J.P.Morgan

AIA Group Ltd

Shareholder return ≈ f(growth, cash flow and capital); acceleration outlook for these three variables

Overweight

1299.HK, 1299 HK

Price: HK$47.35

▲ **Price Target: HK$55.00**
Previous: HK$51.00

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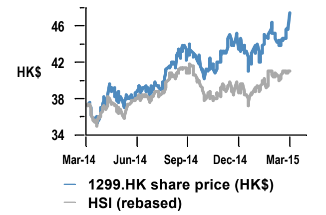
AIA Group surprised the market with strong FY14 results that beat across the board. In our view, the current share price does not fairly capture AIA's: (1) growth acceleration outlook in China/Hong Kong/Malaysia (~50% of NBV); (2) strong free cash flow re-rating momentum; (3) strong balance sheet position for a better capital deployment outlook; and (4) similar comp valuation level to Chinese insurers. We believe **AIA is entering a new virtuous cycle (i.e., growth → free cash flow → capital deployment), with upscale driving shareholder returns**. Thus, we see current levels as an opportunity.

- **Growth king.** AIA's NBV has accelerated by 2.8x since the IPO (~US$0.7B in 2010 vs. ~US$1.8B in 2014), appealing to equity investors as a "growth stock." With an outlook for acceleration in the insurance (protection) market in China, we expect AIA's value growth acceleration to drive upward revisions of NBV expectations. We highlight that China Life has similar (or higher) valuation multiples despite its single-digit NBV growth outlook. Contrary to concerns about local currency weakness and limited upside due to a maturing market, AIA's strong integration synergies following its inorganic expansion into Malaysia and strong sales demand for high-end protection/retirement sales growth in Hong Kong are enough additional drivers to revise up market NBV expectations, in our view.
- **Free cash flow king.** AIA's free cash flow block from in-force policies is expected to be re-rated to ~US$140B (+47%) over the next three years (vs. US$95B/US$65B in Nov-14/Nov-11) with a lowered new business strain on total NBV of up to ~80% in 2017E from ~114%/~101% in 2010/2013.
- **Capital king.** Thanks to the widening free cash flow and strong NBV growth, we expect AIA's progressive dividend policy (~15% DPS increase p.a.) to be aggressive gradually. As Asia-ex countries are adopting stricter solvency standards, we cannot rule out large capital deployment in the ASEAN market with a large-scale increase outlook.
- **Reiterate OW.** Our Dec-15 PT of HK$55 is derived via a multi-stage NBV growth model that yields an implied blended P/EV of 2.1x and a blended new business multiple of 19x for the group. Risks include: (1) slowing NBV growth momentum; (2) longer-than-expected financial market volatility in Asia-ex; and (3) a weaker-than-expected business turnaround in Malaysia.

Price Performance



	YTD	1m	3m	12m
Abs	7.7%	4.8%	8.1%	27.6%
Rel	3.4%	3.2%	2.9%	17.0%

Comp valuation: AIA Group vs. Chinese insurers

X	P/EV (FY15E)	P/BV (FY15E)
AIA Group	1.8	2.3
China Life-H	1.8	2.8
CPIC-H	1.3	2.5

Source: J.P. Morgan estimates, Bloomberg. As of 2-Mar-15.

1Q15 NBV release: Mid-April 2015

AIA Group Ltd (Reuters: 1299.HK, Bloomberg: 1299 HK)

$ in mn, year-end Nov	FY13A	FY14A	FY15E	FY16E	FY17E
EPS ($)	0.24	0.29	0.32	0.37	0.41
EPS growth	(6.3%)	22.2%	11.6%	15.7%	11.2%
BVPS ($)	2.06	2.57	2.68	2.97	3.28
DPS ($)	0.05	0.06	0.07	0.09	0.10
EV per share ($)	2.82	3.09	3.37	3.70	4.09
NBV per share	0.12	0.15	0.18	0.20	0.24
P/E (x)	26.0	21.3	19.0	16.5	14.8
P/BV (x)	3.0	2.4	2.3	2.1	1.9
P/EV	2.2	2.0	1.8	1.6	1.5
Dividend Yield	0.9%	1.1%	1.2%	1.4%	1.6%
ROE	11.0%	12.4%	12.2%	13.1%	13.2%

Source: Company data, Bloomberg, J.P. Morgan estimates.

Company Data	
Shares O/S (mn)	12,006
Market Cap ($ mn)	73,301
Market Cap ($ mn)	73,301
Price (HK$)	47.35
Date Of Price	02 Mar 15
Free Float(%)	-
3M - Avg daily vol (mn)	22.90
3M - Avg daily val (HK$ bn)	1.01
3M - Avg daily val ($ mn)	129.9
HSI	24,823.29
Exchange Rate	7.76
Price Target End Date	30-Dec-15

See page 17 for analyst certification and important disclosures, including non-US analyst disclosures.

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Key catalysts for the stock price:	Downside risks to our view:	Upside risks to our view:
• Strong growth potential from low insurance penetration across the region • Strong positioning in the agency-based protection-type market (i.e., healthcare insurance) • High visibility of future cash flow generation from existing policies with strong balance sheet and conservative actuarial assumptions	• Slowing NBV growth momentum • Longer-than-expected financial market volatility in Asia-ex • A longer-than-expected business turnaround in Malaysia	• Stronger-than-expected equity market/steepening of yield curve • Fast growth of protection insurance demand in ASEAN • Higher penetration of Islamic life insurance market (i.e., family Takaful) in Malaysia/Indonesia

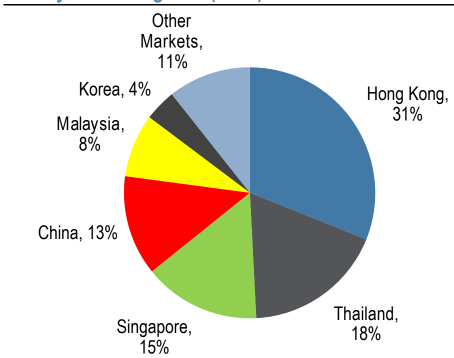
Key financial metrics	FY14A	FY15E	FY16E	FY17E
Net written premium (LC)	17,052	19,017	21,114	23,815
Net earned premium (LC)	17,052	19,017	21,114	23,815
Net earned premium growth	9%	12%	11%	13%
Investment profit (LC)	5,570	6,201	6,655	7,227
Incurred loss (LC)	(16,804)	(17,781)	(19,214)	(21,434)
Underwriting expense (LC)	(3,775)	(4,155)	(4,603)	(5,180)
Underwriting income (LC)	(3,527)	(2,919)	(2,703)	(2,798)
Net income (LC)	3,450	3,844	4,439	4,934
Group embedded value (LC)	37,153	40,340	44,309	48,922
Life embedded value (LC)	37,153	40,340	44,309	48,922
New business value (LC)	1,845	2,172	2,447	2,861
Solvency margin	427%	410%	404%	397%
Investment yield	6%	6%	6%	6%
DPS (LC)	0.06	0.07	0.09	0.10
BVPS (LC)	2.57	2.68	2.97	3.28
ROA	2%	2%	2%	2%
ROE	12%	12%	13%	13%
Payout ratio	22%	23%	23%	24%
Key model assumptions	**FY14A**	**FY15E**	**FY16E**	**FY17E**
Metric #1: EVPS (US$)	3.09	3.37	3.70	4.09
Metric #2: NBV growth (%)	24%	18%	13%	17%
Metric #3: EPS growth (%)	22%	12%	16%	11%

Source: Company and J.P. Morgan estimates.

Valuation and price target basis

We assign AIA Group a Dec-15 PT of HK$55 per share by incorporating a multi-stage growth model to project NBV for each geographical market separately, which yields an implied blended P/EV of 2.1x and a blended new business multiple of 19x for the group.

