SSKI

INSURANCE

Rush Hour

October 2007

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INDIA RESEARCH

October 2007

BSE Sensex: 17291

SECTOR: FINANCIALS

Sector report

Insurance

Rush Hour

The insurance sector has taken off in FY07. It was long coming in view of a ridiculously underinsured population with growing incomes, and hence increasing need for protection and savings. ULIP (Unit Linked Insurance Plans), which unfettered this growth, is a product neatly stapled to meet all these needs. The market is now on a roll and is set to drive insurance penetration over the next few years. The macro conditions are right (like almost everything in India right now seems to be!), players are capitalized, and market potential is enormous and value creation will be the likely outcome. The sector has also been under-represented in terms of market capitalization in the country's overall pie. Value unlocking has, however, begun with small deals and the market has rewarded the high growth private sector plays indirectly through their holding entities. We are very bullish on the sector and believe that size, brand power and aggression in building distribution will be the key success factors in the current formative years.

FY07 - the defining year: The life insurance sector took off into a new orbit in FY07 (95% yoy growth) on the back of the entire market embracing ULIPs as 'the' product. It has also been a defining year for the general insurance sector, which has seen massive tariff deregulation, and laid the foundation for explosive growth powered by retail-focused business models.

Under-served population: The penetration of life insurance in terms of new premiums/ GDP currently stands at ~4% and of general insurance at 0.6% are abysmally low. Going forward, we expect the sector to ride the country's favourable age and income demographics as also changing savings preferences.

Under-represented on market cap…valuations ignoring long-term growth: It's ironic! Insurance, one of the largest market capitalized businesses globally, has no direct listed vehicle in India. While the government continues to hold on to LIC, private sector players have scaled up tremendously and are set to accelerate the process of value-unlock. While valuations have significantly re-rated as reflected in the holding entity market cap, they do not discount the strong growth potential and pale in comparison with emerging economies.

Value to parent

Company	Indian Promoters	Stake (%)	Valuation* (RsBn)	Value per share	Contribution to promoter share price (%)
Life					
Reliance Life	Reliance Capital	100	274	1115	71
ICICI Prudential Life	ICICI Bank	74	355	320	30
Max Newyork Life	Max India	74	50	227	91
HDFC Standard Life	HDFC	82	125	437	17
SBI Life	SBI	74	181	343	18
General					
Reliance General	Reliance Capital	100	70.7	287	18
ICICI Lombard	ICICI Bank	74	66.7	60	6

** Value of economic interest: Source: SSKI Research*

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Changing regulation driving high growth

A strong 95% yoy rise in APE registered in FY07

INVESTMENT ARGUMENT

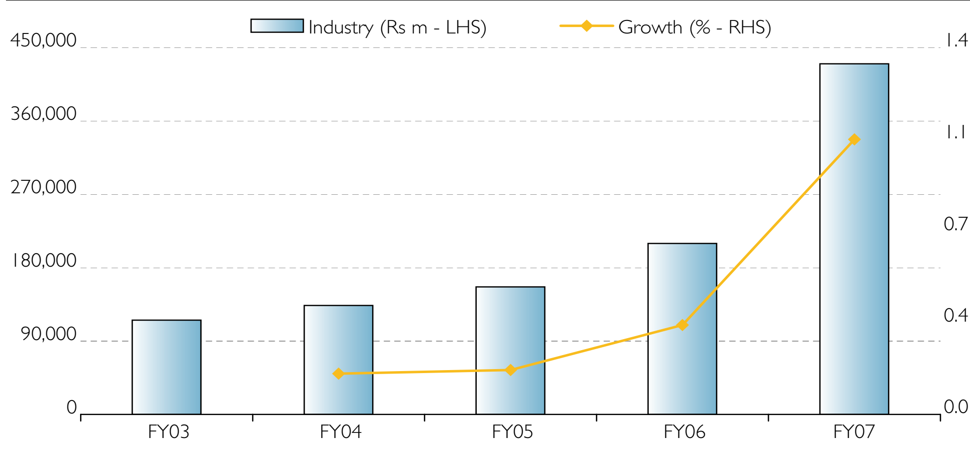
Privatization in 2000 breathed a new life into the insurance industry. Without debate, FY07 was an inflexion point as the industry catapulted to a new growth orbit, influenced by regulation, exploding distribution and wide-scale acceptance of linked products. The case for explosive growth going forward is reinforced by the macro variables of a low social security cover, untapped and rising household savings as also an encouraging demographic profile. While believe the sector will deliver ~33% CAGR over FY07-10 (46% for pvt sector), the growth could come at the expense of margins and believe that the NBAP (New Business achieved profit) margins will moderate by 150-200bps over the next three years. A strong brand, deep pockets and an aggressive posture on distribution will be the key differentiators. Underpinned by strong growth, leading private players have catalyzed the process of value unlocking and benchmark valuations tell the story of a dramatically changing investor perception of value. Consensus valuations have moved between 3-5x in the last 12 months. Being an under-penetrated industry as also under-represented on the stock market (no listed plays so far), value-unlocking is at hand. While public listings are some time away, we believe private sector players will keep setting benchmark valuation through sale of minority stakes.

FY07: A DEFINING YEAR

❑ Changing regulation sets the ball rolling:

Life insurance market has been growing at a healthy pace since the advent of competition in 2000, and registered a CAGR of 40% over FY01-07. In FY07, growth accelerated considerably and weighted new business premium for individual business (APE) grew at a staggering 95% yoy to Rs430bn.

Exhibit 1: Unprecedented yoy growth in APE



Source: IRDA

The chief trigger driving the growth was the changing regulations for unit-link insurance plans (ULIPs), which were to be announced by the Insurance Regulatory Development Authority (IRDA) in July 2006. In the last few years, single premium products were being sold and purchased as a short-term instrument to avail of tax benefits and capitalize on the short-term opportunity offered by equity markets.

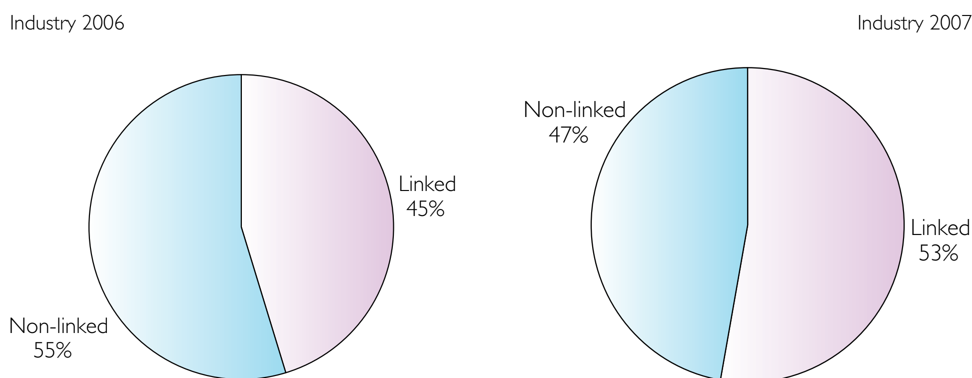
Hence, the aggressive push (primarily single premium products) by both insurance companies and agents pre-July 2006 led to a blazing 115% growth in April-Jun 2006. Expectedly, the IRDA introduced stringent guidelines in July 2006, stipulating a minimum five year term for ULIPs and a lock in period of three years.

❑ ULIPs take over the growth mantle

ULIP expected to remain an attractive proposition for customers

The popularity of ULIP as a potent combination of protection with returns (in an under-penetrated equity ownership environment) has been a major driver for the accelerated growth even post the regulatory changes in July 2006. Robust economic growth, and its impact on investor confidence in a sustained bullish trend in the capital market, has driven strong growth in ULIPs. In fact, insurance companies have seen investors flocking more towards ULIPs in intermediate bearish phases in the market (as the one witnessed in May 2006). Going forward, with a further build up in competitive intensity, the charges are expected to be slashed. This would enhance the attractiveness of the product and its competitiveness vis-à-vis mutual funds.

Exhibit 2: Industry moving towards ULIP



Source: IRDA

❑ Expanding distribution

Private as well as public sector players focusing on ramping up points of sale

Concentrated sales effort, by both private and public behemoths, has increased the penetration of life insurance products. In the current year, almost all private players have aggressively invested in expanding their distribution reach (refer exhibit below). Not only has penetration been deepened in the existing markets, but the distribution network is also being aggressively scaled-up to reach the untapped semi-urban and rural areas for future growth.

Exhibit 3: A widening distribution reach

Distribution	2006		2007	
(no.)	Branches	Agents	Branches	Agents
ICICI Pru Life	177	72,000	583	234,000
HDFC Standard Life	169	33,000	438	74,000
Reliance Life	153	20,231	217	106,000

Source: Companies

LIC's aggressive push to ULIPs – a key contributor to industry growth

❑ LIC strikes back

After losing out consistently to private sector players, LIC decided to shake off the lethargy, which helped it recapture some of the lost ground in FY07. LICs grew 91% and its was able to stem the decline in market share (maintained at 63%). Given its size and distribution reach, LIC's aggressive posture on ULIPs has significantly influenced industry growth and (its own).

❑ A slow start in FY08, but growth to pick up as base effect wears off

In FY08 YTD, growth rates have tapered off from 95% in FY07 to sedate levels of 39%. However, the loss of momentum is not because of sluggish demand and is more a function of the high base of the previous year (there was a surge in Q1FY07 as insurers rushed to beat the 30 June deadline for new and tighter regulations). Private sector insurers have registered growth of 47% YTD FY08 (April-July 2007) as compared to 35% seen for LIC. Generally, the first four months account for 18-20% of the total premium. We believe these growth rates will accelerate for the remainder of FY08 as the base effect wears off. We forecast a 44% growth in sector APE growth for the full year.

LONG-TERM GROWTH DRIVERS

Strong underlying growth factors and low equity ownership to drive penetration

❑ India is STILL an underpenetrated market

After the dream run witnessed in FY07, industry growth rates have moderated during the first four months of the current fiscal. Penetration of life insurance as a per cent of GDP has risen to ~4% (which is comparable to many Asian economies). This has given rise to concerns on the future prospects of the Indian insurance industry. We believe the penetration argument is not accurate as Indian insurance serves three needs - protection, savings and security. Hence, comparisons on penetration need to be viewed in conjunction with the following:

- The penetration is measured in terms of premiums/ GDP, wherein premiums include the component of savings and protection. The Indian industry, being significantly dominated by equity linked products accounts for the savings component also in the premiums (protection is a much smaller component of premiums in linked products). This is not comparable to other economies where premiums are largely for protection, and hence are low.
- A parallel economy which is as large as the declared one leads to overstated penetration.
- The average Indian puts only 6% of his savings in equities, which is abysmally low as compared to other economies. As ULIPs are largely vehicles for investing in equities, a comparison of penetration rates needs to take equity ownership in other countries into account.
- The absence of a social security cover also needs to be taken into account when comparing insurance penetrations. Developed countries have well developed social security systems, which absorb a material portion of financial savings.

On the basis of the elucidated arguments, we believe the industry is still in its growth phase and will ride growing incomes, savings and improving share within household savings. We expect the life insurance segment to register a healthy 33% CAGR over FY07-10, with private players growing faster (46% CAGR vis-à-vis 24% CAGR for LIC). This implies that private players would continue to eat into the market share of LIC.

Exhibit 4: APE growth rates

(%)	2007	2008	2009	2010
Industry	**95**	**44**	**32**	**24**
LIC	78	35	23	15
Private	**104**	**59**	**45**	**35**
ICICI Pru	91	55	40	30
HDFC Std Life	59	60	45	40
Reliance Life	745	196	99	60
SBI Life	264	80	50	40
Max NewYork Life	72	60	45	40
Other Private Players	89	42	34	27

Source: SSKI Research

❑ Growing economy, favourable demographics, increasing product availability

Faster industry and services growth, higher productivity and urbanization driving the Indian economy

India has been experiencing robust economic growth since 2003, driven by structural factors (rather than this being a cyclical upturn). It is one of the fastest growing economies in the world (lagging only China). Key contributors to the phenomenon are:

- High growth rates clocked by industrial and services sectors, coupled with benefits of productivity gains - contributed significantly by the private sector
- Increasing urbanization, along with a shift from agriculture sector (low productivity) to the more productive industry and services sectors
- India is one of the youngest countries in the world and is experiencing a structural shift in income demographics. This is supporting a strong middle class, which will have a sizable kitty of savings that insurers would be vying for
- Increasing trend towards nuclear families also supports the need for protection
- Micro growth drivers like exploding distribution, emergence of alternate distribution channels and a wide product basket serving customer needs will support growth. Finally, continued tax sops will also aid growth.

❑ ULIPs vs mutual fund

ULIPs score over SIPs in the longer term and the benefit of insurance cannot be replicated

Competing for the same rupee of household savings, an obvious comparison to make is between returns earned from ULIPs vis-à-vis mutual funds. Assuming the same fund management performance, the IRR on ULIPs is greater than that on investment in SIP for a product with a tenor longer than 12 years. However, in the short-term, the scenario is reversed with mutual funds yielding a comparatively higher return than ULIPs. This is primarily due to the relative pricing structure with insurance companies charging a higher entry/ exit load, and mortality charges. Over the longer term, the lower AUM fees, a lower expense charge (recurring expenses as a fixed percent of premium as against a percentage of AUM for mutual funds) helps the insurance company score over MFs.

Exhibit 5: Comparative indicative returns of a SIP and ULIP to an investor

Equity-12%				
	PRU ICICI	HDFC Standard	ICICI Pru	Comments
IRR-15 years	8.94%	9.64%	8.57%	• The gap between HDFC and ICICI-Pru and Pru-ICICI is increasing giving weight to variable charges
IRR-12 years	8.87%	9.08%	8.25%	• HDFC Life has taken over mutual funds as the benefit of lower fees charged by HDFC is on an increasing AUM which has overtaken the negative of a fixed higher load. • The gap widens between HDFC and ICICI due to lower variable charges.
IRR-10years	8.80%	8.44%	7.90%	• The gap has significantly reduced as the higher AMC fees charged by mutual funds are making an impact. • HDFC overtakes ICICI as the lower AMC for HDFC has mitigated the downside due to a higher initial load.
IRR-7 years	8.63%	6.57%	6.97%	• Mutual funds is a better performing asset class, though the differential narrows • ICICI is a better performer but the gap has significantly reduced.
IRR- 5 years	8.42%	3.59%	5.65%	• ULIP as a product class underperforms mutual funds due to higher load charged by ULIP • Within insurance asset class, HDFC Standard Life product lags in performance when compared to ICICI-Pru due to the higher load charged by HDFC.

Source:SSKI Research

THE WAY FORWARD

❑ Private sector eating into LIC's market share

Private sector well placed with productive and better trained agency force

Post liberalization in 2000, aggressive private insurers have taken ~37% market share from the incumbent state-owned monopoly, LIC, by FY07. LIC primarily lost ground on account of low premium per policy and its focus primarily on traditional products. To protect its turf in this competitive scenario, LIC aggressively pushed ULIP products which bolstered the average ticket size, and narrowed the gap with private players.

However, there are inherent weaknesses in LIC's business model that need to be addressed to maintain its dominant position.

- Though LIC has over 1m agents, the growing private sector agent force has higher productivity (premium and number of cases per agent). Further, LIC is dependent on agents for 99% of its business, while 30-35% of private players' business is attributable to other alternate channels like bancassurance and corporate agencies.
- LIC may further lose its grip as private players come up with innovative product portfolios and offer better service levels besides effecting aggressive distribution ramp-up in rural areas. This trend may be further aggravated by the younger

population having greater affinity towards popular brands like ICICI, HDFC and Reliance.

- Currently, private players are positioning insurance as an investment and protection product, while LIC continues to focus on insurance more as a tax-saving product. This, we believe, would further dent LIC's market share.

❑ Market share dynamics within the private space

Private players fighting tooth and nail for market share

- Since liberalization, the industry has seen influx of private players. However, not everyone has been able to script a success story. The industry, when in a high-growth phase, tends to make losses. Therefore, players require deep pockets as the business has to be regularly infused with capital to capture the market expansion. Also, insurers need to have an extensive footprint and strong brands to break into untapped markets. The industry is characterized by huge market share swings, as is evidenced below:

Exhibit 6: Huge market share swings among private players

Insurer (%)	2005	2006	2007
Bajaj Allianz	10.4	17.5	20.1
ING Vysya	6.2	3.3	2.8
Reliance Life	0.8	1.1	4.5
SBI Life	4.1	6.3	11.3
Tata AIG	6.8	5.6	3.6
HDFC Standard	9.0	10.7	8.3
ICICI-Pru	33.6	29.9	28.5
Birla Sunlife	13.7	8.2	5.3
Aviva	4.2	5.1	4.3
Kotak Mahindra Old Mutual	4.8	4.7	3.5
Max New York	5.1	5.6	4.9
Met Life	1.2	1.7	2.1
Sahara Life	0.0	0.1	0.1
Shriram Life	-	0.1	0.6
Bharti Axa Life	-	-	0.0
Private total	**100.0**	**100.0**	**100.0**

Source:IRDA

- Bajaj Allianz has gained significant market share by reaping benefits of putting up the largest distribution network among private players.
- HDFC is investing heavily to scale up distribution, which - supported by a strong brand and an effective bancassurance partner - should help it recapture the lost market share to some extent.
- Reliance Life, with the backing of an aggressive sponsor having deep pockets and a well conceptualized strategy, has emerged as the fastest growing private insurance player.
- SBI Life has raised its market share by aggressively leveraging the massive distribution network.
- Birla Sun Life has lost market share due to increased competition in the ULIP space (which it pioneered), a stagnant agency force, loss of high net worth individual business to other players, and limited investment to scale up distribution.

Despite large swings in market share, ICICI-Pru and Bajaj Allianz have maintained the number one and two positions respectively. However, ICICI-Pru has witnessed a marginal market share decline post the entry of Reliance Life in the space.

❑ Market polarization to lead to consolidation

With entry of 7-8 entrants lined up, we expect competition to increase

We expect the competitive intensity to build up in the private space with as many as 7-8 new entrants looking to capitalizing on the attractive opportunity that the sector offers. There are few barriers to entry as IRDA has not placed any limits on the number of players that can operate in the space. We expect the escalating competitive intensity to lead to the market becoming more polarized going forward. Subsequently, consolidation is likely to set in as some of the marginal players are acquired by established companies. While most companies operating in the sector have deep pockets, capital investment could taper off for marginal players on account of unattractive returns for the promoters.

❑ Key success factors

While staying robust (albeit slowing from the heady levels of 2007), we believe growth will increasingly get polarized as some players grow way ahead of industry growth. The following key elements will be critical differentiators:

Brand: A strong brand (LIC, SBI, ICICI, HDFC, Reliance, etc) will be crucial to acquire customers in smaller cities.

Access to capital: Regular capital investment over a longer time-horizon is essential to scale up in distribution, and sustain high costs of customer acquisition, before the company achieves break-even. While deep pockets are a key competitive advantage, the sponsor appetite to take the risk with prospect of returns only over the medium to long term is a key differentiator.

A strong brand, deep pockets, extensive footprint and a profitable AMC – the key requisites for success

Distribution: Insurance being a push product, and with product innovation easy to replicate, a vast distribution network will be the key to future growth acceleration, specifically in the under-penetrated semi-urban and rural areas. Again the posture taken towards distribution scale up will shape success. Initial ramp ups are often less profitable but the single mindedness of the management to commit capital and resources to increase distribution will determine success.

Portfolio returns: With an increasing proportion of the portfolio comprising ULIP products, investment performance would be a critical factor for future business.

With limited capital headroom post BASEL II, we do not expect public sector promoted insurance companies making a big impact. We expect players under our coverage to survive the test by scoring high on the critical factors and growing their business faster than the industry average.

HOW THE PLAYERS STACK UP

We expect our coverage companies to survive the test by scoring high on the critical factors and grow the business faster than the industry average, and continue to capture market share. While Reliance Life would remain the fastest growing insurance company in the country, we expect ICICI-Pru to retain the top slot. We have outlined the key weakness and strengths of our coverage companies.

Exhibit 7: Key strengths and weaknesses

Company	Strengths	Weakness
ICICI Pru Life	• Well recognized financial service brand • Strong backing from promoter to invest heavily in the business	• A higher share of ULIP poses risk in a prolonged market downturn
HDFC Standard Life	• Product portfolio is both stable and profitable, with emphasis on regular premium (over 90%) and individual segment (~93%). Therefore best persistency ratio in industry • Greater control over company-owned distribution network • Strong promoter brand	• Lack of promoter aggression compared to Reliance and ICICI
Reliance Life	• Reliance Life is investing heavily ahead of time in building an enviable distribution network • Strong sponsor backing	• Reliance Life being a late starter could not forge a banc assurance partnership nd hence the distribution is significantly dependent on agency force.
Max New York Life	• The most productive agent force in the industry • Strong product portfolio with longer tenor ULIP policies and traditional products	• Lower brand recognition in semi-urban and rural areas may dent future growth • Slow to adopt multi-channel distribution, and the highly productive agent force comes at a cost
SBI Life	• Premium promoter brand to drive future growth in under penetrated areas • Competitive cost structure due to leveraging the promoter's wide distribution network and branding	• Group business share has declined to 30% in FY07 from 48% in FY04, but is higher than competition, which implies lower blended margins. • Decline in persistency ratio to 52% in FY07 due to short-tenor ULIP policies, should correct with regulatory minimum ceiling

Source: SSKI Research

NBAP (NEW BUSINESS ACHIEVED PROFIT) AS A PROFITABILITY METRIC GAINS ACCEPTANCE

Insurance companies are profitable yet register accounting losses. The paradox simply implies that we need to view profitability of insurance companies in a different way. NBAP is essentially the NPV of all future profit streams from the new business generated during the period of analysis. In other words, when profitability is measured using the NBAP metric, the business appears to be profitable. Then why do insurance companies make accounting losses??? Due to the high customer acquisition costs in the initial years and the conservative regulatory reserve requirements, there is lag till these companies break-even (6-8 years as is global benchmark). Further being in their nascent phase and given their aggressive growth plans, majority of the business value rests in future policies, and not existing policies.

With that said, NBAP is a primary function of persistency (that is lower lapsation in policies written), efficient expense management and appropriate risk management enabling sustainable claims. Based on our analysis for different policies (although nowhere as exhaustive as the actuarial calculations), we arrive at an estimate of NBAP margins yielded by these policies on the business. Term policies due to the

simple risk cover and no return on maturity, have an NBAP margin greater than the unit-linked and endowment policies. (Our margins calculations are appended to this section). Most of the players have a consolidated NBAP margin of around 20%, as products for most of these companies are not very different.

Exhibit 8: Snapshot on the NBAP margins

(%)	ULIP	Endowment	Term
10 yr	22.5	13.4	46
15 yr	63.6	21.8	65.8

Source: SSKI Research

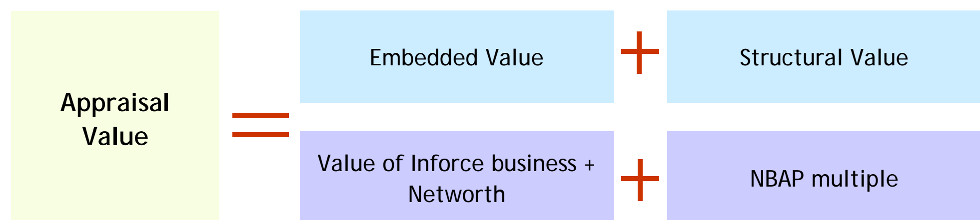
The way the sector dynamics is panning out we see price competition as a reality over the medium term. We expect the NBAP margins across the sector to thus moderate by 150-200 bps over the next three years.

VALUATIONS AND VIEW

❑ Why value a life insurance company on an NBAP multiple?

Traditionally, insurance companies are valued using the appraisal value method, which is nothing but the sum of its Embedded Value (EV) and Structural Value (SV).

Exhibit 9: Valuation of a life insurance company



Source: SSKI Research

EV typically represents the present value of the future profitability of the existing business (value of in-force business and net worth)

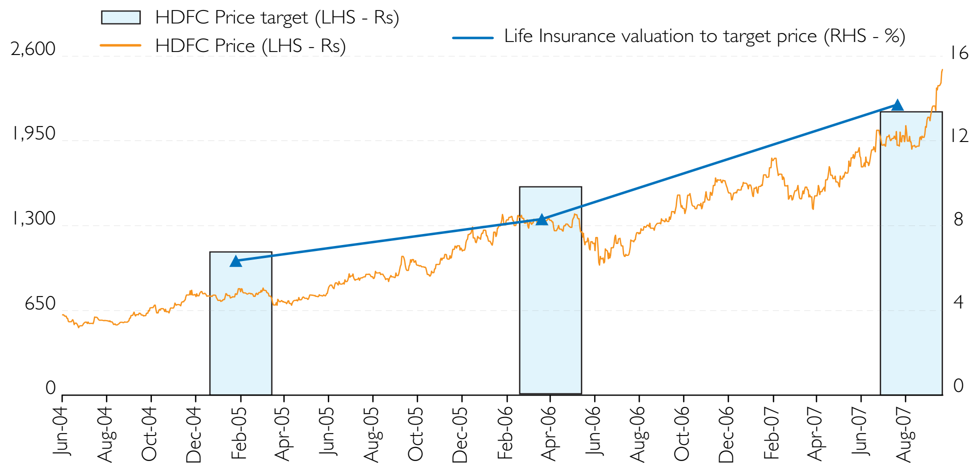
EV typically represents the present value of the future profitability of the existing business (value of in-force business and net worth). On the other hand, structural value attempts to capture the growth potential of the insurance company ie, the present value of policies to be underwritten in the future by a company. As structural value essentially represents the PV of future policies, it is estimated by assigning a multiple to the profits arising out of sales generated in a year.

When a life insurance company is in the growth phase, its EV is likely to be a small component compared to the potential and hence an EV-based valuation is likely to undervalue the company. Hence, we believe the combination of NBAP multiple and EV is more appropriate.

Currently, there is no direct insurance play available and investors desiring to own a pie in the fastest growing financial services segment have to use the Indian partner as the proxy. Over the last 18 months, the value of the insurance business has compounded faster than the core business of the promoter. In the case of ICICI Bank, the value of the insurance business has compounded 5x in the last 18 months. Underpinned by strong growth, private players have catalyzed the process of value unlocking and benchmark valuations tell the story of a dramatically changing investor perception of value.

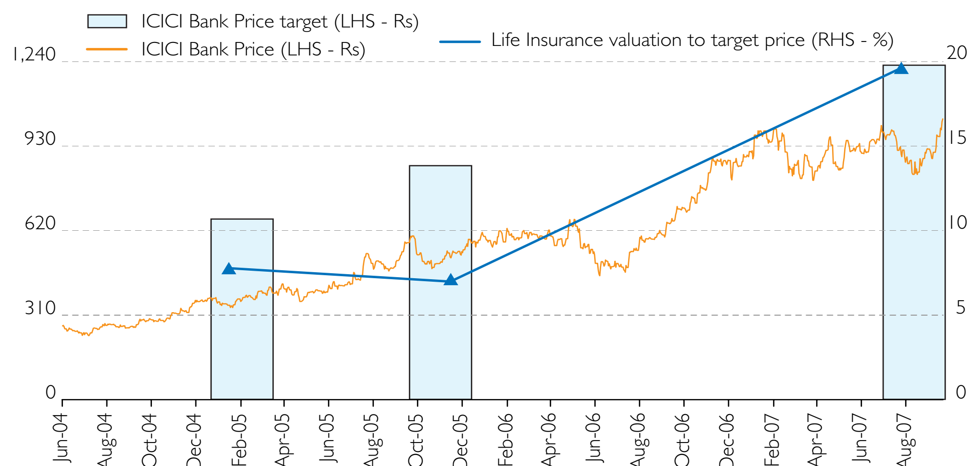
Value of the insurance business has compounded faster than the core business

Exhibit 10: Contribtion of HDFC's Std Life to HDFC's market cap



Source: SSKI Research

Exhibit 11: Contribution of ICICI Pru Life to ICICI's market cap



Source: SSKI Research

❑ Valuation a long way go

Insurance being a capital intensive industry requires a regular infusion of capital by the player to be in the contention. Though the Union Budget for fiscal 2005 had recommended that the ceiling on foreign holding be increased to 49%, we are still some time away . However, as private players gain scale we expect them to keep setting benchmark valuation through sale of minority stakes. Few deals are already underway:

1) ICICI Bank is planning to sell a minority stake in a proposed subsidiary which will house the bank's investment in life insurance, general insurance and mutual fund. However the proposal is still awaiting RBI approval

2) SBI has articulated to follow ICICI Bank's mode of value creation as and when regulatory clarity emerges on holding company structures

3) Reliance Capital has indicated stance to sell minority stake in its insurance ventures (Life and General) in the next 12-18 months .

❑ Comparing valuation across our coverage

Going forward, the implied market cap of the life insurance business is expected to increase faster than the core businesses for all these companies. We have calculated NBAP margins for each player along with the estimated growth in APE. ICICI PRU is the biggest player followed by Reliance Life and HDFC. The value of the parent's stake in most life insurance companies is 20-35% (except for Max New York Life Insurance, which contributes to over 90% of market cap of the parent, Max India). We have assigned a NBAP multiple of 20 to Reliance Life to give credence to strong growth. HDFC Std Life also has been assigned a multiple of 20 to reflect the better profitability and regained growth momentum.

Exhibit 12: Summary Valuation Sheet

			FY10				
Company	Promoters	Comment	Business valuation (Rs bn)	Value of economic interest (Rs bn)	Value per share	Current Share price	Contribution to promoter
Reliance Life	100% economic interest by Reliance Capital	20x NBAP and Embedded Value : 100% stake	274	274	1115	1570	71%
ICICI Prudential Life	74% owned by ICICI Bank	18x NBAP and Embedded Value: 74% stake	532	355	320	1050	30%
Max Newyork Life	Though 74% owned by Max India, we have assumed 51% as it has agreement with New York Life to transfer stake upto 24% as and when regulation permits. For this option , New York Life has compensated Max India by paying a deposit equivalent to 24% of investments into MYNL	18x NBAP and Embedded Value : 50% stake	112	50	227	250	91%
HDFC Standard Life	Though 80% owned by HDFC, we have assumed 50% as it will be compensated by Standard Life for the loss of income (based on pre-tax RoE) on its investment in the core housing finance business	20x NBAP and Enbedded Value: 50% Stake and Excess stake valued at HDFC's Core RoE	218	125	437	2500	17%
SBI Life	74% owned by SBI	18x NBAP and Embedded Value: 74% stake	271	181	343	1950	18%

Source: SSKI Research

In our valuation for ICICI-Pru, we have not ascribed the multiple derived from the likely placement of ICICI Financial, as we believe that:

- PE investors are willing to take a longer term view
- Scarcity premium due to no direct exposure available

Exhibit 13: Comparison with China companies

China Life	~50
Ping An	~40
Cathay Holding	~20
Indian Companies	~18-21

Source/////; Bloomberg, SSKI Research

When compared with Chinese Life Insurers, the Indian players are relatively undervalued offering scope for further upside. However, Chinese insurers also benefits due to a higher share of participating policies wherein the shareholders own a beneficial interest in the underlying asset.

LIFE INSURANCE

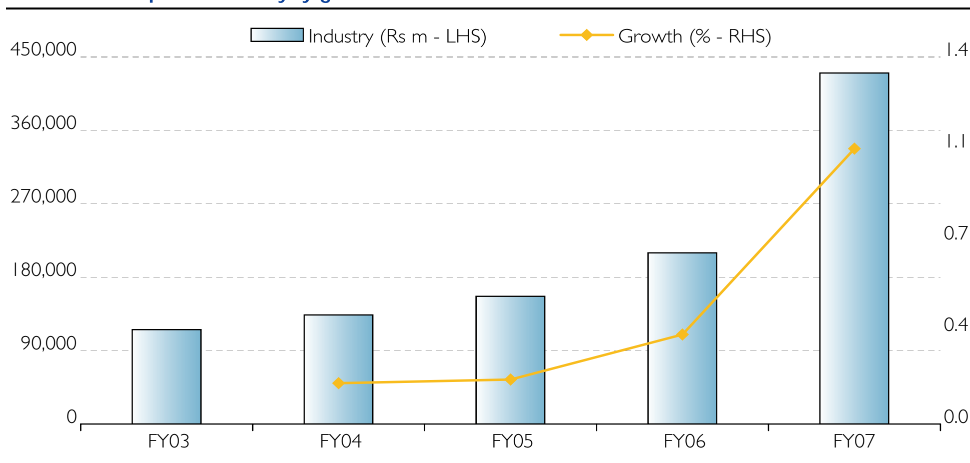
FY2007 was a defining year for the industry influenced by regulation, exploding distribution and wide-scale acceptance of linked products. Growth has tapered off to sedate raising concerns on future prospects. There is a case for explosive growth going forward driven by macro variables of a low social security cover, untapped and rising household savings as also an encouraging demographic profile. While believe the sector will deliver ~33% CAGR over FY07-10 (46% for pvt sector), the growth could come at the expense of margins and believe that the NBAP (New Business achieved profit) margins will moderate by 150-200bps over the next three years. Key success factors would be :A strong brand, deep pockets and an aggressive posture on distribution .With currently no direct valuations attributable to these insurance companies and the explosive context, the value unlock for investors is not far away with consistent upward movement in benchmark prices sure to happen through sales in minority stakes by private players.

FY07: A DEFINING YEAR FOR LIFE INSURANCE

A strong 95% yoy rise in APE registered in FY07

India's life insurance market has been growing at a healthy pace since the advent of competition in 2000. In FY07, growth accelerated considerably and weighted new business premium for individual business (APE) grew at a staggering 95% yoy to Rs430bn.

Exhibit 14: Unprecedented yoy growth in APE



Source: IRDA

To understand the drivers behind the phenomenal growth, we have analyzed the growth in two parts, before July 2006 and post July 2006, with the periods separated by the introduction of ULIP guidelines by the IRDA.

Single premium products more popular as short-term instruments before IRDA introduced stringent guidelines

❑ April-June 2006 – before introduction of ULIP guidelines

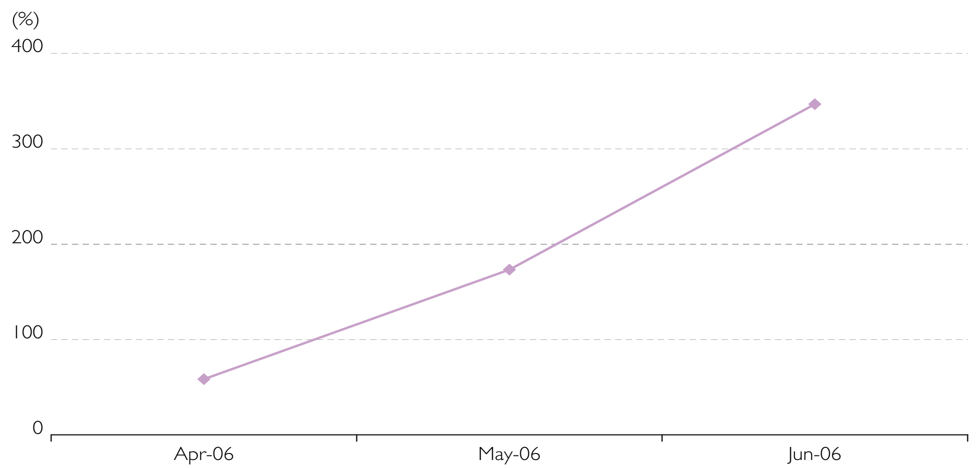
Increasingly, single premium products were being sold and purchased as a short-term instrument to avail of the tax benefits and capitalize on the short-term opportunity offered by equity markets. IRDA, in a bid to curb the trend, introduced stringent guidelines in July 2006. Following are the key guidelines:

- ULIPs for a minimum term of five years
- Minimum sum assured at 125% of first year premium
- No loans allowed on ULIPs
- Minimum lock-in period of three years
- Mandatory to receive cheque payments for premium income above Rs50,000 and documents relating to permanent address.

Single premium policies were pushed aggressively in Q1FY07

Before the formalization of the guidelines, there was an aggressive push by both insurance companies and agents to sell old products, which led to stronger growth in Q1FY07. Growth in single premium policies was a multiplier as the guidelines were essentially aimed to curb the proliferation of these products. Notably, the growth has been driven single-handedly by LIC, wherein share of single premium policies in total portfolio has increased from ~49% in Q1FY06 to ~74% in Q1FY07.

Exhibit 15: Month on Month growth in APE – April- June 2006



Source: IRDA

Growth in single premium products another factor driving sales

Exhibit 16: Share of single premium policies

April to June	2006	2007
Private	18.1	21.2
LIC	48.6	73.6
Industry	41.0	62.4

Source:IRDA

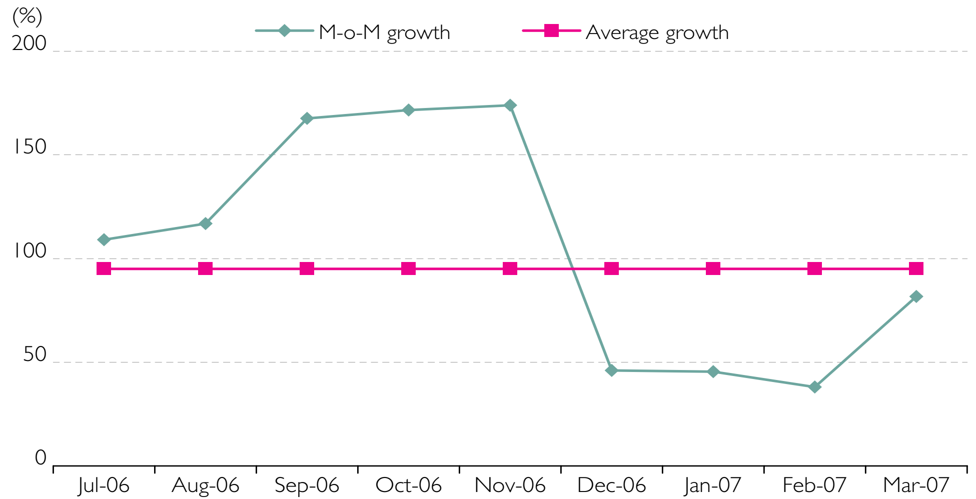
❑ Post July 2006 – after introduction of ULIP guidelines

Tighter regulations failed to dampen ULIP sales

The IRDA had introduced stringent guidelines to bring about a moderation in the growth rate of ULIPs. However, the expected slowdown in insurance sales did not materialize and the industry recorded exceptionally high growth of above 95% over July 2006 to March 2007.

Industry recorded exceptionally high growth of above 95% over July 2006 to March 2007

Exhibit 17: Month on Month growth in APE – July- March 2007



Source:IRDA

Key contributors for the high growth rates are:

LIC's aggressive push to ULIPs – a key contributor to industry growth

Re-emergence of LIC as a key market player

After losing out consistently to private sector players, LIC decided to shake off the lethargy, which helped it recapture some of the lost ground in FY07. LIC, a dormant player in the ULIP market, started aggressively pushing these products. Given LIC's market size and distribution reach, a concentrated effort made by it had a significant impact on the market.

