April

2020

SBI Life

HDFC Life

Max Fin. Services

ICICI Pru

LIC

Sector Primer: Indian Life Insurance

Success is in Scalability

By Prudvi Raj Saya, CA

This is a primer note on the Indian Life Insurance sector, with a focus on the four listed life insurers. The report delves on the life insurance market dynamics, competitive positions of the listed insurers as well as their the market valuations and business fundamentals. The various challenges faced by the industry as well as company-specific situations are analysed in detail.

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Sector Primer: Indian Life Insurance

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Executive Summary

Indian Life Insurance market is an oligopoly. The big five insurers together command ~85% of life insurance sales in the country. By nature in this industry, bigger is better. The biggest of the five, LIC, is a PSU and is the only one not listed. The other four are all privately owned and listed. We will focus our report on the analysis of business, as well as market valuations, of these four private insurers viz. HDFC Life, ICICI Prudential, SBI Life and Max Financial Services.

Bancassurance – cross-selling insurance to bank customers of partner banks – is the key to being a leader in the life insurance business. This is because insurance is essentially a push-product - larger the accessible pool of customers, bank branches and sale agents, larger the scalability for business volumes. Also important is the brand recall and trust. The four listed players lead the private market in these aspects with the biggest banks backing their name. Among the four, SBI Life is the runaway leader in distribution with the massive SBI machine at its disposal.

When it comes to profitability, Value of New Business (VNB) – the industry metric used to measure profits - is maximized when the product portfolio is geared towards a higher-margin protection business. HDFC Life has the most balanced mix of all the insurers in India, thanks to large volumes of credit life-protect policies it sells through its primary bank HDFC Bank. Consequently, it leads peers in terms of VNB margins. It has earned a reputation for a razor-sharp focus on driving profitability, much like its bank partner. The premium valuation that its equity fetches in the market is a testament to this fact.

Max Life (the operating subsidiary of Max Financial) used its long-lasting tie-up with Axis Bank, the third-largest private lender in India, to become the smallest among the big four - not a small achievement. Its product portfolio and business efficiency is nothing to be shy of, even leading the market in few aspects like its participating products, but the thorn in its shoes hurting the valuations has been its shaky relationship Axis bank which is not happy with earning only the commissions. Talks are on-going for an equity deal and depending on how smoothly the differences are sorted, Max Financial is indeed a “double your money” bet.

ICICI Pru has the advantage of calling on its parent banks’ wealthy clientele to push its equity heavy funds, though the business is cyclical. It has been pushing on protection mix like all others as well, but it has been doing so at the cost of overall growth, something that the market is not exactly appreciating.

All in all, we come back to SBI Life and its humongous banking network across the breadth of the country – if it can tap into the massive protection-gap in (semi) rural areas using this scalability – it can be an undisputed market leader over the next decade. Add the market-leading efficiencies and customer-centricity and we have a multi-decade compounder on hand, not unlike the story of HDFC Bank (notwithstanding HDFC Life itself)

Company-specific potential aside, the industry itself is facing down a double whammy with changing tax regime as well as the proposed listing of the mother of all life insurers – LIC, not to mention *the* virus.

Tax changes are decidedly negative with Budget 2020 taking away certain incentives on insurance investments. It is not the end of the world but the grapevine is that the government will continue down this policy path and if it does, things will only get much worse from the tax-advantage angle that ULIP salesmen thrive upon.

LIC's IPO may not have a direct impact on the big four private guys who are already much more efficient. However, the chunk of DII/ FII money allocated to the niche Insurance corner may feel crowded with more market cap in play for essentially the same bet, impacting the valuations in near-term.

Finally, the world itself has gone upside down due to COVID-19 and insurance is taking the beating in the short run along with everyone else. However, once the storm passes, people may wise up to the need for insurance and create the momentum needed to the bridge the protection-gap in India compared to comparable countries. Who knows, this may even have been for the greater good!

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Introduction

There are four listed life insurers in India - HDFC Life, SBI Life, ICICI Prudential and Max Financial. These are four of the big five in the country's life insurance sector. The biggest of them all, the fifth one, is Life Insurance Corporation (LIC).

In this report, we will evaluate the listed life insurers through the lens of fundamental business metrics that matter most.

We will start by looking the recent valuations that Mr Market deems fit to appropriate to each of them, with an analysis of reasons for such pricing as well as what this implies in terms of growth and investor sentiment towards these stocks (HDFC Life) or the lack thereof (Max Life).

With the market context in place, we will dig into more fundamental factors which reveal the inherent strengths and weakness of their businesses along with the path that the managements are taking to achieve stated objectives in terms of growth in volumes as well as profitability. VNB (both the growth and margins thereof), as we will see, is the EPS equivalent for a life insurance company – it is the unit of measurement that investors use to gauge the profitability of the business. So all the business metrics we discuss will be factors that directly influence VNB margin expansion (or lack thereof) as well as growth in the future.

But first of all, we will start with a small discussion on the numbers that matter (Embedded value framework) and what can be safely ignored (Indian GAAP numbers). After all, for the uninitiated, life insurance can be an intimidating sector to get to grips with - some hand-holding may not be presumptuous. But if you know your way around or just want to get entertained, then don't be shy and jump right onto the juicy stuff starting at the 1. Valuation section on page 8.

In the end, the fundamentals we analyse and the concepts we learn throughout the note will bestow us with the capability to choose a winner among the four worthy contenders in terms of long-term potential to compound the share price.

To conclude the note, we will talk about what the future holds for these companies and the industry as a whole. There are a couple of events that happened recently which hold the potential to change the dynamics of the sector substantially – we will discuss them along with closing remarks.

Key Concepts

We will introduce a few concepts and terms in this section for the uninitiated. Feel free to move on to the more fascinating stuff in the next parts but remember that time taken to brush up the basics is not wasted.

Key Concepts I: What is NOT Relevant?

Life insurance contracts are long-term in nature. A term-insurance is a contract for a decade or more. ULIPs investments are locked in for five years on average. Profits on these policies accrue over time. So ideally, acquisition expenses and estimated surplus at the time of initial sales have to be recognized in line with the time-line of the contracts sold.

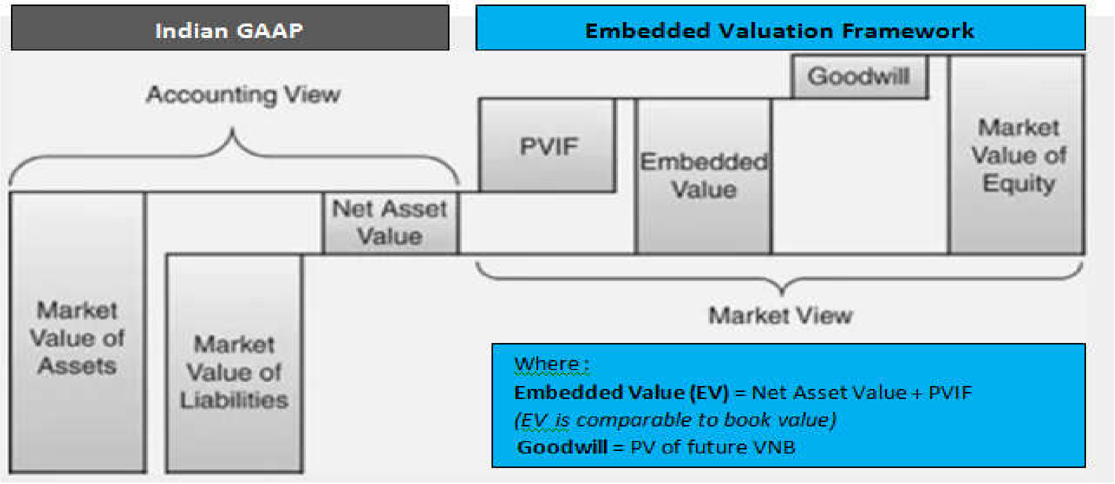
Under traditional GAAP though, this does not happen. A lot of recognition that should happen for true representation does not, in a timely fashion, happen. Acquisition costs are expensed out immediately under normal GAAP whereas the actual profits are recognized in later years as the liabilities run-off as per actuarial estimates. Similarly, when a policy is surrendered by clientele, the loss of future profit is not recognized under the GAAP. Instead, a profit is recognized for the surrender penalties charged.

More importantly, the net worth on the statutory books does not include the Present value of in-force business (PVIF) - the expected net cash flows from business already in place. This is a big part of the insurance companies' inherent value. And only a small part of investments are marked to market under GAAP – a big drawback for analysis of an investment-heavy balance sheet.

In short, Indian GAAP is irrelevant when trying to understand the fundamentals of Life Insurance companies.

