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Acumen at work

BFSI
POSITIVE

THEMATIC	LIFE INSURANCE	October 26, 2020

Vision or Venture?

High growth potential and low risk are usual arguments to justify steep valuations of Indian life insurers. Though we don't subscribe to under-penetration narrative, we do believe in protection and annuity opportunity. We deep-dive to unearth opportunity size of protection and annuity segments. Our study reveals protection could grow 8x in 10 years and ~₹29tn of retirement corpus is estimated to grow at 15% to drive annuity at 20% CAGR. This implies private insurers could grow at ~14.5% CAGR over next decade. Faster VNB compounding of ~18% led by protection/annuity will drive valuations. Turn POSITIVE on the sector backed by structural profitable growth opportunity with low substitution risk. Initiate HDFCL (20% upside) and MFSL (28% upside) with BUY and change our stance to BUY on IPRUL/SBIL. Paucity of hedging instruments with sharp non-parallel fall in yields is key risk to our POSITIVE stance.

Retail protection sum assured to grow 8x by FY30; drive profitability

Retail protection would grow 8x to ₹523bn by FY30, implying 23% premium CAGR, on i) low penetration (our study ~12%); ii) expanding middle class/nuclear families and iii) young population base (returns with >₹0.5mn p.a. income to grow 15%). Direct channel development (suited to sell protection) and higher ad-spends are key to drive market share. Dominance of covered insurers (~70% share) would continue despite competition on access to mass affluent customers/brand recognition. Nevertheless, margins could decline to 50-70% vs 90-110% now. Even at these margins, contribution to VNB would increase to ~2/3rd for large insurers. Key risk: Build-up of interest rate risk.

Accumulation phase indicates annuities as next big opportunity

Annuities could grow at 20% CAGR by FY30 led by 18% CAGR in retirement corpus in FY10-20 to ~₹29tn. Of this, ~19% (₹5.5tn) needs to be compulsorily annuitized at maturity. We estimate retirement corpus to be ₹116tn opportunity by FY30, implying 15% CAGR. This would drive annuity opportunity of ₹2.3tn by FY30, contributing 20-35% to total APE for insurers under coverage, up from 4-5%. Our calculation suggests 25-30% margin for annuities; expect this to sustain given high sensitivity to mortality and investment returns. This would enable annuities to also drive profitability and add 15-30% to VNB by FY30E.

HDFCL (BUY) to compound fastest, MFSL to benefit from Axis deal

While strong brand and cross-sell potential will enable HDFCL to retain protection leadership, ingenious marketing/innovation DNA would enable it to capture lion's share (private) in annuities. This should help VNB compound faster at ~19% vs 13-14% for peers over next decade. Expect MaxL-Axis deal to consummate given Axis' deep intent to manufacture insurance and MaxL's over-dependence on Axis (contributes >40% of VNB). Current valuations discount plausible deal and MaxL's ability to leverage Axis' platform to ramp up protection/annuity. We believe eventually MaxL will rebrand with Axis branding.

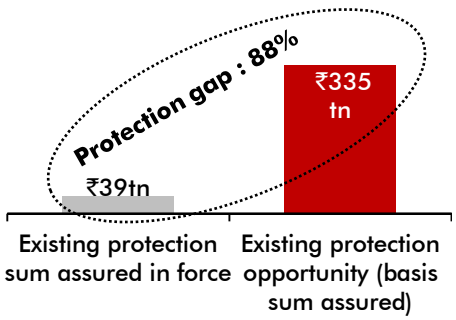
Turn POSITIVE; structural growth opportunity to drive valuations

In Nov'19 we turned SELLers on insurers under coverage (IPRUL/SBIL) given expectation of contraction in premium flows and limited fundamental reasons for upside movement from valuation then (~2.7x/3.2x FY21E P/EV). We expect VNB to compound at ~19% between FY22-25 as in during FY17-21, implying sector P/VNB multiple could remain largely intact at 35-40x over next 12-24 months. Premium over lenders would continue given visibility around faster earnings compounding (~18% vs 11-13% through FY30) and lower risk. When compared to global peers, balance sheet risk for Indian life insurers is negligible.

Key Recommendations

IPRU LIFE	**BUY**
Target Price: ₹576	Upside 41%
SBI LIFE	**BUY**
Target Price: ₹1,009	Upside: 31%
HDFC LIFE	**BUY**
Target Price: ₹677	Upside 20%
MAX FINANCIALS	**BUY**
Target Price: ₹751	Upside: 28%

We estimate retail protection penetration in India to be 12% as of FY20 (refer to exhibit 5)



Source: Ambit Capital research

HDFCL is best-placed on our framework (refer to exhibit 55)

Parameters	HDFCL	IPRUL	SBIL	MaxL
Reach				
Ability to grow protection				
Ability to grow annuity				
Product suit/innovation				
Profitability				
Overall score	**3.4**	**2.8**	**2.4**	**2.0**

Source: Ambit Capital research

Note: - Strong; - Relatively Strong; - Average; - Relatively weak

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Why read this report?

We deep-dive to unearth the opportunity size of the protection and annuity segments in the country. Whilst protection business has already been the key profitability driver for most large private insurers (contributes >40% of VNB for top four private insurers), the annuity business though small is in a sweet spot of becoming a structural growth story. Some key topics and questions that we try answer in this report are:

- **Market size:** What is the growth potential of the life insurance industry? Existing penetration in the protection segment along with understanding addressable market size for protection and annuities
- **Competitive mapping:** Key players in these segments and key growth drivers.
- **Margins:** Taking a deep-dive for margins in the annuity segment.
- **Risks:** Highlight key risk build-up in the protection and annuity segments.

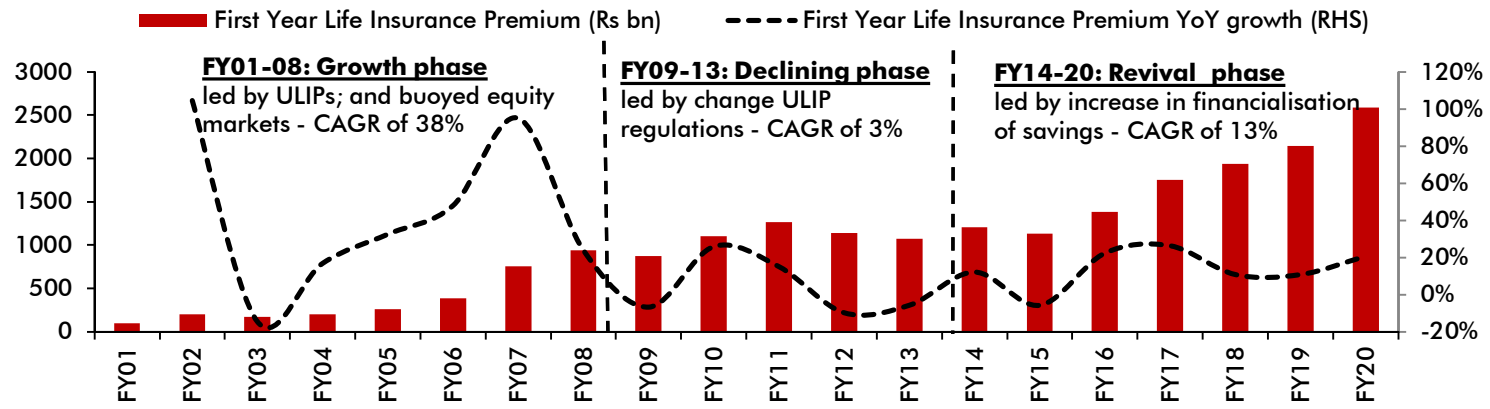
Life insurance industry can post 12.5% CAGR over the next decade

Industry NBP grew at a CAGR of 19% over the last 19 years. Growth hasn't been linear; it picked up recently (14% CAGR over FY14-20) led by increase in financialisation of savings and new product launches. Over the next decade the industry could grow at 12.5% CAGR led by specialized products like protection (23% CAGR) and annuities (20% CAGR). Given cyclical nature, we expect the non-annuities savings business to remain volatile and grow slower at ~8% CAGR.

Premium growth has been high though volatile

The industry has grown at a CAGR of 19% over the last 19 years in terms of new business premium (NBP). However, growth was not linear during this period with the industry having grown at a very rapid pace of 38% CAGR over FY01-08 due to popularity of unit-linked plans and buoyed equity markets. This was followed by a muted phase of 3% CAGR over FY09-13 due to multiple regulatory changes which forced the industry to redesign its products. The pace picked up recently with the industry clocking 14% CAGR over FY14-20 on the back of increase in financialisation of savings and new product launches.

Exhibit 1: NBP of life insurance industry in India has grown at a CAGR of 19% over the last 19 years



Source: IRDA, Ambit Capital research

In 2010, IRDAI tightened regulations for linked products and even the equity markets were jolted post the global financial crisis. This nudged insurers into product and distribution consolidation efforts which led to a prolonged phase (FY09-13) of muted premium growth. The period starting FY14 witnessed stagnation of household savings in physical assets and FY16 onwards large private insurers started to list. This had led to focus expanding from just premium growth to profitability (VNB growth).

Specialized products to drive profitability

The next phase (decade) would rely on specialized products, which only life insurers can sell to drive premium growth and profitability. In our view, supported by demographics and pension structure, the next decade would belong to protection and annuity offerings. Given the high margin structure of these products, industry profitability will only improve even with premium growth rates lower than in the last couple of decades. To envisage industry profitability structure over the next decade we deep-dive to unearth the true potential in protection and annuity offerings.

Protection and annuities to be kingpins

We believe the Indian insurance industry should **grow at ~12.5% p.a. over the next 10 years to ₹8.3tn NBP.** Protection and annuities would be structural secular growth stories while growth of non-annuity savings business would remain volatile given its cyclical nature. We estimate protection to grow at a CAGR of 23% over FY20-30 and annuities to grow at 20% CAGR.

Exhibit 2: Retail protection and annuities would drive the sector's premium and profitability growth

Products	NBP - CAGR FY15-20	Expect NBP CAGR FY20-30	Expected VNB margins	Underlying growth drivers	Remarks
Protection	57%	23%	50-70%	Large untapped potential and rising size of opportunity pie	Growth will be premised on under-penetration, under-protection and rising awareness
Annuities	17%	20%	25-35%	Sharp build-up in retirement fund corpus and compulsory annuitization of partial retirement fund corpus	Growth backed by locked demand potential and expected increased retires. Please refer to our section on annuities for more detail
Non-annuity savings	28%	8%	7-10%	Market and interest rate cycles	Cyclical business with increasing competition from mutual funds and other financial investment options

Source: IRDA, Ambit Capital research

Peeling the layers of growth

Nominal GDP growth of ~9% and increasing share of financial assets would lead to around 12% CAGR in household financials savings. However, insurance sector losing some market share in savings/investment products means that the industry could grow at only 12.5% CAGR. **Building in high growth (23% CAGR) in pure protection and annuities (20% CAGR) business lifts overall growth.** We expect non-annuities savings business to remain volatile and grow slower at ~8% CAGR over the next decade. Additionally, we expect private insurers to grow faster at ~14.5% over the next decade on the back of gain in market share.

Exhibit 3: Top-down dissection of growth – 12.5% CAGR over FY20-30

	FY20	FY21E	FY22E	FY23E	FY24E	FY25E	FY26E	FY27E	FY28E	FY29E	FY30E	10-year CAGR	Comments
Nominal GDP (units) (A)	100	95	104	115	128	142	157	174	194	215	239	9.1%	Nominal GDP growth estimates for India based on our internal estimates
Nominal GDP growth		-5%	9%	11%	11%	11%	11%	11%	11%	11%	11%		
Household savings as a % of GDP (B)	18%	18%	18%	18%	18%	18%	19%	19%	19%	19%	20%		Assuming that household savings rate remains flat for first few years and then moves up marginally
Net financial savings as a % of household savings (C)	37%	38%	39%	39%	40%	41%	42%	42%	43%	44%	45%		However, share of financial savings should go up due to lower returns on physical assets like gold and real estate
Total financial savings (units) (D=A*B*C)	6.7	6.5	7.2	8.1	9.2	10.5	12.1	13.8	15.8	18.1	20.7	12.0%	
Insurance as % of financial savings (E)	17%	17%	17%	17%	17%	16%	16%	16%	16%	16%	16%		We have assumed market-share loss for insurance to other savings and investment products on stiffer competition from mutual funds and other financial investment options
Insurance premiums savings/investments (units) (F=D*E)	**1.1**	**1.1**	**1.2**	**1.4**	**1.5**	**1.7**	**2.0**	**2.2**	**2.5**	**2.9**	**3.3**	**11.0%**	
Annuities (G)	0.2	0.2	0.3	0.3	0.4	0.5	0.5	0.7	0.8	0.9	1.1	20.0%	Annuities will grow faster given locked demand potential. Please refer to our section on annuities for more detail
Non-annuity savings (H)	**1.0**	**0.9**	**0.9**	**1.0**	**1.1**	**1.3**	**1.4**	**1.6**	**1.7**	**1.9**	**2.1**	8.2%	Non-annuity savings business is cyclical and in our view will face stiff competition from mutual funds and other financial investment options
Insurance premium pure protection (units) (I)	0.09	0.11	0.14	0.17	0.21	0.26	0.32	0.39	0.48	0.59	0.73	23.0%	Due to under-penetration, pure protection policies would grow at a fast pace. Please refer to our section on protection for more details
Total insurance premium (J=F+I)	**1.2**	**1.2**	**1.4**	**1.5**	**1.7**	**2.0**	**2.3**	**2.6**	**3.0**	**3.5**	**4.0**	**12.4%**	
Private sector market share (K)	32%	33%	33%	34%	35%	35%	36%	37%	37%	38%	39%		Expect some market-share gain for private sector at the expense of LIC
Private sector insurance premiums (units) (L=J*K)	**0.4**	**0.4**	**0.5**	**0.5**	**0.6**	**0.7**	**0.8**	**1.0**	**1.1**	**1.3**	**1.5**	**14.5%**	

Source: RBI, IRDAI, NSO, MoSPI, Ambit Capital research

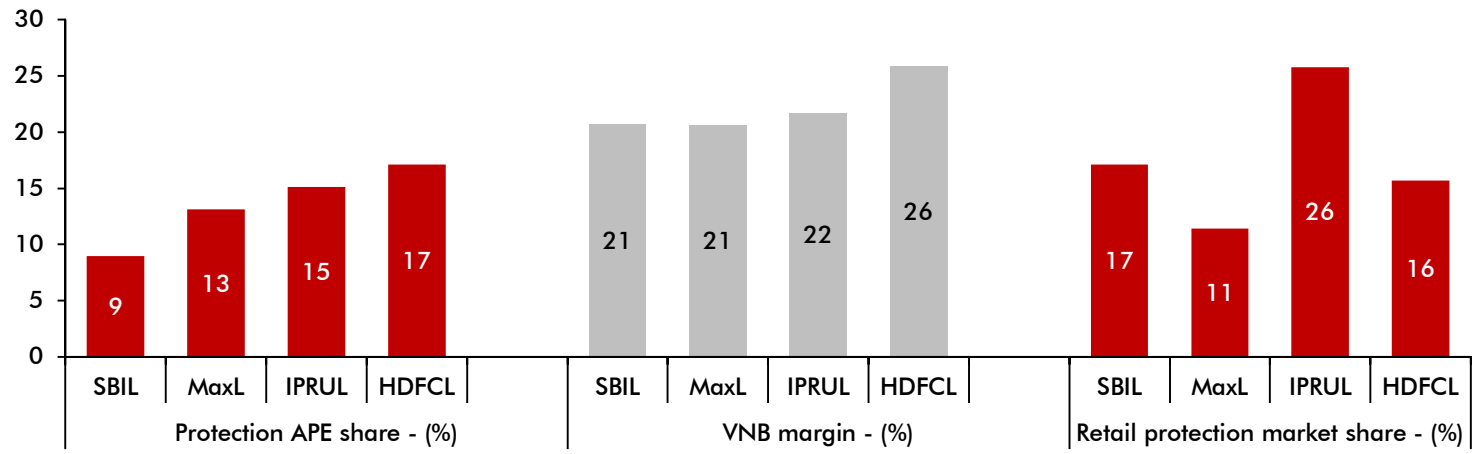
Protection: To grow 8x by FY30, and drive profitability

Retail protection sum assured for the sector could grow 8x to ₹523bn by FY30, implying premium CAGR of 23%. Large part of growth would be front-ended given recent push for accelerated premium offerings. Our analysis suggests low penetration level of ~12% as of FY20. This along with structural growth levers such as an expanding middle class, nuclearisation of families and a young population base would drive high growth. Development of direct channel and initiatives to increase awareness (advertising and promotions) would be key to gain market share. We estimate margins to decline amid rising competition to 50-70% vs 90-110% now, while still maintaining its most profitable product tag. This implies protection could contribute almost 2/3rd of overall profitability (VNB) for most large players over the next decade.

In this section we attempt to answer four key questions on investors' minds:

- What is the size of the total opportunity?
- What is driving growth now?
- Who's placed to do well?
- Key risks to watch out for

Exhibit 4: Currently; HDFCL is the market leader in overall protection while IPRUL is the market leader in retail protection

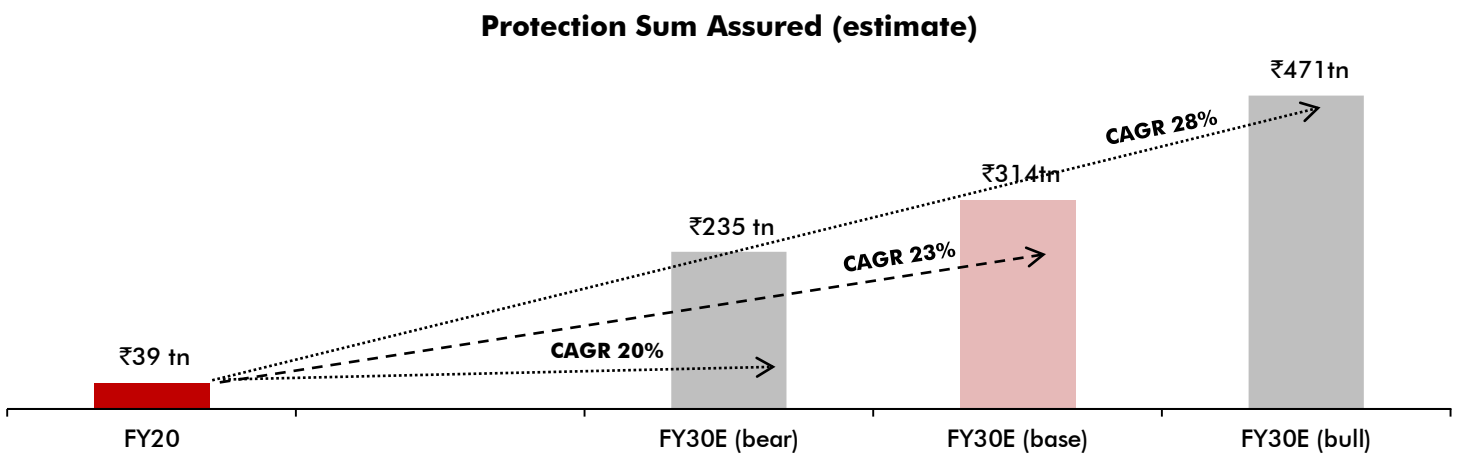


Source: Company, Ambit Capital research

What is the size of the total opportunity?

We estimate sector retail protection sum assured to expand **8x to ₹523bn** by FY30, implying a CAGR of 23%. Large part of growth would be front-ended given recent push for accelerated premium offerings. Our calculation suggests, as of FY20, ~5.3mn retail protection policies would be in force. This implies only ~18% of the addressable market opportunity of ~30mn would be covered. To neutralize the noise in the premiums we make use of protection sum assured data and then back-calculate true APE growth potential.

Exhibit 5: Retail protection to clock >20% CAGR over the next 10 years

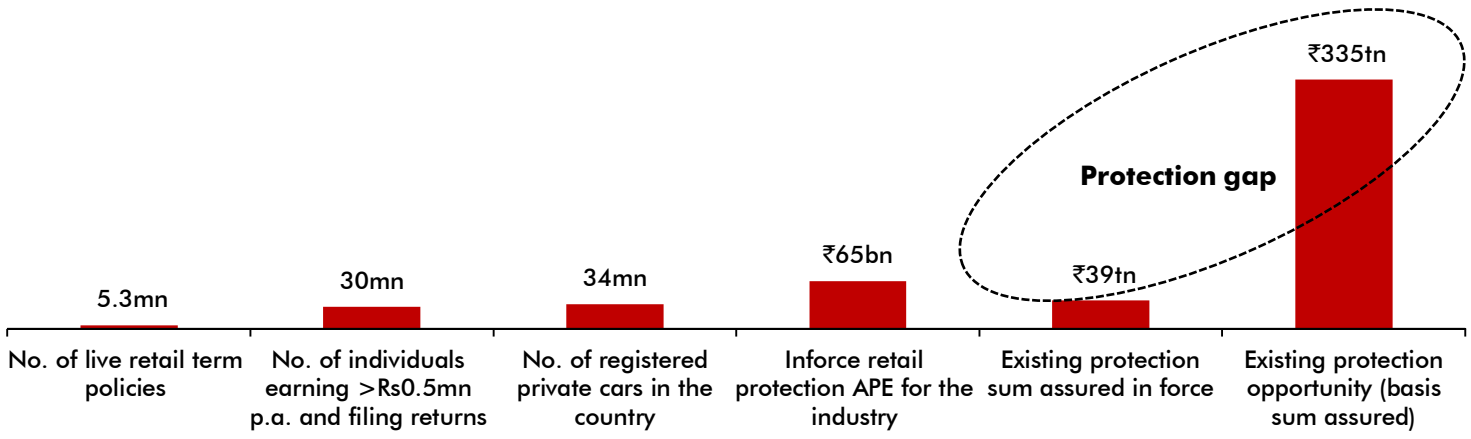


Source: Income Tax Department, IRDAI, MoRTH, Company, Ambit Capital research

Cutting through addressable market opportunity

Addressable market opportunity constitutes individuals earning >₹0.5mn per annum. We take cues from data on return filings published by the income tax department. We estimate as of FY20 the number of individuals earning >₹0.5mn per annum and filling income tax returns to be ~30mn. We also corroborate this with number of private cars registered in the country, which we estimate to be ~34mn. Our analysis excludes individuals earning >₹0.5mn but not filing tax returns. We believe some additional growth can come from this segment but should not meaningfully dent our analysis. We say so because possibility of fraudulent cases in this customer segment is high and hence not an ideal target segment for insurers. We assume individuals earning less than ₹0.5mn would not buy term insurance given higher focus on savings.

Exhibit 6: Key statistics of as at end-FY20



Source: Income Tax Department, IRDAI, MoRTH, Company, Ambit Capital research

We estimate, as of FY20, ~18% of the eligible population subscribes to pure retail term offerings. That said, we estimate current protection penetration (basis sum assured) to be ~12%. The difference between the two signifies the level of under-protection in the country, i.e. ~6%.

