Australian
National
University

ANU Student Managed Fund

Investment recommendation

Suncorp Group Limited

ASX code: SUN

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All dollar amounts in this report are Australian dollars.

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Glossary

AAE – Active Australian Equities

ANU – The Australian National University

ANZ – The Australian and New Zealand Banking Group Limited

FC – Franking Credits

FY23 – Financial Year 2023

GICS – Global Industry Classification Standard

GWP – Gross Written Premium

HY24 – Half Year 2024

IAG – Insurance Australia Group Limited

IAC – Investment Advisory Committee

IOZ – iShares Core S&P/ASX 200 ETF

NEP – Net Earned Premium

NIB – NIB Health Insurance

NTM – Next Twelve Months

NPS – Net Promoter Score

MoS – Margin of Safety

RBA – Reserve Bank of Australia

R&C – Risk and Compliance

ROE – Return on Equity

SUN – Suncorp Group Ltd

SMF – ANU Student Managed Fund

WACC – Weighted Average Cost of Capital

QBE – QBE Insurance Group

Portfolio recommendation

On 28 June 2024, SUN was rebalanced back to its target weight of 10%, after exceeding the +3% threshold, relative to its 10% target weighting in the AAE portfolio. The deviation from the target weight stood at 3.35% and came amidst news that Jim Chalmers had approved ANZ's takeover of SUN's banking business. The SMF received $17.371 per share for the sale of 898 shares, with the proceeds being invested in 499 iShares Core S&P/ASX 200 ETF (IOZ) units.

The key reason underpinning the decision to rebalance SUN is that it is trading above our extant valuation of the company (without franking credits or FC) and further analysis was necessary to determine whether the initial investment thesis remains intact.

Investment thesis

The SMF's original investment thesis was based on SUN's benefit from climate driven premium growth, their strong market position, and strengthening investment income. Since the initial purchase in May 2022, the SMF's expectations regarding the company's positive fundamentals have been confirmed. SUN has consequently delivered a return of 0.37% p.a. in excess of the IOZ. This has been underpinned by:

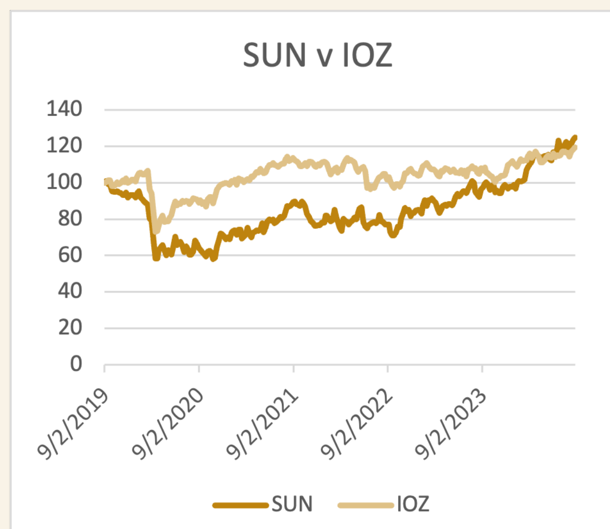
- Near double-digit growth in net earned premiums. This was largely due to SUN's strong pricing power, as SUN has a customer retention of over 90%, meaning that fewer then 10% of consumers switch insurance providers in the case of premium hikes.
- Improved investment income as bond yields have risen and SUN's growth assets have improved in performance.
- Guidance that reinsurance rates will stabilise, following three years of extreme volatility and weak margins.
- Confirmation of the sale of SUN's banking arm to ANZ, with an expected return of capital to shareholders.

AUSTRALIA

ASX code: SUN

Price (at 19/07/2024)	$16.96
Valuation	$16.77
- inc. franking credits	$19.99
Margin of safety (MoS)	-1.14%
- inc. franking credits	17.84%
Dividend yield (2023FY)	3.5%
GICS	Insurance
52-week range	
Recommendation	Rebalance to target weight
Key assumptions	
Required return on equity:	8.09%
Carbon intensity	
SUN	1.80
ASX200	143.42

Five-year share price history



We have since refreshed our forecasts and valuation to recognise management's guidance, the updated information regarding premium renewal rates, and the sale of the banking arm. The market has similarly revalued SUN with this updated information and has created a situation where the share price is now above our valuation, albeit only slightly. This premium to valuation is sufficient to justify rebalancing, especially considering that there is uncertainty regarding the nature of the capital return from the sale of the banking arm, and whether the SMF will benefit from franking credits.

Upside to the investment case

1) Effective management of climate risks driving increased premiums and margin protection

Climate change has increased the frequency and severity of natural disasters, affecting the ability of SUN to measure, predict and apportion risks. This has resulted in an increase in costs. In the past 10 years, insurance claims relating to severe weather events including cyclones, bushfires and floods has increased on average, by 24.11% p.a. (IBISWorld). Given SUN has demonstrated a successful track record in managing this risk since the SMF's initial investment thesis, we remain positive of SUN's ability to continue to increase premiums and thus protect margins into the future. Underpinning this view is the idea that insurers can increase premiums to offset higher costs given all competitors are facing the same margin headwinds.

