Long Runway and High Quality– ICICI Prudential ; Max Financial Services

IPRU IN ; MAXF IN

Grow with India's domestic savings

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The Quality Premium

"Time is the friend of the wonderful company, the enemy of the mediocre."

-Warren Buffett

Executive summary

- ICICI Prudential and the *proforma* HDFC Max are the largest Indian private life insurance players, giving exposure to rising wealth management needs in India
- Investment risk is mostly with the consumer, so think of these as successful asset-gatherers.
- Optionality: India is fast-digitizing, private players will be more nimble than the incumbent, and many newer and more efficient ways of distribution, product innovation can be expected.
- No international exposure. 100% domestic plays.

Fertile ground

- There are many Indias. Urban India is a great market for financial products. Attack on cash economy is good for regulated products.
- Number of taxpayers: 28mn out of 1250mn. 16mn had nil returns. So, 12 mn pay for everything. (2012-13 is the latest publicly realised information)
- Banks are flush with funds. Lower bank deposit rates have increased the relative attractiveness of the equity markets, and the savings plans that insurance industry offers.
- Insurance is being increasingly bundled with other products (bank deposits; remittance services).

Limited competition

- Limited competition due to bancassurance (~70%) being dominant distribution channel for private players
- India insurance industry can grow at 2x GDP, and this can flow through to shareholders, as scale economics are in play.
- India's GDP growth is expected to be around 6-7%, on average, for the next decade, or two, arising from a young population, and a country playing catch-up on infrastructure and productivity growth.
- India's insurance growth rate may sustain at over 12% CAGR over the next 2 decades. Growth in Embedded Value will be at least in line with premia growth, aided by cost efficiencies getting better.

Snapshot

Figures are for FY16, unless noted otherwise	**ICICI Prudential**	**Max Life**	**HDFC Life**	**Proforma HDFC Max**
Market share	11.3%	4.8%	7.6%	12.4%
Agents	121,000+	45,275	117,000+	
Branches	521 offices	205 offices	396 offices (reducing trend)	601
13-month Persistency	82.4%	79%	80%	
61-month persistency	46%	43%	48%	
Expense ratio *	14.6%	13.6%	11.6%	

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Highly successful asset gatherers

Figures are for FY16, unless noted otherwise	**ICICI Prudential**	**Max Life**	**HDFC Life**	**Proforma HDFC Max**
Cost ratio(cost to total weighted received premium)	21% (3 months ended June 2016	22.5%		
Solvency (FY16)	320%	343%	198%	252%
3-year average RoE (FY16)	34.2%	21.4%	35.4%	
AUM (INR bn)	1,039	358	742	1,101
Claims Settlement ratio	96.2 (fiscal 2016)	96.2%		
Grievance ratio	153/10000	305/10000		
Partner banks	**ICICI Bank** (main); Standard Chartered Bank	**Axis Bank** (main); Yes Bank, Lakshmi Vilas Bank	**HDFC Bank** (main); RBL Bank, Saraswat Bank, IDFC Bank	
Distribution mix (%)*: Agency, Banca, Direct, Others	25/**67**/2/6	28/**70**/3/0	13/**71**/12/4	19/**67**/11/2
Product mix (%) – Par./ Non Par./ULIP	12/13/**75**	**58**/14/28	30/15/**55**	42/13/**45**

Note: FY16 indicates end of year for stock figures, and figures for the year for flow figures. Weighted premiums take 10% of single payment premia, plus normal premia.

Shareholder dynamics – ICICI Prudential

- **ICICI Prudential:** 55% ICICI Bank ; 26% Prudential Corporation.
- Prudential may sell down further to floor of 20%. (An opportunity that a block deal may depress price)
- Various Indian Mutual Funds (MFs) with none holding more than 0.5%. No FII in top ten holders, as of 30 Dec 2016.

