CONCORDE RESEARCH

CEE Equity Research | Insurance | Hungary

21 February 2019

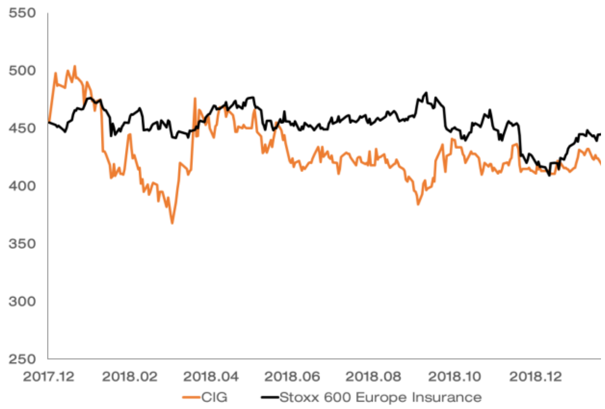
Pannonia

Rating: Accumulate (unch.)

Price target (12-m): HUF 484 (unch.)

Current share price: HUF 421

HUF million	2017	2018	2019F	2020F
GWP	26 992	25 832	26 009	26 381
After-tax profit	2 598	2 106	2 124	2 245
Own equity	9 015	17 437	17 812	17 630
EPS [HUF]	41.4	24.8	22.7	24.0
DPS [HUF]	10.0	18.4	24.8	24.0
BVPS [HUF]	129.0	186.0	190.0	188.1
P/GWP (x)	1.5	1.5	1.5	1.5
P/E (x)	10.2	17.0	18.5	17.5
P/BV (x)	3.3	2.3	2.2	2.2
DVY (%)	2.3	4.4	5.9	5.7
ROE (%)	35.6	15.7	13.2	12.7



Performance	12M	YTD	3M	1M
Absolute	2.8%	2.3%	2.4%	1.1%
BUX relative	0.5%	-1.4%	-3.6%	1.0%

Share price as of 2/21/2019	HUF 421
Number of shares [million]*	94.4
Market capitalization [HUF bn/EUR mn]	39 754/125.2
Enterprise value [HUF bn/EUR bn]	39 754/125.2
Daily turnover 12M [EUR million]	0.27

Bloomberg	CIGP.BU
Reuters	PANNONIA HB
Free float**	ca. 50%
52 week range	298/544
EURHUF	317.4

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After-tax profit beat expectations

- Pannonia reported a IFRS consolidated after-tax profit of HUF 545 mn in Q4/18 versus HUF 330 mn in the same period of a year earlier. As a result, CIG Pannonia reported after-tax profit of HUF 2,106 mn for 2018 compared to HUF 349 mn clean after-tax profit in 2017. We note that Pannonia booked one-off items in 2017 including a non-recurring gain of HUF 3.2 bn arising from the acquisition of MKB Insurance companies, the result of assets held for sale of HUF -475 mn and losses of HUF 473 mn on interest bearing shares.

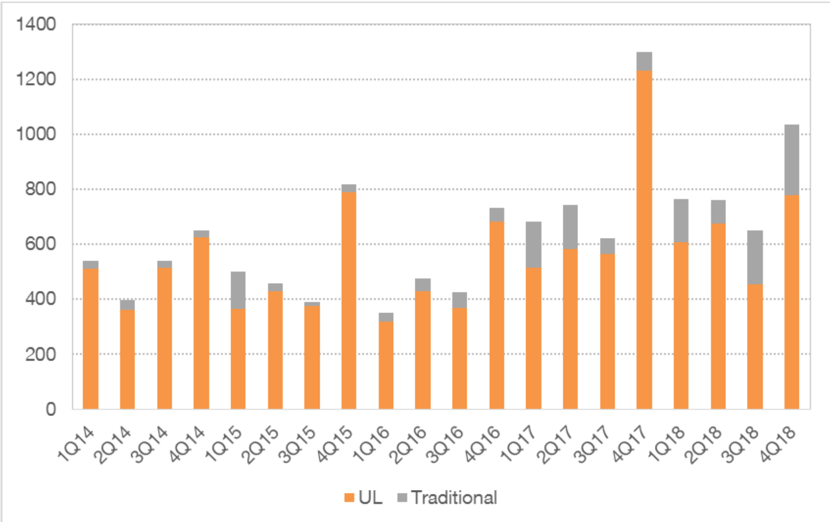
After-tax profit breakdown by segments (HUF mln)

