October 8, 2013

ACTION

Buy

Zurich Insurance Group (ZURN.VX)

Return Potential: 24%

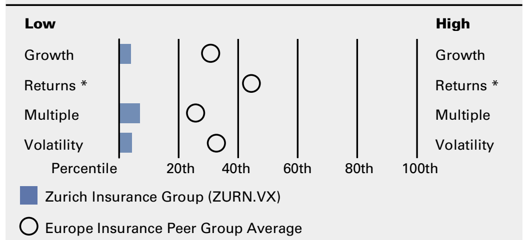
Equity Research

Rising cash flows = rising DPS '14; 'fallen angel', not value trap; Buy

Source of opportunity

We reiterate our Buy on Zurich as our cash flow forecast of US$3.2 bn in 2014 gives us greater confidence in our non-consensus dividend growth forecast (2014E DPS SFr18 vs. consensus SFr17). We also believe that the c.7% yield the market is currently demanding (on 2013 dividend) from Zurich is too penal given the low downside risk. We further make the case for a 100 bp lower yield as a more appropriate level on the basis of long-run stock performance and the 'spread' vs. the Swiss 10 year government bond yield. This valuation tool gives a value of SFr286 (in line with our price target), and SFr270 based on consensus estimates.

Investment Profile



* Returns = Return on Capital

For a complete description of the investment profile measures please refer to the disclosure section of this document.

Catalyst

The upcoming catalyst will be the 3Q13 results on November 14; we believe a clean set of results (i.e., without major reserving/financial restatements) will be the first step towards convincing the market that the management related events of the summer were not related to the financial health of the company. The second catalyst will be the December 5 Investors Day when we expect the announcement of a new set of three-year targets will further reinforce this view. The dividend announcement for next year (February 14) is another near-term catalyst.

Key data	Current
Price (SFr)	230.60
12 month price target (SFr)	286.00
Upside/(downside) (%)	24
Market cap (SFr mn)	33,659.9
Debt/EV (%)	46.1

	12/12	12/13E	12/14E	12/15E
Pretax profit (SFr mn)	4,949.9	4,974.0	5,938.7	6,106.3
Net income (SFr mn)	3,648.3	3,524.0	4,206.9	4,325.7
EPS (SFr)	24.75	23.91	28.54	29.35
ROEV (%)	7.5	--	--	--
Dividend yield (%)	8.0	7.1	7.8	7.8
P/E (X)	8.5	10.0	8.1	7.9
P/EVPS (X)	0.8	1.0	0.9	NM

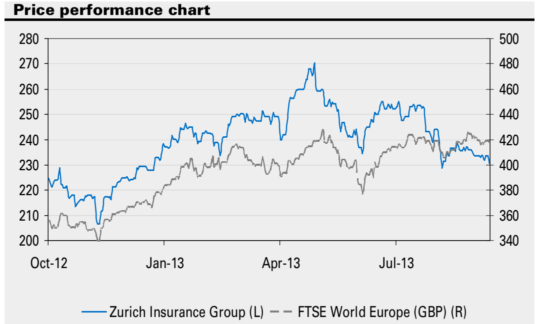
Valuation

We maintain our 12-month RoC based price target of SFr286, implying potential upside of 24%.

Key risks

Key downside risks include a greater than expected impact from recent management changes on the operations of the group leading to a risk to the dividends or to a delay in announcing new targets which could affect investor sentiment. Also, higher than expected large losses could offset the strong underlying loss ratios achieved through repricing the book.

Price performance chart



Share price performance (%)	3 month	6 month	12 month
Absolute	(7.7)	(7.4)	2.6
Rel. to FTSE World Europe (GBP)	(11.8)	(12.9)	(12.4)

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 10/07/2013 close.

INVESTMENT LIST MEMBERSHIP

Pan-Europe Buy List

Coverage View: Neutral

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Zurich Insurance Group: Summary Financials

Profit model ($ mn)	12/12	12/13E	12/14E	12/15E
Non-life pretax result	3,049.0	3,386.1	3,603.4	3,728.5
Life pretax result	1,726.0	1,557.0	1,950.0	1,966.0
Banking pretax result	0.0	0.0	0.0	0.0
Asset management pretax result	0.0	0.0	0.0	0.0
Other pretax result	511.0	492.8	936.3	978.6
Holding company pretax result	0.0	--	--	--
Eliminations	--	--	--	--
Group pretax result	**5,286.0**	**5,435.9**	**6,489.8**	**6,673.0**
Goodwill & other amortisation	0.0	0.0	0.0	0.0
Group exceptional & other items	--	--	--	--
Group pretax result	5,286.0	5,435.9	6,489.8	6,673.0
Minorities & associates	(89.0)	(334.9)	(399.8)	(411.1)
Tax expense	(1,301.0)	(1,249.7)	(1,492.6)	(1,534.8)
Published net income	**3,896.0**	**3,851.3**	**4,597.4**	**4,727.2**
GS normalised net income	**3,896.00**	**3,851.31**	**4,597.35**	**4,727.16**