SUN assumes concentrated weather and earthquake risk in Australia and New Zealand, and is particularly exposed to natural disasters in Queensland, which accounts for 25% of gross written premium (GWP) in Australia. SUN calculates an annual budget for natural disasters based on actuarial models, which it uses in the pricing of premiums. The ability to accurately forecast the likelihood and severity of natural disasters thus underpins profitability. Since the initial investment thesis SUN has continued to maintain its strong track record in forecasting claims. In 1H24, SUN managed around 45,000 natural hazard claims. In New Zealand, SUN benefited from a 'relatively benign weather period with no natural hazard events' (1H24), whilst in Australia was impacted by 6 significant weather events occurring through November and December. Despite this, the cost of natural event was $568 million, $112 million below the Groups allowance to the half financial year. SUN's natural hazard allowance for FY24 is $1.36 billion, and they have used less than 50% of its budget to the halfway point, and thus are well positioned for the remainder of the year. This is also bolstered by SUN's comprehensive re-insurance program to mitigate the risk of major events (see 'Climate risks and unaffordability' section below).

SUN's exposure to short-tail policies allows them to re-price swiftly 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 none to two-year lag on repricing. The capacity for swift repricing enables SUN to protect margins over the long run.

2) Strength of market position

Since the SMF's purchase of SUN in 2022, the company has maintained a strong market position, consistent with the original investment thesis. This led to SUN being able to raise premiums with minimal risk of customer loss, which in turn allowed it to better maintain margins in times of volatile reinsurance costs.

Following the COVID pandemic and increases in the cost of living, consumers have increasingly looked to switch insurance providers to lower living costs[1]. According to Roy Morgan (2023), in 'June 2023 over 8.2 million

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[1] See: *'Australians are increasingly approaching other company's before renewing their household insurance' (Roy Morgan Research, October 2023). New data released by Roy Morgan shows as Australians have faced cost of living pressures over the last two years fewer are automatically renewing insurance policies and are looking for alternative insurance plans.*

household insurance policies were at risk of being switched to another provider, up from around 7.2 million two years ago, [and] 3.7 million in 2020'. Importantly, though, this action taken to potentially switch providers has not resulted in a noticeable proportion of customers switching providers (see *Figure 1* below).

As a result of this customer retention, SUN has been able to benefit from pricing increases, with GWP increasing in 1H24 by 15.6%. SUN has attributed this improvement to an increase in the number of customers, which can be partly attributed to SUN's consistent improvements in technology. Digital sales for SUN's insurance have increased from 61% to 68% since 2022, which indicates strong results for their continual investment in this segment of the business.

Underpinning this strong market position is the structure of the industry itself. The personal insurance industry is concentrated amongst four insurers, with IAG being the largest and SUN as the second largest. The industry also has significant barriers to entry due to stringent regulatory restrictions, meaning that the largest four insurers compete amongst themselves for customers. With all four insurers raising premiums over the last two years, SUN has been able to follow the market trend without facing the risk of competitors undercutting them on price. As such, whilst SUN's customers hold a high level of power, SUN's strong digital product offering and lack of deviation from the market in pricing has allowed them to both maintain their existing customer base and even attract new customers.