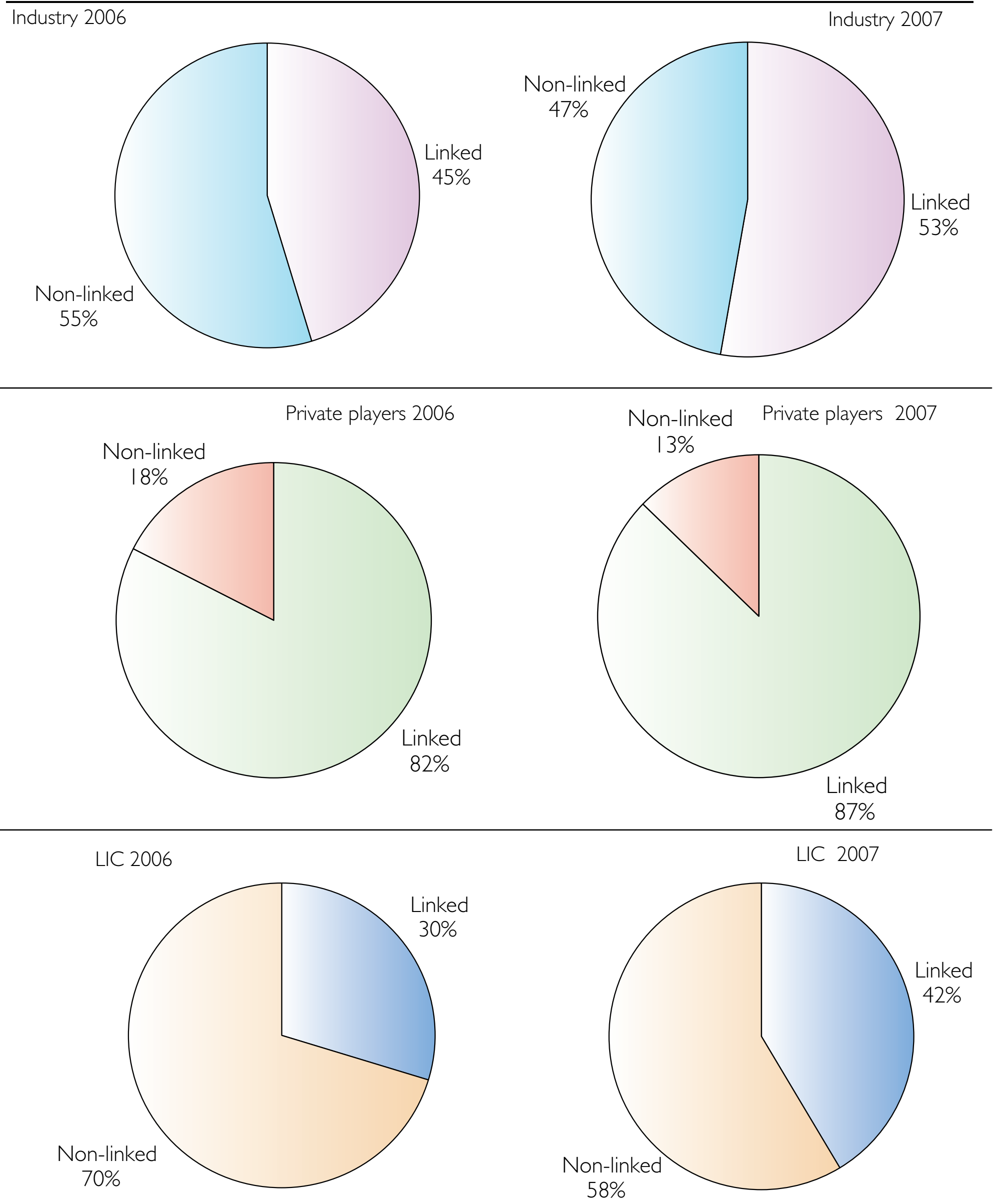
ULIP expected to remain an attractive proposition for customers

Popularity of ULIP

ULIP, by virtue of it being a winning combination offering both protection and returns (in an underpenetrated equity ownership environment), has been a major driver for the accelerated growth registered by the life insurance industry. A booming capital market has also been an important facilitator for the robust growth, as it has increased the popularity of ULIP products. With the competitive intensity likely to escalate, the charges are further expected to be slashed. This, we expect, would enhance the attractiveness of the product.

Private as well as public sector players focusing on ramping up points of sale

Exhibit 18: Linked products dominate the incremental business



Source: IRDA

Expanding distribution

Concentrated sales effort, by both private and public behemoths, has increased the penetration of life insurance products. In the current year, almost all private players have aggressively invested in expanding their distribution reach (refer exhibit below).

Exhibit 19: Players ramping up distribution reach

Distribution	2006		2007	
(no.)	Branches	Agents	Branches	Agents
ICICI	177	72,000	583	234,000
HDFC	169	33,000	438	74,000
Reliance	153	20,231	217	106,000

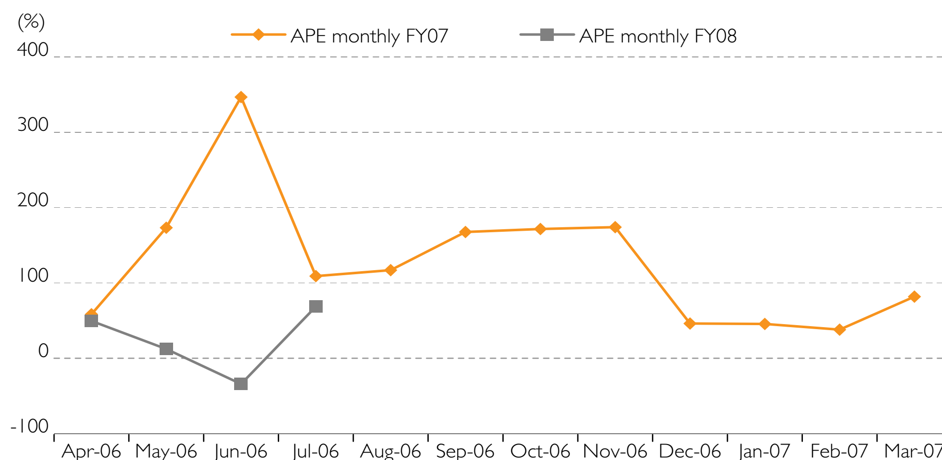
Source: Companies

FY08: The story so far

In FY08 YTD, growth rates have tapered off from 95% in FY07 to sedate levels of 39%. However, the loss of momentum is not because of sluggish demand and is more a function of the high base of the previous year (there was a surge in 1Q FY3/07 as insurers rushed to beat the 30 June deadline for new and tighter regulations). Private sector insurers have registered growth of 47% YTD FY08 (April-July 2007) as compared to 35% seen for LIC. Generally, the first four months account for 18-20% of the total premium. Base effect benefit is likely to kick in by the month of August.

High base effect leads to growth slow down in FY08 YTD

Exhibit 20: APE growth rates



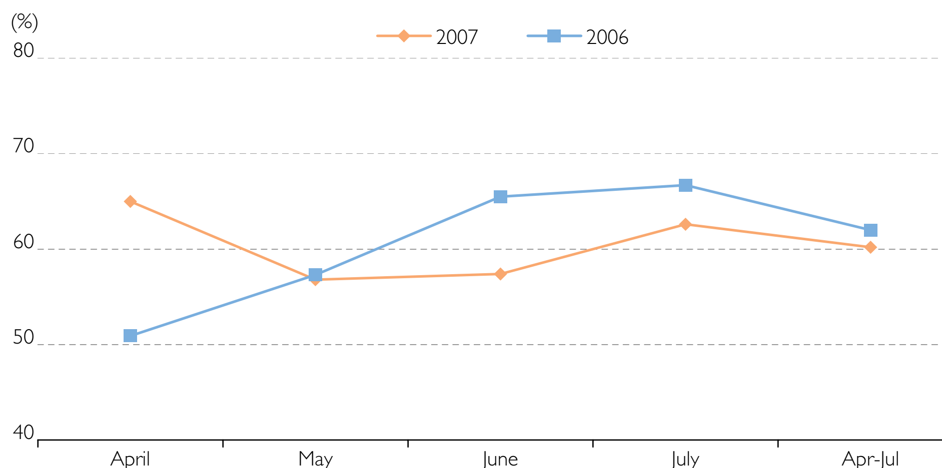
Source:IRDA

❑ After a recoup in FY07, LIC slips on market share YTD FY08

LIC, after putting up a strong show in FY07, has again lost some ground in the first four months of the current fiscal year. Its market share, on an APE basis, has come down to 60% from the 62.5% level maintained in the previous fiscal. Slower growth in the individual single premium segment has contributed to the decline for LIC.

After witnessing market share gains in FY07, LIC saw some slippage in FY08 YTD

Exhibit 21: LIC – market share swings



Source: IRDA

With stricter guidelines in place for ULIPs, growth has tapered off in the single premium segment

❑ Share of single premium policies

The introduction of ULIP guidelines has had the desired effect of curtailing the growth of single premium products. In the first four months of FY08, the share of single premium policies has declined for private insurers as well as LIC. The biggest deceleration has been seen in the individual single premium segment.

Exhibit 22: Share of single premium

	Up to July 2007	Up to July 2006
Private	14.6	20.1
LIC	52.6	67.3
Market	41.8	56.7

Source:IRDA

IS THE PARTY OVER? – WE DON'T BELIEVE IT IS

The entry of private players lent the life insurance industry a fresh lease of life. The well-capitalized private sector companies have had adopted an aggressive approach and introduced innovative products and varied distribution channels besides aggressively creating a wider footprint. After the dream run witnessed in FY07, industry growth rates have moderated during the first four months of the current fiscal. This has given rise to concerns on the future prospects of the Indian life insurance industry. Investor concerns pertain mainly to increasing penetration, ULIP losing out to Mutual Fund and ULIP popularity in a market correction. ULIP has been instrumental in accelerating the growth.

Growth appears sustainable; private sector insurers to grow faster

❑ Concern 1: Penetration catching up; limited scope for growth

We believe the industry is still some time away from seeing a slowdown. An under-penetrated market, when viewed in context of low household ownership of equity along with the continued economic expansion propelling the domestic savings rates, suggests a sustained growth momentum. We expect the life insurance segment to register a healthy 33% CAGR over FY07-10, with private sector players growing faster (46% CAGR vis-à-vis 24% CAGR for LIC). This implies that private sector insurers would continue to eat into the market share of LIC.

Exhibit 23: Future Potential

(Incrs)	2004	2005	2006	2007	2008	2009	2010
GDP (at current market prices)	2,765,500	3,126,600	3,567,200	4,125,700	4,723,927	5,385,276	6,139,215
YoY growth (%)	*13*	*13*	*14*	*16*	*15*	*14*	*14*
Gross Saving (%) as of GDP	29.7	31.1	32.4	33.4	34.0	34.5	35.0
Gross Savings	820,504	973,028	1,156,809	1,377,984	1,606,135	1,857,920	2,148,725
Household Propn as % of Gross Savings	80	69	69	70	72	73	73
Household Propn	657,327	674,834	797,117	964,589	1,156,417	1,346,992	1,568,569
Insurance as % of Household Proportion	10	12	13	15	18	19	20
Insurance	65,500	82,854	105,873	155,286	205,786	260,061	321,106
Penetration (As a % of GDP)	2.4	2.6	3.0	3.8	4.4	4.8	5.2
New Business Premium	18,600	25,529	35,900	75,403	105,777	136,792	166,767
YoY growth (%)		*37*	*41*	*110*	*40*	*29*	*22*
Renewal Premium	46,900	57,325	69,100	79,883	100,009	123,269	154,338
YoY growth (%)		*22*	*21*	*16*	*25*	*23*	*25*

Source: RBI, SSKI Research

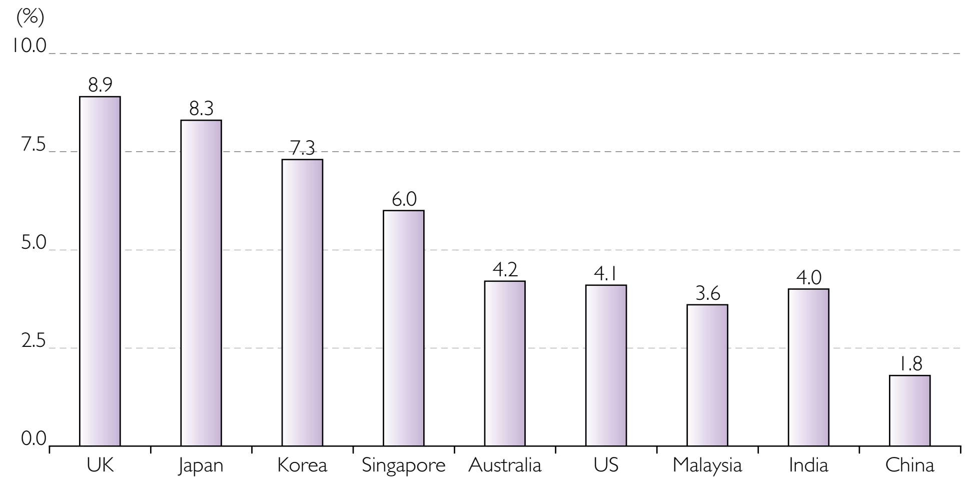
Penetration levels no longer low – a misnomer

Only 35% of India's insurable population estimated to be insured

Penetration of insurance products (total premium as a per cent of GDP), though higher at 4% vis-à-vis 1.2% seen in FY00, still lags penetration levels in developed economies. According to industry estimates, only 35% of India's insurable population is currently covered by insurance, which indicates tremendous potential. Going forward, we expect the life insurance market to witness 25% CAGR over FY07-10, which would take the penetration level up to ~5.5% by FY10.

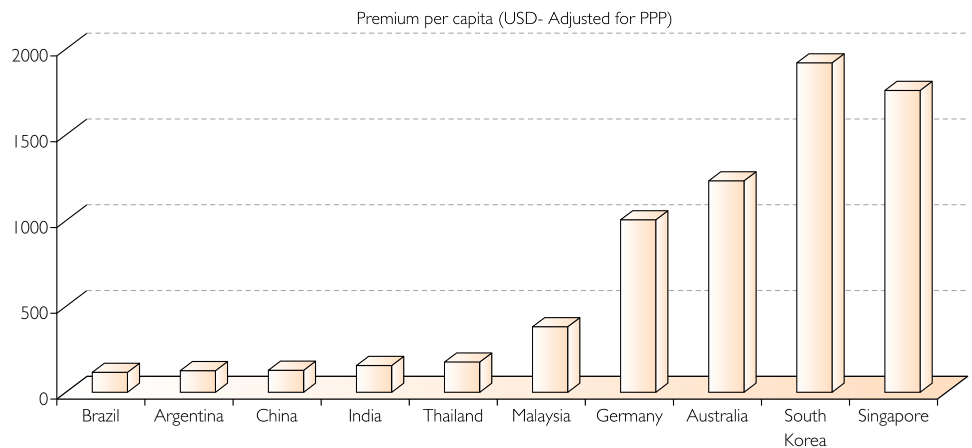
India's penetration level still lags that of developed countries

Exhibit 24: Table on penetration levels



Source: SSKI Research, Swiss RE

Exhibit 25: Table on insurance density



Source:Swiss Re

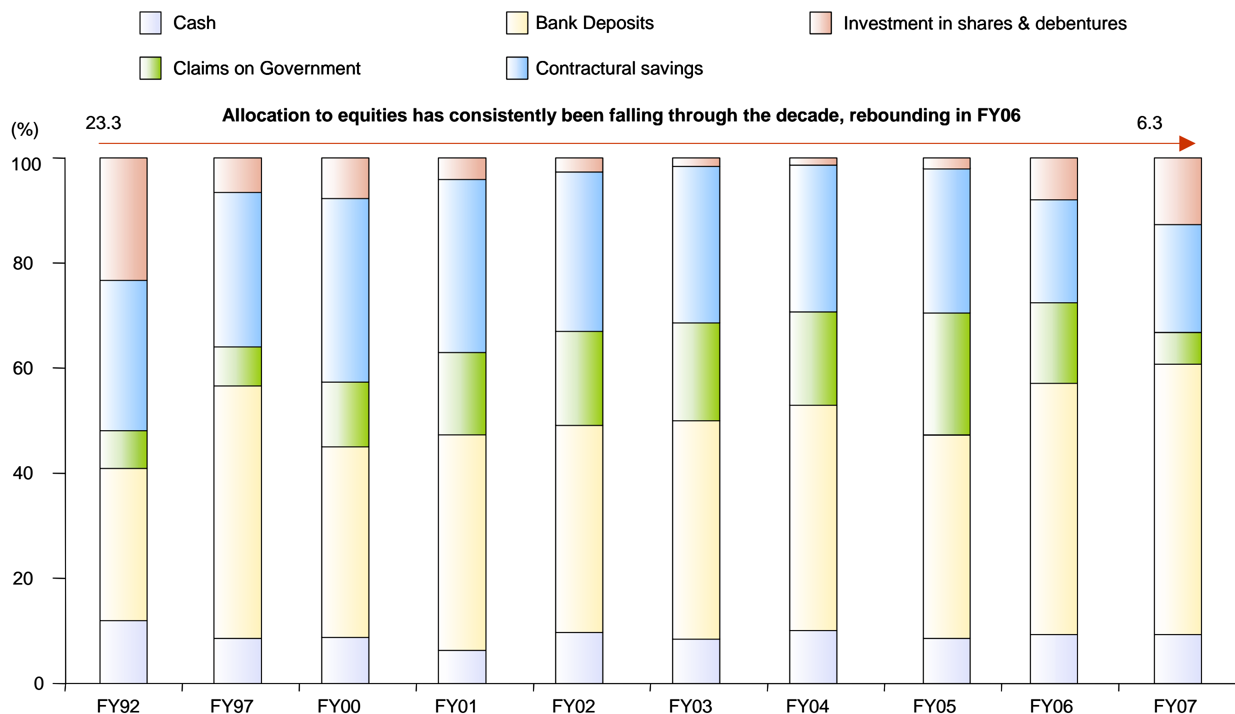
Strong underlying growth factors and low equity ownership to drive penetration

Though penetration has more than doubled over seven years, we still see scope for a further increase (albeit not at the unprecedented rate seen over these years). This can be assigned to two factors: strong underlying growth drivers and that high penetration number is a misnomer considering low household ownership of equity, a parallel economy and absence of social security.

With rising savings rate, we expect a gradual shift towards equity linked financial instruments

Low household ownership of equity: Penetration levels need to be viewed in the backdrop of low household ownership of equity. Given that ULIPs – offering an opportunity to own equity while also availing of the added benefit of insurance – contribute significantly to insurance premium, the classical insurance penetration level is a misnomer. With only 6.0% of the household sector's financial savings invested in equity and equity-related assets, retail participation in equities is one of the lowest in the world. Going forward, we expect India's savings rate to continue rising on the back of a strong structural economic expansion and increasing share of working age population in the total population. In addition, we anticipate an increasing tendency towards riskier asset classes. Given these factors, we believe ULIP will continue to be favoured as a vehicle to increase exposure to the equities market.

Exhibit 26: **Financial Saving break-up**



Source: RBI

A thriving parallel economy: India has a thriving parallel economy, which does not get captured in the calculation of nominal GDP. Hence, the penetration number is overstated. According to industry estimates, the size of the parallel economy is as large as that of the accounted GDP.

Absence of social security increases need for risk cover: In other developed economies (like Singapore, UK, etc), there is an adequate social security system in place, which lowers the need for insurance. In comparison, India does not offer a social security system, as a result of which the populace has to rely on external agencies to provide the much required risk cover.

Faster industry and services growth, higher productivity and urbanization driving the Indian economy

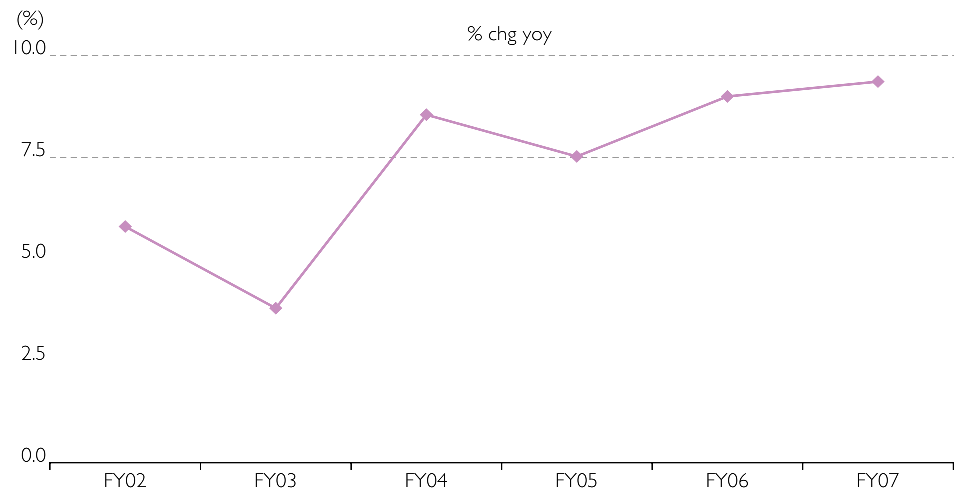
Structural economic expansion to continue

India is experiencing robust economic growth from 2003, driven by structural factors (rather than this being a cyclical upturn). It is one of the fastest growing economies in the world (lagging only China). Key contributors to the phenomenon are:

- High growth rates clocked by industrial and services sectors
- Benefits of productivity gains, contributed significantly by the private sector
- Increasing urbanization, coupled with a shift from agriculture sector (low productivity) to the more productive industry and services sectors.

GDP growth has accelerated to 9.4% in FY07

Exhibit 27: GDP growth rate from 2002



Source: RBI

With these structural drivers getting further entrenched, they augur well for the future prospect of the Indian economy. We expect growth of 8-8.5% in India's GDP over the next few years.

Continued demographic expansion

The key fillip for the insurance sector would come from changing demographics of India. Key trends expected are:

Migration to higher income growing at 40% per annum

Rising affluence levels: With a positive outlook on the Indian economy, we expect an increase in overall income levels and increasing migration from lower income categories to higher income category. According to a study conducted by NCEAR for top 24 cities in India, migration to higher income categories is growing at 40% per annum.

Exhibit 28: Demographics – income levels

	1995-96	2005-06	2009-10
<90	131,176	132,249	114,394
91-200	28,901	53,276	75,304
201-500	3,881	13,183	22,268
501-1000	651	3,212	6,173
1001-2000	189	1,122	2,373
2001-5000	63	454	1,037
5001-10000	11	103	255
10001+	5	52	141

Source:NCEAR

Working population expected to increase from 62.5% of the total in 2002 to 64.1% in 2011

Increasing working population: At an average age of 28.4 years, India is one of the youngest countries in the world. In terms of composition, the working population (considered to be in the age bracket of 15-64 years) is likely to increase from 62.5% of the total in 2002 to 64.1% in 2011. A higher proportion of working population leads to a decline in dependency ratios for the economies.

Exhibit 29: Working population

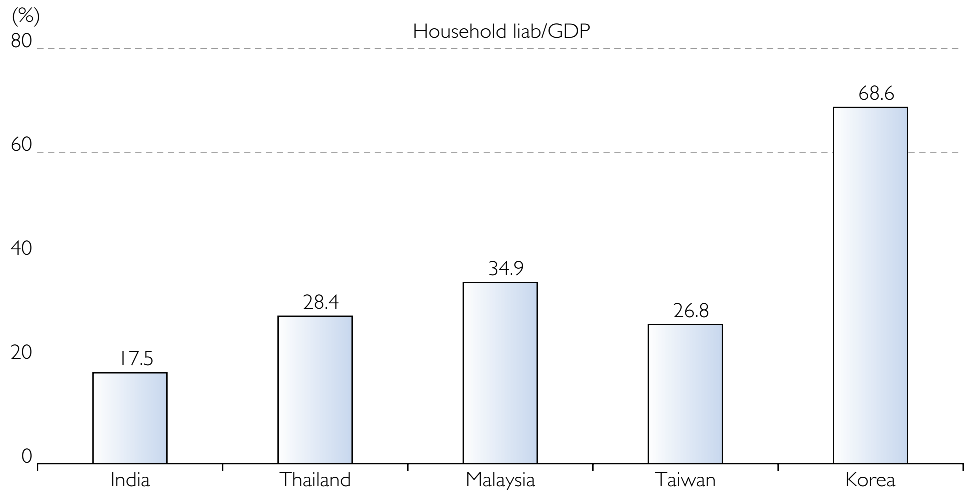
(%)	2005	2025
> 60	9	12
20-59	50	56
0-19	41	32

Source: UN

Increasing dependency ratio due to nuclearization driving need for insurance

Increase in the number of nuclear families: An accelerating trend of a higher proportion of nuclear families in the total number of households vis-à-vis joint families increases the need for insurance as the dependency ratio increases significantly. Low interest rates have fostered a further increase in household debt, mainly in the form of mortgage loans. Household debt as a per cent of GDP, though increasing, continues to be lower than that for global peers. As the proportion of leverage increases and lenders stipulate that the loans availed of be covered under insurance, there would be a greater need for term insurance.

Exhibit 30: Household liabilities penetration



Source: SSKI Research

Other micro factors contributing to the momentum

Minimal penetration beyond Tier 1 & 2 cities; action to shift to smaller cities and rural areas

Newer geographies: Distribution reach will be the key to future growth acceleration for insurance companies as existing geographies get saturated and the focus shifts to new under-penetrated geographies. There is minimal penetration beyond Tier 1 and 2 cities. The focus will be more on selling financial products in semi-urban/ rural areas. Opportunity exists in the largely untapped rural market where ~60% of the total population resides. Private players have identified the same as their next growth engine, and are developing long-term strategies in terms of distribution channels and products to cater to this market.

Players planning to double their agency network

Innovative distribution channels: Globally, insurance – besides through the traditional channels – is also sold at supermarkets, petrol stations and airports. In India too, private players are significantly increasing their distribution reach and marketing efforts. All the companies under our coverage are planning to double their agency network over the next 2-3 years. Also, newer players like Bank of India-Daitchi and Canara-HSBC are likely to launch aggressive marketing efforts. However, the key challenge to this would be increasing attrition rate and productivity.

Continued tax sops: Though tax sops will continue, they will not be the sole factor driving growth. This is highlighted by the fact that premium per capita is increasing which, along with other tax saving instruments, would be higher than the threshold.

Pension sector and health insurance likely to provide a boost

Innovative products: Going forward, the opening up of the pension sector and formulation of adequate guidelines for health insurance could provide a further fillip to the life insurance sector. Introduction of health insurance would improve the profitability of players as these products carry higher margins. With health spends inflating faster than the headline inflation, there would be a greater need for health protection, which would mainly benefit life insurance companies. Pension sector too offers tremendous potential due to its inadequate penetration as only 10% of the working population is covered. With increasing urbanization, awareness levels also are expected to increase, which would stimulate demand for insurance products.

❑ Concern 2: ULIP losing out to Mutual Fund

ULIP vs mutual fund products – short-term loser, long-term gainer

Our analysis of returns delivered by both mutual funds and ULIP…

We have analyzed the return delivered by both mutual funds and ULIP. Though *the past is not comparable to future*, insurance companies would pay significant attention to asset management activities as they gain scale. This would significantly improve their investment performance.

We have compared the IRR available to an investor invested in SIP and ULIP. Our analysis highlights that for the short to medium term, SIP is a more attractive instrument than ULIP. However, comparing the investments over a longer term, ULIP is more attractive. Key differentiators:

…indicate that ULIps score over SIPs in the longer term

- Mutual funds have a comparatively lower entry/ exit load compared to the load charged by insurance companies
- Fund management fee charged by mutual funds is higher compared to insurance companies
- Recurring expenses charged by mutual fund are a per cent of AUM, whereas in case of ULIP it is generally charged as a fixed per cent of premium
- No mortality charges arise in case of mutual funds
- Additionally, the benefit of Insurance through ULIP cannot be replicated by an SIP

Exhibit 31: Key features of sample policies under SIP and ULIP

Company	Pru-ICICI	ICICI Pru Life	HDFC Standard Life
Policy type	SIP	ULIP Life	ULIP Life
Policy name	Pru ICICI Growth plan	Life Time Super	Young Star Plus
Fund	Equity	Equity	Equity
SIP	100	100	100
Sum assured	NIL	2000	2000
Allocation Rate: 1st year	NA	80%	40%
Allocation Rate: 2nd year	NA	93%	99%
Allocation Rate: 3rd year onwards	NA	96%	NA
Load	2.25%	NA	NA
Return assumed	12%	12%	12%
Mortality charge	NIL	As per LIC table applicable for sum at risk	As per LIC table applicable for at risk
Fund management fees	1.75%	2.25%	0.80%
Operating expenses	NA		2.40%
Recurring exp. as % of NAV	1%	NA	NA

Source: SSKI Research

Exhibit 32: Mutual Fund :

(In Rs) (yrs)	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Op Balance	0.0	107.0	223.9	351.5	490.8	643.0	809.2	990.7	1188.8	1405.2	1641.5	1899.5	2181.3	2489.0	2825.0
Investment	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
less: Load	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Net investment	98.0	205.0	321.9	449.5	588.8	741.0	907.2	1088.7	1286.8	1503.2	1739.5	1997.5	2279.3	2587.0	2923.0
Return	11.8	24.6	38.6	53.9	70.7	88.9	108.9	130.6	154.4	180.4	208.7	239.7	273.5	310.4	350.8
Total	109.8	229.0	359.6	502.1	657.8	827.8	1013.5	1216.2	1437.5	1679.3	1943.3	2231.5	2546.3	2890.0	3265.4
Less: AMC	1.9	4.0	6.3	8.8	11.5	14.5	17.7	21.3	25.2	29.4	34.0	39.1	44.6	50.6	57.1
Less: Recurring expenses	1.1	2.3	3.6	5.0	6.6	8.3	10.1	12.2	14.4	16.8	19.4	22.3	25.5	28.9	32.7
Closing Balance	106.7	223.3	350.6	489.6	641.4	807.1	988.1	1185.8	1401.6	1637.3	1894.7	2175.7	2482.6	2817.8	3183.8

Exhibit 33: ICICI PRU LIFE

(In Rs) (yrs)	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Op Balance	0.0	85.3	192.5	313.5	446.1	591.3	750.5	924.8	1115.9	1325.5	1555.3	1807.9	2084.4	2387.1	2718.4
Addition															
Allocation	80.0	92.7	96.0	96.0	96.0	96.0	96.0	96.0	96.0	96.0	96.0	96.0	96.0	96.0	96.0
Investment Income	9.6	21.1	34.4	48.9	64.8	82.3	101.4	122.3	145.3	170.5	198.2	228.5	261.6	298.0	337.7
Expenses															
Mortality charge	2.2	2.2	2.1	2.0	1.9	1.8	1.7	1.5	1.2	0.8	0.0	0.0	0.0	0.0	0.0
Fund management fees	2.0	4.5	7.3	10.3	13.7	17.3	21.3	25.7	30.5	35.8	41.6	48.0	54.9	62.6	70.9
Closing Balance	85.3	192.5	313.5	446.1	591.3	750.5	924.8	1115.9	1325.5	1555.3	1807.9	2084.4	2387.1	2718.4	3081.3

Exhibit 34: HDFC Standard Life

(In Rs) (yrs)	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Op Balance	0.0	39.8	149.1	270.7	405.9	556.5	723.9	910.2	1117.4	1347.9	1604.4	1889.9	2207.1	2559.4	2950.9
Addition															
Allocation	40.0	99.0	99.0	99.0	99.0	99.0	99.0	99.0	99.0	99.0	99.0	99.0	99.0	99.0	99.0
Investment Income	4.8	16.1	29.2	43.8	60.1	78.2	98.3	120.7	145.6	173.3	204.1	238.4	276.4	318.7	365.7
Expenses															
Mortality charge	2.3	2.2	2.0	1.9	1.7	1.5	1.3	1.0	0.7	0.4	0.0	0.0	0.0	0.0	0.0
Admin fees	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4
Fund management fees	0.4	1.2	2.2	3.3	4.5	5.9	7.4	9.0	10.9	13.0	15.3	17.8	20.7	23.8	27.3
Closing Balance	39.8	149.1	270.7	405.9	556.5	723.9	910.2	1117.4	1347.9	1604.4	1889.9	2207.1	2559.4	2950.9	3385.9

Source:SSKI Research

Exhibit 35: Comparative indicative returns of a SIP and ULIP to an investor

Equity-12%				
	PRU ICICI	HDFC Standard	ICICI Pru	Comments
IRR-15 years	8.94%	9.64%	8.57%	• The gap between HDFC and ICICI-Pru and Pru-ICICI is increasing giving weight to variable charges
IRR-12 years	8.87%	9.08%	8.25%	• HDFC Life has taken over mutual funds as the benefit of lower fees charged by HDFC is on an increasing AUM which has overtaken the negative of a fixed higher load. • The gap widens between HDFC and ICICI due to lower variable charges.
IRR-10years	8.80%	8.44%	7.90%	• The gap has significantly reduced as the higher AMC fees charged by mutual funds are making an impact. • HDFC overtakes ICICI as the lower AMC for HDFC has mitigated the downside due to a higher initial load.
IRR-7 years	8.63%	6.57%	6.97%	• Mutual funds is a better performing asset class, though the differential narrows • ICICI is a better performer but the gap has significantly reduced.
IRR- 5 years	8.42%	3.59%	5.65%	• ULIP as a product class underperforms mutual funds due to higher load charged by ULIP • Within insurance asset class, HDFC Standard Life product lags in performance when compared to ICICI-Pru due to the higher load charged by HDFC.

Source:SSKI Research

Exhibit 36: Debt scheme

(%)	PRU ICICI	ICICI PRU	HDFC Standard
IRR-15 years	**5.77**	4.48	4.73
IRR-12 years	**5.77**	4.16	3.68
IRR-10years	**5.77**	3.83	3.63
IRR-7 years	**5.77**	2.96	1.90
IRR- 5 years	**5.77**	1.70	(0.87)

Source:SSKI Research

Debt schemes generate higher returns vis-à-vis insurance products

In debt schemes, a mutual fund outperforms insurance products as the fee charged is comparable to insurance products. Absence of any entry/ exit load in the mutual fund compared to higher load for insurance products also aids in improving returns.

Key assumptions

- The return delivered by the fund management team of both insurance and mutual fund is the same. There could be a variation owing to different skill sets.

Exhibit 37: Comparative profitability between a mutual fund compared and an insurance company

(%)	ICICI PRU	HDFC Life	PRU ICICI
5 yrs	0.0	0.0	4.8
10 yrs	7.8	8.3	5.5
15 yrs	29.8	21.3	2.8

Source: SSKI Research

Insurance companies more profitable than MFs due to difference in persistency and average investment term

As can be seen in the above exhibit, insurance companies tend to be more profitable than mutual funds, which can be assigned to a difference in persistency and average tenor of the investment term between the two products. Life protection provided by an insurance product is the key rationale for the difference.

❑ Concern 3: ULIP's popularity will wane with a market correction

Given the buoyant economic conditions, we do not see a prolonged downturn in stock market

ULIP, offering a winning combination of protection with returns (in an under-penetrated equity ownership environment), has been a major growth driver for the life insurance industry. A booming capital market has also been an important facilitator of the robust growth, wherein the popularity of ULIP products has increased. A prolonged downturn in the stock market could hamper the sales of ULIP products. However, flexibility offered by ULIP allowing a switch from equity to debt would moderate the impact. In our opinion, if the economy continues to see a structural expansion, India would deliver a sustained growth of ~8% over the next five years. Hence, we believe this lowers the possibility of a prolonged downturn in the stock market.

Key attractions of ULIP

ULIP offers dual benefits of returns and insurance cover

- Competitive AMC charges (lower than mutual funds), along with reducing load charges, have positioned ULIP as an attractive investment alternative offering life protection.
- The flexibility offered by ULIP products in terms of free switches between equity to debt has also helped maintained the popularity.
- Indian psyche does not prefer pure risk cover products that do not offer any returns; and this has been a key reason for the success of ULIPs.

Even during market consolidation seen in the period between May to July 2006, popularity of ULIP did not wane. ULIPs accounted for a large proportion of new business premium for life insurers, making up ~86.6% of the new business premium of private insurers. Even for LIC, the share of ULIP has increased from ~30% in FY05 to 42% in FY07.

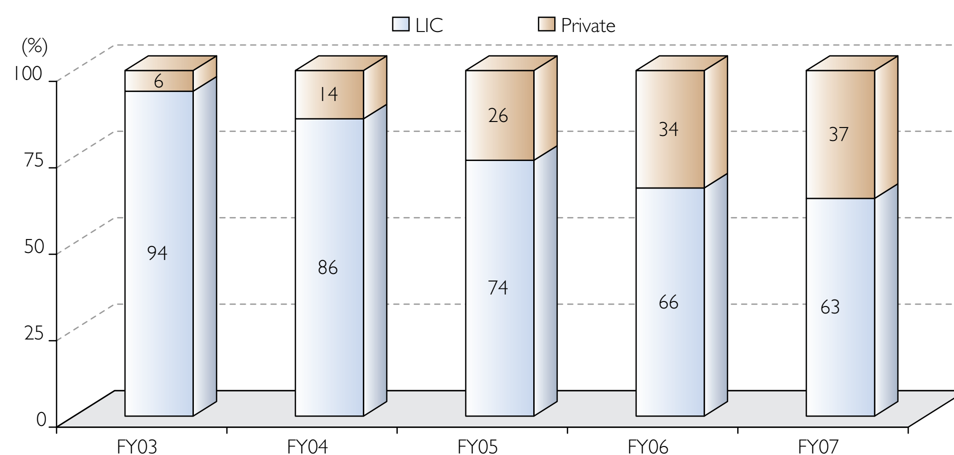
A CHANGING COMPETITIVE LANDSCAPE

❑ Private sector eating into LIC's market share

In six years, private players have captured a market share of 37% in FY07 from LIC

The insurance industry has undergone marked changes in the recent past. A new order has set in after the opening up of the sector to private insurers. The monopolistic life insurance industry (LIC being the only player) witnessed entry of aggressive private insurers from 2001. While obviously ending the incumbent player's monopoly, these private insurance companies – with their smaller base as also aggressive customer acquisition strategies – have been consistently eating into the state insurer's market share. In a span of six years, private players have captured a market share of 37% in FY07 with market share gains driven by a 119% increase in premium income written over FY03-07 vis-à-vis 26% for LIC. Notably, LIC registered a low premium per policy as also slower growth in the number of new policies as compared to other players.

Exhibit 38: Private sector players – improving market share



Source:IRDA

LIC pulling its act together…

LIC recaptured some of the lost ground in FY07…

In FY07, LIC seems to have shaken off the lethargy in its bid to recapture the lost ground. LIC, a dormant player in the ULIP market till recently, has started aggressively pushing ULIP products, which has bolstered the growth of the product. Given LIC's market size and distribution reach, a concentrated effort made by it has had a significant impact on the market. Aggression in ULIP has also helped LIC improve its average ticket size, and thereby close the gap with private players.

…however, inherent weaknesses in the business model are hurdles

…though this does not appear sustainable as private players are too aggressive

Going forward, we believe private players would continue to gain market share at the expense of LIC due to the weaknesses inherent in LIC's business model. We expect LIC's new business premium to grow at a lower 24% as compared to 46% for private players, which implies loss of market share for LIC from 63% in FY07 to 52% in FY10.

Some of the weaknesses prevailing in LIC's business model include:

Private sector has more productive and better trained agency force

- **Agency force: Though LIC has over 1m agents, p**rivate sector's agency force continues to be better trained and highly productive in term of average ticket size and better sales. Private sector players have been investing heavily in expanding their agency force which would continue to be a key advantage. Given the changing demographics towards younger population, we believe that the private sector agency force would be able to relate more to the addressable population.
- **Channel:** LIC primarily is an agency dependent organization (99% of business. As most of the agents work part time, the overall productivity has been lower. On the other hand, private sector players have developed a well balanced distribution mix with alternate channels like bancassurance and corporate agencies accounting for 30-35% of the business.

The younger population relates more to new-age brands like ICICI, HDFC and Reliance

- **Branding:** Though LIC is a well-entrenched brand, changing demographics towards a younger population make popular brands like ICICI, HDFC and Reliance more effective. Also, LIC's well-entrenched footprint in smaller cities and towns is set to be challenged with SBI commencing sale of SBI Life products via its network of 14,000 branches.

