CONCORDE RESEARCH

CEE Equity Research | Insurance | Hungary
18 May 2022

CIG Pannonia

Recommendation: BUY (prev. Neutral)
Target price (e-o-y): HUF 429 (prev. HUF 355)
Share price: HUF 325

Share price as of 23/02/2022	HUF 325	Bloomberg	PANNONIA HB
Number of diluted shares [million]	94.4	Reuters	CIGP.BU
Market capitalization [HUF bn/EUR mn]	30,689/79.6	Free float	42.65%
Daily turnover 12M [HUF million]	0.08	52 week range	HUF 282 – 425

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Q1/22 results: outstanding GWP growth YoY

- CIG Pannonia (Pannonia) posted consolidated after-tax profit of HUF 66 mn for Q1/2022 (-83% YoY) on GWP of HUF 7.6 bln (+52% YoY). Life insurance segment posted after-tax losses of HUF 232 mln compared to profit of HUF 348 mln in Q1/21 due to a significant growth in unit-linked income, while non-life business also generated losses of HUF 273 mln as against losses of HUF 52 mln in the same period a year earlier. Other activities went into the red as well, with after tax losses of HUF 157 mln compared to after-tax losses of HUF 77 mln in Q1/21.
- Total comprehensive loss amounted to HUF 1.3 bln in Q1/22 versus losses of HUF 67 mln in the same period of last year. Other comprehensive losses were HUF 1.3 bln compared to losses of HUF 450 mln profit in the same period a year ago and included a decrease in the fair value of available-for-sale financial assets, out of which HUF 1.45 bln was the unrealized loss on government securities, while there were unrealized gains to the tune of HUF 127 mln on OPUS shares held by Pannonia.
- Despite accelerated GWP growth and losses Pannonia's businesses remained financially stable and fundamentally solid: the consolidated solvency II capital adequacy ratio stood at as high as 249% at the end of March, 2022 compared to 273% at the end of 2021 and 309% at the end of 30 September, 2021. EMABIT's (non-life segment) standalone solvency II capital adequacy ratio should have remained above National Bank of Hungary's minimum requirement of 150%.
- At the Group level, the increase in premium arising from group life insurance products (+57% YoY) was driven by the sales contracts with larger companies, while unit-linked products also saw a robust 32% increase YoY (mainly on the back of surging top-up and single life premiums:). Traditional life insurance products sales remained flat, while non-life segment saw a stunning 1537% increase in GWP, albeit from a very low base. We note that a significant increase in non-life insurance sales is not yet reflected in the net premiums written, as they appear time proportionally over the period covered by the insurance in accordance with the reporting standards in force.

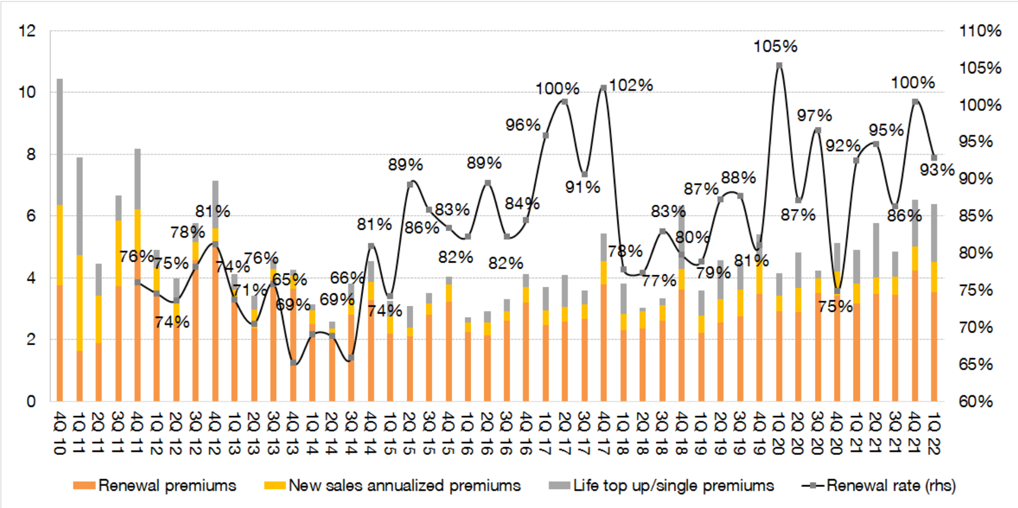
Breakdown of the Group's GWP and after tax profit (HUF mln)

