



Australian
National
University

ANU Student Managed Fund

Investment recommendation

Suncorp Group Limited

ASX: SUN

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Notes:

All dollar amounts in this report are Australian dollars. This report is made available for the sole purpose of demonstrating the analysis undertaken by students enrolled in the University’s Student Managed Fund and its related courses and has been prepared by students who are not licensed to provide financial product advice under the Corporations Act 2001. The information provided does not constitute and should not be relied upon as financial product advice. For financial product advice that takes account of particular objectives, financial situation and needs, readers should consult an Australian Financial Services licensee.

Glossary

AA – Asset Allocation

AAE – Active Australian Equities

AE – Australian equities

AFI – Australian fixed income

ANU – The Australian National University

APRA - Australian Prudential Regulation Authority

ARPC - Australian Reinsurance Pool Corporation

CBE – ANU College of Business and Economics

CET1 – Common equity tier 1 capital

CIO – Chief Investment Officer

CRO – Chief Risk Officer

ESG – Environmental, Social and Governance

FC – Franking credits

GICS – Global Industry Classification Standard

GWP – Gross written premiums

IAC – Investment Advisory Committee

IAG – Insurance Australia Group

IE – International equities

IPS – Investment Policy Statement

IOZ – iShares Core S&P/ASX 200 ETF

MoS – Margin of safety

NEP - Net earned premium

NIM – Net interest margin

QBE – QBE Insurance Group Limited

R&C – Risk and Compliance

ROE – Return on equity

RSFAS – Research School of Finance, Actuarial Studies and Statistics

RT – Relationship Team

RWA - Risk-weighted assets

SMF – ANU Student Managed Fund

SRI – Socially responsible investment

SUN – Suncorp Group Limited

Portfolio recommendation

We recommend that the Student Managed Fund (SMF) establish a **10% weighting** in Suncorp Group Limited (SUN) within the Active Australian Equities (AAE) portfolio, funding the transaction by decreasing the iShares Core S&P/ASX200 ETF (IOZ).

Investment thesis

SUN is a leading Australian financial services company with core operations in general insurance within Australia. It also runs a Queensland-focused retail bank and a small insurance branch in New Zealand.

SUN has a strong positioning within the insurance industry and has successfully managed the growing frequency of natural disasters due to climate change. The SUN share price is languishing compared to pre-COVID levels, despite strong short-term operating performance and positive long-term growth prospects. Our modelling generates a base valuation of \$13.06, implying an 10.17% margin of safety (MoS) excluding franking credits (FC).

The main considerations underpinning our investment thesis include:

- SUN has successfully used the increasing incidence of natural perils to grow premiums, allowing it to manage rising costs and thus protect margins.
- SUN has demonstrated an ability to raise premiums without losing customers, due to its strong market position within an industry where competition is based on brand and service rather than price alone.
- SUN is a high-quality company with favourable financial strength and brand recognition compared to its competitors. While, further investment in technology provides an opportunity for margin expansion.
- Rising interest rates will boost investment income, which should drive higher ROEs.
- SUN's banking business provides an attractive supplementary income stream.
- SUN has a conservative capital position, providing a buffer against unforeseen events.

The following have been identified as risks to SUN:

- Increased risk due to climate change drives premiums to unaffordable levels, resulting in reduced policy sales.
- Increased price competition driven by smaller insurers squeezes margins, as SUN fails to compete on price and loses market share.
- Difficulty in attaining access to reinsurance at an acceptable price.
- High exposure of banking segment to housing, and threats to regional borrowers' ability to meet repayments in a downturn.



AUSTRALIA

ASX code: SUN

Price (at 14/05/2022) \$11.85

Valuation \$13.06

- inc. franking credits \$18.25

Margin of safety (Mos) 10.17%

- inc. franking credits 54.01%

GICS Financials

52-week range \$10.02-13.26

Recommendation **Buy**

Key assumptions

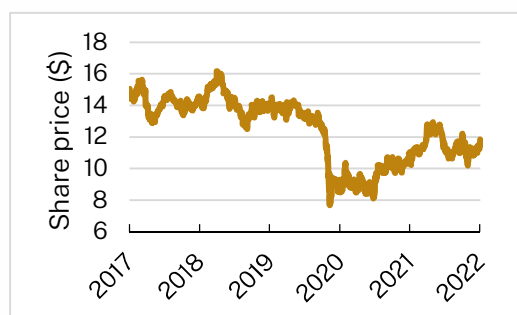
Required return on equity 7.25%

Carbon intensity

SUN 2.80

ASX200 236.08

Five-year share price history



Growing premiums and managing costs in a changing climate

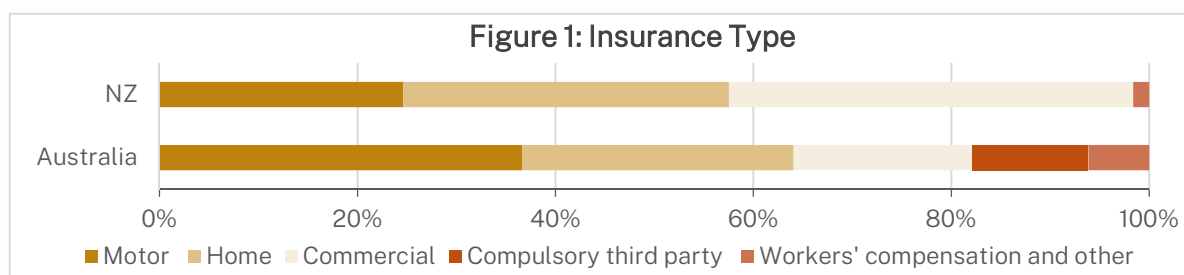
Climate change has increased the frequency and severity of natural perils, leading to an increase in costs and greater general risk for insurers. SUN have a successful track record in managing this risk, using it to increase premiums and thus protect margins.

Natural disaster budget

SUN calculates an annual budget for natural disasters based on actuarial models and uses this in pricing. The ability to accurately forecast the likelihood and severity of natural disasters thus underpins profitability. Historically, SUN has demonstrated strong capability in forecasting claims. For example, its natural hazard costs equalled those forecast in FY2020 despite the Black Summer bushfires. In FY2021, costs marginally exceeded the budget (by 6.3%) due to the many smaller hazards caused by La Nina. In FY2022, costs will be significantly worse than forecast due to the unprecedented flooding. SUN has responded by increasing its natural hazard budget for the year, and has incorporated the higher expected costs into premiums. Ultimately, forecasting natural disasters is an imprecise science. However, SUN's exposure to short-tail risk (see below) allows them to reprice swiftly. Our model incorporates a 0.6% increase in claims ratio over the 10-year forecast period to account for short-term mispricing that may occur.

Exposure to short-tail risk

SUN's exposure to short-tail policies underpins its ability to quickly reprice in response to unforeseen events that signal changes in risk. In both the Australian and New Zealand markets, ~60% of SUN's insurance book is written in the short-tail risk areas of motor and home, which are associated with a one- to two-year lag on repricing. Further, SUN classifies its commercial contracts as short-tail risk. This capacity for swift repricing enables SUN to protect margins over the long run.



Increasing propensity to insure

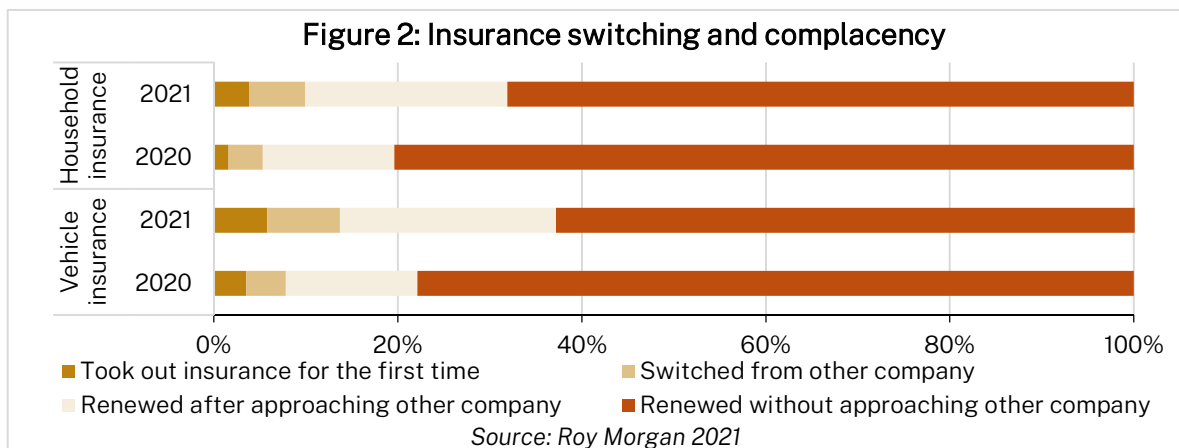
While there is a risk of customer loss in response to higher premiums (see *Risks and risk management*), this may be partially offset by a growing propensity to insure from some customers. This increasing propensity may be driven by growing climate related risks, pushing people who were previously self-insuring towards formal insurance policies.

