CONCORDE RESEARCH

CEE Equity Research | Insurance | Hungary
17 Augustus 2021

CIG Pannonia

Recommendation: Neutral (unch.)
Target price (e-o-y): HUF 355 (prev. HUF 340)
Share price: HUF 315

Share price as of 17/08/2021	HUF 315	Bloomberg	PANNONIA HB
Number of diluted shares [million]	94.4	Reuters	CIGP.BU
Market capitalization [HUF bn/EUR mn]	29,736/84.5	Free float	49%
Daily turnover 12M [HUF million]	0.08	52 week range	HUF 137 – 388

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Staying on track

- CIG Pannonia posted consolidated after-tax profit of HUF 123 mn for Q2/2021 compared to HUF 931 mn in the same period a year earlier on our calculation. After adjusting for the results of non-life assets held for sales, consolidated after-tax profit was HUF 149 mn, down by 83% YoY.
- The decrease in total adjusted after-tax profit compared to Q2/20 was largely due to the following reasons: 1) the after-tax losses of HUF 242 mn and HUF 108 mn of the non-life segment and other activities, respectively, while life segment also reported 11% lower after-tax profit YoY.
- Total comprehensive losses amounted to HUF -112 mn versus a profit of HUF 1.68 bn in the same period of last year. Other comprehensive income included a HUF 235 mn decrease in the fair value of available-for-sale financial assets, of which HUF 178 mn is the unrealized loss on OPUS shares held by Pannonia and the remaining HUF 57 mn was the unrealized loss on government securities.

Breakdown of the Group's GWP and after tax profit (HUF mn)

	Life			Non-life			Other			Cons.			Total		
	2021														
	H1	Q2	Q1	H1	Q2	Q1	H1	Q2	Q1	H1	Q2	Q1	H1	Q2	Q1
GWP	10 676	5 770	4 906	154	81	73	0	0	0	0	0	0	10 830	5 851	4 979
Reported after-tax profit	1 093	754	339	-320	-268	-52	-185	-108	-77	82	255	-173	506	123	383
After-tax adjustments	0	0	0	3	-26	29	0	0	0	0	0	0	3	-26	29
Adjusted after-tax profit	**1 093**	**754**	**339**	**-323**	**-242**	**-81**	**-185**	**-108**	**-77**	**82**	**255**	**-173**	**503**	**149**	**354**
Reported total comprehensive income	454	538	-84	-366	-287	-79	-185	-108	-77	82	255	-173	-179	-112	-67
	Life			Non-life			Other			Cons.			Total		
	2020														
	H1	Q2	Q1	H1	Q2	Q1	H1	Q2	Q1	H1	Q2	Q1	H1	Q2	Q1
GWP	9 232	5 083	4 149	68	46	22	0	0	0	0	0	0	9 300	5 129	4 171
Reported after-tax profit	1 115	844	271	413	413	0	25	141	-116	379	468	-89	1 174	930	244
After-tax adjustments	0	0	0	348	33	315	0	0	0	0	0	0	348	33	315
Adjusted after-tax profit	**1 115**	**844**	**271**	**65**	**380**	**-315**	**25**	**141**	**-116**	**379**	**468**	**-89**	**826**	**897**	**-71**
Reported total comprehensive income	482	1 520	-1 038	364	486	-122	25	141	-116	379	468	-89	492	1 679	-1 187
Change in adj. after-tax profit (YoY)	**-2%**	**-11%**	**25%**	**n.a.**	**n.a.**	**-74%**	**n.a.**	**n.a.**	**-34%**	**-78%**	**-46%**	**94%**	**-39%**	**-83%**	**n.a.**