Thus some smart people back in the day developed a framework that allows an insurance company to disclose its accounts in line with the economic reality of a life insurance business, namely the Embedded Value framework (Figure 1)

Figure 1: Embedded Value framework vs GAAP



Where :
Embedded Value (EV) = Net Asset Value + PVIF
(EV is comparable to book value)
Goodwill = PV of future VNB

Source: EVA/RAROC vs. MCEV Earnings: A Unification Approach (https://link.springer.com/article/10.1057/gpp.2012.5)

Key Concepts II: What is Relevant

Embedded Value (EV) is defined as the "sum of Adjusted Net Asset Value (ANAV) plus Present value of in-force business (PVIF)"

The two elements are a) ANAV - Adjusted Net Asset Value is the regulatory required capital along with surplus over that. This is the Equity on the balance sheet after MTM and adjustments for intangibles etc. b) PVIF: PV of net cash flows from existing business considering the cost of capital and best estimates.

Embedded Value (EV), in other words, is actuarial valuation accrued to the Shareholders of the life insurance company considering the profits on policies already sold (in-force) as of the balance sheet date, including the estimated future renewals and other operating assumptions. In essence, it is a marked-to-market Book Value measure. It lacks one crucial element from being a Market Valuation as well – just like a banks' adjusted book value (assuming it is properly modelled unlike most banks' Balance Sheets) – and that is the estimate of future value creation.

In this framework, the EV moves mainly on account of two broad elements from year to year:

A. **Operating EVOP:** Embedded Value Operating Profit after Tax which constitutes:

i) **Value of New Business (VNB)** which is the operating and incremental addition to EV arising out of New Business written during the year (i.e. PV of net cash flows from New Business). This is comparable to an adjusted PAT in a normal income statement and is the key item for comparison among companies. More specifically, the VNB margin determines the valuation of the company along with the volume of Sales on APE basis. APE, or Annual Premium Equivalent, is an industry-standard term which measures the gross premiums for life insurers on a comparable basis.

   Having a clear idea about what VNB represents and its relation to the volume of sales (APE), is enough to get a clear view of an insurers' business.

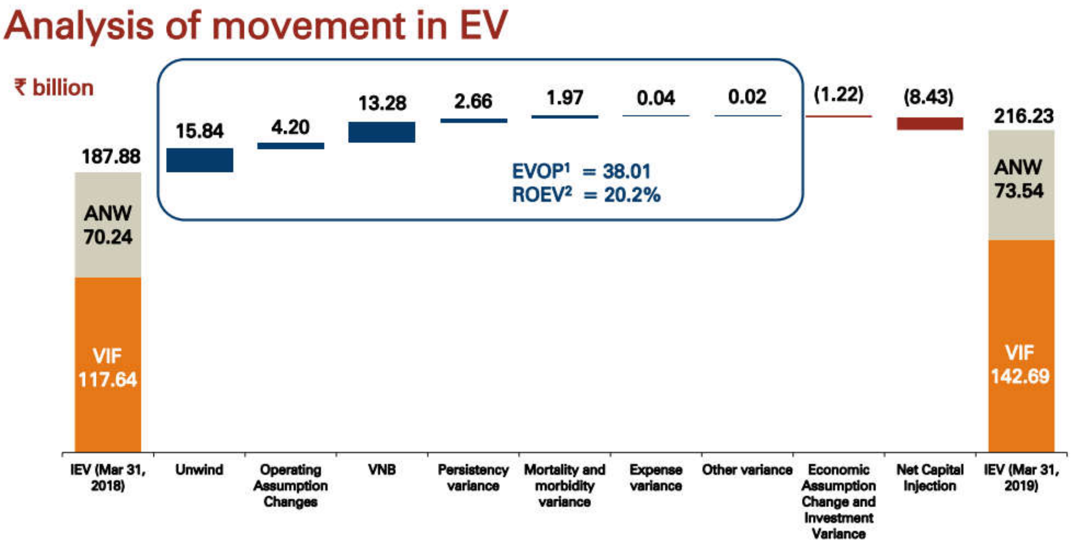
ii) **Unwind** or Run-off return on in-force business – generally at cost of equity on opening EV. This return is accounted for in EV calculation and hence not incremental.

B. **Non-operating aspects** include (i) dividends and other capital movements (ii) assumption changes and variances, some of which are classified as EVOP.

Check out the example in Figure 1Figure 2.

A note of caution here: the assumption changes (resulting from structural changes in the markets or operating environment) over-time can have a profound impact on EV.

Figure 2: Representative EV waterfall chart of ICICI prudential for FY19



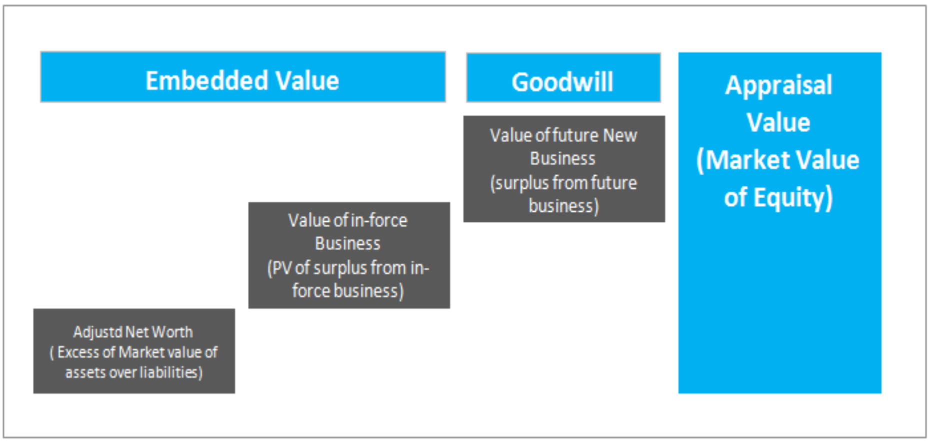
Source: ICICI Prudential company presentation for FY19 results

1. Valuation

The relevant way to value life insurers is by using the Residual Income framework. In this, the Embedded Value (EV) would be the equivalent of “Net Worth”, and the “PV of future VNB” would be the equivalent of “Sum of Excess returns” expected in the future.

In more simple terms, the fair value of a life insurance company would be the sum of **Embedded Value** and the estimated **VNB addition in future**, also called “Goodwill” - together called the **Appraisal Value** as in Figure 3 below.

Figure 3: Market Valuation framework of a Life Insurance Company


Embedded Value
Goodwill
Appraisal Value (Market Value of Equity)
Value of future New Business (surplus from future business)
Value of in-force Business (PV of surplus from in-force business)
Adjustd Net Worth (Excess of Market value of assets over liabilities)

Source: various

It should be obvious by now that the VNB growth estimate is the key to valuations. But more on that later.

First, we will look at the market valuations for the four listed life insurers. Looking at the price charts and then the valuations implied from those prices, we will glean the market's view on these stocks, right from the horse’s mouth.

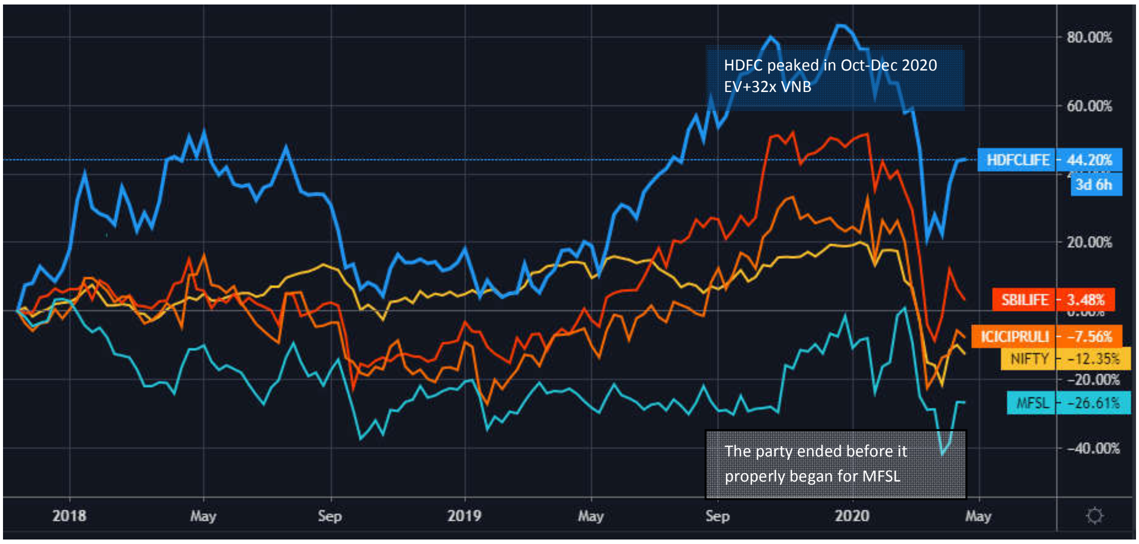
a) The Price Chart

In practice, valuations across the sector are comparable using an EV multiple or a VNB multiple. We will focus on the four private-listed-life insurers from here on: HDFC Life, SBI Life, ICICI Prudential and Max Financial (MFSL).