Strong market position allowing premium growth

SUN's ability to grow premiums without experiencing significant unit loss is underpinned by its market position and the nature of competition within the insurance market.

Complacent consumers

An element of consumer complacency grants a competitive advantage to major insurers like SUN. In 2020, ~80% of people renewed their vehicle and home insurance policies without approaching any other companies, while only ~4% changed insurer. This trend declined slightly in 2021, with the number of switching customers growing to 8% for home and 6% for vehicles. Further, the number of people who approached other companies grew by just under 10% (Roy Morgan 2021).



Historically, complacency has allowed SUN and other major insurers to raise premiums without significant loss of business. Should the increased propensity to switch insurers demonstrated in 2021 continue, insurers may face greater pressure to compete on brand and price. Nevertheless, with complacency remaining at very high levels, it should help SUN secure revenue growth.

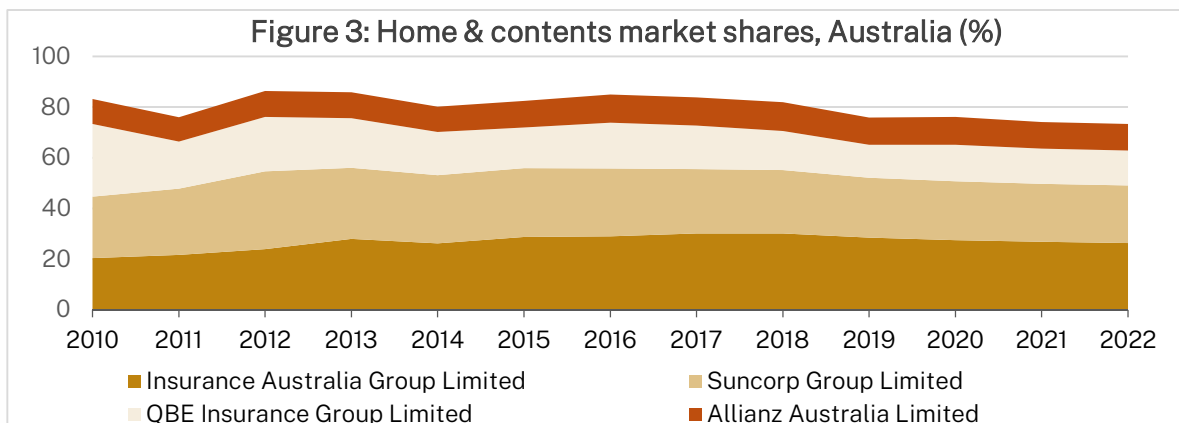
Brand and reputation

Brand recognition and reputation play an important role in Australian insurance. The requirement for insurance to be physically serviced means that consumers are not only interested in price. Rather, they need to trust that the company will be easy to deal with and pay out promptly. To this effect, ~50% of car insurance customers choose based on brand recognition or recommendations from friends and family alone (Mozo 2020).

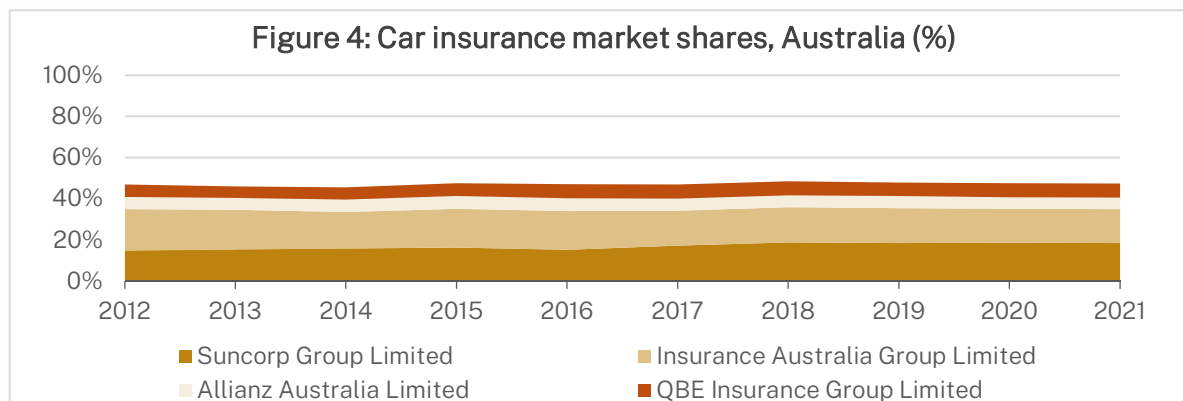
As a major player (see *Market concentration and barriers to entry*) operating some of the most recognised brands (Appendix A), the focus on brand and service provides SUN with a competitive advantage. SUN operates multiple brands and trademarks, each one targeting different market segments (Appendix A). Over the past year, SUN streaked away from its main competitor IAG, positioning itself as the preferred insurance stock. This is driven by SUN's brand recognition (Boyd 2022) and trust, with the highest group customer satisfaction (Roy Morgan 2021). This role of brand has allowed SUN to focus on ensuring that premiums sufficiently cover claims, rather than being forced to provide the lowest premiums to compete for customers. The focus on margin sustainability highlighted by the executive team is reassuring for future returns.

Market concentration and barriers to entry

Australia's home and contents insurance industry operates as an oligopoly, with four insurers holding over 75% market share (Thomson 2022). This high concentration is another reason for lower competition on price. When combined with the emphasis on brand and reputation, the risk that new entrants can effectively compete on price is low.



Australian car insurance is more competitive, with the major insurers only holding ~50% market share. Despite this, SUN has successfully grown from 12% to 19% of market share over the past ten years (Yeoh 2021), strengthening its position within the industry. Further helping to offset the higher risk of entrants and competition is SUN's ability to drive premium growth through strong product offerings (Appendix A) and the benefits of scale, which provide a competitive cost advantage over minor players.



While limited data is available for the New Zealand insurance market, the concentration of brands is higher with 80% of general insurance held by big 4 insurers (Thomson 2022). We have assumed that New Zealand shadows the Australian market, providing SUN with similar benefits.

Finally, the market knowledge required to properly price risk and need for a strong assessment network in times of major crises form an additional barrier to entry for price-competing entrants.

High quality insurance company

SUN is a high-quality insurer, with competitive advantages from high brand recognition (outlined previously), investment in technology and distribution network scale. It also has a conservative capital position.

Investment in technology

SUN's investment in technology offers the potential to reduce costs, improve efficiency and boost customer satisfaction. In FY2021, 21% of SUN's Australian motor and home claims and 65% of deposit accounts were online. Further, SUN's focus on technology has driven a 13.7% increase in digital sales volumes, with technology usage expected to grow (Suncorp 2021).

Notable technology investments include:

- CaPE - a pricing engine to improve risk selection that has been deployed across the mass brands in the home insurance portfolio, and is scheduled to be rolled out to other portfolios. Management expects this to improve risk selection (Suncorp 2021).
- Bingle - an app that allows customers to get quotes, purchase policies and submit claims for comprehensive car insurance.
- Ava - an AI powered employee that answers questions that is being trialled with motor insurance customers at AAMI, part of the SUN network (Appendix A). This adds to AAMI's Intelligent Virtual Assistant, which managed 38,000 questions in its first three months.