	Life	Non-life	Other	Cons.	Total
	2022				
	Q1	Q1	Q1	Q1	Q1
GWP	6 388	1 195	0	0	7 583
Reported after-tax profit	-232	-273	-157	728	66
After-tax adjustments	0	0	0	0	0
Adjusted after-tax profit	**-232**	**-273**	**-157**	**728**	**-1 390**
Reported total comprehensive income	-1 372	-456	-157	728	-1 257
	2021				
	Q1	Q1	Q1	Q1	Q1
GWP	4 906	73	0	0	4 979
Reported after-tax profit	339	-52	-77	-173	383
After-tax adjustments	0	29	0	0	29
Adjusted after-tax profit	**339**	**-81**	**-77**	**-173**	**354**
Reported total comprehensive income	-84	-79	-77	-173	-67
	2020				
	Q1	Q1	Q1	Q1	Q1
GWP	4 149	22	0	0	4 171
Reported after-tax profit	271	0	-116	-89	244
After-tax adjustments	0	315	0	0	315
Adjusted after-tax profit	**271**	**-315**	**-116**	**-89**	**-71**
Reported total comprehensive income	-1 038	-122	-116	-89	-1 187
Change in adj. after-tax profit (YoY)	**n.a.**	**239%**	**104%**	**n.a.**	**-492%**
Change in GWP (YoY)	**30%**	**1537%**	**n.a.**	**n.a.**	**52%**

Source: CIG Pannonia, Concorde's estimate

- As a whole, life insurance GWP rose by 30% YoY in Q1/22 from HUF 4.15 bln to HUF 4.91 bln. Total unit-linked life insurance amounted to HUF 4.66 bln (thereof 32%, ie. HUF 1.51 bln was pension insurance policies), HUF 1.49 bln were traditional life products (thereof HUF 0.29 bln came from pension insurance policies), and HUF 0.24 bln were health insurance policies.
- GWP from renewals amounted to HUF 3.54 bln (+12% YoY), while GWP from the first annual premiums of policies sold was HUF 0.97 bln (50% YoY), while top-up and single premiums came in at HUF 1.88 bln (+72% YoY), accounting for 29% of total life insurance GWP in Q1/22 compared to 22% YoY. Renewal ratio fell QoQ from 100% to 93% but it remained flat YoY. Life segment benefited mostly from the increase in top-up and single premium income as well as growing income from renewals.

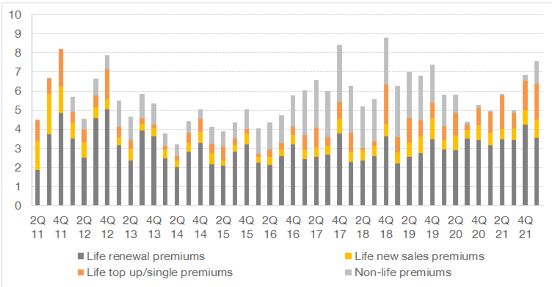
GWP breakdown in the life insurance segment (HUF bln)



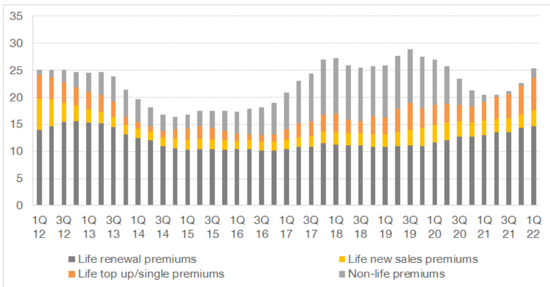
Source: Pannonia, Concorde estimate.