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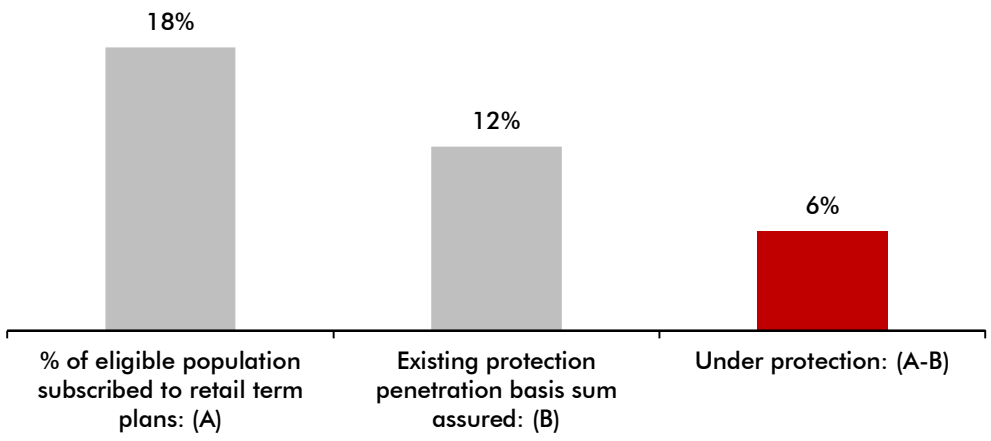
Exhibit 7: We estimate the level of under-protection as of FY20 to be ~6%

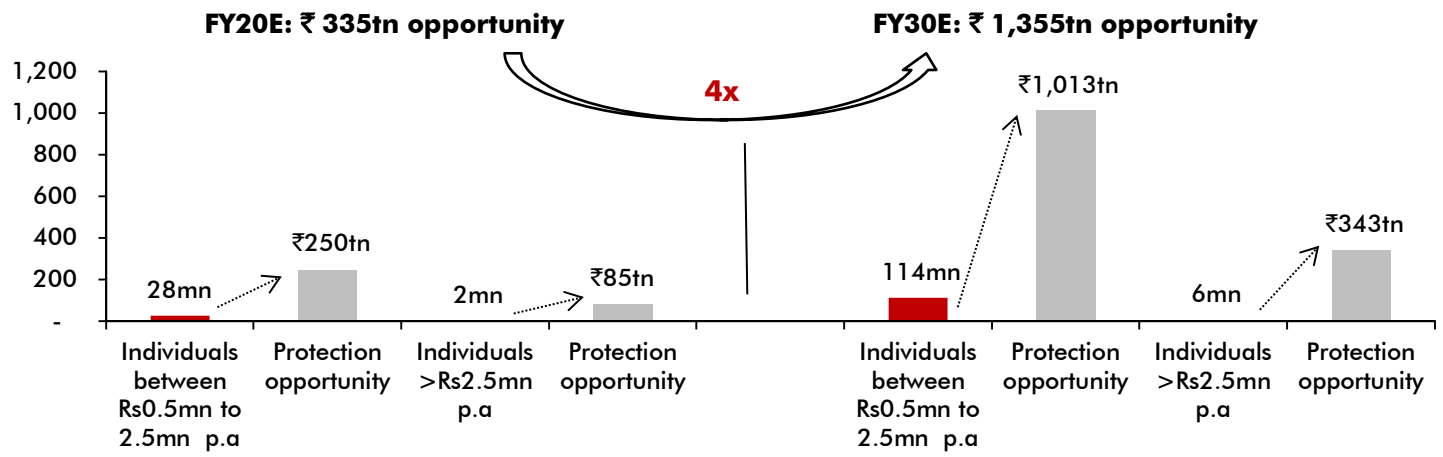


Source: Income Tax Department, IRDAI, MoRTH, Company, Ambit Capital research

Peeling the methodology used

We use number of individuals earning >₹0.5mn per annum and filing income tax returns as our starting point. As mentioned earlier we estimate the size of this population base to be ~30mn as of FY20. We assume minimum required protection cover, i.e. sum assured, as 10x of annual income for individuals earning up to ₹2.5mn per annum. For individuals earning >₹2.5mn per annum we assume minimum required cover of 7x given higher savings cushion in this bracket. We believe that above a certain income threshold the need for protection starts diminishing as existing savings are enough to take care of exigencies. We also corroborated this with existing data of outstanding policies. We multiply average income in each income slab with the number of individuals to arrive at the existing protection opportunity in the country. Basis our house projections on per capita income growth, historical tax return trends and our assumptions on protection multipliers, we estimate the eligible population base and expected protection opportunity in FY30.

Exhibit 8: We estimate protection opportunity will expand by 4x over the next 10 years

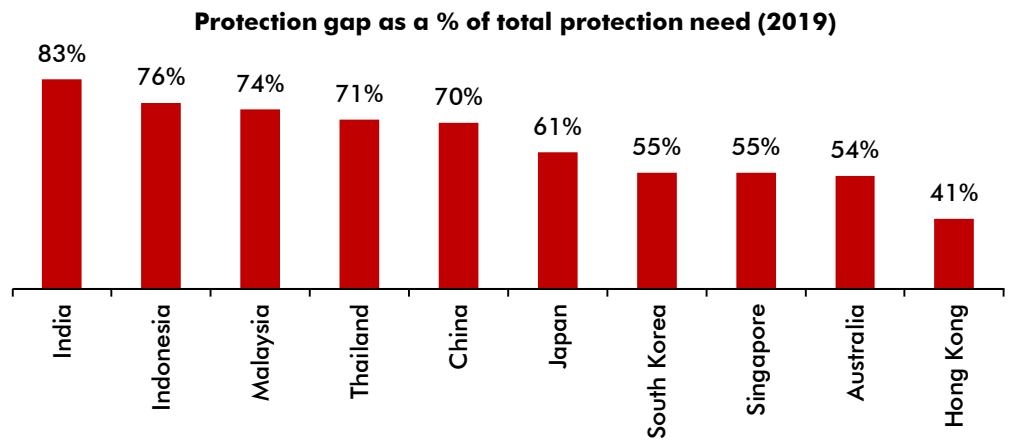


Source: Income Tax Department, NSSO, IRDAI, Company, Ambit Capital research

In our final step, we expect protection penetration to double from ~12% in FY20 to ~23% in FY30 (base case). Our assumption takes cues from the following:

- We first estimate India's GDP per capita in FY30 basis our house view (~USD 5,217).
- We then look at existing (FY19) overall penetration level of countries with GDP per capita in the band of USD4,000-8,000 to arrive at expected penetration level in India in FY30. For e.g. as per Swiss Re Institute's 'Asia mortality protection gap survey 2019' report, life insurance sum assured to GDP of countries like Indonesia and Thailand is ~2x that of India.

Exhibit 9: Protection gap in India is widest amongst leading Asian economies



Source: Swiss Re Asia mortality protection gap survey 2019, Swiss Re Institute; Ambit Capital research

Factoring this, we expect sum assured to clock a CAGR of 23% over the next 10 years. We assume sum assured to APE multiplier of 600 to derive retail inforce protection APE for all periods. To back-test our APE multiplier, we also corroborate our FY20 derived APE numbers with our independent assessment of FY20 inforce APE.

Exhibit 10: Protection APE set to clock 23% CAGR over the next 10 years

Year	Scenario	Multiplier to FY20E penetration	Penetration - [A]	Sum protection assured opportunity (₹ tn) -[B]	Estimated protection sum assured (₹ tn) - [A*B]	Sum assured CAGR FY20-30E	Sum assured to APE multiplier	Derived inforce APE (₹ bn)
FY20E			12%	335	39			65
	Bull	3.0x	35%		471	28%	600	785
FY30E	Bear	1.5x	17%	1,355	235	20%		392
	Base	**2.0x**	**23%**		**314**	**23%**		**523**

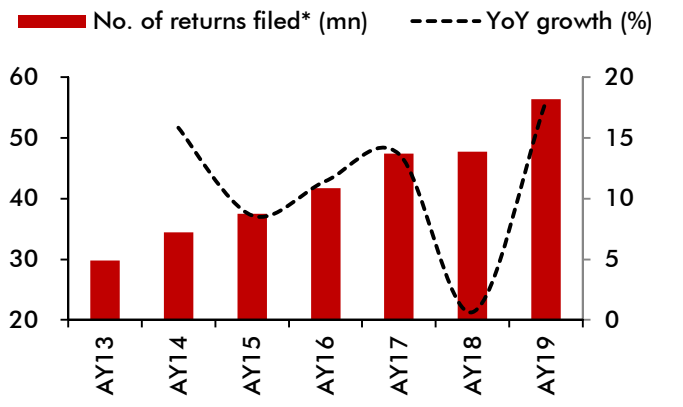
Source: Income Tax Department, IRDAI, MoRTH, Company, Ambit Capital research

India's demographics provide levers for long-term sustainable growth

Our conviction on large protection opportunity is also supported by some of the structural levers presented by India's demographics, like:

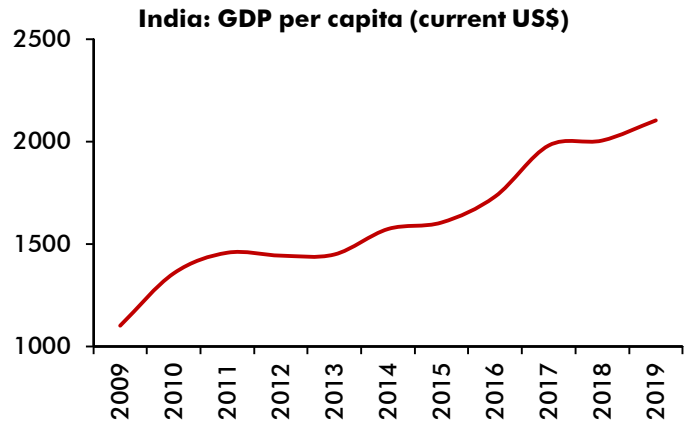
- Increasing formalization of savings, reflected in 11% CAGR between AY13-19 in number of returns filed (individuals + HUFs) filed in the country
- Consistent rise in GDP per capita - CAGR of 7% between 2009-2019
- Rise in nuclear family structures propelled by increasing urbanization
- Young age profile of the country
- Lack of government-backed social security measures for the mass affluent class

Exhibit 11: The number of returns filed has clocked 11% CAGR between AY13-19



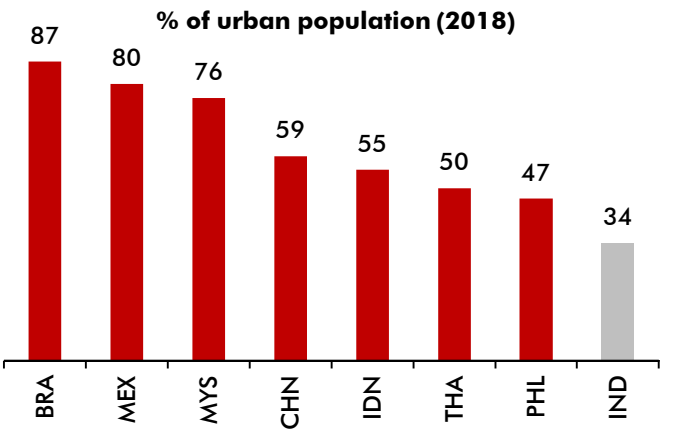
*Source: Income Tax Department, Ambit Capital research; *includes individuals + HUF*

Exhibit 12: Consistent rise in GDP per capita; CAGR of 7% between 2009-2019



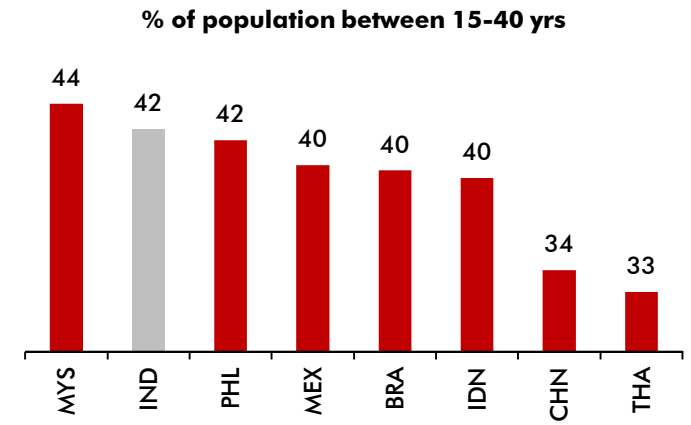
Source: World Bank, Ambit Capital research

Exhibit 13: Scope for increase in urbanization...



Source: United Nations; Ambit Capital research

Exhibit 14: ... backed by a young population base

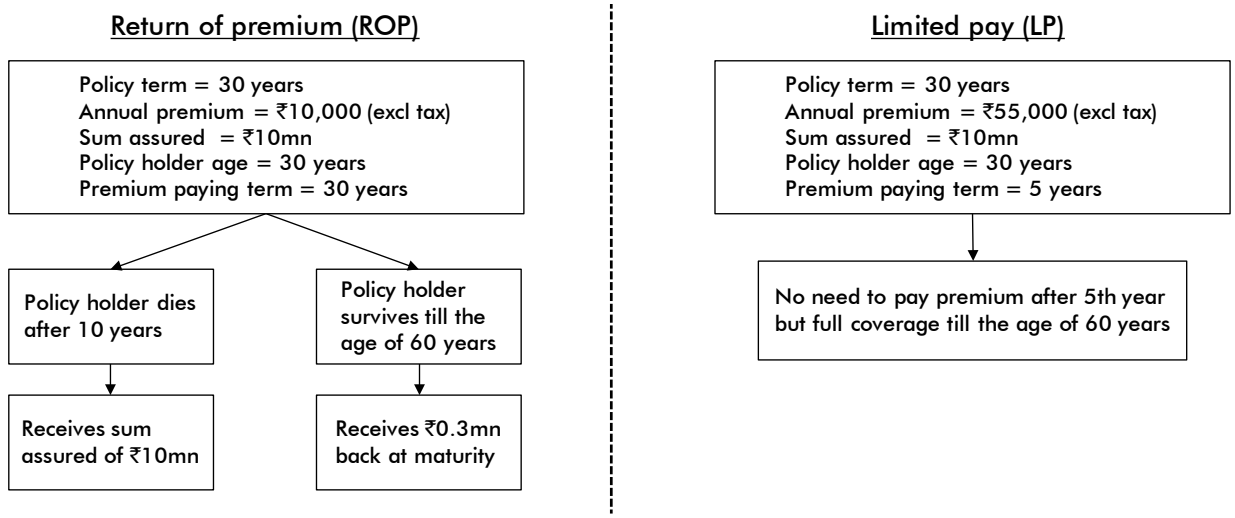


Source: United Nations; Ambit Capital research

What is driving current super normal retail protection growth?

Lower distributor incentives on account of low premium ticket size and higher new business strain (first year negative impact on P&L on account of high reserving requirement and medical check-up expenses) have been key hindrances to selling a regular premium protection offering. To overcome this, insurers are realigning distributor incentives, developing direct channel, focusing on increasing awareness (higher ad-spends) and developing newer product variants with increased flexibility. Limited pay and return of premium (RoP) offering are a few such variants.

Exhibit 15: What exactly are limited pay and return of premium variants of retail term plans?



Source: Company, Ambit Capital research

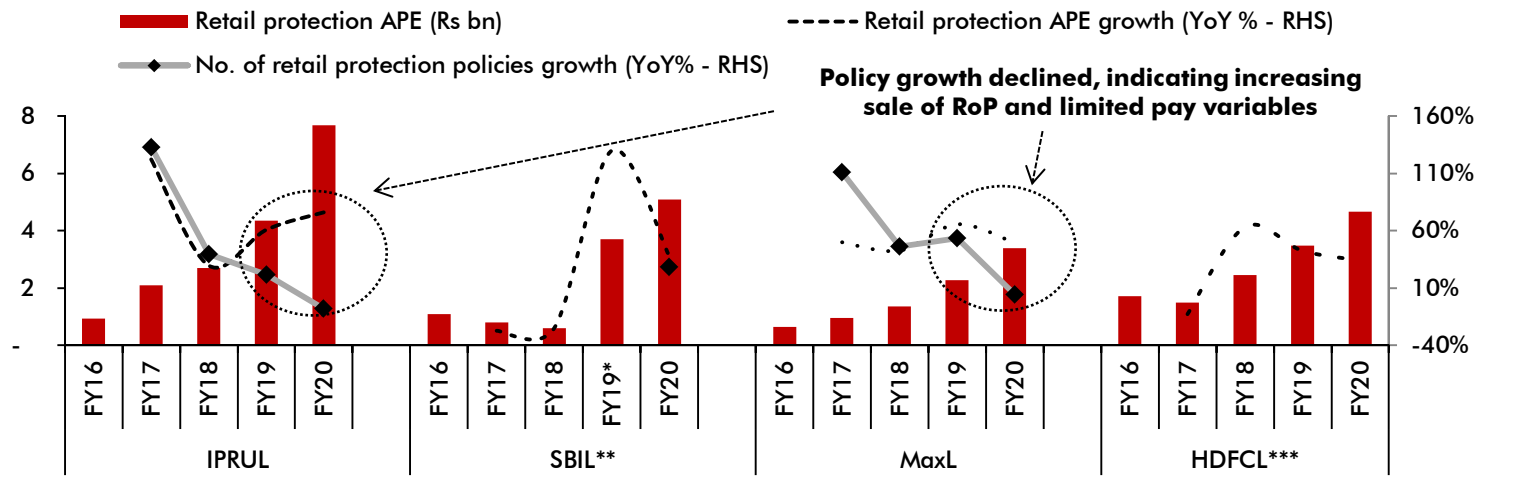
- **Return of premium (RoP):** Accumulated premiums (excluding taxes) are returned to the policy holder at maturity if the holder survives. Premium ticket size of these polices are on an average 2.0-2.5x higher than plain vanilla term plans.
- **Limited pay (LP):** Flexible premium paying term with minimum premium paying term of 5 years. E.g.: A policy holder is 30 years of age and has coverage of 40 years till the age of 70 years. This holder could design the policy to pay accelerated premiums for 10 years.

Limited pay and RoP a customer needs or an incentive realignment story?

Limited pay and return of premium variants (RoP) have higher ticket sizes and hence introduction of these variants have helped pave way for insurers to better incentivize distributors. Almost all the limited pay variants sold have >=5 years as payment paying term. Since any product with 5 or more years as payment paying term gets classified as a regular pay product, distributors end up making higher commissions (up to 40% of first year premium)

- **Front-ending future growth through limited pay and RoP variants:** Retail protection APE for top four private insurers (commanding >70% market share) grew at a supernormal rate of 94%/51% in FY19/20. A large part of the growth came through introduction of limited pay and RoP product variants introduced in 2HFY19. These variants have higher ticket size than the regular pay products. Our interactions with life insurers suggest in FY20 these variants account for 40-75% of total retail protection APE for top four private life insurers (i.e. SBIL, IPRUL, HDFCL and MaxL).

Exhibit 16: Retail protection APE growth in FY20 has been largely on account of sale of RoP and limited pay variants

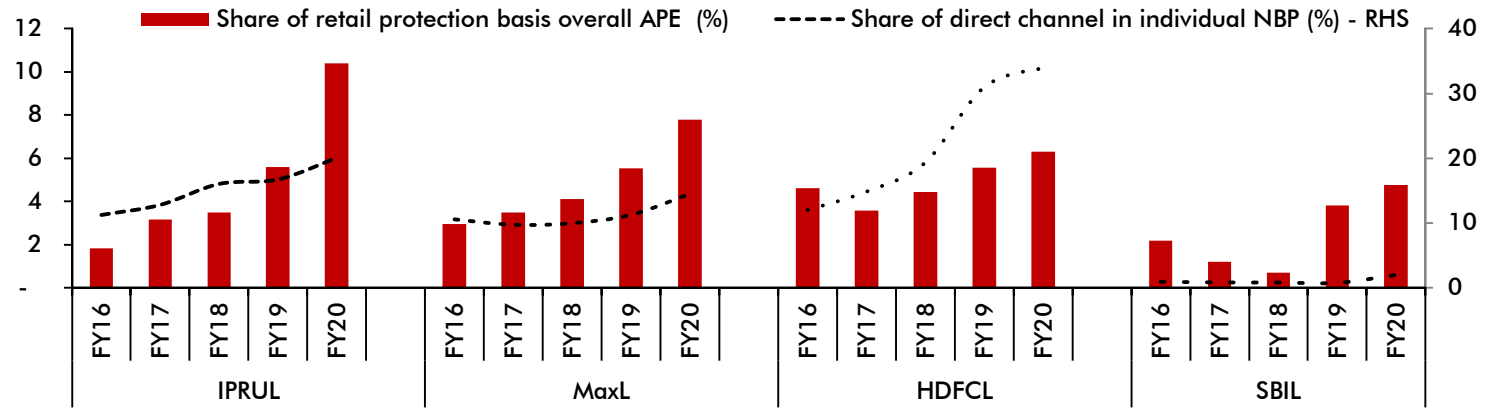


*Source: Company, Ambit Capital research; *FY19 retail APE growth for SBIL is not as per scale (actual YoY retail protection APE growth for FY19 is 517%); **SBIL has started publishing retail protection policy sales count from FY19 onwards; ***HDFCL does not publish data on retail protection policy count*

Total protection opportunity in the country remains finite. Given current growth trajectory is inflated, extrapolating the same going forward would be a mistake.

- **Evolved direct channel**: Direct channel is a better channel for sale of pure protection products as a meaningful portion of sales through this channel is not constrained by a commission-based incentive structure. Bancassurance channel is more attuned to sell investment products given wealth management focus of bank sales force. Given higher commission payouts (higher ticket size) even agents prefer sale of investment products. In the insurers analyzed, HDFCL/IPRUL have the most evolved direct channel (34%/20% contribution of direct channel to individual NBP in FY20) and are best-placed to build a retail protection franchise.

Exhibit 17: IPRUL, MaxL and HDFCL have been developing the direct channel, aiding in higher protection throughput



Source: Company; Ambit Capital research

- **Advertising and publicity:** Advertising and publicity spends of the top four private life insurers increased by ~44% CAGR between FY16-20, with large allocations towards protection offering. This period also coincided with retail protection APE growth of ~48% for these players. Even Swiss Re Institute's 'Asia mortality protection gap survey 2019' report highlights promotions as one of the top triggers of life insurance purchase in India.