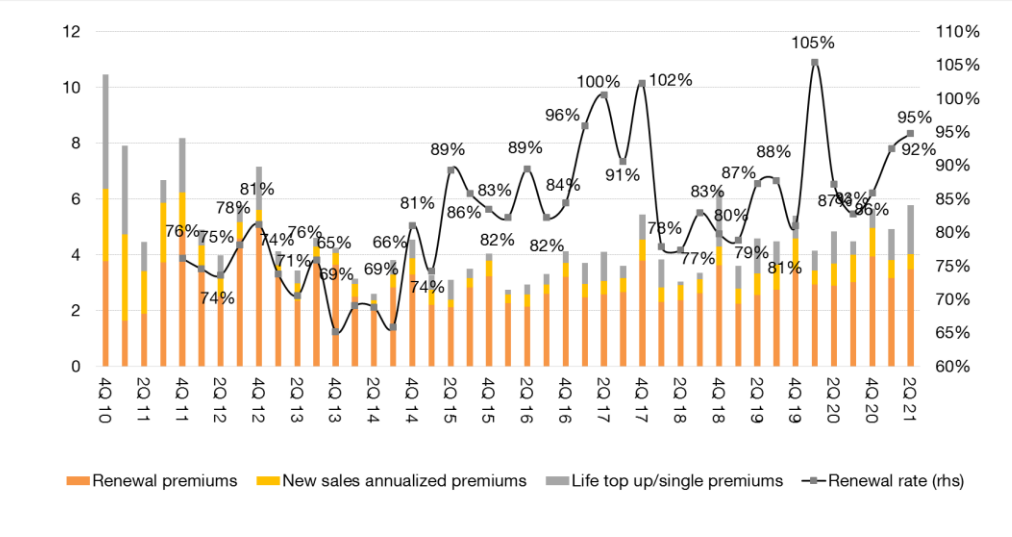
Source: CIG Pannonia, Concorde's estimate

- Pannonia's life insurance business remained financially stable and fundamentally solid, with a solvency II capital adequacy ratio staying as high as 351% at the end of

30 June, 2021. The consolidated capital adequacy ratio was also 351%, improving from 344% at the end of March, 2021.

- In the life insurance segment, the total annualized amount of new sales was HUF 0.88 bn in Q2/21, 24% higher than in the same period a year earlier, driven by increasing new UL insurance contracts (+47% YoY). The annualized amount of traditional life insurance new sales declined by 4% YoY, which might be attributed to temporarily lower group insurance policy sales.
- As a whole, life insurance GWP rose by 14% YoY in Q2/21 from HUF 5.08 bn to HUF 5.77 bn. GWP of unit-linked life insurance reached HUF 4.48 bn (thereof 45%, ie. HUF 2.0 bn was pension insurance policies), HUF 1.2 bn were traditional life products (thereof HUF 0.34 bn came from pension insurance policies), and HUF 0.09 bn were health insurance policies. GWP from renewals was HUF 3.48 bn (+20% YoY), while GWP from the first annual premiums of policies sold was HUF 0.54 bn (-31% YoY)). Top-up and single premiums amounted to HUF 1.76bn (+51% YoY), accounting for 30% of total life insurance GWP in Q2/21 compared to 24% YoY. Renewal ratio improved QoQ from 87% to 95% YoY.

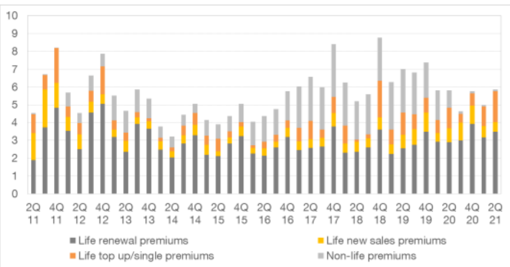
GWP breakdown in the life insurance segment (HUF bln)



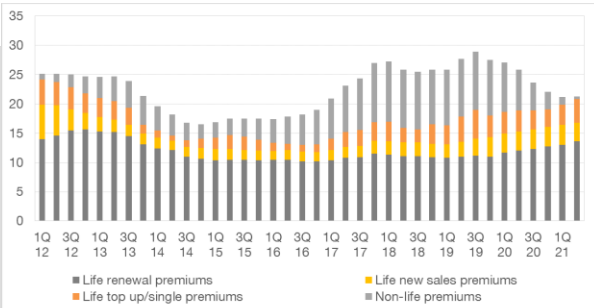
Source: Pannonia, Concorde estimate

- Non-life GWP rose by 76% YoY to HUF 81 mn reflecting the efforts to rebuild some major non-life insurance activities.
- 12-month rolling GWP appeared to have been stabilizing thanks to the improved renewal ratio, higher top-up income and recuperating non-life business sales.