Embedded value ($ mn)	12/12	12/13E	12/14E	12/15E
Adjusted NAV (excl. GW/prefs/other)	32,387.0	30,514.1	32,387.2	34,229.9
Additional in-force	9,325.1	--	--	--
Total embedded value	**35,361.0**	**35,661.0**	**35,861.0**	**36,061.0**
Published shareholders' equity	**34,494.0**	**32,621.1**	**34,494.2**	**36,336.9**

Per share data	12/12	12/13E	12/14E	12/15E
Published EPS ($)	26.43	26.13	31.19	32.07
GS normalised EPS ($)	18.49	--	--	--
DPS ($)	18.58	18.58	19.67	19.67
GS EVPS ($)	266.93	266.93	277.75	0.00
Published BVPS ($)	235.23	222.45	235.23	247.79

Ratios	12/12	12/13E	12/14E	12/15E
Published P/E (X)	8.5	9.8	8.2	7.9
GS operating P/E (X)	8.5	9.8	8.2	7.9
Published ROEV (%)	7.5	--	--	--
GS operating ROEV (%)	10.7	--	--	--

Note: Last actual year may include reported and estimated data.

Source: Company data, Goldman Sachs Research estimates.

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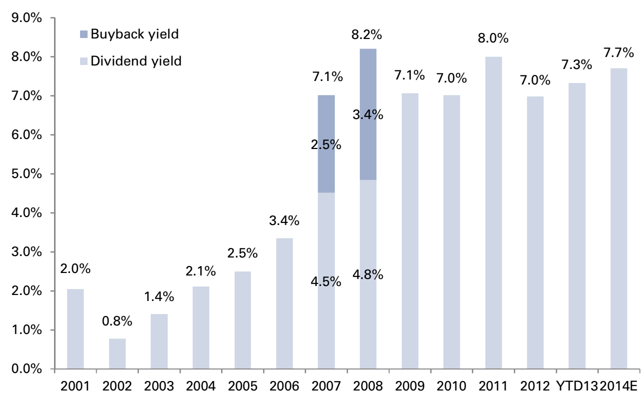
Dividend growth potential suggests stock is a 'fallen angel', not a value trap

We attempt to answer a question we have frequently heard in recent weeks: is Zurich's recent underperformance a buying opportunity or is the stock a value trap which will see further de-rating before it recovers? We think the key to addressing this question is to analyse the cash flows of the group which we forecast at US$2.9 bn for 2013 (US$2.8 bn for 2012), progressing to US$3.2 bn in 2014, which gives us greater confidence in our forecast of an increasing dividend in 2014 vs. a flat consensus outlook (SFr18 in 2014E, SFr17 in 2013E vs. company-compiled consensus (median) 2014 of SFr17).

Stock out of favour despite sustaining high dividend level

We analyse the dividend given the trading history of the stock: Zurich's outperformance in 2007-2008 coincided with the rebasing of capital returns (buybacks took the total yield in 2007 to the 7% level from 3.4% in 2006). The stock has given up this outperformance since 2008, even though the high dividend level was sustained, leading we believe to a disconnect between stock performance and dividends. Therefore, we believe the market is too penal in demanding a >7% yield from the stock, and argue that Zurich should trade at a 100 bp lower yield.

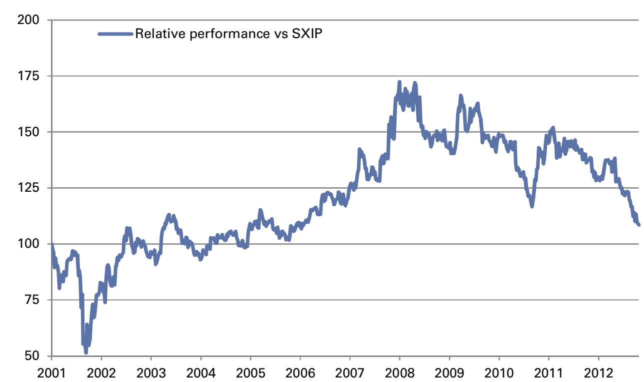
Exhibit 1: Zurich has rebased its capital return yield since 2007…
Year end, %, SFr



YTD13 is our forecast DPS for 2013 of SFr17 divided by share price as of COB October 3, 2013.