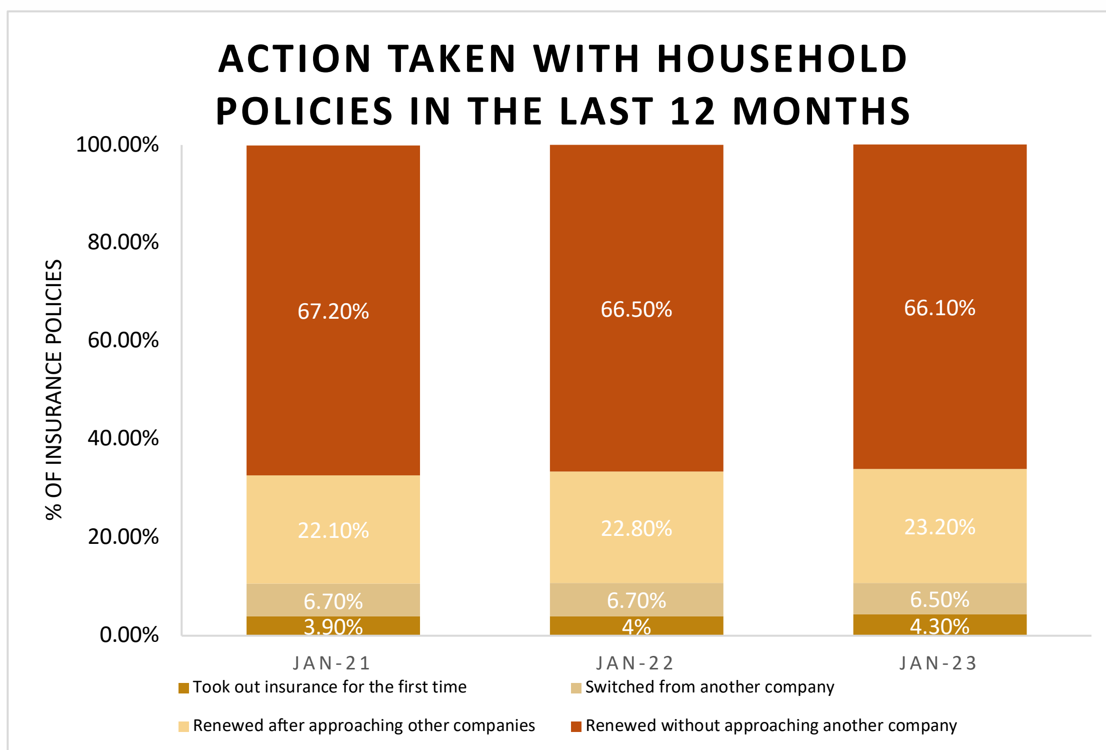

Figure 1: *Roy Morgan Research, October 2023 (see Footnote #1)*

3) Rising Investment Income

The significant increase in interest rates and subsequently bond yields has resulted in SUN benefiting from their fixed income securities. In the HY24 report, interest income from the insurance branch of the group increased 40.5% over the calendar year, attributable to the reinvestment of maturing assets in higher yielding securities. This strategic position has allowed SUN to capitalize on favorable market conditions, boosting their investment income.

Based on RBA guidance and market consensus for maintaining higher interest rates into the medium term, SUN's increased interest income is expected to sustain. However, the SMF forecasts that interest rates may decline to 3.85% by the end of the 2025 calendar year, which could lead to a moderation of investment income

to more normalized levels. Despite this, the yields on fixed income assets are expected to remain above SUN's five-year average yield of 1.77% and therefore this investment thesis still stands.

Downside to the investment case

1) Climate risks and unaffordability

Although climate change presents an upside to the investment case (see above) it may also reduce demand due to red zoning, and a general decrease in insurance affordability. A home is 'red zoned' when the annual premium exceeds 1% of the property replacement value. For example, a home that exists on a flood zone may be 'red-zoned' and thus unable to access insurance thereafter. By 2030, it is estimated that 1 in 25 houses will be uninsurable.[2] This may act as a constraint on premium growth over the long-term. One of the reasons for 'red zoning'/unaffordability is the increasing difficulty of obtaining re-insurance as international insurers become more concerned about Australia's risk profile, leading to an increase in the re-insurance rate.

FY23 has seen rising re-insurance costs for SUN due to significant weather events including the Auckland floods and Tropical Cyclone Gabrielle. However, in 2024 Steven Johnson (Group CEO) noted that, 'it is pleasing to see stability return to global re-insurance markets after three years of disruption'. The FY25 reinsurance program maintains a maximum event retention of $350 million for a first large event and $250 million for a second large event. As noted in the initial investment thesis the federal government is also trying to help address the rising cost of re-insurance in red zones. In 2022, the Albanese government established the Australian Reinsurance Pool Corporation (ARPC), which purports to improve the accessibility and affordability of insurance for households and small businesses in cyclone-prone areas across Australia. Through a $10 billion Government guarantee, SUN will have access to re-insurance at lower rates. We view this positively as it will relieve the pressure on SUN and help them retain red-zone customers by providing re-insurance coverage that is otherwise commercially unviable.

2) Negative customer sentiment

Despite the high level of consumer retention, SUN still faces the risk of customers switching providers in favour of cheaper alternatives. From 2023 to 2024, SUN's home premiums rose by 9.9%, and car insurance premiums rose by almost 16%. This was a major factor in the increased number of consumers who have looked to switch, but ultimately SUN has been able to benefit from these premium increases without a hit to their number of customers. The structure of the industry and actions of competitors has been the main reason that SUN has been able to do this. IAG, SUN's largest competitor, raised home insurance premiums by 20% in 2023, and car premiums by 15%. As such, when SUN's customers look to switch providers, they are unable to find value elsewhere. SUN, even when raising premiums substantially, are offering a cheaper product than their largest competitor.

Despite this strong market position and historical strength in price offering, SUN faces the risk of further price increases leading to consumers taking tangible actions to switch providers. With the increase in consumers looking to switch providers (*Figure 1*), SUN is now in weaker position to increase prices without risking losing customers compared to two years ago when the stock was initially purchased. Although SUN has been able to raise premiums effectively, this has still resulted in negative consumer sentiment toward the brand, with AAMI's Net Promoter Score (NPS) no longer being the highest in the insurance sector, compared with two years ago when the stock was purchased.

