29 April 2015

Sector Research

Life Insurance - India

Sector review

Wheels are turning for the Life Insurance industry

Company	Rec	Target
Aditya Birla Nuvo	Buy	INR2000
Bajaj Finserv	Buy	INR1950
Max India	Buy	INR550
Reliance Capital	Buy	INR550

We expect five major trends in the life insurance space – growth revival, persistency improvements, low interest rates, regulatory changes and cost efficiency – to improve margins and RoEV for the private players. Of these, growth revival will be the most important. We estimate these factors could add up to 30%-40% valuation upgrades on top of normal EV compounding (12%-18%) over the next five years. The top 6 private players should be the biggest beneficiaries of such trends and we expect market share to concentrate towards them. They could also facilitate industry consolidation given better capital availability and strong financial positions. We initiate at BUY on Bajaj Finserv, Max India, Reliance Capital and Aditya Birla Nuvo.

- **Growth trajectory to improve:** We see new business premium growth improving as we expect an increase in financial savings, higher GDP growth, declining interest rates, better capital availability and a benign regulatory environment. We expect the life insurance industry and top 6 private players to grow at CAGRs of 15% and 20% respectively over next five years.
- **Persistency to improve:** We expect persistency to improve given regulatory changes (cap on surrender charges etc.), an improving economic backdrop, stable regulatory environment and pre-2010 unit-linked policies going off book.
- **Interest rates to decline:** In a scenario of declining interest rates and falling inflation, the share of financing savings and insurance should increase. Moreover, the value of the in-force book and new business should rise as interest rates decline, which should lead to valuation upgrades. Only players with high exposure to investment guaranteed products (non-par) will be at a risk.
- **Changing regulatory dynamics:** The Insurance Act 2015 has empowered the IRDA to fix commissions and expenses. We expect the regulator to relax commissions while capping overall expenses. This should benefit large players which can offer higher commissions. Also, open architecture in bancassurance is likely to benefit large non-bank promoted private players. We expect Max India, Bajaj Finserv, Aditya Birla Nuvo and Reliance Capital to benefit.
- **Cost efficiencies:** We expect cost efficiencies on the digitisation of policies, increasing proportion of online channel, scale and the regulator's focus on costs.
- **Initiate at BUY:** We initiate coverage on the Indian Life Insurance sector with BUY recommendations on Bajaj Finserv, Max India, Reliance Capital and Aditya Birla Nuvo. Bajaj Finserv is our preferred pick in the sector given its valuation and positive positioning with respect to the five trends. Max Life is a quality franchise and remains a strong compounding story.
- Our valuations could see upgrades of 30%-40% over the next five years on these trends. Max is pricing in a mid-teens VNB multiple and has low sensitivity to these trends, hence we expect a compounding rate close to RoEVs (c.18%). Bajaj, Birla and Reliance are pricing in single-digit VNB multiples and have high sensitivity to these trends. We expect compounding to be driven by re-rating.

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Introduction

We expect the Indian life insurance industry to benefit from five major trends on the operating level over the next five years (see table 1). Growth revival, in our view, is the most important and could lead to 10%-20% upgrades to valuations alone.

Table 1: Broad expectations in life insurance sector and their implications

Trends	Investec's expectation	Implications
Growth Revival	We expect NBP growth to improve to 20% CAGR for top-6 private players over next five years.	Embedded Value accretion and VNB margins will improve. We expect 10%-20% upgrades to our valuations for every 10% upgrades in growth estimates.
Persistency improvement	We expect persistency to improve due to regulatory changes, better economic environment and players' focus.	EV accretion and VNB margins will improve for Par & UL products. We expect up to18% upgrades to our valuations for every 500bps increase in persistency.
Low interest rates	There is expectation of decline in interest rates in the economy over next 24 months as inflation has softened.	EV and VNB margins will get upgraded for Par & UL products. Non-Par products may get negatively impacted by declining interest rates. We expect up to 10% upgrades to our valuations for every 100bps decline in interest rates.
Changing regulatory dynamics	We expect final guidelines on open architecture in bancassurance, some relaxations in commission pay-out and restrictions on overall expenses.	Large non-bank promoted players are likely to be big beneficiaries. Players with high proportion of participating products may get impacted negatively.
Cost efficiencies	We expect cost efficiencies to improve given increasing share of variable cost structure bancassurance, emergence of online channel and regulator's focus on lower fixed costs.	EV accretion and VNB margins will improve. We expect 3%-17% upgrades to our valuations for every 10% decline in fixed costs.

Source: Investec Securities estimates

In addition to these five trends, we expect IPOs of a couple of life insurance companies over next 18 months – Max India Financial Services (set to list in FY16) will be first pure play on life insurance sector, while HDFC Life is expected to IPO in FY16/FY17. These should raise the profile of the sector, improve disclosures and increase understanding of the sector.

Table 2: How life insurance companies are placed to leverage these trends?

	ICICI	SBI	Bajaj	Max	HDFC	Reliance	Birla	Exide
Trend 1 - Growth	●	◕	◕	◑	◕	◕	◕	◑
Trend 2 - Persistency	◕	◑	◕	◕	◕	◑	◕	◑
Trend 3 - Interest rates	●	◑	◑	◕	●	◔	◑	◔
Trend 4 - Regulations	◔	◔	◕	◑	◑	◕	◕	◕
Trend 5 - Operating costs	◕	◑	●	◑	◑	◕	◕	◕
Overall	◕	◑	◕	◑	◕	◑	◕	◑

Source: Investec Securities estimates

Bajaj Allianz Life is well placed to leverage the emerging trends in the life insurance sector.

Bajaj Allianz Life is best placed among the life insurance companies to benefit from these five trends, in our view. Max Life has a high proportion of participating products, which have the least sensitivity to operating expenses or persistency. Moreover, the company is operating at high persistency with the lowest proportion of fixed costs so the scope for improvement may be limited (see table 2).

Investec

Broad expectations in Indian Life Insurance sector

Trend 1: Insurance industry is expected to witness growth revival

Share of financial savings as a % of GDP is at a 15-year low

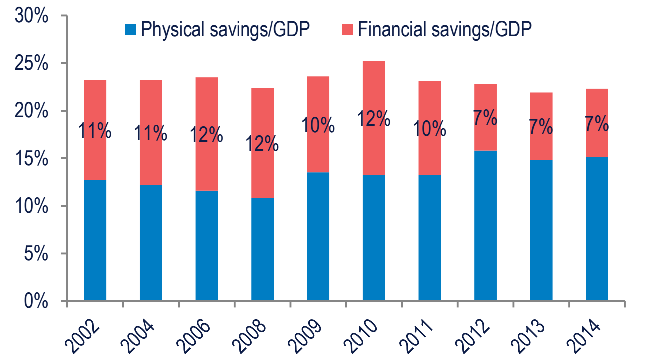
Share of insurance within financial savings is at an eight-year low

We expect the growth outlook for the life insurance sector to improve given the following: (a) financial savings (as a % of nominal GDP) are expected to grow; (b) the share of life insurance within financial savings is expected to remain stable or grow; and (c) nominal GDP is expected to grow at 12%-14% in the next five years.

We expect the life insurance sector to grow at a 15% CAGR over the next five years assuming a marginal uptick in financial savings rate to 8% of GDP, GDP growth of 13% and share of life insurance (within financial savings) remains stable at 17%.

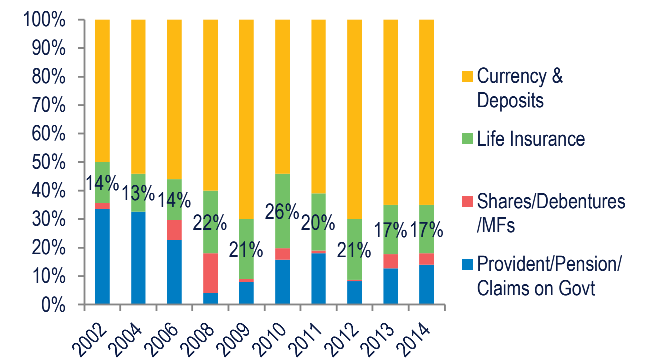
Note that the share of financial savings (financial savings as a % of GDP) and share of life insurance within financial savings have been declining since 2010 (see figures 1 & 2).

Figure 1: Financial savings as % of GDP has come down and…



Source: RBI, Investec Securities estimates

Figure 2: Life insurance share within financial savings has declined



Source: RBI, Investec Securities estimates

Top private players are expected to be gain market share

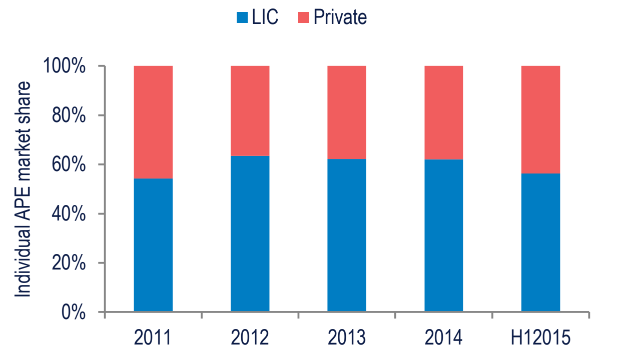
We expect the top private players to be the biggest beneficiaries of the revival in growth in the industry given that they are:

- **Well capitalised and able to attract capital:** The top players are well capitalised, do not require capital and remain most probable IPO candidates. The better capital availability will help them in gaining market share when bottom players will starve for capital.
- **Scale benefits should accrue for large players:** The top players have reached scale and have lower operating expenses compared to other players, which should help them to improve returns to policyholders and shareholders.
- **Regulatory focus on lower fixed costs may benefit large players:** The IRDA may tweak commission rates on the higher side while capping total management expenses (see page 16 for more details). Given large players will enjoy scale benefits, they are likely to benefit from these changes.
- **Top players set to initiate consolidation in the industry:** Mid-size (7^{th} to 18^{th}) players have lost market share, are not profitable, have weak distribution and require capital. Also, these players may not be able to attract capital. On the other hand, the top players are generating cash and should be able to attract capital which can be used for consolidation.

Top private players have gained market share among private in the last five years.

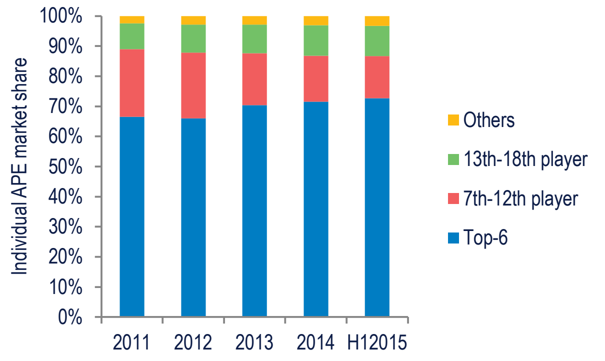
Private players have shown market share gains recently (figure 3) while the top 6 have been gaining market share for the past five years (figure 4). The players in the 7^{th}-12^{th} range have been the biggest losers (figure 4).

Figure 3: Private players have gained some market share recently



Source: IRDA, Investec Securities estimates

Figure 4: Top 6 players have gained market share



Source: IRDA, Investec Securities estimates

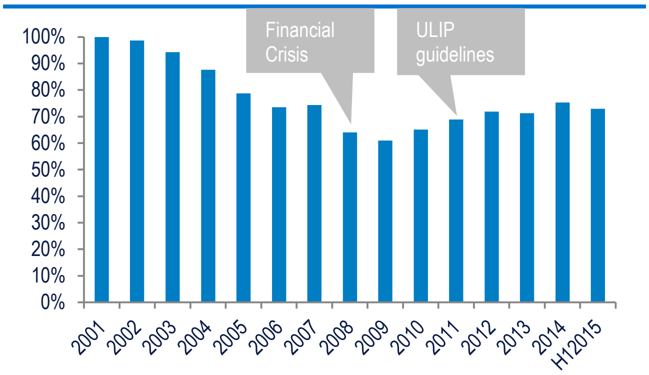
LIC gains market share in time of uncertainty while private players do well in times of prosperity.

Life Insurance Corporation of India may lose market share from hereon

Life Insurance Corporation of India (LIC) lost market share until 2011 when the private industry was riding the unit-linked wave, however, it has gained market share post 2011 (figure 5). This was driven by (a) regulatory changes in unit-linked policies; and (b) risk aversion among the policyholders on weak macro. We observe that LIC gains market share in times of uncertainty while private players do well in times of prosperity.

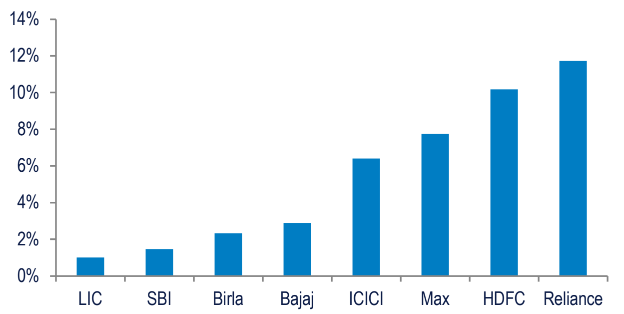
Given expectations of economic revival, improving consumer sentiment and the private sector stabilising post regulatory changes, we expect LIC to lose market share from hereon. Moreover, the emergence of an online sales channel may benefit private players given their focus on this.

Figure 5: LIC New business market share



Source: IRDA, Investec Securities estimates

Figure 6: Proportion of sales coming from direct channel



Source: Company Disclosures, Investec Securities estimates

Given our expectation of 15% premium growth for the Life Insurance sector, the top private players may grow at 20% over the next five years assuming LIC and other than the top 6 players cede 1% market share each year.

Growth revival could change the fortunes of the private players. It will lead to upgrades in margin, embedded value and valuation.

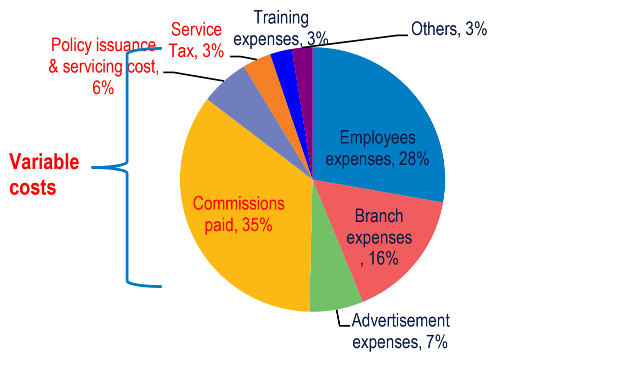
Growth could positively impact life insurers in multiple ways

Growth will have multiple positive impacts on the fortunes of Life Insurance companies as it should lead to positive operating leverage, reductions in cost overruns, improvement in NBAP margins, higher EV accretion and a positive impact on valuations. It should also raise the sector's profile in the eyes of investors.

Operating leverage: More than 55% of operating costs for private Indian Life Insurance companies are of a fixed nature (figures 7 & 8). Hence, growth in gross premiums should facilitate significant positive operating leverage for the players.

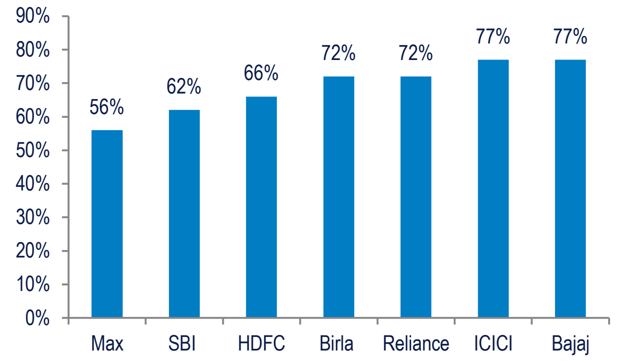
Here, growth in renewal premiums is also very critical, which is a function of persistency and new business growth as a higher renewal premium will mean higher allocation of costs on existing policies versus new policies.

Figure 7: Operating costs break-up for Max Life



Source: Company Data, Investec Securities estimates

Figure 8: Fixed costs as % of total costs for Insurers



Source: Company Data, Investec Securities estimates

Private players have high fixed cost which will lead to positive operating leverage as growth revives.

Cost overruns (on embedded value basis) to reduce: Historically, Indian life insurers have suffered due to high cost overruns, which have impacted their embedded value accretion. This has been due to higher expectations of growth and persistency than actual levels. There are two kinds of overruns:

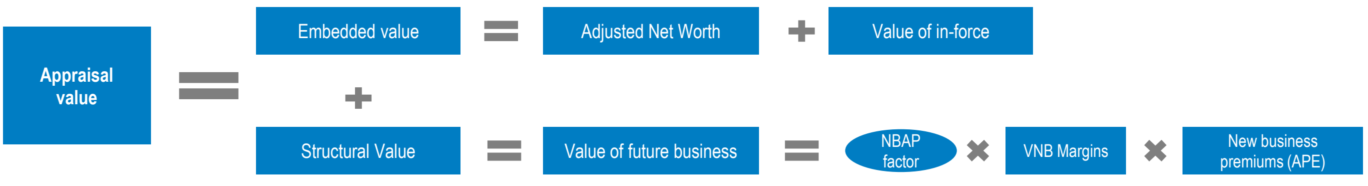
- **Acquisition cost overruns:** The actual acquisition costs are higher than estimated when pricing the policy, leading to acquisition cost overruns. Acquisition cost overruns are associated with new business premiums and should thus be deducted from new business margins (NBM or VNB).
- **Maintenance cost overruns:** Costs allocated to renewal business are more than the estimated costs when pricing the policy. Maintenance cost overruns are on account of a higher fixed cost base, lower persistency and lower-than-expected growth in new business.

Growth would be critical in eliminating acquisition cost overruns while better persistency will lead to lower maintenance cost overruns.

Impact of better growth trajectory on margins, embedded value and valuation

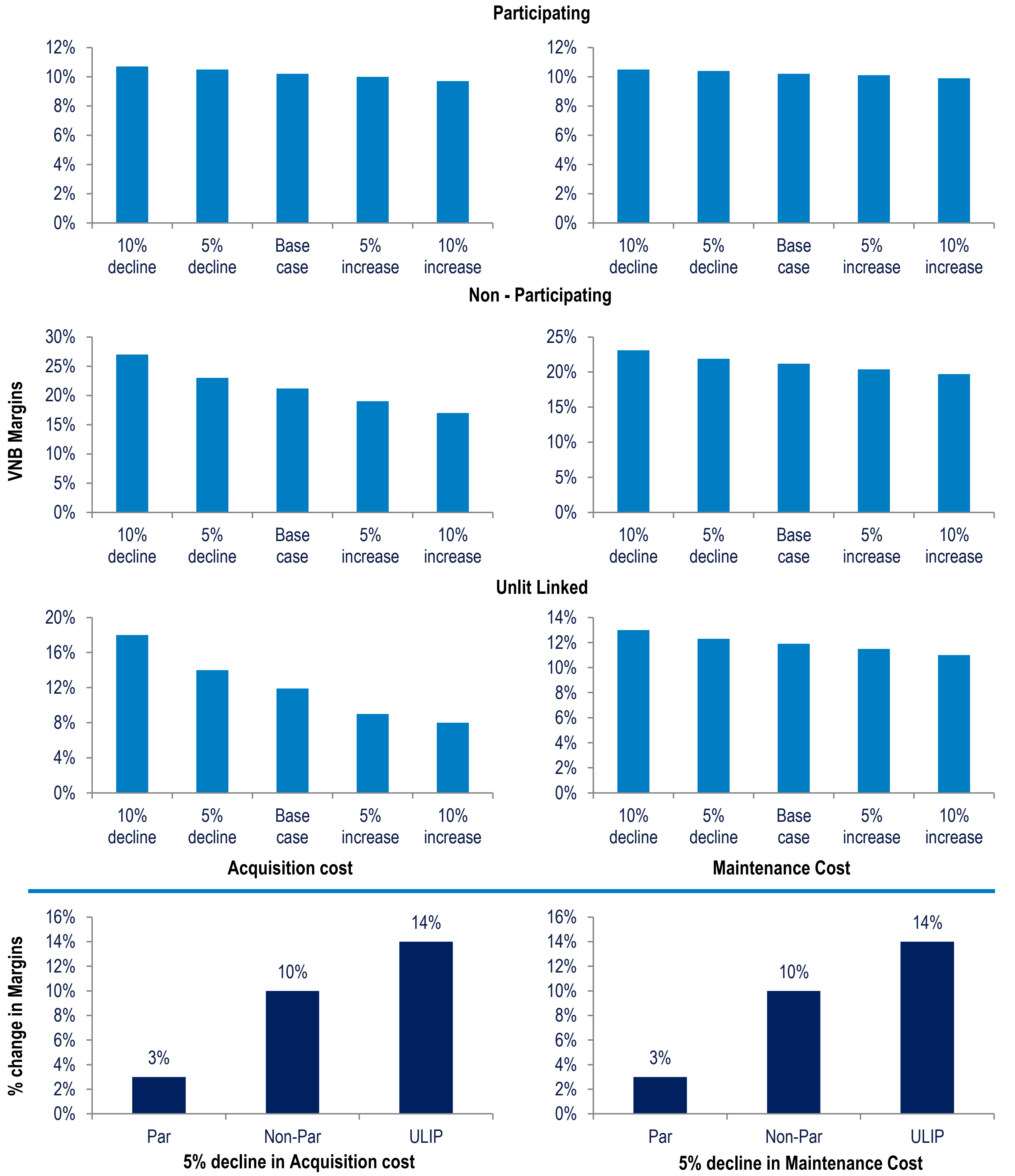
- **Margins:** Once players break even on embedded value basis, the additional operating leverage should lead to margin accretion.
- **Embedded value:** A better growth profile in new business premiums should lead to higher embedded value growth as (a) cost overruns will be lower; (b) margins may be higher; and (c) the value of new business will be higher due to growth.
- **Valuation:** We value life insurance companies on appraisal value methodology. Appraisal value is defined as the summation of embedded value and structural value. Embedded value is the value of the life insurance company assuming it will not underwrite any business from here onwards. Structural value is the value of the future business that the company will underwrite (figure 9).

Figure 9: Valuation of a Life Insurance company



Source: Investec Securities estimates

Figure 10: VNB Margin sensitivity to change in operating cost

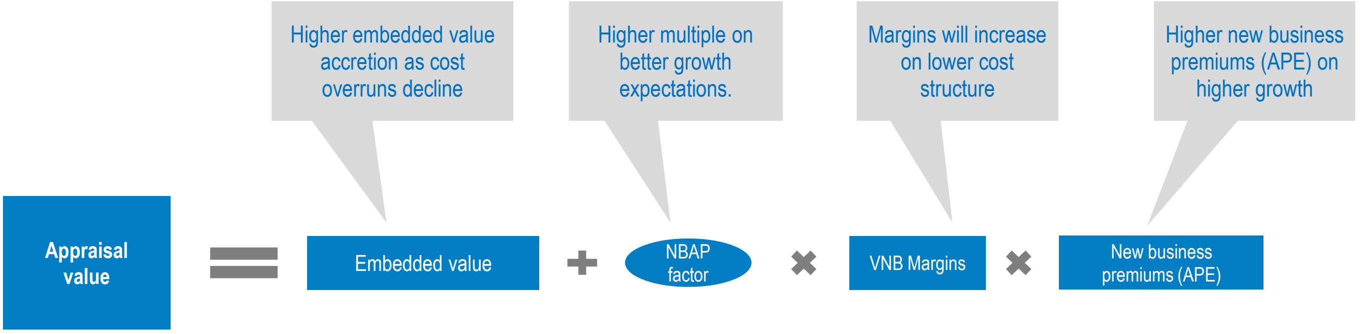


Source: Investec Securities estimates

The valuation impact of better growth trajectory will be threefold:

- Embedded value upgrades.
- Value of new business upgrades (both on account of growth in new business premium and margin improvement).
- NBAP multiple expansion (which is a function of growth rate and sustainability of growth rate).

Figure 11: Impact on Embedded Value of Life Insurance company due to growth upgrade

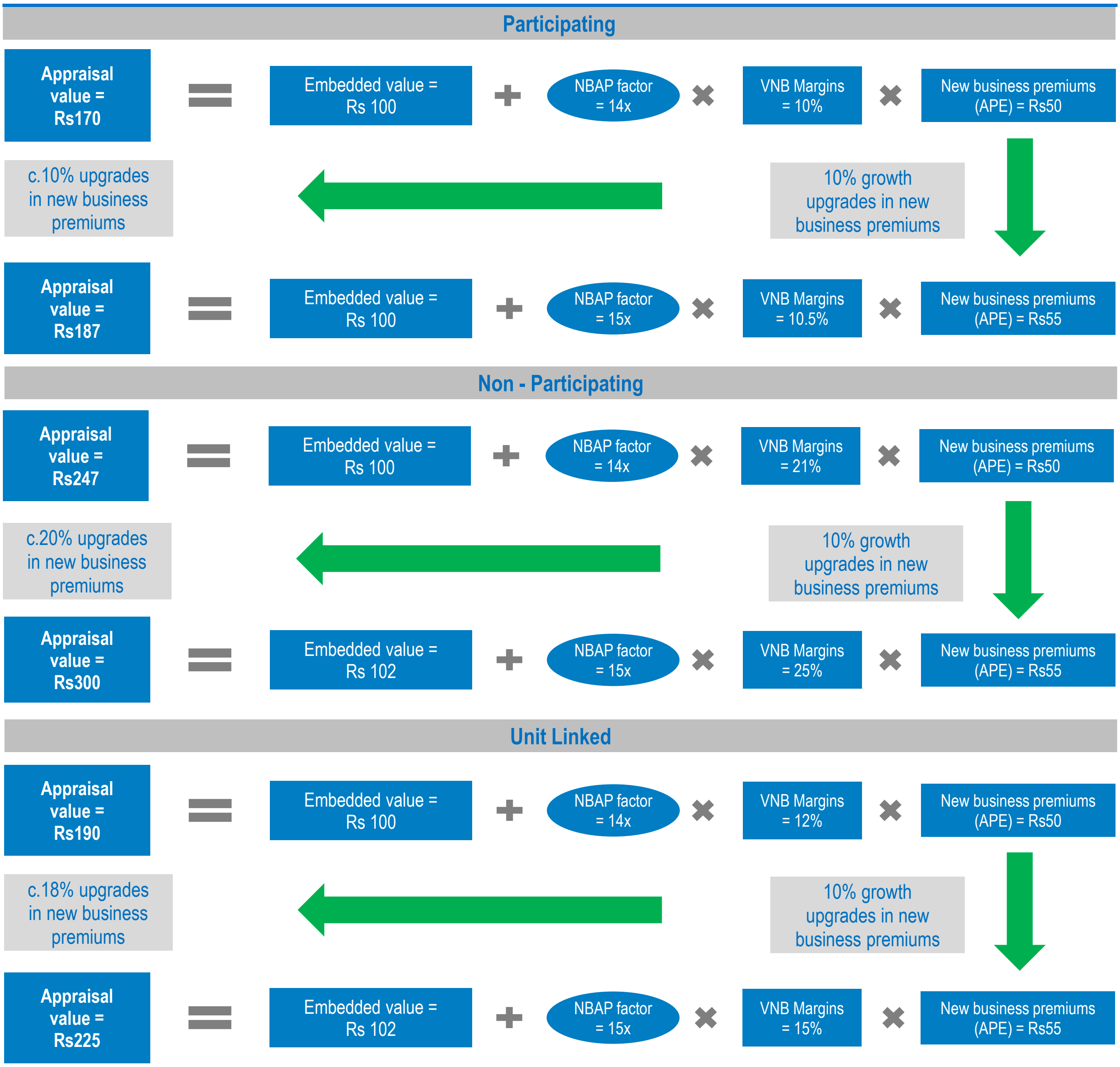


Source: Investec Securities estimates

Sensitivity of valuation with growth rate

Unit-linked and non-participating products have high sensitivity towards new business growth and operating costs. Participating products have low sensitivity to new business growth given that upside in cost savings is shared between policyholders and shareholders in a ratio of 90:10 (see figure 12 for more details).

Figure 12: Valuation upgrades for 10% upgrades to growth estimates on three product structures



Source: Investec Securities estimates

A ten percent growth upgrade in new business premiums will lead to around 10% valuation upgrades for participating policies, 20% for non-participating policies and 18% for unit-linked policies.

Trend 2: Persistency is expected to improve

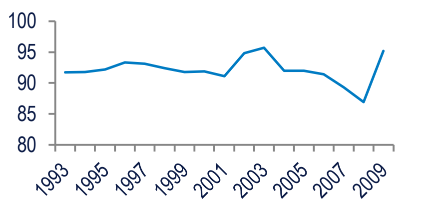
Persistency in India is poor on account of various structural and cyclical reasons. Structural reasons include mis-selling, low trail commissions, high agency attrition, poor product performance, frequent regulatory changes and low tenured products. Cyclical reasons include the economic environment. Globally, we have also witnessed a dip in persistency in the times of uncertainty (see figures 13 & 14).

Indian Life Insurance players have low persistency which has improved in last one year and is expected to further improve on back of structural and cyclical factors.

We expect persistency to improve from current levels as the cyclical factor, i.e. the macroeconomic environment, is favourable and the regulator had addressed some of the structural factors.

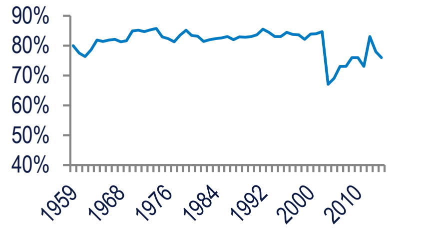
- **Tenure of the product is increased:** The minimum tenure of the product has been increased from 3 years to 5 years. Moreover, the commission structure mandated in the product design guidelines favours long tenured products (see details on regulation on page 29).
- **Surrender penalties are capped:** The IRDA has capped surrender penalties in the unit-linked products in 2010 and mandated minimum surrender benefits in the product design guidelines in 2013. This means the companies will lose out if a policy lapses unlike the case earlier (see details on regulations on page 29).
- **Benign economic environment:** A volatile economic environment has an adverse impact on persistency as cash flows of the policyholders are affected (see figure 13 & 14). As we expect a better economic environment ahead, persistency should improve from hereon.
- **Industry matures:** Globally, companies have witnessed improvement in persistency as the industry matures (see figures 16, 17 & 18). We expect similar trends in India.
- **Regulator's focus on persistency:** The IRDA has taken several steps to improve persistency (capping of surrender charges etc.). One of the recent steps was to standardise persistency disclosures by the life insurance companies. We expect the regulator may increase trail commission which will improve persistency (see section on page 17 for more details).
- **Insurance Act allows soliciting lapsed policies originated by terminated agents:** The attrition rate is very high in the life insurance agency which has impacted persistency. Moreover, lapsed policies originated by the terminated agents could not be solicited by the company. This clause was removed in the Insurance Act, 2015.

Figure 13: Persistency decline in times of uncertainty (UK)



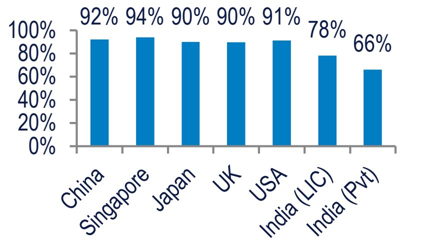
Source: FSA UK, Investec Securities estimates

Figure 14: Same is the case with LIC's persistency



Source: LIC Annual Reports, Padmavati (2008)

Figure 15: 13th month persistency in India is among the lowest



Source: Respective countries' insurance regulator websites, Investec Securities estimates

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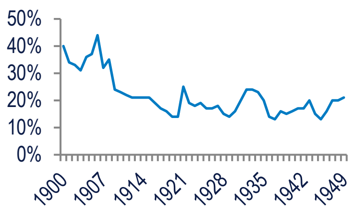
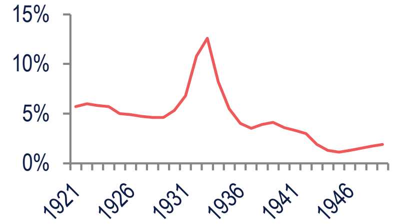
Figure 16: Two year lapse rate (US)



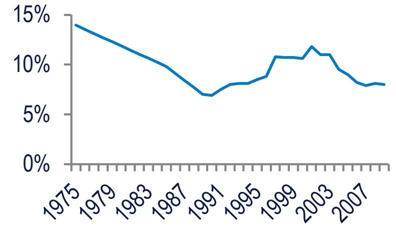
Source: Transactions of Society of Actuaries 1951

Figure 17: After first two year lapse rate (US)



Source: Transactions of Society of Actuaries 1951,Investec Securities estimates

Figure 18: Lapse rate (Japan)



Source: Insurance Issues (April 2013) Gen Re

We have witnessed persistency improvement for all private players in the 37th and 49th month bucket in FY14 and 9MFY15 respectively (see table 3). This is on account of old unit-linked policies (policies sold before unit-linked guidelines of 2010) surrendering or maturing after completing three years. We expect the persistency improvements in the 61st month bucket in FY16 on account of this phenomenon.

Table 3: Improvement in persistency in higher buckets as old ULIP book matures

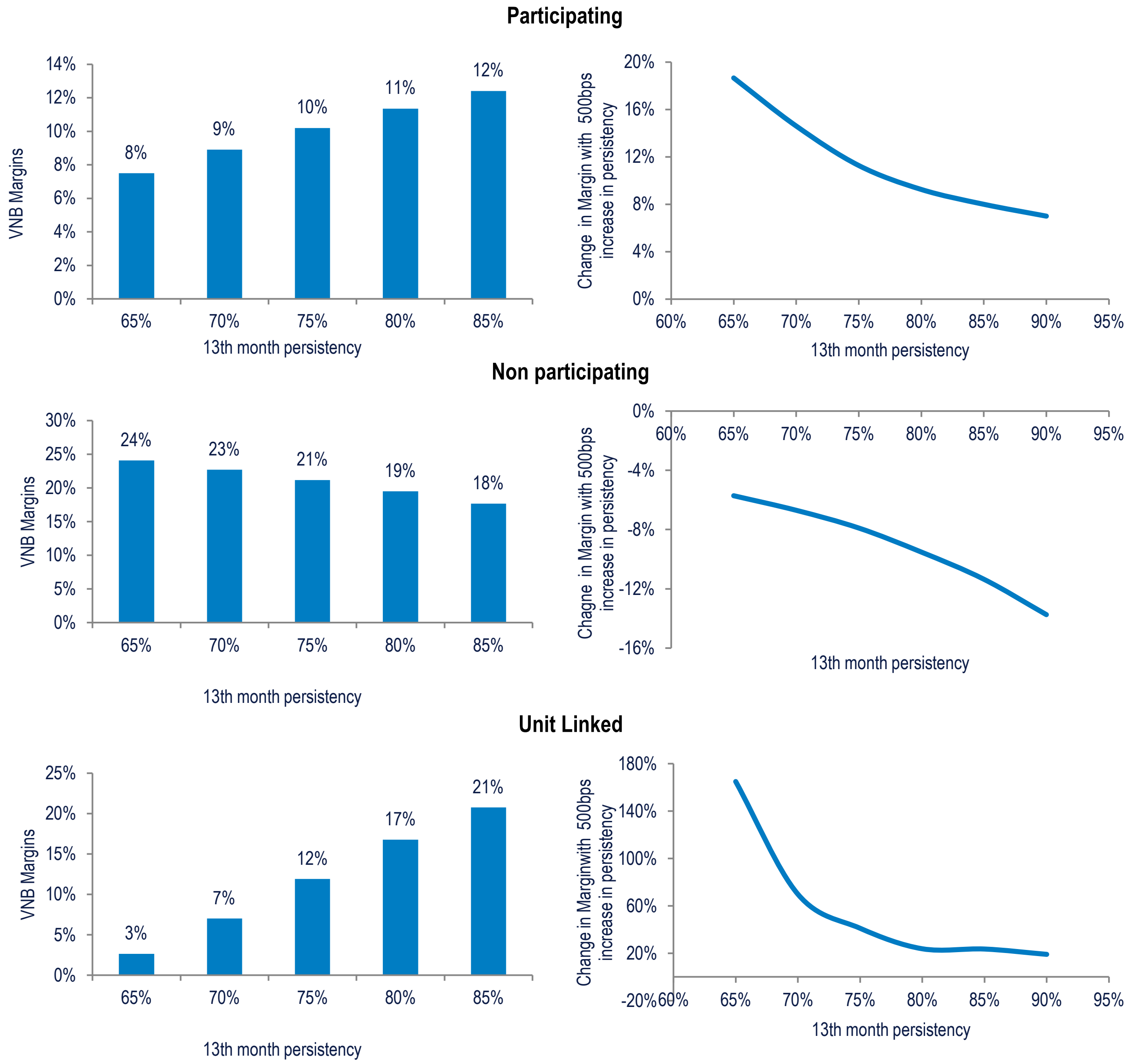
	Bajaj Allianz Life					Max Life				
	FY11	FY12	FY13	FY14	9MFY15	FY11	FY12	FY13	FY14	9MFY15
13th Month	56%	62%	60%	62%	66%	70%	75%	76%	76%	78%
25th Month	42%	59%	50%	49%	49%	60%	62%	64%	66%	66%
37th Month	10%	12%	15%	26%	40%	49%	42%	46%	53%	59%
49th Month	7%	7%	7%	10%	15%	40%	39%	32%	38%	46%
61st Month	6%	6%	4%	4%	6%	39%	31%	26%	23%	30%
	Reliance Life					HDFC Life				
13th Month	53%	56%	54%	60%	58%	76%	77%	72%	72%	71%
25th Month	42%	41%	45%	58%	55%	67%	66%	75%	68%	66%
37th Month	11%	12%	12%	45%	60%	20%	21%	27%	57%	70%
49th Month	9%	8%	9%	13%	25%	9%	11%	20%	20%	57%
61st Month	8%	7%	6%	9%	7%	6%	9%	14%	13%	35%

Source: Company Data, Investec Securities estimates

Impact of improving persistency on cost overruns, new business growth, margins and valuations

- **Cost overruns:** As explained earlier, higher persistency will lead to an increase in the number of in-force polices on which maintenance costs can be allocated and hence lead to lower maintenance cost overruns or under runs as the case may be.
- **New business growth:** There is an expectation that an increase in persistency will lead to a decline in the new business premium as churn among the companies will reduce. Though, we do not have resources to test this hypothesis, our expectation is that the majority of lapsations lead to policyholders moving to other asset classes rather than moving to another company. Hence, we do not expect a major impact from increased persistency on new business premium growth.
- **Margins:** The impact on margins is positive with the increase in persistency in the initial years for all products. However, persistency in the higher buckets has a different impact on different products (see figure 19 on impact of persistency on margins).

