Citi Research
Deep Dive | **Equities**

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Citi Insurance

Cash Rules Everything Around Me – Examining Free Cash Flow Generation for U.S. Life and P&C Insurers

- **Show us the money!** — In our view, free cash flow has become an increasingly important metric for analyzing insurance companies given investor focus on capital return and quality of earnings. This is particularly true for U.S. life insurers, where we see correlation between FCF generation and valuation multiples. This note builds off Citi's analysis of global insurance cash flow (click here for the report) and provides a deep-dive into trends for the U.S. life and P&C sectors.
- **Healthy free cash flow supports capital return theme** — We estimate that both U.S. life and P&C insurers have considerable excess capital and forecast them to deploy 100% of FCF for buybacks, dividends, and M&A in 2014. While we expect companies to gradually draw down excess capital over time, FCF generation provides a good base to forecast capital return over the next few years. Based on our analysis, we see upside potential to consensus buyback expectations for AFL, ALL, CNO, and HIG, and downside risk to forecasts for VOYA.
- **Life insurance valuations correlated with cash flow conversion** — On average, we project US life insurers to generate FCF of 65% of operating earnings over the next few years, albeit with significant differences amongst companies (primarily driven by business/product mix). In general, we observe that insurers with high FCF conversion rates trade at higher P/E multiples. In our view, this is due to these companies' 1) strong capacity to return capital, 2) focus on less capital-intensive products without guarantees, and 3) higher perceived earnings quality.
- **P&C insurers tend to generate higher cash flow (until they don't)** — For the P&C group, we believe that FCF generation over time matters much more than the result in any one year given potential catastrophe losses. While we estimate FCF conversion of ~90% for our coverage companies in 2014 (helped by modest 2013 cats), this drops to nearly 70% when looking at the average for the past 5 years. This is still above the life group average, but by a smaller margin.
- **Cash flow analysis supports our bullish view on CNO** — CNO trades at an 8.0% FCF yield, highest in the life group. The company pays minimal taxes (due to its sizable NOL), and its underlying business also generates strong cash flow given a focus on basic protection products. As a result, we expect CNO to generate among the highest FCF conversion ratios in the sector and return >100% of earnings through buybacks and dividends for the next few years.
- **ALL offers attractive capital return, but pricing remains a concern** — We assume \$2.6B of share repurchases for ALL in 2014, and our cash flow analysis suggests \$700M of additional capacity. However, deteriorating pricing and concern about the focus on growing PIF keep us on the sidelines. For P&C stocks, we don't expect the benefit from capital return to offset multiple contraction as pricing slows.

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Cash Rules Everything Around Me

In our view, cash flow is becoming an increasingly important metric for evaluating insurers as investors focus on companies' quality of earnings and ability to return capital. This is particularly true for the U.S. life insurers given the noise in reported net income, which has made traditional valuation metrics less relevant. While cash flow in any given year is less relevant for P&C insurers (due to variability in catastrophe losses), strong expected 2014 FCF should support near-term capital deployment, which is a key driver for growth given the moderating pricing cycle. In this report we provide a detailed analysis of projected free cash flow generation for U.S. life insurers, U.S. P&C (re)insurers, and insurance brokers.

Key Conclusions

- **Cash flow conversion the primary metric to watch** – Most investors focus on the ratio of FCF to operating earnings, as this provides a measure of capital efficiency and earnings quality and is relatively comparable across companies. For the U.S. life insurers, we forecast median FCF conversion of ~65% for 2014-2016. P&C insurers and brokers have projected FCF conversion of 91% in 2014, but this is inflated by modest cat losses in 2013. Over the past three and five years, the average ratio was 81% and 71%, respectively.
- **Free cash flow a key driver of capital return** – We estimate that both life and P&C insurers have deployable excess capital, a view that is supported by the fact management teams are returning ~100% of FCF to shareholders. For several companies, we forecast share repurchases and dividends to exceed FCF near-term as they draw down excess capital. However, over time, free cash flow will likely be the key governor of capital return for most insurers.
- **Coverage ratios suggest further room to increase dividends** – Median FCF coverage of forecast 2014 dividends is 3.6x, and we expect payout ratios for both life and P&C insurers to trend higher over the next few years. The current median dividend yield for the sector is 1.9%.
- **Cash flow metrics beginning to play a role in valuations** – For life insurers, we observe that companies with higher FCF conversion ratios (such as AMP, PFG, SFG, and TMK) typically trade at higher P/E multiples. In addition, higher cash flow stocks have generally outperformed in recent years. In our view, the proliferation of hedging has created more noise in GAAP earnings (widening the gap between operating and net income) and made book value a less reliable measure of point-in-time value. As traditional valuation metrics become less relevant, we expect investors to increasingly use cash flow as part of their analysis. This is less the case in P&C given the more volatile nature of cash flow.
- **Capital return unlikely to offset headwind of slowing P&C pricing** – We expect P&C insurers to increase share repurchase as a way to grow earnings during the softening pricing cycle. Some notable companies that have already accelerated share repurchases are ACE, ALL, and MMC. While buybacks are a good way to grow EPS in a challenging business environment, our analysis shows that there isn't any benefit to valuation.
- **CNO our favorite stock to play the cash flow theme** – We project CNO to generate free cash flow above operating earnings near term, helped by its sizable NOL. This should enable it to sustain annual buybacks of >5% of its market cap and further boost the dividend. While cash flow conversion will decline over time as the company begins to pay taxes, CNO's underlying business generates strong cash flow given a focus on basic protection products. It currently trades at a FCF yield of 8.0%, highest in our coverage universe.

Summary Cash Flow Data Table

The following table summarizes the key cash flow data and metrics we use to analyze U.S. life and P&C insurers.

Figure 1. Summary Cash Flow Data Table

Market data as of 6/6/14

Company	Ticker	Rating	Price	Market Cap (M)	2014E FCF (B)	2015E FCF (B)	FCF Yield	FCF % of Op Income	Dividend Coverage	Dividend Yield	2014E Buybacks	2014E Capital Return as % FCF
U.S. Life Insurers												
AFLAC Inc.	AFL	2	62.53	28,398	1.7	1.8	5.9%	59.1%	2.5	2.4%	1,000	100.1%
Ameriprise Financial	AMP	2	118.04	22,413	1.3	1.3	5.7%	79.4%	3.0	2.0%	1,404	143.8%
CNO Financial	CNO	1	16.86	3,673	0.3	0.3	8.0%	110.0%	5.9	1.4%	450	169.8%
Hartford Financial	HIG	1	36.23	16,292	1.0	1.2	6.1%	61.4%	3.4	1.7%	1,500	180.8%
Lincoln National	LNC	2	50.76	13,388	0.7	0.8	5.4%	48.0%	4.3	1.3%	500	93.1%
MetLife Inc.	MET	1	54.80	61,682	2.4	3.3	3.9%	37.2%	1.6	2.6%	1,000	103.9%
Principal Financial	PFG	2	48.88	14,382	0.9	0.9	5.9%	68.8%	2.3	2.7%	223	69.0%
Protective Life	PL		69.46	5,477	0.2	0.2	4.1%	60.7%	2.6	1.4%	-	39.1%
Prudential Financial	PRU	1	89.35	41,280	2.3	2.5	5.7%	52.6%	2.3	2.4%	1,000	86.2%
Reinsurance Group	RGA	2	79.23	5,473	0.4	0.4	7.0%	70.9%	4.3	1.5%	248	88.2%
Stancorp Financial	SFG		63.15	2,762	0.2	0.2	7.0%	78.4%	2.2	1.8%	125	111.1%
Torchmark Corp.	TMK	2	82.42	7,237	0.5	0.5	6.2%	82.0%	6.9	0.9%	378	98.4%
Unum Group	UNM	2	35.26	9,076	0.6	0.6	6.6%	66.1%	3.8	1.7%	450	101.3%
Voya Financial	VOYA	2	36.36	9,257	0.5	0.4	5.0%	64.6%	14.2	0.1%	450	104.2%
Median							**5.9%**	**65.4%**	**3.2**	**1.7%**		**100.7%**
U.S. P&C Insurers and Brokers												
ACE Limited	ACE	2	104.92	35,431	0.6	0.6	5.1%	20.6%	0.7	2.5%	921	399.6%
Arthur Gallagher	AJG	2	45.93	7,215	0.3	0.2	6.7%	72.0%	1.5	3.1%	-	67.5%
Allstate Corporation	ALL	2	59.32	25,744	2.2	2.1	1.8%	96.0%	4.6	1.9%	2,598	137.4%
Aon PLC	AON	1	90.51	26,835	1.4	1.5	16.0%	98.3%	5.9	1.1%	1,050	93.4%
AXIS Capital Hldgs	AXS	3	46.74	5,037	0.5	0.4	9.5%	92.5%	4.1	2.3%	455	119.6%
Chubb Corporation	CB	3	94.08	23,003	1.7	1.1	7.5%	96.1%	3.9	2.1%	1,423	107.4%
Marsh & McLennan	MMC	2	51.06	28,063	1.1	1.3	9.4%	70.9%	1.9	2.2%	85	60.1%
Progressive Corp.	PGR	2	25.25	14,948	1.0	1.1	3.8%	98.5%	1.1	2.0%	225	111.9%
RenaissanceRe	RNR	2	105.58	4,281	0.7	0.5	4.0%	164.1%	14.4	1.1%	458	73.7%
Travelers Group	TRV	3	94.36	32,787	3.1	3.2	8.7%	97.8%	4.5	2.3%	2,600	106.4%
Median							**7.1%**	**96.1%**	**4.0**	**2.2%**		**106.9%**

Source: FactSet (for non-Citi covered companies), company reports, and Citi Research estimates

Why Free Cash Flow Matters for Insurers

Please see Global Insurance - Show Us the Money – A Global Analysis of Free Cash Flow, which includes discussion of cash flow trends for European and Asian insurers