Exhibit 18: Top triggers for life insurance purchase

	China	Indonesia	Malaysia	Thailand	India
Unweighted base	1716	886	609	828	571
Top triggers	▪ Agent/broker 37% ▪ Friend 35% ▪ Breadwinner gets old 31%	▪ Friend 29% ▪ For investment 27% ▪ Tax savings 26%	▪ Agent/broker 32% ▪ Friend 31% ▪ For investment 28%	▪ Agent/broker 35% ▪ Tax savings 25% ▪ Friend 23%	▪ For investment 38% ▪ Friend 37% ▪ Agent/broker 29%
Disroptionately high	▪ Breadwinner gets old 31% ▪ Accident/sick/death 25% ▪ Promotions 23%	▪ Tax savings 26% ▪ Parents get old 20% ▪ Inspired by articles 17%	▪ For investment 28% ▪ Promotions 22%	▪ Tax savings 25%	▪ Promotions 27%
	Hong Kong	**Singapore**	**Japan**	**Australia**	**South Korea**
Unweighted base	390	484	342	201	477
Top triggers	▪ Agent/broker 34% ▪ Friend 25% ▪ For investment 20%	▪ Agent/broker 35% ▪ Friend 26% ▪ First salary 15%	▪ Friend 23% ▪ Got married/Baby 22% ▪ Agent/broker 20%	▪ Got married/baby 24% ▪ Bought a property 18% ▪ Purchased with other insurance 16%	▪ Agent/broker 35% ▪ Friend 34% ▪ Accident/sick/death
Disroptionately high	▪ Agent/broker 34% ▪ Breadwinner gets old 19%	▪ Agent/broker 35% ▪ First salary 15%	▪ Friend 23% ▪ Got married/baby 22%		

Source: Swiss Re Asia mortality protection gap survey 2019, Swiss Re Institute; Ambit Capital research Note: Text in orange refers to where consumers receive recommendations; blue refers to financial reasons for considering life insurance, and green to life events that trigger consideration of insurance

- **Product innovation:** Insurers have innovated with various flexible pay structures coupled with add-on riders like critical illness. This has not only led to much better product proposition but also aided in improving the margin profile of the product. Popularity of limited pay and RoP protection product variants post their launch in 2HFY19 is a classic example of product innovation-led success.

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- **Trust in the brand**: A life insurance contract is a long-term contract only invoked in one's absence. Hence, the ability of the insurer to honor claims becomes a prime criterion to select an insurance policy. Additionally, with not much to differentiate among products across insurers and shift towards longer-term contracts (average 20-40 years contract maturity for protection) trust in the brand plays a very important role. LIC along with some large banks (exhibit 19) are the most trusted brands in the BFSI category. Private life insurers owned by large banks and NBFCs enjoy name sharing with their parent shareholders. SBI Life, IPRU Life and HDFC Life all share names with their respective parents, State Bank of India, ICCI Bank, HDFC Limited (parent of HDFC Bank) respectively. Strength of these brands is captured in the survey results in the table below.

List top trusted brands in India (BFSI category-2020).

Exhibit 19: List of top BFSI brands in the country

Rank	Brand Name	Category
1	State Bank of India	Banks – PSU
2	LIC	Life Insurance – PSU
3	ICICI Bank	Banks – Private
4	Punjab National Bank	Banks – PSU
5	HDFC Bank	Banks – Private
10	Bajaj Finance	Financial Services
11	Kotak Mahindra Bank	Banks – Private
12	Axis Bank	Banks – Private

Source: TRA's brand trust report (2020 rankings-BFSI super category), Ambit Capital research

Who is placed to do well?

Access to the mass affluent segment, brand recognition and pricing are key determinants of success in this segment. Analyzing major insurance companies on the above parameters/competitive advantages, IPRUL and HDFCL emerge best-placed to grow and gain market share in the segment.

Exhibit 20: Protection strength estimate framework: IPRUL and HDFCL are best-placed to deliver higher growth in protection business

Retail protection franchise strength estimator	HDFCL	IPRUL	SBIL	MaxL	Measured based on
Market-share estimate	16%	26%	17%	11%	Retail protection APE
Access to addressable market - (50% weight)	**3.2**	**3.4**	**2.2**	**1.6**	
- Reach of primary banca. partner	◐	◕	●	◔	Number of metro/urban bank branches
- Customer profile of major banca. partner	●	◕	◔	◐	Average size of debit card spends for primary banca. partner
- Cross sell potential of primary banca. sales force	●	◕	◔	◐	Credit card to debit card ratio
- Direct channel evolution	●	●	◔	◐	Contribution of direct channel to individual NBP
- Open architecture status of primary banca. partner	◐	●	●	◔	Acceptance of open architecture by primary bancassurance partner
Strength of the brand/trust - (30% weight)	**3.0**	**3.0**	**3.0**	**2.5**	
- Brand recall and perceived safety	◕	◕	●	◔	Based on brand survey and ownership
- Claim settlement ratio	◕	◕	◐	●	Based on historical claim settlement ratio
Product innovation - (10% weight)	**4.0**	**4.0**	**1.0**	**2.0**	
- Product variants/flexibility	●	●	◔	◐	Number of variants of retail protection and flexibility (limited/RoP/whole life coverage, etc.)
Pricing - (10% weight)	**3.0**	**3.0**	**2.0**	**4.0**	
- Sum assured received for per rupee of premium paid	◐	◐	◔	●	Pricing of pure protection product
Final scalability score - weighted average	**3.2**	**3.3**	**2.3**	**2.2**	

Source: Company, RBI, IRDAI, Ambit capital research Note: ● - Strong; ◕ - Relatively Strong; ◐ - Average; ◔ - Relatively weak

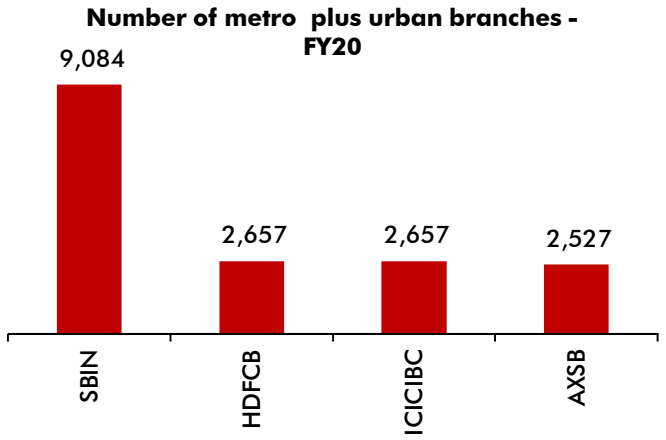
IPRU Life is best-positioned: Benefits from bancassurance channel geared towards selling retail protection (~42% for FY20 vs ~14% for HDFCL). ICICI Bank not accepting open architecture also remains a key positive for IPRUL compared to HDFCL. IPRU Life is well-positioned to capture the mass affluent urban segment with right mix of brand recall, reach and pricing.

HDFC Life is a close second: Best in class in terms of product innovation, execution and adoption of higher-margin health riders. Its primary bancassurance partner HDFC Bank embracing open architecture gives its closest competitor IPRU Life the edge when it comes to cross-sell potential. This has pushed HDFC Life to build its direct channel which has developed well compared to peers. Benefits from aggression and affluent customer profile of primary bancassurance partner.

SBI Life hits below its weight: Beneficiary of pseudo sovereign identity and unmatched entrenched distribution network. Lags behind when it comes to quality of customer profile and aggression of its sales force with respect to its primary bancassurance partner (SBI Bank). Laggard when it comes to product innovation. Pricing in the protection segment remains relatively high compared to peers given inferior mortality experience fueled by entrenched pan-India presence and resultant customer mix. SBI Life has not focused on development of direct channel given possibility of channel conflict with bancassurance and agency channels. In our view, if it sharpens focus on the product segment and improves strategic agility, it can take a lion's share in the segment.

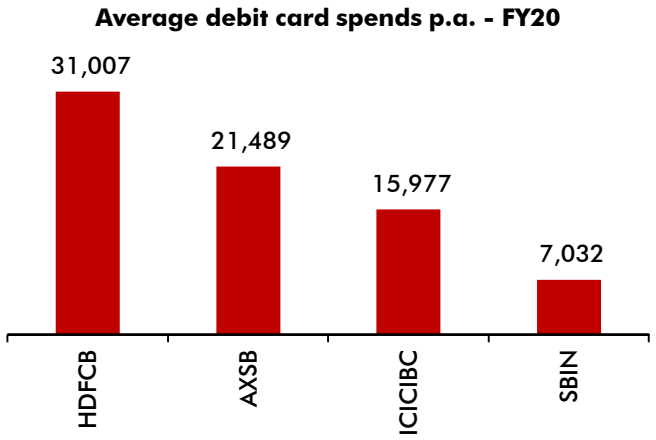
Max Life operates well amid constraints: Amongst the top four private life insurers, Max Life is the only insurer that is not a bank/NBFC-owned franchise. This remains a big constraint for Max Life given distribution is key to building a large life insurance business in India. Additionally, it also lacks when it comes to brand recall and trust compared to bank-backed life insurers. Nevertheless, it overcomes some of its shortcomings by aggressively (compared to larger peers) pricing its protection offering and also benefits from best-in-class claims settlement ratio. Proposed deal with Axis Bank, if it goes through, will be a key breakthrough.

Exhibit 21: SBIL enjoys largest distribution network and customer base...



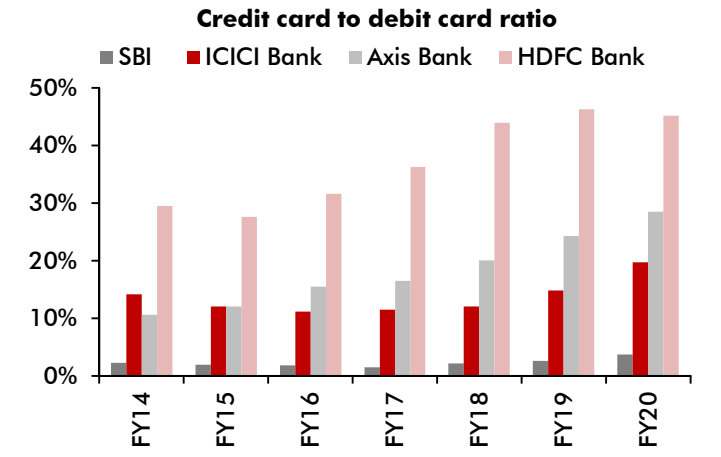
Source: RBI, Company, Ambit Capital research

Exhibit 22: ... but HDFCL/IPRUL have a superior customer mix with higher share of affluent customer segment



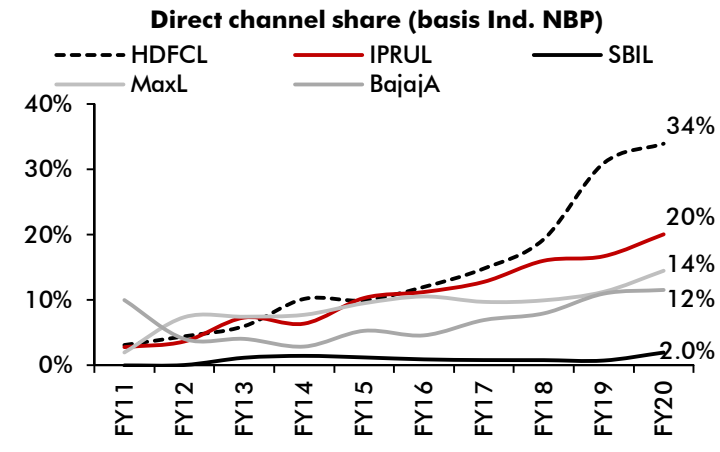
Source: RBI, Ambit Capital research

Exhibit 23: HDFC Bank's ability to cross-sell is superior compared to its peers; benefits HDFCL



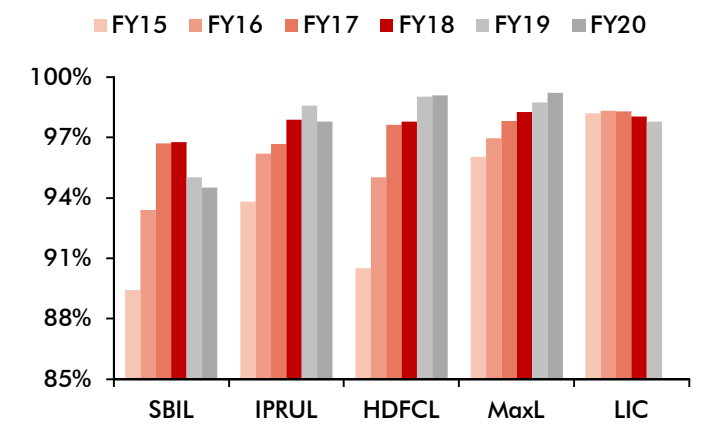
Source: RBI, Company, Ambit Capital research

Exhibit 24: HDFCL/IPRUL both have a more evolved direct channel; key to sustainable protection growth



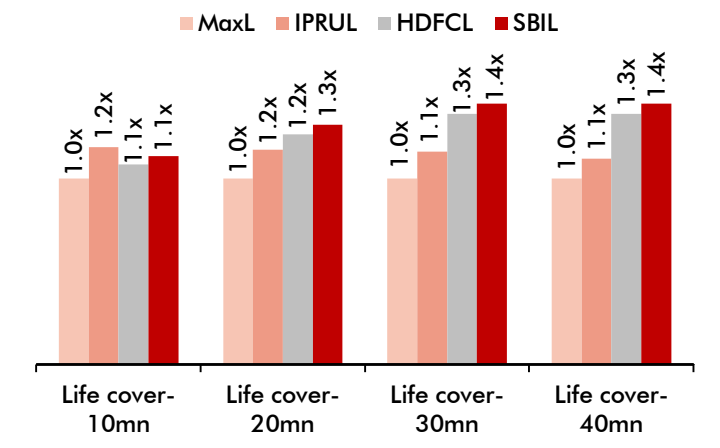
Source: IRDAI, Company Ambit Capital research

Exhibit 25: Claim settlement ratio - MaxL has seen consistent improvement; highest as of FY20



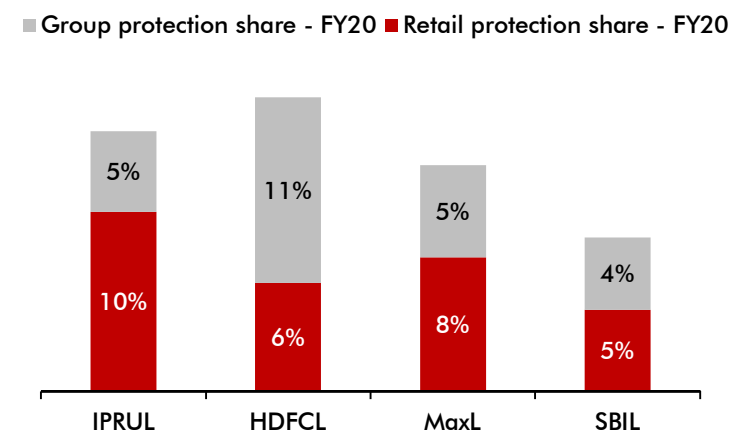
Source: IRDAI, Company, Ambit Capital research

Exhibit 26: Online pricing of regular premium term policies; IPRUL has the most consistent pricing



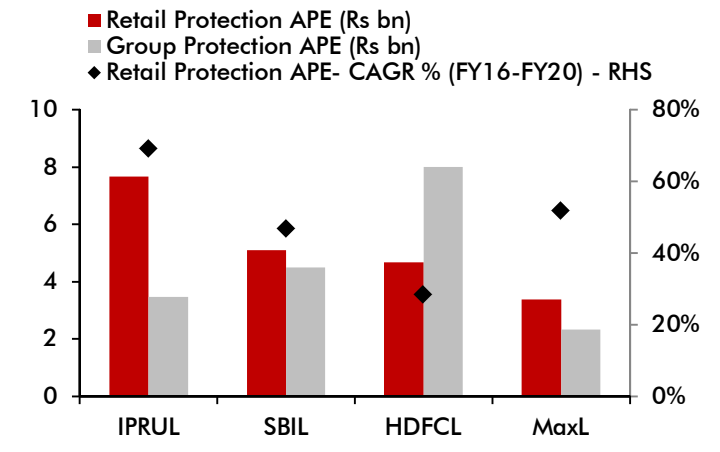
Source: PolicyBazaar; Ambit Capital research Note: Premium for a non-smoker at an entry age of 30 years with cover up to 60 years of age , Male taking salary as 5 to 7 lacs, resident of Maharashtra, graduate and above. (as of 03 September 2020); pricing indexed to MaxL

Exhibit 27: IPRUL/HDFCL remain well-positioned to grow the protection segment



Source: Company; Ambit Capital research

Exhibit 28: IPRU is the market leader and the fastest growing franchise in the retail protection segment



Source: Company; Ambit Capital research

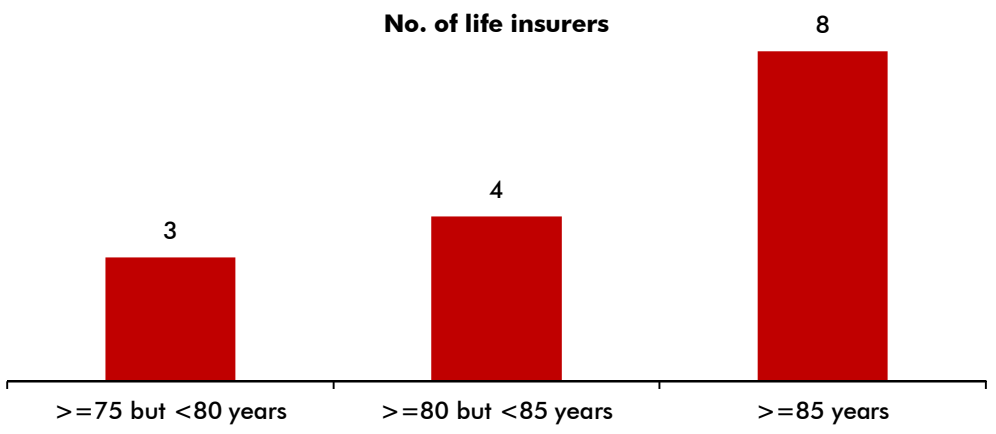
Risk build-up in retail term plans

To lure customers and distributors, life insurers have introduced various variants of term plans. Following are some of the common variants sold in the market:

- **Return of premium (RoP):** Premium ticket size of these polices are on an average 2.0-2.5x higher than plain vanilla term plans.
- **Limited pay (LP):** Holder could design the policy to pay accelerated premiums.
- **Return of premium with limited pay option**: Accumulated premiums returned at maturity plus flexibility of choosing premium paying term.
- **Whole life term plan (WLPs):** Any variant of retail term plan with coverage up to 100 years. Given elongated coverage period sum assured payouts in these policies are practically certain. Typically life insurers charge a higher premium to accommodate certainty of payouts. Our analysis suggests 8 out of 20 insurers selling retail term plans offer coverage of 85 years or higher up to 100 years.

All the above variants have a higher ticket size than the plain vanilla term plans. In case of RoP and WLPs the insurers collect higher premium factoring eventual maturity or death payouts. In the case of LP variants an accelerated premium structure is provided to holders assuming a certain minimum long-term interest on investment. In either case, the insurer bears the interest rate risk.

Exhibit 29: Most life insurers are offering whole life term covers



Source: Policybazaar, Company, Ambit Capital research

Added features are increasing the embedded interest rate risk. Long tenure of these products and almost certain cash outflows at maturity are prime reasons of build-up in interest rate risk. In case of limited pay variants given life insurers are collecting premiums in a short span, interest risk develops if large premium collections happen in low interest rate environment followed by sharp pick-up in later years. Average new policy tenure of >30 years makes hedging in this segment difficult. Though, at this point the share of retail protection is small but as the industry develops we see interest rate risk building up in this segment.

Annuities - The next big opportunity!

Annuities are gaining traction; we estimate it to clock 20% CAGR by FY30 backed by 18% CAGR in retirement corpus (accumulation phase) between FY10-20 to ~₹29tn. Of this, ~19% (₹5.5tn) needs to be compulsorily annuitized at maturity, representing higher locked demand potential. We estimate the retirement corpus to be ₹116tn opportunity by FY30, implying 15% CAGR. Large retirement corpus results in an annuity opportunity of ₹2.3tn by FY30. We estimate annuities to contribute 20-35% to total APE for insurers under coverage; up from 4-5% in FY20. Our calculation suggests 25-30% margin for annuities. We expect this to sustain given high sensitivity to mortality and investment returns. This would enable annuities to also drive profitability and add 15-30% to VNB by FY30E.

In this section we attempt to address the following:

- Evolution of regulations in the segment
- Deep-dive into the annuity opportunity pie
- Understanding margins in the annuity segment
- Key risks embedded in annuities

A snapshot of the pension and annuities market in India and way forward

What are annuities?

Insurance products that guarantee a stream of fixed periodic cash flows at equal intervals over the balance life of the policyholder. This is in return for either a lump-sum upfront premium or annual/monthly premiums for a fixed duration before annuity payment begins. As an example, for an upfront premium paid of ₹100 by a 59-year-old policyholder, the insurer guarantees 7% annuity rate payout (₹7 per annum) till death of the policy holder. If the annuity payouts begin immediately after investment, policy is termed as 'immediate annuity'. If the annuity payouts begin after a particular term, the policies are termed as 'differed annuities'. Contrary to term plans, annuities help insure policyholders from **longevity risk**.

Regulatory tailwinds aid accumulation phase build-up

Extension of National Pensions Scheme (NPS) to all Indian citizens (2009) along with higher tax exemptions on NPS (2018) has given a big boost to retirement savings. Additionally, regulatory changes for pension products offered by life insurers (2019) have brought insurance pensions at a level playing field with NPS. This would help in lifting demand for pension products sold by life insurers.

