CONCORDE RESEARCH

CEE Equity Research | Insurance | Hungary
19 November 2019

CIG Pannonia

Recommendation: Under revision (prev. Neutral)
Target price (e-o-y): Under revision (prev. HUF 315)
Share price: HUF 215.5

Share price close as of 09/26/2019	HUF 215.5	Bloomberg	PANNONIA HB
Number of diluted shares [million]	94.4	Reuters	CIGP.BU
Market capitalization [HUF bn/EUR mn]	20 160/60.5	Free float	50%
Daily turnover 12M [HUF million]	0.07	52 week range	HUF 172.6 – 456.5

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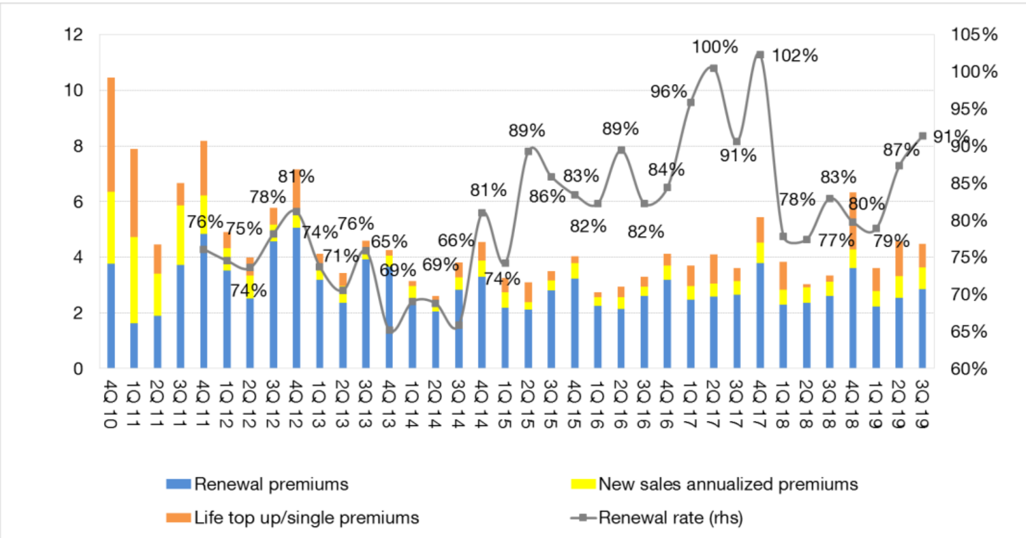
One-off losses overshadowed strong underlying Q3 results

- CIG Pannónia ("the Insurer") reported after-tax profit of HUF 256 mn in Q3/19 compared to HUF 406 mn in the same period last year. Results were affected negatively by provisioning needs of HUF 525 mn for cross-border surety insurance activity pursued by its wholly owned subsidiary, CIG Pannónia First Hungarian General Insurance Company Ltd. (EMABIT) in Italy.
- The Insurer said that based on its best estimate losses (including claims, legal fees and relief in deferred reinsurance fees) arising from its Italian surety insurance activity amounted to nearly HUF 1.3 bn. It added that reinsurance, if it existed, would have been covered HUF 525 mn out of these losses.
- Background to the case is that EMABIT has been operating its Italian cross-border activities since 2014 guaranteeing the concession fee and tax liability of some gaming companies in Italy. This new business (once considered as "niche") generated plenty of revenues, but this year it heavily burdensome to EMABIT as the principals (gaming companies) failed to meet their obligation according to the terms of the agreement with the obligee. At the end of the third quarter, it had 5,553 active contracts in Italy. Total exposure in Italy is EUR 504.5 mn. For a significant portion of the portfolio, about 1,372 contracts, up to a cumulative contractual limit of EUR 319.2 million, the subsidiary has had an assumed reinsurance contract with Africa Re since August 2015. However, the reinsurance contract with Africa Re turned out to be fake, even though the Insurer believed it was a valid contract. It has therefore reported the fraud and filed a complaint with the competent authorities. At the same time, reinsurance brokers involved in the conclusion of the contract have been prosecuted by EMABIT.
- The loss ratio for EMABIT's entire Italian cross-border insurance business in Italy is 33% (total expense for ca. HUF 1.43 bn vs. earned premium of HUF 4,35 bn), while it is 25% for the portfolio with no reinsurance (ie. HUF 519 mn) vs. HUF 2.06 bn earned premium.
- Following the third quarter balance sheet date, EMABIT received a claim on two underwritten insurance policies (covered by the invalid reinsurance contract) with a limit of EUR 5 mn, each to cover the full limit, a total of EUR 10 mn. EMABIT disputes the merits and extent of the claim and initiates consultation with the claimant. Under the contract, the Insurer expects to clarify the circumstances of the basic obligation and to prove the extent of the claim in order to recognize the existence of its obligations.

