Moody's Investors Service

Credit Opinion: Cincinnati Financial Corp

Global Credit Research - 16 Oct 2009

Cincinnati, Ohio, United States

Ratings

Category	Moody's Rating
Rating Outlook	STA
Senior Unsecured	A3
Rated Intercompany Pool Members	
Rating Outlook	STA
Insurance Financial Strength	A1

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Key Indicators

Cincinnati Financial Corp[1]

	2008	2007	2006	2005	2004
Total Assets ($ Mil.)	$ 13,369	$ 16,637	$ 17,222	$ 16,003	$ 16,107
Equity ($ Mil.)	$ 4,182	$ 5,929	$ 6,808	$ 6,086	$ 6,249
Net Income ($ Mil.)	$ 429	$ 855	$ 930	$ 602	$ 584
Gross Premiums Written ($ Mil.)	$ 3,188	$ 3,300	$ 3,321	$ 3,254	$ 3,174
Net Premiums Written ($ Mil.)	$ 3,010	$ 3,125	$ 3,163	$ 3,076	$ 2,997
Gross Underwriting Leverage	1.7x	1.2x	1.1x	1.1x	1.1x
Return on Equity (1 yr.)	8.5%	13.4%	14.4%	9.8%	9.4%
Sharpe Ratio of Growth in Net Income (5 yr.)	24.9%	101.0%	158.6%	---	---
Financial Leverage	18.2%	13.4%	11.7%	12.5%	11.8%
Earnings Coverage (1 yr.)	10.3x	22.6x	24.6x	16.0x	20.9x
Cashflow Coverage (1 yr.)	6.6x	12.7x	10.8x	11.5x	7.3x
High Risk Assets % Invested Assets	35.2%	56.8%	61.4%	61.7%	65.2%
Reinsurance Recoverable % Equity	18.1%	12.7%	10.0%	11.2%	10.9%
Goodwill % Equity	0.0%	0.0%	0.0%	0.0%	0.0%
Adv/(Fav) Dev. % Beg. Reserves (1 yr.)	-9.5%	-7.3%	-3.7%	-5.4%	-6.9%
A&E Net Funding Ratio (1 yr.)	41.8x	12.9x	12.6x	11.6x	11.2x

[1] Information based on GAAP financial statements

Opinion

SUMMARY RATING RATIONALE

Moody's A1 insurance financial strength ratings on the standard market property casualty operating subsidiaries of Cincinnati Financial Corporation (CINF) and the A3 senior debt rating on CINF are based on the company's regional franchise emphasizing a relationship-oriented strategy with agents; solid profitability in small and middle market commercial businesses; strong risk-adjusted capitalization reflecting consistent reserve strength and manageable peak-level catastrophe exposure; and an excellent financial leverage profile accompanied by substantial holding company liquidity.

These strengths are tempered by investment risk due to sizeable position in common equities relative to both total invested assets and shareholders' equity; lagging technology systems relative to some national carriers (though company has completed a number of significant technology enhancements); and continued competition in core commercial lines segments.

Cincinnati Financial Corporation is an Ohio-based holding company whose property and casualty insurance subsidiaries write a broad range of commercial and personal insurance products. CINF is a regional insurer that operates in 37 states primarily in the Midwest and South and distributes products through a growing network of over 1,100 independent agencies.

Credit Strengths

Key strengths/opportunities for the company include:

- Strong regional franchise with a solid service reputation

- Strong, loyal independent agency distribution channel

- Relatively low financial and operating leverage profile

- Strong liquidity with excess capital at holding company

Credit Challenges

Key challenges/weaknesses include:

- Increasingly competitive environment in small and middle-market commercial lines

- Equity investment portfolio poses volatility risk to CINF's capital base

- Sizable common stock dividends reduce fixed charge coverage levels

Rating Outlook

The outlook on the ratings is stable.

What Could Change the Rating - Up

Factors that could contribute to a ratings upgrade include:

- Maintenance of financial leverage below 15%,

- Earnings coverage above 10x

- High risk assets (i.e., investments other than cash and investment grade securities) as a percentage of invested assets maintained below 35%

What Could Change the Rating - Down

Factors that could lead to a ratings downgrade:

- Material decline in profitability (combined ratios consistently in the low 100s)

- Financial leverage in excess of 25%

- Earnings coverage less than 6x

- Annual event-based losses (e.g., events or catastrophes) resulting in a decline of beginning period equity greater than 10%

Notching Considerations

The two-notch spread between CINF's A3 senior debt rating and A1 insurance financial strength rating of its lead operating subsidiaries is due to the substantial financial flexibility and liquidity afforded the holding company by its large investment portfolio. Invested assets at the holding company level represent over 100% of the holding company's current debt outstanding.

