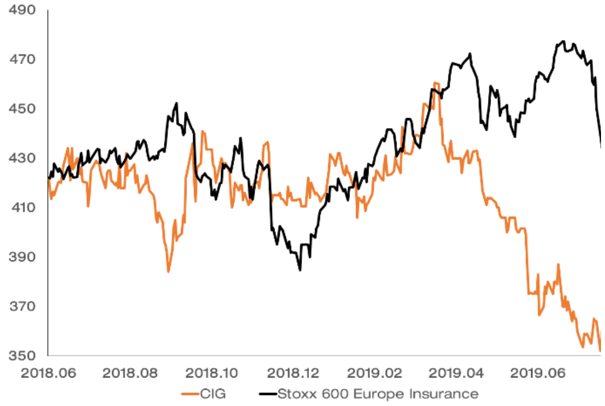
Pannonia

Rating: Neutral (prev. Accumulate)

Price target (12-m): HUF 315 (prev. HUF 496)

Current share price: HUF 320

HUF million	2016	2017	2018	2019F
GWP	18 941	26 933	25 832	26 425
After-tax profits	724	2 598	2 052	300
Own equity	3 972	9 015	17 392	15 876
EPS [HUF]	11.7	41.4	24.2	3.2
DPS [HUF]	0.0	10.0	32.0	25.0
BVPS [HUF]	103.6	143.7	185.6	168.1
P/GWP (x)	1.6	1.1	1.2	1.4
P/E (x)	27.4	7.7	13.2	100.0
P/BV (x)	3.1	2.2	1.7	1.9
DVY (%)	0.0	2.5	7.9	7.8
ROE (%)	12.1	33.5	14.7	1.8



Performance	12M	YTD	3M	1M
Absolute	-15.0%	-11.0%	-17.9%	-7.6%
BUX relative	-22.8%	-13.2%	-17.6%	-5.9%

Share price as of 8/24/2019	HUF 320	Bloomberg	CIGP.BU
Number of shares [million]*	94.4	Reuters	PANNONIA HB
Market capitalization [HUF bn/EUR mn]	30.22/ 92.0	Free float**	50%
Enterprise value [HUF bn/EUR bn]	30.22 / 92.0	52 week range	309/457
Daily turnover 12M [EUR mn]	0.07	EURHUF	328.4

Equity Analyst
Attila Vágó
+361 489 2265
a.vago@con.hu

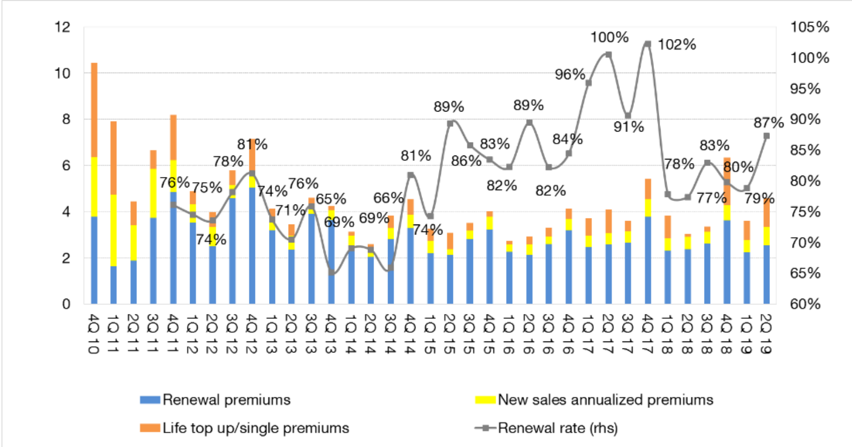
Alkotas Point
55-61 Alkotás utca,
H-1123 Budapest
www.con.hu

The Italian fiasco

- Pannonia reported IFRS consolidated net loss of HUF 1,118 mn in Q2/19 compared to HUF 540 mn after tax profit in the same period of a year earlier mainly due to unexpected significant claims in the non-life segment related to Italian cross-border gaming surety insurance, which resulted in a net loss of HUF 692 mn, and to the realized loss of HUF 1,057 mn on the termination of KONZUM shares (owing to the merger of KONZUM Plc into OPUS Global Plc).
- Consolidated GWP rose 8.6% YoY in Q2/19 to HUF 5.35 bn with life insurance GWP advancing 50% YoY on and non-life GWP rising 10%. Life insurance GWP was mainly driven by new policies sold and an improved ratio of renewals of existing policies.
- In the life segment GWP from the first annual premiums of policies sold was HUF 780 mn in Q2/19 implying a staggering 43.4% growth YoY, while GWP from renewals came in at HUF 2.54 bn (+7.3% YoY). As a result of the latter, the renewal ratio went up to 87% from 79% in Q1/19. Top-up and single premiums (HUF 1,246 mn) were 904% higher than in the same period a year earlier, mainly relating to unit-linked life insurance policies. Within the total life insurance premium income, which

amounted to HUF 4,569 mn- according to IFRS, top-up and single premiums accounted for 27% in Q2/19 compared to 4% in Q2/18.

