CONCORDE RESEARCH

CEE Equity Research | Insurance | Hungary
21 November 2018

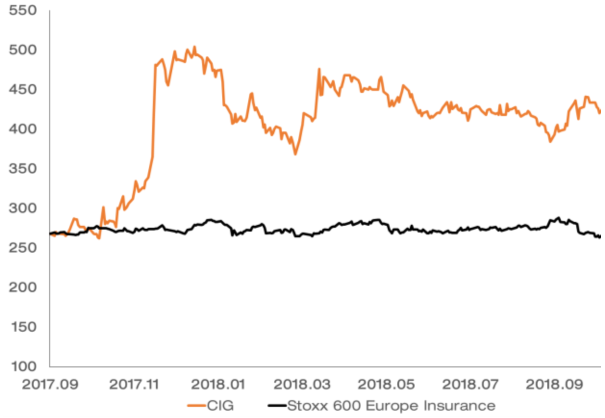
Pannonia

Rating: Accumulate (unch.)

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

Current share price: HUF 415

HUF million	2016	2017F	2018F	2019F
GWP	18 941	26 933	24 143	24 309
After-tax profits	724	2 598	2 009	2 101
Own equity	3 972	9 015	18 989	19 897
EPS [HUF]	11.7	41.4	23.5	22.5
DPS [HUF]	0.0	10.0	20.0	11.3
BVPS [HUF]	103.6	143.7	222.1	213.2
P/GWP (x)	1.4	1.0	1.5	1.6
P/E (x)	35.6	10.0	17.7	18.4
P/BV (x)	4.0	2.9	1.9	1.9
DVY (%)	0.0	2.4	4.8	2.7
ROE (%)	12.1	33.5	10.9	5.2



Performance	12M	YTD	3M	1M
Absolute	38.6%	-15.4%	-4.4%	-4.7%
BUX relative	39.4%	-15.3%	-10.0%	-9.9%

Share price as of 11/21/2018	HUF 415	Bloomberg	CIGP.BU
Number of shares [million]*	94.4	Reuters	PANNONIA HB
Market capitalization [HUF bn/EUR mn]	29.47/91.6	Free float**	~50%
Enterprise value [HUF bn/EUR bn]	29.47/91.6	52 week range	298/544
Daily turnover 12M [EUR million]	0.27	EURHUF	321.6

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Healthy new sales growth and strict cost discipline

- Pannonia reported a IFRS consolidated after-tax profit of HUF 406 mln in Q3/18 compared to HUF HUF -206 mln in the same period of a year earlier. As a result, CIG Pannonia reported ater-tax profit of HUF 1,561 mln for the first nine months of 2018, which means an increase of HUF 1,518 mln compared to last year's corresponding figure after adjusting it for non-recurring items occurred in the same period of last year.

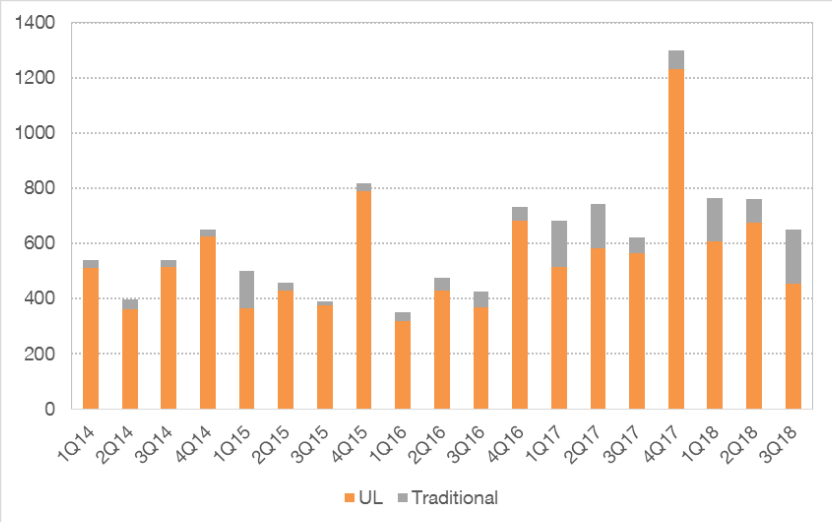
After-tax profit breakdown by segments (HUF mln)

	2018 Q1-3	as a % of total	2018 Q3	as a % of total
Life	969	62%	164	40%
Non-life	567	36%	157	39%
Asset management	278	18%	80	20%
Elimination*	-253	-16%	5	1%
Total after-tax profit	**1,561**	**100%**	**406**	**100%**