Figure 19: Sensitivity of VNB margins to change in persistency

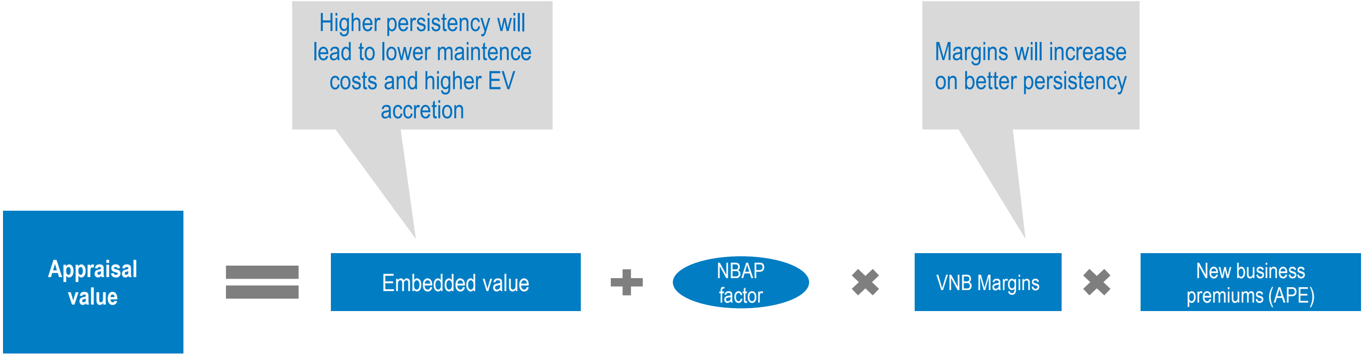


Source: Investec Securities estimates

- **Embedded Value:** EV accretion will accelerate as persistency improvement will lead to margin improvement and cost overrun reduction. Persistency improvement in the in-force business will have a positive impact on the Value of in-force book.
- **Valuation:** Valuations will be impacted on two counts: (a) higher margins will lead to higher value of new business, and (b) higher EV accretion on account of lower cost overruns or under runs (see figure 20).

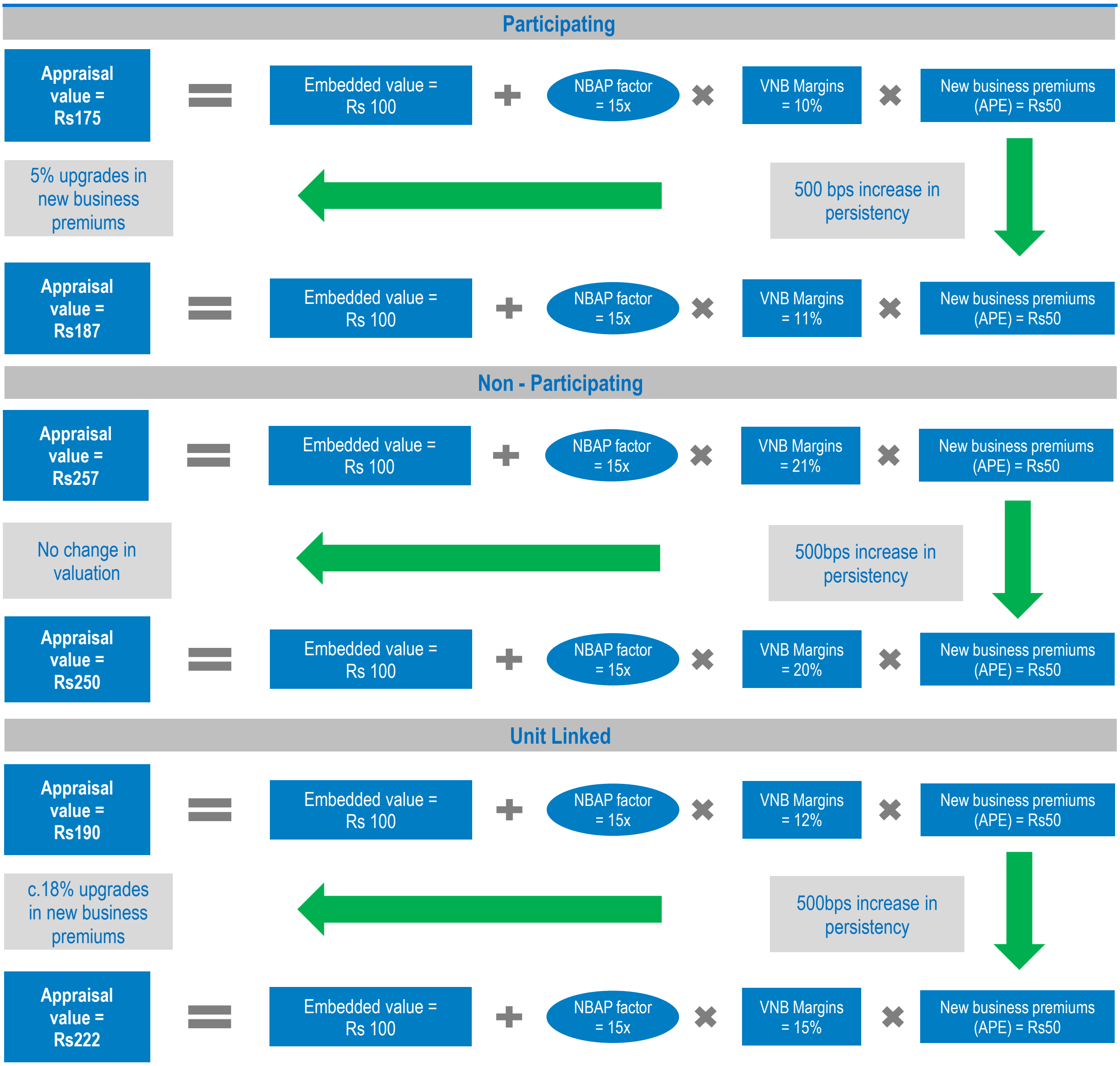
Unit-linked is most sensitive to improvement in persistency followed by participating, while persistency improvement could have a negative valuation impact on non-participating products.

Figure 20: Impact on valuations due to change in persistency



Source: Investec Securities estimates

Figure 21: Valuation upgrades for 500bps increase in persistency



Source: Investec Securities estimates

A 500bps persistency improvement will lead to 5% valuation upgrades for participating policies and 18% valuation upgrades for unit-linked policies. There will not be a significant upgrade in valuation of non-participating polices.

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Trend 3: Interest rate decline

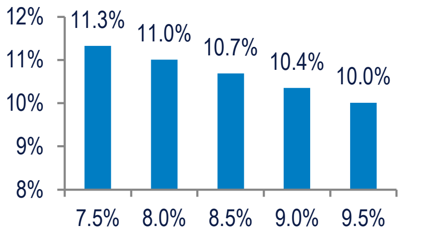
Interest rates in India are expected to decline, which will impact life insurance companies as they primarily invest in fixed income securities for their traditional products. However, the impact is not very linear as:

- Inflation is also expected to remain low and real interest rates positive, which should lead to flow of savings into financial savings and improve new business volumes. A decline in interest rates is likely to disadvantage banks and other institutions offering fixed-interest and guaranteed products rather than equity-linked savings vehicles. This is because the associated decline in uncertainty and increase in wealth encourages savers to take additional risk.
- The value of new business and value of in-force book will also increase as interest rates (risk discount rates) decline.
- On the non-participating policies, the decline in interest rates will lead to a decline in margins as the spread between guarantee and yields declines. However, as interest rates come down, profit margins on the in-force block of business decline, but the values of these margins increase. The effect may be non-linear. If the guaranteed rate is 4% pa, a reduction in interest rates from 8% pa to 7% pa may be beneficial but a reduction from 5% pa to 4% pa will wipe out shareholder value (source: www.theactuary.com).

Given the low penetration of guaranteed products (non-participating) in India, we expect a decline in interest rates to be positive for Indian Life Insurers

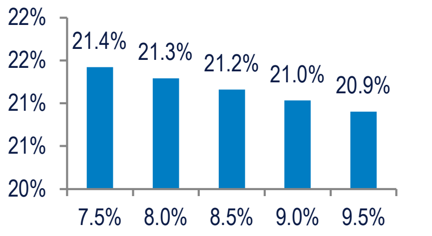
Unit-linked products have the highest positive sensitivity to a decline in interest rates followed by participating policies (see figures 22, 23 & 24). Non-participating products have low sensitivity to a decline in interest rates in a narrow range; however, the product's margin could be negatively affected if interest rates decline to very low levels (less than 6.5%).

Figure 22: Participating product's margins sensitivity to interest rates



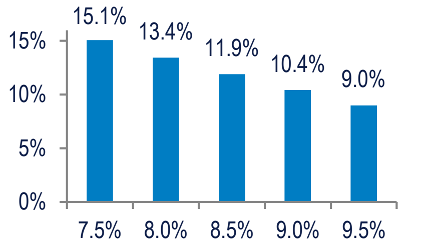
Source: Investec Securities estimates

Figure 23: Non-participating product's margin sensitivity to interest rates



Source: Investec Securities estimates

Figure 24: Unit-linked product's sensitivity to interest rates



Source: Investec Securities estimates

Trend 4: Changing regulatory dynamics could favour large players

Over the next few months, we expect several changes due to powers given to the IRDAI in the Insurance Act 2015. The most critical ones are:

Open architecture in bancassurance

The IRDA has come out with draft guidelines on corporate agency, which aims to open up the bancassurance channel. According to the guidelines, a bank can tie with three life insurers as a corporate agent with a cap on the business from one insurer (see table 4). Based on our interactions with industry participants, we see a high likelihood of these guidelines getting implemented in the current form.

Table 4: Cap on business for one insurance company in draft corporate agency guidelines

Year	Maximum business for one Insurer
1st Year	90%
2nd Year	75%
3rd Year	60%
4th Year and beyond	50%

Source: IRDA

These guidelines will be positive for top non-bank promoted private players, especially those that currently lack a strong banca partner. Bajaj Allianz Life, Reliance Life and Birla Sun Life should be the biggest beneficiaries of the guidelines. Max Life should also benefit as a top quality company and we would expect banks to look to tie up with it.

Bancassurance market – A quick snapshot

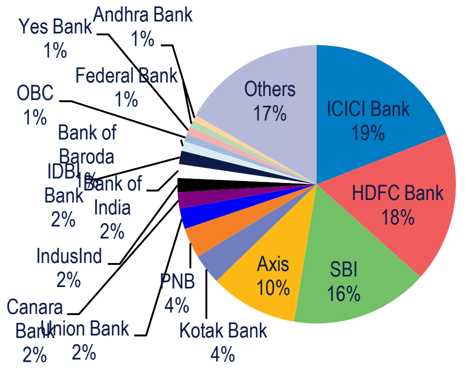
Banks' market share in bancassurance premiums is highly concentrated and is expected to get further concentrated.

In FY14, banks sourced c.Rs100bn in individual new business premiums for the sector with a concentrated market (the top 6 banks command a 71% market share, see figure 25). We believe the market share will get further concentrated towards the top 6 banks as PSU banks continue to lose liability market share. Also, note that beyond the top 6, other banks' contribution is so low that it will not make much difference for top insurance players if they tie up with them. For example, suppose Bajaj Allianz ties up with Union Bank and gets 50% of Union Bank's share, this would be Rs1bn versus its new business premium of Rs26bn (FY14).

Insurers' market share in bancassurance is also highly concentrated but it is expected to fragment post open architecture.

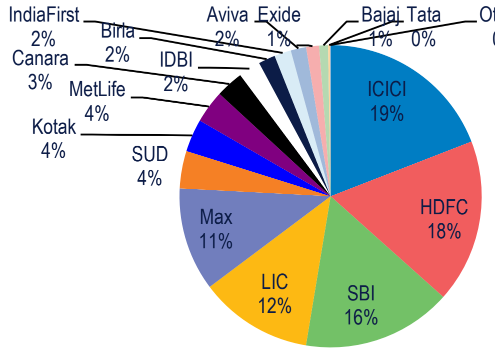
The top 6 life insurance companies get 80% of the bancassurance premiums with the top 3 having banks within the promoter group (see figure 25). LIC is the fourth player, it has a tie-up with more than 15 schedule banks and cooperative banks, which individually have a low market share (<1%) but collectively form a 12% market share. Max Life has fifth position with Axis Bank as a partner.

Figure 25: Banks' share in bancassurance premium



Source: Company Data, Investec Securities estimates

Figure 26: Life insurers' share in bancassurance premium



Source: Company Data, Investec Securities estimates

Bancassurance premiums will be shared among more insurance companies

In our opinion, over the next five years there will be two broad trends in bancassurance assuming open architecture:

- Banks' market share will get further concentrated towards large private banks while.
- Distribution among life insurers will become more uniform with players with low market share gaining (Bajaj, Reliance & Birla) and those with high market share losing (HDFC & ICICI).

We expect large players will not collude, no rush for tie-up with LIC and public sector banks losing market share.

This conclusion is based on following assumptions:

- **No collusion among large banks:** Competitive dynamics may prevent large banks from sourcing business for competitors' insurance companies. Moreover, HDFC Bank and Axis Bank do not hold stakes in life insurance companies leaving limited opportunities for quid pro quo.
- **LIC will not be the default choice for banks:** LIC's product is among the easiest to sell given customers' trust and its size. However, in our opinion, it would not be the first choice among large banks, given that: (a) large banks sell unit-linked products primarily, which is not a strong focus for LIC; (b) LIC agents may protest against a tie-up with a large bank; and (c) LIC may not be as aggressive as other private insurers in going for tie-ups..
- **PSU banks will lose share:** PSU banks (excluding SBI) have not been able to sell life insurance despite their large branch networks. With the requirement of tie-ups with multiple life insurance companies and a cap on business from one life insurer, PSU banks may not be very interested in the bancassurance business. LIC's partners have been able to sell LIC, but we doubt their ability to sell other companies' insurance policies, thereby impacting LIC's business also.

Hence, non-bank players should benefit

We therefore believe open architecture will be positive for non-bank promoted life insurance companies, especially the larger ones with a strong brand name, balance sheet and promoters, namely Max Life, Bajaj Allianz Life, Birla Sun Life and Reliance Life.

Moreover, in an open architecture environment, the agency channel gains importance and will be the deciding factor in a company's success. Non-bank players had focussed on agency and had strong agency networks.

Relaxation in commission payment and constraints on expenses

IRDA's Chairman, Mr TS Vijayan, has said there is a need to increase the remuneration of life insurance agents given the state of the agency channel. The agents make Rs25k($400) per year on average in the private sector, which has reduced the attractiveness of the profession and turned it into a part-time activity. And at the same time, the regulator feels the expenses of life insurance companies are very high despite the majority operating for more than 10 years (see table 5).

Table 5: Recent comments by the IRDA Chairman

	Comments
Need to control fixed costs	• "There are arguments given that cost of distribution is very high and that's why life insurers are not able to sell. I am not very sure about this. For a start-up company, fixed costs will be very high." • "For a mature company variable costs (commissions) should be more than fixed costs. We as an industry are going that way and should reach there in 5-6 years." • "However, some companies are 25% of costs as commissions and 75% as fixed costs even after 10 years of operations."
Need for better agency remuneration	• "Policyholder must be protected but some protection should be given to agents also. Some minimum fixed salary to the agent may be given."

Source: Press reports, Investec Securities estimates

Investec

The Insurance Act 2015 has empowered the regulator to decide on the commissions and expenses of management. We believe the regulator will relax commissions while capping the expenses.

- **Relaxation in commission payment** – The Insurance Act, 2015 has empowered the IRDA to fix the commission structure that was earlier capped in the Insurance Act, 1938 (see table 6). Based on the IRDA Chairman's comments and our interactions with various industry participants, we believe the IRDA will increase the cap on commissions at least for agency channel. If this happens, this will benefit large players as they will have the capital and balance sheet strength to remunerate their agency better. Also, they have sizable agency network to benefit from this regulation.
- **Cap on management expenses –** The Insurance Act, 2015 has empowered the IRDA to cap management expenses. These include all charges wherever incurred whether directly or indirectly by the insurance company, including commission expenses.

Table 6: Cap on commissions in Insurance Act, 1938

	No. of years in operations	
	> 10 Years	< 10 Years
1st Year	35%	40%
2nd & 3th Year	7.5%	7.5%
After 3th Year	5%	5%

Source: IRDA

Cap on expenses of management as per The Insurance Rules, 1939

Expenses of Management ≤ A + B + C

(A) Max (7.5% x T, 90%) X First Year Premium

(B) 15% x renewal premium

(C) 0.5% X Sum assured on policies where no further premium is payable

The IRDA has floated discussion papers for managing the expenses of management, particularly for participating business. Management expenses are currently monitored on an aggregate company level only, which is a function of tenure of product (see explanation on left). The discussion paper is talking about putting caps on management expenses based on line of businesses. Moreover, it says: "For with profits products, the expense assumptions shall be comparable to the corresponding without profit products and such assumptions shall exclude all the implicit margins built in for bonuses."

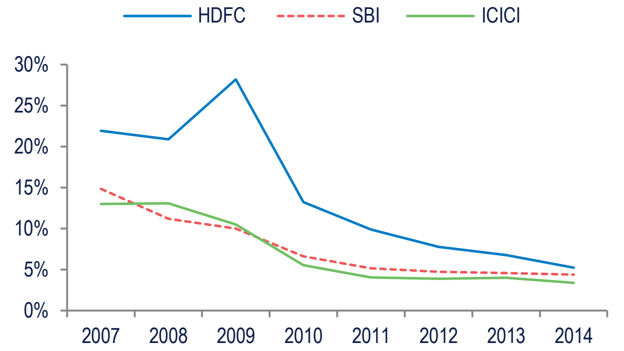
Where expenses are above the allowance, they need to be borne by the shareholder and the solvency requirement is increased. The top companies under our coverage are broadly compliant with Rule 17D on an aggregate basis and on a line of business basis. However, the requirement of expense allocations/assumptions similar across lines of business may be a deterrent, especially for companies with a higher proportion of participating policies.

Trend 5: Cost of operations coming down

As discussed earlier, operating costs as a percentage of new business will come down as the growth rate improves given operating leverage. In addition, we expect operating costs to reduce given the trend of moving towards digitisation in the life insurance industry. The share of internet is increasing, polices are getting digitised and the industry is becoming paperless. Also, there is a focus from the regulator and life insurance companies on reducing operating costs. As a result, the industry has rationalised costs during the last six years (see figures 27-30) and we expect further cost rationalisations in the coming years.

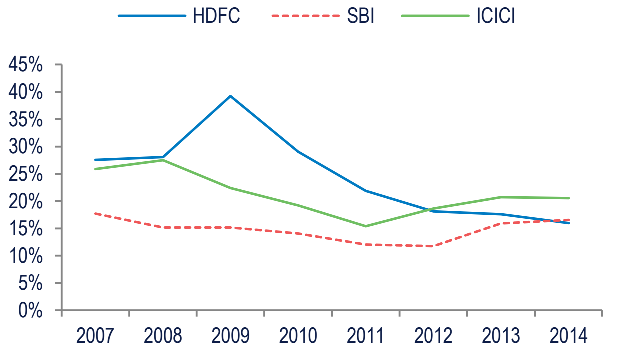
The cost savings will flow to shareholders depending on the product mix as discussed in the section on the impact of growth on valuations.

Figure 27: Opex as % of FUM for bank backed insurers



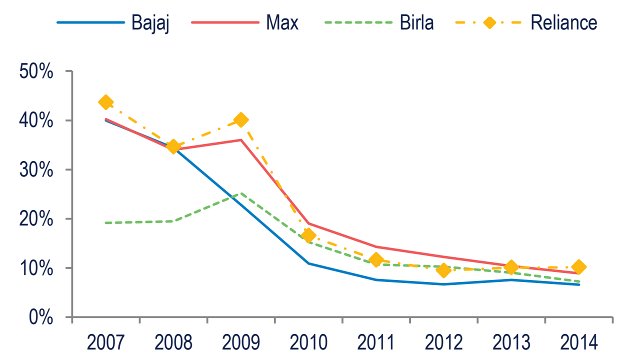
Source: Company Data, Investec Securities estimates

Figure 28: Opex as % of total premium for bank backed insurers



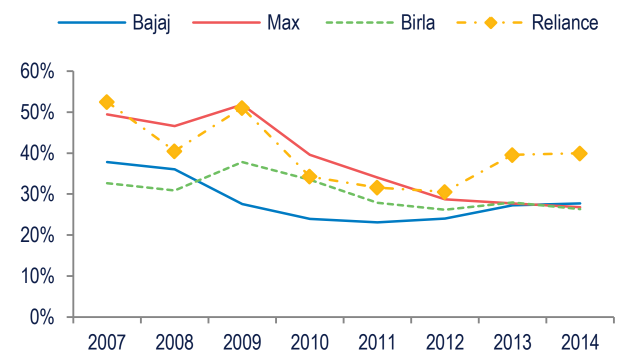
Source: Company Data, Investec Securities estimates

Figure 29: Opex as % of FUM for non-bank backed insurers



Source: Company Data, Investec Securities estimates

Figure 30: Opex % of total premiums for non-bank backed insurers



Source: Company Data, Investec Securities estimates

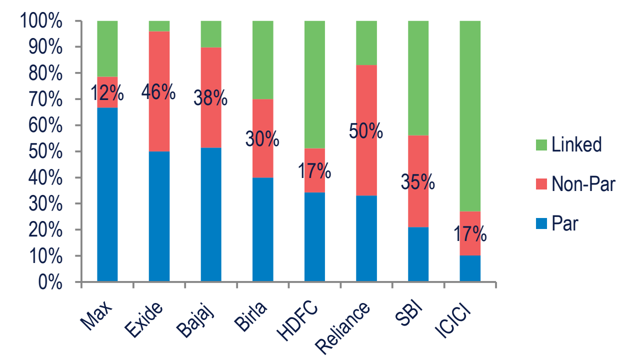
Sensitivity to the five trends

Sensitivity to the five trends will depend on product mix, distribution mix and cost structure.

Sensitivity to the five factors will depend on product mix, distribution mix and current cost structure (see figures 31 & 32). Higher sensitivity to a cyclical metric (interest rate, persistency on unit-linked product) is not necessarily a good thing. For example, ICICI Pru Life has high sensitivity to improvement in persistency given high concentration of unit-linked products, but in a downturn unit-linked policies are likely to get surrendered impacting ICICI Pru Life the most.

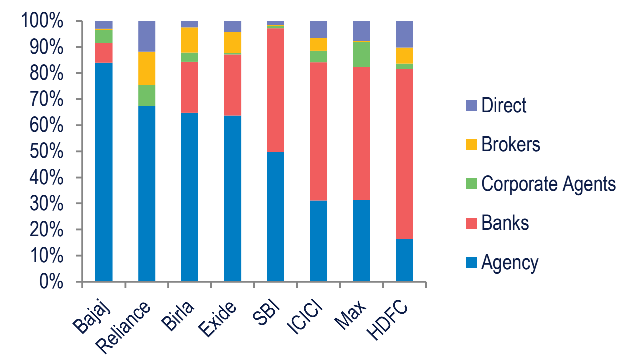
Among these, product mix is the biggest determining factor in terms of sensitivity to these trends. The key criterion for relative standing on each trends are explained in table 7.

Figure 31: Product mix of private players



Source: Company Data, Investec Securities estimates

Figure 32: Distribution mix of private players



Source: Company Data, Investec Securities estimates

Table 7: Key criterion on determining relative standing of life insurance companies with respect to these trends

Trends	Key Criterion
Trend 1 - Growth	UL and Non-Par products are highly levered to improving growth trajectory.
Trend 2 - Persistency	UL has high sensitivity to persistency, Non-Par has negative sensitivity & Par has slight positive sensitivity.
Trend 3 - Interest rates	UL has high positive sensitivity followed by Par. Non-Par is neutral with small decline in Interest rate but could be negative if interest rates decline sharply.
Trend 4 - Regulations	Top non-bank backed private players to benefit. Participating products could get negatively impacted
Trend 5 - Costs	Players with high fixed cost structure (agency led) should benefit

Source: Investec Securities estimates

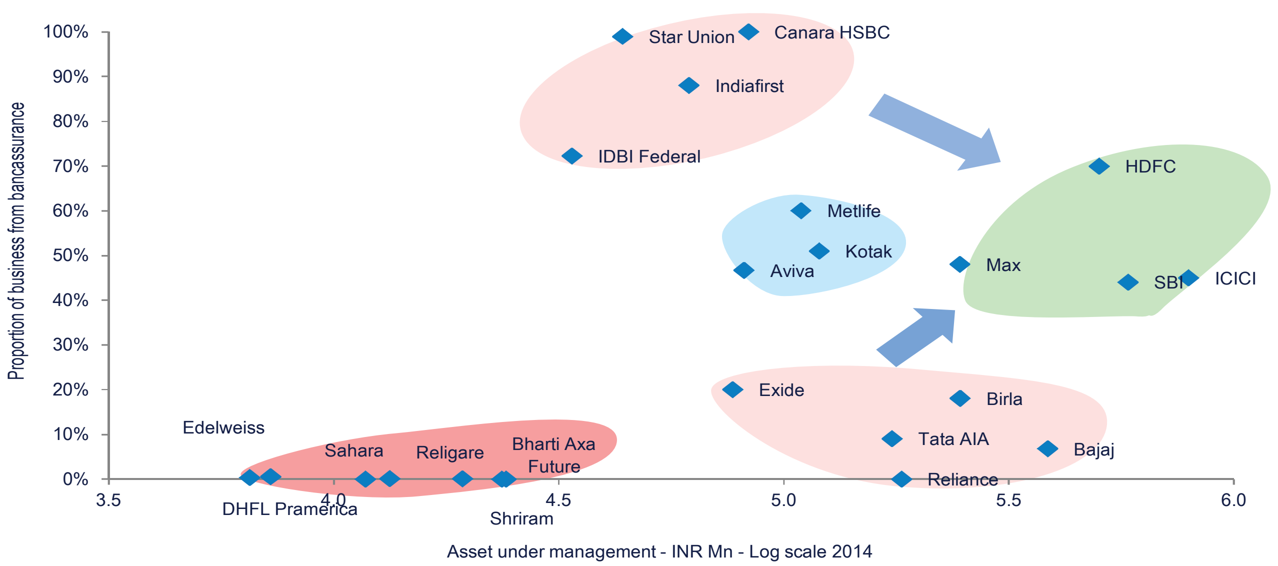
Table 8: Sensitivity of players with respect to these trends

	ICICI Prudential	SBI life	Bajaj Allianz	Max Life	HDFC Life	Reliance Life	Birla Sunlife	Exide Life
Trend 1 - Growth	●	◕	◕	◑	◕	◕	◕	◑
Trend 2 - Persistency	◕	◑	◕	◕	◕	◑	◕	◑
Trend 3 - Interest rates	●	◑	◑	◕	●	◔	◑	◔
Trend 4 - Regulations	◔	◔	◕	◑	◑	◕	◕	◕
Trend 5 - Operating costs	◕	◑	●	◑	◑	◕	◕	◕

Source: Investec Securities estimates

Based on our analysis of the trends and relative standing of the players, we expect the competitive landscape in the Indian life insurance sector to evolve as highlighted in figure 33. Bajaj Allianz Life looks best placed among the companies under our coverage to benefit from these trends.

Figure 33: India Life Insurance – Relative positioning of private players

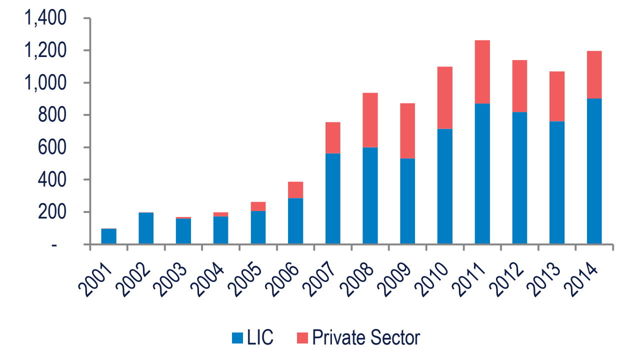


Source: Company Data, Investec Securities estimates

India life insurance industry has seen one complete cycle

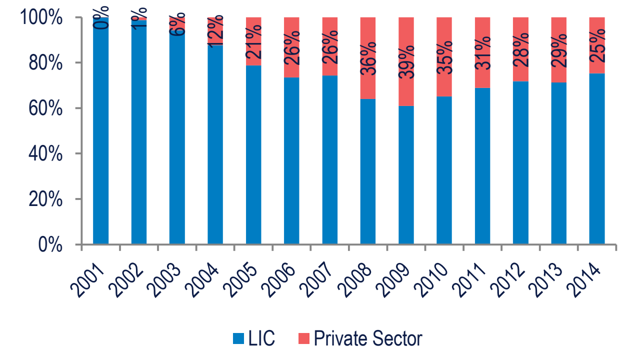
The Indian life insurance industry has seen a full cycle from trough to crest and again to trough during the past 15 years (2001-2015). During the initial years, the private sector gained market share on a low base, booming financial markets and aggressive push of unit-linked products. The private players invested in the agency and built physical infrastructure (branches). They concentrated on unit-linked products and distribution through agency. At the same time, the LIC (public sector life insurance company) also benefitted from the 'rub-off' effect of marketing of life insurance done by the private sector. The growth rate accelerated for the company (new business CAGR of 22% from 1991-2011 increased to 29% from 2001-2008 on a larger base); however, it continued its focus on traditional products. The industry grew by a 30% CAGR during 2002-08 (see figures 34 & 35).

Figure 34: Market share evolution between LIC and private players



Source: IRDA, Investec Securities estimates

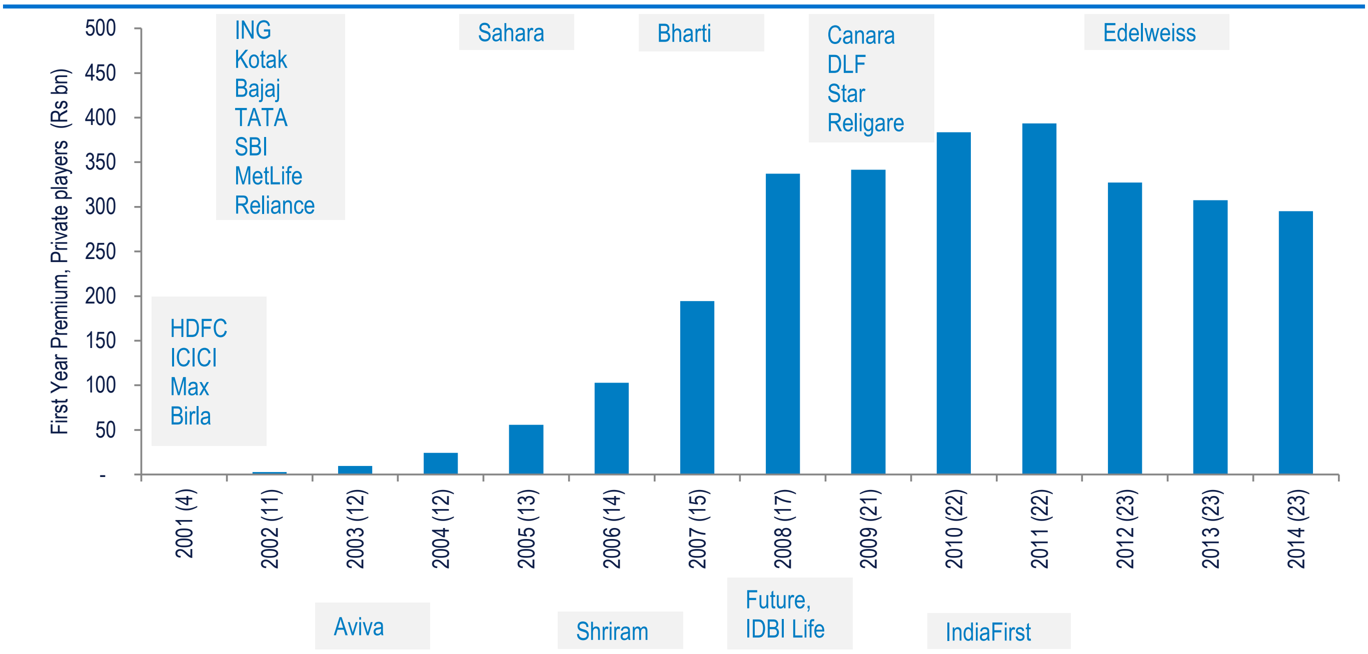
Figure 35: New business premiums (Rs Bn)



Source: IRDA, Investec Securities estimates

Then in 2008, the financial crisis hit the industry and risk aversion crept in. Suddenly, unit-linked became a bad word and business, especially for the private sector, declined. This impacted the economics given the high fixed cost structure of these players on account of significant growth in the branch network, agency network and employee base over the last seven years.

Figure 36: Entry of private players in the Indian Life Insurance sector



Source: IRDA, Investec Securities estimates

As the financial sector was coming out of the crisis, the insurance sector was hit by regulations in 2010 on unit-linked policies. This further impacted the private sector for which more than 90% of business was coming from unit-linked policies as the ability to pay commissions were reduced to less than one-third. The regulations were effected overnight, which gave no time for the private sector to prepare for them. The agency channel was particularly impacted as a) it became difficult to sell unit-linked products and b) remuneration for selling the products was reduced (see section on regulations on page 29 for more details).

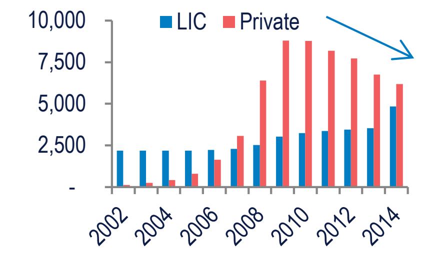
As new business premium declined, cost rationalisation became the key focus. The number of agents reduced, branches were shut down and the employee base was reduced (see figures 37-39). This also meant a reduction of share of business from a high fixed cost agency network and increase of share from bancassurance, which is a variable cost channel. As a result, players with strong bancassurance partners gained market share. The only exception was LIC, which gained market share despite no strong bancassurance.

In terms of products, the share of unit-linked products declined and share of traditional products (participating and non-participating) increased (see figures 40 & 41).

Figure 37: No. of agents in '000s

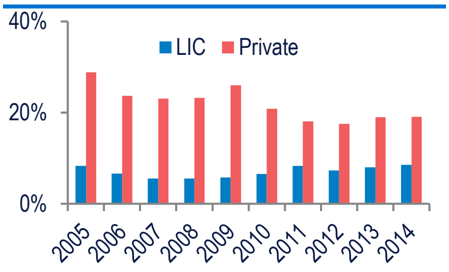
Source: IRDA, Investec Securities estimates

Figure 38: No. of offices



Source: IRDA, Investec Securities estimates

Figure 39: Operating expense ratio

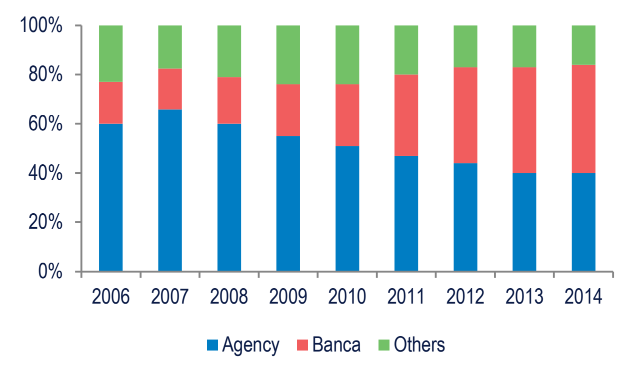


Source: IRDA, Investec Securities estimates

The regulator gave notice of product design guidelines in 2013 to be implemented from 1 January 2014. This time the final guidelines were issued after consultation with all stakeholders and adequate time was given. These guidelines have an adverse impact on the margin of traditional products, but the impact on the growth was relatively lower (compared to unit-linked guidelines).

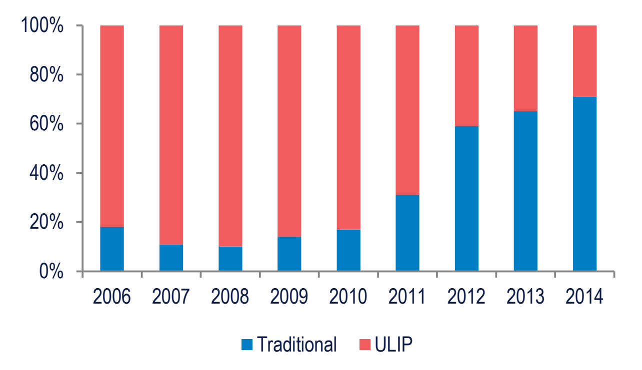
The industry has stabilised since then and bancassurance led players continued to gain market share. Robust equity markets mean an increasing proportion of unit-linked products and growth has come back for the top private players.

Figure 40: Distribution mix of private players



Source: IRDA, Investec Securities estimates

Figure 41: Product mix of private players

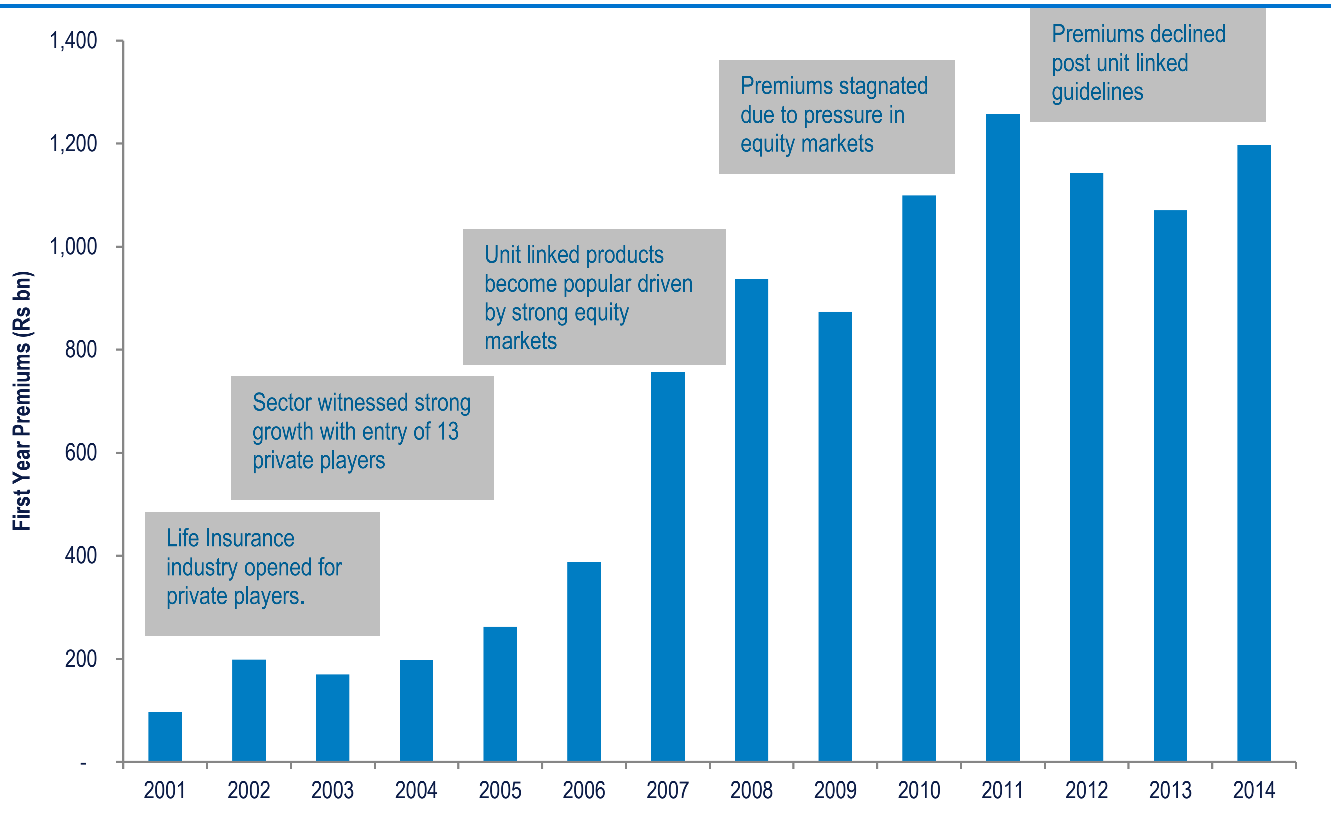


Source: IRDA, Investec Securities estimates

The private sector life insurance industry has completed a full cycle and is back to growth again. However, we believe the quality of growth is significantly better this time than in the initial phase (2002-2008) given higher protection/mortality cover, a balanced product mix, higher product tenure and better persistency.