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[2] 'Uninsurable nation: Australia's most climate vulnerable places' (Climate Council, 2022). In this report, the Insurance Council found that climate change is creating an insurability crisis in Australia due to worsening extreme weather and sky-rocketing insurance premiums.

Uncertainties

Banking arm sale

The sale of SUN's banking arm has now received the necessary regulatory approval (Competition Tribunal, Federal Treasurer and legislative change in Queensland) leaving open the issue of how SUN will return capital to shareholders. SUN has said they remain committed to returning any capital more than the needs of the business and have clarified that they intend this to be the vast majority of the previously flagged $4.1 billion net proceeds out of the sale price of $4.9 billion (Christine McLoughlin, Board Chairman). SUN have indicated that they anticipate capital return to occur in March 2025. Whilst there is no clarity pertaining to the method of capital return to shareholders, SUN previously mentioned in 2022 that it will occur through a combination of: pro-rata capital return, a fully franked special dividend, and potentially a share buyback. To reflect this, we have incorporated into our earnings the bank sale and have assumed a capital return from March 25 of $4.1 billion and have incorporated a sensitivity analysis on the impact of a special dividends (with varying payout ratios) on our valuation (*Figure 2*).

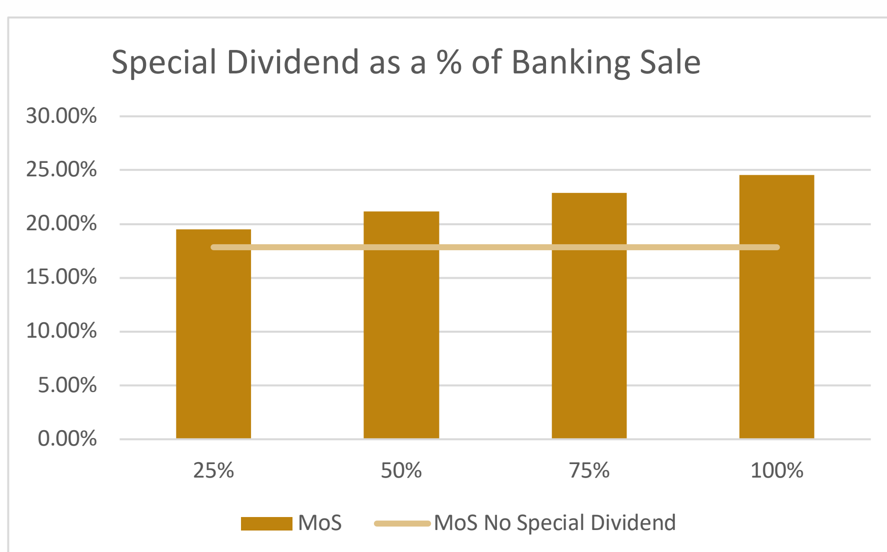


Figure 2: *Special dividend (SMF Forecast)*

The sale of the banking arm represents a significant milestone in management's efforts to refine the strategic focus of SUN, though questions remain about the effectiveness of this approach. The SMF, however, views the sale positively, as exiting the banking sector (and locking in the upside) reduces exposure to the cash rate outlook (affecting NIM and bad debts), and wage inflation. It also provides flexibility regarding capital management.

Key model updates

Our discounted cash flow (DCF) model generates a base case valuation of $16.77 excluding FC, and $19.99 with FC. This implies a MoS of -1.14% and 17.84%, respectively.

	Bear Case	Base Case	Bull Case
Cost of equity (Ke)	8.09%	8.09%	8.09%
Insurance value per share	$7.84	$12.40	$14.36
Bank value per share	$3.21	$3.21	$3.21
Group share value, ex. FC	**$11.86**	**$16.77**	**$18.87**
Group share value, inc. FC	$13.99	$19.99	$22.55
Current share price	**$16.96**	**$16.96**	**$16.96**
MoS ex. FC	**-30.06%**	**-1.14%**	**11.26%**
MoS inc. FC	-17.51%	17.84%	32.94%

Table 1: *Scenario analysis*

Our modelling indicates that SUN is trading close to its intrinsic value (excluding FC), prompting the decision to rebalance. However, the SMF continues to see upsides in the investment case for SUN and the valuable exposure it provides to the insurance sector.

Dividend commitment and franking credits

Since the initial investment, SUN has continued to pay fully franked dividends, with a 5-year average payout ratio of 75%. SUN's current dividend yield is 4.48% (fully franked), providing additional value to the SMF given the tax-free status. Our valuation including franking credits is boosted by 18.98% under the assumption that SUN continues to pay out earnings as fully franked dividends other than those needed to fund increases in equity capital.