Source: Company data, Goldman Sachs Global Investment Research.

Exhibit 2: …but the market has not rewarded the stock for sustaining the high dividend level
Indexed to December 2001, relative to SXIP



Source: Datastream.

To value this non consensus 2014 DPS of SFr18, we believe an appropriate yield on the stock should be 6.3% (100 bp below our YTD13 yield of 7.3%) which would give a valuation consistent with our 12m RoC based price target of SFr286; this compares with a value of SFr270 using a flat DPS (consensus view).

Investors Day, and low US medical claims inflation

Regarding the Investors Day (December 5t), we believe the market will focus on the cash flow update and whether Zurich is going to move the focus of its targets towards reported combined ratios through developing a strategy to control large losses. We also analyse recent trends in US medical claims and related cost trends in workers' compensation; we conclude that we are comfortable with a 2% reserve release forecast run rate. We therefore reiterate our Buy recommendation and believe the stock is a 'fallen angel' and not a 'value trap'.

Cash flow projections give us confidence in our non-consensus dividend growth for 2014

We provide here our estimate of net cash flows (net of interest expenses) that we expect Zurich to present at its Investors Day. We base this forecast on the previous year's (2012) Business Operating Profit even though we recognize that the dividends paid by Zurich's subsidiaries will be based on statutory earnings (this proxy was also used by Zurich at its Investors Day presentation in 2012). We would also highlight the following points regarding this forecast:

- **Non life:** we have factored in a US$100 mn charge for capital required (was $0 last year) as growth in exposures was stronger in 2012 in our view (local currency growth in FY12 was 7% vs. 0% in FY11). The low tax and other ratio reflect Zurich's efficient organizational structure regarding the Irish entity. The Germany adjustment reflects the US$400 mn charge taken last year (and not repeated this year). We note that the large loss impact in the two reporting periods (2011 and 2012) has been similar and hence we do not make any adjustments for large losses.
- **Life:** we have been fairly conservative as we have factored in some growth from Santander but this number could surprise positively.
- **Farmers:** our 'taxes and others' loss of US$700 mn reflects US taxes and also Farmers Re losses in 2013 (which were about the level of 2012).
- **Non core**: we have factored in a US$170 mn capital release from Zurich Specialties London (ZSL) and applied a ratio of two-thirds cash impact (in line with that seen in 2012).

Exhibit 3: Zurich's cash flow expected to cover the dividend in 2013…
US$ mn, %

BOP to cash flow 2013	Non life	Life	Farmers	Non core	Others (inc interest)	Total
2012 BOP	2,095	1,352	1,415	130	(903)	**4,089**
Capital required for growth	(100)	(350)	0	0	0	(450)
Taxes and Others	(100)	(473)	(700)	0	0	(1,273)
Adjust for Germany	400	0	0	0	0	400
ZSL transfer to Swiss Re	0	0	0	113	0	113
2013 cash flow	**2,295**	**529**	**715**	**243**	**(903)**	**2,879**
% of 2012 BOP	110%	39%	51%	187%	100%	70%

Source: Goldman Sachs Global Investment Research.

Overall, the US$2.9 bn cash flow is about 70% of the 2012 BOP (reported) and compares to our forecast SFr17 DPS (or c.US$2.7 bn). Zurich had commented at its 1H2013 results that its cash flows were comfortable and were higher than last year's 1H, and that the economic position of the group was largely unchanged (Z ECM ratio at FY was 114%).

Downside risks to 2013 dividend manageable in our view

Since there is a time lag (i.e., subsidiaries pay dividends in 2013 based on statutory 2012 earnings), we are reasonably comfortable with our US$2.9 bn cash flow forecast. There is downside risk from a lower than expected cash component of the ZSL transfer (we forecast US$113 mn), but we believe this is manageable, particularly given the central liquidity pool of 'several billion USD', as stated at the Investors Day 2012.

2014 cash flow of US$3.2 bn should cover our SFr18 DPS forecast (vs. cons SFr17)

More importantly, if we were to roll this cash flow forecast forward by one year we would get to US$3.2 bn cash flow for 2014 which should support our forecast dividend growth in 2014 – DPS of SFr18 (US$2.9 bn). Since the 2014 DPS will be driven off 2013 earnings, the risk to the downside will come from potential weakness in 2H13 earnings.

