J.P.Morgan

25 March 2015

China Life Insurance - H (2628 HK)

2H14 first cut: Good results overall, but more fundamental improvements needed to drive share price upside

Neutral

Price: HK$33.15

24 Mar 2015

Price Target: HK$30.00

PT End Date: 30 Jun 2015

Besides a 30% y/y annual profit increase (NP: ~Rmb32B), which was pre-announced on 30 January, China Life broadly delivered better-than-expected results in 2H14. Key positives are the 1) agency headcount increase (+14% y/y), 2) strong balance sheet (solvency ratio: 294%, +68%p y/y), and 3) quarterly surrender ratio improvement (i.e., better signal on less cash out-flow pressure). However, we equally argue that its 1) strong EV growth (+33% y/y) and good annual earnings were mainly due to favorable financial market conditions, 2) the company started to top up additional liability reserves in the P/L following the lower interest rate environment, and 3) lower asset mix on interest-bearing assets implies volatile book value/EV/earnings outlook potential in view of the financial market conditions. **As China Life's share price has already run up since Nov-14 in tandem with favorable financial market conditions and the expectation of a strong agency business turnaround, we do not expect this result to drive short-term share price momentum**. Instead, we believe 1) management's view on the agency business (or protection business) development outlook, 2) reform agenda/execution plans for 2015, and 3) the policy surrender ratio outlook delivered in the results presentation (9am Hong Kong Time, 25 March) will be more relevant for near-term share price momentum. We maintain our forecasts pending further review following the analyst briefing.

- **Surrender ratio improvement appears to be on track.** A key positive in China Life's 2H14 result should be a better-than-expected policy surrender ratio trend. During 4Q, surrender growth was only 3% y/y (vs. 36% y/y in 4Q13). In our view, thanks to 1) lower single savings sales during 2H (-17% y/y), 2) rise in longer-duration policies in the sales mix, and 3) favorable A-share market conditions (demand increase for longer-duration participating policy sales), China Life's quarterly surrender ratio (or cash out-flow pressure) peaked during 1H14. Thus, the company should be in a better environment to develop 'value' growth in 2015, which investors generally regard to be a positive share price catalyst at this stage.

- **Higher investment return vs. fast liability reserve top-up.** In view of China Life's high FY14 earnings base, we want to have a balanced view on its earnings momentum for 2015. China Life's FY14 NP grew by ~Rmb7.4B, and around Rmb5.8B of this (or 78% of the NP increase) came from both equity and debt investment gains. As the company's source of profit is mainly the investment spread margin (= investment return - funding cost), further momentum in the A-share market as well as bond yield flattening would be needed to generate strong earnings momentum in 2015, in our view. To be fair, following the lower bond yield, liability reserve provisioning increased to Rmb28B (+49% y/y, +42% q/q) in 4Q14. Moreover, the lower asset mix on interest-bearing asset (bonds/deposits: 45%/36%, -3%p/-2%p y/y) would mean a potentially volatile earnings outlook depending on the financial market conditions in China. In short, **in order to invest in China Life as a proxy to the A-share market, we advise monitoring long-term bond yields, as changes in liability reserves are likely to offset increases in investment returns, particularly in a monetary easing cycle.**

- **Better-than-expected NBV growth, but we need more clarity**. Besides strong EV growth (+33% y/y) due to large valuation gains on adjusted net worth (ANW), China Life's better-than-expected 2H NBV growth (actual: ~ Rmb 9.8B, +12% y/y vs. JPMe: ~8.8B) should be another positive outcome. However, its 2H NBV momentum seems to be driven by better-than-expected NBV growth in non-agency channels (e.g. bancassurance, group insurance) where we expect further margin compression, and so we would need more clarity on its product margin outlook in the bancasurance channel. Factoring in the 14% y/y increase in agency headcount, only an 11% y/y NBV increase suggests further room for agency productivity improvement.

- **Price target, valuation and risks.** We maintain our forecasts and Neutral rating pending the analyst briefing. Upside risks include a successful transformation to a protection-type business model and an A-share market rally, alleviating impairment losses. Downside risks include rapid weakening of its capital position as A-share markets consolidate, and an ongoing premium market share decline.

