

Equities

13 January 2012 | 29 pages

RSA Insurance Group (RSA.L)

Earnings pressures offset by attractive yield

- Company Update
- Rating Change
- Target Price Change
- Estimate Change

- **Downgrade to Neutral** – RSA's recent performance has suffered from the resignation of its CEO and CFO, but the shares performed broadly in line with the sector in 2011 (-2% relative SXIP). We don't expect a material change in strategy in 2012 and believe the business has a strong position in its markets. However, RSA lacks earnings momentum (only 4% EPS growth in 2012 and 2013) and we see some potential earnings pressures which we discuss in this report. The attractive 8.8% dividend yield appears supported by capital generation, but we do not see 12.9% 2012 ROE as sufficiently attractive given the shares trade on a modest premium at 7.9x 2012 PE (sector 7.3x). We downgrade our recommendation to Neutral with a new TP of £1.15.
- **Lower Scandinavian earnings and reserve releases** – In the last 4 years RSA's underwriting result has been driven by the Scandinavian business (avg 55% u/w profits) which in turn has benefitted from significant reserve releases from Trygg Hansa (2010: 2% group COR). We review Scandinavian business in detail and expect a declining contribution to group underwriting profits (2010 COR: 85%, 2013 COR 90%). Furthermore, we expect lower reserve releases across the group generally (avg 73% u/w profits) to offset some of the positive impact from price increases.
- **Lower investment returns** – Investment returns are 3 times more important to group earnings than underwriting (avg 75% of operating profits). RSA has taken action to lengthen the duration of its portfolio (2010: 3.1yrs, Q311 3.4yrs) and has increased its weightings in corporate bonds. We forecast a gentle decline in yields (20bps in 2012 and 2013), but every 20bps decline beyond our forecasts lowers group PBT by 4%. We lower our 2011E estimates by 4% on weather-related losses and 2012-2013E estimates by 15% and 19% respectively to reflect lower investment returns and a slightly worse combined ratio.
- **Better value elsewhere in the sector** – Among UK non-life insurers, we believe the Lloyd's insurers offer similar returns (avg Lloyd's RONTA 17% vs RSA 19%) at lower valuations (avg Lloyd's 1.1x NTA vs RSA 1.4x) with greater exposure to increasing catastrophe pricing and lower dependence on investment returns.

Neutral	2
<i>from Buy</i>	
Price (12 Jan 12)	£1.11
Target price	£1.15
<i>from £1.45</i>	
Expected share price return	3.8%
Expected dividend yield	8.7%
Expected total return	12.5%
Market Cap	£3,912M
	US\$5,993M

Price Performance (RIC: RSA.L, BB: RSA LN)



RSA Insurance Group (GBP)

Year to 31 Dec	2009A	2010A	2011E	2012E	2013E
Profit Before Tax (£M)	554.0	474.0	649.5	683.2	710.6
Diluted EPS (p)	12.1	9.7	13.5	13.8	14.0
Diluted EPS (Old) (p)	12.1	9.7	14.1	16.3	17.3
PE (x)	9.2	11.4	8.2	8.0	7.9
DPS (p)	8.3	8.8	9.2	9.6	10.1
Net Div Yield (%)	7.4	7.9	8.3	8.7	9.1
Embedded Value Per Share (p)	72.1	67.7	64.9	78.3	84.4
Price / EVPS (x)	1.5	1.6	1.7	1.4	1.3

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Fiscal year end 31-Dec	2009	2010	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	9.2	11.4	8.2	8.0	7.9
P/E reported (x)	9.2	11.4	8.2	8.0	7.9
P/BV (x)	1.1	1.1	1.1	1.0	1.0
P/BV adjusted (x)	1.1	1.1	1.1	1.0	1.0
Dividend yield (%)	7.4	7.9	8.3	8.7	9.1
P/Embedded Value (x)	1.5	1.6	1.7	1.4	1.3
Per Share Data (p)					
EPS adjusted	12.1	9.7	13.5	13.8	14.0
EPS reported	12.1	9.7	13.5	13.8	14.0
BVPS	98.6	104.3	105.2	109.9	114.3
BVPS adjusted	98.6	104.3	105.2	109.9	114.3
DPS	8.3	8.8	9.2	9.6	10.1
Embedded Value per share	72.1	67.7	64.9	78.3	84.4
Profit & Loss (£M)					
Pre-tax profit	554	474	649	683	711
Tax	-135	-119	-156	-164	-171
Extraord./Min. int./Pref. div.	-10	-18	-14	-14	-14
Reported net income	409	337	480	505	526
Adjusted earnings	409	337	480	505	526
Growth Rates (%)					
Pre-tax profit	-27.0	-14.4	37.0	5.2	4.0
EPS adjusted	-30.0	-19.5	38.6	2.6	1.4
Dividend	7.1	6.8	4.0	5.0	5.0
Balance Sheet (£M)					
Total assets	22,041	23,887	23,096	23,720	24,529
Investments	14,287	14,789	14,925	15,421	16,074
Goodwill/intangibles	969	1,209	1,209	1,209	1,209
Other Assets	6,785	7,889	6,962	7,090	7,246
Separate Account Assets	0	0	0	0	0
Total liabilities	18,453	19,992	19,075	19,424	19,957
Life policy reserves	0	0	0	0	0
Non-life policy reserves	14,404	15,923	14,967	15,216	15,650
Total Debt	1,612	1,613	1,613	1,613	1,613
Other Liabilities	2,437	2,456	2,496	2,594	2,694
Separate Account Liabilities	0	0	0	0	0
Shareholders' funds	3,588	3,895	4,020	4,296	4,572
Profitability/Solvency Ratios (%)					
ROE adjusted	11.6	9.6	12.9	12.9	12.6
ROA adjusted	1.8	1.5	2.0	2.2	2.2
Total debt to capital	31.0	29.3	28.6	27.3	26.1
Total debt to equity	44.9	41.4	40.1	37.5	35.3

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Earnings pressures offset by attractive yield

Our 2012 EPS forecast is 8% below consensus

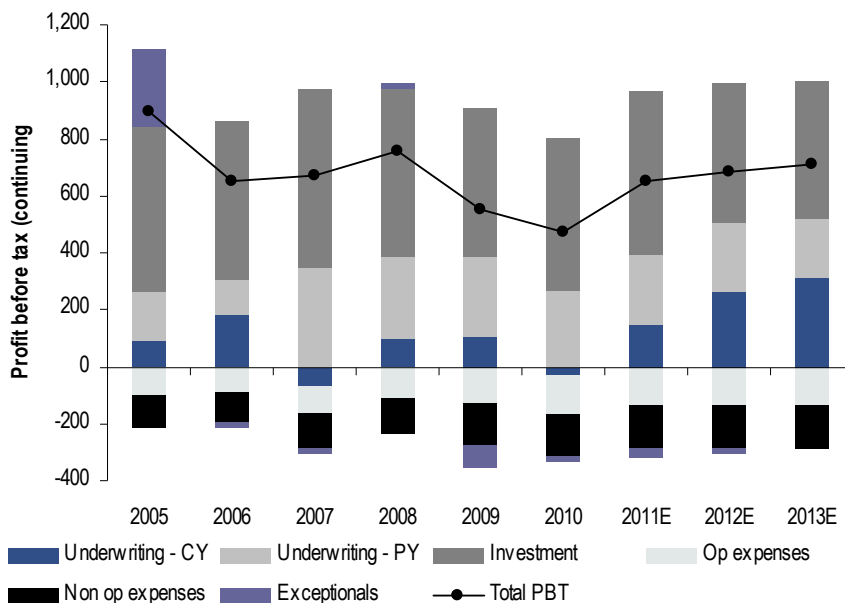
Earnings have been relatively constant and driven by investment returns and reserve releases

Earnings growth in 2011, but limited momentum in 2012-2013

We forecast an improvement in RSA's profits to £649m in 2011, which reflects a lower impact from bad weather (£255m in 2010) and realized equity gains (£120m in 2011). However, in the medium term we expect RSA's earnings to remain broadly stable as higher underwriting returns from better pricing are offset by a reduction in investment returns due to sustained low interest rates. Our 2012 EPS forecast is 8% below consensus. In our view, this lack of earnings momentum could weigh on RSA shares and we discuss some potential earnings pressures throughout this report.

Figure 1 below shows the composition of RSA's profits in the last 5 years. It shows that profits have remained relatively constant when adjusting for exceptionals (average annual profits were £715m with a low of £629m in 2009 and high of £790m in 2007). It also shows that investment returns and prior year releases have been a key driver of group profits which is why we focus on them in this report.

Figure 1. RSA group earnings for 2011-2013E are expected to be broadly flat



Note: Excludes US business for 2005-7. Exceptionals include gains/losses on disposal and restructuring costs
Source: Company data; Citi Investment Research and Analysis

In this report we look in detail at the following issues

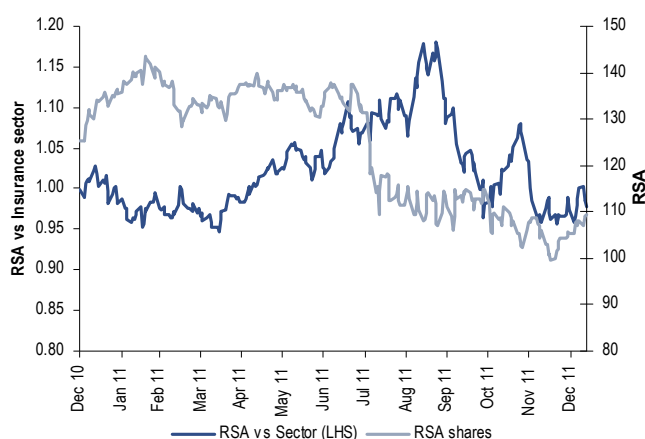
- We suggest the benefits of price increases on the underwriting result will be partially offset by i) lower Scandinavian profits following a normalization in Trygg Hansa's performance, and ii) lower reserve releases across the group as a whole. 1% deterioration in our forecast combined ratio lowers profits by 13%.
- We forecast lower investment returns due to the impact of a prolonged period of low interest rates. 40bps decline in our forecast investment yield lowers profits by 9%.
- We estimate that RSA's capital generation should support its 8.8% dividend yield, which is an attraction. However, if earnings pressures deteriorate beyond our current expectations, this could put pressure on the dividend.