In line with the development of such technologies, SUN achieved a decline in employee headcount pre-COVID despite growing revenues, indicating increasing labour efficiency. The trend was interrupted in 2020 as the company hired to meet the rise in physical claims owing to COVID and natural calamities. However, we expect a reversion to this efficiency trend post COVID, helping SUN to improve cost margins.

Strong distribution network scale

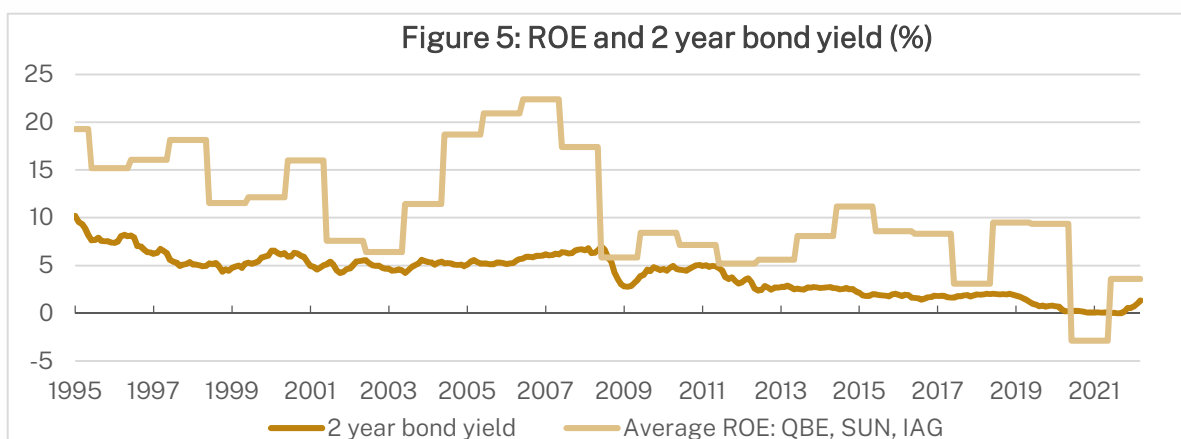
SUN has a presence in every state in Australia, with its size providing scale advantages. The large network allows SUN to manage claims more efficiently than smaller insurers, especially when large numbers of assessors are required. Further, SUN uses its size to bulk-buy building materials at lower rates, helping to reduce repair costs in a high inflation environment (Insurance ews 2021).

Conservative capital position

SUN's prescribed capital is 1.71 times the regulatory minimum (Morningstar 2022). An excess capital buffer helps cover unforeseen insurance or bad debt events and allows room for balance sheet growth. SUN also has accumulated profit reserves that can be used to finance future capital expenditures.

Boost in investment income due to rising interest rates

Rising bond yields benefit insurers by increasing their investment income on fixed income and other securities. Historically ROE has tended to be higher when interest rates are higher, with a clear albeit imperfect correlation shown in Figure 5. As Australia moves towards a higher interest rate environment due to inflationary pressures and central bank policy tightening, it is expected that investment income and hence ROE will increase.



On the other hand, rising interest rates can also increase the cost of capital (Appendix A), with our updated cost of equity reflecting effects flowing from monetary policy normalization. This means that the increase in ROE due to higher investment income need not flow directly into higher valuations. Historically, SUN's ROE has exceeded the cost of equity, allowing the company to create value. We forecast this to continue. From FY2023, our investment income forecasts assume a 2.98% return on fixed income and a 7.44% return on growth assets (Appendix C).

Banking business

SUN's banking component provides an attractive supplementary income stream, comprising 36% of profit after tax and 33% of our valuation. Ultimately, the banking component is an attractive business that provides diversification from SUN's main insurance business in the case of adverse events (Walsh 2021).

While NIMs will be assisted by rising interest rates (by four basis points for every 25 basis points increase in the cash rate, according to JP Morgan 2022), we assume that this will be more than offset by industry competition. Our model assumes that NIMs trend to 1.97% in FY2026 compared with 2.07% in FY2021. Risk-weighted assets (RWA) are forecasted to grow at a conservative 1.5% per annum. We also assume that the common equity tier 1 capital ratio (CET1) increases to 12%. Overall, our forecasts have bank ROE shifting down to 8%-8.5% versus 9.21% in FY2021 and an

expected 8.56% in FY2022. The main downside risk is that the housing market recoils harder than expected (see *Risks in the banking business*). We allow for this possibility in the worst-case scenario, where the bank valuation drops by 42%.

Return on equity (ROE)

SUN's 5-year historical average ROE is 7.68%. Management's focus on marketing of key brands, managing loss ratios and driving digital sales have facilitated a stable ROE (Morningstar 2022). As seen in Appendix A (Figure 7), SUN's historical ROE has been more stable than its main competitors, QBE and IAG. This greater stability in ROE implies better risk management and consistency of value creation compared to major competitors. For example, while IAG experienced higher ROE for a short period owing to the NRMA brand being the most recognised in the market, its ROE has fallen below the cost of equity in recent years. QBE has likewise experienced several periods of ROE significantly below cost of equity.

Following the sale of the Australian life insurance and wealth divisions, we have calculated the ROE for both the historical and forecast period by considering only the banking and remaining insurance divisions. This leads to ROE forecasts moving higher than reported historically, noting that the 5-year average ROE achieved by the banking and insurance (ex-life) divisions of 8.93% is higher than the group average ROE (Figure 6, Appendix A).

The insurance division has a historical average ROE of 9.2%, and we have forecast a trend up from 8.9% in FY2021 to 10.5% by the end of the forecast period (Figure 11, Appendix C). The increase is driven by the expected rise in premiums, higher investment earnings and cost efficiencies as outlined above.

The banking division has a historical average ROE of 8.33%, and stood at 9.21% in FY2021. We have forecasted a trend down to 8.16% by the end of the forecast period (Figure 12, Appendix C). The fall is driven by the longer-term impact of competition on NIM and SUN's higher funding and operational costs relative to the majors, and the increase in equity capital (as discussed above).

Combined, SUN's group ROE (banking and insurance) has been forecast to increase from 9.01% in FY2021 to 9.74% by the end of the forecast period. Group ROE in FY2022 has been forecasted to drop temporarily to 7.48% due to the impact of the recent flood disasters in Australia, before recovering in FY2023 (Figure 6). Historical and forecasted group ROE is greater than the cost of equity, indicating value creation. The market's sustained depression of SUN's share price suggests that the market is not pricing in the full potential for higher ROE.

Risks and risk management

Red zones

While climate change provides potential for increased pricing power (see *Growing premiums and managing costs in a changing climate*), it also carries risk of reduced demand for insurance due to red zoning. A home is classified as uninsurable or 'red zoned' when the annual premium exceeds 1% of the property replacement value. A recent report outlined that 4% of Australian homes could be uninsurable by 2030 (Climate Council 2022). Similar trends are forecast in New Zealand. Our baseline forecasts assume that climate change will itself result in a slight decrease in margins and reduce premium growth by ~0.5% annually. This is a conservative measure, given other insurance lines are less exposed to climate change.

Access to reinsurance

SUN engages reinsurance, with a maximum event retention of \$250 million. Capping expenses for any singular event minimises exposure to individual natural hazards. However, SUN faces the risk of international reinsurers becoming more concerned about Australia due to an escalating risk profile, leading to a need to spend more to maintain reinsurance programs. This risk, however,

is also faced by SUN's competitors, which increases the likelihood that increasing reinsurance costs could be passed on to consumers industry wide.

Additionally, the Federal Government has taken measures to address the rising cost of reinsurance in red zones. The *Australian Reinsurance Pool Corporation (ARPC)* has been extended to cyclones and cyclone related flood damage, allowing insurers to access reinsurance at lower rates. This alleviates pressure on premiums for policies where reinsurance becomes otherwise unaffordable. The recent flood events prompted calls from MPs of both parties to expand the pool to all flooding, noting these high-risk areas were impacted by high levels of underinsurance due to unaffordable premiums. Any extension of the scheme would help SUN retain red-zone customers by providing reinsurance coverage for otherwise commercially unviable policies.