NBV by market segment (FY14)



Source: Company Reports

Sensitivity analysis	EPS	
Sensitivity to	FY15E	FY16E
1% chg net earned premium growth	-0.3%	-0.2%
1% chg in investment yield assumption	14.2%	13.2%
1% chg in loss ratio assumption	-3.7%	-3.6%
1% chg in expense ratio assumption	-3.7%	-3.6%

Source: J.P. Morgan estimates.

JPMe vs. consensus, change in estimates

EPS (LC)	FY15E	FY16E
JPMe old	0.32	0.38
JPMe new	0.32	0.37
% chg	*1%*	*-1%*
Consensus	0.30	0.34

Source: Bloomberg, J.P. Morgan estimates.

Comparative metrics

	CMP	Mkt cap	P/E (x)		P/EV (x)		P/BV (x)		YTD
	(LC)	($M)	FY14E/A	FY15E	FY14E/A	FY15E	FY14E/A	FY15E	stock perf.
AIA Group	47.4	73,545	21	19	2.0	1.8	2.4	2.3	9.7
Ping An-H	86.4	101,833	15	13	0.9	0.9	2.7	2.0	9.2
China Life-H	33.3	155,602	23	19	2.0	1.8	3.1	2.8	9.4
CPIC-H	40.3	48,677	24	18	1.5	1.3	2.7	2.5	2.2
New China Life-H	43.2	22,809	26	16	1.2	1.1	2.5	2.1	10.3

Source: Bloomberg, J.P. Morgan estimates. Prices are as of 2 March 2015.

Investment thesis

Contrary to market concerns about weak currency and volatile macro conditions in ASEAN and the limited potential for NBV growth surprises from its record NBV base, AIA Group surprised the market with strong FY14 results that beat across the board (please see our note, AIA Group Ltd: First cut at 2H FY14 results- Beat across the board). In our view, the current share price does not fairly capture AIA's: (1) growth acceleration outlook in China/Hong Kong/Malaysia (~50% of NBV); (2) free cash flow re-rating momentum from the 28M individual in-force policies (undiscounted basis: ~US$95B in Nov-14 vs. ~US$69B in Nov-11); (3) strong balance sheet position as a share price driver; and (4) similar comp valuation level to Chinese insurers. We believe **AIA is entering a new virtuous cycle (i.e., growth → free cash flow → capital deployment), with upscale driving shareholder returns**.

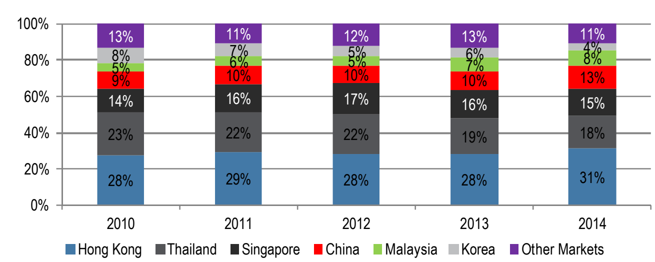
I. Growth king

NBV acceleration of 2.8x since 2010

AIA shares appeal to equity investors as a "growth stock." Its US$667M in NBV in 2010 has increased to ~US$1.845M over the last five years. Within Asia, the company's growth profile (or growth drivers) has changed largely across the region.

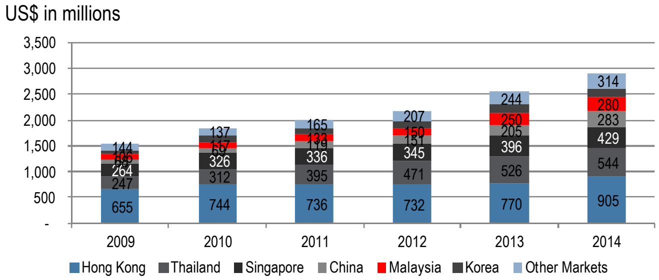
Based on NBV, for the last five years: (1) China and Malaysia have become important countries for growth; (2) growth exposure to Thailand has continuously declined; (3) Hong Kong has regained its position as a growth country; and (4) Korea has seen the least dynamic geographic exposure, with a lowered contribution.

Figure 1: AIA Group: NBV by market segment



Source: Company reports. Note: Prior to HK reserve and capital requirement adjustments and unallocated group office expense.

Figure 2: AIA Group: Operating profit after tax by market segment



Source: Company reports. Note: The group corporate center is not included here.

In its earnings presentation, the company clearly identified the following long-term structural growth drivers in Asia: (1) large population growth (or demographics); (2) rapid urbanization; (3) rising income and wealth; (4) low social welfare; and (5) low private coverage (or a substantial life protection gap). Given that the company is clearly in the leading position in each geographical region, the outlook for overall long-term NBV acceleration on the back of both product margin and volume makes sense to us. Our NBV projections for the next 20 years in each country partially factor in these expectations, with ~10.5% NBV growth p.a. for the first 10 years (2015E-2024E) and ~4.9% NBV growth p.a. for the following 10 years (2025E-2034E).

Near-term NBV upside potential from China/Hong Kong/Malaysia

The company's overall reported FY14 NBV margin was ~49.1% (after HK reserves, capital requirements and group office expense adjustments) vs. 48.9% in 2013. Thus, a key question is whether there is more room to improve NBV margins from the current high base and where potential areas for positive NBV contributions are.

In particular, the market seems to be concerned about China, Hong Kong and Malaysia due to disagreements about the outlook for healthcare market acceleration. These stem from the short track record and record NBV margin (China), high sales base and limited market growth outlook as the market matures (Hong Kong) and local currency weakness and smaller-than-expected APE growth (Malaysia).

We expect price momentum to be driven by a buildup of expectations for future NBV growth momentum following the market acceleration in China, more evidence of AIA's strong integration synergy following the inorganic expansion into Malaysia, and strong sales demand for high-end protection/retirement sales growth in Hong Kong.

Table 1: AIA Group: NBV by market segment

US$ in millions, %

	2012			2013			2014		
	NBV	NBV margin	APE	NBV	NBV margin	APE	NBV	NBV margin	APE
Hong Kong	366	58.4%	604	468	57.6%	781	619	62.3%	952
Thailand	287	53.9%	532	319	56.3%	565	361	63.2%	572
Singapore	220	65.1%	339	269	67.3%	400	299	61.2%	489
Malaysia	69	46.0%	151	120	37.8%	319	161	50.1%	320
China	**124**	**57.5%**	**215**	**166**	**66.4%**	**249**	**258**	**83.1%**	**311**
Korea	68	28.5%	237	91	26.8%	338	82	21.7%	380
Other Markets	167	27.0%	618	220	32.0%	689	212	31.3%	676
Subtotal	**1,301**	**47.8%**	**2,696**	**1,653**	**48.9%**	**3,341**	**1,992**	**53.1%**	**3,700**

Source: Company reports. Note: Prior to HK reserve and capital requirement adjustments and unallocated group office expense.

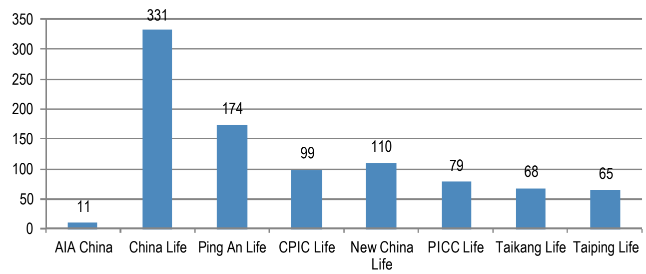
Additional key areas for NBV surprises

We also look at areas likely to lift NBV (or growth) expectations and identify the consensus revision candidates in China and Korea.