Exhibit 30: Evolution of pension market in India

Year	Event	Features/Impact
2003	Establishment of the interim Pension Fund Regulatory and Development Authority (PFRDA)	GoI's initiative to promote, develop and regulate pension sector in India
2004	Shift from defined benefit to defined contribution scheme	NPS introduced for central (civil) government employees
2009	Defined contribution scheme expanded and extended to all citizens	NPS extended to all Indian citizens
2010	IRDAI mandates 4.5% guaranteed return to be offered by life insurers	Led to collapse of life insurers participation in the pension market
2011	Removal of 4.5% guarantee but capital protection guarantee retained	Directionally a positive move but life insurers remain circumspect
2018	NPS reforms	1) Withdrawal from NPS on retirement made tax-free 2) For central government employees; GoI's contribution increased to 14% of the basic salary from 10% earlier
2019	IRDAI regulations 2019 *(please click here to read full note)*	1) Up to 60% of pension corpus can be commuted vs 33.3% earlier 2) 50% of pension corpus can be used to buy annuities from vendor other than the original pension seller vs need to buy only from the original pension seller earlier 3) Partial withdrawals on ULIP pensions permitted (max 25% of fund; max 3 times in policy tenure; on specific life events) 4) For insurers offering annuities, the options offered should at least cover a life annuity and return of premium annuity vs no restrictions on annuity types offered earlier

Source: IRDAI, PFRDA, MoF, Ambit Capital research

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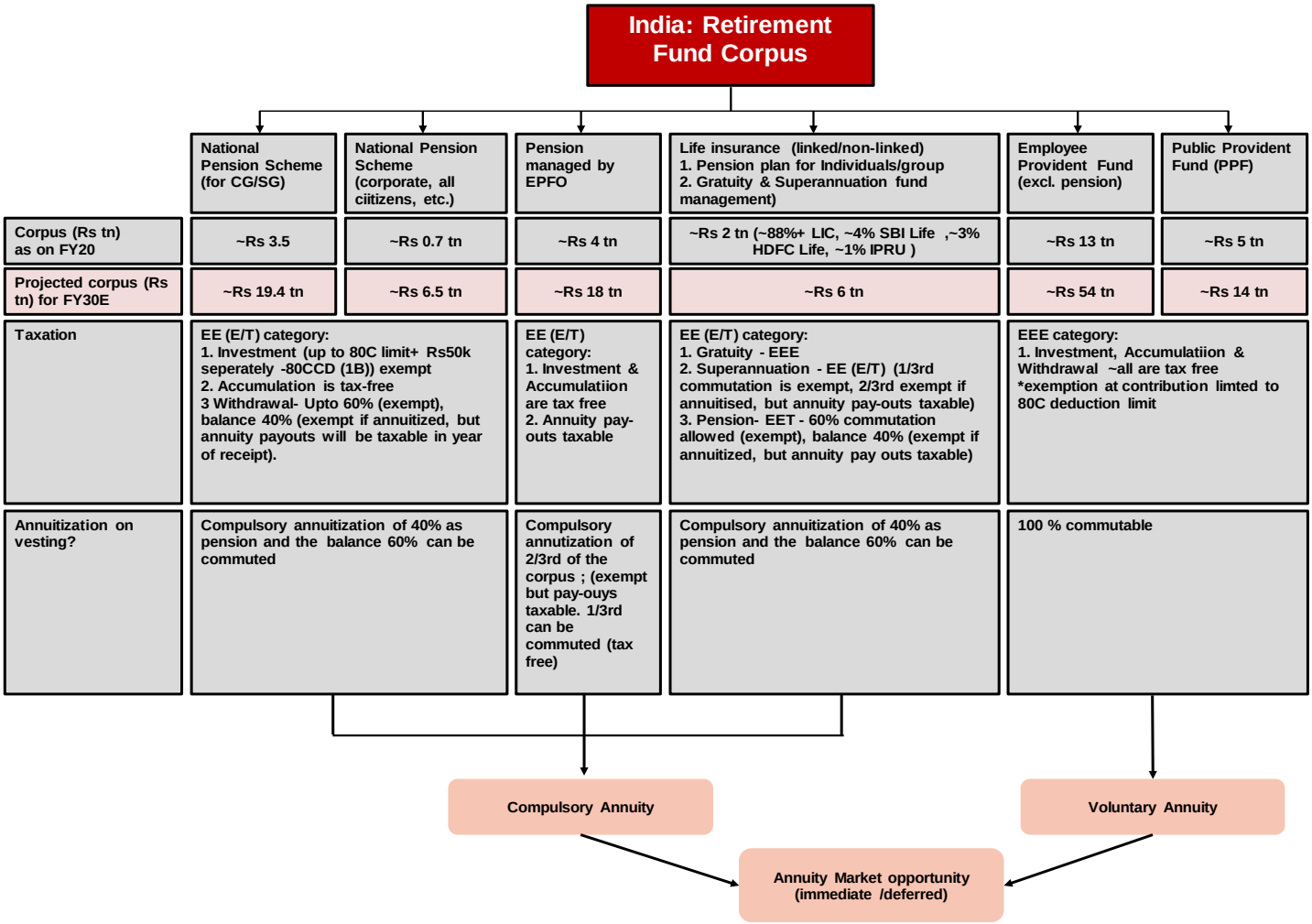
Deep-dive into the annuity opportunity pie

Growth opportunity in annuities would come from (i) build-up in retirement fund kitty; ~19% of retirement fund requires compulsory annuitization (largest opportunity) and (ii) annuities sold to policyholders over and above compulsory annuitization arising out of voluntary need. We take a detailed view on opportunity size, taxation and regulations around anodization on vesting to understand the build-up in the accumulation phase for annuities.

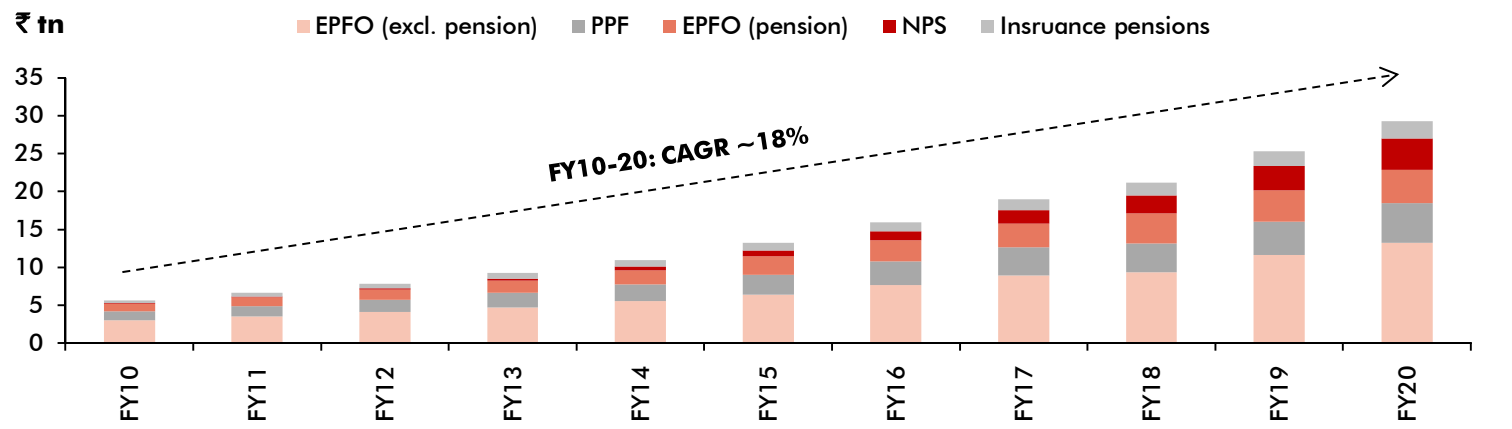
Exhibit 31: Peeling the layers of India's pension and annuity market



Source: MoF, EPFO, NPS Trust, PFRDA, IRDAI, Ambit Capital research

The Indian retirement fund corpus (ex-defined benefit liabilities) has grown at a CAGR of **18% over FY10-20**. We estimate the accumulated retirement corpus to be **~₹29tn** as at end-FY20. The ride has been smooth with the corpus having grown consistently at >15% in almost each year of the last decade. The pace has picked up recently with NPS growing consistently >30% over last five years on the back of better tax incentives and opening up to the private sector. NPS now contributes ~14% to the retirement fund corpus.

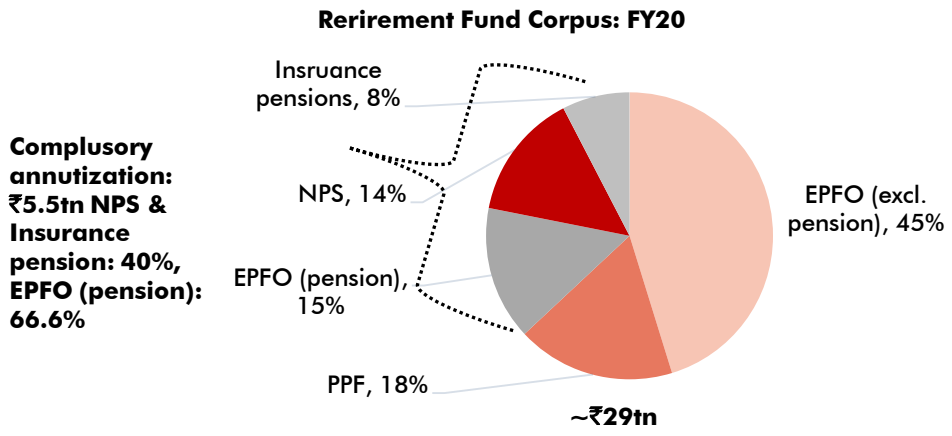
Exhibit 32: Accumulation phase indicates faster growth trajectory



Source: MoF, EPFO, NPS Trust, PFRDA, IRDAI, Ambit Capital research

Out of the total estimated retirement fund corpus of ~₹29tn, close to 19% (₹5.5tn) needs to be compulsorily annuitized at maturity. This includes funds accumulated under NPS (~₹1.7tn), pensions accumulated by life insurance companies (~₹0.9tn) and pensions accumulated by EPFO (~₹2.9tn).

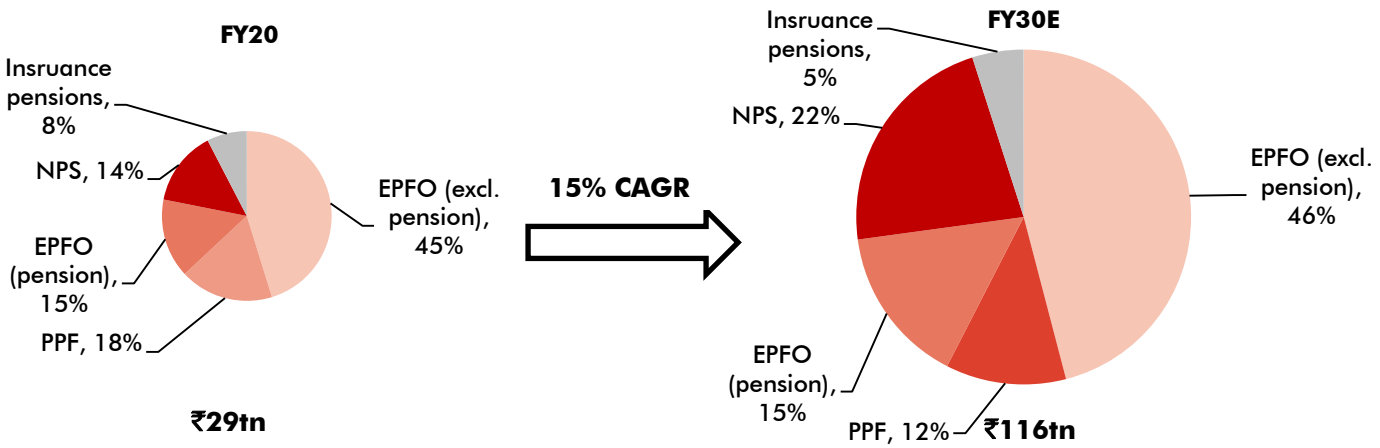
Exhibit 33: Almost 37% of overall retirement funds need to be partially annuitized



Source: MoF, EPFO, NPS Trust, PFRDA, IRDAI, Ambit Capital research

Factoring nominal GDP growth of 11% for the next decade and employment growth rate (increase in aggregate headcount) of 4%, we estimate India's retirement savings corpus to grow at a CAGR of 15% over FY20-30. This would take India's retirement savings corpus to ~₹116tn by end of FY30 (excluding defined benefit liabilities).

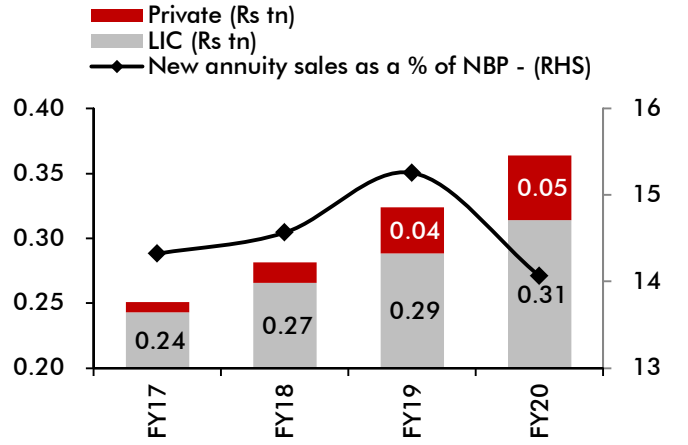
Exhibit 34: Retirement funds are on track for a period of consistent high growth over the next decade



Source: MoF, EPFO, NPS Trust, PFRDA, IRDAI, Ambit Capital research

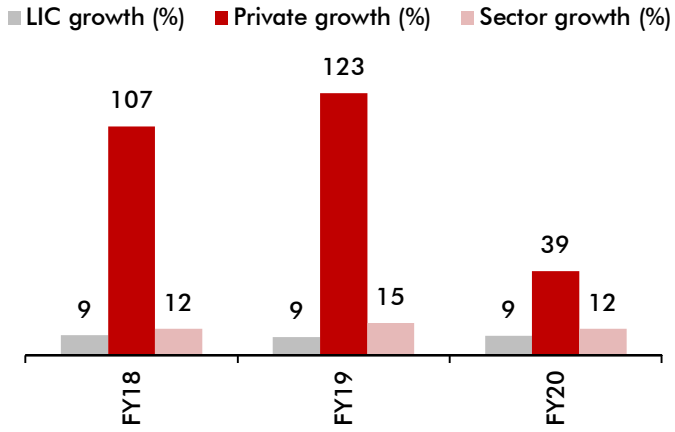
The annuity market is currently dominated by LIC with 85%+ share in new annuity sales. Annuities are largely single premium products and, on an average over the last four years, have contributed ~14% of the overall new business premiums. New annuity for the sector has grown at 13% CAGR over FY17-20. This period saw a surge in growth from private players clocking CAGR of ~86% vs 9% for LIC. The top four private players, i.e. HDFCL, SBIL, IPRUL and MaxL, along with LIC constitute almost the entire annuity market in the country. Given longevity of contracts, brand name and stability of insurance franchise play a very important role in sales of annuity along with retail protection products.

Exhibit 35: Annuity market is dominated by LIC...



Source: Company, IRDAI, Ambit Capital research

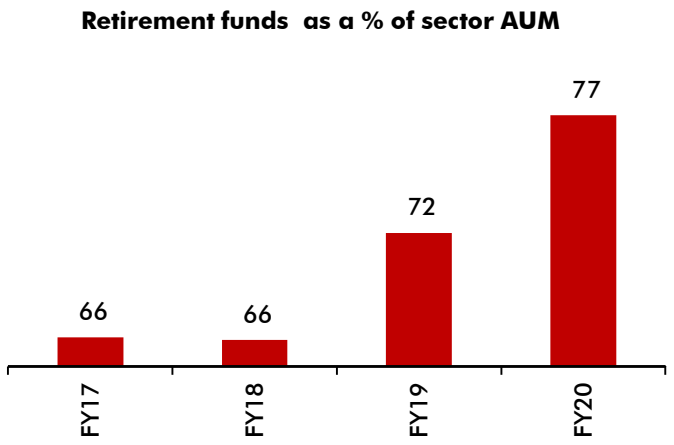
Exhibit 36: ... but private players are growing faster



Source: Company, IRDAI, Ambit Capital research

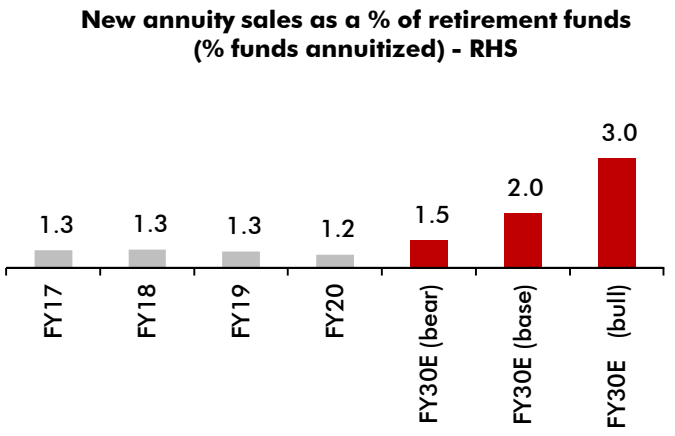
Retirement funds as a percentage of sector's AUM are on the rise. They form ~77% of the sector's AUM as of FY20 vs ~66% in FY16. This represents higher locked demand potential for annuities going forward. Shift of central government pension plans from defined benefit to defined contribution in 2004 and subsequent opening up of NPS to all citizens in 2009 have aided in driving the sharp rise in retirement funds. Percentage of retirement funds annuitized every year, i.e. new annuity sales as a percentage of retirement funds, has been in the range of 1.2-1.3% over FY17-20. As more numbers of employees rolled into defined contribution scheme in 2004 start to retire, we expect percentage of retirement funds annuitized every year to gradually rise. In our base/bull/bear case scenarios we estimate 2.0%/3.0%/1.5% of retirement funds to be annuitized by FY30.

Exhibit 37: Retirement funds are clocking a faster growth than the sector's AUM...



Source: IRDAI, Company, Ambit Capital research

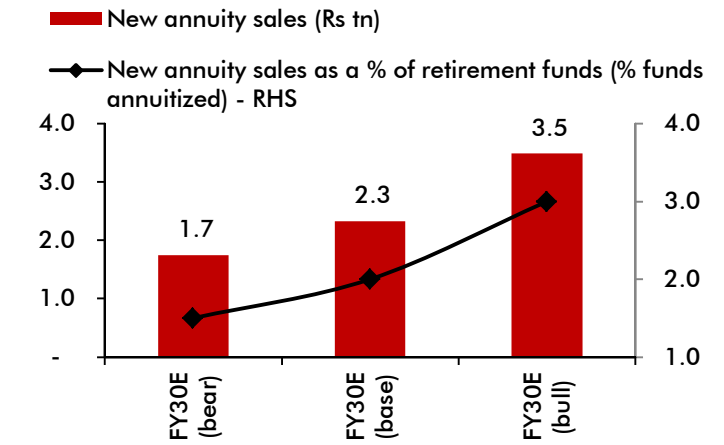
Exhibit 38: ... this should lead to higher share of retirement funds being annuitized going forward



Source: IRDAI, Company, Ambit Capital research

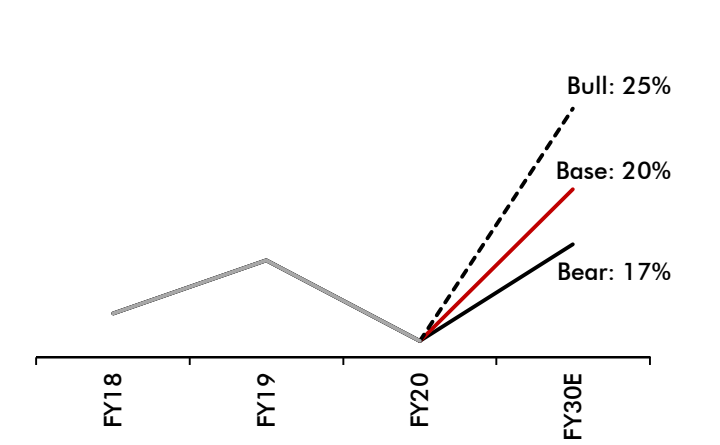
Our base case estimate of 2% of retirement funds to be annuitized by FY30 implies new annuity sales growing to ~₹2.3tn by FY30. This implies annuities for the sector should clock a CAGR of 20% between FY20-30. Our bull case and bear case estimates for annuity growth are 25% and 17% CAGR respectively.

Exhibit 39: New annuity sales could be ~₹2.3tn market annually...



Source: IRDAI, Company, Ambit Capital research

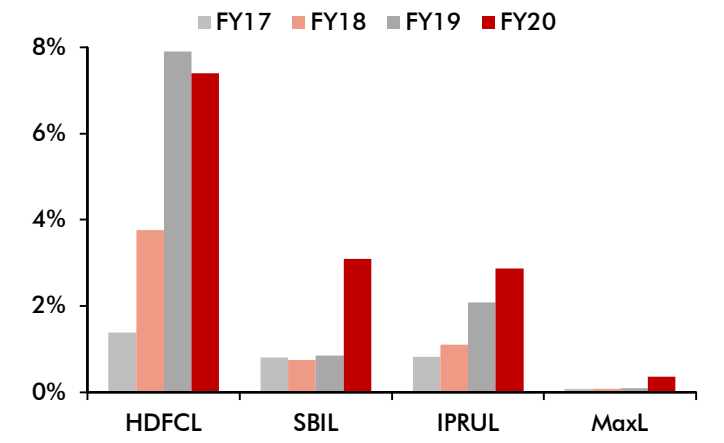
Exhibit 40: ... implying 20% CAGR through FY20-30; higher than estimated growth rate for the sector



Source: IRDAI, Company, Ambit Capital research

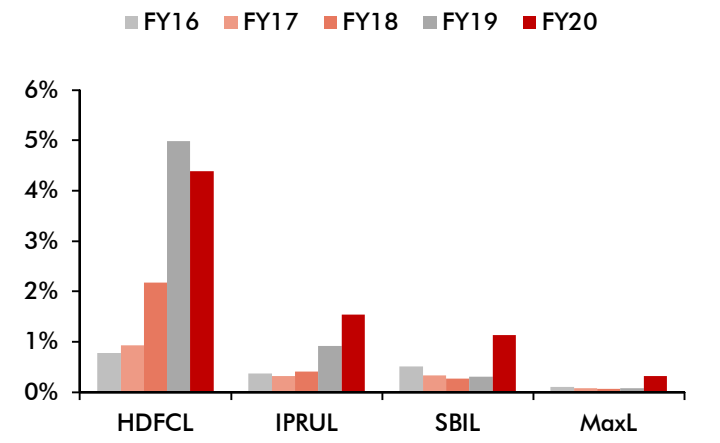
Within private life insurers, HDFCL commands the highest annuity market share of ~7.4% as of FY20. SBIL and IPRUL have posted sharp uptick in FY20 and command ~3.0% of the annuity market share. Annuities contributed up to 4-5% of total APE for the top four private life insurers as of FY20.

Exhibit 41: Within private life insurers, HDFCL commands higher annuity market share of ~7.4%



Source: IRDAI, Company, Ambit Capital research

Exhibit 42: Annuities' contribution to total APE increased to 4-5% for HDFCL



Source: IRDAI, Company, Ambit Capital research

Annuity margin: High but sensitive!

Our calculations suggest annuities make margin upward of 30% in most cases. This is higher than the current overall company-level VNB margins for most private insurers. Our calculations assume mortality experience at 70% of LIC's annuitants experience table. This is on account of the reach of private insurers largely concentrated in metro and large cities with better customer income profile, superior healthcare facilities and, hence, lower mortality rates.

Exhibit 43: VNB margins of annuities are typically higher than overall company-level margins

Particulars	Value/ Remark	Comments
Type of annuity	Immediate life annuity	Online purchase
Premium paying term	Single	
Entry age (years)	60	Male
Purchase price (₹) - (A)	10,00,000	
Less: Tax deducted (₹) - (B)	17,682	GST rate of 1.8%
Investable amount (₹) - ('C)= [A-B]	9,82,318	
Annuity payable (₹) - (D)	82,122	Annual payout frequency
Annual payout rate to policy holder - ('E) = [D/C]	8.4%	
Death and surrender benefit	NA	
Return of premium	NA	
Return on investment made by insurance company - ('F)	6.5%	Assuming insurance company locks in 30-year g-sec, paying 6.5% as annual coupon
Income earned - (G)	**78,159**	**NPV of Y discounted at investment rate**
Less: commissions paid - (H) = [0.54%*C]	5,350	54bps: Based on FY20 segmental reporting
Less: operating expenses - (I) = [3.92%*C]	38,537	392bps: Based on FY20 segmental reporting
Pre-tax VNB - (J) =[G-H-I]	**34,272**	
Tax expense	-	Surplus from annuities are tax-free for life insurers
Post tax VNB - (K)	**34,272**	
APE - (L)	1,00,000	10% of purchase price
VNB margins - (M) = [K/L]	**34%**	

Source: Company; Ambit Capital research

In our calculation, we assume a life insurance company makes a spread of 90-100bps on each annuity contract. We assume this basis interaction with some independent actuaries and life insurance companies.

