

PICC Group (1339 HK)

Neutral

Price: HK\$3.92

27 Mar 2015

Price Target: HK\$4.20

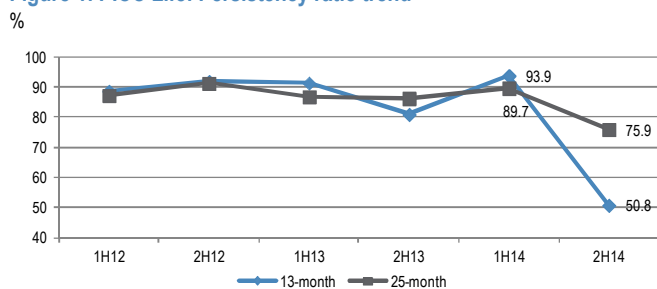
PT End Date: 30 Jun 2015

2H14 first cut: Strong bottom line thanks to P&C operation, but little value contribution for Life/ Health

Thanks to strong profit growth for PICC P&C, lowered losses from PICC Health, and higher investment income, the company strongly beat consensus earnings (FY14 NP: actual: ~ Rmb13B vs Consensus: ~Rmb11B). Besides ~90% of group net profit contributed from PICC P&C, the improved solvency ratio for PICC Group (182%, +34%p y/y) is a key positive for the 2H results. However, we found clear signs of business challenges for PICC Life/ Health (FY14 NBV growth (y/y): -10%/ -43%) with a larger-than-expected policy cancellation trend. Thus, despite strong earnings growth, we believe its poor business operations in life/health would cap the group's share price momentum from current levels. We will review our forecasts following the analyst briefing.

- **Inefficient group capital structure likely to cap its share price upside.** One of key challenges valuing PICC Group as a 'composite insurer' should be its very low earnings/value contribution for non-P&C operations (i.e., Life, Health etc.). Despite similar asset size for PICC P&C/ PICC Life (Rmb ~366B/ ~354B, as of Dec-14), PICC P&C contributes ~90% of group profit (ROE: 21%), whilst the earnings contribution for PICC Life/ Health together is only ~8% (ROE: ~7% for Life/ loss making for Health). However, ~27% of Group NAV was still allocated for Life/ Health in FY14. As we do not expect a meaningful earnings/ value re-rating for life/health due to its relatively weak agency distribution channel/ business model, in our view, the group's inefficient capital structure would cap its share price upside potential for a while. To be fair, once the company downsides its life operation meaningfully reshuffling the bancassurance business model and re-allocating group capital from life into P&C for higher ROE generation, minority shareholders would get the most benefit from this consideration, in our view.
- **Weaker-than-expected value delivery for Life/ Health.** One of the key surprises in the 2H results should be its policy surrender ratio trend, in our view. Based on the total number of contracts, the company's 13-month persistency ratio as of Dec-14 has sharply declined to 50.8% (vs 93.9% in Jun-14). This would imply that half of new policies sold during 2014 have cancelled for a year. Although we believe that this change was due to its significant product mix change from 'participating policies' to 'traditional policies', we cannot rule out the policy mis-selling potential. In addition, the company has adopted the most aggressive economic assumptions in the EV/NBV calculation (i.e., risk discount rate (RDR): 10%, investment yield: 5.75%). At this point, we are concerned whether its Rmb-1.9B of assumption change variance (vs FY14 VIF: ~16.9B) in FY14 EV reporting fairly reflects its recent experience on policy persistency/morbidity margins. Moreover, its life NBV margin compression in 2H (Rmb ~1.1B, -33%) was largely due to significant NBV contraction in its bancassurance channel (-76% y/y) seemingly due to competition/investment spread margin compression. Considering its relatively weak agency forces, following the monetary easing outlook as well as the life pricing liberalisation, overall NBV margin recovery is expected to face pressure for a while. Finally, due to quasi-public healthcare insurance underwriting and small scale, the business turnaround (or NBV/ earnings growth) on its health operation is not likely for a while as well, in our view.
- **Price target, valuation and risk risks.** We maintain our forecasts and Neutral rating and will review following the analyst briefing. Upside (downside) risks include strong (weak) earnings growth as PICC P&C continues to improve (to erode faster than expected) its combined ratio and an A-share market rally (correction) lifting (lowering) investment income.