ICICI Prudential traded at its FY21E EV + 21x VNB before the COVID-19 crisis, implying a perpetual VNB growth of 8-9% discounted at the cost of capital of, say, 12%. The market price of ICICI Pru also implied an EV multiple of 2.5x, meaning investors were willing to pay the 2.5x over FY21E EV, given the growth prospects. This is pretty expensive compared to many other markets including the other Asians insurers but wait until you’ve heard about the valuations that the top-rated life Insurer in India bar none, HDFC Life, fetches. At its peak in Jan-2020, HDFC Life sold for 5.1x EV, or FY20E EV +35x VNB.

However, the gold rush to the newly discovered potential of quality life insurers in the country didn’t last long. Things changed drastically in February-March.

Figure 4: Weekly Price Chart for four Indian listed life insurers



HDFC peaked in Oct-Dec 2020 EV+32x VNB

The party ended before it properly began for MFSL

Source: Tradingview

In February, a couple of things happened which will have a lasting impact on all the industry prospects, both on business fundaments as well as equity valuation. First, tax benefits on Life insurance-related investments were potentially threatened in the Budget announced in Feb-2020, though the actual impacts on sales will be known only in the next year or so. HDFC Life almost shrugged it off, falling a mere 10% before looking ready to summit the next peak in its view, but just then COVID-19, the mother of all crisis, hit the world in March 2020. The fall off the cliff in the chart in Figure 4 above shows just that, followed by the recovery rally.

The impact from the tax changes to the sales volumes may be longer-lasting compared to the Pandemic, though we cannot discount a complete paradigm shift over the next year or two. We will dig into these aspects at the end of this note, by which time some of the dynamics in play will become easier to digest.

Right now, we will look at the market multiples that these stocks fetch.

b) Implied Valuations

Let us start with a simple comparison of valuations that the four companies trade at (Figure 5)

Figure 5: Valuation Table – Before and after the Crisis

Company	HDFC Life	ICICI Pru	SBI Life	Max Financial
EV 2021E/share	123	189	323	433
VNB 2021E/share	12	13	27	44
Price on 28th Feb 2020	**544**	**471**	**890**	**577**
EV multiple	4.4x	2.5x	2.8x	1.3x
VNB multiple over FY21E EV	**EV+35x**	**EV+21x**	**EV+21x**	**EV+3x**
VNB multiple gross	45x	36x	33x	13x
Implied VNB growth*	***9.8%***	***9.2%***	***9.0%***	***4.3%***
Price on 20th March	**340**	**236**	**530**	**288**
EV multiple	2.8x	1.3x	1.6x	0.7x
VNB multiple over FY21E EV	**EV+18x**	**EV+4x**	**EV+8x**	**EV-3x**
VNB multiple gross	28x	18x	20x	6x
Implied VNB growth*	***8.5%***	***6.4%***	***6.9%***	***-3.4%***
Fall from peak	***-38%***	***-50%***	***-40%***	***-50%***
Price on 20th April 2020	**497**	**370**	**685**	**422**
EV multiple	4.1x	2.0x	2.1x	1.0x
VNB multiple over FY21E EV	**EV+31x**	**EV+14x**	**EV+13x**	**EV+0x**
VNB multiple gross	42x	28x	25x	9x
Implied VNB growth*	***4530.5%***	***5002.7%***	***4440.1%***	***2183.3%***

**Implied perpetual VNB growth as per Gordon Growth model, assuming a cost of capital of 12% for all companies.*

Source: Trading View, company reports, estimates.

The above table tells the market sentiment story for the four companies. HDFC Life is the leader in terms of investor interest. It trades at 2.8x EV after the market fall, comparable only to the highest-rated banks in India in P/BV terms. The stark difference from peers is a recognition of HDFC Life's focus on driving profitability through a balanced product mix. They have driven their business mix towards VNB-accretive products before anyone else started on that journey and now stand the tallest in terms of VNB growth and margins. The weapon? Protection.

Another interesting tale is that of Max Financial Services Limited (MFSL), which owned ~70% of Max Life Insurance until recently (the only subsidiary that it operates), and now holds more than 93% of the same, thanks to a share swap agreement with Mitsui Sumitomo (its JV partner). The stock trades below its one-year forward EV which essentially implies that if you pay for the book value now, you get all the growth (if any) for free. This compares to, well, an NPA laden-PSU bank. But therein lies the irony, the business profile and fundamentals for Max Life are very comparable to the remaining three listed insurers, even better in some respects. So what gives?

For one thing, the holding subsidiary structure is usually penalised by the market with a 20-30% discount from the pure business valuation. But even keeping that aside, the primary reason it trades at such low valuations is that its relationship with its primary Banca partner, Axis Bank is on shaky grounds.

We will dig into that story later, but one thing to look up and take notice right at the start is that Max's issues with Axis Bank are temporary and things look set to get resolved in a quarter or less towards a more stable relationship, or eh, no relationship. But the dice are loaded in favour of continuation of this partnership – something the market does not seem to be factoring in at all in the valuations. So we have a "double-your-money-or-nothing" kind of bet here, for the adventurous type.

SBI Life and ICICI Prudential are great businesses, but their growth has not been as break-neck as that of HDFC Life, and as things stand – the pair-trade involving HDFC Life on the short side does not exist, not in the near-term at least.

SBI Life would rank slightly better than ICICI Pru (and some will argue - even HDFC Life) on volumes, mix and efficiencies, as you'd see in the coming sections, but the market treats them essentially the same at ~EV+14x VNB (see valuation table above). This means that we indeed have a pair trade between ICICI Pru and SBI Life, with SBI Life on the long side - but remember, we are only talking about the long-term potential, not short-term sentiments.

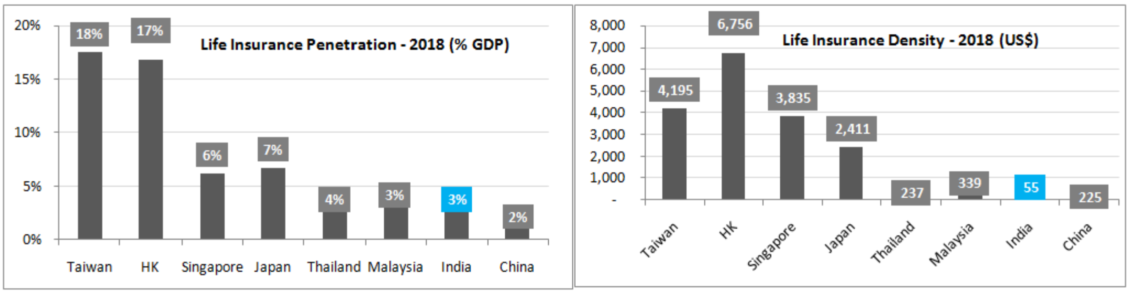
2. Market

a) Scale

India is terribly under-penetrated in terms of any financial inclusion metric you can name, whether it be financial investments or rural bank-loan uptake or just the plain-vanilla term insurance. So it is common-sense that the same applies to insurance as the majority of Indians, especially the middle and lower-middle class, consider even term protection insurance as discretionary.

The below charts (Figure 6) should drive home the point that the sky is the limit when it comes to market expansion, on paper.

Figure 6: Life Insurance Penetration and Density in India vs. peer regions



Source: IRDAI, company presentations

Having said that, it is not a certainty that the penetration gap in the above chart will converge with peers for India because this gap has been there for a long time now and hasn't shown significant progress – might just be the nature of the beast. This is especially true for savings products – policies with a mix of investments and insurance. There is direct competition from the mutual fund industry for exactly the class of customers that insurers have targeted all these years. For now, insurers still have tax benefits on their side.

On the other side on the argument is the fact that the largest life insurance players have been growing at 15-18% CAGR over the past five years, far above the GDP growth rate. There is ambition and the demography is set for more of such growth to come, even if it may not show up in headline graphs.

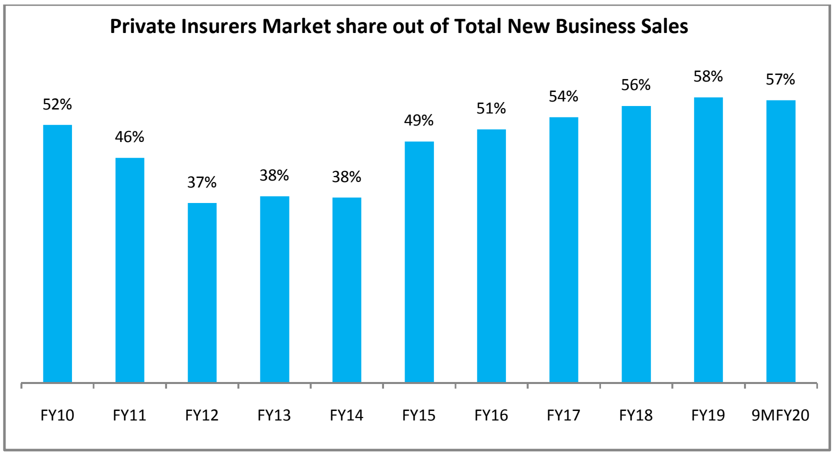
More importantly, and this may just be the "Buy" argument on the sector – drum rolls – Protection is the mantra. Term life insurance, or pure-protection without the add-on investment, has been the main growth driver for Indian life insurers over the past couple of years across the companies. It is a growth driver not just for the volume of sales but also for the profitability it creates. And the market for this product segment is humongous - no exaggeration.

