MOI GLOBAL

# The Magic of Insurance

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With its funny accounting, I have seen even veteran investors shy away from insurance.

I was assessing my relative strengths recently, and I realized that being comfortable with insurance accounting was one. An industry veteran asked me to look at the Indian life insurance companies, and thanks to him, I found a couple of gold nuggets.

**ICICI Prudential** has finished six months on the stock market. **HDFC Life** is in the process of merging with a listed company, Max Financial Services, over the course of 2017, and the combined entity will be India's largest life insurer. These are unique, high-quality franchises.

Despite their large sizes (~11.3% market share for ICICI Prudential; and 12.4% *pro forma* for the merged HDFC Max entity), these two giants do not face off in the market directly. Bancassurance is the dominant (~70% share) distribution channel for these players, and they both use their respective parent's bank branch network (~4,500 each) to reach customers. Max uses Axis Bank and a few other banks in addition. Excessive competition is the enemy of high capital returns, and where competition can be avoided legally, it is good for the capital provider.

Axis Bank has a special place in my heart, as it is my first 100-bagger. Holding it ever since its IPO in 1998, I have seen it through falls of 30% thrice, 50% once and even 70% once. I was very keen to see if ICICI Pru and HDFC Max would turn out to be 100-baggers. I came to the conclusion that I am looking at stocks that may turn out to be at least 20-baggers, over 20 years. Getting to 100x is possible, but not easy, as the starting point is different.

I realize that the market is more mature now than in 1998. No chance of getting a bargain price of a forward P/E of 9x (UTI Bank's number in 1998; UTI Bank eventually was renamed Axis Bank). These insurance stocks trade at high P/E multiples *prima facie* — they are not the relevant metric, as the business is still not mature, so the numbers are high (P/E of 100-300x), as these companies just got out of the J-curve (companies going through a period of losses are in the cup of the "J"), and profitability is still nascent. Insurance is a long gestation business, and it takes time to prime the pump. About 15 years. The leading private sector players in India have recently passed this mark. As they keep growing their customer base, their cost ratios and expense ratios may trend to the incumbent's level, a 20% improvement. And possibly beyond.

Price to book is useful for financial entities, and is a good measure for a bank, combined with return on assets, return on equity, and rest of CAMELS ratios to build a picture of a bank in the analyst's head. For insurance companies, analysts use Embedded Value (EV). This is an addition of "book" (net asset value), plus an expected value of future profits. In most businesses, companies are discouraged or prohibited from counting future profits on the conservatism principle. In insurance, it is ok, because of the contracts (the policies).

Insurance accounting is primarily different because the costs are not all expensed in year one, and it is not certain that future premiums will come in. (If the premium doesn't come in, the contract is broken. A broken contract may be profitable, and is not always loss-inducing). A new policy can cause a loss in year one, but it may well have a positive net present value (NPV), based on future premiums, and expectations of future costs. Costs are both tangible costs such as commission expenses, overheads such as travel and rent, as well as financial costs reserved for the risk, such as mortality risk, or other risk allowances.

Just like a bank, insurance companies have their own money too. A bank may easily have 10 dollars for each dollar of shareholders' equity, from deposits, and interbank borrowing, aside from corporate borrowing. ICICI Pru has about 20x in liabilities compared to its equity base. But an insurer is safer than a bank due to contractual restrictions on liquidity of its liabilities. Banks have to be protected by use of a Deposit Insurance scheme to avoid a bank run, as they not designed to function if a substantial part of their liabilities are taken out. Insurance policyholders know, or ought to know, that the Insurance company payouts on a cancelled policy can be substantially lower (could even be zero) than premia paid in, and these are usually clearly laid out in policy documents. Insurance companies have *built-in* protection on the liabilities.

It will be sad if many policyholders cancel their policies, but an insurance company doesn't collapse like a bank would. Indian insurers saw lapse ratios of as high as 80% (5-year), and they still survived. They shrank their agent base, adjusted their commission structure (stern guidance from the regulator helped), and evolved their product pitch and distribution methods.

Insurance companies have handcuffs on them on the other side: they are severely constrained on what they can invest in. They have restrictions on investing outside their home country (Indian insurers: 0% allowed outside India). They have limits on how much can be held in non-investment grade debt. A severe restriction on matching asset-liability tenures makes them the buyer of negative-yielding or zero yielding debt, such as we now see in Europe, and in Japan. No private bank would usually be able to sell such debt to an individual client.

There is a breakeven point for new policies, and insurance companies can lose money on new policies if cancelled too soon, given that agent commissions, and overhead costs cannot be clawed back. However this is not true for all types of policies, and long-lived plans can have substantially higher premia in earlier years than the real risk cost, and a lapse in such plans do not hurt the insurer, and they can book a profit on the lapse.

At present, Indian insurers see a high lapse rate of as much as 50% of policies lost in the first five years. This may be from relative lack of maturity of two groups: insurance agents, and customers. The industry has responded by cutting first-year commissions to a very modest 5.6% average for private sector players. Life Insurance Corporation (LIC), the incumbent, pays 7% on average. These commissions were as high as 50% of first-year premia in the run-up to 2008.

LIC had a 50+-year headstart, and its assets under management is about 20x the two private sector leaders, who manage about INR 1trillion each (~USD 15bn). In incremental market share, the private sector as a whole is capturing more than half the annual sales. The newcomers were allowed in 2000. They have shown a better understanding of efficiency, information technology investments, direct sales, and as a result, they have evolved to using bancassurance as one of the most efficient forms of distribution.

India’s GDP growth is expected to be around 6-7%, on average, for the next decade, or two, arising from a young population, and a country playing catch-up on infrastructure and productivity growth. India’s insurance growth rate may sustain at over 12% CAGR over the next 2 decades. Growth in Embedded Value will be at least in line with premia growth, aided by cost efficiencies getting better.

High rate of capital compounding, and a long, long runway, gives a pair of great compounders. The businesses could grow steadily, organically, without infusion of equity capital. Insurers will likely use their 25% sub debt, preference share and debenture allowance.

The implied excess return (based on recent share prices), of return on capital over the cost of capital, is only 1-2%. I expect these stocks to earn well over a 4% spread over time, and possibly upto 8% spread over cost of capital, giving a discount to fair value of 33-66% . The key assumption is that growth rates in insurance premia will stay over 12% on average over the next 20 years (2x GDP growth). Further upside will come from cost efficiency improvements to incumbent levels, and possibly beyond. Market maturity – and agent maturity – will help improve persistency over time. (Persistency is a measure of how long the policies sold stay active. The lower the lapse rate, the higher the persistency.)

Growth acceleration can come from unlocking of future profit pools (more pure protection; higher adoption of health insurance, critical illness cover).

Inorganic acquisitions by these leading private sector insurers to kill off competition, or tuck-in acquisitions to expand product range/geographic coverage, could be additive.

Stock could stagnate during periods of weak consumer confidence, as India’s policy environment on direct and indirect taxes is always evolving. These stocks are only suitable for consideration by investors with horizons of greater than 3 years, giving the companies time to adjust their tactics and strategy, and recover from any economic, regulatory or social shocks.

*Disclosure: No positions held in the stocks mentioned, except a personal long position is held in Axis Bank since 1998.*