Exhibit 44: Our interactions suggest life insurers lock in a spread of 90-100bps on sales of an annuity

Particulars	Value	Comments
Return on investment - (a)	6.5%	Coupon from a 30-year g-sec
IRR of all net cash flows to the insurance company - (b)	5.6%	Assuming mortality rate of 70% of LIC's historical mortality experience
Spread made on the annuities - ('c) = [a-b]	**0.94%**	

Source: Company; Ambit Capital research

Current competition in annuity markets is stiff but benefits from practical presence of only five large insurers, i.e. LIC, HDFCL, SBIL, IPRUL and MaxL. We lay out our calculation methodology below. Please note calculations below are for immediate annuities sold and derive some of the values from the exhibit 42 above.

Exhibit 45: Unwrapping annuity margin calculation (immediate annuity version)

Year	Age	U	V = U*70%	W2 = (1-V/1000)*W1	C	X = D*W	Y= C+X
		Mortality Rate (death/1000) from LIC table	Adjusted mortality rate (death/1000) from LIC table	Persistency accounting for death	Premium paid	Annuity payable	Net cash flows
0	60			100%	-9,82,318		-9,82,318
1	61	12	8	99%		81,448	81,448
2	62	12	8	98%		80,778	80,778
3	63	12	8	98%		80,093	80,093
4	64	13	9	97%		79,373	79,373
5	65	14	10	96%		78,602	78,602
6	66	15	11	95%		77,761	77,761
7	67	17	12	94%		76,834	76,834
8	68	22	15	92%		75,660	75,660
9	69	24	17	91%		74,403	74,403
.	.	.	.	.		.	.

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.	.	.	.	.	.	.
.	.	.	.	.	.	.
51	111	433	303	0.2%	199	199
52	112	450	315	0.2%	136	136
53	113	467	327	0.1%	92	92
54	114	485	339	0.1%	61	61
55	115	503	352	0.0%	39	39
56	116	522	365	0.0%	25	25
57	117	1000	700	0.0%	7	7

Source: Company; Ambit Capital research

High margin sensitivity to drive profitability for annuities

Our calculations also suggest annuity margins are highly sensitive to:

- mortality rates, and
- investment returns, i.e. spread over implied guaranteed return.

Exhibit 46: Sensitivity of annuity margin to mortality and spread over implied return

		Mortality experience (% of LIC mortality experience)					
		50%	**60%**	**70%**	**80%**	**90%**	**100%**
Spread over implied guaranteed return	**0.65%**	-46%	-16%	11%	35%	56%	76%
	0.75%	-37%	-7%	19%	42%	63%	83%
	0.85%	-28%	1%	27%	50%	70%	90%
	0.95%	-19%	9%	34%	57%	77%	96%
	1.05%	-10%	17%	42%	64%	84%	102%
	1.15%	-2%	25%	49%	71%	91%	109%
	1.25%	7%	33%	57%	78%	97%	115%

Source: Company, Ambit Capital research

As discussed earlier, annuities are up for a period of high growth backed by fast build-up of the retirement fund corpus. This would result in hyper competition in the annuity segment. Nevertheless, given high sensitivity we believe life insurers would not price annuities very aggressively, keeping some cushion for safety. Hence, in our view, the annuity business would add more to profits (VNB) in the long run. The top four private players, i.e. HDFCL, SBIL, IPRUL and MaxL, are expected to benefit most out of this given presence of key success ingredients in the annuity market such as superior brand name, entrenched distribution and long track records.

Available variants of annuities: Customizing to customer needs

Annuity variants offered by life insurers range from:

- Immediate annuity (most popular);
- Deferred annuity (only select layers offer this given higher interest rate risk); and
- Pension bundled with annuity offering (accumulation in terms of pension + at maturity accumulated corpus is used to buy an annuity).

Between the three broad categories mentioned above, multiple product variants with different cash flows structures and death benefits are offered. We summarize different variants in the table below.

Exhibit 47: Summary: Annuity variants primarily differ in cash flow structures and death benefit payouts

Sr. no.	Annuity variants	Payouts (living period)	Payouts (death)
1	Life annuity	Payable at uniform rate in arrears for the life of the annuitant.	Nil
2	Life annuity with return of purchase price	Payable at uniform rate in arrears for the life of the annuitant.	100% of the purchase price

3	Life annuity with return of balance purchase price	Payable at uniform rate in arrears for the life of the annuitant.	Purchase price less all annuity instalments made prior to death If annuity payments > purchase price, then no benefits will be paid
4	Life annuity with a guarantee period	Payable in arrears for the life of the annuitant or until the end of guarantee period, whichever is later.	Nil
5	Life annuity with 5% escalation	Payable in arrears for the life of the annuitant. The annuity will increase annually by 5% p.a. of the annuity amount at inception.	Nil
6	Life annuity with return of purchase price in parts	Payable at uniform rate in arrears for the life of the annuitant. At the end of 7 years, 30% of the purchase price is paid to the annuitant on survival.	Death beyond 7 years-70% of the purchase price Death within 7 years – full purchase price
7	Life annuity with return of purchase price on diagnosis of critical Illness	Payable at uniform rate in arrears for the life of the annuitant.	Death/critical Illness before specified age (85): 100% of purchase price refunded back

Source: Company policy brochures; Ambit Capital research

Key risks embedded in annuities

- **Longevity risk:** Lower-than-expected/factored mortality could lead to higher payouts, suppressing profitability and margins. Our conversations with private life insurance companies in India suggest most of them use LIC's annuitant's experience table and multiply the same by a factor (e.g. 0.75x) basis their experience and target customer segment.
- **Interest rate risk:** Annuities typically are long-duration contracts with most of the premiums received in advance. Hence, typically a significant portion of the premium proceeds are used to buy investments (in most cases g-secs) to lock-in the price and create a hedge. Though, annuities are reprised quite frequently to mimic the changes in the interest rates offered by investment products used to hedge. However, insurers are still exposed to interest rate risk on account of following:

Exhibit 48: Causes of interest rate risk in annuities

Sr. No.	Cause	Impact
1	Interest rate fluctuations between reset period	Asset liability mismatch for the policies sold between reset periods.
2	Lack of understanding of underlying liabilities (mortality experience different than what was factored/anticipated)	Asset-liability mismatch resulting in re-investment risk in declining interest rate regimes.
3	Shallow bonds markets	Lack of availability of longer tenor bonds could result in asset duration being lower than the underlying liabilities. This could result in re-investment risk in declining interest-rate regimes.

Source: Ambit Capital research

Addition of return of purchase price (RoP) feature can reduce longevity risk

Our analysis suggests that by adding RoP on death feature insurers typically reduce annual payout rate to the policyholder by 170-210bps. Hence, this product emulates characteristics of a fund management business. This acts like a hedge towards mortality assumptions, in turn reducing longevity risk. Given lower longevity risk in this variant compared to annuities with no RoP feature, we estimate margins to be lower in this variant.

Exhibit 49: Annuity policies with RoP feature typically pay out 170-210bps lower than life annuity policies with no RoP feature

Particulars	Life annuity	Life annuity with RoP	Difference
Investable amount - (A)	9,82,318	9,82,318	-
Annuity payable - (B)	82,122	63,065	19,057
Annual payout rate to policy holder - ('C) = [A-B]	**8.4%**	**6.4%**	**1.94%**

Source: Company illustrations; Ambit Capital research

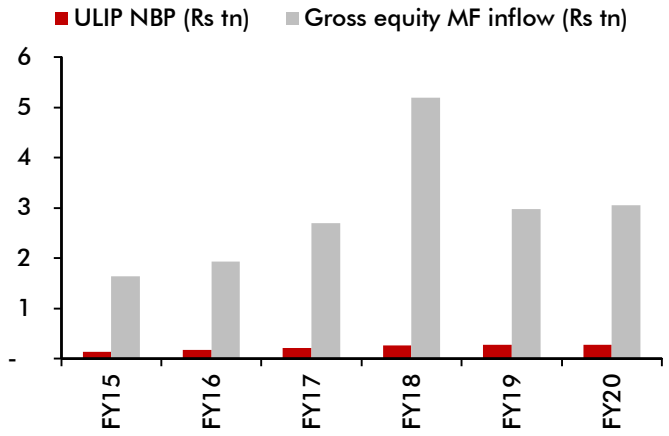
Non-annuity savings is a cyclical play

We estimate non-annuity savings (ULIPs/par-non-par) to clock CAGR of ~8% over FY20-30. Our estimates factor volatile nature of ULIP flows and their structural unattractiveness versus mutual funds. We also factor in unattractiveness of traditional products given their low returns compared to alternatives. Even guaranteed-return products (non-annuity) are an opportunistic play hinged on the credit growth cycle.

Unit-linked products are volatile and face competition from mutual funds...

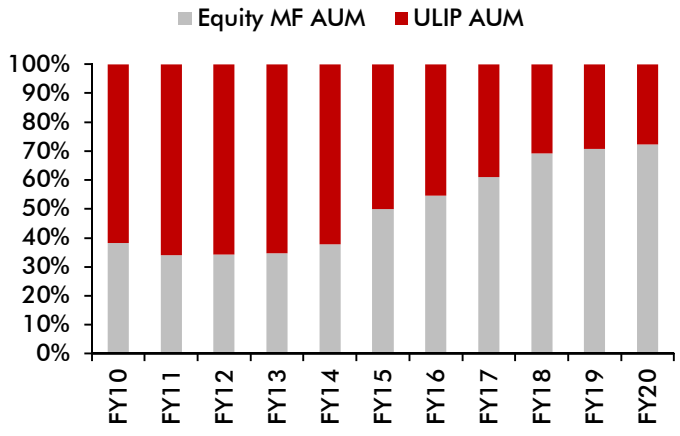
ULIPs form just ~15% of premiums for the industry and ~45% for private sector insurance companies. However, data suggests that equity mutual funds are gaining market share from insurance companies.

Exhibit 50: Equity MF flows have been substantially higher than ULIP flows in the last 6 years



*Source: IRDAI, AMFI, Ambit Capital research, *ULIP NBP for FY20 is an estimate*

Exhibit 51: Equity MF AUM has grown at a CAGR of 16% between FY10-20 while ULIP AUM has remained flat



*Source: IRDAI, AMFI, Ambit Capital research, *ULIP AUM for FY20 is an estimate*

Even after significant improvement in ULIP features, on most parameters mutual funds still score over ULIPs in an investment horizon of less than 7-8 years. One area where ULIPs score over mutual funds is tax benefit on maturity proceeds under section 10(10D). Nevertheless, sharp under-performance of ULIP flows over mutual fund flows highlights that benefit under section 10(10D) is not the prime incentive for an average retail investor to invest in ULIPs. Higher flexibility in purchase and exit of mutual funds is well-appreciated by many retail investors.

Exhibit 52: Mutual funds score over ULIPs for investment horizons of less than 7-8 years

	ULIPs	Mutual Funds
Tax Benefit	All unit-linked plans offer tax benefits under section 80C. Maturity proceeds are tax-free under section 10(10D), if sum assured is >10 times of annual premium.	Investments in tax-saving funds are eligible for section 80C benefits. LTCG tax of 10% on maturity proceeds.
Switching Option	Unit-Linked Insurance Plans (ULIP) allows you to switch your investment between the funds linked to the plan. This enables you to change the risk return.	No switching option is available. If you are not satisfied with the performance of the fund, you can exit completely from the same by paying exit charges, if applicable.
Overall Charges	Charges in a unit-linked plan include mortality charges for the life insurance provided. In addition, premium allocation charge, fund management charge and administration charges are applicable.	Mutual fund charges include the annual fund management charge, other charges (up to 2%) and an exit load, if applicable.
Charges	2.25% to 4.0% + mortality charges	Total expenses of 1.0% to 2.0%
Lock in period	5 years in case of ULIPs	3 years in case of ELSS funds. For other open-ended products, no lock-in is there.
Average returns for investors	8.5-14%	8.5-18%

Source: IRDA, SEBI, Ambit Capital research

...even traditional products face competition given low returns

Traditional insurance products also don't have higher returns with IRR at just 4.0-5.5%; this is much lower compared to other products. Moreover, despite tax exemptions on insurance policies, post-tax returns are still not better than that of mutual funds.

Exhibit 53: Pre-tax returns on insurance savings products is much lower than other financial products

Savings products	Pre-tax return on investments	Post-tax* return on investments
Fixed deposits (SBI 5-year deposit rate)	5.40%	4.30%
Savings deposits	2.7%-7.0%	2.2%-5.7%
Public Provident Fund	7.10%	7.10%
National Pension Scheme	9.0%-12.0%	9.0%-12.0%
Debt MF	8%-11%	6.4%-8.8%
Employee Provident Fund	8.50%	8.50%
Par insurance	**4.0%-5.5%**	**4.0%-5.5%**

*Source: Ambit Capital research; Note average 5-year returns for all products; *20% tax rate assumed*

Guaranteed-return products (non-annuity) are opportunistic play

Sharp premium rise in this segment is opportunistic given muted bank credit growth and surge in deposits for most large banks. Deposit growth has been higher than credit growth over the last few quarters, which makes sales of guaranteed-return products a good opportunity for banks to earn fee income which otherwise bear the burden of negative carry on deposits. Additionally, net returns offered to policyholders are 4-5.5%, which in many cases is higher than post-tax return on current banks deposit rates (over the last 12 months bank deposit rates have come-off by 70-180bps). A significant portion of non-par sales happens through the bancassurance channel. Thus, their relative attractiveness versus may not sustain when the credit growth cycle reverses.

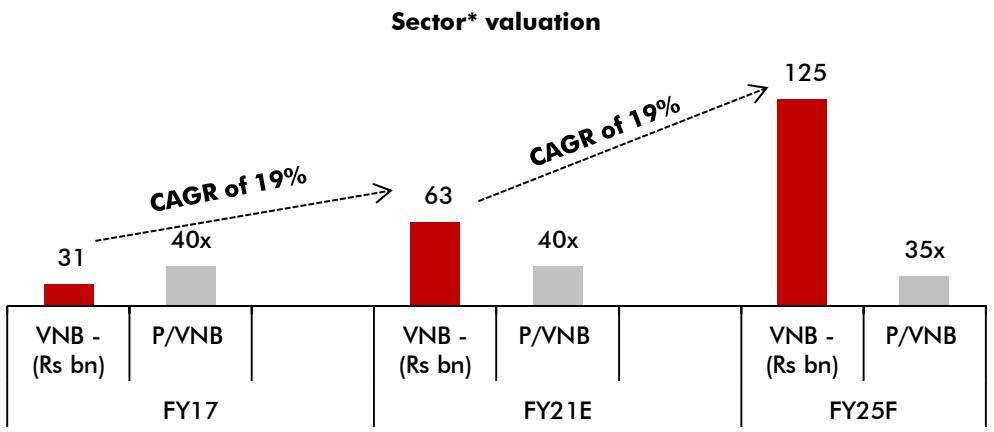
Structural growth opportunity with no legacy pain to drive valuations

In Nov'19 we turned SELLers on insurers under coverage (IPRUL/SBIL) given expectation of contraction in premium flows and limited fundamental reasons for upside movement from valuation then (~2.7x/3.2x FY21E P/EV). After correcting 30% between Nov'19-Mar'20, insurers recovered faster than lenders as they emerged a safer alternate within BFSI. Markets still imply a much lower VNB growth trajectory of 11-17% CAGR over the next 10 years. We see upside given i) faster growth in protection (~23% CAGR), ii) huge annuity opportunity (~20% CAGR), and iii) low substitution risk. The pandemic could aid in harnessing protection demand as seen post outbreak of SARS. Expect VNB to compound at ~19% between FY22-25 as in during FY17-21E. This Implies that the sector P/VNB multiple could remain largely intact at 35-40x over the next 12-24 months. Premium over lenders would continue given i) visibility around faster earnings compounding at ~18% vs 11-13% through FY30 and ii) lower balance sheet risk. Interest rate risk for Indian life insurers is negligible compared to global peers at this point.

Valuation multiple to remain largely intact

Indian life insurance names have been listed only for the last 4-5 years, and so it's not possible to see how stocks have behaved across cycles. Valuations of Indian insurers are reliant on disclosures around value of new business (VNB) and embedded value (EV) as earnings/book value are not reflective of actual business performance under current accounting standards. Between FY17-21E, VNB for the sector comprising four listed life insurers (IPRUL, SBIL, HDFCL and Max Financials) has grown at a CAGR of ~19% and P/VNB multiples during this period have ranged between 35-40x. Over the next 3-4 years (FY22-25), we expect VNB to grow at ~19%. Hence, we expect the P/VNB multiple to remain largely intact at ~35x over the next 12-24 months. This implies 20-25% IRR for the sector.

Exhibit 54: Comparable VNB compounding to keep multiples largely intact



*Source: Company, Bloomberg, Ambit Capital estimates, * sector VNB is addition of VNBs for HDFCL. SBIL, IPRUL and Max Financials, sector P/VNB is average of HDFCL. SBIL, IPRUL and Max Financials*

Within our coverage universe; HDFCL is best placed

In the earlier section (refer exhibit 20) we have seen IPRUL and HDFCL as best-placed to scale the protection franchise. When it comes to profitability and scaling up of retirement opportunities (annuity), HDFCL with its diversified product mix and innovation DNA scores well while SBIL scores well due to its pseudo sovereign identity. HDFCL has been at the forefront with respect to profitability and innovation. SBIL backed by >22k bank branches of SBI scores highest on reach. Overall, within our coverage, HDFCL is best-placed to compound is VNB over the long term (~19% CAGR vs 13-14% for peers by FY30).

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Exhibit 55: HDFCL fares best on our framework; VNB should compound fastest

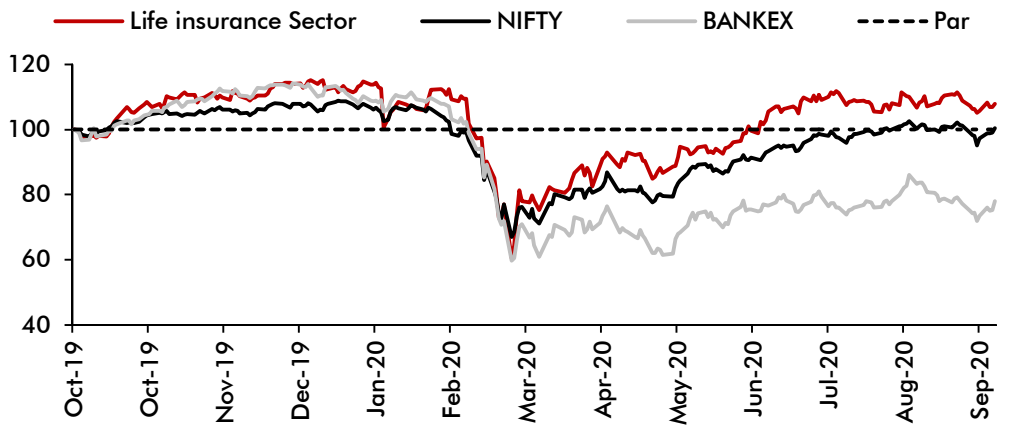
	Reach	Ability to grow protection	Ability to grow annuity	Product suit/innovation	Profitability	Overall score
HDFCL	◕	◕	◕	●	●	3.4
IPRUL	◕	◕	◑	◕	◕	2.8
SBIL	●	◑	◕	◔	◑	2.4
MaxL	◑	◑	◔	◑	◕	2.0

Source: Ambit Capital research Note: ● - Strong; ◕ - Relatively Strong; ◑ - Average; ◔ - Relatively weak

Lower risk and better growth prospects led to recent outperformance

Insurance stocks witnessed sharp volatility (higher than market) over the last 12 months. In February, life insurance stocks tanked by 10-15% on the back of GoI's announcement (Union Budget 2020) to make section 80C of the income tax act optional. Then in March the stocks tanked further in alignment with >20% correction in equity markets led by onset of Covid-19. Starting April, recovery has been sharper compared to both Bankex and Nifty. Insurers have outperformed lenders as weakening cash flows amid lockdown exposed lenders to the double whammy of asset quality and growth challenges. With multiple headwinds, lenders would have a long-tail recovery. This is where the much lower risk of the life insurance business comes in handy. Moreover, growth for life insurers is expected to bounce back faster given pandemic-driven demand for protection.

Exhibit 56: Insurance stocks have outperformed the market led by low balance sheet risk and expectation of sharper protection-led recovery

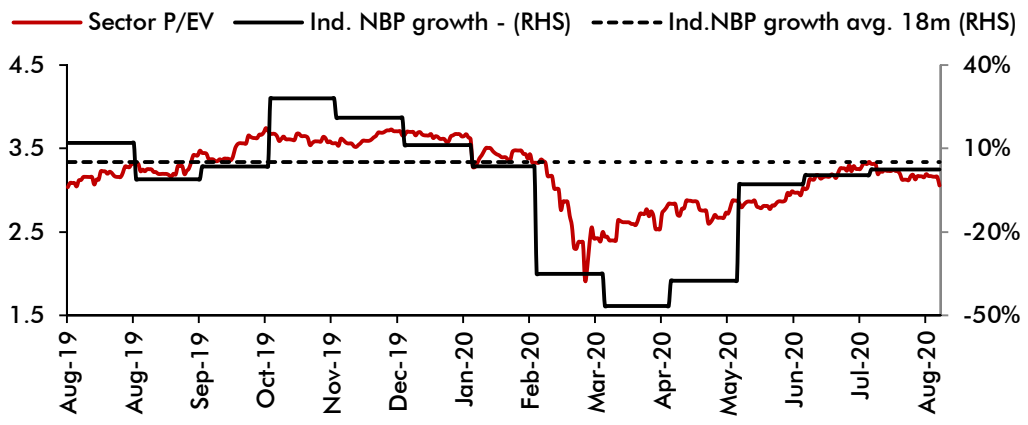


*Source: Bloomberg, Ambit Capital research; *sector is average return for HDFCL. SBIL, IPRUL and Max Financials*

Pandemic a push to harness huge protection opportunity

Challenges of non-lending FIs would be confined to muted growth over the next 2-3 quarters. We expect premium to recover from 3QFY21. Additionally, for all insurers under our coverage the share of high-margin protection offering (4-10x more margin than investment products) in the overall product mix has been increasing, which has supported profitability. In fact, the latent demand for protection products has been higher post the onset of the pandemic. Even post the SARS outbreak in 2003, there was a sharp uptick in new business sales for life insurers in East Asian regions of China, Hong Kong and Singapore due to increasing demand for protection.

