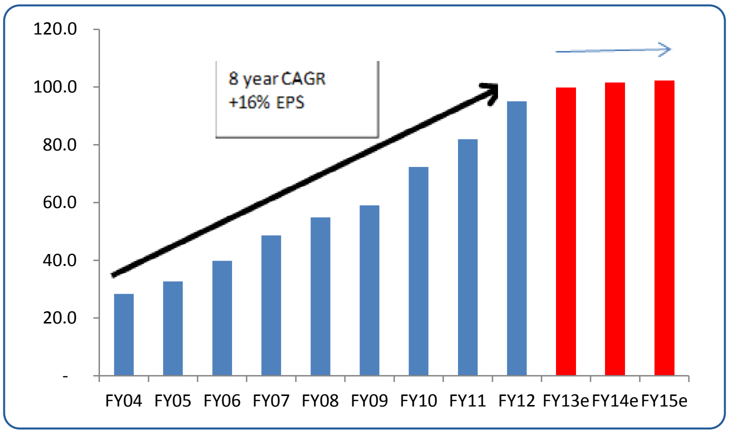
Background:

Admiral Group was founded in the UK in 1993 as a predominantly direct-sales short-term motor insurance business. The company does not have a broker force and sells mainly telephonically, on the internet and through online price-comparison websites (it owns price-comparison websites in the UK and elsewhere). The model is similar to OUTsurance locally.

The group has grown rapidly and now has an 11% market share of the motor insurance industry in the UK, making it the second-largest motor insurer in the country. It currently has 3mn cars insured there.

Its earnings track record since listing in 2004 is exemplary, and yet the analyst community appears to have written off the group's growth prospects (which we detail later) over the next few years – consensus forecasts are shown in red in Figure 1 below.

Figure 1: Admiral EPS growth track record and forecast, GBp/share



Source: Company data, Anchor Capital

Auto insurance is a cyclical industry and the issue facing the UK motor insurance industry at the moment is that it is currently in a down-cycle or poor pricing cycle, with rates down 10% YoY. Typically, when premium rates "harden" and profitability improves, so does interest by the industry in writing new business and hence supply expands and pricing worsens as the market becomes increasingly competitive.

Figure 2: Confused.com/ Towers Watson market premium rate movements:

Source: Company data

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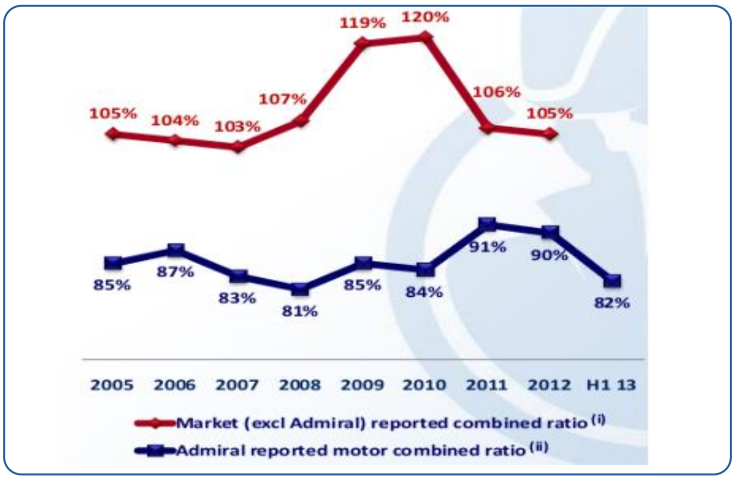
It is in this market where Admiral prides itself on being an efficient operator and disciplined writer of business: because its cost ratio is better than the industry (due to its direct business model e.g. OUTsurance in SA), it remains profitable whilst the industry as a whole is losing money. The group has been disciplined not to write bad business in the down-cycle, which has meant stalling revenue growth and the company not growing its insured numbers recently. Conversely it has also had falling claim rates and hence better margins. When the insurance cycle turns up again the group typically gains significant market share as it prices up but not to the same extent as the market – it can afford to do this because its margins and cost ratios are better:

Admiral combined ratio (claims as % of premium + operating expenses as % of premium) vs industry – sustainably profitable

<u>Figure 3: Reported combined ratio: Admiral vs market:</u>



Source: Company data

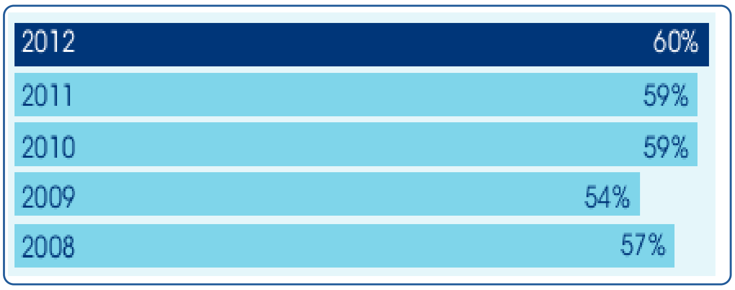
An indication of the group's conservatism in writing business is that it creates reserves at the outset of a policy being written at the conservative end of expectations and, as the claims come through better than what has been provided for, the group releases from these reserves – as shown below. The company has consistently had a fair chunk of releases each year. In 1H13, some "bearish" analysts pointed to the fact that results were buoyed by big reserve releases, but we note that they were by no means much larger than historically. The group also points out that its reserve margin remains high.