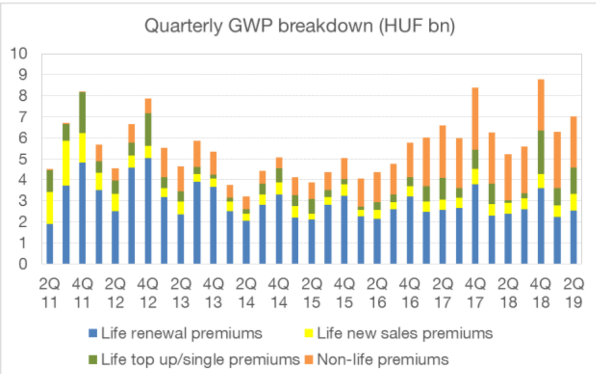
GWP breakdown in the life insurance segment (HUF bln)

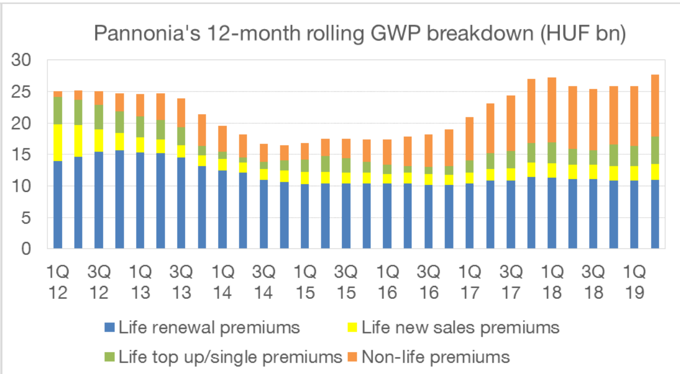


Source: Pannonia, Concorde estimate

- Traditional life insurances (endowment, pure endowment and healthcare policies) represented ca. 24% of total annualized premiums of new sales vs. 11% in Q2/18 reflecting the gradual shift in the product mix towards to risk and traditional products, including group insurance. As traditional insurance policies usually generate a lower amount of annualized premiums than unit-linked insurance policies, the life segment's GWP growth should slow down in the longer run but its profitability is likely to stay elevated, if other things remain unchanged. The increase in the amount of the annualized premium of new sales in the life segment was mainly thanks to the independent broker channel and other business development channel.
- In the non-life segment the net portfolio development was largely positive in Q2/19 (+118.9% YoY) as a result of enhanced activity of the newly formed financial intermediary subsidiary.

Quarterly consolidated GWP breakdown (HUF bln) 12-m rolling GWP breakdown (HUF bln)





Source: Pannonia, Concorde estimate

- In the sale of insurance policies sold in the half of 2019 the tied agent network accounted for 19% (H1/18: 28%), the independent brokerage network 28% (H1/18: 38%) and the bank channel 18% (H1/18: 27%), respectively, while the newly established financial intermediary subsidiary sold 8% (H1/18: 0%), and other business development's share accounted for 26% of the new sales (H1/18: 7%).
- Investment results were slightly positive in Q2/19 (HUF 165 mn vs. HUF 333 mn in Q2/18). Earnings from the MKB-Pannónia Fund Management Company to the Group which are reflected in the return on investments accounted for using the equity method, went up from HUF 35 mn in

Q2/18 to HUF 76 mn in Q2/19 thanks to better performance of capital markets.