Mitigation of insurance risks

Australia's approach to natural disasters shifted following a 2015 inquiry, which highlighted that spending on mitigation is only 3% of that spent on clean-up and recovery (Productivity Commission 2015). A shift toward mitigation is reflected in Federal Government announcements, which include a \$600 million *Preparing Australia Program* and an *Emergency Response Fund* with the remit to draw down \$50 million annually for resilience building. More attention on mitigation will be positive for SUN's business, although the impact is not readily quantifiable.

Risk in the banking business

The key risks to the banking business are the high exposure to housing (Table 1), inability to compete with the big-four banks due to scale, and adverse weather conditions impacting the ability of regional borrowers to meet financial obligations. We have incorporated the scale and adverse weather risks through cutting NIMs from 2.07% in FY2021 to 1.97% by FY2026 and then 1.93% by the end of the forecast period, and ROE from 9.21% in FY2021 to 8.16% by the end of the forecast period).

The main risk to our valuation would be a housing collapse. As this is only a possibility, we have included it in our downside risk scenario, decreasing asset growth rates and increasing impairments. While approximately 80% of SUN's lending is secured (through mortgages), the protection that this offers is somewhat limited in the event of a housing collapse. Our worst-case scenario results in our bank valuation declining by 42%.

The housing exposure risk is lessened by SUN's loan portfolio being concentrated in Queensland (49% of total housing loans – see Table 1). The average rental yield for residential properties in Brisbane is 3.4%, versus 2.3% in Sydney and 2.4% in Melbourne (SQM Research 2022). This could suggest that property in Queensland is more fairly valued and will be less sensitive to interest rate increases, as a higher discount rate is already partly reflected in property prices. As such, we view the risk of significant declines in property values as being less pronounced in Queensland.

Table 1: SUN banking segment split

Region	QLD	NSW	VIC	Other
Lending business split	49%	27%	13%	11%
Nature	Housing	Commercial	Agriculture	Consumer
Lending business split	80%	12%	7%	1%

SRI considerations

The SMF Risk and Compliance (R&C) team has conducted an in-depth SRI analysis for SUN and formed the opinion that it complies with the SMF SRI Policy. Detailed analysis appears in Appendix D, which we summarise here. One issue is the insurance industry pattern of questionable practices relating to avoidance of claim payouts. For instance, key SUN competitors have faced large class actions and litigation concerns regarding business interruption insurance

during the COVID-19 pandemic. Though SUN has also faced similar concerns during this volatile period, the severity and magnitude of its violations is notably less. In addition, SUN has applied due diligence and undertaken customer remediation in its former financial planning businesses, and has implemented solid practices through its “Dispute Resolution Principles and Guidelines”. SUN shows a low level of social harm within the insurance industry, and significant improvements with respect to corporate trustworthiness, including transparency, compliance, and accountability – a key investment preference under the SMF SRI Policy.

SUN’s actions on climate change and responsibility in financial services create some social benefits, and are also in line with the sustainable business practices that the SMF supports. SUN has a low carbon intensity score of 2.8, and commits to achieving net-zero emission by 2050. In FY2021, fossil fuel exposure was less than 0.1% of Gross Written Premium and less than 0.3% of invested assets. Its sustainable growth strategy actively engages in responsible underwriting, lending and investment activities. SUN has been working with government and implementing its Financial Inclusion Action Plan to address insurance unaffordability due to climate change.

Overall, we believe that SUN is more likely to create social benefits than cause an unacceptable level of social injury, and is unlikely to give rise to significant reputational risk.

Valuation summary

Our discounted cash flow (DCF) model generates a base case valuation of \$13.06 excluding FC, and \$18.25 including FC. This valuation provides a MoS of 10.17% and 54.01% excluding and including FC, respectively.

Table 2: Valuation Summary

	Base Case	Best Case	Worst Case
Insurance value per share	\$8.45	\$10.34	\$4.96
Bank value per share	\$4.08	\$4.87	\$2.83
Group share value, ex. FC	\$13.06	\$15.84	\$8.12
Group share value, inc. FC	\$18.25	\$22.14	\$11.30
Current share price	\$11.85	\$11.85	\$11.85
MoS ex. FC	10.17%	33.64%	-31.51%
MoS inc. FC	54.01%	86.81%	-4.64%

The positive MoS indicates that SUN is attractively valued with a buffer for the potential downside risks outlined in previous sections. This presents SUN as an attractive investment opportunity for the SMF, especially when combined with cash flow reliability owing to the company’s competitive advantages and a positive industry outlook, as well as access to franking credits (see below).

Dividend commitment and franking credits

SUN pays a fully franked dividend, with a 60-80% dividend payout ratio commitment, providing additional value given the SMF’s tax free status. SUN’s current dividend yield of 5.3% is fully franked, amounting to a gross yield of 7.6%. Our valuation including franking is boosted by 39.8% under the assumption that SUN continues to pay out earnings other than those needed to fund increases in equity capital as fully franked dividends.

Summary of key model inputs

Our model is structured around SUN's three main segments: Insurance Australia, Insurance New Zealand, and Banking. The two insurance segments feed into a combined insurance valuation. Revenue growth peaks at 5.1% before stabilising at 3.6% by the start of the second stage forecasts in 2027. The combined ratio peaks in 2022 at 96.1%, accounting for the recent floods,

before declining to 93.2% in 2024, after which it remains broadly stable, reaching 93.4% over the second stage forecasts to 2032. This reflects the impact of a declining expense ratio due to technology and an increasing claims ratio to account for short term mispricing (Appendix C).

The banking model assumes annual growth in lending assets declines from 3% in FY2022 to a stable 1.5% by the second stage. Net interest margins (NIM) start at 2.02% in FY2022 (below the FY2021 margin) and trend to a steady 1.97% by 2025. Operating expenses/net interest income trends down from 58% to 55% by the end of the second stage, half the management target.

An equity cost of capital (k_e) of 7.25% has been used to discount the free cash flows.

Scenario analysis

Our best-case scenario adjusts key assumptions upwards, including larger premium growth, cost margin reduction, declining bank costs and favourable NIMs (Appendix E). These more optimistic assumptions produce a valuation of \$15.84, with a MoS of 33.64%. Our worst-case scenario similarly adjusts the key assumptions downwards, including larger reductions in policies sold, cost margin increases, declining loan growth, increased bank impairments due to negative property market outlook, failure to meet bank cost targets and unfavourable NIMs (Appendix E). Adjusting our assumptions to be more pessimistic produces a valuation of \$8.12, with a MoS of -31.51%.

Appendix

Appendix A: Key company analysis

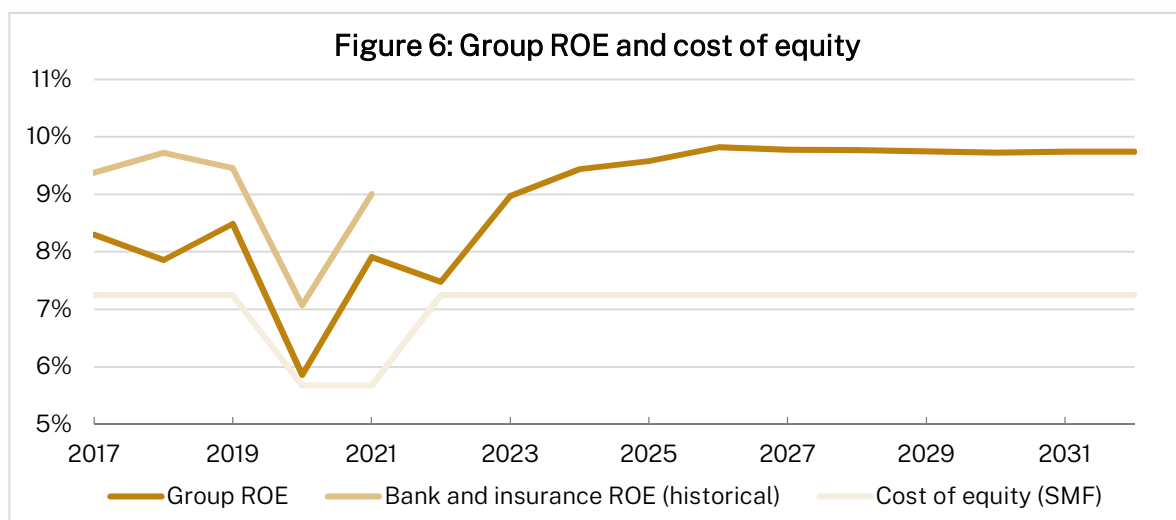
Table 3: Detailed breakdown of SUN business segments