	2018 Q1-4	as a % of total	2018 Q4	as a % of total
Life	1 241	59%	272	50%
Non-life	754	36%	187	34%
Asset management	367	17%	89	16%
Elimination*	-256	-12%	-3	0%
Total after-tax profit	**2 106**	**100%**	**545**	**100%**

*Note: * Last year dividend from Asset Management*
Source: Pannonia, Concorde's estimate

- Consolidated GWP amounted to HUF 8.8 bn in Q4/18 (-5% YoY) as a combined result of portfolio restructuring, a significant increase in the top-up and single premiums due to reclassification of some investment contracts to life insurance contracts and also to the expiry and surrenders of the unit-linked insurances. It is important to note that, at the end of last year Pannonia decided to change its accounting policy regarding the classification its single premium insurance policy contracts which contain an initial insurance risk of exactly 5 percent, which alone resulted in an increase of HUF 1.7 bn in the life segment's premium income.
- The life insurance segment's GWP was HUF 6.3 bn in Q4/18 (+5% YoY) and accounted for 72% of the total consolidated GWP. Annualized premium of new policies sold dropped 20% YoY in Q4/18, predominantly driven by a plunge in new unit-lined life policies sales (-37% YoY), while new traditional insurance product sales rose 267% YoY. Traditional life insurances (endowment, pure endowment and healthcare policies, which represented ca. 25% of new sales vs. 5% a year earlier) are clearly gaining traction. GWP from renewals arrived at HUF 3.6 bn in Q4/18 (-4% YoY). As a consequence, the renewal ratio fell from 102% in Q4/17 to 80% in Q4/18 and was also 3pps lower QoQ. Top-up and single premiums product sales advanced by 127% YoY mainly due to reclassification of investment contracts to insurance contracts.

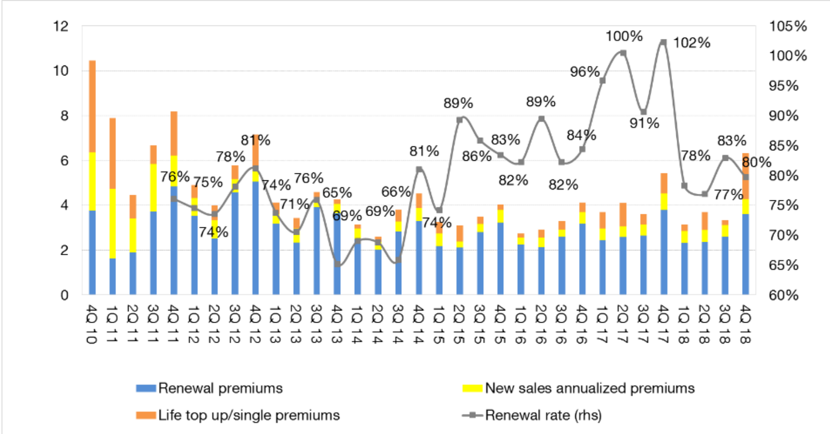
New sales breakdown of the life segment (HUF bln)



Source: Pannonia, Concorde's estimate

- In 2018, new life policy sale fell 4% YoY with UL insurance products dropping more than 10% and traditional life insurance policies rising more than 50% YoY.

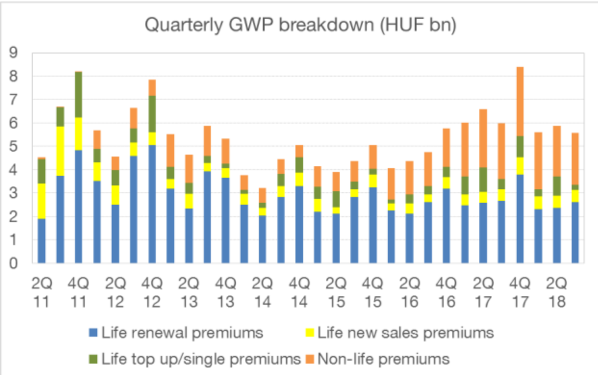
GWP breakdown in the life insurance segment (HUF bln)