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

- Consolidated GWP amounted to HUF 5.6 bln (-7% YoY) in Q3/18 as a combined result of portfolio restructuring, a significant decline in the top-up and single premiums due to reclassification of some life insurance contracts to investment contracts (from which income can no longer be recognized as written premium according to EU IFRS), and also to the expiry and surrenders of the unit-linked insurances.
- The life insurance segment's GWP was HUF 3.35 bln in Q3/18 (-9% YoY) and accounted for 60% of the total consolidated GWP. Annualized premium of new policies sold rose 5% YoY, predominantly driven by traditional life policies (+250% YoY), while new UL product sales (including pension insurances) dropped 19% YoY. Traditional life insurances (endowment, pure endowment and healthcare policies, which represented ca. 30% of new sales vs. 9% a year earlier) are clearly growing in popularity. GWP from renewals arrived 2% lower YoY at HUF 2.6 bln in Q3/18, so the renewal ratio dropped from 91% in Q3/17 to 83% but it recovered from 77% QoQ. Top-up and single premiums product sales decreased 50% YoY mainly due to reclassification.

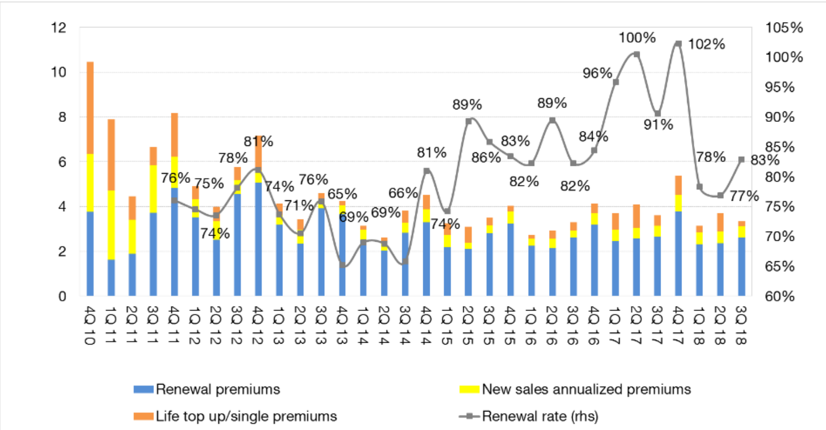
New sales breakdown of the life segment (HUF bln)



Source: Pannonia, Concorde's estimate

- In the first nine months of 2018 new life policy sale rose 6% YoY with UL insurance products increasing 5% and traditional life insurance policies rising 14% YoY.

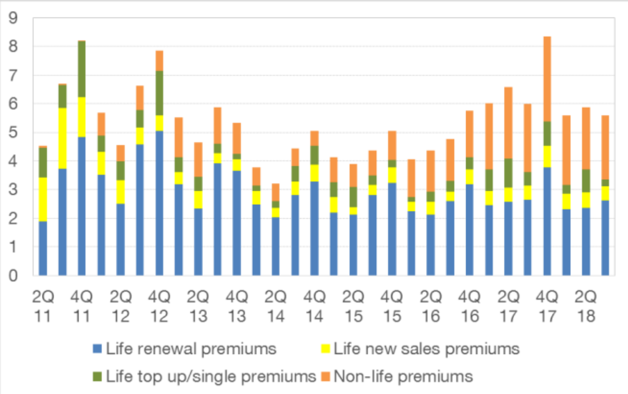
GWP breakdown in the life insurance segment (HUF bln)



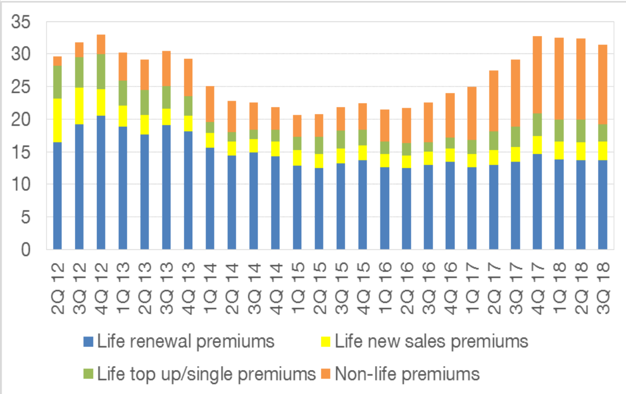
Source: Pannonia, Concorde estimate

- As a consequence of portfolio clean-up the non-life insurance segment's GWP also dropped 6% YoY to HUF 2.2 bln and contributed 39% to the total consolidated GWP.