Exhibit 57: Recovery in premiums would aid in driving valuations

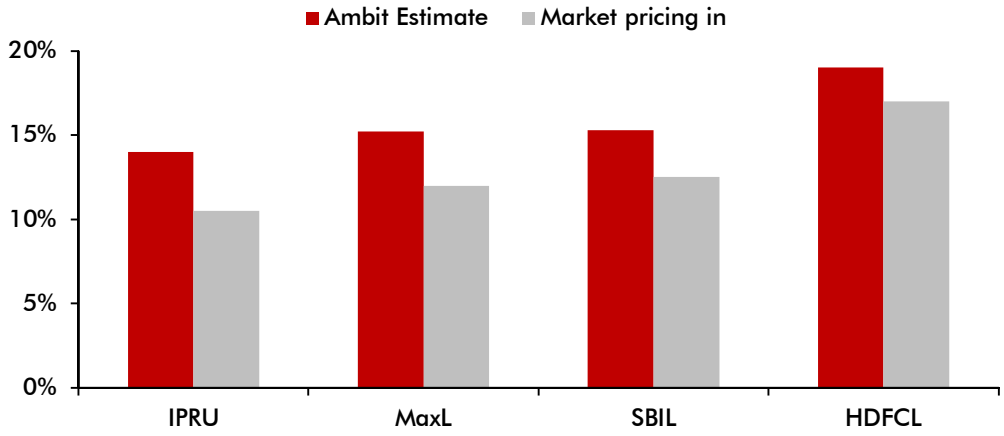


Source: Bloomberg, Ambit Capital research

What is the market pricing in?

- We calculate the long-term VNB growth implied at current valuations based on our valuation framework, i.e. appraisal value method. We believe the market, post the price correction of ~20% since Union Budget 2020, is now implying a much lower VNB growth trajectory of 11-17% CAGR over next 10 years.
- On balance, we see upside to such growth estimates given 1) faster growth in the protection segment (~23% CAGR between FY20-30E) and 2) rising demand for annuities, which we estimate will grow at CAGR of ~20% over the next decade.

Exhibit 58: Our analysis suggests market is pricing in 15-20% lower long-term VNB growth vs our estimates

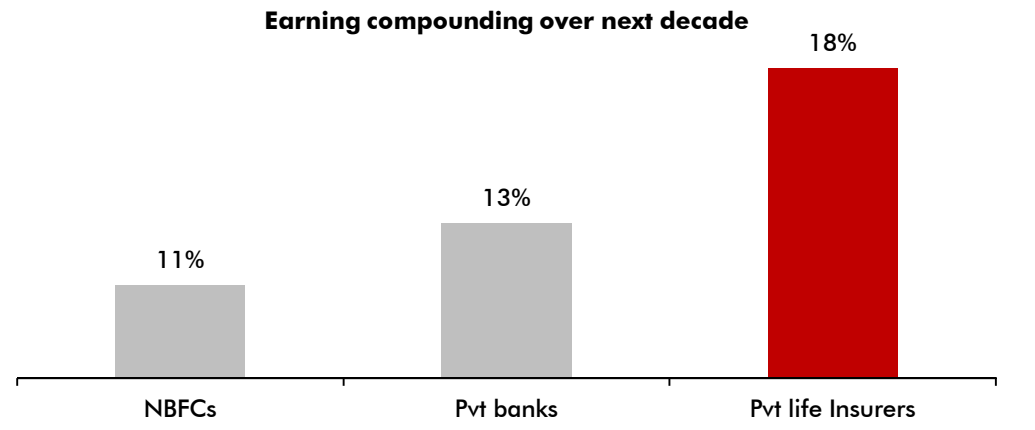


Source: Ambit Capital research

Life insurers would continue to command premium over lenders

- Over the next decade (FY21-31), we expect earnings (VNB) of life insurers to grow at a CAGR of ~18%, much higher than 11-13% for lenders.

Exhibit 59: Profitability of life insurers will outpace that of lenders next decade



Source: Ambit Capital research

- A large part of incremental growth (~50-70% over next 10 years) for life insurers would come from segments with low substitution risk (protection and annuity). Only a life issuer can offer a term plan and an annuity policy.
- Even balance sheet risk for life insurers would remain lower than that of lenders.

Hence, to evaluate the competitive strength of the life insurance industry, we analyzed different financial sub-segments on Porter's Five Forces model. The analysis suggests that life insurers are better-placed than lenders. Amongst the sub-segments, growth potential is highest for general insurers followed by life insurers. Penetration and substitution risk are lowest for general insurers. Since life insurance industry is highly regulated and capital intensive, the threat of new entrants is also low.

Exhibit 60: Life insurance has competitive edge over lenders

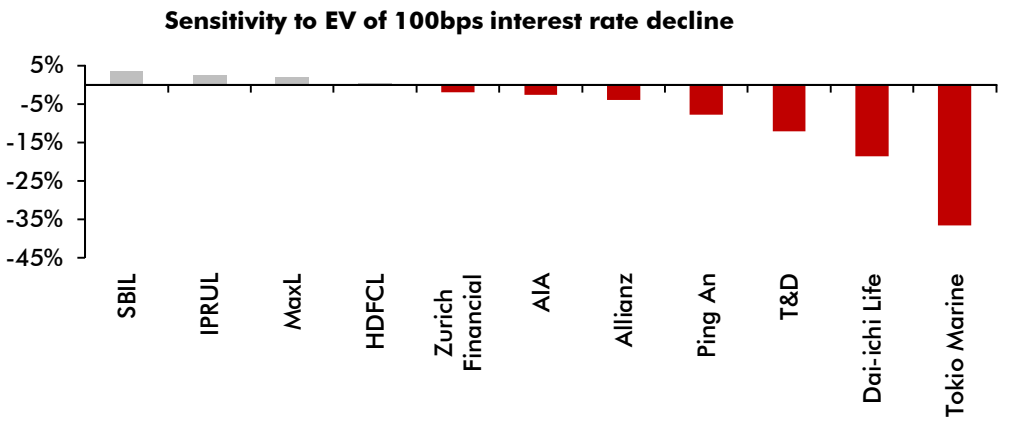
	Valuations (P/B, FY20)	Industry Growth Potential	Bargaining power of suppliers	Bargaining power of buyers	Competitive intensity	Substitution threat	Threat of new entrants	Overall Score
Private Banks	3.2	◕	◕	◑	◕	◑	◕	◕
PSU Banks	0.7	◑	◕	◑	◑	◑	◕	◑
NBFCs/HFCs	0.8	◑	◑	◕	◑	◕	◔	◑
Life Insurance	10	◕	●	◕	◕	◑	●	◕
General Insurance	9.3	●	●	◕	◕	●	◕	●

Source: Ambit Capital research; Note: ● - Strong; ◕ - Relatively Strong; ◑ - Average; ◔ - Relatively weak

Well-placed on risk compared to global peers

With respect to balance sheet risk Indian insures are much better placed compared to global peers. This can be gauged by the lower sensitivity of EV to decline in interest rates compared to global peers. Lower proportion of guaranteed book has helped Indian insurers to prevent balance sheet risk.

Exhibit 61: Indian insurers have amongst the lowest levels of EV sensitivity to interest rate changes vs global peers



Source: Company, Ambit Capital research

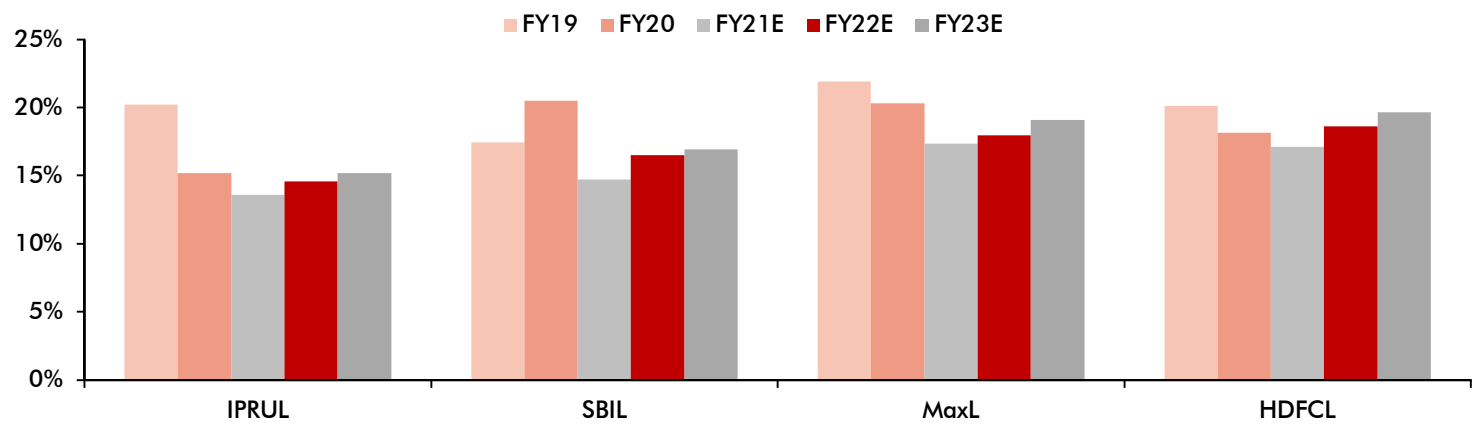
Profitability (VNB) for insurers under coverage is set to compound at by 24% between FY21-23 driven by i) rising share of protection benefitting from huge under-penetration and latent demand post pandemic, ii) lower risk of disruption given exclusivity to sell protection offering (no threat of competing products from non-life insurers), and iii) low proportion of guarantees on the legacy book.

Exhibit 62: Comparison of historical, current and target valuations

	IPRU	SBIL	HDFCL	MaxL
CoE	14.0%	14.0%	14.0%	14.5%
Target Price	576	1,009	677	751*
CMP--as on 25/10/2020	409	771	565	589
Upside/Downside	41%	31%	20%	28%
Price to EV (X)				
Implied - FY22E	2.8x	3.0x	4.8x	2.2x
Implied - FY23E	2.5x	2.6x	4.0x	2.0x
Current - FY22	2.0x	2.3x	4.0x	1.8x
Historical since listing – 1yr fwd	2.5x	2.8x	4.5x	1.9x
VNB multiple (X)				
Implied - FY22E	44.5x	43.1x	55.1x	26.5x
Implied - FY23E	36.6x	35.7x	42.3x	21.1x
Current - FY22	31.7x	32.9x	45.9x	20.9x
Historical since listing – 1yr fwd	39.9x	38.9x	52.6x	21.4x

*Source: Ambit Capital research; *target price for MFSL*

Exhibit 63: Life insurers under coverage to see steady RoEV improvement



Source: Company, Ambit Capital research

Exhibit 64: Peer comparison table of important parameters

Particulars (₹ bn)	IPRU			HDFCL			SBIL			MaxL		
	FY18	FY19	FY20	FY18	FY19	FY20	FY18	FY19	FY20	FY18	FY19	FY20
Total APE	78	78	74	55	63	74	86	97	107	33	41	43
APE growth (YoY %)	18%	0%	-5%	32%	13%	18%	27%	13%	11%	21%	23%	6%
APE Mix (%)												
Individual ULIPs	82%	80%	65%	50%	46%	23%	67%	71%	70%	41%	42%	38%
Individual Par	11%	9%	12%	25%	15%	16%	24%	19%	11%	43%	40%	30%
Individual Non Par	5%	7%	16%	13%	22%	44%	2%	4%	12%	12%	14%	27%
Protection	3%	6%	10%	4%	6%	6%	1%	4%	5%	4%	6%	8%
Non Protection	1%	1%	5%	9%	17%	38%	1%	0%	7%	8%	8%	19%
Individual Total APE	97%	95%	92%	88%	83%	83%	93%	94%	92%	96%	96%	95%
Group Protection	2%	4%	5%	7%	11%	11%	5%	3%	4%	4%	4%	5%
--Credit Life	1%	2%	3%	7%	11%	10%	2%	1%	1%	1%	1%	1%
--Group Term	1%	2%	2%	0%	1%	1%	2%	2%	3%	3%	3%	5%
Group Non Protection	0%	1%	3%	5%	6%	6%	3%	3%	4%	0%	0%	0%
Group APE	3%	5%	8%	12%	17%	17%	7%	6%	8%	4%	4%	5%
Protection (Overall)	6%	9%	15%	11%	17%	17%	5%	7%	9%	8%	10%	13%
Profitability												
VNB	13	13	16	13	15	19	14	17	20	7	9	9
VNB Margins (%)	17%	17%	22%	23%	25%	26%	18%	20%	21%	20%	21%	21%
Persistency (basis premium)												
13th month	87%	86%	87%	87%	87%	90%	83%	85%	86%	81%	83%	87%
25th month	78%	77%	78%	77%	80%	80%	75%	77%	79%	72%	71%	73%
37th month	69%	71%	70%	71%	72%	74%	70%	71%	72%	62%	64%	64%
49th month	64%	65%	67%	62%	68%	67%	64%	66%	67%	57%	58%	60%
61st month	55%	58%	59%	51%	52%	55%	58%	57%	60%	53%	53%	53%
Closing EV	188	216	230	152	183	207	191	224	263	75	89	100
ROEV (Post Cost Overruns)	23%	20%	15%	22%	20%	18%	18%	17%	20%	21%	22%	20%
Solvency Ratio - Reported	252%	215%	194%	192%	188%	184%	206%	213%	195%	275%	242%	207%
AUM	1,387	1,593	1,517	1,066	1,256	1,272	1,144	1,393	1,588	522	628	685

Source: Company, Ambit Capital research

Exhibit 65: Relative valuation table

Company	Mcap (US$bn)	CMP	Reco	Target Price	Up/ (down)	ROEV (%)			EV growth (%)			P/EV			P/VNB			VNB growth (%)		
						FY20	FY21E	FY22E	FY20	FY21E	FY22E	FY20	FY21E	FY22E	FY20	FY21E	FY22E	FY20	FY21E	FY22E
ICICI Prudential	8.0	409	Buy	576	41%	13.6%	14.6%	15.2%	6.5%	13.7%	12.5%	2.6	2.2	2.0	36.6	39.1	31.7	20.9%	-6.4%	23.5%
SBI Life	10.5	771	Buy	1009	31%	14.7%	16.5%	16.9%	17.3%	10.9%	15.0%	2.9	2.6	2.3	38.3	40.8	32.9	16.9%	-6.1%	23.9%
HDFC Life	15.5	565	Buy	677	20%	17.1%	18.6%	19.7%	12.9%	18.4%	17.5%	5.5	4.7	4.0	59.3	57.4	45.9	24.7%	3.4%	24.9%
Max Financials	2.2	589	Buy	751	28%	17.3%	18.0%	19.1%	11.6%	12.1%	12.6%	2.2	2.0	1.8	24.7	25.1	20.9	4.8%	-1.8%	20.3%

Source: Company, Ambit Capital research

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IPRUL – The retail protection Goliath!

(IPRU IN, BUY, 41% upside)

Turn BUYers – Visible levers to sustainable improvement in profitability

In Nov'19 we turned SELLers on life insurers under coverage given expectation of contraction in premium flows and limited fundamental reasons for upside movement from valuation then (2.7x FY21E P/EV). In the last 12 months IPRUL has corrected 16% and now trades at 2.0x FY22E P/EV. We believe the market is now implying a much lower VNB growth trajectory of 10-11% CAGR over the next 10 years. We see upside to these estimates given IPRUL's strong foothold and ability to scale its retail protection franchise and increasing presence into newer product/customer segments. We estimate IPRUL's VNB to clock CAGR of 14% till FY30. Additionally, we see large growth opportunity in the annuity segment. Strong brand recognition with robust distribution franchise places IPRUL in a sweet spot to gain traction in annuities over the next 10 years. Expect annuities to add ~15% to IPRUL's VNB by FY30.

Strong fundamentals intact; expect VNB growth to outpace APE growth

VNB growth will outpace APE as protection mix improves riding on an able direct channel (~15% of FY20 APE). We expect VNB growth to be the strong at 12% over FY20-23 vs 5% for APE. Bancassurance channel is geared towards selling retail protection (~42% for FY20 vs ~14% for HDFCL) and exclusive sales arrangement with ICICI Bank is a key differentiator and strength of IPRUL. It's well-positioned to capture the mass affluent urban segment with the right mix of brand recall, reach and pricing. Relatively low sensitivity/exposure to areas with seeming regulatory constraints improves visibility of profitability. Margin expansion capabilities along with scope for further improvement in operating metrics make current valuations of 2.0x FY22E EV compelling. With visible levers to improvement in profitability and stability of EV, valuation discount to peers (13-50%) should narrow. TP of ₹576 implies 2.8x FY22E P/EV.

Key risks to our stance: ICICI Bank embracing open architecture and prolonged weakness in equity markets.

Exhibit 66: Change in estimates table

	New Estimates		Old Estimates		Change	
	FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
Recommendation	**BUY**		**SELL**			
Target price (₹)	**576**		**360**		60%	
Assumptions						
APE growth	-18.0%	20.0%	-10.0%	10.0%	80%	100%
VNB margin	24.8%	25.5%	24.3%	24.8%	56	79
Outputs (₹ mn)						
VNB (₹ bn)	15.0	18.6	16.1	18.1	-7%	3%
EVOP (₹ bn)	31.3	38.2	32.4	37.4	-3%	2%
Embedded Value (₹ bn)	261.9	294.8	258.0	290.1	2%	2%
ROEV (%)	13.6%	14.6%	14.1%	14.5%	(47)	7

Source: Company, Ambit Capital research

SBIL – Will last long; really long!

(SBILIFE IN, BUY, 31% upside)

Turn BUYers – Ability to hit hard in credit life and annuities

In Nov'19 we turned SELLers on life insurers under coverage given expectation of contraction in premium flows and limited fundamental reasons for upside movement from valuation then (3.2x FY21E P/EV). In the last 12 months SBIL has corrected 22% and now trades at 2.3x FY22E P/EV. We believe market is now implying a much lower VNB growth trajectory of ~12.5% CAGR over the next 10 years. We see upside to these estimates given potential to play big in the annuity and credit life segments. Pseudo sovereign identity and unmatched entrenched distribution network (>22k bank branches and 2nd largest agency force) could propel annuities. Expect annuities to clock ~25% CAGR between FY20-30 and add ~20% to VNB by FY30. Exclusive sales arrangement with the country's largest disburser of retail mortgage loans with a large existing customer base could immensely benefit the credit life segment. We estimate SBIL's VNB to clock CAGR of 13% till FY30.

Large untapped potential; valuations discount growth longevity

A large and untapped bancassurance distribution channel adds visibility of healthy premium growth. Sizeable potential for improvement in banca-branch productivity (retail banca-NBP/branch of ~₹3mn vs ₹7-9mn for peers) and lowest operating cost (FY20: ~10% vs 13-21% for peers) are key enablers to drive premium growth. We expect 6% APE growth between FY20-23. Lack of intent to develop direct channel (~2% of FY20 APE vs 12-34% for peers) given possibility of channel conflict and higher price (historically has been selling 14-15% premium than peers) have resulted in subpar performance in retail protection. In our view, if SBIL sharpens focus on the product segment and improves strategic agility, it can take away a lion's share in the segment. Longevity of growth potential and expectation of sustained superior operating metrics make current valuation of 2.3x FY22 EV reasonable. TP of ₹1,009 implies 3.0x FY22E P/EV.

Key risk to our stance: SBI embracing open architecture.

Exhibit 67: Change in estimates table

	New Estimates		Old Estimates		Change	
	FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
Recommendation	**BUY**		**SELL**			
Target price (₹)	**1,009**		**728**		39%	
Assumptions						
APE growth	-12.0%	18.0%	0.0%	12.0%	-12.0%	6%
VNB margin*	22.0%	23.0%	21.3%	22.4%	64	61
Outputs (₹ mn)						
VNB (₹ bn)	18.9	23.4	20.8	24.5	-9%	-4%
EVOP (₹ bn)	38.7	48.2	42.0	50.4	-8%	-4%
Embedded Value (₹ bn)	291.5	335.2	304.8	355.2	-4%	-6%
ROEV (%)	14.7%	16.5%	16.0%	16.5%	(124.6)	(2.4)

Source: Company, Ambit Capital research

Financials (IPRUL)

Policyholders Account

(₹ mn)	FY19	FY20	FY21E	FY22E	FY23E
First year premium	69,785	65,078	53,364	64,037	74,282
Renewal premium	205,654	209,432	223,919	226,753	238,339
Single premium	33,858	59,797	49,034	58,841	68,255
Gross Written Premiums	309,298	334,307	326,316	349,630	380,877
Net Premiums Earned	305,783	328,790	320,931	343,859	374,591
Investment Income	102,144	(125,169)	(86,915)	(70,570)	(58,333)
Total Income	**414,003**	**219,395**	**234,383**	**273,683**	**316,687**
Commission Expenses	16,038	15,860	13,530	15,367	15,367
Operating expenses	25,528	28,469	31,467	36,288	41,484
Benefits paid (Net)	141,885	193,026	171,494	163,414	161,228
Change in valuation of policy liabilities	210,030	(50,569)	1,354	43,602	82,021
Total Expenses	**400,538**	**196,211**	**225,117**	**266,967**	**309,379**
Surplus/(deficit) after tax	**12,333**	**21,870**	**8,741**	**6,335**	**6,894**
Transfer to Shareholders' account	10,770	19,887	6,758	4,353	4,911

Source: Ambit Capital research

Shareholders Account

(₹ mn)	FY19	FY20	FY21E	FY22E	FY23E
Amounts transferred from Policyholders' account	10,770	19,887	6,758	4,353	4,911
Income from investments	6,443	6,628	6,155	6,719	7,114
Total Income	**17,306**	**26,525**	**12,922**	**11,081**	**12,035**
Total Expenses	**5,694**	**15,855**	**431**	**370**	**402**
Profit before Tax	11,612	10,670	12,491	10,712	11,633
PAT	**11,389**	**10,670**	**12,491**	**10,712**	**11,633**

Source: Ambit Capital research

Balance Sheet

(₹ mn)	FY19	FY20	FY21E	FY22E	FY23E
Sources of Funds					
Share capital	14,358	14,359	14,359	14,359	14,359
Reserve and surplus	54,353	60,994	65,816	68,589	71,257
Net worth	70,423	72,125	80,175	82,947	85,616
Policyholders' funds	1,513,451	1,442,536	1,444,616	1,484,243	1,565,029
Funds For Future Appropriations	10,344	12,327	14,309	16,292	18,274
Total Liabilities	**1,594,218**	**1,526,987**	**1,539,100**	**1,583,482**	**1,668,919**
Applications of Funds					
Shareholders' investments	79,861	74,152	80,956	85,712	90,363
Policyholders' investments	400,712	467,503	544,680	621,248	709,565
Total Investments	480,573	541,655	625,636	706,960	799,928
Asset held to cover linked liabilities	1,109,458	970,850	892,560	849,901	836,649
Total Assets	**1,594,218**	**1,526,987**	**1,539,100**	**1,583,482**	**1,668,919**

Source: Ambit Capital research

Premium Flows

Particulars	FY19	FY20	FY21E	FY22E	FY23E
NBP (₹ mn)	103,644	124,875	102,398	122,877	142,538
APE (₹ mn)	77,990	73,810	60,524	72,629	84,250
NBP Growth (%)	12.5	20.5	(18.0)	20.0	16.0
APE Growth (%)	0.1	(5.4)	(18.0)	20.0	16.0
Conservation Ratio (%)	81.6	76.0	82.0	82.0	82.0
Commission ratio (%)	5.2	4.7	4.1	4.4	4.0

