CONCORDE RESEARCH

CEE Equity Research | Insurance | Hungary
20 February 2018

Pannonia

Rating: Neutral (prev. Sell)

Price target w/ Konzum (12-m): HUF 452 (unch.)

Price target w/o Konzum (12-m): HUF 352 (unch.)

Current share price: HUF 445

HUF million	2016	2017F	2018F	2019F
GWP	18 941	26 933	28 796	31 032
After-tax profits	724	2 598	1 580	1 760
Own equity	3 972	9 015	10 021	11 336
EPS [HUF]	11.7	40.8	22.6	25.2
DPS [HUF]	0.0	11.1	11.3	12.6
BVPS [HUF]	103.6	126.4	143.4	162.3
P/GWP (x)	1.5	1.1	1.1	1.0
P/E (x)	38.2	11.0	19.8	17.7
P/BV (x)	4.3	3.2	3.1	2.8
DVY (%)	0.0	2.5	2.5	2.8
ROE (%)	12.1	34.4	15.9	16.5

Performance	12M	YTD	3M	1M
Absolute	96.4%	-15.9%	48.7%	-16.2%
BUX relative	73.6%	-13.9%	49.4%	-13.8%

Share price closing as of 2/20/2018	HUF 445	Bloomberg	CIGP.BU
Number of shares [million]	71.3	Reuters	PANNONIA HB
Market capitalization [HUF bn/EUR mn]	31.87/ 102.3	Free float	70%
Enterprise value [HUF bn/EUR bn]	31.87 / 102.3	52 week range	201/544
Daily turnover 12M [EUR million]	?	EURHUF	311.5

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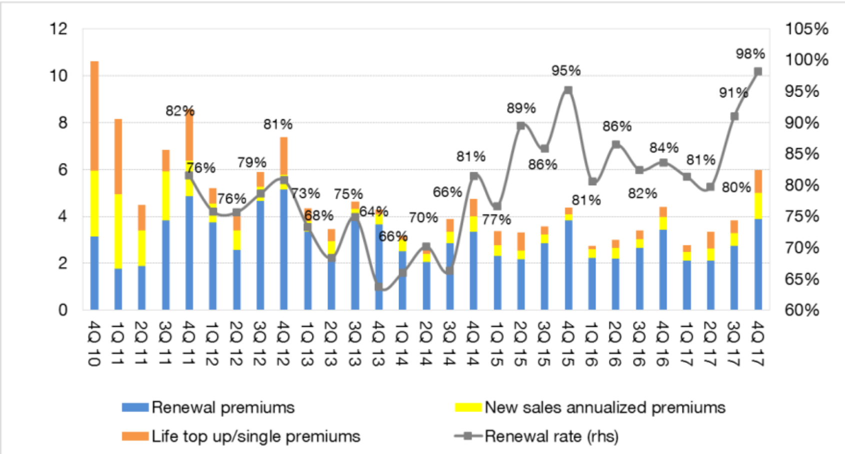
FY2017 results were very much in line with expectations

- Pannonia reported a full-year IFRS consolidated after-tax profit of HUF 2.6bn on GWP of 26.9bn in 2017, very much in line with our estimate of HUF 2.6bn for after-tax profit and HUF 27bn for GWP. After-tax profit rose 271% YoY mostly driven by the positive impact of badwill realized on the acquisition of the MKB insurance companies. Contribution to results were more or less evenly split between CIG Pannonia (ca. HUF 1.2bn) and realized badwill (ca. HUF 1.4bn) on the purchase of MKB insurance companies. (NTRL)
- The insurer reached HUF 2.1bn after-tax profit in its life segment for 2018 (+95% YoY) on GWP of HUF 15.9bn (+18% YoY) predominantly driven by a full reversal of impairment losses of ca. HUF 1bn previously booked for investments in its non-life subsidiary EMABIT. Adjusting for this one-off result, the profit after tax was HUF 1.1bn, ca. 3% higher compared to previous year, clearly beating our estimate of HUF 0.9bn for FY2017. The higher clean profit after tax was achieved as a combined result of the additional costs associated with organizational restructuring and the merge of the previous MKB life insurance company.
- We note that the change of technical reserves in the balance sheet and the change of technical reserves in the life segment's income statement

differed from each other as the impact of the acquisition of MKB insurance companies (the positive difference between the value of newly consolidated assets and liabilities) were directly recorded in own equity.

