
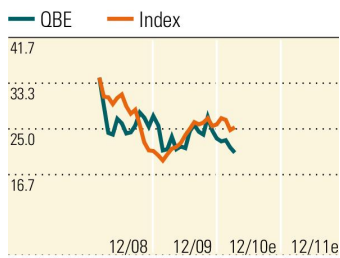


QBE Insurance Group Limited QBE

Snapshot

Business Risk	Low-Medium
Price Risk	Medium
Moat Rating	Narrow
Fair Value \$	27.55
Market Cap \$Mil	19,335
Morningstar Style Box	
Last Price \$	18.68
52 Week High/Low \$	25.70/18.42
Shares Issued Mil	1,035
Sector	GICS - Insurance
Company Beta	0.50
Sector Beta	0.90

Price vs. Market



NPAT	1,859.0	1,970.0	1,870.0	1,920.0
EPS¢	205.5	192.8	180.7	183.7
EPS Chg%	-5.3	-6.2	-6.3	1.7
DPS	126.0	128.0	130.0	132.0
Franked%	20	20	20	20
Div Yld%	5.1	6.0	7.0	7.1
P/E	12.1	11.2	10.3	10.2

Source: Morningstar analyst estimates.

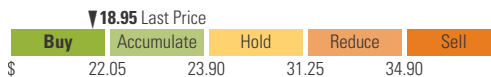
Business Description

QBE Insurance Group (QBE) is a leading provider of general insurance and reinsurance services in Australia, the Pacific, Asia, the Americas and Europe. QBE has operations in 45 countries and has made almost 120 successful acquisitions since 1982. QBE is one of the best managed and profitable insurance groups in the global general insurance and reinsurance industry.

No big surprises in market update

Analyst Recommendation: **Buy**

17 June 2010



Investment Rating

QBE is one of the best managed insurance groups in the global general insurance and reinsurance industry. An enviable track record of strong earnings with a minor blemish following the events of September 11, 2001 is testament to a first class business model and conservatism. Extensive risk management is in place to protect all stakeholders. Throughout QBE diversification is used to reduce the overall risk profile by spreading exposures by product and geography. Overlaying fundamental procedures and strategies is a level of prudence providing significant comfort. A growth strategy based on the combination of organic growth and insightful acquisitions has and should deliver well above average growth in earnings and dividends. QBE is an excellent stock for inclusion in long term growth portfolios.

Event

► Half yearly market update focused on QBE's Northern hemisphere operations, global developments and insurance market conditions.

Impact

► QBE's market update confirmed previous guidance for an insurance profit margin between 16% and 18% for FY10 despite challenging market conditions. 1H10 earnings are expected to be at the bottom of the range due to soft revenue growth, higher claims costs and lower investment returns.

► QBE confirmed large risk and catastrophe claims of \$555m to 31 May 2010 compared to its full year allowance of \$1.1Bn.

► Premium rate increases of 2% to 3% on renewed

business are tracking ahead of the 2% target. The weaker revenue outlook is a reflection of softer operating conditions in key European and US businesses and not pricing pressure.

► QBE still expects FY10 investment returns to be slightly higher than the FY10 guidance of 3%, despite lower than expected returns in 1H10.

► There is no change to our FY10 NPAT estimate following the Market Update.

Recommendation Impact

Fair Value is unchanged and Price Triggers are retained

QBE Insurance Group Limited QBE

Peter Warnes

Morningstar Analyst

Analyst Note

No big surprises but outlook for revenue growth softer than expected

QBE's half yearly market update in London confirmed previous guidance for an insurance profit margin between 16% and 18% for full year FY10 despite challenging market conditions. 1H10 earnings are expected to be at the bottom of the range due to soft revenue growth, higher claims costs and lower investment returns.

QBE confirmed large risk and catastrophe claims of \$555m to 31 May 2010 compared to its full year allowance of \$1.1bn. These large risk claims totalled \$458m at the same stage last year. Large risk claims include \$108m for Perth storms, \$91m for Chilean earthquake, \$76m for Melbourne storms and \$29m for the Deepwater Horizon catastrophe in the Gulf of Mexico. The relatively low financial exposure (A\$29m) to the BP oil disaster in the Gulf of Mexico confirms our positive view on QBE's financial exposure and underpins QBE's expertise in laying off risk via effective reinsurance arrangements. QBE noted its smaller claims less than \$2.5m are in line with expectations.

