

New China Life Insurance - H (1336 HK)

Neutral

Price: HK\$42.50

25 Mar 2015

Price Target: HK\$42.00

PT End Date: 30 Jun 2015

2H14 first cut: Weak fundamentals vs. high market expectations

We believe New China Life's share price movement for the last six months was largely supported by upward FY14 EPS revisions thanks to the A-share market rally. However, contrary to high market expectations, the company's overall FY14 NP was ~15% below consensus (actual: Rmb6.4B, +45% y/y vs. consensus: Rmb7.6B). Its higher investment yield in FY14 (5.8%) was largely offset by higher-than-expected surrender payments. We also see that the overall liability provisioning level in 2H14 was quite low compared to its past reserving practice. Given that the insurance product mix has not changed meaningfully, it would be reasonable to expect higher liability reserving top-ups in 2015. The mitigating share price factors should be 1) strong 2H14 NBV growth (+14%) with strong product margin, 2) improved solvency ratio (227%, +57%), and 3) larger-than-expected NBV contributions from the agency channel. In short, the overall near-term share price reaction is likely to be volatile as weaker-than-expected fundamentals and FY14 earning miss appear to be new major negatives. We maintain our forecasts pending the analyst briefing.

- **Earning miss.** Contrary to high market expectations following the A-share market rally, New China Life's FY14 net profit (Rmb6.4B, 45% y/y) was ~15% below the high market expectations (vs. consensus/ JPM: Rmb7.6B/Rmb6.9B). Based on our observation, the miss was mainly due to record surrender amounts in 4Q14 (Rmb21B, +175% y/y). The overall quarterly policy surrender trend and liability reserving status in 2H14 suggest that the company's fundamentals are not strong enough to drive the price up from the current level. We believe that as the strong share price movement since Sep-14 was largely triggered by upward FY14 earnings consensus revisions following strong A-share market movements, the FY14 earnings miss is likely to have a negative near-term impact on the share price.
- **Challenging fundamentals ahead.** Reviewing its surrender figures, liability provisioning level, and persistency ratios, we do not think fundamentals will support share price momentum during 2015. First, and different from China Life, **overall cash outflow (or surrender ratio) cycle does not appear to have peaked.** Thus, we think it is fair to estimate an Rmb14B (+15% y/y) quarterly surrender outlook in 2015. Second, considering flattened bond yield trends in China and the company's product mix, we believe **its provisioning level for insurance reserves in the P/L implies large additional provisioning top-ups in 1Q15** as the 2H14 provisioning level does not fairly reflect the top-line growth profile. Third, despite its strong investment return (5.8%, +0.6%p y/y vs. China Life/Ping An: 5.4%/ 5.1%), we believe its further asset mix change (non-standard assets: >20% of AUM vs. 3% in 2012) remains a concern. To manage the volume, under the scenario of life insurance price liberalization, the company might consider taking on more risk in the balance sheet, offering better returns to participating policyholders. Finally, despite its strong solvency recovery thanks to favorable market conditions/sub-debt issuance, under the new solvency framework (C-ROSS), factoring in its asset mix/ insurance product mix, we do not think that its solvency ratio is enough to support its top-line growth.
- **Solid NBV growth/ agency product margin acceleration are key mitigating factors.** Although strong EV growth (+32% y/y) was largely supported by economic experience variances (i.e., better-than-expected investment return in FY14), strong 2H14 NBV growth (+14% y/y) and >40% NBV margin in the agency channel remain key positives. Contrary to our expectation of NBV margin pressure in the agency channel due to single-savings product structure, the better-than-expected NBV margin in the agency channel seems to suggest the company is partially benefiting from the protection market acceleration in China as one of largest life insurers (market share: 8.7% in 2014), we think.
- **Price target, valuation and risk risks.** We maintain our forecasts pending the analyst briefing. Upside risks are: 1) sooner-than-expected restructuring results; 2) a stronger-than-expected rally in A-share markets; and 3) rapid branch network expansion, driving premium growth. Downside risks are: 1) weaker-than-expected A-share market movement; 2) China long-term bond yield flattening driving the reserving provisioning top-up; and 3) a faster-than-expected asset quality deterioration cycle.