<u>Figure 4: Claims reserve releases (Admiral net share):</u>

Source: Company data

One attraction of the business is that it reinsures a lot of the business (75%) it writes and gets favourable rates from the reinsurers, largely due to a reputation of writing low-risk business. This results in a capital-light business model where returns on capital are very high. The group has consistently delivered >50% ROEs in recent years.

<u>Figure 5: Return on Capital:</u>



Source: Company data

Importantly, the group is extremely conservative with how it manages its "float" (the premiums it collects which have not yet been paid out in claims, essentially free funding for Admiral). As of FY12, the company had cash and other financial assets of GBP2.2bn and only generated investment income of GBP16mn. This is because it does not invest in equities but only holds cash and near cash/liquid short-term bonds. While the group could be far more aggressive and add value here, the flipside is that the downside is low and you aren't placing a P/E multiple on a significant component of fickle investment-related earnings. Thus, in essence, the group's earnings are purely "insurance related" and there could be upside if they optimise the balance sheet or if interest rates rise. It doesn't appear to be a high priority for the business to optimise returns on its float, with management rather focussing on continuing to do the basics of underwriting well.

<u>Figure 6: Admiral summarised balance sheet – FY11 & FY12, GBPmn</u>:

ASSETS	**2 615**	**3 204**
Financial assets	1 583	2 005
Cash	225	217
Reinsurance assets	640	803
Other	168	180
LIABILITIES	**2 221**	**2 744**
Insurance contracts	1 334	1 697
Trade & payables	857	1 007
Tax	30	40
Equity	**394**	**461**
ROE		60.4%

Source: Company data

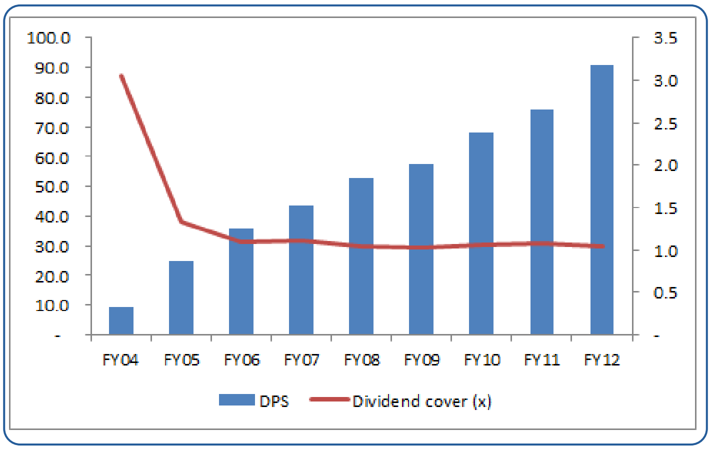
Figure 7: Admiral Plc years ending 31 December:

GBPmn	FY11	FY12	% ch	1H12	1H13	% ch
Insurance premium revenue	960	1 157	21%	561	570	2%
Insurance prem. Ceded - rein	-514	-658	28%	-314	-329	5%
Net insurance premiums	**446**	**499**	**12%**	**247**	**241**	**-2%**
Other revenue	349	361	3%	187	166	-11%
Profit commission	62	108	75%	48	40	-15%
Investment & interest income	14	16	16%	7	7	-3%
Net revenue	**870**	**984**	**13%**	**488**	**455**	**-7%**
Insurance claims & handling	-786	-929	18%	-457	-414	-9%
Recovered from reinsurance	422	525	24%	257	265	3%
Net insurance claims	**-364**	**-405**	**11%**	**-200**	**-149**	**-26%**
Operating expenses	-189	-215	14%	-107	-114	7%
Share scheme charges	-19	-21	11%	-10	-11	6%
Profit before tax	**299**	**345**	**15%**	**172**	**181**	**6%**
Taxation expense	-78	-86	11%	-44	-44	2%
effective tax rate	*26.0%*	*25.0%*		*25.4%*	*24.5%*	
Earnings	**221**	**258**	**17%**	**128**	**137**	**7%**
Diluted shares in issue	271	272	1%	271	273	
Diluted EPS	**82**	**95**	**16%**	**47**	**50**	**6%**
DPS	**76**	**91**	**20%**	**45**	**49**	**9%**
Dividend cover (x)	1.1	1.0		1.1	1.0	
Share price	1 233					
PE multiple	**15.1**	**13.0**				
Dividend yield	**6.1%**	**7.3%**				