The thought process of all industry stakeholders has changed for the better. Companies are now focusing on costs, persistency and productivity. The regulator is much more consultative and collaborative now (as opposed to 2010). The customer also understands the product and is willing to commit long-term money as opposed to speculative money earlier.

Figure 42: First Year premiums of the Industry during last 14 years



Source: IRDA, Investec Securities estimates

How should one look at the industry?

How life insurance companies make money

Life Insurance companies make money on four types of businesses: Mortality/longevity; Spreads; Fee-based & Participating

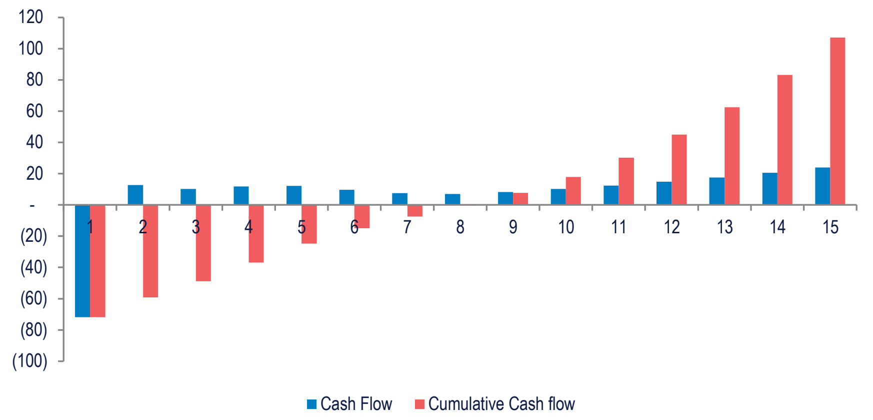
Life insurance is a long-term product with premium flowing over the life of the policy (5-30 years or more). Benefits are paid over the life of the policy and on the death of the policyholder.

There are four types of businesses through which life insurance companies make money in India:

- **Mortality/longevity business:** The insurance company takes mortality and longevity risk and charges a fee from the policyholder. The company makes or loses money based on the mortality/longevity experience.
- **Spread business:** Life insurance companies offer investment guarantees in some products (Non-Participating traditional products). They will earn or lose, based on the investment experience of the company.
- **Fee-based business:** Insurance companies charge fees on assets under management for unit-linked business, which is similar to asset management companies.
- **Participating business:** Policyholders participate along with shareholders in the profitability of the policies. In India, a maximum of 10% of profits (surplus) generated on participating business could flow to shareholders.

The characteristics of the business are such that shareholders have to incur significant costs upfront (commissions, operating expenses etc.) while revenue is lower in initial years, which increases as the policy gets older (see the cash flows of a typical life insurance policy for a shareholder in figure 43).

Figure 43: Cash flow of a typical unit linked policy



Source: Investec Securities estimates

Life Insurance reporting is complex and difficult to understand. The statutory accounting disclosures in India give little information on company performance. What adds to the difficulty, especially in India, are inconsistent and incomplete embedded value disclosures by companies. We have attempted to analyse the popular accounting practices in the sector.

Statutory disclosures

Statutory disclosures do not give adequate information about performance of the company.

Indian Life Insurance companies are required to make disclosures in line with the IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000. These statutory disclosures are exhaustive with a lot of information but lack usability from an analyst perspective as it is difficult to assess the performance and value the company using them. The drawbacks of these disclosures are as follows:

- **Acquisition costs are up-fronted:** Life Insurance is a long-term business where the policies incur losses in the first year and generate positive cash flows in subsequent years. In statutory accounting, entire costs are up-fronted and expensed through the P&L which violates the 'matching principle' and hence gives little information on the current year's performance.

- **Separate accounts for policyholders and shareholders:** Statutory accounting requires separate accounts for policyholders (Revenue account or Technical account) and shareholders (shareholders' account) versus the single account under IFRS. This further complicates the matter as how the two accounts interact causes confusion.
- **Actuarial estimates of some key line items:** The policyholders' liabilities are actuarially determined with several forward-looking assumptions (persistency, mortality, expenses, returns etc). It becomes very problematic projecting this line item for the future and statutory profitability has high sensitivity to it.

Statutory accounting will show low profitability when a business is growing given the up-fronting of costs (new business strain) and high profitability when new business growth dwindles. Therefore, statutory profitability and net worth are nowhere close to the economic profitability or economic wealth of the company.

Embedded value addresses the shortcomings of statutory disclosures and captures economic value of the policies from shareholders' perspective.

Embedded Value accounting

Embedded Value accounting is developed with the peculiarities associated with life insurance business in mind and it tries to captures the economic value of the policy from a shareholder perspective.

Embedded value is defined as the value of the company if one assumes the company stops underwriting any incremental business and zero cost associated with the incremental business. Mathematically, it is the summation of present value of profits of all the policies (value of in-force book, VIF) underwritten until now and surplus capital. The surplus capital is over and above capital for regulatory requirement.

EV gives a proxy for the economic value of the firm and the change in embedded value gives an idea of the company's performance. Hence, it is a much better accounting methodology for analysing the company's performance from a shareholder perspective. See table 9 for a simplistic illustration of embedded value accounting methodology.

Table 9: An simplistic illustration of embedded value calculations

Year	0	1	2	3	4	5	6	7	8	9	10
Premium (P)	100	100	100	100	100	100	100	100	100	100	100
Cash flows (CF_t)	-19	0	1	3	5	7	10	12	15	18	21
PV of cash flows @12%	-17	0	1	2	3	4	4	5	5	6	6
Value of new business (VNB)	**19**										
VNB Margin (%) = (VNB/P)	**19%**										
Net Worth (start of year) (NW_t)	30	11	11	12	16	21	28	37	50	64	82
VIF (start of year) (VIF_t)	0	40	45	44	41	38	33	28	21	15	8
EV (start of year) ($EV_t = NW_t + VIF_t$)	30	51	56	56	57	58	61	65	71	79	90
Net Worth (NW_{t+1}) = ($NW_t + CF_t$)	11	11	12	16	21	28	37	50	64	82	103
VIF (end of year) (VIF_{t+1})	40	45	44	41	38	33	28	21	15	8	0
EV (end of year) ($EV_{t+1} = CF_{t+1} + VIF_{t+1}$)	**51**	**56**	**56**	**57**	**58**	**61**	**65**	**71**	**79**	**90**	**103**

Source: Investec Securities estimates

However, there are also some drawbacks – mainly on account of the assumptions to estimate future profitability of the policies. The Embedded Value accounting requires long term assumptions at the initiation of policies which can be significantly different from reality. The assumptions are broadly in two categories: (a) economic assumptions, and (b) non-economic assumptions.

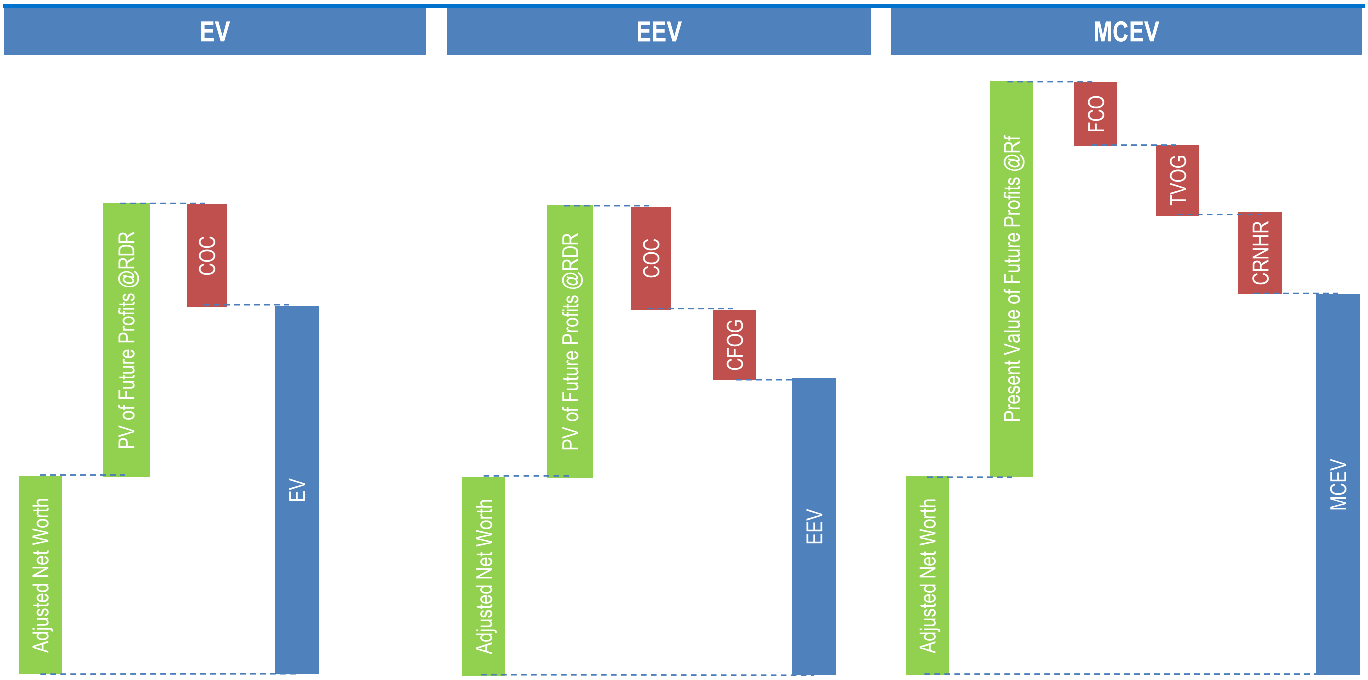
Economic assumptions include investment return, the risk discount rate and inflation assumptions. Non-economic assumptions are persistency, costs and mortality assumptions.

Embedded value suffers due to long term assumptions made for computing it.

There are three broad methodologies for embedded value calculations: (a) Embedded Value (EV) methodology or Achieved Profit Methodology (APM); (b) European embedded value (EEV); and (b) Market consistent embedded value (MCEV). See figure 44 for a comparison of these.

- **Embedded Value Methodology:** The value of adjusted net worth plus discounted value of future profits from existing business minus cost of capital. Also called achieved profit methodology.
- **European Embedded Value:** The value of adjusted net worth plus discounted value of future profit from existing business minus cost of capital minus cost of financial options and guarantees.
- **Market Consistent Embedded Value:** The value of adjusted net worth plus discounted value of future profits (at risk-free rate) from existing business minus frictional cost of capital minus time value of financial options and guarantees (TVFOG) minus cost of residual non-hedgeable risks (CRNHR). MCEV is calculated using risk neutral market consistent economic assumptions. Hence, the risk discount rates and investment return rates are assumed to be risk free rates in this methodology.

Figure 44: Comparison of three embedded value methodologies



Source: Investec Securities estimates

Glossary on embedded value methodology

EV = ANW (FS + RC) + VIF (PVFP – COC)

EEV = ANW (FS + RC) + VIF (PVFP – COC – CFOG)

MCEV = ANW (FS + RC) + VIF (PVFP – FCOC – CRNHR – TVFOG)

- **Adjusted Net Worth (ANW) –** the realisable value of statutory capital and free surplus after taking into consideration market value of assets and liabilities.
- **Cost of capital (CoC) –** the cost of holding required regulatory (solvency) capital by the company.

- **Cost of options and guarantees (CFOG)** – the intrinsic cost of options and guarantees.
- **Frictional cost of capital (FCOC)** – cost of capital is renamed under MCEV with impact of taxes and transaction costs factored into the calculation.
- **Time value of options and guarantees (TVFOG)** – the time value of options and guarantees. TVFOG is used in MCEV with the intrinsic value of the options and guarantees priced in the cash flows (PVFP).
- **Costs of residual non-hedgeable risks (CRNHR)** – the costs associated with the risks that cannot be hedged through any financial instruments. The non-hedgeable risks include mortality, morbidity, longevity, persistency, operating expenses etc.

The major reason for the introduction of MCEV was to make embedded value comparable across companies which were problematic in EEV given the difference in economic assumptions (risk discount rates and investment return rates).

In an Indian context, the EEV will be slightly lower than EV as financial options and guarantees are minimal in India, MCEV will be higher than both the EEV and EV given that future profits are discounted at a lower discount rate (risk-free rate) and the TVFOG component is low in India.

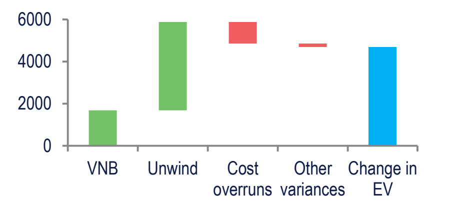
Cost overruns and low persistency have been problems in India

Embedded value growth for Indian Life Insurers has been impacted by cost overruns and low persistency.

During the last five years, companies in India suffered on account of low persistency and high cost overruns due to volatile capital markets, declining growth, mis-selling and changing product regulations. The extent of the problem had been so severe that negative variances have led to virtually no growth in embedded value (see figures 45-56) for some players. The subdued growth of embedded value has impacted shareholder returns and investor confidence in the sector.

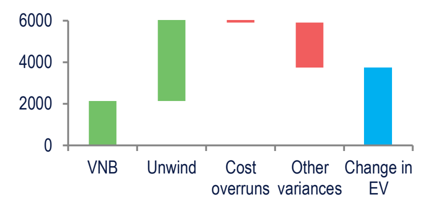
We expect a better embedded value growth profile from hereon on structural and cyclical trends in the sector (discussed earlier in the report on pages 3-20).

Figure 45: Max Life EV Walk - 2012



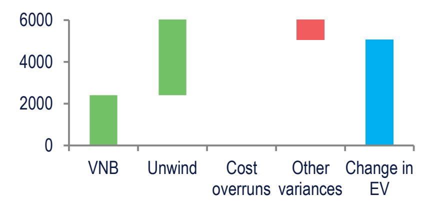
Source: Investec Securities estimates

Figure 46: Max Life EV Walk - 2013



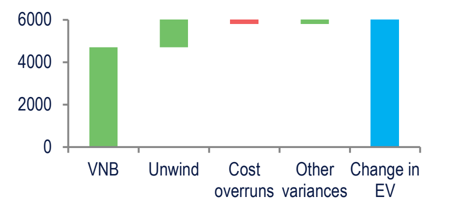
Source: Investec Securities estimates

Figure 47: Max Life EV Walk - 2014



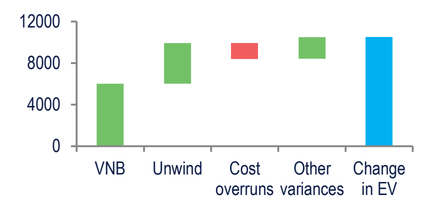
Source: Investec Securities estimates

Figure 48: HDFC Life EV Walk - 2012



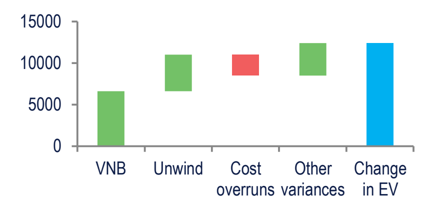
Source: Investec Securities estimates

Figure 49: HDFC Life EV Walk - 2013



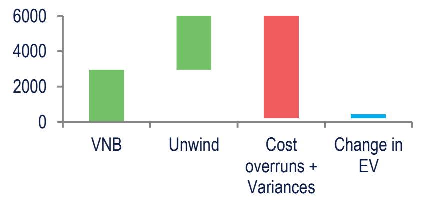
Source: Investec Securities estimates

Figure 50: HDFC Life EV Walk - 2014



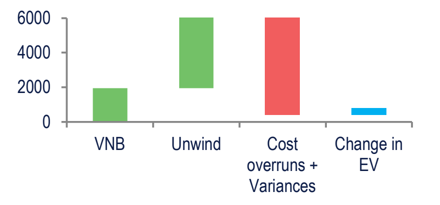
Source: Investec Securities estimates

Figure 51: Birla Sun Life EV Walk - 2012



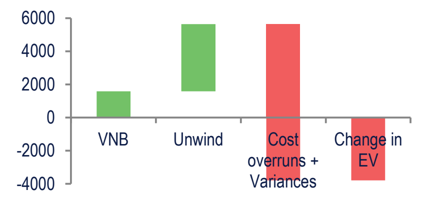
Source: Investec Securities estimates

Figure 52: Birla Sun Life EV Walk - 2013



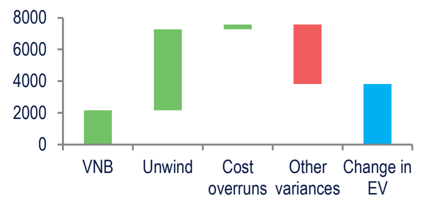
Source: Investec Securities estimates

Figure 53: Birla Sun Life EV Walk - 2014



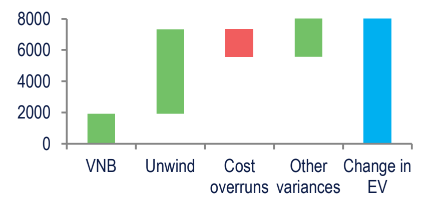
Source: Investec Securities estimates

Figure 54: Bajaj Allianz Life EV Walk - 2012



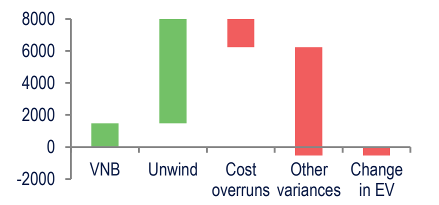
Source: Investec Securities estimates

Figure 55: Bajaj Allianz Life EV Walk - 2013



Source: Investec Securities estimates

Figure 56: Bajaj Allianz Life EV Walk - 2014



Source: Investec Securities estimates

Note that the players that have been able to control cost overruns are those with best-in-class persistency and growing new business premiums, while players with poor persistency and declining premiums have been reporting higher cost overruns and other negative variances.

Investec

Regulations have been an issue in the past

The sector has been under pressure for the last five years on account of frequent regulations, especially on the product and distribution side. The major regulatory changes in the industry have been as follows:

- **Unit-linked product guidelines (2010):** Unit-linked guidelines limited the insurers' ability to pay intermediaries by capping the overall charges on the product (see table 10). The other changes include an increase in the minimum lock-in period to 5 years (previously 3 years), a cap on surrender charges (see table 11) and an increase in mortality cover (see table 12).

Table 10: Overall charges are capped

Tenure of product	Max allowable reduction in yield (annualized)
5	4.00%
6	3.75%
7	3.50%
8	3.30%
9	3.15%
10	3.00%
11 and 12	2.75%
13 and 14	2.50%
15 and thereafter	2.25%

Source: IRDAI, Investec Securities estimates

Table 11: Surrender charges are capped

Year in which discontinued	Premium < Rs.25,000/-	Premium > Rs.25,000/-
1	Rs3,000	Rs6,000
2	Rs2,000	Rs5,000
3	Rs1,500	Rs.4,000
4	Rs1,000	Rs2,000
5 and onwards	NIL	NIL

Source: IRDAI, Investec Securities estimates

Table 12: Mortality cover is increased

	Age at entry	
	<45 Years	>45 Years
Single Premium (SP)	125% of SP	125% of SP
Regular Premium (RP)	Max (10 x RP, 0.5 x T x RP)	Max (7 x RP, 0.25 x T x RP)

Source: IRDAI, Investec Securities estimates

- **Variable insurance product guidelines (2010):** Variable insurance product gives the flexibility to change the mortality and savings proportions of an insurance policy as an individual's need changes. They are also known as Universal Life products. Variable insurance products are banned on the unit-linked platform in the 2010 guidelines. Commissions and expenses were capped, constraining the insurers' ability to pay the intermediaries (see table 14). Surrender charges were also capped in the guidelines (see table 13).

Table 13: Surrender charges are capped on VIP

Policy Year	Minimum surrender benefit payable
1st,2nd & 3rd	Entire balance in the policy account should be paid at the end of lock-in period
4th & 5th	98% of the balance in policy account should be paid immediately
After 5th	Entire balance in the policy account should be paid immediately

Source: IRDAI, Investec Securities estimates

Table 14: Commissions to the intermediary are capped

Year	Maximum expense (inc. commission)
1st	27.5% of the first year premium
2nd & 3th	7.5% of second and third premium
4th	5% of the 4th year & subsequent premium
On Top-up premiums	3% of top-up premium

Source: IRDAI, Investec Securities estimates

- **Pension product guidelines (2010):** The requirement of a guarantee (non-zero) and buying an annuity from the same insurer limited the attractiveness of the product for both policyholder and insurer.
- **Product design guidelines (2013):** Product design guidelines banned NAV guaranteed products. It also capped commissions and surrender charges (see tables 15-17 below for more details). The implication of the guidelines was a decline in the margins on the products.

Table 15: Commissions are capped and linked to the tenure of the product

Premium paying term	1st Year	2 & 3 Years	>3 Years
5	15%	7.5%/5%*	5%
6	18%	7.5%/5%*	5%
7	21%	7.5%/5%*	5%
8	24%	7.5%/5%*	5%
9	27%	7.5%/5%*	5%
10	30%	7.5%/5%*	5%
11	33%/30%*	7.5%/5%*	5%
12 years or more	35%/30%*	7.5%/5%*	5%

Source: *For brokers, IRDA

Table 16: Minimum surrender benefit on the traditional products

	Regular premium company	Single premium company
2 & 3 Year	30% of premium paid less SBP	70% of premium paid less any survival benefit paid
4, 5,6 & 7 year	50% of premium paid less any SBP	90% of premium paid less any survival benefit paid
Last 2 years if policy term < 7 years	90% of premium paid less any SBP	90% of premium paid less any survival benefit paid

Source: IRDA

Table 17: Minimum mortality cover

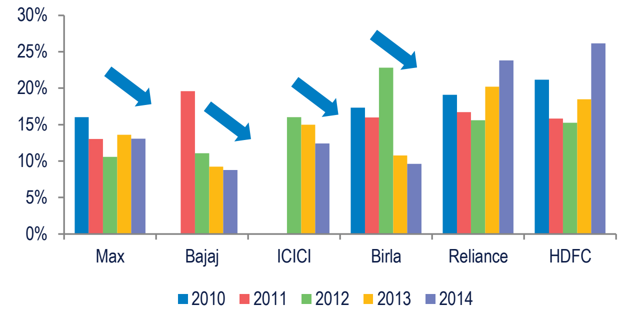
	Age at entry	
	Less than 45 years	45 years and above
Single premium (SP)	125% of SP	110% of SP
Regular premium (RP)	Max(10x RP, 105% of all the premiums)	Max(7x RP, 105% of all the premiums)

Source: IRDA

So to recap the common themes: (a) insurers' reduced ability to pay to intermediaries; (b) a cap on surrender charges; (c) a higher protection component; and (d) increased tenure of the product.

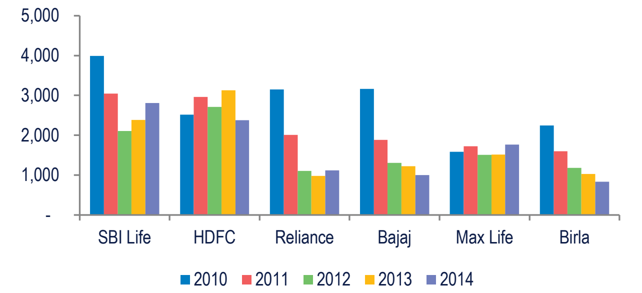
These changes have affected growth and margins in the sector (see charts below). The agency-based players have been particularly affected by the guidelines as the entire agency network needs to be trained with regard to new product designs, which is a herculean task with an force of over 2m agents. Moreover, the slow product approval process at the IRDA impacted product availability. The IRDA took 6-9 months in product approval and each product needs to be filed with the regulator for approval post the guidelines.

Figure 57: VNB Margins have declined for most players since 2010



Source: Company Data, Investec Securities estimates

Figure 58: Individual APE have declined since 2010



Source: Company Data, Investec Securities estimates

One can question the implementation of these regulations, but the direction and intent was right in our view. Moreover, we believe unit-linked guidelines may actually have saved the industry. If insurers were to continue with the aggressive practices of the pre-2011 era, the industry would have attracted widespread media and public scrutiny, which could lead to a crisis, as we have seen in the microfinance industry.

Bancassurance and direct channel has gained share for private players.

How life insurance is distributed in India

Until 2008, life insurance had been primarily distributed through the agency channel, contributing more than 80% of the individual business. However, post the unit-linked guidelines (which impacted the economics for agents); the bancassurance channel emerged as the second largest channel with a size of c.Rs100bn new business premium (FY14).

The emergence of the bancassurance channel has been facilitated by the regulations (which impacted the insurer's ability to remunerate agents), high fixed cost structure of agency (which impacted agency channel economics during downturn), changing regulations (operation hurdle to train millions of agent in line with new regulations) and private banks gaining market share (private banks have been successful in cross-selling life insurance).

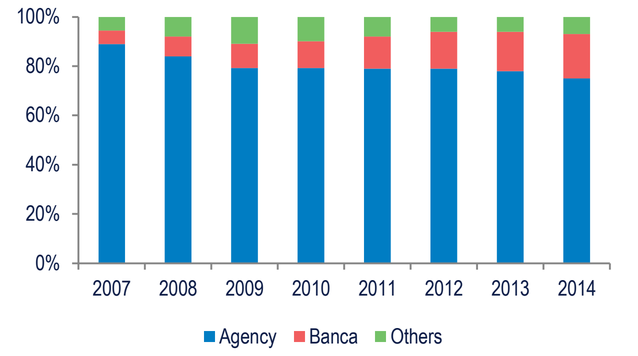
For private players, the bancassurance channel now is as large as the agency channel in terms of new business premium. During the last five years, a strong bancassurance partner was the single most important factor behind the market share gains of the insurance companies.

The third channel which is gaining traction is direct channel on account of increasing online sales and increasing trend of salaried agents.

The other channels like corporate agency, insurance brokers and referrals have lost share on account of regulation:

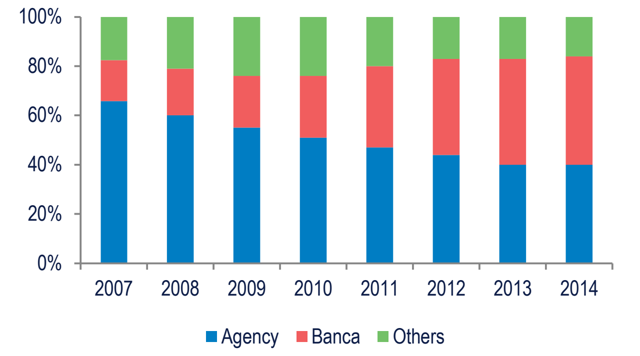
- The IRDA put a cap on commission on the referral business in 2010.
- Corporate agency and insurance broking sourced low quality business which impacted persistency. Hence, after a cap on surrender penalties, these channel become uneconomical.

Figure 59: Distribution mix of total sector



Source: IRDA, Investec Securities estimates

Figure 60: Distribution mix for private players



Source: IRDA, Investec Securities estimates

A diversified distribution strategy is critical

Both agency and bancassurance channels are critical. Agency is a high fixed cost channel with high initial investment and is owned and control by the company. Bancassurance, on the other hand, is a variable cost structure channel but the insurer has limited control of the channel. The bancassurance channel has gained share because of a low base (insurance distribution through banks in a meaningful manner started only in 2008) and agency was under pressure as highlighted earlier. We expect this trend to reverse given our expectation of increasing commissions for agency, open architecture in bancassurance and economic revival. Hence, from the perspective of insurers, high dependence on any one channel could be risky.

What products are sold in India?

The products are offered on three platforms:

- **Participating** – A minimal return is guaranteed and policyholders participate in the profit of the policy. Also called with-profit policies. In India, the surplus is shared in a 90:10 ratio with 90% going to the policyholder and 10% to the shareholder as prescribed by the Insurance Act, 1938.
- **Non-participating** – This is a guaranteed product where the pay-outs are fully guaranteed at the start of the policy. Policyholders do not participate in the profits of the policy. Pure protection products fall under this category.
- **Unit-linked** – The benefits are linked to the value of a specific block of assets (equity, bonds etc.). There are no guarantees on the pay-outs.

In terms of timing of cash flow and needs of the policyholder, the products are classified in the following manner:

- **Pure protection (Term insurance)** – The product covers the mortality risk for a specific term (tenure of the product). A fixed pay-out is guaranteed in the event of death of the policyholder.
- **Endowments/savings** – In addition to covering mortality risk, the product pays back a sum to the policyholder.
- **Pension/Annuities** – In addition to the mortality risk, the product provides a savings avenue for retirement. The fund can be converted into a fixed annuity at the time of retirement, which will cover longevity risk.

New business strain

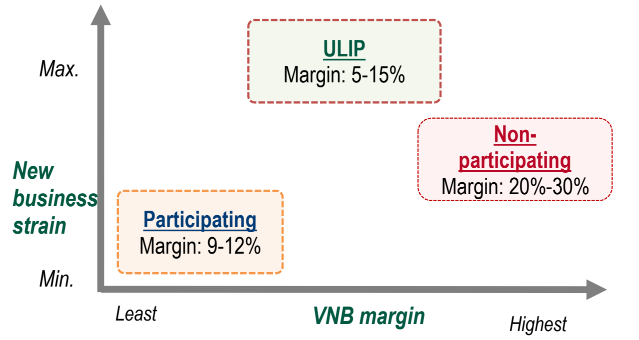
*"New business strain arises when the early years' premiums under a contract are inadequate to cover the initial commission, expenses and statutory reserving. Strain mainly arises at contract inception, but it is possible to have further strains in subsequent years, usually lower. Rapidly growing insurance companies experience high strain. New business strain leads to statutory losses for Life Insurance Companies in its initial years of operation." **ICICI Prudential Life, Glossary of Insurance terms***

Margins and new business strain on the products

Non-participating products have the highest margins and medium new business strain. Participating products have the lowest margins but lowest new business strain, resulting in the lower capital requirement of these policies and leading to a higher return on capital (see figure 61). Note that participating products are least sensitive while unit-linked are most sensitive to changes in assumptions like expense, persistency and investment return assumptions (see pages 3-20 for more details).

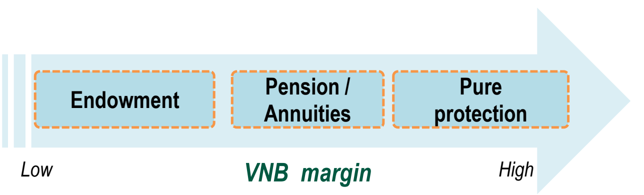
In terms of second classification, pure protection products offer highest margins and endowment/saving products offer lowest margins (see figure 62). One of the reasons for the low margins of Indian life insurance companies (vs. global peers) is a high proportion of endowment products in the product mix.

Figure 61: New business strain versus margins for products classified on product platform



Source: Investec Securities estimates

Figure 62: VNB margins for products classified based on cash flows



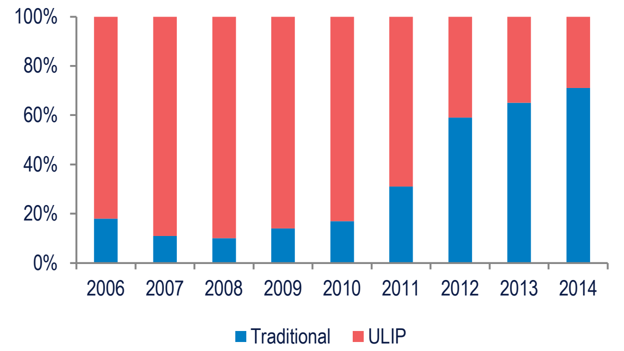
Source: Investec Securities estimates

How the composition of product mix has changed?

Life insurance is a push product and hence the product sold is proportional to intermediaries' remuneration which is a function of regulations and insurer's strategy. Hence, the product mix with respect to product platform is transitory to that extent. For example, unit linked contributed c.90% of sales in 2010 for private players which reduced to less than 30% in 2014 (see figure 63).

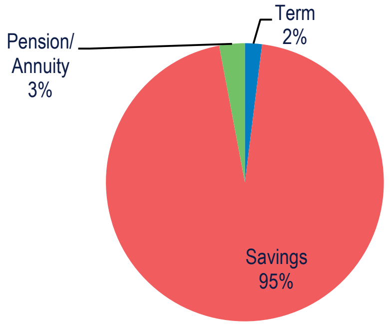
However, as per the second classification of products, the mix is usually static with more than 90% of new business contributed by endowment/savings plans (see figure 64). Pure protection products are gaining traction but their contribution remains low. Pension products failed to attract insurers' and policyholders' attention on account of regulations, taxation and requirement for a mandatory annuity from same insurer.

Figure 63: Product mix for private players based on platform



Source: IRDAI, Company Data, Investec Securities estimates

Figure 64: Product mix based on the timing of cash flows (2014)

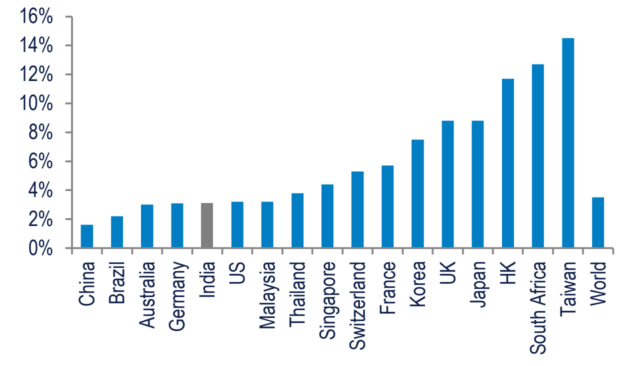


Source: Investec Securities estimates

Indian Life Insurance industry vs other geographies

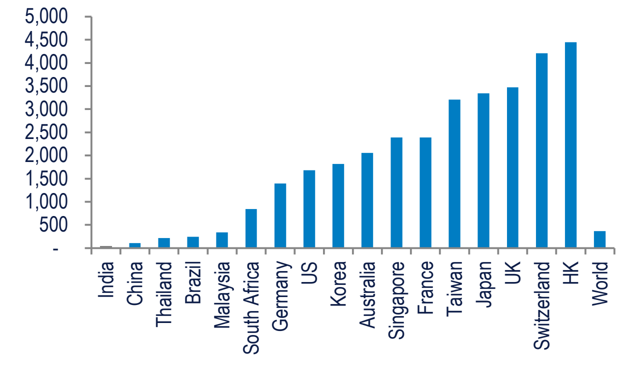
- **Penetration and density:** India has one of the lowest levels of life insurance penetration and density in the world (see figures 65 & 66).

Figure 65: Life Insurance penetration (Premium as % of GDP)



Source: IRDAI, Swiss Re, Investec Securities estimates

Figure 66: Life Insurance density (Premium per Capita)



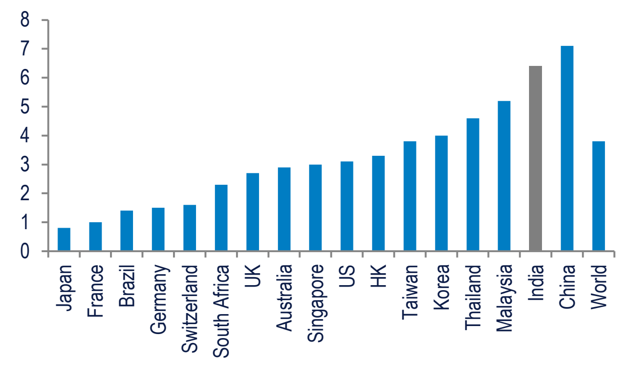
Source: IRDAI, Swiss Re, Investec Securities estimates

- **GDP growth and demography:** India has one of the youngest populations and highest estimated GDP growth rates (see figure 67 & 68).

Figure 67: Median age of the population

Source: IMF, Investec Securities estimates

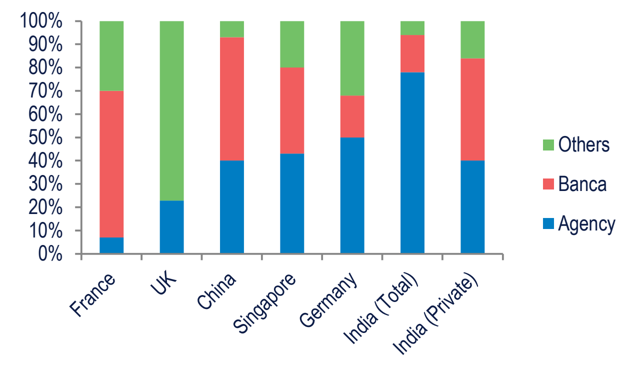
Figure 68: GDP growth forecast (2015)



Source: IMF, Investec Securities estimates

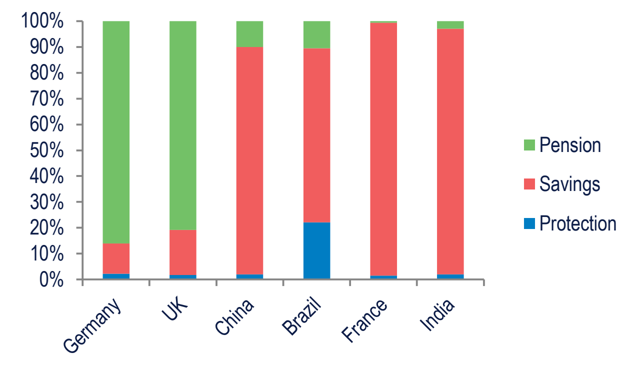
- **Distribution mix and product mix:** India has one of the highest proportion of business coming from the agency channel due to the success of LIC's agency channel. Savings products form the highest proportion of insurance sales in India (see figures 69 & 70).