China

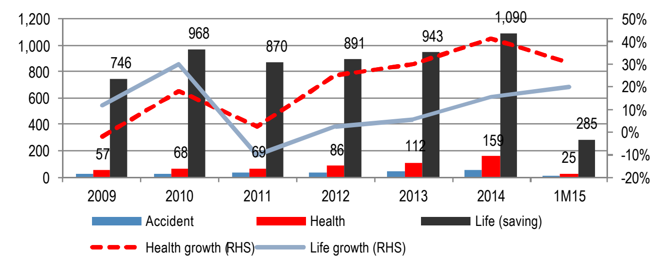
Given the view that the current NBV margin is too high, our projections do not factor in further margin improvement in China. As shown in China Life's 2013 corporate day presentation, profit for many life insurers in China depends largely on investment spread margin (= investment return - funding cost). Despite fast demand increases for critical illness (CI) insurance or healthcare coverage, particularly in tier 1 cities, we believed investment spread margin would account for 50%+ of profit in China. In addition, the company's premium income for 2014 was only about Rmb11B (vs. ~Rmb331B for China Life and ~Rmb174B Ping An Life).

Figure 3: China life insurance industry: Premium Income (2014)
Rmb in billions



Source: CIRC.

Figure 4: China life insurance industry: Premium income breakdown by product
Rmb in billions



Source: Company reports.

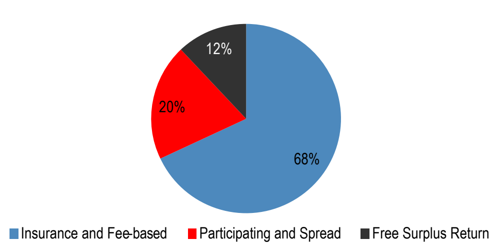
However, following the company's further disclosures on its AIA China operations during this year's earnings presentation, we have begun to think that **further NBV margin improvement (or better-than-expected NBV growth) in China is possible**.

First, the healthcare insurance market is accelerating, particularly in tier 1 cities (i.e., structural market expansion), following increases in household wealth and risk awareness. Considering AIA's agency-based distribution model, we believe the company could capture the acceleration in the protection market's momentum faster than the market expects by selling higher medical coverage riders.

Second, we think agency recruiting and retention trends may be stronger than expected, driving better productivity. According to the company's disclosures, overall FY14 NBV/agent is 3.0x higher than industry peers'. This would mean that its agency income level is likely to be much higher than peer insurers'. Thus, we cannot rule out a virtuous cycle of large headcount increases building the agency force and productivity improvement potential driving higher NBV growth momentum.

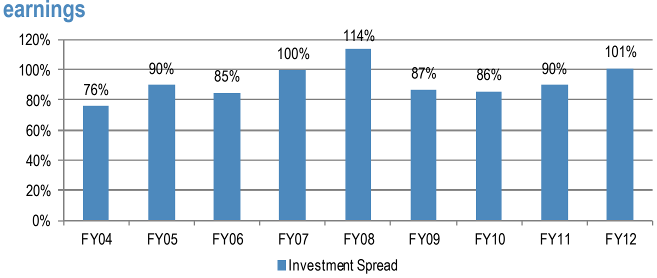
In conclusion, although we expect China to be a Top 3 NBV contribution country within AIA Group by the end of 2016, replacing Singapore, the fast market acceleration, further product mix shift into protection (or healthcare), and scale/productivity increases in the agency channel could mean that China NBV acceleration is possible even in 2015 or mid-2016, exceeding AIA Singapore and driving upward estimate revisions.

Figure 5: AIA China: Sources of statutory earnings (2014)



Source: Company reports.

Figure 6: China Life: Investment spread in three sources of statutory earnings



Source: Company reports.

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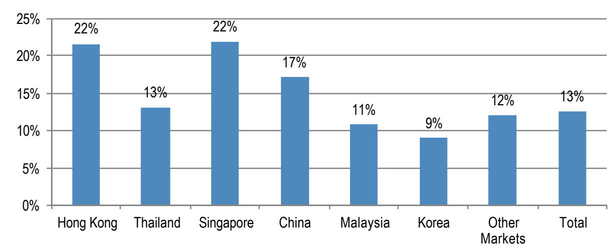
Korea

Unlike its strong NBV growth in China and other markets, the company has posted subpar performance in Korea. AIA Korea's ~8% group NBV contribution in 2010 declined to ~4% in 2014, with only ~37% NBV growth for the last five years. During the sales period, the group's/China's NBV increased by 214%/438%. However, given that AIA still allocates ~7.8% of group capital to Korea, it is clearly an NBV/ROE dilution area when valuing the company.

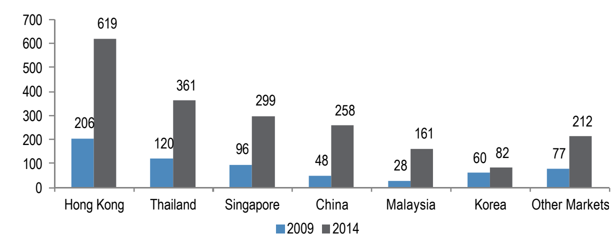
Although management remains optimistic about Korea's operational outlook, we believe the Korea operation is not likely to turn around near-term without any consideration of changing its positioning (or formation) in Korea or scaling down. Rather, we believe Korea will serve as a "value overhang" for the group.

Figure 7: AIA Group: Operating return on allocated equity by segment
%



Source: Company reports.

Figure 8: AIA Group: NBV comparison by market segment
US$ in millions

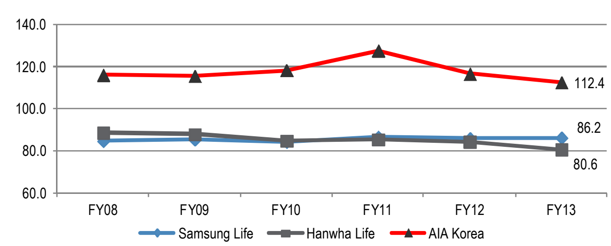


Source: Company reports.

To be fair, we also believe the Korea life insurance market remains attractive due to: (1) demographics (aging population); (2) low protection coverage compared to household wealth levels; (3) high inheritance tax rates (up to ~50%); and (4) favorable changes in cancer claim patterns.

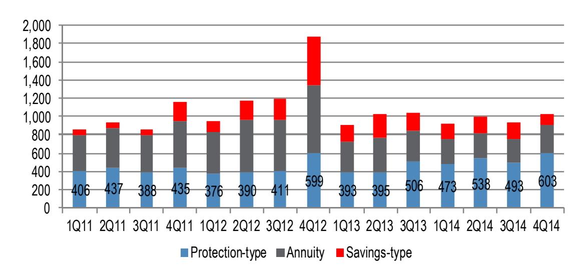
Overall top life insurers like Samsung Life (SLI) deliver >7-10% protection APE growth y/y, on average. The protection product is largely skewed toward whole life (purely covering the death benefit) instead of healthcare under the extended life expectancy. Following the first retiring of Baby Boomers, upside still exists in terms of retirement market growth. Finally, the corporate pension reserve has started to generate positive fee growth since this market became mandatory in 2012, with a 60-70bp spread margin outlook longer-term. From that perspective, the market characteristics seem to fairly match AIA Group's growth strategy, in our view.

Figure 9: Korea life insurers: Claim loss ratio trend
%



Source: Korea Life Insurance Association (KLIA).

Figure 10: SLI: Quarterly APE breakdown by product
Won in billions



Source: Company reports.