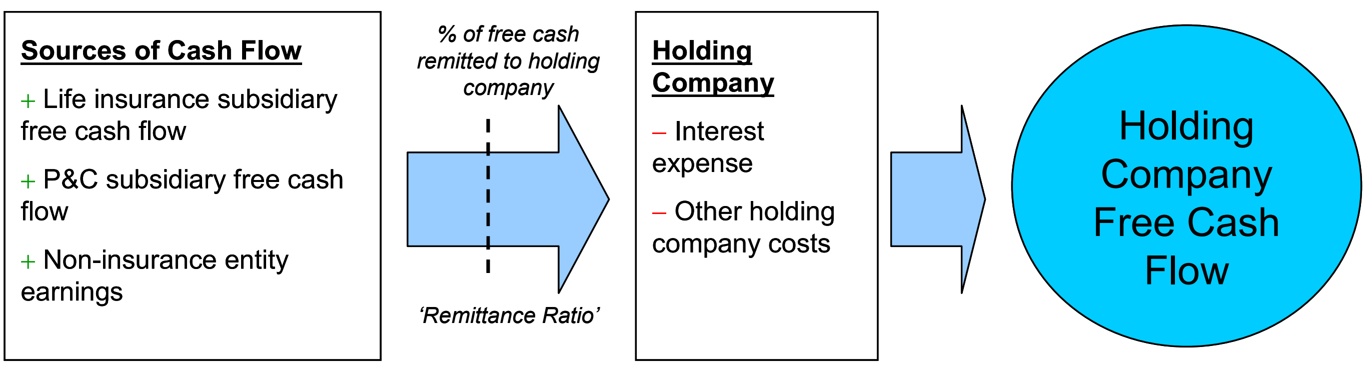
We believe that free cash flow has become an increasingly important metric for analyzing insurers. In addition to being the primary source for capital return to shareholders, cash flow also provides a way to gauge a company's quality of earnings and compare global insurers. As a result, we are seeing more investors use cash flow to supplement traditional valuation metrics. In addition, many company management teams have begun to place greater emphasis on the topic. However, projecting free cash flow for an insurance company is challenging given limited and/or inconsistent disclosure and regulatory limitations on the amount of dividends that can be paid to a holding company. This report, which builds off Citi's global analysis of insurance free cash flow, provides a deep-dive analysis of cash flow generation for U.S. life and P&C (re)insurers, as well as the insurance brokers.

How We Define Free Cash Flow for Insurers

We use the concept of 'holding company free cash flow' – the most comparable measure of cash generation, in our view

We focus on holding company free cash flow', which we believe offers the most comparable measure of cash generation across companies and sectors. We define this as the amount of money that an insurer brings to the holding company minus after-tax interest expense and other hold co expenses. As shown below, there are three primary sources of cash flow: 1) dividends from insurance subsidiaries, 2) earnings from non-insurance businesses, and 3) income generated at the holding company (such as investment income). In our view, free cash flow should be viewed as a source for capital return to shareholders, so our definition is prior to dividends and share repurchases.

Figure 2. The definition of 'holding company free cash flow'



Source: Citi Research

Key Drivers of Insurance Free Cash Flow

Insurance businesses generate significant cash over time, but how quickly cash flows emerge differs by policy type

Insurance is a highly cash generative business over time, but how quickly those cash flows emerge varies significantly for different types of business. As a result, business mix is a key determinant of an insurers' free cash flow conversion rate. Long-tail lines (such as life insurance) are often cash flow negative during the first few years after a policy is issued and then throw off significant cash in later years. By contrast, short-tail lines (such as personal lines P&C) or fee-based products (asset management, broker fees) produce cash flow immediately. While the basic formula for holding company free cash flow is the same for both life and P&C companies, there are also key differences, which we address in more detail below.

Figure 3. Key drivers of insurance subsidiary cash flow

Life Insurance	P&C Insurance
+ Earnings from in-force block	+ Reported earnings
+ Release of capital from in-force block	+/- Capital needed for growth
- Acquisition costs (commissions, underwriting expenses)	
- New business required capital	

Insurance Free Cash Flow

Source: Citi Research

Life Insurance: Business Mix & Growth Key Drivers of FCF Generation

Life insurance cash flows are the combination of in-force cash flow less capex to fund new business growth

For all of our coverage companies, the biggest source of cash flow is dividends from their regulated insurance subsidiaries. The maximum dividend that can be paid each year without getting regulatory approval depends on the state where the subsidiary is domiciled. In most states, life insurers can pay ordinary dividends equal to the greater of prior year statutory earnings or 10% of statutory surplus. However, a handful of states (including New York) limit dividends to the lesser of prior year earnings or surplus. Special dividends above the “ordinary” level require regulatory approval. Statutory earnings differ from GAAP net income in a few key ways, most notably that stat accounting does not permit the deferral of acquisition costs and typically uses more conservative reserve assumptions. As a result, growing companies typically report statutory earnings that are lower than GAAP earnings, which is one reason cash flows from insurance subsidiaries are typically below operating earnings.

Business mix is the primary driver of FCF variations between life companies

Business mix plays a significant role in determining how much cash flow insurers generate. In general, companies that write significant amounts of long-duration, capital-intensive business tend to generate lower cash flow than insurers whose mix is more skewed toward shorter-tail or fee-based products. This is because longer-duration products typically have higher initial selling expenses and require more reserves, reducing cash flow in the early years. By contrast, products such as asset management require very little capital and produce cash flow that is close to earnings. In addition, most insurers’ asset management subsidiaries are owned directly by the holding company, so there is no regulatory process to approve dividends. Most sales of new insurance contracts, especially those with longer durations, are cash flow negative in the first year given high acquisition costs (especially commissions).

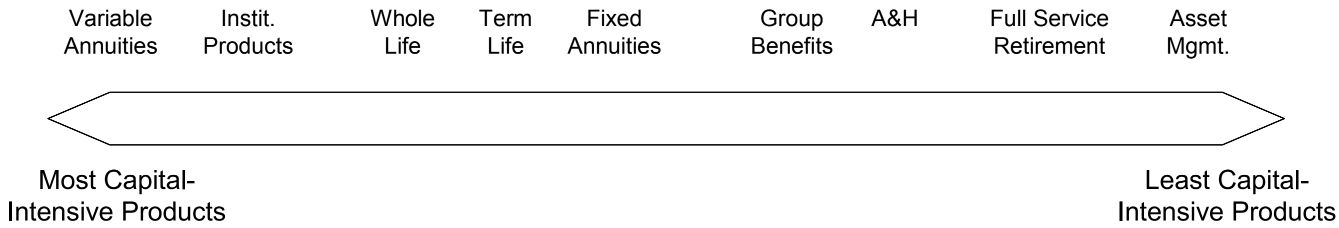
Growth rates also affect the level of free cash flow as new sales consume capital

As mentioned above, new business acquisition costs are not deferrable under statutory accounting, so sales create strain on statutory earnings and near-term dividend potential. Therefore, all else being equal, a company that is growing faster will have lower FCF than a slower growth company. Unlike many European companies which break out capex expense for new business directly, new business

strain for U.S. companies is embedded within statutory earnings, making it harder to distill the factors driving cash flows. The figure below attempts to show the relative capital strain for different types of life insurance products. For P&C, the capital strain depends primarily on the duration of the risk being underwritten.

Figure 4. Spectrum of Life Insurance Products by Capital Intensity

Product placement is representative and may vary by company or contract design



Source: Citi Research

P&C: Shorter-Tail Lines Generally Produce Higher Cash Flow, but CAT Events Create Volatility in Cash Flows to the Holding Company

P&C insurers have a less complex cash flow model, but catastrophic losses make subsidiary dividends less predictable

With respect to the P&C universe, the largest source of recurring unrestricted cash is dividends from the subsidiaries to the parent company. None of our P&C underwriters generates material earnings/cash flow from unregulated entities. Each year, cash is generated at the subsidiary level. A portion of this cash must be left behind to accommodate growth in premiums, while changes to reserves and catastrophe losses would need to be taken into account. Similar to the life companies, the maximum dividend that can be paid each year without getting regulatory approval depends on the state where the subsidiary is domiciled. In most states, a subsidiary can pay dividends equal to the greater of prior year statutory net income or 10% of statutory surplus. As such, earnings from 2013 should have a direct impact on the amount of dividends that can be moved to the parent in 2014.

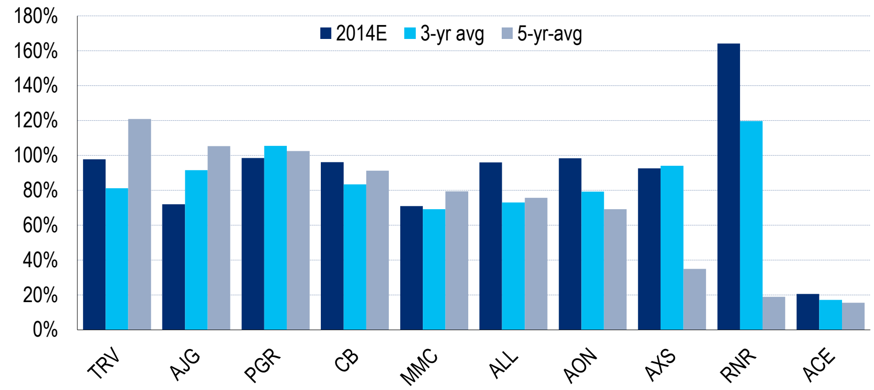
For the brokers, we view free cash flow (cash flow from operations less capital expenditures) as a close proxy for unrestricted cash. Brokers are not as highly regulated as the underwriters, so whatever free cash flow they generate can be used to buy back stock, pay dividends, make acquisitions, or fund growth.

Given the potential for catastrophe losses or significant reserve development, P&C cash flow tends to be significantly more volatile than life cash flow on an annual basis. Figure 5 on the next page demonstrates this by comparing projected free cash flow conversion (as a percentage of operating earnings) for 2014 with the average levels over the past three and five years.

Free cash flow as a percentage of operating income has averaged 71% over the past five years. The brokers tend to have the highest free cash flow as a percentage of operating income, averaging 85% for this period, while the reinsurers produced the lowest. This was largely due to a bad year in 2012, when operating income was negative at both Axis and RenaissanceRe, showcasing the volatility in cash flow for reinsurers. The primary underwriters had average cash flow conversion of 81%.

