J.P.Morgan

Asia Pacific Equity Research

29 March 2015

PICC Property and Casualty (2328 HK)

2H14 first cut: Better-than-expected earnings, but DPS cut, higher reinvestment risk potential remain concern

Neutral

Price: HK$15.74

27 Mar 2015

Price Target: HK$15.00

PT End Date: 30 Jun 2015

Thanks to larger-than-expected investment gain, the company delivered strong FY14 net profit which beat market expectation. However, overall underwriting margin in 2H was below our expectation (combined ratio: actual 98.5%, -1%p y/y vs. JPMe: 96.8%) due to higher expense ratio. Despite the earnings beat, **we do not expect this result to drive short-term share price momentum** considering: 1) weaker-than-expected underwriting margin in 2H, 2) dwindling dividend yield angle post its FY14 DPS cut, 3) rising reinvestment risk potential, and 4) skewed non-auto underwriting profit structure into the agricultural insurance. Instead, we believe: 1) management's view on auto pricing liberalisation which is implemented from April, 2015, 2) longer-term underwriting margin outlook in the highly profitable agricultural line which the government is likely to cap excess margin, and 3) clarity on mid-term dividend payout plan which is expected to be discussed in the results presentation (11:15am Hong Kong Time, 30 March) will be more relevant for near-term share price momentum. We maintain our forecasts pending further review following the analyst briefing.

- **Earnings beat, good underwriting cycle, but weaker-than-expected underwriting profit.** Reviewing past share price movements on results days, the company's share price has shown high correlation with consensus revisions post the result given, in many cases, the unpredictability of the underwriting cycle and its asset allocation remaining quite conservative. However, despite it being ~9% ahead of consensus net profit (Actual: ~Rmb 15B vs. JPMe/Consensus: ~14.2B/~13.9B), we do not think that its strong bottom line reporting would drive short-term price momentum. Contrary to our expectation, its underwriting profit in 2H was not strong. Its better-than-expected 2H claim loss ratio (66%, -4%p y/y) was offset by higher expense ratio. Net-net basis, overall combined ratio in 2H14 stayed at ~98.5%, -1%p y/y (vs. JPMe: 96.8%). Larger-than-expected realized gains/unrealized trading gain (FY14: Rmb1.3B vs. FY13: Rmb -0.3B) supported strong bottom line reporting. Interestingly, whilst overall underwriting margin in the non-auto P&C (except agricultural line) was down to Rmb ~1.4B (-5% y/y), the agricultural line became its profit source with ~28% of its total underwriting profit during 2014. (Underwriting profit in FY14: Auto/ Non-auto/ Agricultural: 3.8B (+23% y/y)/ 1.4B (-5% y/y)/ 2.1B (49% y/y)) As we believe that consensus would partially reflect its current underwriting trend, we do not expect immediate consensus revisions on underwriting margin outlook. Instead, during the result presentation, if management hints on: 1) mid-term underwriting margin outlook in the agricultural line which the government is not likely to allow an excess underwriting margin, and/or 2) underwriting margin outlook in the auto insurance line post the pricing liberalization from next month (April, 2015), it would trigger consensus change as overall the market seems to have a mixed view on those agendas, we think.

- **Rising reinvestment risk potential**. We believe the upward consensus earnings revisions for FY14-16 so far would be partially due to better-than-expected financial market conditions following monetary easing in China. Thanks to equity capital raising last year and favourable financial market conditions, the company's solvency ratio in Dec-14 has improved to 239% (+59%p y/y). However, despite the large free surplus, the company's asset allocation has become more conservative with higher asset allocation into deposit (38%, +5%p y/y). In our view, ahead of the introduction of C-ROSS (new solvency framework) which newly factors in the asset risk in the calculation, the company's asset allocation becomes more conservative which minimizes asset risk charge. However, the auto insurance risk change which accounts for ~70% of its total underwriting is expected to benefit following the reserve release under C-ROSS**; its significant asset allocation changes into the risk-free asset for a year which looks fair reflecting the dilemma for the short-liability duration insurer (<1 year) under the current monetary easing cycle (or low interest rate environment)**. Thus, the reinvestment risk should be newly factored in its further earnings estimation.