RSA has performed in line with the sector, but is not undervalued

On 7.9x 2012 PE RSA trades in line with historic multiples

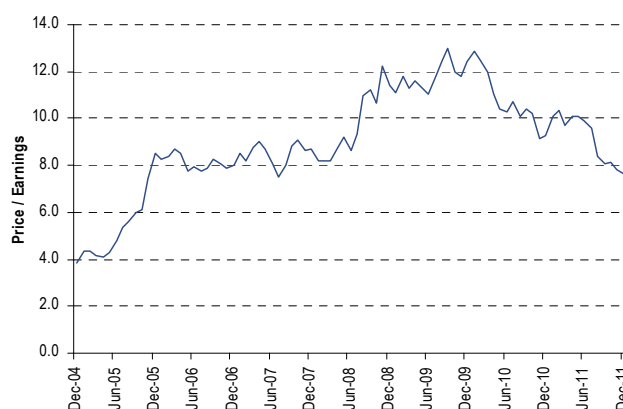
During 2011 RSA performed broadly in line with the European insurance sector (-2% relative). This was surprising given the company's defensive qualities and reflects the impact of CEO and CFO resigning. However, looking at RSA's historic PE trading range suggests that on 7.9x 2012 EPS the shares trade in line with 2006/2007 multiples and therefore don't look undervalued in our view. Among UK non-life insurers, we believe the Lloyd's insurers offer similar returns (Lloyd's RONTA 17% vs RSA 19%) at lower valuations (Lloyd's 1.1x NTA vs RSA 1.4x) with greater exposure to increasing catastrophe pricing and lower dependence on investment returns.

Figure 2. RSA performed in line with sector in 2011



Source: Datastream; Citi Investment Research and Analysis

Figure 3. RSA's PE is in line with historic range



Source: Datastream; Citi Investment Research and Analysis

What would change our view?

We would turn more positive on RSA under the following circumstances:

- Commercial insurance pricing accelerates in RSA's major markets (especially UK or Scandinavia).
- Interest rates increase materially which would halt investment return declines.

We would turn more negative on RSA under the following circumstances:

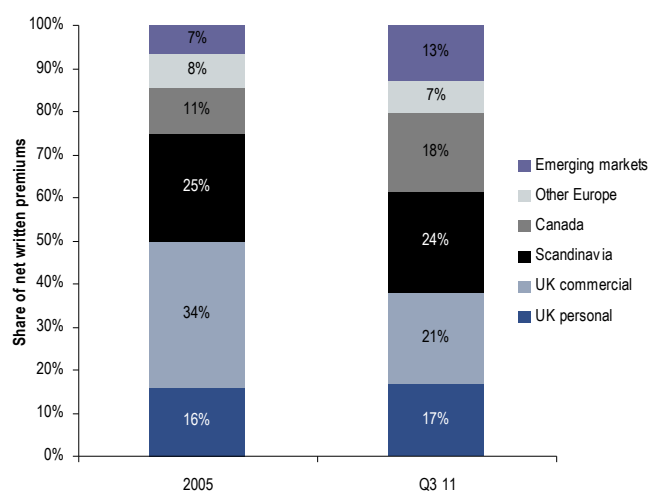
- The contribution from reserve releases declines more rapidly than we had assumed.
- Investment performance declines more rapidly than we had assumed or default rates increase notably.

RSA has diversified away from UK commercial

RSA's business has changed considerably

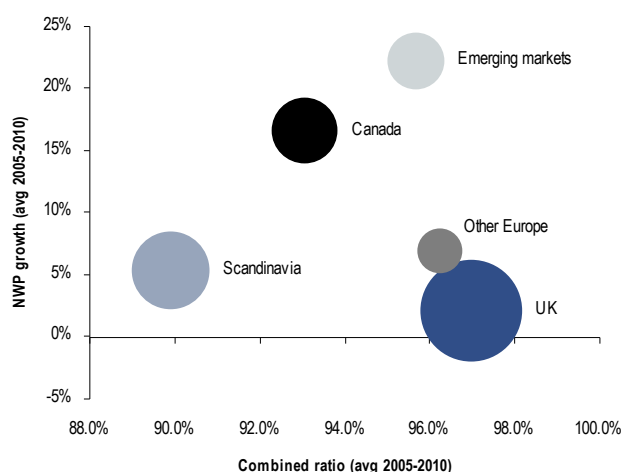
Over the last 6 years RSA has increasingly diversified its business away from being heavily dependent on the competitive UK commercial market. Figure 4 shows the change in RSA's net written premiums between 2005 and Q3 2011. It illustrates that Canada and the Emerging Markets business (i.e. Latin America and Asia) have grown their share to 18% and 13% of NWP respectively, whilst the UK commercial business has shrunk to 21% of NWP. Figure 5 shows the characteristics of each of RSA's businesses during 2005-2010: i) Scandinavia is low growth but high u/w margin, ii) Canada is high growth and medium u/w margin, iii) Emerging markets is high growth but low u/w margin, and iv) UK is low growth and low u/w margin.

Figure 4. RSA's business has diversified away from UK



Source: Company data; Citi Investment Research and Analysis

Figure 5. Characteristics of each of RSA's businesses (2005-2010)



Source: Company data; Citi Investment Research and Analysis

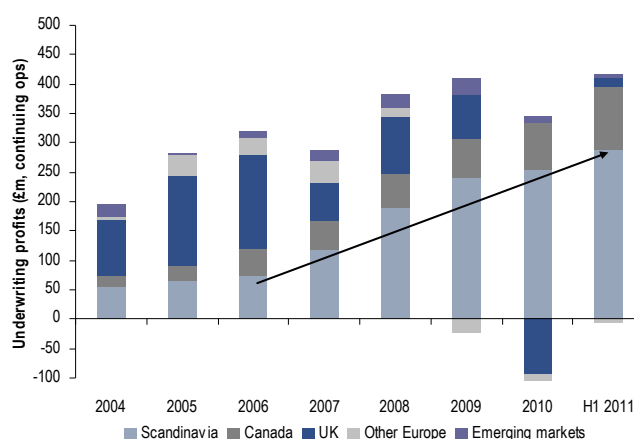
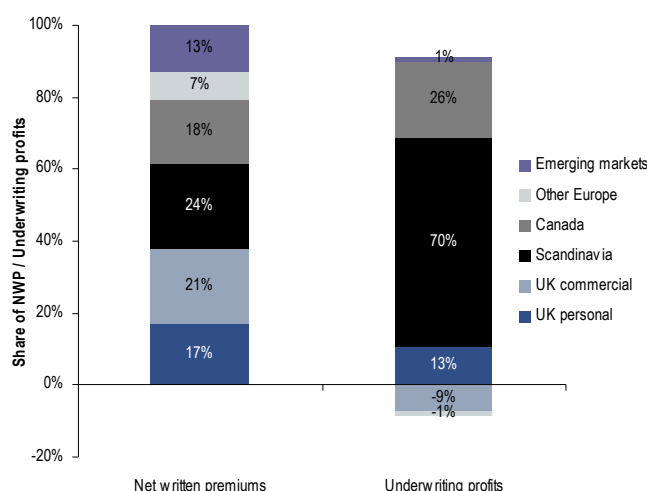
U/W improving but there are some risks

Scandinavia drives 55% of group underwriting profits

Scandinavia has been driving group underwriting profits

RSA's underwriting profits have been far more concentrated than its net written premiums. Figure 6 shows that underwriting profits have been far more concentrated in Scandinavia (70% profits) and Canada (26%) compared with other regions that have struggled to generate profits (e.g. Other Europe). Figure 7 shows the historic composition of underwriting profits and highlights that the Scandinavian business has been key to RSA's improving underwriting result. Between 2008 and 2010 the Scandinavian business has accounted for average 55% of group underwriting profits. Consequently, if Scandinavian earnings come under pressure, this would be a potentially significant risk to RSA's future earnings.