There is also a genuine need as well among the masses for life protection. As awareness among the rural areas improves, the volume of such policies being sold can grow exponentially for a long period of time. Add to that the growing market for credit-protect life policies (policies that pay the bank/ NBFC when a retail borrower defaults due to death, severe illness etc.), and it is a no-brainer that the life insurance industry will continue to grow at a faster pace than the Indian GDP for many years to come.

b) Competitive Positions

In India, the biggest life insurer has always been the big public sector company LIC, which is also the only PSU allowed to sell life insurance. It is unlisted yet, but an IPO with the government divesting a minority stake is on the cards. In terms of market share, private insurers have started eating into the total pie since privatization in 2000 and now have a larger market share than LIC, driven by aggressive growth since FY15 (Figure 7).

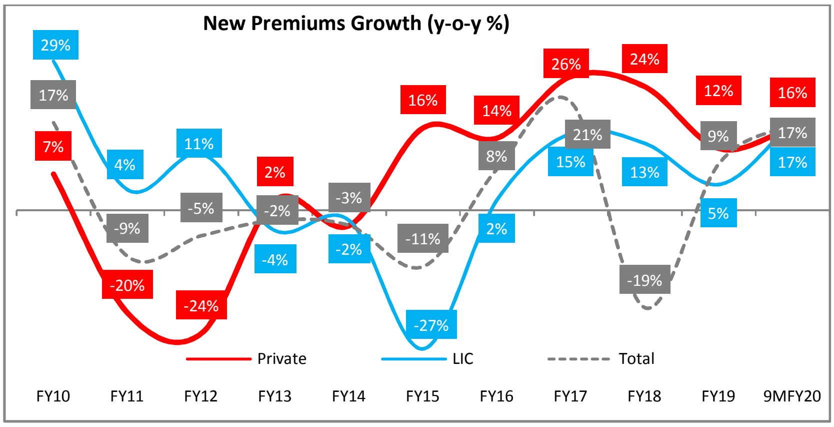
Figure 7: Insurance Market shares for LIC and Private Life Insurers



Source: IRDAI, company presentations

Private Insurers have been growing at ~18% on average over the last five years compared to a 4% average growth reported by LIC (Figure 8)

Figure 8: Business growth for Private life insurer's vs. LIC

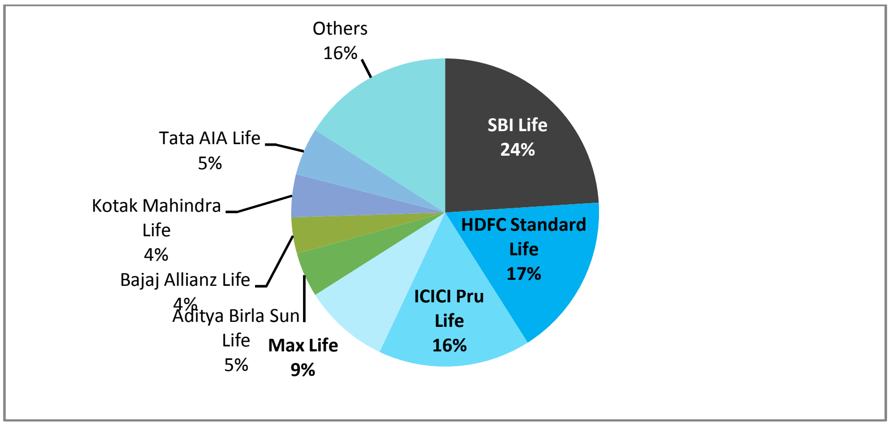


Source: IRDAI, company presentations

It is also a well-documented fact that private insurers are substantially more efficient and profitable than LIC which tends to keep only a small portion of surplus for itself. It distributes the majority with its policy-holders without differentiating the surplus generated from participating books or otherwise. The ratio of distribution is 95:5 on the whole book for LIC (i.e. 5% goes to shareholders) whereas private insurers distribute on a 90:10 basis - that too only on the participating book, with all surplus out of non-par/ linked business going directly to shareholders. On the asset side, LIC is burdened with being the investor of last resort for many a divestment gone wrong as well as troubled PSUs and banks. When the cupboard is finally opened, no one is sure what sort of skeletons it will unveil. All this means that the proposed listing is not particularly threatening for the big four, though there is more to the IPO which is discussed later.

When it comes to competitive analysis of private life insurers, the punch line is this - the top four accounts for ~65% of the private insurance market. Add LIC with around 43% of total market share and the top five insurers command more than 85% of the total market share. This is essentially an oligopoly in a high-growth business in a deeply under-penetrated market. The size of the pie in **Figure 9** is bound to get bigger and the share of big four in the pie would only grow over time.

Figure 9: Private Insurers Market shares (% of Individual New Business Premium) – FY19

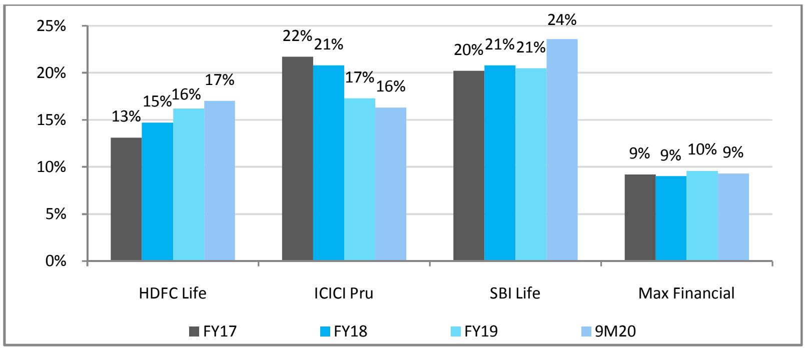


Source: IRDAI, company presentations

The top four players have unique moats in strong and reliable Banca partners (with an asterisk for Max Life), as well as agency networks, which the other smaller players lack. All the four command the biggest distribution networks in the country and along with LIC have a stronghold on 70% of the bancassurance network. Though HDFC Life and Max Life's relationships with their primary banks are slightly complicated, they are still in a superior position compared to most smaller insurers. New and upcoming insurers would find it quite impossible to find any big banks willing to take them in and give up the relationships set in stone by the virtue of holding-subsidiary relationships with the big four. Hence the barriers to entry are pretty high.

Among the four listed players, HDFC Life has been growing its market share consistently, thanks to its success in sourcing high volumes of group credit-life protection business through its primary Banca HDFC Bank - it is now the second-biggest insurer in the private space only after SBI Life which has been growing its share as well, leveraging the biggest bank network in India to strengthen its leadership position.

Figure 10: Private Life Insurance Market shares development (% Individual NBP)



Source: IRDAI, company presentations

Both of them are eating into ICICI Pru's share **(Figure 10)** which is having trouble growing its ULIP sales over the last few years.

Meanwhile, Max Financial is doing well to hold onto its share of a growing pie. Its success mantra has been to sell the highest amount of Participating products among the peers – a product seemingly side-lined by others.

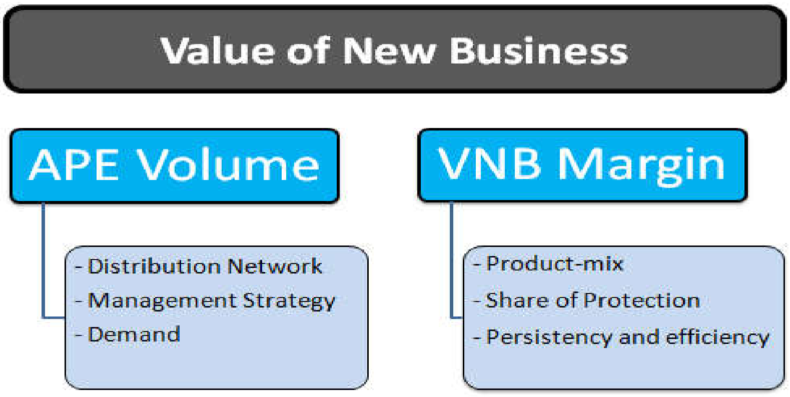
3. Business Fundamentals

a) Value of New Business

VNB represents the value created for equity shareholders in a particular period and hence determines the market valuations. It is the reason that HDFC Life fetches a premium valuation and also why SBI Life looks under-valued. It is the reason that ICICI Pru chooses to give up overall growth in favour of protection growth. It is also the reason that experts call for caution on the optimism around LIC's planned IPO.