Table 1: New China Life: 2H14 earnings results

Rmb in millions, %

	1H14	2H14	H/H Chg	Y/Y Chg	2H14E	Vs. est.	2014	Y/Y Chg	2014E	Vs. est.
Gross w. premiums & fees	66,927	43,140	-36%	-18%	43,083	0%	110,067	6%	110,010	0%
Reinsurance ceded	-213	-191	-10%	45%	103	n.m.	-404	38%	-110	n.m.
Net w. premiums & fees	66,714	42,949	-36%	-18%	43,186	-1%	109,663	6%	109,900	0%
Chg. in unearned prem. res.	-195	2	n.m.	-97%	85	-98%	-193	17%	-110	76%
Net earned premium & fees	66,519	42,951	-35%	-18%	43,271	-1%	109,470	6%	109,790	0%
Total technical outgo	-65,665	-47,496	-28%	-13%	-44,229	7%	-113,161	8%	-109,894	3%
Acquisition costs	-4,140	-3,501	-15%	11%	-4,103	-15%	-7,641	19%	-8,243	-7%
Administrative expenses	-5,181	-6,154	19%	12%	-5,150	20%	-11,335	14%	-10,331	10%
Total expenses	-9,321	-9,655	4%	12%	-9,252	4%	-18,976	16%	-18,573	2%
Underwriting profit	-8,467	-14,200	68%	35%	-10,210	39%	-22,667	30%	-18,677	21%
Total investment income	13,506	18,278	35%	33%	16,070	14%	31,784	30%	29,576	7%
Operating Profit/(Loss)	5,126	4,288	-16%	42%	5,414	-21%	9,414	43%	10,540	-11%
Finance Costs	-872	-1,348	55%	44%	-1,348	0%	-2,220	13%	-2,220	0%
Profit before tax	4,523	3,259	-28%	32%	4,180	-22%	7,782	57%	8,703	-11%
Income tax expense	-774	-601	-22%	165%	-967	-38%	-1,375	n.m.	-1,741	-21%
Net profit/(loss)	3,748	2,658	-29%	19%	3,212	-17%	6,406	45%	6,960	-8%

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

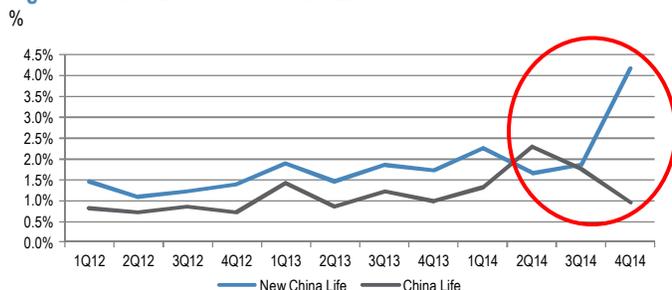
Table 2: New China Life: 2H14 EV/ NBV results

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	73,141	85,260	17%	32%	74,633	14%	64,407	85,260	32%	74,633	14%
New business value	2,472	2,440	-1%	14%	1,026	n.m.	4,236	4,912	16%	3,498	40%
New business margin	8.5%	17.8%	9.3%p	7.3%p	9.3%	8.4%p	10.6%	11.5%	0.9%p	8.6%	2.9%p

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

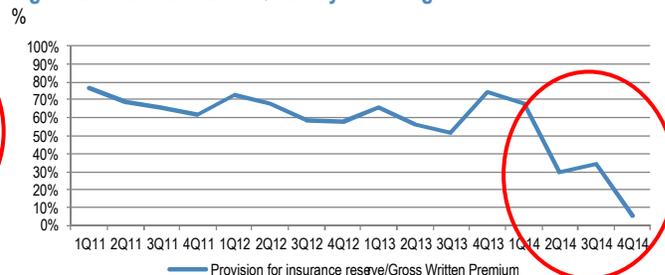
Figure 1: China Life vs. New China Life: Surrender ratio trend



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: New China Life: Quarterly reserving trend



Source: Company reports.