Figure 6. Underwriting profits more concentrated than premiums (H111) Figure 7. RSA's underwriting profits driven by Scandinavia



Source: Company data; Citi Investment Research and Analysis

Note: H1 2011 underwriting profits are annualised

Source: Company data; Citi Investment Research and Analysis

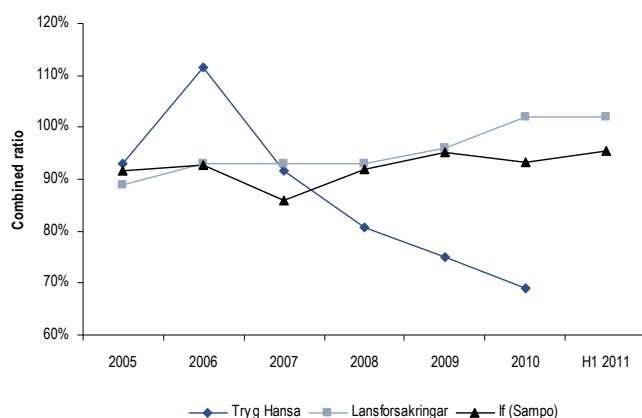
Trygg Hansa has been making material releases

Trygg Hansa is RSA's Swedish insurance business and accounts for 52% of Scandinavian premiums (12% group premiums), with Codan's Danish operations representing the remainder. Trygg Hansa is the third largest player in Sweden (16% market share in 2012). Its underwriting results have significantly outperformed its peers in recent years, which has been a key driver of RSA's strong results in Scandinavia. Figure 8 shows Trygg Hansa's combined ratio relative to the other largest players in the market.

In 2010 Trygg Hansa releases equated to 2% group combined ratio

Reviewing Trygg Hansa's underwriting profits in more detail shows that its outperformance has been driven by material reserve releases. This can be seen in Figure 9. Trygg Hansa released 17% of net earned premiums in 2010, 10% in 2009 and 6% in 2008. In 2010 Trygg Hansa's reserve releases added around £150m or 2.0% to RSA's net earned premiums. This represents around 1/3 of the group underwriting result of £493m (assuming 2010 severe weather losses of £255m are added back). If these releases were to fall to a more normalized level of around £50m that would require approximately 1.2% improvement in RSA's group combined ratio.

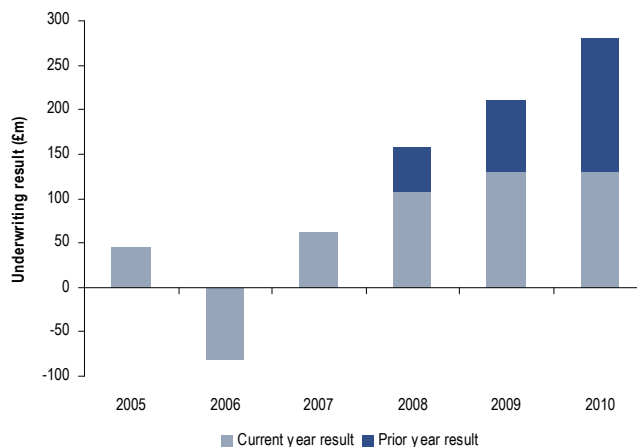
Figure 8. Trygg Hansa has outperformed Swedish peers



Note: Trygg-Hansa H1 2011 results not available

Source: Company data; Citi Investment Research and Analysis

Figure 9. Trygg Hansa has made significant reserve releases



Source: Company data; Citi Investment Research and Analysis

This level of releases for Trygg Hansa seems unsustainable

The sustainability of Trygg Hansa's reserve releases has an important impact on the ability of RSA's Scandinavian business to maintain its excellent underwriting results (eg 81.7% combined ratio in H1 2011). Determining this is made difficult by the fact that 2010 accounts are the latest available data point for Trygg Hansa. It seems that the main driver of releases has been i) motor third party liability and ii) disability and accident insurance. The 2010 annual report states that:

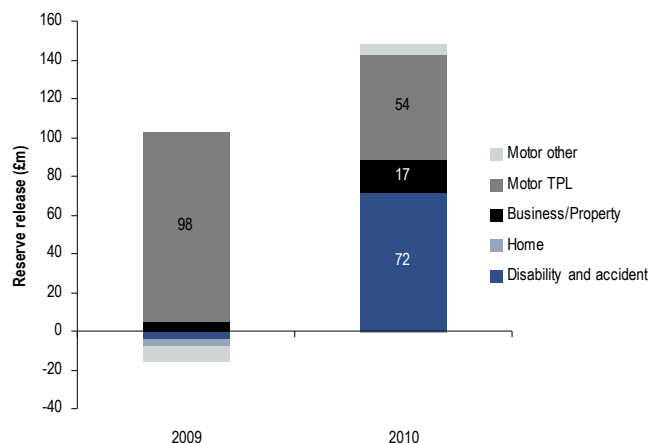
*"The favourable run-off result for motor third-party liability insurance is attributable to a continued adaptation of reserve levels to the **favourable trend in the number of severe personal injury claims from motor third-party liability insurance**, and to a lower IBNR requirement resulting from faster settlement of personal injury claims."*

*In disability and accident insurance, adult products made the greatest contribution to run-off gains. Here, also, Trygg-Hansa sees a continuation of the preceding year's **trend of claims that are finally settled earlier than anticipated and at lower average amounts**. For this segment, there has been a separate model for so-called burnout claims, which are based on assumptions about frequency and average claim amount."*

It seems unlikely that Trygg Hansa's releases are sustainable at current levels

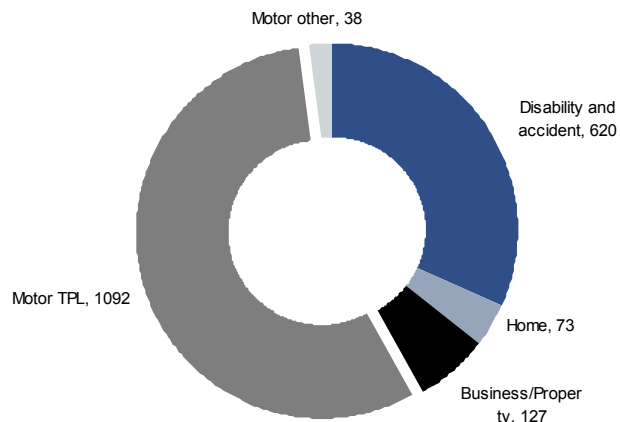
Figure 10 shows the contributors to Trygg Hansa's reserve releases by line of business. It shows that Motor TPL has been a key driver of releases in 2009 and 2010. It seems unlikely that this is sustainable long term trend and consequently our forecasts assume a reduction in Scandinavian underwriting profits. However, we note Figure 11 which shows the composition of Trygg Hansa's reserves. Motor TPL reserves represent around £1.1bn or 56% reserves, which means that releases in the £10ms are not unreasonable to expect going forward. Nevertheless, we don't think releases at 2009/2010 levels (£100-150m) are sustainable.

Figure 10. Releases driven by Motor TPL and disability/accident (£m)



Source: Company data; Citi Investment Research and Analysis

Figure 11. Motor TPL represents bulk of Trygg Hansa's reserves (£m)

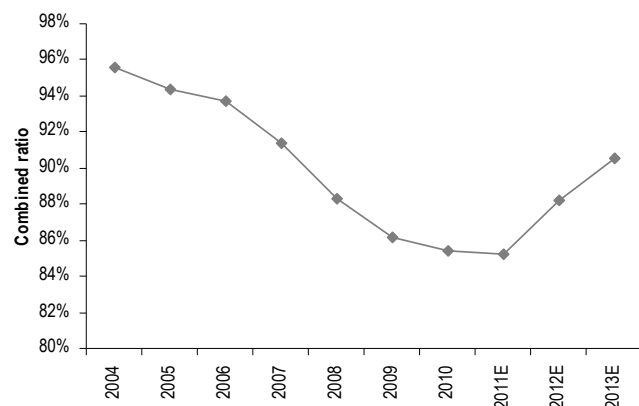


Source: Company data; Citi Investment Research and Analysis

Forecast lower Scandinavian profits

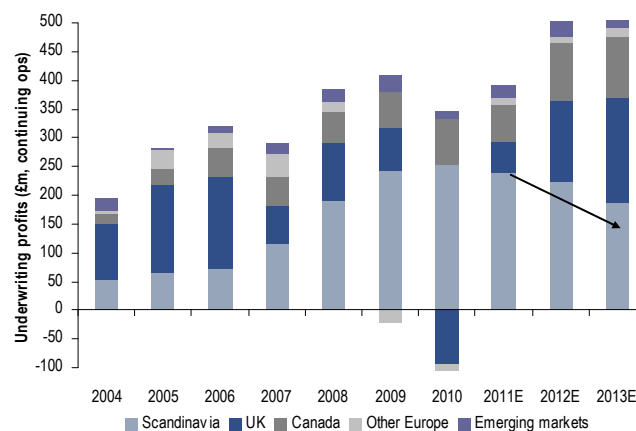
In our view, the profitability of Trygg Hansa's operations is likely to normalize and this will put some downward pressure on Scandinavian underwriting profits. Figure 12 shows that we forecast Scandinavian combined ratios to normalize to around 90%. Figure 13 shows the resulting lower contribution from Scandinavia to RSA's total underwriting profits.