Exhibit 4: …and supports our growing dividend in 2014 (SFr18 vs. cons median SFr17)
US$ mn, %

BOP to cash flow 2014	Non life	Life	Farmers	Non core	Others (inc interest)	Total
2013E BOP	2,914	1,327	1,482	52	(930)	**4,846**
Capital required for growth	(100)	(350)	0	0	0	(450)
Taxes and Others	(100)	(464)	(700)	50	0	(1,214)
2014 cash flow	**2,714**	**513**	**782**	**102**	**(930)**	**3,181**
% of 2013 BOP	93%	39%	53%	196%	100%	66%

Source: Goldman Sachs Global Investment Research, Company-compiled consensus.

Risk to 2014 DPS is largely from 2Q13 level of large losses continuing into 2H13

Given the one year lag in cash flows and earnings, we believe the risk to 2014 DPS growth will be from earnings in 2H13 relating to large losses in 2H13 continuing at the very high level seen in 2Q13. This would mean a run rate of non-life BOP for 3Q13 and 4Q13 of c.US$0.6 bn (US$563 mn in 2Q13) per quarter, implying that our forecast non-life BOP for 2H13 of US$1.6 bn would be about US$0.3 bn too high. If we were to exclude this from our 2013 forecast (only for this scenario), then this would reduce the 2014 group cash flow forecast (all else equal) to US$2.8 bn. In this scenario, Zurich would still be able to maintain a dividend in 2014 at SFr17 (in line with consensus view).

However, we do think that this high level of large losses was an anomaly as the high frequency was an industry-wide issue and can also be seen in the context of the historical run rate of these losses (Exhibit 7).

Cash flow forecasts in the context of historical remittance ratios

Further, to put our cash flow forecasts into context, we show the cash flow history of the group since 2010, compared with the BOP of the previous year. The cash flow/BOP ratio rises from 52% in 2010 to 68%/66% in 2011/2012; we think this goes little higher in 2013 to 70% (with the non life ratio at 110%) owing to the one-off effects of German reserving not being repeated in 2013.

Exhibit 5: Cash flow profile by segment
US$ bn, %

Cash flow, US$bn	2010	2011	2012	2013E	2014E
Non-life	2.1	2.4	2.2	2.3	2.7
Life	0.5	0.6	0.5	0.5	0.5
Farmers	1.2	1.0	0.8	0.7	0.8
Non core	0.1	0.3	0.5	0.2	0.1
Others*	(1.0)	(1.0)	(1.2)	(0.9)	(0.9)
Total	**2.9**	**3.3**	**2.8**	**2.9**	**3.2**
BOP, US$bn	2010	2011	2012	2013E	2014E
Non-life	2.7	2.2	2.1	2.9	3.2
Life	1.5	1.4	1.4	1.3	1.4
Farmers	1.7	1.5	1.4	1.5	1.6
Non core	(0.2)	(0.0)	0.1	0.1	0.1
Others	(0.8)	(0.8)	(0.9)	(0.9)	(0.9)
Total	**4.9**	**4.2**	**4.1**	**4.8**	**5.4**
Cash flow/previous year BOP	2010	2011	2012	2013E	2014E
Non-life	61%	90%	98%	110%	93%
Life	34%	41%	37%	39%	39%
Farmers	77%	59%	54%	51%	53%
Non core	nm	nm	nm	nm	nm
Others	nm	nm	nm	nm	nm
Total	**52%**	**68%**	**66%**	**70%**	**66%**

* Others in 2012 include Germany and contribution to the Central liquidity pool.

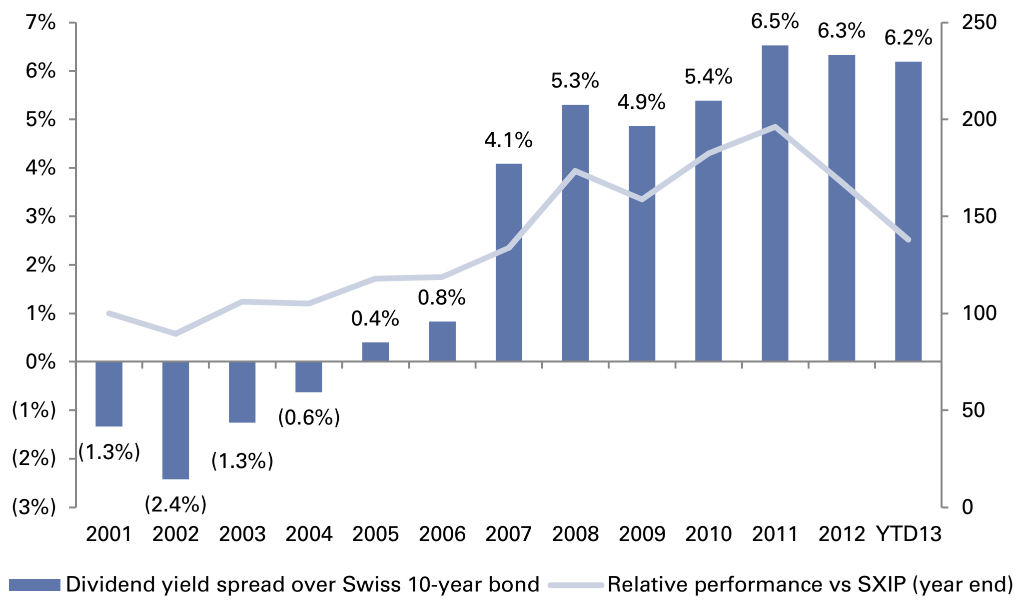
Source: Company data, Goldman Sachs Global Investment Research.