Segment name	Description
Insurance (Australia)	<p>(a) Design, manufacture and delivery of general insurance products and services to customers in Australia.</p> <p>(b) Key products – home, contents, motor, commercial property, etc.</p> <p>(c) Key brands – Suncorp, AAMI, APIA, GIO, CIL, Shannons (motor), etc.</p>
Banking & Wealth	<p>(a) Design, manufacture and delivery of banking, superannuation and fund administration services to customers in Australia.</p> <p>(b) Key products – commercial, agribusiness, small business, home loans, savings and transaction accounts, foreign exchange, etc.</p> <p><i>Note: On 1 April 2022, SUN completed sale of its Australian wealth business to LGIAsuper.</i></p>
Suncorp NZ	<p>(a) Design, manufacture, and delivery of general and life insurance products to customers in NZ.</p> <p>(b) Key products – home and contents, motor, commercial property, etc.</p> <p>(c) Key brands – Suncorp, Asteron Life, AA Insurance, Vero (general).</p>
Corporate	<p>(a) Investment of group capital, business combinations and divestments.</p>

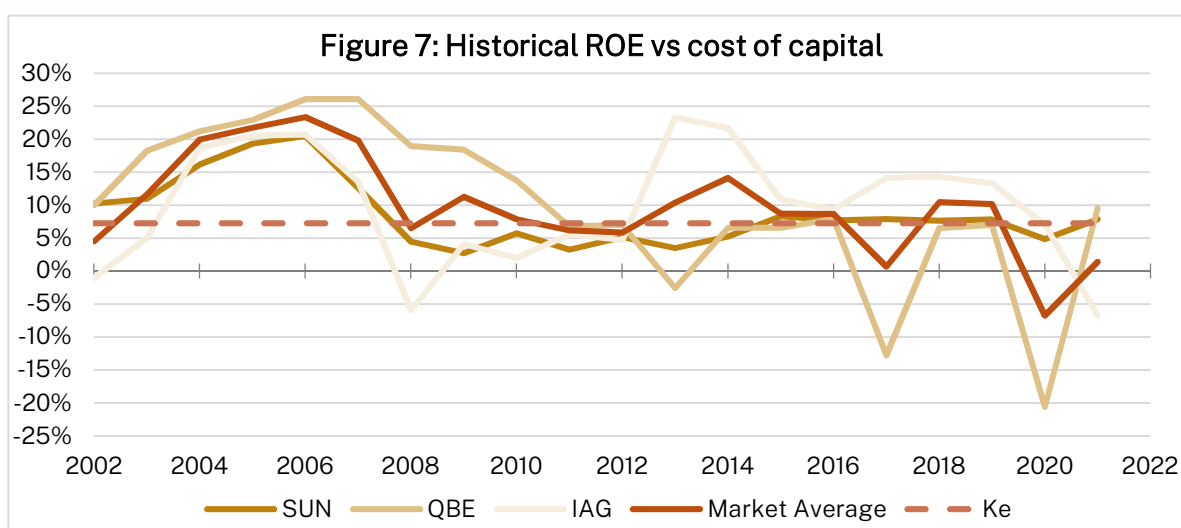
Table 4: SUN brand recognition analysis

Bingle	Target audience is people wanting car insurance that is affordable and straightforward. Bingle offers comprehensive car insurance and third-party car insurance. Bingle won the ‘Canstar award’ for outstanding value car insurance consecutively from 2017 to 2021 (Bingle 2022).
AAMI	Offers a wide range of insurance products including car, home, building, contents, business, life, pet, etc. AAMI has national leadership and is showing the highest net promoter score (NPS) since 2016 (Boyd 2022). AAMI has won multiple awards starting from 2006 relating to ‘cheapest home & contents insurance’, ‘people choice award’, etc. (AAMI 2022). Further, AAMI also won the ‘gold winner: car insurance, life insurance’ in 2022 (Quality service awards 2022).
Shannons	Shannons target audience is motoring enthusiasts. Apart from auctions of vintage vehicles and insurance, it aims to provide a community feel (Suncorp 2021). It is SUN’s second biggest motor brand and has seen double digit growth owing to good pricing, risk selection and brand positioning (Boyd 2022). Further, as per Morgan 2021, Shannons showed a 91% general insurance satisfaction.
APIA	APIA provides specialist insurance to Australians who are over 65 years. Their products include insurance for car, home, contents, funeral, health, assisted living, etc. APIA won the ‘gold winner: home & contents insurance’ in 2022 and was recognised as the go-to insurance for retirees (Quality service awards 2022)

SUN ROE and cost of equity analysis



SUN vs competitors: ROE and cost of equity analysis



Appendix B: Key financial summary

Table 5: Group insurance key financials

Financial year (A\$ million)	2019(A)	2020(A)	2021(A)	2022(E)	2023(E)	2024(E)	2025(E)
Total net earned premiums	8,609	8,662	9,003	9,460	9,766	10,130	10,549
% growth	1.8%	0.6%	3.9%	5.1%	3.2%	3.7%	4.1%
Combined ratio	93.8%	94.1%	93.1%	96.1%	94.1%	93.2%	93.1%
NPAT	826	629	747	591	819	915	954
Insurance ROE	10.0%	7.8%	8.9%	6.9%	9.4%	10.3%	10.5%
Financial year (A\$ million)	2026(E)	2027(E)	2028(E)	2029(E)	2030(E)	2031(E)	2032(E)
Total net earned premiums	10,968	11,363	11,773	12,197	12,636	13,091	13,563
% growth	4.0%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%
Combined ratio	93.2%	93.2%	93.2%	93.3%	93.3%	93.3%	93.4%
NPAT	986	1,022	1,056	1,093	1,130	1,170	1,210
Insurance ROE	10.6%	10.6%	10.6%	10.6%	10.6%	10.6%	10.5%

Table 6: Banking key financials

Financial year (A\$ million)	2019(A)	2020(A)	2021(A)	2022(E)	2023(E)	2024(E)	2025(E)
Net interest income	1,163	1,191	1,242	1,340	1,359	1,379	1,400
% growth	-1.5%	2.4%	4.3%	7.9%	1.5%	1.5%	1.5%
NPAT	363	249	419	399	404	412	417
Banking ROE	8.48%	5.77%	9.21%	8.56%	8.25%	8.00%	7.99%
CET1 ratio	9.3%	9.3%	10.1%	11.0%	11.5%	12.0%	12.0%
Financial year (A\$ million)	2026(E)	2027(E)	2028(E)	2029(E)	2030(E)	2031(E)	2032(E)
Net interest income	1,428	1,442	1,457	1,457	1,456	1,471	1,486
% growth	2.0%	1.0%	1.0%	-0.01%	-0.01%	1.0%	1.0%
NPAT	446	444	451	454	457	466	473
Banking ROE	8.42%	8.25%	8.26%	8.19%	8.13%	8.17%	8.16%
CET1 ratio	12.0%	12.0%	12.0%	12.0%	12.0%	12.0%	12.0%

Appendix C: Valuation summary

Insurance segment

Revenue

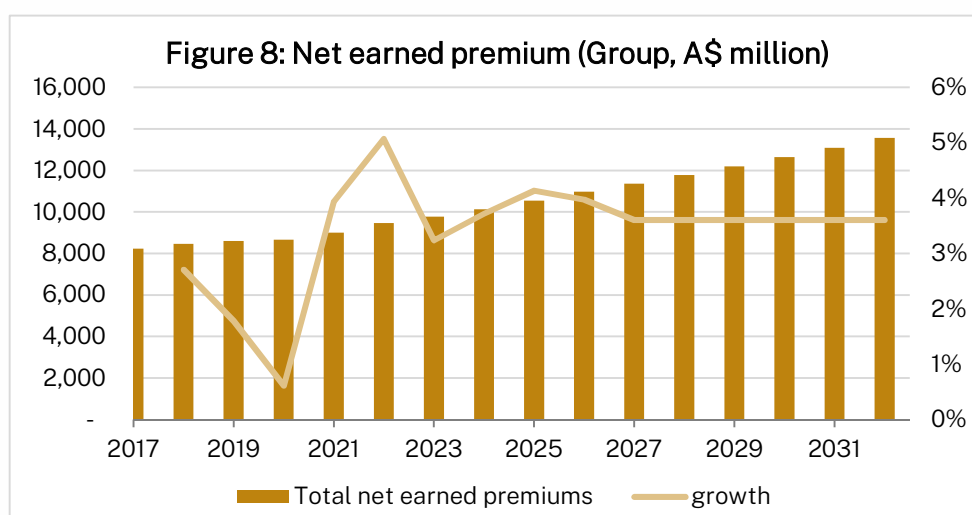


Table 7: Net earned premium forecasts

Financial year (AUD \$million)	2020(A)	2021(A)	2022(E)	2023(E)	2024(E)	2025(E)	2026(E)
Australia	7,265	7,540	7,840	8,062	8,353	8,698	9,042
New Zealand	1,397	1,463	1,620	1,704	1,776	1,850	1,926