LIC could lose out as it is positioned mainly as a provider of tax-saving instruments

- **Positioning of insurance as a tax saving product:** Given the argument of customers increasingly buying insurance to meet their investment and protection needs, LIC would also lose out as it is positioned mainly as a provider of tax-saving instruments.
- **Deeper penetration:** LIC will face tough competition as private players expand their distribution beyond the well-banked segment, metros and urban areas, and roll out their network in smaller towns – currently the domain of LIC. Private players, through innovative product offerings and better service levels, are well placed to make a dent in LIC's stronghold.

❑ Private insurance space ripe for consolidation

A deepening divide between performers and laggards heralds a market consolidation

We expect the current market share divide between performers and laggards to become starker. Subsequently, consolidation is expected to set in as some of the marginal players (mainly companies facing fund constraints) would start exiting or selling out. Also, some marginal player may continue to lose market share and get further marginalized, making funding the business an unattractive proposition for either partner.

Market shares – highly volatile

Private players fighting tooth and nail for market share

Private insurers have seen large swings in their market share. However, the top two among private players, ICICI-Pru and Bajaj Allianz, have maintained the number one and two position respectively though ICICI-Pru has witnessed a marginal decline post the entry of Reliance Life in the space. Bajaj Allianz has gained significant market share by reaping benefits of putting up the largest distribution network among private players. HDFC also has lost some ground, and is planning to rapidly ramp up its distribution network. Along with a strong brand and an effective bancassurance partner, this should help the insurer recapture the lost market share to some extent.

Exhibit 39: Huge market share swings among private players

Insurer (%)	2005	2006	2007
Bajaj Allianz	10.4	17.5	20.1
ING Vysya	6.2	3.3	2.8
Reliance Life	0.8	1.1	4.5
SBI Life	4.1	6.3	11.3
Tata AIG	6.8	5.6	3.6
HDFC Standard	9.0	10.7	8.3
ICICI-Pru	33.6	29.9	28.5
Birla Sunlife	13.7	8.2	5.3
Aviva	4.2	5.1	4.3
Kotak Mahindra Old Mutual	4.8	4.7	3.5
Max New York	5.1	5.6	4.9
Met Life	1.2	1.7	2.1
Sahara Life	0.0	0.1	0.1
Shriram Life	-	0.1	0.6
Bharti Axa Life	-	-	0.0
Private total	**100.0**	**100.0**	**100.0**

Source: IRDA

SBI Life and Reliance Life – the rising stars

SBI Life and Reliance Life are the emerging stars in the private insurer space. Reliance Life, with the backing of an aggressive sponsor having deep pockets and a well conceptualized strategy, has emerged as the fastest growing private insurance player. Since the acquisition of AMP Sanmar, Reliance Life has been one of the fastest growing life insurance businesses in India. The company reported a stupendous rise of 380% yoy in new business premium in FY07 (way above the 100% yoy rise reported by domestic life insurance industry) with first year regular premium growing by 8.5x. This has led to Reliance Life clocking significant market share gains from 1.1% in FY06 to 4.5% in FY07 on APE basis. From being number 12 in the space, the company's ranking has also improved to number seven in FY07.

The other big gainer, SBI Life, has raised its market share to 11.3% in FY07 from 4.1% in FY04. The phenomenal growth over the last two years has been driven by aggressive leveraging of its massive distribution network.

Key losers – Birla Sunlife and Tata AIG

Birla Sunlife, being the pioneer of ULIP in India, has lost market share from 13.7% in FY05 to 5.3% in FY07. The key reason for the drop is increasing competition in the ULIP segment, coupled with stagnating agency force and a loss of high net worth individual business to other players. The company was also hit by a management change and its inability to invest ahead of time in distribution.

The way forward – increasing competition

With entry of 7-8 entrants lined up, we expect competition to increase

We expect the competitive intensity to build up in the private space with as many as 7-8 new entrants looking to enter the arena. There are few barriers to entry as IRDA has not placed any limits on the number of players that can operate in the space. The basic qualifications stipulated are easily met by a majority of the foreign insurance companies. Considering the growth profile and attractiveness of India's insurance sector, we see an influx of players in the space.

We do not see insurance companies promoted by the PSU consortia capable of making a big impact. With the advent of BASEL II, the capital requirement will significantly increase for the banking business, thereby limiting their flexibility in funding the capital-intensive life insurance business. Also, due to the presence of multiple banks floating a single insurance venture in consortium, this could give rise to branding issues.

As the industry growth rates taper off, we expect a significant build up in competitive pressure, which would lead to a shakeout in the industry. In such a scenario, the key to survival would be:

An established brand: The biggest names include LIC and SBI with ICICI, HDFC and Reliance being the next in line. As mentioned earlier, a strong brand becomes essential and would be a key differentiator as players tap the smaller cities in their quest for future growth.

A strong brand, deep pockets, extensive footprint and a profitable AMC – the key requisites for success

Capital flexibility: Life insurance is a capital-intensive business, wherein building an extensive distribution network entails a huge cost and customer acquisition costs are also high. Therefore, companies take longer to break even and regular capital infusions are required to grow the business. The amount of capital infused in the life insurance business will determine the pace of growth of the player and its ability to retain or improve upon market share. The capital committed by key players is sizeable and makes it difficult for marginal players to compete.

Distribution reach: The success of a well-entrenched insurance business rests on a vast distribution network. Distribution reach will be the key for future growth acceleration as the existing geographies get saturated and focus shifts to newer under-penetrated geographies. There is minimal penetration beyond Tier 1 and 2 cities and going forward, the focus will be more on selling insurance products in semi-urban/ rural areas.

Performance of asset management business: As a significant portion of the life insurance premium would be through ULIP, the investment performance would be a critical factor for future business. Players like ICICI-Pru and Reliance Life have an advantage as they can easily apply the expertise gained in their mutual fund business to the insurance business.

Players growing faster than industry and capturing a higher share are the potential winners

We expect our coverage companies to survive the test by scoring high on the critical factors and grow the business faster than the industry average, and continue to capture market share. While Reliance Life would remain the fastest growing insurance company in the country, we expect ICICI-Pru to retain the top slot.

Exhibit 40: APE growth rates

(%)	2007	2008	2009	2010
Industry	**95**	**44**	**32**	**24**
LIC	78	35	23	15
Private	**104**	**59**	**45**	**35**
ICICI Pru	91	55	40	30
HDFC Std Life	59	60	45	40
Reliance Life	745	196	99	60
SBI Life	264	80	50	40
Max NewYork Life	72	60	45	40
Other Private Players	89	42	34	27

Source:SSKI Research

Exhibit 41: Key strengths and weaknesses

Company	Strengths	Weakness
ICICI Pru Life	• Well recognized financial service brand • Strong backing from promoter to invest heavily in the business	• A higher share of ULIP poses risk in a prolonged market downturn
HDFC Standard Life	• Product portfolio is both stable and profitable, with emphasis on regular premium (over 90%) and individual segment (~93%). Therefore best persistency ratio in industry • Greater control over company-owned distribution network • Strong promoter brand	• Lack of promoter aggression compared to Reliance and ICICI
Reliance Life	• Reliance Life is investing heavily ahead of time in building an enviable distribution network • Strong sponsor backing	• Reliance Life being a late starter could not forge a banc assurance partnership nd hence the distribution is significantly dependent on agency force.
Max New York Life	• The most productive agent force in the industry • Strong product portfolio with longer tenor ULIP policies and traditional products	• Lower brand recognition in semi-urban and rural areas may dent future growth • Slow to adopt multi-channel distribution, and the highly productive agent force comes at a cost
SBI Life	• Premium promoter brand to drive future growth in under penetrated areas • Competitive cost structure due to leveraging the promoter's wide distribution network and branding	• Group business share has declined to 30% in FY07 from 48% in FY04, but is higher than competition, which implies lower blended margins. • Decline in persistency ratio to 52% in FY07 due to short-tenor ULIP policies, should correct with regulatory minimum ceiling

Source:SSKI Research

Exhibit 42: Comparative Analysis

(%)	ICICI Pru Life	HDFC Std Life	SBI Life	Reliance Life	Max New York Life	Comments
Commission/Total Prem	7	7.5	7	10	15	SBI Life enjoys an edge over competition due to highly competitive bancassurance model
Expenses/Total Prem	19	20	12	43	35	Reliance Life has the highest expense ratio, in line with its aggressive expansion plan
Distribution (nos)	234,000	74,000	35,000	106,000	25,000	Reliance Life surpassing HDFC Std Life and closing on the gap with ICICI Pru Life
Product mix: ulip	95	92	65	88	60	ICICI Pru Life enjoys the highest share, however, it is susceptible to any prolonged market downturn
Product mix: single /regular	85.0	80.0	67.0	75.0	83	MYNL and ICICI Pru Life enjoy a higher regular business
Product mix: group/ individual	83.4	83	69	86	99.4	MYNL clearly at the top, negligible exposure to the low margin group business
Premium per policy (Rs)	20,770	33,602	24,972	15,897	13,865	Reflects HDFC Std Life 's ability to write quality business
Agency channel mix	61	54	52	95	70	Reliance Life being a late starter could not forge a bancassurance partnership, HDFC Std Life and SBI Lifehave a well diversified distribution mix
Persistency ratio	70	89	52	70	80	SBI Life suffered the brunt of short term policies written in FY06; HDFC Std Life well ahead of competition
Market Share (Pvt)	28.5	8.3	11.3	4.5	4.9	ICICI
3 year CAGR- APE	92	112.4	156	199.4	81.4	

PROFITABILITY

Conservative accounting policies coupled with aggressive ramp up will prolong the break-even period

Insurance companies are profitable yet register accounting losses. Life insurance companies worldwide require six to eight years to break even due to high set-up and customer acquisition costs as well as conservative solvency (reserves for actuarial liabilities) norms. Every new policy underwritten entails a loss in the initial years and starts making profits subsequently, resulting in accounting losses in the initial years. Accounting losses are more pronounced for companies pursuing aggressive growth. Currently barring SBI Life (reported a marginal profits) and Bajaj Allianz (due to proliferation of the actuarial funded products, which were recently banned by IRDA), no other insurance players is reporting profits. Infact for most of them, the extent of loss has significantly increased in FY07, a function of the high growth. Considering the plans of investing heavily in setting up an expansive distribution to be ready for the next phase of growth we believe that we are still some time away from companies to break-even and then start reporting sizeable profits. As this aggressive expansion leads to higher share of new business premium as against renewal premium, the trend of accounting losses will continue.

Exhibit 43: Table on accounting losses.

(Rs m)	FY05	FY6	FY07
ICICI Pru	(2,117)	(1,877)	(6,489)
HDFC Std Life	(897)	(1,287)	(1,256)
MYNL	(994)	(603)	(600)
Reliance Life	(540)	(984)	(3,151)
SBI Life	(115)	20	37

Source: SSKI Research

NBAP captures the underlying economic profits

Hence in the absence of an accounting profit, New Business Achieved Profit (NBAP) is the key metric to understand the profitability of a life insurer. NBAP is essentially the NPV of all future profit streams from the new business generated during the period of analysis. The paradox simply implies that we need to view profitability of insurance companies in a different way. With that said, profitability in the insurance industry is a primary function of persistency that is lower surrenders in policies written, efficient expense management and appropriate risk profiling enabling sustainable claims.

Based on our rudimentary analysis for different policies, we arrive at an estimate of margins yielded by these policies on the business (New Business Achieved Profit) in a year. NBAP is essentially the NPV of all future profit streams from the new business generated during the period of analysis. NBAP margins for each product would differ. Typically, NBAP margins for non-participating products are likely to be the highest as these products entail only claims payout and insurance companies do not have to share the returns generated out of investment of premium income. On the other hand, under linked products, the risk of investments is borne entirely by the policyholder and returns generated on the investment fund are returned to the policyholder

Exhibit 44: Snapshot on the NBAP margins

	ULIP	Endowment	Term
10 yr	22.5	13.4	46
15 yr	63.6	21.8	65.8

Source: SSKI Research

We have attempted to calculate the NBAP margins for the popular selling policies of the insurance company under our coverage.

Exhibit 45: Comparison on blended margins:

Companies	FY05	FY06	FY07	FY08	FY09	FY10	Comment
ICICI Pru Life	22.0%	22.0%	19.8%	19.6%	19.2%	19.2%	Increasing competition will lead to dip in margins
HDFC Std Life	19.0%	19.0%	21.5%	21.1%	20.6%	20.6%	Increasing share of ULIP coupled with longer tenor will help sustain competitive pressures
Reliance Life	15.0%	17.0%	19.4%	18.2%	17.6%	17.7%	A high cost structure couple with competitive pressure will take toll on margins
SBI Life	16.5%	16.5%	16.7%	18.2%	18.1%	18.3%	Increasing share of individual regular premium to enhance margins
Max NewYork Life	21.5%	21.0%	20.7%	21.0%	20.2%	20.2%	Longer tenor polices underwritten offset the impact of higher cost structure

Going forward, we believe that the margins on these policies are expected to come under pressure due to:

- Increasing competition will lead to aggressive pricing
- Aggressive expansion plan would delay the period of steady state leading to upside pressure on cost
- Maintaining comfortable persistency could be an issue.

❑ Global Comparison:

We have analyzed the NBAP margins for some of the global insurers and find that the Indian insurer lag behind due to intense competition and the high start cost.

Exhibit 46: Global comparison

China Life	~27%
Aviva UK	~23%
Prudential UK	~30%
Aviva Asia	~ 24%

Source: Bloomberg,SSKI Research

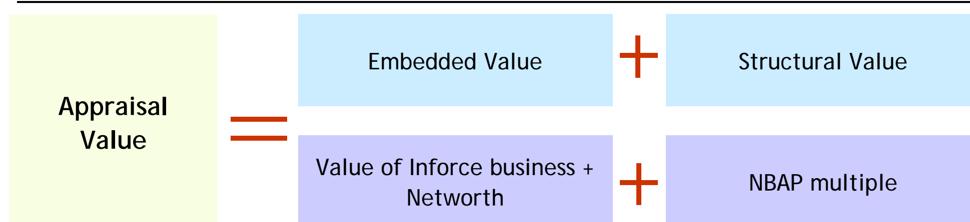
In all we believe that the insurance companies are not guzzling money, the operations are intrinsically profitable, though expect to witness some pressure going forward.

VALUATIONS AND VIEW

❑ Why value a life insurance company on an NBAP multiple?

Traditionally, insurance companies are valued using the appraisal value method, which is nothing but the sum of its Embedded Value (EV) and Structural Value (SV).

Exhibit 47: Valuation of a life insurance company



Source: SSKI Research

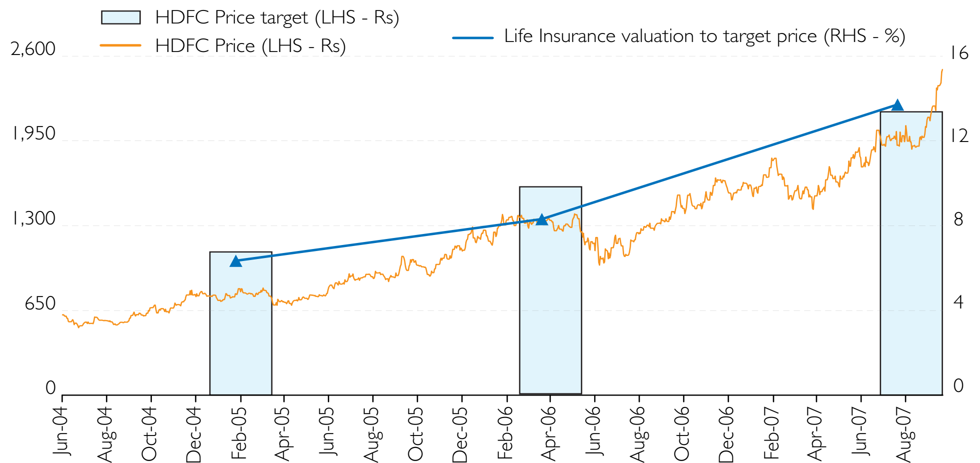
EV typically represents the present value of the future profitability of the existing business (value of in-force business and net worth)

EV typically represents the present value of the future profitability of the existing business (value of in-force business and net worth). On the other hand, structural value attempts to capture the growth potential of the insurance company ie, the present value of policies to be underwritten in the future by a company. As structural value essentially represents the PV of future policies, it is estimated by assigning a multiple to the profits arising out of sales generated in a year.

When a life insurance company is in the growth phase, its EV is likely to be a small component compared to the potential and hence an EV-based valuation is likely to undervalue the company. Hence, we believe the combination of NBAP multiple and EV is more appropriate.

Currently, there is no direct insurance play available and investors desiring to own a pie in the fastest growing financial services segment have to use the Indian partner as the proxy. Over the last 18 months, the value of the insurance business has compounded faster than the core business of the promoter. In the case of ICICI Bank, the value of the insurance business has compounded 5x in the last 18 months. Underpinned by strong growth, private players have catalyzed the process of value unlocking and benchmark valuations tell the story of a dramatically changing investor perception of value.

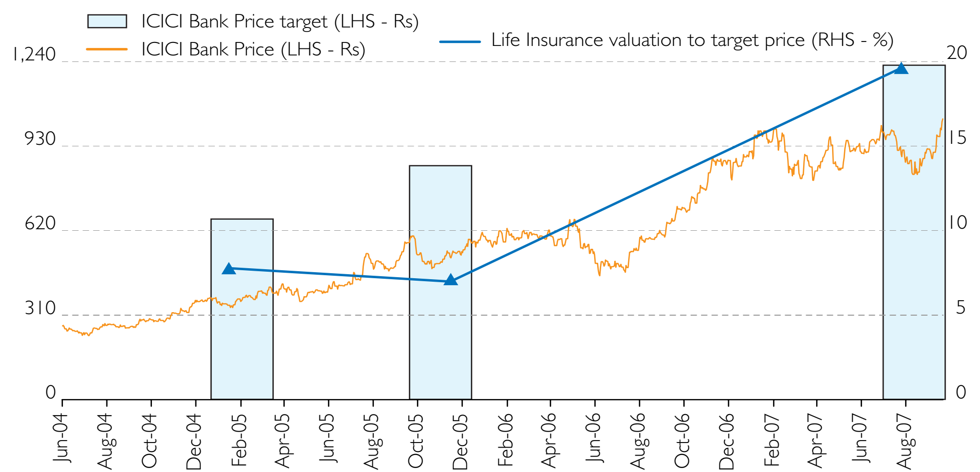
Exhibit 48: Contribtion of HDFC's Std Life to HDFC's market cap



Source: SSKI Research

Value of the insurance business has compounded faster than the core business

Exhibit 49: Contribution of ICICI Pru Life to ICICI's market cap



Source: SSKI Research

❑ Valuation a long way go

Insurance being a capital intensive industry requires a regular infusion of capital by the player to be in the contention. Though the Union Budget for fiscal 2005 had recommended that the ceiling on foreign holding be increased to 49%, we are still some time away . However, as private players gain scale we expect them to keep setting benchmark valuation through sale of minority stakes. Few deals are already underway:

- ICICI Bank is planning to sell a minority stake in a proposed subsidiary which will house the bank's investment in life insurance, general insurance and mutual fund. However the proposal is still awaiting RBI approval
- SBI has articulated to follow ICICI Bank's mode of value creation as and when regulatory clarity emerges on holding company structures
- Reliance Capital has indicated stance to sell minority stake in its insurance ventures (Life and General) in the next 12-18 months .

❑ Comparing valuation across our coverage

Going forward, the implied market cap of the life insurance business is expected to increase faster than the core businesses for all these companies. We have calculated NBAP margins for each player along with the estimated growth in APE. ICICI PRU is the biggest player followed by Reliance Life and HDFC. The value of the parent's stake in most life insurance companies is 20-35% (except for Max New York Life Insurance, which contributes to over 90% of market cap of the parent, Max India). We have assigned a NBAP multiple of 20 to Reliance Life to give credence to strong growth. HDFC Std Life also has been assigned a multiple of 20 to reflect the better profitability and regained growth momentum.

Exhibit 50: Summary Valuation Sheet

			FY10				
Company	Promoters	Comment	Business valuation (Rs bn)	Value of economic interest (Rs bn)	Value per share	Current Share price	Contribution to promoter
Reliance Life	100% economic interest by Reliance Capital	20x NBAP and Embedded Value : 100% stake	274	274	1115	1570	71%
ICICI Prudential Life	74% owned by ICICI Bank	18x NBAP and Embedded Value: 74% stake	532	355	320	1050	30%
Max Newyork Life	Though 74% owned by Max India, we have assumed 51% as it has agreement with New York Life to transfer stake upto 24% as and when regulation permits. For this option , New York Life has compensated Max India by paying a deposit equivalent to 24% of investments into MYNL	18x NBAP and Embedded Value : 50% stake	112	50	227	250	91%
HDFC Standard Life	Though 80% owned by HDFC, we have assumed 50% as it will be compensated by Standard Life for the loss of income (based on pre-tax RoE) on its investment in the core housing finance business	20x NBAP and Enbedded Value: 50% Stake and Excess stake valued at HDFC's Core RoE	218	125	437	2500	17%
SBI Life	74% owned by SBI	18x NBAP and Embedded Value: 74% stake	271	181	343	1950	18%

Source: SSKI Research

In our valuation for ICICI-Pru, we have not ascribed the multiple derived from the likely placement of ICICI Financial, as we believe that:

- PE investors are willing to take a longer term view
- Scarcity premium due to no direct exposure available

Exhibit 51: Comparison with China companies

China Life	~50
Ping An	~40
Cathay Holding	~20
Indian Companies	~18-21

Source: Bloomberg, SSKI Research

When compared with Chinese Life Insurers, the Indian players are relatively undervalued offering scope for further upside. However, Chinese insurers also benefits due to a higher share of participating policies wherein the shareholders own a beneficial interest in the underlying asset.

KEY CHALLENGES

❑ Attrition rate

Insurance products distributed mainly through agents; retaining agency force a key challenge

With distribution of insurance products relying heavily on agents, retaining the agency force is going to be a key challenge. We see a shortage of people with the relevant insurance expertise, especially in the areas of middle management, qualified underwriters and actuaries. The influx of fresh competition, coupled with rapid expansion plans of existing players, would lead to staff poaching and rising wage bills. The success of any life insurer is dependent on the ability to attract and retain the right people and it will be a key monitorable.

❑ Expense check

A consistently rising wage bill leads to cost over-runs, and thus pressure on margins

Managing the expense overrun is likely to be another key challenge for industry players. Rapid expansion of the insurance business, coupled with rising attrition rate, has made it difficult to control the wage bill. Most of the players have admitted to having an expense overrun, which has put pressure on margins. The break-even period for players has also got extended due to the higher than anticipated business traction and expense rates.

❑ Consolidation in the stock market

Popularity of ULIP has been a major driver of the industry's growth. A prolonged downturn in the market could hamper the sales of ULIP products.

GENERAL INSURANCE

When the penetration levels in India are juxtaposed against global benchmarks, it is evident that only the tip of the general insurance iceberg has been explored .The general insurance industry has transformed stupendously from an erstwhile public sector oligopoly to a market determined competitive landscape. With private players growing aggressively on the back of their strong brands, distribution scale-up and product innovation, this metamorphosis is more substantial. Changing regulation will lead to paradigm shift in the industry, an opportunity for the private players to make further inroads. In the general insurance space, we believe ICICI Lombard, Reliance General and Bajaj Allianz will lead the pack in lapping up the opportunity on offer.

AN UNDER-PENETRATED MARKET OFFERS HUGE GROWTH POTENTIAL

In India, general insurance penetration stands at 0.6% of GDP as compared to 4% for life insurance

India has been an under-penetrated market for non-life/ general insurance products compared to developed and developing countries. Though the advent of private players has improved the situation, general insurance penetration stands at 0.6% of GDP as compared to 4% for life insurance. Globally, general insurance penetration accounts for ~20% of life insurance penetration; taking this as a benchmark, general insurance penetration should be at 0.8% of GDP for India. The low penetration levels can be assigned to the following:

❑ Absence of a retail model

Regulations and a high claims ratio restricted focus to corporate business

Public sector insurers were never keen to develop a retail-focused business model, and their preference tilted heavily towards corporate business given that:

- Third-party motor insurance was mandatory and rates for the same were governed by regulatory tariffs, which was not enough to compensate the claims.
- Claims ratio in motor insurance is one of the highest. A high claims ratio, coupled with malpractices in loss estimation and overcharging by workshops in connivance with surveyors, kept motor insurance business unprofitable.
- Tariffs for fire and engineering policies were kept high to cross-subsidize the losses suffered in motor insurance.

❑ Opportunity offered by retail

Low retail penetration and under-tapped rural markets by private insurers…

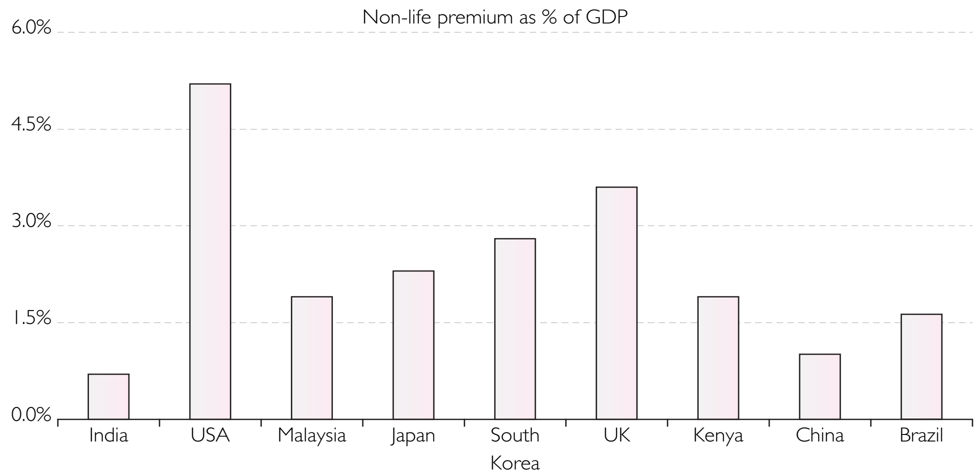
Although motor insurance is a well-penetrated category (due to third-party insurance being mandatory), it offers significant opportunity for market share swings as service levels still remain the key differentiator and public sector companies are plagued by inefficiencies. Besides motor insurance, the other categories of retail finance offer a huge growth opportunity. For example, home insurance – one of the largest categories in developed markets like the US – is virtually untapped with less than 1% of houses insured. Health insurance is another opportunity waiting in the wings with only ~1.5% of health spends estimated to be routed through insurance.

❑ Inability of general insurers to effectively reach rural population

More than two-thirds of India's population lives in rural and semi-urban areas. Insurance penetration among this population base is very low, and hence offers substantial growth potential. Product innovation and increased distribution reach are likely to increase general insurance penetration in rural India.

…leave ample scope for growth on the back of innovative products and higher distribution reach

Exhibit 52: India an under-penetrated general insurance market



Source: Swiss Re

Exhibit 53: Insurance per capita – abysmally low for India (USD)

India	4
USA	2,072
Malaysia	90
Japan	831
South Korea	412
UK	1,294
Kenya	8
Russia	114
China	13
Brazil	66

Source: Swiss Re

COMPETITIVE LANDSCAPE

Sector opened up to private sector in 1999

The general insurance business was nationalized after the promulgation of General Insurance Business (Nationalization) Act, 1972. Post-nationalization, the general insurance business was undertaken by General Insurance Corporation of India (GIC) and its four subsidiaries – Oriental Insurance Company, New India Assurance Company, National Insurance Company and United India Insurance Company. Nationalization lent the industry solidity, growth and reach. However, there was a feeling that insurance companies were insensitive to the needs of the market, slow to adopt modern practices and upgrade technical skills, and as such not fully responsive to customer needs.

The Committee on Reforms in the Insurance Sector in 1994 recommended the opening of the sector to private participation to induce a spirit of competition among insurers and provide a choice to the consumers. The insurance sector was opened up in the year 1999 to facilitate entry of private players into the industry.

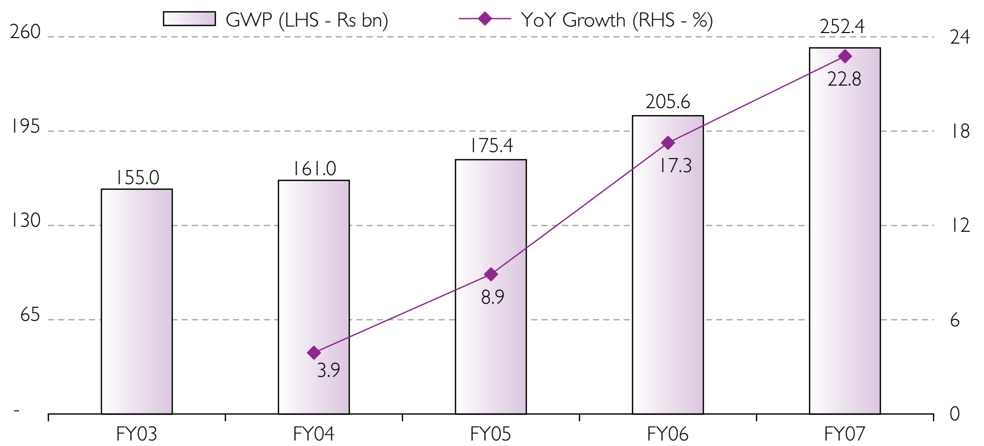
❑ A new order post liberalization

Private sector general insurance companies have shown a 95% CAGR in GWP; (9% CAGR for four public sector companies)

India's new breed of insurance companies has been quick to establish itself and grow market share in the industry's rapidly expanding premium base, though not every player has been successful. The general insurance industry has shown a 25% CAGR over FY03-07 with GWP of Rs253bn for FY07. Interestingly, private sector general insurance companies have shown a 95% CAGR in GWP (9% CAGR for the four public sector companies), and a stupendous rise in market share from 4% in FY02 to 35% in FY07. Sluggish performance of the public sector insurers, as also tariff pricing, has ensured that overall growth rates in general insurance lag the growth registered by life insurance counterparts.

Overall, 25% CAGR over FY03-07 with GWP of Rs253bn for FY07

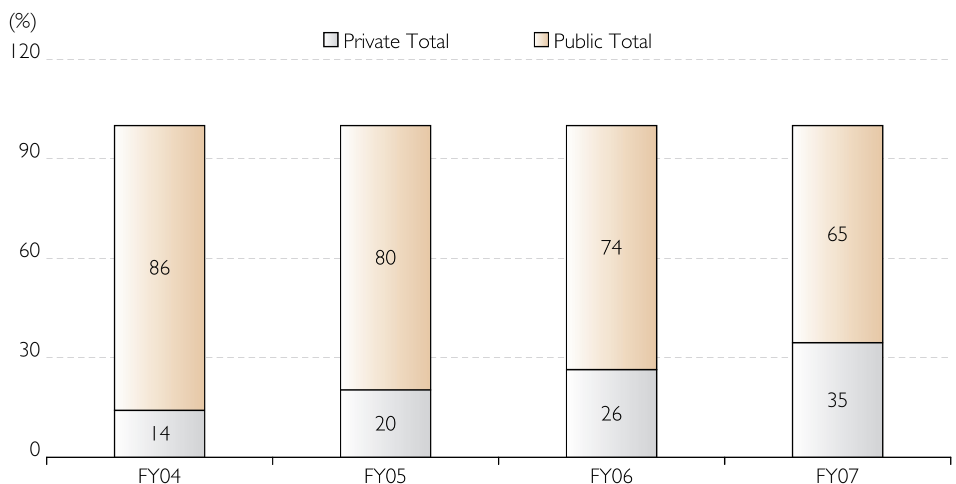
Exhibit 54: GWP -Industry growth over FY03-07



Source:IRDA

A stupendous rise in market share of private sector players from 4% in FY02 to 35% in FY07

Exhibit 55: Market share private /public



Source:IRDA

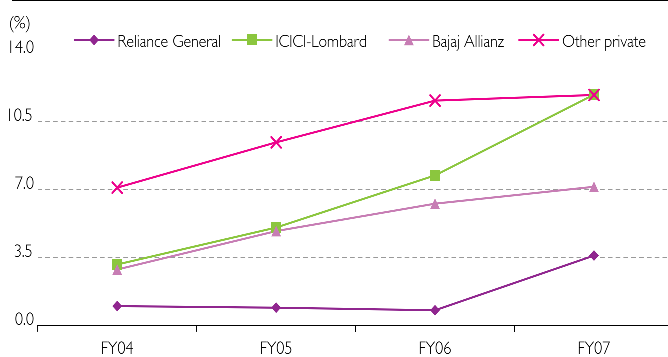
Leading state-owned companies earlier not too keen on developing the retail model

While the influx of private players with foreign JV partners has accelerated growth in the insurance market, not all new entrants to the market have been successful. However, ICICI Bank and Bajaj Auto, two Indian companies, have managed to quickly capture market share and don the mantle of leadership among private players in the non-life insurance segment. Using their strong brand presence to quickly establish an independent insurance offering, these companies have been

aggressive in the roll-out of distribution networks and product range. In addition, both local partners have the financial strength to support the rapid expansion. Recently, Reliance General has also emerged as a serious contender in the space, willing to invest heavily in the distribution game. On an incremental basis, these three players have higher market shares than public sector companies.

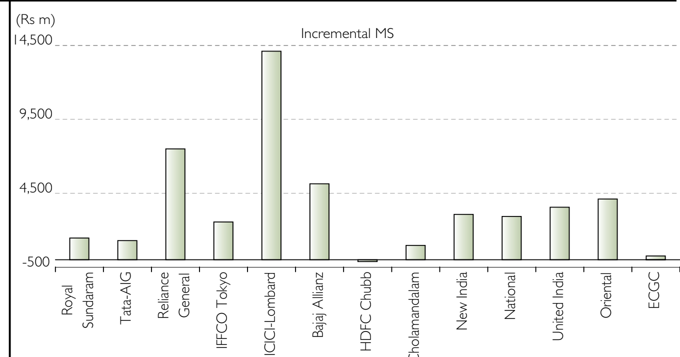
As compared to the life insurance industry, general insurance industry is less competitive. Besides ICICI Lombard, Bajaj Allianz and Reliance General, there are no other serious players in the space. Going forward with the business model getting retail heavy , the above players have the requisite strengths to capitalize on the opportunity.

Exhibit 56: Private players' growth rates



Source: IRDA

Incremental business



Source: IRDA

Exhibit 57: Market share movement of players

Premium	Market share industry				% growth
(%)	FY04	FY05	FY06	FY07	2-yr CAGR
Royal Sundaram	1.6	2.0	2.2	2.4	34.5
Tata-AIG	2.3	2.8	3.0	3.0	25.8
Reliance General	**1.0**	**1.0**	**0.8**	**3.7**	**137.5**
IFFCO Tokyo	2.1	3.0	4.4	4.6	50.6
ICICI-Lombard	**3.2**	**5.2**	**7.8**	**12.0**	**84.2**
Bajaj Allianz	**3.0**	**5.0**	**6.4**	**7.2**	**45.4**
HDFC Chubb	0.7	1.0	1.0	0.8	3.4
Cholamandalam	0.6	1.0	1.1	1.3	36.6
New India	25.6	22.6	23.2	20.1	14.2
National	22.1	21.3	17.3	15.3	2.6
United India	19.6	17.3	15.5	14.0	9.0
Oriental	18.2	17.9	17.3	15.7	13.6
Total	**100.0**	**100.0**	**100.0**	**100.0**	**9.9**

Source: IRDA

DEREGULATION DRIVING CHANGE IN BUSINESS MODEL

❑ De-tariffing of general insurance

Since 1 January 2007, 55% of the insurance premium out of price control

With effect from 1 January 2007, all products except third-party liability on motor insurance have moved to a free pricing regime (within limit). Post this, 55% of the insurance premium (including fire, engineering and private motor insurance) is now out of price control. The de-tariff regime allows insurance companies to set their own prices for insurance products. However, to avoid cut-throat competition, the government has adopted a step-by-step approach towards full de-regulation. Companies today are allowed to set these prices only within the slab prescribed by the regulator. Free pricing is expected to lead to a paradigm shift in the industry, thereby:

- allowing for risk-based pricing and product profitability on a standalone basis;
- exerting pricing pressure on profitable portfolios like fire, engineering and private motor insurance; and
- leading to higher premium in loss-making portfolios, like group health and marine, as cross-subsidization is bound to come down.

De-tariffing enables private insurers to align the policy price to the extent of risk

The de-tarrifing will allow private companies to capitalize on the opportunity by adjusting their pricing based on the risk taken, and thus improve profitability. Insurers have already announced ~70% hike in Motor TPL (third-party liability) for commercial vehicles, and discounts on fire (up to 50%) and own motor damage (up to 20%) policies.

De-tarriffing making a dent on growth

Insurers have seen a huge churn in business post the de-tariffing and a growth slowdown

In its aftermath, detariffing has led to a decline in growth rates. After registering growth of 22.3% in FY07 and 16% in April 2007, the industry growth rate has slipped to 4% in May 2007. There has been a huge churn of business following detariffing and many companies had advanced their insurance purchase in April to take advantage of a soft market. Besides detariffing, a slowdown in auto sales has also resulted in lower premium.

Exhibit 58: Detarrifing taking toll on GWP growth rates

M-o-M growth rates	April	May	June	July	Apr-Jul
Royal Sundaram	12	(6)	17	16	10
Tata-AIG	4	(4)	4	24	6
Reliance General	215	255	207	148	205
IFFCO Tokyo	(12)	(45)	(17)	(30)	(26)
ICICI-Lombard	36	(22)	5	24	12
Bajaj Allianz	18	23	47	34	29
HDFC Chubb	38	(14)	27	15	17
Cholamandalam	126	39	81	54	78
New India	8	1	5	9	6
National	8	11	5	6	8
United India	3	3	4	11	5
Oriental	0	2	2	7	3
Private Total	**37**	**4**	**29**	**26**	**25**
Public Total	5	5	3	8	5
Total	**16**	**5**	**12**	**14**	**12**

Source: IRDA

However, the dust has not yet settled on the detariffing front. With all price restrictions set to be removed soon, competition is expected to further intensify. At present, non-life insurers have to use standard policy wordings, and terms and conditions. Thus, there are standard insurance products in the market and customers do not have much of a choice.

Full de-regulation round the corner

All price restrictions set to go; policy wordings and terms and conditions to be out of IRDA control from 31 March 2008

Effective 31 March 2008, the IRDA is expected to lift controls on policy wordings and terms and conditions on general insurance policies. The policy measure would enable insurers to adopt risk based pricing mechanism. As soon as general insurers are freed from the shackles of standard products, they would offer innovative propositions to customers with products adequately pricing in the risk. Private sector players are expected to be the biggest beneficiaries of this development. Insurers could offer a motor insurance policy that provides for settlement of the full claims amount without any deduction for depreciation (as is the current practice). General insurers could also reimburse travel expenses or make available a rent-a-car service for the period the insured motorcar remains in a garage for repairs. Players are also toying with the idea of providing a service whereby the company would arrange for towing of a failed motorcar to a garage for repairs and get it delivered at the doorstep of the customer. Similar flexible covers would also be made available in fire and engineering insurance availed of by companies.

We see escalated price based competition

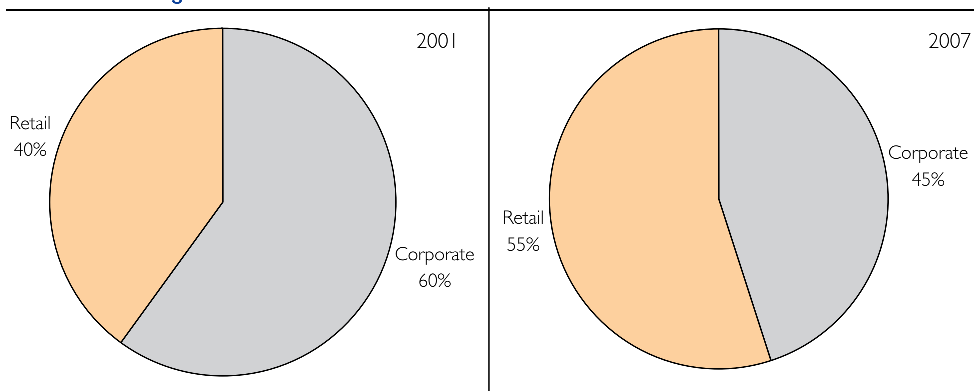
In the interim, competition is expected to intensify till the market stabilizes. This would lead to price competition, thereby putting pressure on profitability.