How should we value this dividend level?

Having made our case for a SFr18 DPS in 2014, we think the next logical question is how to value this, or, what level of yield is appropriate for the stock. To answer this, we look at a long run ‘spread’ between Zurich’s dividend yield and the Swiss 10 year government bond and note the following:

- The spread saw a distinct increase from 0.8% to 4.1% in 2006-2007 (helped also by the buyback yield of 2.5%) – this was accompanied by relative outperformance (vs. SXIP).
- This spread then again increased in 2011 to 6.5% – but after this period, the stock has been underperforming on a relative basis.

Exhibit 6: Market not rewarding Zurich’s yield spread over Swiss government bonds
Zurich’s dividend yield spread over Swiss 10-year bond (LHS), Zurich’s relative performance vs. SXIP (indexed, RHS)



YTD 13 is our forecast DPS for 2013 of SFr17 divided by share price as of COB October 3, 2013.Dividend yield for 2007 and 2008 includes buyback.

Source: Datastream, Company data, Goldman Sachs Global Investment Research.

The average spread between 2007 and 2010 is 4.9% compared with 6.4% for 2011 to 2013, i.e., a difference of c.150 bp. If the Swiss 10 year bond rises from the current 1% to 1.5% by 2014, as per our Economists’ forecasts, the rest of this excess spread is 100 bp, leading to our conclusion that the market is too penal by 1 pp.

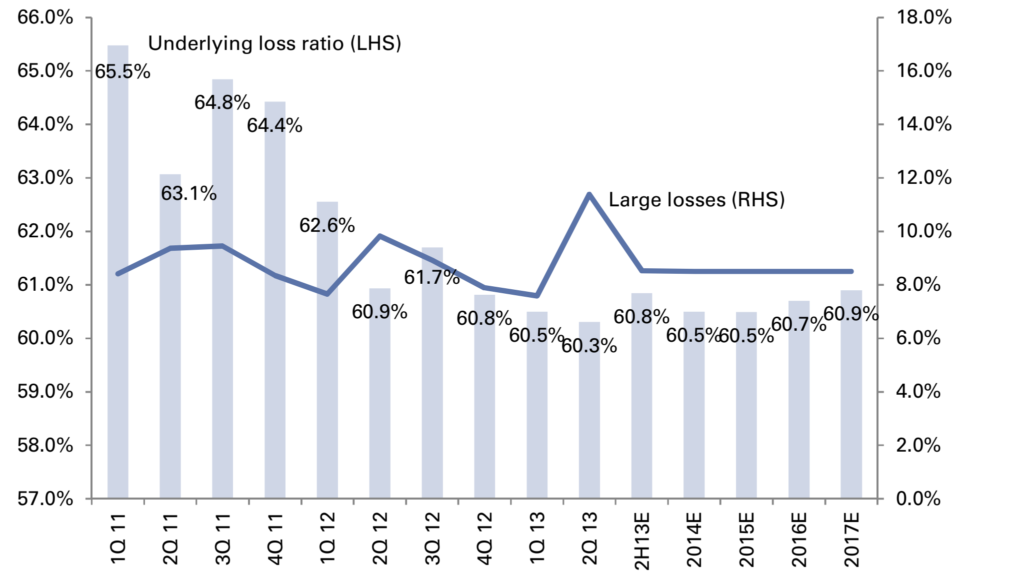
We estimate the stock yields 7.3% (2013E YTD), and so if we were to value the 2014 dividends at 6.3%, we would get to a valuation in line with our 12m RoC based price target of SFr286 (24% potential upside). If instead, we were to use the consensus dividend in 2014 of SFr17, we would get to a value of SFr270 (17% upside).

December 5 Investors Day: What do we expect?

Given recent management events, there has been much debate as to what to expect at the Investors Day. We believe Zurich will proceed with its new targets (previous targets were for a three year period 2010-2013) and we anticipate a focus on moving the debate around underwriting to the ‘reported’ combined ratio, above and beyond the underlying level which has improved substantially already.

