CONCORDE RESEARCH

CEE Equity Research | Insurance | Hungary
22 May 2019

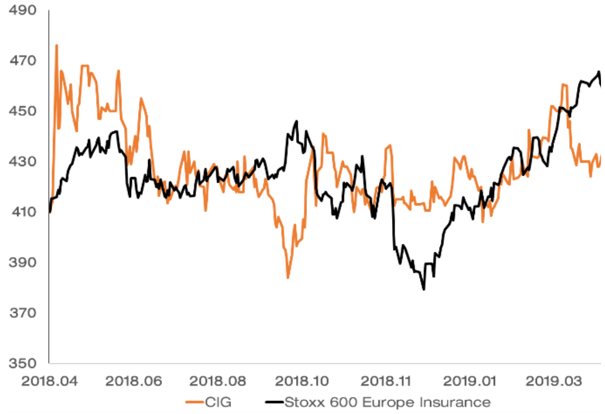
Pannonia

Rating: Accumulate (unch.)

Price target (12-m): HUF 496 (unch.)

Current share price: HUF 410

HUF million	2016	2017	2018	2019F
GWP	18 941	26 933	25 832	26 425
After-tax profits	724	2 598	2 052	2 069
Own equity	3 972	9 015	17 392	15 679
EPS [HUF]	11.7	41.4	24.2	22.1
DPS [HUF]	0.0	10.0	32.0	28.9
BVPS [HUF]	103.6	143.7	185.6	167.3
P/GWP (x)	2.0	1.5	1.5	1.5
P/E (x)	34.8	9.8	16.8	22.3
P/BV (x)	3.9	2.8	2.2	2.4
DVY (%)	0.0	2.5	7.9	7.1
ROE (%)	12.1	33.5	14.7	12.5



Performance	12M	YTD	3M	1M
Absolute	-8.9%	-0.1%	-3.5%	-4.7%
BUX relative	-15.3%	-1.2%	-0.7%	3.1%

Share price as of 5/22/2019	HUF 410	Bloomberg	CIGP.BU
Number of shares [million]*	93.7	Reuters	PANNONIA HB
Market capitalization [HUF bn/EUR mn]	38.72/ 118.6	Free float**	50%
Enterprise value [HUF bn/EUR bn]	38.72 / 118.6	52 week range	245/544
Daily turnover 12M [EUR mn]	0.07	EURHUF	326.6

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Q1 results reflect stable underlying earnings performance

- Pannonia reported an IFRS consolidated after-tax profit of HUF 508 mn in Q1/19 compared to HUF 615 mn in the same period of a year earlier mainly due to the revaluation difference of the employee share based payment program (caused by price fluctuations of CIGPANNONIA shares), the the first quarter loss after launching CIG Pannonia Financial Intermediary Plc. and lower profit contribution from MKB Fund Manager YoY. That means that Pannonia's underlying earnings performance remained by and large flat YoY.
- Consolidated GWP remained flat YoY at HUF 6.3 bln as a combined result of a 6% decline of 6% in life insurance GWP and an increase of 10% in non-life GWP. Life insurance GWP fell mainly because of a decrease of 17% in top-up and single premiums mainly relating to unit-linked life insurance policies.
- In the life segment GWP from the first annual premiums of policies sold was HUF 550 mn in Q1/19 (+3% YoY), while GWP from renewals came in at HUF 2.23 bn (-5% YoY). As a result of the latter, the renewal ratio remained at around 79% YoY on our estimate.