Net Earned Premiums

Our forecasting of SUN's short-term Net Earned Premiums (NEP) was adjusted to account for recent market events and management guidance. Our expectation of strong NEP growth in 2024 (13%) is reflective of strong 1H24 earnings, and management's indication that 2H24 is expected to mirror 1H24. Our 2025 NEP growth forecast was adjusted from 3.84% to 4.07% to account for the recent reinsurance update, where management relayed that 2025 reinsurance rates were expected to be flat following a volatile three years of reinsurance costs. Our long-term expectations regarding NEP remain largely unchanged, with long term growth of 4%. These forecasts remain conservative, considering that SUN was able to increase their motor earned premiums by 13% and home insurance premiums by 11% in 1H24, whilst increasing customer growth by 2% in the same period. This reassures the initial investment thesis that even when premiums are increased, customer complacency ensures that few customers look to switch their provider or to not take on insurance.

Scenario Analysis

Following the confirmation of the bank sale, our scenario analysis no longer considers the possibility of the sale not occurring within our possible range of outcomes. We ran a scenario analysis with the bull case representing a scenario where SUN's combined operating ratio is above and below their target range of 88%-90%. The bull case represents a scenario where SUN continues to raise premiums and is faced with lowering reinsurance costs. In addition, this scenario assumes that SUN's expense ratio will be lower as a result of lower catastrophe claims. The bear case represents a scenario where customer complacency is depressed in the case of future premium rises, reinsurance rates remain volatile, and catastrophe claims are above expectations going forward. The results of the scenario analysis are represented graphically below:

