CNA Financial

Downgrading to Underperform following rally into 4Q23 results

Rating Change: UNDERPERFORM | PO: 43.00 USD | Price: 46.42 USD

06 February 2024

Equity

Strong performance during November-to-January rally

CNA's share price has advanced 14% since the market pivoted to risk-on last Nov. Along with other P&C insurers, CNA reported strong 4Q23 results, which contributed to another lift for the stock price. Investment yields have risen more quickly than our model had estimated, and we increase our nearer-term EPS forecasts (2024-1H25) to reflect this. That said, a 4.75% yield in taxable and a 4.00% yield in tax-exempt P&C float compares to current 3- to-5-year U.S. Treasury yields at 4.10-4.25%. We downgrade CNA to Underperform from Neutral as our new price objective, including dividends, implies lower-than-peer stock returns in our coverage universe. We have concerns that underwriting margins are at peak for CNA as well as commercial insurance carriers more broadly. We lower our Income Rating to 8 (same/lower) from 7 (same/higher).

4Q23 core EPS of $1.33

CNA's $1.33 4Q23 EPS exceeded our $0.97 forecast and the Street consensus. The key variances with our forecast included $62mn of variable private equity gains in excess of our forecast ($0.18/sh) and $35mn of fewer catastrophe losses ($0.10/sh). The still strong 91.5% accident-year ex-catastrophe combined ratio was nonetheless up 50bps from 4Q22 and 80bps from 9M23, and the modestly lower underwriting margin was expense-driven, with underlying loss ratios largely flattish at a hair above 60% for the past two years.

Expecting lower P&C underwriting margins going forward

Management is confident that pricing is above loss trend, although with 4Q23 renewal pricing up 4% and exposure up 1%, it is not clear that this is keeping pace with the company's estimated 6-6.5% loss trend. We model very modest P&C underwriting margin deterioration (ex-catastrophe) of just under 50bps annually through 2026. Should the tailwind of continuing low loss trend in workers' comp abate, there could be strain on margins in general liability and commercial auto lines.

Price objective to $43; downgrading to Underperform

WE increase our PO to $43 from $37 due to a combination of the peer P/E/ multiple expanding (to 10.7x from 10x previously) and the increase to our EPS forecast due to higher interest rates being achieved more quickly. Our 2025 EPS estimate is below 2024's due to anticipation of variable private equity gains in 1Q24. CNA joins other peers such as CB (Chubb) and TRV (Travelers) at Underperform in our ratings. Upside risk is transactions that could lower CAN's exposure to long-term care (LTCi) insurance and a pivot to higher dividend-yielding stocks in a low interest yield environment.

Estimates (Dec) (US$)	2022A	2023A	2024E	2025E	2026E
EPS	3.84	4.71	5.15	5.10	5.45
GAAP EPS	3.28	4.43	5.15	5.10	5.45
EPS Change (YoY)	-5.2%	22.7%	9.3%	-1.0%	6.9%
Consensus EPS (Bloomberg)			5.09	5.06	NA
DPS	3.60	2.88	3.76	3.84	3.96
Valuation (Dec)					
P/E	12.1x	9.9x	9.0x	9.1x	8.5x
GAAP P/E	14.2x	10.5x	9.0x	9.1x	8.5x
Dividend Yield	7.8%	6.2%	8.1%	8.3%	8.5%

Key Changes

(US$)	Previous	Current
Inv. Opinion	B-2-7	B-3-8
Inv. Rating	NEUTRAL	UNDERPERFORM
Price Obj.	39.00	43.00
2024E EPS	4.75	5.15
2025E EPS	4.90	5.10
2026E EPS	5.40	5.45

