

It's Not Complicated: Buybacks Are Cyclical

Increasing Stock Buybacks are Expected, Not Necessarily Bullish

- **A common source of pushback on our cautious cyclical call for P&C Insurance in 2014 is whether this cycle is “different” from past cycles.** But one idea that is *not* different is that companies might increase stock buybacks. **Stock buybacks are cyclical: they tend to decrease as pricing accelerates (with capital raises in extreme cases), and increase as pricing decelerates and declines.**
- **From 1986 to 2005, the correlation of price increases to net capital issuance is strongly positive (69%).** In the 3 hard markets of this period, there was net issuance caused by the cycle turns and net capital return all other times. Net capital return over this period was about 1% of surplus per annum, including issuance.
- **But with companies buying back shares *and* raising price over 2011-13, is that not different? It could have been if companies hadn't already raised capital from the financial crisis.** In fact, many investors speculated that there *would* be a hard market in 2009 given capital destruction from the crisis. This did not come to pass, and we think a case can be made that the 2011-13 hard market is simply the delayed cycle anticipated in 2009.
- **Recent buybacks have already increased versus history, and this has not noticeably increased valuations, absolute or relative.** Average capital return was 3% of surplus per annum during 2006-13, and 4% during 2011-13. Yet post-crisis (2010-13) average valuations remain below pre-crisis (1980-2007), whether measured absolutely (1.04x book vs. 1.27x) or relatively (0.47x relative book vs. 0.55x).
- **All this suggests is that buybacks are expected by the market, and may not represent new bullish information.** The companies in our coverage have much higher average capital returns than the industry, which is not surprising given the presence of mutual and private companies. Our coverage's average capital return during 2008-13 was 7.3% of equity, versus 2.7% of surplus for the industry. While our current assumptions for 2014 (-7.8%) are similar to 2013 actual (-8.1%), we tend to model only announced programs, and thus we would expect upside to buybacks versus our current models (which would come out of book value growth). Yet none of this seems to have changed the basic cyclical behavior of insurance stocks, which is the basis of our current cautious view on the group.

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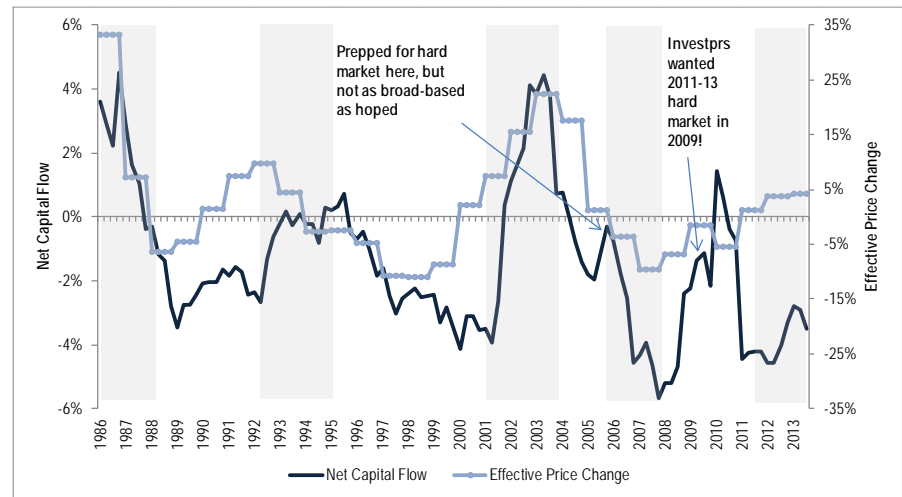
Buybacks: It's Not Different This Time

Our cautious view on P&C Insurance in 2014 is largely predicated on the way stocks have behaved in past periods of price increases (so-called *hard markets*). Put simply, stock prices tend to decline rather indiscriminately once pricing decelerates, which we believe is the situation for 2014. More details on this can be found in our [US P&C Insurance Initiation - 2nd Half of Hard Market is 2nd Worst Time to Own the Group](#). In discussions with clients, pushback to this view has revolved around what might be different this time, whether at the industry or company level. There are many ways that things *are* different, and we expect to discuss these issues in future research, though overall these don't sway our current view.

This note discusses one topic that comes up frequently where we *don't* think things are different, namely capital management. We have found that many investors may not be aware of the historical relationship that capital management (principally share buybacks) bears to the pricing cycle itself, and we hope this analysis helps to fill this gap.