Recent Results

For the six months ended June 30, 2009, CINF reported total revenue of $1.8 billion and net income of $17 million. The low net income during the first half of 2009 was driven by a number of factors including the weak economy resulting in lower exposure rated premiums, Midwest storm losses and loss cost inflation and lower investment income. As of June 30, 2009, shareholders' equity was approximately $4.1 billion.

DETAILED RATING CONSIDERATIONS

Moody's rates Cincinnati Financial Corporation's property and casualty operating companies A1 for insurance financial strength, which is in line with the adjusted rating indicated by the Moody's insurance financial strength rating scorecard.

Insurance Financial Strength Rating

The key factors currently influencing the rating and outlook are:

Factor 1 - Market Position, Brand and Distribution: A

Cincinnati Financial ranks among the top 25 property/casualty insurers in the US, as measured by net premiums written and is a strong regional insurer with a significant premium concentration in the Midwest United States. The company remains committed to a strategy that emphasizes long-term relationships with its agents while aligning its interests with those of its agents by providing a consistent and stable market for a substantial portion of an agency's typical risks, superior claims service, and long term profit sharing arrangements. This relationship-oriented strategy has enabled the company to enhance its market position in its profitable `main street' commercial lines book, thus helping allay concerns regarding the company's scale relative to larger national carriers. We therefore see the company's market position to be more in line with A-rated insurers rather than the Baa indicated by the scorecard's metrics.

Moody's believes that continued improvements in technology are essential for the company to remain competitive as customers and agents increasingly demand more web-based tools and policy processing capabilities. CINF has made significant strides in technology improvements. In particular, the transition completed in 2008 to its Diamond system, together with improved rate segmentation, now is driving growth of new personal lines business. Early in 2010, agents will receive a new version of that system including ease-of use features such as integrated, pre-filled data. The company also recently began deploying its new policy administration system that quotes and issues commercial package and commercial auto policies. The system supports CINF's growth in small and middle market commercial lines, complementing its superior claims service and strong agency ties.

Although CINF's GAAP underwriting expense ratio is in line with similarly rated peers, it has increased each year since 2002 largely reflecting the company's profit sharing and commission arrangements with agents, recent technology enhancement initiatives and stock option expensing.

Factor 2 - Product Focus and Diversification: A

The group's commercial lines business accounts for about 77% of the company's consolidated net written premiums with personal lines representing almost one quarter of the business and life insurance the remainder. The company's business mix carries generally short to medium tail exposures and focuses on small to mid-size accounts where prices tend to fluctuate less dramatically with the underwriting cycle (compared to large accounts). This profile results in a moderate risk profile in terms of estimating ultimate claim costs.

CINF actively markets its P&C business in 37 states, but approximately half of its net earned premiums are derived from its top 5 states, the largest being Ohio (21%) followed by Illinois (9%) and Indiana (7%). The company entered Texas, its 35th state, in the second half of 2008, and Colorado and Wyoming in 2009. Although the company has manageable natural catastrophe exposure, the added risk due to its concentration of business in Midwestern states is more reflective of A-rated insurers rather than the Aa indicated by the scorecard metrics.

Factor 3 - Asset Quality: A

CINF's fixed income portfolio is conservative and high quality (87% investment-grade) and provides sufficient liquidity to support its liabilities. At June 30, 2009, the company's equity investments represented approximately 60% of shareholders' equity, which is high relative to peers but meaningfully improved from historical levels. As of June 30, 2009, shareholders' equity at CINF has declined approximately $2.7 billion since year-end 2006, largely due to the decline in fair value of the company's holding in Fifth Third Bank (FITB) common stock during the same period. With a rebound in the equity markets and narrowing of credit spreads, the company's portfolio held $520 million in pretax net unrealized gains at June 30, 2009.

CINF has significant exposure to investment volatility given its sizable position in common equities relative to both total invested assets and shareholders' equity. That said, over last several quarters, consistent with revised investment guidelines, the company has reduced its common stock exposure to the financial services sector including the sale of its remaining equity positions in bank stocks (including FITB) as of March 31, 2009. Moody's expects the company to continue to enhance its investment risk management practices.

The company's use of reinsurance has been consistently low and the company's reinsurance program features a diversified group of reinsurers of good credit quality. CINF carries no goodwill or other intangible assets on its balance sheet. Given the sizable (though reduced) equity position relative to peers, Moody's views the company's asset quality to be more in line with A-rated insurers rather than the Aa indicated by the scorecard's metrics.

Factor 4 - Capital Adequacy: Aa

CINF's gross underwriting leverage (GUL), a blunt measure of capital adequacy, remains stable at approximately 1.7x, which compares favorably to its A-rated peers. Notwithstanding the company's meaningful 2008 decline in equity due to volatility in the investment portfolio, Moody's believes the company's current capitalization is sound, but is in line with Aa insurers rather than the Aaa scorecard metric.