Shareholder dynamics – Max Life

❖ **Max Financial Services (MFS)** (owns 68% of Max Life: Mitsui Sumitomo Insurance (MSI) 25%, Axis Bank 6%, IDFC 1%):

- 30.5% Promoters
- 14.5% Mutual funds (Reliance Nippon 5%)
- 20.7% FII (Vanguard, Norges Bank, Fidelity, Wasatch : Around 1% each)
- 12.7% FPI ; 12.1% FDI ; 8% retail
- Real free float is very modest.
- *Goldman Sachs has stakes through subsidiaries, of 15.5%.*
- *KKR has 9.95%*

Shareholder dynamics – the merger

- **HDFC Life :** *61.6% HDFC* ; *35% Standard Life*
- ***Merger ratio of HDFC Life and Max Life is 69%:31%.***
- Proforma holding would be mathematically: HDFC 42.5%, Standard Life 24.1%, Mitsui Sumitomo Insurance (MSI) 7.8%
- MFS Promoters will be 6.5% of new entity.
- All others would be 19.1%
- Foreign holding adds up to 41.5%, ex-Standard Life.
- HDFC and Standard Life will be the promoter group (66.6%). (*Including the erstwhile MFS promoters will make it 80.9%. MFS and MSI will have to give up all Director seats).*

Catalysts

- Merger between HDFC Life and Max Financial is expected to close in 4Q. This is probably in the price.
- **India Stack**: eKYC in India will leapfrog First World standards. Telemedical underwriting (doctors on phone) – the IT boom, the BPO boom, and the KPO boom: they all have residual benefits for India, and India can surprise on innovation.
- *India stack is a bunch of APIs (Application Program Interface) that allows access to a digital locker of key identification documents. Access can be controlled by biometrics, and varying levels of permission could be set. The unlocking of productivity will benefit all service-based industries, including insurance.*

Ways to express a view

- Go long the stock
- Use listed options to sell cash-secured puts
- Market-neutral: pair with short position on PSU Banks - their long-term compounding is inferior due to misallocation. In the near-term, lower interest rates will compress their NIMs, while it helps insurers sell more.
- Relative valuation: ICICI Prudential is slightly cheaper. Max Life has event risk, in case merger ratio is renegotiated (Axis Bank as bancassurance partner is a key asset) Merger between HDFC Life and Max Financial is expected to close in 4Q. This is probably already fully in the price.

FAQ

- Isn’t India expensive?
  - Indian companies are usually older than many Asian listed companies, having the oldest stock exchange in Asia. Companies use the lower of cost or market for valuing property. Book tends to be understated. Don’t be scared by high price-to-book of India companies. Look for overall metrics on capital efficiency.
- Isn’t low free-float a problem?
  - Limited liquidity can cause pro-cyclical moves in share price, based on flows. Invest only if your process can accommodate such swings.
- Isn’t insurance a long-gestation business?
  - It is. About 15 years is typical. The companies in this study have crossed that mark, and are on the cusp of rapidly growing profits from a small base. A long runway gives them plenty of room to grow.

Appendix: Ratios and data

- **ICICI Prudential**
- Ticker: IPRU IN Equity on Bloomberg
- Founded: 2000
- Head office: Mumbai, India
- Employees: (31-March-2016): 10,663 ; Agents 121,016
- Market cap (31-March 2017): 543.5 bn (USD 8.4 bn at INR64.8 per USD)
- Price per share: INR 378
- Price to book: 10.2x
- Expense Ratio (FY16): 13.6%
- Shares outstanding: 1,435.5million
- Free float: 13.24%
- Dividend yield: 0.3% trailing 12 months
- Auditor: B S R & Co, S R Batliboi & Co

Data is from Bloomberg (31 March 2017), unless specified otherwise.

Appendix: Ratios and data

- **Max Financial Services**
- Ticker: MAXF IN Equity on Bloomberg
- Founded:2000
- Head office: New Delhi, India
- Employees: (28-February-2017) 9, 364 (Agents: 51,192)
- Market cap (31-March 2017): 153.7 bn (USD 2.37 bn at INR64.8 per USD)
- Price per share: INR 574
- Price to book: 7.8x
- Expense Ratio (FY 16): 13.6%
- Shares outstanding: 267.3 million
- Free float: 72.5%
- Dividend yield: 0.3% trailing 12 months
- Auditor: Deloitte Haskins and Sells

Data is from Bloomberg (31 March 2017), unless specified otherwise.

Appendix: Insurance key ratios

- Loss ratio: what you expect to lose due to the risk you have accepted
- Expense ratio: your cost of running the business (salaries, commissions, rent, travel, etc..)
- Combined ratio: add the loss ratio and expense ratio. Ideally should be below 100%. Insurance industry can survive with combined ratios over 100% too, as timing of claim can be quite different from premium paying period, allowing investment income from the premia collected (float) to be earned and kept. Such income may or may not be shared with policyholder, depending on policy.