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Stock Data

Price	46.42 USD
Price Objective	43.00 USD
Date Established	6-Feb-2024
Investment Opinion	B-3-8
52-Week Range	36.17 USD - 44.86 USD
Mrkt Val (mn) / Shares Out (mn)	12,574 USD / 270.9
Free Float	7.8%
Average Daily Value (mn)	8.85 USD
BofA Ticker / Exchange	CNA / NYS
Bloomberg / Reuters	CNA US / CNA.N
ROE (2024E)	13.9%
Net Dbt to Eqty (Dec-2023A)	NA
ESGMeter™	Medium

ESGMeter is not indicative of a company's future stock price performance and is not an investment recommendation or rating. ESGMeter is independent of BofA Global Research's equity investment rating, volatility risk rating, income rating, and price objective for that company. For full details, refer to "BofA ESGMeter Methodology".

Refer to important disclosures on page 7 to 9. Analyst Certification on page 5. Price Objective Basis/Risk on page 5.

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Income Statement Data (Dec)

(US$ Millions)	2022A	2023A	2024E	2025E	2026E
Total Earned Premiums	8,667	9,480	10,313	10,762	11,110
Net Investment Income	1,805	2,264	2,451	2,488	2,673
Total Revenue	**11,879**	**13,299**	**14,432**	**14,959**	**15,531**
Total Cost of Benefits and Claims	(6,386)	(7,068)	(7,740)	(8,106)	(8,381)
S,G & A (Including Commissions)	NA	NA	NA	NA	NA
Total Operating Expenses	**(10,798)**	**(11,781)**	**(12,699)**	**(13,251)**	**(13,692)**
Pre-Tax Operating Earnings	**1,081**	**1,518**	**1,734**	**1,707**	**1,839**
Income Tax Expense	(187)	(313)	(330)	(318)	(350)
Operating Earnings After Tax	**1,048**	**1,284**	**1,404**	**1,390**	**1,489**
Net Income (Reported)	**894**	**1,205**	**1,404**	**1,390**	**1,489**
Diluted Shares	273	272	272	273	273
Operating Earnings Per Share	3.84	4.71	5.15	5.10	5.45
Net Income (Reported) Per Share	3.28	4.43	5.15	5.10	5.45

Balance Sheet Data (Dec)

(US$ Millions)	2022A	2023A	2024E	2025E	2026E
Fixed Income Securities	38,667	41,410	49,922	52,516	58,401
Total Cash and Investments	43,652	47,037	49,922	52,516	58,401
Total Assets	**60,927**	**64,711**	**67,596**	**70,190**	**76,075**
Reserves	25,099	23,304	23,247	23,056	22,629
LT Debt	2,781	3,031	2,789	2,789	2,790
Total Liabilities	**52,102**	**54,818**	**57,319**	**59,565**	**65,038**
Total Equity	**8,825**	**9,893**	**10,277**	**10,625**	**11,037**
Total Equity (Ex FAS 115)	**12,382**	**12,565**	**11,749**	**10,897**	**11,037**
Book Value per Share (Reported)	32.58	36.52	37.88	39.10	40.56
Book Value per Share (Ex FAS 115)	45.71	46.38	43.31	40.11	40.56

Ratios (Dec)

(US$ Millions)	2022A	2023A	2024E	2025E	2026E
Expense Ratio	NM	NM	NM	NM	NM
Loss Ratio	73.7%	74.6%	75.1%	75.3%	75.4%
Combined Ratio	**73.7%**	**74.6%**	**75.1%**	**75.3%**	**75.4%**
Avg Assets / Avg Eq (Ex FAS 115) Ratio	5.1x	5.0x	5.4x	6.1x	6.7x

Growth Rates (YoY) (Dec)

(US$ Millions)	2022A	2023A	2024E	2025E	2026E
Total Earned Premium	6.0%	9.4%	8.8%	4.4%	3.2%
Net Investment Income	-16.4%	25.4%	8.3%	1.5%	7.4%
Total Revenue	-0.2%	12.0%	8.5%	3.6%	3.8%
Operating Earnings per Share	-5.2%	22.7%	9.3%	-1.0%	6.9%
Asset	-8.6%	6.2%	4.5%	3.8%	8.4%
Reported Book Value per Share	-31.0%	12.1%	3.7%	3.2%	3.7%

