CONCORDE RESEARCH

CEE Equity Research | Insurance | Hungary
24 May 2018

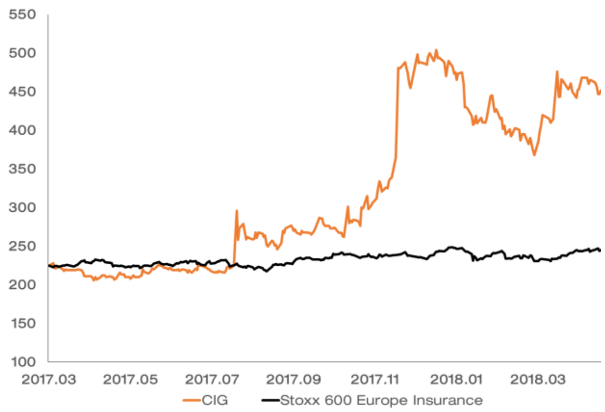
# Pannonia

## Rating: Neutral (unch.)

## Price target (12-m): HUF 470 (HUF 452)

Current share price: HUF 460

| HUF million | 2016 | 2017F | 2018F | 2019F |
|---|---|---|---|---|
| GWP | 18 941 | 26 933 | 28 796 | 31 032 |
| After-tax profits | 724 | 2 598 | 1 710 | 1 920 |
| Own equity | 3 972 | 9 015 | 18 005 | 19 141 |
| EPS [HUF] | 11.7 | 40.8 | 20.0 | 20.6 |
| DPS [HUF] | 0.0 | 10.0 | 8.4 | 10.3 |
| BVPS [HUF] | 103.6 | 126.4 | 192.9 | 205.1 |
| P/GWP (x) | 1.7 | 1.2 | 1.1 | 1.1 |
| P/E (x) | 39.3 | 11.3 | 23.0 | 22.3 |
| P/BV (x) | 4.4 | 3.6 | 2.4 | 2.2 |
| DVY (%) | 0.0 | 2.5 | 1.8 | 2.2 |
| ROE (%) | 12.1 | 34.4 | 12.7 | 10.3 |




| Performance | 12M | YTD | 3M | 1M |
|---|---|---|---|---|
| Absolute | 116.0% | -5.7% | 7.7% | 1.8% |
| BUX relative | 105.9% | 3.3% | 14.7% | 7.3% |

| | | | |
|---|---|---|---|
| Share price closing as of 5/24/2018 | HUF 460 | Bloomberg | CIGP.BU |
| Number of shares [million]* | 71.3 | Reuters | PANNONIA HB |
| Market capitalization [HUF bn/EUR mn] | 32.77/ 102.8 | Free float** | 70% |
| Enterprise value [HUF bn/EUR bn] | 32.77 / 102.8 | 52 week range | 208/504 |
| Daily turnover 12M [EUR million] | 0.3 | EURHUF | 318.79 |

*Note: w/o the share capital by KONZUM*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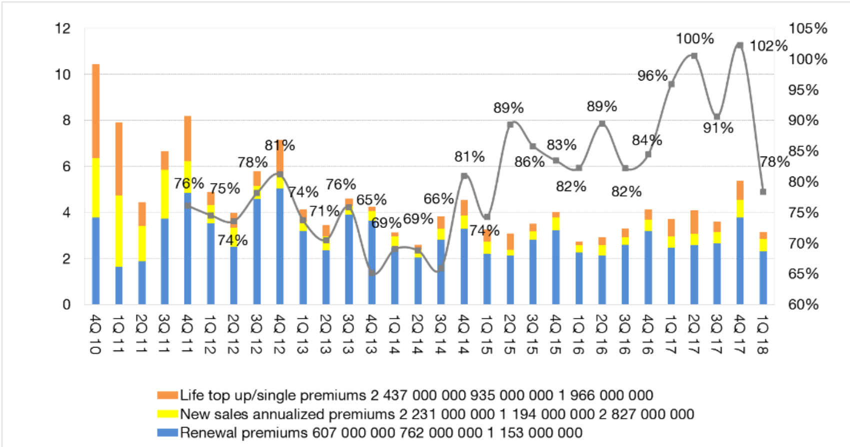
## Q1 results reflect a noteworthy efficiency improvement

- Pannonia reported a IFRS consolidated after-tax profit of HUF 615 mln in Q1/18 that compared to HUF 2.5 bln in the same period of a year earlier. After adjusting for the impact of one-offs gains resulting from the acquisition of MKB Insurance Company (HUF 3.2 bln), the result of the assets held for sale (HUF -463 mln) and the revaluation loss on interest-bearing shares (HUF 215 mln) for Q1/17, after-tax profit could have increased by ca. HUF 600 mln on the year.
- Consolidated GWP amounted to HUF 5.6 bln (-7% YoY) as a combined result of portfolio restructuring, a significant decline in the top-up and single premiums due to reclassification of some insurance contracts to investment contracts (and so cannot be recognized as written premium according to EU IFRSs), and also to the surrenders of the unit-linked insurances. The life insurance segment accounted for 56% of total GWP (within which pension insurance policies represented ca. 33%), while the non-life insurance segment contributed 44% to the total GWP.