Figure 12. Forecast normalized combined ratios for Scandinavia



Source: Company data; Citi Investment Research and Analysis

Figure 13. Forecast RSA's dependence on Scandinavia to decline



Source: Company Data; Citi Investment Research and Analysis

Reserve releases have been a key driver of RSA's profits

Reserve releases account for average 65% group underwriting result

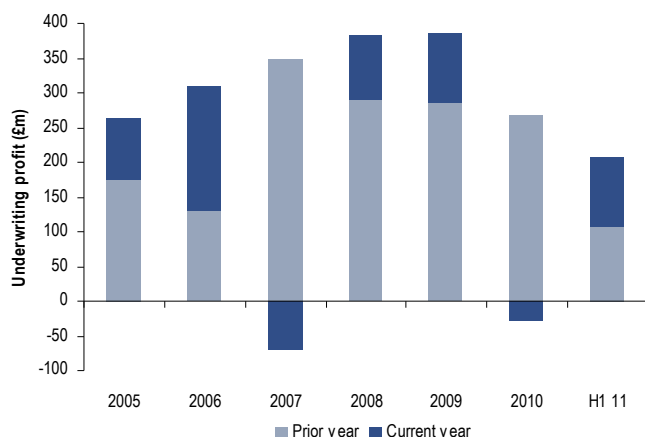
Releases from prior year reserve across the whole group have been a significant contributor to group earnings and are therefore a key component of the investment case. Between 2005 and H1 2011 prior year releases have represented between £150m and £350m per annum. This represents average 65% of the group's underwriting result and 29% of group operating profits. Although RSA doesn't disclose the regional breakdown of reserve releases, our analysis of Trygg Hansa suggests that RSA's Scandinavian operations have contributed meaningfully although guidance from management is that release are from across all areas of the business.

Figure 14 shows RSA's reported underwriting result split between current and prior year underwriting profits, and highlights how significant the impact of reserve releases has been. It should be noted that reporting partly understates current year underwriting profits since they are reported net of any reserving buffer being booked in the current year (i.e. the current year profits are understated by potential future reserve releases on the current year's business). However, given the competitive market it is likely that the reserving buffer in current year business has been lower across the whole industry.

Reserve release have been a feature of the market but likely to decline

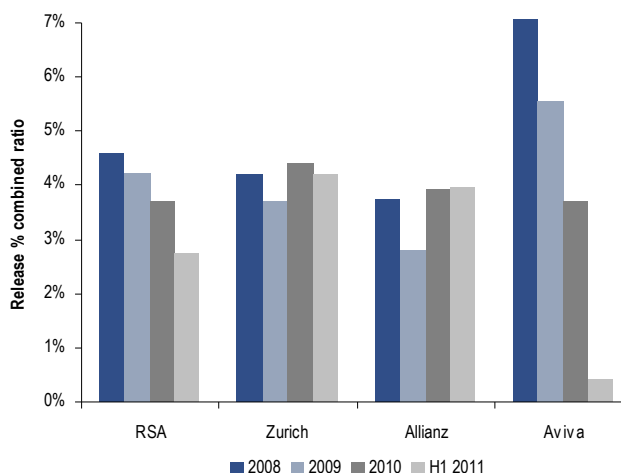
Reserve releases have been an important feature of most non-life insurance groups. Figure 15 shows releases relative to net earned premium for a number of large non-life insurers. It is interesting to note that RSA and Aviva have seen the strongest declining trend in releases.

Figure 14. Prior year releases have dominated underwriting profits



Source: Company data; Citi Investment Research and Analysis

Figure 15. Most non-life players have seen significant reserve releases



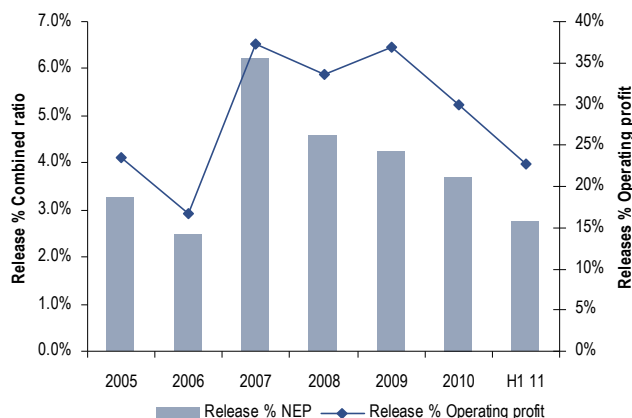
Source: Company data; Citi Investment Research and Analysis

Reserve releases have been declining for the group overall

Figure 16 shows the contribution from reserve releases relative to net earned premiums and operating profit. Both have been declining since 2007 and have raised concern over the sustainability of reserve releases which is an issue given their significance for earnings.

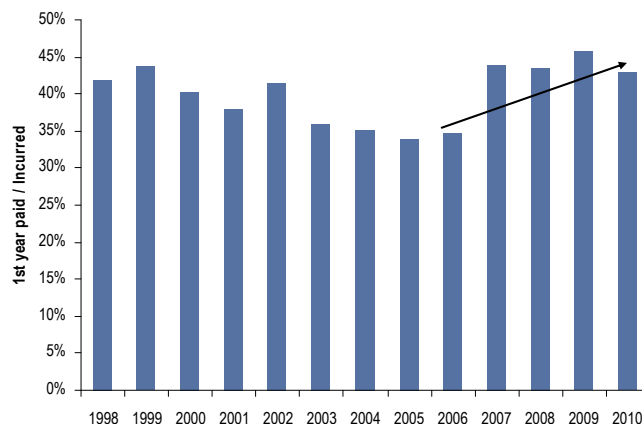
Figure 17 shows a deteriorating 1st year paid claims to incurred claims ratio for RSA's UK operations. This ratio is used as an indicator of how prudently reserves are being set in the first year of business (i.e. the higher the proportion of paid rather than reserved claims, the less prudent reserves are likely to be). It should be noted that the change in this ratio could be attributable to a number of other factors: i) quicker settlement of claims as claims handling procedures are improved, and ii) change in the mix of business towards shorter tail classes.

Figure 16. RSA's contribution from releases has been declining



Source: Company data; Citi Investment Research and Analysis

Figure 17. UK paid to incurred has deteriorated

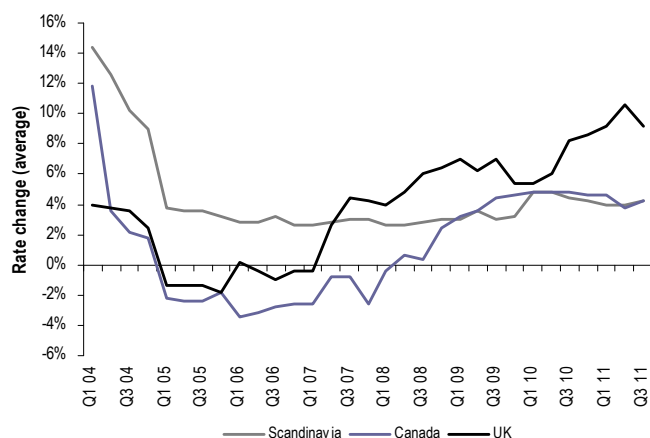


Source: FSA returns; Citi Investment Research and Analysis

Price increases will partially offset lower reserve releases

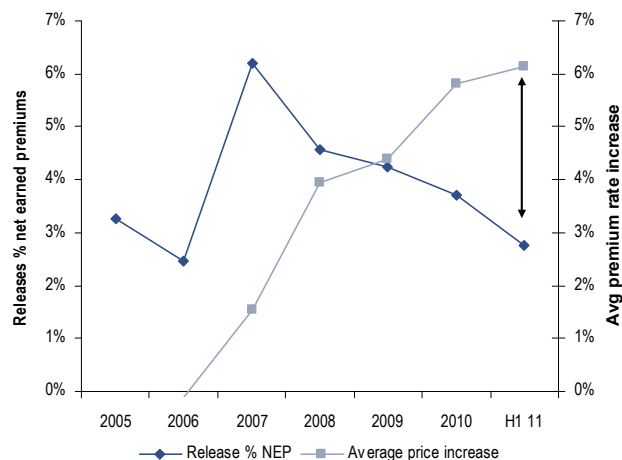
RSA has consistently achieved price increases in recent years and Figure 18 shows the average price increases reported since 2004. There is a clear positive trend in pricing for the UK and Canadian business in particular since around 2007. Scandinavia has seen a lower but more consistent rate increase for an extended period of time. Figure 19 makes a simplified comparison of group pricing and reserve releases. It shows that group pricing gathered momentum at the same time as releases began to slow. Better pricing will clearly lead to an improvement in current underwriting year profitability and help to offset anticipated lower reserve releases.

Figure 18. RSA's pricing momentum accelerated in 2007



Note: based on average of rate movement reported by line of business in each country
Source: Company data; Citi Investment Research and Analysis

Figure 19. Price increases will partly offset lower releases



Note: group price increases based on average of all regions
Source: Citi Investment Research and Analysis

**Management guides that reserves are
£100m's to the right side of best estimate**

Forecast declines in reserve releases

We believe RSA's reserve releases will continue to decline as business from the very profitable underwriting years 2004-6 matures and releases from more recent years prove to be more modest. The message from RSA's management, however, on releases has been clear that investors should expect significant reserve releases going forward. This extract is from recent H1 2011 results:

The Group continues to adopt a prudent reserving policy for both current year and overall reserves. At 30 June 2011, reserves remain significantly to the right side of best estimate and given our prudent reserving policy, we continue to expect positive prior year development to be a significant feature of the underwriting result.

Our forecasts assume a gradual decline in releases which is offset by stronger current year underwriting profits, as shown in Figure 20 and Figure 21.