- Operating costs dropped 7.6% YoY and accounted for 31.6% of GWP (vs. 37.5% of GWP in Q2/18), of which fees, commissions and other acquisition costs represented 72% (vs. 64% in Q1/18), while admin costs and other expenses accounted for the rest.
- Acquisition costs rose 3.6% YoY, whereas gross premiums earned increased by 8.6% YoY. The primary reason for the rise in acquisition costs was that the new sales rose significantly in both core segments, especially those for traditional insurance products, as compared to the previous year. Other admin costs decreased by 26.7% YoY mainly due to cost cuts. Other income dropped by 12% YoY driven by the decline of the existing non-life insurance portfolio.
- Net claims and related settlement expenses dropped 2.6% YoY in Q2/19, as a combined result of a decline in the number of unit-linked surrenders and a significant increase in claims in the non-life segment net claims due to losses on the gaming surety insurance activity (the insurer has suspended the activity of the Italian cross-border gaming surety due to the high risk exposure of the product. In the non-life segment claim ratio came to 31% compared with 33% in Q12/18.
- Net RBNS and IBNR reserves increased by HUF 692 mn, primarily due to the significant provisioning of large claims in the Italian surety product. Pannonia created a significant amount of provisions (ie technical reserves) for possible losses and related claim settlement costs on gaming surety activity in Italy (the beneficiary is the Italian Customs and Monopoly Agency (ADM), which is responsible for the supervision of gambling in Italy). Earlier ADM had submitted a request for drawdown of insurance promissory notes for five clients (gaming organizers) whose contractual obligations (concession fees and tax payment obligations) were guaranteed by Pannonia in a total value of EUR 12.8 mn (with reinsurance to the tune of ca. 50% of losses on our estimate). Pannonia expects that it might take several months, even years, to determine the exact amount of claims and settle them. The insurer's best estimates of expected value of claims (including expected claim payments, attorney and expert costs) was HUF 1,229 mn in Q2/19, while the recoverable amount from regressions, reinsurance and commission reversals was HUF 537 mn, thus net losses arising from gaming surety activity reduced Pannonia's Q2 results by HUF 692 mn. Although Pannonia has decided to suspend and review its cross-border gaming insurance business in Italy, there is the risk that it may incur further losses on gaming surety activity, while claim settlement costs can also exceed the current estimates making it necessary for Pannonia to create even more reserves to cover them.
- Total reported other comprehensive income was positively impacted by the an increase in the fair value of available-for-sale financial assets of HUF 1,175 mn arising from unrealized exchange losses on KONZUM shares (HUF -331 million), increase in other comprehensive income on termination of Konzum shares (HUF + 1,057 mn) and the results from unrealized exchange rate gains of HUF 449 mn on Hungarian government bonds.
- In the first six month of 2019 Pannonia generated consolidated after-tax loss of HUF 610 mn compared to after-tax profit of HUF 615 mn in the same period of last year. The life insurance business brought HUF 1,152 mn after tax profits in H1/19 vs HUF 805 mn in H1/18 (+43% YoY). Excluding dividends of HUF 1,127 mn paid by the non-life segment from its earnings generated in the previous years and dividends of HUF 342 mn received from the asset management company, while adding back realized losses of HUF 1,059 mn on KONZUM shares the life segment reached ca. HUF 742 mn underlying after-tax profit in H1/19 on our

estimate vs. ca. HUF 550 mn in H1/2018 (+35% YoY). The non-life segment's after tax loss amounted to HUF 275 mn in H1/19 compared to after-tax profit of HUF 410 mn in H1/18, and asset management business delivered HUF 159 mn after tax profit vs. HUF 193 mn in H1/18.

Pannonia's underlying after-tax profit development (HUF mn)

	H1/18	H1/19	Ch.(%)
Life (reported w/o asset management)	612	993	62.3
Adjustments*	0	-410	n.a.
Life (underlying)	612	583	21.2
Non-life	410	-275	n.a.
Asset management	193	159	-17.6
Total underlying	**1,215**	**467**	**-61.6**

Note: Adjustments are the result of dividends received from the non-life segment and the asset management company and the one-off realized loss arising from the termination of KONZUM shares. EMABIT (engaged in non-life insurance business) and MKB-Pannónia Fund Management paid dividends in a total value of HUF 1,469 mn to the parent Company (the life insurance business), out of which EMABIT transferred HUF 1,127 mn and MKB-Pannónia Fund Management transferred HUF 342 mn as dividends from their 2018 earnings.
Source: Pannonia, Concorde estimate