Figure 5. P&C Cash Flow Tends to Be Volatile on an Annual Basis

Free cash flow / operating earnings



Source: Company reports and Citi Research estimates
Note: Free cash flow for ACE only includes dividends taken from insurance subsidiaries

Releasing Capital from International Subsidiaries a Potential Issue

Company specific factors also play a role in relative cash flow generation, e.g. geographical diversification

One potential issue for both life and P&C insurers is repatriating capital/earnings from foreign subsidiaries. Similar to the U.S., dividends from foreign subs are subject to approval from the local regulator. Regulatory regimes vary by country, but most rely on some form of statutory accounting that differs from U.S. GAAP. Some countries, notably Japan, have more conservative standards than the U.S., which can result in a relatively low percentage of U.S. GAAP earnings being available for repatriation. We note that some companies have developed other means of accessing cash from international subsidiaries, including intra-company borrowing. Our analysis attempts to look at cash flow available for repatriation, whether or not it is actually brought to the holding company (since some insurers may choose not to repatriate for tax reasons, but they still retain access to the cash flow should an attractive opportunity to deploy it arise). However, many insurers do not directly disclose cash flows from international subsidiaries.

Other Potential Capital / Dividend Traps

Negative surplus related to prior losses can also suppress dividend capacity

Another item that can affect an insurer’s ability to withdraw dividends from its subsidiaries is historical losses (either operating or investment losses). If a U.S. insurance subsidiary has negative retained surplus it is ineligible to pay an ordinary dividend, even if the entity has positive statutory earnings. This affected cash flows for several insurers following the financial crisis, and remains an issue for some older runoff blocks. While this capital is not permanently trapped, in the short-run it reduces free cash flow conversion as a percentage of GAAP operating earnings.

Analyzing Industry Cash Flow Trends

Figure 6 and Figure 7 below provide our estimates for 2014 free cash flow generation for both life and P&C insurers. On the following pages, we examine the data in more detail and highlight our key conclusions.

Figure 6. Summary of 2014 Estimated Free Cash Flows (U.S. Life Insurers)
$ in millions

	AFL	AMP	CNO	HIG	LNC	MET	PFG	PL	PRU	RGA	SFG	TMK	UNM	VOYA
Dividends from life insurance subs	1,986	783	239	333	752	3,849	610	305	2,095	336	195	505	687	814
Dividends from P&C subs		(25)	-	800	-	125	-	-	-	-	-	-	-	-
Earnings from non-insurance entities		739	168	87	134	171	351	-	698	58	36	-	50	137
Gross free cash flow to hold co.	1,986	1,498	407	1,221	886	4,145	961	305	2,794	394	232	505	737	951
Holding company interest expense	(129)	(72)	(42)	(230)	(169)	(722)	(88)	(79)	(404)	(91)	(20)	(50)	(88)	(188)
Other holding company expenses	(185)	(150)	(70)	-	-	(1,020)	(20)	-	(54)	78	(20)	(5)	(50)	(300)
Total enterprise free cash flow	**1,672**	**1,276**	**295**	**991**	**717**	**2,403**	**852**	**226**	**2,336**	**381**	**192**	**451**	**599**	**463**
Operating earnings	2,831	1,608	268	1,612	1,493	6,458	1,240	372	4,440	537	245	549	907	716
FCF as % of operating earnings	**59.1%**	**79.4%**	**110.0%**	**61.4%**	**48.0%**	**37.2%**	**68.8%**	**60.7%**	**52.6%**	**70.9%**	**78.4%**	**82.0%**	**66.1%**	**64.6%**
Capital Return Summary														
Common dividends	674	432	50	291	167	1,496	365	19	1,013	88	48	65	157	33
Share repurchases	1,000	1,404	450	1,500	500	1,000	223	-	1,000	248	125	378	450	450
Total capital return	1,674	1,836	500	1,791	667	2,496	588	19	2,013	336	173	443	607	483
Capital return as % of FCF	100.1%	143.8%	169.8%	180.8%	93.1%	103.9%	69.0%	8.4%	86.2%	88.2%	90.2%	98.4%	101.3%	104.2%
Capital return as % of op. earnings	59.1%	114.2%	186.8%	111.1%	44.7%	38.6%	47.4%	5.1%	45.3%	62.5%	70.7%	80.7%	66.9%	67.4%

Source: FactSet (for non-Citi covered companies), company reports and Citi Research estimates

Figure 7. Summary of 2014 Estimated Free Cash Flows (U.S. P&C Insurers and Brokers)
$ in millions

	ACE	AJG	ALL	AON	AXS	CB	MMC	PGR	RNR	TRV
Dividends from life insurance subs	74	-	494	-	-	-	-	-	-	-
Dividends from P&C subs	751	322	1,976	1,528	538	2,000	1,223	1,170	707	3,330
Earnings from non-insurance entities	-	-	-	-	-	-	-	-	-	-
Gross free cash flow to hold co.	825	322	2,470	1,528	538	2,000	1,223	1,170	707	3,330
Holding company interest expense	(196)	(45)	(226)	(154)	(60)	(205)	(108)	(71)	(17)	(239)
Other holding company expenses	(3)	-	-	-	-	(60)	-	(100)	(4)	-
Total enterprise free cash flow	**626**	**277**	**2,244**	**1,374**	**478**	**1,735**	**1,115**	**999**	**686**	**3,091**
Operating earnings	3,045	385	2,337	1,397	516	1,804	1,571	1,014	418	3,159
FCF as % of operating earnings	**20.6%**	**72.0%**	**96.0%**	**98.3%**	**92.5%**	**96.1%**	**70.9%**	**98.5%**	**164.1%**	**97.8%**
Capital Return Summary										
Common dividends	856	187	485	233	116	440	585	893	48	689
Share repurchases	921	-	2,598	1,050	455	1,423	85	225	458	2,600
Total capital return	1,777	187	3,083	1,283	571	1,863	670	1,117	505	3,289
Capital return as % of FCF	284.0%	67.5%	137.4%	93.4%	119.6%	107.4%	60.1%	111.9%	73.7%	106.4%
Capital return as % of op. earnings	58.4%	48.6%	131.9%	91.8%	110.7%	103.2%	42.6%	110.2%	120.9%	104.1%

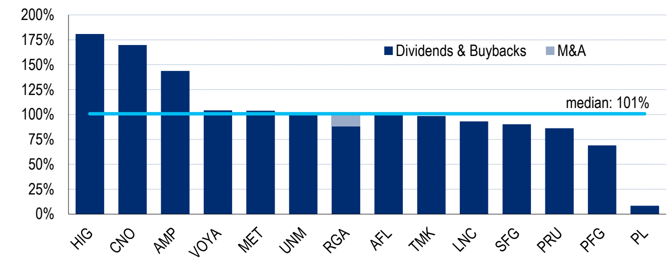
Source: Company reports and Citi Research estimates

Strong Correlation Between Cash Flow and Capital Return

We view FCF as a key indicator of future capital return. On average, we project insurers to return >100% of FCF through dividends and buybacks in 2014

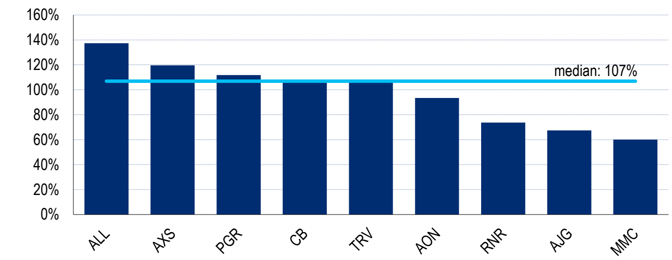
A key reason we believe investors should focus on free cash flow is its high correlation with insurers' capital return to shareholders. On average, we project insurers to return close to 100% of free cash flow through buybacks and dividends in 2014, supporting management claims that companies have excess capital. The number would be even higher if we include a placeholder for M&A as some companies have suggested they are accumulating capital for potential transaction opportunities. As a result, we expect investors to continue using free cash flow as a key tool for forecasting future capital return.

Figure 8. Capital Return as % of FCF (Life)
Based on 2014 estimates



Source: FactSet (for non-Citi covered companies), company reports and Citi Research

Figure 9. Capital Return as % of FCF (P&C)
Based on 2014 estimates



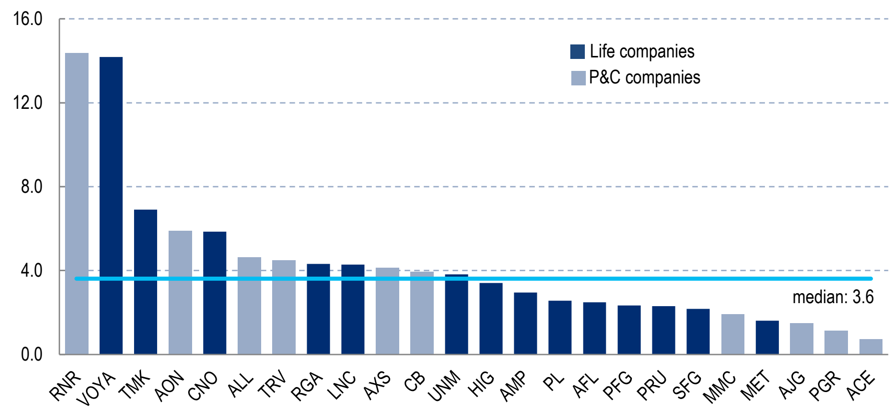
Source: Company reports and Citi Research estimates

Dividend Coverage Ratios Suggest Payouts Could Rise

We estimate that current free cash flow coverage of common dividends is 3.6x

The universe of insurers we analyzed has median free cash flow coverage of forecast dividends of 3.6x, suggesting payout ratios could continue to increase. This has been a trend among life insurers the past few years, and we forecast most companies to grow dividends more quickly than earnings (on average 22% versus 8%, respectively, in 2014). Notably, companies like VOYA and CNO, which both recently initiated dividends, appear to have significant capacity to raise payouts.