The next few sections will focus on the expected VNB trajectory for the big four in the context of the various factors that can help this cause (or hurt it). **Figure 11: Thesis map for VNB** gives away the high-level picture to keep in mind while thinking about VNB potential.

Figure 11: Thesis map for VNB



Value of New Business

APE Volume

- Distribution Network
- Management Strategy
- Demand

VNB Margin

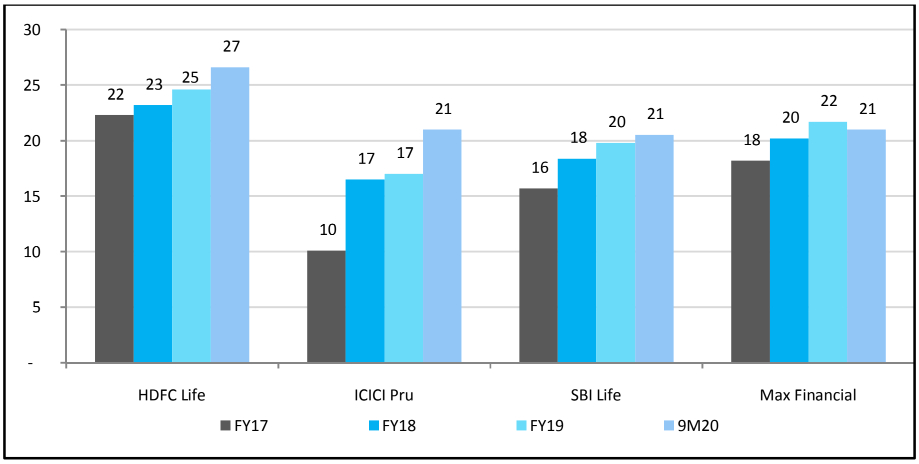
- Product-mix
- Share of Protection
- Persistency and efficiency

Source: various

VNB margin (Figure 12) is the number that is on everyone's radar quarter after quarter. Even though the final margin number can only be determined after an actuarial audit at financial year-end, quarterly development holds for the most part.

It is the number that differentiates the winners. Here, HDFC Life has proven itself over several years now and it's premium valuations in the insurance space seem well justified on this basis as well as by sheer growth in VNB in rupee terms.

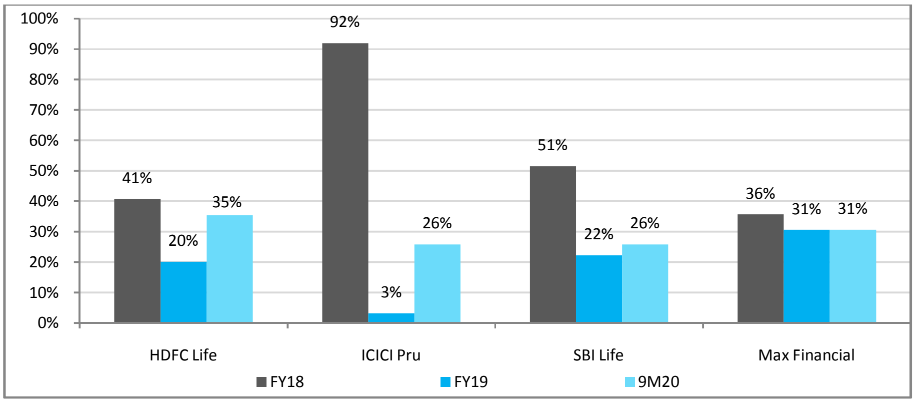
Figure 12: VNB margin development (% APE)



Source: IRDAI, company presentations

That's not to say that other players are not doing their bit, quite the opposite - Figure 13

Figure 13: VNB Growth



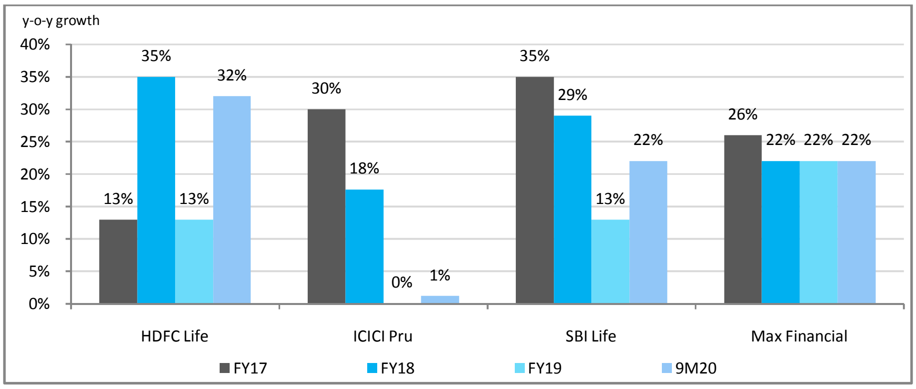
Source: IRDAI, company presentations

b) Annual Premium Equivalent (APE)

APE is the standard measure of comparison for new business sales across the industry, used to mitigate the variations caused by lumpy single premiums. It is sum of new regular premiums (renewed every year) plus 1/10th of single (one-time) premiums. Point to note is that it does not include renewal premiums as they are accounted for at the point of first sale per persistency ratio assumptions.

Figure 14 tells the story in terms of volumes, almost. The total APE growth has been great for three of the four companies. ICICI Pru, on the other hand, is struggling to grow at the overall level.

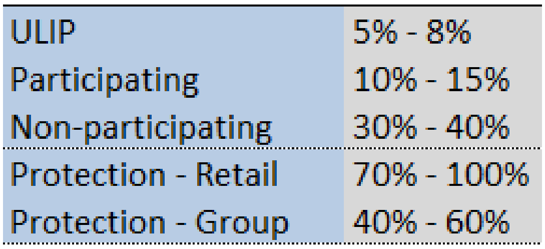
Figure 14: Total APE Growth



Source: IRDAI, company presentations

Over the last couple of years, for all the four, there has been a clear narrowing of strategy to rebalance the product mix towards a higher proportion of protection. This has been a key success formula which has enabled aggressive VNB growth. This is because, depending on features, protection products fetch VNB margins of 60%-100% on APE. Refer **Figure 15** below for VNB margins per product type.

Figure 15: VNB margin range by product (% of APE)



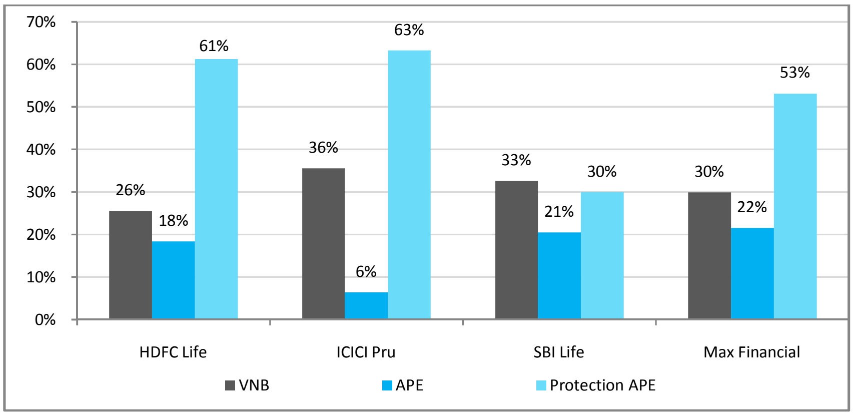
ULIP	5% - 8%
Participating	10% - 15%
Non-participating	30% - 40%
Protection - Retail	70% - 100%
Protection - Group	40% - 60%

Source: analyst calls, presentations, estimates

Savings products are comparatively less profitable resulting in much lower profitability despite much greater volumes and ticket sizes. All savings products are not made equal though, it is better to have more non-participating policies that have higher VNB margins and Participating products are then to be preferred over ULIPs for the same reason.

However, it has to be said, ULIPs have the advantage of being very capital-light in underwriting terms, what with shareholders taking all the risks. Many ULIP returns beat the benchmark or comparable mutual funds on a post-tax basis even after costs because of being very tax-efficient. Initial investments are exempt to an extent and redemptions are entirely exempt under the current tax laws. This is one of the reasons these products attract many HNI investors who want to achieve an aggressive risk-reward profile while availing superior tax benefits. HDFC Life and ICICI Prudential have built substantial back-books of equity-linked-funds by catering to the wealthy clientele of their primary banks.

