AozoraStep

Direct Line Insurance Group: Car and repair price deflation could lead to a surge in profits

Company:	Direct Line Insurance Group (DLG LN)	**Market Cap:**	£2.25bn
Industry:	Insurance	**Solvency II:**	192%*
Country:	UK	**Revenue:**	£4bn*
Date:	8th November 2023	**Net Income:**	£100mio*
Dividend:	-	**Net insurance margin:**	>10%
Entry:	£2.2bn	**Target:**	£3.25bn (+48%)

*estimated based on doubling H1 23 results and certain guidance from management

Why Direct Line Insurance?

- 40% of revenues is motor insurance, which had a £180mio loss in H1 23 due to inflation. This is now reverting, as they write profits again
- Sold their brokered commercial insurance business for £520mio + £30mio earn out, which will increase their solvency II ratio from 147% to at least 192%
- Very strong and conservative investment portfolio with 1/3 in cash, ½ in investment grade
- Sensitivity analysis shows high protection in case of interest rates declines with 100bps decline leading to only 1% decline in solvency II
- Priority is on margins rather than volumes in Home insurance, Commercial market remains positive and Rescue and other personal lines is growing with a new pet platform later this year

About Direct Line Insurance Group

Direct Line Insurance Group is a UK focused insurance company that focuses on Motor Insurance (44%), Home Insurance (24%), Rescue Insurance (21%) and other insurance such as Pet Insurance or Commercial Insurance (2% & 6%). The company has lost more than half of their market value due to rising car and car parts prices as well as higher car theft, which has led to losses in their Motor Insurance business. In H1 23

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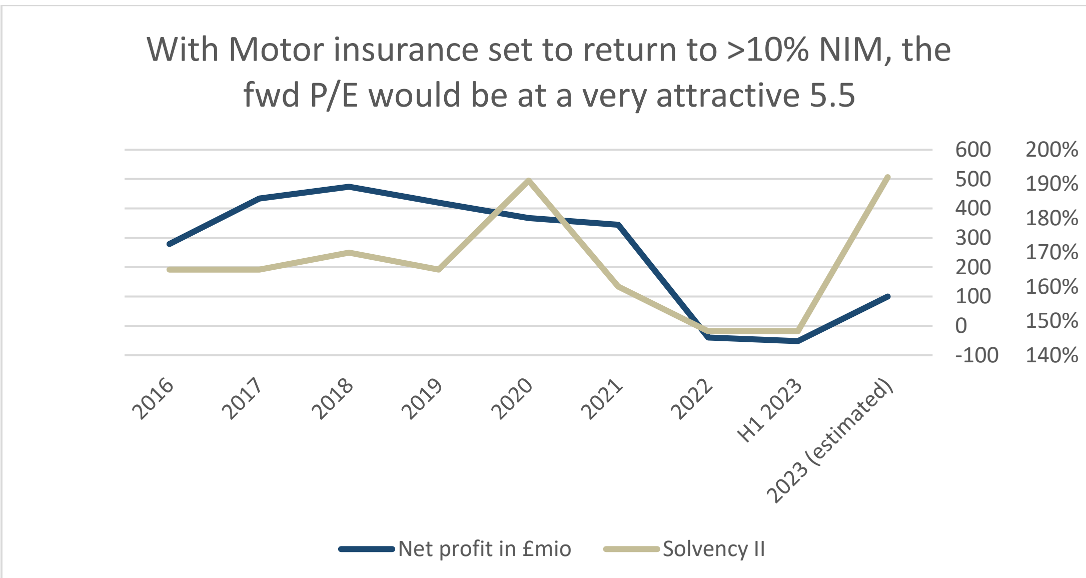
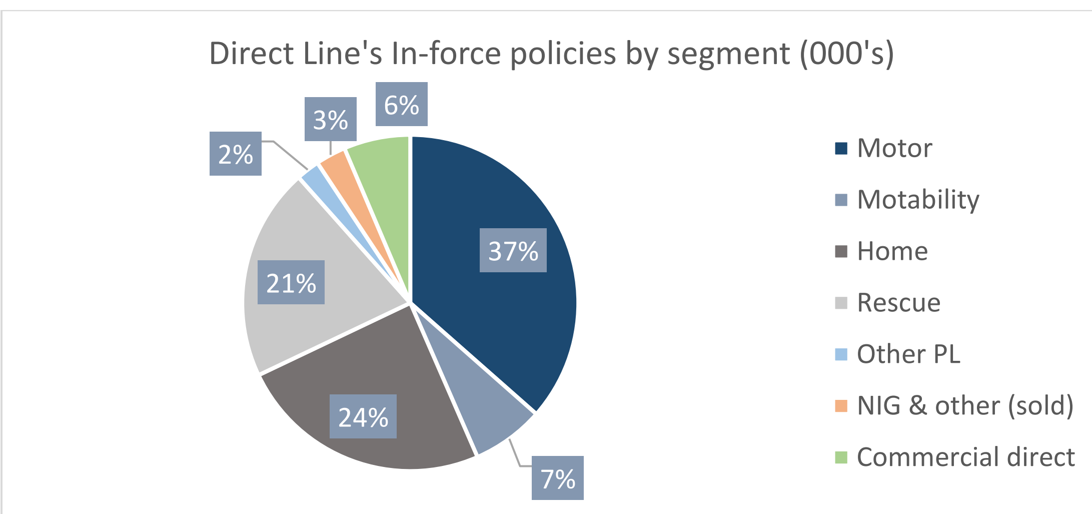
these losses amounted to £180mio, which led to overall losses of over £50mio. However, car and car parts prices have begun to come down and Direct Line as well as the entire industry began to adjust pricing. In Q3 23, premiums written have started to become profitable with a 10% net insurance margin target. With the sale of part of their Commercial Insurance businesses for £520mio + £30mio earn out, Direct Line has substantially boosted their solvency II capital ratio to above 192% - the highest ever. This strong solvency II ratio together with a return to profitability should lead to attractive returns for shareholders.