Performance Metrics (Dec)

(US$ Millions)	2022A	2023A	2024E	2025E	2026E
Operating ROE	9.7%	13.7%	13.9%	13.3%	13.8%
Operating ROE (Ex FAS 115)	NA	NA	NA	NA	NA
Operating Return on Average Assets	1.6%	2.0%	2.1%	2.0%	2.0%
Operating Margin	8.8%	9.7%	9.7%	9.3%	9.6%
Long Term Debt to Cap Ratio (Ex FAS 115)	18.3%	19.4%	19.2%	20.4%	20.2%
Net Income % Operating Income	85.3%	93.8%	100.0%	100.0%	100.0%
Amtz of DAC % Pretax Profit bef Amtz of DAC	71.0%	65.6%	64.5%	66.0%	65.1%

Company Sector

Insurance - Non-Life

Company Description

CNA is a large commercial P&C carrier with its core businesses focused on the U.S. and U.K. markets. As the company struggled with peer-equivalent profitability for decades, the current and former top management has been working to narrow the company's focus and trim its expense bloat. Given that the company is 90% owned by the Loews Corporation, the current amount of float is maintained with recurring special common shareholder dividends as opposed to share repurchases.

Investment Rationale

We continue to expect CNA to face some headwinds in attracting shareholder interest due to its low level of float and the weight of a run-off long-term care insurance book, though the stock does offer an attractive dividend yield via its special dividends. The LTCi book overhang, low EPS growth and potential for peak margins form the basis of our Underperform rating with downside to our price objective.

Stock Data

Average Daily Volume	190,550

Quarterly Earnings Estimates

	2023	2024
Q1	1.19A	1.42E
Q2	1.13A	1.20E
Q3	1.06A	1.32E
Q4	1.33A	1.22E

We downgrade CNA to Underperform from Neutral, we due to (1) a lack of share price upside including special dividends (particularly when compared with other opportunities in the peer group); and 2) our concerns that underwriting margins for both CNA and the commercial P&C peer group have peaked. We have only very modest combined ratio deterioration modeled in our forecast (less than 50bps annually) from the currently record underwriting margins (at least a 15-year peak). The P&C industry is historically quite cyclical, although our estimates do not assume material decline from the peak. That said, a 5% EPS CAGR over the next three years could be lower if margins deteriorate from peak levels more quickly. Some of CNA's peers have solved for this by buying back stock to increase EPS, but, given the low float at CNA, the company instead has returned capital in the form of special dividends. This means a very attractive (although not guaranteed) dividend yield, but less EPS growth when compared with peers.

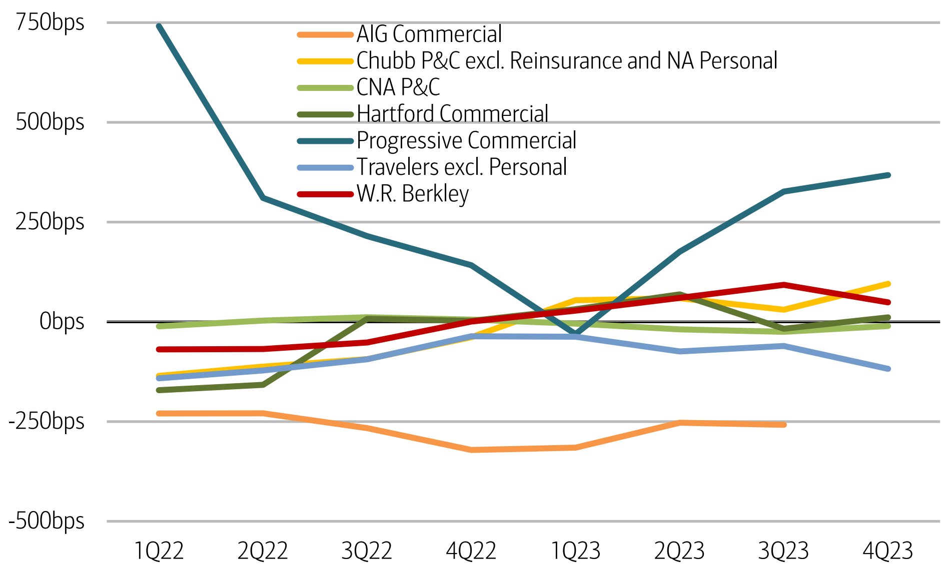
Peak margins for commercial P&C?