- **Dwindling dividend investment angle.** One of the key differentiated investment theses for the company should be the dividend investment angle. Following its solid earnings reported from 2011, the company has maintained an attractive dividend payout policy. In particular, post its ~60% dividend payout ratio in 2013, coupled with its strong earnings re-rating expectation in 2014, we believe that the market generally expects higher FY14 DPS declaration potential. (Actual: Rmb 0.27/share vs. Consensus: Rmb 0.32/share) Thus, overall market disappointment on its year-end dividend collection would be a new negativity in FY14 results.

- **Price target, valuation and risk risks.** We maintain our forecasts pending the analyst briefing. Downside (and Upside) risks include a faster-than-expected worsening in the underwriting cycle (better-than-expected underwriting cycle), a sharp pullback in A-share markets (further recovery in A-share market post the kickoff on the HK-SH Connect), and the return of a price war due to better short-term sector outlook than in the life sector (near-term auto pricing liberalisation).

Table 1: PICC P&C: 2H14 earnings results

Rmb in millions, %

	1H14	2H14	HoH Chg	YoY Chg	2H14E	Vs. Est	2013	2014	YoY Chg	2014E	Vs. Est
Gross premiums written	**132,118**	**120,919**	**-8%**	**12%**	**124,432**	**-3%**	**223,525**	**253,037**	**13%**	**256,550**	**-1%**
Reinsurance premiums ceded	(16,861)	(14,418)	-14%	-23%	(21,133)	-32%	(31,769)	(31,279)	-2%	(37,994)	-18%
Net premiums written	**115,257**	**106,501**	**-8%**	**19%**	**103,299**	**3%**	**191,756**	**221,758**	**16%**	**218,556**	**1%**
Increase in unearned prem. res.	(15,611)	5,022	n.m.	-14%	5,230	-4%	(9,210)	(10,589)	15%	(10,381)	2%
Net premiums earned	99,646	111,523	12%	17%	108,529	3%	182,546	211,169	16%	208,175	1%
Net claims incurred	(62,211)	(73,736)	19%	10%	(75,029)	-2%	(120,902)	(135,947)	12%	(137,240)	-1%
Total expenses	(31,848)	(36,083)	13%	31%	(29,980)	20%	(55,684)	(67,931)	22%	(61,828)	10%
Underwriting result	**5,587**	**1,704**	**-70%**	**n.m.**	**3,520**	**-52%**	**5,960**	**7,291**	**22%**	**9,107**	**-20%**
Investment income	**5,454**	**8,006**	**47%**	**78%**	**6,199**	**29%**	**9,597**	**13,460**	**40%**	**11,653**	**16%**
Other income/expense	(773)	(537)	-31%	-54%	(1,335)	-60%	(2,118)	(1,310)	-38%	(2,108)	-38%
Operating pre-tax profit	**10,268**	**9,173**	**-11%**	**149%**	**8,383**	**9%**	**13,439**	**19,441**	**45%**	**18,651**	**4%**
Taxation	(2,478)	(1,848)	-25%	145%	(1,998)	-8%	(2,881)	(4,326)	50%	(4,476)	-3%
Net profit	**7,790**	**7,325**	**-6%**	**150%**	**6,385**	**15%**	**10,558**	**15,115**	**43%**	**14,175**	**7%**
KEY RATIO:	**1H14**	**2H14**	**HoH Chg**	**YoY Chg**			**2013**	**2014**	**YoY Chg**	**2014E**	
Premium growth (YoY)	14.3%	12.1%	-2%p	-5%p			15.5%	13.2%	-2%p	14.8%	
Retention ratio	87.2%	88.1%	1%p	5%p			85.8%	87.6%	2%p	85.2%	-
Loss ratio	**62.4%**	**66.1%**	**4%p**	**-4%p**			**66.2%**	**64.4%**	**-2%p**	**65.9%**	**-**
Expense ratio	**32.0%**	**32.4%**	**0%p**	**3%p**			**30.5%**	**32.2%**	**2%p**	**29.7%**	**-**
Combined ratio	**94.4%**	**98.5%**	**4%p**	**-1%p**			**96.7%**	**96.5%**	**0%p**	**95.6%**	**-**
Investment yield (including gains)	4.3%	6.1%	2%p	2%p			4.4%	5.3%	1%p	4.9%	-
Effective tax rate	24.1%	20.1%	-4%p	0%p			21.4%	22.3%	1%p	24.0%	-
Return on asset	4.6%	4.3%	0%p	2%p			3.6%	4.6%	1%p	4.5%	-
Return on equity	25.6%	20.5%	-5%p	9%p			20.5%	21.1%	1%p	22.8%	-

