An Investment Analyst Values A European Insurance Company

Graham Warren

Our approach to valuing a European insurance company is in four stages:

1. We **adjust published balance sheets** onto as realistic and consistent basis as possible. For life companies we naturally include embedded values. For non-life companies we adjust for over-reserving (if clear!). We remove some tax from unrealised gains.

2. We **forecast the real returns** as far ahead as is sensible (effectively three to ten years).

3. We **calculate cost of equity** as risk free rate, plus Beta, multiplied by the risk premium.

4. We **derive a target price** based on forecast returns relative to cost of equity. This is based on a non-linear model which allows high returns stemming only from a cycle peak, to be distinguished from high returns due to a sustainable competitive advantage, for example a distribution or speciality advantage.

Our model is based on the concept that for a stock to trade at book value, its returns on equity need to be equal to its cost of equity. Superior returns justify a premium to book, whether these superior returns stem from life or non-life, while inferior returns clearly justify a discount to book.

In calculating the forecast returns, the key accounting issues can be summarised as:

1. Establishing a normalised level of total return from equities and from real estate investments.

2. Determining future life margins on an embedded value basis.

3. Determining future non-life margins.

This approach is broadly consistent with more traditional appraisal values, but has three main practical advantages.

First, for the general investor the valuation model allows the investor to tailor the valuation to suit his views on future returns. It also allows insurance companies to be valued alongside non-insurance companies, and thus to be included in general financial discussions on capital structure etc.

Second, it acknowledges more explicitly than appraisal values the possibility of having sustainable high returns on non-life insurance.

Third, it discourages the idea that life margins are fixed at the point of sale. In some life markets, especially US and France for example, this can be a helpful reminder.

Perhaps as interesting as this theoretical framework will be our current estimates for our universe of European insurance and reinsurance shares, recent trends in these valuations and a comparison between UK and Continental markets. This discussion will reflect contemporary market developments. Watch this space.