The company estimates that the pre-tax loss to surplus of a 1 in 250 year event would be 20% of consolidated surplus, which Moody's views as somewhat high for its rating level. CINF remains exposed to tornado, wind and hail in the Midwest, which is where the company experienced significant catastrophe losses during 2008 and 2006. As it relates to terrorism, CINF has experienced high take-up rates on terrorism coverage offered to insureds, consistent with standard commercial and regional standard carriers with middle-market clients. For 2009, the company estimates its TRIA deductible will be $383 million (compared to $395 million for 2008), or approximately 9.2% of year-end 2008 shareholders' equity.

Factor 5 - Profitability: A

The company's pre-tax operating income and GAAP combined ratio have steadily improved since 2000, although the ratio increased almost 10 points during 2008 from the prior year, largely reflecting higher than expected catastrophe losses. Adverse prior-year loss development in the workers' compensation book and catastrophe losses in the homeowner book drove the company's loss ratio higher during the first half of 2009. CINF's historical ROEs, which are somewhat constrained because of the company's very strong capitalization, have exceeded 10% twice in the last seven years, which is more in line with A-rated insurers rather than the Aa indicated by the scorecard metrics.

Moody's expects that over the near to medium term, CINF will continue to underwrite selectively as underwriting margins will continue to face pressure from increasingly challenging underwriting and economic conditions.

Factor 6 - Reserve Adequacy: Aa

Through the end of 2008, the company had experienced favorable reserve development over the last decade. During the first half of 2009, CINF recorded favorable development of overall reserves, though the company recorded adverse development on workers' compensation reserves due to changed assumptions about loss cost inflation. That said, Moody's believes that CINF's booked core reserves are within a reasonable range. The company has modest exposure to legacy asbestos and environmental (A&E) liability claims. A&E reserves account for about 4% of total reserves, net of reinsurance.

Factor 7 - Financial Flexibility: Aa

CINF's financial flexibility benefits substantially from its conservative use of debt (at approximately 18% of total capital), good earnings and cash flow coverage characteristics, and substantial liquid investments at the parent company (cash and marketable securities of $1.05 billion at June 30, 2009). Maximum dividend capacity without prior regulatory approval is $336 million for 2009, which is almost half of the company's total debt. CINF's coverage of interest and preferred dividends relative to statutory dividend capacity and unrestricted cash and investments at the holding company is very strong for its rating level.

Moody's considers CINF's financial flexibility to be in line with expectations for a Aa rated company rather than the Aaa indicated by the scorecard metrics because of the company's substantial equity portfolio and because of its relatively limited use of the debt and equity capital markets. The company has access to a total of $225 million through two lines of credit agreements which expire in August 2010 and July 2012. Approximately $176 million of that amount is unused and available during times of stress.

Rating Factors

Cincinnati Financial Corp

Financial Strength Rating Scorecard [1][2]	**Aaa**	**Aa**	**A**	**Baa**	**< Baa**	**Score**	**Adjusted Score**
Business Profile						**A**	**A**
Market Position, Brand and Distribution (25%)						**Baa**	**A**
Market Share Ratio					**X**		
Relative Market Share Ratio			**X**				
Expense Ratio % NPW				**X**			
Product Focus and Diversification (10%)						**Aa**	**A**
Product Focus		**X**					
P&C Product Diversification		**X**					
Geographic Diversification			**X**				
Financial Profile						**Aa**	**Aa**
Asset Quality (5%)						**Aa**	**A**
High Risk Assets % Invested Assets				**35.2%**			
Reinsurance Recoverable % Equity	**18.1%**						
Goodwill % Equity	**0.0%**						
Capital Adequacy (15%)						**Aaa**	**Aa**
Gross Underwriting Leverage	**1.7x**						
Profitability (15%)						**A**	**A**
Return on Equity (5 yr. avg.)		**11.1%**					
Sharpe Ratio of Growth in Net Income (5 yr.)				**24.9%**			
Reserve Adequacy (10%)						**Aa**	**Aa**
Adv/(Fav) Reserve Dev. % Beg. Reserves (5 yr. avg.)	**-6.6%**						
A&E Net Funding Ratio (5 yr. avg.)		**12.6x**					
Financial Flexibility (20%)						**Aaa**	**Aa**
Financial Leverage	**18.2%**						
Earnings Coverage (5 yr. avg.)	**18.9x**						
Cashflow Coverage (5 yr. avg.)	**9.8x**						
Aggregate Profile						**Aa3**	**A1**

[1] Information based on GAAP financial statements. [2] The Scorecard rating is an important component of the company's published rating, reflecting the stand-alone financial strength before other considerations (discussed above) are incorporated into the analysis