Source: Company data

Because Admiral generates such a high ROE, it generates substantial cash and pays most of its earnings out as a dividend each year – total payout (ord + special) has averaged 90% of earnings in recent years, and management see no reason to change this:

Figure 8: Admiral dividends per share (GBp) and cover ratio:



Source: Company data

This dividend pay-out results in an extremely attractive dividend yield – based on the current share price, the **stock trades at a dividend yield of 7.5%-8% to FY13.**

The group has also recently launched household insurance in the UK – the market for this is half the size of the motor business, but it seems it is well suited to them as 30% of home insurance is price-comparison led. Management expect this operation to become profitable within a quicker time frame than their international operations.

International expansion:

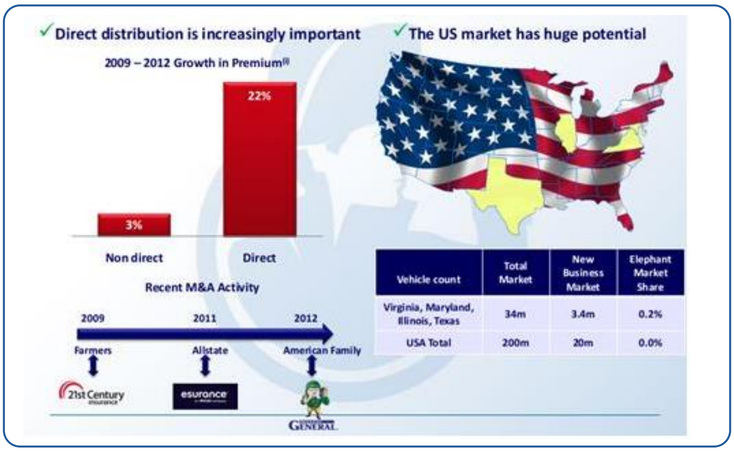
Outside of the UK, the group has been expanding into various regions including the following countries for its motor insurance and price-comparison businesses:

- US
- France
- Spain

These operations are collectively still loss-making and are in the development phase. Importantly, growth here is organic and the group is carefully adopting a "test and learn" approach. In the US, our discussions with IR suggest that the company believes pricing in the US is "lazy" and not data-based to the extent Admiral does in the UK (they reckon the UK is one of the most viciously competitive auto insurance markets in the world). They are also of the view that their offering (internet-based, price-comparison driven) will be well suited to gaining market share there. Time will tell, but the group believes it is headed in the right direction here and importantly they won't be married to boxing on in a market if the requisite headway is not being made (they have previously pulled out of markets where things haven't worked).

The scope of the opportunity in the US is big: in the states they have entered (Virginia, Maryland, Illinois and Texas) the company has a total market of 34mn vehicles, where Elephant (Admiral's US brand) has a 0.2% market share. Here we note that a **10% US market share would equal their entire auto insurance business in the UK.**

Figure 9: The US market looks promising for Elephant:



Source: Company data

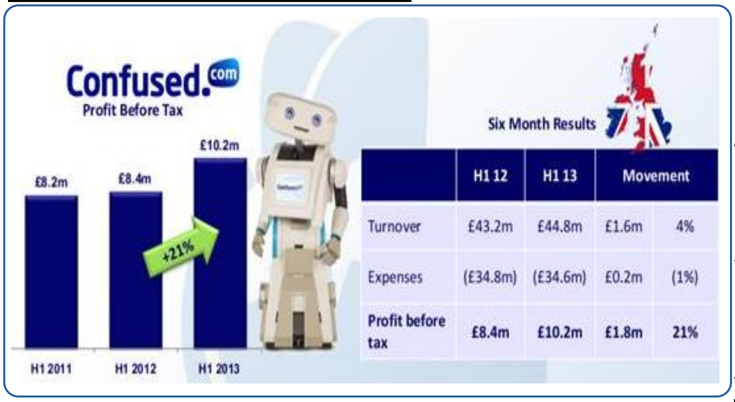
Figure 10: European consolidated results:

Source: Company data

Figure 11: European price comparison makes money

Source: Company data

Figure 12: UK price comparison:



Source: Company data

Figure 13: International Car Insurance financial performance:

Non-GAAP format income statement*[1]

£m	2010	2011	2012
Turnover	77.6	122.1	162.9
Total premiums written	71.0	112.5	148.5
Net insurance premium revenue	18.7	27.2	43.3
Investment income	0.1	0.2	0.1
Net insurance claims	(15.9)	(28.3)	(49.4)
Net insurance expenses	(16.5)	(16.2)	(27.4)
Underwriting result	**(13.6)**	**(17.1)**	**(33.4)**
Net ancillary income	5.3	8.0	8.9
Other revenue and charges	0.3	(0.4)	–
International Car Insurance result	**(8.0)**	**(9.5)**	**(24.5)**