Figure 20. Forecast reserve releases to decline

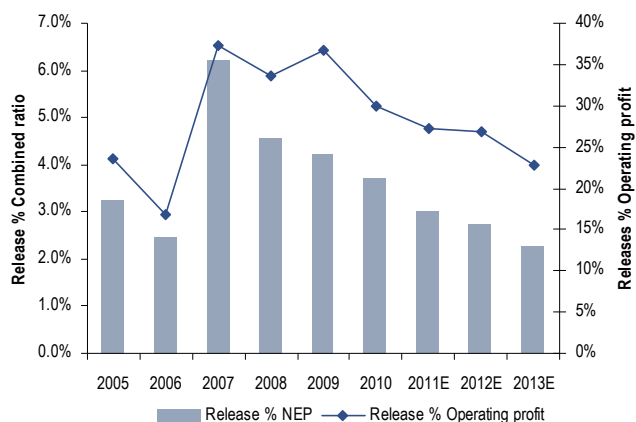
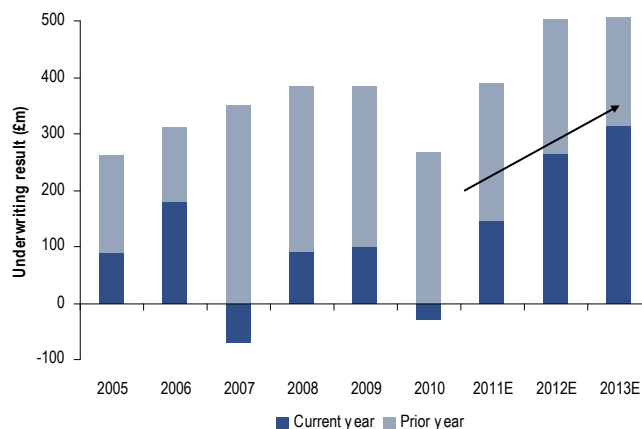


Figure 21. Forecast current year underwriting profits to offset this



Source: Citi Investment Research and Analysis

Source: Citi Investment Research and Analysis

1% combined ratio deterioration lowers PBT by 13%

The key risks to RSA's underwriting result are: i) a more rapid decline in reserve release than we currently forecast, or ii) a more limited uptick in current year underwriting profitability as a result of price increases. In order to demonstrate this we include a sensitivity of RSA's earnings to changes in the group combined ratio. The table below shows the impact of changes to our 2012 forecast combined ratio. For example, if RSA's price increases lead to a 1% better combined ratio than we currently forecast (i.e. from 94.2% to 93.2%), this would lead to a 13% increase in our profit forecasts.

Figure 22. Sensitivity of 2012E profits to changes in the underwriting result

Combined ratio	Underwriting result (£m)	Profit before tax (£m)	Change from forecast COR	Change from forecast PBT
92.2%	678	857	-2.0%	25%
92.7%	634	814	-1.5%	19%
93.2%	591	770	-1.0%	13%
93.7%	547	727	-0.5%	6%
94.2%	504	683	0.0%	0%
94.7%	460	640	0.5%	-6%
95.2%	417	596	1.0%	-13%
95.7%	373	553	1.5%	-19%
96.2%	330	509	2.0%	-25%

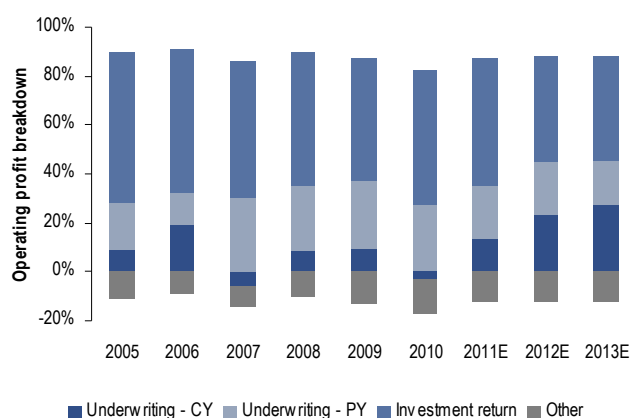
Source: Citi Investment Research and Analysis

Investment returns under pressure

Investment returns represent average
75% operating profits

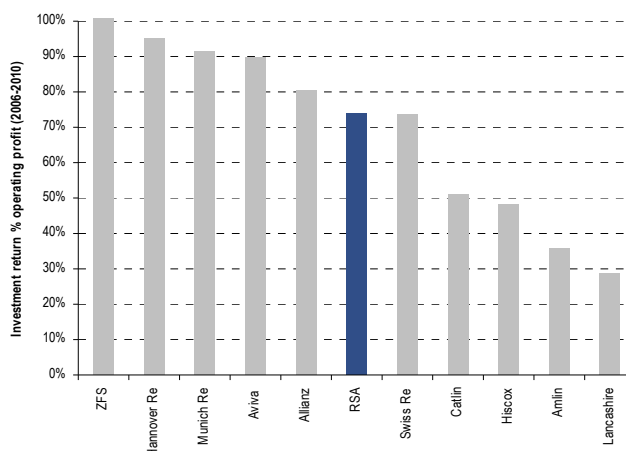
RSA's earnings are heavily dependent on investment returns. Figure 23 shows the composition of RSA's operating profits. 75% of RSA's operating profits derive from investment returns between 2005-2010. Figure 24 shows the share of operating profits from investment returns for a number of large non-life insurance groups. Both reinsurers and large commercial writers tend to derive 70-100% of their operating profits from investment returns. Lloyd's insurers are much more geared to underwriting returns as investment returns represent 30-50% of operating profits during the same period. Whilst this analysis puts RSA in the middle of the pack in terms of dependence on investment returns, the group's exposure to investment returns remains high in absolute terms.

Figure 23. Investment returns drive operating income



Source: Company data; Citi Investment Research and Analysis

Figure 24. RSA is in the middle of the pack (2006-2010)



Source: Company data; Citi Investment Research and Analysis

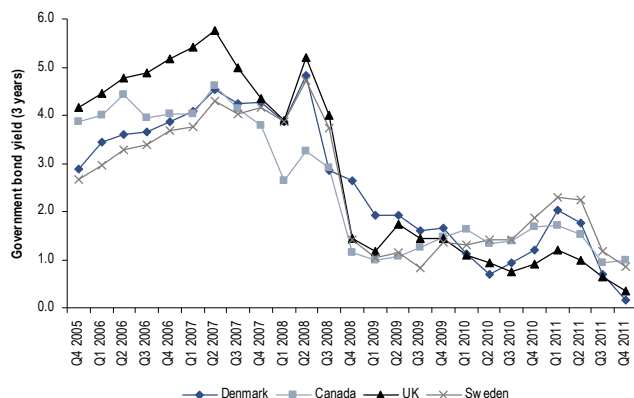
RSA has maintained investment yields

Figure 23 below shows that 3 year government bond yields in RSA's major operating countries have dropped materially during the financial crisis. During this time RSA has managed to maintain a healthy investment return. For example, at H1 2011 RSA delivered a 4.4% investment return (3.5% excluding realized gains). RSA's investment return can be seen in Figure 24 including and excluding realized gains.

We forecast 20bps decline in yields in
2012/2013

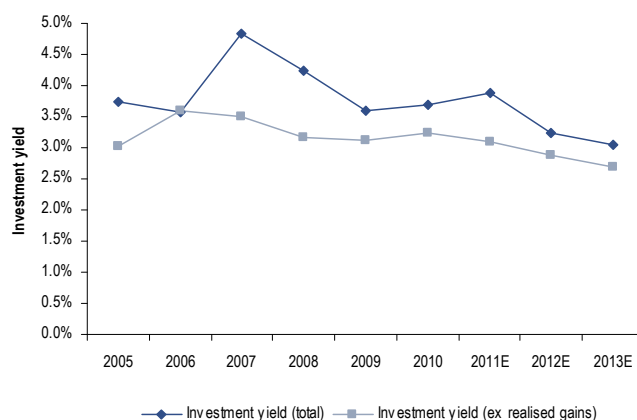
We forecast that RSA's investment return will gently decline in the next 3 years on the basis that interest rates stay low during this period. The reported yield in 2012 drops by 90bps compared with 2011 to reflect a normalization in the level of realized gains. We forecast 20bps decline in the investment yield (excluding realized gains) for 2012 and 2013.

Figure 25. Government bond yields have dropped significantly



Source: Datastream; Citi Investment Research and Analysis

Figure 26. RSA's investment yield has held up well

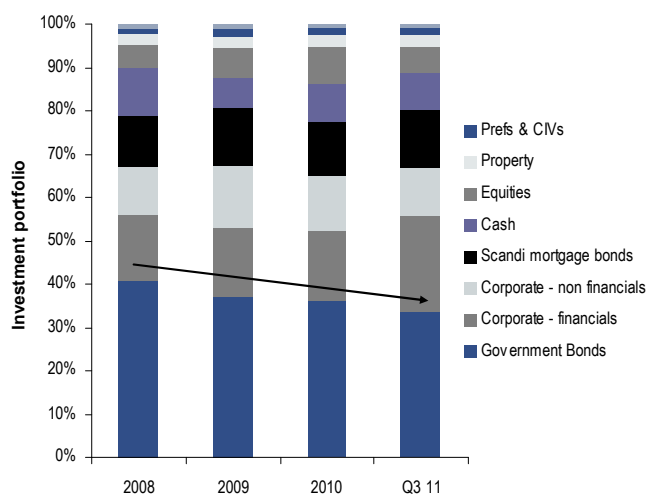


Source: Citi Investment Research and Analysis

RSA's investment portfolio has seen a consistent decline in government bond investments, which have been re-allocated to corporate bonds during 2011. Figure 27 shows the change in RSA's investments between 2008 and Q3 2011. We note RSA has increased its financial corporate bond holdings during 2011 £3.2bn at Q3. RSA's £3.2bn financial bond portfolio contains i) £2.1bn in banks (of which £0.3bn is subordinated and £0.1bn is Tier 1), ii) £0.8bn is non bank financials, and iii) £0.3bn is in supranational/sovereign backed entities. Exposure to peripheral European sovereign credit was £146m or 1% investment at Q3.

