CONCORDE RESEARCH

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23 August 2018

Pannonia

Rating: Accumulate (prev. Neutral)

Price target (12-m): HUF 484 (HUF 470)

Current share price: HUF 423

HUF million	2016	2017F	2018F	2019F
GWP	18 941	26 933	25 992	26 621
After-tax profits	724	2 598	2 050	2 144
Own equity	3 972	9 015	18 543	20 289
EPS [HUF]	11.7	41.4	24.0	23.0
DPS [HUF]	0.0	10.0	11.7	11.5
BVPS [HUF]	103.6	143.7	216.9	217.4
P/GWP (x)	1.7	1.0	1.4	1.5
P/E (x)	39.3	11.3	23.0	22.3
P/BV (x)	4.4	2.9	2.0	1.9
DVY (%)	0.0	2.4	2.8	2.7
ROE (%)	12.1	33.5	13.3	10.6

Performance	12M	YTD	3M	1M
Absolute	62.6%	-14.0%	-7.4%	-1.4%
BUX relative	66.9%	-5.5%	-2.6%	-1.9%

Share price as of 8/23/2018	HUF 423	Bloomberg	CIGP.BU
Number of shares [million]*	94.4	Reuters	PANNONIA HB
Market capitalization [HUF bn/EUR mn]	39.93/ 123.5	Free float**	50%
Enterprise value [HUF bn/EUR bn]	39.93 / 123.5	52 week range	245/544
Daily turnover 12M [EUR million]	0.3	EURHUF	323.3

Note: w/o the share capital by KONZUM

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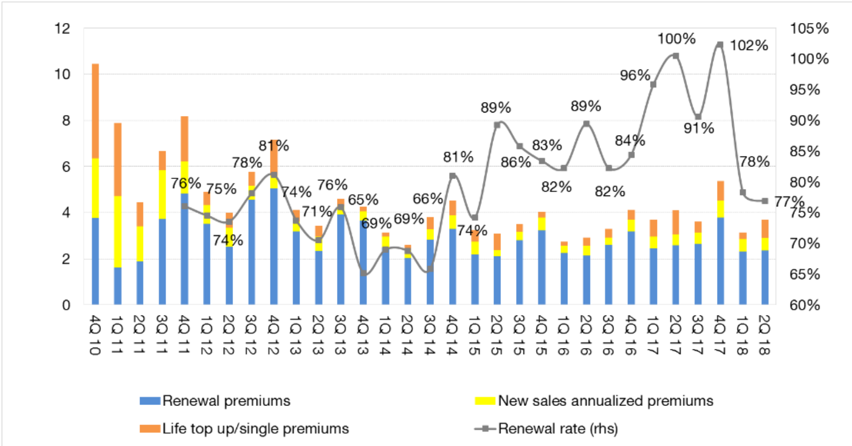
Q2 results reflect steady earnings improvement

- Pannonia reported a IFRS consolidated after-tax profit of HUF 540 mln in Q2/18 compared to HUF 615 mln in Q1/18 and HUF -31 mln in the same period of a year earlier.
- Consolidated GWP amounted to HUF 5.9 bln (-11% YoY) in Q2/18 as a combined result of portfolio restructuring, a significant decline in the top-up and single premiums due to reclassification of some insurance contracts to investment contracts (which can no longer be recognized as written premium according to EU IFRS), and also to the expiry and surrenders of the unit-linked insurances. The life insurance segment's GWP was HUF 3.7 bln (-9% YoY) and accounted for 63% of the total consolidated GWP Unit-linked and traditional pension insurance policies rose 31% YoY to HUF 1.6 bln and altogether represented ca. 42% of the life segment's GWP.
- The non-life insurance segment's GWP also dropped 13% YoY to HUF 2.2 bln and contributed 37% to the total consolidated GWP.

- In the life insurance segment GWP from renewals was 9% lower YoY at HUF 2.4 bln in Q2/18, so the renewal ratio dropped from 100% in Q2/17 to 77%. Top-up and single premiums were also 22% lower YoY, mainly relating to unit-linked life insurance policies and due to reclassification. In contrast, GWP from the first annual premiums of insurance policies sold rose 12% YoY to HUF 544 mln mainly on the back of pension insurances trending up. Traditional life insurances (endowment, pure endowment and healthcare policies that represent ca. 20% of new sales vs. 5-8% a year earlier are also growing in popularity. 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.