❑ Industry moving towards annuity-based, retail-focused model

Private insurers focusing on retail segments like travel and home assurance

The share of corporate business in general insurance portfolio has declined from 60% in 2001 to 45% in FY07. At the time of liberalization, non-motor retail was virtually non-existent. Post liberalization, private insurers have focused on developing alternative retail products like travel, home assurance, etc. As the corporate segment is saddled with competitive pricing and saturated market (which leaves them little bargaining power), private sector insurers shifting focus to developing a retail-heavy business model.

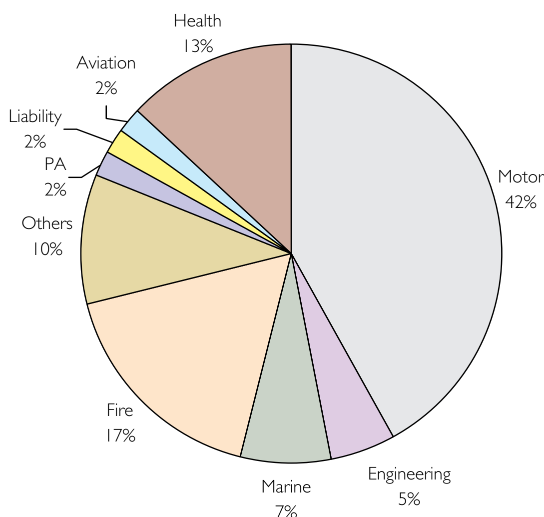
Exhibit 59: Going retail



Source:IRDA

Currently, motor insurance comprises the largest portion of the pie

Exhibit 60: Business mix



Source: IRDA

Though the dependence on corporate business is still high, the proportion is expected to come down with a pick-up in the share of health insurance and the anomaly in fire insurance premium getting corrected on the back of de-tariffing.

❑ Expanding distribution footprint

To break into rural markets, companies need to invest heavily into distribution

With the industry shifting focus from corporate to retail and rural population increasingly opting for insurance cover, expanding their reach would be a key differentiator for industry participants. Companies under our coverage, Reliance General and ICICI Lombard, are investing heavily in building a formidable distribution network. However, this will lead to higher set-up costs, which would impact their profitability in the near term.

Exhibit 61: Distribution

(nos)	2007	2010
ICICI Lombard		
Branches	220	~450
Intermediaries	15,000	35,000
Reliance General		
Branches	85	~350
Intermediaries	18,300	30,000

THE WAY FORWARD

General insurance industry expected to post 22% CAGR over the next three years

Given the significant opportunities available in the retail space, particularly health, we expect the industry to grow at 22% over the next three years. Private players will continue to eat into the market share of public sector players and grow faster at 43 % as against a sedate 7% for the latter. Hence, the market share of private sector insurers is estimated to increase to 55% by FY10. We expect ICICI Lombard to continue gaining market share and capture the top slot, Reliance General Insurance is all set to join the league of top three general insurance companies in India.

Exhibit 62: Future likely industry scenario

Name of General Insurance Market Share (%)	Mar-10	Mar-09	Mar-08	Mar-07	Mar-06
RGL	14	11	8	4	1
ICICI-Lombard	18	17	14	12	8
Other private	23	21	20	19	18
Private	55	49	42	34	26
Public	45	51	58	66	74

Source: IRDA, SSKI Research

❑ Valuing General Insurance

General insurance companies typically report losses in high-growth phase

General Insurance companies typically report accounting losses in the initial years of business due to the conservative accounting standards followed in India. These companies are required to recognize premium income over the term of the policy (i.e. one year), whereas costs are accounted for upfront. Hence, companies are bound to report accounting losses in a high growth phase. To assess the true economic profit of Insurance companies, we have used the measure of combined ratio and investment returns.

Combined ratio normalizes earnings, and is more reflective of a growing business. Below, we have illustrated a typical combined ratio.

The measure of combined ratio and investment returns helps assess true economic profit

Exhibit 63: Combined ratio methodology

S.No	Particulars	Definition	(%)
a	Loss Ratio	Net claims / Total premium earned	72
b	Expense Ratio	Opex / Net premium	35
c	Commission Ratio	Comm/ Net premium	(12)
	Combined Ratio (a+b+c)		**95**

Source: SSKI Research

❑ Investment return

The combined ratio so derived should be added to investment income on investments which represent premium income and shareholders' funds. We have worked out a typical investment income under steady state assumptions.

Combined ratio added to investment income on investments, i.e. premium income and shareholders' funds

Exhibit 64: A typical calculation for investment return

Particulars	(Rs)
NWP	100
Multiplier	1.35
Investments	135
Return Assumption (%)	7
Investment returns	9.5

Source: SSKI Research

Normalized earnings – Combined Ratio + Investment Return

Global players trade at 14-24x one-year forward earnings. Considering the rapid growth trajectory for the business, we believe Indian general insurance companies, especially private players should command a multiple of 18-20x.

Global players trade at 18-24x 1-year forward earnings …

Exhibit 65: Regional comparison

	Currency	M cap(bn)	1-year forward PE (x)
DONGBU Insurance	KRW	2,251	18.3
HYUNDAI Insurance	KRW	1,560	20.4
Samsung Insurance	KRW	8,812	23.6

Source: Bloomberg

Exhibit 66: Valuation Summary

Company	Promoters	Comment	Business Valuation (Rs bn)	Value per Share	Current Share price	Contribution to promoter
Reliance General	100% economic interest by Reliance Capital	20x Normalised Profits	70.7	287	1570	18
ICICI Lombard	74% owned by ICICI Bank	20x Normalised Profits	90.2	60	1050	6

Source:SSKI Research

ANNEXURE

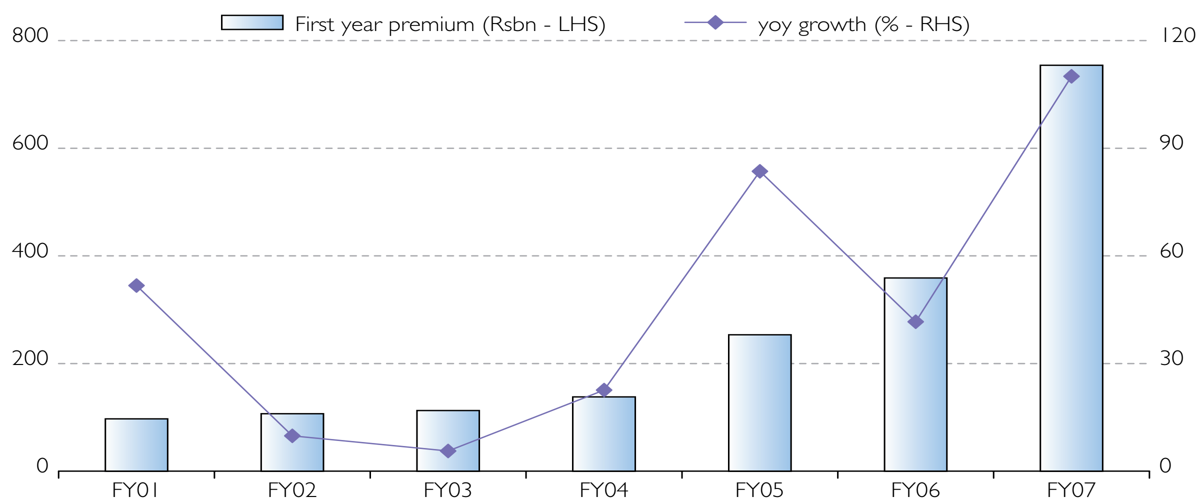
INSURANCE IN INDIA: A BRIEF HISTORY

The Indian insurance business, for an extended period of time, was run by national insurers. Life insurance business was nationalized in 1956 under the aegis of the Life Corporation of India (LIC). It was in the early 1990s that economic reforms provided an impetus to liberalization of the industry. The market was finally liberalized in 2000.

❑ Market growth post opening up

Liberalization has led to phenomenal growth in India's insurance market. Macroeconomic trends like a booming economy, coupled with rising household incomes, and microeconomic trends including higher awareness and introduction of innovative products have been the key factors driving the rapid expansion in the insurance market.

FYP growth



Source:IRDA

❑ Evolution of industry since liberalization

Opening up of the insurance market to private and foreign players, and a consequent conversion of a monopolistic market to a liberalized one, has transformed the industry. At least 15 players have established business in the last six years and have captured a larger slice of the increasing pie. The private players have been quite proactive and have gained a firm foothold.

List of entrants in the life insurance business post liberalization

	Status
Bajaj Allianz	Private
ING Vysya	Private
Reliance Life	Private
SBI Life	Private
Tata AIG	Private
HDFC Standard	Private
ICICI Prudential	Private
Birla Sunlife	Private
A v i v a	Private
Kotak Mahindra Old Mutual	Private
Max New York	Private
Met Life	Private
Sahara Life	Private
Shriram Life	Private
Bharti Axa Life	Private
L I C	Public

Source: IKDA

The new players have helped improve penetration in the life insurance sector through:

- Introduction of innovative products
- New sales channels
- A wider distribution network

❑ Entry of foreign insurers

Foreign insurers transfer not only capital but also know-how to the domestic market. New and more sophisticated insurance products are introduced as well as innovative distribution channels are set up, thus helping insurers to reach a broader spectrum of population. In other developing countries, insurers have successfully developed alternative distribution channels (e.g. insurance marketing through supermarkets, petrol stations and airports).

Evolution of industry since liberalization

	FY00	FY07
Number of players	1	16
New Business Premium (bn)	64	754
Total premium (bn)	270	1600
Penetration (as a % of GDP)	1.2	4.0
Insurance premium per capita (Rs)	~280	~900

Source:IRDA,SSKI Research

Products, distribution, servicing

	Pre 2000	Post 2000
Products	Bundled products with little flexibility for customer	• "Building blocks" approach • UL products • Limited UW products • Focus on pensions
Distribution	Tied agency	• Multiple channels of distribution • Corporate agents, banks, brokers, DSF
Servicing	Branch network	• Call centres • E-mail • Websites • Branch network

Source:IRDA,SSKI Research

A PRIMER ON INSURANCE

❑ Types of insurance policies

Insurance policies can be broadly classified as follows:

Single premium v/s regular premium

- For single premium policies, only one premium is required to be paid upfront while regular premium policies entail payment of premium at regular intervals over the period of the policy.

Unit linked v/s traditional

- A unit-linked policy is similar to a traditional policy with respect to offering benefits of investment along with protection. However, under a unit-linked policy, the return on investment accrues fully to the insured, while the insurance company retains about 10% of the profit on a traditional policy.

Only risk (term) v/s investment + risk (endowment)

- The key difference between the two is that a term policy offers only risk protection and it has no value at maturity, whereas an endowment policy offers the benefit of both a risk cover and an investment avenue.

Participating v/s non-participating

- In a participating policy, the policyholder is entitled to 90% of the policy profits, whereas there is no such entitlement in the case of a non-participating policy, though the insurance company shares the return in the form of bonus.

❑ Popular forms of policies

Unit-linked

ULIP is a non-traditional policy and it has gained popularity only after entry of private players in the insurance market. Post that, it has seen a significant increase in demand and accounts for 80-90% of the incremental market share. The policy is called unit-linked as returns to the policyholders are linked to the performance of the fund. The instrument's popularity can be assigned to the fact that it offers the double benefit of protection and return on investment. It is also a more transparent product than a normal endowment product, as the policy document highlights the load that is to be deducted for operating premium. Unit-linked policies are quite similar to SIP schemes of mutual funds.

Term insurance

Term insurance is the simplest form of an insurance policy, which covers only the risk of the insured. There is no maturity value and the policy expires at the end of the term. Typically, the sum assured, as a proportion is much higher than under ULIP or an endowment policy. This policy is not very popular in India, as it does not offer any return benefit and thus does not appeal to the Indian psyche.

Participating policy

Endowment policies, combining the risk as well as savings element, were the most popular form of insurance in India before ULIPs. However, the product is less transparent than a ULIP, as the deduction for expenses is not mentioned in the policy document.

Key features of various insurance policies

	Unit Linked	Endowment Policy	Term Policy
Key Features	• Insurance companies have to upfront mention the load charges that will be deducted from the premium income towards risk premium, operating expenses and agent's commission • Return on investment in a ULIP would accrue fully to the insured • Popular due to combination of investment product and protection	• In case of an endowment policy insurance companies deduct charges from the Premium amount (the deduction is largely adhoc and is based after factoring in a Level of expected mortality and economies of scale) and the balance is invested. • In case of participating policies 90% of the profit is given to the policyholder • It is less transparent than ULIP	• The term policy has no maturity value and the insurance company is liable to pay any amount only in the event of death of the insured. • Non – participating, the return is not required to be shared with the policyholders
Income for the Insurance Co.	• Asset management fees • Expense savings : Lower actual expenses than what is priced in the policy • Mortality savings: Actual mortality experience is better than what is priced in the policy	• Mortality savings: • Economies of scale: if better than estimated result in cost savings • Surplus return on investments	• Mortality savings: contributes significant portion of overall return • Higher return on investments as the entire Fund belongs to the insurance company
Solvency Requirement	•1% of reserves + 0.3% of SAR (additional 1% for linked business with guarantees)	•4% of reserves + 0.3% of Sum at Risk	• 4% of reserves + 0.3% of Sum at Risk
Investment Regulation	• Approved investments: Not less than 75% • Unapproved Investments: not more than 25%	• Government Securities: Not less than 25% • Other approved Government Securities (including G-Sec) : not less than 50% • Infrastructure and Social Sector: not less than 15% • Others : not exceeding 35%- of which unapproved investments: not exceeding 15%	• Government Securities: Not less than 25% • Other approved Government Securities (including G-Sec) : not less than 50%3) • Infrastructure and Social Sector: not less than 15%4) • Others : not exceeding 35%- of which unapproved investments: not exceeding 15%
NBAP	23%	13%	46%

Source: IRDA, Company Annual Reports, SSKI Research

❑ Illustrations of NBAP margins under different types of policies

We have calculated the NBAP margins under three different policy types to capture the valuation of an insurance company.

ULIP

Age	30 years
Premium	100
Sum assured	2500
Investment Year 1	80%
Investment Year 2 onwards	95%
Return assumed	12%
Mortality	As per LIC table applicable for Sum at Risk
Fund Management fees	1.75%
Operating expenses	2.00%

ULIP

	1	2	3	4	5	6	7	8	9	10
Funds A/C										
Op Balance	0	80	179	284	394	509	630	757	890	1,030
Addition										
Allocation	80	95	95	95	95	95	95	95	95	95
Investment Income	6	12	19	26	34	42	50	59	69	78
Expenses										
Mortality charge	2	2	2	2	2	3	3	3	3	4
Admin fees	2	2	2	2	2	2	2	2	2	2
Fund management fees	1	3	5	7	9	11	14	16	18	21
Closing Balance	80	179	284	394	509	630	757	890	1,030	1,177

	1	2	3	4	5	6	7	8	9	10
Technical A/C										
Income										
Premium	100	100	100	100	100	100	100	100	100	100
Mortality fee	2	2	2	2	2	3	3	3	3	4
Admin fee	2	2	2	2	2	2	2	2	2	2
Fund Management fees	2	3	6	8	11	13	16	20	24	28
Total	106	108	110	112	115	118	121	125	129	133
Expenses										
Commission/Cost of Acqn	20	8	5	3	3	3	3	3	3	3
Allocation	80	95	95	95	95	95	95	95	95	95
Operating expenses	21	7	7	4	4	4	4	4	4	4
Claims	2	2	2	2	2	2	2	3	3	3
Total	123	111	109	104	104	104	104	104	104	105
Profit/(loss)	(15)	(3)	1	8	10	12	15	18	21	25
Profit / (loss) post tax	(15)	(3)	1	7	9	11	13	16	19	22
PV	22									
Margin	22.5%									

Source: SSKI Research

Endowment policy

Assumption	
Age	30 years
Premium	100
Sum assured	2000
Return assumed	7%
Mortality	As per LIC table applicable for Sum at Risk

	1	2	3	4	5	6	7	8	9	10
Reserve A/C										
Opening Balance		48	121	199	283	373	469	571	681	799
Transfer from P&L A/C	45	65	65	65	65	65	65	65	65	65
Return (7%)	3	8	13	19	24	31	37	45	52	60
Closing Balance	48	121	199	283	373	469	571	681	799	924
Company A/c										
Income										
Premium	100	95	90	90	90	90	90	90	90	90
Investment income	3	8	13	19	24	31	37	45	52	60
Total	**103**	**103**	**103**	**109**	**115**	**121**	**128**	**135**	**142**	**151**
Expenses										
Transfer to reserve	45	65	65	65	65	65	65	65	65	65
Commission/Cost of Acqn	35	7	8	5	5	5	5	5	5	5
Op expenses + Depn	25	8	8	8	9	9	10	10	11	11
Claims	2	2	2	2	2	2	2	2	2	2
Total	107	82	83	81	81	82	82	83	83	84
Profit/(loss)	(4)	21	20	28	33	39	46	52	59	67
90% to be shared with policyholders		15	18	25	30	35	41	47	54	60
Net Profit	(4)	6	2	3	3	4	5	5	6	7
Net Profit Post Tax	(4)	5	2	2	3	3	4	5	5	6
PV	**13.4**									
Margin	**13%**									

Source: SSKI Research

Term policy

Assumption	
Age	30 years
Premium	100
Sum assured	52500
Return assumed	7%
Mortality	As per LIC table applicable for Sum at Risk

	1	2	3	4	5	6	7	8	9	10
Reserve A/C										
Opening Balance		20	75	133	195	260	328	398	470	545
Amt Invested	20	55	58	63	65	68	70	73	75	75
Closing Balance	20	75	133	195	260	328	398	470	545	620
Company A/c										
Income										
Premium	100	100	100	100	100	100	100	100	100	100
Investment income	1	5	9	14	18	23	28	33	38	43
Total	101	105	109	114	118	123	128	133	138	143
Expenses										
Commission/Cost of Acqn	40	8	8	5	5	5	5	5	5	5
Op expenses + Depn	40	38	35	33	30	28	25	23	20	20
Claims	52	54	55	58	62	66	71	76	82	91
Total	133	99	99	97	97	99	101	104	108	116
Profit/(loss)	(32)	6	10	17	21	24	26	28	30	27
Profit/(loss) post tax	(32)	5	9	15	18	21	23	25	26	24
PV	**46**									
Margin	**46%**									

Source: SSKI Research

Snapshot on the NBAP margins

	ULIP	Endowment	Term
10 yr	22.5	13.4	46
15 yr	63.6	21.8	65.8

Source:SSKI Research

❑ Regulation

Insurance is a federal subject in India. Life insurance here is governed by the Insurance Act, 1938 and Insurance Regulatory & Development Authority Act, 1999. Insurance Regulatory and Development Authority (IRDA) was constituted in 1999 as an autonomous body to regulate and develop the business of insurance and reinsurance in the country with the key objective of promoting market efficiency and ensuring consumer protection. The regulatory framework is applicable for both private and state-owned insurers. To protect the interest of consumers, the IRDA has introduced regulations in various areas like:

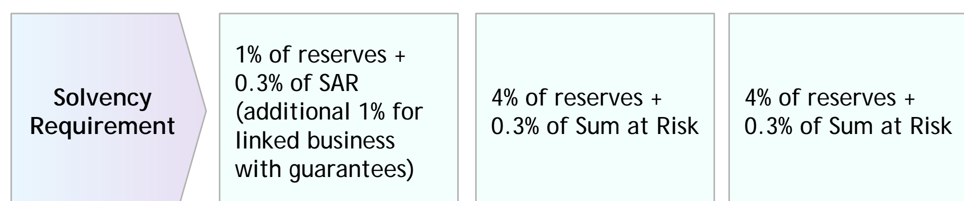
- Solvency margins
- FDI
- Appointed actuary
- Sales mix: Agent training, number of cross selling
- Capital requirement
- Investment provision
- Rural selling

❑ Solvency margins

Solvency is an insurance company's ability to pay the claims of policyholders (= policyholder assets - policyholder liabilities). For growing companies, this amount is typically funded by raising capital in the initial years. Also to be noted is the fact that linked policies generally require lower capital (about a quarter of that of traditional life products) as the policyholder bears the investment risk. The other major risk element includes mortality risks (which are priced into the product). Solvency norms for the life insurance business are typically expressed as a ratio of the Available Solvency Margin (ASM) to Required Solvency Margin (RSM). The IRDA specifies that this ratio should not be lower than 1.5x. Industry feedback indicates that most of the companies are just about meeting this requirement.

- Available solvency margin: Excess of value of assets (over the value of life insurance liabilities and other liabilities of policyholders' fund and shareholders' funds.
- "Solvency Ratio" means the ratio of the amount of Available Solvency Margin to the amount of Required Solvency Margin.
- Required Solvency Margin: Every insurer shall determine the required solvency margin which is specified in Form K under Insurance Regulatory and Development Authority (Actuarial Report and Abstract) Regulations, 2000.

Solvency requirement



Source:IRDA

❑ Emerging trends

Managing the additional capital requirement, which would increase if the strong growth momentum is sustained, is the key challenge for insurance companies going forward. Smaller players would find the challenge much more difficult to manage as the business would require continuous fund infusion. Therefore, an increase in FDI would be a big relief in this scenario. Also, this would lead to consolidation in the industry as weaker players (facing lack of capital) would be potential targets for players with strong backing. Private insurers are still few years away from a situation, wherein they would see release of capital from maturity payments. Going forward, we see the trend moving to a more risk based capital formulae, which would differentiate players in terms of the risk they undertake rather than the current mechanism, wherein all players are treated equally irrespective of the extent of risk that they undertake.

❑ FDI

According to the currently prevailing FDI norms, foreign participation in an Indian insurance company is restricted to 26% of its equity/ ordinary share capital. Thus, as of now, FDI up to 26% in the insurance sector is allowed on the automatic route, subject to obtaining a license from the Insurance Regulatory & Development Authority (IRDA). The foreign joint venture partner, either by itself or through its subsidiary companies or nominees, may participate to the extent of 26% of the paid up equity in the insurance company.

The guiding principle for laying down such a stringent requirement has been as much to restrict entry to reputed groups with long-term commitments as also to ensure that adequate capital is injected to fund various requirements evolving with operations and to fuel growth of the insurer.

The Union Budget for fiscal 2005 had recommended that the ceiling on foreign holding be increased to 49%. However, the matter is still under discussion. This would be the required impetus for the industry which will require significant fresh infusion of funds in the near future to maintain the pace of growth being witnessed recently. The increase in foreign participation would result in increased commitment of the foreign partner to the industry, thereby also leading to knowledge transfer. Equity participation from a foreign partner would also help ease pressure on domestic players that are unable to infuse capital in the business so as to maintain growth.

❑ Appointed actuary

The IRDA introduced the system of Appointed Actuary (AA) in the year 2000. The regulatory framework lays down that no insurer can transact life insurance business in India without an AA. While in the case of life insurers an AA must be a full time employee, the AA need not necessarily be an employee of the company, but could be a consultant in the case of non-life insurers.

❑ Insurance agents

New agents must complete at least 100 hours (to be soon scaled down to 50 hours) of practical training from an approved institution when seeking a license for the first time. For renewing agents, only a minimum 25 hours of training is required. In addition, new applicants must have passed the pre-recruitment examination in life or general insurance business, or both, as the case may be, conducted by the Insurance Institute of India, Mumbai, or any other examination body.

REGULATION OF INVESTMENTS

The IRDA provides a number of investment restrictions depending on the line of business. In the following exhibit, we highlight the current investment limits. The IRDA has laid down specific guidelines to regulate the investments of life insurance companies. According to Section 27 or Section 27A of the IRDA (Investment Amendment) Regulations, 2001, every insurer carrying on the business of life insurance shall invest and at all times keep invested the controlled fund (other than funds relating to pension and general annuity business and unit linked life insurance business) in the following manner:

Life insurance – investment norms

Life insurane business	
Government Securities	Not less than 25%
Other Approved Government Securities (including G-Sec)	Not less than 50%
Infrastructure and Social Sector	Not less than 15%
Others	Not exceeding 35%
of which unapproved investments	*Not exceeding 15%*
Pension and general annuity business	
Government Securities	Not less than 20%
Other Approved Government Securities (including G-Sec above)	Not less than 40%
Other Approved Securities	Not more than 60%
Unit Linked Life Insurance Business	
Approved investments	Not less than 75%
Unapproved Investments	Not more than 25%

Source: IRDA

❑ Capital requirement

An entity carrying on the business of life insurance is required to have a minimum paid-up equity capital of Rs1bn. The minimum paid-up equity capital requirement for an entity carrying business as a reinsurer is Rs2bn.

❑ Rural sector obligation

Every insurer that begins to carry on insurance business after the commencement of the Insurance Regulatory and Development Authority Act, 1999 has to ensure that it undertakes the following obligations, during the first five financial years, pertaining to the persons in rural and social sector. The obligations are summarized in the following exhibit:

Social sector chart from IRDA site

Rural Sector	
7%	in the first FY
9%	in the second FY
12%	in the third FY
14%	in the fourth FY
16%	in the fifth FY
18%	in the sixth FY
of the total policis written direct in that year	
Social Sector	
5000	in the first FY
7000	in the second FY
10000	in the third FY
15000	in the fourth FY
20000	in the fifth FY
25000	in the sixth FY
lives referes to new lives insured during the FY and in force as on 31st March of that year	

Source: IRDA

ACCOUNTING POLICY

❑ Valuation

- Shareholders' investments and non-linked policyholders' investments
  a) All debt securities are considered as 'held to maturity' and accordingly stated at historical cost
  b) Equity shares as on balance sheet date are stated at fair value of closing price of stock exchange. Unrealized gain/ loss arising due to changes in fair value of equity shares is taken to a separate account "Fair Value Change Account" and carried forward in the balance sheet.

- Linked business
  c) Central government securities are valued at prices obtained from the rating agency CRISIL. State government securities are valued at historical cost. All other debt securities are valued as per CRISIL Bond Valuer.
  d) Equity shares as on balance sheet date are stated at fair value of closing price of stock exchange. Unrealized gain/ loss arising due to changes in fair value of equity shares is recognized in the fund's revenue account.

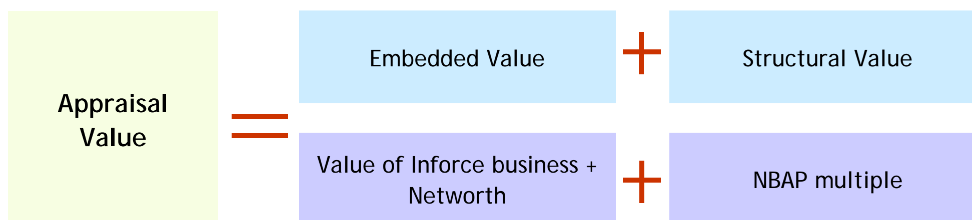
VALUATION

Life insurance companies worldwide require six to eight years to break even due to high set-up and customer acquisition costs as well as conservative solvency (reserves for actuarial liabilities) norms. Every new policy underwritten entails a loss in the initial years and starts making profits subsequently, resulting in accounting losses in the initial years. Accounting losses are more pronounced for companies pursuing aggressive growth. In the absence of an accounting profit, New Business Achieved Profit (NBAP) is the key metric to understand the profitability of a life insurer. NBAP is essentially the NPV of all future profit streams from the new business generated during the period of analysis.

❑ Why value a life insurance company on an NBAP multiple?

Traditionally, insurance companies are valued using the appraisal value method, which is nothing but the sum of its Embedded Value (EV) and Structural Value (SV).

Valuation of a life insurance company



Source: SSKI Research

EV typically represents the present value of the future profitability of the existing business (value of in-force business and net worth). On the other hand, structural value attempts to capture the growth potential of the insurance company ie, the present value of policies to be underwritten in the future by a company. As structural value essentially represents the PV of future policies, it is estimated by assigning a multiple to the profits arising out of sales generated in a year.

Insurance companies report accounting losses in the initial years mainly because of two reasons:

- High cost of customer acquisition essentially arising due to commissions paid to agents. These costs are entirely expensed out of P&L and NOT amortized over the life of the policy.
- Each policy, depending on the amount of sum assured, would have regulatory reserve requirement. In other words, the insurance company has to invest in assets (debt or equity), the market value of which is sufficient to cover the potential liability in the event of the death of a policyholder. The excess of the market value of assets over the potential liability of payment of sum assured is also known as Solvency Margin. In India, the insurance company has to maintain a solvency ratio of 1.5 times of solvency margins assured.

In the growth phase, a higher share of new premium in the overall premium income will result in losses. However, assuming the policyholder continues to pay premium over the life of the policy, the company generates profits. NBAP is nothing but the present value of all future profits on account of new business sales, based on assumptions related to mortality, operating expenses, inflation, investment returns and risk-discount rates.

When a life insurance company is in the growth phase, its EV is likely to be a small component compared to the potential and hence an EV-based valuation is likely to undervalue the company. Hence, we believe the combination of NBAP multiple and EV is more appropriate.

❑ NBAP margin depends on external and internal factors

To understand the NBAP margin, one needs to look at the primary revenue streams and expense heads over the life of a policy for the insurance company.

Revenue stream: Premium income and investment income.

Expense heads: Operating expenses, payout of returns to policyholders and claims payout.

Each category of products (participating/non-participating, linked/non-linked) would have a different cost structure in terms of:

a) The amount of premium charged;

b) The investment yield generated, depending on the asset allocation;

c) Operating expenses, depending on the commission paid for sourcing;

d) Payback to policyholders, depending on asset allocation and whether policyholders share the gains.

Hence, NBAP margins for each product would differ. Typically, NBAP margins for non-participating products are likely to be the highest as these products entail only claims payout and insurance companies do not have to share the returns generated out of investment of premium income. On the other hand, under linked products, the risk of investments is borne entirely by the policyholder and returns generated on the investment fund are returned to the policyholder.

Companies

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Company update

ICICI Prudential Life Insurance

Leading from the front!

1 October 2007

BSE Sensex: 17291

ICICI Prudential Life Insurance Company (ICICI-Pru), the undisputed leader in the life insurance space and one of India's first private insurers, is also the first to set up an in-house fund management team. On the back of aggressive distribution scale-up, branding and constant product innovation, ICICI-Pru has retained the top slot. It is also a beneficiary of the strong brand name of the parent, ICICI Bank. ICICI-Pru is a 74:26 joint venture between ICICI Bank and Prudential Plc, UK. We value ICICI-Pru at 18x FY10E NBAP and add Embedded Value to arrive at a value of Rs320 per share of ICICI Bank, after assuming a 10% holding company discount.

Leading the pack: ICICI-Pru leads the Indian private sector insurance space with an overall market share of 10.6% in FY07 (2% in FY03). The company has managed to maintain its leadership status on the back of a multi-channel distribution network, aggressive advertising to create brand awareness comparable to LIC, and product innovation with variants for different lifecycle and related income needs.

An enviable distribution model: To sustain its leadership in the competitive industry landscape, ICICI-Pru has scaled up its operations by investing heavily in distribution. The multi-channel distribution model, along with due emphasis on rural areas, has yielded results. Currently, while the agency channel contributes 60% towards total premium, the remaining comes from more than 18 bancassurance partners. The alliances with microfinance institutions and NGOs have aided ICICI-Pru's inroads into rural areas with more than 0.5m rural lives covered as of March 2007.

Value creator: Strong topline growth and efficient operations have led to expense and commission ratios showing a positive movement down South. With a prudent business plan in place, we expect ICICI-Pru to register a 40% CAGR in its NBAP over FY07-10 and reach Rs24.0bn by FY10. We have valued ICICI-Pru at 18x FY10E NBAP and have added Embedded Value to arrive at a fair value of Rs320 per share of ICICI .It accounts for around 30% of ICICI Bank's current share price.

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Key Financials

(Rs m)	2006	2007	2008	2009	2010
APE	23,240	44,490	68,960	96,543	125,506
yoy growth (%)	58.5	91.4	55.0	40.0	30.0
Margins	22.0	19.8	19.6	19.2	19.2
Embedded Value	14,049	26,809	43,440	67,151	99,462
Structural Value					432,846
Appraisal Value					532,308
Per Share Value of ICICI bank					320

Source: Company, SSKI Research

INVESTMENT ARGUMENT

ICICI-Pru, a 74:26 JV between ICICI Bank and Prudential Plc of the UK, is the largest private life insurer in India. It has maintained its leadership by focusing on customer-centric product innovation, rapidly building up a distribution network and investing in brand-building. The company has created a scalable model by replicating its strategy in other businesses. We have valued the life insurance company using the Appraisal Value, which is a combination of Embedded Value and Structural Value (as defined by a multiple of NBAP). We have valued ICICI-Pru at 18x FY10E NBAP and added Embedded Value to arrive at a fair value of Rs320 per share of ICICI Bank after providing for a 10% holding company discount.

❑ ICICI-Pru – India's largest private insurer

ICICI-Pru grew its market share from 2% in FY03 to 10% in FY07

Since inception, ICICI-Pru has been the largest private sector insurance company in India and has steadily gained market share (defined as share of weighted new business premium for individual business) from 2% in FY03 to 10.6% in FY07. ICICI-Pru clearly leads the private sector with ~28.5% market share in FY07. It has built and sustained its leadership on the back of product innovation, rapid expansion in distribution network, significant investments in brand-building and leveraging the strengths of its promoters – ICICI Bank and Prudential Corporation – in the areas of local knowledge, customer base and insurance expertise. However, recently the market share has slipped to 27.5% of late due to entry of aggressive players like Reliance Life.

Exhibit 1: Increasing market share

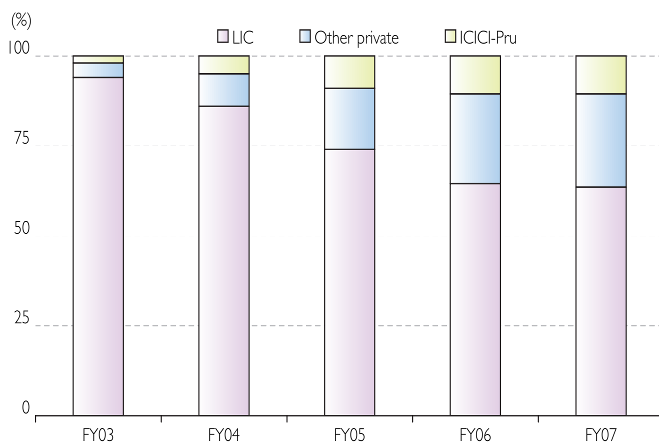
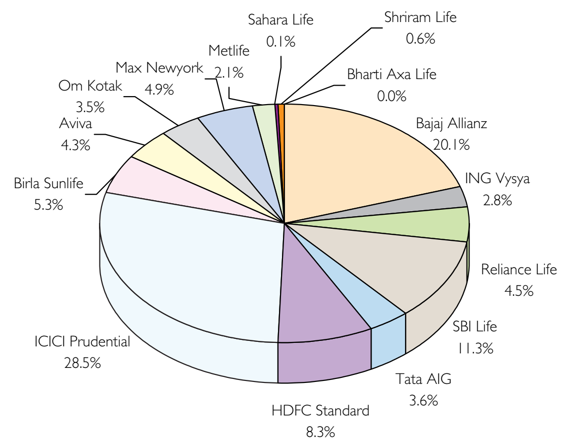


Exhibit 2: Leadership among private life insurers



Source: IRDA, Market share calculated on weighted average individual new premium with 10% weightage given to single premiums

❑ A customer-centric approach in product offerings

ICICI-Pru's product portfolio covers both investment and protection needs

Over the years, ICICI-Pru has developed a comprehensive product portfolio covering both investment and protection needs. Products also cater to various life stages and related income needs. The company has been capitalizing on new opportunities arising from distinct customer needs, such as health products (e.g., critical illness plan, cancer care plan and diabetes care plan) and annuity cards for pension holders.

ICICI-Pru has scaled up its distribution network to ~421 locations in India

❑ A rapidly expanding distribution reach

ICICI-Pru has substantially scaled up its distribution network with presence in more than 421 locations in India. Its distribution strategy is driven by a multi-channel approach with advisors (agency channel) bringing in the largest share of business (~60%), which is adequately complemented by bancassurance (through more than 18 partners), corporate agents/ brokers and an in-house sales team for the group business. The company has tied up with more than 50 microfinance institutions (MFIs) and NGOs to increase its rural coverage.

Exhibit 3: Distribution network – a rapid ramp up

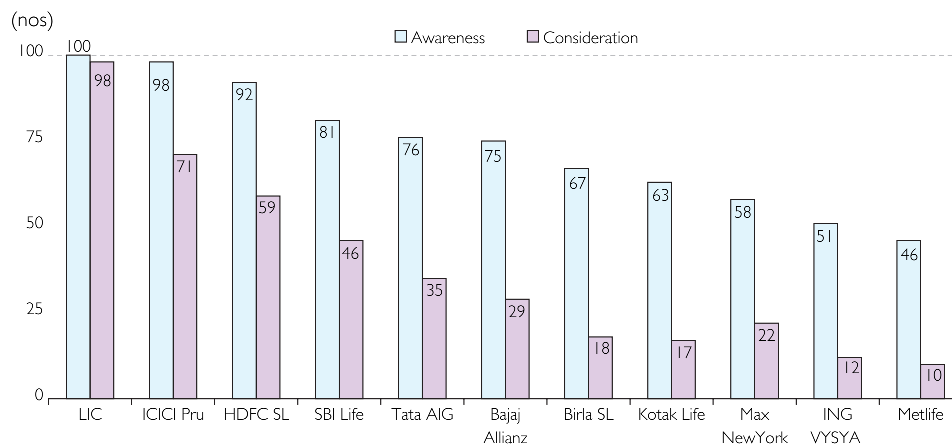
(nos)	Mar-03	Mar-04	Mar-05	Mar-06	Mar-07
Locations	25	54	74	132	421
Branches	29	70	107	177	583
Advisors	18,000	33,000	57,000	72,000	234,000
Non-agency share (%)	27	28	30	37	40

Source: Company

❑ Investing heavily in brand-building

ICICI-Pru is arguably one of the largest advertisers among life insurers. The company, striving to own the protection platform in the consumer mind space, is building its advertising campaigns around this objective. Independent market research surveys show that ICICI-Pru has successfully created a high level of brand awareness.

Exhibit 4: Brand awareness of ICICI-Pru



Source: A C Nielsen

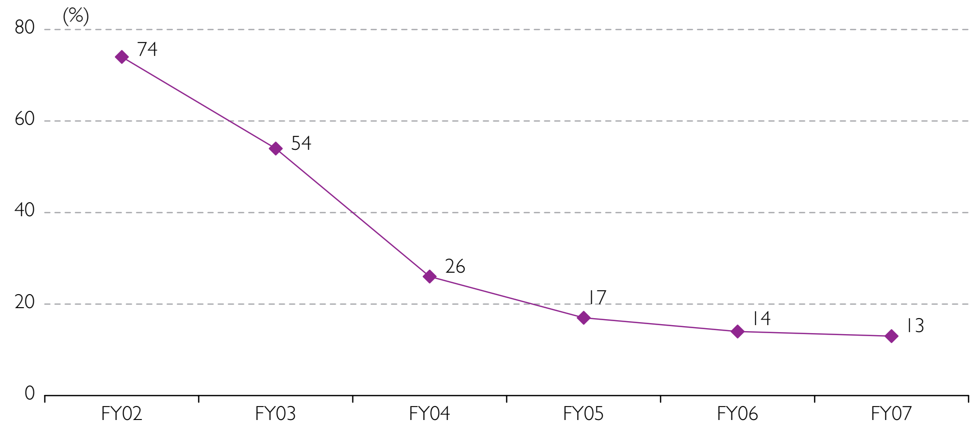
ICICI-Pru's robust and scalable processing operations enable it to respond quickly to customer needs and reduce costs

❑ Efficient operations – another key strength

ICICI-Pru has developed robust and scalable processing operations, which enable it to respond quickly to customer needs and reduce costs. It has developed a strong technology backbone to facilitate policy administration, customer relationship management and business development activities. ICICI-Pru has also cut its expense ratio consistently over the past five years from 74% in FY02 to 14% in FY07. Expense ratio (defined as: operating expenses/ total premium less 90% of single premium and less 50% of limited pay products; operating expense excludes the cost of acquisition) is a key metric to judge an insurer's efficiency.