To achieve this, the only missing part in our view is Zurich’s strategy regarding controlling the large losses (with both underlying improving and reserve releases stable), which Zurich has described in the past as random in nature.

Exhibit 7: Underlying loss ratio has benefited from past efforts; large losses remain high
%



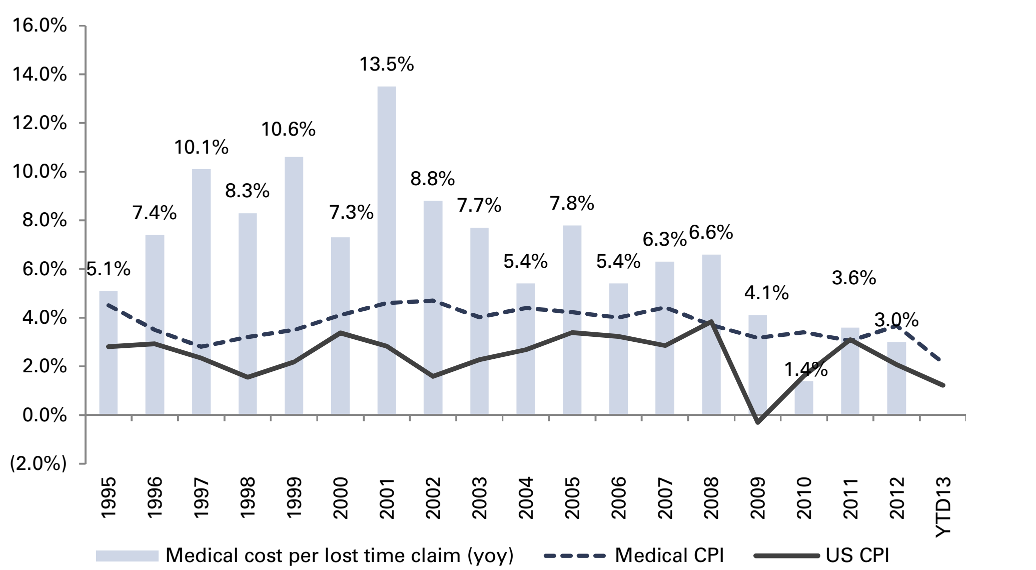
Source: Company data, Goldman Sachs Global Investment Research.

Reserve releases: We are comfortable with a 2% run rate

We analyze one of the key areas where the P&C industry has difficulty in estimating reserve levels owing to the very long tail of the book: workers' compensation in the US (where Zurich has a large presence).

With medical CPI in the US in 2013 at its lowest point (2%) since at least 1995, we again look at the recent data points on medical costs and reserve releases in the US. As we have written in the past, our metric of choice (see *INSights – Inflation: a question of definition*, April 6, 2011) is the medical cost per lost time claim, which is also running at the lowest level since 1994 (including the exceptionally low increase of 1.4% in 2010, which was low probably as a result of a sudden upsurge in the frequency of small lost-time claims).

Exhibit 8: Medical claims costs converging with medical CPI
Medical costs represent costs for injuries that resulted in time off work; 2012 data is preliminary for the medical costs; YTD13 data represents data to August 2013



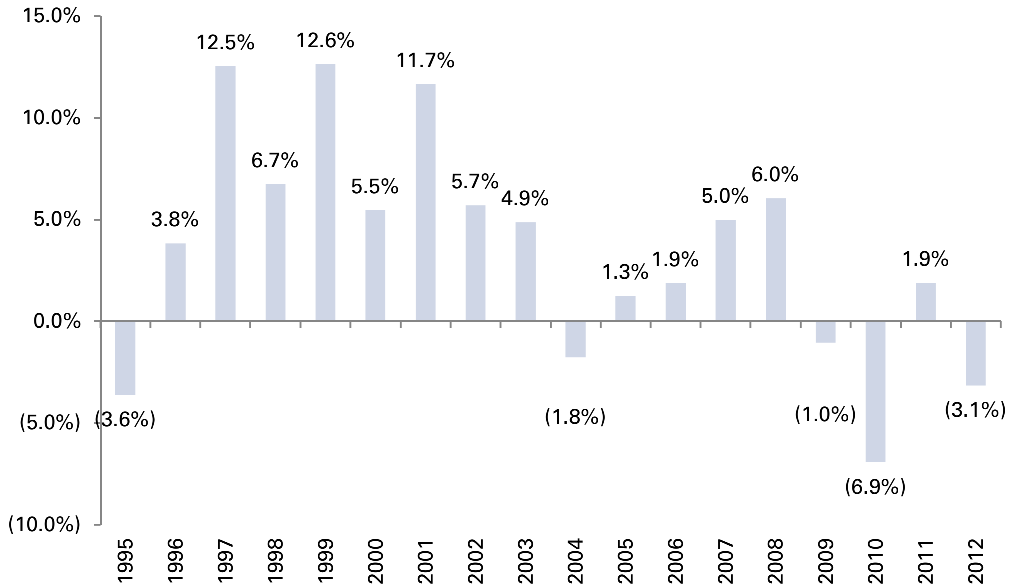
Source: Datastream, NCCI.