Figure 16: CAGR of VNB and APE - FY2017-20E



Source: IRDAI, company presentations

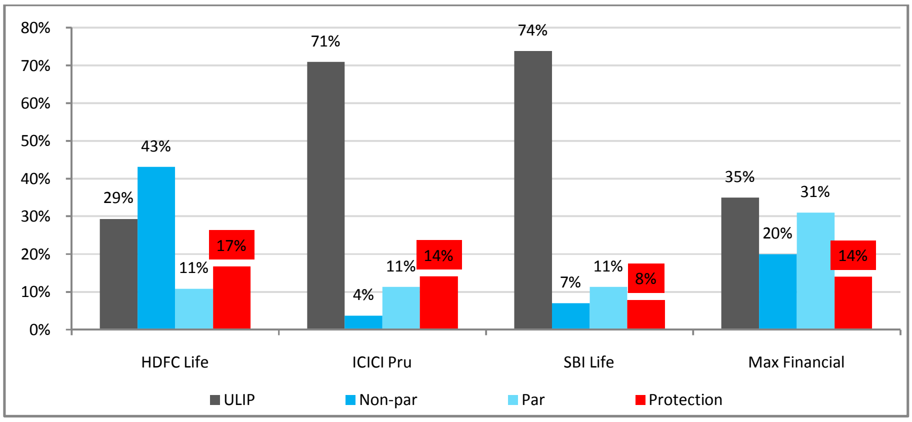
The above CAGR chart (Figure 16) shows the trade-off that ICICI Pru is taking. The stated focus for the company is VNB growth in absolute terms. The biggest lever they have for that is to increase the level of protection in overall business to get in line with peers like HDFC Life. The strategy of focusing its big distribution machine on aggressively selling Protection has been pretty successful. More than half of their VNB in FY19 is from protection products which formed only ~10% of total APE sales, highlighting the extravagant margins that can be achieved on these products.

ICICI Pru's VNB margin has more than doubled since FY17 from ~10% to ~21% of APE thanks to this obsession-level focus. Obsession is the word to use because they gave up growth in other areas of business for the 'protection' cause. ULIP sales almost stagnated in FY19 and 9MFY20, and when pushed on it, the management said the industry growth was slowing down as well. SBI Life, in their results call, promptly negated this by saying they didn't have any problems in growing their savings products at ~20% in FY19 and similar levels in the current year.

To be fair, ICICI Pru, along with HDFC Life, caters to a different type of customers with their savings products - the affluent/ HNI type who use ULIPs to play the markets while availing tax benefits. The share of equity in the ULIP funds is 40-50% for ICICI Pru and HDFC Life vs. ~25% for the other two. The result is high ticket-size sales and a very cyclical business during volatile markets along with exponential growth during the bull-runs.

Although protection is also a big focus for all others, they have not given up on other products, growing them at very good rates along with protection – a stark contradiction to ICICI Pru.

Figure 17: product Mix (% APE) – as at 9MFY20

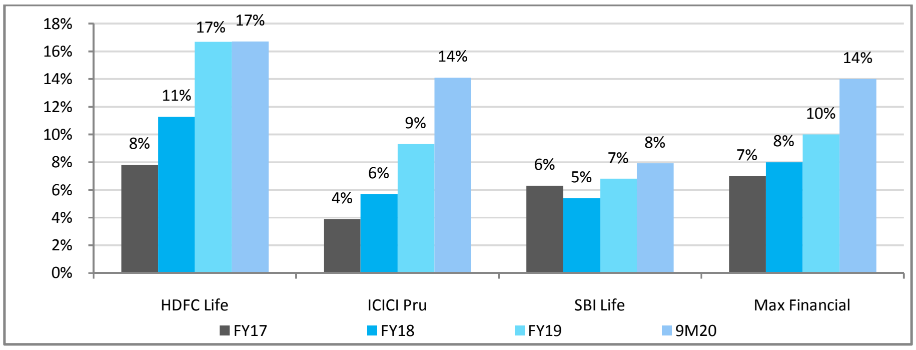


Source: IRDAI, company presentations

Max Life has historically sold more Participating products than peers (Figure 18) – a product that is not the primary focus for many other life insurers. Market leadership in this particular niche space helped Max Life achieve market shares that beat most smaller insurers. Focusing on Participating products (whose margins are better than that of ULIPs) has also helped it achieve higher VNB margins placing it in the top three insurers in terms of profitability. Along with that, their share of protection products in the APE mix is second only to HDFC Life – resulting in a product profile geared towards profitability.

If there is one reason to point fingers at SBI Life, It is that it has been slower to start on the "protection" ride than others and not as aggressive as, say, an ICICI Pru. But that is being corrected as we speak, with the rhetoric from the management more and more echoing the focus on protection-led growth. It has several levers that it can pull to achieve its desired mix of more than 10% protection in APE over the next two quarters - the most recent development being a new protection product with limited-pay features, something Max Life also sells well. It can, of course, fine-tune its huge banking network with its rural presence towards this pursuit over the medium-term. Given the under-penetration of pure protection insurance in rural areas, it is not difficult to imagine SBI Life becoming a market leader in this segment in the next decade.

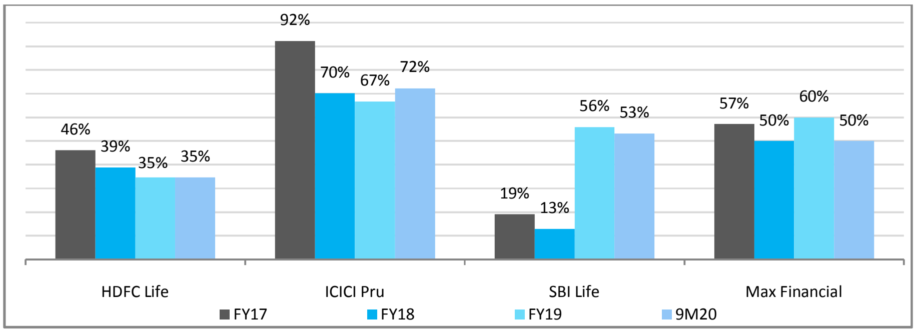
Figure 18: Share of protection (% APE)



Source: IRDAI, company presentations

As things stand, HDFC Life has the best product-mix among the big four thanks to the large volumes of credit-protection products it sells through HDFC Bank. It consistently sells more proportion of protection than peers **(Figure 18)**

Figure 19: share of Retail protection (% total protection APE)



Source: IRDAI, company presentations

It is worthwhile to introduce a nuance here: among protection businesses, not only is retail protection (pure term insurance) more profitable but it is also stickier in terms of persistency resulting in better outcomes overall. ICICI Pru aces in this aspect **(Figure 19)** – a big reason why its VNB margin on protection book is above the industry average (100-120% per latest disclosure).

But that does not mean the group protection is not desirable. Group protection mainly consists of credit-life protection products that pay when a borrower defaults on payments to a bank or NBFC. It is mainly sold through Banca channels or bulk agreements with a bank for a portfolio of loans. HDFC Life specialized in this niche segment since the last several years, using it to build a product mix that is an envy of every other insurer in the country. This is a credit to the profit focus of HDFC Life's management which has built strong tie-ups over the years for this product with not only HDFC Bank but also several other lenders.

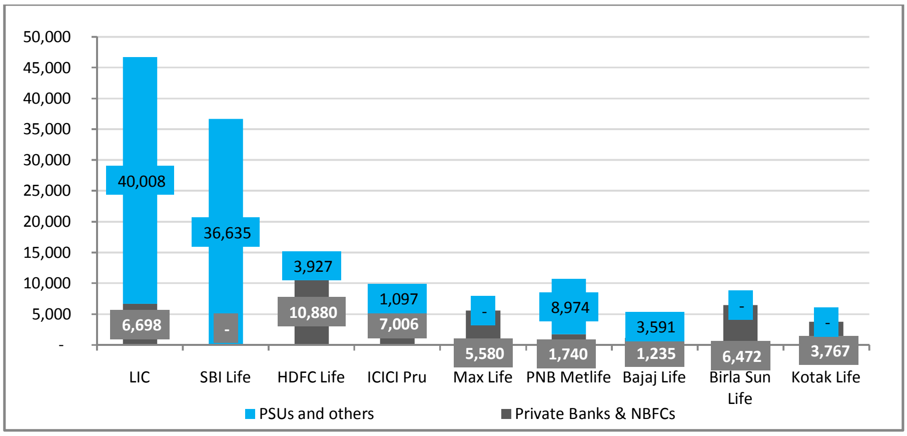
Despite HDFC Life having a first mover and market leader advantage in Group protection, things are changing with competition realizing the growth potential of this segment thanks to the growing lending in the Indian economy as well as lower penetration levels in various niche pockets.

c) Sales Channels

Insurance is mainly a push product. Policyholders prefer to buy insurance from familiar sources, viz. the banks they already deal with for other financial needs. Insurance sales are also a factor of trust and brand recall. These aspects make the bancassurance (sales through bank branches) network a critical factor for the success of any insurer. Having a well-known bank backing your credibility is a real moat, and this fact cannot be missed when looking at three of the four covered here. SBI Life and ICICI Pru are part of bigger banking groups whereas HDFC Life shares the holding company with HDFC bank. All three not only share the banking network of their parents but also the brand names – pretty much household names in India.