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

Table 2: PICC P&C: Combined ratio trend by line

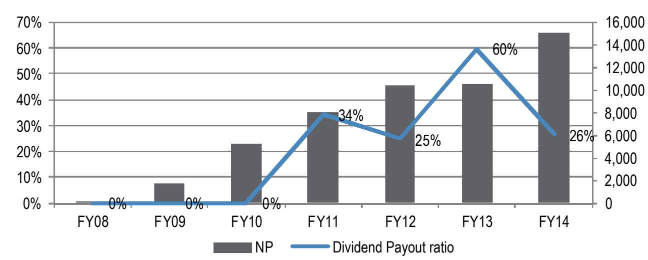
%	2009	2010	2011	2012	2013	2014	Ch. YoY
Auto	**101.5%**	**97.4%**	**95.5%**	**96.3%**	**97.8%**	**97.7%**	**-0.1%p**
Commercial property	125.5%	104.2%	95.8%	98.4%	111.7%	97.8%	-13.9%p
Cargo	85.8%	86.9%	73.4%	76.5%	67.1%	90.7%	23.5%p
Liability	102.3%	98.4%	93.1%	92.0%	88.8%	93.6%	4.9%p
Accidental injury	108.4%	99.2%	96.9%	95.6%	95.9%	99.5%	3.6%p
Agricultural	**n.m.**	**n.m.**	**n.m.**	**n.m.**	**88.7%**	**83.3%**	**-5.4%p**
Others	93.9%	98.8%	80.8%	87.5%	86.6%	90.1%	3.6%p
Total loss ratio	102.2%	97.7%	94.0%	95.1%	96.7%	96.5%	-0.2%p

Source: Company reports.

Note: Prior to 2013, the agricultural line was integrated into the others.

Figure 1: PICC P&C: Net profit vs. Dividend payout ratio

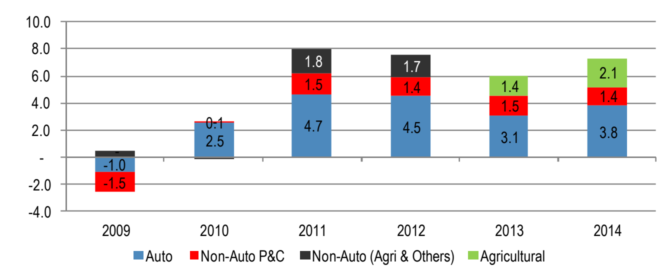
Rmb in millions, %



Source: Company reports

Figure 2: PICC P&C: Underwriting profit breakdown

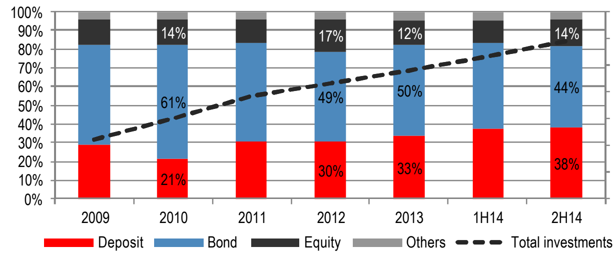
Rmb in billions



Source: Company reports.

Figure 3: PICC P&C: Asset Allocation trend

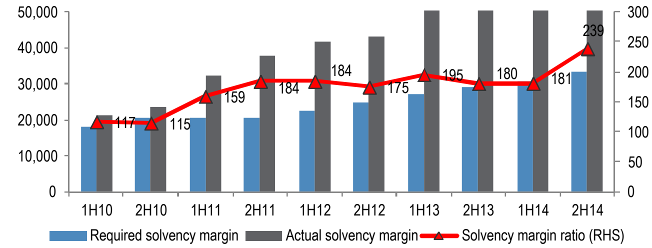
Rmb in billions, %



Source: Company reports

Figure 4: PICC P&C: Solvency ratio trend

Rmb in millions, %



Source: Company reports

Investment Thesis

As the largest P&C insurer in Asia-ex Japan, we think the company is set to deliver stable profitability (ROE>20%) as it benefits most from the fast-growing auto insurance market, given that underwriting margins are largely based on scale. Rising government subsidies on agricultural insurance and/or organic market growth from non-life operations (i.e., casualty) are potential sources of upside in the medium to long term. But for now, post strong outperformance for a year, we see limited upside from current levels.