Source: Ambit Capital research

Product Mix

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Individual ULIPs	80%	65%	47%	46%	43%
Individual Par	9%	12%	18%	16%	16%
Individual Protection	6%	10%	18%	21%	23%
Individual Non Par Savings	1%	5%	8%	8%	8%
Total Individual	**95%**	**92%**	**90%**	**91%**	**91%**
Group Protection	4%	5%	6%	5%	5%
Group Savings	1%	3%	4%	4%	4%
Total Group	**5%**	**8%**	**10%**	**9%**	**9%**

Source: Ambit Capital research

Valuation

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Embedded Value (₹ mn)	216,240	230,310	261,950	294,794	333,347
VNB (in ₹ Mn)	13,280	16,050	15,024	18,554	22,603
VNB Margin	17.0%	21.7%	24.8%	25.5%	26.8%
RoEV (%)	20.2%	15.2%	13.6%	14.6%	15.2%
EPS (₹.)	7.9	7.4	8.7	7.5	8.1
BPS (₹.)	49.0	50.2	55.8	57.8	59.6
P/EV	2.7	2.6	2.2	2.0	1.8
ROA (%)	0.8%	0.68%	0.81%	0.69%	0.72%
ROE (%)	16.4%	15.0%	16.4%	13.1%	13.8%

Source: Ambit Capital research

Financials (SBIL)

Policyholders Account

(₹ mn)	FY19	FY20	FY21E	FY22E	FY23E
First year premium	90,572	98,288	86,493	102,062	117,372
Renewal premium	191,974	240,422	274,684	292,921	320,339
Single premium	47,348	67,637	59,521	70,234	80,769
Gross Written Premiums	329,894	406,347	420,698	465,218	518,480
Net Premiums Earned	328,904	403,240	417,481	461,661	514,516
Investment Income	112,081	29,968	151,044	182,669	218,566
Total Income	**442,612**	**438,428**	**568,794**	**644,628**	**733,414**
Commission Expenses	13,769	16,249	15,918	17,867	17,867
Operating expenses	20,930	24,131	30,038	34,455	39,142
Benefits paid (Net)	152,331	161,753	187,309	224,834	265,853
Change in valuation of policy liabilities	235,917	206,049	316,718	345,306	383,187
Total Expenses	**429,058**	**415,715**	**555,608**	**628,876**	**713,239**
Surplus/(deficit) after tax	**10,866**	**18,946**	**10,999**	**13,139**	**16,829**
Transfer to Shareholders' account	9,985	14,627	6,678	8,819	12,509

Source: Ambit Capital research

Shareholders Account

(₹ mn)	FY19	FY20	FY21E	FY22E	FY23E
Amounts transferred from Policyholders' account	9,985	14,627	6,678	8,819	12,509
Income from investments	5,057	4,767	6,828	8,286	10,051
Total Income	**15,177**	**19,461**	**13,574**	**17,173**	**22,628**
Total Expenses	**1,448**	**5,326**	**393**	**497**	**655**
Profit before Tax	13,729	14,135	13,182	16,676	21,973
PAT	**13,268**	**14,222**	**13,262**	**16,778**	**22,107**

Source: Ambit Capital research

Balance Sheet

(₹ mn)	FY19	FY20	FY21E	FY22E	FY23E
Sources of Funds					
Share capital	10,000	10,000	10,000	10,000	10,000
Reserve and surplus	64,601	78,839	89,101	102,429	120,569
Net worth	75,764	87,431	99,101	112,429	130,569
Policyholders' funds	1,351,399	1,531,011	1,892,627	2,254,853	2,656,563
Funds For Future Appropriations	2,816	7,137	11,457	15,778	20,098
Total Liabilities	**1,429,978**	**1,625,579**	**2,003,185**	**2,383,059**	**2,807,230**
Applications of Funds					
Shareholders' investments	57,232	68,279	82,862	100,510	122,970
Policyholders' investments	644,724	734,199	835,497	937,325	1,053,675
Total Investments	701,956	802,479	918,359	1,037,836	1,176,645
Asset held to cover linked liabilities	691,291	785,653	1,046,496	1,305,869	1,589,823
Total Assets	**1,429,978**	**1,625,579**	**2,003,185**	**2,383,059**	**2,807,230**

Source: Ambit Capital research

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Premium Flows

Particulars	FY19	FY20	FY21E	FY22E	FY23E
NBP (₹ mn)	137,920	165,925	146,014	172,296	198,141
APE (₹ mn)	97,000	107,400	94,512	111,524	128,253
NBP Growth (%)	25.8	20.3	(12.0)	18.0	15.0
APE Growth (%)	13.5	10.7	(12.0)	18.0	15.0
Conservation Ratio (%)	85.2	85.1	82.0	82.0	82.0
Commission ratio (%)	4.2	4.0	3.8	3.8	3.4

Source: Ambit Capital research

Product Mix

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Individual ULIPs	71%	70%	65%	63%	58%
Individual Par	19%	11%	7%	6%	5%
Individual Protection	4%	5%	7%	10%	14%
Individual Non Par Savings	0%	7%	10%	11%	12%
Total Individual	**94%**	**92%**	**90%**	**90%**	**90%**
Group Protection	3%	4%	5%	5%	6%
Group Savings	3%	4%	5%	4%	4%
Total Group	**6%**	**8%**	**10%**	**10%**	**10%**

Source: Ambit Capital research

Valuation

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Embedded Value (₹ mn)	224,010	262,810	291,523	335,238	387,040
VNB (in ₹ Mn)	17,190	20,100	18,874	23,386	28,274
VNB Margin	19.8%	20.7%	22.0%	23.0%	24.0%
RoEV (%)	17.4%	20.5%	14.7%	16.5%	16.9%
EPS (₹.)	13.3	14.2	13.3	16.8	22.1
BPS (₹.)	75.8	87.4	99.1	112.4	130.6
P/EV	3.4	2.9	2.6	2.3	2.0
ROA (%)	1.0%	0.93%	0.73%	0.77%	0.85%
ROE (%)	18.8%	17.4%	14.2%	15.9%	18.2%

Source: Ambit Capital research

Premium Flows

Particulars	FY19	FY20	FY21E	FY22E	FY23E
NBP (₹ mn)	137,920	165,925	146,014	172,296	198,141
APE (₹ mn)	97,000	107,400	94,512	111,524	128,253
NBP Growth (%)	25.8	20.3	(12.0)	18.0	15.0
APE Growth (%)	13.5	10.7	(12.0)	18.0	15.0
Conservation Ratio (%)	85.2	85.1	82.0	82.0	82.0
Commission ratio (%)	4.2	4.0	3.8	3.8	3.4

Source: Ambit Capital research

Product Mix

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Individual ULIPs	71%	70%	65%	63%	58%
Individual Par	19%	11%	7%	6%	5%
Individual Protection	4%	5%	7%	10%	14%
Individual Non Par Savings	0%	7%	10%	11%	12%
Total Individual	**94%**	**92%**	**90%**	**90%**	**90%**
Group Protection	3%	4%	5%	5%	6%
Group Savings	3%	4%	5%	4%	4%
Total Group	**6%**	**8%**	**10%**	**10%**	**10%**

Source: Ambit Capital research

Valuation

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Embedded Value (₹ mn)	224,010	262,810	291,523	335,238	387,040
VNB (in ₹ Mn)	17,190	20,100	18,874	23,386	28,274
VNB Margin	19.8%	20.7%	22.0%	23.0%	24.0%
RoEV (%)	17.4%	20.5%	14.7%	16.5%	16.9%
EPS (₹.)	13.3	14.2	13.3	16.8	22.1
BPS (₹.)	75.8	87.4	99.1	112.4	130.6
P/EV	3.4	2.9	2.6	2.3	2.0
ROA (%)	1.0%	0.93%	0.73%	0.77%	0.85%
ROE (%)	18.8%	17.4%	14.2%	15.9%	18.2%

Source: Ambit Capital research

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INITIATING COVERAGE | **MAXF IN EQUITY** | **October 26, 2020**

About to get its 'wings'

MaxL (only operating entity of MFSL) partnered with Axis a decade ago to become 4th largest private insurer. As existing distribution tie-up comes to an end in Sept'21, its cardinal to get regulatory approval for 18% stake sale in MaxL to Axis (proposed JV) for establishing a long-term distribution reach. This is key to maintain existing market share as Axis contributes 55-60% of its retail premiums and >40% of VNB. We believe eventually MaxL could get completely rebranded with Axis branding, improving brand recognition. This would aid in uplifting protection and annuity franchise. Deal should consummate (modifications possible) given Axis' deep-rooted intent to manufacture life insurance and MaxL's over-dependence. Expect RoEV of 17-19% (FY20-23) backed by margin expansion-led VNB CAGR of 14%. Current valuations discount plausible deal and ability to leverage Axis' platform over the long term. Risk: Break-up of all partnerships with Axis.

Competitive position: MODERATE Changes to this position: STABLE

Deal with Axis crucial; could give edge over the long term

Lack of long-term distribution visibility pushed MaxL in augmenting its agency channel (₹0.2mn productivity vs ₹0.16mn for peers). This enabled it to deliver APE CAGR of 19% over FY16-20 vs 15% for private sector. Given Axis' deep intent to manufacture life insurance, MaxL could eventually rebrand with Axis branding. Thus, the deal is important not only to maintain market share but also expand presence in more profitable protection and annuity segments. The deal would also aid in bringing down promoter leverage.

Expect deal to consummate; Axis' open architecture not a negative

The deal would be value accretive. Axis benefits given i) long track record, ii) MaxL contributes >90% to its insurance fee and iii) it's the largest life insurer open for investment. Manufacturing insurance is not viable given i) RBI preference for holding company structure, ii) long gestation (>10 years) and iii) stiff competition. MaxL would benefit from i) stable distribution; ii) higher customer retention and iii) viability to leverage Axis platform. Axis' open architecture indicates lower possibility of starting own insurance operations.

VNB growth to be strong led by margin expansion

We expect 17-19% (FY20-23) RoEV backed by margin expansion-led VNB CAGR of 14% and APE of ~6%. VNB growth would be back-ended albeit slowdown. Protection would grow fastest (~32% CAGR), enabling margin to expand to ~26% in FY23 vs ~21% now. We don't adjust our forecast margins for indirect payoffs via share buyback arrangement (200-300bps impact) given assumption of deal to consummate. We expect sub-debt issuance in FY22.

Current valuation factors more negatives than positives

We value MaxL using appraisal value, implying valuation of 2.2x FY22 EV. Our implied valuation factors 90% probability of deal consummating. Break-up of all partnerships with Axis could result in 17% downside. Stock trades at 1.8x FY22E EV, 37% discount to peers despite comparable operating metrics owing to lack of certainty of deal and overhang of promoter leverage (~92%). Visibility of distribution arrangement in any form would drive a rerating.

Key metrics

Year to March	FY19	FY20	FY21E	FY22E	FY23E
APE (₹ bn)	41	43	39	44	52
VNB margins (%)	20.9	20.6	22.5	24.2	25.7
VNB (₹ bn)	9	9	9	11	13
Embedded Value (₹ bn)	89	100	112	126	143
P/EV (x)	2.5	2.2	2.0	1.8	1.5
RoEV (%)	21.9	20.3	17.3	18.0	19.1

Source: Company, Ambit Capital research

BFSI – Insurance

Recommendation

Mcap (bn):	₹159/US$2.2
3M ADV (mn):	₹1018/US$13.8
CMP:	₹589
TP (12 mths):	₹751
Upside (%):	28

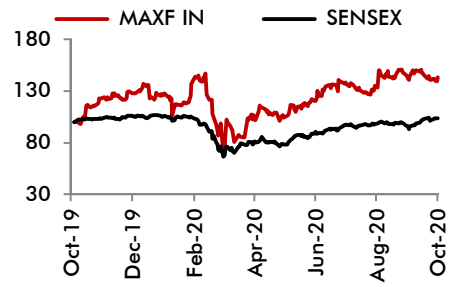
Flags

Accounting:	GREEN
Predictability:	AMBER
Earnings Momentum:	RED

Catalysts

- Consummation of JV deal with Axis Bank over next 12 months
- Protection APE growth of >25%

Performance (%)



Source: Bloomberg, Ambit Capital research

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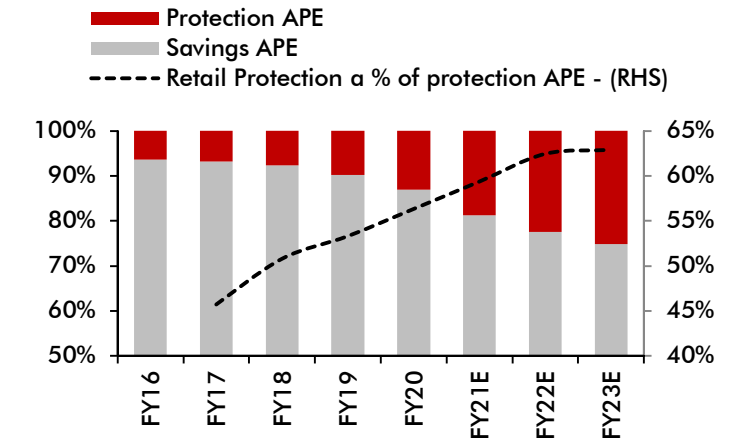
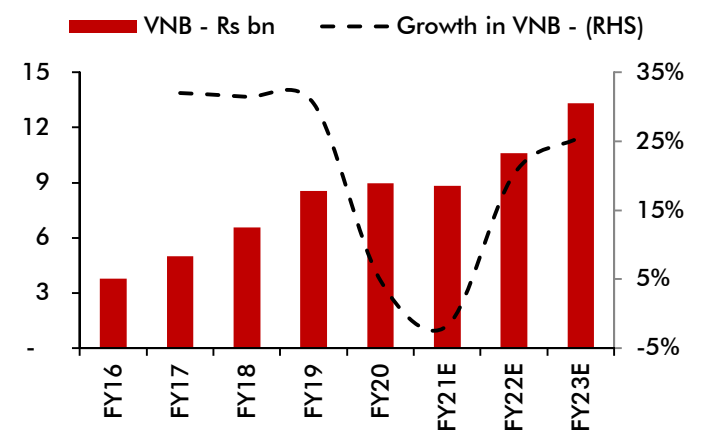
The Narrative in Charts

Increasing share of margin-accretive protection segment to drive margin expansion



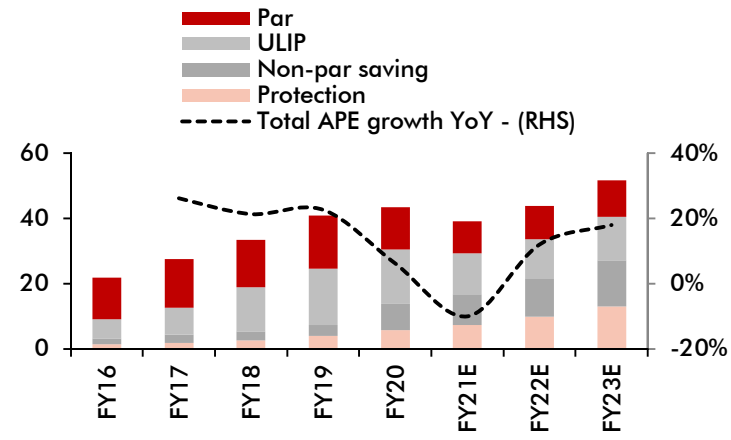
Source: Company, Ambit Capital research estimates

VNB to grow at ~14% CAGR over 20-23 largely led by margin expansion



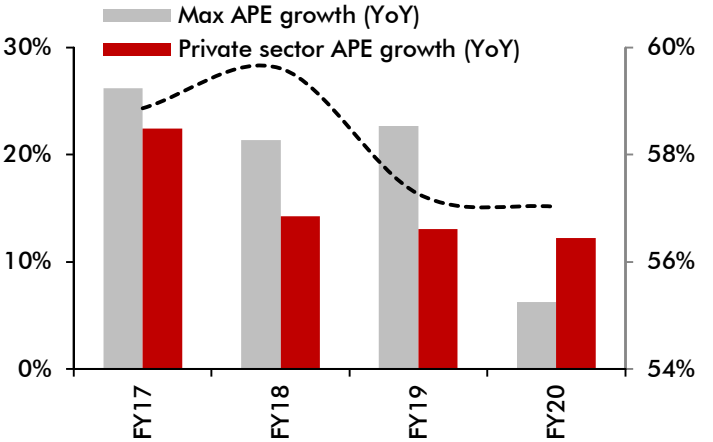
Source: Company, Ambit Capital research

Building in modest APE CAGR of ~6% led by non-par



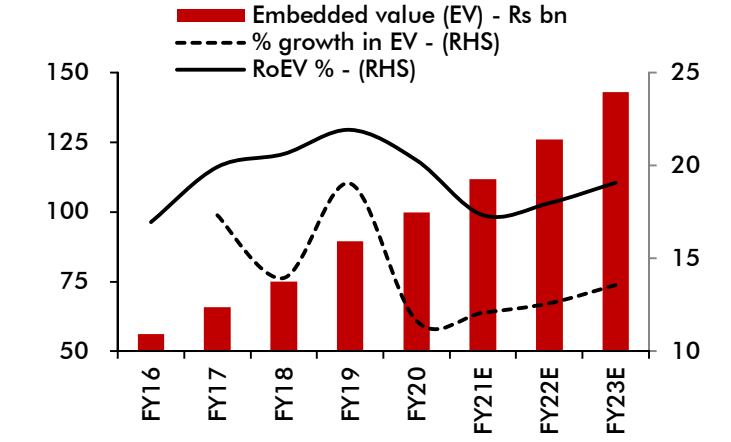
Source: Company, Ambit Capital research estimates

Deal with Axis Bank key to drive rerating



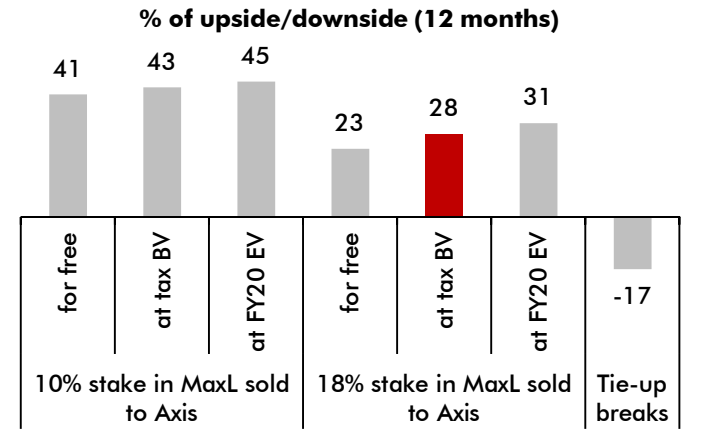
Source: Company, Ambit Capital research

Expect deal to consummate, leading to consistent double-digit growth in EV and RoEV of >17% through FY23



Source: Company, Ambit Capital research estimates

Consummation of deal (18%) at articulated price of ₹28.6 (tax BV) could drive stock closer to fair value



Source: Company, Ambit Capital research estimates

MaxL: A well-run franchise

Max Financial Services Limited (MFSL) is the holding company of Max Life Insurance (MaxL) with a majority holding of ~72.5%. MaxL owns no other operating business. MaxL is a joint venture between MaxL and Japan's Mitsui Sumitomo Insurance, a Japan-headquartered leading global life insurer holding ~25.5%. MaxL began its operations in FY01 and is the 4th largest private life insurer in the country with ~3.5% APE market share as at end-FY20. It's been among the few successful non-bank sponsored life insurers given a well laid out product strategy and partnership with Axis Bank early on. It partnered with Axis Bank in 2011 which contributes 50-60% of its new premiums (basis APE). It offers both savings and protection products through a multi-channel distribution platform, including bancassurance, individual agents and a direct sales force.

Exhibit 1: Max Life is the most profitable non-bank sponsored life insurer

Year	Event
2001	Started commercial operations
2003	First bancassurance and corporate agency relationship
2005	Completed ₹5bn of premiums
2007	Sold more than 1mn policies
2009	Entered the health insurance segment
2011	Tie-up with Axis Bank
2012	Reached US$1bn mark in total revenue and recorded its maiden shareholders' profit Became the largest non-bank owned private life insurance company in India
2016	Max Financial was created as a result of demerger of the erstwhile Max India Entered into an agreement to merge with HDFC Life
2017	Called off merger with HDFC Life; Axis Bank contract renewed
2018	Crossed AUM of ₹500bn
2020	Joint Venture with Axis Bank announced

Source: Company, Ambit Capital research

Managing well amid constraints

MaxL has managed to be 4th largest private life insurer with APE market share of ~3.5% as of FY20. Growth has been profitable and well-diversified driven by well laid out product strategy and longstanding partnership with Axis Bank (contributes ~56% of total APE). It's the most profitable non-bank sponsored private life insurer with VNB CAGR of ~24% between FY16-20.

A more engaging and visibly sustainable bank-backed distribution infrastructure remains a key constraint for MaxL compared to larger peers. To overcome this, in June'16 it entered an agreement to merge with HDFC Life. However, in Nov'16, the regulator (IRDAI) raised concerns over the proposed deal structure citing discomfort around Section 35 of the Insurance Act 1938. Ultimately, in July'17, the merger was called off by both parties. After the fallout MaxL enhanced its focus on agency and direct channels along with strengthening its partnership with Axis Bank. In April'20, MaxL announced a proposed joint venture with Axis Bank in which the latter would hold 18% stake in MaxL. Regulatory approvals are pending. Given long-term synergistic benefits to both parties there is high probability that the proposed deal would consummate. This would add visibility and sustainability around the distribution arrangement and drive a rerating.

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Exhibit 2: MaxL: SWOT analysis; well-placed to build a larger protection franchise

STRENGTH	WEAKNESS
Best-in-class execution: Max Life had a well laid-out product strategy cut out to corroborate with its agency distribution infrastructure. It also partnered with Axis Bank (3rd largest private bank) early on (2011) which helped it achieve scale at the same time being profitable. It's the 4th largest private life insurer with 3.5% market share (basis APE) and continues to be the most profitable non-bank sponsored life insurer. **Agent productivity deserves a pat:** Max Life has the second most productive agent workforce after SBI Life, amongst private life insurers. Per agent productivity in FY19 was high at ~₹0.20mn p.a. vs average of ~₹0.12mn for HDFCL/IPRUL and ~₹ 0.25mn for SBIL. High productivity amongst agents helps diversify distribution platform. **Well-diversified product: Max Life remains a well-diversified,** retail-focused franchise. Dependence of cyclical lower margin ULIPs is lowest amongst large peers; 38% vs average of 52%. Individual APE contributed ~95% to total APE in FY20.	**Overhang of promoter leverage:** This has been a drag for the stock over the last three years. Management has articulated reduction of promoter pledge to 50-60% from existing 90-95% on the back of monetisation through some combination of stake sale in Max Financials and assets in the healthcare space. Cementing of deal with Axis Bank will render additional comfort. **High operating cost player:** Relatively higher dependence on agency channel and being non-bank sponsored life issuer makes Max Life a relatively high-cost player. Its total expense ratio is high at ~21% as of FY20 vs ~10-17% for large peers. Increase in scale and consummation of deal with Axis Bank could lead to some cost efficiencies.
OPPORTUNITIES	**THREATS**
Deal with Axis Bank will add distribution edge: Axis Bank is the third-largest private bank in the country with an entrenched network of 4,528 branches as of July'20. Joint venture with Axis Bank will bring synergy and additional growth opportunities. **Protection and credit life a big opportunity:** Retail protection/credit protect contributes ~8%/~1.0% to total APE and ~26%/2% to VNB as of FY20. Axis Bank (primary bancassurance partner for Max Life) is well-placed (~26mn million customer base and a strong brand) to provide a robust platform to grow this segment.	**Fallout of deal with Axis Bank:** This could impact Max Life disproportionally; given Axis Bank contributes ~56% of its total APE.