However, we see limitations for AIA in the Korea market due to its weak distribution channel and legacy book in protection coverage. While major Korea life insurers have legacy on their old high-yield guarantee products (i.e., negative investment spread), AIA seems to have a large legacy book on its old protection coverage (i.e., negative morbidity margin). In addition, business penetration into whole life has been limited by the limited exclusive agency size, in our view. Given that distribution's bargaining power is shifting from the intermediaries to the manufacturers (or insurers) in the way of lowering commission rates, without strengthening the exclusive agency forces, this should remain a challenge area for group NBV creation in terms of capital allocation, in our view. In conclusion, we believe any changes to the company's positioning in Korea should drive another NBV revision case from the current low base of expectations.

Other markets

We believe AIA's strong NBV growth momentum across the region for the last few years provides a clear anchor for future growth expectations. However, considering the company's overcapitalized balance sheet and stricter RBC introduction across the region, we cannot rule out the potential for large capital releases in the ASEAN market to capture the inorganic growth opportunity. This would drive another NBV revision for the company. We discuss this agenda in the following section, under the subtitle "stricter solvency region and better capital deployment outlook."

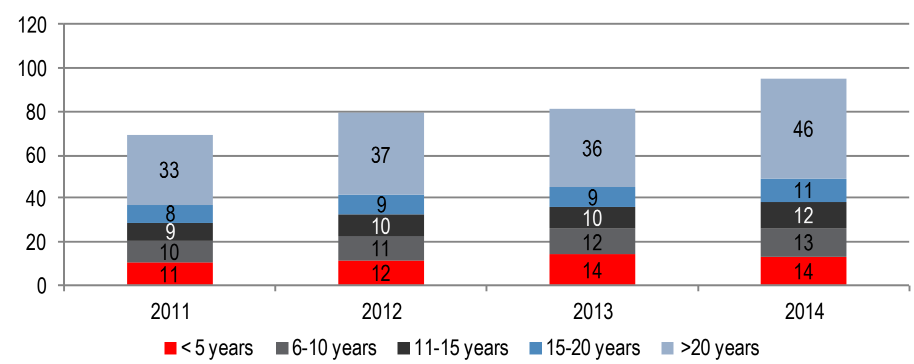
II. Free cash flow king

Strong free cash flow growth from in-force policies

Despite its large scale and market concerns about limited potential for scale increases due to its high base, the company has strongly improved fundamentals since its 2010 IPO, leveraging its new customers and ~28M existing individual policyholders. As a result, its undiscounted after-tax distributable earnings from in-force policies re-rated to ~US$95B in Nov-14 from ~US$69B in Nov-11. Based on our projections, **the free cash flow block from in-force policies should be re-rated to ~US$140B (+47%) over the next three years**, supporting an earnings re-rating and better capital consumption for value growth.

Figure 11: AIA Group: Projected after-tax distributable earnings from in-force policies

US$ in billions



Source: Company reports. Note: The above free cash flow projection is based on undiscounted numbers (without consideration of the time value of money). On a discounted basis, total aggregated free cash flow was ~US$21.3B in 2011 and ~US$29.4B in 2014.

Key drivers of free cash flow acceleration for the next couple of years

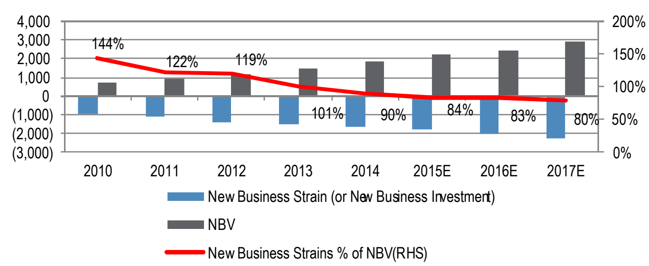
Reviewing the last four years' free surplus/EV movement, we have identified key factors possibly driving the widening of FCF for the next couple of years.

First, the company's payback period on new policies has shortened to 4.0 years from 5.0 years in 2010. Management explained in its earnings presentation that this is due to product mix changes (i.e., A&H protection sales increases), lower upfront commissions (or a lower DAC portion) and re-pricing effects. In our view, it clearly suggests mortality/morbidity profit base increases, a better-than-expected persistency ratio outlook (due to increased backloading commission size) and a positive operational experience outlook following rapid adjustment to the pricing error.

Next, overall NBV strain (or new business investment) on total NBV declined to up to 90% of NBV as of 2014 due to economies of scale and product mix changes. Based on our projections, **overall new business strain on total NBV will decline to ~80% by 2017**. This would mean that **AIA's free surplus generation would accelerate with a lowered cash consumption outlook** driving an earnings re-rating from its in-force policies.

Figure 12: AIA Group: New business strain as % of NBV

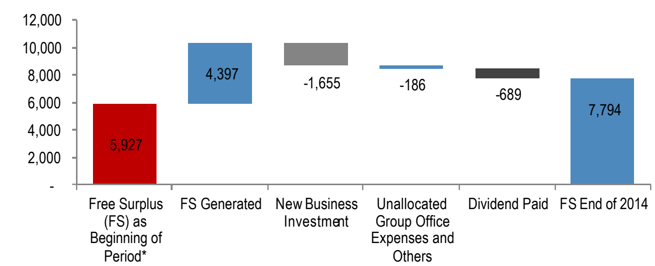
US$ in millions, %



Source: Company reports and J.P. Morgan estimates.

Figure 13: AIA Group: Movement on free surplus

US$ in millions



Source: Company reports. * Free Surplus as Beginning of Period is post-Citibank upfront payment.

Review of economic assumptions

Next, the question is whether the long-term cash flow assumption is conservative enough. The company has consistently delivered positive operational variance on its EV movement, with a 90%+ VIF-to-NAV conversion. The increasing returns and capital efficiencies of new business also suggest adequate pricing practices with agile pricing error adjustments.

Thus, we review AIA's economic assumptions and compare them to those of multi-national competitor U.K. Prudential Asia. In our view, overall risk discount rate and investment return assumptions (compared to 10-year bonds) look conservative (or reasonable). Thus, overall economic assumption variance is not expected to dent free cash flow assumptions much, in our view.

Table 2: AIA Group vs. U.K. Prudential: Economic assumptions comparison

%

Risk discount rate	Hong Kong	Singapore	Thailand	Malaysia	China	Korea
AIA Group	7.0	6.8	9.0	8.8	9.8	9.5
Prudential						
New Business	4.3	4.3	10.6	6.6	10.6	6.8
VIF	4.2	5.0	10.6	6.6	10.6	7.1
Difference (=AIA- Pru's VIF)	***2.8***	***1.8***	***-1.6***	***2.2***	***-0.9***	***2.4***
Investment return	**Hong Kong**	**Singapore**	**Thailand**	**Malaysia**	**China**	**Korea**
AIA Group	2.5	2.2	3.6	4.2	3.7	3.6
Prudential	2.6	2.3	3.8	4.1	4.1	3.2
Difference (=AIA- Pru)	***-0.1***	***-0.1***	***-0.2***	***0.1***	***-0.4***	***0.4***
10-year bond yield (31-Dec-14)	***2.1***	***2.3***	***2.8***	***4.1***	***3.6***	***2.6***

Source: Company reports. Note: AIA numbers are based on FY14 annual report disclosures. U.K. Prudential Asia numbers are based on 1H14 reports.

III. Capital king

Progress and sustainable dividend policy with upside

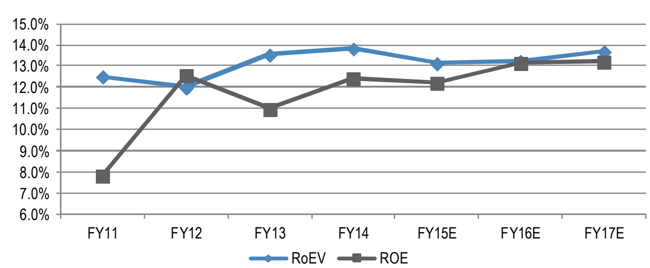
Unlike other insurers in Asia-ex, AIA has a progressive dividend policy that generally increases DPS by 15% p.a., regardless of bottom-line volatility. Reflecting this practice, overall market expectations for DPS remain conservative. However, during FY14 reporting, the company increased its DPS by 18% y/y, to HK$50cents from HK$42.55cents. Although we remain at 15% DPS increases p.a. for FY15E-17E, we believe there is room for better-than-expected DPS declarations, supporting better shareholder returns, considering the strongly improved capital position and solid earnings outlook.