Figure 69: Distribution mix of Life Insurance



Source: Insurance Europe, Regulators' websites, Investec Securities estimates

Figure 70: Product mix of life insurance



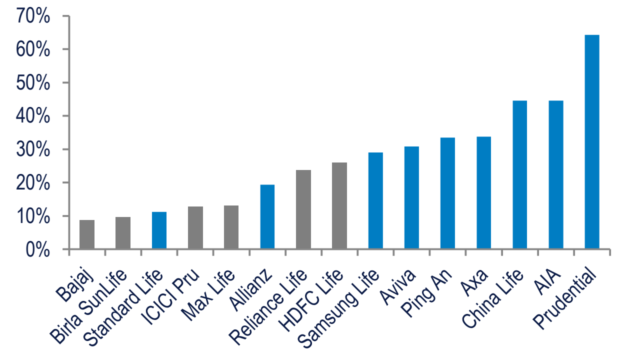
Source: Insurance Europe, Regulators' websites, Investec Securities estimates

India insurers' vs Global Insurance companies

Indian Life insurance players are still in the nascent stage (less than 15 years old) versus global player (over 50 years old). Hence, the two (Indian players and their global counterparts) are not strictly comparable. Still, we try to compare them to illustrate the long-term potential of the Indian players. Indian players have:

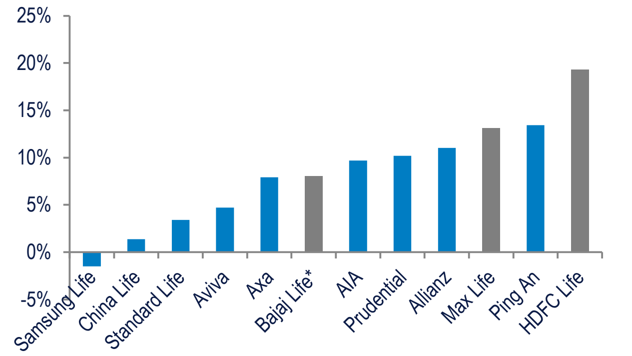
- **Low VNB margins:** Margins are lower (versus global players) in India given strict regulations, a lower proportion of high margin pension/annuity products, low persistency and low tenure of products in India (see figure 71).
- **High return on embedded value:** The RoEVs are higher for Indian players despite low margins due to (a) high discount rates which increases the un-wind of VIF and return on shareholders' funds; and (b) a high contribution from VNB to embedded value due to relatively newer businesses – VNB/EV would be highest in India (see figure 72).

Figure 71: Margins (VNB) are low in India



Source: Company data

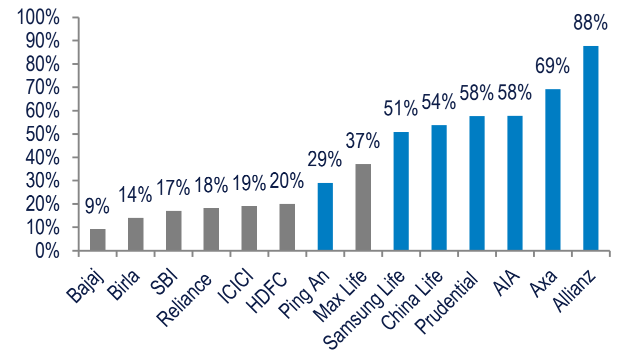
Figure 72: RoEV is high despite low VNB margins



Source: Company data

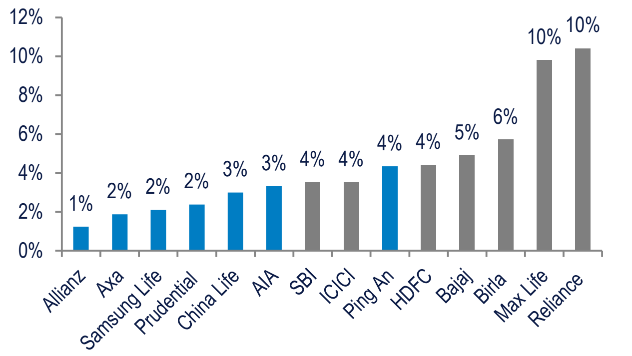
- **Low commissions payout:** Commissions as a percentage of new business premium (APE) are a fraction of global peers despite the lower age of Indian Insurers (see figure 73).
- **High operating expenses:** Despite paying lower commissions compared to global peers, operating costs are much higher. This could be a source of operating leverage for Indian life insurance companies given the fixed nature of these costs as discussed earlier (see figure 74).

Figure 73: Commissions/acquisition costs as % of APE



Source: Company data

Figure 74: Total operating costs (comm + opex) as % FUM



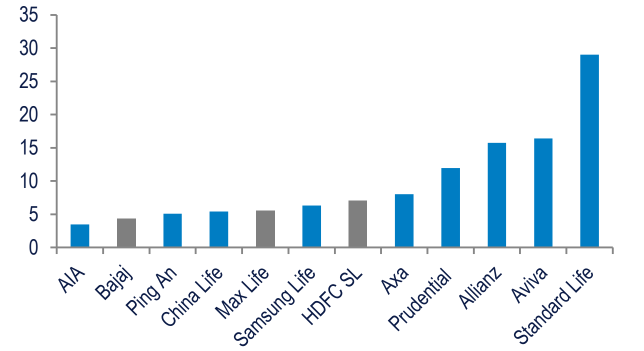
Source: Company data

- **Lower risk on balance sheet:** The guarantees are minimal in India with the majority of products sold as participating and unit-linked with no or minimal guarantees. Also, annuities which cover longevity risks form a negligible portion of the product mix for Indian insurers. Hence, balance sheet risks are lower in India.

  In addition to this, Indian life insurers deliver higher value addition per unit of FUM. FUM/EV is a measure of the FUM that is needed for one unit of embedded value (see figure 75).

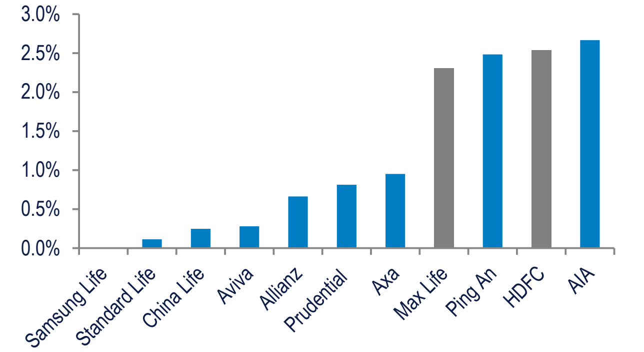
  Moreover, EV Profit/FUM is one of the largest for Indian players signifying higher value addition for shareholders per unit of FUM (see figure 76).

Figure 75: FUM/EV (leverage) for life insurers



Source: Company data

Figure 76: EV Profit as percentage of FUM



Source: Company data

- **Low Valuations:** Indian life insurance companies are not directly listed, but their implied valuations – based on either the market capitalisation of holding companies or recent transactions – are typically lower than their Asian counterparts and higher than developed countries counterparts.

Table 18: Relative valuations of life insurance companies

	Implied Market Value	P/EV	Implied VNB Multiple	P/VNB	P/FUM	FY15E RoEV
Indian Life Insurers						
Reliance Life	718	1.5	4.7	15.2	0.3	10%
Birla Sun Life	774	1.5	9.7	30.6	0.2	10%
Bajaj Allianz	1,423	1.2	8.7	59.8	0.3	12%
Max Life	1,814	2.0	17.7	34.8	0.5	16%
HDFC Life	2,827	2.3	13.4	23.6	0.4	20%
Foreign Insurance Players						
AIA	80,585	2.1	22.5	43.7	0.7	12%
China Life	136,213	1.9	17.0	36.6	0.5	33%
Ping An	107,976	3.5	26.6	37.2	0.7	30%
Samsung Life	18,815	0.8	(3.8)	16.6	0.1	2%
Aviva	32,652	1.6	9.9	25.7	0.1	5%
Axa	60,867	1.3	6.4	26.1	0.1	8%
Prudential	63,697	1.8	6.5	14.7	0.1	11%
Standard Life	13,992	1.1	2.7	28.8	0.0	3%
Allianz	30,906	1.9	9.5	20.6	0.1	-12%

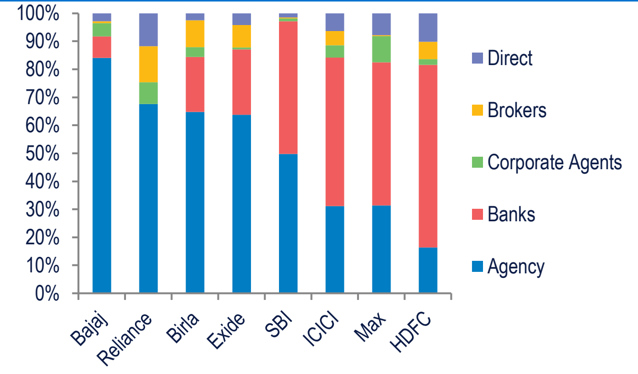
Source: Factset, Investec Securities estimates

Relative positioning of life insurance companies

We analyse life insurance companies on various parameters, including distribution product mix and persistency, concluding that Max Life and HDFC Life top most metrics.

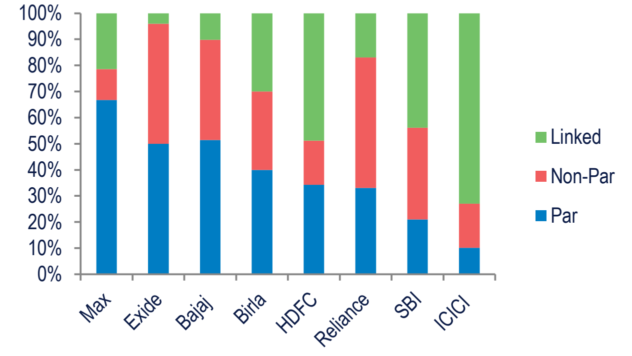
- **Distribution:** We rate companies with a balanced distribution mix with more than 50% of business coming from the agency network and 30%-40% business coming from bancassurance as the ideal mix.
- **Product mix:** Again, we rate companies with a balanced product profile highly. High dependency on a particular product, especially unit-linked products, has caused problems for the industry in the past. Also, tenure of the product is important to shareholders' value creation and we thus rate companies with long tenure of products.

Figure 77: Distribution mix (2014)



Source: Company data

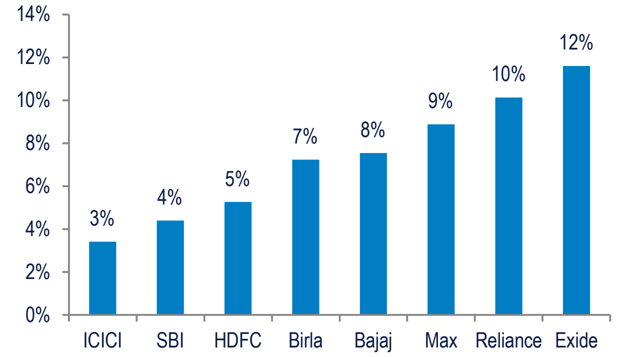
Figure 78: Product Mix (2014)



Source: Company data

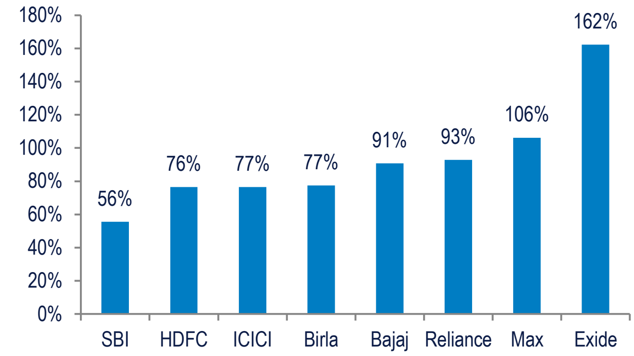
- **Operating expenses:** Operating expenses are the key to measuring the operating efficiency of a life insurance company and a driver for embedded value accretion.

Figure 79: Expenses (opex + commissions) as % of FUM (2014)



Source: Company data

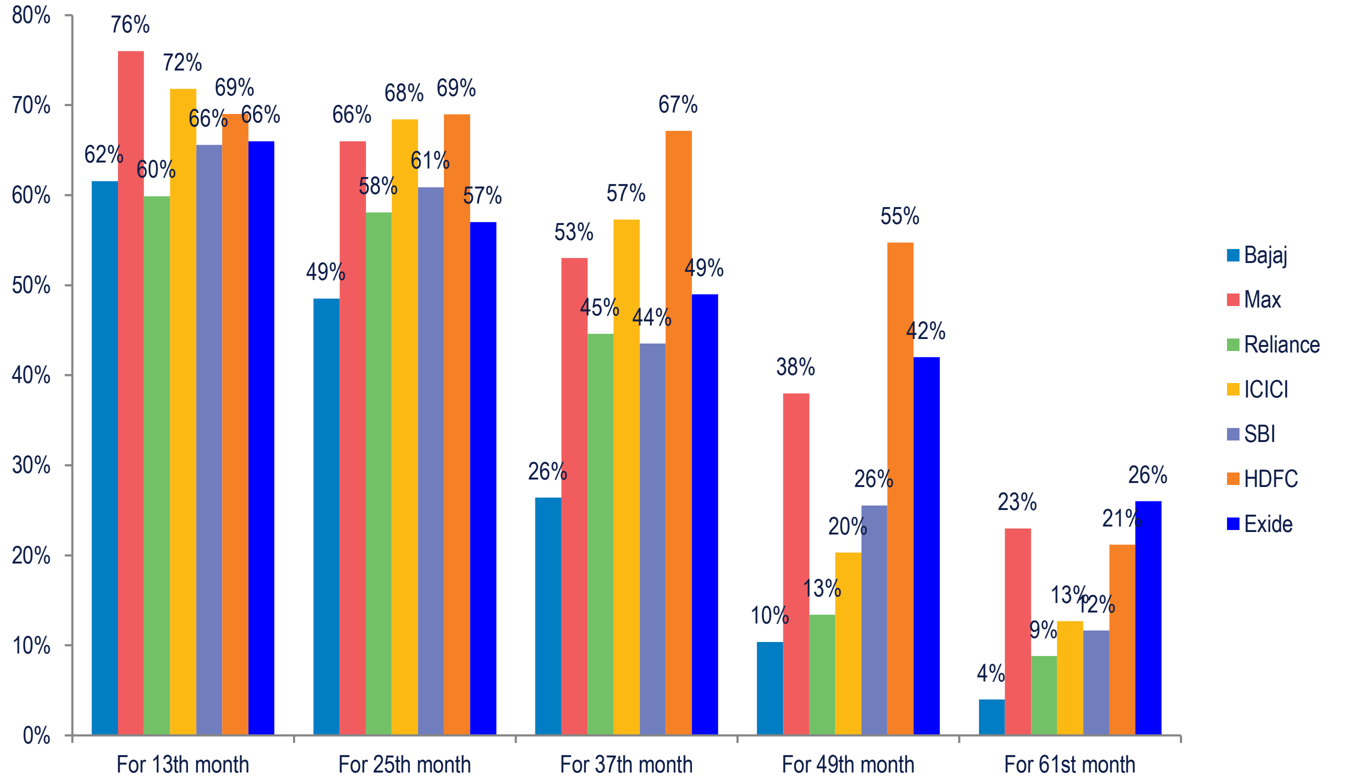
Figure 80: Expenses (opex + commissions) as % APE (2014)



Source: Company data

- **Persistency:** In our view, persistency is one of the most important metrics in evaluating a life insurance company. Persistency measures the renewal rate of policies which in turn measures the quality of selling, quality of product, product performance etc. HDFC Life and Max India are at the top among the private players. Max Life and Exide Life have the best persistency in the 61st month bucket on account of higher traditional products in the product mix.

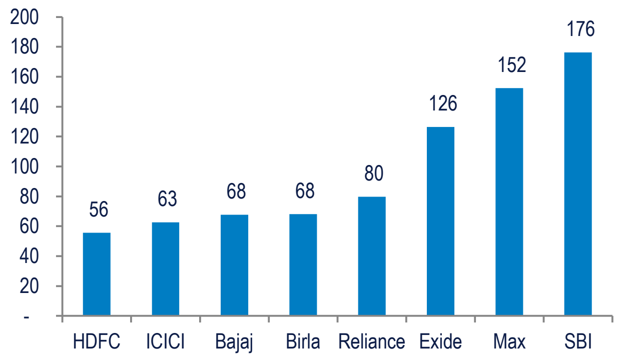
Figure 81: Persistency of Indian Life Insurance Players



Source: Company data

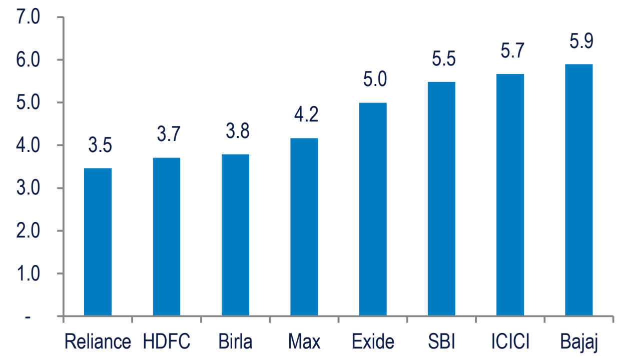
- **Agents' productivity:** We believe that a strong agency network is a must for a life insurance company to build a sustainable business model given the nature of the product and control over the channel. Hence, we value the companies with strong agency channels and apply a metric to measure the strengths of these. Agents' productivity is measured in two parts: (a) premium per agent and (b) agency commission per premium paid.

Figure 82: Premium per agent



Source: Company data, Investec Securities estimates

Figure 83: Premium through agency per one rupee commission paid



Source: Company data, Investec Securities estimates

- **Embedded value growth:** Not all of these eight companies have disclosed embedded value numbers. Hence, we can rate only the companies that do so. HDFC Life and Max Life rate highly on consistent growth in embedded value.

Table 19: Relative positioning of top private players on six key metrics

	ICICI Prudential	SBI life	Bajaj Allianz	Max Life	HDFC Life	Reliance Life	Birla Sunlife	Exide Life
Distribution	●	●	◑	●	◕	◑	◑	◑
Product Mix	◔	◕	◕	●	●	◔	◕	●
Expense ratio	●	●	◑	◑	●	◑	◑	◔
Persistency	◕	◕	◑	●	●	◑	◑	◕
Agents' productivity	◕	●	◕	●	◑	◑	◑	●
EV growth	◑	◑	◑	●	●	◑	◔	◑

Source: Investec Securities estimates

Our valuation of Indian Life Insurers

We value life insurers on discounted embedded value methodology which is a form of discounted cash flow where embedded value profits are discounted instead of cash flows. Then we compare the valuation with appraisal value methodology to compare the NBAP multiple for these companies.

Table 20: Birla Sun Life Valuation

Rs. Mn	Value	Comments
FY16E Embedded Value	35,202	Pre-dividend; assuming 10% upgrades on translation to MCEV
Structural Value	44,873	Discounting future VNBs using two stage DCF
FY17E VNB	3,110	13% VNB Margin
Implied VNB Multiple	14	
Total Valuation	**80,076**	

Source: Company Data, Investec Securities estimates

Table 21: Bajaj Allianz Valuation

Rs. Mn	Value	Comments
FY16E Embedded Value	89,202	12% APE growth in FY16E; 11% VNB Margin
Structural Value	41,028	Discounting future VNBs using two stage DCF
FY17E VNB	2,560	12% VNB Margin
Implied VNB Multiple	16	
Total Valuation	**130,231**	

Source: Company Data, Investec Securities estimates

Table 22: Max Life Valuation

Rs. Mn	Value	Comments
FY16E Embedded Value	66,165	Pre-dividend; assuming 10% upgrades on translation to MCEV
Structural Value	91,340	Discounting future VNBs using two stage DCF
FY17E VNB	4,046	13.5% VNB Margin
Implied VNB Multiple	23	
Total Valuation	**157,506**	

Source: Company Data, Investec Securities estimates

Table 23: Reliance Life Valuation

Rs Mn	Value	Comments
FY16E Embedded Value	30,529	Our estimate of EV as company does not disclose
Structural Value	44,448	Discounting future VNBs minus cost overruns using two stage DCF
FY17E VNB	5,127	20% VNB margin and 15% APE growth
Implied VNB Multiple	9	
Total Valuation	**74,977**	

Source: Company Data, Investec Securities estimates

Aditya Birla Nuvo (ABRL.NS)

India | Life Insurance

BUY

Price: INR1573.00

Target: INR2000.00

Forecast Total Return: 27.7%

Market Cap: INR205bn

Average daily volume: 19k

Multiple drivers to help re-rating

ABNL's financial services businesses have been overlooked by the market, in our view, due to the group's unrelated interests including telecoms, apparel and manufacturing. However, in the last three years, its financial services businesses have scaled up (NBFC AUM: Rs155bn, AMC AUM: Rs1,200bn, Life Insurance AUM: Rs288bn) and some low return businesses were divested (IT-ITes & Carbon Black). We expect the financial services businesses to do well over the next five years along with further rationalisation of the group structure (the apparel arm is expected to merge with listed Pantaloons). BUY.

- **ABNL's core businesses seem undervalued:** The implied market valuation for ABNL's core businesses (ex-IDEA) is less than Rs100bn (assuming a 15% holding company discount). This is low compared to the scale of operations, which include the fourth largest AMC in India, one of the top 7 players in life insurance, an NBFC with an asset book of Rs155bn, and the largest branded apparel manufacturer. We believe this is due to a complex group structure and combination of businesses in unrelated industries.
- **Financial services done well:** ABNL's financial services businesses (Life Insurance, AMC and NBFC) have grown at a higher rate than the industry. AMC's equity AUM has grown by >100% in FY15E, NBFC has scaled up its loan book at an >80% CAGR (FY10-9MFY15), Life Insurance has stabilised and premiums grew by >20% yoy during 11MFY15. We expect the contribution from financial services to increase in consolidated profitability. We also expect the majority of incremental capital to be invested in financial services.
- **Corporate structure rationalisation to drive re-rating:** During the last two years, ABNL has divested IT-ITes and Carbon Black which were low return, low margin and low growth businesses. We expect the corporate structure to be simplified further with the apparel business merging with listed entity Pantaloons.
- **Initiate at BUY:** We initiate at Buy on ABNL with a target price of Rs2000. ABNL's financial services businesses contribute 38% to our valuation where we see potential for upgrades as the businesses scale up and return ratios improve. Around 50% of valuation comes from IDEA, which we value at market prices.

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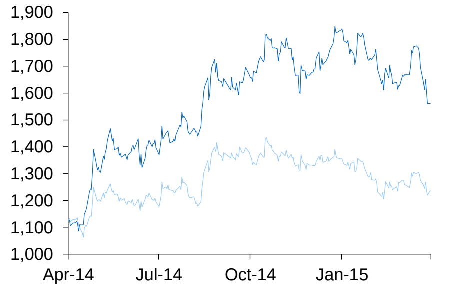
Financials and valuation — Year end: 31 March

	2013A	2014A	2015E	2016E	2017E
Total income (INRm)	275,186	282,406	310,155	320,347	359,293
Operating profit (INRm)	28,465	33,280	41,291	49,916	59,178
PBT (normalised) (INRm)	15,257	17,670	20,733	26,342	31,376
Embedded value (INRm)	40,540	33,069	33,646	35,944	39,833
EPS (normalised)(INR)	87.0	87.9	98.1	125.4	149.2
DPS (INR)	5.2	6.5	7.6	9.7	11.6
Embedded value per share (INR)	333	254	259	276	306
BV/share (INR)	721.8	860.6	949.9	1,064.0	1,199.7
PE (normalised) (x)	18.0	17.8	15.9	12.4	10.5
Dividend yield (%)	0.3	0.4	0.5	0.6	0.7
P/BV (x)	2.2	1.8	1.6	1.5	1.3
ROA (%)	2.3	2.1	2.1	2.4	2.5
Group ROE (%)	11.3	10.2	10.3	11.8	12.4

Source: Company accounts/Investec Securities estimates

Price Performance



	1m	3m	12m
Price	(4.0)	(14.9)	37.8
Price rel to India S&P BSE 500 - BSE	(2.3)	(8.6)	9.4

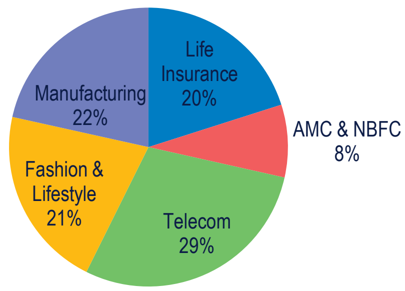
Source: FactSet

Figure 84: Aditya Birla Nuvo – Company Snapshot

Aditya Birla Nuvo Ltd. is a diversified conglomerate with a portfolio of businesses within financial services, manufacturing, and fashion & lifestyle. Its financial services business includes Life Insurance, Asset Management, NBFC, Insurance Broking, Equity Broking and Private Equity. The company also has a 23.3% stake in Aditya Birla Group's telecoms company IDEA. Founded in 1956, the company is headquartered in Mumbai, India.

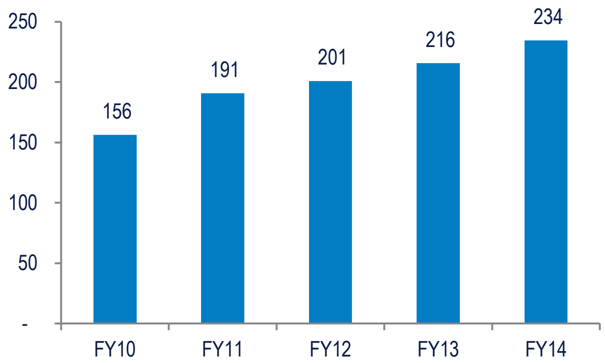
Source: Investec Securities estimates

Figure 85: FY14 Revenue breakup



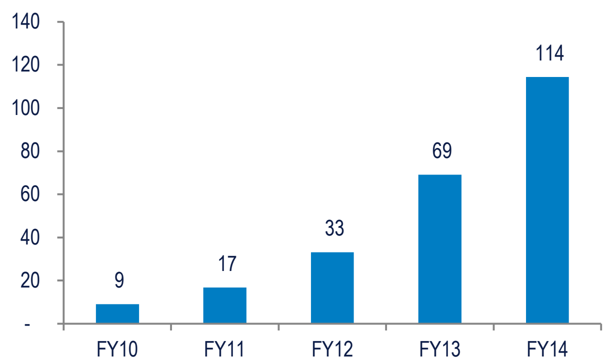
Source: Investec Securities estimates

Figure 86: Life Insurance AUM (Rs Bn)



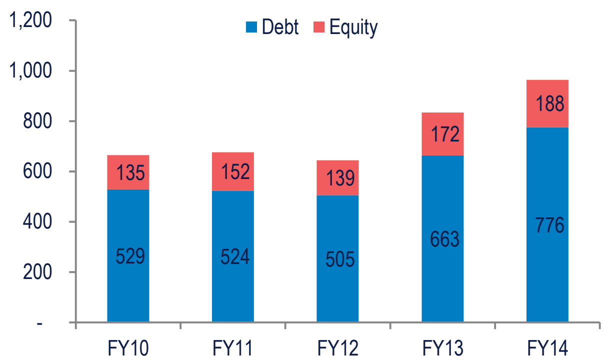
Source: Investec Securities estimates

Figure 87: NBFC AUM (Rs Bn)



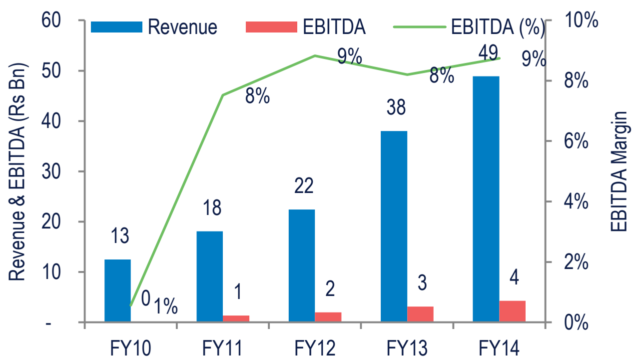
Source: Investec Securities estimates

Figure 88: Asset Management AUM



Source: Investec Securities estimates

Figure 89: Fashion & Lifestyle – Performance

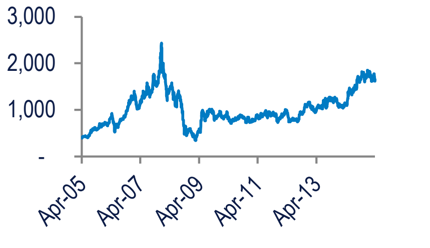


Source: Investec Securities estimates

ABNL's stock has done well…

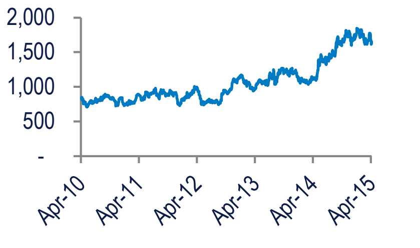
ABNL has performed well for shareholders over the last 10, 5 and 3 years, generating returns in excess of 15% CAGR for all periods (see figures below).

Figure 90: ABNL – 15% CAGR return in 10 Years



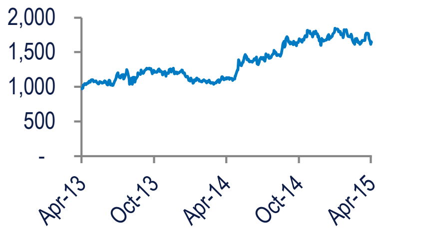
Source: Bloomberg, Investec Securities estimates

Figure 91: ABNL - 15% CAGR return in 5 Years



Source: Bloomberg, Investec Securities estimates

Figure 92: ABNL - 19% CAGR return in 3 Years



Source: Bloomberg, Investec Securities estimates

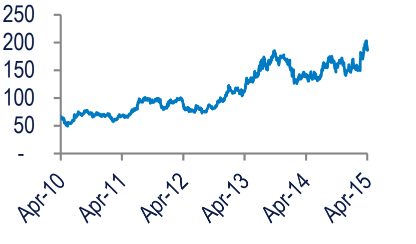
…but core businesses still not valued adequately

However, the majority of value creation is due to its stake in Idea Cellular, which has generated shareholder returns at a CAGR of 28% over the last 3 years and 23% in the last 5. The market values ABNL's core subsidiaries at Rs58bn assuming no holding company discount, and at Rs95bn assuming a 15% holding company discount (see figures 13 & 14).

Figure 93: IDEA – 13% CAGR return since IPO

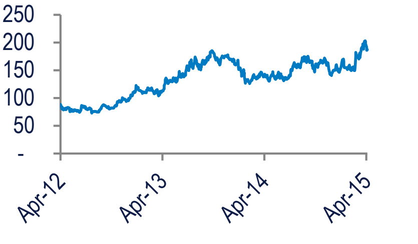
Source: Bloomberg, Investec Securities estimates

Figure 94: IDEA - 23% CAGR return in 5 Years



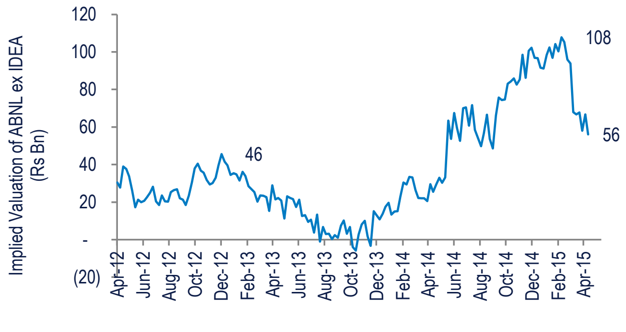
Source: Bloomberg, Investec Securities estimates

Figure 95: IDEA – 28% CAGR return in 3 Years



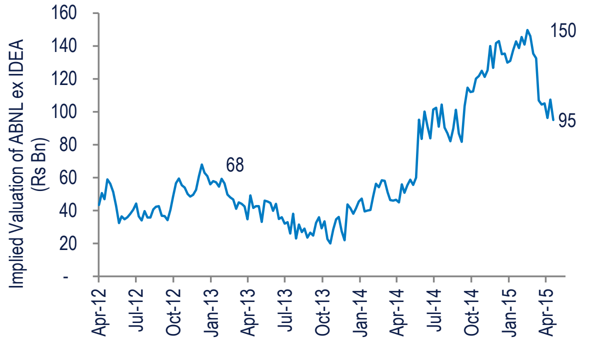
Source: Bloomberg, Investec Securities estimates

Figure 96: Implied Valuation of ABNL (ex Idea) with 0% holding company discount



Source: Bloomberg, Investec Securities estimates

Figure 97: Implied Valuation of ABNL (ex Idea) with 15% holding company discount



Source: Bloomberg, Investec Securities estimates

Compare these valuations with the core businesses of ABNL:

- A Life Insurance company that is one of the top 7 private players.
- The fourth largest asset management company.
- A NBFC with an asset book of Rs155bn as of December 2014, growing at more than 40%.
- The largest branded apparel and linen manufacturer in India.

Investec

Financial Services businesses are well placed

Birla Sun Life Insurance has now stabilised

Birla Sun Life is an agency dependent company which has lost markets share over last five years.

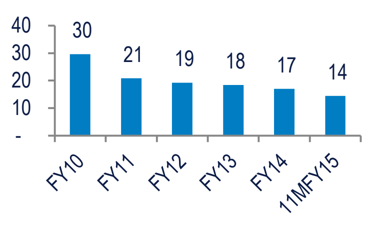
Birla Sun Life has been losing market share for the last five years given: (a) the absence of a strong bancassurance partner, (b) agency coming under pressure, and (c) changing product regulations.

A number of product regulations hit the company particularly hard. It had a high proportion of unit-linked products in 2010 that were impacted post regulations in 2010 and a high proportion of NAV guaranteed products that were banned in 2013. As a result, embedded value (before dividends) has been under pressure on account of high cost overruns and has not grown for the last three years. However, in the last two years, the company has stabilised new business premiums and we expect it to show growth from hereon given the following:

The business has now stabilised and we expect it to show more than 15% growth from FY16E onwards.

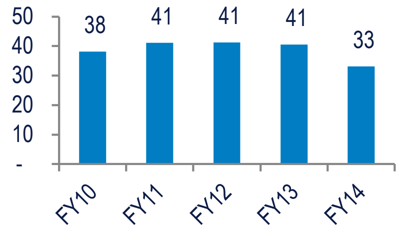
- **Growth revives in the industry:** As highlighted in the thematic section, we expect the life insurance industry to grow at a 15% CAGR and the top 6 private players to grow at a 20% CAGR over the next five years.
- **Bancassurance channel opens up:** Birla Sun Life lacks a strong bancassurance partner. It would therefore be one of the biggest beneficiaries of open architecture in bancassurance.
- **Agency starts delivering:** The agency channel for the company has stabilised. The number of agents grew in FY15 after four years of declines. Moreover, the company has revamped the agency strategy with a focus on counselling-based and need-based selling. All employees (1000+) are on tablets where they can customise products for customers and explain them better using visual graphics.
- **Revamped product strategy delivers:** The company has revamped the product strategy post product design guidelines. The company has focussed on pure term product, which now forms c.10% of premiums for the company. It also offers combined products where non-par product could be combined with unit-linked product. This combination should provide an opportunity to participate in the upside through equity with downside protection through guarantees in non-par.

Figure 98: New business premiums have stabilised (Rs Bn)



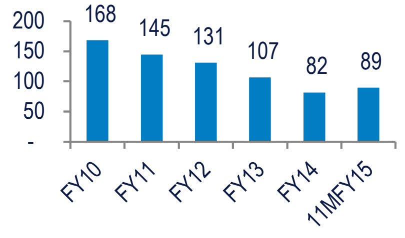
Source: Company Data, Investec Securities estimates

Figure 99: Embedded Value has not grown in last five years (Rs Bn)



Source: Company Data, Investec Securities estimates

Figure 100: No. of agents for Birla Sun Life in '000s



Source: Company Data, Investec Securities estimates

Embedded value growth should improve

As new business growth improves, we believe embedded value accretion should increase as cost overruns should decline and the value of new business should be higher. We expect embedded value (before dividends) growth of more than 8% over the next three years (FY14-FY17E).

Valuations

We value Birla Sun Life using appraisal value methodology (embedded value + structural value). We use absolute valuation methodology to estimate the structural value. This is estimated by discounting new business profits using a two-stage DCF model with 10 years of explicit forecasts and then subsequent years of declining growth to terminal growth. We assume a terminal growth rate of 5% and cost of equity at 14.5%. The implied VNB multiple is 14x. We see potential for upgrades if (a) the company starts disclosing more details on embedded value, (b) cost overruns come down and c) the growth rate improves.

Table 24: Birla Sun Life Insurance – Appraisal Value Methodology

Rs. Mn	Value	Comments
FY16E Embedded Value	35,202	Pre-dividend; assuming 10% upgrades on translation to MCEV
Structural Value	44,873	Discounting future VNBs using two stage DCF
FY17E VNB	3,110	13% VNB Margin
Implied VNB Multiple	14	
Total Valuation	**80,076**	

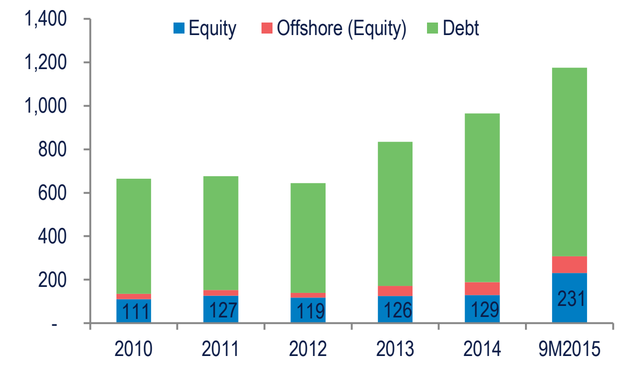
Source: Investec Securities estimates

Asset management is going strong

Birla Sun Life AMC has been one of the best performers in FY15.

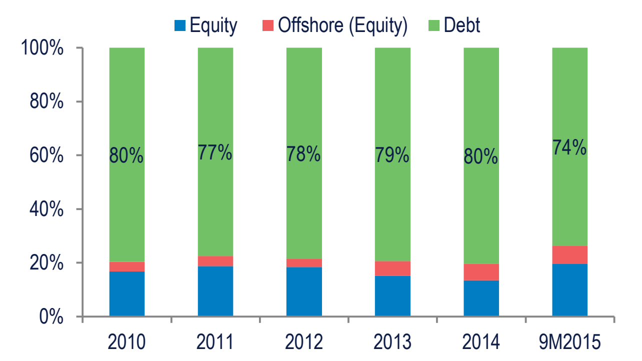
Birla Sun Life Asset Management is among the top 5 asset managers in India and one of the fastest growing asset management companies in FY15 (AUM growth of 34% in FY15E). Historically, the company used to have a high proportion of debt in AUM, which was mostly institutional debt. This has impacted profitability margins, return ratios and the company valuation. However, in FY15, the equity AUM has grown at more than 100% yoy and now forms 26% of AUM, driven by strong marketing, an innovative branding campaign and strong distribution.

Figure 101: Birla Sun Life AMC – AUM mix (Rs Bn)



Source: Company Data, Investec Securities estimates

Figure 102: The share of equity AUM has increased

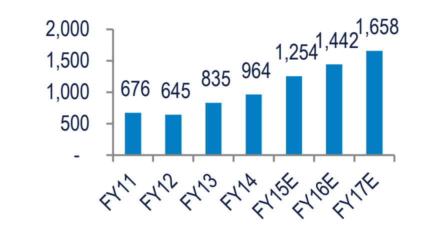


Source: Company Data, Investec Securities estimates

Equity AUM proportion to rise, driving higher profitability and valuations

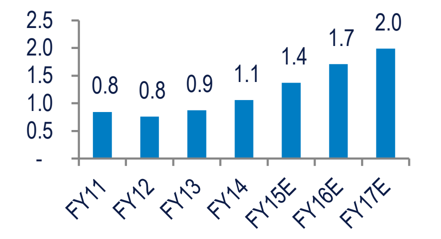
Birla Sun Life is the fifth largest asset manager in terms of equity AUM, which it has grown at 109% in FY15 versus 34% for overall AUM growth (source: AMFI). We expect equity AUM growth to outpace overall AUM growth given robust equity markets, interest in equity markets coming back, and the company's aggressive marketing push. Since equity AUM is significantly more profitable than debt AUM, the company's profitability should improve. We expect a PAT CAGR of 23% over FY14-FY17E and RoEs to be > 20%.

