CONCORDE RESEARCH

CEE Equity Research | Insurance | Hungary
30 March 2020

CIG Pannonia

Recommendation: Under revision (prev. Neutral)
Target price (e-o-y): Under revision (prev. HUF 315)
Share price: HUF 129

Share price close as of 30/03/2020	HUF 129	Bloomberg	PANNONIA HB
Number of diluted shares [million]	94.4	Reuters	CIGP.BU
Market capitalization [HUF bn/EUR mn]	12,616/35.1	Free float	50%
Daily turnover 12M [HUF million]	0.07	52 week range	HUF 100 – 457

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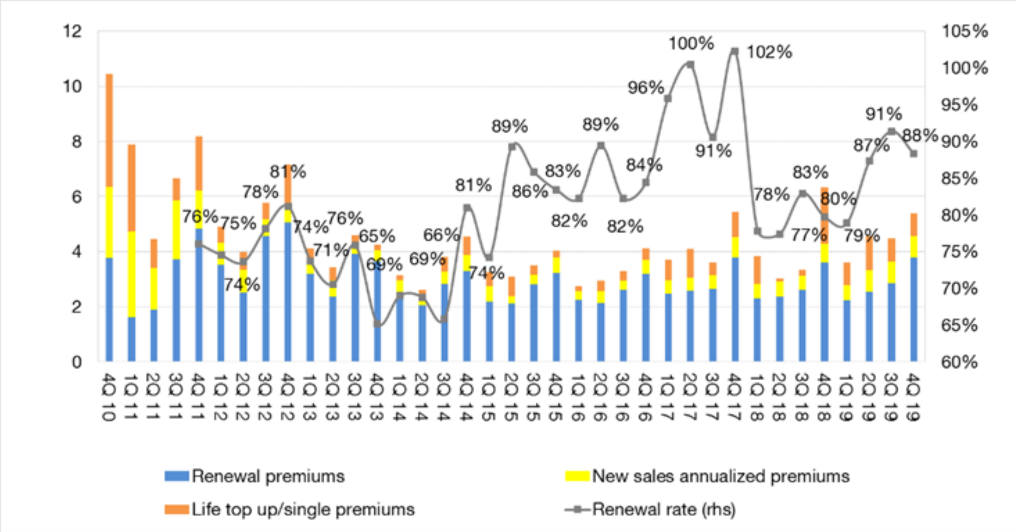
Impairments sent earnings into the red

- CIG Pannonia (Pannonia) reported consolidated net losses of HUF 641mn for FY2019, compared with a net income of HUF 1,794mn for FY2018. The insurer's profit plummeted for two main reasons: 1) significant claims and related misconduct of the Italian cross-border insurance product in non-life segment with a total impact of HUF 2,390mn loss; and 2) the conversion of Konzum / OPUS shares resulting in a HUF 1,056mn exchange loss based on OPUS share price of HUF 446 as at 30 June 2019. Without these effects, Pannonia's profit after tax for 2019 would have been HUF 2,805mn vs. HUF 1,794mn in 2018.
- We note that unrealized losses on OPUS has increased by HUF 724mn by the year-end of 2019, and by a further HUF 1,085mn so far this year. Altogether, CIG has had (unrealized and realized) losses of HUF 2,861mn on OPUS shares ever since it purchased them.
- Life GWP reached HUF 18,041mn and was 9% higher than in the comparative period. In the life segment, the new acquisition amounted to HUF 4,286mn, implying an increase of 33% compared to the previous year's amount. Non-life GWP amounted to HUF 9,451mn, 1.8% higher than in 2018.
- In the life segment GWP from the first annual premiums of policies sold was HUF 2,895mn in 2019 implying a staggering 28% growth YoY, while GWP from renewals came in at HUF 11,412 bn (+4.8% YoY). As a result of the latter, the renewal ratio went up to 88% at the end of 2019 from 80% at the end of 2018. Top-up and single premiums (HUF 3,734mn) were 10% than in 2018, mainly relating to unit-linked life insurance policies. Within the total life insurance premium income, top-up and single premiums accounted for 21% in 2019, remaining unchanged compared to 2018.

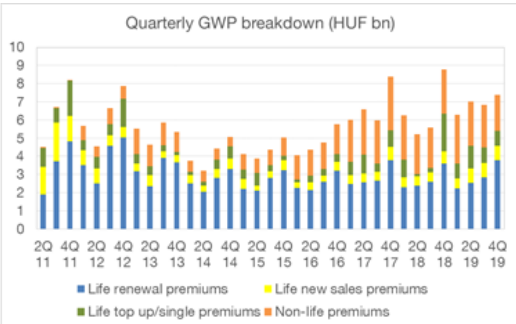
GWP breakdown in the life insurance segment (HUF bln)



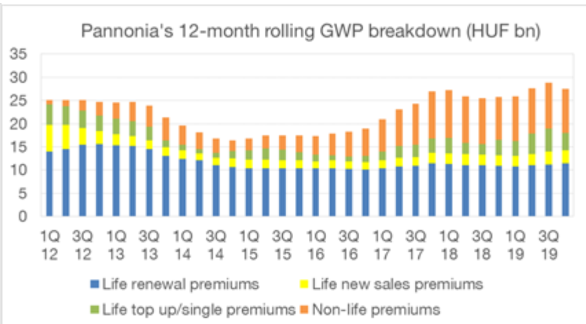
Source: Pannonia, Concorde estimate

- In 2019, traditional life insurances (endowment, pure endowment and healthcare policies) accounted for ca. 32% of total annualized premiums of new sales vs. 22% in 2018 as part of the Insurer's strategy of shifting the product mix gradually 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 theoretically continue to 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 (30%) and other business development channel together with the newly established financial vehicle company PPK (31%).