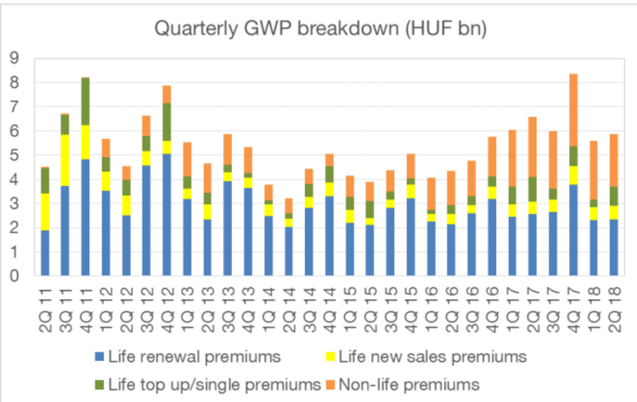
GWP breakdown in the life insurance segment (HUF bln)



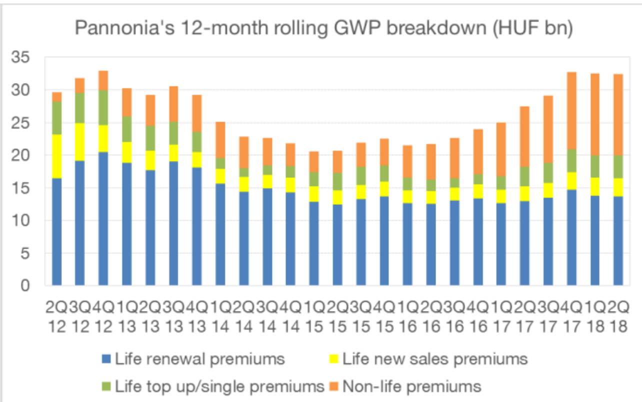
Source: Pannonia, Concorde estimate

- In the non-life segment the net portfolio development was negative (HUF -192 vs. HUF -297 mln in Q2/17) as a result of portfolio clean-up. Meanwhile, claims and related settlement expenses dropped 34% YoY, resulting in an improvement in the claim ratio from 44% to 36%.

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 first half of 2018 the tied agent network accounted for 28% (H1/17: 38%), the independent brokerage network 38% (H1/17: 33%) and the bank channel 27% (H1/17: 29%), respectively.
- Investment results were slightly positive in Q2/18 (HUF 100 mln vs. HUF -1.5 bln in Q2/17) that were mainly caused by correction on the emerging markets (in the wake of significant capital outflows) and the weakness in the HUF against hard currencies. Income from fund management (HUF 103 mln) recorded according to the equity method were better than

expected and almost doubled compared to Q2/17 on higher amount of asset under management (ca. HUF 100 bln).

- Operating costs remained flat on the year and accounted for 41% of GWP (vs. 37% of GWP in Q12/17), of which fees, commissions and other acquisition costs represented more than 70%, while admin costs and expenses the rest. Acquisition costs rose 5% YoY on the back of a 3% YoY increase in total annualized premiums from new life insurance sales (HUF 759 mln vs HUF 739 mln), while representing ca. 108% of new sales. With trial commission and bonuses paid to policyholders and independent agents for loyalty and better than planned performance, fees and commissions represented 120% of new sales. In the non-life segment acquisition costs remained flat YoY at around HUF 900 mln. Other operating costs (11% of GWP vs. 11% of GWP in Q2/17) fell 7% YoY as a result of cost savings at the MKB Insurance company acquired last year. The net claim expenditure increased by 20% as compared to Q2/17, mainly due to the increase in the surrenders of the unit-linked insurances.
- The available solvency capital of the life and non-life insurance segments were 348% and 180%, respectively, at 30 June, 2018, so each fulfilled the 150% Solvency Capital requirement expected by National Bank of Hungary (NBH).
- The NBH approved Pannonia's acquisition of the shares in KONZUM Investment and Asset Management Plc (KONZUM). Accordingly, the insurer purchased 1,368,851 pieces of shares at a price of HUF 3,000 HUF each share, which represent 6,56% of all KONZUM shares introduced to the Budapest stock market. Revaluation impact of KONZUM's shares will be reflected as other comprehensive income in Pannonia's P&L.
- Simultaneously, the NBH also approved the share capital increase of HUF 8.2 bln in Pannonia by KONZUM subscribing 23,466,020 pieces of new "A" series ordinary shares issued by Pannonia with the face value of HUF 40, and with the issue price of HUF 350. As a result of the transaction, KONZUM acquired a 24.85% stake in Pannonia, whereby becoming the insurer largest stakeholder. After the capital increase Pannonia's total number of ordinary shares has increased by 33% to 94,428,260, while its shareholders' equity rose 86% to HUF 17.76 bln, implying a BVPS of HUF 188.
- After the completion of the two share transactions, Pannonia's excess capital has risen HUF 4.1 bln on our estimate (accounting for 23% of its new own equity) that the insurer can use for further asset acquisitions or even dividend payments.
- Pannonia looks keen to seek 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% domestic market share, and meanwhile constantly growing earnings. After the capital increase by KONZUM we believe that Pannonia's capital flexibility is at a sufficient level to reach its market share goal.
- **Outlook: Total annualized premium of new life policy sales might end up around HUF 3.3-3.5 bln in 2018 (more or less the same as in 2017), while Pannonia is likely to remain on track to keep a tight lid on costs. As a result of the significantly better than expected non-life claim ratio and asset management performance we lift our after-tax profit estimate by 20% from HUF 1.71 bln to HUF 2.05 bln for 2018. We raise our profit estimate from HUF 1.92 bln to HUF 2.14 bln for 2019 as well. We acknowledge the management's commitment to create shareholder value by running their pro-active business model, focusing on special challenges, i.e finding niche markets in the intersection of needs, trends and frustrations. Our new EPS estimate is HUF 24 for 2018 (vs. our prev.**