Net earned premium (NEP) for the group is derived from the Australian and New Zealand insurance segment. NEP for the Australian segment is forecasted using a weighted growth rate based on a combination of GDP growth (30%), population growth (10%), industry forecasts (20%), number of cars and households (10%), cost of natural disasters (20%) and the historical average (10%). NEP for the New Zealand segment is forecasted using a weighted growth rate based on a combination of GDP growth (30%), population growth (30%) and the historical average (40%).

Revenue growth peaks in 2022 at 5.1% and stabilises at 3.6% from 2027 onwards. The peak in revenue growth is in line with the market consensus for high premium growth related to climate change. The model is built in nominal Australian dollars (A\$), under the assumption that the

exchange rate between the A\$ and New Zealand dollar (NZ\$) will remain relatively stable consistent with trends over the years.

Combined ratio, claims ratio and expense ratio

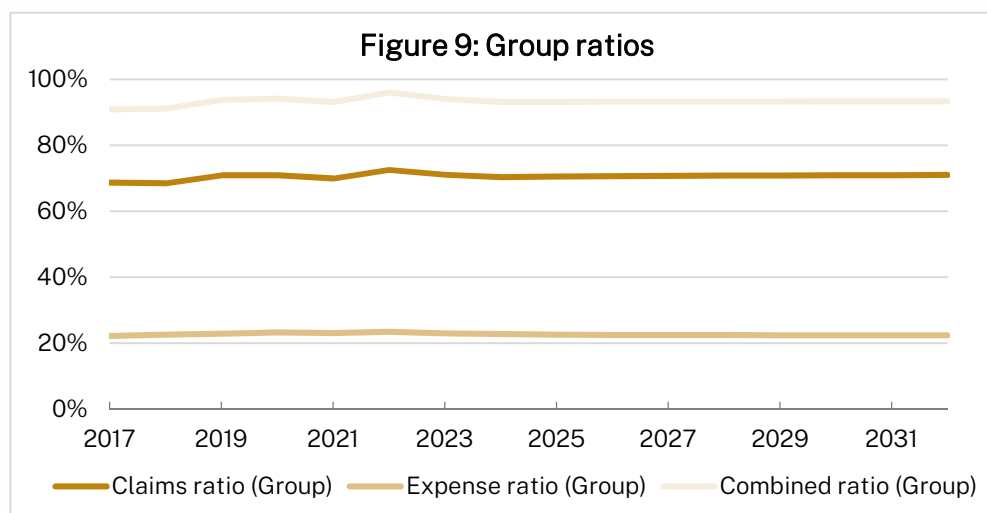


Table 8: Insurance ratio forecasts

Financial year	2020(A)	2021(A)	2022(E)	2023(E)	2024(E)	2025(E)	2026(E)
Australia							
Claims ratio	74.9%	72.9%	76.0%	74.3%	73.3%	73.5%	73.6%
Expense ratio	21.6%	21.8%	21.7%	21.1%	20.9%	20.7%	20.6%
Combined ratio	96.6%	94.7%	97.7%	95.3%	94.2%	94.1%	94.2%
New Zealand							
Claims ratio	49.8%	55.0%	56.1%	56.3%	56.4%	56.5%	56.7%
Expense ratio	31.7%	29.9%	32.0%	32.0%	31.9%	31.9%	31.8%
Combined ratio	81.5%	84.9%	88.2%	88.2%	88.3%	88.4%	88.5%

As seen in table 8, claims ratios in both segments increase marginally over the forecasts. This allows for an increasing frequency and severity of natural perils and any short-term mispricing that may result. The expense ratio is forecasted to fall versus the historical average due to the benefits of digitization and an expected reduction in expenses due to investment in technology, as discussed earlier.

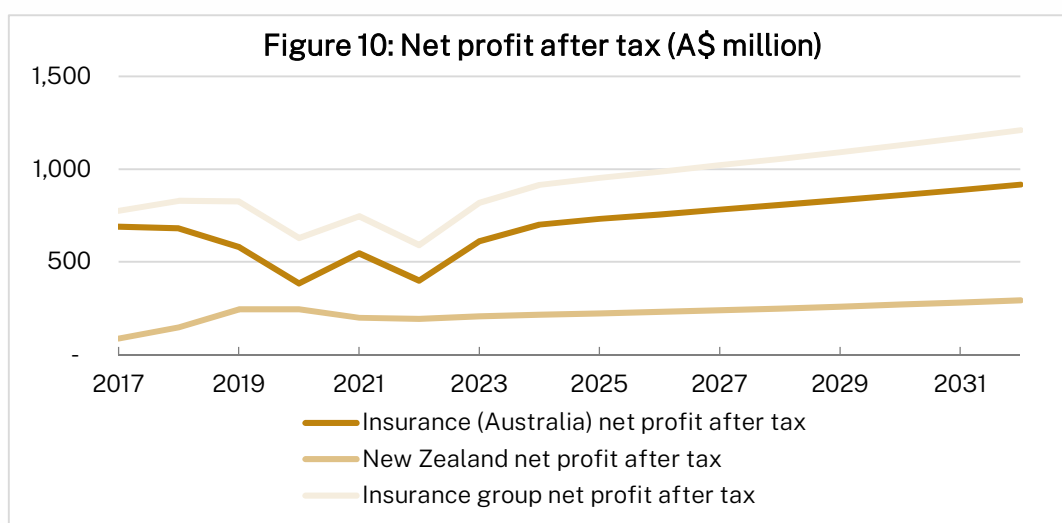
The above ratios are calculated as a percentage of net earned premiums, which are expected to rise in part due to higher premiums to cover climate risks. The net effect is that the value of both claims and costs increases in dollar terms in a steady manner. Insurance margins, as described by the group combined ratio, decrease in the short-term to 93.2% in 2024, before stabilising to end the second stage forecasts at 93.4%. This reflects the opposing effects of declining operating expenses and marginally increasing claims.

Table 9: Investing income forecasts

Financial year (A\$ million)	2020(A)	2021(A)	2022(E)	2023(E)	2024(E)	2025(E)	2026(E)
Insurance funds	256	244	224	306	317	329	341
Shareholders' funds	76	156	95	131	135	141	146
Total investment income	333	400	319	436	452	469	487

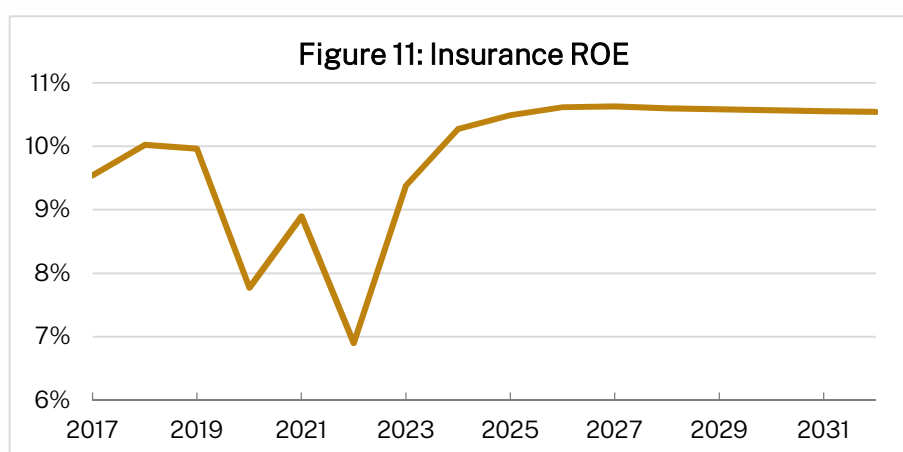
Investment income is expected to rise due to higher interest rates. Assumed returns are 2.98% on fixed income securities and 7.44% on growth assets from FY2023 onwards.