Source: Direct Line Insurance Group



Source: Direct Line Insurance Group

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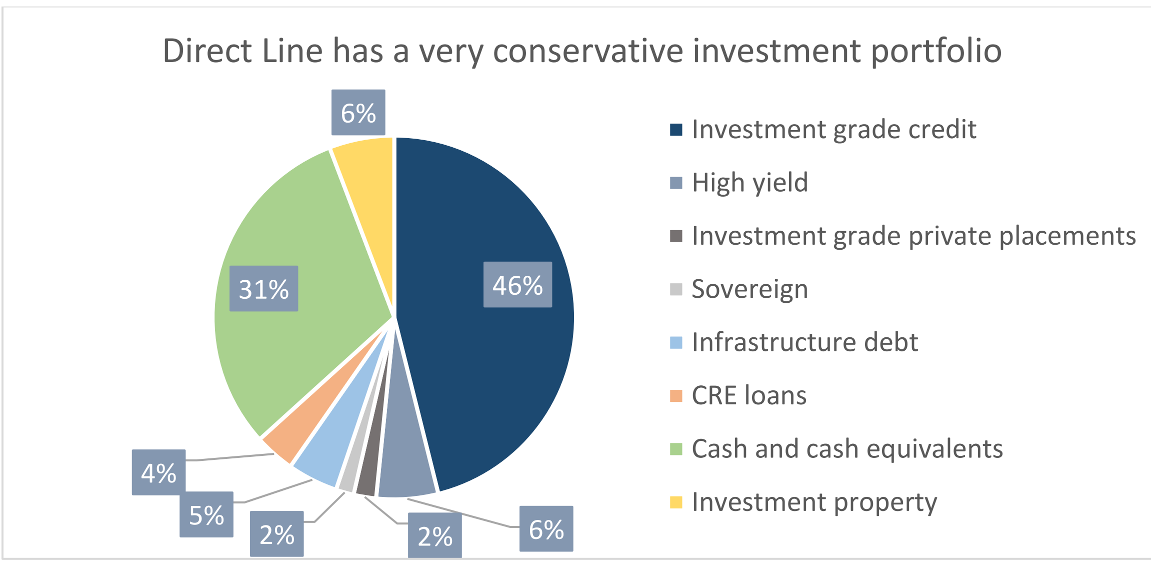
A strong investment portfolio + high downside protection

Direct Line has a very conservative investment portfolio, which as of 30th June 2023 had around 1/3 in cash or cash equivalents, and around half in investment grade credit. On top of this, Direct Line Insurance Group has such a strong solvency II ratio at 192% that even if all their worst-case scenarios under their sensitivity analysis come true, their solvency ratio would only drop to 152% - higher than on 30th June 2023. In light of the economic uncertainties and a recovery to profits in their motor division, this sets up for an extremely attractive investment proposition with high potential to the upside, including dividends and share buybacks, and low potential to the downside.