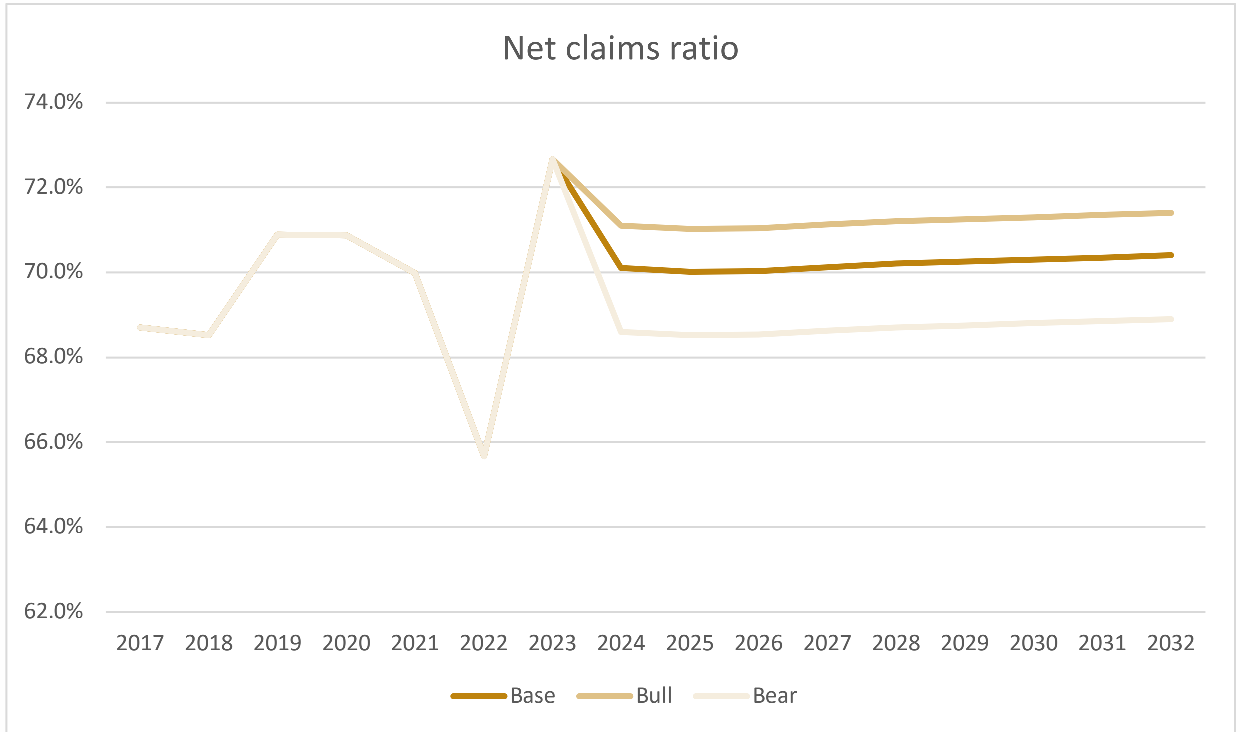


Figure 3: *Net Claims Ratio (SMF Forecast)*

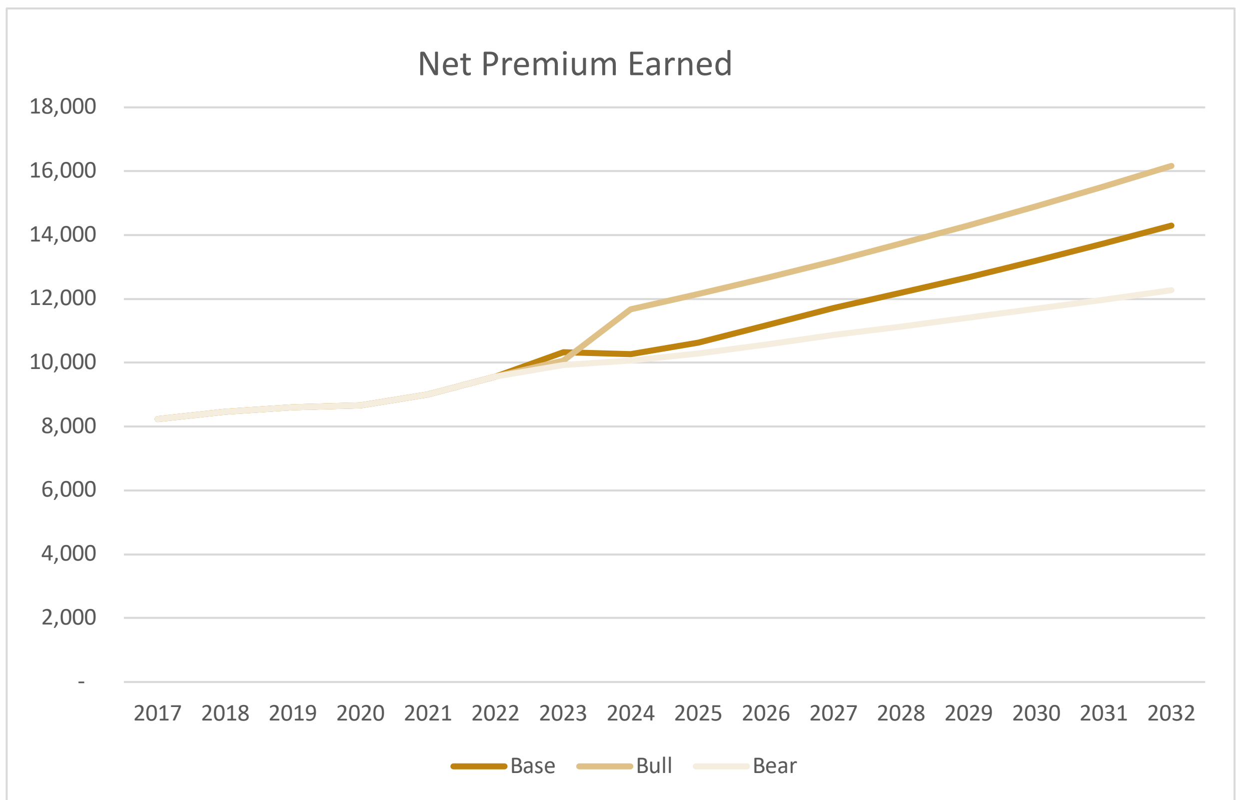


Figure 4: *NEP (SMF Forecast)*

Return on Equity (ROE)

SUN's 5-year historical average ROE is 8.33%. Management has indicated that a key strategic target is to deliver a sustainable return on equity throughout the cost of equity cycle. SUN's ROE has been forecasted to increase to 14.80% based on outstanding HY24 results. This improvement aligns with management emphasis of growth in GWP as a key driver of ROE, alongside expectations of stable operating expenses for the remainder of FY24.

As seen in *Figure 5,* SUN's historical ROE has been more stable than its main competitors QBE & IAG. This greater stability implies better risk management, and consistent ability to create value for shareholders, relative to its competitors. For instance, whilst IAG experienced high returns due to the notoriety of the NRMA brand, its ROE fell below the cost of equity in recent years. Similarly, QBE has experienced significant fluctuations and delivered negative returns in 2017 and 2020.

Following the sale of the banking arm, the group's ROE is expected to increase due to decreased overhead costs, in tandem with a reduction in equity. In FY23, the ROE for the insurance and banking arms were closely aligned at 10.5% and 10.16% respectively. Over a longer horizon, the insurance branch posted a 5-year historical ROE of 8.2%, slightly trailing the banking segments 8.45%, largely due to an outlier year in 2022 where insurance ROE dropped to 3.9%.

Looking ahead, SUN's ROE is expected to increase to 15.17% over the long-term forecasting horizon, driven by continued efficiency increases and growth in GWP. This trajectory suggests that SUN is in a solid position to continue to deliver shareholder value.