Premium rate increases of 2% to 3% on renewed business are tracking slightly ahead of the 2% target announced with the FY09 result in February. The weaker revenue outlook is a reflection of softer operating conditions in key European and US businesses and not pricing pressure. The American and European markets represent 67% of group forecast annualised gross written premium.

QBE still expects FY10 investment returns to be slightly higher than the FY10 guidance of 3%, despite lower than expected returns in 1H10. QBE specifically confirmed no direct exposure to sovereign bonds in Greece, Portugal or Spain, but QBE holds a total of \$280m in fixed interest securities with highly rated Spanish banks Santander and BBVA. QBE's short duration investment portfolio is well positioned for the eventual increase in interest rates across the northern hemisphere, but timing remains uncertain.

QBE continues to seek well priced acquisition and distribution opportunities, noting it has balance sheet capacity to acquire a further \$1Bn of gross written premium in 2010. The CEO confirmed potential

opportunities are increasing, but we believe any major acquisition will require QBE to raise new capital as surplus capital is roughly in line with its benchmark of 1.5 times minimum capital requirement (MCR). QBE confirmed it is well prepared for any potential regulatory changes that may impact capital adequacy requirements.

Medium to long term earnings growth remains leveraged to a recovery in economic conditions in Europe and the US, further acquisitions, increasing interest rates and a lower exchange rate. We expect QBE's 2H10 premium income will benefit from acquisitions and a weaker A\$, but clearly the international insurance industry remains competitive and large claims costs are tracking higher than expected. Despite tough market conditions, QBE's updated margin and revenue targets for FY10 are approximately in line with our forecasts and at this stage we see no reason to change our FY10 earnings and dividends assumptions. We retain our FY10 NPAT forecast of \$1.87Bn and dividend of 130cps.

Despite the softer business outlook we are confident QBE management can continue delivering strong underlying business performance. The QBE business culture of consistent outperformance is deeply embedded across the group, and despite QBE's share price falling 25% over the past six months we retain our positive view on its fundamental value and confirm our BUY recommendation on the stock.

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QBE Insurance Group Limited QBE

A beacon among global peers

Bulls Points

- ▶ Excellent business model based on conservatism.
- ▶ Insurance is a risk-taking business but risk management policies minimise risk as shown by outstanding earnings growth over the long-term.
- ▶ Strong operational management team well versed in assessing risk.
- ▶ Robust balance sheet and strong cash flow provides funds for expansion without resorting to new equity capital.

Bears Points

- ▶ Growth is highly dependent on continuing acquisitions.
- ▶ Acquisitions have to be larger to be meaningful raising the possibility of integration risk.
- ▶ Management succession unclear with CEO O'Halloran probably retiring within two years.
- ▶ Increasing currency risk as acquisitions tend to be offshore.
- ▶ Insurance margin has peaked making earnings growth more difficult to achieve going forward.

Thesis Last Updated: 17 Jun 2010

QBE Insurance Group is one of the best managed global general insurance and reinsurance companies. Operating in 47 countries with around 80% of shareholders funds invested in offshore subsidiaries. It boasts an enviable track record of earnings growth with a minor setback following the events of September 11, 2001. This is testament to a strong business model and conservative policies adopted throughout the organisation. Extensive risk management is in place to protect all stakeholders.

The nature of QBE's business requires a strong focus on risk management. QBE has demonstrated over many years that it has an effective risk management structure with a clear focus on key profit drivers. Diversification is used to reduce the overall risk profile spreading exposures by product and geography. Some 115 acquisitions have been made over a 25 year period as management grows the business by a combination of organic growth complemented by astute and insightful value adding acquisitions.

QBE's earnings and dividend growth is without peer in the Australian insurance industry. Over the past decade EPS CAGR has been 19.0% despite the 2001 loss from 9/11-related events while DPS CAGR has been 16.8%. Gross written premium increased from \$2.4bn in 1998 to \$14.45bn in 2009, net earned premium rose from \$1.9bn to \$12.15bn and insurance profit increasing from \$147m to \$2.18bn. These impressive growth drivers were achieved while capital and risk ratios were maintained at industry leading levels.