- With the reversal of impairment losses Pannonia should have generated enough free surplus to pay dividend after its 2017 fiscal year profit on our estimate. Pannonia earlier said that it would pay dividend of HUF 10 per share after the business year 2017, provided that the conditions of the payment of dividends apply. From 2018 and onwards Pannonia wishes to pay a maximum of 50% of the after-tax profit available for the payment of dividends of the current year to its shareholders.
- Pannonia's non-life segment delivered HUF 439mn profit after tax (+116% YoY) on GWP of HUF 8.7bn (+47% YoY) for 2017, falling short of our estimate of HUF 543mn for after tax profit while GWP was in line with our estimate.
- As for life GWP from the first annual premiums of policies sold was HUF 2.57bn (+51% YoY). The renewal premiums of policies concluded in the previous years have increased by 3% YoY to HUF 10.85bn in 2017. Renewal rate rose to a record level of 98% in Q4/17 compared to 84% in Q4/2016.

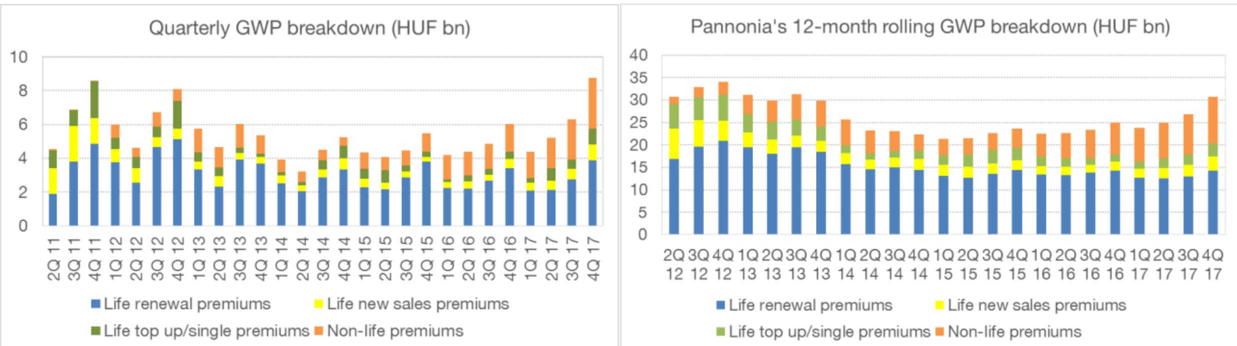
Figure 1 Pannonia's life insurance renewal rate



Source: Pannonia, Concorde

- Top-up and single premiums were 188% higher than in the same period a year earlier, totaling to HUF 2.48bn, and accounted for 16% of total GWP (vs. 10% in 2016).

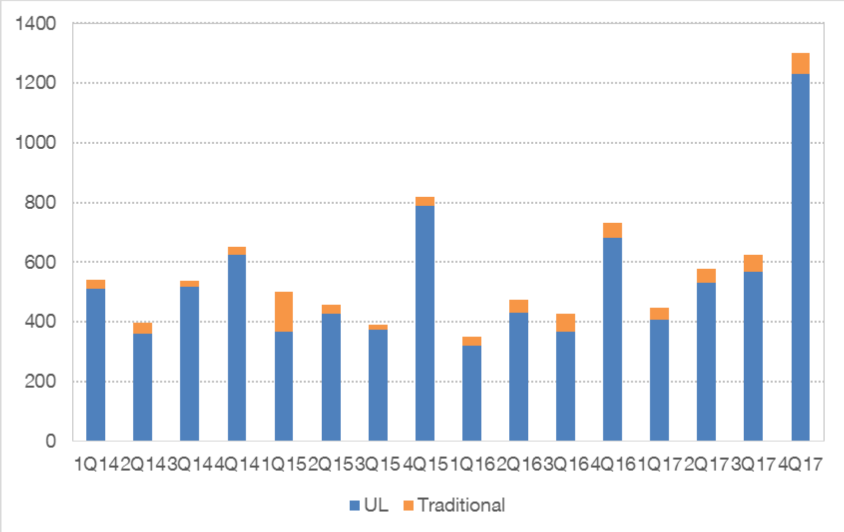
Figure 2 Pannonia's premium income developments



Source: Pannonia, Concorde

- As for the breakdown of regular life insurance premium, UL-linked type products (incl. pension insurances) represented an increasing share.