- The insurer's shareholders' equity increased from HUF 17.39 bn to HUF 17.96 bn (+3% YoY) on the back of the life segment's earnings contribution.
- 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 321% and 151%, respectively, as at 30 June, 2019, so both segments fulfilled the 150% Solvency Capital adequacy requirements of the Supervisory Authority despite revaluation losses on KONZUM shares and loss due to gaming surety activity in Italy.
- A the recent Annual General Meeting the shareholders approved the reduction of Pannonia's share capital through the decrease of the nominal value of the shares in order to the distribution of excess capital. Due to the reduction of the share capital Pannonia's share capital shall decrease from 3.777.130.400 HUF to 3.116.132.580 HUF and the nominal value of the shares from HUF 40 to HUF 33. The capital reduction will affect ca. 17.5 per cent of the equity thus the expected amount of the total payment would be approx. HUF 3 bn, or HUF 31.96 per share paid possibly in early September. The reduction of capital will also add to an improvement of the insurer's ROE. As for the effect of the capital reduction, it corresponds to a 7.9 per cent DIVY on the basis of the share price at the date of share registration for the AGM.
- <u>Outlook</u>: Total annualized premium of new life policy sales is likely to exceed our original expectation of HUF 3.0-3.3 bn and end up amounting to ca. HUF 3.5 bn in 2019 (+10% YoY). We also expect Pannonia to remain highly committed to keeping a tight lid on controllable operating costs especially in the light of unexpected claims and related costs arising from gaming surety activity in Italy.
- We expect the non-life segment to generate losses in the region of HUF 70 mn at best this year due to huge losses recorded on gaming surety activity in H1, while realized losses recorded as investment expenses in H1 on terminated KONZUM shares should hinder the life segment's ability to generate as much profit as expected previously. In the second half of 2019, we believe the life segment should generate more or less the same amount of underlying earnings as in the first half of the year (ca. HUF 600 mn), and the non-life segment should reach HUF 200 mn after-tax profit, provided that there will be no further provisioning needs for the loss-making gaming surety product in Italy. The asset management is expected to report somewhat lower profit in the

remainder of the year (HUF 120 mn on our estimate) due to global stock market turbulences. Putting it all together, Pannonia should have after-tax profit of as much as HUF 920 mn in H2/19, with which its full-year reported after-tax profit may arrive at HUF 300 mn, while its net profit adjusted for net of extraordinary items may amount to HUF 1.5 bn compared with our previous estimate of HUF 2.1 bn. We still believe that Pannonia could generate net profit of ca. HUF 2.4 bn by 2022, implying a 4-year EPS GAGR of ca. 3-4%.

- As the capital reduction does not have an effect on retained earnings generated in the life segment in the previous years, the base for dividend payments remains theoretically high allowing Pannonia to keep dividend at approx. HUF 25 a share going forward (implying ca. 8% DIVY based on the current share price). Nevertheless, there is absolutely no guarantee that Pannonia will keep this high dividend next year taking into account the significant loss generated in the non-life segment recently.
- **We earlier stressed that if Pannonia fails to make significant inorganic steps within a foreseeable future, we will feel it appropriate to reduce significantly our TP.** Clearly, Pannonia's mid-cap status and rising speculative purchases of its shares by local individuals have so far helped shield the insurer's ca. EUR 100 mn market cap from global swings in sentiment. The share price was holding firm supported by heightened expectations that Pannonia could deliver outstanding earnings growth by forming a mutually fruitful cooperation with the KONZUM Group. Local investors got enamored by the extent of participation of the KONZUM in a large capital injection into Pannonia taking place last year that the insurer was believed to use for value-creative acquisitions. With caution thrown to the wind, the share price got highly inflated, bearing little relation to the insurer's intrinsic value beyond a certain level. There seemed that regular market participants were engaged in a speculative exercise which was not supported by conventional valuation techniques. Fear of missing out on what could be an once-in-a-lifetime opportunity spurred more speculation, drawing an increasing number of participants into the fold and making the stock more susceptible to herd behavior. In addition, as a domestic mid-cap company drawing little attention from international institutional investors, Pannonia is usually slower to react to global sentiment. The stock is not part of any EM strategies or ETFs, so there is typically no selling pressure affecting it when global markets turn south.
- That said, concerns are mounting among investors that earnings weakness in the non-life segment and an impending slowdown in economic activity and thus in savings (hence customers' presumably less appetite for risk insurance products) could drag down the insurer's profitability, and that the insurer is on a path toward lower earnings growth. Yet, Pannonia had decent new life insurance sales growth in H1/19, which was much better than expected, so that is a clear counter act, suggesting that the insurer's return to profit may be on track for the second half of the year. That is why we do not expect there to be any kind of persistent decline in profitability is reasonable to assume for the coming years.
- Even so, questions are being asked whether Pannonia really has the ability to take risk to succeed in expanding niche market segments abroad, and, if not as recent evidence shows in Italy, what else would be necessary for Pannonia to keep its earnings performance prominent, and if it apparently has no enough capital base to take meaningful risk why so high multiples should be justified to apply for its valuation.
- Pannonia trades at 100x 2019 earnings (14.3x 2020 prospective earnings) and 1.8x on a current P/BV basis, compared with peers' corresponding multiples of 10.0x and 1.1x. Evidently, there is the risk,