12%+ RoEV/ROE outlook

The company's solvency ratio has continuously improved since 2011 on the back of widened valuation gains on its AFS bonds, solid earnings growth and ~US$2B in debt capital raises. Despite large increases in the capital buffer (or shareholders' funds), the company has managed its RoEV and ROE well above 12%, with efficient capital allocation into growth countries like China (organic growth) and Malaysia (inorganic growth). Considering the condition of its balance sheet, we expect AIA to allocate more capital to capture growth in the region, generating solid ROE/RoEV.

Figure 14: AIA Group: RoEV vs. ROE

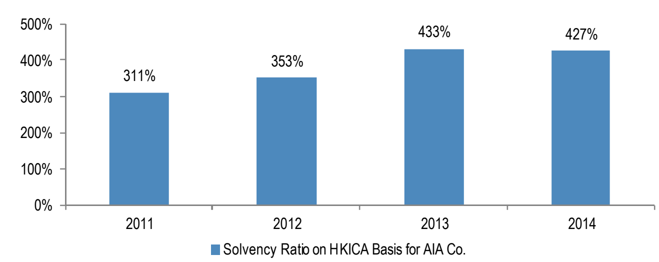
%



Source: Company reports and J.P. Morgan estimates. Note: We exclude the variance in economic assumptions and capital movement in this calculation.

Figure 15: AIA Group: Solvency ratio trend for AIA Co.

%



Source: Company reports.

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Stricter solvency region and better capital deployment outlook

In addition to potential DPS upside and a stable ROE generation outlook, the key question is whether the company really needs keep substantial capital on the balance sheet without large capital deployments to shareholders near-term. In our view, AIA's strong balance sheet should serve as a "new" share price catalyst for the next couple of years.

We want to put the solvency II framework into perspective. Starting from Singapore and Korea in 2016, a gradual adoption of strengthened solvency standards across Asian countries suggests further capital-raising potential, particularly for insurers owned by local banks selling single savings-type products.

In our view, similar to HSBC's series of insurance business disposals across EM, many local banks in the region will consider disposing of insurance operations to avoid additional capital burdens (or lower group ROE) and/or to turn passive in insurance underwritings. In addition to Singapore, Thailand and Indonesia are countries where AIA could increase scale with better capital allocation, in our view.

In short, AIA Group's ample experience in each country and strong balance sheet position suggest strong potential for scale increases and/or better deployment of its excess capital going forward. (For details, see Asia Insurance: Beyond 3Q: Positive Outlook on Several Fronts, dated 25 November 2014.)

Table 3: AIA Group: Credit ratings

	Rating agency	Financial Strength rating	Counterparty Credit rating	Latest rating date
AIA Co.	S&P	AA- / Stable / --	AA- / Stable / --	22-Jul-14
	Moody's	Aa3 / Stable	NA	29-Jan-15
AIA International	S&P	AA- / Stable / --	AA- / Stable / --	22-Jul-14
	Moody's	Aa3 / Stable	NA	29-Jan-15
AIA Group Limited	S&P	NA	A / Stable / A-1	22-Jul-14
	Moody's	NA	A3 / Stable	29-Jan-15

Source: Company reports.

Estimate revisions

Earnings

We fine-tune FY15E/16E earnings and introduce FY17E earnings. Our process factors in the company's recent operations and investment trend. First, considering the shortened pay period and/or lower DAC, we revise down sales commission expense. Second, following the company's scale growth and better expense control, we also reduce overall expenses. Third, on the investment side, reflecting the lower long-term bond yield trend across the region, we lower our investment yield assumption on interest-bearing assets. Finally, we normalize realised and unrealised gains (losses) up to ~US$2B from FY13's low base (~US$0.6B). The company's average realized and unrealised gains (losses) p.a. since 2007 was ~US$4.3B.

Table 4: AIA Group: FY15/16 earnings revisions

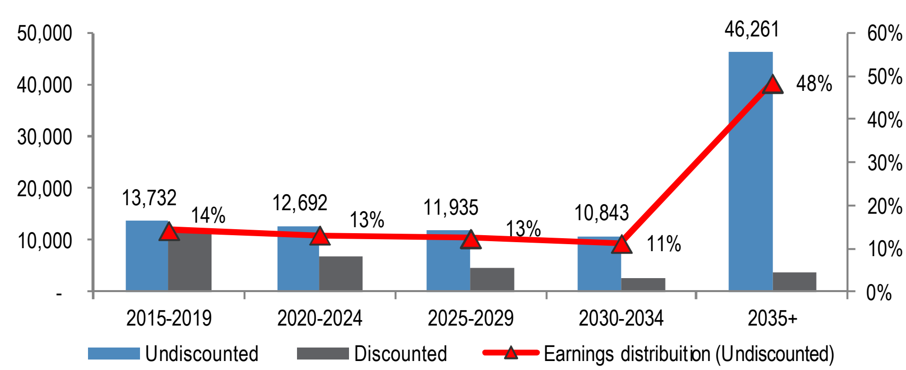
US$ in millions

	FY15E			FY16E			
	New	Old	Chg	New	Old	Chg	FY17E
Total weighted premium income (TWPI)	21,325	21,466	-1%	23,932	24,415	-2%	26,993
Annualized first-year premiums	4,219	4,360	-3%	4,817	5,219	-8%	5,563
Premiums and fee income	**20,231**	**20,364**	-1%	**22,704**	**23,162**	-2%	**25,608**
Net premiums and fee income	19,017	19,244	-1%	21,114	21,888	-4%	23,815
Net ins. & invest. contract benefits	(17,781)	(17,801)	0%	(19,214)	(19,700)	-2%	(21,434)
Total expenses	(4,155)	(4,234)	-2%	(4,603)	(4,815)	-4%	(5,180)
Commission expenses	(2,339)	(2,367)	-1%	(2,597)	(2,692)	-4%	(2,929)
Operating expenses	(1,816)	(1,867)	-3%	(2,006)	(2,123)	-6%	(2,251)
Underwriting profit	**(2,919)**	**(2,790)**	5%	**(2,703)**	**(2,627)**	3%	**(2,798)**
Investment return	8,283	8,042	3%	8,866	8,808	1%	9,625
Recurrent return	6,201	6,509	-5%	6,655	7,216	-8%	7,227
Realized & unreal. gains/(losses)	2,082	1,533	36%	2,210	1,592	39%	2,399
Other income and expenses	(220)	(165)	33%	(227)	(166)	37%	(232)
Profit/(loss) before tax	**5,144**	**5,086**	1%	**5,936**	**6,016**	-1%	**6,595**
Tax expense	(1,286)	(1,271)	1%	(1,484)	(1,504)	-1%	(1,649)
Attributable net profit	**3,844**	**3,800**	1%	**4,439**	**4,499**	-1%	**4,934**

Source: J.P. Morgan estimates.

Figure 16: AIA Group: Profile of after-tax distributable earnings from in-force policies

US$ in millions



Source: Company reports.

AIA's projected after-tax distributable earnings from in-force policies from 2015 to 2019 is ~US$13.7B (undiscounted basis). It means that, under the assumption of level earnings for the next five years, without new top-line growth, **the company's**

annual earnings power from in-force policies is likely to be ~US$2.7B. We believe the overall assumption supports high long-term cash flow visibility, given that: (1) the company's free cash flow is based on an 8.25% discount rate and 3.25% bond yield (weighted average), which is lower than the current interest rate environment and a relatively higher cost of capital; and (2) the company recognized the positive actuarial variances from in-force policies for the last couple of years.