Source: Direct Line Insurance Group

<u>Direct Line Insurance Group sensitivities</u>

Sensitivities	30-Jun-23
Motor injury claims equivalent to 2008/09	-5%
One-off catastrophe loss equivalent to 1990 storm Daria	-10%
One-off catastrophe loss based on extensive river Thames flooding	-10%
Increase in Solvency II inflation assumption for PPOs by 1%	-9%
1% increase in credit spreads	-5%
1% decreas in interest rates with no change in PPO real discount rate	-1%

Source: Direct Line Insurance Group

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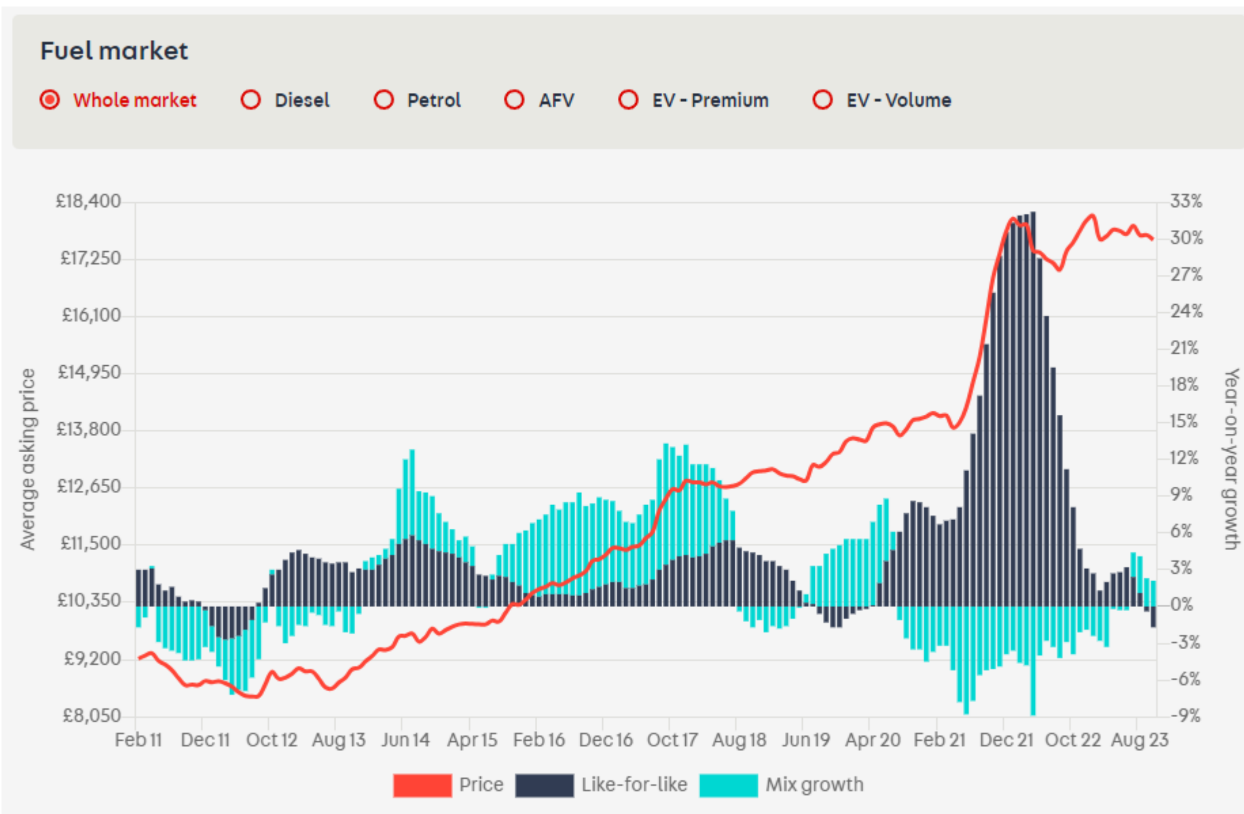
Used car prices

Used car prices in the US have already begun to come down[1], and the UK is now following suit, particularly visible in the EV segment[2]. With insurance premiums at record highs and used car prices stable or falling, this will ultimately lead to stronger net insurance margins and would demonstrate a compelling valuation for Direct Line Insurance. At the same time, the labour market is easing and we see more and more companies laying off workers. This is positive for repair costs, where the single biggest element is labour. Capacity for repair times has also improved, which has reduced the level of total losses in H1 2023 already.

Autotrader used car prices



Source: Autotrader

[1] https://site.manheim.com/en/services/consulting/used-vehicle-value-index.html
[2] https://plc.autotrader.co.uk/news-views/retail-price-index/

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