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Figure 1. US Industry Net Capital Flows vs. Effective Price Changes, 1986-2013



NOTE: Shaded regions are hard markets. Net Capital Flows are New Funds less Shareholder Dividends as a percentage of Policyholder Surplus. Effective Price Change is an estimate of Price Change less Loss Trend.

Source: ISO, SNL Financial, Citi Research

It turns out that capital management is highly correlated to the pricing cycle.

First, we look at this at a high level, using industry data provided by ISO (Figure 1). We have constructed a measure of *net capital flows*, which is new funds raised less shareholder dividends paid, all as a percentage of policyholder surplus (the statutory equivalent of equity). We compare this to the *effective price change* (price change less loss trend) for a composite of commercial lines business, which we can estimate using information about industry loss ratios.

From 1986 to 2005, the correlation of price increases to net capital issuance is strongly positive (69%). In the 3 hard markets of this period (1985-87, 1992-94, and 2001-03), there was net issuance caused by the cycle turns and net capital return all other times. Issuance was lower after the 1992-94 cycle as this cycle was more about catastrophic losses versus the balance sheet destruction from deficient loss reserves in the other two cycle. Net capital return over this period was about 1% of surplus per annum, including issuance, so the industry still managed to return capital on a net basis despite some major holes to fill.

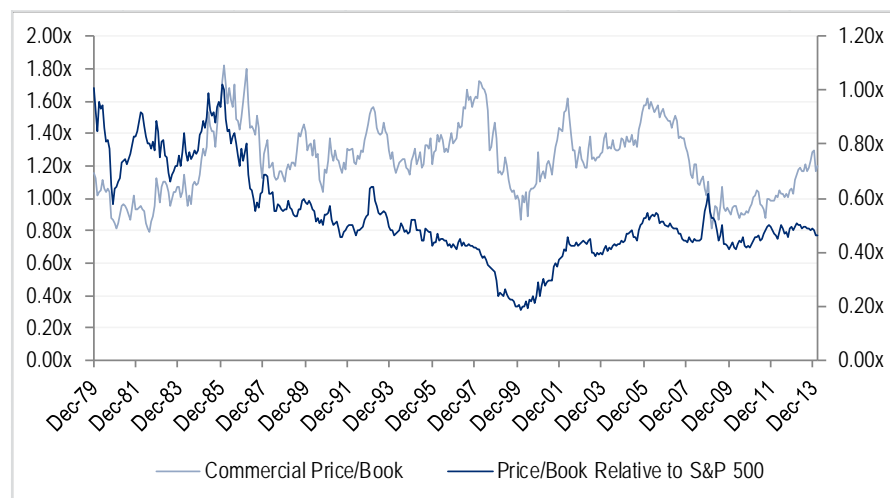
The next two cycles, 2005-07 and 2011-present do seem to have some differences compared to the prior cycles, but we believe there are some good reasons for this that do not negate the basic relationship. For example, after the major hurricanes of 2004-05, the industry sharply slowed buybacks in preparation for a harder market in 2006, as we highlight in Figure 1. But this ended up being mostly a reinsurance event, and so at the industry level net capital returns resume (there is more net issuance if one looks at reinsurance alone).

But with companies both buying back shares and raising price over the 2011-13 period, surely this must be a counterexample to the historical norm. Well, it could have been if companies hadn't already raised capital from the financial crisis! It is important to recall that many investors speculated that there would be a hard market in 2009 given capital destruction from the crisis. This did not come to pass, and we think a case can be made that the 2011-13 hard market is simply the delayed cycle anticipated in 2009:

- Why no hard market in 2009? At the time, companies did not view the unrealized capital losses as permanent, in the same way as they view reserve deficiencies, for example. We also had conversations with company executives in later years that suggested that companies were quite wary of raising prices in the middle of an economic crisis given the relationship damage that could do.
- So, why a hard market by 2011? After some discipline in 2009, soft market behavior resumed in 2010, comparable to 2007 just before the crisis. Also, by 2011 it was clear that interest rates were not rising, so price increases were viewed as needed from a profitability standpoint.

So in a sense, the capital raising from the crisis *are* connected to the current hard market, but in an unusually lagged sense, given highly unusual circumstances!