especially after earnings miss, that Pannonia's multiples converge fast towards the market and industry peers' lower valuations, even if it offers one of the highest dividend yields in the regional insurance sector.

- Now that Pannonia reported significant losses in the non-life business and there is no sign of deepening cooperation with KONZUM (OPUS) that would result in higher profit growth for the insurer in the short term, we no longer believe that Pannonia will be able to live up to investors' elevated expectations and no longer believe that the insurer could extract potentially significant synergies from the partnership with OPUS, or will be able to make another meaningful acquisitions in the foreseeable future, either. We are of the view that if OPUS were really interested in exploiting any potential synergies with Pannonia, they would have already begun to forge a closer business relationship. In the total sale of insurance policies sold, the share of bank channel (which reflects well how fast cooperation between Pannonia and the financial service providers controlled by the OPUS Group improves) dropped 9pps on the year, although it should have actually risen. It seems that the financial service providers within the OPUS group are increasingly focusing on meeting the financing needs of the group's own industrial members, while they seem to pay less attention to deepening partnership in non-core activities. If we are right, Pannonia has no other option but to grow only on its own (forming a new financial intermediary company clearly reveals this trend). That, however, might not be enough to develop the growth of its businesses as fast as required in order for investors to justify its hefty valuation. If Pannonia were to make an acquisition today, it would in fact be too late, given that it would take at least a year to complete the transaction and it would take another year to fully integrate the acquired assets into the group's operations. So the other big hope that Pannonia will take the lead in consolidation among smaller domestic insurance carriers is also slowly evaporating.
- The intention of OPUS with Pannonia is also unclear. OPUS has a minority stake in Pannonia that it purchased at a price of HUF 350 a share and that was considered as a blessing as long as Pannonia's rapid earnings growth and nice dividends fostered appreciation of the price of KONZUM (OPUS) shares. Investors OPUS was believed to go into Pannonia to make money by extending its activity towards financial intermediaries. But investors wanted to see their relationship dynamics, who actually knew what to do, who was along for the ride, and who had relevant experience on the part of OPUS in the insurance business, where they intended to go from there, whether they were looking at a buy-out of Pannonia or willing to consider some form of acquisitions, or when they wanted to decide to close partnership and exit, or OPUS just simply wanted to have access to technology, contracts, clients. Investors have not got answers as yet to these questions, while the premium, which was built into Pannonia's valuation after the capital increase by KONZUM (OPUS), has now completely disappeared.
- Putting it all together, we expect Pannonia to remain overcapitalized and see a slowdown in its earnings growth for the coming years. We still believe that Pannonia will be able to keep on paying handsome dividends to shareholders but with lower earnings growth potential, Pannonia's lofty valuation can hardly be justified. **Therefore we cut our 12-m TP from HUF 496 to HUF 315 a share, while downgrading our rating on the stock from Accumulate to Neutral.**

Peers' comparative valuation

	Price (local currency)	P/E 2019F	P/BV 2018	Dividend yield 2019F	ROE 2019F
VIG	23.4	9.7x	0.6x	4%	6%
UNIQA	8.3	11.9x	0.8x	7%	7%
PZU	37.2	9.9x	2.0x	8%	20%
AEGON	3.6	5.3x	0.3x	8%	6%
Zurich	350.3	13.0x	1.6x	6%	12%
Generali	16.3	9.6x	0.9x	6%	9%
Allianz	201.0	10.6x	1.2x	5%	11%
Peer group's average		**10.0x**	**1.1x**	**6%**	**10%**

Source: Bloomberg

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Accumulate	Total return is expected to be in the range of 10-20%
Neutral	Total return is expected to be in the range of 10%-(-10%)
Reduce	Total return is expected to be in the range of -10-(-20%)
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(https://www.con.hu/wpcontent/uploads/2016/04/Methodology_concorde_research.pdf?tstamp=201710021038)

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