“Accident-year” numbers have “crested”

In looking at underwriting margins, investors often focus on the “underlying” loss ratio, defined as losses excluding volatile catastrophe activity and adjustments to the reserves set up for prior-year losses that have been revised due to new data regarding individual claims and broader trends. This is called the “‘accident-year ex-catastrophe” loss ratio. This measure appears flattish year-over year for CNA and Hartford, deteriorating for Chubb and Berkley, and improving for Travelers and AIG. Progressive with commercial business that is essentially monoline commercial auto has experienced year-over-year deterioration. CNA, which writes commercial auto liability, indicates that pricing has surged from up 9% to up 14% in 4Q23 to counter rising commercial auto loss trends.

Exhibit 1: Year-over-year change in trailing-12-months AY ex-cat loss ratio (trailing 12 months)

Many investors look to accident-year ex-catastrophe loss ratios as an indicator of the relationship between the pace of pricing and the pace of the loss trend. In commercial lines, most P&C carriers see the loss ratio as flattish to deteriorating though AIG (yet-to-report 4Q23) and Travelers have continued to see improvement.



Source: Company filings

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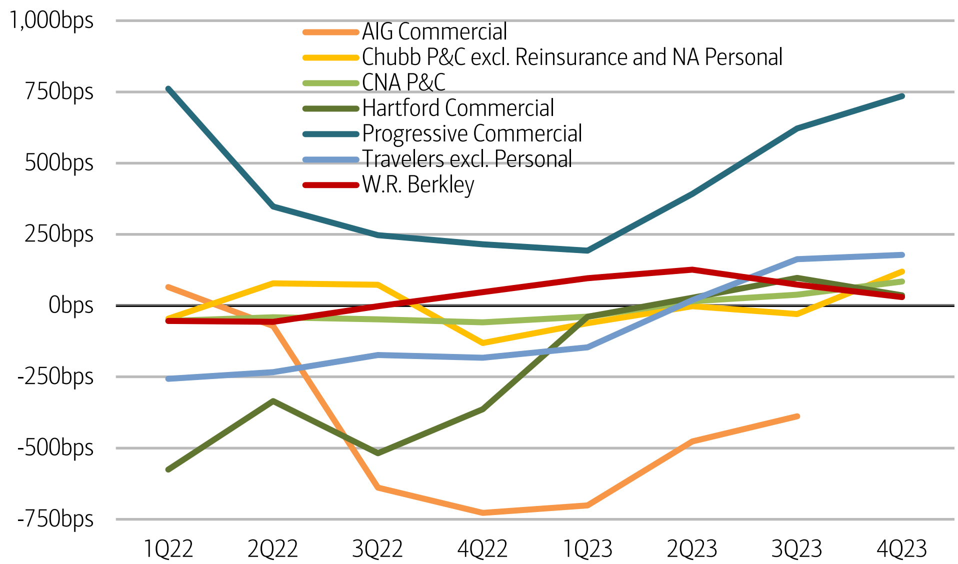
Given adverse loss reserve development charges at AXIS, Markel and Selective in 4Q23 (and at Progressive as well in its commercial auto business), investors are rightly concerned about the adequacy of price over loss trend. We believe underwriting margins have peaked for the commercial P&C peer group including CNA. The potential for deterioration was likely masked by the suppression claims incidence during the pandemic, but that is no longer acting as a benefit.