Table 1: China Life: 2H14 earnings results

Rmb in millions, %

	1H14	2H14E	H/H Chg	Y/Y Chg	2H14E	Vs. est.	2014E	Y/Y Chg	2014E	Vs. est.
GWPs & policy fees	**197,250**	**133,760**	-32%	9%	**137,849**	-3%	**331,010**	1%	**335,099**	-1%
Reinsurance ceded	(259)	**(256)**	-1%	-6%	**(76)**	n.m.	(515)	-7%	(335)	54%
Net writ. premiums & policy fees	**196,991**	**133,504**	-32%	9%	**137,773**	-3%	**330,495**	1%	**334,764**	-1%
Chg in unearned prem. reserves	(3,216)	**2,826**	n.m.	n.m.	**2,212**	28%	(390)	-58%	(1,004)	-61%
Net earned premium & policy fees	**193,775**	**136,330**	-30%	10%	**139,985**	-3%	**330,105**	2%	**333,760**	-1%
Total technical outgo	**(191,025)**	**(151,093)**	-21%	14%	**(152,080)**	-1%	**(342,118)**	3%	**(343,105)**	0%
Total expenses	**(24,937)**	**(27,642)**	11%	7%	**(28,625)**	-3%	**(52,579)**	4%	**(53,562)**	-2%
Underwriting profit	**(22,187)**	**(42,405)**	91%	23%	**(40,721)**	4%	**(64,592)**	11%	**(62,908)**	3%
Total investment income	45,372	**61,104**	35%	39%	**57,105**	7%	106,476	20%	102,477	4%
Other income	80	**(861)**	n.m.	n.m.	**1,714**	n.m.	(781)	75%	1,794	n.m.
Provision for guaranteed fund	(401)	**(300)**	-25%	19%	**(268)**	12%	(701)	10%	(669)	5%
Pre-tax profit	**22,864**	**17,538**	-23%	89%	**17,831**	-2%	**40,402**	37%	**40,695**	-1%
Income tax expense	(4,310)	**(3,578)**	-17%	n.m.	**(3,829)**	-7%	(7,888)	78%	(8,139)	-3%
Profit before m. int.	**18,554**	**13,960**	-25%	61%	**14,002**	0%	**32,514**	30%	**32,556**	0%
Minority interests	(147)	**(156)**	6%	38%	**(132)**	18%	(303)	25%	(279)	8%
Net profit/(loss)	**18,407**	**13,804**	-25%	61%	**13,869**	0%	**32,211**	30%	**32,276**	0%

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

Table 2: China Life: 2H14 EV/ NBV results

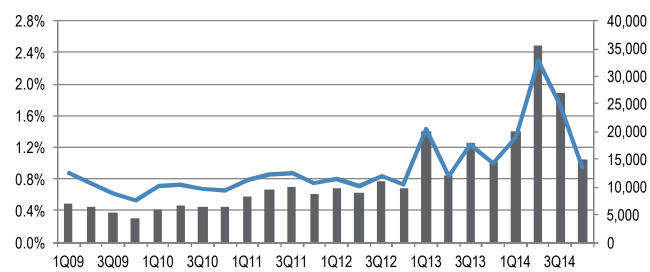
Rmb in millions, %, %p

	1H14	2H14	H/H Chg	Y/Y Chg	2H14E	Vs. est.	2013	2014	Y/Y Chg	2014E	Vs. est.
Embedded value	390,367	454,906	17%	33%	395,400	15%	342,224	454,906	33%	395,400	15%
New business value	13,459	9,794	-27%	12%	8,837	11%	21,300	23,253	9%	22,296	4%
First-year premiums	91,328	51,592	-44%	-7%	45,083	14%	135,563	142,920	5%	136,411	5%
New business margin	14.7%	19.0%	4.2%p	3.3%p	19.6%	-0.6%p	15.7%	16.3%	0.6%p	16.3%	0%p

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

Figure 1: China Life: Quarterly surrender ratio trend

%

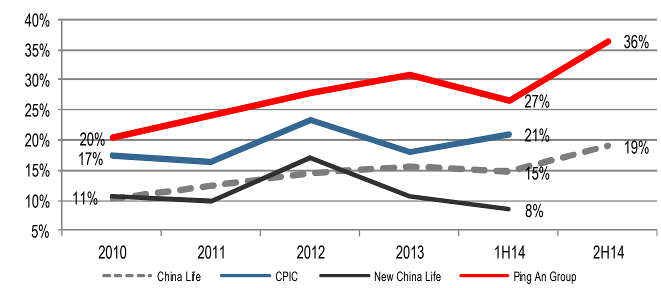


Source: Company reports and J.P. Morgan estimates.

Note: Surrender ratio= Surrender Payment / (Liability of long-term insurance at the beginning of period + premium of long-term insurance contract)

Figure 2: China life insurers: NBV margin trend

%

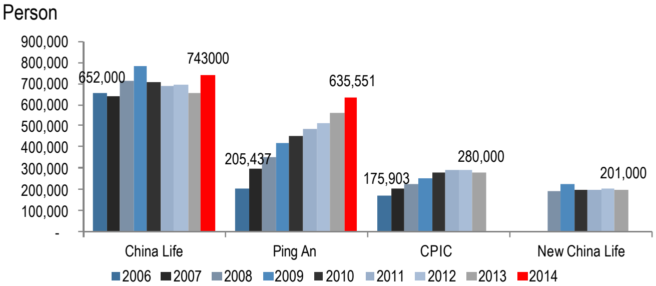


Source: Company reports.