Quarterly consolidated GWP breakdown (HUF bn)



12-m rolling GWP breakdown (HUF bn)



Source: Pannonia, Concorde estimate.

- The other operating income of HUF 209 mn in Q2/21 came mainly from fund management operation (HUF 140 mn), which remained by and large flat YoY despite a previously sold unit-linked product portfolio.
- Investment results were positive at HUF 1.36 bn in Q2/21 (vs. HUF 3.19 bn in Q2/20) as a result of continued good performance in the global stock markets triggered by the cyclical recovery from the economic shock triggered by the coronavirus pandemic last year. In contrast, in the first half of 2021 inflation expectations increased, which led to rising bond yields and therefore lower bond prices.
- Operating costs declined by 2% YoY in Q2/21 and accounted for 27% of GWP (vs. 32% in Q2/20), of which fees, commissions and other acquisition costs represented 63% (vs. 57% in Q2/20), while admin costs and other expenses (mainly provisions) accounted for the rest. Acquisition costs rose by 8% YoY mainly due to the increasing sale of UL insurance products, and accounted for ca. 113% of annualized premium of new sales compared to 130% YoY.
- Net claims and related settlement expenses increased by 43% YoY in Q2/21 partly due to higher life segment claims expenditures in the aftermath of the surrenders of unit-linked products.
- The amount of net change in reserves was HUF 1.97 bn, which is made up almost entirely by the increase of unit-linked life insurance reserves.
- As for life insurance policies sold in H1/21 the share of the tied agent network is 13%, independent brokers bring in 44% and the bank and other business developments represented 43% of new sales.

New strategy

- Pannona’s new growth strategy aims to achieve HUF 1.2 billion more technical profit and HUF 25.3 billion more GWP by 2023 compared to 2020, based on improving cost efficiency, higher new insurance products, and a more intensive use of digital and banking sales channels. The strategic plan includes investment spending in a value of HUF 1.4 bn. Pannonia has been granted by HUF 800 million of state support from the National Office for Research, Development and Innovation that it intends to use for the development of personalized insurance products based on artificial intelligence.
- The new strategy envisages a total increase of about HUF 38 billion in GWP over the next three years compared to 2020, which we consider as an ambitious objective. Although we do not rule out the possibility of reaching this income goal, we see a number of risks related to the market acceptance of Pannonia’s life insurance products in the future, the targeted very low level of cost content associated with new sales (ca. 3%) and new sales through bank channels.
- We expect Pannonia's consolidated GWP to increase to HUF 34.5 bn by 2023, which represents 78% of Pannonia's own gross premium income target for 2023. Within GWP, the share of the non-life business may be 30 percent in 2023.
- In 2021, Pannonia's consolidated net profit may reach HUF 1.65 bn, of which MKB Pannónia Alapkezelő may account for HUF 400 mn. Therefore EPS may increase to HUF 17 from HUF 7 (+ 149%) last year. Pannonia's net profit is likely to increase further to HUF 1.99 bn in 2022 and HUF 2.37 bn in 2023, mainly supported the expected improvement in the non-life business’ profitability. As a result, EPS may grow to HUF 21 in 2022 and HUF 25 in 2023. Of course, rebuilding the non-life business will be a time-consuming, costly and capital-intensive process presumably requiring an additional capital contribution by the parent company in an amount of

HUF 1 bn at least in order for EMABIT to be able to maintain its capital requirement ratio at around 150-160%.