We assign a narrow moat rating to QBE. This is based on the combination of a diversified product offering overlaid by extensive geographical spread through 47 countries and extensive processes and internal controls that identify and manage risks in all key areas of risk exposure. This effective business model based on a conservative approach to risk management ensures risk management is tailored to suit business requirements whilst remaining within risk tolerances. The return on average shareholders' equity is comfortably above the cost of capital - and was 18.4% in 2009. The conservatism that is instilled in underwriting extends to the management of the investment portfolio where 95% of investment funds are held in highly liquid and highly rated short-dated

government or corporate bonds.

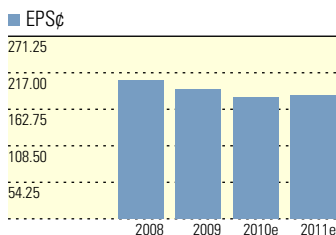
While the global insurance market can be competitive, the fall out from the US sub-prime debacle has resulted in significant losses in the investment portfolios of many insurance companies. Several have had to re-capitalise. Any major property catastrophes will result in firming premium rates. Probability of adequacy of outstanding claims is well above APRA's 75% minimum requirement and was 88.1% in 2009 using risk free government bond rates. QBE continues to earn underwriting surpluses despite strong competitive pressures. Group combined operating ratio has been below 90% for five consecutive years 2005-2009.

Valuation Last Updated: 02 Mar 2010

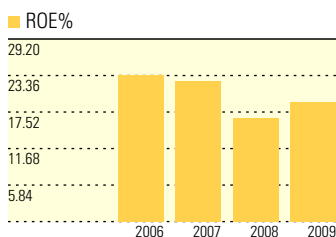
Our fair value is \$27.55 reflecting a PE multiple of 15 FY11 EPS. The multiple takes into account the combination of a solid and successful business model, impressive long-term growth in EPS, DPS and total shareholder returns, a first class conservative management team and appropriate and conservative risk management policies throughout the organisation. It recognises the risk of potential large claims that can arise in the property catastrophe sector. The maximum event retention is 3.5% of net earned premium with the largest individual risk being \$69bn for a San Francisco earthquake. Over the next five years we expect growth in gross written premiums of 7-8% per annum with net earned premium growth of 8-10%, excluding new acquisitions. Growth will be driven by the combination of organic growth and acquisitions. A combined operating ratio (COR) - the percentage of total claims, commissions and expenses to net earned premium - around 90% will ensure underwriting surpluses continue. Conservative management of the large investment portfolio should underpin solid growth in insurance profit and maintain an insurance margin between 15%-20% over the next five years.

QBE Insurance Group Limited QBE

EPS



ROE



Risk Last Updated: 28 Oct 2009

With over 75% of premium income sourced offshore, earnings are exposed to currency volatility - primarily US\$ and £Stg. Conditions in the global insurance market can be unpredictable. It is not the size of a catastrophe but the frequency that can do most damage. Claims inflation can impact reserves which ultimately must be replenished. Higher interest rates impact discount rates on which future claims liabilities are calculated. After a period where the insurance margin has increased to over 20% the risk margin within the unearned premium reserve is falling indicating a peaking of the insurance margin. QBE's geographically diversified operations significantly increase compliance requirements in multiple jurisdictions.

position and a low risk profile. Extensive risk management is in place to protect all stakeholders. QBE's growth strategy is based on organic growth from existing diversified operations supplemented by astute value-adding acquisitions. QBE has made over 130 acquisitions over the past 25 years and currently operates in 47 countries.

Financial Overview

Growth

Revenue or premium growth in A\$ is expected to slow given the strength of the A\$. We anticipate growth of 7% over the next two years in both gross written and net earned premium in the absence of significant acquisitions. Premium rates in both the US and Europe are expected to lift in 2011.

Profitability

NPAT is expected to fall about 5% in 2010 due mainly to lower investment yields as short term interest rates in both the US and Europe remain at or below 1.0%. Insurance margin is expected to steady around 17%. Further accretive acquisitions are always possible but are not in our forecasts.