Note: NBV margin = NBV/ First Year Premium (FYP)

Figure 3: China life insurers: agency headcount trend

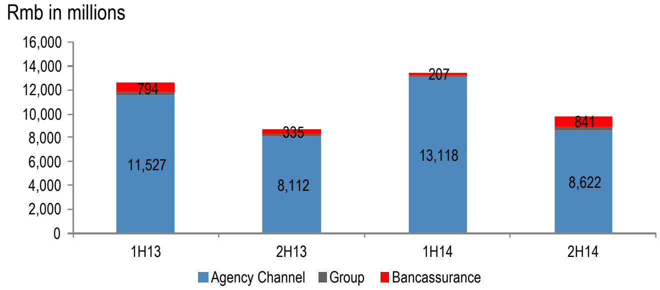
Person



Source: Company reports.

Figure 4: China Life: NBV breakdown by channel

Rmb in millions



Source: Company reports.

Investment Thesis

A decreasing policy surrender ratio during the quarter and a muted reserve growth trend would suggest that its asset-gathering business model has largely stabilised with a gradual 'value' focused business transformation. Thus, we would see upside potential following its fundamental improvement. To be fair, we are concerned about its intention to seek a higher investment yield allocating more to risky assets and low interest rate environment. In addition, following the downward trend on the long-term bond yield, starting from 4Q14, the company would need to top-up its additional reserve, working adversely on its earnings. Finally, given its large asset allocation to bank deposits, the policy rate cut would impact negatively earnings. Thus, once the company pays more attention to insurance profit (i.e., mortality/ morbidity profit base increase) rather than investment returns, we believe we would see a clearer long-term fundamental re-rating case with a gradual decoupling from financial market volatility.

Valuation

Our Jun-15 PT for China Life-H of HK$30 is based on our multi-stage NBV growth model, which yields an implied P/EV of 1.6x and NBM of 11x.

Valuation summary

HK$	
Embedded value (31 December 2014E)	17.3
Expected return on EV	1.6
New business value (2015E)	1.0
Experience variance	(0.5)
Market value adjustments	0.0
Capital movement	(0.5)
Embedded value (31 December 2015E)	18.9
Goodwill	11.4
New business value (2015E)	1.0
New business multiple (x)	11x
Share price equivalent (Dec-15)	30.3
Target price (Jun-15)	30.0

Source: Company data, J.P. Morgan estimates

Risks to Rating and Price Target

Upside risks to our rating and price target include: 1) successful sales of critical illness products, lifting NBV growth via margin improvement; and 2) an A-share market rally, alleviating further impairment losses.

Downside risks to our rating and price target include: 1) a rapid deterioration in capital position as A-share markets pull back further; and 2) an ongoing premium market share decline as competition intensifies.

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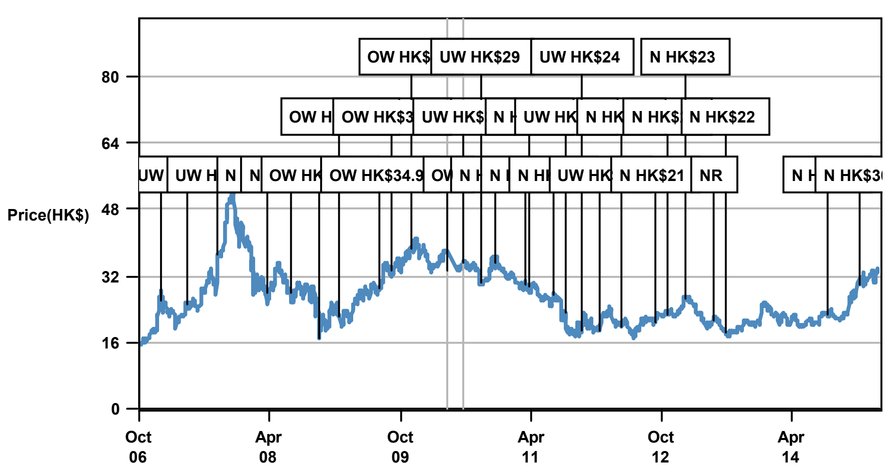

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
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05-Jan-07	UW	26.10	17.00
17-Apr-07	UW	25.15	23.20
28-Aug-07	UW	37.15	33.00
17-Mar-08	N	27.75	31.10
26-Jun-08	N	28.00	29.60
28-Oct-08	OW	16.70	29.60
16-Jan-09	OW	22.20	28.40
07-Jul-09	OW	28.90	34.90
25-Aug-09	OW	33.25	35.10
16-Nov-09	OW	38.70	45.00
14-Apr-10	OW	33.40	--
18-Jun-10	UW	35.00	33.00
02-Sep-10	UW	30.30	29.00
29-Oct-10	N	35.00	37.00
07-Mar-11	N	30.05	34.00
23-Mar-11	N	29.20	32.00
07-Jul-11	N	27.25	31.00
24-Aug-11	UW	22.95	22.00
27-Oct-11	UW	18.76	24.00
09-Jan-12	UW	19.00	20.00
13-Apr-12	N	19.80	20.00
02-Sep-12	N	20.95	21.00
27-Oct-12	N	22.55	22.00
09-Jan-13	N	26.30	23.00
07-May-13	NR	21.30	--
22-Jun-13	N	18.52	22.00
28-Aug-14	N	22.65	23.00
08-Jan-15	N	29.80	30.00

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