Expense ratio down from 74% in FY02 to 14% in FY07

Exhibit 5: A declining expense ratio – improving efficiency



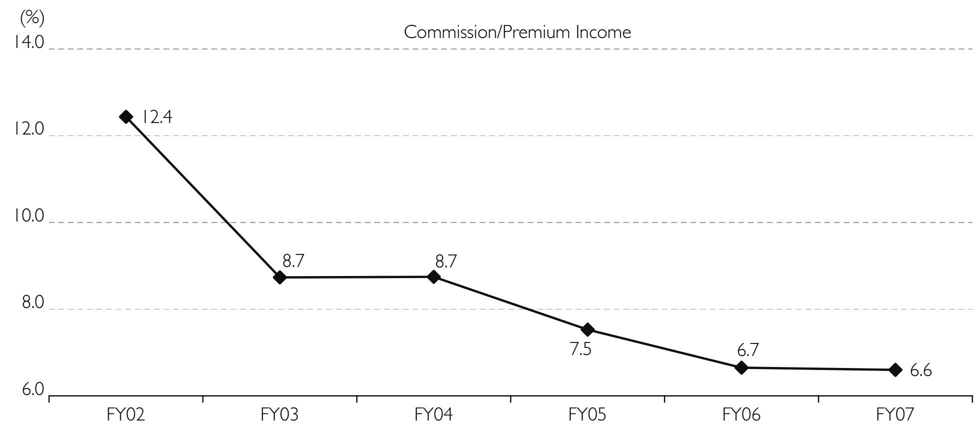
Source: Company

❑ Declining commission cost

Higher share of ULIP and higher proportion of renewal premiums in premium incomes lower commission costs

Over the years, ICICI-Pru has been witnessing a decline in its commission ratio (defined as commission expense/ total premium income). ULIPs typically carry lower commissions vis-à-vis traditional products. Additionally, with a higher proportion of renewal premium in the overall premium income has also led to lower commission costs.

Exhibit 6: Declining commission cost



Source: Company

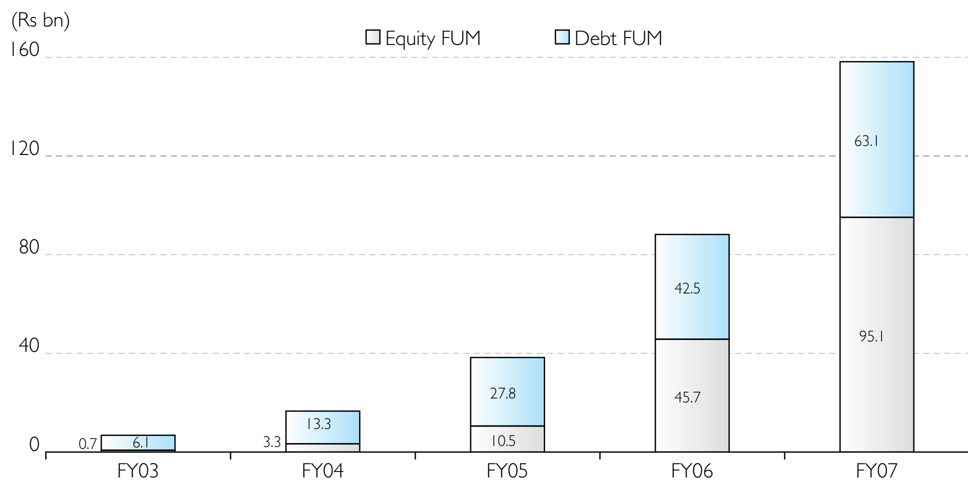
❑ Emerging as one of the largest retail fund managers

ICICI-Pru – India's first private insurer to create an in-house fund management team

ICICI-Pru was the first private life insurance company to create an in-house fund management team, which has subsequently been made mandatory by the IRDA. The investment team operates in a well-defined risk management framework developed around the principles of safety and stability of returns. With more than Rs95bn of equity funds under management, largely from retail clients, ICICI-Pru is emerging as a leading manager of retail equity funds. Its funds under management (FUM) showed a CAGR of 135% over FY03-07.

Impressive built up in FUM with a tilt towards equity

Exhibit 7: Healthy growth in FUM



Source: Company

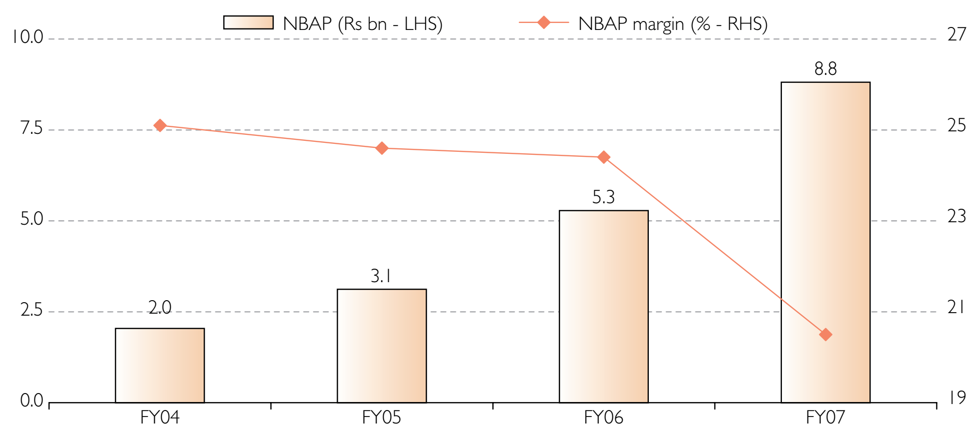
Financials And Valuation

ICICI-Pru's NBAP has grown to Rs7.81bn over FY03-07, a 95% CAGR over the period. NBAP margins continue to be comfortable at 20%.

❑ ICICI-Pru the first company disclosing NBAP and NBAP margins

ICICI-Pru is the first life insurer in India that discloses its NBAP margin and underlying economic assumptions as well as sensitivity. In the absence of disclosures from other insurance companies, it is difficult to compare ICICI-Pru's NBAP margins with those of peers. However, considering that ICICI-Pru is the largest private insurer and that it does not rely too much on single-premium policies (the least profitable) like some competitors, we expect its NBAP margins to be one of the highest among private life insurers. ICICI-Pru's NBAP has shown robust growth over the past five years and NBAP margins have more or less stabilized at 20%.

Exhibit 8: NBAP and NBAP margin movement



Source: Company

❑ Calculation of a sample ULIP policy

Exhibit 9: Features of ULIP

Policy type	ULIP Life
Policy name:	Life Time Super
Fund	**Equity**
Age	30 years
Assumption	
Age	30 years
Premium	100
Sum assured	2000
Allocation Year 1	80%
Allocation Year 2	93%
AllocationYear 3 onwards	96%
Return assumed	12%
Mortality	As per LIC table applicable for Sum at Risk
Mortality Spread	10%
Fund Management fees	2.25%
Persistency Rate	90%

Exhibit 10: ULIP policy – NBAP margins for ICICI Pru Life's Life Time Super

Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
(Rs)															
Funds A/C															
Op Balance	**-**	**85**	**182**	**287**	**397**	**514**	**637**	**769**	**909**	**1,059**	**1,221**	**1,395**	**1,583**	**1,787**	**2,008**
Addition															
Allocation	80.0	83.3	82.1	78.0	74.1	70.4	66.9	63.5	60.3	57.3	54.5	51.7	49.1	46.7	44.4
Investment Income	9.6	20.0	31.5	43.5	56.3	69.8	84.2	99.6	116.1	133.8	152.9	173.6	195.9	220.1	246.3
Expenses															
Mortality charge	2.2	2.2	2.1	2.1	2.0	2.0	1.9	1.8	1.7	1.5	1.3	0.0	0.0	0.0	0.0
Admin fees	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Fund management fees	2.0	4.2	6.7	9.2	11.9	14.7	17.7	21.0	24.4	28.1	32.1	36.4	41.1	46.2	51.7
Closing Balance	**85**	**182**	**287**	**397**	**514**	**637**	**769**	**909**	**1,059**	**1,221**	**1,395**	**1,583**	**1,787**	**2,008**	**2,247**
Technical A/C															
Income															
Premium	100.0	90.0	85.5	81.2	77.2	73.3	69.6	66.2	62.9	59.7	56.7	53.9	51.2	48.6	46.2
Mortality fee	2.2	2.2	2.1	2.1	2.0	2.0	1.9	1.8	1.7	1.5	1.3	-	-	-	-
Fund Management fees	2.0	4.2	6.7	9.2	11.9	14.7	17.7	21.0	24.4	28.1	32.1	36.4	41.1	46.2	51.7
Total	*104.3*	*96.4*	*94.3*	*92.5*	*91.1*	*90.0*	*89.3*	*89.0*	*89.0*	*89.4*	*90.1*	*90.3*	*92.3*	*94.8*	*97.9*
Expenses															
Commission/Cost of Acqn	20.0	4.5	2.5	2.0	1.9	1.8	1.7	1.7	1.6	1.5	1.4	1.3	1.3	1.2	1.2
Allocation	80.0	83.3	82.1	78.0	74.1	70.4	66.9	63.5	60.3	57.3	54.5	51.7	49.1	46.7	44.4
Operating expenses	21.0	10.0	5.0	5.0	5.0	3.0	3.0	3.0	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Claims	2.0	2.0	1.9	1.9	1.8	1.8	1.7	1.7	1.5	1.4	1.2	-	-	-	-
Total	**123.0**	**99.7**	**91.5**	**86.9**	**82.8**	**77.0**	**73.3**	**69.8**	**65.9**	**62.7**	**59.5**	**55.6**	**52.9**	**50.4**	**48.0**
Profit/(loss)	(18.8)	(3.3)	2.8	5.6	8.2	13.0	16.0	19.1	23.0	26.7	30.6	34.8	39.4	44.4	49.9
Profit / (loss) post tax	(18.8)	(3.3)	2.4	4.9	7.2	11.3	13.9	16.7	20.0	23.2	26.6	30.2	34.3	38.7	43.4
PV -10years	20.5														
Margin (%)	**20.5**														
PV - 15 years	58.3														
Margins (%)	**58.3**														

Source: SSKI Research

International life insurers valued at 20-40x NBAP

❑ Valuing ICICI-Pru at Rs320 per share of ICICI Bank

ICICI-Pru has aggressive expansion plans and we expect it to continue leading private life insurers (excluding LIC), however market share could slip marginally to 26% considering the aggression of newer players like Reliance Life. We expect ICICI-Pru's NBAP to show a 40% CAGR over FY07-10 to reach Rs24.0bn by FY10. NBAP margin is expected to stabilize at ~20% considering the product mix and our calculation of Product NBAP. However, rising competition will lead to aggressive pricing of policies, thereby putting pressure on profitability.

Internationally, life insurers are valued at anywhere between 20x and 40x NBAP, depending on the market's growth potential and profitability of the business.

Exhibit 11: Insurance valuation

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Opening Balance of Value in Force (VIF)		135	649	2,144	5,648	11,495	21,799	38,180	61,641
APE	615	2,253	6,413	14,660	23,240	44,490	68,960	96,543	125,506
NBAP Margins (%)	22.0	22.0	22.0	22.0	22.0	19.8	19.6	19.2	19.2
NBAP	135	496	1,411	3,225	5,113	8,810	13,547	18,498	24,047
In force unwinding (13%)		18	84	279	734	1,494	2,834	4,963	8,013
Estimated VIF at close of year	135	649	2,144	5,648	11,495	21,799	38,180	61,641	93,701
Shareholders Funds					12,083	21,027	26,027	31,027	36,027
less: debit balance					(9,528)	(16,017)	(20,767)	(25,517)	(30,267)
Net					2,555	5,010	5,260	5,510	5,760
Embedded Value: {A}					14,049	26,809	43,440	67,151	99,462
Structural Value: {B}									
NBAP									24,047
Multiple									18
Value									432,846
Appraisal Value: {A} +{B}									532,308
ICICI'Stake (%)									*74*
Value of ICICI's Stake									393,908
Less: Holding company discount									*10*
Less: 10% Holding company discount									39,391
Value attributable to ICICI's Stake (74%)									354,517
Share cap of ICICI (m)									1,109
Value per share of ICICI Bank (Rs)									320

Source: ICICI Bank, SSKI Research

We have valued ICICI-Pru at Rs320 per share of ICICI Bank, which is 18x FY10E NBAP plus Embedded Value

We value ICICI-Pru using the Appraisal Value, which is a combination of Embedded Value and Structural Value (as defined by a multiple of NBAP). In the initial years of operations, majority of the company's value is derived from Structural Value rather than Embedded Value. We have valued ICICI-Pru at 18x FY10E NBAP and added Embedded Value to arrive at a value of Rs320 per share of ICICI Bank after providing for a holding company discount.

Exhibit 12: Financial summary

(Rs bn)	2005	2006	2007	2008	2009	2010
Regular Premium-(a)	14.5	22.9	43.7	67.8	94.9	123.3
Single Premium	1.3	3.1	7.9	11.9	16.6	21.6
Renewal Premium	7.8	16.6	27.5	53.4	96.9	153.5
10% of Single Premium- (b)	0.1	0.3	0.8	1.2	1.7	2.2
APE - (a) +(b)	14.7	23.2	44.49	69.0	96.5	125.5
Total premium	23.6	42.6	79.1	133.0	208.4	298.4
Growth Rates (%)						
Regular Premium-(a)		58	91	55	40	30
Single Premium		139	154	50	40	30
Renewal Premium		113	66	94	82	58
10% of Single Premium- (b)		139	154	50	40	30
APE - (a) +(b)		59	91	55	40	30
Total premium		80	86	68	57	43
Persistency rate (%)		74	70	75	78	78

Source: Company, SSKI Research

Exhibit 13: Business mix

	2008	2009	2010
ULIP	97.0	97.0	97.0
Par	2.0	2.0	2.0
Term	1.00	1.00	1.00
Margins (%)			
ULIP	19.5	19.0	19.0
Par	14.0	14.0	14.0
Term	45.0	45.0	45.0
Weighted Average	19.6	19.2	19.2

Source: Company, SSKI Research

Company update

1 October 2007

BSE Sensex: 17291

HDFC Standard Life

Back in contention!

HDFC Standard Life (HDFC SL) is back on its feet! From being the third largest private insurance player in FY06, HDFC SL slipped in FY07, having lost about 200bp of market share. Fuelled by aggressive promotion, distribution ramp-up and increased capital support from promoters, HDFC SL is on track to revive its market share. HDFC SL will also benefit from a strong promoter brand and greater control over its distribution network. HDFC SL is a joint venture between HDFC and Standard Life of UK, with HDFC holding an 81.9% stake in FY07. We value HDFC's 50% stake in HDFC SL at 20x FY10E NBAP and Embedded Value to arrive at a value of Rs348 per share of HDFC, while the remaining 31.9% HDFC stake is valued at Rs89 per share as per agreement between the partners, taking the total valuation to Rs437 per HDFC share.

Back on track for steady growth: With promoter commitment to invest in the insurance business ~Rs6bn p.a. for the next three years, HDFC SL is in the process of recovering its lost market share. Aggressive distribution expansion, aided by substantial promotion efforts is a key element of the strategy. The greater control over company-owned distribution network, quality product portfolio and strong promoter brand will further aid the recovery.

Strong product profile and high persistency: HDFC SL has one of the most profitable product portfolios in the industry with regular premiums of over 90%, implying a stable stream of revenues. The focus on individual segment further strengthens the margin profile. In addition, the ULIP proportion has increased significantly from 84% in FY06 to 95% in FY07. As a result of this strong product profile, the persistency ratio is the best in the industry (89% for FY07).

A differentiated distribution franchise: The distribution network is well-aligned to drive the HDFC SL machinery. HDFC Bank, a group company, is the main bancassurance partner. Due to the ownership model, HDFC SL has greater control over its network, and therefore the pace of growth. The proportionate contribution of the agency channel has reduced to 54% in FY07 from 98% in FY02. The multi-distribution model adopted with increasing contribution from corporate agents, brokers and telemarketing is congruent with the objective of wider and deeper access.

Key financials (Rs m)

	FY06	FY07	FY08	FY09	FY10
APE	8,473	13,492	21,587	31,301	43,822
yoy growth (%)	115.9	59.2	60.0	45.0	40.0
Margins (%)	19.0	21.5	21.1	20.6	20.6
Embedded Value			16,224	24,710	36,817
Structural Value					180,722
Appraisal Value					217,539
Per Share Value of HDFC Limited					437

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INVESTMENT ARGUMENT

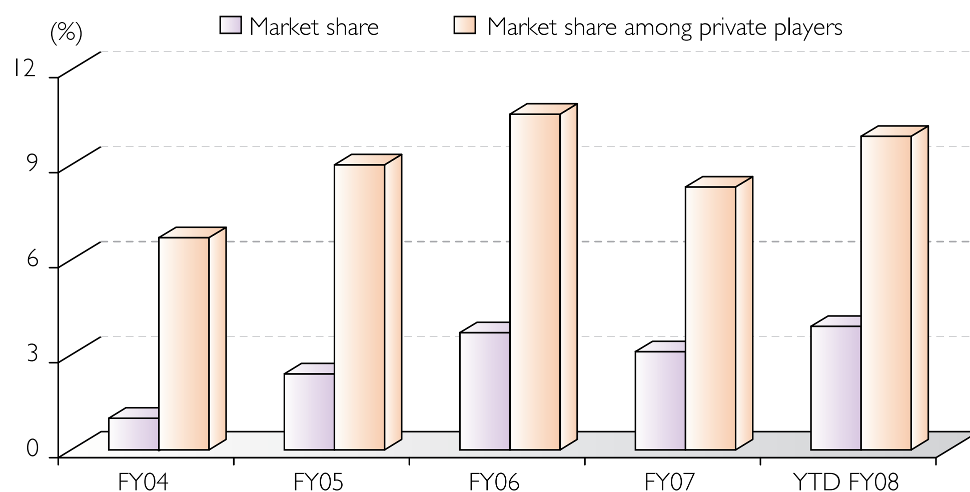
HDFC SL lost market share in FY07 as it scaled up investments in the distribution network, and had to concede its number three rank in the private insurance space. However, with the promoter HDFC (81.9% holding as on 31 March 2007) committed to investing Rs6bn each year for the next three years in the insurance business, HDFC SL is well set to grow aggressively. HDFC SL gains from greater control over the distribution network and the product portfolio being profitable with a high persistency. Currently regular premium products form ~90% of the portfolio and the individual segment accounts for 93% of the business. Finally, the strong promoter brand is the icing on the cake. Using 20x FY10E NBAP and Embedded Value methodology for the 50% stake and RoE of core HDFC business for the remaining 31.9% stake, we value HDFC SL at Rs437 per share of HDFC.

❑ Regaining market position

Extensive coverage, strong brand, parent support, and differentiated distribution – key strengths of HDFC SL

HDFC SL was the third largest private player, and on par with Bajaj Allianz once adjusted for single premium products. But, with investments to scale-up operations yielding results with a lag, HDFC SL's market share slipped from 10.6% in FY03 to 8.6% in FY07. However, with renewed focus on expanding depth and width of coverage, ably supported by the strong promoter brand value, sponsor capital commitment (of ~Rs6bn for each of the next three years), a robust product profile and differentiated company-owned distribution network, HDFC SL is geared to grow aggressively and be back on track. The recouped market share to 9.9% in YTD FY08 from 8.3% in FY07 is indicative of the recovery.

Exhibit 1: Market share on a rebound



Source: IRDA

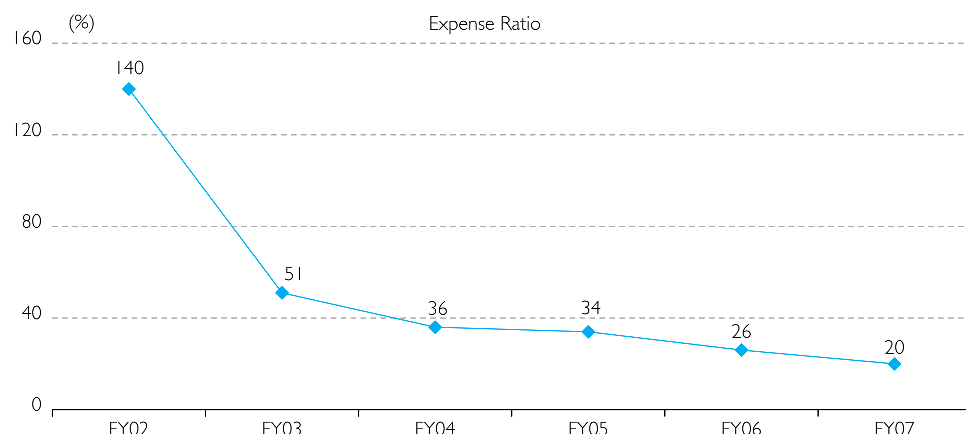
Lower commissions on ULIP component and a larger ticket size …

❑ Efficiency – a direct fall out of volumes

With first year and renewal premiums registering a CAGR of 139% over FY02-07, HDFC SL has followed an above industry growth trajectory. As on 31 March 2007, HDFC SL covered over 877m lives. Higher volumes have led to a consistent decline in operating expenses as a proportion of total premium from 26% in FY06 to 20% in FY07. This downward trend in the operating expense ratio is also due to the lower commission payable on the significantly increased ULIP component, and a larger ticket size.

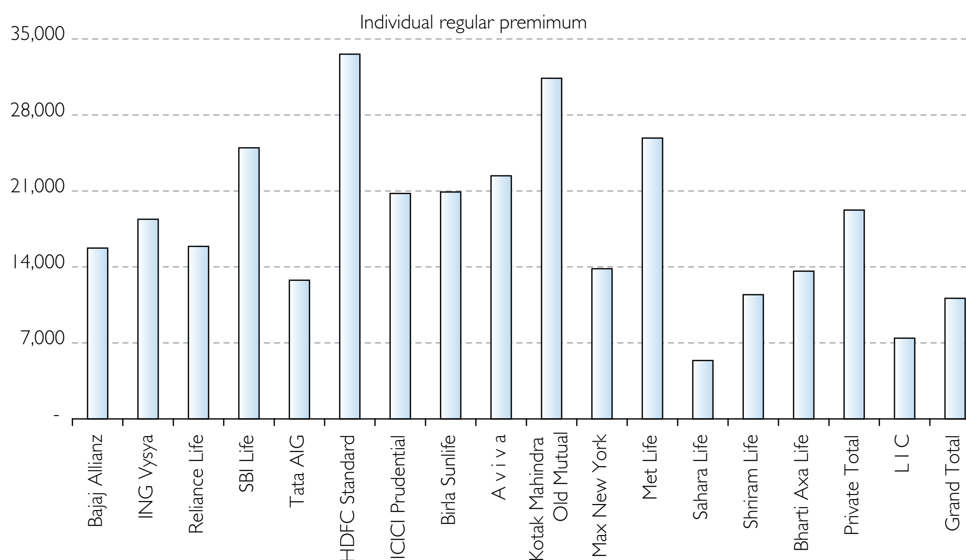
…drove a decline in operating expenses from 26% of total premium in FY06 to 20% in FY07

Exhibit 2: Declining operating ratio with increased volumes



Source: Company, SSKI Research

Exhibit 3: TICKET SIZE (INDIVIDUAL BASIS)



Source: IRDA

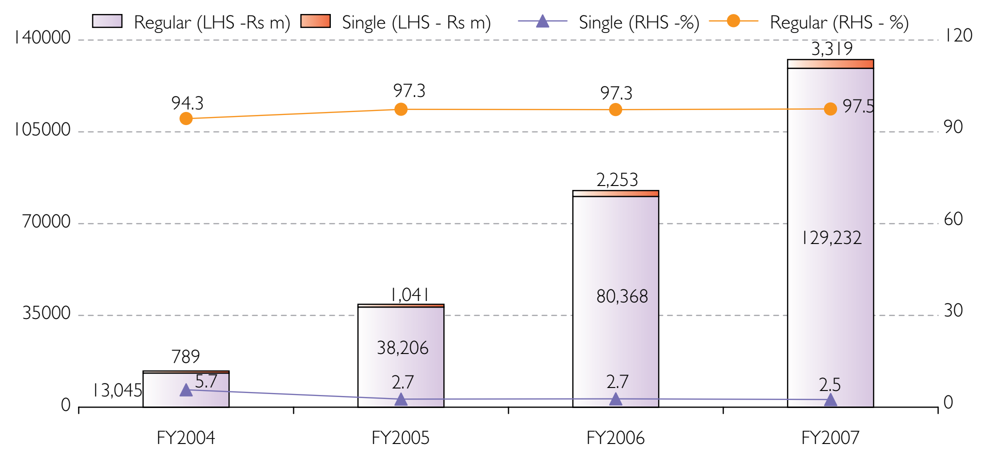
Percentage of regular premiums (an average 97% between FY04-07) among the highest in the industry

STRONG PRODUCT PROFILE AND HIGH PERSISTENCY

❑ Regular premium – among the highest in industry

Single premium products are not a strategic priority at HDFC SL, contributing only 2.5% of the premium in FY07. By implication, the percentage of regular premiums – at an average 97% between FY04-07 – is among the highest in the industry.

Exhibit 4: Regular and single premium products - contribution to total premium



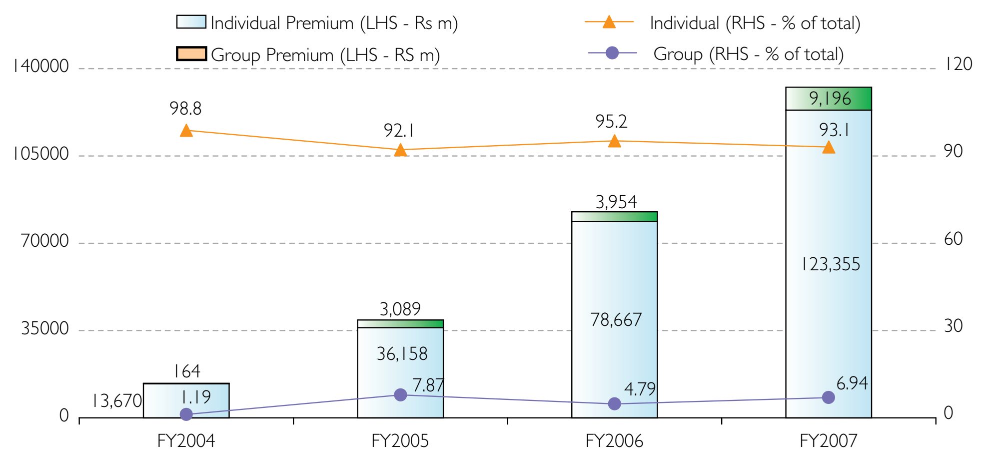
Source: IRDA

Focus is on individual segment with higher margins, generating regular premium

❑ Group premiums – a marginal proportion

HDFC SL is focusing on the individual segment, with higher margins and regular premium inflows being the key attractions. Though group premium has increased yoy in absolute terms, there is a decline in percentage contribution.

Exhibit 5: Individual and group premium products - a profitable mix



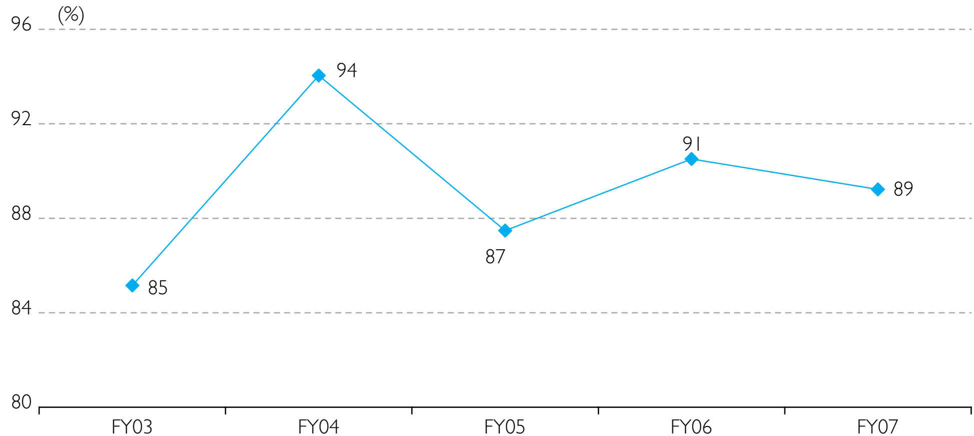
Source: IRDA

❑ A healthy persistency ratio

As a consequence of the robust product profile consisting of a higher proportion of regular premium products with consistent focus on the individual segment, HDFC SL has the best persistency ratio (at a healthy average of 89% over FY03-07) in the industry.

Persistency ratio at a healthy average of 89% over FY03-07; the best in the industry

Exhibit 6: The best persistency ratio in the industry



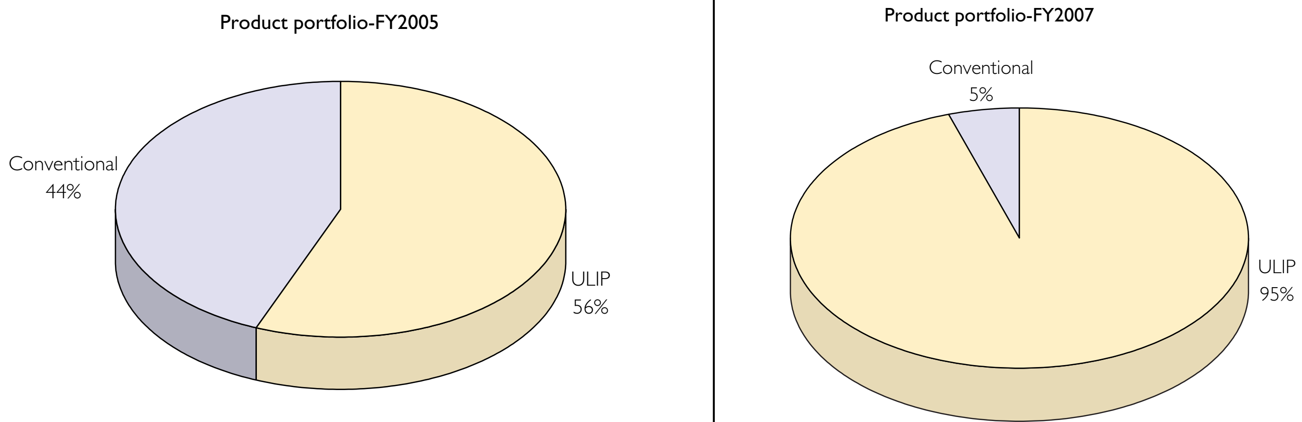
Source: Company, SSKI Research

❑ A wholesome mix

ULIP policies formed 95% of premium in FY07 vs 56% in FY05, thereby increasing the ticket size

ULIP policies accounted for 95% of HDFC SL's premium in FY07 as against 56% in FY05, the increased proportion also implies a higher average ticket size. Further, these ULIP products have one of the highest entry load charges, but the lowest annual management charge in the industry. This pricing structure explains the lower lapsation rates, and correspondingly the higher persistency ratios.

Exhibit 7: Product mix –make over between FY05 to FY07



Source: Company

❑ Product to profitability – a desirable end product

A varied portfolio translates into consistent topline growth

HDFC SL currently has 21 retail and six group products in its portfolio with the option to build on top desirable features with varied riders. Also, these products cater to different needs of protection, pension, savings and investment, with greater emphasis on savings and pension. This varied portfolio translates into consistent topline growth.

More significantly, the increased ULIP component and the pricing structure discussed above make HDFC SL's overall NBAP margins comparable with industry leaders.

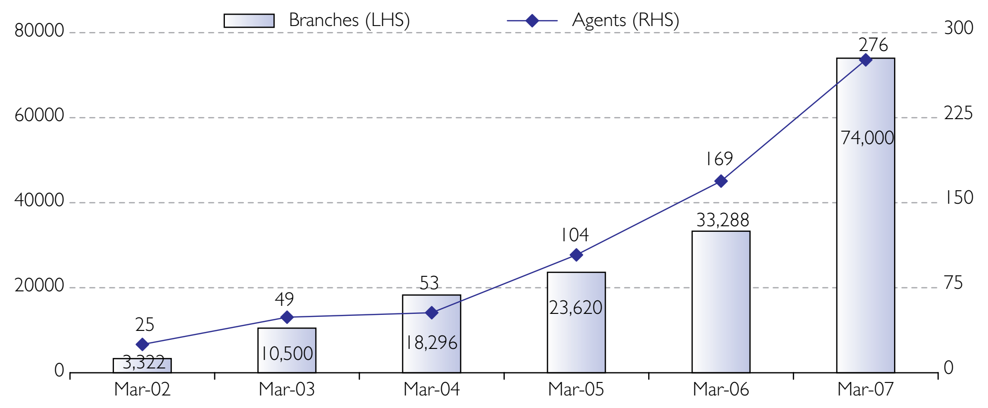
A DIFFERENTIATED DISTRIBUTION FRANCHISE

❑ Vast network being deepened further

Network being upgraded to drive volume growth and reclaim market share

HDFC SL has wide coverage across 693 cities and towns through 276 branches and 79,000 agents as of March 2007. HDFC Bank, a group company, is the main bancassurance partner. Further, 833 corporate agents and other sales intermediaries including banks are distributing HDFC SL insurance products. The expanding distribution franchise is being geared to capitalize the benefits from the aggressive promotion campaign to drive volume growth, and to regain market share.

Exhibit 8: Scaling up to regain foothold



Source: Company

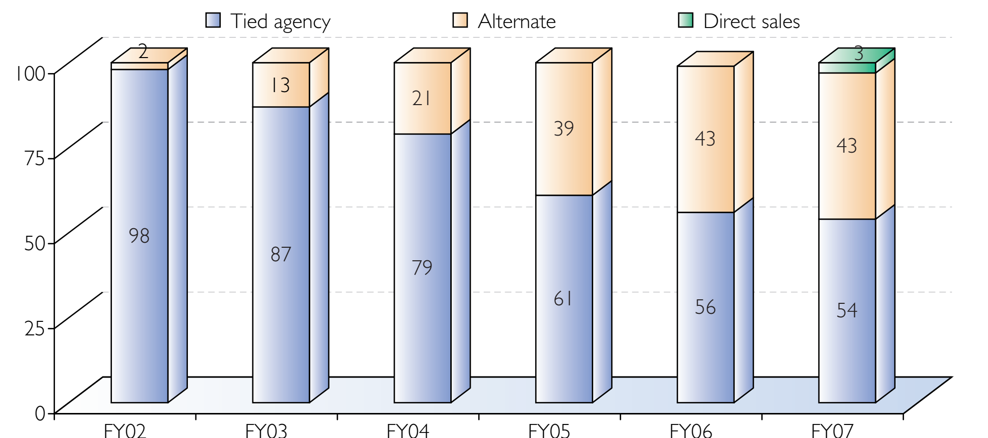
❑ Distribution channel – greater control

A multi-distribution approach ensures wider, deeper and specialized access for product range

Unlike the industry practice, HDFC SL has not adopted the franchise model, but owns its branch network. This imputes into greater control over distribution, and thereby steadier growth. Further, though majority of the sales at HDFC SL are attributable to the tied agency network, growth in this channel has slowed down (contributions down to 54% in FY07 against 98% in FY02). Alternate channels such as brokers and corporate agents are providing an increased contribution, while direct sales through internet and telemarketing account for 3% of the sales in FY07. This multi-distribution approach will enable wider, deeper and specialized access for the large product variants offered by HDFC SL.

Distribution a healthy mix of agency network, brokers, corporate agents and direct sales

Exhibit 9: Distribution mix – greater control



Source: Company

❑ Calculation of NBAP margin

We have attempted to calculate NBAP margins of a popular HDFC SL ULIP policy:

Exhibit 10: Features of sample ULIP policy

Policy Type	ULIP Life
Policy name:	Young Star Plus
Fund	Equity
Age	30 years
Premium	100
Sum assured	2000
Allocation Rate 1st	40%
Allocation Rate : 2rd year onward	99%
Return assumed	12%
Mortality	As per LIC table applicable for Sum at Risk
Fund Management fees	0.80%
Operating expenses	2.40%
Mortality Spread	10%
Persistency	95%

Source: Company, SSKI Research

Exhibit 11: NBAP margin – sample ULIP policy

Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
(Rs)															
Funds A/C															
Op Balance	**-**	**39.8**	**143.7**	**254.2**	**372.3**	**499.1**	**635.8**	**783.7**	**944.3**	**1,119.2**	**1,310.2**	**1,519.3**	**1,748.7**	**2,000.9**	**2,278.2**
Addition															
Allocation	40.0	94.1	89.3	84.9	80.6	76.6	72.8	69.1	65.7	62.4	59.3	56.3	53.5	50.8	48.3
Investment Income	4.8	15.5	27.5	40.2	53.9	68.7	84.6	102.0	120.9	141.5	164.1	188.9	216.1	246.1	279.0
Expenses															
Mortality charge	2.3	2.2	2.0	1.9	1.7	1.6	1.4	1.2	1.0	0.8	0.5	0.3	-	-	-
Admin fees	2.4	2.3	2.2	2.1	2.0	1.9	1.8	1.7	1.6	1.5	1.4	1.4	1.3	1.2	1.2
Fund management fees	0.4	1.2	2.1	3.0	4.1	5.2	6.3	7.6	9.0	10.6	12.3	14.1	16.1	18.4	20.8
Closing Balance	**39.8**	**143.7**	**254.2**	**372.3**	**499.1**	**635.8**	**783.7**	**944.3**	**1,119.2**	**1,310.2**	**1,519.3**	**1,748.7**	**2,000.9**	**2,278.2**	**2,583.5**
Technical A/C															
Income															
Premium	100.0	95.0	90.3	85.7	81.5	77.4	73.5	69.8	66.3	63.0	59.9	56.9	54.0	51.3	48.8
Mortality fee	2.3	2.2	2.0	1.9	1.7	1.6	1.4	1.2	1.0	0.8	0.5	0.3	-	-	-
Admin fee	2.4	2.3	2.2	2.1	2.0	1.9	1.8	1.7	1.6	1.5	1.4	1.4	1.3	1.2	1.2
Fund Management fees	0.4	1.2	2.1	3.0	4.1	5.2	6.3	7.6	9.0	10.6	12.3	14.1	16.1	18.4	20.8
Total	**105.0**	**100.6**	**96.5**	**92.7**	**89.2**	**86.0**	**83.0**	**80.4**	**78.0**	**75.9**	**74.1**	**72.6**	**71.5**	**70.9**	**70.8**
Expenses															
Commission/Cost of Acqn	20.0	1.0	0.9	0.9	0.8	0.8	0.7	0.7	0.7	0.6	0.6	0.6	0.5	0.5	0.5
Allocation	40.0	94.1	89.3	84.9	80.6	76.6	72.8	69.1	65.7	62.4	59.3	56.3	53.5	50.8	48.3
Operating expenses	32.5	12.5	5.0	5.0	3.0	3.0	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Claims	2.1	1.9	1.8	1.7	1.6	1.4	1.3	1.1	0.9	0.7	0.5	0.2	-	-	-
Total	94.6	109.4	97.1	92.4	86.0	81.8	77.3	73.4	69.8	66.2	62.9	59.6	56.5	53.8	51.3
Profit/(loss)	10.5	(8.8)	(0.5)	0.3	3.2	4.2	5.8	6.9	8.2	9.7	11.3	13.0	14.9	17.1	19.5
Profit / (loss) post tax	9.1	(8.8)	(0.5)	0.2	2.8	3.6	5.0	6.0	7.2	8.4	9.8	11.3	13.0	14.9	17.0
PV-12years	21.9														
Margins (%)	**22.0**														

Source: Company, SSKI Research

FUTURE OUTLOOK

❑ Growth in business

We project the industry to post a healthy CAGR of 33% over FY07-10. With promoter's commitment to adequately fund the growth of the company and the aggressive distribution expansion underway, we expect HDFC SL to grow its APE by ~48% over FY07-10.