Earnings estimates (IFRS, HUF mn, if not otherwise stated)

	2020	2021*	2022*	2023*	2024*
GWP	**19 319**	**21 466**	**26 133**	**34 588**	**37 364**
Unit-linked reserves	74 122	80 332	81 284	74 895	56 962
Other reserves	17 064	17 213	19 124	22 761	25 219
Total reserves	**91 186**	**97 545**	**100 409**	**97 656**	**82 181**
Own capital	**13 894**	**15 541**	**16 589**	**17 459**	**17 827**
Other liabilities	7 616	8 078	8 198	7 819	6 604
After-tax profit	**660**	**1 647**	**1 992**	**2 370**	**2 602**
EPS (HUF)	7.0	17.4	21.1	25.1	27.6
DPS (HUF)**	0.0	10.0	15.9	18.7	20.5
BVPS (HUF)	148.3	164.6	175.7	184.9	188.8
ROE (%)	4.8	11.2	12.4	13.9	14.7

*Note: ** Dividends are paid to shareholders by the listed CIG Life Insurance Plc. In addition to its own non-consolidated annual after-tax profit, Pannonia can also use the profit reserve of previous years for paying dividend. EMABIT and the MKB Pannonia Fund Manager may pay dividends to Pannonia out of their profit and profit reserves, which in turn will go to Pannonia only the following year (after approval by the General Meeting of EMABIT and the MKB Pannonia Fund Manager), thereby increasing Pannonia's profits and thus its dividend base.*
*Source: CIG Insurance, * Concorde estimate*

- Benchmarking Pannonia (based on earnings multipliers) to peers has its limits, given that the majority of European insurers can be considered mature complex insurance carriers. Among the peers, subject to the above-mentioned limitations, the Polish PZU and the Austrian VIG can be the best references for Pannonia's comparative assessments. PZU has no business in the markets where Pannonia is present, while VIG is a serious rival trying to outperform Pannonia in the Hungarian insurance market.

- Pannonia's shares are currently trading at 15.2 times 2022 EPS and 2.2 times P/BV using the 2020 yearend book value, which corresponds to a premium of 77% and 100% compared to the average of similar ratios for PZU and VIG. Pannonia's exceptionally high relative valuation can be attributed to investor's high expectations for a substantial increase in earnings, and the confidence in the new management's ability to steer Pannonia's ship in the right direction. In fact, Pannonia has smaller exposures in every main market segment relative to its foreign-owned insurance competitors. Nevertheless, it seems reasonable to expect that the current huge gap in valuation will narrow over time if Pannonia's future results more or less confirm the rate of income growth that can be assumed based on the current valuation.

- Although neither our earnings forecast nor our valuation incorporate the potential impact of any future acquisition transactions on Pannonia's results and capital position, we attempted to quantify how much share price appreciation potential could result from investing its available excess equity in acquisitions and business development with a ROE that is in line with the sector average, and the financial targets set by management in the new strategic plan are fully met. We must emphasize that this is a more optimistic scenario than our basic assumptions regarding Pannonia's future profitability. We are convinced that in the medium term Pannonia has the resources for this new strategic plan and has the opportunity to gain a share of over 5 percent in the domestic insurance market, while its own and its subsidiary (EMABIT) may also remain sound. If these assumptions prove to be correct and there are clear signs that Pannonia is able to meet its ambitious strategic objectives, the intrinsic value of the shares could reach HUF 446, which is 36 and 31 percent more than the price (HUF 327) offered by HUNGARICUM Alkusz recently for the free float in the framework of a public offer, and our 12-m target price, respectively.

- **We raise our 12-months TP from HUF 340 to HUF 355 due to roll-over, leaving our Neutral rating on Pannonia shares unchanged.**

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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%)
Sell	Total return is expected to be lower than -20%
Under Revision	The stock is put Under Revision if the covering analyst considers new information may change the valuation materially and if this may take more time.

Coverage in transition	Coverage in transition rating is assigned to a stock if there is a change in analyst.

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Valuations and risks:

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