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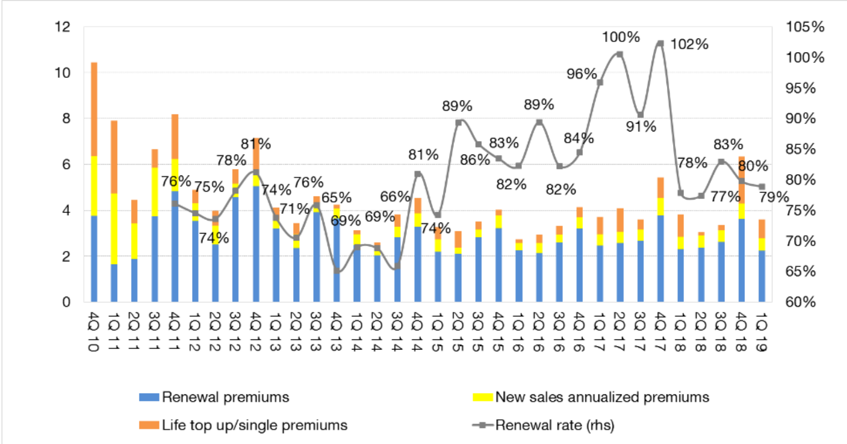
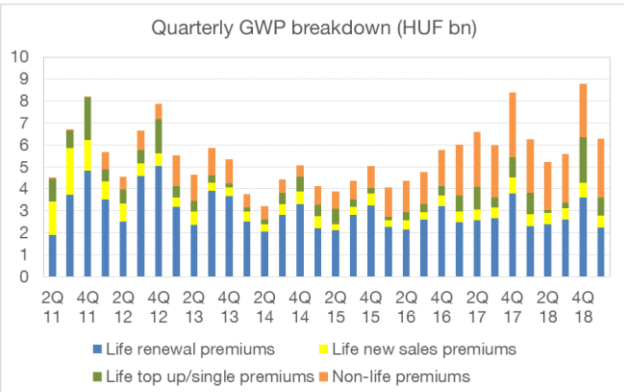
GWP breakdown in the life insurance segment (HUF bln)



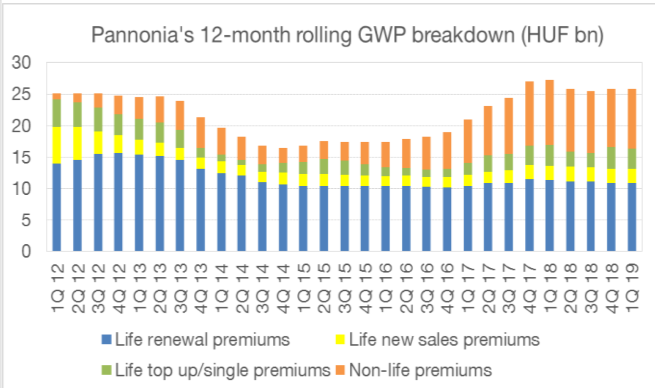
Source: Pannonia, Concorde estimate

- Traditional life insurances (endowment, pure endowment and healthcare policies) represented ca. 49% of new sales vs. 21% a year earlier reflecting the gradual shift in the product mix shifted towards to risk and traditional products, including group insurance. As traditional insurance policies usually generate a lower amount of annualized premiums than unit-linked insurance policies, life segment GWP is prone to decline in the longer run but profitability is likely to stay elevated, if other things remain unchanged. The increase in the amount of the annualized premium of new sales in the life segment was mainly thanks to the independent broker channel and other business development channel.
- In the non-life segment the net portfolio development was negative (HUF -475 mn vs. HUF 106 mn in Q1/18) as a result of portfolio clean-up and the termination of the retail casco business. Meanwhile, claims and related settlement expenses rose by 10% YoY, resulting in a claim ratio of 48% compared with 41% in Q1/19.

Quarterly consolidated GWP breakdown (HUF bln)



12-m rolling GWP breakdown (HUF bln)



Source: Pannonia, Concorde estimate

- In the sale of insurance policies sold in the quarter of 2018 the tied agent network accounted for 14% (Q1/18: 28%), the independent brokerage network 25% (Q1/18: 47%) and the bank channel 18% (Q1/18: 25%), respectively, while the newly established financial intermediary subsidiary sold 4%, and other business development's share accounted for 39% of the new sales.
- Investment results were vast positive in Q1/19 (HUF 3.44 bn vs. HUF 187 mn in Q1/18) driven by very decent market performance in all asset classes. However, earnings from the MKB-Pannónia Fund Management Company to the Group which are reflected in the return on investments accounted for using the equity method, went down somewhat to HUF 73 mn vs. HUF 90 mn in the corresponding period of last year.