EV and NBV

The company's record NBV growth momentum since 2010 has surprised the market almost every quarter with strong NBV growth. Given that the APE growth rate on an annual basis since 2010 was ~14% p.a., it would be fair to argue that the company's strong NBV growth of 20%+ y/y has been supported largely by product mix changes (or NBV margin enhancement). In our view, the company's record NBV margin above 50% (4Q14 NBV margin: 54.2%, +6.9%p y/y) will stay at current levels for a while. Although further NBV margin improvement would yield additional upside, our long-term NBV estimate models gradual NBV margin compression following the peak in 2015 from 50.8% in 2016 to 29.6% for the next 20 years, due to stricter regulations for better customer protection, rising competition and a more reserved outlook on new protection policies as the mortality/morbidity experience builds up.

Table 5: AIA Group: FY16E EV and NBV assumptions (FY15E-FY34E)

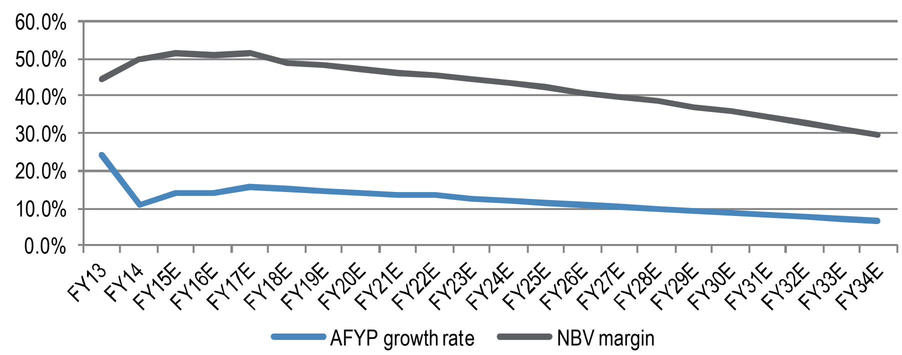
$ in millions, %

Breakdown of EV	FY16E	Long-term NBV assumptions	
Adjusted net worth (ANW)	15,728	Blended annualized FYP growth (FY15E)	14.0%
Value of in-force business (VIF)	28,581	Blended annualized FYP growth (FY34E)	6.4%
New business value (NBV) (FY16E)	2,447	Blended new business margin (FY15E)	51.5%
Embedded value (= ANW + VIF)	**44,309**	Blended new business margin (FY34E)	29.6%

Source: J.P. Morgan estimates.

Figure 17: AIA Group: Volume growth and NBV margin projections

%



Source: J.P. Morgan estimates, Company reports.

In particular, we cut our long-term growth estimates for Korea, Singapore and Hong Kong following market saturation. Due to the outlook for healthcare/unit-linked product acceleration, we revise up our China long-term NBV margin outlook. The Malaysia number has been adjusted following the business integration with ING Malaysia (i.e., a high base).

Table 6: AIA Group: Summary of long-term NBV assumptions by country

%, x

Hong Kong:	New (FY15E-FY34E)	Old (FY14E-FY33E)	China:	New (FY15E-FY34E)	Old (FY14E-FY33E)
Annualized FYP growth (FY14E) → (FY15E)	21.9%	21.9%	Annualized FYP growth (FY14E) → (FY15E)	24.9%	24.9%
Annualized FYP growth (FY33E) → (FY34E)	1.2%	10.0%	Annualized FYP growth (FY33E) → (FY34E)	11.2%	15.0%
New business margin (FY14E) → (FY15E)	60.6%	60.6%	New business margin (FY14E) → (FY15E)	57.7%	57.7%
New business margin (FY33E) → (FY34E)	41.3%	30.0%	New business margin (FY33E) → (FY34E)	37.6%	35.0%
Implied new business multiple	28x	31x	Implied new business multiple	42x	38x
Thailand:	**New**	**Old**	**Korea:**	**New**	**Old**
Annualized FYP growth (FY14E) → (FY15E)	1.2%	1.2%	Annualized FYP growth (FY14E) → (FY15E)	12.4%	12.4%
Annualized FYP growth (FY33E) → (FY34E)	9.7%	8.0%	Annualized FYP growth (FY33E) → (FY34E)	-13.8%	2.0%
New business margin (FY14E) → (FY15E)	53.9%	53.9%	New business margin (FY14E) → (FY15E)	28.7%	28.7%
New business margin (FY33E) → (FY34E)	31.8%	35.0%	New business margin (FY33E) → (FY34E)	4.0%	10.0%
Implied new business multiple	11x	15x	Implied new business multiple	7x	9x
Singapore:	**New**	**Old**	**Other geographical markets:**	**New**	**Old**
Annualized FYP growth (FY14E) → (FY15E)	22.3%	22.3%	Annualized FYP growth (FY14E) → (FY15E)	-1.9%	-1.9%
Annualized FYP growth (FY33E) → (FY34E)	-8.5%	15.0%	Annualized FYP growth (FY33E) → (FY34E)	5.6%	6.0%
New business margin (FY14E) → (FY15E)	66.7%	66.7%	New business margin (FY14E) → (FY15E)	26.2%	26.2%
New business margin (FY33E) → (FY34E)	22.0%	35.0%	New business margin (FY33E) → (FY34E)	11.4%	15.0%
Implied new business multiple	14x	34x	Implied new business multiple	15x	14x
Malaysia:	**New**	**Old**	**Overall:**	**New**	**Old**
Annualized FYP growth (FY14E) → (FY15E)	0.3%	0.3%	Annualized FYP growth (FY14E) → (FY15E)	14.0%	10.7%
Annualized FYP growth (FY33E) → (FY34E)	14.7%	15.0%	Annualized FYP growth (FY33E) → (FY34E)	6.4%	12.0%
New business margin (FY14E) → (FY15E)	45.0%	45.0%	New business margin (FY14E) → (FY15E)	51.5%	49.9%
New business margin (FY33E) → (FY34E)	40.6%	35.0%	New business margin (FY33E) → (FY34E)	29.6%	29.0%
Implied new business multiple	21x	41x	Implied new business multiple	22x	17x

Source: J.P. Morgan estimates.

Solvency/free surplus

We revise our estimates of AIA's solvency/total free surplus, factoring in: (1) a larger-than-expected increase in shareholders' funds; (2) a lower capital consumption outlook for growth; and (3) a decreasing % of new business strain on total NBV. If the company's top-line growth per annum remains in the low teens, under the scenario of limited volatility in the long-term bond yield, its solvency ratio on a HKICO basis should stay at the ~400% level by 2017, in our view.

Table 7: AIA Group: Solvency ratio/total free surplus revisions

US$ in millions, %, %p

	FY15E			FY16E			
	New	Old	Chg	New	Old	Chg	FY17E
Solvency margin ratio	409%	377%	31.8%p	401%	370%	31.5%	394%p
Total free surplus	9,865	6,791	45.3%	11,771	6,152	91.3%	14,574

Source: J.P. Morgan estimates.

Investment Thesis, Valuation and Risks

AIA Group Ltd *(Overweight; Price Target: HK$55.00)*

Investment Thesis

AIA Group is the leading life insurer across Asia-ex, based on agency operations. For the last 90 years, the company has focused on managing its leading positions in Hong Kong, Singapore and Thailand. Low insurance penetration across the region, favorable demographic changes and household income growth (i.e., rising GDP per capita) in China and ASEAN countries are expected to support strong NBV growth momentum, with solid margins and volume growth as the market transforms into an agency-based protection-type market, where AIA has had a strong competitive edge for the last 90 years and the barriers to entry are very high. The high visibility of future cash flow generation from existing policies, a strong balance sheet and conservative actuarial assumptions should act as further share price drivers, in our view, particularly as the Asia-ex financial market shows higher volatility.