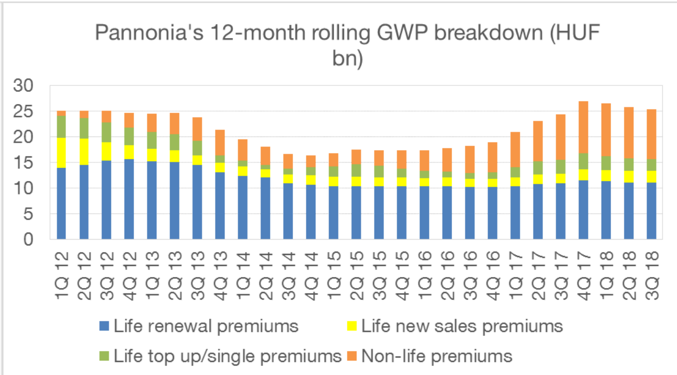
Source: Pannonia, Concorde estimate

- As a consequence of portfolio clean-up the non-life insurance segment's GWP also dropped 18% YoY to HUF 2.45 bn, whereby contributing by 28% to the total consolidated GWP.

Quarterly consolidated GWP breakdown (HUF bln)



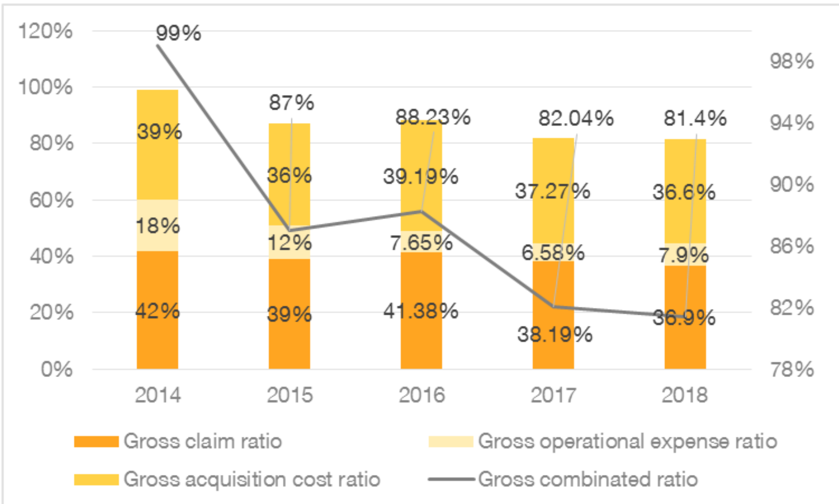
12-m rolling GWP breakdown (HUF bln)



Source: Pannonia, Concorde estimate

- Claims and related settlement expenses decreased by a significant 22% YoY in Q4/18 mainly as a result of a more effective claim settlement process of both traditional life insurances and a decrease in the surrender of the unit-linked insurances. In the non-life segment claims rose 45% YoY in Q4/18. In 2018, the combined ratio of the non-life segment came down to 81.4% compared to 82% in 2017 on our calculation.