Figure 103: Strong AUM growth expected



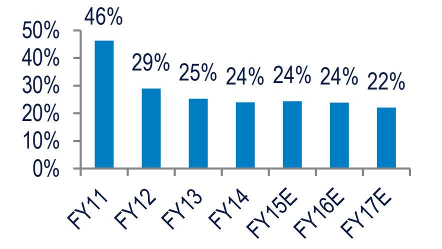
Source: Company Data, Investec Securities estimates

Figure 104: PAT CAGR of 23% FY14-FY17E



Source: Company Data, Investec Securities estimates

Figure 105: Health RoEs



Source: Company Data, Investec Securities estimates

Scale is a competitive advantage in this business

Scale is a big advantage in the business and costs are predominantly of a fixed nature. Scale enables the company to remunerate intermediaries better, spend more on marketing and increase visibility. This in turn helps attract retail equity AUM, which is the highest margin business. It becomes a virtuous circle that has resulted in big players becoming larger and smaller players getting marginalised.

Valuation

We value the company at 4.0% of AUM at Rs58bn. We see valuation upgrade potential as the proportion of equity AUM in overall AUM increases.

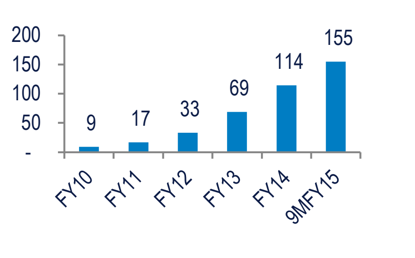
Aditya Birla Finance

Aditya Birla Finance has scaled its book at more than 75% CAGR and is not a sizable NBFC with loan book of more than 150bn.

Aditya Birla Finance is a NBFC operating primarily in the wholesale segments of Mortgage, SME, Infrastructure and capital market. The company has grown its loan book at a 75% CAGR over the last three years despite a challenging macro environment. The loan book growth is largely grown on account of loans against property, SME and loans against shares segment.

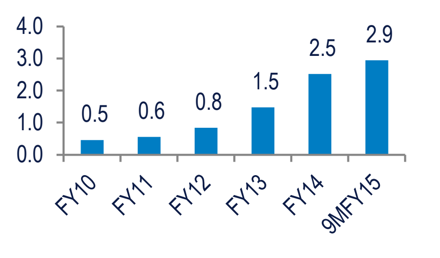
In the past five years, the majority of growth was funded via capital injection by the promoter as RoEs were low. However, RoEs have now scaled up from 10% in FY11 to 13.6% in 9MFY15 and growth has slowed down due to base effect, thus the capital requirement for growth should come down.

Figure 106: AUM CAGR of 80% (Rs Bn)



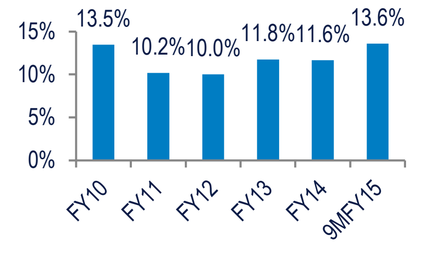
Source: Company Data, Investec Securities estimates

Figure 107: PAT CAGR of 48% (Rs bn)



Source: Company Data, Investec Securities estimates

Figure 108: RoEs improving

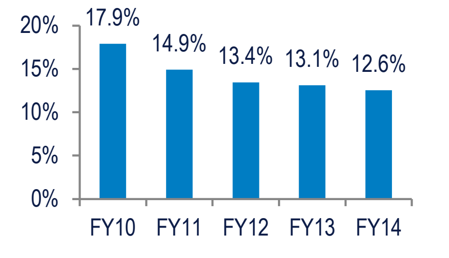


Source: Company Data, Investec Securities estimates

Conservative management, concentrates on high quality borrowers

Management is conservative, in our view, lending with concentration only to high quality borrowers. Though this is not evident from the high growth the company has delivered, the relatively low yields on the loans highlight the focus on quality borrowers (see figure 26). For example, the company concentrates only on category-A builders in construction finance lending and operates in select Tier-1 centres. As a result, the highest yield on loans (except construction finance) for the company is 14%.

Figure 109: Yields have come down



Source: Company Data, Investec Securities estimates

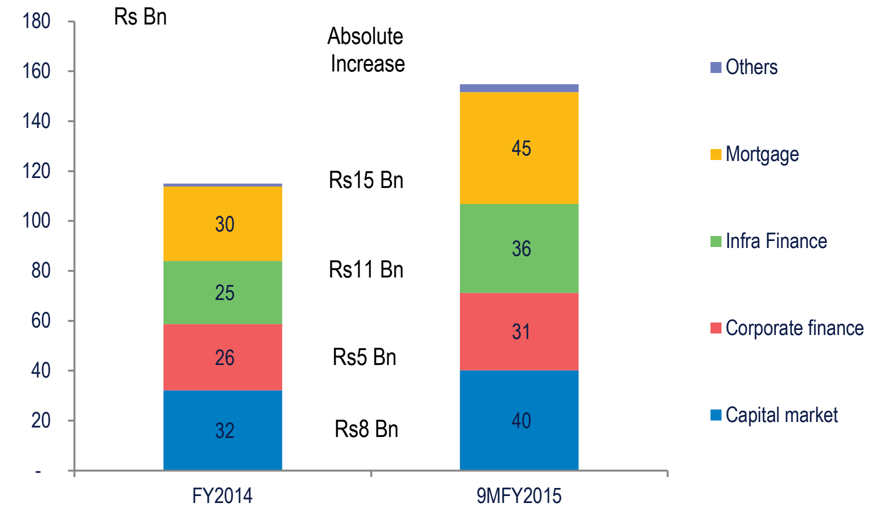
High growth but still small in each segment

The company has exhibited very high growth rates on a decent base in the past. This is despite weak macroeconomic conditions in the country and systemic credit growth at a CAGR below 17% during this time. In financing business, we believe strongly in the adage that *"Nothing can be done at once hastily and prudently"*.

However, in the case of Aditya Birla Finance what give us comfort is that the absolute growth in each segment is low versus the market size and potential. Each segment is still small and growth in absolute numbers looks quite comfortable. This also provides us with comfort on the growth potential over the medium term.

For example, loan book growth for 9MFY15 is 35% YTD, which looks high; however, the absolute change in each segment is low. Mortgages have grown by Rs15bn, which is less than 0.2% of the current market size.

Figure 110: Absolute increase in loan book of each segment is low



Source: Company Data, Investec Securities estimates

Funding cost to improve return ratios

The company's current credit rating is AA+, which we believe is likely to get upgraded to AAA over the next 12-18 months given the group backing and size of the business. This coupled with operating leverage in the business should improve return ratios. We expect RoAs to improve to 2% and RoEs to 15% in FY16E.

Table 25: DuPont Analysis of NBFC

	FY10	FY11	FY12	FY13	FY14	FY15E	FY16E	FY17E
NII	6.2%	6.1%	4.8%	4.0%	4.2%	4.5%	4.6%	4.6%
Fee Income	0.2%	0.3%	0.5%	0.8%	0.5%	0.6%	0.6%	0.6%
Other Income	0%	0%	0%	0%	0%	0%	0%	0%
Total Income	**6.5%**	**6.4%**	**5.3%**	**4.9%**	**4.8%**	**5.0%**	**5.1%**	**5.1%**
Employee expenses	1.1%	1.1%	1.0%	1.0%	0.9%	0.9%	0.9%	0.9%
Other expenses	1.2%	1.2%	0.7%	0.7%	0.6%	0.6%	0.6%	0.6%
Credit costs	-0.5%	0.3%	0.5%	0.6%	0.7%	0.7%	0.7%	0.7%
PBT	4.7%	3.7%	3.0%	2.6%	2.6%	2.8%	2.9%	3.0%
PAT	3.0%	2.4%	2.0%	1.7%	1.7%	1.9%	2.0%	2.0%
RoE	**13.5%**	**10.2%**	**10.0%**	**11.8%**	**11.6%**	**13.1%**	**14.5%**	**14.5%**
Leverage (x)	4.5	4.2	5.0	6.8	6.8	7.0	7.4	7.3

Source: Company Data, Investec Securities estimates

Valuation

We value the company at Rs29bn or 1.2x FY16E book value. The valuation is lower than peers like Capital First, which is trading at 2.2x FY16E book value with inferior return ratios. We see potential for valuation upgrades as RoEs scale up to 15% and growth moderates to around 20%, as we expect.

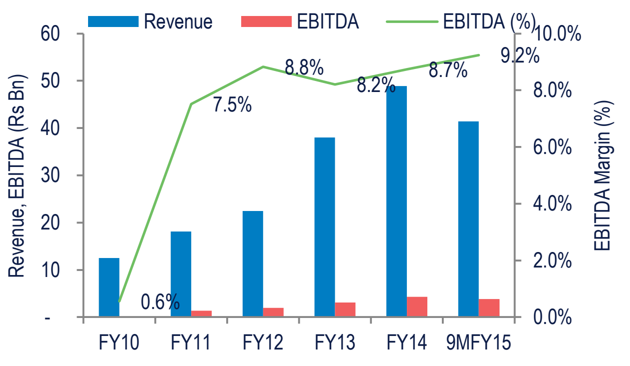
Fashion & lifestyle – Market leader

This is another area of focus for the company, which acquired Pantaloons format stores, making it the largest retail company in India in branded apparel. The company has the best brands (Allen Solly, Van Heusen, Louis Philippe, Peter England, People, Planet Fashion, The Collective) in the upper middle class male segment under its flagship company, Madura Garments. The acquisition of Pantaloons has provided the company entry into the female apparel segment.

The company has 1703 Exclusive Brand Outlets (EBOs) under Madura Garments and 118 EBOs under Pantaloons as of December 2014, which translates to a combined retail space of 4.6m square feet.

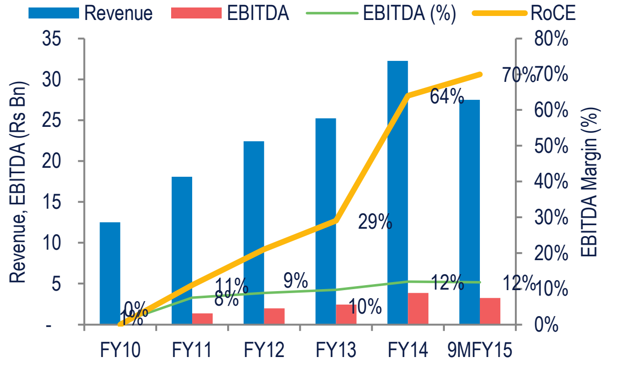
The segment (ex-Pantaloons) has done well with industry-leading EBITDA margins and strong return ratios. Pantaloons' performance has been under pressure post acquisition as the company made several strategic changes. The business has now stabilised and shows an improvement in performance.

Figure 111: Fashion & Life style segment performance



Source: Company data

Figure 112: Madura Garments performance



Source: Company data

Valuation

We value the segment (ex-Pantaloons) at 6x FY16E EBITDA and Pantaloons at market prices. The enterprise value of the Fashion & Lifestyle segment is Rs32.5bn.

Other businesses

Textiles (JayaShree Textiles): Linen driving growth

JayaShree Textiles is the largest manufacturer of linen fabric and linen yarn in India and leading manufacturer of wool tops and worsted yarn. JST has converted linen fabric to a lifestyle commodity and owns well-known brand Linen Club Fabrics. The company has 57 Exclusive Brand Outlets (EBOs) and the company focuses on this segment as it is high margin. The share of sales of linen fabric through EBOs and MBOs increased to 50% in FY14, from 41% in FY12. In FY14, its revenue has grown by 14% and the EBITDA margin by 12%, with the company generating a return on capital employed (RoCE) of 57%.

Rayon business (India Rayon)

The rayon business is another star performer with strong revenue growth and stable EBITDA margins. Revenue grew at a 12% CAGR and the EBITDA margin remained stable at c. 20% over FY00 to FY14. The RoCE also remained strong at 24%.

Fertilizers (Indo-Gulf Fertilizer)

It is one of the largest manufactures of urea in India. This business was impacted due to a delay in payments of subsidies by the government, which affected the working capital cycle. As a result, the return ratios declined and the standalone balance sheet deteriorated.

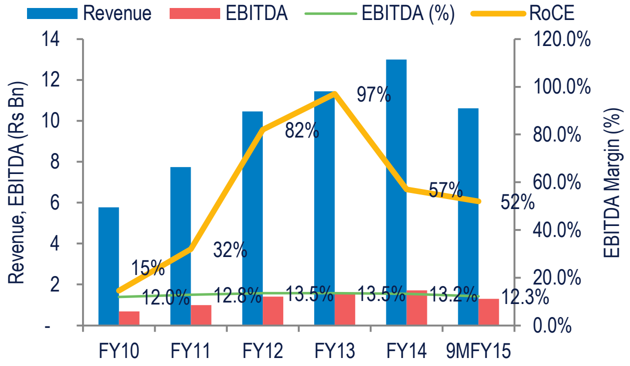
The situation has improved since then and return ratios have improved, but it still remains a laggard compared to the other businesses.

Insulators (Aditya Birla Insulators)

The insulators business has been a laggard given the commodity nature of business and competition from cheap imports from China. The RoCE remained around 15%.

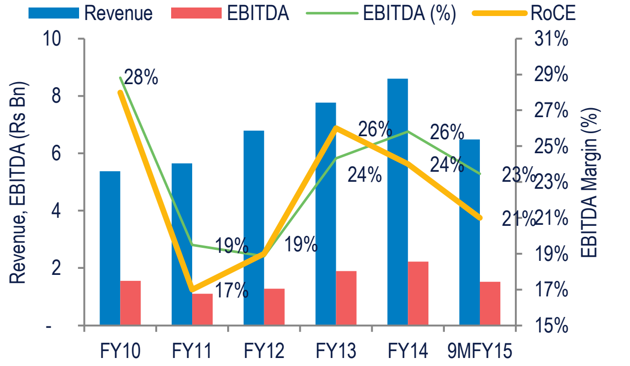
We cautiously assign valuations based on the valuation of its key peers which operate in these segments.

Figure 113: JayaShree Textiles – High RoCE



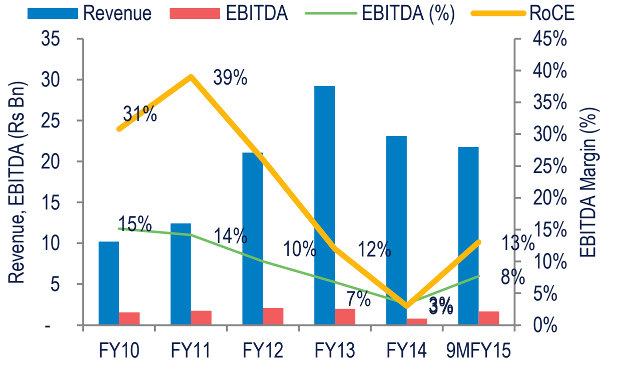
Source: Company data

Figure 114: Rayon Business – Decent return ratios and margins



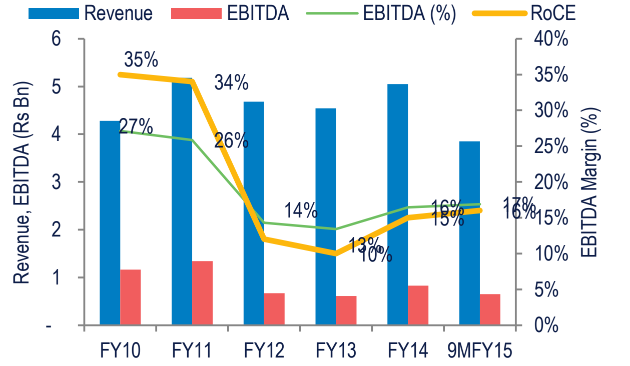
Source: Company data

Figure 115: Fertilizer – Return ratio & margins declined in FY14



Source: Company data

Figure 116: Insulators – Return ratio remains subdued



Source: Company data

ABNL's corporate structure concentrating towards financial services

The market may start looking at the company as diversified financial services play as opposed to an industrial conglomerate.

ABNL has divested its IT-ITes and Carbon Black businesses in the past three years. These were both small in their respective segments, growing at very low rates and generating low RoCEs. Over the next two years, we expect the company to divest its Insulator business and merge Madura Garments (Fashion & Lifestyle business) with listed company Pantaloons.

These steps should (a) simplify the corporate structure, (b) increase the proportion of financial services businesses, and (c) increase capital allocation towards financial services businesses. We believe these will be critical in realising the full potential valuation of the financial subsidiaries.

Aditya Birla Nuvo – SOTP Valuation

Table 26: Aditya Birla Nuvo – Sum of the parts Valuation

Rs Mn	Valuation	ABNL Stake	Value per share	Comments
Life Insurance	80,076	74%	455	FY16E EV + 14x FY17E VNB
NBFC	29,147	100%	224	1.0x FY16E Book Value
Asset Management	50,456	50%	194	3.5% of FY16E AUM
Idea	664,000	23%	1,189	Based on current market price @ Rs185 per share
Fashion & Manufacturing	37,838	100%	291	
Fashion & Lifestyle	32,512	100%		Implied FY16E EV/EBITDA multiples of 6x
Manufacturing	33,926	100%		Implied FY16E EV/EBITDA multiples of 4x-7x
Less: Standalone debt	(28,600)			FY15E Standalone debt
Total Valuation			**2,353**	
Less holding company discount (15%)			353	
Total SOTP Valuation			**2,000**	

Source: Investec Securities estimates

Investec

Summary Financials (INRm)

Year end: 31 March

Income Statement	2013	2014	2015E	2016E	2017E
Income from operations	252,959	255,933	257,166	289,487	325,627
Other operating income	22,227	26,474	52,989	30,861	33,666
Total income from operations	**275,186**	**282,406**	**310,155**	**320,347**	**359,293**
Claims incurred	-36,586	-36,654	-38,870	-43,580	-43,931
Operating expenses	-212,227	-216,186	-233,708	-230,566	-259,897
Total expenses	**-248,814**	**-252,840**	**-272,578**	**-274,145**	**-303,829**
Operating profit	**26,373**	**29,566**	**37,577**	**46,202**	**55,464**
Other income	2,093	3,714	3,714	3,714	3,714
Net interest	-13,209	-15,610	-20,558	-23,574	-27,802
PBT (normalised)	**15,257**	**17,670**	**20,733**	**26,342**	**31,376**
Exceptional items	0	50	-133	0	0
PBT (reported)	15,257	17,720	20,600	26,342	31,376
Taxation	-3,418	-5,500	-7,049	-8,956	-10,668
Net profit	11,839	12,220	13,551	17,386	20,708
Profit attributable	10,589	11,430	12,753	16,307	19,394
EPS (reported) (INR)	87.0	87.9	98.1	125.4	149.2
EPS (normalised) (INR)	**87.0**	**87.9**	**98.1**	**125.4**	**149.2**
DPS (INR)	5.2	6.5	7.6	9.7	11.6
Av. no. of shares (m)	122	130	130	130	130
Total no. of shares (m)	130	130	130	130	130

Balance sheet	2013	2014	2015E	2016E	2017E
Property Plant & Equipment	106,770	130,450	117,405	129,146	142,060
Intangible assets	48,250	49,820	49,820	49,820	49,820
Policyholder assets	229,290	247,640	295,662	319,650	351,464
Investments and other non current assets	3,540	4,100	4,100	4,100	4,100
Cash and equivalents	24,150	10,890	10,890	10,890	10,890
Other current assets	97,730	122,800	173,214	215,593	268,446
Total assets	**509,730**	**565,700**	**651,091**	**729,199**	**826,780**
Total Debt	-186,002	-205,400	-232,800	-273,173	-322,263
Other long term liabilities	-4,728	-5,060	-5,060	-5,060	-5,060
Policyholder Liabilities	-215,760	-235,570	-281,158	-302,974	-332,503
Total Liabilities	**-406,490**	**-446,030**	**-519,018**	**-581,207**	**-659,826**
Net assets	**103,240**	**119,670**	**132,073**	**147,991**	**166,954**
Shareholders' funds	93,840	111,890	123,495	138,334	155,983
Minority interest	9,400	7,780	8,578	9,657	10,971
Total Equity	**103,240**	**119,670**	**132,073**	**147,991**	**166,954**

Source: Company accounts, Investec Securities estimates

Target Price Basis

Sum of the parts valuation

Key Risks

(1) A substantial decline in Interest rate could lead to negative spread on non-participating products; (2) Delay in open architecture could lead to low new business premium growth; (3) A delay in corporate structure rationalisation.

Investec

Bajaj Finserv (BJFS.NS)

India | Life Insurance

BUY

Price: INR1355.00

Target: INR1950.00

Forecast Total Return: 44.1%

Market Cap: INR215bn

Average daily volume: 22k

A Dark Horse

The market has overlooked the insurance subsidiaries of Bajaj Finserv despite structural improvements in the sector (Insurance Act 2015, opening of banca expected, motor pool dismantled). Bajaj's GI has been a top performer in the sector with the best RoE and combined ratio in the industry. We expect a revival in growth for Bajaj's life business as agency has stabilised and banca is expected to open. We price in a 74% stake in both life and general (assuming Allianz's option to be worthless) and initiate at a BUY rating with 44% implied upside. We highlight Bajaj Finserv as our top pick in the sector.

- **Insurance subs' market valuation unchanged in last three years:** The majority of the increase in Bajaj Finserv's market cap in the last three years is due to Bajaj Finance (its listed subsidiary). During this period, the Insurance Bill was passed and the Motor third party pool was abolished, while bancassurance is expected to open up and there is clarity on the Allianz call option.
- **Growth revival expected in Life Insurance:** Bajaj Life is one of the biggest underperformers of the past five years due to problems in its distribution channels. However, the agency channel has now stabilised while the contribution of other channels is negligible. With an expectation of growth in agency and banca opening up, we expect growth for the company from FY16E.
- **General Insurance – Best franchise in India:** Bajaj General has had a strong run over the last three years with the RoE improving to 28% (in FY14) from 14% (in FY12) and a combined ratio below 100%. We believe its competitive advantage in the passenger cars segment and management's strategy of concentrating on profitable business are both sustainable.
- **Bajaj Finance has created its niche:** Bajaj Finance operates in consumer durable and 2-W/3-W vehicle financing, which have high entry barriers owing to operational difficulties and low ticket sizes. Also, it has built a sizable loan book in mortgages with a long tenure and stable loans. The mix of highly profitable segments (with high entry barriers) and low-volatility segments implies a sustainable business with high return ratios.
- **Valuation:** We have taken a 74% stake in life and a 74% stake in general insurance as the deal between Allianz and Bajaj Finserv is most likely to happen at fair value (versus pre-determined valuation). We initiate with a BUY rating and highlight Bajaj Finserv as our top pick in the insurance space.

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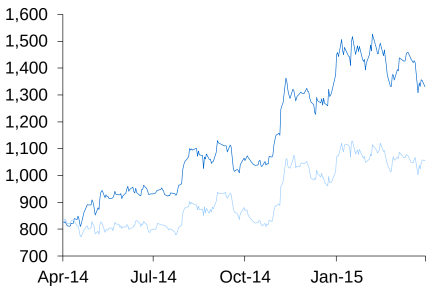
Financials and valuation — Year end: 31 March

	2013A	2014A	2015E	2016E	2017E
Total income (INRm)	164,968	170,257	163,436	186,945	215,725
Operating profit (INRm)	39,117	44,635	53,676	65,189	79,748
PBT (normalised) (INRm)	27,081	29,016	31,548	36,592	43,775
Embedded value (INRm)	76,529	76,010	81,669	89,202	98,344
EPS (normalised)(INR)	58.8	97.0	88.7	116.3	138.2
DPS (INR)	1.5	1.8	2.0	2.3	2.5
Embedded value per share (INR)	504	477	513	560	618
BV/share (INR)	490.0	584.9	688.6	805.0	943.1
PE (normalised) (x)	22.6	13.7	15.0	11.4	9.6
Dividend yield (%)	0.1	0.1	0.2	0.2	0.2
P/BV (x)	2.7	2.3	1.9	1.7	1.4
ROA (%)	3.9	2.5	2.3	2.3	2.3
Group ROE (%)	11.5	16.6	12.9	14.5	14.6

Source: Company accounts/Investec Securities estimates

Price Performance



	1m	3m	12m
Price	(1.8)	(3.2)	63.6
Price rel to India S&P BSE 500 - BSE	(0.1)	4.0	29.9

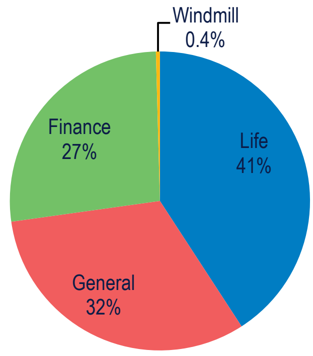
Source: FactSet

Figure 117: Company Snapshot

Bajaj Finserv holds a 74% stake in Bajaj Allianz Life, a 74% stake in Bajaj Allianz General and 62% in Bajaj Finance. It also has windmills with installed capacity of 65.2MW. It was formed in April 2007 as a result of its demerger from Bajaj Auto Limited to further the Group's interests in financial services.
Bajaj Finance is a diversified NBFC with lines of business in mortgages, consumer durable financing, home loans, personal loans, and SME loans etc. Its insurance businesses are in JVs with Allianz SE of Germany.
The company has banking aspirations and applied for a banking licence in the last application round but was unable to secure one.

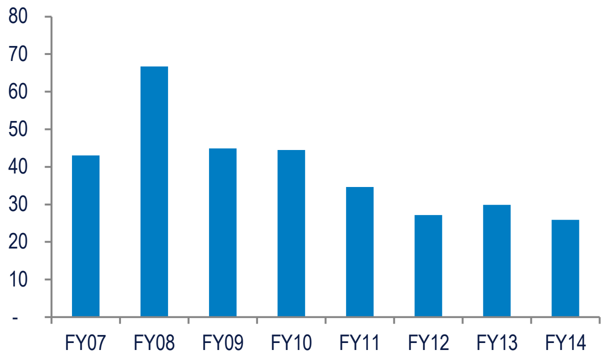
Source: Company data

Figure 118: BJFIN's Revenue breakup



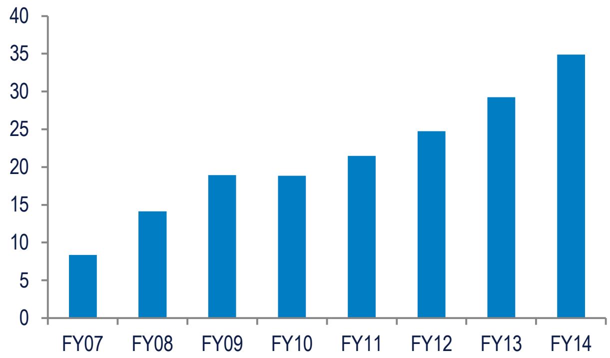
Source: Company data

Figure 119: Bajaj Life – New business premiums (Rs Bn)



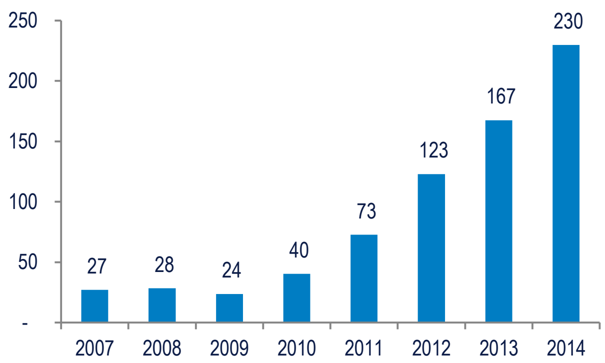
Source: Company data

Figure 120: Bajaj General – Net Earned Premium (Rs Bn)



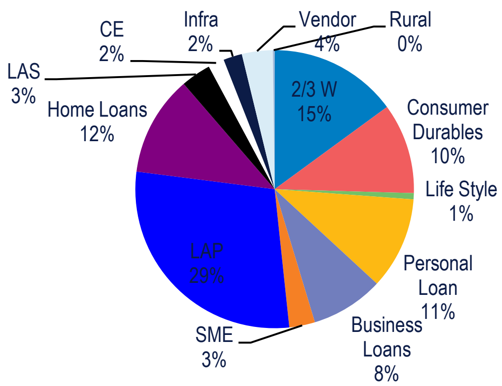
Source: Company data

Figure 121: Bajaj Finance - AUM



Source: Company data

Figure 122: Bajaj Finance – AUM breakup FY14



Source: Company data

Bajaj Finserv's insurance subs are underappreciated

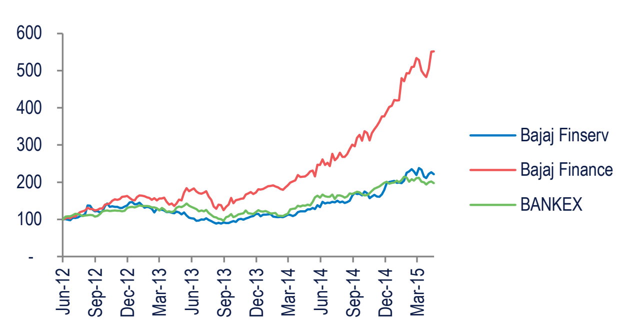
The market has ignored the insurance subsidiaries of Bajaj Finserv over the past three years, evident from the implied valuations of insurance subsidiaries (see figure 8). Share price returns have therefore largely been driven by an increase in the market valuation of Bajaj Finance, up 5.5x in the past three years (see figures 7 & 8).

The implied valuation of life and general insurance subsidiaries have not changed in last three years despite improvement in operating environment of these companies.

In these three years, the operating environment of general insurance business has improved significantly following the dismantling of the motor third party pool in 2012. The RoE has risen from 5% in FY11 to 28% in FY14. The Insurance Amendment bill was passed, which increased the foreign ownership limit to 49% from 26% and opened up the opportunity for insurance companies to list on stock exchanges. In the Life Insurance sector, IRDA has circulated draft guidelines on Corporate Agency, which aims to open up the bancassurance channel and should be very positive for Bajaj Allianz Life Insurance.

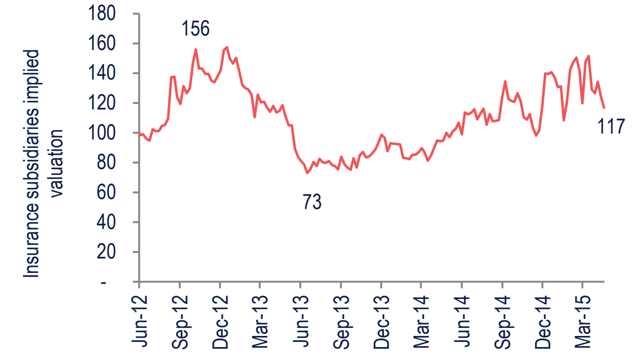
At current market prices, both insurance subsidiaries are valued at Rs117bn, meaning Bajaj Allianz Life and Bajaj Allianz General are valued at just Rs60bn each (see Figure 8). Bajaj Allianz Life reported an embedded value of Rs76bn and net worth of Rs59bn as of FY14. Bajaj Allianz General reported PAT of Rs4bn, net worth of Rs17bn and a RoE of 28% for FY14.

Figure 123: Majority of Bajaj Finserv's share price increase is contributed because of Bajaj Finance share price movement



Source: Bloomberg, Investec Securities estimates

Figure 124: Insurance subsidiaries implied valuations (from market prices) have not increased in last three years (Rs Bn)



Source: Bloomberg, Investec Securities estimates

Bajaj Allianz Life could be a dark horse

Bajaj Allianz Life is among the biggest underperformers in the life insurance sector over the past five years due to: (a) high dependency on the agency channel; (b) Bancassurance partners moving out; (c) problems in other third party channels (corporate agency & referral); and (d) surrenders in unit-linked policies. Its market share (retail APE) has fallen from 8.0% to 2.2% over the past five years (see figure 10). However, we expect this trajectory to reverse over the next five years for the following reasons:

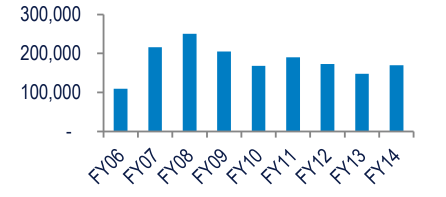
- **New business premiums bottomed out:** Over the past five years, the company has experienced problems on multiple counts:
  - Corporate agents left (Standard Chartered, Syndicate Bank and Dewan Housing).
  - Micro insurance (c.10% of business in 2011) declined to zero as the company await micro insurance guidelines.
  - Company rationalised corporate agency due to poor persistency and mis-selling. Premiums declined by 93% from the channel, which used to form 21% of individual premiums in FY10.
  - Direct channel (13% of premium in FY10) declined to virtually zero on the poor quality of business.

- Referral (9% of FY10 premium) declined to zero post guidelines on referrals, which capped the payment structure on referrals.

These have resulted in the share of channels other than agency becoming less than 15% in FY14, down from 45% in FY10 (see figure 11).

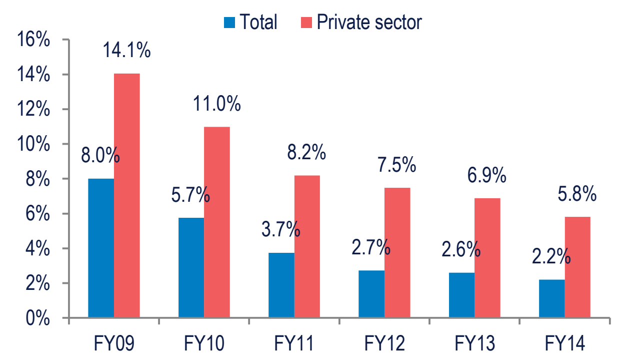
- **Agency has stabilised and other channels have become negligible:** The agency channel has stabilised for the company, performing in line with competitors over the past four years (see figure 12). The major loss has been due to other channels whose contribution is negligible now.
- **Focus on agency should help:** The company is now focusing on agency and has made several changes to incentives, training and recruitment. The results of these steps are visible in recent performance. The agency network has been increasing and the company posted strong growth in January-February 2015 (see figure 9).
- **Distribution through Bajaj Finance should help:** The share of premiums from Bajaj Finance (group NBFC) has been increasing (see figure 17).
- **Open architecture in banca will be positive:** It has almost negligible business from the banca channel post the end of the tie-up with Standard Chartered. Hence, open architecture should be a big positive for the company. In our opinion, the company stands a good chance of a tie-up with a large private bank given its strong brand name, balance sheet size and the fact it is non-bank promoted.

Figure 125: No. of agents – Bajaj Allianz Life



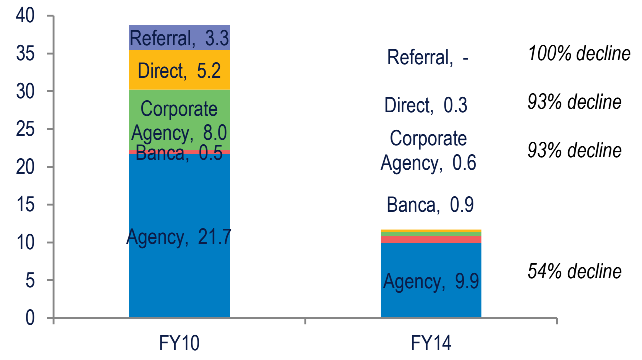
Source: Company data

Figure 126: Bajaj Allianz Life's market share (Individual APE)



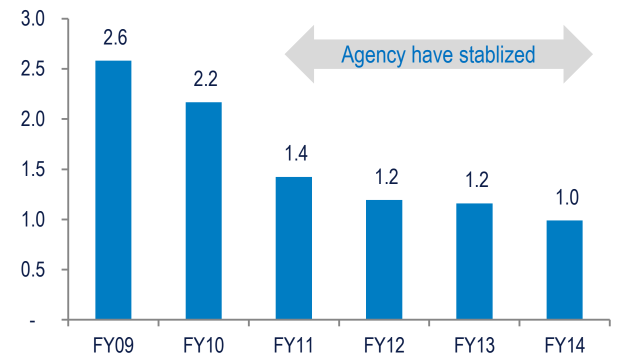
Source: IRDAI, Investec Securities estimates

Figure 127: Distribution mix (Rs Bn)



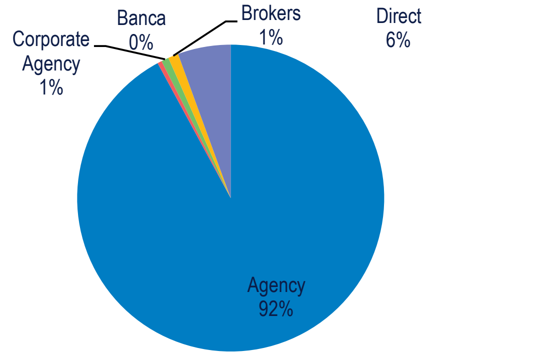
Source: Company Data, Investec Securities estimates

Figure 128: Agency channel has stabilised over last four years



Source: Company data

Figure 129: Agency has become 92% of business (9MFY15)

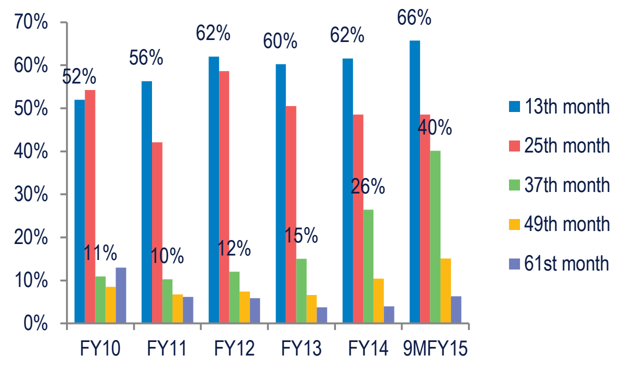


Source: Company data

Quality of business is expected to improve

- **Persistency is improving:** The company has taken some key steps to curb mis-selling and improve persistency: (a) persistency is now an integral part of salesforce KPIs and incentives; (b) customer credit checks through credit bureaus; (c) post-sale verification calling; and (d) graphic illustration of the policy at the time of sale. The impact of these steps is already visible in 13th month persistency (see figure 14) and we expect it to percolate to higher buckets over the next five years.
- **Management's strong focus on cost control:** Bajaj Allianz Life is one of the first companies in the sector to break even on statutory profits (profitable since 2010). Also, during the high growth years (2005-08), the company concentrated on operating expenses when others were burning capital. Over the last three years, the company has kept operating costs under check. Despite growth coming down and the contribution of variable costs distribution channels (corporate agency, brokers) coming down, cost ratios are looking better than in previous years (see figures 15 & 16).
- **Group business is majorly non-fund based:** The proportion of group business has risen for the company over the past five years in the absence of growth in individual business. The group business is nearly a zero margin business for the industry. However, the company has been focusing on non-fund based business within group business, which has a positive margin. Non-fund business forms c.50% of the group business for the company.