- EMABIT cross-border guaranteed a total of EUR 12.8 mn for a group of Italian gaming companies on which it reported preliminary losses of HUF 692 mn in Q2/19. Apart from these exposures there might be more, the size of which are not yet disclosed, but the reported additional losses on them have been HUF 525 mn already provisioned. These numbers reflect EMABIT's best estimates at the moment, which may, of course, change (the actual loss may be more or less). Reinsurance, regression (resulting in lower than the estimated final loss rate), reclaims of brokerage commission can have a positive impact on the loss rate, while further unknown claims and claim settlement costs may have a negative impact on it.
- On October 22, 2019, the National Bank of Hungary (NBH) as the supervisory authority with immediate effect prohibited EMABIT from writing of new insurance contracts in the guarantee and surety sectors and also the extension of contracts already concluded at the Issuer's subsidiary, until the completion of an activity-based target investigation, but for a period not exceeding one year.
- Based on Solvency II report for the third quarter of 2019, EMABIT'S solvency margin stood at 102% compared to 150% required normally by the NBH to keep a prudent level of solvency. As there is the risk that EMABIT's regulatory capital might fall below the statutory level for the next three months, the NBH under the Article 309 of the Insurance Law required EMABIT to prepare a recovery plan and take prudent and reliable measures to ensure the sound operation of its insurance business, with enhanced risk management and controls, - in particular with regard to the insurance risks already undertaken in its cross-border activity in the guarantee and surety sector. It is worth noting that, EMABIT had as at September 30, 2019 liquid investments to the tune of HUF 9.3 bn and net reserves and other liabilities of HUF 5.7 bn, allowing for it to meet its payment obligations. EMABIT has so far paid out HUF 478 mn of the claims to the beneficiary Customs and Monopoly Agency (ADM), which is responsible for the supervision of gambling in Italy, on a request for drawdown of insurance promissory notes for five clients. In the case of the remaining four claims, claim settlement is still ongoing.
- EMABIT's former CEO resigned his office shortly after the first losses on the Italian gaming surety insurance were disclosed, and the CEO of the CIG Pannonia Group, who has had proven track record of running the life insurance business has been elected to helm the non-life segment as well.
- In case that EMABIT's capital adequacy ratio falls below the statutory level due to additional losses on surety insurances the NBH may even call for EMABIT to restore its capital position to the required level. We believe the parent CIG Pannonia will certainly be able to inject more capital in to buttress its non-life insurance daughter, at the expense of a weakening of its own liquidity position and capital adequacy (the same risk exposure requires higher capital needs). The capital increase can easily be made from the amounts of capital increase previously placed in the capital reserve of the parent life insurer, which had solvency margin of 312% at the end of September, 2019. Losses should in principle not affect the life insurer's ability to pay dividends even after the recent capital reduction which accounted for 17.5% of the life insurer own capital or HUF 3 bn (HUF 31.96 a share).
- Currently, EMABIT is recorded on the parent life insurer's B/S at a cost of ca. HUF 5.3 billion. This may be reviewed (in part) if the auditor considers the incident as a cause for the deterioration in EMABIT's profit outlook, and therefore there may be need to lower the fair value estimate for EMABIT. In this case, the loss of EMABIT would already have a profound impact on the consolidated profit as well as on the life insurance company's stand-alone results. If that were the case, the life insurance company's capital adequacy as well as dividend payment ability would be affected.

- We add that losses on the Italian gaming surety insurances were completely unexpected. EMABIT was about to deliver another year of strong revenue and profit growth, underpinned by excellent new business sales. The Insurer said that without one-off losses its net results in the first nine months of 2019 would have been around HUF 2 bn, implying 28% growth YoY, as its underlying insurance activities other than in Italy remained very prosperous.
- Consolidated GWP rose 19% YoY in Q3/19 to HUF 6.82 bn with life insurance GWP increasing by 28% YoY and non-life GWP rising by 5%. Life insurance GWP was mainly driven by new policies sold and an improved ratio of renewals of existing policies.
- In the life segment, the new acquisition was HUF 3.2 bn in the first nine months of 2019 which is nearly 150% of the previous year's amount. With its new intermediary subsidiary (PPK), which sold insurance policies of HUF 309 mn in annualized premiums in in the first three quarters of 2019, and it also started its credit intermediation business, the Insurer's sales channels continued to expand, while its product mix shifted towards to risk and traditional products, including the rise of group insurance.
- In the life segment GWP from the first annual premiums of policies sold was HUF 779 mn in Q3/19 implying a staggering 52.7% growth YoY, while GWP from renewals came in at HUF 2.85 bn (+9.2% YoY). As a result of the latter, the renewal ratio went up to 91% from 83% in Q3/18. Top-up and single premiums (HUF 843 mn) were 269.7% higher than in the same period a year earlier, mainly relating to unit-linked life insurance policies. Within the total life insurance premium income, which amounted to HUF 4,569 mn- according to IFRS, top-up and single premiums accounted for 27% in Q2/19 compared to 4% in Q2/18.