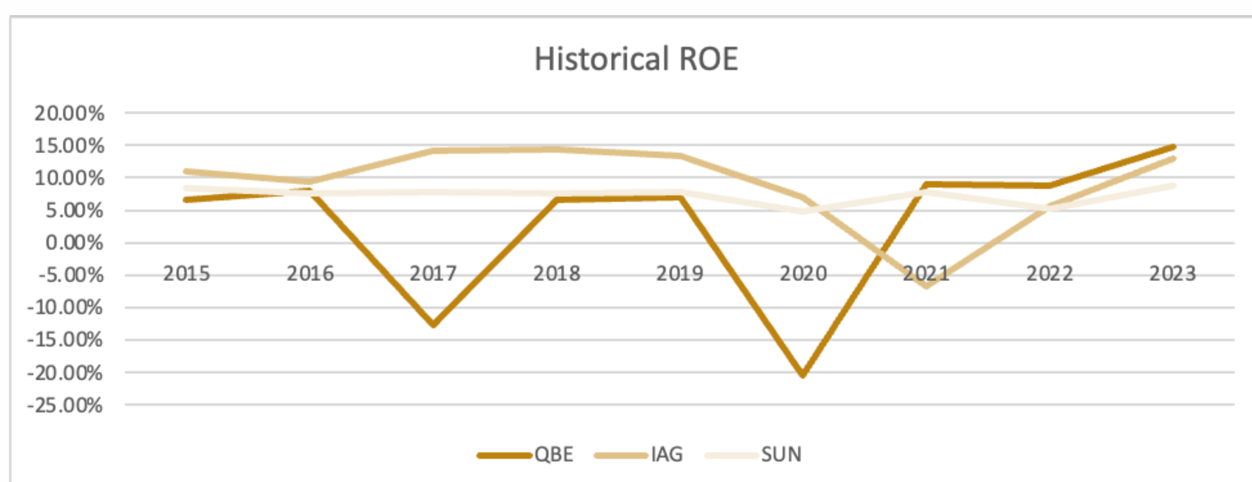


Figure 5: *Historical ROE against competitors*

Group Ratios

As seen in *Table 2*, claims ratios are expected to stabilise and remain flat over the forecast horizon. Historically, this figure has remained consistently between 67-73% of premiums and we expect that claims remain on the higher end of this range to reflect the increasing frequency and costs of natural disasters related to climate change. A conservative approach is taken with regard to the expense ratio, whereby it is expected to remain steady at about 22% of premiums, despite the group potentially benefiting from investments in technology.

The combined ratio of the group reflects both the claims and expense ratios as a proportion of the net earned premiums. Despite forecasting NEP increases, this is matched with the increased costs associated with claims, hence the net effect is that dollar amounts increase, however the ratios remain stable.

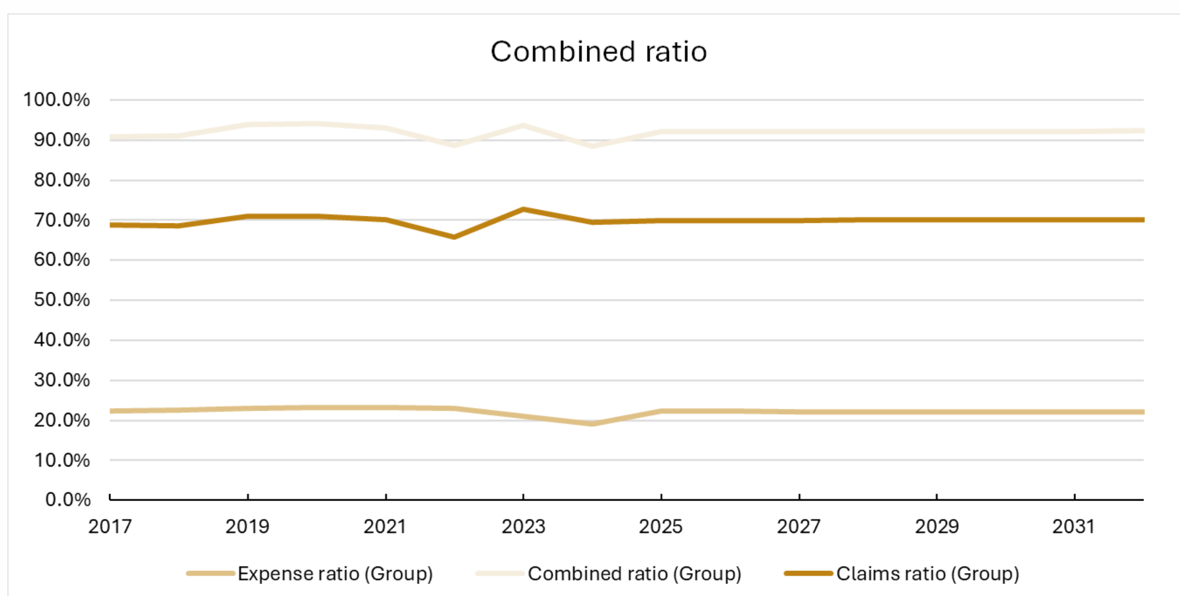


Figure 6: *Combined ratio (SMF Forecast)*

Financial year	2022(A)	2023(A)	2024(E)	2025(E)	2026(E)	2027(E)	2028(E)
Australia							
Claims ratio	67.3%	73.6%	70.3%	71.6%	71.6%	71.7%	71.8%
Expense ratio	21.7%	19.1%	17.5%	20.8%	20.7%	20.6%	20.5%
Combined ratio	89.1%	92.7%	87.9%	92.3%	92.2%	92.2%	92.3%
New Zealand							
Claims ratio	57.6%	67.6%	64.3%	60.7%	60.8%	61.0%	61.0%
Expense ratio	28.7%	30.6%	28.1%	30.2%	30.2%	30.2%	30.2%
Combined ratio	86.3%	98.2%	92.5%	90.9%	91.0%	91.1%	91.2%