- In the life insurance segment GWP from renewals was 6% lower YoY, so the renewal ratio dropped from 96% to 78%. Top-up and single premiums were also 59% lower YoY, mainly relating to unit-linked life insurance policies and due to reclassification. In contrast, GWP from the first annual premiums of insurance policies sold rose 8% YoY.

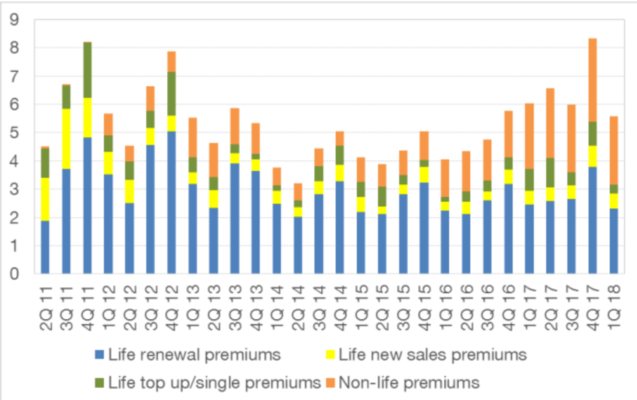
GWP breakdown in the life insurance segment (HUF bln)



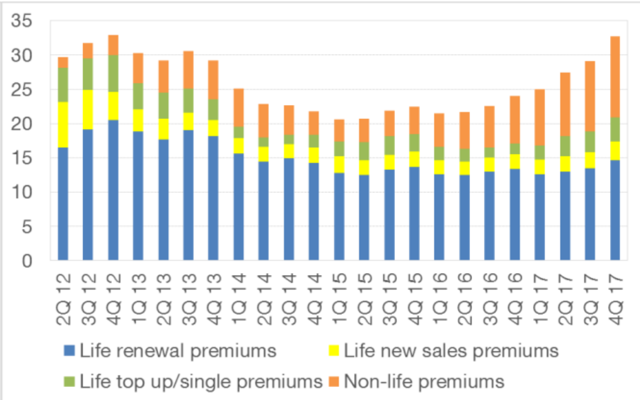

*Source: Pannonia, Concorde estimate*

- In the non-life segment GWP advanced 5% YoY while the change in claim payments lagged behind premium growth.

Quarterly consolidated GWP breakdown (HUF bln)




12-m rolling GWP breakdown (HUF bln)




*Source: Pannonia, Concorde estimate*

- As for life insurance policies sold in the first quarter of 2018 the share of the tied agent network is 28% (Q1/17: 41%), while the independent brokerage network was 47% (Q1/17: 39%) and the bank channel was 25% (Q1/17: 20%).
- Investment results were negative (HUF -945 mln vs. HUF 2.1 bln adjusted result in Q1/17)) that were mainly caused by correction on the global stock markets and the weakness in the USD against the HUF. Income from fund management (HUF 205 mln) also declined by 6% compared to Q1/17.
- Operating costs were down 4% YoY to HUF 2.1 bln in Q1 (38% of GWP vs. 37% of GWP in Q1/17), of which fees, commissions and other acquisition costs represented more than 70%, while admin costs and expenses the rest. Acquisition costs rose on the back of a 12% increase in total annualized premiums from new life insurance sales (from HUF 682 mln to HUF 765 mln), while accounting for 120% of new sales. In the non-life segment the earned premiums and parallel the acquisition costs significantly declined as a result of the portfolio sales. Other operating costs (9% of GWP vs. 13% of GWP in Q1/17) fell significantly

(-32% YoY) as a result of massive cost savings at the MKB Insurance company acquired last year.