❑ Assumptions on margins

Considering the business mix and tenor for HDFC SL polices, we expect the company to deliver average NBAP margins of 21% over FY08-10.

Exhibit 12: Business mix

(%)	FY07	FY08	FY09	FY10
Business mix				
Ulip	92	95	95	95
Particpating	6	4	4	4
Term	2	2	2	2
NBAP				
Ulip	22	21	21	21
Particpating	13	13	13	13
Term	46	46	46	46
Weighted Average	21.5	21.1	20.6	20.6

Source: SSKI Research

❑ Valuations and view

We see HDFC SL well placed to track industry growth and maintain the high profitability levels

After having lost market share in FY07, we believe HDFC SL is well-positioned to grow in line with industry average on the back of renewed aggression, and maintain its distinction as one of the higher profitable insurers. We expect HDFC SL's NBAP to show a 46% CAGR over FY07-10 to reach Rs9.0bn by FY10. We have valued HDFC's 50% stake in HDFC SL at 20x FY10E NBAP and added Embedded Value to arrive at a value of Rs348 per share of HDFC. The residual 30% stake in HDFC SL has been valued using the RoE for HDFC's core business, implying a total valuation of Rs437 per share of HDFC.

Exhibit 13: Valuation

(Rs m)	2004	2005	2006	2007	2008	2009	2010
Opening Balance of Value in Force (VIF)	199	506	1,317	3,098	6,399	11,785	19,771
APE	477	925	8,473	13,492	21,587	31,301	43,822
NBAP Margins (%)	19	19	19	21	21.1	20.6	20.6
NBAP	281	746	1,610	2,898	4,554	6,454	9,036
In force unwinding (13%)	26	66	171	403	832	1,532	2,570
Estimated VIF at close of year	506	1317	3,098	6,399	11,785	19,771	31,377
Shareholders Funds			6,332	8,360	14,360	20,360	26,360
less: debit balance			(3,166)	(4,421)	(9,921)	(15,421)	(20,921)
Net			3,166	3,939	4,439	4,939	5,439
Embedded Value: {A}			**6,264**	**10,338**	**16,224**	**24,710**	**36,817**
Structural Value: {B}							
NBAP							9,036
Multiple							20
Value							180,722
Appraisal Value: {A} +{B}							**217,539**
Appraisal Value: {A} +{B} (in USD)							**5,438**
HDFC Stake (Economic Interest)							50%
Value of HDFC Stake							110,945
Less: Holding company discount							10%
Less: 10% Holding company discount							11,094
Value of HDFC Stake							99,850
Share cap of HDFC							287
Value per share							348
Value of Excess stake							25,569
Total Value							125,420
Value per share of HDFC Limited							437

Source: SSKI Research , Company

Exhibit 14: Financial summary

(Rs bn)	2005	2006	2007	2008	2009	2010
FYP	3.8	8.3	13.2	21.1	30.5	42.7
RP	2.0	5.3	12.1	22.7	39.4	62.9
SP	1.0	2.2	3.3	5.3	7.7	10.8
Premium	6.9	15.7	28.6	49.1	77.6	116.5
10% of SP	0.1	0.2	0.3	0.5	0.8	1.1
Ape- new business	3.9	8.5	13.5	21.6	31.3	43.8
Ape-total business	5.9	13.7	25.6	44.3	70.7	106.7
YoY growth (%)						
FYP	171	116	59	60	45	40
RP	127	163	129	88	73	60
SP	52	109	53	60	45	40
GPI	131	129	82	72	58	50
Ape- new business	166	116	59	60	45	40
Ape-total business	151	132	86	73	60	51
Persistency (%)	87	91	89	90	90	90

Source: Company, SSKI Research

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Max New York Life Insurance

Back in action?

Unrated

1 October 2007

BSE Sensex: 17291

Max New York Life Insurance (MNYL) has had a rollercoaster ride of late! Due to emphasis on profitable growth, MNYL's market share (among private players) declined from 6.3% in FY04 to 4.7% in FY07. But YTD FY08, market share is up to 6.7%. Predominantly an agency-driven model, MNYL has the most productive agency force in the industry. The recovery in market share is driven by multi-channel distribution approach and increased ULIP portfolio. MNYL is a 74:26 JV between Max India and New York Life. At 18x FY10E NBAP and adding Embedded Value to it, we value MNYL at Rs227 per share of Max India, assuming 50% ownership by promoters and after providing for a 10% holding company discount.

Differentiating through productivity and product mix: MNYL has the most productive agent force in the industry with premium per agent of ~Rs25,360 against an average of ~Rs12,920 for other private sector players. Second, its product portfolio is biased towards longer-tenor ULIP policies and traditional products, wherein margins earned are better.

Changing gears: To regain market share, MNYL has adopted a multi-channel distribution approach with bancassurance and corporate agents contributing 25% to GWP against virtually nothing in 2001. MNYL has also sized up the ULIP portfolio, which is growing at 75%, though it still forms a relatively smaller proportion of the total book. This change in strategy has yielded results with market share bouncing back to 6.7% for YTD FY08.

Fighting the brand battle: In existing markets, MNYL gains from leveraging the promoter brands: Max India is a prominent industrial house with interests in Healthcare and Clinical Research, and New York Life is a Fortune 100 company with over US $200bn of assets under management. However, for MNYL to achieve its vision of being a top quartile insurance player, gaining access to B and C towns, and rural areas will be a key challenge. Despite aggressive investment in distribution, MNYL has lower brand recognition in these areas compared to premium brands like LIC and SBI. Hence, MNYL's ability to grow in the future will be completely dependent on their differentiated service quality and productive agent force.

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Key financial

(Rs m)	2006	2007	2008	2009	2010
APE	4,445	7,667	12,267	17,787	24,901
yoy growth	105.6	72.5	60.0	45.0	40.0
Margins	21.0	20.7	21.0	20.2	20.2
Embedded Value			9,579	14,586	21,613
Structural Value					90,396
Appraisal Value					112,009
Per Share Value of Max India					227

INVESTMENT ARGUMENT

MNYL has the distinction of having the most productive agent force in the industry with a remarkable lead over competitors. Though MNYL temporarily lost foothold in FY07 due to need for fine-tuning the product and distribution mix, market share for YTD FY08 has recovered. Historically only an agency driven model, MNYL is increasingly adopting a multi-channel approach to grow aggressively in existing and under-penetrated markets. Further, the increased ULIP portfolio has led to margin expansion over the endowment policy mix. However, the portfolio continues to be relatively well-balanced as against peers. Going forward, MNYL needs to focus on its branding strategy to gain recognition in semi-urban and rural areas – the future growth engines. MNYL is a JV between Max India (74% stake) and New York Life (26%).

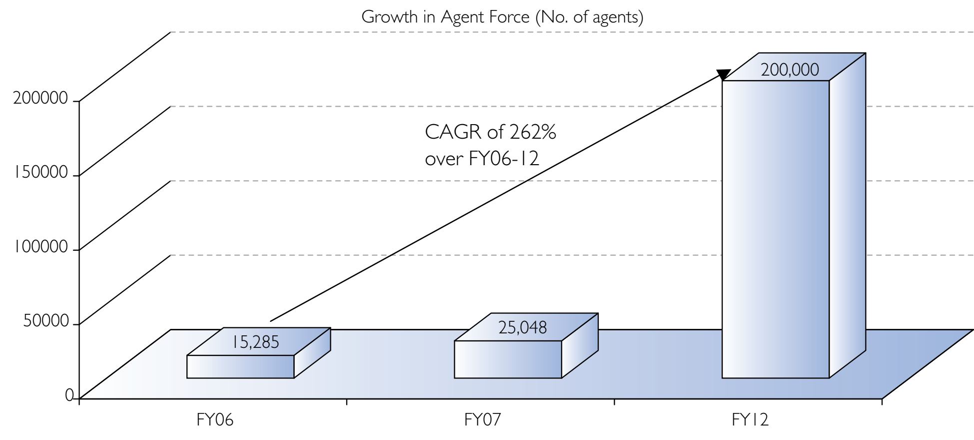
DIFFERENTIATING THROUGH PRODUCTIVITY AND PRODUCT PORTFOLIO

❑ The most productive agent force

Agency force estimated to increase from 28,000 to 200,000 over the next 5 years

MNYL's agency network spreads over 172 field offices across 120 locations with around 28,000 exclusive sales agents, expected to increase to 200,000 over the next five years. Although, limited in number the agent force is the most productive in the insurance industry. However, this highly productive agent force comes at a cost, exerting downward pressure on margins.

Exhibit 1: Growing agent force

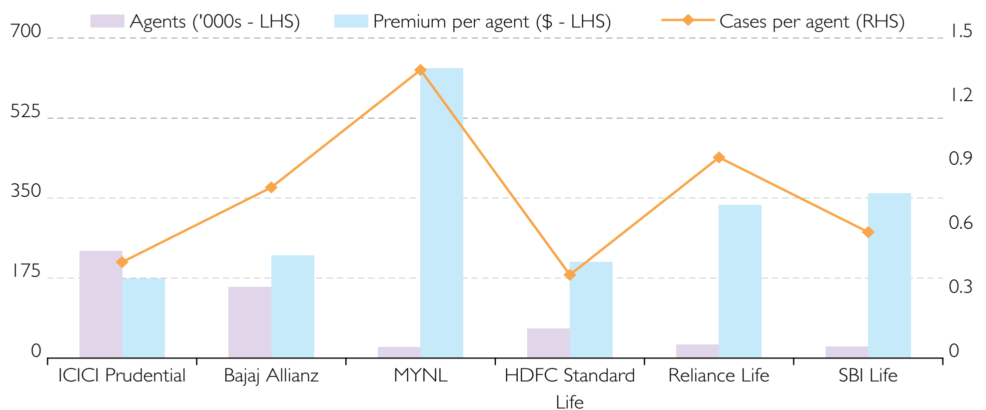


A simple peer analysis, based on data as on 30 June 2007, reveals that MNYL's premium per agent stands at ~Rs25,360, which is 76% higher than the closest competitor, SBI Life. Another metric corroborates the above inference with the number of cases per agent at MNYL being 44% higher than the closest competitor, Reliance Life. A corresponding measure at MNYL is the number of active agents, defined as agents closing at least 12 cases per annum. Currently, 60% of the agents qualify as active, which explains MNYL's lead in the productivity charts.

Another credential which substantiates the quality of agents is the fact that 201 of the agents qualified for the Million Dollar Round Table (MDRT) membership in 2005, making MNYL move up in the MDRT Top 50 global list.

MNYL's premium per agent of ~Rs25,360 is 76% higher than the closest competitor, SBI Life

Exhibit 2: Agent productivity – a comparison



Source: IRDA

MNYL sales manager: agent ratio is 1:15-18 against the industry norm of 1:30

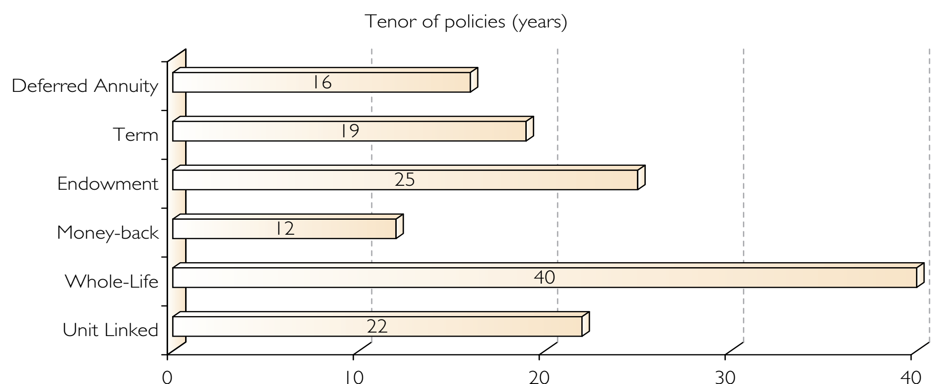
The productive agent force is a function of two primary factors. First, the high-quality continuous in-house training provided to all agents, and more significantly, the 400 hours invested in training at MNYL against the mandatory 100 hours stipulated by the IRDA, which gives MNYL's its cutting edge. Second, the management style adopted at MNYL tilts towards a narrower span of control, indicated by a sales manager: agent ratio of 1:15-18 as against 1:30 of competitors. A lower sales manager: agent ratio contributes to making the agent force one of the most motivated in the industry. Going forward, productivity may decline marginally with increased scale and span of control reducing the competitive advantage, but productivity for MNYL will continue to be higher than competition.

❑ A well-balanced product mix

MNYL gaining economies of scale, operating costs on a downward trend

At MNYL, the product portfolio is biased towards protection-oriented traditional policies and longer-tenor ULIP products. The inference from this portfolio composition is that despite charges being aligned with competition, MNYL should earn better margins. However, the benefits are offset due to MNYL's expensive business model entailing higher employee costs, higher infrastructure costs and lack of economies of scale. Nevertheless, operating costs have been consistently showing a southward trend on the back of economies of scale, as reflected in the decline in expense to premium ratio, which is down to 50% in three years from the inception levels of >100%.

Exhibit 3: Tenor of policies

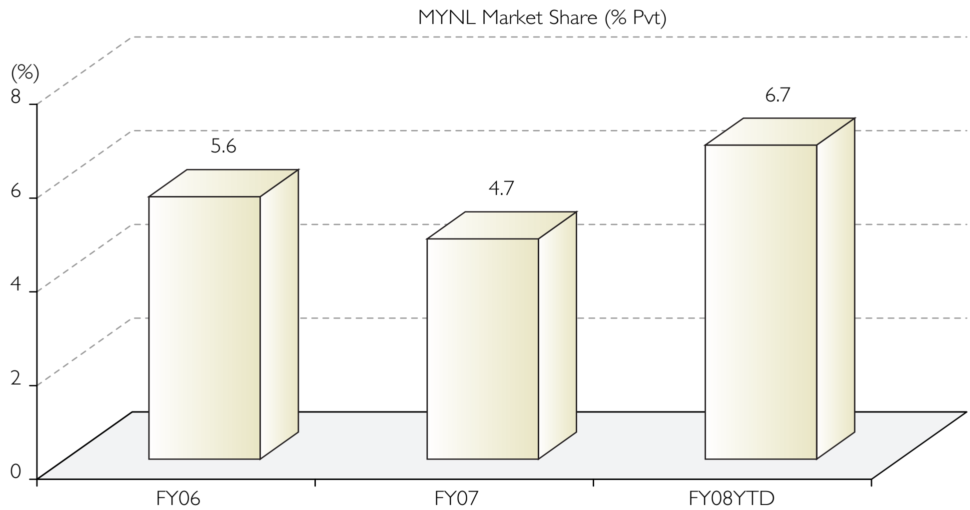


Source: Company

CHANGING GEARS

To achieve MNYL's vision of being a top quartile life insurance company in India, the management undertook the following steps to regain a foothold:

Exhibit 4: Regaining lost market share by changing gears



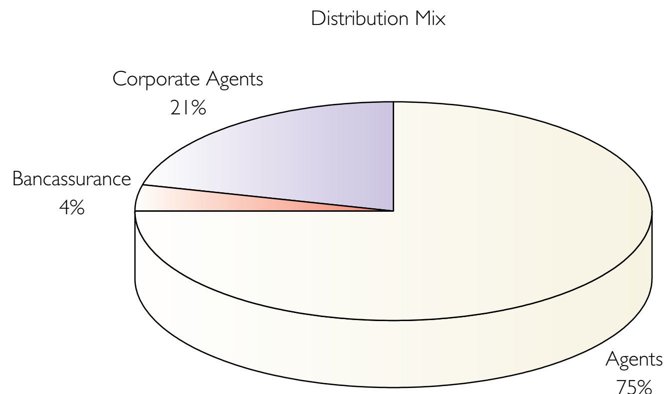
Source: IRDA

❑ Adopting a multi-channel distribution strategy

From being 100% agent driven, MNYL diversifies mix with alternate channels

Since inception, MNYL has focused on individual agents as its primary channel of distribution. Being almost 100% agency-driven, MNYL has shifted gears to identify alternate distribution channels. Currently, ~75% of the business is attributable to agents, and the remainder 25% is split between bancassurance and corporate agents. Out of the 25%, 4% of the sales come from bancassurnace, delivering a 50-60% yoy growth. Currently, MNYL has partnerships with 17 banks having presence across 40 locations to cross-sell its insurance products. Yes Bank Ltd. is the sizeable bank with others being rural cooperative banks. The remaining 21% is attributable to corporate agents such as Amsure (a JV between Amway and Hollard Life assurance of South Africa), Indiabulls, Citi-financial and Peerless Abasan Finance (an NBFC).

Exhibit 5: Distribution mix



Source: Company

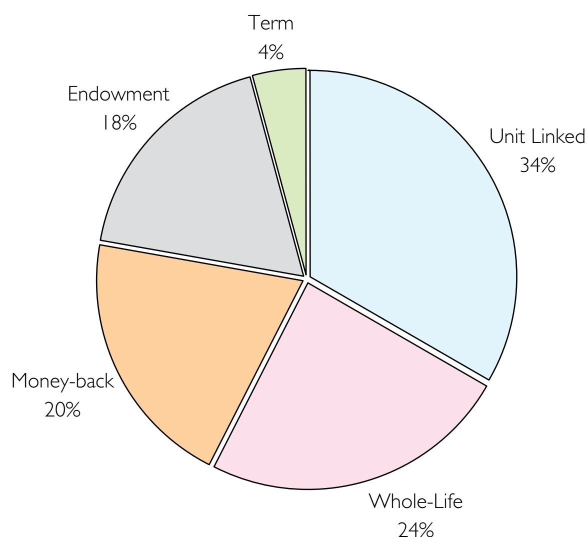
Going forward, there is substantial investment planned to scale up both agency and bancassurance, while maintaining the proportion at 70:30. However, in absolute terms, this expansion will lag behind that of top players, posing challenges to MNYL's market position.

❑ Transition from traditional product to unit-linked policies

MNYL a late entrant in ULIP; though growing, proportion of ULIP still lower than peers

Unit linked products comprised 33% of MNYL's portfolio as on 30 June 2007, with the remainder was in traditional policies such as whole-life (24%), money-back (20%), endowment (18%) and term (4%). With the first products on the ULIP platform launched in 2003, MNYL was a late entrant in the ULIP space, primarily because New York Life globally writes traditional long-tenor policies. Though there is a margin trade-off, this transition to a relatively higher ULIP basket corresponds with the high growth in gross premium. The ULIP component for MNYL is growing at 75%, which is higher than the industry average.

Exhibit 6: Product portfolio – June 2007



Source: Company

FIGHTING THE 'BRAND' BATTLE

MNYL pitted against well-recognized brands like LIC, SBI and ICICI in the new growth markets

As competition intensifies in the urban areas, penetration beyond metros into 'B' and 'C' towns, and rural areas will be a key survival challenge for MNYL. The company has lower brand recognition in these remote areas when compared to the likes of LIC, SBI and ICICI. In essence, to continue to grow MNYL will have to fight the brand battle. It will have to offer a greater value proposition to customers than competition, with customized high-quality service by leveraging the trained, efficient and motivated insurance agent base.

❑ Calculation of NBAP margins

We have attempted to calculate NBAP margins of a popular ULIP policy of Max NewYork life

Exhibit 7: Key features of the policy

Company Name	MaxNewYork
Policy Type	Ulip Life
Policy name:	Classic
Fund	Equity
Age	30 years
Premium	100
Sum assured	2000
Allocation Rate 1st	75%
Allocation Rate : 2nd year onward	80%
Alocation rate: 3rd year onwards	95%
Return assumed	12%
Mortality	As per LIC table applicable for Sum at Risk
Fund Management fees	1.25%
Operating expenses	2.00%
Inflation on expenses	5.00%
First year charge	2.00%
Mortality Spread	10%
Persistency Rate	90%

Exhibit 8: Margin calculation

Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Funds A/C															
Op Balance	0.0	38.7	117.8	197.2	289.9	384.7	482.4	584.2	691.0	804.1	924.5	1053.5	1192.5	1343.2	1508.4
Addition															
Allocation	75.0	72.0	64.8	69.3	62.3	56.1	50.5	45.4	40.9	36.8	33.1	29.8	26.8	24.1	21.7
Investment Income	9.0	12.8	21.4	31.5	41.7	52.3	63.4	75.0	87.2	100.3	114.3	129.4	145.7	163.7	183.2
Expenses															
Mortality charge	2.2	2.3	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.1	1.9	1.7	0.0	0.0
Admin fees	2.0	1.9	2.0	2.1	2.2	2.3	2.4	2.5	2.7	2.8	2.9	3.1	3.2	3.4	3.6
Fund management fees	1.1	1.5	2.6	3.7	4.9	6.2	7.5	8.8	10.2	11.8	13.4	15.2	17.1	19.1	21.4
First year charge	40.0														
Closing Balance	38.7	117.8	197.2	289.9	384.7	482.4	584.2	691.0	804.1	924.5	1053.5	1192.5	1343.2	1508.4	1688.4
Technical A/C															
Income															
Premium	100.0	90.0	81.0	72.9	65.6	59.0	53.1	47.8	43.0	38.7	34.9	31.4	28.2	25.4	22.9
Mortality fee	2.2	2.3	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.1	1.9	1.7	0.0	0.0
Admin fee	2.0	1.9	2.0	2.1	2.2	2.3	2.4	2.5	2.7	2.8	2.9	3.1	3.2	3.4	3.6
Fund Mangement fees	1.1	1.5	2.6	3.7	4.9	6.2	7.5	8.8	10.2	11.8	13.4	15.2	17.1	19.1	21.4
First year charge	40.0														
Total	145.3	95.7	87.8	80.9	75.0	69.7	65.2	61.4	58.1	55.5	53.3	51.5	50.2	47.9	47.9
Expenses															
Commission/Cost of Acqn	20.0	6.8	6.1	3.6	3.3	3.0	2.7	2.4	2.2	1.9	1.7	1.6	1.4	1.3	1.1
Allocation	75.0	72.0	64.8	69.3	62.3	56.1	50.5	45.4	40.9	36.8	33.1	29.8	26.8	24.1	21.7
Operating expenses	45.0	17.5	15.0	10.0	7.5	5.0	5.0	5.0	5.0	5.0	5.0	3.0	3.0	3.0	3.0
Claims	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	1.9	1.7	1.5	0.0	0.0
Total	142.0	98.3	87.9	84.9	75.1	66.1	60.2	54.8	50.0	45.7	41.7	36.1	32.7	28.4	25.9
Profit/(loss)	3.3	-2.6	-0.1	-4.0	-0.2	3.7	5.1	6.6	8.1	9.8	11.5	15.4	17.5	19.5	22.0
Profit / (loss) post tax	2.8	-2.6	-0.1	-4.0	-0.1	3.2	4.4	5.7	7.1	8.5	10.0	13.4	15.2	17.0	19.1
PV-15 years	**23.3**														
Margins	**23.3%**														

Source: SSKI Research

FUTURE OUTLOOK

❑ Growth in business

Going forward, with substantial investment planned to scale up distribution coupled with increasing focus on ULIP we expect MNYL to grow APE by 48% over FY07-10.

❑ Assumptions on margins

Margins are expected to remain stable as the benefit of increasing share of ULIP is undone by slightly lower margins on newer ULIP policies.

Exhibit 9: Business Mix

(%)	2007	2008	2009	2010
ULIP	67.6	80.0	82.5	82.5
Participating	31.1	18.5	16.5	16.5
Non- participating	1.3	1.5	1.0	1.0
Total	100.0	100.0	100.0	100.0
Margins				
ULIP	22.0	21.5	20.5	20.5
Participating	17	17	17	17
Non- participating	45	45	45	45
Weighted Average	20.7	21.0	20.2	20.2

Source: SSKI Research

❑ Valuations and view

We expect MNYL's NBAP to show a 46% CAGR over FY07-010 to reach Rs5.0bn by FY10. We have valued MNYL at 18x FY010E NBAP and added Embedded Value to arrive at a value of Rs227 per share of Max India.

Exhibit 10: Valuation (Rs million)

	2004	2005	2006	2007	2008	2009	2010
Opening Balance of Value in Force (VIF)	213	511	1,042	2,111	3,975	7,071	11,577
APE	1,255	2,162	4,445	7,667	12,267	17,787	24,901
NBAP Margins (%)	22	22	21	21	21.0	20.2	20.2
NBAP	270	465	933	1,590	2,578	3,587	5,022
In force unwinding (13%)	28	66	135	274	517	919	1,505
Estimated VIF at close of year	511	1042	2,111	3,975	7,071	11,577	18,104
Shareholders Funds			5,632	6,632	8,132	9,632	11,132
less: debit balance			(3,923)	(4,623)	(5,623)	(6,623)	(7,623)
Net			1,709	2,009	2,509	3,009	3,509
Embedded Value: {A}			**3,819**	**5,984**	**9,579**	**14,586**	**21,613**
Structural Value: {B}							
NBAP							5,022
Multiple							18
Value							90,396
Appraisal Value: {A} +{B}							**112,009**
Appraisal Value: {A} +{B} (in USD)							**2,732**
Value of Max India Stake (50%)							56,004
Less: 10% Holding company discount							5,600
Value of Max India Stake (50%)							50,404
Value per share of Max India							227

Source: Company, SSKI Research

Exhibit 11: Financial Summary (Rs million)

	2004	2005	2006	2007	2008	2009	2010
FYP	1,242	2,143	4,415	7,505	12,021	17,431	24,403
RP	780	1,798	3,168	5,882	10,040	16,546	25,483
SP	131	193	299	1,616	2,453	3,557	4,980
GPI	2,153	4,134	7,882	15,003	24,515	37,535	54,867
Reinsurance	(32)	(47)	(85)	(149)			
NPI	2,121	4,087	7,797	14,854	24,515	37,535	54,867
10% of SP	13.1	19.3	29.9	162	245.3	355.7	498.0
APE-New Buss	1,255	2,162	4,445	7,667	12,267	17,787	24,902
APE- Tot Buss	2,035	3,960	7,613	13,548	22,307	34,333	50,384
YoY growth (%)							
FYP	116	73	106	70	60	45	40
RP	166	131	76	8	71	65	54
SP	34	47	55	440	52	45	40
GPI	123	92	91	90	63	5	46
APE-New Buss	115	72	106	72	60	45	40
APE- Tot Buss	132	95	92	78	65	54	47
Persistency (%)	90	89	80	78	75	75	75

Source: Company, SSKI Research

Company update

Reliance Life

Firing on all cylinders!

1 October 2007

BSE Sensex: 17291

Reliance Life is growing at an unprecedented pace. Despite a late entry in the life insurance space (with the acquisition of AMP Sanmar in July 2005), the business has attained a market share of 5.5% till YTDFY08 (1.1% in FY06). Reliance Life registered a 380% yoy rise in new business premium in FY07. A better product mix with a healthy proportion of ULIPs and regular premium is the icing on the cake. With an accelerated pace of expansion, we expect Reliance Life to register a 110% CAGR over FY07-10, with market share improving to ~13% in FY10. Reliance Life is 100% owned directly or indirectly by the Reliance Capital. We have valued Reliance Life at 20x FY010E NBAP and added Embedded Value to arrive at a value of Rs1,115 per share of Reliance Capital.

An unprecedented growth story: The spectacular growth story of Reliance Life, as told by the statistics, is a direct fall-out of the substantial distribution scale-up, strong brand and sponsor support. The product portfolio reflects favourable trends with 88% of new business premium in FY07 coming from ULIPs and regular premium at 96% in FY07. Reliance Life is a strong contender for a slot among the top three life insurance companies in India.

Distribution is the crux: With distribution being pivotal to growth and profitability for an insurer, and in the absence of a bancassurance alliance, Reliance Life has been aggressively expanding its agency force. With the channel contributing 90% of the business (relatively higher than peers), the company intends to scale up the current agent force of 130,000 to 250,000 by FY10. Reliance Life is also actively leveraging the Reliance Money customer base to cross-sell insurance to achieve synergies across group companies.

A franchise that differentiates: Being 100% owned by Reliance Capital, Reliance Life has a strong sponsor and brand support, which infuses confidence on the company's prospects. The stage is set for Reliance Life to sustain the high growth levels in the future as the sponsor is sufficiently well capitalized to fund the business.

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Key financials

(Rs m)	2006	2007	2008	2009	2010
APE	854	7,218	21,366	42,529	67,926
yoy growth (%)	142.8	745.4	196.0	99.1	59.7
Margins (%)	17.0	19.4	18.2	17.6	17.7
Embedded Value				18,238	34,043
Structural Value					239,777
Appraisal Value					273,821
Per Share Value of RCL					1,115

Source:SSKI Research

INVESTMENT ARGUMENT

Though a late entrant, Reliance Life (100% owned by RCL) is the fastest growing life insurance company in India. Post the acquisition of AMP Sanmar Life Insurance in July 2005, it has gained significant market share. A rapid build-up in distribution network, combined with a low base and favorable industry prospects, has driven the strong growth in the business. Led by above-industry growth rates, we expect Reliance Life to rank among the top three private life insurers in India. We expect the company's market share to rise from 5.5% currently to ~13% in FY10. We have valued Reliance Life at 20x FY10E NBAP and added Embedded Value to it, which implies Rs1,115 per share of Reliance Capital. .

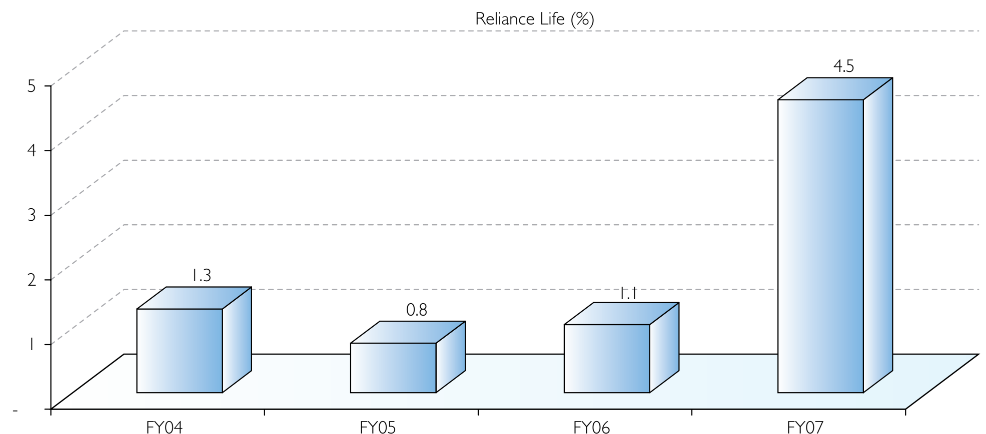
❑ India's super fast express

Reliance Life among India's fastest growing life insurance companies

Since the acquisition of AMP Sanmar in July 2005 for Rs1bn, Reliance Life has been one of the fastest growing life insurance businesses in India. The company reported a stupendous rise of 380% in new business premium in FY07 with first year regular premium growing by 8.5x, and grew faster than the over 100% growth registered by the domestic life insurance industry. This has led to Reliance Life clocking significant market share gains from 1.1% in FY06 to 4.5% in FY07 on an APE basis. From being at number 12 in the space, the company's ranking has improved to number seven in FY07. The strong growth can be attributed to the rapid build-up in distribution network, combined with a low base and favorable industry prospects.

Market share up from 1.1% in FY06 to 4.5% in FY07 on an APE basis

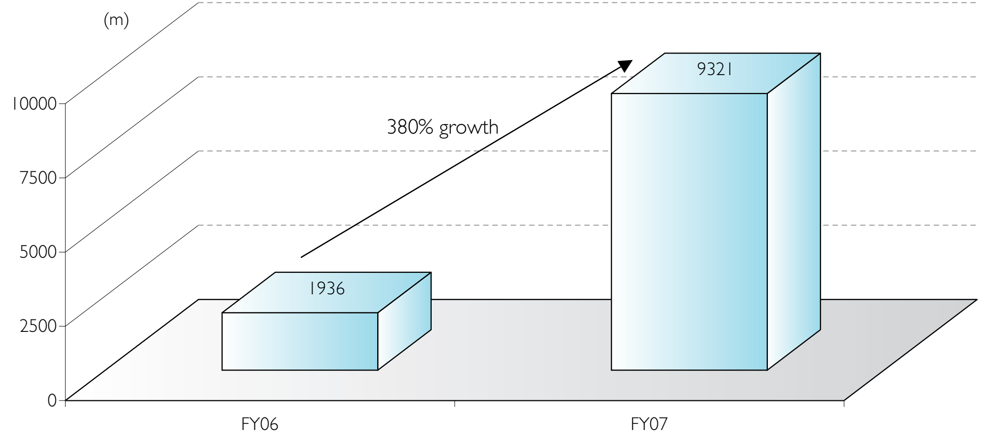
Exhibit 1: Market share gains



Source: Company, IRDA

First year regular premium grew by 8.5x in FY07

Exhibit 2: New business premium



Source: Company

The business has been slow starter over April-July 2008, registering a growth of 104% (still well above the industry growth rates); however, the management articulates that it has used this non-peak season for the industry to build up resources, which should augur well for the remaining part of the year. It is noteworthy that the share of business from single premium has come down from 23% in FY06 to 3% in FY07

❑ Rapid scale up in distribution network

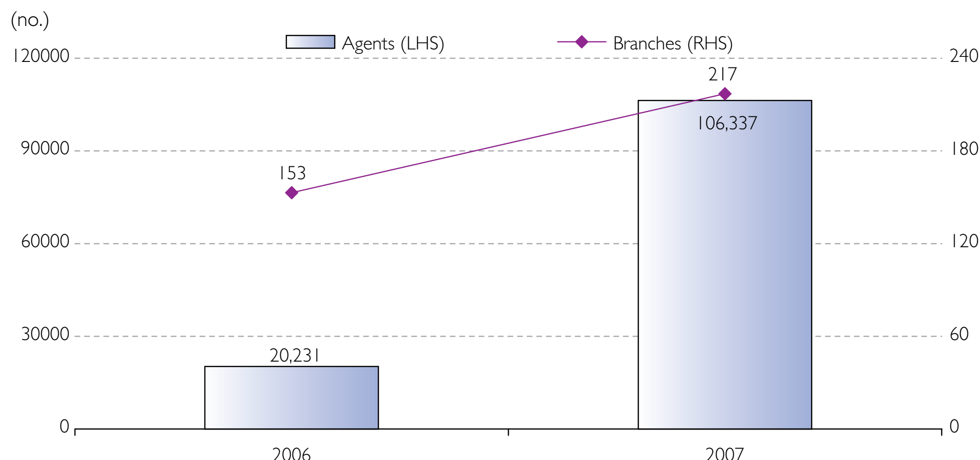
Sales force planned to be ramped up from 130,000 currently to 250,000 by FY10

An extensive distribution network is the key success factor in the insurance space. Reliance Life, post acquisition of AMP Sanmar, has invested heavily into building a distribution network that compares favorably with other private players. As of March 2007, the company had the third largest agency force among private players, next only to ICICI Pru and Bajaj Allianz.

Being a late entrant in the market, it could not forge a bancassurance tie-up with a meaningful bank. Hence, unlike competitors, ~90% of the business is derived from the agency force. The company has ambitious plans of further ramping up its sales force from 130,000 currently to 250,000 by FY10. RCL would reap the benefits of aggressive expansion in its distribution footprint and by leveraging the group's existing customer bank. Distribution reach is going to be the key for future growth acceleration as the existing geographies get saturated and the focus shifts to newer under-penetrated geographies.

Distribution reach key to growth as existing geographies get saturated and focus shifts to under-penetrated geographies

Exhibit 3: Distribution ramp up



Source: Company

Exhibit 4: Catching up with peers on the distribution front

	FY06		FY07	
(no.)	Branches	Agents	Branches	Agents
ICICI PRu	177	72,000	583	234,000
HDFC Standard Life	169	33,000	438	74,000
Reliance Life	153	20,231	217	106,000

Source: Company reports

Exhibit 5: Share of non-agency business

(%)	FY06	FY07
ICICI PRu	37	39
HDFC Standard Life	44	46
Reliance Life	5	5

Source: Company reports

❑ ULIPs contributing a higher share of growth

ULIPs contributed ~88% of Reliance Life's new business premium in FY07

A strong growth of 100% recorded by the industry in FY07 can be attributed to the increasing popularity of ULIPs as an investment vehicle, which also provides insurance cover. Much of the growth posted by Reliance Life has been through ULIPs, which contributed around 88% of the new business premium in FY07. The share has further improved to 96% till YTDFY08.

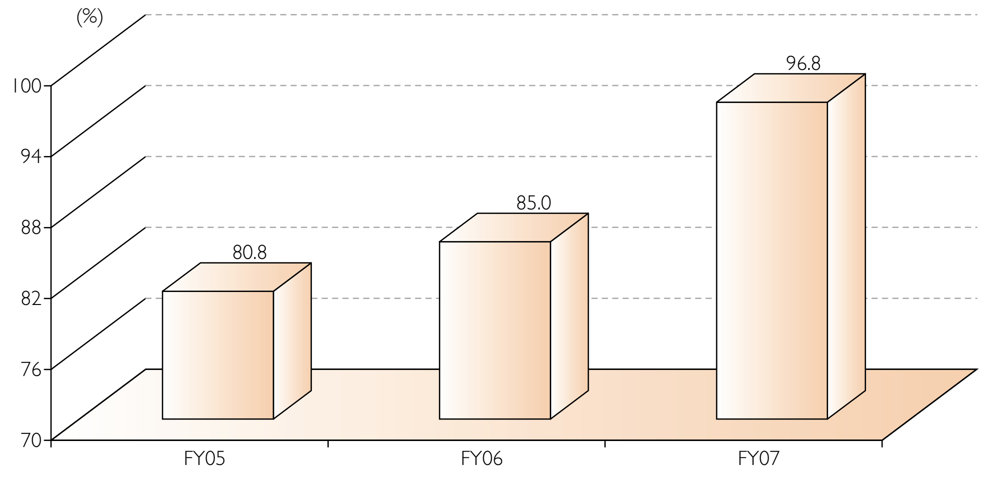
❑ An increasing share of regular business

Regular business on APE basis grew from 80% in FY05 to ~96% in FY07…

It is noteworthy that RCL has reported a significant jump in premium growth with an increasing share of regular business. Regular business (on APE basis) increased from 80% in FY05 to around 96% in FY07. This reflects improving profitability as regular business commands higher NBAP than single premium policies.