In the context of this low medical claims inflation environment, it is interesting to see that the US P&C industry's reserve releases also appear to have stabilized at the 2% level (total releases since 2006 of c.US$67 bn, vs. US$101 bn of reserve additions 1993-2005).

We believe this low level of medical claims inflation has a positive read across for Zurich which has a large exposure to the US workers' compensation business.

We also show in Exhibit 9 the net loss cost trends for workers' compensation (detailed calculation in the Appendix).

Exhibit 9: US workers' compensation net loss cost change
%

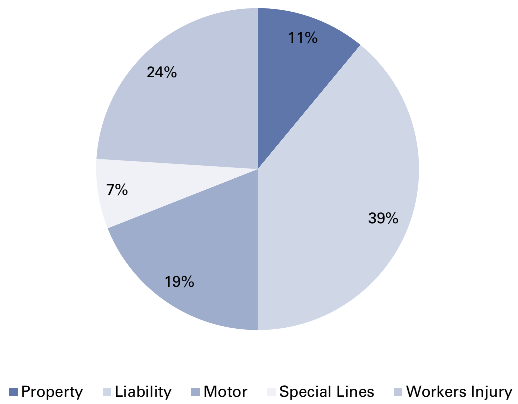


Source: Datastream, NCCI.

On the topic of the improvement in underlying loss ratio, we should highlight Zurich's comments that the Global Corporate line had seen an improvement in motor, construction and energy, and the NAC segment benefited from an improvement in property (and also some re-underwriting efforts). The acquisition of Zurich Santander helped lower the underlying loss ratio by 50 bp. Zurich had highlighted at its Investors Day last year that part of the reason for this improvement was a very focused portfolio management (e.g., its four tier client rating system which is available at the underwriter level).

On reserving, we note as well that The Zurich Way of Reserving (in place since the restructuring of the group began in about 2004) has ensured a fairly conservative approach, which can be seen in the comparison of reserve levels to ultimate loss ratios for the US market where Zurich reports a higher number than the industry.

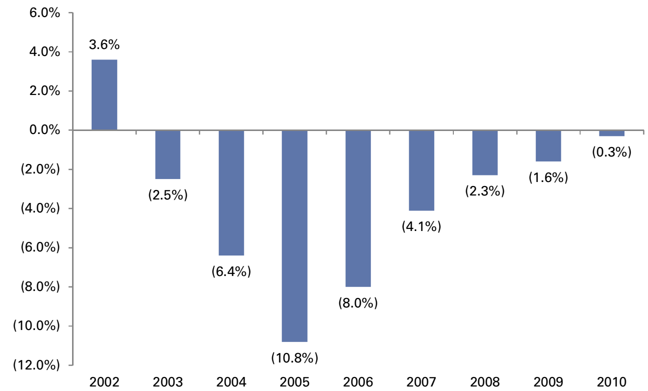
Exhibit 10: Zurich US$55 bn reserves by line, 3Q12
%, long tail orientation of Zurich's reserves



Workers Injury includes Workers Compensation in the US and Employers Liability in the UK

Source: Company data.

Exhibit 11: Zurich's reserve releases – less from the recent underwriting years
%, break-out of Zurich's cumulative reserve releases by accident year; negative is a release



Source: Company data.