Valuation

We assign a Dec-15 price target of HK$55. Our PT is derived via a multi-stage growth model to project NBV for each geographical market separately, which yields an implied blended P/EV of 2.1x and a blended new business multiple of 19x for the group.

	HK$/share
Embedded value (November 30, 2016E)	28.72
Goodwill	30.71
New business value (FY16E)	1.59
New business multiple (x)	19x
Share price equivalent (November 30, 2016E)	**59.43**
Dec-15 price target	**55.00**

Source: J.P. Morgan estimates.

Risks to Rating and Price Target

Key downside risks include: (1) slowing turnaround momentum as AIA catches up with main rival Prudential; (2) longer-than-expected financial market or political volatility in Asia-ex or ASEAN countries; and (3) a longer-than-expected business turnaround in Malaysia following the ING Malaysia acquisition.

AIA Group Ltd: Summary of Financials

Income Statement ($ in millions)	FY13	FY14	FY15E	FY16E	FY17E
GWP & Policy fees	16,666	18,225	20,231	22,704	25,608
Net written premiums	15,707	17,052	19,017	21,114	23,815
Net earned premiums	15,707	17,052	19,017	21,114	23,815
Total technical outgo	(14,487)	(16,804)	(17,781)	(19,214)	(21,434)
Total expenses	(3,471)	(3,775)	(4,155)	(4,603)	(5,180)
Underwriting profit	(2,251)	(3,527)	(2,919)	(2,703)	(2,798)
Net Investment Income	5,160	5,570	6,201	6,655	7,227
Realized & unreal. Investment income	870	2,634	2,082	2,210	2,399
Other income/expenses	(238)	(332)	(220)	(227)	(232)
Pre-tax profit	3,541	4,345	5,144	5,936	6,595
Tax	(692)	(877)	(1,286)	(1,484)	(1,649)
Minorities	(25)	(18)	(14)	(13)	(12)
Net profit	2,824	3,450	3,844	4,439	4,934

Balance sheet ($ in millions)	FY13	FY14	FY15E	FY16E	FY17E
Bonds	87,768	102,328	106,997	117,343	126,249
Equities	26,102	28,827	29,721	32,595	35,069
Deposits	6,047	5,605	5,944	6,519	7,014
Other Investments	3,753	3,884	4,458	4,889	5,260
Total Investments	124,798	142,028	148,606	162,977	175,346
Total Assets	147,402	166,919	177,194	190,428	215,659
Total insurance reserves	112,134	121,034	129,223	138,116	148,599
Subordinated debts	1,950	2,934	2,934	2,934	2,934
Total liabilities	122,575	135,964	144,977	154,777	176,231
Minority Interest	145	149	163	176	188
Shareholders' funds	24,682	30,806	32,054	35,475	39,240

Income Statement growth rates	13,Y/Y	14,Y/Y	15E, Y/Y	16E, Y/Y	17E, Y/Y
GWP & policy fees	20.6%	9.4%	11.0%	12.2%	12.8%
Net earned premiums	20.3%	8.6%	11.5%	11.0%	12.8%
Net Investment Income	15.6%	7.9%	11.3%	7.3%	8.6%
Total technical outgo	8.3%	16.0%	5.8%	8.1%	11.6%
Total expenses	16.4%	8.8%	10.1%	10.8%	12.5%
Underwriting profit	(31.8%)	56.7%	(17.2%)	(7.4%)	3.5%
Pre-tax profit	(4.7%)	22.7%	18.4%	15.4%	11.1%
Net profit	(6.5%)	22.2%	11.4%	15.5%	11.2%

Capital Strength	FY13	FY14	FY15E	FY16E	FY17E
Shareholders' funds to insurance liab.	22.1%	25.6%	24.9%	25.8%	26.5%
Solvency margin ratio (group operation)	433.0%	426.8%	410.0%	403.6%	397.1%

First-year premiums	FY13	FY14	FY15E	FY16E	FY17E
Single premiums	3,325	4,497	3,855	4,817	5,563
Regular premiums	2,815	3,087	3,834	4,335	5,006
AFYPs	3,341	3,700	4,219	4,817	5,563

Profitability measure	FY13	FY14	FY15E	FY16E	FY17E
Loss ratio	92.2%	98.5%	93.5%	91.0%	90.0%
Expense ratio	22.1%	22.1%	21.9%	21.8%	21.8%
Combined ratio	114.3%	120.7%	115.4%	112.8%	111.8%
Total investment yield (incl. gains/losses)	5.0%	6.1%	5.7%	5.7%	5.7%
ROA	2.0%	2.2%	2.2%	2.4%	2.4%
ROE	11.0%	12.4%	12.2%	13.1%	13.2%

Per share data	FY13	FY14	FY15E	FY16E	FY17E
EPS	0.24	0.29	0.32	0.37	0.41
Y/Y	(6.3%)	22.2%	11.6%	15.7%	11.2%
DPS	0.05	0.06	0.07	0.09	0.10
Payout ratio	23.3%	22.4%	23.1%	22.9%	23.7%
BVPS	2.06	2.57	2.68	2.97	3.28
No. of shares	12,006	12,008	11,964	11,964	11,964
Group embedded value	2.82	3.09	3.37	3.70	4.09
Life operation embedded value	2.82	3.09	3.37	3.70	4.09
Y/Y	7.7%	9.8%	9.0%	9.8%	10.4%
New business value	0.12	0.15	0.18	0.20	0.24
Y/Y	25.4%	23.8%	18.2%	12.6%	16.9%

Balance sheet growth rates	13,Y/Y	14,Y/Y	15E, Y/Y	16E, Y/Y	17E, Y/Y
Bonds	7.7%	16.6%	4.6%	9.7%	7.6%
Equities	10.3%	10.4%	3.1%	9.7%	7.6%
Deposits	(3.4%)	(7.3%)	6.1%	9.7%	7.6%
Total investments	8.0%	13.8%	4.6%	9.7%	7.6%
Total Assets	9.6%	13.2%	6.2%	7.5%	13.2%
Total insurance reserves	12.8%	7.9%	6.8%	6.9%	7.6%
Total liabilities	13.9%	10.9%	6.6%	6.8%	13.9%
Shareholders' funds	(7.5%)	24.8%	4.1%	10.7%	10.6%

Source: Company reports and J.P. Morgan estimates.