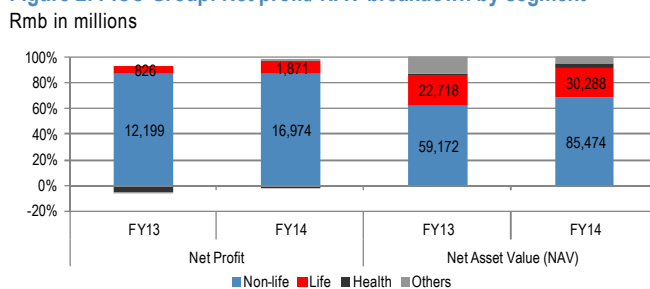
Figure 1: PICC Life: Persistency ratio trend



Source: Company reports

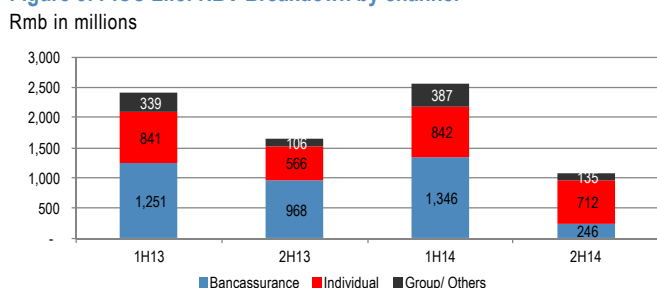
Note: The persistency ratio for a given year is the proportion of the total # of long-term individual life policies issued in the proceeding year that remain in force as of the 13th/25th month following the issuance

Figure 2: PICC Group: Net profit/ NAV breakdown by segment



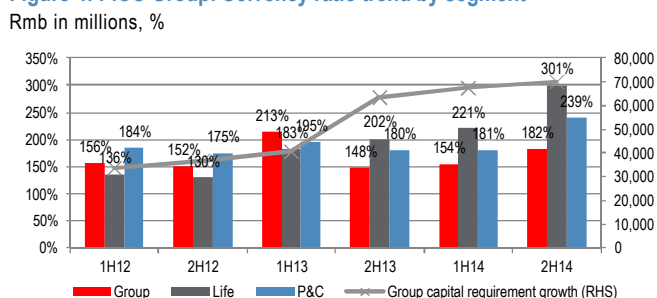
Source: Company reports.

Figure 3: PICC Life: NBV Breakdown by channel



Source: Company reports

Figure 4: PICC Group: Solvency ratio trend by segment



Source: Company reports

Table 1: PICC Group: 2H14 earnings results

Rmb in millions, %

	1H14	2H14	Ch. HoH	Ch. YoY	2H14E	Vs. Est	2013	2014	Ch. YoY	2014E	Vs. Est
Gross written premium & fees	204,544	144,625	-29%	-2%	148,102	-2%	306,421	349,169	14%	352,646	-1%
Premium ceded to re-insurers	(18,163)	(14,625)	-19%	-23%	(26,166)	-44%	(33,811)	(32,788)	-3%	(44,329)	-26%
Net written premium & fees	186,381	130,000	-30%	1%	121,935	7%	272,610	316,381	16%	308,316	3%
Chg. in unearned premium reserves	(17,195)	6,428	n.m.	-6%	6,517	-1%	(9,350)	(10,767)	15%	(10,678)	1%
Net premium earned & fees	169,186	136,428	-19%	1%	128,404	6%	263,260	305,614	16%	297,590	3%
Total technical outgo	(134,596)	(104,164)	-23%	-7%	(96,423)	8%	(208,290)	(238,760)	15%	(231,019)	3%
Total expenses	(37,611)	39,782	n.m.	n.m.	(19,186)	n.m.	(51,209)	2,171	n.m.	(56,797)	n.m.
Underwriting profits	(3,021)	(10,158)	236%	12%	(3,570)	n.m.	(11,144)	(13,179)	18%	(6,591)	100%
Investment income	14,145	19,281	36%	54%	12,594	53%	27,829	33,426	20%	26,739	25%
Other operating income	(1,697)	4,044	n.m.	13%	3,599	12%	2,172	2,347	8%	1,902	23%
Profit before tax	11,962	11,458	-4%	204%	5,937	93%	15,670	23,420	49%	17,899	31%
Income tax	(2,710)	(1,995)	-26%	27%	(1,819)	10%	(3,615)	(4,705)	30%	(4,529)	4%
Net income before MIs	9,252	9,463	2%	n.m.	4,119	n.m.	12,055	18,715	55%	13,371	40%
Minority interests	(2,638)	(2,968)	13%	83%	(2,407)	23%	(3,934)	(5,606)	43%	(5,045)	11%
Net income	6,614	6,495	-2%	n.m.	1,712	n.m.	8,121	13,109	61%	8,326	57%