Figure 10. Insurers Have Median FCF Coverage of Dividends of 3.6x
Based on estimates 2014 free cash flow and common dividends

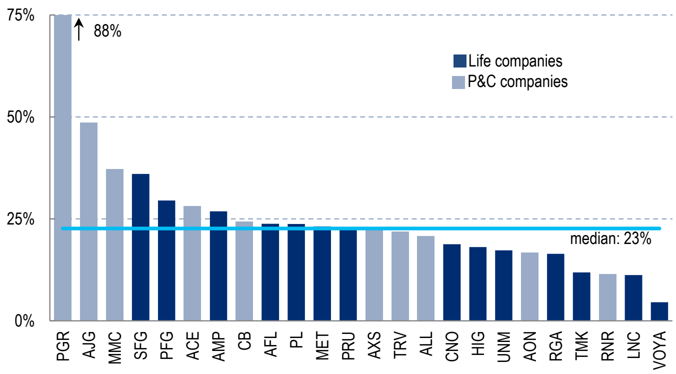


Source: FactSet (for non-Citi covered companies), company reports and Citi Research estimates

We expect payout ratios for both life and P&C insurers to continue rising

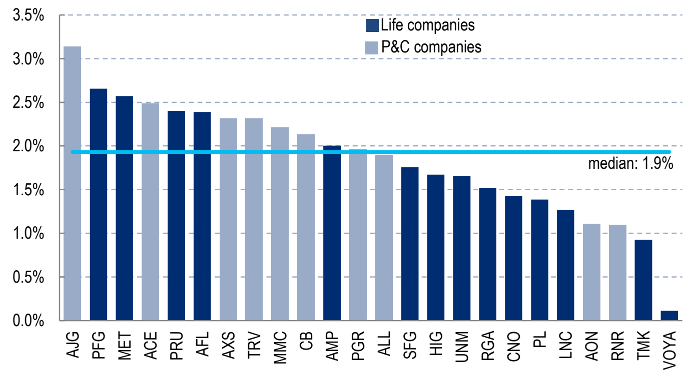
Currently, U.S. life insurers offer a 1.9% dividend yield, the same as our P&C coverage universe. The median payout ratio for the life group is now 22.6%, and we believe a mid-20% ratio is sustainable over time. In the past few years, most companies have increased dividends faster than earnings, a trend we expect to continue near-term. Payout ratios for P&C insurers are also projected to rise further.

Figure 11. 2014E Dividend Payout Ratios
2014E dividend / 2014E operating EPS



Source: FactSet (for non-Citi covered companies), company reports and Citi Research

Figure 12. Current Dividend Yields
Dividend yield as of 6/6/14



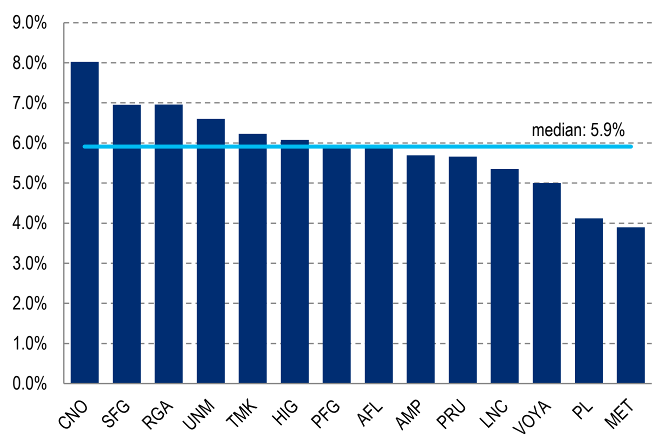
Source: FactSet (for non-Citi covered companies), company reports and Citi Research

FCF Yields Generally in the 6-7% Range

We estimate an average insurance holding company free flow yield of just over 6%

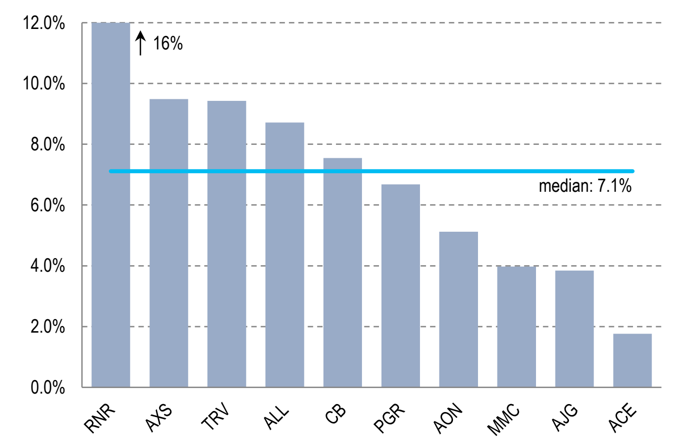
The median FCF yield is around 6% for both the life insurance group and the overall universe of companies we analyzed. For comparison, FCF yields for S&P 500 industrial, consumer staple, and technology companies are 5%, 4%, and 6%, respectively. As discussed previously, we consider current FCF yield to be a more useful metric for analyzing life insurers given greater stability in cash flow. For the P&C universe, looking at a normalized measure of cash flow likely makes more sense given potential yearly volatility.

Figure 13. FCF Yield (Life)
Based on 2014E FCF; as of 6/6/14



Source: FactSet (for non-Citi covered companies), company reports and Citi Research

Figure 14. FCF Yield (P&C)
Based on 2014E FCF; as of 6/6/14



Source: Company reports and Citi Research estimates

What Does FCF Yield Really Mean for Insurers?

We lack the data to compare historical FCF yields for insurers but hope to build this out over time

The key question is what FCF yield is appropriate for insurers? Given limited historical data on holding company free cash flow, it is difficult to construct a historical trading range. This is something we hope to build out over time as we track cash flow data, but for now our conclusions are more anecdotal. In our view, 6-7% FCF yields appear relatively attractive for businesses with long-term embedded cash flows. While paying ~15x cash flow may seem expensive, we argue that this is reasonable compared to other industries. In addition, our definition

of holding company free cash flow is relatively conservative as it does not account for capital retained in the insurance subsidiaries to fund growth. If an insurer were to stop growing and just run off its in-force block, cash flow generation and the FCF yield would increase significantly.

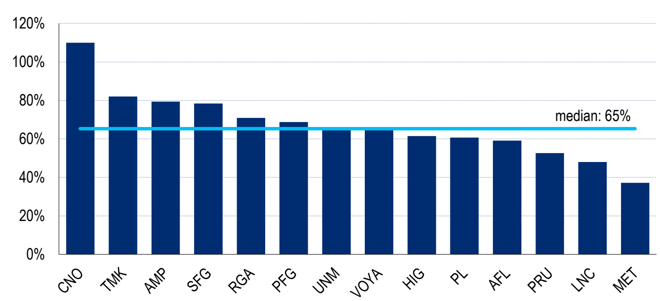
For now, we believe most investors are likely to use FCF yield as a relative metric more than an absolute measure for valuing insurance stocks. Within the life space, CNO stands out as undervalued based on its cash flow generation. For P&C names, the relatively high FCF yields for RNR (16%) and AXS (10%) provide some support for the stocks, but could be heavily impacted by catastrophic events.

Investors Focus on Insurers w/ High FCF Conversion…

Investors tend to focus primarily on FCF as a percentage of operating earnings, which we refer to as FCF conversion

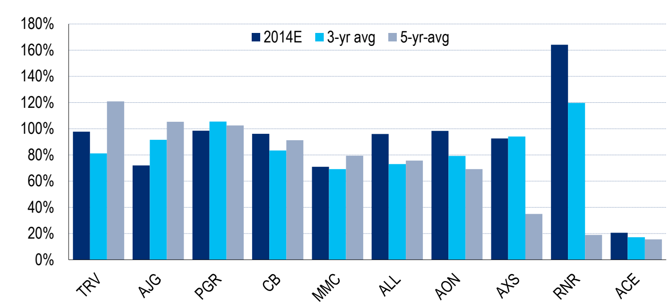
When analyzing free cash flow, we have found that most investors focus primarily on cash flow conversion, or the level of FCF as a percentage of operating earnings. This is seen as both a measure of a company's capital efficiency as well as a gauge of earnings quality. One common criticism leveled against insurers, particularly life insurers, is the sometimes wide gap between operating earnings and net income. Many investors therefore view cash flow as a better measure of a business's true economics or dividend potential. The median FCF conversion rate for 2014 is 65% for U.S. life insurers and 91% for P&C, although there can be relatively wide dispersion between companies given differences in business mix. For P&C companies, we believe average FCF conversion over a longer period is more relevant given the potential for catastrophe losses to distort results in a single year.

Figure 15. FCF as % of Operating Earnings (Life)
Based on 2014 estimates



Source: FactSet (for non-Citi covered companies), company reports and Citi Research

Figure 16. FCF as % of Operating Earnings (P&C)
Sorted by 5-year average



Source: Company reports and Citi Research estimates

Business mix is the primary driver of differences in cash flow conversion rates

- **Business mix the key differentiating factor for life insurers** – Much of the difference in the cash / net income ratio between companies can be explained by business mix or geographical diversification. In general, companies that either focus on basic protection products (CNO, TMK, SFG) or derive significant earnings from asset-management businesses (AMP, PFG) have stronger cash flow conversion than those with significant exposure to capital-intensive products (annuities, guaranteed UL, LTC). Business mix also matters for P&C insurers given different characteristics between long-tail and short-tail lines, as well as differences for catastrophe exposed lines.
- **Growth rates also matter** – Writing new business consumes capital, so companies that are growing quickly tend to produce less cash. However, given relatively slow sales growth in both the life and P&C sectors in recent years, we do not believe this is having a material impact on current cash flow numbers.

- **Company specific considerations** – Within our analysis, a couple of companies stand out for company-specific reasons. On the life side, CNO and VOYA benefit from paying minimal cash taxes due to large deferred tax assets. On the other hand, MET's cash generation is depressed, in part due to a lack of dividends from its Japan business (MET took a $1.3B special dividend in 2012). Within P&C, the offshore reinsurers also benefit from a lack of taxes. However, holding company cash flow for some of the brokers (and ACE) may be understated as not all earnings from foreign subsidiaries are repatriated.
- **Not a perfect measure, but has some validity (especially for life insurers)** – As mentioned above, looking at FCF conversion for any year can be misleading since dividends may be inflated (or hurt) by unusual prior year stat earnings, reductions to statutory surplus (in excess of stat earnings), or special dividends. However, over time, cash flow conversion has been relatively consistent for both life and P&C names. As we discuss on page 14, there is relatively strong correlation between FCF conversion and stock valuation and performance for the life insurance sector.
- **Cash flow conversion for P&C insurers less relevant in any one year** – P&C cash flow can be highly skewed by the occurrence (or absence) of large loss events. Since dividend capacity is based largely on prior year results, projected FCF for 2014 is benefiting from the absence of significant catastrophe activity for most carriers in 2013. In our view, the more relevant metric is average free cash conversion over a multi-year period. If we look at the 3-year average, the ratio drops to 81%. The 5-year average is 71%. On this basis, cash flow conversion is still above the life sector, but the gap is much narrower.