Note: Quarterly reserving = Provision for insurance reserve/ GWPs

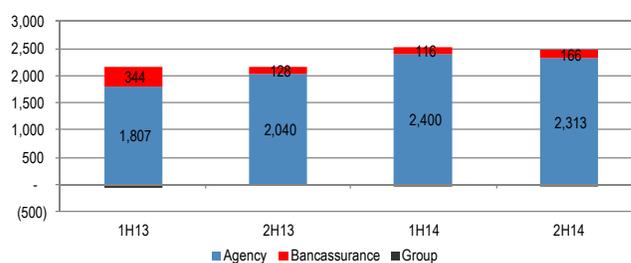
Figure 3: New China Life: FY14 EPS revisions



Source: Bloomberg

Figure 4: New China Life: NBV breakdown by channel

Rmb in millions



Source: Company reports.

Investment Thesis

Despite its earnings recovery in 2013 on the back of it recovering from a large impairment loss, its insurance operation showed little evidence of fundamental improvement in that year. We think its relatively small balance sheet will remain a key disadvantage during this period of strong industry growth. However, a strong A-share market recovery and further monetary easing from the government should work as upside catalysts.

Valuation

Our New China Life-H PT (Jun-15) of HK\$42 is derived from a multi-stage NBV growth model, which yields an implied P/EV of 1.4x and implied NBM of 7x.

Embedded value (31 December, 2014)	29.6
Expected return on EV	2.5
New business value (2014)	1.5
Experience variance	(0.9)
Market value adjustments	(0.0)
Capital movement	(0.3)
Embedded value (31 December, 2015)	32.4
Goodwill	11.1
New business value (2015)	1.5
New business multiple (x)	7.4x
Fair Value (Dec-15)	43.6
Price Target (Jun-15)	42.0

Source: J.P. Morgan estimates.

Risks to Rating and Price Target

Upside risks to our rating and price target include: 1) sooner-than-expected restructuring results; 2) a stronger-than-expected rally in A-share markets; and 3) rapid branch network expansion, driving premium growth.

Downside risks to our rating and price target include: 1) a weaker-than-expected A-share market movement; 2) a flattening China long-term bond yield driving reserve provisioning top-up; and 3) a faster-than-expected asset quality deterioration cycle.

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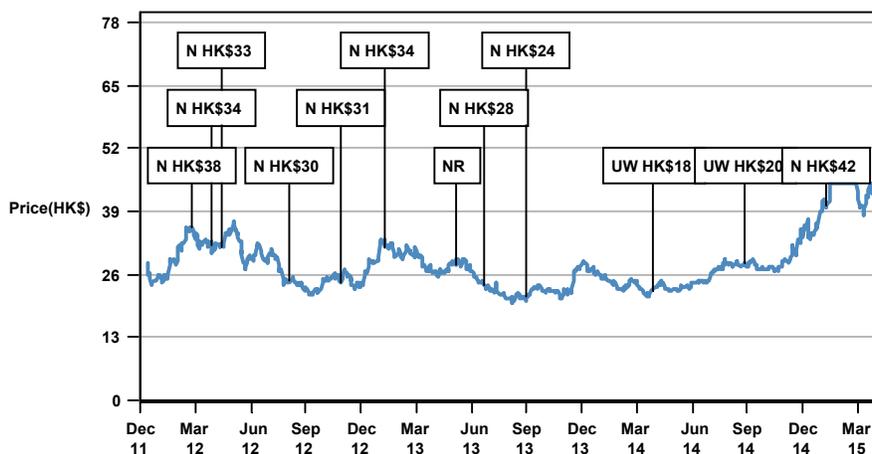
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New China Life Insurance - H (1336.HK, 1336 HK) Price Chart



Date	Rating	Share Price (HK\$)	Price Target (HK\$)
23-Feb-12	N	35.80	38.00
29-Mar-12	N	32.10	34.00
13-Apr-12	N	31.50	33.00
02-Aug-12	N	24.60	30.00
29-Oct-12	N	24.20	31.00
09-Jan-13	N	31.75	34.00
07-May-13	NR	28.10	--
22-Jun-13	N	23.70	28.00
28-Aug-13	N	21.30	24.00
27-Mar-14	UW	22.40	18.00
27-Aug-14	UW	28.20	20.00
08-Jan-15	N	40.15	42.00

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

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