- The net claim expenditure increased by 36% as compared to Q1/17, mainly due to the increase in the surrenders of the unit-linked insurances.
- The available solvency capital of the life and non-life insurance segments were 264% and 181%, respectively, at 31 March, 2018, so each fulfilled the 150% Solvency Capital requirement expected by National Bank of Hungary (NBH) which is the Supervisory Authority.
- The NBH approved Pannonia's acquisition of the shares in KONZUM Investment and Asset Management Plc (KONZUM). Accordingly, the insurer purchased 1,368,851 pieces of shares at a price of HUF 3,000 HUF each share, which represent 6,56% of all KONZUM shares introduced to the Budapest stock market. Revaluation impact of KONZUM's shares will be reflected as other comprehensive income in Pannonia's P&L.
- Simultaneously, NBH also approved the share capital increase of HUF 8.2 bln in Pannonia by KONZUM subscribing 23,466,020 pieces of new "A" series ordinary shares issued by Pannonia with the face value of HUF 40, and with the issue price of HUF 350. As a result of the transaction, KONZUM acquired a 24.85% stake in Pannonia, whereby becoming the insurer largest stakeholder. After the capital increase Pannonia's total number of ordinary shares has increased by 33% to 94,428,260, while its shareholders' equity rose 86% to HUF 17.76 bln, implying a BVPS of HUF 188.
- After the completion of the two share transactions, Pannonia's excess capital has risen HUF 4.1 bln (23% of its new own equity) on our estimate that it can use for further asset acquisitions.
- Pannonia looks keen to seek acquisition targets at an affordable price in order to realize economies of scale and extract cross-selling opportunities offered by its new banking partners. Pannonia may target a 5% to 10% domestic market share, and meanwhile constantly growing earnings. After the capital increase by KONZUM we believe that Pannonia's capital flexibility is at a sufficient level to reach its market share goal.
- <u>Outlook</u>: **we raise our after-tax profit estimate by 8% from HUF 1.58 bln to HUF 1.71 bln for 2018, and by 9% from HUF 1.76 bln to HUF 1.92 bln for 2019**, acknowledging that Pannonia has taken strenuous efforts to save costs and achieved better-than-expected Q1 results in its non-life insurance segment. In addition, until there is no news about further transactions we expect Pannonia to invest new excess capital to government bonds yielding some gains that we now also incorporates into our earnings model. **We also project that Pannonia could generate net profit of ca. HUF 2.56 bln by 2022, implying a 5-year EPS GAGR of ca. 6% by 2022 without additional earnings that can potential arise from partnering with KONZUM. Taking into account, however, the effect of share capital increase by KONZUM, we need to lower our EPS estimate for 2018 and 2019, respectively to HUF 20.0 and HUF 20.6 from our previous estimates of HUF 22.6 and HUF 25.2.**
- **We previously estimated that if Pannonia uses the full amount of this additional excess capital for further acquisitions and achieves a 19% after-tax ROI on newly acquired assets, its annual after-tax profit may increase by up to 50%, potentially implying an EPS of ca. HUF 30.** On top of that we believe there is a significant upside in earnings given the fact that the countrywide branch networks of friendly domestic banks which are or will be under direct or indirect control of KONZUM or its shareholders can potentially (and perhaps exclusively) be available for Pannonia in the future and very supportive to its sales activity.

- That said, we stress that our current level of knowledge about the potential collaboration with KONZUM does not allow us to predict with certainty whether their cooperation will be sustainable and value creative at all. Only when we will have a clue about how much synergy can really be achieved from cooperation with KONZUM will we really be able to make a better estimate on how much profits can additionally be generated on a sustainable basis as a result of their partnership.
- **Based on our earnings revision and roll-forward we lift our 12-m TP from HUF 452 to HUF 470 a share while maintaining our Neutral rating on the share.** Pannonia is currently trading at 23x on a 2018E P/E basis and 2.4x on a current P/BV basis. On the basis of 2018E P/E ratio Pannonia is trading at a 70% premium over peers' corresponding multiple, while its P/BV multiple of 2.4x is in line with its peer's. Pannonia's relative lofty valuation 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 develop growth of its businesses on a sustainable basis.

Comparative valuation

| | Mrk price (LCY) | P/E (x) 2018F | P/BV (x) 2017 | DIVY (%) 2017 | ROE (%) 2017 |
|---|---|---|---|---|---|
| Pannonia | 460 | 20.0 | 2.4 | 2.2 | 34.4 |
| VIG | 26.24 | 11.6 | 2.3 | 3.6 | 5.8 |
| UNIQA | 10.35 | 13.8 | 0.7 | 5.1 | 7.1 |
| PZU | 37.54 | 10.5 | 3.6 | 6.5 | 19.5 |
| Triglav | 34.4 | 10.9 | 3.2 | 7.3 | 9.3 |
| Peer group's average | | 11.7 | 2.4 | 5.6 | 10.4 |

*Source: Bloomberg, Concorde*

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|---|---|
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| 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% |
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