Quarterly consolidated GWP breakdown (HUF bln)



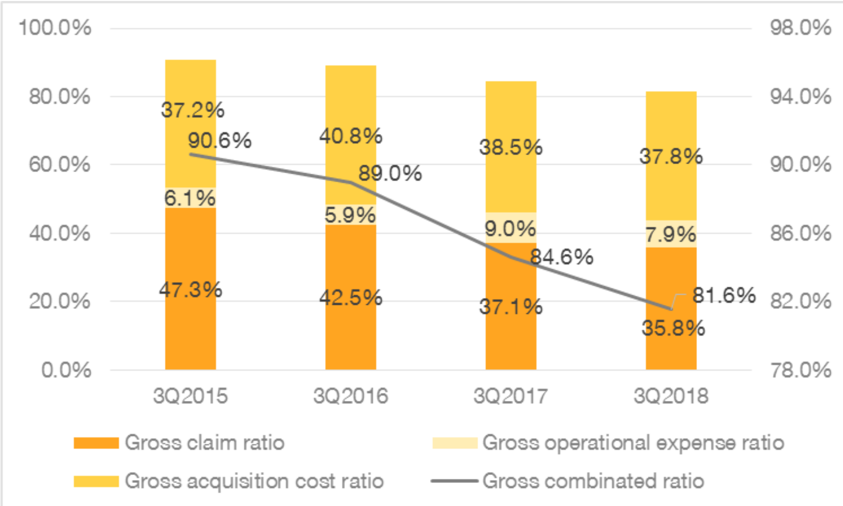
12-m rolling GWP breakdown (HUF bln)



Source: Pannonia, Concorde estimate

- Claims and related settlement expenses increased 2% YoY in Q3/18, mainly due to the increase in the surrender of the unit-linked insurances. In the non-life segment claims dropped more than 30% as a result of portfolio cleaning leading an improvement in the claim ratio from 37% to 36%. The combined ratio also came down from 85% to 82%.

Cost ratios of the non-life segment

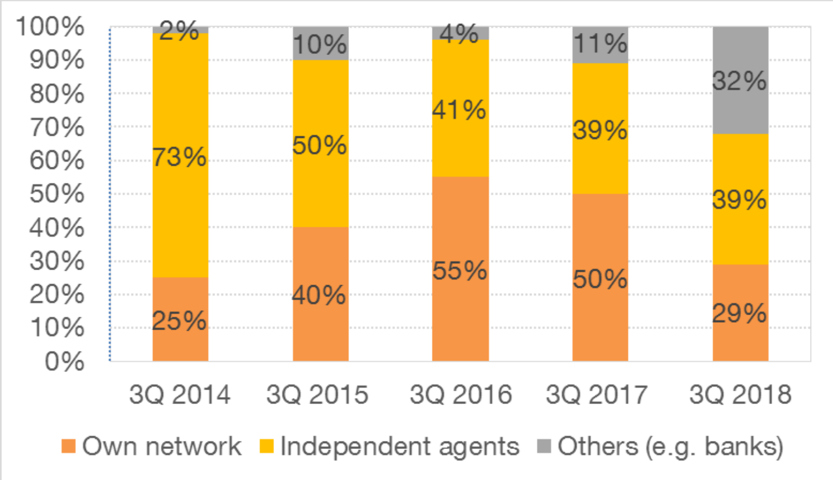


Source: Pannonia, Concorde estimate

- Operating costs fell 13% YoY in Q3/18 and accounted for 37% of GWP (vs. 40% of GWP in Q3/17), of which fees, commissions and other acquisition costs represented more than 71% (vs. 58% in Q3/17), while admin costs and other expenses the rest. Acquisition costs rose 6% YoY on the back of a 5% increase in total annualized premiums from new life insurance sales (as compared to the same period of the previous year HUF 651 mln vs HUF 621 mln) while in the non-life segment the change of the product mix has been shifted from dwelling and CASCO insurance business lines toward the products with higher acquisition cost ratio which in turn led to a rise of ca. 95% YoY in acquisition costs. With trial commission and bonuses paid to policyholders and independent agents for loyalty and better than planned performance, fees and commissions were down 35% YoY and represented about 120% of new life policy sales. Admin costs decreased a whopping 41% YoY and accounted for 9% of GWP vs. 14% in Q3/17, as a result of cost savings at the MKB Insurance company acquired last year.

- In the sale of insurance policies sold in the first nine months of 2018 the tied agent network accounted for 28% (H1/17: 38%), the independent brokerage network 38% (H1/17: 33%) and the bank channel 27% (H1/17: 29%), respectively.