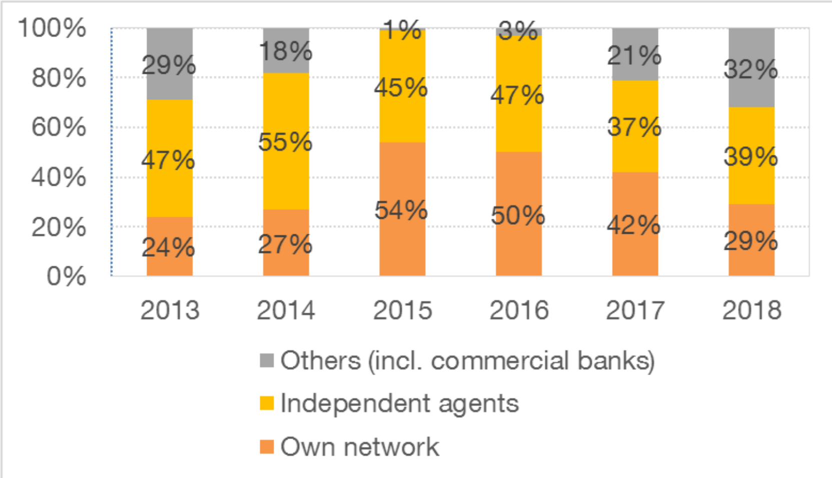
Cost ratios of the non-life segment



Source: Pannonia, Concorde estimate

- Operating costs fell 18% YoY in Q4/18 and accounted for 27% of consolidated GWP (vs. 34% of consolidated GWP in Q4/17), out of which fees, commissions and other acquisition costs represented 68% (vs. 60% in Q4/17), while admin costs and other expenses accounted for 32%.
- Acquisition costs went down by 4% YoY in Q4/18 driven predominantly by lower acquisition costs in the non-life segment (-33% YoY). Meanwhile, acquisition costs in the life segment rose 72% YoY, with trial commission and bonuses paid to policyholders and independent agents for loyalty and better than planned performance. Admin costs decreased 10% YoY and accounted for only 6% of consolidated GWP vs. 7% in Q4/17, mainly as a result of cost cuts at the acquired MKB Insurance companies.
- In the sale of insurance policies sold in 2018 the tied agent network accounted for 29% (2017: 42%), the independent brokerage network 39% (2017: 37%) and the bank channel 32% (2017: 21%), respectively.

New life policy breakdown by sales channels



Source: Pannonia, Concorde estimate

- Profit from fund management recorded according to the equity method amounted to HUF 89 mn, with which full year profit from fund management went up from HUF 253 mn to HUF 367 mn on utiliizing cost synergies from a closer cooperation with MKB Fund Management, while amount of asset under management (>HUF 100 bln) remained more or less the same as in the corresponding period of last year due to weak performance of almost all publicly traded assets.
- Total reported comprehensive income came in at HUF 1.1 bn and was negatively impacted by the decrease in the fair value of available for-sale financial assets (HUF -1.05 bn) due to the unrealized losses on KONZUM shares (HUF 0.73 bn) and unrealized losses of Hungarian state bonds (HUF 0.32 bn).
- The shareholders' equity increased from HUF 9 bn to HUF 17.44 bn (+93% YoY) by the end of 2018 thanks to a higher comprehensive income and the capital increase by private placement (HUF +8.2 bn), while the dividend payment dividend reduced equity by HUF -934 mn.
- The available solvency capital ratio (based on own capital plus the present value of future expected profits) of the life and non-life insurance segments were 346% and 183%, respectively, as at 31 December, 2018, so both segments fulfilled the 150% Solvency Capital adequacy requirements of the Supervisory Authority despite revaluation losses on government papers and KONZUM shares.

- Outlook: We keep our estimate for total annualized premium of new life policy sales at HUF 3.2 bn in 2019 (flat on 2018), with the risk that new alternative savings instruments (like pension government bonds) may hamper penetration of UL product going forward. As a result of reclassification of existing single premium insurance contracts) we raise our GWP forecast for 2019 from HUF 24.3 bn to HUF 26.2 bn.
- With improving non-life cost ratios, strict cost discipline and increasing earnings contribution from asset management, we remain confident that Pannonia will be able to deliver HUF 2.16 bn after-tax profit for 2019, implying an EPS of HUF 23 (-5% YoY). We also expect that Pannonia could generate after-tax profit of ca. HUF 2.41 bln by 2021, implying a 3-year clean EPS GAGR of 4% on 2018 EPS, though without incorporating any additional profits that can potentially arise from deeper cooperation with KONZUM. The risk to our earnings projection is a lower than anticipated renewal ratio in the life segment going forward due to the expiry and the increase in the surrender of life policies contracted ten years ago en masse, and to new savings forms sponsored by the government. We believe further cost significant savings are hard to make in light of ballooning IT costs and wage increases.
- Although rising interest rates and floundering KONZUM shares are currently weighting on Pannonia's comprehensive results, the insurer should benefit from higher yields at which it will be able to invest newly generated premiums in the future, while asset management fees may stabilize. Notwithstanding huge fluctuations time-to-time in other comprehensive results caused by mark-to-market revaluation of available for sales securities held on B/S (government bonds and KONZUM shares, in particular), Pannonia shouldn't change its dividend plan for the forthcoming years (dividend can be paid from the after-tax profit and retained profits until the total own equity is higher than the share capital).
- Pannonia intends to distribute not only the parent (life insurance) company's unconsolidated full annual net profit, but also the parent company's entire retained profit reserve to shareholders. At the end of last year, the profit reserve of the life insurance company including the profit after tax for the year 2018 amounted to HUF 1.73 bn, which should imply dividend of HUF 18.4 a share (DIVY of 4.4%) compared to market expectations of HUF 20 which would correspond to a slightly higher dividend yield of 4.7% based on the current share price. Although the dividend that can theoretically be paid is only HUF 1.5 lower than the average of analysts' expectations, it is a big challenge facing the insurer to pay HUF 20 in the prevailing accounting and legal framework. (For example, share buybacks are also subject to the same rules as dividends, ie whether the insurer pays dividends or repurchases own shares, both of which are limited to the amount of accumulated retained earnings.)
- That said, it is also conceivable that the dividend will exceed HUF 20 per share next year. To wit, Pannonia does not necessarily need to increase its after-tax profit, just keep it flat compared to last year's figures. As there is new acquisition target on the insurer's investment horizon, and the former hopes that KONZUM will effectively support Pannonia's expansion in the domestic insurance market have not yet come through, while the insurer is clearly over-capitalized and thus it should be able to pay out all its available retained earnings to shareholders. The non-life business had profit reserves in a total of HUF 1.2 bn at the end of last year, which can be transferred to the parent company as dividend, and then paid out fully to the parent company's shareholders, as well as the net earnings coming from the fund management company (around HUF 0.3 bn), while the life business itself is also expected to achieve HUF