Valuation

Our Jun-15 price target of HK$15.00 is based on 3.2x P/BV. Our target P/BV multiple is derived by relating a normalized ROE (calculated based on an 'over-the-cycle' underwriting and investment performance) to a required return with growth credited.

Valuation summary	HK$
Adjusted book value (FY15)	5.00
P/BV multiple	3.2x
Share price equivalent (Dec-15)	16.00
Price Target (Jun-15)	15.00
Key assumptions:	
Cost of equity	11.1%
Return on equity	22.0%
Growth	6.0%
Combined ratio	94.4%
Investment yield	3.5%
Effective tax rate	25.0%

Source: J.P. Morgan estimates.

Risks to Rating and Price Target

Downside (upside) risks to our rating and price target include a faster-than-expected deterioration in the underwriting cycle (better-than-expected underwriting cycle), a sharp pullback in the A-share market (further recovery in the A-share market after the kickoff on the HK-SH Connects), and the return of a price war due to a better short-term sector outlook than in the life sector (near-term auto pricing liberalisation).

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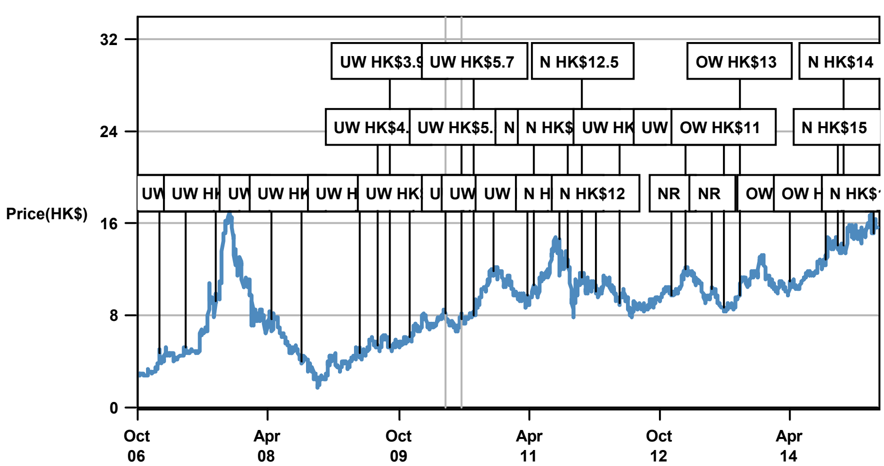
PICC Property and Casualty (2328.HK, 2328 HK) Price Chart



Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Break in coverage Apr 14, 2010 - Jun 18, 2010.

Date	Rating	Share Price (HK$)	Price Target (HK$)
05-Jan-07	UW	4.70	3.60
18-Apr-07	UW	5.29	4.20
22-Aug-07	UW	9.23	7.90
16-Apr-08	UW	7.64	5.90
19-Aug-08	UW	4.03	3.20
16-Apr-09	UW	4.73	3.80
07-Jul-09	UW	5.38	4.10
23-Aug-09	UW	5.29	3.92
16-Nov-09	UW	6.03	4.60
14-Apr-10	UW	8.17	--
18-Jun-10	UW	7.70	5.50
12-Aug-10	UW	7.98	5.70
02-Nov-10	UW	11.78	7.20
25-Mar-11	UW	9.68	7.40
18-Apr-11	N	10.56	9.00
03-Aug-11	N	14.58	11.00
12-Sep-11	N	12.22	11.50
06-Nov-11	N	11.28	12.50
05-Jan-12	N	10.14	12.00
09-Apr-12	UW	9.07	8.00
15-Nov-12	NR	9.73	--
15-Jan-13	UW	12.10	9.50
07-May-13	NR	10.28	--
22-Jun-13	OW	8.65	11.00
27-Aug-13	OW	9.79	13.00
30-Mar-14	OW	10.98	14.00
24-Aug-14	OW	12.82	15.00
16-Oct-14	N	14.06	15.00
05-Nov-14	N	14.14	14.00
11-Mar-15	N	15.12	15.00

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