Note – Pre-launch costs excluded

Source: Company data

Figure 14: Key performance indicators:

£m	2010	2011	2012
Reported loss ratio	85%	104%	114%
Reported expense ratio	88%	60%	63%
Reported combined ratio	**173%**	**164%**	**177%**
Vehicles insured	195,000	306,000	436,000
Other revenue per vehicle	£34	£32	£25

Source: Company data

For the whole of the international market, Admiral insures 436,000 vehicles (up from 195k in 2010) and continues to incur losses as scale has not yet been achieved. Collectively, if the group achieves traction in these markets it could conceivably create a whole new growth leg for the company and there is little reason to believe they can't have businesses collectively the same size as their UK business in time to come.

Valuation:

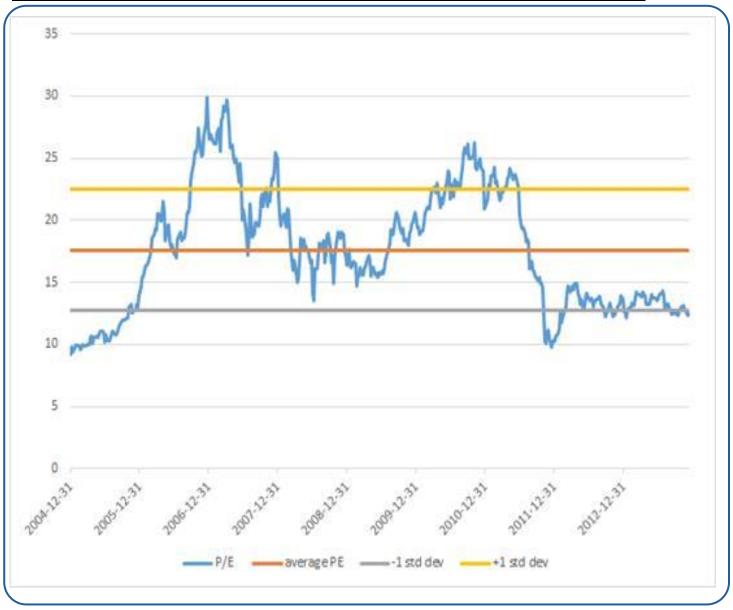
What we like about this company is that expectations for growth from the sell-side appear very muted for the next few years and are probably informed by the market's expectation of premium rates continuing to come under pressure in the core UK market. This could impact on top-line growth, but costs could continue to benefit from better claims experience/ reserve releases. However, the cycle will turn at some stage and Admiral will likely benefit from market share gains and decent pricing when it does. So, expectations are low and this is reflected in the share price – the stock has done nothing for a long time, while earnings delivery has been consistent.

Figure 15: Admiral share price performance:

Source: Company data

This has resulted in the share de-rating quite dramatically in recent years, with the current trailing rating one standard deviation below its mean over the 9-10 years since listing:

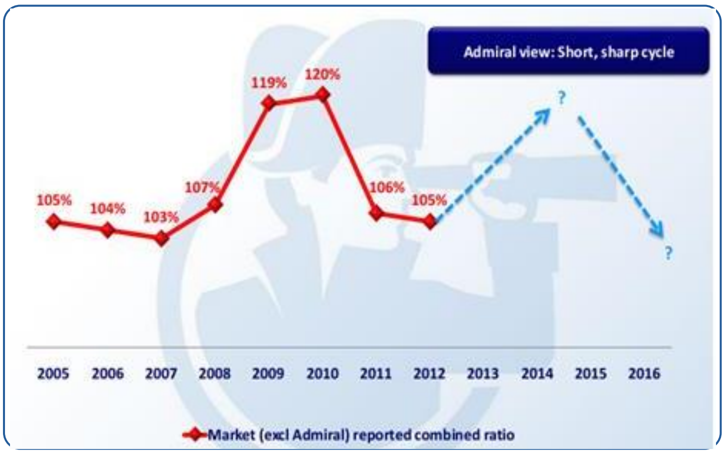
Figure 16: Admiral Group plc trailing P/E multiple:



Source: Company data

Our conclusion is that the downside risk associated with this share is below average, while investors are compensated for patience with a very attractive dividend yield (~8% fwd). We could be too early in buying, but the yield makes up for this and we think this is a quality operation. The UK cycle should also turn at some stage (Admiral's best guess is peak in industry losses in 2014/2015; see below).

Figure 17: Market prospects—market combined ratio*:*



Source: Company data

We have included Admiral Plc in our High Street equity model portfolio at an initial 3%-4% weight.

Sean Ashton

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