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

Table 2: PICC Life/Health: EV/ NBV Trend

Rmb in millions, %

	1H14	2H14	Ch. HoH	Ch. YoY	2H14E	Vs. Est	2013	2014	Ch. YoY	2014E	Vs. Est
Life & Health EV	45,429	51,877	14%	32%	44,177	17%	39,354	51,877	32%	44,177	17%
NBV (at 100%)	2,979	965	-68%	-46%	627	54%	4,551	3,944	-13%	3,606	9%

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

Investment Thesis

We believe the company's value comes from its profitable non-life operation, PICC P&C. Thus, value creation from its non-life operation structurally increases the company's value, and vice versa. However, at this stage, life and health operations do not seem to be generating stable underwriting margins due to limited scale and/or rising competition. As those operations are growing fast, further capital injection potential with higher acquisition expense recognition could dent the company's earnings outlook, in our view.

Valuation

Our Jun-15 PT of HK\$4.2 is derived by applying a P/BV methodology to PICC P&C, appraisal value methodology to PICC Life and PICC Health, and finally a 20% discount to excess capital at the holding company.

SOTP valuation

	Stake	HK\$/share	Methodology
PICC P&C	69%	3.8	P/BV valuation methodology for PICC P&C with P/BV of 3.2x
PICC Life	80%	0.8	Appraisal value methodology with implied new business multiple of 2.9x
PICC Health	90%	0.1	Based on new business multiple of 2.0x
Others		(0.1)	20% discount to excess capital at holding company
Share price equivalent (Dec-15)		4.4	
Target Price (Jun-15)		4.2	

Source: J.P. Morgan estimates.

Risks to Rating and Price Target

Upside risks to our rating and price target include strong earnings growth as PICC P&C continues to improve its combined ratio, better-than-expected cash flow generation from the life/healthcare insurance operations, and an A-share market rally lifting investment income.

Downside risks to our rating and price target include sooner-than-expected equity capital raising given the strong growth at PICC Life and downward adjustments in investment yield assumptions should the investment outlook remain bleak.

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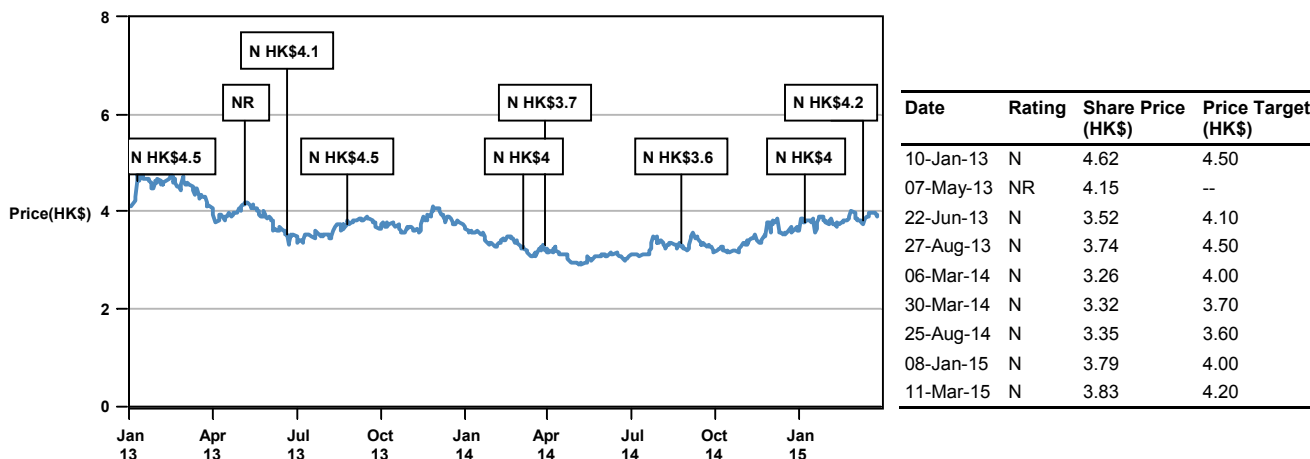
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PICC Group (1339.HK, 1339 HK) Price Chart



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

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