Financial Health

QBE maintains a strong balance sheet with capital adequacy multiple at 1.6 times regulatory requirements at 31 December 2009. At 31 December 2009 the weighted average cost of borrowings was 6.8%. Gearing - debt/equity - was 29.1%. Return on average equity for FY09 was 18.4%.

Strategy Analysis Last Updated: 17 Jun 2010

QBE's strategic objective is to remain a highly respected and successful general insurance and reinsurance group by earning underwriting surpluses in each insurance division and country combined with above benchmark investment returns. The objectives of management are to grow shareholder wealth over the long-term while maintaining a sound solvency

QBE Insurance Group Limited QBE

Forecasts	Actual				
	31 Dec 2005	31 Dec 2006	31 Dec 2007	31 Dec 2008	31 Dec 2009
Profit & Loss \$Mil					
Net Earned Premiums	7,386	8,158	10,210	11,087	12,149
Claims Expense	-4,417	-4,551	-5,553	-6,388	-7,328
Underwriting Profit	808	1,200	1,438	1,275	1,262
Investment Income	855	895	1,136	1,324	879
Unrealised Gains	61	6	-	-	460
Profit Before Tax	1,523	2,012	2,549	2,420	2,432
Income Tax	-425	-519	-615	-554	-448
Outside Equity Int.	-7	-10	-9	-7	-14
Profit after Tax	1,091	1,483	1,925	1,859	1,970
Significant Items after Tax	-	-	-	-	-
Reported Profit after Tax	1,091	1,483	1,925	1,859	1,970
Preference Dividends	-	-	-	-	-
Ratios					
Claims Ratio %	59.80	55.79	54.39	57.62	60.32
Expense Ratio %	29.26	29.50	31.53	30.88	29.29
Combined Ratio \$	89.06	85.29	85.92	88.50	89.61
Return on Equity %	21.15	23.36	22.53	16.53	19.13
Solvency Ratio %	69.85	76.21	82.42	99.87	83.51
Cash Flow \$Mil					
Premiums Received	8,756	10,483	12,667	13,098	14,333
Outward Reinsurance Paid	-1,479	-1,874	-2,108	-1,691	-1,977
Claims Paid	-4,620	-6,025	-7,053	-7,651	-8,434
Reinsurance Received	1,309	1,805	1,665	1,396	1,405
Net Operating Cashflow	1,987	2,039	2,374	2,251	1,908
Acquisitions & Investments	-3,750	-2,283	-4,717	-3,779	-1,981
Sale of Invest. & Subsid.	1,439	421	1,431	2,751	991
Net Investing Cashflow	-2,203	-1,881	-3,201	-1,585	-1,841
Proceeds from Issues	-	-	772	2,227	-112
Dividends Paid	-224	-497	-809	-1,068	-854
Net Financing Cashflow	161	-162	804	650	-900
Net Increase Cash	-55	-4	-23	1,316	-833
Cash at Beginning	1,121	1,061	1,019	988	2,736
Exchange Rate Adjust.	-5	-38	-8	432	-302
Cash at End	1,061	1,019	988	2,736	1,601
Balance Sheet \$Mil					
Cash & Equivalent	1,061	1,019	988	2,736	1,601
Receivables	4,964	5,075	5,878	6,685	5,725
Investments	9,411	13,895	24,417	18,321	13,728
Other Current Assets	1,532	1,506	2,053	2,979	1,875
Current Assets	16,968	21,495	33,336	30,721	23,069
Receivables	2,856	2,386	3,098	3,399	2,258
Investments	8,157	6,053	93	7,734	9,762
PP&E	232	260	435	505	384
Other (inc Intangibles)	1,452	1,563	2,651	6,024	5,491
Non-Current Assets	12,697	10,262	6,277	17,662	17,895
Total Assets	29,665	31,757	39,613	48,383	40,964
Trade Creditors	1,282	1,466	1,832	1,915	1,272
Unearned Premiums	4,287	4,642	5,698	7,126	6,148
Outstanding Claims	4,904	5,098	5,906	7,240	6,258
Borrowings	435	114	561	2,083	901
Provisions	164	194	92	366	413
Other	-	-	867	312	-
Total Liabilities	11,072	11,514	14,956	19,042	14,992
Unearned Premiums	-	-	-	-	687
Outstanding Claims	10,179	10,171	12,323	13,964	11,775
Borrowings	1,730	2,287	3,158	2,702	2,110
Provisions	313	424	478	1,203	940
Other (inc Creditors)	1,212	1,012	155	227	162
Non-Current Liabilities	13,434	13,894	16,114	18,096	15,674
Net Assets	5,159	6,349	8,543	11,245	10,298