Figure 130: Persistency improvements in last five years



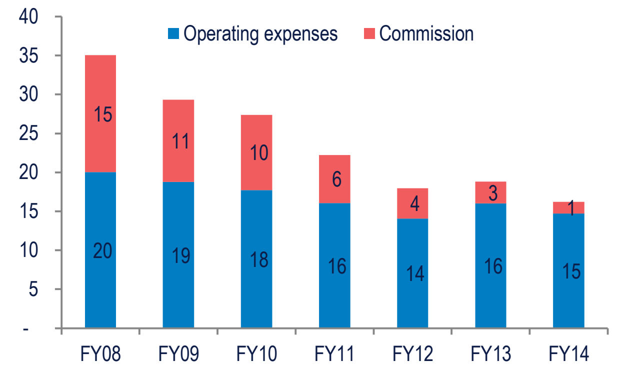
Source: Company Data, Investec Securities estimates

Table 27: Expected persistency improvements with bucket

	FY12	FY13	FY14	9MFY15	FY16E	FY17E
13th month	62%	60%	62%	66%	68%	69%
25th month	59%	50%	49%	49%	52%	54%
37th month	12%	15%	26%	40%	42%	44%
49th month	7%	7%	10%	15%	25%	28%
61st month	6%	4%	4%	6%	9%	15%

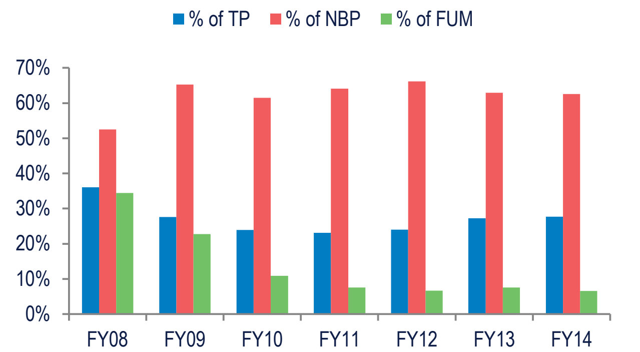
Source: Company Data, Investec Securities estimates

Figure 131: Operating expenses have come down



Source: Company Data, Investec Securities estimates

Figure 132: Operating expenses ratios have come down

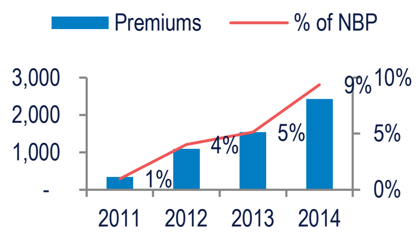


Source: Company Data, Investec Securities estimates

Bajaj Finance distribution reach should benefit:

Bajaj Finance has more than 300 branches and over 5m customers with a strong cross-sell focus. The cross-sell focus is also visible from the metrics that management measures and discloses in its quarterly presentations. Bajaj Finance contributed Rs2,430m to new business premiums for BALIC, which has growth at a 90% CAGR over the last three years. Bajaj Finance is investing in expanding its reach to Tier-3 & Tier-4 centres, which should also benefit BALIC.

Figure 133: Premiums from Bajaj Finance (Rs mn)



Source: Company Data, Investec Securities estimates

RoEV should improve from current levels

BALIC's EV has grown at a CAGR of 6% over the past three years (versus 13% for Max, 20% for HDFC). EV growth has been impacted by cost overruns, low NBP growth and a large capital base. Given our expectation of NBP growth accelerating, persistency improving and costs reducing, EV growth should accelerate from here on. We expect RoEVs to improve to 11% over the next three years.

Valuations

We value Bajaj Life using appraisal value methodology (Embedded Value + Structural Value). The structural value is estimated by discounting new business profits using a two-stage DCF model with 10 years of explicit forecasts and then subsequent years of declining growth to terminal growth. The terminal growth rate is assumed at 5% and cost of equity at 13%. The implied VNB multiple is 16x (see table 2).

Table 28: Bajaj Allianz Life Insurance

Rs. Mn	Value	Comments
FY16E Embedded Value	89,202	12% APE growth in FY16E; 11% VNB Margin
Structural Value	41,028	Discounting future VNBs using two stage DCF
FY17E VNB	2,560	12% VNB Margin
Implied VNB Multiple	16	
Total Valuation	**130,231**	

Source: Company Data, Investec Securities estimates

Sensitivity of valuations to growth rate and margins

We see potential for valuation upgrades as growth visibility improves and note that growth will also have a positive impact on the VNB margins (as highlighted in the front section). Hence, there will be double positive leverage on the valuations due to growth revival (see table 3).

Table 29: Sensitivity to valuations and VNB Margins

		VNB Margins			
		8%	**10%**	**12%**	**14%**
APE growth	**0%**	104,006	108,078	112,149	116,221
	5%	109,183	114,407	119,630	124,854
	15%	124,518	133,152	141,787	150,422
	20%	135,512	146,591	157,671	168,751

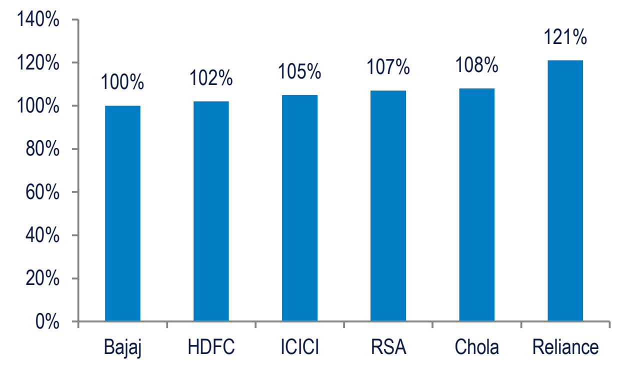
Source: Investec Securities estimates

Bajaj Allianz general insurance – High quality franchise

- **Lowest combined ratio in the industry –** BAGIC has operated at combined ratios below 110% over the last eight years, which is impressive given a) high competition; (b) the impact of motor third party pool losses; and (c) high interest rates in India (high interest rates lead to high combined ratios in the industry).

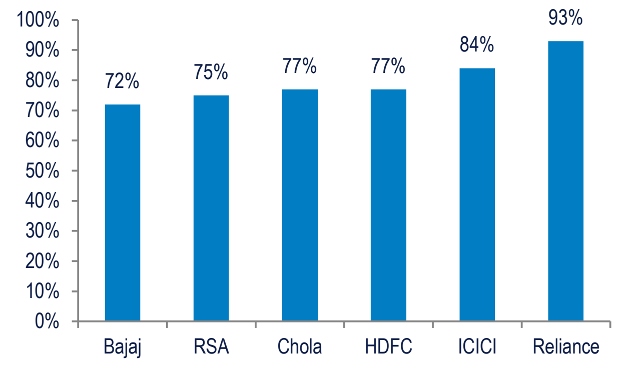
- **Strong GWP growth rates –** GWP growth at 16% CAGR (vs industry growth of 19%) over the last five years.
- **Focus on profitable business –** It is easy to show growth in the general insurance business, but an eye on profitability is the key to generating shareholder value over the long-term. The company has been consistently profitable and generates one of the highest RoEs in the sector.
- **Strong distribution –** The company was one of the first entrants in the general insurance business and built significant in-roads into passenger vehicle dealerships across the country.
- **Sustainable competitive advantages in the passenger cars segment:** BAGIC has a strong presence in the passenger vehicle segment, especially in private cars. It has more than a 10% market share in the motor-own damage segment, which is primarily within passenger vehicles.
  - **Early mover in the segment –** BAGIC was one of the earlier entrants in the non-life space, developed relationships with the dealers and remained consistent in its strategy.
  - **Scale gave a competitive advantage –** Apart from the cost benefits that scale brought the company; it also provided access to behavioural data on customers, helping it to price risks much better. Moreover, as it became sizable, it started to account for significant claims business of the automobile dealers. Hence, dealers could not ignore it and were forced to source business for the company.

Figure 134: Bajaj operates with lowest combined ratio (FY14)



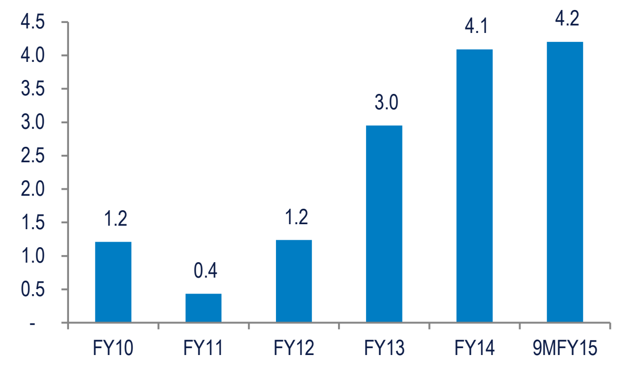
Source: Company data

Figure 135: and lowest claims ratio (FY14)



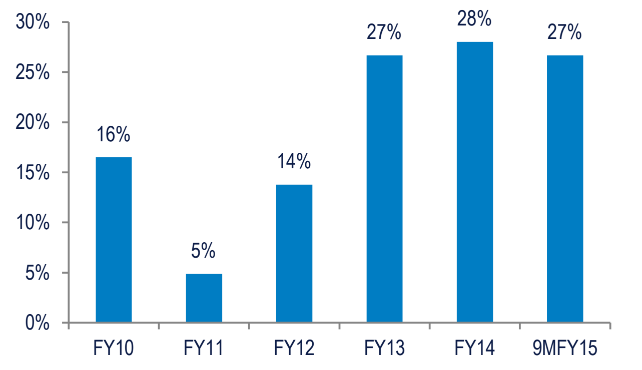
Source: Company data

Figure 136: Strong PAT growth



Source: Company data

Figure 137: High return on equity



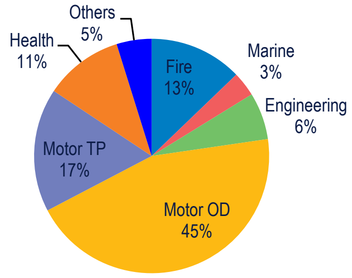
Source: Company data

Flip-flop strategy at the periphery drives higher returns

The company has a core portfolio including motor, health and other usual lines of business, which constitute 85%-90% of the gross premium. The company follows a flip-flop strategy in the remaining 10%-15% of the business. For example, it was one of the first players in the high value cars when other players were afraid of offering product in that segment, which it then exited when competition became aggressive. In the current year, the company has ventured into agriculture insurance (basically weather insurance) in line with this strategy. This approach has played out well in the past, enabling the company to generate higher returns. Though there are no guarantees it will play out in the future, we believe this is the right strategy in the non-life business.

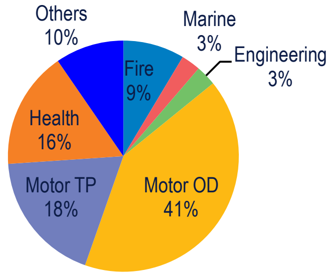
The non-life business goes through cycles just like other sectors; to generate high returns, companies should be willing to retreat when profitability is not adequate. As Warren Buffet said, most insurers failed to walk away from under-priced business, which is the main source of losses for the P&C companies. In our view, BAGIC has remained disciplined and walked away from businesses that did not make sense.

Figure 138: Product mix in FY10



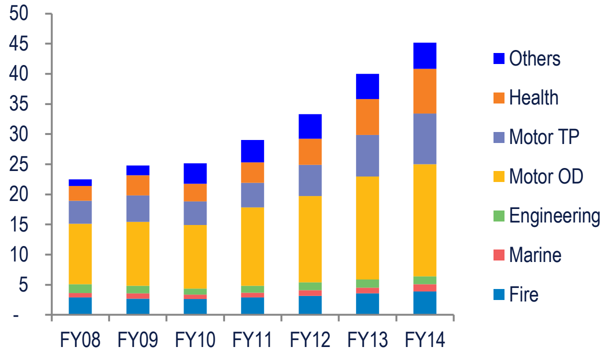
Source: Company Data, Investec Securities estimates

Figure 139: Product mix in FY14



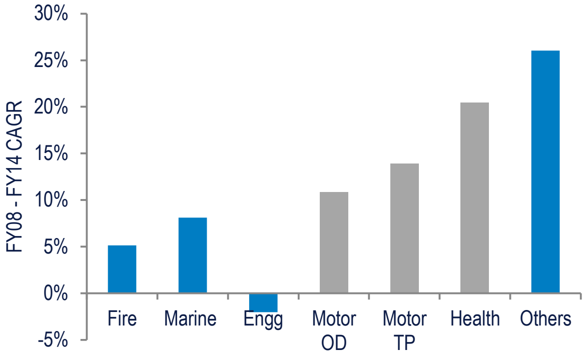
Source: Company Data, Investec Securities estimates

Figure 140: Premium breakup segment wise (Rs Bn)



Source: Company Data, Investec Securities estimates

Figure 141: Retail lines have grown at higher pace than commercial



Source: Company Data, Investec Securities estimates

Health Insurance should be a growth driver

India is massively under-insured in terms of health insurance. And with the increasing average age, rising healthcare costs and rising customer awareness, the health insurance sector is expected to grow by 15% over the next five years (source: WHO). For BAGIC, the health insurance segment has grown at a CAGR of 20% versus sector growth of 15% over 2008-2014. We expect BAGIC to show 18% growth in the health insurance segment, given its strong distribution network and good brand name.

Combined ratio and RoEs to sustain

We expect the combined ratio to improve in FY15E and remain at those levels given that: (a) provisions on the erstwhile motor third party portfolio ended in FY14; (b) premium hikes in the third party segment reduced the related claims ratio; (c) scale benefits/operating leverage should reduce the operating expense ratio.

Table 30: BAGIC DuPont Analysis

	2011	2012	2013	2014	2015E	2016E	2017E
Claims ratio	81%	77%	72%	72%	72%	73%	74%
Combined ratio	**111%**	**107%**	**102%**	**100%**	**97%**	**97%**	**98%**
Investment return	9%	10%	10%	10%	9%	9%	9%
Investment/NEP	1.5	1.6	1.6	1.7	1.8	1.9	1.9
Investment return/NEP	14%	15%	16%	17%	17%	17%	18%
PBT/NEP	3%	8%	14%	17%	19%	20%	20%
PAT/NEP	2%	5%	10%	12%	13%	14%	14%
NEP/Assets	2.6	2.8	2.6	2.4	2.1	1.9	1.7
RoA/RoE	**5%**	**14%**	**27%**	**28%**	**28%**	**26%**	**24%**

*NEP = Net-earned premium, Source: Company Data, Investec Securities estimates

Valuations

We value BAGIC using a discounted cash flow model with a cost of equity at 13% and terminal growth rate of 4.5%. We value the business at Rs119bn, implying 4.1x FY16E net worth, 18x FY16E earnings and 1.3x FY16E float. We value the other general insurance businesses in India at 14x-20x FY16E earnings and believe BAGIC deserves a premium over its peers given best-in-class return ratios and growth ratios.

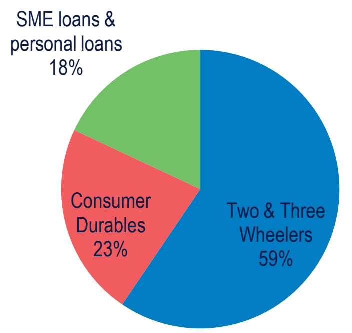
Bajaj Finance – A unique financing business

Bajaj Finance is a diversified NBFC with lines of businesses in vehicle financing (two/three wheelers), mortgages, SME loans, consumer durables, personal loans, home loans, infrastructure, construction equipment and rural financing. The company has come a long way from its position in 2008 when it faced huge losses due primarily to the unsecured nature of the book. The company has since diversified into secured segments of loans against property and home loans. These segments have low churn rate (velocity), a long tenure and low credit costs.

The company is one of the best performers among the listed NBFCs in India, generating more than 30% CAGR return for shareholders over the last five years:

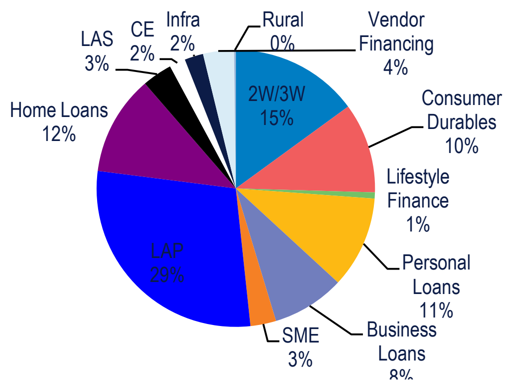
- **Strong growth in difficult times –** The company has grown its loan book at a CAGR of 57% over the last five years. This is despite the company having experienced growth pressure in its infrastructure book, construction equipment book and two-wheeler financing book.
- **Credit costs have remained under control –** NPAs and credit costs (provisions + write-offs) have remained under control during this cycle, despite operating in a risky segment with limited collateral.
- **High return on equity** – The company has generated RoAs/RoEs of more than 3.5% and 20% over the last three years, ranking among the top NBFCs in terms of return ratios.

Figure 142: AUM book break up (FY08)



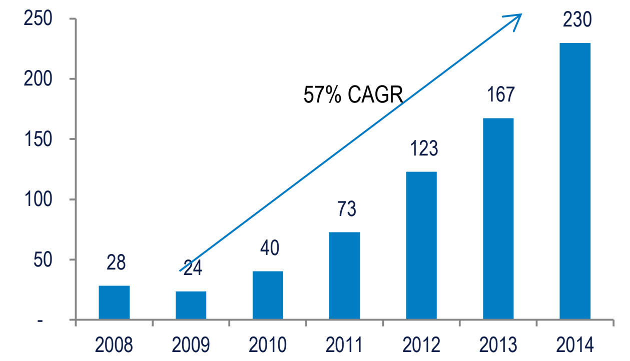
Source: Company Data, Investec Securities estimates

Figure 143: AUM breakup (FY14)



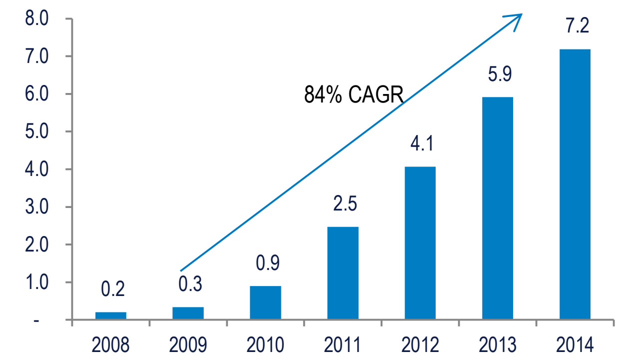
Source: Company Data, Investec Securities estimates

Figure 144: Bajaj Finance – Loan book growth (Rs bn)



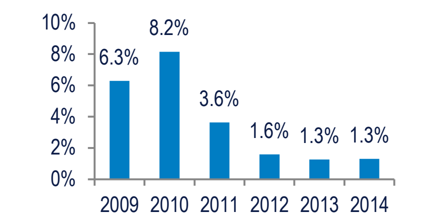
Source: Company Data, Investec Securities estimates

Figure 145: PAT growth of 89% CAGR



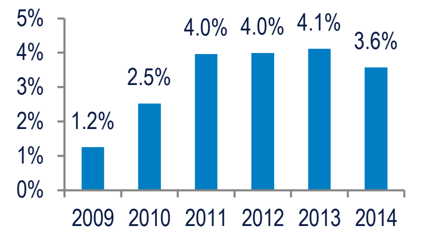
Source: Company Data, Investec Securities estimates

Figure 146: Credit costs have come down



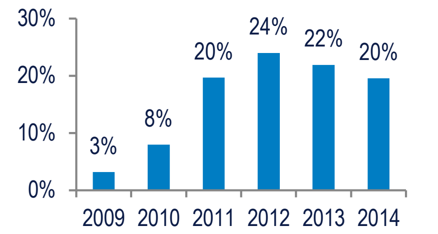
Source: Investec Securities estimates

Figure 147: RoAs have improved



Source: Investec Securities estimates

Figure 148: and so is RoEs



Source: Investec Securities estimates

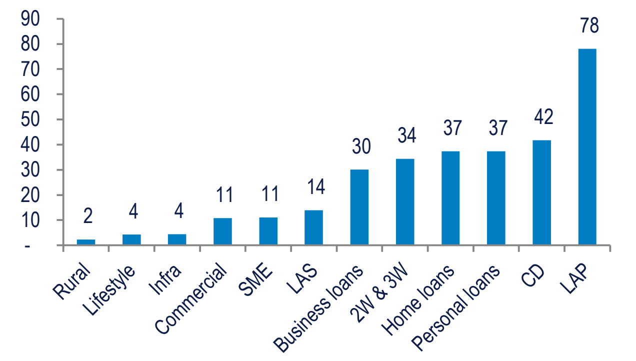
A diversified player in niche small segments

Bajaj Finance has found its niche in segments like consumer durable financing, lifestyle financing, loans against shares and unsecured business loans. These segments are significantly smaller than segments like mortgages, infrastructure and vehicle finance. They have small ticket size loans and lower tenure loans (less than one year), which result in high velocity (churn rate) and require very high operating rigour. Also, these segments suffered badly during the 2008 financial crisis given the unsecured nature of the products. The qualities of small-sized segments, high operating rigour and history of past losses has kept competition at bay over the last few years, allowing the company to earn high returns on capital.

Moreover, it is the preferred financier of Bajaj Auto's products, which has given the company access to the high yielding two-wheeler and three-wheeler financing segments. The company has more than a 20% market share in two-wheeler financing.

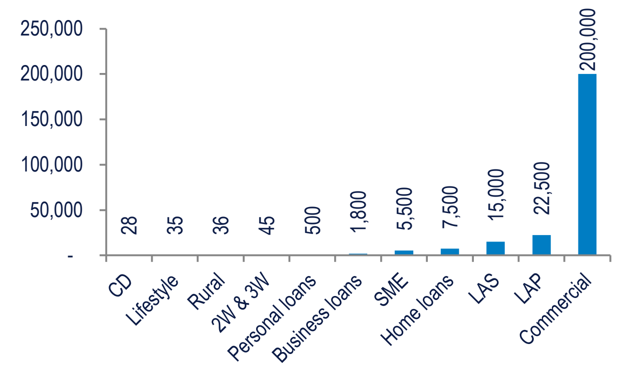
Also note that though AUM passed the Rs300bn mark, making it the third largest NBFC in India, the size of each line of business is still small compared with the potential and should thus enable the company to grow at above the industry average.

Figure 149: Size of each segment is small vs. potential (Rs Bn)



Source: Company Data, Investec Securities estimates

Figure 150: Ticket size in Rs '000s



Source: Company Data, Investec Securities estimates

Structural drivers have helped the company in this cycle

The majority of segments discussed above where the company has competitive advantages are unsecured and risky segments, which suffered significant losses in the previous cycle. However, the company demonstrated strong asset quality in these segments in the current cycle on account of: (a) structural changes in the industry; and (b) corrective steps taken by the company following its experience in 2008. The biggest structural change in retail credit was the development of CIBIL (credit bureau), which brought credit discipline to the retail borrowers.

The company has also learnt from its experience of 2008, approaching the business differently after the financial crisis. It reduced its branch network, cut down on dealer relationships and incorporated changes in credit underwriting. In addition, management has focused on increasing the proportion of long-term secured loans (mortgages and infrastructure) to reduce overall risks in the business.

Mortgages could be problematic area in future

Bajaj Finance has been active in mortgage business (primarily loans against property) over the last five years. The mortgage book has grown at more than a 75% CAGR over the same period and stands at Rs78bn as of 9MFY15. We believe loans against property could be a problematic segment given (a) high rates of growth in the past; b) significant players entering the segment; c) it is lightly regulated versus home loans; and d) subjectivity in credit assessment. We believe one or all of the following will happen, which will reduce return ratios in the segment: yields may come down on increasing competition, credit costs may rise given difficulties in credit assessment or regulators may clamp down on the sector.

Valuations

Bajaj Finance is a listed company and we value the company based on the market price of Bajaj Finance. The current market capitalisation of the company is Rs205bn at Rs4,100 per share.

Bajaj Finserv – Valuation

We value Bajaj Finserv using a sum-of-the-parts methodology with a 74% stake in Bajaj Allianz Life Insurance and a 74% stake in Bajaj Allianz General Insurance. We value Bajaj Finserv's 61.5% stake in Bajaj Finance at the market valuation.

Table 31: Bajaj Finserv – Sum of the parts valuation

Business Segment	Valuation	Stake	Per Share Value	Comments
Life Insurance	130,231	74%	605	Appraisal value methodology FY16E EV + 16x FY17E VNB
General Insurance	119,049	74%	553	Discounted cash flow - 14.5x FY16E PAT
Bajaj Finance	204,845	62%	791	Current market cap Rs4100 per share
Total SOTP Valuation			**1,950**	

Source: Investec Securities estimates

Allianz call option is likely to be worthless

Allianz SE, the company's foreign JV partner in both life and general insurance businesses, holds call options to increase its stake in life insurance to 74% and general insurance to 50% at pre-determined valuations. This represents a 16% CAGR return on capital invested by Bajaj in these subsidiaries, which is a fraction of our valuation for these subsidiaries.

However, RBI came out with guidelines on 15th July 2014 on the transfer of shares from residents of India to non-residents, which state that the transaction should happen at fair value (see link for more details on the guidelines).

Moreover, in March 2015, the RBI rejected the proposal by Tata Sons to buy back shares in TATA Docomo from Docomo at a pre-determined price. This further strengthened our conviction that RBI will not approve a stake increase by Allianz at a pre-determined price.

Summary Financials (INRm)

Year end: 31 March

Income Statement	2013	2014	2015E	2016E	2017E
Income from operations	126,732	121,137	100,829	108,632	119,252
Other operating income	38,235	49,120	62,607	78,312	96,472
Total income from operations	**164,968**	**170,257**	**163,436**	**186,945**	**215,725**
Claims incurred	-114,219	-110,007	-88,840	-95,602	-103,806
Operating expenses	-11,632	-15,615	-20,920	-26,154	-32,171
Total expenses	**-125,851**	**-125,622**	**-109,760**	**-121,756**	**-135,976**
Operating profit	**39,117**	**44,635**	**53,676**	**65,189**	**79,748**
Other income	8,254	10,630	11,275	12,520	14,465
Net interest	-12,036	-15,619	-22,127	-28,596	-35,974
PBT (normalised)	**27,081**	**29,016**	**31,548**	**36,592**	**43,775**
Exceptional items	0	0	0	0	0
PBT (reported)	27,081	29,016	31,548	36,592	43,775
Taxation	-4,939	-7,105	-8,111	-9,864	-11,897
Net profit	32,020	36,121	39,659	46,456	55,671
Profit attributable	15,736	15,441	16,517	18,520	21,994
EPS (reported) (INR)	103.6	97.0	103.7	116.3	138.2
EPS (normalised) (INR)	**58.8**	**97.0**	**88.7**	**116.3**	**138.2**
DPS (INR)	1.5	1.8	2.0	2.3	2.5
Av. no. of shares (m)	152	159	159	159	159
Total no. of shares (m)	159	159	159	159	159

Balance sheet	2013	2014	2015E	2016E	2017E
Property Plant & Equipment	7,806	8,330	8,458	8,592	8,733
Intangible assets	4,290	4,290	4,290	4,290	4,290
Policyholder assets	379,538	387,798	405,379	428,599	455,875
Investments and other non current assets	52,941	66,218	80,020	95,089	112,528
Cash and equivalents	16,031	20,610	20,610	20,610	20,610
Other current assets	111,623	172,181	242,247	320,435	405,138
Total assets	**572,230**	**659,427**	**761,004**	**877,615**	**1,007,174**
Total Debt	-129,907	-197,496	-263,492	-338,535	-418,805
Other long term liabilities	-927	-927	-927	-927	-927
Policyholder Liabilities	-334,392	-332,477	-344,621	-359,459	-376,870
Total Liabilities	**-465,226**	**-530,900**	**-609,039**	**-698,922**	**-796,603**
Net assets	**107,004**	**128,527**	**151,964**	**178,693**	**210,571**
Shareholders' funds	78,015	93,112	109,628	128,149	150,143
Minority interest	28,989	35,415	42,336	50,544	60,428
Total Equity	**107,004**	**128,527**	**151,964**	**178,693**	**210,571**

Source: Company accounts, Investec Securities estimates

Target Price Basis

Sum of the parts valuation

Key Risks

(1) Regulatory risk on the expenses management guidelines; (2) Delay in open architecture could lead to low new business premium growth; (3) A substantial decline in Interest rate could lead to negative spread on non-participating products.

Investec

Max India (MAXI.NS)

India | Life Insurance

BUY

Price: INR428.55

Target: INR550.00

Forecast Total Return: 29.3%

Market Cap: INR114bn

Average daily volume: 119k

Quality life insurance franchise

Max India has generated value by building high quality businesses, using capital judiciously, bringing in the right partners and selling stakes at opportune times and good valuations. We see it as having one of the best life insurance franchises in India. Healthcare has broken even and can fund future growth without equity infusion. Max Bupa is going strong and expected to break even in FY18E. Max India has generated an IRR of c.28% and c.23% respectively on its investments Max Life and Max Healthcare. We expect them to compound capital at >15%, while Max Bupa should be the next value creator. We initiate with a target price of Rs550, implying 29% upside. Buy.

- **Best quality life insurance franchise:** We believe Max Life has best persistency, best quality agency and a strong bancassurance channel. This led to it gaining market share and compounding EV at 15% CAGR over the last five years. We estimate the growth revival, persistency improvements and product mix changes (increase in proportion of non-par & pension products) could lead to margin & RoEV expansion, to 14% & 19% respectively over next five years.
- **Healthcare well placed to capture growth:** Max Healthcare is generating cash of more than Rs800m annually. This, in conjunction with Life Healthcare infusing Rs4bn cash into the company, means it may not need further equity capital infusion for future growth. It plans to add 1500 more beds, mainly in its existing hospitals to take advantage of the increase in FSI. Max India has funded MHC very efficiently, using stake sales to fund expansion and generating an IRR of 23%.
- **Health Insurance could be a next big growth driver:** Max India has a history of creating strong business and generating shareholder wealth. We see Max Bupa as the next growth driver over the next five years. The company is well managed, profitability oriented, growing at a healthy pace and operating in an attractive sector.
- **Strong compounding story:** Max India remains a strong compounding story from here; we expect Max Life to compound capital at 17% (RoEV) and MHC at 15% (EBITDA growth FY16E-FY20E) over the next five years. Max Bupa could be the next value creator and could generate higher returns (>20%). Ahead of the planned demerger, we value the company on a SOTP basis, deriving a fair value of Rs550.

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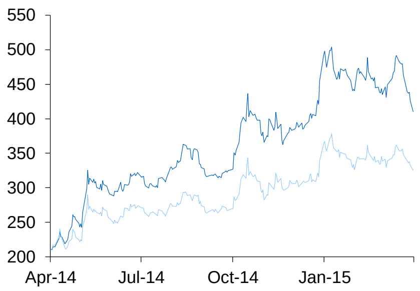
Financials and valuation — Year end: 31 March

	2013A	2014A	2015E	2016E	2017E
Total income (INRm)	97,620	116,263	149,027	138,475	158,270
Operating profit (INRm)	2,142	3,108	6,498	4,371	6,041
PBT (normalised) (INRm)	3,114	2,745	3,178	3,265	4,515
Embedded value (INRm)	37,560	39,530	46,508	51,993	58,048
EPS (normalised)(INR)	3.9	5.2	5.3	7.6	10.2
DPS (INR)	12.5	3.6	4.8	4.8	5.8
Embedded value per share (INR)	142	149	175	195	218
BV/share (INR)	114.0	114.5	120.8	122.9	126.2
PE (normalised) (x)	104.5	78.3	77.0	54.3	40.3
Dividend yield (%)	3.1	0.9	1.2	1.2	1.4
P/BV (x)	3.6	3.6	3.4	3.3	3.3
ROA (%)	3.7	0.5	1.2	0.5	0.6
Group ROE (%)	3.4	4.6	4.4	6.1	8.1

Source: Company accounts/Investec Securities estimates

Price Performance



	1m	3m	12m
Price	(5.7)	(16.7)	90.6
Price rel to India S&P BSE 500 - BSE	(4.0)	(10.5)	51.3

Source: FactSet

Figure 151: Company Snapshot

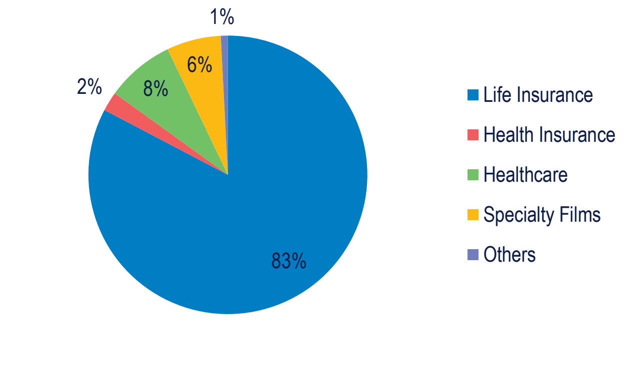
Max India has interests in life insurance, health insurance, healthcare, specialty films and senior living. The company started operations in 1985 with the primary business of specialty films. Over the next 16 years, Max India ventured into diverse businesses, including telecoms in partnership with Hutchison.

Notable during the transformation phase was Max India's exit from the telecom sector and entry to life insurance and healthcare segments. The company has since generated value for all stakeholders (shareholders, employees, and partners). Management's capital allocation track record has been excellent.

Currently, life insurance is the largest business within the group, contributing 83% to revenue and c.80% to valuation.

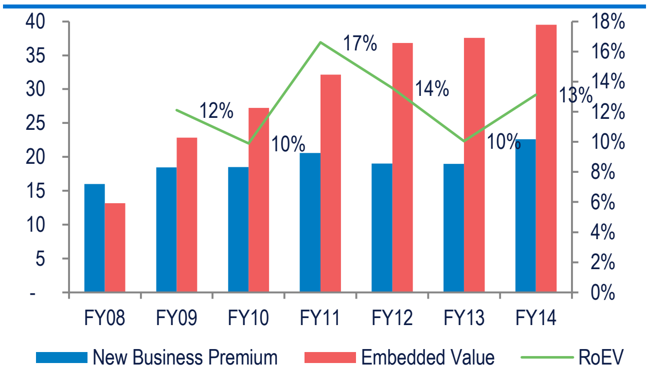
Source: Company Data, Investec Securities estimates

Figure 152: Revenue breakup (FY14)



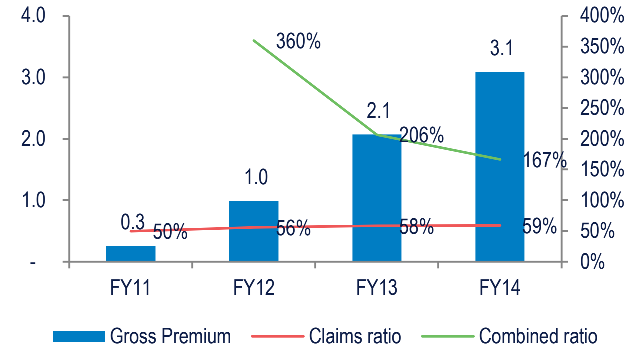
Source: Company data

Figure 153: Life Insurance business – Performance (Rs bn)



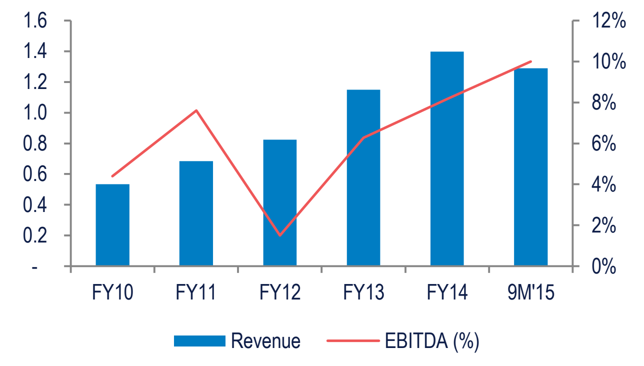
Source: Company data

Figure 154: Health Insurance Business – Performance (Rs bn)



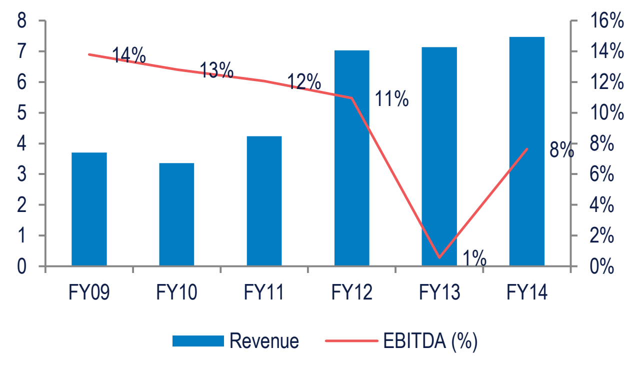
Source: Company data

Figure 155: Healthcare business – Performance (Rs Bn)



Source: Company data

Figure 156: Specialty films business – Performance (Rs bn)



Source: Company data

Max Life – a high quality life Insurance company

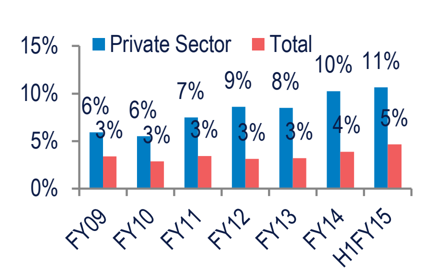
Max Life is the only non-bank promoted private player (among top 10 players) to gain market share over last five years

Max Life is the largest non-bank promoted private life insurance company in India (in terms of individual new business premiums) and the only non-bank company (among top 10 players) to gain market share during the last five years. It has remained focused on sustainability and profitability, while ignoring popular fads in the market. The company had one of the highest proportions of traditional products in the pre-2010 era, when others were selling more than 90% unit-linked products.

We believe it is the best quality insurance franchise in India given its:

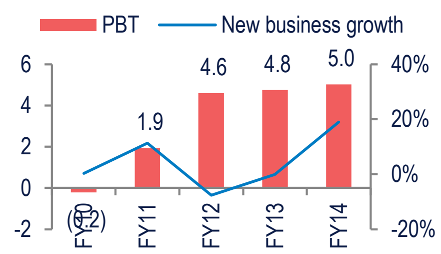
- **Consistent performance:** Max Life has been one of the most consistent players in terms of new business growth, statutory profitability, and embedded value accretion.
- **Best in class persistency:** Its persistency is the best among the private players across all time buckets, especially in higher buckets (49th/61st month).
- **High and sustainable RoEV:** Max Life reported a RoEV of 13% for FY14 and broke even on a cost overrun basis. Its average RoEV is 13% with EV compounding of 15% over the last five years (highest among private players after HDFC Life).
- **Best disclosures in the sector:** It is among the pioneers in India to start disclosing embedded value accounts, and the only Indian company to disclose embedded value sensitivity.
- **Balanced product strategy:** Focussed on long-term traditional products with a balanced product portfolio. This strategy enabled the company to gain market share post Unit-Linked Product guidelines in 2010, which impacted other private players that were concentrating mostly on Unit-Linked Products. Similarly, it didn't participate in the NAV guaranteed products in 2012-13 which were later banned by the IRDAI.
- **Balanced distribution strategy:** A diversified distribution mix with a focus on agency and bancassurance. It continued to invest in its agency channel during the last three years when others were cutting theirs. It has one of the most productive agency Bancassurance partnerships, with Axis Bank and Yes Bank, which accounts for c.55% of new business premiums, provides access to 3,100 branches and a 14m client base across India.