- Operating costs rose by 8% YoY and accounted for 36% of GWP (vs. 34% of GWP in Q1/18), out of which fees, commissions and other acquisition costs represented 71% (vs. 70% in Q1/18), while admin costs and other expenses the rest.
- Acquisition costs increased by 9% YoY despite the fact that gross premiums earned remained flat. The primary reason for this was that in both core segments the new sales rose significantly, especially those of traditional insurance products, as compared to the previous year. Other admin costs went also higher by 6% YoY due to increasing wage pressure ant IT costs. Other income dropped by 14% YoY in parallel with the decline in the existing portfolio.
- Net claims and related settlement expenses dropped 11% YoY in Q1/19, mainly due to a decline in the number of unit-linked surrenders. In the non-life segment net claims rose 106%.
- Total reported comprehensive income was negatively impacted by the decrease in the fair value of available for-sale financial assets (amounting to HUF -149 mn) due to the unrealized losses from the KONZUM shares and Hungarian state bonds.
- The shareholders' equity increased from HUF 17.39 bn to HUF 17.75 bn (+2% YoY) mainly on the back of the total comprehensive income.
- The available solvency capital ratio (based on own capital plus the present value of future expected profits) of the life and non-life insurance segments were 323% and 181%, respectively, as at 31 March, 2019, so both segments fulfilled the 150% Solvency Capital adequacy requirements of the Supervisory Authority despite revaluation losses on government papers and KONZUM shares.
- A the recent Annual General Meeting the shareholders approved the reduction of Pannonia's share capital through the decrease of the nominal value of the shares in order to the distribution of excess capital. Due to the reduction of the share capital Pannonia's share capital shall decrease from 3.777.130.400 HUF to 3.116.132.580 HUF and the nominal value of the shares from HUF 40 to HUF 33. The capital reduction will affect ca. 17.5 per cent of the equity thus the expected amount of the total payment would be approx. HUF 3 bn, or HUF 31.96 per share to be paid in late August or early September. As for the effect of the capital reduction, it corresponds to a 7.9 per cent DIVY on the basis of the share price at the date of share registration for the AGM.
- As the capital reduction does not have an effect on retained earnings generated in the previous years, the base for dividend payments remains high allowing Pannonia to keep dividend in the neighborhood of approx. HUF 25-30 a share going forward on our estimate (implying ca. 7% DIVY based on the current share price).
- The reduction of capital will also add to an improvement of ROE which so may be more aligned with the level investors may require to justify Pannonia's currently above average earnings and asset based multiples (18.4 x P/E and 2.4 x P/BV).
- **Outlook: Total annualized premium of new life policy sales might amount to around HUF 3.0-3.3 bn in 2019 (by and large the same as in 2018). We expect Pannonia to remain highly committed to keeping a tight lid on controllable operating costs and achieve as much after tax profit this year as last year. We keep our after-tax profit estimate at HUF 2.1 bn for 2019 implying an EPS of HUF 22.1.**
- **We also project that Pannonia could generate net profit of ca. HUF 2.56 bn by 2022, implying a 4-year EPS GAGR of ca. 6%.**
- **We maintain our 12-m TP at HUF 496 a share as well as our Accumulate rating on the share.** Pannonia is currently trading at 18.4x on a 2019E P/E basis and 2.4x on a current P/BV basis. On the basis of 2019E P/E

ratio Pannonia is trading at a 120% premium over peers' corresponding multiple, while its P/BV multiple is also twice as high as that of its peers' average. Pannonia's relative reach valuation in terms of P/E still clearly reflects investors' belief that the insurer could extract potentially significant synergies from the partnership with its minority shareholder KONZUM (OPUS), or it will be able to make another meaningful acquisitions in the foreseeable future. Evidently, Pannonia has to provide greater disclosure about how it aims to develop growth of its businesses at a clip as rapidly on a sustainable basis as required in order for investors to justify this reach valuation. However, that does not seem like a small challenge that Pannonia can overcome easily, in our opinion. **We stress, however, that if Pannonia fails to make meaningful inorganic steps within a year or there is no clear sign that the cooperation with KONZUM (OPUS) can result in higher profits in the near future, we will feel it appropriate to reduce significantly our TP.**

Comparative valuation

	Price (local currency	P/E 2019F	P/BV 2018	Dividend yield 2018F	ROE 2019F
Pannonia	407.0	22.3x	2.4x	8%	13%
VIG	23.8	10.0x	0.7x	4%	6%
UNIQA	8.8	12.4x	0.9x	6%	7%
PZU	40.0	10.8x	2.2x	7%	19%
AEGON	4.3	6.0x	0.4x	7%	7%
Zurich	326.0	11.8x	1.6x	6%	13%
Generali	16.3	10.0x	1.1x	6%	10%
Allianz	201.7	10.6x	1.3x	5%	11%
Triglav	33.7	10.4x	1.0x	7%	9%
Peer group's average		**10.2x**	**1.1x**	**6%**	**10%**

Source: Bloomberg, Concorde

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Neutral	Total return is expected to be in the range of 10%-(-10%)
Reduce	Total return is expected to be in the range of -10-(-20%)
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