- In the non-life segment, GWP rose by 316% YoY in Q4/21 and 194% YoY in 2021. Despite significantly lower claims provision (mainly on the Italian surety insurance portfolio) than in the previous year losses increased in Q4 due to the cost of implementing the new growth strategy which was announced this summer.
- 12-month rolling GWP appeared to have started increasing 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

- Indeed, all main sales channels increased their sales volume, with independent brokers generating an outstanding 302% growth YoY followed by the bankin channels which delivered 35% growth and the own network 8% YoY, supported by the increased sales network and newly launched products in line with the new growth-driven business strategy. The share of own network was 11% in 2021 (2020: 12%), independent brokers brought in 46% (2020: 42%) and the bank and other business developments represented 53% of new business sales of HUF 4.54 bln (+37% YoY) compared to 54% in 2020. In February, Pannonia concluded a framework agreement with the Hungarian Bankholding Group (Bankholding) for a period of 20 years, according to which Bankholding Group member banks, ie MKB Bank and Takarékbank, will sell exclusively the life and non-life insurance products of the CIG Pannonia Group. Although the sales of the banking channel improved by 35% YoY, however, the impact of the strategic agreement with Bankholding has not yet materialized in Q1/22.
- Investment results were positive at HUF 3.53 bln in Q4/21 (vs. HUF -5.85 bln in Q4/20) as a result of continued good performance in the global stock markets on the back of the cyclical recovery from the economic shock in the aftermath of the

coronavirus pandemic, while increased inflation expectations triggered higher bond yields and therefore lower bond prices.

- The total operating cost of the Issuer was HUF 2.2 bln, of which HUF 1.5 bln was related to the fees, commissions and other acquisition costs, and HUF 578 mln was related to other operating costs (+27% YoY) and HUF 110 mln is other expenses (-1% YoY). Acquisition costs show a significantly increasing trend overall (+64% YoY), while gross earned premiums increased by 37%. This is primarily due to an increase in other acquisition costs than commissions, following the development and recruitment of new business lines, organizations and employees, and the related implementation of Pannonia's Growth Strategy. Life acquisition costs rose by 41% YoY, accounting for 73% of new businesses in Q1/22 vs. 84% YoY, and while in the non-life segment acquisition costs jumped by 442% YoY.
- Net claims and related settlement expenses decreased by 5% YoY mainly due to lower life segment claims expenditures in the wake of the lower number of surrenders of unit-linked products, while traditional and group claims increased, but less than the decrease in unit-linked repurchases.
- The net decrease in insurance reserves was mainly attributed to a drop in unit-linked life insurance reserves led by lower yields generated on unit-linked products.

Outlook

- 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.
- With incorporating the potential impact of the 20-year strategic agreement with Bankholding on future GWP, we expect Pannonia's consolidated GWP to increase to HUF 38.5 bn by 2023 (previously HUF 32.5 bln), which is in line with Pannonia's own gross premium income target for 2023. Within GWP, the share of the non-life business may be ca. 30 percent in 2023.
- Pannonia's net profit is likely to increase to HUF 2.01 bln in 2022 and HUF 2.42 bln in 2023 (previously HUF 1.99 bln and 2.37 bln) supported by both rising life GWP and an expected improvement in the non-life business' profitability. As a result, EPS may grow to HUF 21 in 2022 and HUF 26 in 2023 (previously HUF 21 and HUF 25). We note that rebuilding the non-life business will be a time-consuming, costly and capital-intensive process presumably requiring further capital contribution by the parent company in an amount of HUF 0.5-1 bn in order for EMABIT to be able to maintain its capital requirement ratio at around 150-160%.