Table 2: *Combined ratio (SMF Forecast)*

Conclusion and recommendation

SUN's recent positive price action, driven by the approval of selling its banking arm, has triggered a rebalancing of the position in the SMF portfolio. This in turn has led the AAE team to further investigate SUN to determine whether the initial investment thesis still stands. Following removal of the banking arm from the valuation, the team continues to see upside in SUN's insurance business, which is well positioned for future growth. A fundamental valuation of the firm indicates a target price of $16.77, providing a MoS of –1.14% (or 17.84% with franking credits). Despite the current valuation, the original investment thesis based on increased premiums driven by climate change, strong market position, and elevated investment income remains true. Our analysis, based on conservative assumptions, continues to present a potential upside for the fund, especially when considering the benefit of franking credits. However, with SUN trading above our target price, we see no compelling reason to maintain the 3.35% overweighting in our portfolio. Therefore, we recommend selling down to the IAC endorsed target weight of 10% and allocating the proceeds to the iShares Core S&P/ASX 200 ETF (IOZ).

Revised SUN valuation at (8/08/24)

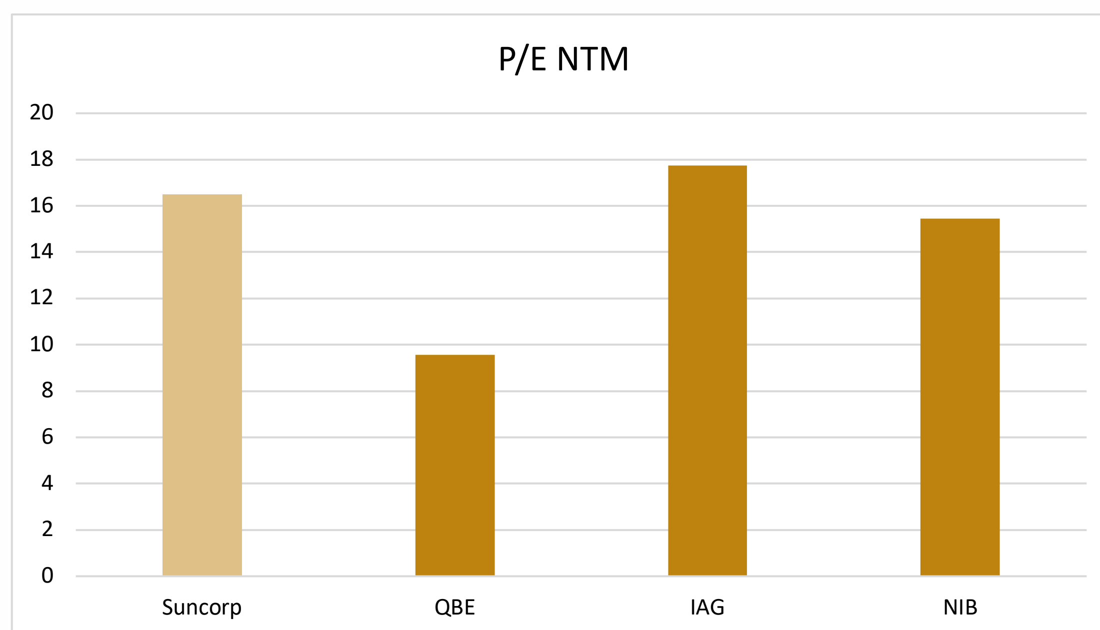
Valuation ex. franking credits	$16.77
Franking credits	$3.22
Valuation inc. franking credits	$19.99
Current share price	$16.96
MoS ex. franking	-1.14%
MoS inc. franking	17.84%

Appendix

A Key financial summary

Financial year	2022(A)	2023(A)	2024(E)	2025(E)	2026(E)	2027(E)	2028(E)
Total NEP	9,559	10,3222	11,664	12,154	12,655	13,181	13,730
% growth		0.62%	3.94%	6.14%	4.12%	4.15%	4.17%
Combined ratio	88.60%	93.60%	89.94%	92.34%	92.27%	92.27%	92.34%
NPAT	329	900	1,278	1,097	1,148	1,195	1,238
ROE	3.88%	10.52%	14.80%	12.57%	13.01%	13.39%	13.71%

B Multiples



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