…but Shouldn't Ignore the Benefits of Long-Tail Business

Long-tail business contributes significant earnings and cash flow over time that does not have to be "re-sold" each year

In our view, investors may be under-appreciating the embedded value within long-tailed books of business. While these blocks generate low cash flow in early years, cash generation builds over time. In addition, these blocks provide a significant long-term earnings stream, producing cash and earnings for a number of years, even if sales were to cease. By contrast, short-duration products need to be constantly re-sold to maintain earnings. Therefore, it could be argued that insurers with sizable in-force blocks of long-tail liabilities should trade at higher free cash yields than those with short-tail books and higher FCF conversion. The big hurdle is skepticism around the quality of long-tail exposures given concerns about in-force variable annuity, secondary guarantee universal life (SGUL), and long-term care blocks. In our view, if companies such as LNC or MET could better illustrate the embedded value and future cash flow within their long-tail blocks, it could help them close the current valuation gap versus peers with higher FCF conversion.

Managements Placing Greater Emphasis on Cash Flow

Many U.S. life insurers have improved cash flow disclosure and are beginning to provide guidance

Over the past few years, we have seen improved cash flow disclosure from U.S. insurers, and several management teams are providing guidance for cash flow and capital generation. This has been especially true among the life insurers, where companies appear to be acknowledging the inherent imperfections in GAAP operating earnings. Life insurers have also done a better job illuminating how cash flows will develop in existing blocks of business, especially variable annuities. We view this trend favorably, and believe it has resulted in higher valuations for insurers that have been able to show sustainable high free cash flow generation. As a result, we encourage management teams to continue providing more transparency on the sources and uses of cash flow and capital.

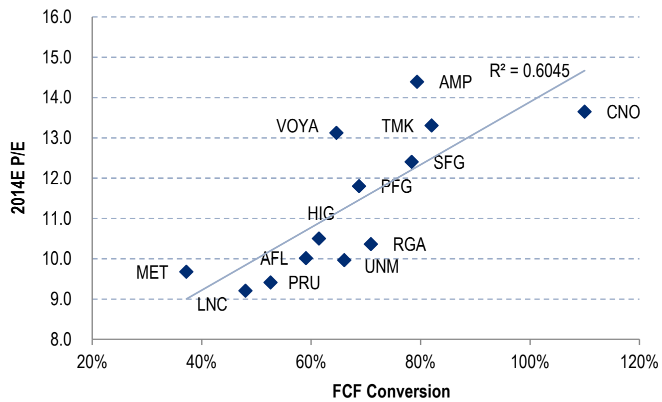
Implications for Valuation & Stock Returns

For life insurers, we see correlation between higher FCF conversion and higher P/E multiples

In our view, cash flow will play an increasing role in valuation, particularly for life insurers. While limited historical data makes it difficult to back-test historical performance, we see positive correlation between cash flow conversion rates and valuation multiples. Over recent periods, there has also been a noticeable linkage between cash flow conversion and stock returns for life insurers. We focus on cash flow conversion as this is a more stable metric over time and is not influenced by the current stock price (unlike FCF yields).

Figure 17. FCF Conversion vs. 2014E P/Es (Life)

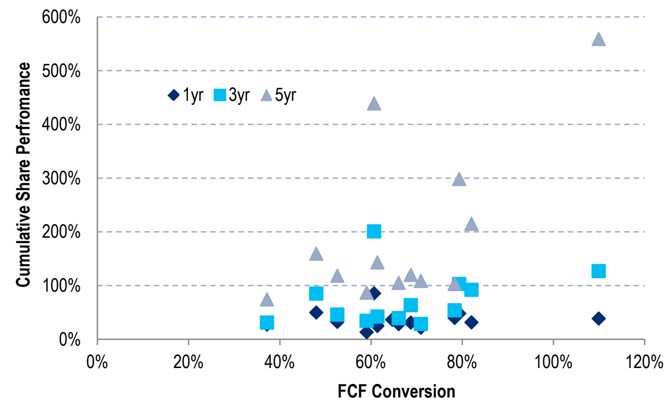
Based on estimated 2014 FCF conversion



Source: FactSet, company reports, and Citi Research estimates
Note: Pricing as of 6/6/14

Figure 18. FCF Conversion vs. Share Performance (Life)

Based on estimated 2014 FCF conversion

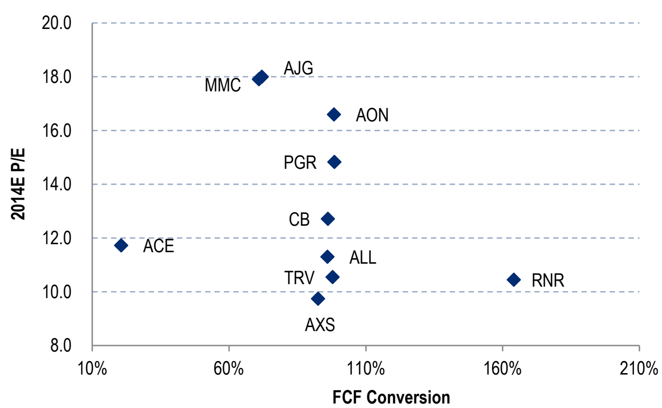


Source: FactSet, company reports, and Citi Research estimates
Note: Pricing as of 6/6/14

This relationship is less clear for P&C stocks, which supports our view that investors focus less on cash flow than other factors in valuing these companies. Whereas life insurance investors often view high cash flow generation as a key driver for generating attractive returns, P&C investors tend to look at high cash flow as an output of disciplined underwriting and investing. In addition, FCF conversion is a more volatile metric for most P&C insurers on an annual basis.

Figure 19. FCF Conversion vs. 2014E P/Es (P&C)

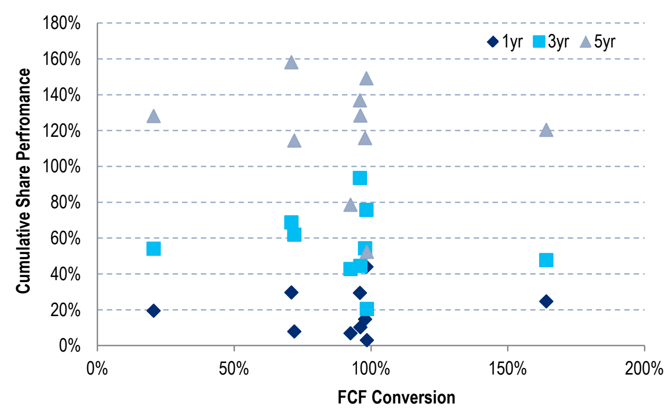
Based on estimated 2014 FCF conversion



Source: FactSet, company reports, and Citi Research estimates
Note: Pricing as of 6/6/14

Figure 20. FCF Conversion vs. Share Performance (P&C)

Based on estimated 2014 FCF conversion



Source: FactSet, company reports, and Citi Research estimates
Note: Pricing as of 6/6/14

Key Conclusions for U.S. Life Insurers

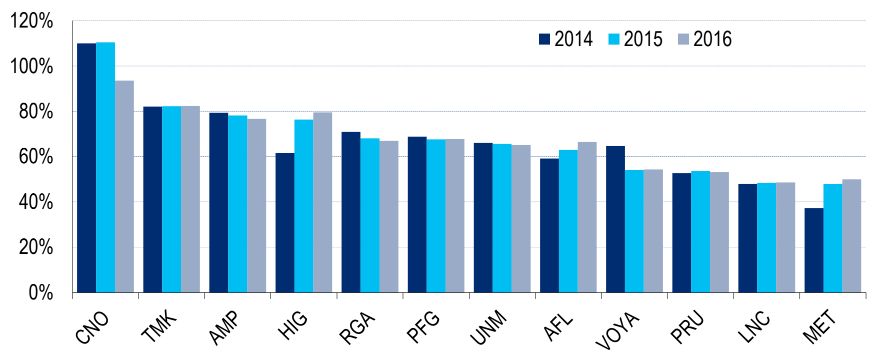
Cash Flow Conversion to Remain Key Metric

U.S. life insurers on average generate FCF equal to ~65% of operating earnings

We expect investors to continue focusing primarily on FCF as a percentage of operating earnings since this makes it easy to compare capital generation across companies. This is also the metric that most companies guide to when forecasting cash flow. As more companies shift away from capital-intensive lines (variable annuities, guaranteed UL) and focus on shorter-tail or fee-based products, FCF conversion should trend slightly higher. However, we forecast FCF conversion to remain in the 60-65% range for the overall industry.

The companies where we project the most improvement in future years are HIG (increased dividends from Talcott Resolution) and MET (higher Japan dividends, benefits from merging statutory entities). On the other hand, we expect FCF conversion to decline for CNO (as it begins to pay some income tax) and VOYA (normalization from unusually strong statutory earnings in 2013).

Figure 21. Projected FCF Conversion Rates for 2014-2016
Sorted by 2015 estimates



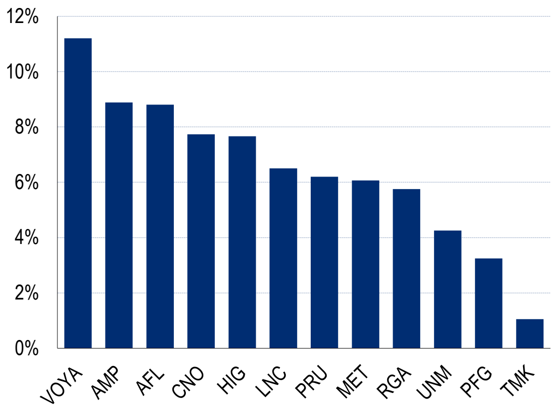
Source: Company reports and Citi Research estimates

Healthy Cash Flow Supports Capital Return Theme

We define excess capital as money that could be used without the insurer being subject to a ratings downgrade

We expect share repurchases and dividend increases to remain key themes for the life insurance sector given strong balance sheets and healthy cash flows. In our view, most of our coverage companies have deployable “excess” capital, which we define as unencumbered cash which can be spent without jeopardizing a company’s rating. In coming up with our estimates, we look at risk-based capital (RBC) ratios relative to minimum thresholds, holding company liquidity above 2x fixed cost coverage, and any restrictions on moving capital to the holding company (such as negative earned surplus in an insurance subsidiary). In many cases, our estimates are more conservative than the excess capital numbers provided by management. We expect most insurers to continue holding more capital than they have historically as a buffer against adverse market movements, effectively raising the minimum RBC threshold.