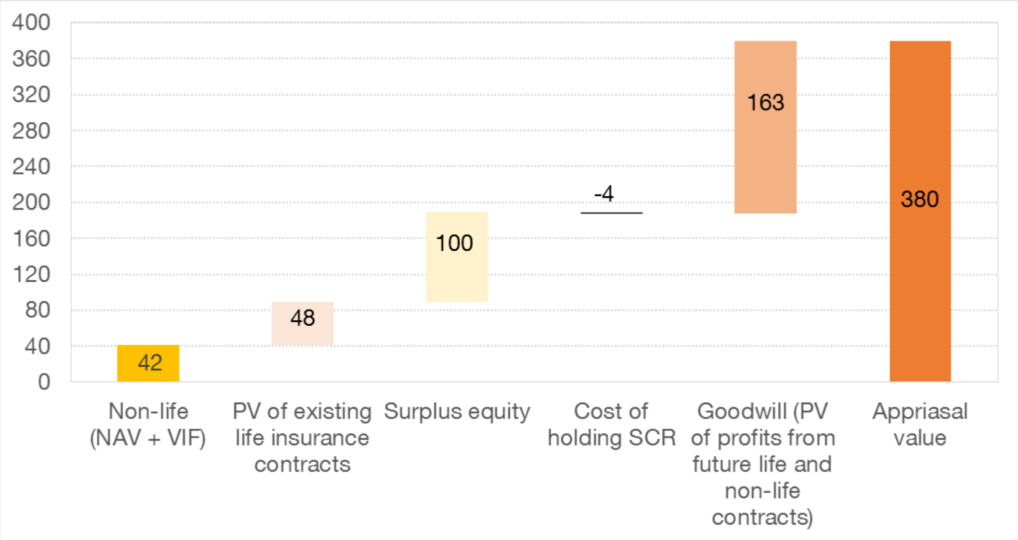
Estimates (IFRS, HUF mln, if not otherwise stated)

	2021	2022E	2023E	2024E	2025E
GWP	22 713	30 171	38 529	42 193	43 604
Own capital	**13 168**	**13 478**	**14 197**	**14 721**	**15 674**
After-tax profit	**1 682**	**2 010**	**2 419**	**3 066**	**3 658**
EPS (HUF)	17.8	21.3	25.6	32.5	38.7
DPS (HUF)**	18.0	18.0	21.7	23.0	28.0
BVPS (HUF)	139.4	142.7	150.3	155.9	166.0
ROE (%)	12.4	15.1	17.5	21.2	24.1

*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

- Pannonia's shares are currently trading at 15.2 times 2022 EPS and 2.3 times P/BV using the 2021 yearend book value, which corresponds to a premium of 19% and 135% compared to the average of corresponding 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.
- We have already incorporated potential results from strategic cooperation with Bankholding into our earnings forecasts and valuation model. 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 subsidiary (EMABIT) may also remain sound (we note that although the daunting Italian exposure has been significantly reduced over the course of the past two years but it still continues to pose a risk to EMBAIT's equity position until legal disputes are settled in a reassuring manner). We also believe that the strategic cooperation with Bankholding will work to the mutual benefit of both parties and that Pannonia will be able to meet its ambitious strategic objectives with a profound support from strategic cooperation with Bankholding.
- Earlier we held the view that if Pannonia was able to meet its ambitious strategic objectives, our TP would be HUF 446 (best case scenario) Now that strategic cooperation has been established between Bankholding and Pannonia we raise our estimate for the intrinsic value of Pannonia's shares from HUF 340 to HUF 380, implying a 12-m TP of HUF 429 (previously HUF 355).
- Our new TP is lower than our previous estimate reflecting a best case scenario because of a new level of risk free rates that we feel appropriate to consider for valuation. Although insurance carriers should be pleased with the rise in yields as it helps them to deliver on yields promised to insurance policy holders and fulfil capital requirements, while also make it possible for them to earn more asset management fees, the new "inflationary regime", which may stay with us for quite a while, should be certainly negative for overall equity market. Even so, our new TP leaves a 32 percent upside potential from the current share price and also 32% higher than the

price (HUF 327) offered by HUNGARICUM Alkusz for the free float last year in the framework of a public offer, respectively.



Source: CIG Insurance, Concorde estimate

We upgrade Pannonia from Neutral to Buy.

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Rating	Trigger
Buy	Total return is expected to exceed 20% in the next 12 months
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.

Securities prices:

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Valuations and risks:

Analysis of specific risks to set stock target prices highlighted in our investment case(s) are outlined throughout the report. For details of methodologies used to determine our price targets and risks related to the achievement of the targets referred to in the main body of the report or at Rating Methodology on our website, visit (https://www.con.hu/wp-content/uploads/2016/04/Methodology_concorde_research.pdf?tstamp=201710021038)

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