Quarterly consolidated GWP breakdown (HUF bn)



12-m rolling GWP breakdown (HUF bn)



Source: Pannonia, Concorde estimate

- Investment results were positive in 2019 at HUF 8,895mn, including realized losses on KONZUM / OPUS shares. 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, increased by 21% on the year to HUF 442mn.
- Operating costs increased by 13.7% YoY and accounted for 38.5% of GWP in 2019 (vs. 36.1% of GWP in 2018), of which fees, commissions and other acquisition costs represented 65.6% (unch. YoY), while admin costs and other expenses (mainly provisions) accounted for the rest.
- Consolidated acquisition costs rose 13.7% YoY mainly due to the rise in new sales in both core segments, especially those for traditional insurance products, as compared to the previous year. Other admin costs decreased by 12.9% YoY mainly due to cost

cuts. Despite lower wage costs other operating cost also rose 14.3% due to increased admin costs. Other income increased by 41.7% YoY thanks to higher income in non-life insurance business.

- Consolidated net claims and related settlement expenses rose by 15.9% YoY in 2019, 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.
- Due to massive losses on Italian surety insurance activities the solvency ratio of CIG's wholly-owned non-life subsidiary (EMABIT) fell to 60% at the end of 2019 as against the 150% level required by the supervisory watchdog, National Bank of Hungary (NBH). By January, 2020 EMABIT had to prepare a Recovery Plan required by the NBH, detailing the events related to its Italian businesses, as well as the various potential measures it planned to take to restore its solvency adequacy, including the possibility of disposing individual portfolio items (e.g. the profitable Hungarian and Polish business lines).
- According to EMABIT, about 33% of Italian exposures (EUR 124mn) has already expired on 31 December 2019 decreasing from EUR 507mn to EUR 383mn, and 83% of the total Italian exposure will have run off by the end of 2020. The size of non-reinsured Italian surety insurance portfolio has decreased to EUR 256mn by the end of 2019. For the most exposed and problematic product types (such as Gaming which accounts for ca. 20% of total Italian exposure and 59% of non-reinsured portfolio), duration is less than six months. However, some of the contracts allow claims to be made even after the expiration date, for up to 1 year. EMABIT has settled the EUR 3.2mn claim at the end of November 2019 and created provisions for the rest of possible losses (altogether resulting in HUF 2,390mn losses in 2019).
- Due to massive losses on Italian surety insurance activities EMABIT's own equity dropped to HUF 1,955mn at the end of 2019 compared with HUF 4,417mn at the end of 2018. Consequently, the listed parent company, CIG Pannonia Life, had to book impairment losses of HUF 3,330mn on its investments in EMABIT last year, as we had expected it to do so, thereby its retained earnings narrowed to all but zero, constraining its ability to pay dividend in the short term.
- We note that if EMABIT went into bankruptcy because of any further sizeable losses on its Italian insurance activity (we attribute a low probability to this case), the maximum capital that it could lose is its remaining own equity of HUF 1,955mn. That is the maximum amount of investment at risk for the parent CIG Pannonia Life too.
- It is increasingly likely that the parent CIG Pannonia Life will not be willing to inject more cash into EMABIT buttress its daughter company's capital position, at the expense of a weakening of its own liquidity position and capital adequacy (the same risk exposure requires higher capital needs). With is in mind, Pannonia's management has concluded that EMABIT as a going concern is unsustainable. Therefore, the whole activity of EMABIT had to be defined as discontinued activity according to IFRS.
- It is worth noting, however, that the decline in EMABIT's solvency margin has no significant impact on the capital adequacy of the parent company, CIG Pannonia Life, which stood at 343%, while the consolidated capital adequacy was 268% at the end of 2019.
- We estimate that if CIG Pannonia Life has to write down its entire remaining investments in EMABIT (HUF 1,955mn) and simultaneously opts to dispose of its Opus shares (most probably in exchange for a half of CIG shares which are currently owned by OPUS), its capital adequacy will likely fall below 200%, let alone the impact

of supervisory fines imposed recently by the NBH in a total amount of HUF 131mn (ca. 7% of CIG Pannonia Life's underlying pre-tax earnings in 2019), while also rejecting the reorganization plan of the insurer's Italian units.

- **As it is too early to quantify the exact amount of losses that may arise from the Italian cross-border gaming surety insurances, as well as the negative impact of coronavirus on the insurer's operation, we continue to suspend our earnings forecasts and TP on Pannonia.**

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Accumulate	Total return is expected to be in the range of 10-20%
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Reduce	Total return is expected to be in the range of -10-(-20%)
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