Figure 22. Excess Capital a Meaningful % of Market Cap
Estimated excess capital divided by market cap (as of 6/6/14)



Source: SNL Financial, FactSet, company reports, and Citi Research estimates

Figure 23. Most Life Insurers Have Deployable Excess Capital
$ in millions; RBC ratios as of 3/31/14 where available

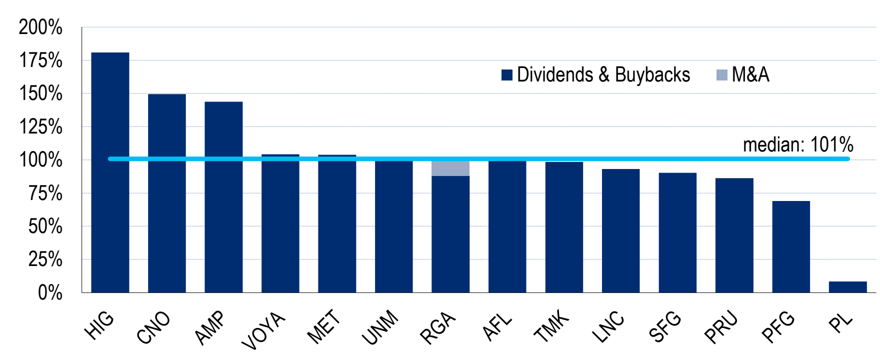
	Current RBC Ratio	RBC Ratio Threshold	Excess Capital	Hold Co. Liquidity	Target Liquidity	Excess Liquidity	Total Excess Capital
AFL	788%	500%	2,000	1,300	800	500	2,500
AMP	525%	425%	591	2,300	900	1,400	1,991
CNO	427%	400%	128	306	150	156	284
HIG	430%	375%	749	1,900	1,400	500	1,249
LNC	501%	450%	808	562	500	62	870
MET	450%	425%	1,539	4,700	2,500	2,200	3,739
PFG	438%	400%	416	350	300	50	466
PRU	457%	425%	1,008	3,200	1,650	1,550	2,558
RGA	285%	275%	65	550	300	250	315
TMK	342%	325%	71	60	55	5	76
UNM	403%	375%	265	622	500	122	387
VOYA	525%	450%	1,026	462	450	12	1,038

Sources: SNL Financial, company reports, and Citi Research estimates

On average, excess capital equals 6.5% of market cap, suggesting companies have significant capacity for share repurchases, dividends, and M&A.

Given our estimated excess capital, we expect most insurers to return all of the free cash flow they generate to shareholders. For 2014, our models assume buybacks, dividends, and announced M&A of slightly over 100% of FCF. This is consistent with the actual behavior we saw in 2013, and we are encouraged that company management teams' are acting as though they have excess capital.

Figure 24. Life Insurers Returning Most Free Cash Flow to Shareholders
2014E capital return / 2014E FCF



Source: FactSet (for non-Citi covered companies), company reports Company reports and Citi Research estimates

Risks to Free Cash Flow Story

In our view, the key risks to sustaining (or improving) the current level of free cash flow generation are required capital contributions to insurance subsidiaries or reduced statutory earnings due to a market decline or investment losses. We consider the most likely triggers for a statutory reserve charge to be sustained low interest rates, poor long-term care experience, or adverse variable annuity policyholder behavior. However, we believe this is unlikely near term. A pick-up in sales growth would also increase capital consumption and depress near-term stat earnings, although we expect the impact to be relatively modest.

Cash Flow Will Continue to Play a Role in Valuation

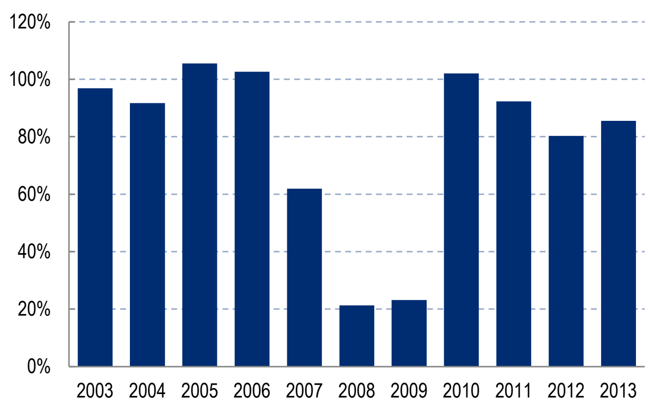
As shown in Figure 17 and Figure 18, we have seen correlation between cash flow and valuation for life insurers. In our view, there are several reasons that we expect investors to continue using cash flow data to supplement traditional valuation metrics when analyzing life insurers:

- **Key driver of capital return** – As shown in Figure 8 and Figure 9, insurers are returning close to 100% of holding company free cash flow to investors, so this is a key metric for projecting future dividends and share repurchases.

Please see our report Where Have All the Earnings Gone? Deconstructing the Recent Lack of Book Value Growth for MET and PRU for more discussion of the gap between operating and net income

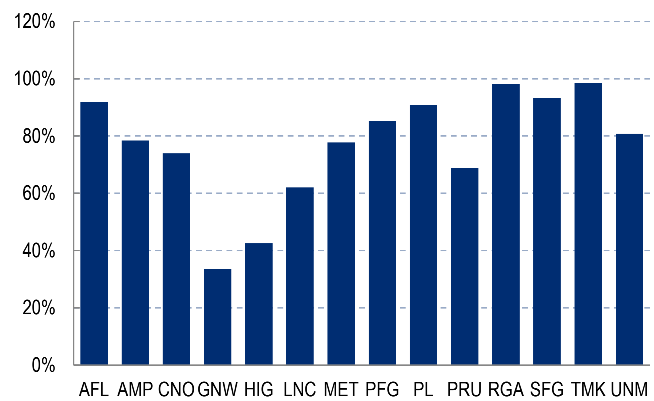
- **Operating earnings and GAAP book value becoming less relevant** – Life insurers have seen increased volatility in net income, which we attribute largely to the proliferation of hedging for market and currency risks. Most hedge assets are required to be marked-to-market through net income, but liability changes are not. This creates a mismatch, so at any given time, book value is not a true representation of economic value. Similarly, there has been a wide gap between operating EPS and net EPS for many life insurers. While much of this noise has been driven by asymmetric accounting and non-economic items, it has raised questions about the quality of earnings. Cash flow provides another way to look at economic value creation and is less affected by accounting noise. While we are not suggesting FCF yield or a DCF approach will supplant P/BV or P/E as the primary approach for valuing insurers, we think cash flow generation will continue to play a role in how investors think about fair multiples.

Figure 25. Life Insurers' Gap Between Net and Operating EPS
Net EPS / operating EPS, shows industry average



Source: Company reports and Citi Research estimates

Figure 26. Results Vary Considerably from Company to Company
Average net EPS / operating EPS for 2003-2013



Source: Company reports and Citi Research estimates

Key Conclusions for U.S. P&C Sector

Share Repurchases to Accelerate as Pricing Cycle Slows

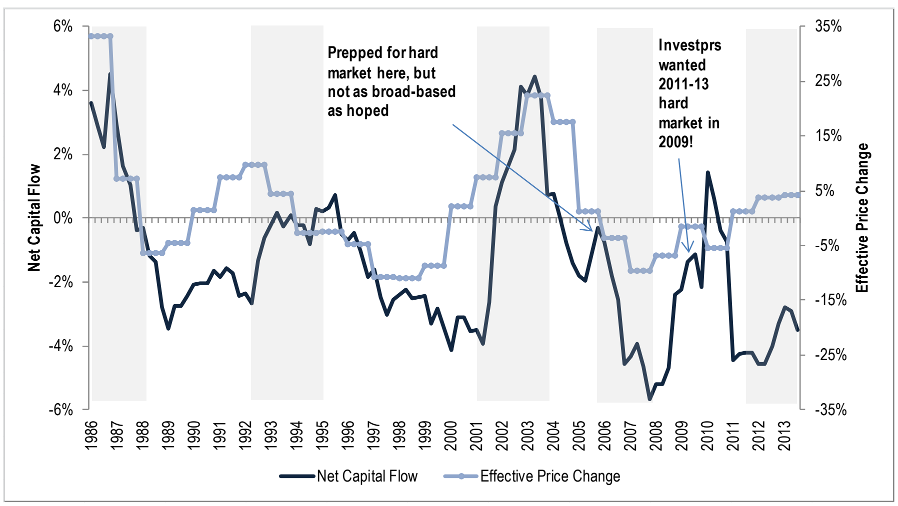
In our view, most P&C insurers are over-capitalized, so all cash flow should be available to shareholders. We expect the P&C underwriters to increase share repurchase as a way to grow earnings during the softening pricing cycle. Historically, during the second half of a hard market share repurchases tend to increase. Pricing is still increasing in most lines, albeit at a slowing rate. With limited growth opportunities available for the industry, we think companies will turn to share repurchase as a way to increase EPS. A number of companies have already committed to this theme of accelerating share repurchase, including ACE, Allstate and Marsh & McLennan.

Increasing Buybacks Good for Earnings Growth…

While share repurchase is a good way to grow EPS when the business environment is becoming more difficult, our analysis shows that there isn't any benefit to valuation from share repurchase in P&C. We view stock buybacks are cyclical: they tend to decrease as pricing accelerates (with capital raises in extreme cases), and increase as pricing decelerates and declines.

It is apparent from the figure below that recent buybacks have increased versus history. Average capital return was 3% of surplus per annum during 2006-13, and 4% during 2011-13.

Figure 27. US Industry Net Capital Flows vs. Effective Price Changes, 1986-2013



Source: ISO, SNL Financial, Citi Research
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.

…but Our Analysis Shows that it Won't Help Valuation

Some clients have argued that higher buybacks could support higher valuations. Yet as the chart 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.

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.

For more on share repurchase cyclicality, see our note: It's Not Complicated: Buybacks Are Cyclical - Increasing Stock Buybacks are Expected, Not Necessarily Bullish published on Feb 27th.