"Calendar-year" loss ratios are getting worse

The loss ratio excluding only the volatile catastrophe losses reveals the industry trend becoming broadly worse year-over-year. We believe investors sometimes focus too much on the "accident-year" numbers. Companies have a lot of discretion in setting loss picks, and it is always possible to take adverse development in a prior legacy year of underwriting while reducing the loss ratio in the current period. We believe it is useful to look at calendar-year ex-catastrophe underwriting margins as well.

Exhibit 2: Year-over-year change in trailing-12-months CY ex-cat loss ratio (trailing 12 months)
Several companies benefitted from the suppression of claims incidence during the pandemic to release 2020-2022 accident-year reserves, which boosted calendar-year results. As such, when one looks at calendar-year ex-catastrophe results, almost all the commercial carriers reported margin contraction in 2023 (AIG excluded) as there was less benefit from favorable development.



Source: Company filings

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With the notable exception of AIG, most of the large commercial P&C carriers see their ex-catastrophe loss ratios getting worse as the benefit of favorable prior-year loss development appears to be declining. From this we believe that underwriting margins may have peaked.

Price objective basis & risk

CNA Financial (CNA)

Our price objective of $43 is based on 80% of the average consensus large-cap P&C peer P/E multiple (10.7x), compared with a 75-100% range where it has traded in the past. We think the discount is appropriate given the overhang associated with its closed-block long-term care book and its general inability/aversion to repurchasing its own shares, even when trading at a discount to perceived fair value. Trading history around a range validates this relative multiple.

Upside risks include sustained higher interest rates which ameliorate the reserve pressures on the LTCi book and allow the company to earn more income on its investment float. Additional upside risk could come from majority owner Loews buying the remaining limited float trading today. Downside risk is presented by a return to the low interest rate environment, causing a decline in earnings power and potentially leading the company to miss our EPS expectations. The volatility associated with catastrophes also created the risk of missing and exceeding our EPS outlook. The company's recent premium growth could be indicative of adding less/unprofitable clients to its book of business, thus adversely impacting future earnings and increasing the probability of a future reserve charge serves as an additional downside risk. We believe underwriting margins for CNA and the commercial P&C group more broadly have peaked, which has the potential for downside versus our forecasts.

Analyst Certification

I, Joshua Shanker, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

US - Insurance Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
BUY				
	Aflac	AFL	AFL US	Joshua Shanker
	Allstate Corp.	ALL	ALL US	Joshua Shanker
	American International Group	AIG	AIG US	Joshua Shanker
	Arch Capital	ACGL	ACGL US	Joshua Shanker
	Assurant	AIZ	AIZ US	Grace Carter, CFA
	Axis Capital	AXS	AXS US	Joshua Shanker
	BRP Group, Inc.	BRP	BRP US	Joshua Shanker
	Cincinnati Financial Corporation	CINF	CINF US	Grace Carter, CFA
	Corebridge Financial	CRBG	CRBG US	Joshua Shanker
	Everest Group Ltd	EG	EG US	Joshua Shanker
	Intact Financial	YIFC	IFC CN	Grace Carter, CFA
	Intact Financial	IFCZF	IFCZF US	Grace Carter, CFA
	MetLife	MET	MET US	Joshua Shanker
	Progressive	PGR	PGR US	Joshua Shanker
	RenaissanceRe	RNR	RNR US	Joshua Shanker
	The Hartford	HIG	HIG US	Joshua Shanker
	Voya	VOYA	VOYA US	Joshua Shanker
	W.R. Berkley	WRB	WRB US	Joshua Shanker
NEUTRAL				
	Aon	AON	AON US	Joshua Shanker
	Brown & Brown	BRO	BRO US	Grace Carter, CFA
	Lincoln National	LNC	LNC US	Joshua Shanker
	Marsh McLennan	MMC	MMC US	Joshua Shanker
	Principal Financial Group	PFG	PFG US	Joshua Shanker
	Prudential Financial	PRU	PRU US	Joshua Shanker
	The Hanover	THG	THG US	Grace Carter, CFA
	Trupanion	TRUP	TRUP US	Joshua Shanker