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Disclosure and Research Methodology

Research Methodology

We seek undervalued stocks with a medium to long-term investment time horizon. Companies that make the best investments tend to be those able to grow earnings per share year after year and which are able to grow at rates above the average of the market. Earnings growth supports a solid and growing dividend stream which is the essence of shareholder return.

In searching for the best businesses in the market, we want to see an ability to turn revenue into profits and a record of strong returns to equity. The ability to generate strong free cash flow is critical as this is where the funds come from to pay dividends or to invest in new growth areas. The greatest free cash flow generators will have strong margins, good controls over working capital and limited requirement for capital expenditure. The best businesses will also have robust balance sheets including a not onerous level of debt. We believe in strong, experienced and disciplined management.

Recommendations

Our qualitative recommendations are simple and easy to understand:

- Buy: Substantially undervalued
- Accumulate: Modestly undervalued
- Hold: Appropriately priced, neither buy nor sell
- Reduce: Sell part holding
- Sell: Sell all holdings now
- Avoid: Not investment grade

Economic Moats

The pursuit of high quality businesses is central to our investment philosophy. These offer the greatest gains to the long term investor, so long as they are bought at a reasonable price. The concept of economic moats is valuable in assessing the quality of a business, with the phrase popularised by Warren Buffett and Charlie Munger. Just as wide moats protected castles from invaders in medieval times, businesses with wide economic moats have strong defences against their profits being competed away.

We ascribe a moat rating to each stock researched: Wide, Narrow or None.

The moat is the competitive advantage that one company has over other companies in the same industry. Wide moat firms have unique skills or assets, allowing them to stay ahead of the competition and earn above-average profits for many years. Returns on their invested capital will exceed the cost of that capital. Without a moat, highly profitable firms can have their profits competed away. Other companies will see how attractive the market is and try to move in to reap some of the rewards themselves.

Sources of economic moats include innovation skills or first mover advantages, a superior cost position, the ability to provide a range of products to suit the needs of a variety of markets, high switching costs or locking out of competitors.

The moat rating is just one of the ingredients used in determining whether a company is undervalued, though it is obviously an important one. We are not saying that no-moat companies should be avoided. Simply, the very best long term investments are in wide moat firms bought when they are undervalued.

Intrinsic Value

Intrinsic Value (otherwise known as Fair or Underlying Value) is the analyst's interpretation of what the stock is worth today. The stock is considered to be undervalued when the quoted price is below this point or overvalued where the price is above it.

Whether to invest in a stock will depend on consideration of the prospective return and the risk undertaken. Prospective return includes both share price moves and dividend yield. Our analysts incorporate the stock's risk in their intrinsic value. Other things being equal, lower risk stocks will have greater intrinsic value than higher risk ones. A stock becomes a buy when the quoted share price is at a discount to intrinsic value that provides a sufficient prospective return.

Business Risk

Business risk encompasses all operational risk and financial risk. Companies with low business risk have the most reliable earnings streams. A change in business conditions may reduce earnings predictability and therefore increase risk. Examples are market entry of a new competitor, unfavourable shifts in the economy, changes in key management personnel, major investment in an uncertain new venture or acquisition, and increased interest burden caused by higher debt levels or raised interest rates.

Pricing Risk

Pricing risk reflects the premium or discount implied in the current price of the shares. Many growth stocks trade on high earnings multiples giving them high pricing risk though they may have low business risk. Investors should consider their risk tolerance before investing in the share market. Many investors will decide to have only low risk stocks in their portfolio though others will accept higher risk levels in order to pursue higher returns.

Declaration

Declaration of personal shareholdings, disclosure list.

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