est. of HUF 20) and HUF 23 for 2019 (vs. our prev. est. of HUF 21). Earlier management guidance suggested a net income of HUF 1.6-1.7 bln for 2018.

- **We also project that Pannonia could generate net profit of ca. HUF 2.56 bln by 2022, implying a 5-year clean EPS GAGR of ca. 15% not incorporating any additional earnings that can potentially arise from deeper cooperation with KONZUM. The risk to our profit estimate is a lower than projected renewal ratio in the life segment caused by the expiry and surrenders of life policies contracted ten years ago en masse, and also by new tax rules according to which tax exemption on whole-life, endowment and healthcare insurance products previously offered and sold to firms will be terminated as of next January. In response, Pannonia may have no other option but reduce costs and change its product mix towards less costly life insurances.**
- **Earlier we estimated that if Pannonia uses the full amount of this additional excess capital for further acquisitions and achieves a 19% after-tax ROI on newly acquired assets, its annual after-tax profit may increase by up to 50%, potentially implying an EPS of ca. HUF 30.** On top of that we believe there is a significant upside in earnings given the fact that the countrywide branch networks of friendly domestic banks which are or will be under direct or indirect control of KONZUM or its shareholders can potentially (and perhaps exclusively) be available for Pannonia in the future and very supportive to its sales activity. Now we see that potential synergies are being exploited more slowly, but we still believe that there should be mutual benefits of close cooperation between the insurer and KONZUM. Until there is no news about further transactions or sign of deeper collaboration between Pannonia and KONZUM we expect Pannonia to invest new excess capital to government bonds now yielding negative gains for now due to the rising yield environment.
- Although rising interest rates are currently weighting on Pannonia's comprehensive results, the insurer should benefit from higher yields at which it will be able to invest newly generated premiums in the future, while deterioration in asset management fees may also halt. Notwithstanding huge fluctuations time-to-time in other comprehensive results caused by mark-to-market revaluation of available for sales securities held on B/S (government bonds and KONZUM shares, in particular), Pannonia shouldn't change its dividend plan for the forthcoming years (dividend can be paid from the after-tax profit and retained profits until the total own equity is higher than the share capital). If it cannot find further suitable acquisition targets it can raise dividend instead, in our view.
- **That said, we stress that our current level of knowledge about the potential collaboration with KONZUM does not allow us to predict with certainty whether their cooperation will be sustainable and how value creative it will be at all. We would need more clarity on the nature of their alliance to make a better estimate on how much profits can additionally be generated on a sustainable basis as a result of their partnership.**
- **We lift our 12-m TP from HUF 470 to HUF 484 a share while upgrading our rating from Neutral to Accumulate on the share.** Pannonia is currently trading at 17.6x on a 2018E P/E basis and 2.3x on a current P/BV basis. On the basis of 2018E P/E ratio Pannonia is trading at a 70% premium over peers' corresponding multiple, while its P/BV multiple is in line with its peer's. Pannonia's relative reach valuation in terms of P/E clearly reflects investors' firm belief that the insurer could extract potentially significant synergies from the partnership with KONZUM. Evidently, in order for investors to justify this reach valuation,

Pannonia has to provide greater disclosure about how to develop growth of its businesses on a sustainable basis.

Comparative valuation

	Price (local currency)	P/E 2018F	P/BV 2017	Dividend yield 2017	ROE 2017
Pannonia	423.0	17.6x	2.3x	2%	34%
VIG	23.4	10.4x	2.3x	4%	6%
UNIQA	8.2	11.5x	0.7x	6%	7%
PZU	40.9	12.0x	3.4x	6%	19%
Triglav	30.8	9.7x	3.2x	8%	10%
Peer group's average		**10.9x**	**2.4x**	**6%**	**10%**

Source: Bloomberg, Concorde

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