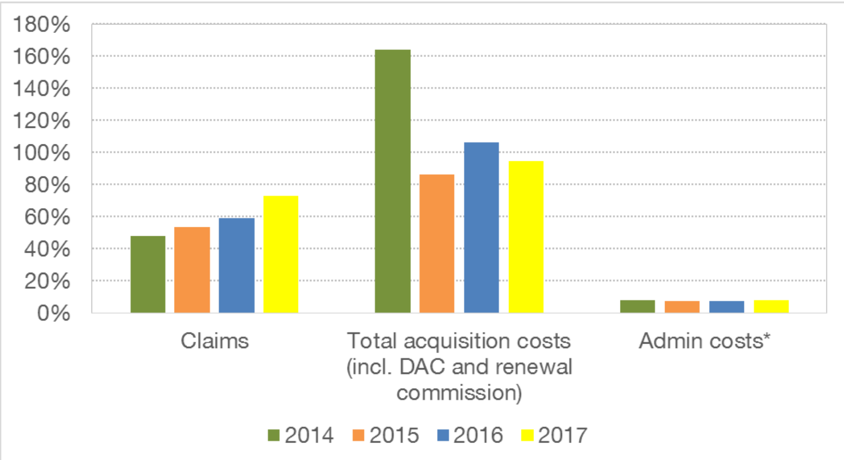
Figure 3 New sales breakdown of regular life insurances



Source: Pannonia, Concorde

- The share of the tied agent network in life insurance policies sold in 2017 was 48% , the performance of broker channel accounted for 40%, while the banking channel represented 12%.
- Over the course of 2017 Pannonia has constantly put considerable efforts into streamlining its business with a series of efficiency measures including cost cuts and thorough overhauling its distribution channels. We believe the full impact of cost efficiency measures implemented in recent years will remain in place to bolster profit growth, even with the increased costs associated with the acquired MKB insurance companies.

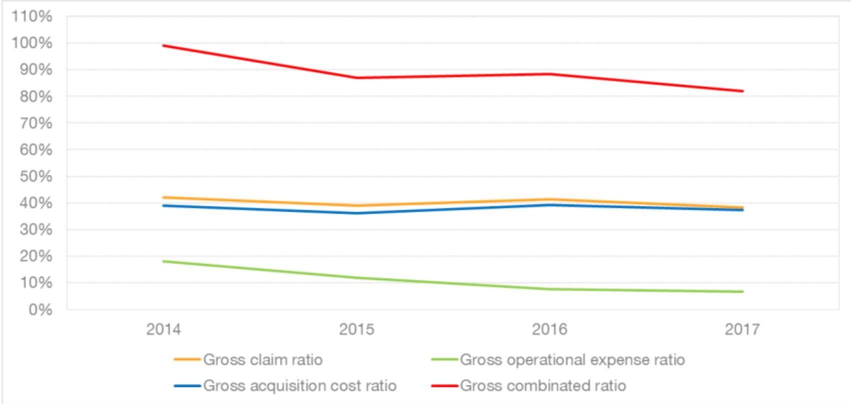
Figure 4 Life operating costs as a % of life insurance GWP



Source: Pannonia, Concorde

- The marketing of new pension insurance and long term care products sales via sales networks (which tends to be more captive and partnered with friendly domestically owned commercial banks), coupled with rigorous cost control also lent support to improve YoY.