GWP breakdown in the life insurance segment (HUF bln)

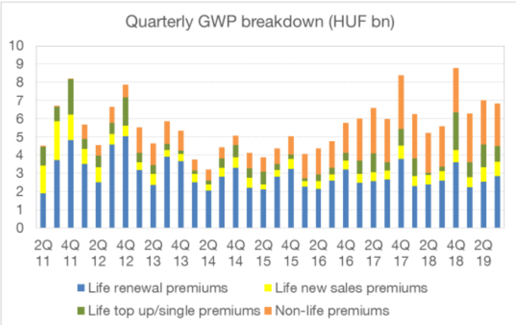


Source: Pannonia, Concorde estimate

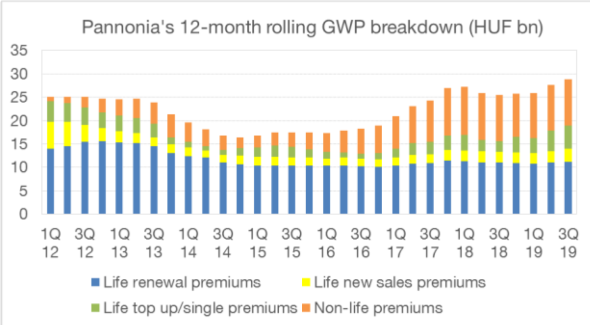
- Traditional life insurances (endowment, pure endowment and healthcare policies) accounted for ca. 28% of total annualized premiums of new sales vs. 30% in Q3/18 as part of the Insurer's strategy of shifting the product mix gradually towards to risk and traditional products, including group insurance. As traditional insurance policies usually generate a lower amount of annualized premiums than unit-linked insurance policies, the life segment's GWP growth should theoretically slow down in the longer run but its profitability is likely to stay elevated, if other things remain unchanged. Unit linked insurances also performed well with HUF 663 mn generated in annualized premium of new sales (+44.8% YoY), representing 72% of total annualized premiums of new sales vs. 70% in the same period last year. The increase in the amount of the annualized premium of new sales in the life segment was mainly thanks to the independent broker channel (28%) and other business development channel together with PPK (34%).

- In the non-life segment the net portfolio development was also positive in Q3/19 (+4.5% YoY).

Quarterly consolidated GWP breakdown (HUF bn)



12-m rolling GWP breakdown (HUF bn)



Source: Pannonia, Concorde estimate

- Investment results were positive in Q3/19 at HUF 2.94 bn. 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, remained by and large flat at HUF 84 mn compared to the same period last year.
- Operating costs increased by 42.3% YoY and accounted for 43.3% of GWP in Q3/19 (vs. 36.3% of GWP in Q3/18), of which fees, commissions and other acquisition costs represented 62% (vs. 71% in Q3/18), while admin costs and other expenses (mainly provisions) accounted for the rest.
- Acquisition costs rose 25.2% YoY, whereas gross premiums earned increased by 19.1% YoY. The primary reason for the rise in acquisition costs was that the new sales rose significantly in both core segments, especially those for traditional insurance products, as compared to the previous year. Other admin costs decreased by 12.9% YoY mainly due to cost cuts. Other expenditures rose significantly from HUF 102 mn to HUF 675 mn due to provisioning needs for the expected losses on the Italian cross-border surety insurance activities. Other income dropped by 9.4% YoY driven by the decline of the existing non-life insurance portfolio.
- Net claims and related settlement expenses rose by 39.8% YoY in Q3/19, as a combined result of a decline in the number of unit-linked surrenders and a significant increase in claims in the non-life segment net claims due to losses on the gaming surety insurance activity.
- Total reported other comprehensive income of HUF 47 mn was negatively affected by deferred income tax expense of HUF 18 mn and an decrease in the fair value of available-for-sale financial assets of HUF 191 mn, the latter was a combined result of unrealized exchange losses on OPUS shares (HUF -394 million) and unrealized exchange rate gains of HUF 204 mn on Hungarian government bonds.
- In the first nine month of 2019 CIG Pannonia generated consolidated after-tax loss of HUF 354 mn compared to after-tax profit of HUF 1,561 mn in the corresponding period last year. The life insurance business brought HUF 1,558 mn after tax profits in the first nine months of 2019 vs HUF 971 mn in the same period of 2018 (+60.5% YoY). The non-life segment's after tax loss amounted to HUF 510 mn in the first nine

months of 2019 compared to after-tax profit of HUF 565 mn in the same period last year.

- After capital reduction the insurer's shareholders' equity decreased from HUF 17.96 bn to HUF 14.99 bn.
- **The case will likely drag on for months or even years. It is too early to quantify the exact amount of losses that may arise from the Italian cross-border gaming surety insurances. We warn that our profit estimates for the coming years as well as out TP may also need to be revised, but we will only be able to provide the new estimates once more public information is available on the approximate amount of losses on gaming surety insurance activities in Italy.**

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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%
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