...indicating higher profitability as regular business commands higher NBAP than single premium policies

Exhibit 6: Regular premium as % of total premium



Source: Company

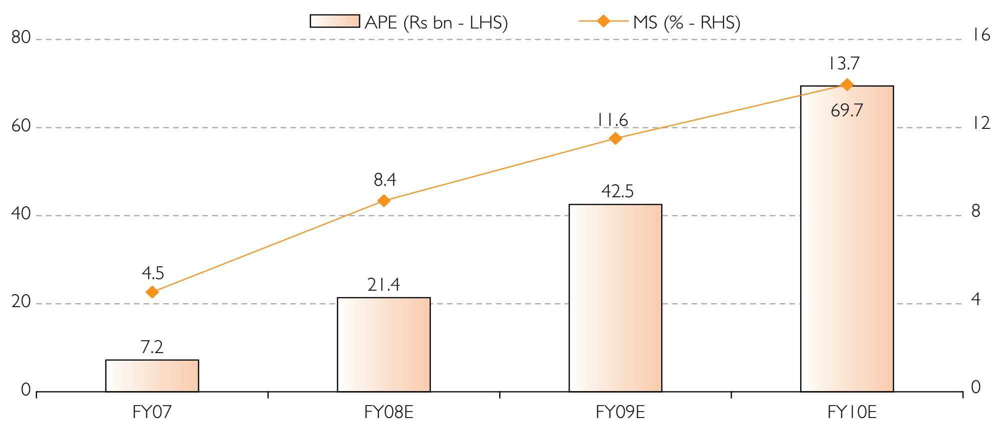
FUTURE INSURED

The industry expected to post a healthy CAGR of 33% over FY07-10

We project the life insurance industry to post a healthy CAGR of 33% over FY07-10. We believe Reliance Life would remain the fastest growing life insurance player in India. As the company capitalizes on the rapid build-up in its distribution network and leverages the existing customer base of the group, it is expected to report a robust 110% CAGR over FY07-10. Another driver supporting growth is the marketing of life insurance products through the Reliance Money platform.

Led by above industry growth rates, we expect Reliance Life to emerge as one of the top three private life insurance players in India. We estimate market share to improve from 5.5% currently to ~13% in FY10.

Exhibit 7: Growth unlimited in APE business



Source: Company, SSKI Research

Below, we have calculated NBAP margins for Reliance Life's popular selling plan – Money Guarantee.

Exhibit 8: Key features of the policy

Policy Type	Ulip Life
Policy name:	Money Guarantee plan
Fund	**Equity**
Age	30 years
Premium	100
Sum assured	2000
Allocation Rate 1st	70%
Allocation Rate : 2nd year	93%
Alocation rate:3rd year onwards	95%
Return assumed	12%
Mortality	As per LIC table applicable for Sum at Risk
Fund Management fees	1.40%
Operating expenses	3.00%
First year charge	0.20%
Mortality Spread	10%
Persistency	90%

Exhibit 9: ULIP policy – NBAP margins for Reliance Life Money Guarantee Plan

Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
(Rs)															
Funds A/C															
Op Balance	**-**	**68**	**162**	**258**	**356**	**456**	**560**	**668**	**782**	**903**	**1,032**	**1,171**	**1,320**	**1,482**	**1,660**
Addition															
Allocation	70.0	83.3	77.0	69.3	62.3	56.1	50.5	45.4	40.9	36.8	33.1	29.8	26.8	24.1	21.7
Investment Income	8.4	17.6	28.0	38.6	49.5	60.8	72.6	85.0	98.1	112.2	127.2	143.5	161.1	180.4	201.4
Expenses															
Mortality charge	2.2	2.2	2.2	2.1	2.1	2.1	2.1	2.1	2.0	1.9	1.8	1.6	1.3	-	-
Admin fees	3.0	2.8	2.8	2.9	2.9	3.0	3.0	3.1	3.2	3.2	3.3	3.4	3.4	3.5	3.6
Fund management fees	1.1	2.4	3.7	5.1	6.5	8.0	9.6	11.2	12.9	14.7	16.7	18.8	21.1	23.6	26.4
First year charge	4.0														
Closing Balance	**68**	**162**	**258**	**356**	**456**	**560**	**668**	**782**	**903**	**1,032**	**1,171**	**1,320**	**1,482**	**1,660**	**1,853**
Technical A/C															
Income															
Premium	100.0	90.0	81.0	72.9	65.6	59.0	53.1	47.8	43.0	38.7	34.9	31.4	28.2	25.4	22.9
Mortality fee	2.2	2.2	2.2	2.1	2.1	2.1	2.1	2.1	2.0	1.9	1.8	1.6	1.3	-	-
Admin fee	3.0	2.8	2.8	2.9	2.9	3.0	3.0	3.1	3.2	3.2	3.3	3.4	3.4	3.5	3.6
Fund Mangement fees	1.1	2.4	3.7	5.1	6.5	8.0	9.6	11.2	12.9	14.7	16.7	18.8	21.1	23.6	26.4
First year charge	4.0														
Total	**110.3**	**97.3**	**89.7**	**83.0**	**77.2**	**72.2**	**67.8**	**64.2**	**61.1**	**58.6**	**56.7**	**55.1**	**54.1**	**52.5**	**52.8**
Expenses															
Commission/Cost of Acqn	20.0	4.5	4.1	1.8	1.6	1.5	1.3	1.2	1.1	1.0	0.9	0.8	0.7	0.6	0.6
Allocation	70.0	83.3	77.0	69.3	62.3	56.1	50.5	45.4	40.9	36.8	33.1	29.8	26.8	24.1	21.7
Operating expenses	27.5	12.5	5.0	5.0	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Claims	2.0	2.0	1.9	1.9	1.9	1.9	1.9	1.9	1.8	1.8	1.6	1.4	1.2	-	-
Total	**119.5**	**102.2**	**87.9**	**78.0**	**68.4**	**62.0**	**56.2**	**51.0**	**46.3**	**42.0**	**38.1**	**34.5**	**31.2**	**27.3**	**24.8**
Profit/(loss)	(9.2)	(4.9)	1.8	5.0	8.8	10.2	11.6	13.2	14.8	16.6	18.5	20.6	22.9	25.2	28.0
Profit / (loss) post tax	(9.2)	(4.9)	1.5	5.0	4.4	8.9	10.1	11.5	12.9	14.5	16.1	17.9	19.9	22.0	24.4
PV- 10 years	17.4														
Margin (%)	**17.4**														
PV-15 years	37.6														
Margins	**37.6**														

Source: SSKI Research

VALUATION OF RELIANCE LIFE

❑ Valuing Reliance Life at 20x FY10E NBAP and Embedded Value

We expect Reliance Life to be among the top three private life insurers with share of ~13% by FY10E

Reliance Life has aggressive expansion plans and we expect it to continue to be among the top three private life insurance players with a market share of ~13% by FY10. We expect Reliance Life's NBAP to increase to reach Rs12bn by FY10 from Rs1.4bn currently. As rising competition exerts pressure on profitability across companies, and aggressive pricing of policies and attractive commissions for agents likely continue, NBAP margins are expected to stabilize at 17.5% considering the product mix and our calculation of product NBAP.

Life Insurance, being a highly capital intensive business in view of the stringent capital requirements, needs constant capital infusion to grow. Reliance Life, 100% owned by Reliance Capital (16% direct stake with the remaining held through associate companies/ subsidiaries), faces no capital constraint as the parent is significantly capitalized and commands strong financial flexibility. We have built in a further fund infusion of ~Rs15bn in the venture over the next three years.

We value Reliance Life using the Appraisal Value, a combination of Embedded Value and Structural Value

We have valued the life insurance company using the Appraisal Value, which is a combination of Embedded Value and Structural Value (as defined by a multiple of NBAP). In the initial years of operations, majority of the value of the company is derived from Structural Value. Considering the above average growth in business we have valued Reliance Life at 20x FY10E NBAP and added Embedded Value to arrive at a value of Rs1,115 per share of Reliance Capital.

Exhibit 10: Business mix

	FY07	FY08E	FY09E	FY10E
NBAP Margin (%)				
ULIP	19.3	18.0	17.5	17.5
Term	45.0	45.0	45.0	45.0
Group	5.0	5.0	5.0	5.0
Endowment	10.0	10.0	10.0	10.0
Product Mix (%)				
ULIP	83.0	85.0	88.0	88.0
Term	5.0	4.0	3.0	3.0
Group	0.0	0.0	0.0	0.0
Endowment	13.0	11.0	10.0	9.0
Weighted Average	**19.4**	**18.2**	**17.6**	**17.7**

Source: SSKI Research

Exhibit 11: Appraisal valuation

(Rs m)	2006	2007	2008	2009	2010
Opening Balance of Value in Force (VIF)	53	205	1,633	5,734	13,969
APE	854	7,218	21,366	42,529	67,926
NBAP Margins (%)	17.0	19.4	18.2	17.6	17.7
NBAP	145	1,401	3,889	7,490	11,989
In force unwinding (13%)	7	27	212	745	1,816
Estimated VIF at close of year	205	1,633	5,734	13,969	27,774
Shareholders Funds	3,329	6,640	10,640	15,640	20,640
less: debit balance	(2,220)	(5,371)	(8,371)	(11,371)	(14,371)
Net	1,109	1,269	2,269	4,269	6,269
Embedded Value: {A}	**1,314**	**2,902**	**8,003**	**18,238**	**34,043**
Structural Value: {B}					
NBAP					11,989
Multiple					20
Value					239,777
Appraisal Value: {A} +{B}					**273,821**
Appraisal Value: {A} +{B} (in USD)					**6,679**
Value of Reliance Stake					273,821
Per share of Reliance Capital					1,115

Source: SSKI Research

Exhibit 12: Summary financials

(Rs bn)	FY06	FY07	FY08E	FY09E	FY10E
FYP	0.7	7.0	21.0	41.9	67.1
RP	0.3	0.7	5.0	18.2	42.1
SP	1.2	2.3	4.0	6.1	8.5
GPI	2.2	10.0	30.0	66.2	117.7
10% of SP	0.1	0.2	0.4	0.6	0.9
APE-New business	0.9	7.2	21.4	42.5	67.9
APE- Total business	**1.2**	**7.9**	**26.4**	**60.7**	**110.0**
YoY growth (%)					
FYP		852	200	100	60
RP		137	591	263	131
SP		93	75	50	40
GPI		347	199	120	78
APE-New business		745	196	99	60
APE - Total business		585	232	130	81

Source: SSKI Research

SBI-Life Insurance

Brand is brawn!

1 October 2007

BSE Sensex: 17291

Unrated

SBI Life Insurance Company (SBI-Life), though a slow starter, has emerged as India's number three life insurer among the private sector players. Going forward, the powerful parent brand – a key differentiator for SBI-Life – would give it extensive mileage to acquire customers in under-penetrated areas. Further leveraging the robust distribution franchise and competitive cost structure would yield impressive results for SBI-Life. State Bank of India (SBI) Group, with more than US $155bn in assets, has a 74% stake in SBI-Life, while Cardiff SA of France holds 26%. We value SBI-Life at US $6.6bn or Rs343 per share of SBI, based on 18x FY10E NBAP and Embedded Value.

Slow but steady build-up in scale: SBI-Life has unconditional access to SBI Group's 14,000 branches, which makes its distribution bandwidth one of the widest in the industry. With improving productivity across the 4,500 branches that cross-sell insurance products, SBI-Life has rapidly scaled up its operations. Though SBI-Life was slow to adopt multi-channel distribution to 'push' its insurance products beyond SBI customers, the agency force has now been sized up to 25,000 within three years from launch. Going forward, SBI's strong corporate brand will enable SBI-Life to acquire customers when current markets saturate, and competition shifts to 'B' and 'C' towns and rural areas.

Cost competitiveness – a key differentiator: SBI-Life derives considerable operating leverage in terms of lower infrastructure and employee costs from access to the promoter's distribution franchise. Together with the lower corporate branding bill, this converts into a competitive cost structure and provides a sustainable advantage to SBI-Life.

Realigning the product portfolio: Currently ULIP products constitute 70% of SBI-Life's product portfolio, as against 95% for competitors. Further, though the Group business share has declined to 30% in FY07 from 48% in FY04, it is higher than competition, which implies lower blended margins. Another trend observed is the drop in persistency ratio to 52% in FY07 from 93% in FY06, primarily a function of the short-term ULIP policies written last year. However, the trend is expected to correct as regulation now prescribes a minimum duration of five years for ULIP policies. We have valued SBI-Life at 18x FY10E NBAP and added Embedded Value to arrive at a value of Rs343 per share of SBI.

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Key financials

(Rs m)	2006	2007	2008E	2009E	20010E
APE	4,947	18,022	32,440	48,660	68,124
yoy growth	170.8	264.3	80.0	50.0	40.0
Margins	16.5	16.7	18.2	18.1	18.3
Embedded Value			17,764	30,019	47,248
Structural Value					224,034
Appraisal Value					271,282
Per Share Value of SBI					343

Source:SSKI Research

INVESTMENT ARGUMENT

Despite being a late entrant in the insurance space, SBI-Life has evolved efficiently and effectively to capitalize the under-penetrated sector. It has achieved the distinction of being the third largest private player in a short span of time. The strength of SBI-Life's business model rests on access to the parent's distribution network with coverage even in semi-urban and rural areas, and the competitive cost structure due to lower infrastructure and employee costs. However, with the market shifting beyond Tier 1 and 2 cities, the powerful parent brand will be a key differentiator for SBI-Life. SBI Group holds in 74% stake, while Cardiff SA of France holds 26% in SBI-Life. We value the 74% stake in SBI-Life at US $6.6bn or Rs343 per share of SBI, based on 18x FY10E NBAP and Embedded Value.

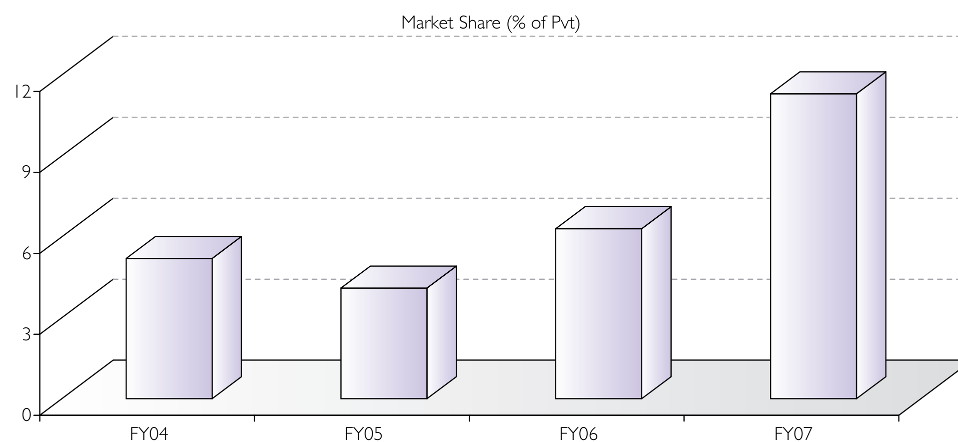
SLOW BUT STEADY BUILD-UP IN SCALE

❑ Distribution – leveraging the SBI legacy

SBI-Life has access to 14,000 branches of its promoter; 4,500 of the 'active' branches account for 95% of gross premium

A strong distribution backbone lends SBI-Life agility and cost advantages to compete with leaders such as LIC and ICICI-Prudential. SBI-Life enjoys access to 14,000 branches of its promoter SBI Group, of which 4,500 branches are already actively cross-selling SBI-Life products and contribute 95% of the gross premiums. The active branches are expected to expand to 100% of the SBI network by end-FY08. Cross-selling benefits are reflected in the consistent market share gained by SBI-Life.

Exhibit 1: SBI-Life's increasing market share (% of private market)



Source: Company

However, SBI-Life has been slow to adopt the multi-channel distribution approach, primarily due to Cardiff SA (a 100% subsidiary of BNP Paribas) predominantly being a bancassurance player. As on 31 March 2007, the agency force has expanded to 25,356 agents, which increases visibility for the SBI-Life brand with agents 'pushing' products beyond the SBI Group customer base. The business case for agents is further enhanced with annualized ticket size being ~Rs20,000 higher than bancassurance (Exhibit 2). However, there is a slip in the market share with a decline from 11.3% in FY07 to 8% in FY08 YTD, potentially due to the higher growth in single premium products and with the alternate channels in process of being streamlined to yield anticipated results.

Agency force expanded to push products beyond SBI customer base

Exhibit 2: Distribution channels - contribution to GWP performance

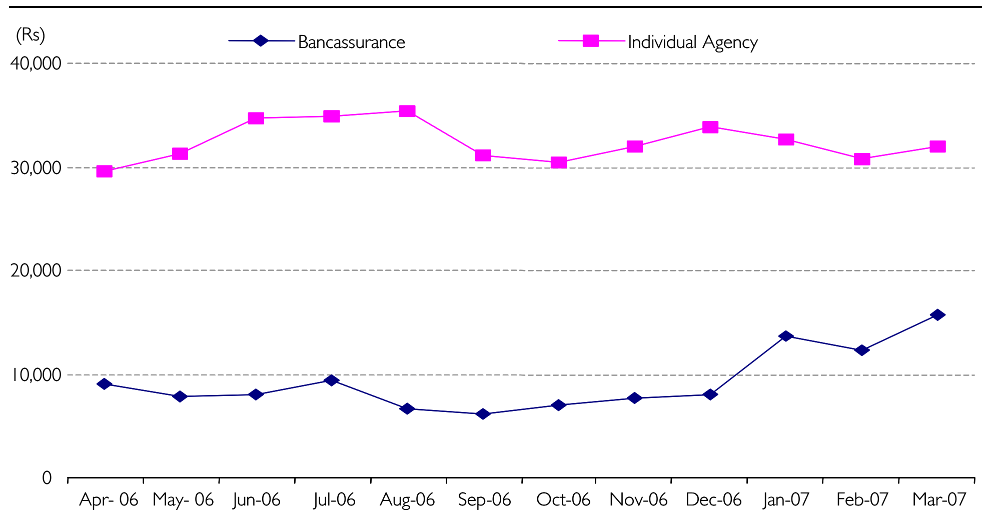
	Current	3 years ago	Remark
Bancassurance	39%	95%	-Currently selling 4,500 active SBI branches -Target to cover 14,000 SBI branches (100%)
Agency	45%	Nil	-Launched in 2005 -1,500 MDRT
Group corporates	17%	5%	-New decentralized structure with 16 corporate relationship managers divided across 8 regions -Access to SBI's 100 million accounts

Source: Company

Further, group corporates business is increasingly contributing to SBI-Life's topline with the decentralized structure (including 16 corporate relationship managers split across eight regions) and ready access to SBI's 100m accounts yielding results.

Annualized ticket size from agency business is ~Rs20,000 higher than bancassurance

Exhibit 3: Annualized ticket size



Source: Company

❑ Brand power – the premium resonance

A strong brand would facilitate customer acquisition in B and C towns and rural areas

SBI Group has accumulated premium brand value over its more than 200 years of existence in India's banking space. The strong SBI brand significantly augments SBI-Life's ability to acquire customers in 'B' and 'C' towns and rural areas on the back of the 'SBI trust' bandwagon. This becomes extremely crucial for growth when metros and 'A' towns saturate. Not having the same pan-India and premium brand resonance like SBI-Life, other competitors will require substantial efforts to make inroads into these hinterlands and capture mind share and market share.

COST-COMPETITIVENESS: A KEY DIFFERENTIATOR

The lower cost of acquisition with the strong bancassurance franchise and lower branding outlay compared to peers make SBI-Life's cost structure competitive. Unlike product variations which are soon replicated by competition, thereby eroding any exclusivity benefits to the innovator, the cost structure of SBI-Life is a sustainable competitive advantage based on strong underlying fundamentals (elaborated below). This cost structure is additional armour in SBI-Life's weaponry and has contributed to the expanding bottomline. Further, it will act as a shield if the industry landscape were to become aggressively competitive as in a price-war scenario.

❑ Lower infrastructure costs

Given parent's strong distribution network, SBI-Life has only 135 branches

SBI-Life, with access to SBI's 14,000 branches, does not need to set up a vast network of dedicated branches. Consequently, there were only 135 SBI-Life branches as on 31 March 2007, which is substantially lower than competitors.

❑ Lower employee costs

Despite majority of the sales being through bancassurance, only 6,117 bancassurance sales personnel are on SBI-Life's payroll. The remainder employee support and costs are borne by the parent, SBI. As of July 2007, SBI-Life has a total permanent headcount of 3,000.

❑ Corporate branding – a low cost-centre for SBI-Life

SBI-Life does not require investing heavily into corporate brand building

SBI-Life, as a subsidiary of SBI, does not have to invest heavily, unlike some of its competitors, into building a strong corporate brand image. Marketing efforts thus have to be largely limited to creating purchase consideration for specific products (e.g., the Old Boy campaign). All-in-all, this implies a smaller branding bill for SBI-Life, which augments its ability to offer competitive policy prices.

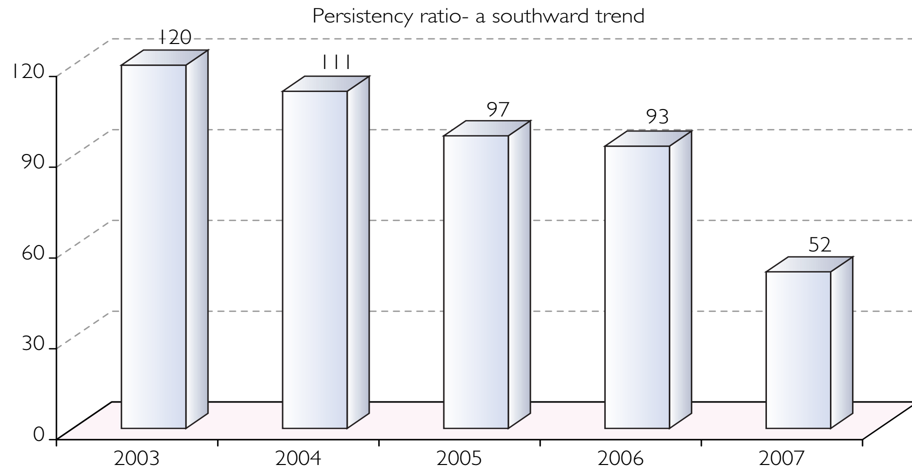
REALIGNING THE PRODUCT PORTFOLIO

❑ Persistency ratio – a setback in FY07

SBI-Life's persistency ratio, at 93% in FY06, was one of the best in the industry, but fell to 52% in FY07. The decline can be attributed to the fact that ULIP guidelines before July 2006 permitted writing short-term policies that did not require compulsory payment of the renewal premium, if the fund value was greater than Rs10,000. Therefore, SBI-Life received low renewal premium on its ULIP products in the last quarter of FY07, which led to the sharp decline in persistency ratio. However, we expect the trend to be corrected as regulation now prescribes a minimum duration of five years for ULIP products.

Declining persistency ratio due to earlier ULIP guidelines not requiring renewal premium payment for fund value of >Rs10,000

Exhibit 4: Persistency ratio – a southward trend



Source: Company, SSKI Research

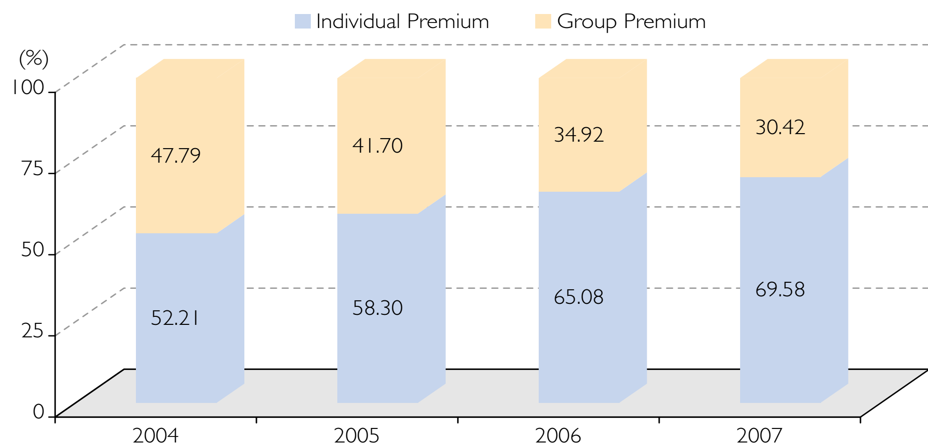
❑ Product portfolio

Individual vs. group premium – strengthening the margin profile

Individual premiums are evidenced to be increasingly contributing a larger percentage to gross premiums as against group premiums. With higher competition in the group space creating pressure on margins, this trend augurs well for the margin profile of the SBI-Life portfolio. However, group premium continues to be higher than that for competitors, which implies that the blended margin is lower for SBI-Life.

Higher proportion of individual premium augurs well for margins

Exhibit 5: Individual and group premium (% of GWP)



Source: IRDA

Single premium vs. regular premium – towards a healthier balance

Earlier, there was concern about SBI-Life's product portfolio being biased towards single premium products. But, this trend is consistently improving with single premium as a proportion of APE being 4% in FY07 against 74% in FY02. This translates into reduced volatility in the portfolio and better margins.

Single premium as a proportion of APE stands at 4% in FY07 against 74% in FY02

Exhibit 6: Ratio of APE

(%)	2002	2003	2004	2005	2006	2007
FYP	26	72	78	50	62	79
RP	0	3	14	39	33	17
SP	74	25	8	11	5	4
APE	100	100	100	100	100	100

Source: Company

ULIP products – better returns and lower solvency margin requirements

Rising share of ULIP implies higher margins and lower solvency margin requirements

SBI-Life was a late entrant in the ULIP space, but has ramped up significantly with the ULIP portfolio now accounting for 70% of total premiums. This indicates better margins and lower solvency margin requirements for SBI-Life. However, the contribution from traditional products continues to be relatively higher for SBI-Life with other key competitors having a ULIP component of 88-95% in their portfolios.

Exhibit 7: Features of sample UPLI policy

Company Name	SBI Life
Policy Type	Ulip Life
Policy name:	Unit Plus 2
Fund	Equity
Age	30 years
Premium	100
Sum assured	2000
Allocation Rate 1st	75%
Allocation Rate : 2nd and 3rd year	93%
Alocation rate:4th and 5th year	95%
Allocation rate: 6th year onwards	98%
Return assumed	12%
Mortality	As per LIC table applicable for Sum at Risk
Fund Management fees	1.50%
Operating expenses	2.88%
Inflation on expenses	2.00%
Mortality Spread	10%
Persistency	90%

Exhibit 8: NBAP MARGINS- SAMPLE ULIP POLICY (Rs)

Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Funds A/C															
Op Balance	0.0	77.6	172.1	267.1	365.6	466.6	573.0	684.0	800.7	924.3	1056.0	1197.2	1349.4	1514.1	1694.1
Addition															
Allocation	75.0	83.3	74.9	69.3	62.3	57.9	52.1	46.9	42.2	38.0	34.2	30.8	27.7	24.9	22.4
Investment Income	9.0	18.7	29.1	39.8	50.8	62.3	74.4	87.1	100.5	114.9	130.2	146.8	164.7	184.3	205.6
Expenses															
Mortality charge	2.2	2.2	2.1	2.1	2.1	2.1	2.1	2.0	2.0	1.9	1.8	1.5	1.2	0.0	0.0
Admin fees	2.9	2.6	2.7	2.8	2.8	2.9	2.9	3.0	3.0	3.1	3.2	3.2	3.3	3.4	3.4
Fund management fees	1.3	2.7	4.1	5.6	7.2	8.8	10.5	12.3	14.2	16.2	18.3	20.6	23.1	25.9	28.8
Closing Balance	77.6	172.1	267.1	365.6	466.6	573.0	684.0	800.7	924.3	1056.0	1197.2	1349.4	1514.1	1694.1	1889.9
Technical A/C															
Income															
Premium	100.0	90.0	81.0	72.9	65.6	59.0	53.1	47.8	43.0	38.7	34.9	31.4	28.2	25.4	22.9
Mortality fee	2.2	2.2	2.1	2.1	2.1	2.1	2.1	2.0	2.0	1.9	1.8	1.5	1.2	0.0	0.0
Admin fee	2.9	2.6	2.7	2.8	2.8	2.9	2.9	3.0	3.0	3.1	3.2	3.2	3.3	3.4	3.4
Fund Mangement fees	1.3	2.7	4.1	5.6	7.2	8.8	10.5	12.3	14.2	16.2	18.3	20.6	23.1	25.9	28.8
First year charge	0.0														
Total	106.4	97.5	90.0	83.4	77.7	72.8	68.6	65.1	62.2	59.9	58.1	56.7	55.8	54.6	55.1
Expenses															
Commission/Cost of Acqn	20.0	4.5	4.1	3.6	3.3	1.2	1.1	1.0	0.9	0.8	0.7	0.6	0.6	0.5	0.5
Allocation	75.0	83.3	74.9	69.3	62.3	57.9	52.1	46.9	42.2	38.0	34.2	30.8	27.7	24.9	22.4
Operating expenses	20.0	10.0	5.0	5.0	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Claims	2.0	2.0	1.9	1.9	1.9	1.9	1.9	1.8	1.8	1.7	1.6	1.4	1.1	0.0	0.0
Total	117.0	99.7	85.9	79.8	70.0	63.4	57.5	52.2	47.3	42.9	38.9	35.2	31.8	27.9	25.4
Profit/(loss)	(10.6)	(2.2)	4.1	3.6	7.7	9.4	11.1	13.0	14.9	16.9	19.1	21.5	24.0	26.7	29.8
Profit / (loss) post tax	(9.3)	(2.2)	3.5	3.6	6.7	8.2	9.7	11.3	13.0	14.7	16.7	18.7	20.9	23.2	25.9
PV – 10 yrs	19.3														
Margin (%)	19.3														

Source: SSKI Research

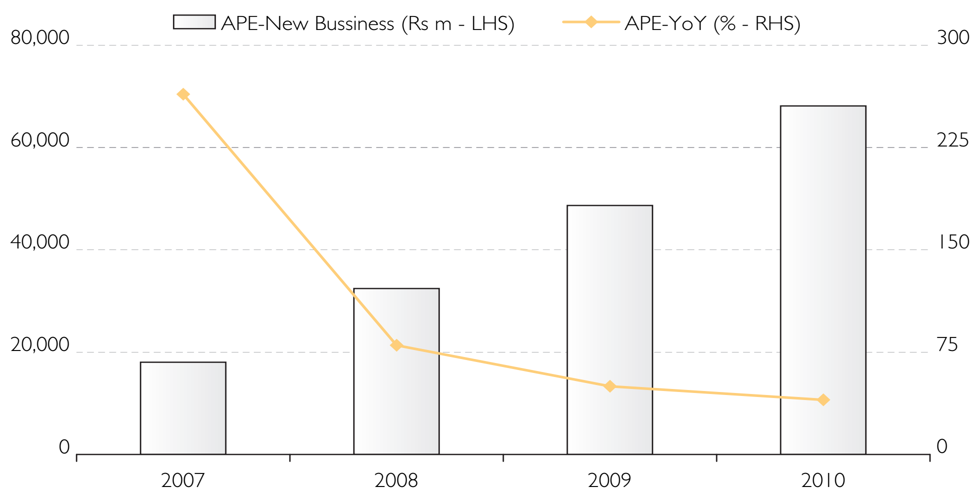
FUTURE OUTLOOK

❑ Growth in business

APE for new business at SBI-Life grew by 264%, against industry growth of 87%, in FY07

In FY07, APE for new business at SBI-Life grew by 264%, as against the industry growth of 87%. We expect this trend to persist given increasing strength of SBI's bancassurance franchise and benefits from the premium branding.

Exhibit 9: APE growth to continue beating industry average



Source: SSKI Research

❑ Assumptions on margins

Share of group business coming down; margins inching up

Though we have assumed historic margins of 17% for SBI-Life considering the higher share of low margin group business, we expect margins to inch upwards as the share of group business get replaced with higher margin individual ULIP policies pressure due to intensifying competition, and therefore have assumed margins of ~18% going forward (after factoring in the estimated product mix).

We have assumed margins of ~18% going forward

Exhibit 10: Business Mix

	2008	2009	2010
Margin (%)			
ULIP	19.5	19.0	19.0
Term	45	45	45
Group	8	8	8
Endowment	15	15	15
Product Mix (%)			
ULIP	75	78	78
Term	4	4	4
Group	20	18	15
Endowment	1%	0	3
	100	100	100
Weighted Average (%)	18.2	18.1	18.3

Source: SSKI Research

We value SBI-Life at Rs343 per share of SBI

❑ Valuations and view

We believe SBI-Life is well-positioned to grow above industry average on the back of its low expense ratio and minimal accumulated losses, and maintain its distinction as one of the few profitable insurers. We expect SBI-Life's NBAP to show a 48% CAGR over FY07-10 to reach Rs12.4bn by FY10. We have valued SBI-Life at 18x FY10E NBAP and added Embedded Value to arrive at a value of Rs343 per share of SBI.

Exhibit 11: Valuations (Rs mn)

	2004	2005	2006	2007	2008E	2009E	20010E
Opening Balance of Value in Force (VIF)	39	230	561	1,450	4,653	11,154	21,409
APE	1,122	1,827	4,947	18,022	32,440	48,660	68,124
NBAP Margins (%)	16.5	16.5	16.5	17	18.2	18.1	18.3
NBAP	185	301	816	3,014	5,896	8,805	12,446
In force unwinding (13%)	5	30	73	189	605	1,450	2,783
Estimated VIF at close of year	230	561	1,450	4,653	11,154	21,409	36,638
Shareholders Funds			4,408	4,906	6,906	8,906	10,906
Less: debit balance			(334)	(297)	(297)	(297)	(297)
Net			4,074	4,610	6,610	8,610	10,610
Embedded Value: {A}			**5,524**	**9,263**	**17,764**	**30,019**	**47,248**
Structural Value: {B}							
NBAP							12,446
Multiple							18
Value							224,034
Appraisal Value: {A} +{B}							**271,282**
Appraisal Value: {A} +{B} (in USD)							**6,617**
Value of SBI Stake (74%)							200,748
Less: 10% Holding company discount							20,075
Value of SBI Stake (74%)							180,674
No of shares							526
Value per share (Rs) of SBI							343

Source: Company, SSKI Research

Exhibit 12: Financial Summary (Rs million)

	2005	2006	2007	2008	2009	2010
FYP	1,491	4,577	17,176	31,143	46,714	65,399
RP	1,163	2,475	3,646	13,534	31,274	54,591
SP	3,358	3,701	8,463	12,976	19,464	27,250
GPI	6,012	10,753	29,285	57,653	97,452	147,240
Reinsurance	(19)	(22)	(50)	(49)	(48)	(47)
NPI	5,993	10,731	29,235	57,604	97,404	147,193
10% of SP	336	370	846	1,298	1,946	2,725
APE-New Buss	1,827	4,947	18,022	32,440	48,660	68,124
APE- Tot Buss	2,990	7,422	21,668	45,974	79,934	122,716
YoY growth (%)						
FYP	47	207	275	81	50	40
RP	525	113	47	271	131	75
SP	219	10	129	53	50	40
GPI	166	79	172	97	69	51
APE-New Buss	63	171	264	80	50	40
APE- Tot Buss	129	148	192	112	74	54
Persistency (%)	97	93	52	65	70	70

Source: Company, SSKI Research

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Company update

ICICI Lombard General Insurance

Pole Position

1 October 2007

BSE Sensex: 17291

ICICI Lombard is no exception to the ICICI growth style! Having turned profitable in the first year of operations, ICICI Lombard has emerged as the largest private sector player with a market share of 34.5% and growth above industry average. It is in a sweet spot to capitulate to the No. I position in the industry as it leverages the strength of its parent being the largest consumer asset financing company in the country in a business which is going retail. ICICI Lombard is a 74:26 joint venture between ICICI Bank and Fairfax Financial Holding of Canada. Applying the methodology of normalized earnings, we have valued ICICI Lombard at Rs 90.2bn, implying a value of Rs60/share of ICICI Bank which is an upgrade from our earlier valuation Rs13/share.

On course to be numero uno: ICICI Lombard has undertaken initiatives to capitalize on the vast potential of the retail segment which is set to gather pace. It has the backing of the country's dominant consumer financier which will enable it to capitalize on the opportunity gap resulting in overall market leadership.

Product innovation coupled with multi channel distribution - the key differentiators: ICICI Lombard has differentiated itself from other general insurers by offering innovative product variants to the retail and rural segments - future growth engines for the insurance industry. The effort to enhance product offering is across segments - health, home, motor and rural ICICI Lombard is aggressively scaling up the depth and width of the distribution network.

Strong growth in normalized earnings: We expect the ICICI Lombard to continue to grow above industry average (41% CAGR in GWP over FY07-10). Considering the combined ratio at 96%, we expect the normalized earning to grow at robust pace of 58% over FY07-10. We believe that a multiple of 20x is warranted for ICICI Lombard, as it will continue to occupy the top slot and is witnessing robust growth in normalized earnings. Applying the methodology of normalized earnings, we value ICICI Lombard at Rs90.2bn (20x FY10 normalized earnings), which implies a value of Rs60per share of ICICI Bank.

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Key financials

(Rs m)	2006	2007	2008	2009	2010
GWP	15,829	29,891	43,735	62,210	83,368
Combined ratio (%)	97	98	96	96	96
Normalised Earnings	724	1,141	2,028	3,066	4,511
yoy growth (%)		58	78	51	47
Multiple					20
Valuation					90,229
ICICI Stake (74%)					66,770
No of shares					1,108
Value per share of ICICI Bank					60

INVESTMENT ARGUMENT

ICICI Lombard, a 74:26 joint venture between ICICI Bank and Fairfax Financial Holding of Canada, is currently the largest private sector general insurer all set to takeover the No 1 slot from the incumbent PSUs. ICICI Lombard, like ICICI group's other businesses, has been growing significantly faster than the overall market on the back of a strong retail franchise. Besides market leadership in terms of premium income generation, the company has several firsts to its credit including introduction of weather insurance in the country, biometric smart cards for health insurance policyholders in rural India and development of an in-house team of surveyors in the motor insurance business. ICICI Lombard has been profitable from the first full year of operations. Applying the methodology of normalized earnings, we have valued ICICI Lombard at Rs90.2bn, which implies a value of Rs60per share of ICICI Bank.

ICICI LOMBARD: STRENGTHENING DOMINANCE

ICICI Lombard remains the largest private sector general insurance company in India with an overall 12% market share (in terms of GWP) and a 34.5% share of private sector insurance for April-July2007. It is the largest player in the industry in health and personal accident covers. In terms of business, the company is incrementally doing:

- ~25% of new cars insured
- 12% of the existing cars on road
- 20% of new two-wheelers insured
- 20% of health policies

Over the years, ICICI Lombard has consistently increased its market share by focusing on:

- Product innovation
- A rapid scale-up of distribution network
- High quality claims servicing, and
- Building annuity income streams from retail customers as also reducing dependence on the lumpy corporate business.