Max Life, an exception, is also a lesson. They have grown to become one of the four big insurers thanks to the strong relationship with Axis bank, the third-largest private lender in the country. However, their struggles with making this relationship stick have been a huge reason they sell below their EV now.

Figure 20: Addressable Banca Channels

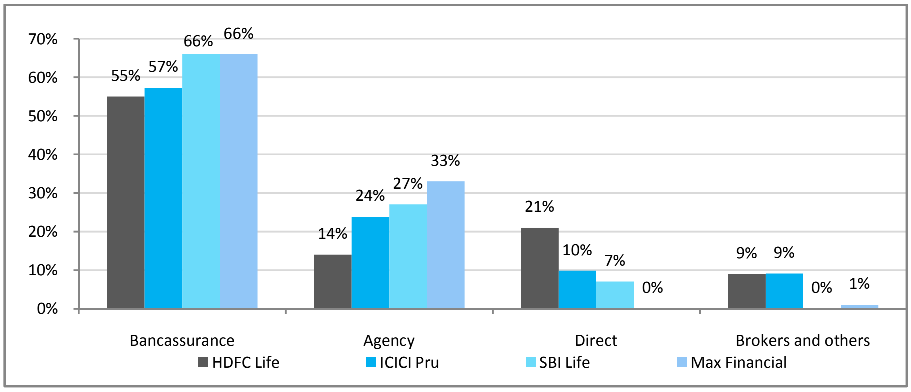


Source: IRDAI, company presentations

SBI Life is the clear leader among the big four in the scale of distribution network. SBI Life lags only LIC in terms of bank branches it has access to **(Figure 20).** And SBI bank doesn't sell for anyone except SBI Life - an exclusivity bound to stay. SBI bank sells insurance as seamlessly as it lends money to its retail customers – a big reason SBI Life's commission costs are the cheapest among the top four. Much like SBI bank, SBI Life also caters to the masses, evidenced by one of the lowest ticket sizes in the industry. What's noticeable is that SBI Life has also nurtured its agency network all the while - its agency mix in APE is second only to Max Life which doesn't have a permanent Banca partner yet (Figure 21).

ICIC Prudential can be said to be the second-best in terms of distribution as its relationship with ICICI bank mirrors that of SBI Life with its bank. This exclusivity is a huge strength although ICICI bank's network is smaller compared to HDFC bank. What ICICI Pru lacks in scale compared to an SBI Life is made up with the access it gets to ICICI Bank's wealthy client base in urban areas as well as the competitive push it can get by incentivizing the sales personnel.

Figure 21: Channel Mix (% APE)

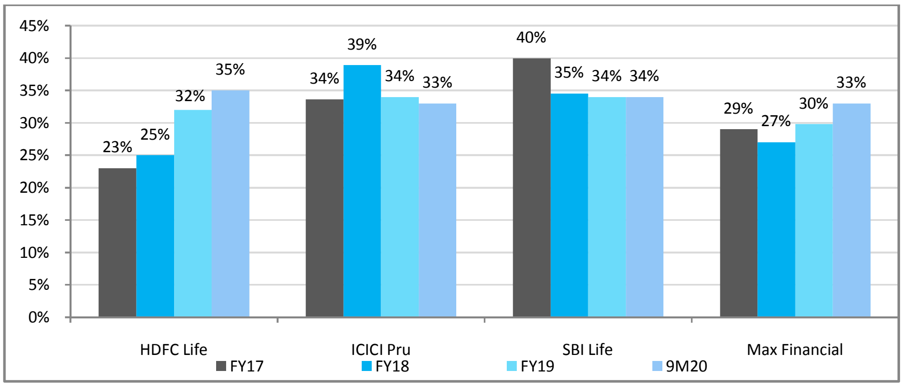


Source: IRDAI, company presentations

Things aren't as straight-forward for HDFC Life and Max Life. HDFC Life does not have an exclusive agreement with HDFC Bank anymore because HDFC, the holding company also has another smaller insurance subsidiary. It is not clear how the relationship will move going forward but given that only two-thirds of HDFC Bank's insurance sales went to HDFC Life in the current FY, the company can no longer take the relationship for granted, though it can be assumed that HDFC Bank would still give primacy to HDFC Life. This is the reason HDFC Life has been strengthening its agency network, its digital offerings as well as other Banca relationships on the side. It shows the most significant improvement in sales through proprietary channels among the insurers (Figure 22)

Another industry-leading metric for HDFC Life is that it sells 21% of its APE through direct sales, a large portion of which is digitally sold, confirming its digital leader status among peers (Figure 21)

Figure 22: Sales through Proprietary Channels (Direct & Agency channels as %APE)



Source: IRDAI, company presentations

Max Life has had a strong Banca relationship with Axis Bank for long, acting as an exclusive insurance partner for India's third-largest private lender. However, things changed over the last couple of years and Max Life seemingly didn't act soon enough. Back in FY2017-18, Max Life sold around 60% of its insurance through Axis Bank. Then, the management targeted reducing this to 35-40% of sales, in favour of drastically strengthening its proprietary channel sales to make up for the difference. That did not work out as planned – Axis still sells 55% of Max Life's APE and proprietary channels still sell only 34% of total APE (Figure 22), in line with peers who have more stable Banca relationships. The Banca partnership is due for renewal in FY21 and it is not a foregone conclusion by any means.

Complicating things, the Banca tie-up with Axis is no longer exclusive either, Axis has recently added LIC to its list of promoted insurers.

The saying goes *"Relationships are important in life, but it is more important for those relationships to have life in them"*

The key issue of contention for Axis Bank has been that it has only 2% equity stake in Max Life and hence doesn't stand to create much value for itself by using its strong franchise to sell for an unrelated insurer. This has been sought to be rectified by Max Financial, the holding company for Max Life, even if it may be a little late in the day. Axis bank is now in negotiations with Max and the consensus is for Axis to take a 20% stake in Max Life, giving the bank more skin in the game. This should, if it materializes, give the investors more confidence about the future of Max Financial and bring its valuation in line with peers (after a holding company discount of 20-30%, of course). After all, it does not lag the peers in other aspects of the business.

Another pebble in Max Life's shoes has been its other Banca partner Yes Bank, which sells around ~14% of its APE (though it accounts for less than ~4% of its VNB). Yes bank is on the brink of bankruptcy after its NPA's exploded recently – implying a lower contribution to sales from this counter in the near-term.

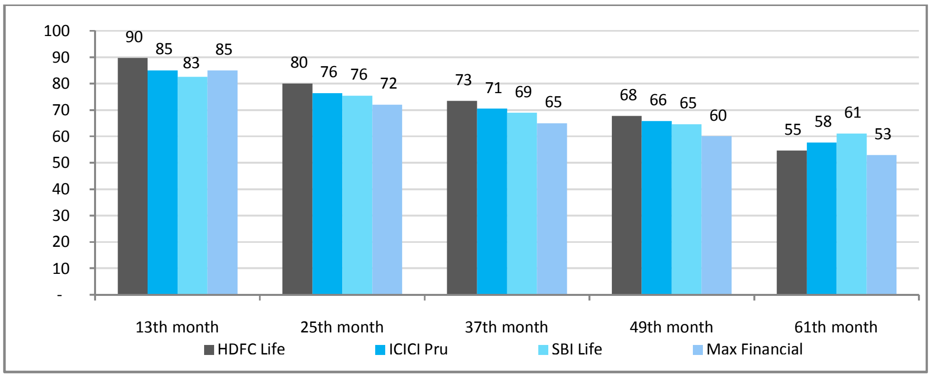
Efficiency

Apart from the big angles discussed in the above sections – viz. APE sales, product mix and distribution network – there are a few nuances that help understand the quality of business and operating efficiency of production. These aspects make up key dynamics in the VNB margin picture though they are always a work in progress in terms of significant improvements.

d) Persistency

Persistency tells the story of renewals - the proportion of regular policies that are renewed after a certain period of initial sales. It is an important assumption in VNB margin calculation for the products sold. The persistency ratios must be maintained at least at the current levels (the base assumption for VNB calculation) and ideally improved over time. Otherwise, the management runs the risk of adverse variances in the short run and margin contraction over time, hurting profitability.