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JPM Q-Profile

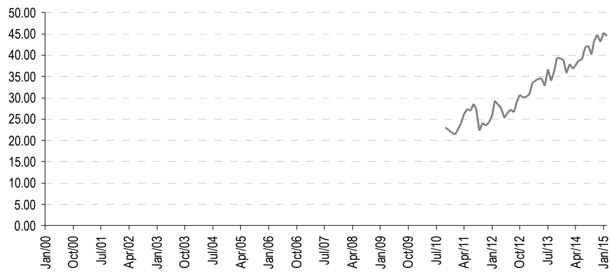
AIA Group Limited (HONG KONG / Financials)

As Of: 20-Feb-2015

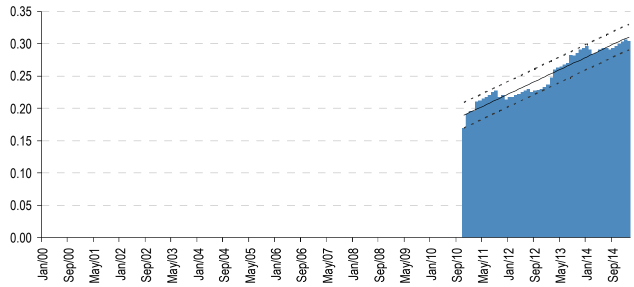
Global Equity Quantitative Analysis

Quant_Strategy@jpmorgan.com

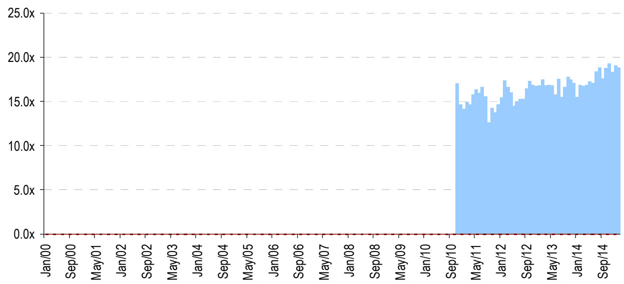
Local Share Price Current: 44.45



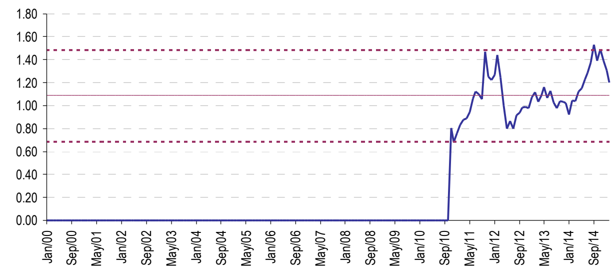
12 Mth Forward EPS Current: 0.30



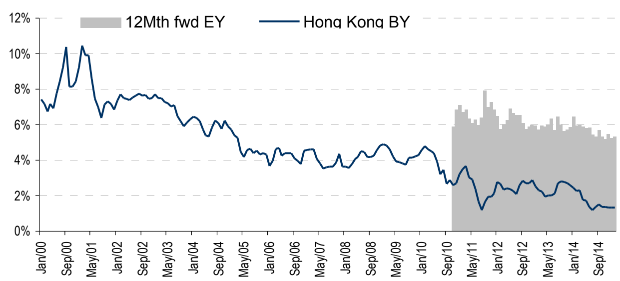
PE (1Yr Forward) Current: 18.8x



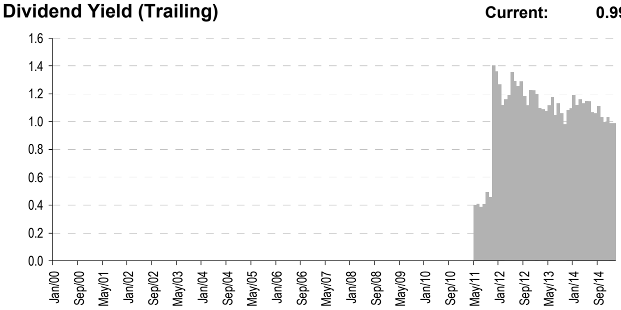
P/E Relative to Hong Kong Index Current: 1.20



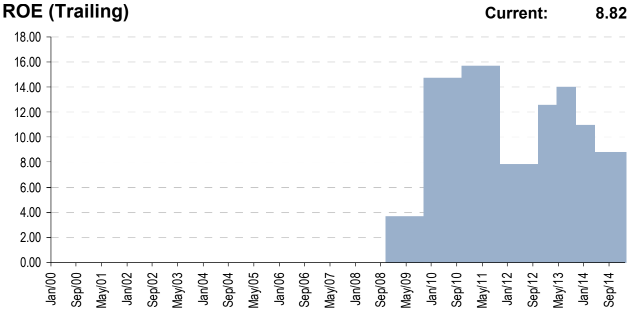
Earnings Yield (& Local Bond Yield) Current: 5%



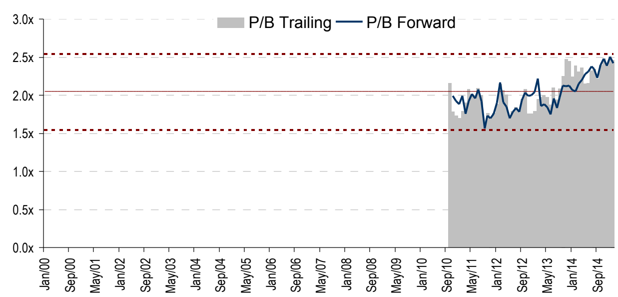
Dividend Yield (Trailing) Current: 0.99



ROE (Trailing) Current: 8.82



Price/Book (Value) Current: 2.5x



Summary

AIA Group Limited								**As Of:**			20-Feb-15
HONG KONG	**TICKER**	**1299 HK**						**Local Price:**			44.45
Financials								**EPS:**			0.30
	Latest	**Min**	**Max**	**Median**	**Average**	**2 S.D.+**	**2 S.D. -**	**% to Min**	**% to Max**	**% to Med**	**% to Avg**
12mth Forward PE	**18.81x**										
P/BV (Trailing)	**2.46**	1.63	2.51	2.01	2.05	2.55	1.55	-34%	2%	-18%	-17%
Dividend Yield (Trailing)	**0.99x**	0.00	1.40	1.09	0.91	1.78	0.04	-100%	42%	11%	-8%
ROE (Trailing)	**8.82**	3.65	15.70	10.99	10.74	19.10	2.38	-59%	78%	25%	22%

Source: Bloomberg, Reuters Global Fundamentals, IBES CONSENSUS, JPMorgan Quantitative & Derivative Strategy

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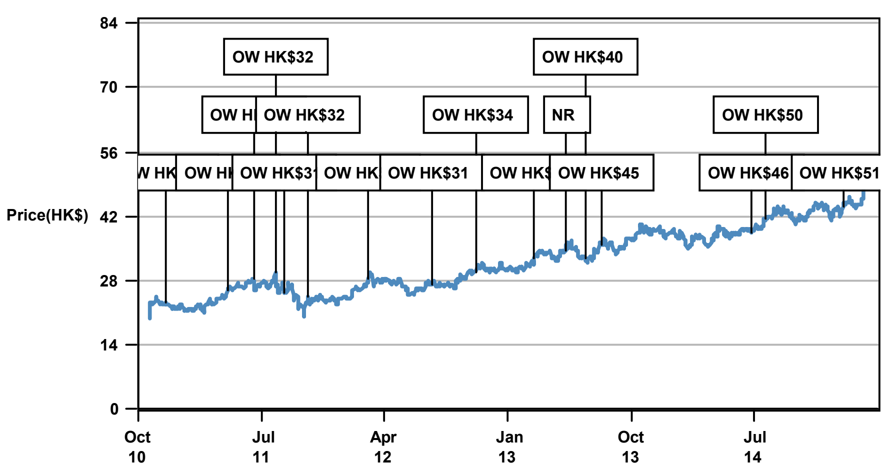
AIA Group Ltd (1299.HK, 1299 HK) Price Chart



Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Break in coverage May 07, 2013 - Jun 22, 2013.

Date	Rating	Share Price (HK$)	Price Target (HK$)
02-Dec-10	OW	22.90	26.00
18-Apr-11	OW	25.70	28.00
14-Jun-11	OW	28.15	30.00
02-Aug-11	OW	29.55	32.00
22-Aug-11	OW	25.40	31.00
14-Oct-11	OW	24.40	32.00
24-Feb-12	OW	28.30	34.00
16-Jul-12	OW	27.05	31.00
18-Oct-12	OW	29.80	34.00
27-Feb-13	OW	32.85	36.00
07-May-13	NR	34.65	--
22-Jun-13	OW	32.50	40.00
27-Jul-13	OW	35.70	45.00
23-Jun-14	OW	38.30	46.00
27-Jul-14	OW	41.55	50.00
13-Jan-15	OW	43.90	51.00

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