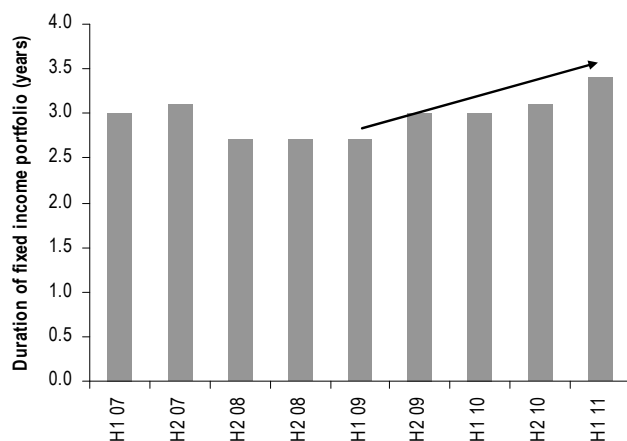
RSA's fixed income duration has been gradually extending to 3.4 years as at Q3 2011. Figure 28 shows the historic duration of RSA's fixed income investments.

Figure 27. RSA's investment breakdown



Source: Company data; Citi Investment Research and Analysis

Figure 28. RSA's fixed income portfolio duration has been extending



Source: Company data; Citi Investment Research and Analysis

40bps lower investment yield lowers PBT by 9%

The table below shows the sensitivity of our 2012 profit before tax forecast to a change in RSA's investment yield. For example, if our forecast yield were to decline by 40bps, then our 2012 profit before tax would be downgraded by 9%.

Figure 29. Sensitivity of 2012 profits to changes in the investment result

Investment yield	Investment return (£m)	Profit before tax (£m)	Change to forecast yield	Change to forecast PBT
2.4%	370	564	-0.80%	-17%
2.6%	400	594	-0.60%	-13%
2.8%	430	624	-0.40%	-9%
3.0%	460	653	-0.20%	-4%
3.2%	490	683	0.00%	0%
3.4%	519	713	0.20%	4%
3.6%	549	743	0.40%	9%
3.8%	579	773	0.60%	13%
4.0%	609	803	0.80%	17%

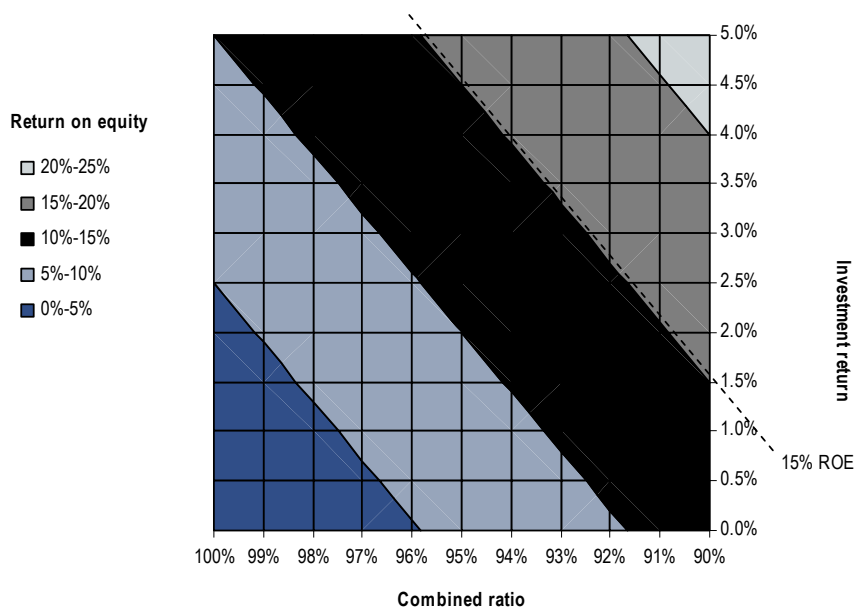
Source: Citi Investment Research and Analysis

ROEs are sensitive to changes in investment returns

1% decline in investment return requires
2% better COR to maintain ROE

Return on equity for non-life companies are very sensitive to changes in investment returns since companies tend to hold bigger investments than the premium the write. The chart below is based on a model insurance company that is broadly consistent with RSA – NWP/Capital of 150% and Investments/Capital of 250. It shows that for every 1% decline in investment yields companies need to improve combined ratio by around 2% to maintain the same return on equity.

Figure 30. Sensitivity of ROEs to change in COR and investment returns for model company



Source: Citi Investment Research and Analysis

Dividend yield is a key attraction

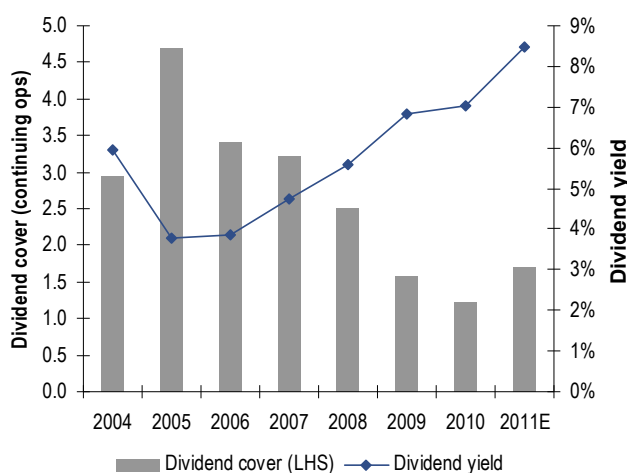
Capital generation supports dividend but a pressures on earnings could threaten this.

RSA's 8.8% dividend yield is a key attraction of the stock, although we believe it has also been a source of debate. Our view is that the pressures on earnings we have discussed in earlier sections of this report are unlikely to be an issue for the dividend in the short term. On our estimates RSA's capital generation should comfortably cover the cost of the dividend. However, if any of the potential risks we outlined deteriorate more than we expect then there could be pressure on the dividend over time.

Figure 30 below shows the rise in RSA's dividend yield, which has increased from 3% in 2006 to almost 9% in 2011. It also shows the corresponding decline in the group's dividend cover - in 2005 RSA's dividend was covered 4.5x, whereas we estimate that the 2011 dividend will be covered 1.7x, which is still comfortable.

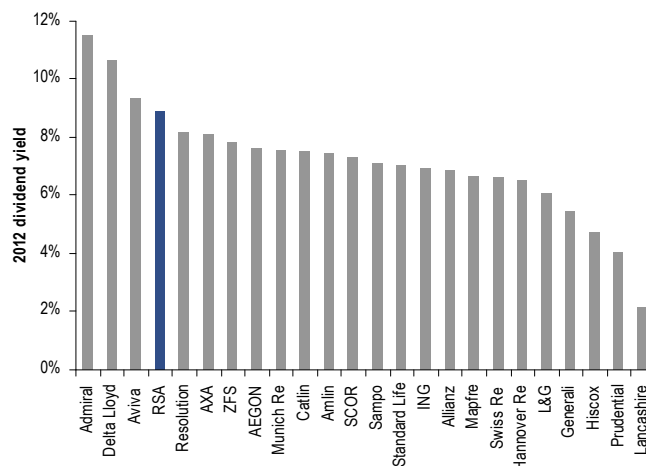
Dividend yields across the European insurance sector remain relatively high by historic standards. Figure 31 shows that RSA's offers one of the more attractive yields (sector average is 7.2%).

Figure 31. RSA's yield has increased and dividend cover declined



Note: yield based on year end share price and declared dividend
Source: Company data; Citi Investment Research and Analysis

Figure 32. RSA offers one of the more attractive yields in the sector

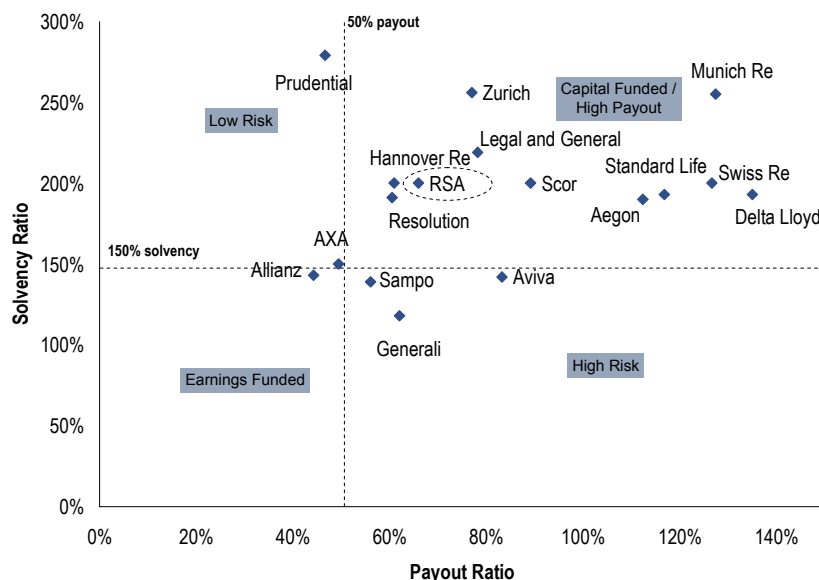


Source: Company data; Citi Investment Research and Analysis

On our forecasts RSA will payout 65-70% earnings in dividend

Looking at the relationship between solvency levels and dividend payout ratios suggests that RSA does not look stretched relative to other European insurers. Figure 32 shows 2011 payout ratio relative to most recently reported solvency position and suggests RSA is towards the middle of the pack. We note that our forecasts assume a 65-70% payout ratio for RSA in 2012/13 which is relatively high and could over time become a constraint on the group's growth plans. However, we do not believe that it looks sufficiently high to raise any concern over the dividend in the short term.