0.9-1.0 bn after tax profit next year, which can also be paid out fully to shareholders. All this together creates the base for the insurer to pay approx. HUF 24.8 as share dividend in 2020, implying a DIVY of 5.9% on our estimate. Increasing dividend would certainly benefit the principal owners controlling management rights and KONZUM, and thus the minority owners.

- What is alarming, however, is that the share price performance is daunting. Over the past year Pannonia shares have underperformed the European insurance benchmark index (SXIP) by 7% in terms of total return in EUR, signaling that share price rally ahead of the news that KONZUM would inject capital into the insurer has waning conviction behind it. Institutional investors are seen preferring to stay on the slidelines bemoaning that Pannonia's goals as to where it is going with respect to its excess capital, and the challenges and risks that this involves are unclear. Investors tend to invest in companies that are undervalued compared to their growth opportunities that can be exploited at costs lower than the required rate of return, but the possibility of higher dividend payments going forward might send a bad message that Pannonia cannot utilize its excess funds arising from the last year's capital increase, which currently is more of a burden than an opportunity to finance growth, and in fact it only worsens the return on equity. No doubt it would be more beneficial for Pannonia to reinvest the excess funds back into business development, but it seems that it has used only its own internally generated funds so far for this purpose while keeping all its excess funds in bank deposits and government bonds in the absence of new acquisition targets.
- We believe that the key domestic driver (growth) is holding up, the fundamental backdrop for the insurance sector looks healthy, the weakness of the competitors within some savings market segments could turn into a tailwind, but valuation likely reflects a lot of lucrative business opportunities already.
- **We leave our 12-m TP at HUF 484 a share (implying a 15% upside potential from the current share price). We keep our Accumulate rating on Pannonia.**
- Pannonia is currently trading at a P/E multiple of 18.5x based on 2019E earnings and a P/BV multiple of 2.3x on yearend-2018 book value. On the basis of 2018E P/E ratio Pannonia is trading at a 68% premium over peers' corresponding multiples, while its P/BV multiple implies a 77% premium over peer's average P/BV. Pannonia's relative reach valuation in terms of P/E clearly reflects investors' firm belief that the insurer could extract potentially significant synergies from the partnership with KONZUM. Evidently, in order for investors to justify this reach valuation, Pannonia has to provide greater disclosure about how to use its excess cash to develop fast its businesses on a sustainable basis.

Comparative valuation

	Price LCY	P/E 2019F	P/BV 2018F	DIVY 2018F	ROE 2018F
VIG	21.68	9.8x	0.6x	4.2%	5.6%
UNIQA	8.39	11.7x	0.9x	6.1%	6.9%
PZU	43.19	12.2x	2.6x	5.8%	21.9%
Triglav	32.40	10.2x	1.0x	7.7%	9.4%
CIG Pannonia	422.0	18.5x	2.3x	4.4%	15.7%
Peer group's average		**11.0x**	**1.5x**	**5.9%**	**10.9%**

Source: Bloomberg, Concorde

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Neutral	Total return is expected to be in the range of 10%-(-10%)
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