Appendix

Exhibit 12: Zurich's dividend yield vs. major government bond yields (10 year)
%

Year end	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	YTD13
Zurich dividend yield	2.0%	0.8%	1.4%	2.1%	2.5%	3.4%	4.5%	4.8%	7.1%	7.0%	8.0%	7.0%	7.3%
Government 10 year bond yields	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	YTD13
Switzerland	3.4%	3.2%	2.7%	2.7%	2.1%	2.5%	2.9%	2.9%	2.2%	1.6%	1.5%	0.7%	1.1%
Germany	4.8%	4.8%	4.1%	4.1%	3.4%	3.8%	4.2%	4.0%	3.3%	2.8%	2.7%	1.6%	1.8%
US	5.0%	3.8%	4.3%	4.2%	4.4%	4.7%	4.0%	2.3%	3.8%	3.3%	1.9%	1.8%	2.6%
Zurich spread vs. government bonds	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	YTD13
Switzerland	(1.3%)	(2.4%)	(1.3%)	(0.6%)	0.4%	0.8%	1.6%	1.9%	4.9%	5.4%	6.5%	6.3%	6.1%
Germany	(2.8%)	(4.0%)	(2.7%)	(2.0%)	(0.9%)	(0.4%)	0.3%	0.9%	3.8%	4.2%	5.4%	5.4%	5.5%
US	(3.0%)	(3.1%)	(2.9%)	(2.1%)	(1.9%)	(1.4%)	0.5%	2.6%	3.2%	3.7%	6.1%	5.2%	4.7%

Source: Datastream, Company data, Goldman Sachs Global Investment Research.

Exhibit 13: US workers' compensation costs declined in 2012 driven by falling claims frequency
% change yoy

US Workers' comp Loss drivers %	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Lost time claims Frequency (A)	(4.2%)	(4.4%)	(9.2%)	0.3%	(6.5%)	(4.5%)	0.5%	(3.9%)	(2.3%)	(4.5%)	(6.9%)	(4.5%)	(4.1%)	(3.7%)	(6.6%)	(4.5%)	(2.2%)	(4.3%)	(5.7%)	(3.8%)	(0.9%)	(5.0%)
Total Severity (B)	**7.8%**	**(1.8%)**	**(4.9%)**	**13.9%**	**6.8%**	**13.3%**	**17.8%**	**17.3%**	**20.7%**	**17.4%**	**22.7%**	**11.9%**	**12.3%**	**6.4%**	**12.2%**	**11.7%**	**12.3%**	**13.8%**	**6.1%**	**(1.0%)**	**5.8%**	**4.0%**
Lost time claims Severity	*1.0%*	*(3.1%)*	*(2.8%)*	*4.9%*	*1.7%*	*5.9%*	*7.7%*	*9.0%*	*10.1%*	*10.1%*	*9.2%*	*3.1%*	*4.6%*	*1.0%*	*3.1%*	*5.6%*	*6.2%*	*8.8%*	*0.7%*	*(3.0%)*	*2.2%*	*1.0%*
Medical cost per lost time claim	*6.8%*	*1.3%*	*(2.1%)*	*9.0%*	*5.1%*	*7.4%*	*10.1%*	*8.3%*	*10.6%*	*7.3%*	*13.5%*	*8.8%*	*7.7%*	*5.4%*	*9.1%*	*6.1%*	*6.1%*	*5.0%*	*5.4%*	*2.0%*	*3.6%*	*3.0%*
Average weekly wage (C)					3.6%	4.2%	5.2%	5.6%	4.7%	6.3%	2.3%	1.1%	2.7%	4.3%	3.5%	4.7%	4.6%	2.7%	1.1%	2.3%	2.9%	2.0%
Net Loss cost change (A*B/C)					(3.6%)	3.8%	12.5%	6.7%	12.6%	5.5%	11.7%	5.7%	4.9%	(1.8%)	1.3%	1.9%	5.0%	6.0%	(1.0%)	(6.9%)	1.9%	(3.1%)
US real GDP growth yoy					2.5%	3.7%	4.5%	4.4%	4.8%	4.1%	1.1%	1.8%	2.5%	3.6%	3.1%	2.7%	1.9%	(0.0%)	(2.6%)	2.8%	2.1%	2.0%

Source: Datastream, NCCI.

Exhibit 14: Zurich has also given up its outperformance vs. US non life peers
Indexed; comparison of Zurich's relative performance since 2002 low vs. an equal weighted average of Travelers, Chubb, ACE, Allianz, Zurich

Source: Datastream.

Disclosure Appendix

Reg AC

We, Vinit Malhotra, CFA, In-Yong Hwang and Elizabeth Rogers, hereby certify that all of the views expressed in this report accurately reflect our personal views about the subject company or companies and its or their securities. We also certify that no part of our compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

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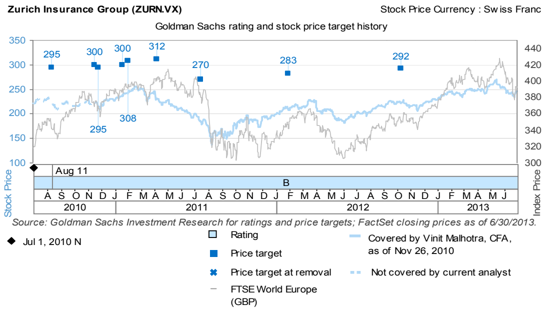

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