Figure 33. RSA's payout ratio



Source: Citi Investment Research and Analysis

We have estimated RSA's capital generation over the coming years. The main purpose is to assess whether the group can pay its dividend and maintain its growth ambitions. On our calculations we believe RSA generates sufficient capital to pay the dividend and fund new growth opportunities (Figure 34). Our methodology is set out below:

- To estimate capital generated from operating activities we have taken net income and added back goodwill amortization.
- We deduct the cost of the dividend assuming that RSA maintains a similar level of scrip dividend (i.e around 30%). This seems reasonable given that RSA's current valuation is lower than it has been historically.
- We estimated the capital cost of RSA's growth plans. This is based on a 50% capital requirement for the increase in net written premiums for the next financial year. We assume premiums grow 9% in 2011, 7% in 2012 and 6% in 2013.
- Net capital generation reflects the residual after meeting the capital costs of the net dividend and top line growth plans.
- This analysis suggests that the capital generated beyond the dividend and funding growth leaves limited scope for acquisitions in 2012/2013. However, these could be financed from retained earnings as appears to have been the case in 2010.

Figure 34. RSA's capital generation

	2010	2011E	2012E	2013E
Net income	337	480	505	526
FX and unrealised gains	74	-3	0	0
Goodwill amortisation	29	35	35	35
Capital generated from ops	440	512	540	561
Dividend	-290	-313	-335	-361
Scrip dividend	96	101	106	111
Net dividend cost	-194	-212	-229	-250
Capital generation post div	246	300	311	311
Cost of growth*	-351	-271	-255	-270
Net capital generation	-105	29	56	41

* Cost of growth based on 50% capital required for increase in next years premiums

Source: Citi Investment Research and Analysis

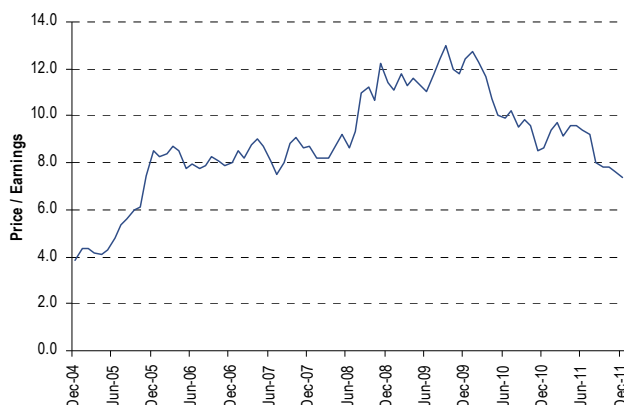
Valuation and shareholder returns

RSA delivers 4% NAV growth and 9% yield in 2012

On our estimates RSA continues to trade on a premium to the insurance sector. The shares trade on 7.9x 2012 PE and 1.40x 2012 net tangible assets (NTA). This compares with the insurance sector on 7.3x 2012 PE. We forecast RSA to deliver 12.9% ROE and 18.7% RONTA in 2012. Shareholders can expect RSA will grow its NAV by 4.1% and pay 8.8% dividend yield in 2012. Whilst we believe these returns are attractive, we believe similar returns are available at lower valuations elsewhere in the sector.

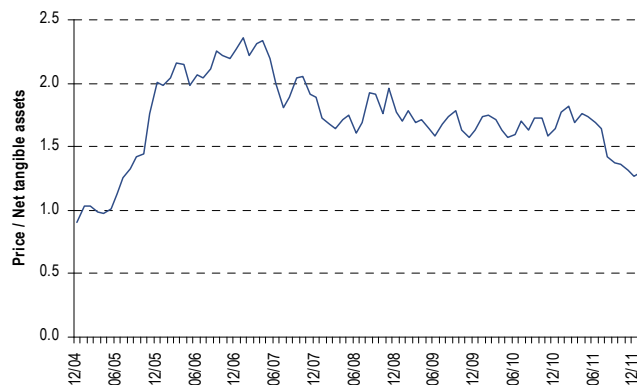
Figure 34 below shows RSA's historic P/E multiple based on 1 year forward earnings. Despite the recent decline in the shares, RSA's current earnings multiple is similar to levels during 2006-7. Figure 35 shows RSA's historic P/NTA multiple based on 1 year forward net tangible assets. There has been a decline in this multiple following senior management changes at RSA during H2 2011. However, we note that a number of other companies in the European insurance sector trade on significant discounts to tangible assets.

Figure 35. RSA's PE has dropped but is not compellingly cheap



Source: Company data; Datastream; Citi Investment Research and Analysis

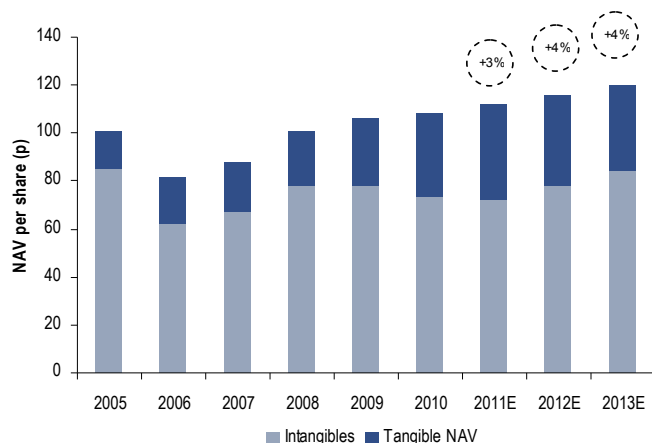
Figure 36. RSA's P/NTA has declined but is higher than many peers



Source: Company data; Datastream; Citi Investment Research and Analysis

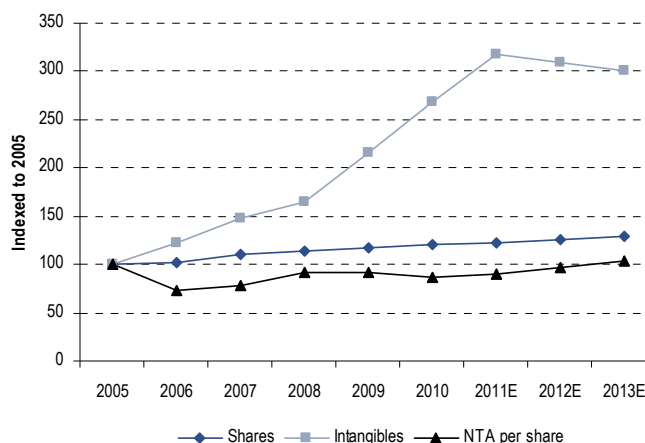
Figure 36 below shows RSA's historic change in NAV and net tangible assets per share since 2005. NTA per share is a frequently used metric for valuing non-life companies and, interestingly, this has remained relatively static for RSA (Figure 37). RSA has previously argued that they focus on earnings growth rather than NTA growth. Figure 38 shows that throughout this period the reason that NTA per share remained static is that RSA's intangibles relating to goodwill on acquisitions and capitalized software development.

Figure 37. Tangible NAV has remained flat



Source: Company data; Citi Investment Research and Analysis

Figure 38. Intangibles have increased considerably



Note: Intangibles includes goodwill and capitalized software development costs

Source: Company data; Citi Investment Research and Analysis

We have lowered our target price by 20% to 115p to reflect increased pressure on investment returns across the group as well as declining reserve releases.

We value RSA on the basis of a SOTP model and a discounted earnings approach. We value RSA's UK business based on 1.3x NTA reflecting its strong market position. We value the international operations on 1.6x NTA based on the high profitability of the Scandinavian operations and high growth in Canada. We value the Emerging markets business on 20x earnings.

Figure 39. RSA valuation

	Capital (£m)	Return on Capital	Cost of Capital	P/NTA	P/E	Valuation (£m)
UK non-life	1,500	11.9%	9.6%	1.27	10	1,900
International non-life	2,040	14.5%	9.6%	1.60	9	3,256
Emerging Markets non-life	665	9.0%	10.2%	0.83	20	554
Other*	238					-167
Total	4,443	11.9%	9.6%	1.25	9	5,543
Debt						-1,439
Group valuation				1.37	8.1	4,104
Target price (p)						115

* group reinsurance and pension deficit

Source: Citi Investment Research and Analysis

Forecasts

The tables below show our key forecasts for RSA. We have made the following changes to our previous earnings forecasts

- 2011 EPS has declined 4% to reflect the impact of £60m weather related losses from Denmark, Italy and Thailand.
- 2012 EPS has declined 15% to reflect lower investment returns (forecast 3.2% total yield) and £20m solvency 2 costs.
- 2013 EPS has declined 19% to reflect lower investment returns (forecast 3.0% total yield) and a slightly worse combined ratio (forecast 94.3%).