Figure 157: Max Life – Market share



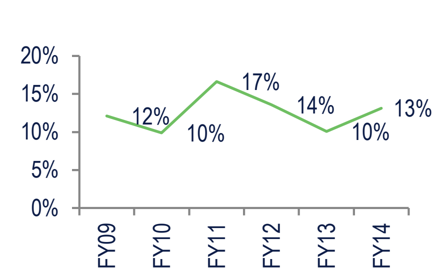
Source: Company data

Figure 158: PBT (Rs Bn) & new business growth



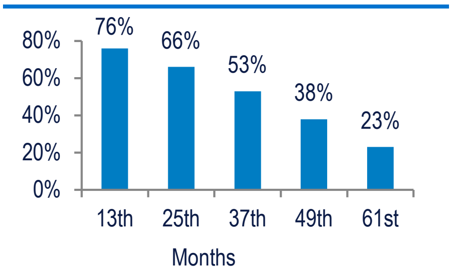
Source: Company data

Figure 159: Consistent RoEV



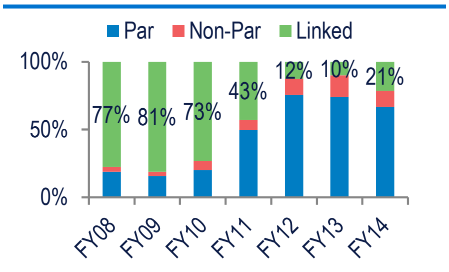
Source: Company data

Figure 160: Best in class persistency



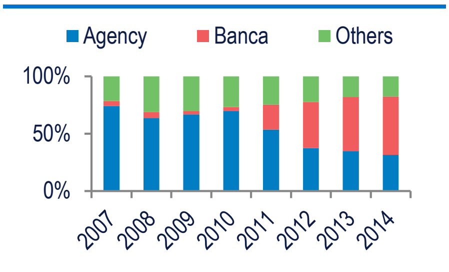
Source: Company data

Figure 161: Diversified product mix



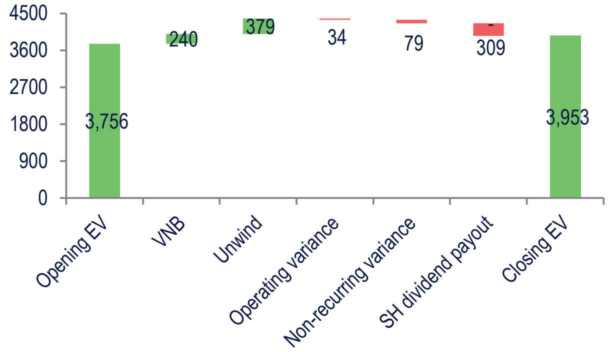
Source: Company data

Figure 162: Diversified distribution mix



Source: Company data

Figure 163 Max Life FY2014 EV walk (Rs Mn)



Source: Company data

Table 32: Max Life – EV sensitivity disclosures

	Value of In force	Value of New Business
RDR + 100bps	-4.20%	-7.20%
RDR - 100bps	4.70%	8.00%
Investment Return + 100bps and RDR + 100 bps	-2%	-0.10%
Investment Return - 100bps and RDR - 100 bps	2.20%	0.00%
Investment Return + 100bps	2.3%	7.7%
Investment Return - 100bps	-2.4%	-7.4%

Source: Company data

Operating RoEV to improve

We expect operating return on embedded value (RoEV) to increase from current levels of 15%-16% over the next three years as:

- **Product mix changes** – Max Life has a low proportion of high margin Non-Participating products, which we expect to increase slightly as the company got regulatory approval for a couple of non-par products recently. Also, the increase in proportion of Unit-Linked Products, which are popular given the upbeat capital markets, will be margin accretive.
- **New business premium growth accelerates** – As highlighted in the thematic section, we expect growth rates to increase for the top 6 private players, which should help RoEV expansion.
- **Operating efficiency improves** – Life Insurance is a high fixed cost business, which should enjoy operating efficiency gains as growth rates improve. We expect operating costs as a % of FUM and as a % of total premium to reduce to 4.8% (6.4% in FY14) and 16.5% (17.4% in FY14) in FY17E respectively.
- **Persistency improves** – Persistency should improve over the next three years as a) pre-2010 Unit-Linked policies go out of the system and b) the focus on persistency (from management and regulator) shows results. We expect the persistency in the 49th and 61st month buckets to improve to 50% (38% in FY14) and 40% (23% in FY14) in FY17E respectively.

We expect RoEV to improve to 19% over the next three years and margins to increase to 13.5%.

Max Life could play a role in industry consolidation given surplus capital availability

Max Life could participate in the consolidation of the industry

Max Life has a capital surplus, with a solvency ratio of 469% versus a regulatory requirement of 150%. At the same time, the company is generating free cash flows in excess of Rs4bn on an annual basis. Given our expectation of smaller players getting marginalised, Max Life could participate in consolidation in the industry further strengthening its market positioning and distribution.

Open architecture in bancassurance should be a positive for the company in the long run

Bancassurance guidelines a 'known unknown'

As highlighted in the thematic section, draft guidelines on corporate agents are aimed at opening up the bancassurance channel. We see a high likelihood of these guidelines getting implemented in the current form. However, the exact impact of the guidelines on Max Life is not certain. The share of business from its current bancassurance partnership would likely decline post implementation of these guidelines and there will be the opportunity for tie-ups with other banks.

In our opinion, it will be positive for the company as a) dependence on one bank will reduce and b) avenues of tie-ups with multiple banks will open up. It should be noted that Max Life is the largest non-bank promoted private life insurer, which should help it to be a suitable partner for banks.

Final guidelines on expenses management could be a risk

As also highlighted in the thematic section, the IRDAI has floated a discussion paper to regulate the management expenses of life insurance companies. The guidelines, if implemented in their current form, could impact profitability by c.Rs800m (or 16% of FY14 PBT). However, the impact could be lower if a) final guidelines are diluted from their draft form, or b) adequate time is given to comply with the guidelines.

Our conversations with industry participants indicate that the regulator wants to implement the guidelines on management expenses, but that many believe the final guidelines will be significantly diluted from their current form.

Valuation

We value Max Life using appraisal value methodology (Embedded Value + Structural Value). We have increased its embedded value by 10% to make allowance for transition towards MCEV from EEV.

We have used absolute valuation methodology to estimate the structural value. We discount new business profits using a two stage DCF model with 10 years of explicit forecasts and then assume subsequent years of declining growth down to terminal growth. The terminal growth rate is assumed at 5% and cost of equity at 13.5%. The implied VNB multiple is 23x.

In our view, this multiple is justified given what we see as a high quality franchise and high sustainability of growth and margins.

Table 33: Valuation of Max Life

Rs. Mn	Value	Comments
FY16E Embedded Value	64,695	Pre-dividend; assuming 10% upgrades on translation to MCEV
Structural Value	91,340	Discounting future VNBs using two stage DCF
FY17E VNB	4,046	13.5% VNB Margin
Implied VNB Multiple	23x	
Total Valuation	**157,506**	

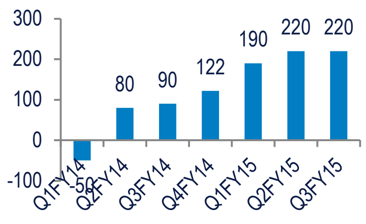
Source: Investec Securities estimates

Max Healthcare – on the verge of breakeven

Max Healthcare operates 12 hospitals in North India (9 in National Capital Region and one each in Mohali, Bhatinda and Dehradun). Recently started hospitals are Mohali, Bhatinda, Dehradun and Shalimar Bagh, while others have been in operation for more than five years. Life Healthcare and Max India each hold 46.25% and IFC holds a 7.5% stake in the company.

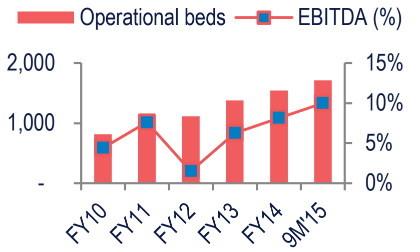
The total operational beds are 1,717 as of Dec'14, which will increase to 2,000 as capacity utilisation improves in these hospitals. Management expects to further expand bed capacity in the existing hospitals, taking advantage of an increase in the FSI (floor space index) in New Delhi. EBITDA margins have improved with higher utilisation. The company has already broken even on a cash basis and we expect it to break even on a profitability basis in FY16E.

Figure 164: Cash profits have increased



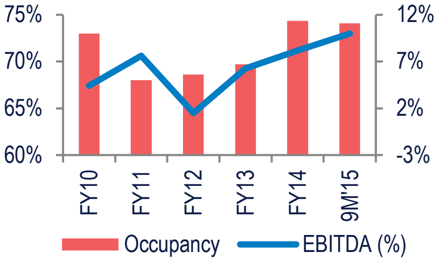
Source: Company data

Figure 165: Operational beds and EBITDA Margins



Source: Company data

Figure 166: EBITDA margins improve as occupancy improved



Source: Company data

Business is adequately capitalised

The company has plans to increase beds by an additional 1,500 over the next four to five years, with most in existing hospitals, taking advantage of the increase in FSI in New Delhi. This will require capex of c.Rs7.5bn over the next five years. The company has received a cash infusion of c.Rs4bn from its partner, Life Healthcare. In addition to this, the company is expected to generate Rs1bn in cash on a yearly basis. Hence, with debt funding of around Rs3bn, the company should not require any further equity capital injection. Hence, there should not be any additional capital requirement in the business for Max India.

Table 34: Capital allocation in Max Healthcare by Max India (Rs Mn)

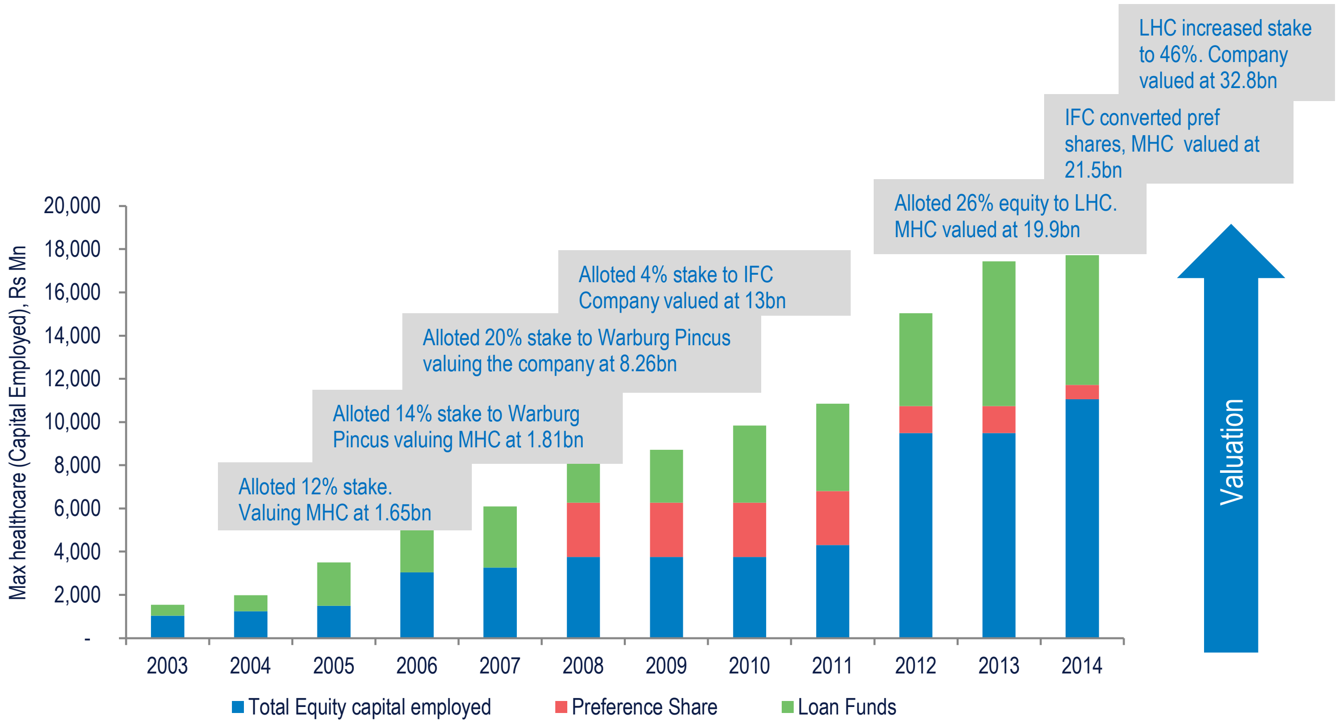
Year	Capital allocated)
2003	1,038
2006	407
2007	216
2012	1,400
2015 (LHC Deal)	(3,830)
2015 Valuation of 46% stake	(15,088)
IRR	**23%**

Source: Investec Securities estimates

Max India has managed capital requirements astutely

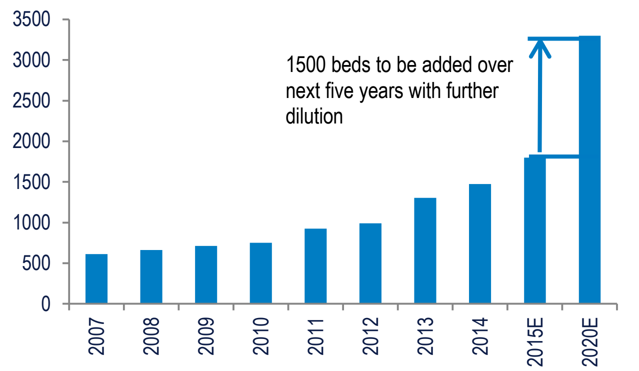
Healthcare is a capital intensive business with long gestation periods and hence capital management is very important. Max India has demonstrated the ability to bring quality partners (both strategic as well as financial) to address the funding requirements of the company at adequate valuations. Moreover, in the process, we estimate it has generated more than 23% IRR on its investment (assuming the exit valuation subscribed by Life Healthcare).

Figure 167: Deals in Max Healthcare over last 12 years – Value creation driven by the deals



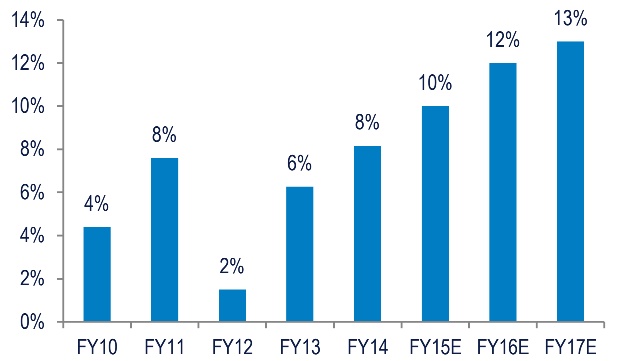
Source: Company data, Investec Securities estimates

Figure 168: Around 1500 beds to be added over next five years without any further dilution



Source: Company data, Investec Securities estimates

Figure 169: EBITDA margins are expected to improve



Source: Company data, Investec Securities estimates

Valuation

We value Max Healthcare at Rs32,000m, using DCF methodology, with cost of equity of 13% and a terminal growth rate of 5%. This implies an EV/EBITDA multiple of 17x in FY17E. Peers Apollo Hospitals and Fortis Healthcare are trading at 17x EV/EBITDA (based on consensus). We note the recent deal with Life Healthcare valued the company at Rs32,800m.

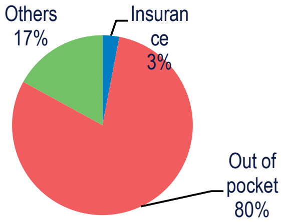
Max Bupa could be a significant value driver

Max Bupa is a standalone health insurer in India. It started its operations in FY11 and has been growing strongly since then. The company has been concentrating on profitable retail business and has almost exited the low/negative margin group business. Claims ratios have been very stable at around 50%, among the lowest within the peer group and combined ratios are reducing as operating leverage is playing out.

Health insurance: Underpenetrated & offering a strong growth opportunity

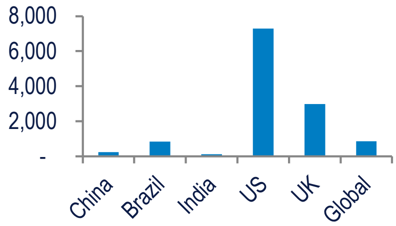
Health insurance penetration in India is very low and we expect it to improve given favourable demographics, rising disposable incomes, increasing awareness about the product and increasing tax incentives.

Figure 170: 80% of healthcare costs are paid from pocket



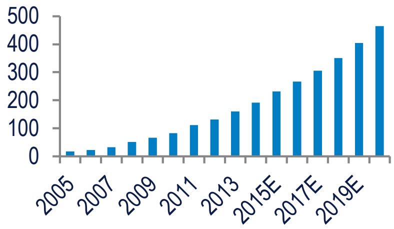
Source: WHO World Health Statistics, 2010

Figure 171: Healthcare spending per capita (PPP)



Source: WHO World Health Statistics, 2010

Figure 172: Health Insurance industry to grow at CAGR of 15% over next 5 years (GWP, RsBn)

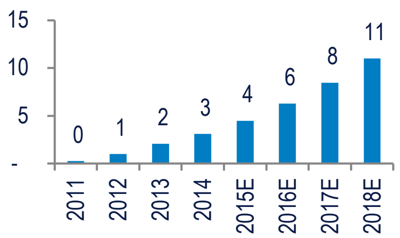


Source: WHO World Health Statistics, 2010

Losses have peaked and should start coming down from hereon

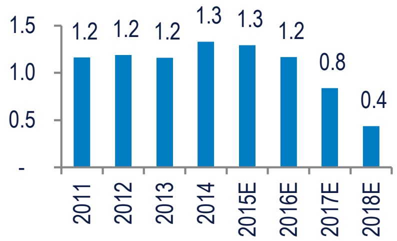
In our opinion, the reported loss has peaked in FY14 and it should start coming down from his year onwards. Moreover, we expect the company to breakeven in FY18 once the gross premium reaches Rs10bn.

Figure 173: Max Bupa GWP (Rs bn)



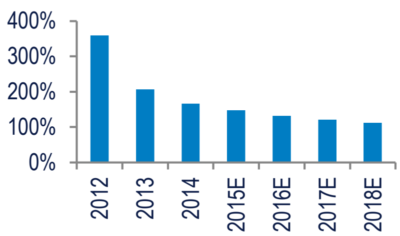
Source: Company data, Investec Securities estimates

Figure 174: Max Bupa losses (Rs Bn)



Source: Company data, Investec Securities estimates

Figure 175: Max Bupa Combined ratio



Source: Company data, Investec Securities estimates

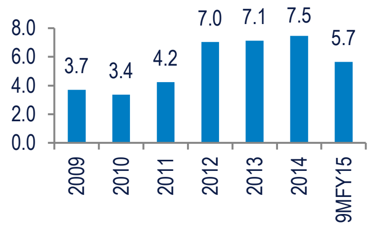
Valuation

We have valued Max Bupa at 1.5x the capital employed in the business, which values the entity at Rs11,250m.

Max Speciality films is showing signs of improvement

The EBITDA margin and profitability of the entity has improved recently, which we expect to be sustained given low crude oil prices and the benign competitive environment in the packaging industry.

Figure 176: MSF – Revenue (Rs bn)

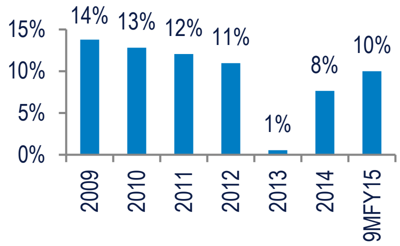


Source: Company data

Figure 177: MSF – PAT (Rs bn)

Source: Company data

Figure 178: MSF – EBITDA margin



Source: Company data

Valuation

We valued the entity at the open offer price offered by the promoter in the demerger process, i.e. Rs1,700m (see overleaf).

Corporate restructuring allays capital allocation concerns

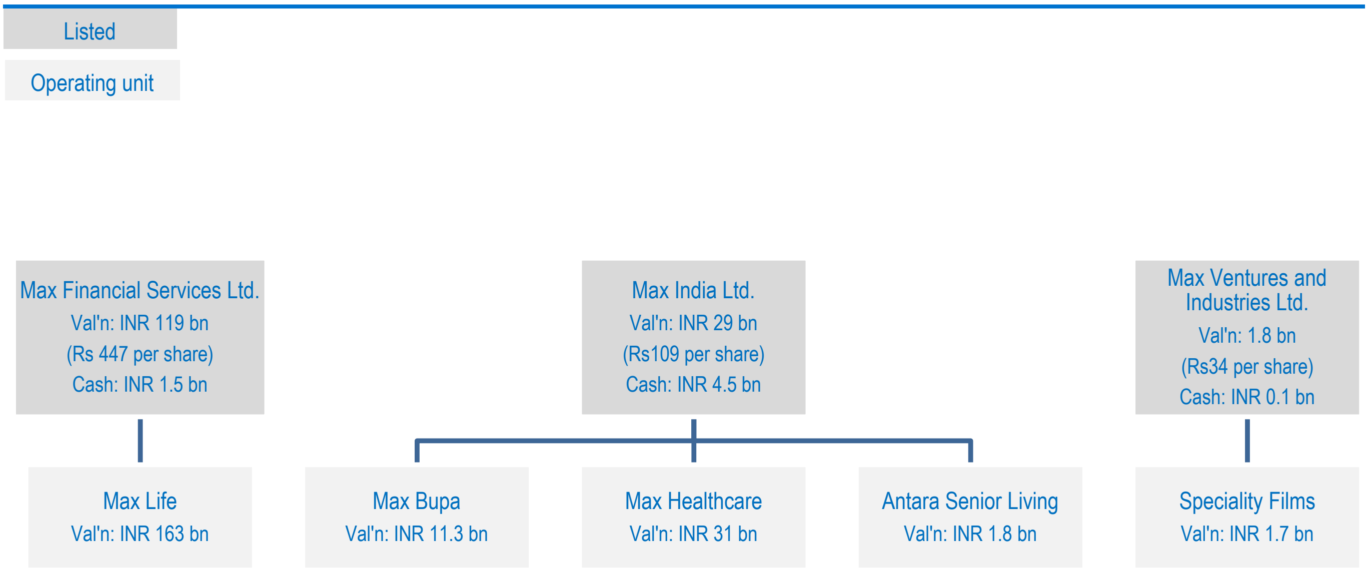
Max India has recently announced its intention to split the company into three listed entities. The first entity will hold 72.2% of Max Life, the second entity a 46% stake in Healthcare, a 74% stake in Health Insurance and 100% of the senior living business, while the third will holds the Specialty Films business. This new corporate structure should alleviate one of investors' biggest concerns, on capital allocation, and provides an opportunity of pure play on the Indian Life Insurance sector.

Max Life has been generating free cash flows and paying dividends (c.75% of PAT). Max Healthcare may not require further capital infusion from Max India over the next five years, but Max Bupa will still require capital which Max India will fund through the proceeds it will receive from the sale of a 23% stake in Max Bupa to Bupa.

The Max India promoter will also make an open offer to shareholders in Max Ventures and Industries Limited at a valuation of c.Rs1,700mn, which we think will provide a good opportunity to shareholders to exit this business at a decent valuation. We see this as a commodity business and note that peers have failed to generate shareholders' returns.

We would recommend investors stay invested in Max Financial Services and Max India, post the listing of the three separate entities.

Figure 179: Max India corporate structure post vertical split



Source: Investec Securities estimates

Max India – Valuation

Table 35: Max India – Sum of the parts valuation

Business Segment	Valuation	Max India Stake	Value per share	Methodology
Life Insurance	157,506	72.2%	427	Appraisal Value Method (FY16E EV + 23x FY17E NBAP)
Max Healthcare	31,000	46.5%	54	15x FY17E EBITDA
Max Bupa	11,250	74.0%	31	1.5x Value of Capital Infused
Antara Senior	1,800	100.0%	7	1.0x Value of Capital Infused
Speciality Films	1,700	100.0%	6	Based on Open offer valuation by promoter
Cash	6,500		24	
Total SOTP Valuation			**550**	

Source: Investec Securities estimates

Investec

Summary Financials (INRm)

Year end: 31 March

Income Statement	2013	2014	2015E	2016E	2017E
Income from operations	81,632	91,231	95,669	110,880	127,431
Other operating income	15,988	25,032	53,359	27,594	30,840
Total income from operations	**97,620**	**116,263**	**149,027**	**138,475**	**158,270**
Claims incurred	-27,530	-30,680	-38,435	-46,668	-53,556
Operating expenses	-67,948	-82,476	-106,744	-87,435	-98,673
Total expenses	**-95,478**	**-113,156**	**-145,179**	**-134,104**	**-152,229**
Operating profit	**2,142**	**3,108**	**3,848**	**4,371**	**6,041**
Other income	616	569	300	300	300
Net interest	-845	-932	-970	-1,406	-1,827
PBT (normalised)	**3,114**	**2,745**	**3,178**	**3,265**	**4,515**
Exceptional items	8,000		2,650		
PBT (reported)	11,114	2,745	5,828	3,265	4,515
Taxation	-1,419	-650	-932	-653	-993
Net profit	8,495	2,095	4,896	2,612	3,521
Profit attributable	7,841	1,394	3,819	2,011	2,711
EPS (reported) (INR)	29.6	5.2	14.3	7.6	10.2
EPS (normalised) (INR)	**3.9**	**5.2**	**5.3**	**7.6**	**10.2**
DPS (INR)	12.5	3.6	4.8	4.8	5.8
Av. no. of shares (m)	265	266	266	266	266
Total no. of shares (m)	266	266	266	266	266

Balance sheet	2013	2014	2015E	2016E	2017E
Property Plant & Equipment	13,610	14,945	15,159	16,051	16,886
Intangible assets	100	100	100	100	100
Policyholder assets	204,716	246,335	312,160	351,391	390,124
Investments and other non current assets	6,197	5,001	8,078	11,218	12,982
Cash and equivalents	3,621	3,945	3,945	3,945	3,945
Other current assets	4,338	12,725	10,842	12,842	15,842
Total assets	**232,481**	**282,951**	**350,184**	**395,447**	**439,779**
Total Debt	-6,763	-6,994	-7,377	-13,447	-13,612
Other long term liabilities	-190	-148	-148	-148	-148
Policyholder Liabilities	-187,900	-237,107	-301,216	-339,244	-381,718
Total Liabilities	**-194,853**	**-244,249**	**-308,741**	**-352,840**	**-395,478**
Net assets	**37,628**	**38,701**	**41,442**	**42,608**	**44,302**
Shareholders' funds	30,278	30,496	32,160	32,724	33,608
Minority interest	7,350	8,205	9,282	9,883	10,693
Total Equity	**37,628**	**38,701**	**41,442**	**42,608**	**44,302**

Source: Company accounts, Investec Securities estimates

Target Price Basis

Sum of the parts valuation

Key Risks

(1) Regulatory risk on the expenses management guidelines; (2) Open architecture in bancassurance could lead to loss of business from current partnetships.

Investec

Reliance Capital (RLCP.NS)

India | Life Insurance

BUY

Price: INR406.10

Target: INR550.00

Forecast Total Return: 37.6%

Market Cap: INR103bn

Average daily volume: 732k

Value pick or value trap?

Reliance Capital has not created value for shareholders in the last 5 years (5Y CAGR return = -10%). However, the operating performance of key subsidiaries has improved during the last five years – Reliance Life is on a growth path with high margins; Reliance General has turned around; Commercial Finance's RoEs have scaled to 16% and AMC has maintained its market leading position. We believe the key to re-rating will be deleveraging and improvement in consolidated profitability and see FY16 as a year of balance sheet deleveraging. We initiate with a target price of Rs550. BUY.

- **Operating performance of key subsidiaries improved:** Reliance Capital's subsidiaries have done well over the last two years and gained the ground ceded in FY10-FY13. Reliance Life is back on a growth path with a clear product and distribution strategy. Reliance General turned profitable in FY14 and we expect RoE>15% in FY16E. Reliance AMC grew AUM in FY13 & FY14 after declines in FY11 & FY12. We see its RoE moving to >25% in FY16E. Commercial Finance has transformed its loan book to fully secured loans, with credit costs controlled, NIMs improved and RoEs scaled up (RoEs ~15% in FY16E).
- **Balance sheet deleveraging will be key:** Despite strengthening subsidiaries' positioning, RCAPT has not delivered returns for shareholders. Consolidated profitability has remained under pressure on account of financial investments in non-core assets. We expect profitability to improve as the company divests its non-core assets and takes other deleveraging measures.
- **FY16 will be a crucial year:** We expect the company to receive more than Rs4bn from stake sales in Reliance Life, Reliance General, Yatra and other investments. Consolidated RoEs could improve to 15% if these plans come to fruition and cash is used to de-lever the balance sheet.
- **Initiate with BUY:** We initiate with a BUY with the expectation that management will deliver on its guidance of de-leveraging. We value the company on a SoTP basis, with no valuation attributed to non-core investments and broking business. There are possibilities of valuation upgrades of each entity; however the re-rating of the stock is contingent on balance sheet deleveraging.

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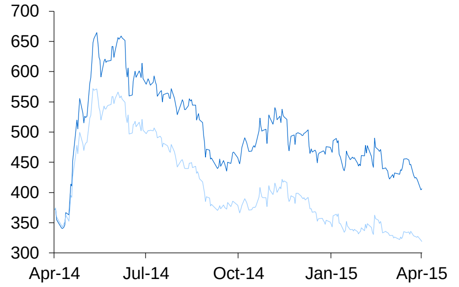
Financials and valuation — Year end: 31 March

	2013A	2014A	2015E	2016E	2017E
Total income (INRm)	74,800	74,670	82,938	92,794	104,789
Operating profit (INRm)	31,780	33,550	37,412	42,004	46,611
PBT (normalised) (INRm)	8,300	8,470	11,136	13,773	15,912
Embedded value (INRm)	25,316	26,055	27,823	30,529	34,237
EPS (normalised)(INR)	32.9	30.2	32.6	39.9	46.2
DPS (INR)	12.5	7.8	7.3	8.6	10.0
Embedded value per share (INR)	103	106	111	120	135
BV/share (INR)	484.7	501.7	511.5	541.4	575.9
PE (normalised) (x)	12.4	13.4	12.4	10.2	8.8
Dividend yield (%)	3.1	1.9	1.8	2.1	2.5
P/BV (x)	0.8	0.8	0.8	0.8	0.7
ROA (%)	2.4	2.0	2.1	2.5	2.7
Group ROE (%)	6.8	6.0	6.3	7.4	8.0

Source: Company accounts/Investec Securities estimates

Price Performance



	1m	3m	12m
Price	(4.2)	(14.8)	9.8
Price rel to India S&P BSE 500 - BSE	(2.5)	(8.5)	(12.8)

Source: FactSet

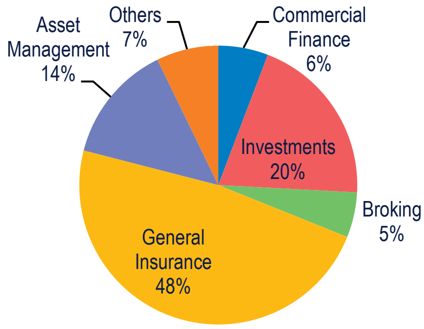
Figure 180: Reliance Capital – Snapshot

Reliance Capital is a diversified financial services company with interests in asset management; insurance; commercial finance; equities broking; wealth management services; distribution of financial products; asset reconstruction; proprietary investments and other activities in financial services.

The company is part of the Rs1,800bn Anil Dhirubhai Ambani group. Reliance Capital was incorporated in 1986 at Ahmedabad in Gujarat as Reliance Capital & Finance Trust Limited. In 2002, RCL shifted its registered office to Jamnagar in Gujarat before it finally moved to Mumbai in Maharashtra, in 2006. It has a balance sheet size of Rs385bn and net worth of Rs124bn as of FY14.

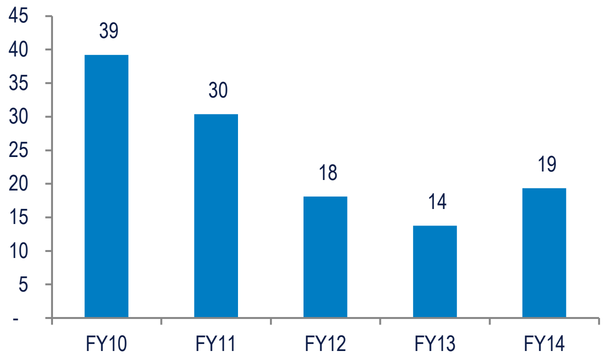
Source: Company data, Investec Securities estimates

Figure 181: Revenue breakup FY14



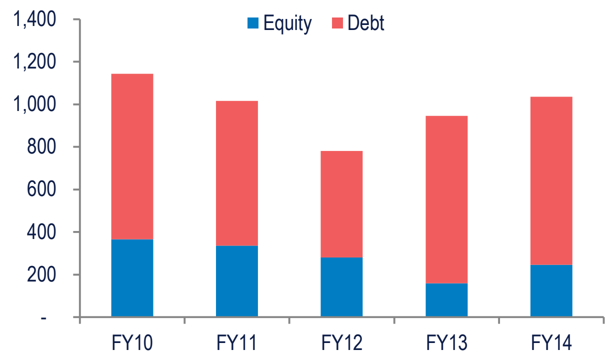
Source: Company Data, Investec Securities estimates

Figure 182: Reliance Life – New business Premium (Rs Bn)



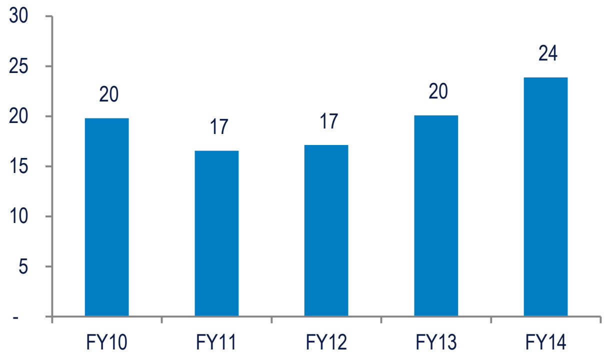
Source: Company data

Figure 183: Reliance AMC – Asset Under Management (Rs Bn)



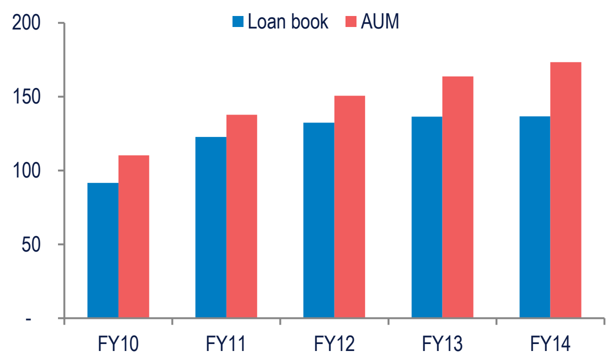
Source: Company data

Figure 184: Reliance General Insurance (Rs bn)



Source: Company data

Figure 185: Reliance commercial finance (Rs bn)



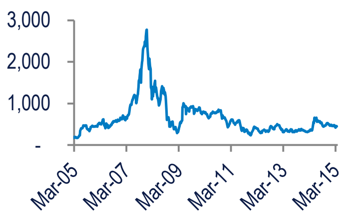
Source: Company data

RCAPT has not created value for shareholders

Reliance Capital has been a classic example of a "Value Trap". Investopedia defines a value trap as "*A stock that appears to be cheap because the stock has been trading at low multiples of earnings, cash flow or book value for an extended time period. Stock traps attract investors who are looking for a bargain because these stocks are inexpensive. The trap springs when investors buy into the company at low prices and the stock never improves.*"

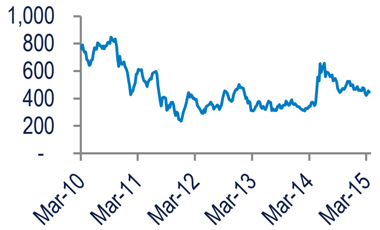
RCAPT has not created value for the shareholders over the last three and five years (see RCAPT's share price charts below). The divergence between the operating business's valuation and RCAPT's market valuation continue to increase. The reason is the use of leverage (at standalone balance sheet level) to invest in equities. Leverage magnifies profits on the upside and losses on the downside and could impair the company's net worth in a worst case scenario – making it an expensive company.

Figure 186: 10% CAGR return in last 10 years



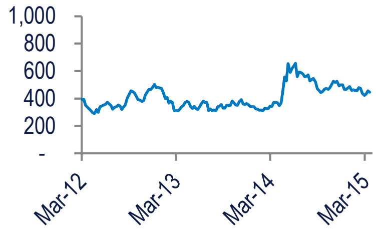
Source: Bloomberg

Figure 187: -10% CAGR return in last 5 years



Source: Bloomberg

Figure 188: 3% CAGR return in last 3 years



Source: Bloomberg

In this note, we explore:

- How the operating performance of RCAPT's subsidiaries have improved over the last five years.
- How the balance sheet can be deleveraged and why we think that it is a focus area of current management.
- What we think market is pricing in.
- Why we think that the stock is a value pick, and not a value trap.

RCAPT's core business' performance have improved

Reliance Capital's key subsidiaries (Life Insurance, General Insurance, Commercial Finance and Asset Management) have shown improvement in their operating performance over the last five years. The focus on profitability and RoEs is clearly visible from the investor presentation and results' conference calls. Segment RoEs are an integral part of management KPIs and are disclosed/discussed in each investor presentation. We discuss below how the operating performance of each business has improved.

Reliance Life Insurance

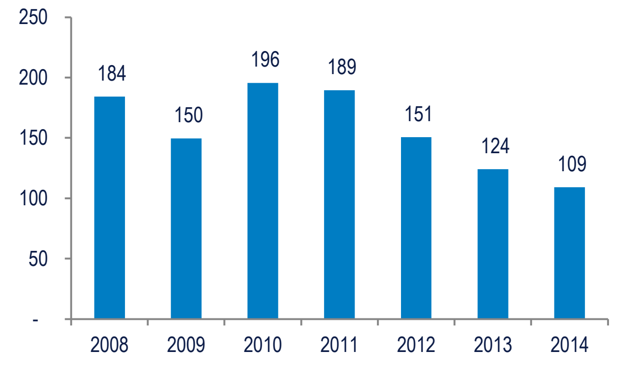
Reliance Life is among the few players to show growth in FY14 and 9MFY15.