Company Highlights

CNO Financial and Ameriprise Financial are the best cash flow and capital return stories in the US life space

Among U.S. life insurers, we consider Buy-rated CNO Financial (CNO) to be the most attractive cash flow and capital return story in our coverage universe. Neutral-rated Ameriprise (AMP) should also be able to continue returning >100% of earnings through buybacks and dividends near-term. In addition, our analysis suggests that improving cash flow for AFL and HIG could enable capital return for these companies to exceed consensus expectations. On the other hand, we believe buyback expectations for VOYA may be too optimistic.

We believe Allstate represents the best capital return story in P&C, but see limited upside give deteriorating pricing

Within the P&C group, we broadly do not expect the benefit from capital deployment to be able to offset the drag from deterioration in pricing. However, further increases in buybacks and dividends could continue to support the group near-term. In our view, Neutral-rated Allstate (ALL) offers the most compelling capital return story as we see potential for upside to buyback estimates given strong cash flow and re-deployment of the proceeds from the Lincoln Benefit Life sale.

The following section goes through some of the company specific highlights in more detail. We have grouped insurers by business mix or category.

Protection Focused Life Insurers

In general, life insurers with a focus on basic protection products (notably AFL, CNO, TMK, RGA, SFG, and UNM) generate stable and above-average free cash flow. This is especially true of group and supplemental products, which have relatively low capital requirements.

Figure 28. AFL Projected Cash Flow
$ millions

	2014E	2015E
Repatriation from AFL Japan	1,245.1	1,470.6
Contribution from Aflac U.S.	229.9	236.8
Total dividend from Aflac	1,475.0	1,707.4
Allocated expenses	43.0	44.3
Management fees	287.0	295.6
Investment redemption	134.0	-
Other	181.0	186.4
Total cash inflows	**2,120.0**	**2,233.7**
Operating expenses	(74.0)	(76.2)
Interest expense	(197.0)	(192.0)
Debt repayment	(325.0)	-
Other	(111.0)	(100.0)
Total cash outflows	**(707.0)**	**(368.2)**
Free cash flow	**1,413.0**	**1,865.5**

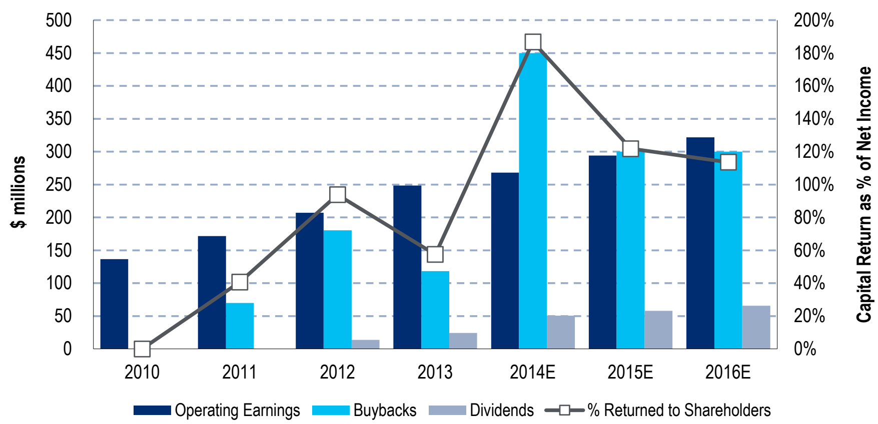
Source: Company reports and Citi Research estimates

Aflac (AFL) cash flow and capital return should continue to trend higher – At its recent investor day, management forecasted 2015 repatriation from Japan of ¥110-¥150B (~$1.1-$1.5B). The midpoint of the range would be roughly in-line with planned repatriation for 2014 (¥127B) despite meaningfully higher FSA earnings (up ~15% ex. 2013 reinsurance benefit) and further build in the solvency margin (projecting an SMR of 780-830% assuming flat rates). While we expect management to maintain a meaningful SMR cushion above its 500-600% minimum target given potential volatility, a ratio near 800% seems excessive. In our view, if the SMR continues to increase over the next few quarters, the repatriation target is likely to increase, similar to 2014. Based on management's cash flow disclosure, we forecast FCF of ~$1.9B next year (pre-dividend) if repatriation comes in at the high end of the target range. FCF would increase further if the company executes additional reinsurance transactions. Even after including our assumed dividend of ~$700M, this yields significant buyback capacity. We currently model 2015 share repurchases of $1.1B but believe this may be conservative.

CNO Financial (CNO): superior cash flow story to continue – CNO generates considerable free cash flow as a result of its business mix and the fact that it currently pays minimal cash taxes. Given the company's focus on protection oriented life and supplemental health products, its insurance subsidiaries provide relatively predictable statutory earnings and dividends. In 2014, CNO expects to generate about $500M of capital through statutory earnings and fee/interest income at the holding company. Subtracting interest expense ($40M), mandatory debt amortization payments ($60M), capital required for growth ($100M), and other holding company expenses (~$10M) leaves approximately $300M of free cash flow for buybacks and dividends. This does not include the OCB sale to Wilton Re, which is expected to generate net proceeds of ~$200M. As a result, we expect management to continue returning significant capital to shareholders and see upside to consensus buyback assumptions (our model assumes $450M of buybacks in 2014 and $300M in 2015). In our view, management is likely to provide an update on capital return plans at investor day on June 26.

We believe investors under-appreciate the sustainability of CNO's cash flow story. While management estimates that FCF will decline ~$50M in 2016 as the company begins to pay some taxes, we project FCF conversion to remain in the 90% range for the next several years (as CNO will continue to benefit from its non-life NOL). This should allow management to sustain meaningful share repurchases and continue increasing the dividend payout ratio. Our $300M repurchase estimate for 2015 represents 8% of the current market cap.

Figure 29. We Forecast CNO to Continue Returning Significant Capital to Shareholders
$ in millions



Source: Company reports and Citi Research estimates

Multi-line Life Insurers

The diversified U.S. life insurers (a group in which we are including LNC, MET, PL, and PRU) generate the lowest free cash flow conversion rates among our coverage universe. This is primarily due to their relatively larger exposure to long-tail liabilities and products with guarantees. In our view, this is a key reason (in addition to the regulatory risk for MET/PRU) that these stocks trade at lower P/E multiples.

Lincoln National (LNC): Cash flow visibility improving – LNC has generated consistent statutory earnings in recent years, and we are encouraged that the company has become less reliant on reserve securitizations. From 2008-2012, statutory earnings averaged 83% of GAAP earnings, but they were only 60% of GAAP excluding reserve financings. Given the decline in term and universal life sales, we expect a lower reserve financing benefit going forward. Management still expects statutory earnings in the $800M range, with gross cash flows to the holding of ~$900M. This implies total free cash flow of just under 50% of operating earnings, below the group average. In our view, the primary driver of LNC's lower FCF is its focus on more capital-intensive businesses (annuities and individual life), although this could gradually improve as it pivots to products without guarantees.

Improving FCF generation is expected to be a key driver for MET to improve overall returns

MetLife (MET): Improving cash flow key to long-term story – MET is guiding to FCF conversion of ~35% in 2014, with that ratio improving to 45-55% in 2015/16. This would bring MET from having the lowest cash flow generation in our coverage universe to being roughly in-line with LNC and PRU. In our view, improving cash flow, and being able to return the excess capital being generated to shareholders, will be key levers to improve overall returns. The key near-term drivers of improved cash flow conversion are expected to be 1) a resumption of dividends from Japan, 2) higher dividends from U.S. subsidiaries, driven in part by capital efficiency benefits from the 4-way merger of statutory entities, and 3) lower sales of capital-

intensive products. Longer-term, we believe FCF conversion in the 50-60% range is achievable as MET's mix continues to shift toward international and basic protection products and interest rates normalize.

Prudential (PRU): Steady capital generation – PRU has consistently generated FCF of ~50% of earnings, a ratio we expect to continue near-term but which could trend up slightly over time. In its international business, capital generation is typically ~60% of earnings, although this is not all repatriated to the U.S. holding company. In the U.S., PRU benefits from having less capital intensive asset management and annuity businesses, although it also has significant exposure to variable annuities and individual life. Over time, as sales shift to less capital-intensive annuities and away from SGUL, cash conversion could improve modestly.

Life / Asset Management Hybrids

AMP and PFG both generate significant capital on an annual basis given their focus on asset management type businesses. However, they take divergent approaches to deploying that capital, with AMP focused on share repurchases and PFG emphasizing dividends and M&A.

Ameriprise (AMP): Superior capital return story rolls on – We project AMP to generate free cash flow of 80-90% of net income over time, which should enable the company to continue deploying significant capital for buybacks and dividends. Over 60% of earnings now come from the company's asset and wealth management businesses, which generate fee income and require limited capital. Even within its insurance businesses, about 40% of earnings come from fee income, and some of the capital strain is mitigated through the use of reinsurance. If annuity and life sales accelerate, the capital strain could reduce cash flow to the low end of our target range. Given AMP's cash flow dynamics and current excess capital position, we expect the company to continue returning the vast majority of its earnings to shareholders. Our model forecasts the company to deploy over 100% of net income for buybacks and dividends for at least the next three years, driving above-average EPS growth and further ROE expansion.

Principal Financial (PFG): Dividends, M&A focus for capital deployment – PFG's cash flow conversion lags AMP's despite having a similar percentage of fee-based earnings. We attribute this in part to its business structure, as Principal Global Investors is owned by Principal Life Insurance Company as opposed to the holding company (so asset management earnings are part of the insurance dividend process). In addition, PFG is investing to grow its international business and is likely repatriating less cash. Nevertheless, we expect the company to generate over $800M of FCF in 2014, above management's guidance for capital return of $500-700M. Over time, management expects to return 65-70% of net income. PFG targets getting to a 40% dividend payout ratio over the next few years (~31% currently), so we expect most of the incremental growth in capital return to go toward dividends. In addition, management has been clear it would like to make additional acquisitions of boutique asset managers. As a result, we assume relatively modest share repurchases.