New life policy breakdown by sales channels



Source: Pannonia, Concorde estimate

- Income from fund management (HUF 88 mln) recorded according to the equity method went up by 76% compared to Q3/17 on higher amount of asset under management (>HUF 100 bln), and cost synergies arising from close cooperation with MKB Fund Management.
- 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 349% and 176%, respectively, at 30 September, 2018, so both segments fulfilled the 150% Solvency Capital adequacy requirements of the Supervisory Authority event though total comprehensive income was HUF -134 mln (vs. HUF -88 mln in Q3/17) due to revaluation losses on government papers and KONZUM shares.
- According to recent news KONZUM and OPUS will merge in the way of a merger by acquisition in which OPUS will take over KONZUM. Upon the transaction KONZUM shareholders will receive OPUS shares in exchange for their KONZUM shares. The exchange rate will be based on a valuation method (either mrk cap or book value or fair value estimate) which has not yet been decided. As known, in the framework of complex share purchase transactions, Pannonia purchased 13,688,510 pieces of shares at a price of HUF 300, 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, Pannonia raised its capital by HUF 8.2 bln issuing 23,466,020 pieces of new "A" series ordinary shares with the face value of HUF 40 and an issue price of HUF 350, all of which have been subscribed by KONZUM. As a result of the transaction, KONZUM acquired a 24.85% stake in Pannonia, whereby becoming the insurer' largest single 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 above HUF 4 bln on our estimate (accounting for 23% of its new own equity) that the insurer can use for further asset acquisitions or even dividend payments.
- 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. We believe that Pannonia's capital flexibility is at a sufficient level to reach its market share goal.

- Outlook: **We lowered our estimate for total annualized premium of new life policy sales by 10% to HUF 3.0 bln in 2018 (flat on 2017) from HUF 3.3 bln, recognizing that we were a bit bullish about how fast UL product penetration could grow on the back of pension insurances this year. Also noteworthy is lower-than-previously expected top up and single premium income, which ultimately led us to reduce our GWP estimates for both 2018 and 2019 from HUF 26 bln and HUF 26.6 bln to HUF 24.1 bln and HUF 24.3 bln, respectively. Accordingly, we fine-tuned downward our FY2018 after-tax profit forecast from HUF 2.05 bln to HUF 2.0 bln, implying an EPS of HUF 23.5 (compared to our previous estimate of HUF 24.0). Management guidance suggested after-tax profit of HUF 1.6-1.7 bln for 2018.**
- 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 2.1 bln after-tax profit for 2019, implying EPS of HUF 22.5 (-5% YoY mainly due to higher number of wght. no. of shares). We also expect that Pannonia could generate after-tax profit of ca. HUF 2.49 bln by 2021, implying a 3-year clean EPS GAGR of ca. 16% on 2017 clean after-tax profit (adjusted for the HUF 1.4 bln badwill impact of the MKB Insurance acquisition), 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 that can be caused by the expiry and surrenders of life policies contracted ten years ago en masse, and also by new tax rules according to which tax exemption on whole-life, endowment and healthcare insurance products previously offered and sold to firms will be terminated as of next January. In response, Pannonia may have no other option but to make further cost cuts and speed up the process of changing its product mix towards less costly traditional life insurances.
- 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 deterioration in asset management fees may also halt. 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). Even if temporarily, Pannonia may change its dividend policy in the absence of new suitable acquisition targets and ample excess cash it is sitting on at present, and can distribute even its entire 2018 after-tax profit, implying dividend of HUF 20 per share (corresponding to a 4.8% DIVY on current share price), in our opinion.
- **However, if Pannonia opts to use the full amount of its excess capital for further acquisitions and achieves a 19% after-tax ROI on newly acquired assets (it has earned close to 50% on the acquisitions of MKB Insurance companies so far on our estimate), 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. Now we see that potential synergies are being exploited more slowly, but we

still believe that there should be mutual benefits of close cooperation between the insurer and KONZUM. As a sign of this the long-term strategic cooperation agreement between Takarék Mortgage Bank (considered as a close business partner in the future) and Allianz has been terminated early October, with a one-year notice period, opening the way for forming new business alliances. **That said, we must stress that our current level of knowledge about the potential collaboration with KONZUM does not allow us to predict with certainty whether their alliance will be successful and value creative at all. We need more clarity on the nature of their cooperation, if any, to make a better estimate on how much profits Pannonia may additionally generate based on their partnership.**

- **We leave our 12-m TP at HUF 484 a share (implying a 17% upside potential from the current share price), while maintaining our Accumulate rating on Pannonia.**
- Pannonia is currently trading at 17.7x on a 2018E P/E basis and 1.9x on a current P/BV basis. On the basis of 2018E P/E ratio Pannonia is trading at a 65% premium over peers' corresponding multiples, while its P/BV multiple implies a 21% discount to that of its peer's average. 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 develop fast its businesses on a sustainable basis.

Comparative valuation

	Price (LCY)	P/E 2018F	P/BV 2017	Dividend yield 2017	ROE 2017
VIG	23.6	10.4x	2.3x	4%	6%
UNIQA	8.2	11.4x	0.7x	6%	7%
PZU	41.5	11.9x	3.5x	6%	20%
Triglav	29.4	9.3x	3.2x	9%	10%
Peer group's average		**10.7x**	**2.4x**	**6%**	**11%**

Source: Bloomberg, Concorde

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