Net profit after tax



The rise in net profit after tax flows from the forecasts for net premium earned, claims ratio, expense ratio and investment income.

Insurance ROE



The ROE falls in FY2022 owing to increased claims from the recent floods. It then increases as SUN reprices, stabilising above historical rates at 10.6% in the second stage.

Banking segment

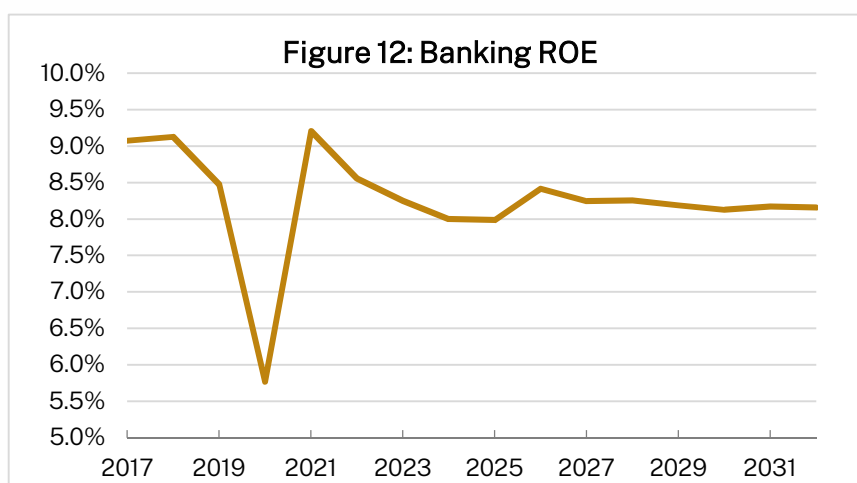


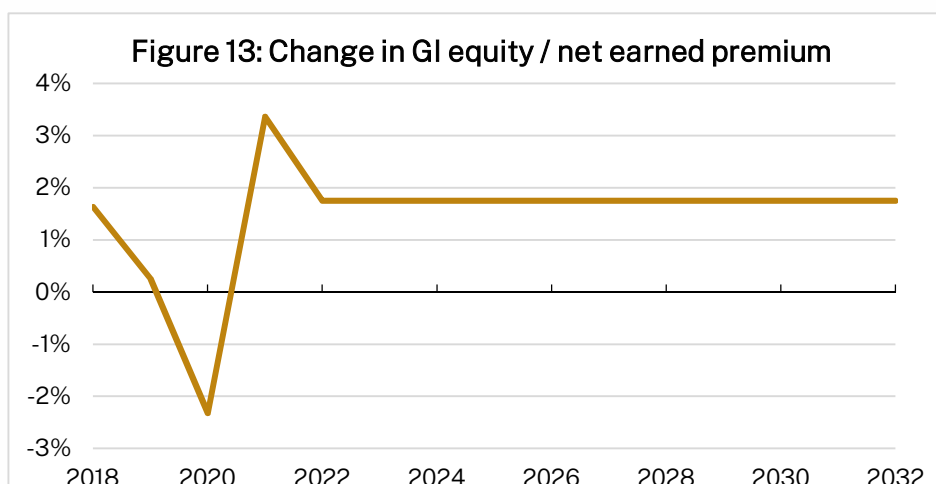
Table 10: Banking segment forecasts

Financial year	2020(A)	2021(A)	2022(E)	2023(E)	2024(E)	2025(E)	2026(E)
Net interest margin	1.94%	2.07%	2.02%	2.00%	1.98%	1.97%	1.97%
NPAT	249	419	399	404	412	417	446
Banking ROE	5.77%	9.21%	8.56%	8.25%	8.00%	7.99%	8.42%

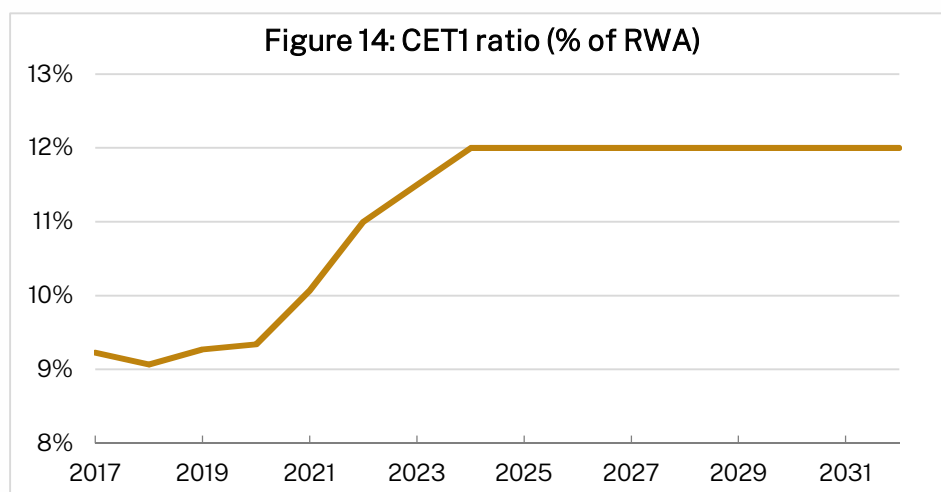
The bank ROE is forecasted at 8.56% in FY2022, before declining and then stabilising at ~8.2% in the second stage. The ROE forecasts reflect the combination of NIMs being assisted in the short-term by rising interest rates (analyst reports indicate a four-basis point increase in NIMs for every 25-basis point increase in cash rate, JP Morgan 2022), the longer-term impact of competition noting SUN's higher funding and operational costs relative to the leading banks, and an increase in CET1 ratio to 12%. This leaves SUN with a lower ROE than consensus estimates for the leading banks (sourced from Factset). Over FY2022 to FY2026, the consensus average forecasted ROE for ANZ, CBA, NAB and WBC is 10.13%, whereas our average forecasted ROE for SUN is 8.24% over the same period.

Required reinvestment in equity

For both the insurance and banking segments, a portion of net earnings is required to be reinvested into equity capital to support growth in the book. For the insurance segment (Figure 13), the required reinvestment is calculated with reference to the general insurance equity capital to net earned premium ratio, which we held consistent with historic levels.



For the banking division (Figure 14), the calculations are based on a CET1 to risk-weighted assets ratio that is forecasted to increase from 10.1% to 12% to reflect an increase in regulatory requirements from 7% to 9.25%.



Weighted average cost of capital

The SMF baseline cost of equity is 7.25%, reflecting the Asset Allocation (AA) team’s estimate of the implied expected return that is priced into the Australian equity market. A 7.25% discount rate also happens to align with the return required for the SMF to achieve its target absolute return of inflation plus 4.5%, assuming long-term inflation of about 2.5%.

Appendix D: SRI considerations

Assessment of SUN’s compliance with the SMF SRI Policy focused on three main areas of corporate trustworthiness, climate change actions and responsible financial services.

Corporate trustworthiness, including transparency, compliance, and accountability

In the past, SUN has been under scrutiny in relation to compliance concerns regarding its general licensee obligations. In 2015, the Australian Securities and Investments Commission (ASIC) identified SUN-owned Guardian Advice (GA) as deficient in the advice provided to retail clients (ASIC, 2019). SUN proceeded to take its first steps in addressing remediation measures shortly after this specific incident was flagged. Bound by ASIC commitments, SUN completed a comprehensive remediation program and funded compensation of GA clients that totalled \$1,431,167 as of September 2019. SUN held itself accountable and renounced involvement within the financial planning business that entailed GA. Under this remediation program, SUN took further action to compensate clients who were potentially at risk of receiving poor advice from sources using risk metrics applied from the GA network. Following this ASIC-identified shortfall, SUN has shown no material evidence of transparency, compliance and accountability concerns within its business operations to date, which is affirmation of effective remedial measures. We are satisfied with SUN’s actions as evidence of transparency, compliance and accountability.