US - Insurance Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
	Unum	UNM	UNM US	Joshua Shanker
UNDERPERFORM				
	Arthur J. Gallagher & Co.	AJG	AJG US	Joshua Shanker
	Chubb Ltd	CB	CB US	Joshua Shanker
	CNA Financial	CNA	CNA US	Joshua Shanker
	Goosehead Insurance Inc.	GSHD	GSHD US	Joshua Shanker
	Selective	SIGI	SIGI US	Grace Carter, CFA
	Travelers Cos	TRV	TRV US	Joshua Shanker
	Willis Towers Watson	WTW	WTW US	Joshua Shanker

*iQ*method SM Measures Definitions

Business Performance	**Numerator**	**Denominator**
Return On Capital Employed	NOPAT = (EBIT + Interest Income) × (1 – Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5 Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings	**Numerator**	**Denominator**
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt – Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit	**Numerator**	**Denominator**
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap = Current Share Price × Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price × Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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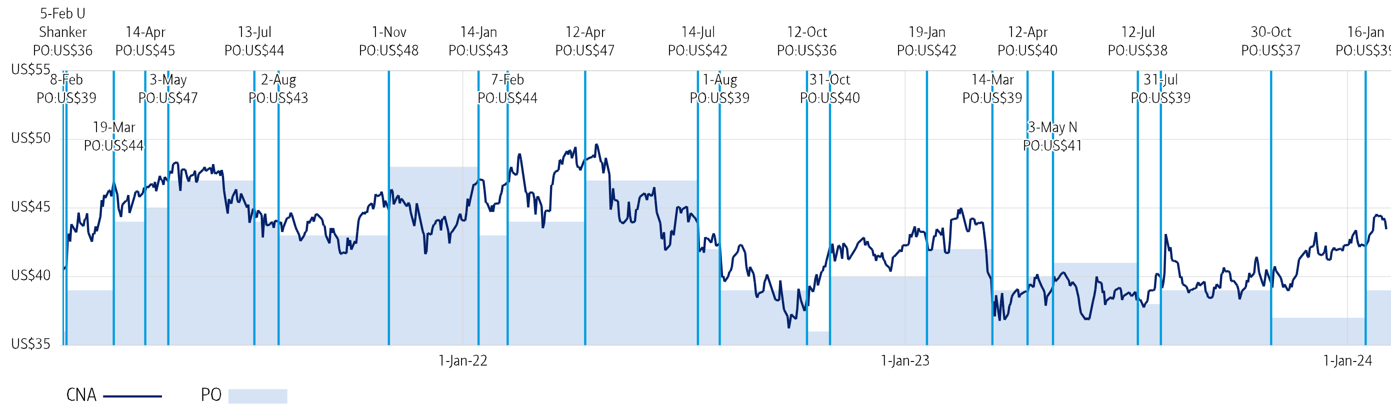
Disclosures

Important Disclosures

CNA Financial (CNA) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of a date no more than one trading day prior to the date of the report.

Equity Investment Rating Distribution: Financial Services Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships R1	Count	Percent
Buy	156	53.79%	Buy	94	60.26%
Hold	72	24.83%	Hold	48	66.67%
Sell	62	21.38%	Sell	35	56.45%

Equity Investment Rating Distribution: Global Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships R1	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
Hold	832	23.54%	Hold	454	54.57%
Sell	807	22.84%	Sell	383	47.46%

R1 Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster[R2]
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

R2 Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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