Figure 40. RSA earnings forecasts

RSA Group (£m)	2009	2010	2011E	2012E	2013E
Net written premiums	6,737	7,455	8,158	8,700	9,209
Growth	4%	11%	9%	7%	6%
Underwriting result	386	238	392	504	522
Combined ratio	94.6%	96.4%	95.2%	94.2%	94.3%
Regular investment income	595	569	555	531	518
Realised gains	69	68	116	53	55
Unrealised gains	-41	-5	0	0	0
Unwind of discount	-100	-94	-94	-94	-94
Total investment income	523	538	578	490	479
General Insurance result	909	776	969	993	1,001
Investment expenses and loan interest	-30	-33	-33	-33	-33
Central expenses	-60	-63	-60	-60	-60
Associates	-42	-44	-44	-44	-44
Group operating result	777	636	832	856	864
Interest on debt	-116	-118	-118	-118	-118
Reorganisation charge	-75	-5	-30	-20	0
Amortisation of goodwill	-25	-29	-35	-35	-35
PBT (continuing)	554	474	649	683	711
Tax	-135	-119	-156	-164	-171
PAT (continuing)	419	355	494	519	540
Minorities	-1	-9	-5	-5	-5
Preference dividend	-9	-9	-9	-9	-9
Profit attributable to shareholders	409	337	480	505	526

Source: Company Data; Citi Investment Research and Analysis

Figure 41. RSA segmental underwriting results

NON-LIFE NWP	2009	2010	2011E	2012E	2013E
UK - personal	1,095	1,241	1,378	1,460	1,548
UK - commercial	1,537	1,684	1,735	1,804	1,858
International - personal	2,063	2,308	2,469	2,604	2,703
International - commercial	1,186	1,228	1,395	1,476	1,546
Emerging Markets	833	964	1,157	1,330	1,530
Discontinued operations	0	0	0	0	0
Group reinsurance	23	30	25	25	25
Total	6,737	7,455	8,158	8,700	9,209
NON-LIFE U/W RESULT	2009	2010	2011E	2012E	2013E
UK - personal	28	-54	69	88	108
UK - commercial	47	-41	-17	54	74
International - personal	183	252	239	236	205
International - commercial	99	73	78	99	104
Emerging Markets	29	12	23	27	31
Discontinued operations	0	0	0	0	0
Group reinsurance	0	-4	0	0	0
Total	386	238	392	504	522
Combined ratio	94.6%	96.4%	95.2%	94.2%	94.3%

Source: Company Data; Citi Investment Research and Analysis

Figure 42. RSA change in equity

SHAREHOLDERS' EQUITY	2009	2010	2011E	2012E	2013E
Opening equity	3,839	3,491	3,766	3,891	4,167
Net income	409	337	480	505	526
Dividends	-264	-290	-313	-335	-361
Other movements	-493	228	-41	106	111
Closing equity	3,491	3,766	3,891	4,167	4,443
Less: goodwill, prefs, IAS 19	-832	-1,192	-1,323	-1,288	-1,253
Tangible equity	2,659	2,574	2,568	2,879	3,190
NAV per share (p)	99	104	105	110	114
NAV per share (ex IAS 19)	106	108	112	116	120
NTA per share	78	74	72	78	84

Source: Company Data; Citi Investment Research and Analysis

RSA Insurance Group

Company description

RSA is one of the leading UK non-life insurers with particular strength in commercial lines. The group also has sound market positions in Scandinavia (mainly Denmark and Sweden) through its ownership of Codan, as well as in Canada, Chile and Ireland.

Investment strategy

RSA's recent performance has suffered from the resignation of its CEO and CFO, but overall the shares performed broadly in line with the sector in 2011 (-2% relative SXIP). We don't expect a material change in strategy in 2012 and believe the business has a strong position in its core markets. However, on our forecasts RSA lacks earnings momentum (only 4% EPS growth in 2012 and 2013) and we see a number of potential earnings pressures which we discuss in this report. The attractive 8.8% dividend yield appears supported by capital generation, although a deterioration in earnings pressures could impact this. However, we do not see 12.9% 2012 ROE as sufficiently attractive given the shares trade on a modest premium at 7.9x 2012 PE (sector 7.3x) and we therefore have a Neutral recommendation.

Valuation

We value RSA on the basis of a SOTP model and a discounted earnings approach. Our SOTP methodology values the UK business based on 1.3x NTA reflecting its strong market position and the international operations on 1.6x NTA based on the high profitability of the Scandinavian operations and high growth in Canada. We value the Emerging markets business on 20x earnings. We apply a cost of capital of 9.6% reflecting the defensive characteristics of RSA's business. Our SOTP suggests a valuation of £1.15. We sense check this with a DCF model which suggests a £1.16 value. Consequently, we set our price target at £1.15.

Risks

The main downside risks relate to weather and catastrophe losses, non-life reserving, and whether or not core operations can continue to generate the sound returns achieved in recent years without a 'turn' in the pricing cycle. If the impact of these risk factors is more negative than we anticipate, then the share price is unlikely to reach our target price.

Appendix A-1

Analyst Certification

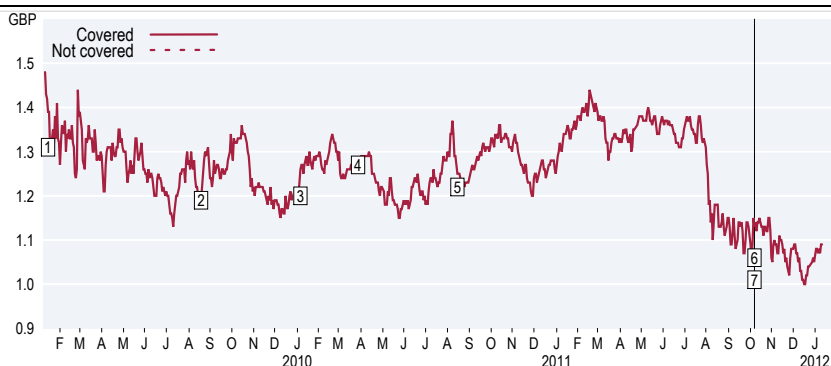
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IMPORTANT DISCLOSURES

RSA Insurance Group (RSA.L)

Ratings and Target Price History Fundamental Research

Analyst: Thomas Dörner
Covered since September 5 2011



	Date	Rating	Target Price	Closing Price
1	12-Jan-09	2M	*1.55	1.48
2	19-Aug-09	2M	*1.32	1.19
3	6-Jan-10	*1M	*1.40	1.26

* Indicates change

	Date	Rating	Target Price	Closing Price
4	29-Mar-10	1M	*1.45	1.28
5	16-Aug-10	*1H	1.45	1.25
6	7-Oct-11	Stock rating system changed		

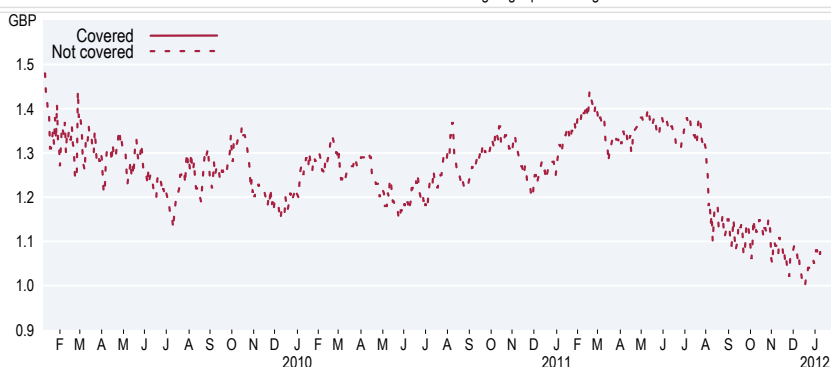
	Date	Rating	Target Price	Closing Price
7	7-Oct-11	*1	1.45	1.13

Rating/target price changes above reflect Eastern Standard Time

RSA Insurance Group (RSA.L)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Thomas Dörner
Covered since September 5 2011



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Citi is acting as financial advisor to SCOR SE in respect to the acquisition of AEGON's Transamerica Reinsurance business.

Thomas Dörner, Analyst, holds a long position in the securities of Resolution, Lancashire Holdings.

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Data current as of 31 Dec 2011

	12 Month Rating			Relative Rating		
	Buy	Hold	Sell	Buy	Hold	Sell
Citi Investment Research & Analysis Global Fundamental Coverage	57%	34%	9%	10%	79%	10%
% of companies in each rating category that are investment banking clients	45%	41%	40%	49%	43%	41%

Guide to Citi Investment Research & Analysis (CIRA) Fundamental Research Investment Ratings:

CIRA's stock recommendations include an investment rating and an optional risk rating to highlight high risk stocks.

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Investment Ratings: CIRA's investment ratings are Buy, Neutral and Sell. Our ratings are a function of analyst expectations of expected total return ("ETR") and risk. ETR is the sum of the forecast price appreciation (or depreciation) plus the dividend yield for a stock within the next 12 months. The Investment rating definitions are: Buy (1) ETR of 15% or more or 25% or more for High risk stocks; and Sell (3) for negative ETR. Any covered stock not assigned a Buy or a Sell is a Neutral (2). For stocks rated Neutral (2), if an analyst believes that there are insufficient valuation drivers and/or investment catalysts to derive a positive or negative investment view, they may elect with the approval of CIRA management not to assign a target price and, thus, not derive an ETR. Analysts may place covered stocks "Under Review" in response to exceptional circumstances (e.g. lack of information critical to the analyst's thesis) affecting the company and / or trading in the company's securities (e.g. trading suspension). As soon as practically possible, the analyst will publish a note re-establishing a rating and investment thesis. To satisfy regulatory requirements, we correspond Under Review and Neutral to Hold in our ratings distribution table for our 12-month fundamental rating system. However, we reiterate that we do not consider Under Review to be a recommendation.

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