Exhibit 1: GWP growth for ICICI-Lombard

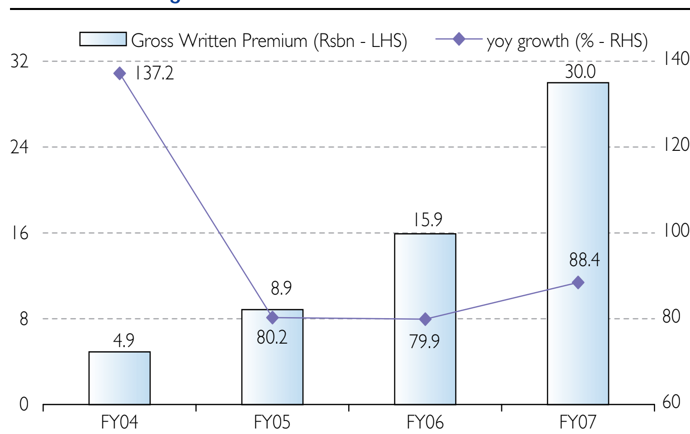
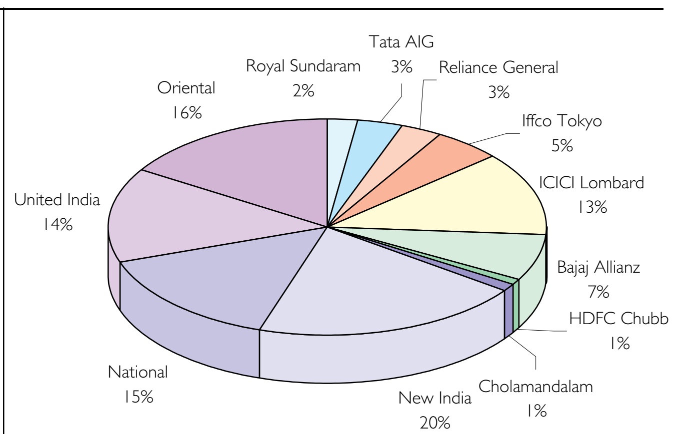


Exhibit 2: Market share of ICICI-Lombard



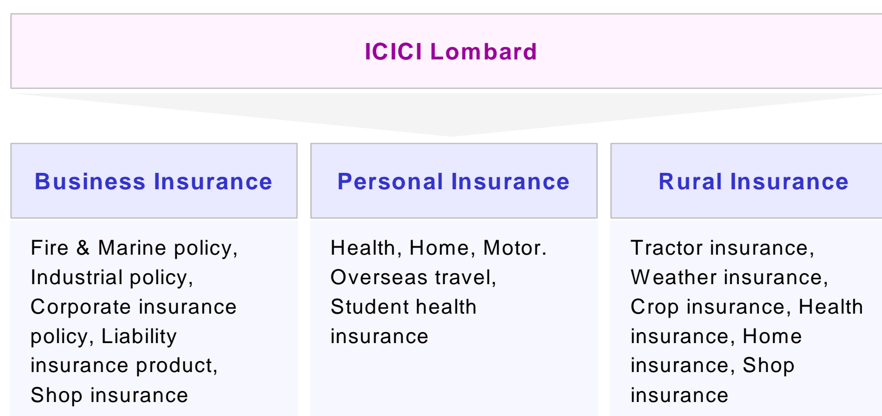
Source: IRDA

ICICI-Lombard pioneer of weather insurance and issuance of biometric cards for health insurance policyholders in India

❑ ICICI-Lombard – at the forefront of product innovation

ICICI-Lombard has developed a comprehensive product portfolio catering to both retail and corporate customers. Its product portfolio for the business segment consists of standard products such as fire and marine insurance, industrial insurance as also new products like liability insurance and key man insurance. Products catering to retail consumers include health, home, motor, overseas travel and student medical insurance. In the rural insurance space, ICICI-Lombard is the pioneer with innovations like weather insurance and issuance of biometric cards for health insurance policyholders to its credit.

Exhibit 3: ICICI Lombard – a comprehensive product portfolio



Source: Company

ICICI Lombard has rapidly scaled up its distribution network to ~220 branches…

❑ Rapid scale-up of distribution network

ICICI Lombard has rapidly scaled up its distribution footprint with a network of more than 220 branches. The company follows a multi-channel strategy to reduce dependence on a single channel and accelerate its growth momentum. While its own sales force, agents and brokers continue to bring in majority of the business, channels such as bancassurance, online marketing and telemarketing are also scaling up to become material contributors. In fact, these alternate channels generated 30-35% of the total business in FY07.

…and is increasingly adopting a multi-channel strategy

Exhibit 4: Multi-channel strategy

(nos)	Mar-2004	Mar-2007
Offices	74	220
Employees	561	4,770
Telecallers	-	1,250
Website	1	Multiple
Bancassurance	2 bank partners	5 bank partners
Agents, brokers and intermediaries	1,000	15,000

Source: Company

Leading state-owned companies were never keen on developing the retail model

❑ Thrust on building an annuity-based, retail-focused model

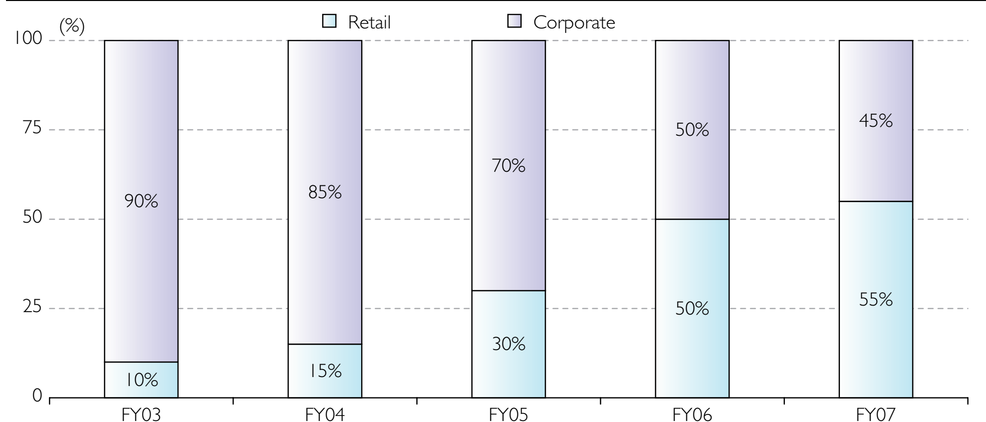
Till recently, leading state-owned general insurers were not very keen on developing the retail insurance model. These companies typically made losses in their core retail business (mainly motor insurance) with corporate business (fire and engineering) as the highest profit making segment. The trend can be attributed to the following factors:

- Third-party motor insurance was mandatory and rates for the same, governed by regulatory tariffs, were not enough to compensate the claims.
- Claims ratio in motor insurance is one of the highest. A high claims ratio, coupled with malpractices in loss estimation and overcharging by workshops in connivance with surveyors, meant that insurance companies could not make profits in motor insurance.
- On the other hand, tariffs for insurance policies against fire and engineering were kept high to cross-subsidize the losses suffered in motor insurance.

ICICI Lombard focused on developing a robust annuity-based retail-focused business model

On the contrary, private sector players have taken various initiatives such as developing a team of own valuers and tying up with automobile service stations to get better rates to generate operating efficiencies in high-claims categories like motor insurance. Since inception, ICICI Lombard too has focused on building a retail-focused and annuity-based business. Recognizing that the corporate business is lumpy (and highly volatile) in terms of premium income generation as also crystallization of claims, and that intense competition more often than not shifts bargaining power in the hands of corporates, ICICI Lombard has been focused on developing a robust annuity-based, retail-focused business model.

Exhibit 5: Building a retail-focused business model



Source: Company

ICICI-Lombard deals with only S&P A-rated companies for reinsurance

❑ Reinsurance strategy driven by risk perception of the category

ICICI Lombard follows a judicious strategy of reinsuring the risks depending on its perception of risk in the product category and ability to withstand losses arising out of claims from a particular product category. For example, whereas it typically reinsures ~70% of the value of the underlying asset in corporate products (like fire and engineering), only the mandatory 20% and 80% of the risk standing on its own books is reinsured in retail product categories. At company level, ~50% of risks are reinsured. The company has an internal policy of not going below S&P A-rated reinsurance companies. It has some of the top-rated companies like Swiss Re (AA rated), Hanover Re (AA), Coface (AA) and Odyssey Re (A) as reinsurance partners.

FUTURE OUTLOOK

We expect ICICI Lombard to number No 1 in the overall industry. We estimate the company's market share to scale up from 12% in the first four months of FY08 to 18% by FY10. We expect ICICI Lombard to deliver a CAGR of 41% over FY07-10.

Exhibit 6: Estimated market share of general insurers

Name of General Insurance	Mar-10	Mar-09	Mar-08	Mar-07	Mar-06	FY 2005
Market Share (%)						
RGL	14	11	8	4	1	1
ICICI-Lombard	18	17	14	12	8	5
Other private	23	21	20	19	18	15
Private	55	49	42	34	26	21
Public	45	51	58	66	74	79

Source: IRDA, SSKI Research

❑ GWP – above industry growth rates

General insurance business set to register 41% CAGR in GWP

Driven by strong growth in the motor and health insurance business, we expect ICICI Lombard to record a CAGR of 41% over FY07-10 in gross written premium. The company will reap the benefits of its aggressive distribution ramp up and leverage the strong brand of the group. The share of miscellaneous business is expected to increase from 82% in FY07 to 86% in FY10.

Exhibit 7: Business traction

Total	2005	2006	2007	2008	2009	2010
GWP (Rs m)	8,739	15,829	29,891	43,735	62,210	83,368
yoy growth (%)		81.1	88.8	46.3	42.2	34.0

Source: Company, SSKI Research

Exhibit 8: Gross Written Premium : Business mix

Business Mix (%)	2005	2006	2007	2008	2009	2010
GWP						
Fire	31.7	19.5	13.2	11.3	9.9	9.2
Marine	9.4	5.4	5.2	5.1	4.8	4.8
Misc	58.8	75.1	81.6	83.7	85.3	85.9
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Company, SSKI Research

❑ Reinsurance proportion to fall with higher share of retail business

Higher share of retail business retained vis-à-vis the corporate business

As the share of retail business increases in the overall revenue profile, the risk retained with ICICI Lombard will go up as it retains a higher share of the retail business as compared to corporate business.

Exhibit 9: Reinsurance as a % of GWP

Business Mix	2005	2006	2007	2008	2009	2010
Reinsurance as % of GWP						
Fire	87.1	89.5	85.8	85.0	85.0	85.0
Marine	79.8	90.7	89.6	85.0	85.0	85.0
Misc	49.9	42.4	44.1	38.0	37.0	36.0
Total	64.6	54.2	51.9	45.7	44.1	42.9

Source: Company, SSKI Research

Higher share of miscellaneous business to offset higher claims in fire business

❑ Claims ratio likely to be stable, in line with business mix

ICICI Lombard recorded a significantly high claims ratio (claims as a percent of NWP) of 48% in FY06 owing to natural calamities like Mumbai floods, Gujarat floods and the J&K earthquake hitting business of general insurers. However, claims ratio is expected to be stable with the share of miscellaneous business going up which would compensate for the increase in claims on the fire business.

Exhibit 10: Claims as per cent of NWP

Business Mix	2005	2006	2007	2008	2009	2010
Claims as % of NWP						
Fire	33.8	47.7	38.0	42.0	40.0	40.0
Marine	126.7	253.5	71.2	67.5	67.5	65.0
Misc	45.6	51.0	56.8	56.5	57.3	56.9
Total	48.2	53.0	56.1	56.1	56.9	56.6

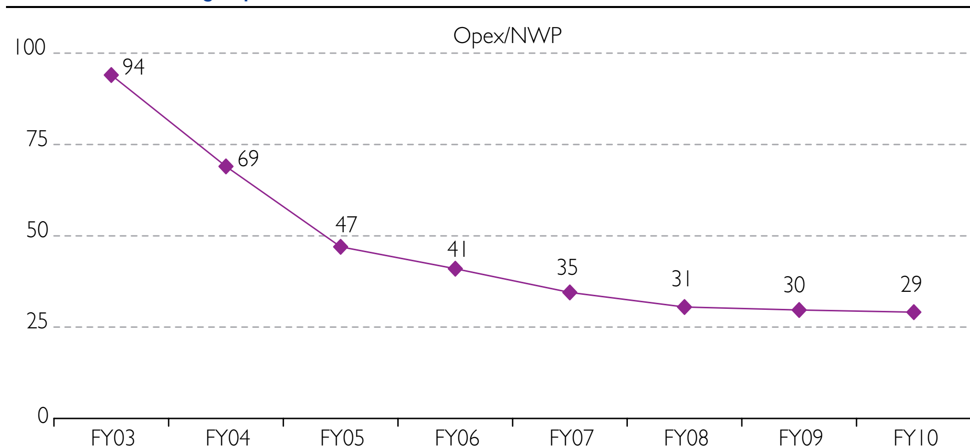
Source: Company, SSKI Research

❑ Improving operating efficiencies driven by economies of scale

Expense ratio down from 55% in FY05 to 36% in FY07, expected to fall further to 29% by FY10

ICICI Lombard has been improving upon its operating efficiencies over the years and its expense ratio (operating expenses as a percent of net written premium) has declined from 55% in FY05 to 36% in FY07. The decline has been driven by economies of scale and aggressive use of technology in the areas of origination, customer service and claims processing. Going forward, we expect the ratio to further improve to 29% by FY10.

Exhibit 11: Declining expense ratio



Source: Company, SSKI Research

VALUATION OF ICICI LOMBARD

Applying the methodology of normalized earnings, we value ICICI Lombard at Rs90.2bn, which implies a value of Rs60per share of ICICI Bank.

❑ Combined ratio

We have assumed a combined ratio of 96% for FY10 on the basis of ICICI Lombard's business mix and higher claims ratio.

Exhibit 12: Combined ratio

Total	2005	2006	2007	2008	2009	2010
Loss ratio :(Claims /Total premium earned)	72	74	76	74	74	73
Commission ratio (net): (Commision/Net premium)	(28)	(17)	(13)	(8)	(7)	(7)
Opex ratio(net) : Opex/Net premium	46	41	34	31	30	29
Combined Ratio: (a+b+c)	90	97	98	96	96	96

Source: SSKI Research

❑ Investment return

We have used a yield of 8-8.5% to calculate the investment return.

Exhibit 13: Investment income

Total	2005	2006	2007	2008	2009	2010
NWP	3,209	7,339	14,508	23,877	34,949	47,791
Average		52,748	10,923	19,193	29,413	41,370
Mutliply		1.24	1.18	1.25	1.30	1.33
Investments		9,065	17,105	29,847	45,434	63,323
Avg investment			13,085	23,476	37,640	54,378
Investment Income		516	1,348	2,113	3,199	4,622
Yield (%)		5.7	7.9	8.3	8.3	8.3

Source: Company, SSKI Research

A multiple of 20 warranted for the Leader

The addition of combined ratio and investment return would lead to calculation of normalized earnings. We believe that a multiple of 20x is warranted for ICICI Lombard, as it will continue to occupy the top slot and is witnessing robust growth in normalized earnings. Applying the methodology of normalized earnings, we value ICICI Lombard at Rs90.2bn, which implies a value of Rs60per share of ICICI Bank.

Exhibit 14: Normalized earnings

	2006	2007	2008	2009	2010
Normalised Earnings	724	1,141	2028	3,066	4,511
Multiple					20
Valuation					90,229
ICICI Stake (74%)					66,770
No of shares					1,108
Value per share of ICICI Bank					60

Source: Company, SSKI Research

Exhibit 15: Summarized financials

Total (Rs m)	2005	2006	2007	2008	2009	2010
GWP	8,739	15,829	29,891	43,735	62,210	83,368
yoy growth (%)		81.1	88.8	46.3	42.2	34.0
Less: Reinsurance ceded	5,643	8,581	15,527	19,973	27,405	35,757
% of GWP	64.6	54.2	51.9	45.7	44.1	42.9
Net premium	3,209	7,339	14,508	23,877	34,949	47,791
% of GWP	36.7	46.4	48.5	54.6	56.2	57.3
adjust for change in reserve for unexpired risks	(1,053)	(2,062)	(3,841)	(5,688)	(7,903)	(10,868)
% of GWP	(12.0)	(13.0)	(12.9)	(13.0)	(12.7)	(13.0)
Total premium earned	2,156	5,277	10,667	18,189	27,046	36,923
% of NWP	67	72	74	76	77	77
Claims	1,548	3,893	8,138	13,395	19,880	27,028
% of NWP	48.2	53.0	56.1	56.1	56.9	56.6
Commision (net)	(893)	(1,257)	(1,905)	(1,931)	(2,542)	(3,249)
% of NWP	(27.8)	(17.1)	(13.1)	(8.1)	(7.3)	(6.8)
Opex	1,474	2,983	4,987	7,310	10,426	13,946
% of NWP	45.9	40.6	34.4	30.6	29.8	29.2
Loss ratio :(Claims /Total premium earned) (%)	72	74	76	74	74	73
Commission ratio (net): (Commision/Net premium) (%)	(28)	(17)	(13)	(8)	(7)	(7)
Opex ratio(net) : Opex/Net premium (%)	46	41	34	31	30	29
Combined Ratio: (a+b+c) (%)	90	97	98	96	96	96
Underwriting surplus: (100%- Combined ratio) (%)	10	3	2	4	4	4
Underwrting surplus : (Surplus*Net premium)	324.1	199.7	355.9	913.9	1,376.9	2,111.4
Investment Income	309.7	880.8	1,347.7	2,112.8	3,199.4	4,622.2
PBT	618.9	1,080.5	1,703.7	3,026.7	4,576.3	6,733.5
Tax	204.3	356.6	562.2	998.8	1,510.2	2,222.1
PAT	414.7	724.0	1,141.4	2,027.9	3,066.1	4,511.5

Source: Company, SSKI Research

Company update

1 October 2007

BSE Sensex: 17291

Reliance General Insurance

Charging ahead

Reliance General Insurance (RGI) - a wholly-owned subsidiary of Reliance Capital - is racing up the ladder! Despite its focus on underwriting group businesses before reorganization in June 2005, the company is well positioned to capture a higher share of the lucrative retail insurance segments. This transformation has been achieved with substantial investment in scaling the distribution franchise and by developing a diversified retail portfolio. Retail business generates annuity income streams, and acts as a hedge against clustered revenues from the corporate portfolio. Extrapolating the high growth trajectory, we expect RGI to register 90% CAGR in GWP over FY07-10 emerging as one of the top three general insurance companies in India. Using the normalized earnings method, we have valued RGI at Rs70.7bn (20x FY10 normalised earnings), i.e. Rs287 per share of Reliance Capital.

Building a strong distribution muscle: RGI is leaving no stone unturned for capturing incremental market share in the general insurance space. The company has grown exponentially across distribution channels. As RGI continues to leverage the 50m group customer base and spread wings to rural areas, we expect intermediaries to increase to 30,000 in FY10 (18,300 in FY07). A direct fall-out of this expanding distribution machinery is reflected in a 462% increment in GWP in FY07 and consistent market share gains (current market share -7%).

Retail is the way forward: With higher competition, volatility and margin pressure in the corporate arena, RGI is strategically moving towards the retail segment. The stable retail income stream has contributed a significant 55% to revenues in FY07 as against 10% in FY04. The focus on the annuity motor and health insurance businesses is set to grow further as the company would also benefit from groups foray in the consumer finance business. RGI has a broad-based product portfolio with offerings across segments including home, property, auto, travel, commercial insurance and other specialty insurance products.

Earnings set to multiply: We expect RGI to continue to be the fastest growing company in the space with GWP CAGR of 90% over FY07-10. With combined ratio settling at 96%, normalized earnings are set to multiply 7x over the next 3 years. Applying the methodology of normalized earnings, we value RGI Insurance at Rs70.7bn, which implies a value of Rs287 per share of Reliance Capital. Considering the current run-rate in the growth we believe that there could an upside to our growth estimate.

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Key financials

Year to March 31 (Rs m)	FY06	FY07	FY08	FY09E	FY10E
GWP	1,623	9,122	23,787	41,527	62,190
Combined Ratio (%)	88	91	95	96	96
Normalised Earnings	148	522	1,210	2,147	3,535
yoy growth (%)		253	132	77	65
Multiple (x)					20
Valuation					70,705
Value per share of Reliance Capital					287

Source:SSKI Research

GENERAL INSURANCE: SERIOUS SCALE

Reliance General Insurance (RGI), a 100% subsidiary of Reliance Capital (RCL) is the fastest growing general insurance company in India (462% yoy growth in GWP in FY07). The company is consistently moving up on the ranking charts. The rapid traction in business has come on the back of a comprehensive product bouquet, aggressive distribution ramp up and thrust on a retail-focused model. We expect RGI to emerge as one of the top three general insurance companies in India. Applying the methodology of normalized earnings, we have valued RGI at Rs70.7bn, which contributes Rs287 per share of RCL.

❑ Fastest growing insurance company

India's only 100% owned private sector insurance company

RGI, a 100% subsidiary of RCL, is the fastest growing general insurance company in India with 462% yoy growth in GWP in FY07. It is rapidly moving up the ranking charts and currently occupies the number two slot in the private sector (number five position a year ago). In the current fiscal, while industry players have generally witnessed a slow down or even negative growth as they are reeling under pressure from de-tariffing, RGI continues to grow at a scorching pace (~200% yoy growth in GWP over April-July 2007). Contrary to the perception that the corporate portfolio would have formed a bigger chunk of the business, RGI has managed to mobilize almost 50% of the business from its retail exposure. The company's recently launched health insurance policy has done well and 40% of the total premium has come from the motor insurance segment. The fast pace of growth can be attributed to the following:

Lapping up market share gains along the way

- Comprehensive product offering
- Aggressive distribution ramp up
- Going retail

Exhibit 1: RGI's share in private market

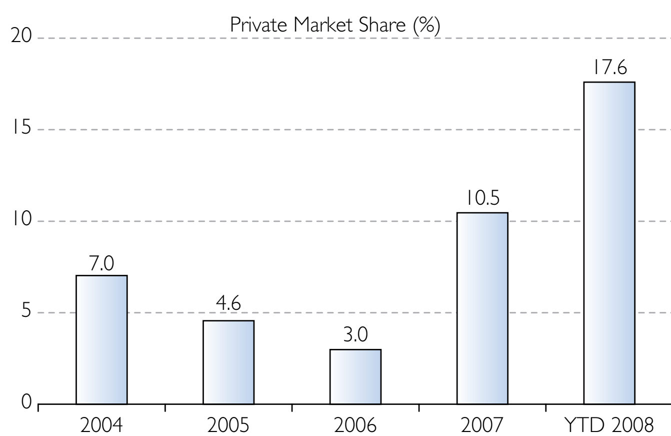
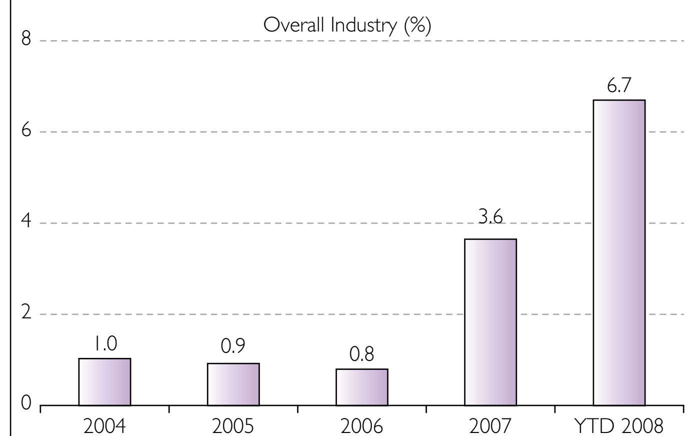


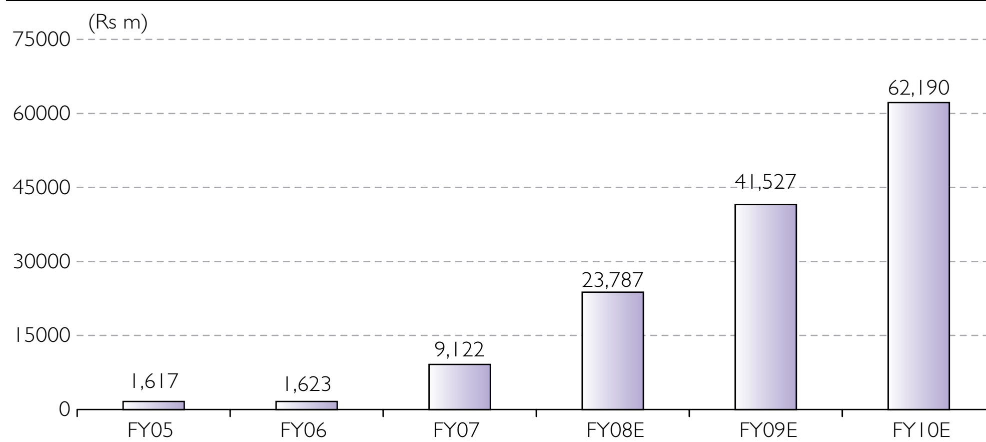
Exhibit 2: RGI's share in overall industry



Source: IRDA, SSKI Research

GWP expected to clock CAGR of 90% over FY07-10

Exhibit 3: RGI – GWP expected to jump year after year

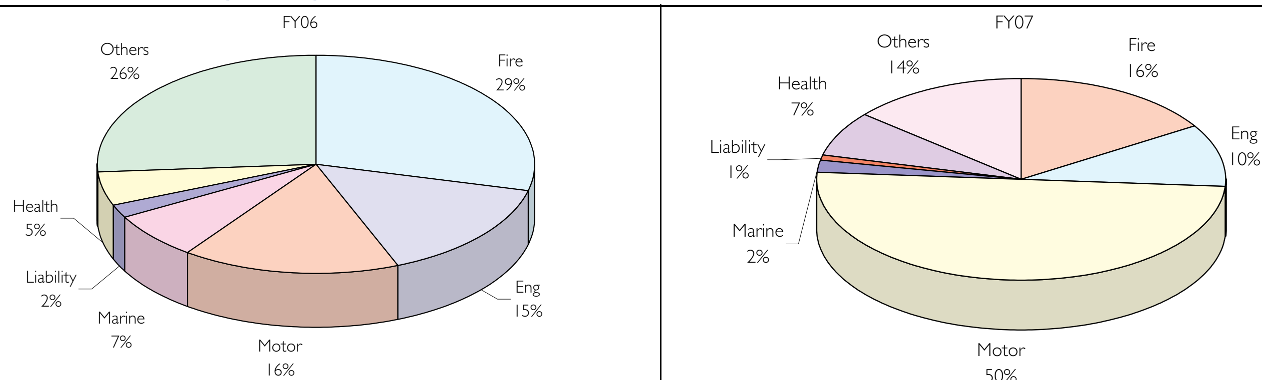


Source: Company, SSKI Research

❑ A comprehensive product bouquet

RGI offers a comprehensive product portfolio encompassing home, property, auto, travel, marine, commercial insurance and other specialty insurance products. Notably, the business mix has undergone a radical shift over the last year. From a corporate-heavy portfolio tilted towards fire, engineering and marine products, the company has shifted focus to retail products like motor and health insurance.

Exhibit 4: A diversified product portfolio



Source: Company

Motor insurance is the most profitable segment in the insurance space. Within motor insurance, RGI has stayed away from the business of insuring commercial vehicles which is plagued by high "third party" claims.

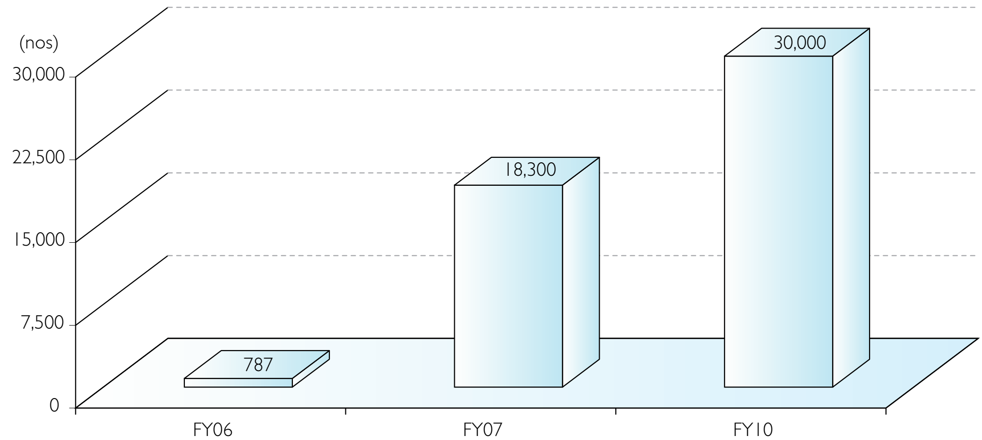
The vast client base of group companies can be leveraged for beefing up distribution network

❑ Aggressive ramp up in distribution network

The aggressive expansion undertaken in the distribution network over the last 18 months (85 branches currently) has been one of the key contributors to the rapid growth of RCL's insurance business. The number of intermediaries (including direct agents, dealers, etc) associated with the business has jumped from 787 in FY06 to 18,300 in FY07. Going forward, the company is expected to continue leveraging the vast client base of group companies (~50m customers). Increasing rural business and better awareness about insurance products would lead to further expansion in the distribution network. We expect RGI's distribution network to attain a reach of around 30,000 intermediaries by FY10.

Number of intermediaries expected to increase from 787 in FY06 to 30,000 by FY10

Exhibit 5: Growth in intermediaries (FY10E)



Source: Company

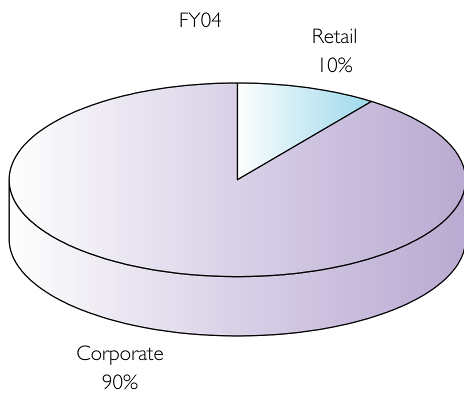
RGI shifting away from the lumpy and competitive corporate business in favour of retail segment

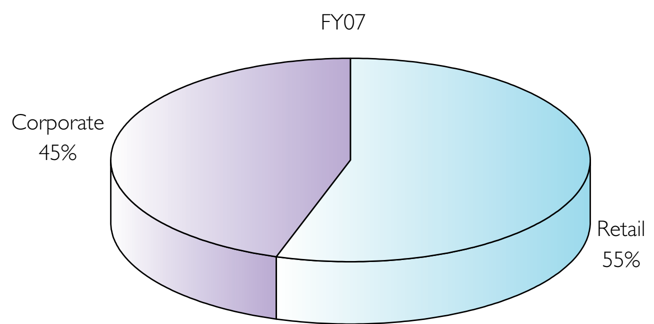
Going retail

Prior to reorganization of the business in June 2005, RGI used to primarily underwrite for the Reliance group, and hence business growth was subdued. However, post the reorganization, general insurance business received a renewed thrust with retail business being the key growth vehicle.

RGI has adopted a strategy of shifting away from corporate business, which is lumpy and highly volatile in terms of both premium income generation and crystallization of claims. Also, the corporate market is highly competitive and bargaining power, more often than not, lies with the corporate rather than the insurance company. Going forward, retail business is expected to further gain momentum owing to the significant opportunity available in the market.

Exhibit 6: Business mix shifting to retail





Source: Company

RGI sees ample scope to capitalize on the market opportunity in retail motor insurance

❑ Capitalizing on the gap

Motor insurance, which is one of the most attractive retail segments, is well-penetrated. Nevertheless, it offers tremendous scope for market share swings. The state-owned insurance companies suffered in the segment due to a high claims ratio, coupled with malpractices in loss estimation and overcharging by workshops in connivance with surveyors. Hence, leading state-owned general insurers were never keen on developing the retail insurance model.

Notably, besides ICICI Lombard and Bajaj Allianz, there are hardly any serious players in the space. This leaves ample scope for RGI to capitalize on the market opportunity.

FUTURE OUTLOOK

We expect RGI to remain one of the top three general insurance companies in India. We estimate the company's market share to scale up from 7% in the first four months of FY08 to 13-14% by FY10. We believe that after registering a stupendous growth of 462% in FY07, the company is on track to post a CAGR of 90% over FY07-10.

Exhibit 7: Future industry scenario

Name of General Insurance	Mar-10	Mar-09	Mar-08	Mar-07	Mar-06
Market Share (%)					
RGL	14	11	8	4	1
ICICI-Lombard	18	17	14	12	8
Other private	23	21	20	19	18
Private	55	49	42	34	26
Public	45	51	58	66	74

Source: IRDA, SSKI Research

General insurance business set to register 90% CAGR in GWP

❑ Growth in GWP – above industry average

Driven by strong growth in the motor and health insurance business, we expect RGI to record a CAGR of 90% over FY07-10 in GWP. This would be achieved on the back of aggressive distribution ramp up and as the company leverages the group's existing customer bank. The share of miscellaneous business is expected to increase from 82% in FY07 to 87% in FY10.

Exhibit 8: Business traction

(Rs m)	FY06	FY07	FY08E	FY09E	FY10E
GWP	1,623	9,122	23,787	41,527	62,190
yoy growth (%)	*0.4*	*462.0*	*160.8*	*74.6*	*49.8*

Source: Company, SSKI Research

Exhibit 9: GWP – business mix

(%)	FY07	FY08E	FY09E	FY10E
Fire	16.0	12.3	12.3	12.3
Marine	2.0	1.2	1.0	0.8
Misc	82.1	86.5	86.7	86.9
Total	**100.0**	**100.0**	**100.0**	**100.0**

Source: Company, SSKI Research

Higher share of retail business retained vis-à-vis the corporate business

❑ Reinsurance proportion to fall with higher share of retail business

As the share of retail business increases in the overall revenue profile, the risk retained with RGI will go up as it retains a higher share of the retail business compared to corporate business. The company, as a policy, retains the maximum permissible risk with itself in the motor insurance business.

Exhibit 10: Reinsurance as a per cent of GWP

(%)	FY07	FY08E	FY09E	FY10E
Fire	78.0	80.0	80.0	80.0
Marine	50.1	50.0	50.0	50.0
Misc	38.4	37.0	34.7	30.8
Total	**45.0**	**42.4**	**40.4**	**37.0**

Source: Company, SSKI Research

We have factored in a higher claims ratio due to cyclicality of business and high growth traction

❑ Claims ratio likely to increase in line with business mix

RGI recorded a significantly low claims ratio (claims as a percent of NWP) of 34% in FY07 owing to a significant increase in the miscellaneous business where claims ratio is lower. Claims ratio is set to further improve with the share of miscellaneous business going up. However, we have increased the claims ratio to factor in the cyclicality in the business and adjust for the high growth traction.

Exhibit 11: Claims as % of NWP

Business mix (%)	FY07	FY08E	FY09E	FY10E
Fire	52.6	60.0	60.0	60.0
Marine	65.3	65.0	65.0	65.0
Misc	32.4	31.7	31.9	31.7
Total	**34.3**	**33.3**	**33.4**	**33.1**

Source: Company, SSKI Research

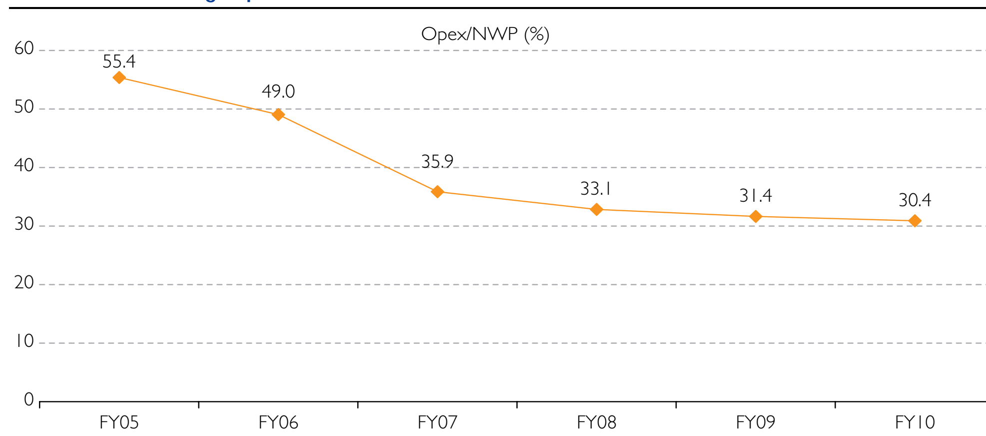
Expense ratio, down from 55% in FY05 to 36% in FY07, expected to fall to 31% by FY10

❑ Improving operating efficiencies driven by economies of scale

RGI has been improving upon its operating efficiencies over the years and its expense ratio (operating expenses as a percent of net written premium) has declined from 55% in FY05 to 36% in FY07. The decline has been driven by economies of scale and aggressive use of technology in the areas of origination, customer service and claims processing. Going forward, we expect the ratio to further improve to 31% by FY10.

A declining expense ratio – improving operating efficiencies

Exhibit 12: Declining expense ratio



Source: Company, SSKI Research

WE VALUE RGI AT RS287 OF RELIANCE CAPITAL

Applying the methodology of normalized earnings, we value RGI Insurance at Rs70.7bn, which implies a value of Rs287 per share of Reliance Capital.

Combined ratio

We have assumed a combined ratio of 96% for FY10 considering RGI's business mix and higher claims ratio.

We have assumed a combined ratio of 96% for FY10

Exhibit 13: Combined ratio

(%)	FY07	FY08E	FY09E	FY10E
Loss ratio :(Claims /Total premium earned)	71	72	73	73
Commission ratio (net): (Commission/Net premium)	(16)	(11)	(9)	(8)
Opex ratio(net) : Opex/Net premium	36	33	31	30
Combined Ratio: (a+b+c)	**91**	**95**	**96**	**96**

Source: SSKI Research

Investment return

We have used a yield of 8-8.5% to calculate the investment return.

Exhibit 14: Investment income

(Rs m)	FY07	FY08E	FY09E	FY10E
NWP	5,043	13,732	24,805	39,276
Multiply (x)	1.3	1.3	1.3	1.4
Investments	6,332	17,851	32,247	53,023
Avg investment	4,262	12,091	25,049	42,635
Investment Income	327	1,088	2,129	3,624
Yield (%)	5.2	8.5	8.5	8.5

Source: Company, SSKI Research

A multiple of 20 warranted for the fastest growing general insurance company

The addition of combined ratio and investment return will lead to calculation of normalized earnings. We believe that a multiple of 20x is warranted for RGI, as it is the fastest growing general insurance business and is witnessing robust growth in normalized earnings. Applying the methodology of normalized earnings, we value RGI at Rs70.7bn, which implies a value of Rs287 per share.

Exhibit 15: Normalized earnings

(Rs m)	FY09E	FY10E
Normalized earnings	2,147	3,535
Multiple (x)		20
Valuation		70,705
No of shares (m)		246
Value per share (Rs)		287

Source: Company, SSKI Research

Exhibit 16: Summarized financials

(Rs m)	FY06	FY07	FY08E	FY09E	FY10E
GWP	1,623	9,122	23,787	41,527	62,190
yoy growth (%)	*0.4*	*462.0*	*160.8*	*74.6*	*49.8*
Add: reinsurance accepted	25	22	38	66	99
yoy growth (%)	*(39.8)*	*(11.5)*	*73.0*	*75.0*	*50.0*
Less: Reinsurance ceded	1,093	4,101	10,093	16,788	23,013
% of GWP	67.3	45.0	42.4	40.4	37.0
Net premium	555	5,043	13,732	24,806	39,276
yoy growth (%)	*(10.4)*	*808.0*	*172.3*	*80.6*	*58.3*
adjust for change in reserve for unexpired risks	(16)	(2,601)	(7,423)	(13,501)	(21,541)
Total premium earned	**540**	**2,443**	**6,309**	**11,304**	**17,735**
yoy growth (%)	*12.4*	*352.5*	*158.3*	*79.2*	*56.9*
Claims	344	1,732	4,573	8,279	12,987
Commission (net)	(140)	(794)	(1,487)	(2,240)	(3,077)
Opex	272	1,809	4,547	7,801	11,940
Loss ratio: (Claims /Total premium earned - %)	64	71	72	73	73
Commission ratio (net): (Commission/Net premium - %)	(25)	(16)	(11)	(9)	(8)
Opex ratio (net) : Opex/Net premium (%)	49	36	33	31	30
Combined Ratio: (a+b+c) (%)	**88**	**91**	**95**	**96**	**96**
Underwriting surplus: (100%- Combined ratio - %)	12	9	5	4	4
Underwriting surplus: (Surplus*Net premium)	68	453	718	1,076	1,653
Add:					
Investment Income		327	1,088	2,129	3,624
PBT	221	779	1,806	3,205	5,277
Tax	73	257	596	1,058	1,741
PAT	**148**	**522**	**1,210**	**2,148**	**3,535**

Source: Company, SSKI Research

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