Reliance Life is the sixth private player in terms of new business premium (FY14) and had assets under management of Rs170bn as of Dec'14. It has been an underperformer post 2010 Unit-Linked guidelines on account of having no bancassurance partnership, which has been the biggest success factor over last five years. However, the company has stabilised in FY14, showing 40% growth in new business premiums. The company also showed positive growth during 9MFY15 (+12% YoY).

Reliance Life has one of the widest distribution network only second to Life Insurance Corporation of India.

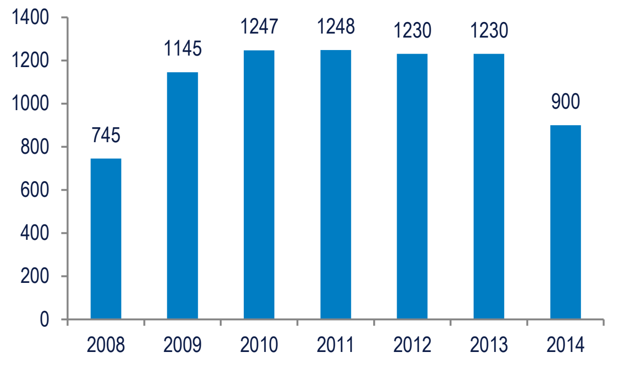
- **Wide distribution reach:** Reliance Life has the biggest distribution reach in terms of branches, after LIC of India (more than 900 branches and more than 100K agents). The company broadly maintained its reach when others closed down their offices post 2010 (see figures 10 & 13).
- **Product mix skewed towards non-participating:** The company has a high percentage of non-participating (guaranteed) products in its product mix which results in high new business margins (see figure 15). Although margins are high, the risks are also significant as these products have long term guarantees (c.4% return guarantee). The Unit-Linked proportion increased during 9MFY15 due to strong returns in equity markets over the last 12 months.
- **High dependence on agency distribution – open architecture in Banca will be positive:** With no bancassurance partner, Reliance Life has high dependence on the agency channel which has impacted new business growth from 2010-2014 (see figure 16). The company has been working on a fixed salaried employee structure for selling insurance, which is gaining traction (classified under Direct Channel). The open architecture in bancassurance will be a big positive for the company and could generate Rs1,000mn (5% of its FY14 new business premium) even if it gets just 1% share in bancassurance premiums.
- **Margins have improved and costs have been controlled:** New business margins have increased consistently on account of the increase in non-participating products in the product mix. This is despite adverse regulations in terms of "Product Design Guidelines" which have reduced margins for the entire sector. The company has also controlled operating expenses over the last five years with opex ratio (Operating expenses + commissions as % of Total Premium) and opex/AUM declining steadily (see figure 18).

Figure 189: Reliance Life – Insurance agents in '000s



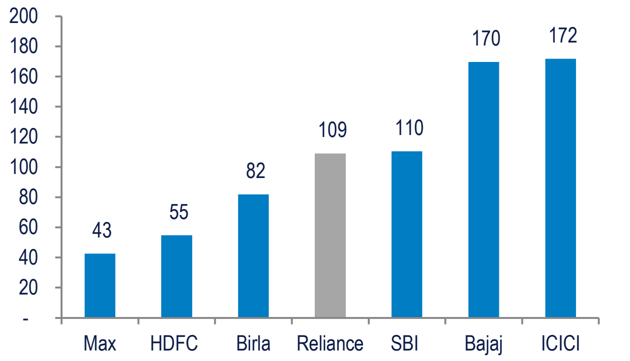
Source: IRDA

Figure 190: Reliance Life – No. of offices



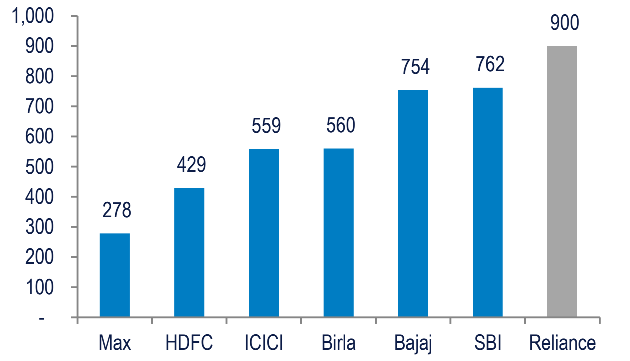
Source: IRDA

Figure 191: No. of agents for private players (FY2014)



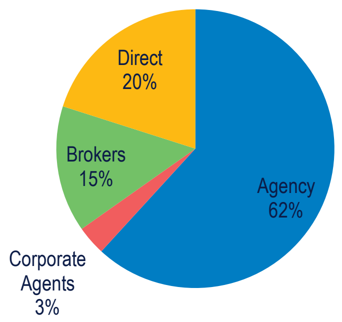
Source: IRDA

Figure 192: No. of offices for private players (FY2014)



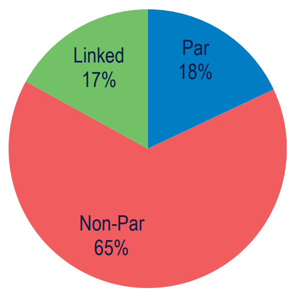
Source: IRDA

Figure 193: Distribution mix for Reliance Life (9MFY15)



Source: Company data

Figure 194: Product mix for Reliance Life (9MFY15)



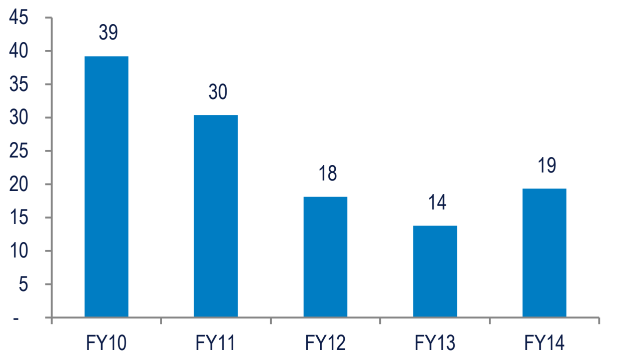
Source: Company data

Higher growth + higher margins + lower costs + improving persistency => higher EV accretion

Though, the company does not disclose embedded value, the mix of higher growth rate in FY14 & FY15E, higher VNB margins (on high share of non-participating products) and lower operating costs (operating leverage) should lead to higher RoEVs as compared to previous years.

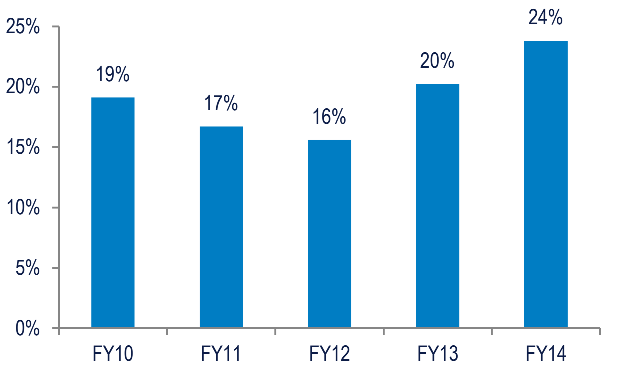
NBP grew 12% during 9MFY15 versus industry growth of -15%. We expect the company to continue to show growth and to be a beneficiary of open architecture in bancassurance.

Figure 195: New business premiums have grown in FY14 (Rs Bn)



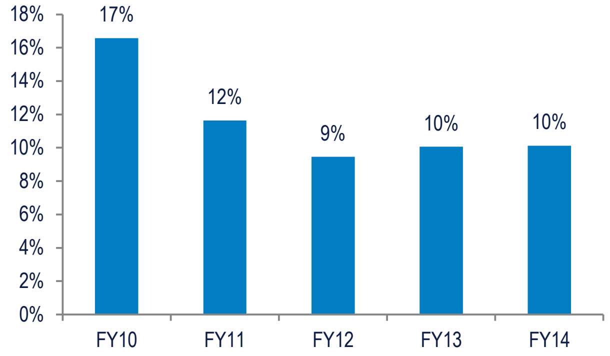
Source: Company data

Figure 196: VNB Margins have improved in FY14



Source: Company data

Figure 197: Opex/AUM has declined in the last four years



Source: Company data

Table 36: Persistency rates have improved for the company

	FY11	FY12	FY13	FY14	9MFY15
13th Month	53%	56%	54%	60%	58%
25th Month	42%	41%	45%	58%	55%
37th Month	11%	12%	12%	45%	60%
49th Month	9%	8%	9%	13%	25%
61st Month	8%	7%	6%	9%	7%

Source: Company data

Reliance Life – Valuation

We value Reliance Life using appraisal value methodology (Embedded Value + Structural Value). We have used absolute valuation methodology to estimate the structural value, by discounting new business profits using a two-stage DCF model with ten years of explicit forecasts and then subsequent years of declining growth rates down to terminal growth. The terminal growth rate is assumed at 5% and cost of equity at 14.5%. The implied VNB multiple is 9x. We see potential for upgrades to this if a) company starts disclosing embedded value, and b) cost overruns come down. Nippon Life has valued the company at Rs115bn in 2011.

Table 37: Reliance Life - Valuations

Rs Mn	Value	Comments
FY16E Embedded Value	30,529	Our estimate of EV as company does not disclose
Structural Value	44,448	Discounting future VNBs minus cost overruns using two stage DCF
FY17E VNB	5,127	20% VNB margin and 15% APE growth
Implied VNB Multiple	9	
Total Valuation	**74,977**	

Source: Investec Securities estimates

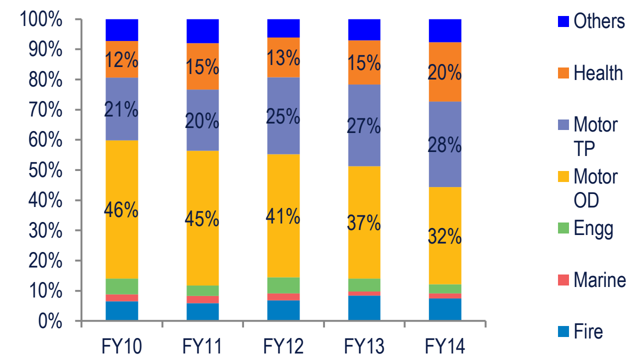
Reliance General is a turnaround story

Reliance General Insurance – Turnaround sustained

Reliance General Insurance has sustained its turnaround after turning profitable in FY14 on account of:

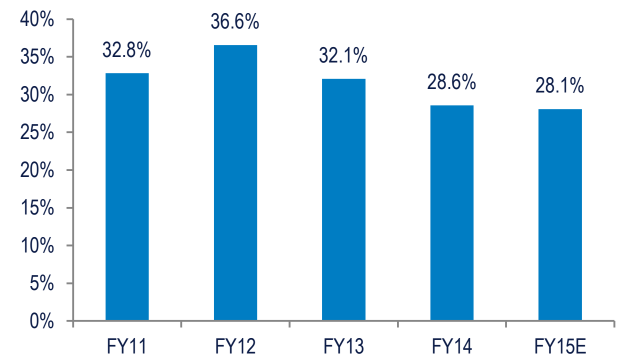
- **Third party motor pool losses fully provided:** The losses on the erstwhile motor pool which was dismantled in 2012 were amortised over three years which impacted profitability from FY12 to FY14. These losses are now behind us and hence have had a positive impact on profitability in the current year.
- **Losses on incremental third party product reduced:** Third party motor premiums have increased by more than 100% since FY11, improving the profitability of the third party motor segment.
- **Management steps to boost profitability:** Management has taken following steps to boost profitability
  - **Exited loss making segments**: The company has exited certain categories of vehicles, certain geographies and certain customer segments which were loss-making.
  - **Increased use of technology to reduce fraud**: Currently more than 95% of the cover notes for policies are issued via tablets, which has reduced the instances of fraud. Earlier, they were issued manually and there were instances of pre-dated policies issued post an accident.
  - **Business mix change**: The company has increased the proportion of health insurance, which is profitable and has high potential given very low penetration. The share of motor own-damage has declined as company exited from loss-making segments (see figure 19).
  - **Cost control**: Management has focused on operating efficiencies. Coupled with operating leverage this has enabled the company to reduce its opex + commission ratio over the last five years by more than 400bps (see figure 20).

Figure 198: Business mix change over last five years



Source: Company data

Figure 199: Opex + commission ratio has declined



Source: Company data

Profitability and combined ratios to improve further

We expect profitability and the combined ratio to improve further as the factors highlighted above continue to feed through. In addition we expect structural changes in the motor segment which should help the company:

- Penalties on driving vehicles without Insurance have increased by ten times to Rs10,000 in Motor Vehicle Act, 2015.
- Road Safety and Transport Bill is expected to be tabled in parliament in FY16. The bill proposes to cap the pay-out on third party claims to Rs1.5mn, from no limit currently and reduce the limitation time (time during which claim could be reported) to one year from three years earlier.

RoEs to improve to more than 15%

We expect RoEs to improve to over 15% in FY16E as combined ratios decline to normalised levels of 110% (see table 3). Note that the company has had several one-off items in FY15 which impacted RoEs. There were claims on J&K Floods, Hud-Hud Cyclone and one time impact on health insurance policies sold before FY11.

Table 38: RoEs are expected to improve to more than 15% over next two years

	2011	2012	2013	2014	2015E	2016E	2017E
Claims ratio	103%	109%	93%	92%	88%	82%	82%
Combined ratio	**136%**	**145%**	**125%**	**121%**	**116%**	**110%**	**109%**
Investment return	9%	9%	9%	12%	11%	9%	9%
Investment/NEP	147%	208%	219%	204%	201%	201%	203%
Investment return/NEP	13%	18%	20%	24%	21%	18%	17%
PBT/NEP	-23%	-28%	-5%	4%	5%	8%	8%
PAT/NEP	-23%	-28%	-5%	4%	5%	8%	8%
NEP/Assets	184%	174%	182%	214%	228%	230%	225%
RoA/RoE	**-41%**	**-48%**	**-9%**	**8%**	**11%**	**19%**	**18%**

Source: Company data, Investec Securities estimates

Valuation

We value Reliance General Insurance using a two-stage DCF model with cost of equity at 14% and a terminal growth rate of 4%, generating a valuation of Rs20.2bn. This implies 1.7x FY16E P/B and 10x FY16E earnings.

Investec

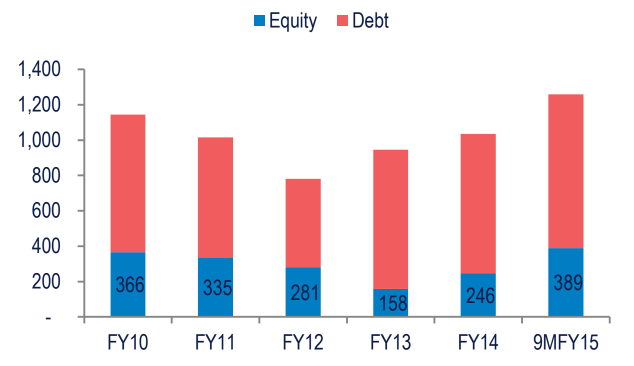
Reliance AMC – a strong franchise

Reliance AMC is one of the most profitable AMCs in India.

Reliance Asset Management Company is among the top three AMCs in India with AUM of Rs1,261bn as of Dec'14. Moreover, it has a strong reach in the Beyond-15 (B15) cities versus the industry (20% of AUM comes from B15 centres versus 15% for the industry). This is despite the fact that company does not have a strong bank partner for distribution. The company can charge 30bps higher fees if new inflows from B15 cities are at least 30% of gross new inflows in the scheme, or 15% of the average assets under management, whichever is higher.

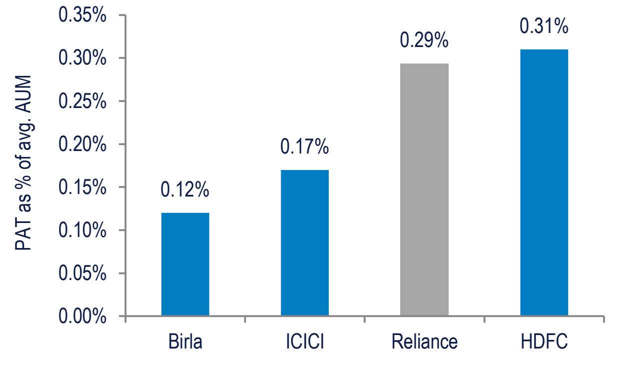
Moreover, within debt, the company has high proportion of retail debt, which is higher margin than corporate debt. This, in addition to higher business from B15 cities, enabled the company to be one of the most profitable (in terms of PAT per AUM) versus other non-bank players in the AMC space.

Figure 200: Reliance Mutual Fund AUM (Rs Bn)



Source: Company data

Figure 201: Reliance AMC is one of the most profitable AMCs

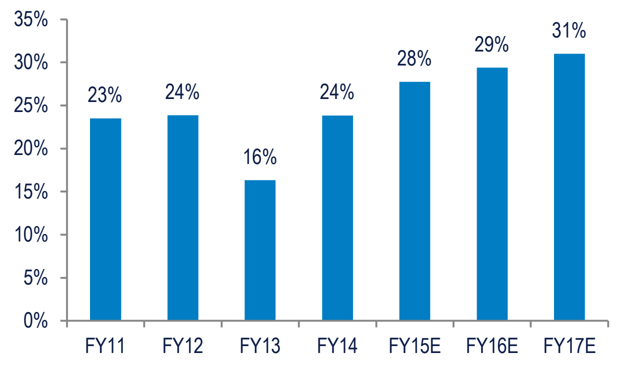


Source: Company reports

Run-down of equity AUM has been arrested

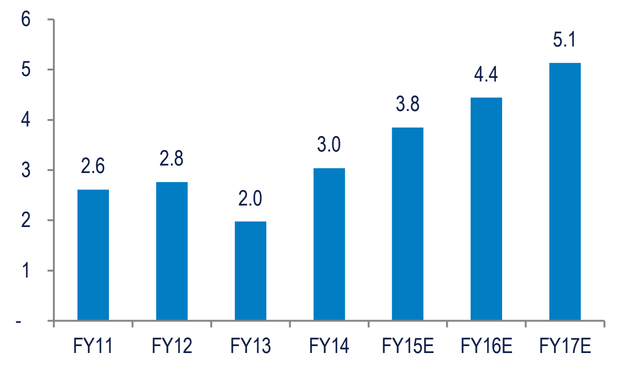
Equity AUM declined sharply in FY13 on the back of weak equity markets and challenges in distribution (SEBI capped the pay-out to distributor). However, the company emerged stronger in FY14 and 9MFY15, recovering the lost ground. This has happened despite the absence of a strong bank relationship for distribution. The company improved financial performance (RoEs scaled to 24% FY14). We expect PAT growth of 19% CAGR over FY14-FY17E and RoEs to improve to 30% given company is paying out 70% of profits as dividends (see figures below).

Figure 202: RoEs are expected to improve to 30% in FY17E



Source: Investec Securities estimates

Figure 203: PAT (Rs bn) to grow at 19% CAGR over FY14-FY17E



Source: Investec Securities estimates

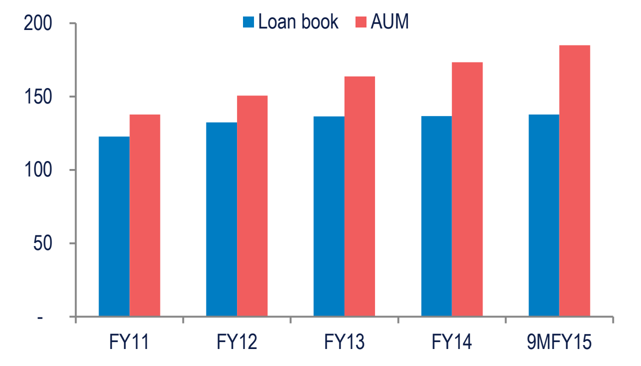
Valuation

We value the company at 3.5% of FY16E AUM, giving a valuation of Rs55bn. Nippon Life has recently increased its stake in the company at a valuation of Rs73bn.

Commercial Finance – returning to growth

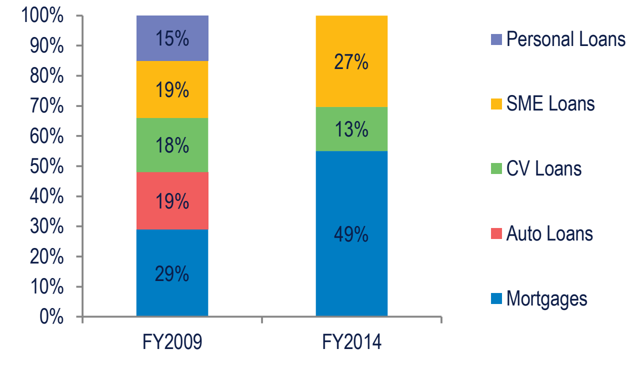
Commercial Finance has also been turned around post the credit losses during the financial crisis (2008). Over the last five years, the company has transformed its loan book from unsecured to secured loans. Moreover, management's strong focus on profitability has resulted in muted AUM growth at 8% versus c.17% CAGR credit growth for the country.

Figure 204: Muted loan book and AUM growth for last 5 years (Rs Bn)



Source: Company data

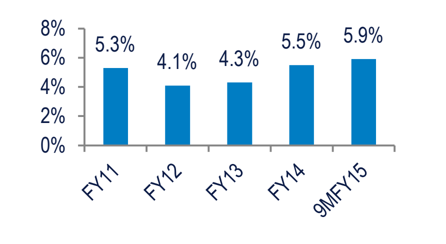
Figure 205: Loan book composition moved towards secured loans



Source: Company data

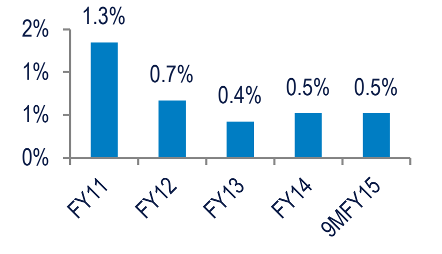
As a result of these steps, RoE has improved to 16% from less than 10%, credit cost has reduced to 0.5% from 1.3% and NIMs have improved to 5.8% from 5.3% over FY11 and 9MFY15 (see figures below).

Figure 206: NIMs have improved



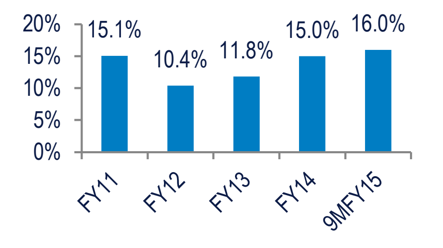
Source: Company data

Figure 207: Credit costs have declined



Source: Company data

Figure 208: RoEs have improved



Source: Company data

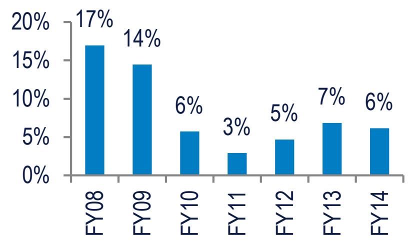
We believe the company will now focus on growth as the demand for credit improves and housing loans will be a focus area for the company. The company caters mainly to the self-employed segment where there is relatively low competition and significantly higher potential compared to the salaried segment. We expect the company to sustain its RoE at around 15%. The company is a AAA rated company and has low cost of funds compared to NBFCs of comparable size.

Valuation

We have valued the company at 1.2x FY16E net worth, deriving a valuation of Rs32bn.

Balance sheet leverage is the biggest concern

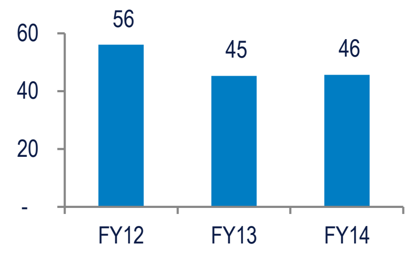
Figure 209: RCAPT – Consolidated RoEs



Source: Company data

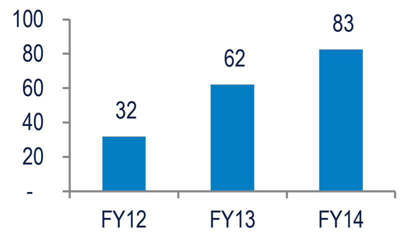
The company has made financial investments worth Rs46bn (other than in subsidiaries) and made corporate loans of Rs80bn as of Mar'2014; including investments in Reliance Group companies (Reliance Media Works, Reliance Broadcast Limited). Moreover, the company has borrowings of Rs133bn to finance these investments and loans. The consequent leverage of the balance sheet negatively impacts the consolidated profitability and RoE. RoE has been further impacted by the revaluation of Reliance Capital's investment in Reliance Life by Rs4bn, when Nippon upped its stake in the entity.

Figure 210: Investments in non-core assets (Rsbn)



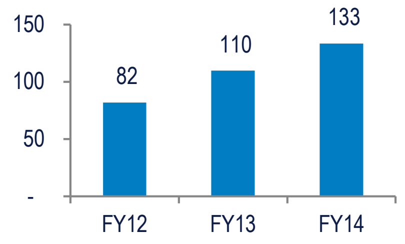
Source: Company data, Investec Securities estimates

Figure 211: Corporate loan book (Rsbn)



Source: Company data, Investec Securities estimates

Figure 212: Borrowings (other than commercial finance borrowings) have increased (Rsbn)



Source: Company data, Investec Securities estimates

Over the last twelve months, the company has deleveraged its balance sheet by exiting some investments, raising some capital and selling part stakes in listed investments.

- **Reliance Media Works:** RMW's films & media services business was merged with a listed entity, Prime Focus (PRIF IN, CMP: Rs51, NOT RATED) and then its movie exhibition business was sold to Carnival Cinemas. This led to debt reduction of c.Rs7bn at RCAPT level and conversion of RCAPT's stake from an unlisted entity to a listed entity.
- **Stake sale in AMC to Nippon:** Nippon Life has increased its stake by 9% to 35% in Reliance AMC, paying Rs6.6bn.
- **Sale of listed equities:** The Company has sold listed equities with a book value of more than Rs1bn, including TV Today Network and TV18 Broadcast and Reliance Communication (Source: Factset).
- **Preferential shares issued to Sumitomo Mitsui Trust Bank (SMTB):** SMTB bought a 2.77% stake in Reliance Capital at Rs3.7bn.

Over the next 12-18 months, we expect the deleveraging process to accelerate:

- **Stake sale in Reliance Life:** We expect Nippon Life will increase its stake in Reliance Life to 49% which could lead to cash inflow of Rs2.5bn, in our view.
- **Stake sale in General Insurance:** RCAPT has been looking for a JV partner in its general insurance business. The deal could be finalised in FY16 and we estimate it could lead to a cash inflow of Rs1bn.
- **Stake sale in Yatra:** RCAPT holds 16% stake in Yatra which we expect to sell for c. Rs0.5bn in FY16.
- **Stake sale of other unlisted & listed equities:** In our view, the company will initiate the process of sell-down of other listed & unlisted investments, and we would not expect new major investments going forward.
- **Run-down of low yielding corporate loan book:** The company will let its corporate loan book run down and not incrementally do business in this book.

The potential proceeds from these stake sales (more than Rs4bn) are likely to be used for debt reduction and capitalization of Commercial Finance business. The other businesses should not require capital over the medium term.

If these steps are implemented as guided by the management, we expect consolidated RoEs to improve to 15% in FY17E (on adjusted net-worth = Net-worth –revaluation reserve) and in are view are critical for the stock to escape from the value trap.

In our view, there is a clear road-map of balance sheet deleveraging by the management which is also visible from steps taken in FY15.

Reliance Capital – Valuation

Table 39: Reliance Capital Sum of the Parts Valuation

	Valuation	Stake	Value per share	Methodology
Life Insurance	74,977	74%	220	Appraisal Value Method (FY16E EV + 9x FY17E VNB)
Asset Management	55,070	56%	123	3.5% of FY16E AUM
Commercial Finance	32,319	100%	128	1.2x FY16E Net-Worth
General Insurance	20,169	100%	80	Discounted Cash flow (1.7x FY16E BV, 10x FY16E Earnings)
Total			**550**	

Source: Investec Securities estimates

Summary Financials (INRm) Year end: 31 March

Income Statement	2013	2014	2015E	2016E	2017E
Income from operations	53,900	62,070	69,254	78,808	89,940
Other operating income	20,900	12,600	13,685	13,986	14,849
Total income from operations	**74,800**	**74,670**	**82,938**	**92,794**	**104,789**
Claims incurred	-19,110	-22,527	-25,008	-28,605	-33,754
Operating expenses	-24,400	-19,853	-21,779	-23,445	-25,683
Total expenses	**-43,510**	**-42,380**	**-46,787**	**-52,050**	**-59,438**
Operating profit	**31,290**	**32,290**	**36,152**	**40,744**	**45,351**
Other income	490	1,260	1,260	1,260	1,260
Net interest	-23,480	-25,080	-26,276	-28,231	-30,699
PBT (normalised)	**8,300**	**8,470**	**11,136**	**13,773**	**15,912**
Exceptional items	0	0	0	0	0
PBT (reported)	8,300	8,470	11,136	13,773	15,912
Taxation	-1,270	-1,640	-2,227	-2,892	-3,501
Net profit	7,030	6,830	8,909	10,881	12,411
Profit attributable	8,120	7,470	8,177	10,143	11,727
EPS (reported) (INR)	32.9	30.2	32.6	39.9	46.2
EPS (normalised) (INR)	**32.9**	**30.2**	**32.6**	**39.9**	**46.2**
DPS (INR)	12.5	7.8	7.3	8.6	10.0
Av. no. of shares (m)	247	247	250	254	254
Total no. of shares (m)	247	247	254	254	254

Balance sheet	2013	2014	2015E	2016E	2017E
Property Plant & Equipment	4,340	4,820	4,820	4,820	4,820
Intangible assets	0	0	0	0	0
Policyholder assets	0	0	0	0	0
Investments and other non current assets	150,870	161,570	167,191	176,287	186,237
Cash and equivalents	15,820	26,630	26,630	26,630	26,630
Other current assets	179,080	192,930	192,930	213,435	237,016
Total assets	**350,110**	**385,950**	**391,571**	**421,172**	**454,702**
Total Debt	-225,100	-255,770	-253,711	-273,774	-296,292
Other long term liabilities	-140	-830	-830	-830	-830
Policyholder Liabilities					
Total Liabilities	**-225,240**	**-256,600**	**-254,541**	**-274,604**	**-297,122**
Net assets	**124,870**	**129,350**	**137,030**	**146,568**	**157,580**
Shareholders' funds	119,710	123,910	129,906	137,499	146,266
Minority interest	5,160	5,440	7,125	9,068	11,314
Total Equity	**124,870**	**129,350**	**137,030**	**146,568**	**157,580**

Note: Life Insurance is not consolidated in the financial statements it is treated as an associate
Source: Company accounts, Investec Securities estimates

Target Price Basis

Sum of the parts valuation

Key Risks

(1) A substantial decline in Interest rate could lead to negative spread on non-participating products; (2) Delay in open architecture could lead to low new business premium growth; (3) Adverse newsflow around ADAG group.

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	Expected total return 12m performance	Count	All stocks % of total	Corporate stocks Count	Corporate stocks % of total
Buy	greater than 10%	165	55%	82	50%
Hold	0% to 10%	99	33%	12	12%
Sell	less than 0%	35	12%	0	0%

Source: Investec Securities estimates

Stock ratings for Indian stocks — Stock ratings for research produced by Investec Bank plc

	Expected total return 12m performance	Count	All stocks % of total	Corporate stocks Count	Corporate stocks % of total
Buy	greater than 15%	3	50%	0	0%
Hold	5% to 15%	3	50%	0	0%
Sell	less than 5%	0	0%	0	

Source: Investec Securities estimates

Stock ratings for African* stocks — Stock ratings for research produced by Investec Securities Limited

	Expected total return 12m performance	Count	All stocks % of total	Corporate stocks Count	Corporate stocks % of total
Buy	greater than 15%	23	37%	5	22%
Hold	5% to 15%	22	35%	4	18%
Sell	less than 5%	17	27%	3	18%

Source: Investec Securities estimates

*For African countries excluding South Africa, ratings are based on the 12m implied US dollar expected total return (ETR). This is derived from the expected local currency (LCY) ETR by making assumptions on the 12month forward exchange rates for the respective currencies. For South African stocks, ratings are based on the ETR in rand terms.

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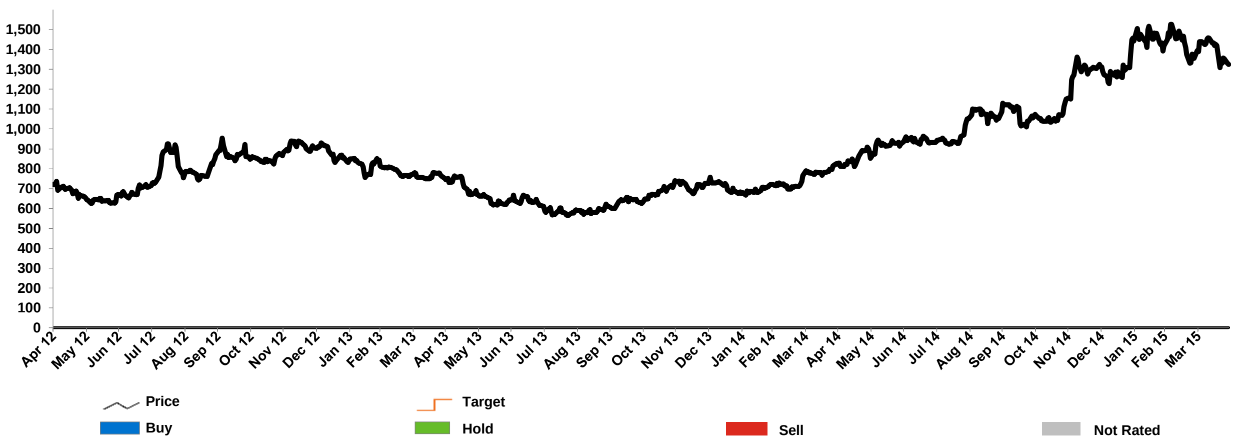

Source: Investec Securities / FactSet

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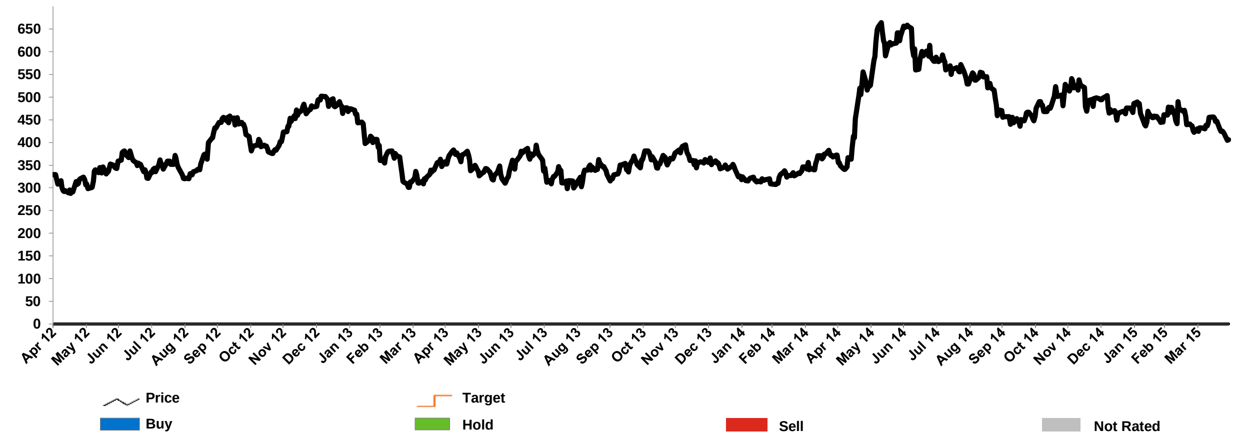

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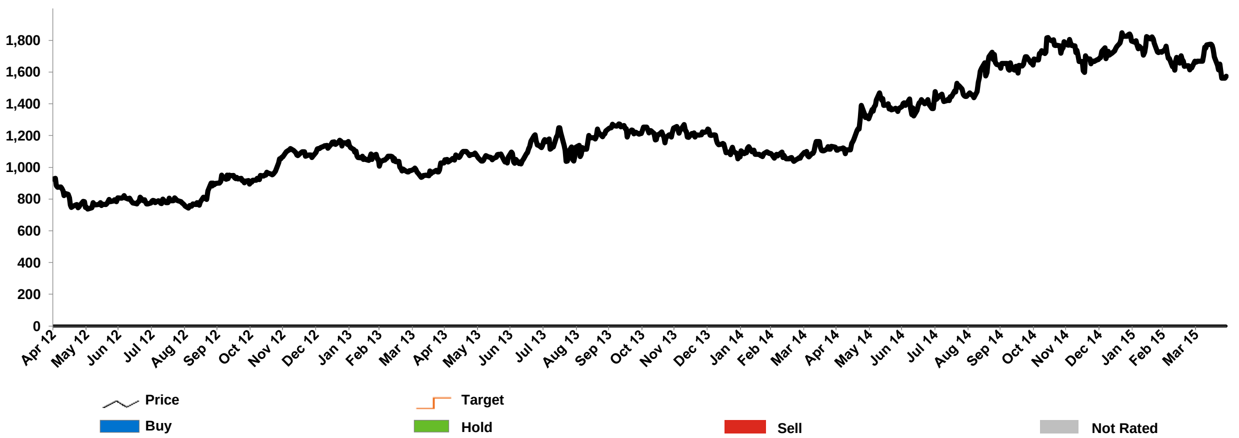

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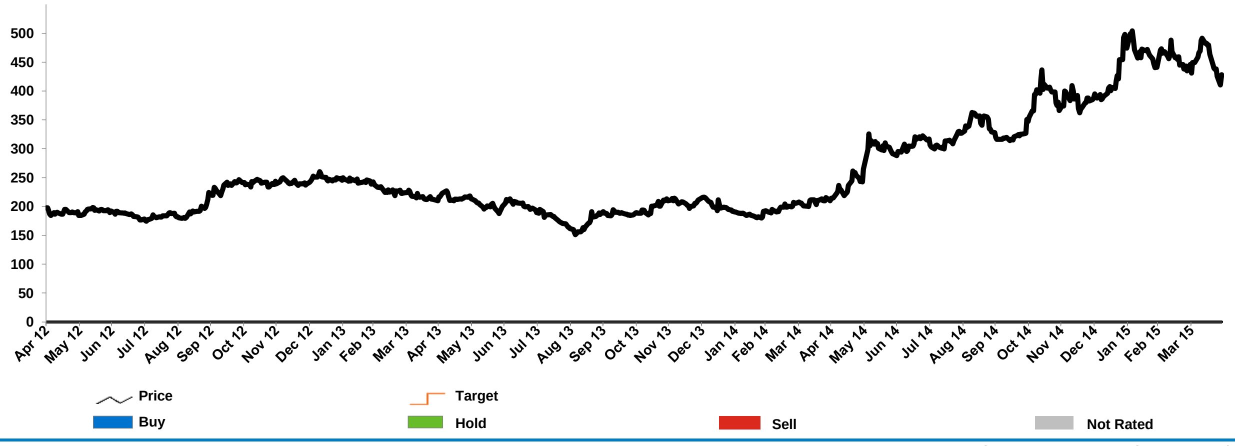

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