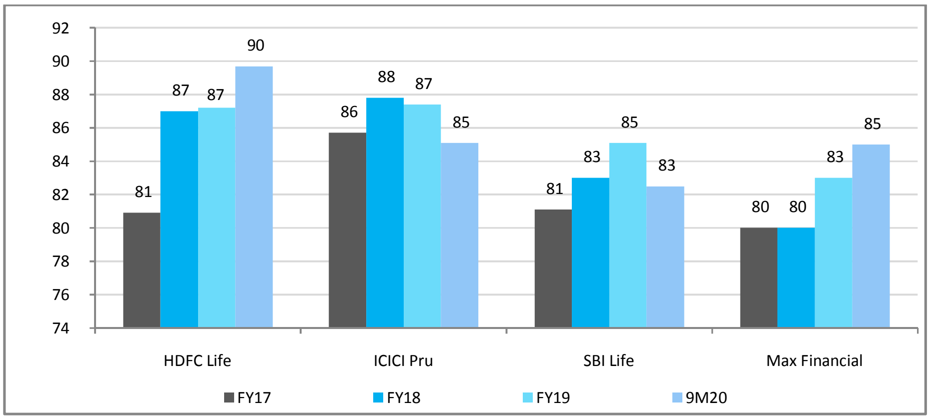
Figure 23: Persistency ratios over different spans



Source: IRDAI, company presentations

To their credit, all the big four insurers have been pretty stable in their persistency numbers and even improving them substantially over the years, thanks to customer-centric policies and products. However, Max Life is the lowest performer among the pack, especially in the far-out spans (Figure 23).

Figure 24: 13-month persistency development



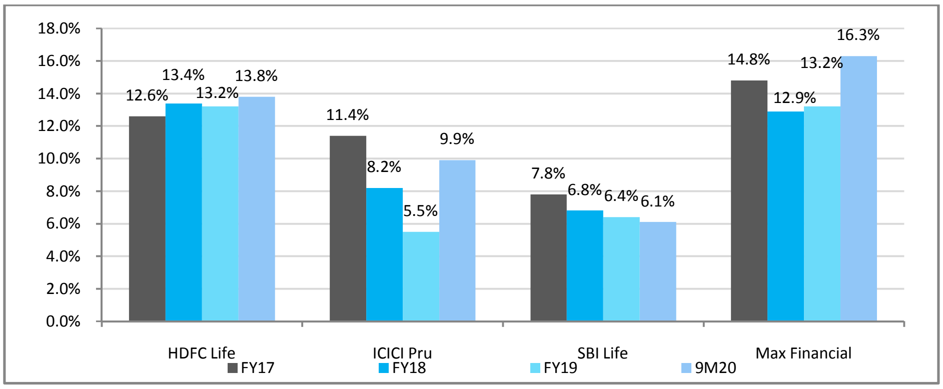
Source: IRDAI, company presentations

13-month persistency, the percentage of policies that get renewed after a year of sale are generally tracked widely and tell the story of product satisfaction and after-sales support. In this area, HDFC Life has shown substantial improvement (Figure 24)

e) Cost Efficiencies

Cost ratios are composed of commissions as well as operating overheads. They are important for reasons similar to persistency – they are an important factor in the VNB margin. It is also important to stick to the assumed or target expense ratios, lest the VNB calculations end up being unreliable. However, there can be one-time exceptions to the rule to accommodate investments and so on.

Figure 25: Cost-Ratio Development



Source: IRDAI, company presentations

This has been the case for Max Life recently, their expense overruns resulted in a VNB margin loss of ~2% as they continue to invest in proprietary sales channels. While this is expected to be a one-off, the management is wary of the investor curiosity in the matter, going by recent analyst calls. This is because these overruns come on the top of already the worse efficiency numbers among peers.

Figure 25 makes it obvious that SBI Life is the market leader in terms of cost ratios as well. It is not just their strategy of leveraging the SBI Banks capabilities with the lowest commissions among peers, but their overhead costs are also the best in class showcasing the management's efficiency.

It is worth mentioning here that ICICI Pru managed to be second-only to SBI Life by leveraging its digital capabilities – both client-facing as well as back-end. HDFC Life also pushes digital innovations drawing on the well-known IT-culture of HDFC Bank.

4. A Note on the Managements

Amitabh Chaudhry, the current CEO of Axis Bank – was the man leading HDFC Life for nine years before bagging the banking office. He was instrumental in HDFC Life setting up an industry-leading franchise. The current CEO Vibha Padalkar spent ten years at the company in key roles before she became the CEO in 2018 – she is already taking the company to the next level, going by the results in the past year or so. Similarly, Prashant Tripathy of Max Life has been with the company forever, helping build the franchise from ground-up.

SBI Life's CEO Sanjeev Nautiyal was appointed in 2018 and immediately set the compass in the direction of profitability, focusing on growing the protection business. He has come through the ranks of SBI bank and presumably brings strong connections to the mothership.

ICICI Prudential appointed N.S. Kannan, a veteran ICICI banker, to the CEO role after the previous CEO moved to back to head the bank itself (a proof that the insurance business is very integral to the overall group). The new CEO's task is cut out with the need to improve the volume growth in competitive times. Looking at his track record so far, if ICICI does not come back stronger than before in this race, it won't because of a lack of effort on his part.

All in all, if one is looking at weaknesses in any of these companies, the management is the last place to start. But, there are always new mountains to climb, the work is cut out in near-term due to the health crisis, and also in the medium-term future given the challenges.

5. Picking a Winner

Before we move to the final section dealing with the big-picture issues, it may be relevant to point at a couple of simple observations about the big four.

- SBI Life, with the backing of its parent, has access to distribution scale which is hard to contest, even by the other two big players – ICICI Pru and HDFC Life. Bancassurance is the single biggest moat in this business - SBI Life leads the pack among the big four. If it can channel this behemoth towards the under-penetration of protection insurance in rural India, it can deliver some serious growth.

  SBI Life is also a master of efficiency, again driven by lower commissions and overheads on Banca sales. Its persistency levels are among top-three in the overall industry – proof of its

customer-focus. Its product mix is competitive as well, and moving towards becoming optimal by the quarter.
Combine all these fundamental strengths with a very reasonable valuation metrics (see valuation section in page 10 above), and we have a potential long-term compounder on hand.

- HDFC Life is the undisputed leader in terms of VNB margins and product mix and it shows in its premium valuations. However, this expensive valuation also makes it difficult to see much more upside in the share price.0

- ICICI Pru share price is troubled by the lack of overall sales growth. Despite management's conviction that this is temporary and what matters is Protection, the market seems to persist in its doubts.

- Max Life, though boosting an efficient business and sound product-mix, is troubled by the unstable relationship with Axis. This may, however, get resolved pretty soon and those punters who showed faith through the rough waters of last year or more may be thoroughly rewarded. Only one way to know.

6. Headwinds on the horizon, but Bright Lights too

Three recent developments – all three happened in the last three months – pose serious questions of the four listed private insurers. They may have opened up some new growth avenues as well.

a) COVID – 19

The short term impact is the same on life insurance as it is in most other industries – loss of business. However, a couple of consequences may last longer and in fact, change the game. There is a threat here as but a far bigger opportunity.

- The more uncertain development is the unprecedented volatility in Equity markets – this will repel some percentage of the populace away from the high-ticket ULIPs that the likes of ICICI Pru sell heavily. However, the cycle may reverse if we come out of the crisis stronger than before – not unlikely.
- The more significant side-affect is that people will buy more protection going forward because of an increase in awareness among the population about the mortality of human life and the consequences of loss of income on the immediate family's welfare. Protection, as we discussed, is what the insurers want to sell as well, so it will be for the mutual benefit.

b) Withdrawal of tax benefits

- The budget 2020 has given taxpayers a choice – stay with the existing income tax regime which allows availing of existing deductions (including on life insurance investments); or, choose a new tax regime with reduced effective tax rates but no tax exemptions and deductions. The plan is to move away from exemptions completely over the medium-term.
  How popular this scheme is still up for debate

- More importantly, the redemptions of life insurance maturity proceeds are still exempt from capital gains – they haven't been touched yet.

  So it still advantage life insurance over mutual funds and other mediums of market investments. But if some corners are to be believed and the government intends to make life insurance investments on par with mutual funds even in tax-treatment of redemptions as well, we are in for some rough waters. At any rate, the government has made the first move and the players beware now!

c) LIC IPO

- The third wild-card is the proposed IPO of LIC with the government planning to put up a minority stake on the block to raise some divestment money. This is not going to hurt the existing listed insurers directly but the impact may be in terms of fund-flows in a market where only a certain percentage of equity would be moving towards Financials, of which insurance would be a smaller fish. With the entry of a mammoth player like LIC - even a minute stake would dwarf the free-floats of most listed financial companies in India – there would be lesser funds to go around as LIC would presumably attract a significant chunk of FII/ DII investments.
- Add to that, the reasonable presumption that LIC would be pushed by Mr Market to become more efficient and competitive means that the existing players would rather not think about the eventualities.

As an African proverb goes "Smooth seas do not make skilful sailors". The larger message being that the journey ahead is likely to be more fruitful than painful for the big four listed life insurers in India.

About the Author

"Prudvi Raj Saya is a Chartered Accountant and CFA Level 3 pass-out (membership pending). He has around 8 years of post-qualification experience in the financial domain with exposure across audit, taxation and financial research verticals. He currently works in investment banking, in sell-side equity research covering European Insurance"