Figure 5 Cost ratios of Pannonia's non-life segment



Source: Pannonia, Concorde

- The available solvency capital in the life segment stood at 260% at 31 December 2017, which significantly exceeded the 150% Solvency Capital Requirement of the Supervisor Authority (which in turn contains a 50% volatility puffer). In the non-life segment the solvency capital adequacy was 191% according to the Solvency II.
- Outlook: we maintain our earnings estimates for the forthcoming years until more clarity is available on the potential benefits from the recent strategic cooperation agreement with Konzum holding group. We expect an increase in OpEx due to wage pressures while new sales should accelerate on the back of new banking channels. New business margin is also expected to remain solid. In all, we anticipate that Pannonia's net income could come in at HUF 1.6bn in 2018 and HUF 1.8bn in 2019, implying an EPS of HUF 22.6 for 2018 and HUF 25.2, respectively). We also expect Pannonia to generate net profit of c. HUF 2.4bn by 2022, implying a 5-year EPS GAGR of c.10 percent by 2022 if not for additional earnings potential arising from partnering with Konzum.
- **In our last comprehensive report on Pannonia (published last December) we established a 12-month TP of HUF 352 a share, implying a 21% downside from the current share price, while stressing that Pannonia shares may even be ca. 30 percent higher valued (at HUF 452) than our TP estimate should the insurer's partnership agreement and mutual capital increases with Konzum be implemented successfully.** Of importance, Pannonia is still waiting for the approval of the Supervisory Authority on mutual capital increases. That said, **we re-rate the stock to Neutral from Sell as the probability that they will eventually form partnership has increased considerably after Pannonia's EGM approved the capital increase by Konzum.**
- **We reiterate that our current level of knowledge about the potential deal with Konzum does not allow us to predict whether such a cooperation is sustainable and value creative at all, simply because neither of these companies had experience to carry out any such large transactions and form of collaboration beforehand. Only when we have a clue about where and at what costs Pannonia intends to invest the additional equity to be received from Konzum and how much synergy can really be achieved from collaboration with Konzum will we really be able to make a better estimate on how much profits can additionally be generated on a sustainable basis by partnering with Konzum. That said, we believe there is a significant upside in earnings therefrom given the countrywide branch network of friendly domestic banks that can potentially (and perhaps exclusively) be available for Pannonia in the future.**
- Pannonia looks keen to seek further acquisition targets at an affordable price in order to realize economies of scale and extract cross-selling opportunities offered by its new banking partners. Pannonia may target

a 5 to 10 percent market share, and meanwhile constantly growing earnings. If the partnership with Konzum is realized, Pannonia's capital flexibility for sizeable acquisitions may be sufficient to reach its market share goal, in our view.

- Pannonia is currently trading at 19.8x on a 2018 P/E basis and 3.2x on a current P/BV basis. On the basis of 2018 P/E ratio and a forecasted ROE of 16.1% on average for the next five years Pannonia now is trading at a 47% premium over PZU and 56% premium over VIG, respectively. Pannonia's relative lofty valuation clearly reflects investors' firm belief in potentially beneficiaries partnership with Konzum. Evidently, in order for investors to ascribe this high multiple to Pannonia's business, we think Pannonia has to provide greater disclosure about how to develop growth of its businesses on a sustainable basis.

Comparative valuation

		Market cap. (EUR th)	Embedded Value (EV) (EUR th)	Equity	BV	Market cap/EV	P/E FY1	P/BV	Div yield (%)	ROE (%)	Solvency ratio
Pannonia	HUN	101.02		29.00	0.42		19.80x	3.20x	2.2	34.40	>2.0
VIG	AUT	3527.68	8116.60	5881.90	42.30	0.43x	12.70x	1.43x	2.91	5.90	
PZU	POL	9177.32		8331.40	3.73		13.49x	4.40x	3.18	21.24	2.70
UNIQUA	AUT	2963.31	5068.00	3121.90	10.60	0.58x	18.10x	1.85x	5.13	3.51	0.86
Anadolu	TUR	671.22		203.50	0.47		10.45x	3.52x	4.4	25.14	3.67
Sigorta	TUR	421.13		360.00	0.72		9.92x	1.86x	1.5	12.87	1.39

Source: Bloomberg, Concorde

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Buy	Total return is expected to exceed 20% in the next 12 months

Accumulate	Total return is expected to be in the range of 10-20%
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%)
Sell	Total return is expected to be lower than -20%
Under Revision	The stock is put Under Revision if covering analyst considers new information may change the valuation materially and if this may take more time.
Coverage in transition	Coverage in transition rating is assigned to a stock if there is a change in analyst.

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Valuations and risks:

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(https://www.con.hu/wpcontent/uploads/2016/04/Methodology_concorde_research.pdf?tstamp=201710021038)

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