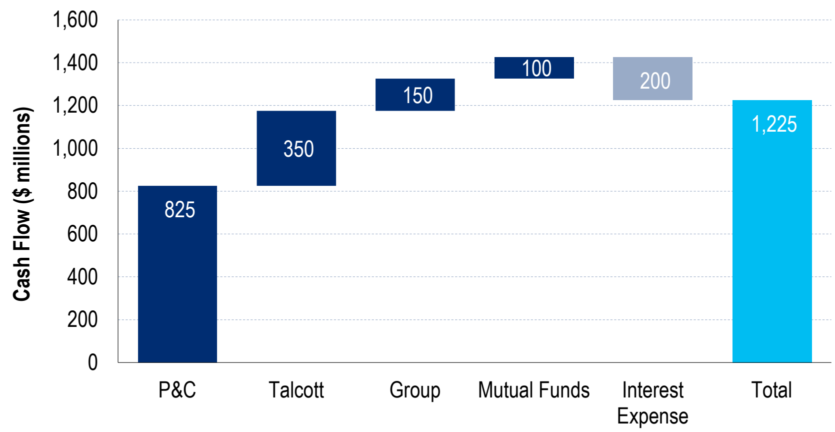
Special Situations

We believe capital return expectations for HIG may be conservative and expect management to update its plan when the Japan sale closes

Hartford Financial (HIG): Capital return story still ramping up – We see further room for HIG to increase capital return given the sale of its Japan business, increased dividend potential from the U.S. blocks within Talcott, and strong capital generation in its core businesses. In addition, we see the target level of liquidity at the holding company coming down over time as HIG repays debt and its equity market exposure declines. Management's current capital plan includes $2B of

buybacks in 2014-2015 ($1.7B remaining) and $656M of debt repayment. We expect this to be updated once the Japan sale closes. Our model assumes an incremental $700M of buybacks and $400M of debt repayment using the capital released by the sale. In total, we assume buybacks of $1.5B in 2014, $1.2B in 2015, and $1.1B in 2016. This could be conservative given expected improvement in free cash flow over the next few years as Talcott begins to release material capital. As shown below, we forecast HIG to generate a little over $1.2B of FCF in 2015 (up from $990M in 2014).

Figure 30. Projected 2015 Free Cash Flow for HIG
$ in millions



Source: Company reports and Citi Research estimates

Our analysis of VOYA's FCF generation suggests capital return expectations may be becoming too optimistic

Voya Financial (VOYA): Are buyback expectations too high? – In our view, one of the most controversial names in the life group is VOYA given divergent expectations for sustainable cash flow and buyback capacity over the next few years. On the company's 1Q conference call, management guided to FCF generation equal to 50% of after-tax operating earnings for 2015/2016. Based on our earnings estimates, this implies FCF of ~$400M in 2015 and ~$425M in 2016. This compares to our forecast of $463M for 2014. Management suggested the reason for the decline is that 2014 stat dividends were inflated by the benefit from the Lehman settlement in 2013 as well as the strong equity market.

While management guidance appears somewhat conservative to us, especially given VOYA's tax assets, we believe investors may be optimistic in extrapolating 2014 FCF going forward. We believe consensus buyback expectations for 2015 are now in the $500M range, with some investors assuming a significantly higher amount. We also assume a sizable increase in the dividend, with total estimated payments of $110M in 2015. Even if our $400M estimate for cash flow in 2015 is too low, investors appear to be assuming the company draws down excess capital at its insurance subsidiaries over the next few years. This seems reasonable as the current RBC ratio of 525% is well in excess of the company's 425% target. However, we expect VOYA to maintain an RBC ratio of at least 450% for the foreseeable future, and getting additional capital out would likely require special dividend approval. As shown in the table on the next page, our current capital deployment assumptions imply that the company reduces excess capital by $285M (or roughly 1/3) over the next three years. In our view, this is reasonable, but we see limited upside to our forecast in a normal market environment.

Figure 31. VOYA Free Cash Flow & Capital Deployment Rollforward
$ in millions; assumes 2015/16 FCF of 50% of operating earnings

	2014	2015	2016
Holdco Liquidity, beginning	600	580	370
Statutory Dividends	814		
Investment Management Earnings	137		
SLDI Capital Contribution	(150)		
Interest Expense	(188)		
Intra-company Loan Repayment	(100)		
Re-branding Expenses	(50)		
Free Cash Flow	463	400	425
Assumed Share Repurchases	(450)	(500)	(500)
Assumed Common Dividends	(33)	(110)	(130)
Holdco Liquidity, ending	580	370	165
Liquidity Target	450	450	450
Potential Further Capital Deployment	**130**	**(80)**	**(285)**

Source: Company reports and Citi Research estimates

P&C Personal Lines

With pricing slowing in personal lines, we think the underwriters will look to accelerate share repurchases to grow earnings. Underwriters have historically increased share buybacks during similar periods in history, when pricing is still going up, but at a decelerating rate.

Allstate's (ALL) sale of Lincoln Benefit Life could enable the company to further increase share repurchases. For the last 3 years, earnings growth at the company has primarily been driven by margin expansion in Homeowners. With pricing now slowing, Allstate is now favoring PIF growth over margin growth in Homeowners. As a result, Allstate will likely need to find other ways to grow EPS. In early 2014, Allstate closed its acquisition of Lincoln Benefit Life, which should add about $1 billion in cash at the parent company. As a result, we think Allstate has additional flexibility to increase the size if its share repurchase, which would act as a catalyst for upside to our EPS estimates. If the full $700 million in remaining cash is deployed this year at $58 per share, we estimate the EPS benefit would be $0.10-0.15 per share, after factoring in lost investment income.

Figure 32. Allstate Can Increase Its Share Buyback

Ending cash balance, 2013	$2,560
Expected subsidiary dividends (2014E)	$2,470
Share repurchase	($2,598)
Dividends	($485)
Interest expense	($226)
Lincoln Benefit Life proceeds	$1,000
Ending cash balance, 2014 (projected)	**$2,721**
Cash retained at parent	$2,000
Remaining cash available for deployment in 2014	**$721**

Source: Citi Research

We think Progressive (PGR) will pay another special dividend in 2014. Although Progressive does repurchase shares, dividends are the preferred method of capital deployment for the company. This is driven mainly by the stock's valuation, at over 2x book value. We think Progressive will end the year with about $650 million in cash above and beyond the $1 billion or so that the company likes to keep available. This should allow for the company to pay another $1 per share, or about 4%, special dividend later in the year, or early in 2015.

Figure 33. Progressive Can Pay A $1 Per Share Special Dividend

Ending cash balance, 2013	**$1,800**
Shareholder dividends YTD	($890)
Share repurchase	($225)
Subsidiary dividends (2014)	$1,170
Interest expense	($71)
Other sources and uses	($125)
Ending cash balance, 2014	**$1,659**
Cash retained at parent	$1,000
Remaining cash available for special dividend	**$659**

Source: Citi Research

P&C Commercial Lines

Our commercial lines coverage is a little more disparate when it comes to returning capital to shareholders. Historically, during the second half of a hard market, share repurchases tend to increase. Commercial lines carriers are still raising prices, albeit at a slowing rate, which makes profitable capital deployment easier when compared to some current reinsurance markets.

For 2014 we are estimating that CB will return 107% of their free cash flow of $1.7 billion to shareholders. This estimate includes $1.4 billion (82% of free cash flow) returned in the form of share repurchases and $440 million (25%) paid out in dividends. For ACE, we are expecting a much lower level of capital return in 2014 when compared to their peers. We estimate $921 million returned in the form of share repurchases and $856 million (25%) paid out in dividends. ACE is keeping a much more conservative balance sheet. ACE's premiums to surplus ratio of 0.5x is well below that of Chubb's 0.8x.

P&C Reinsurers

The reinsurers within our coverage are big on returning capital to shareholders. We believe that this is a result of slowing/declining prices. Historically, share repurchases have increased during the second half of a hard market as capital becomes more difficult to deploy profitably. For reinsurers, that is especially the case as some lines of business are seeing negative pricing (Property Cat Reinsurance down 15% - Guy Carpenter). For more on share repurchase cyclicality, see our note: It's Not Complicated: Buybacks Are Cyclical - Increasing Stock Buybacks are Expected, Not Necessarily Bullish published on Feb 27th.

For 2014 we estimate that AXS will return 120% of their free cash flow of $478 million to shareholders. This projection includes $455 million (95% of free cash flow) returned in the form of share repurchases and $116 million (24%) paid out in dividends. For RNR, we are estimating that they will return 74% of their free cash flow of $686 million to shareholders. This estimate includes $458 million (67% of free cash flow) returned in the form of share repurchases and $48 million (7%) paid out in dividends. We believe that the lower dividend payout ratio for RNR is a reflection of the business that it's in. Property catastrophe reinsurance, RNR's main business, is a more volatile business by its very nature.

Brokers

With commercial pricing slowing in the US, we think the brokers in will buy back more stock and make acquisitions to offset pressure on organic growth rates. Unlike the underwriters, where free cash flow (operating cash flow less capital expenditures) doesn't translate directly into deployable cash, it does for the brokers. This is why free cash flow is so important for the brokers, because whatever free cash flow they generate can be used entirely for growth initiatives, share repurchase or acquisition. In other words, while free cash flow (operating cash flow less capital expenditures) is much higher for the underwriters (10-15% FCF yield), not all of that can be deployed, while free cash flow for the brokers (3-5% yield) can all be deployed.

We expect Marsh & McLennan (MMC) to accelerate share repurchases in 2014. Marsh & McLennan has been buying back stock for years, but it hasn't been enough to offset option dilutions. In 2013, Marsh & McLennan bought back $550 million in stock, but its share count rose 1.2% year over year. This year, we think Marsh & McLennan will buy back over $700 million in stock and expect its share count to fall by a little under 1%. This should help boost EPS growth at a time when organic growth rates are being pressured by moderating US commercial pricing.

Arthur J. Gallagher's (AJG) capital deployment strategy favors acquisition. Year to date, Gallaher has announced two major acquisitions, Wesfarmers and Noraxis, which will cost the company $1.4 billion. This is well ahead of the company's free cash flow of about $275 million, which falls to about $65 million after factoring in dividends. As a result, Gallagher has tapped the equity and debt markets to raise capital for the acquisitions, while also using available cash on hand. With a debt to capital ratio approaching 50%, much higher than the other brokers, we think Gallagher will likely have to use a portion of its free cash flow to lower its debt levels, while the $65 million in excess free cash earned in 2014 will likely go to acquisition.

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Appendix A-1

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