Concepts surrounding social harm are ever-present within the insurance industry, typically relating to claim payout reluctance. Under the challenges posed by COVID-19, insurers have felt increasing pressure to support business losses. The reputation of the insurance industry during the COVID-19 pandemic has been tarnished via its persistent actions to blur the lines between policy exclusions to “quarantinable disease” under the Quarantine Act 1908 and “listed human disease” under the Biosecurity Act 2015. If the reference in policy exclusions is under “listed human disease”, insurers could reject claims for business interruptions for COVID-19-based

reasons. Many other industry competitors have discrete litigation underway regarding business interruption wordings in response to the COVID-19 pandemic. For example, QBE has been entangled in class actions by businesses seeking compensation for losses sustained during the COVID-19 pandemic, after the insurer refused to pay business interruption claims. Similarly, IAG has disclosed that it could be exposed to approximately \$1 billion in business-related claims due to policy wording errors (SMH, 2021). Considering large-scale social harm impact and resulting claim payments, potential for judicial determinations at a broader industry level is of concern to SUN in the future. Though SUN also has existing class actions and litigation concerns regarding these matters, their severity and magnitude are notably less than competitors. There is still potential for industry-led social harm from this area in the future, although SUN appears to have a superior record to competitors.

Climate change actions

SUN has a low carbon intensity score of 2.8, allowing room for more carbon intensive holdings to enter the SMF portfolio. SUN also has a target of achieving net-zero emissions by 2050. In addition, SUN's Fossil Fuel Sensitive Sector Guideline commits to phasing out the underwriting exposure to thermal coal by 2025 and investment exposure to oil and gas by 2040. In FY2021, fossil fuel exposure was less than 0.3% of invested assets and less than 0.1% of Gross Written Premium. SUN also continues to invest in low-carbon solutions and seeks to increase exposure to businesses with a positive environmental impact. SUN had \$321 million of low-carbon investment in place during FY2021, including green bonds and renewable energy infrastructure.

Responsible financial services

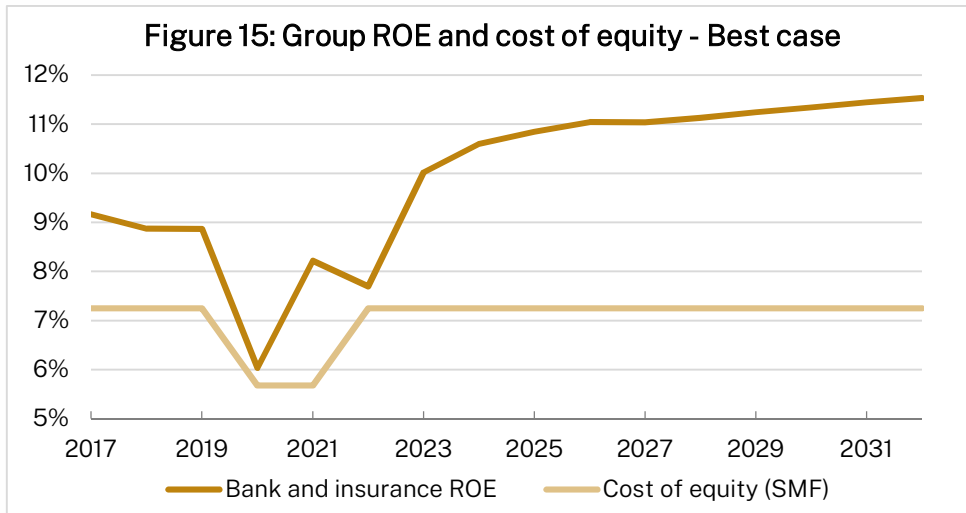
Due to climate change, insurance premiums have become elevated and even unaffordable, especially in catastrophe-prone areas. SUN has been working collaboratively with the government to improve affordability. For example, through the Queensland Government's Household Resilience Program, SUN delivers a Cyclone Resilience Benefit to provide customers in North Queensland with home insurance premium reductions of up to 20 per cent. Furthermore, SUN's Financial Inclusion Action Plan commits to building understanding of the barriers for people to assessing insurance, and designing insurance to improve financial resilience and inclusion.

Appendix E: Scenario analysis

Best case

The optimistic 'best case' outlook sees high premium growth as large natural disasters drive growth in premium prices while acting to increase propensity to consume insurance, thus preventing policy sale loss despite rising premiums. Cost ratios also decline as SUN can respond to strong demand by pricing more conservatively, thus leading to higher margins.

Banking operating expenses are reduced in line with the company's target, driven by technological advancements. Additionally, NIMs are more favourable than forecast due to the beneficial effect of higher-than-expected interest rates. These more optimistic assumptions produce a valuation of \$15.84, with a MoS of 33.64%. Further, as seen in the chart over, the ROE exceeds even the highest historical levels as well as cost of equity, creating significant value.

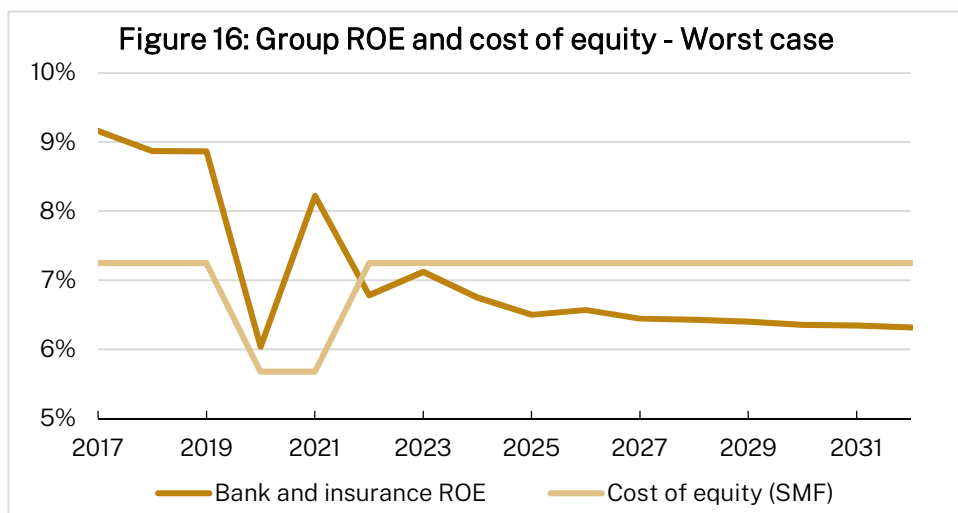


Worst case

The worst-case scenario sees an increase in premiums due to climate change resulting in reduced demand for insurance and hence subdued revenue growth. SUN struggles with forecasting natural disasters, causing short-term mispricing and hence higher claims ratios. Further, the loss of customers reduces the scale advantages that SUN experiences and contributes to increased expense margins.

Banking experiences poor lending asset growth and higher impairments due to housing market challenges caused by rising interest rates. Further, the bank proves unable to make any meaningful reduction in operating expenses and NIMs are less favourable than forecast due to either lower interest rate rises and/or competing away of the benefits of higher rates.

Adjusting our model assumptions in line with this more pessimistic outlook produces a valuation of \$8.12, with a MoS of -31.51%. Further, the group ROE falls below cost of equity, suggesting that SUN destroys shareholder value through growing its book.



Appendix F: Other items considered

Financial services Royal Commission

The final report of the Royal Commission released in 2019 outlined 15 recommendations that impact on the insurance industry. While many recommendations are yet to be implemented, the *Financial Sector Reform (Hayne Royal Commission Response) Bill 2020* legislated changes to the sale of add-ons, hawking, commissions caps, claims handling licences and duty of disclosure to customers. Most of these changes are relatively minor and will have limited impact on the business model of SUN and other major insurers.

COVID-19 impact lawsuit

SUN has made a provision for potential business interruption claims of \$211 million. Based on the latest High Court ruling, the claimants were given an opportunity to further pursue the claim before the trial judge. A potential risk arises regarding whether the provisions would be sufficient in the case of an adverse outcome. Despite this risk, any additional expense would be a one-off that would not have a significant impact on SUN's long-term profitability.

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