Figure 2. Commercial Composite Price/Book, Absolute and Relative, 1980-2014



Source: FactSet, Citi Research

It is apparent from Figure 1 that recent buybacks have increased versus history. Average capital return was 3% of surplus per annum during 2006-13, and 4% during 2011-13. Some clients have argued that higher buybacks could support higher valuations. Yet as Figure 2 suggests, valuations have not noticeably increased, whether considered on an absolute or relative basis, despite higher

levels of capital return. If we take simple averages, post-crisis (2010-13) average valuations remain below pre-crisis (1980-2007), whether measured absolutely (1.04x book post vs. 1.27x pre) or relatively (0.47x relative book post vs. 0.55x pre). There are many factors that influence valuation, of course, but it's hard to say from the available data that increased buybacks have aided valuation.

Figure 3. Net Capital Issuance (Return) as Percentage of Shareholder Equity, 2008-15E

Company	2008	2009	2010	2011	2012	2013	2014E	2015E	2014E YOY Change	2008-13 Average
ACE Limited	-6.0%	-1.9%	-2.9%	-1.9%	-2.5%	-2.2%	-5.7%	-2.8%	-355 bp	-2.9%
Allstate	-8.3%	-9.2%	-3.0%	-7.3%	-6.6%	-9.3%	-7.6%	-7.1%	167 bp	-7.3%
AXIS	-8.7%	-5.1%	-14.4%	-4.9%	-8.3%	-9.7%	-9.0%	-8.6%	76 bp	-8.5%
Chubb Corp.	-12.5%	-9.7%	-15.5%	-13.6%	-8.2%	-10.6%	-11.3%	-8.2%	-66 bp	-11.7%
Progressive	-5.7%	-2.6%	-16.2%	-21.2%	-17.0%	-7.1%	-5.6%	-4.9%	147 bp	-11.6%
RenaissanceRe	0.0%	0.0%	-13.1%	-6.8%	-15.6%	-6.6%	-7.8%	-7.4%	-118 bp	-7.0%
Travelers	-11.3%	-14.8%	-22.4%	-14.5%	-8.3%	-12.4%	-8.9%	-8.4%	356 bp	-14.0%
XL Group	37.3%	6.3%	-6.1%	1.1%	-4.5%	-7.2%	-6.7%	-7.5%	53 bp	4.5%
Average	-1.9%	-4.6%	-11.7%	-8.6%	-8.9%	-8.1%	-7.8%	-6.9%	33 bp	-7.3%
Average (Personal Lines)	-8.4%	-8.9%	-13.9%	-14.3%	-10.6%	-9.6%	-7.4%	-6.8%	223 bp	-11.0%
Average (Commercial Lines)	-9.2%	-5.8%	-9.2%	-7.8%	-5.4%	-6.4%	-8.5%	-5.5%	-210 bp	-7.3%
Average (Reinsurance)	9.5%	0.4%	-11.2%	-3.5%	-9.5%	-7.8%	-7.8%	-7.8%	4 bp	-3.7%
Industry Statutory	-2.4%	-2.2%	-0.7%	-4.2%	-3.3%	-3.5%	-4.0%	-4.0%	-50 bp	-2.7%

Source: Company Reports, Citi Research

(ACE.N; US\$96.76; 2); (ALL.N; US\$54.23; 2); (AXS.N; US\$43.59; 3); (CB.N; US\$87.14; 3); (PGR.N; US\$24.18; 2); (RNR.N; US\$95.72; 2); (TRV.N; US\$83.85; 3); (XL.N; US\$29.95; 3)

One final possibility is that public companies may be increasing buybacks, and that could help valuations incrementally. It is indeed the case that the companies in our coverage have much higher average capital returns than the industry. But this should not be surprising, given the presence of mutual and private companies which may engage in little to no capital management.

Our coverage's average capital return during 2008-13 was 7.3% of equity, versus 2.7% of surplus for the industry. While our current assumptions for 2014 (-7.8%) are similar to 2013 actual (-8.1%), we tend to model only announced programs, and thus we would expect upside to buybacks versus our current models (which would come out of book value growth). Yet none of this seems to have changed the basic cyclical behavior of insurance stocks, which is the basis of our current cautious view on the group.

In this note we have focused on what the insurance industry and companies *have done* with respect to capital management versus the pricing cycle. The question of what *should* they do is harder and more subjective. It has been our experience that managements have a hard time satisfying investor demands for more capital return, and other constituent's demands for ever more secure balance sheets. It is possible that some company may come up with a novel approach that allows for both, and we should be on the lookout for such opportunities. But as things stand today, the available information suggests that increased buybacks are expected by the market, and may not represent new bullish information.

Appendix A-1

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