Source: Company, Ambit Capital research

Diversified APE mix (ULIP/PAR/non-par/Protection – 38%/30%/18%/13%), well-oiled agency channel and a comparable persistency ratio (FY20: 87% (13M) vs average of 88% for large peers) enable MaxL to sustain it strong growth trajectory. MaxL has been able to profitably grow its APE at ~19% CAGR over FY16-20 (vs industry average of 19%, private average of 15%) while also growing VNB at 24% CAGR. Solvency ratio remains adequate at 212% as of 1QFY21 (peer average of 211%) vs regulatory requirement of 150%. Given expectation of sharp growth in the protection segment, we expect MaxL to raise sub-debt/capital over the next 12-18 months.

Stock price factoring more negatives than positives

MaxL's stock price has been volatile over the last 12 months given announcements around the proposed merger and overhang of promoter leverage (~92% as of June'20). The stock has moved up by 52% over the past 12 months and has outperformed both peers (on an average up by 35%) and Nifty (up by 45%). MaxL is trading at 1.8x 1-year forward P/EV and 12-50% discount to peer valuations. This is despite comparable operating metrics as uncertainty around deal/renewal of distribution partnership with Axis Bank prevails. High promoter pledge of ~92% has also been an overhang on the stock. Our estimates indicate that at current levels, the stock is building in a high possibility of the deal with Axis Bank not consummating or a distribution partnership with Axis Bank not getting renewed. In our view, given long-term synergistic benefits to both parties, there is a high probability (~90%) that the proposed deal would consummate. This would add visibility and sustainability around the distribution arrangement and drive a rerating. Efforts around promoter deleveraging would also get a push.

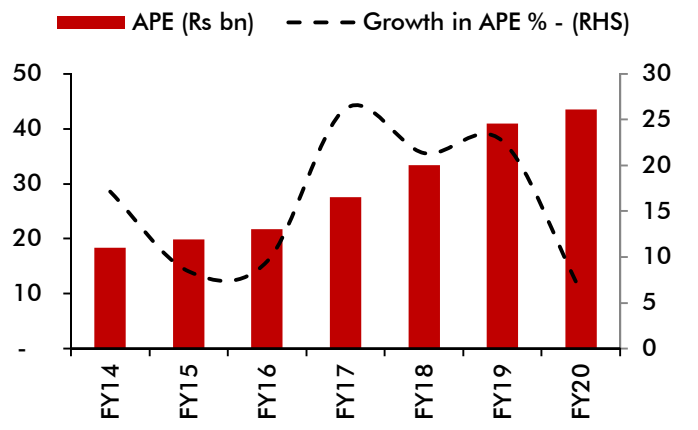
Operating metrics compare well

MaxL's VNB grew by 24% between FY16-20. This led to stable RoEV of ~20% (average), in line with larger peers. VNB growth outpaced APE which grew slower at 19%, implying margin expansion of ~330bps to ~21%. High growth of 42% in protection APE led to margin expansion. Overall APE growth was led by 29% growth in ULIPs (larger base and ticket size). Consummation of deal with Axis Bank would cement sustainability of VNB expansion over the long term. Persistency tracks well when compared to large peers.

Premium growth has been faster than peers...

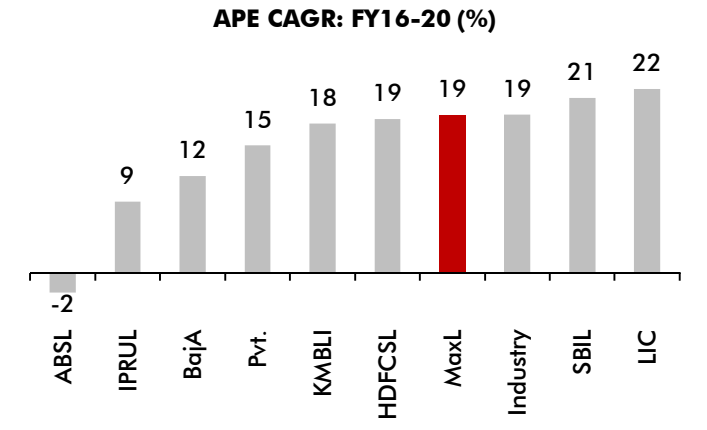
APE for MaxL grew at a CAGR of 19% between FY16-20; faster when compared 15% for the private sector. Growth was driven by ULIPs which grew faster at a CAGR of 29% between FY16-20.

Exhibit 3: Max Life's premium growth (basis APE) has been strong



Source: Company, Ambit Capital research

Exhibit 4: APE grew faster at 19% CAGR between FY16-20 vs 15% for private peers

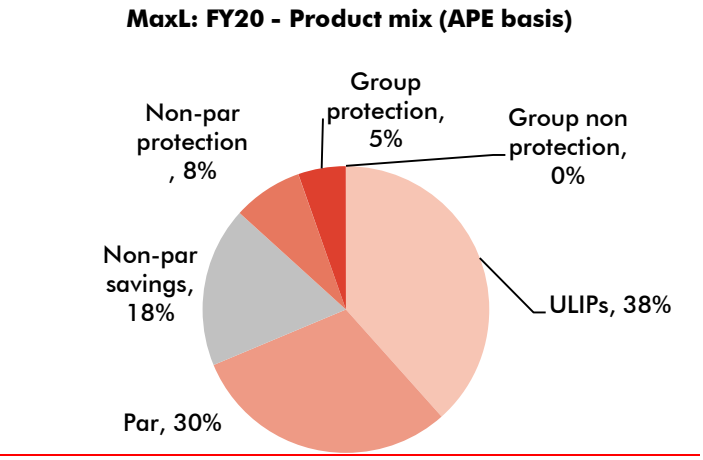


Source: Company, Ambit Capital research

...led by ULIPs

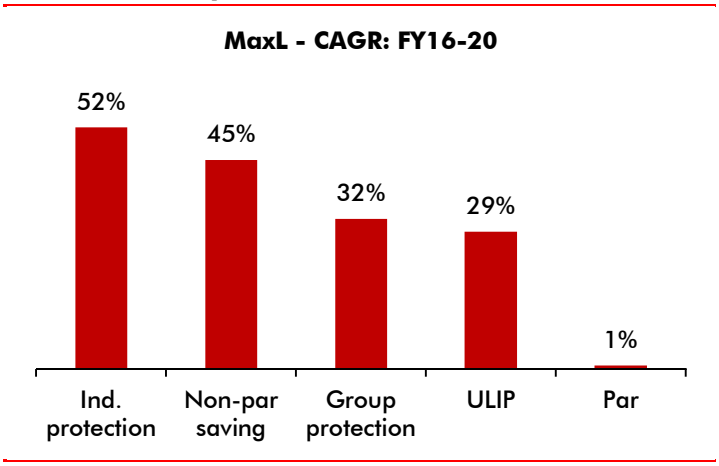
This led to share of ULIPs in overall APE increasing to 38% in FY20 vs 27% in FY16. APE growth was also aided by faster growth of protection APE, which grew at a CAGR of 42% during FY16-20. Par segment growth was muted at CAGR of ~1%.

Exhibit 5: ULIP now contributes ~38% to overall APE...



Source: IRDAI, Company, Ambit Capital research

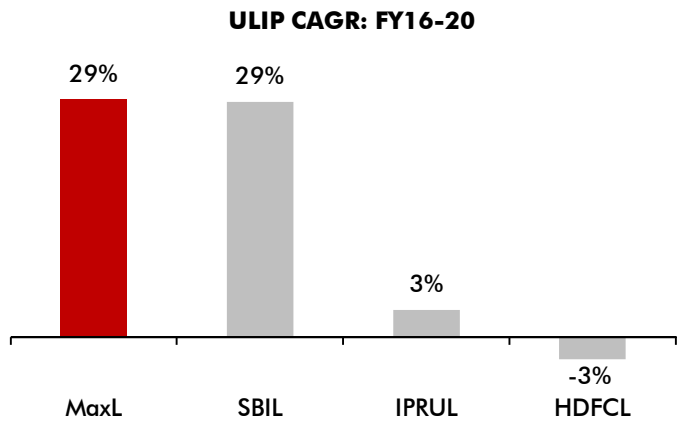
Exhibit 6: ...led by robust CAGR of 29% between FY16-20



Source: Company, Ambit Capital research

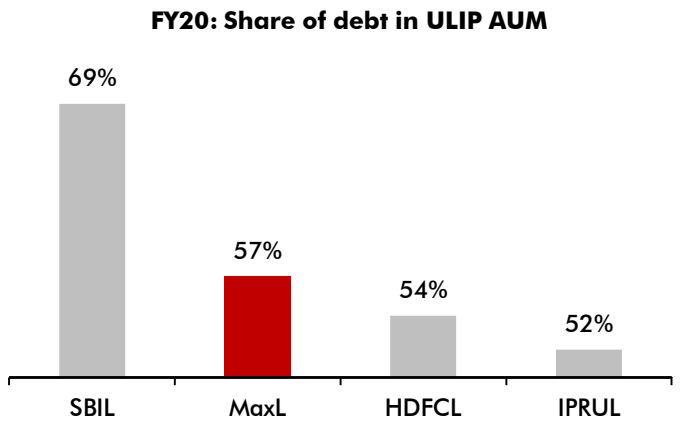
Growth in ULIPs between FY16-20 was significantly higher than most large private peers. This was driven by i) focus on debt ULIPs (57% linked AUM parked in debt vs 52%-69% for large peers and ii) strategic call to reduce concentration on par products which led to part of par sales getting channelized into ULIPs. The par segment's contribution to APE has come down from 58% in FY16 to 30% in FY20.

Exhibit 7: Growth in ULIPs was even faster than peers...



Source: Company, Ambit Capital research estimates

Exhibit 8: ... led by focus on debt ULIPs

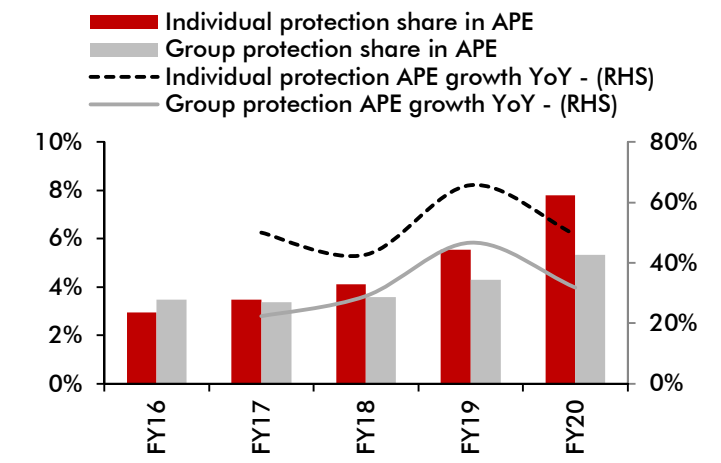


Source: Company, Ambit Capital research

Increasing focus on individual protection

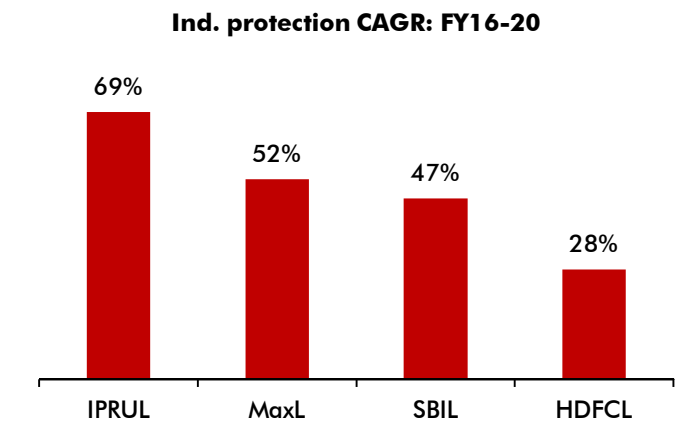
Adverse profitability impact of increasing share of lower-margin ULIPs was offset by increased focus on the individual protection segment. Individual protection APE grew at a CAGR of 52% between FY16-20. This has helped in improving the overall margin profile from ~17% in FY16 to ~21% in FY20. Growth in the individual protection segment has been faster for most bank-sponsored private peers given better brand recall and higher perceived safety (refer exhibit 20 of the thematic). Consummation of deal with Axis Bank will not only boost opportunity in the individual protection segment but also enable faster growth in the group protection segment.

Exhibit 9: Strong growth in protection APE has supported margins



Source: Company, Ambit Capital research

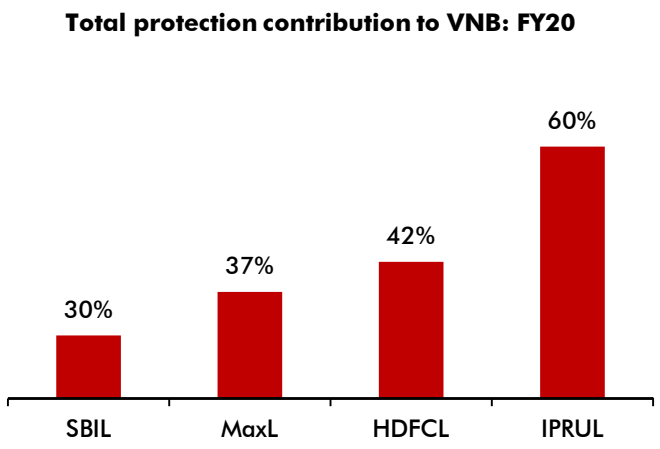
Exhibit 10: Individual protection APE growth has been second only to IPRUL



Source: Company, Ambit Capital research

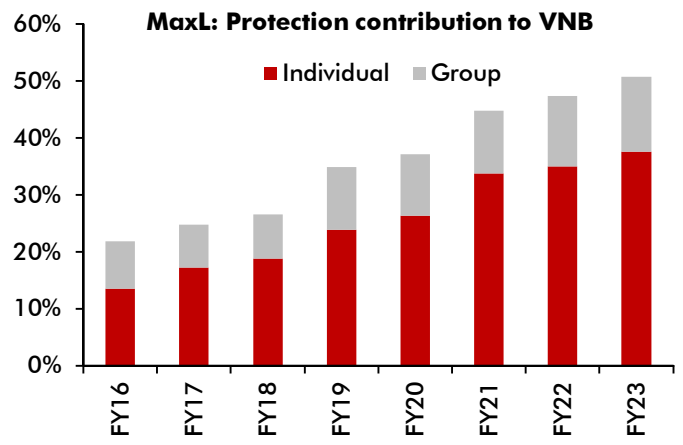
We see the protection segment contributing ~37% to VNB as of FY20 with individual protection contributing ~26%. For most large peers, contribution of protection segment to VNB has been much higher at 30-60% given higher margins in the individual segment and faster growth. Higher margins are driven by better pricing power (refer exhibits 20 and 26 of the thematic). By FY23, we expect protection segment to contribute ~50% to total VNB for MaxL. Existing sub-scale (compared to large private peers) presence in the protection segment and expectation of improvement in perceived safety and distribution with consummation of deal with Axis Bank present opportunities to expand margins in a meaningful way.

Exhibit 11: Protection segment has scope contribute more to VNB...



Source: Company, Ambit Capital research

Exhibit 12: ...driven by potential in both individual and group segments

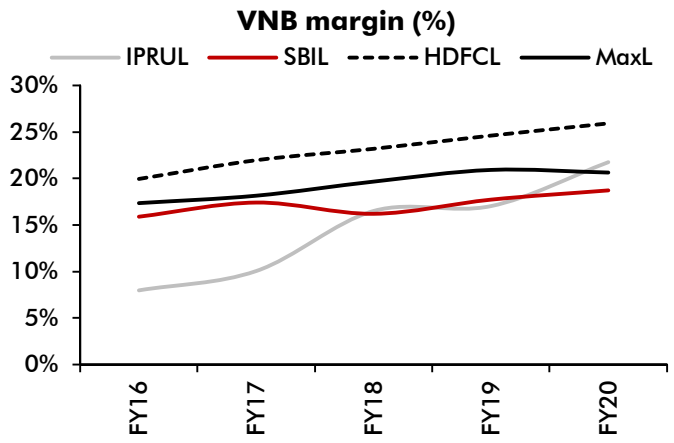


Source: Company, Ambit Capital research

Margin expansion has been linear

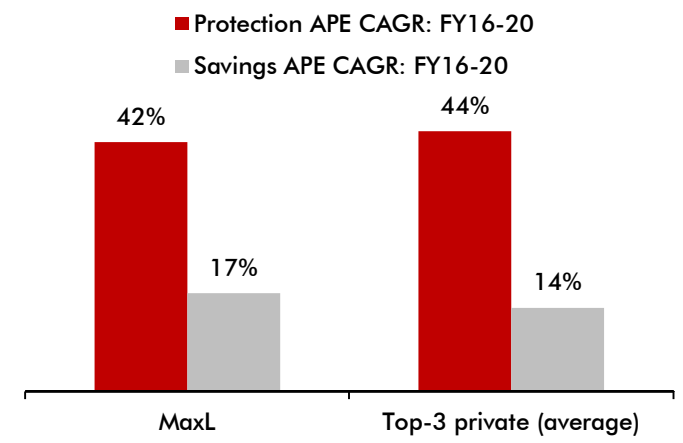
Margin expansion for MaxL has been rather linear when compared to most large peers (FY16-20: 328bps vs average of ~800bps for peers). This was on the back of relatively high savings APE growth.

Exhibit 13: Margin expansion has been linear for MaxL...



Source: Company, Ambit Capital research

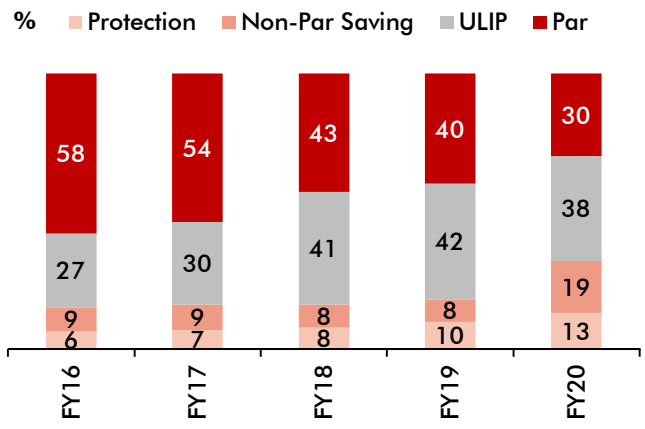
Exhibit 14: ... consequent to faster growth in savings APE



Source: Company, Ambit Capital research

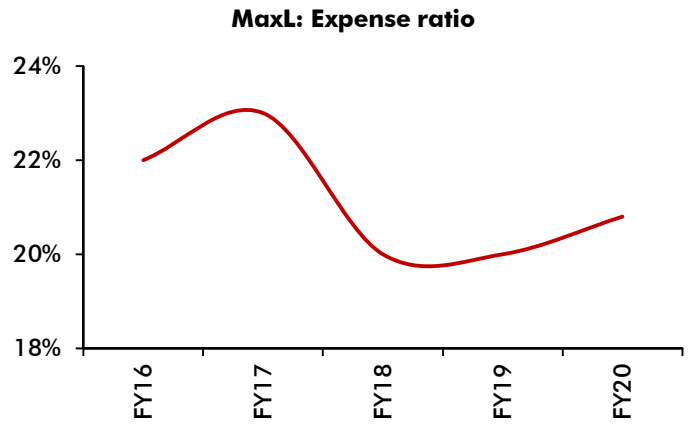
Margin expansion took a back seat in FY20 despite increase in share of protection (13% of APE in FY20 vs 10% n FY19) and strong growth in the non-par savings segment (~19% of APE in FY20 vs ~8% in FY19). Both these segments typically have higher margins than overall company margins and hence ideally should be margin-accretive. While the share of non-par savings did increase, the new sales mix tilted more towards guaranteed return products vs earlier, implying lower margin profile for the non-par segment itself compared to before. Additionally, increased investment in the proprietary channel (agency and direct) elevated the expense ratio. That clubbed with downward interest rate movement had an adverse impact on margins.

Exhibit 15: Share of protection has > than doubled over last 5 years



Source: Company, Ambit Capital research

Exhibit 16: Investment in proprietary channel elevated expense ratio in FY20

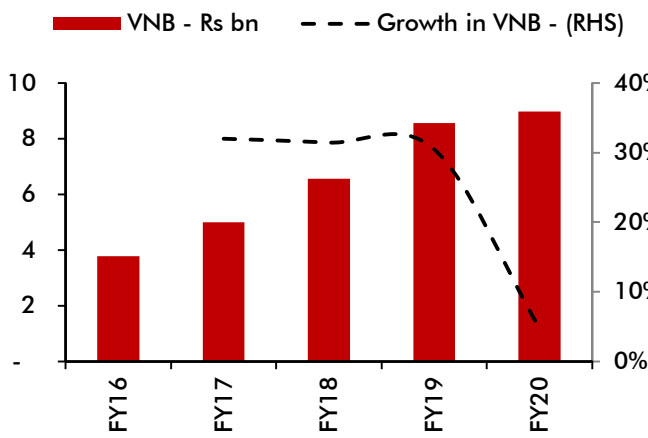


Source: Company, Ambit Capital research

VNB growth has been commendable

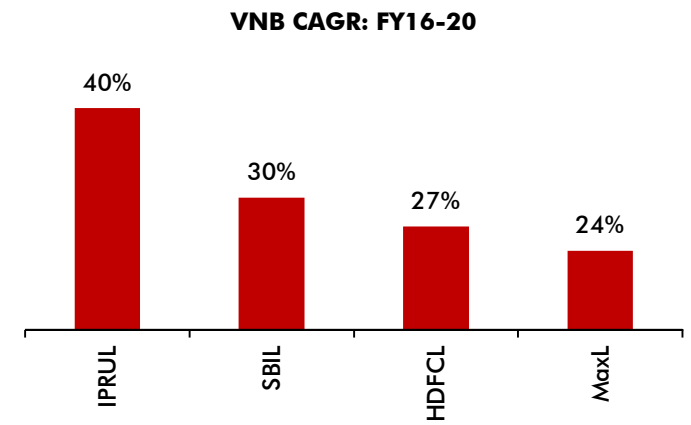
Secular growth across most product segments led to consistent 30%+ VNB expansion between FY17-19. VNB growth in FY20 was subdued (4.8% YoY) on account of slower APE growth and lower margins driven by higher opex. VNB growth for MaxL over the last four years is not far behind when compared to bank-sponsored insurers.

Exhibit 17: VNB growth has been strong barring FY20



Source: Company, Ambit Capital research

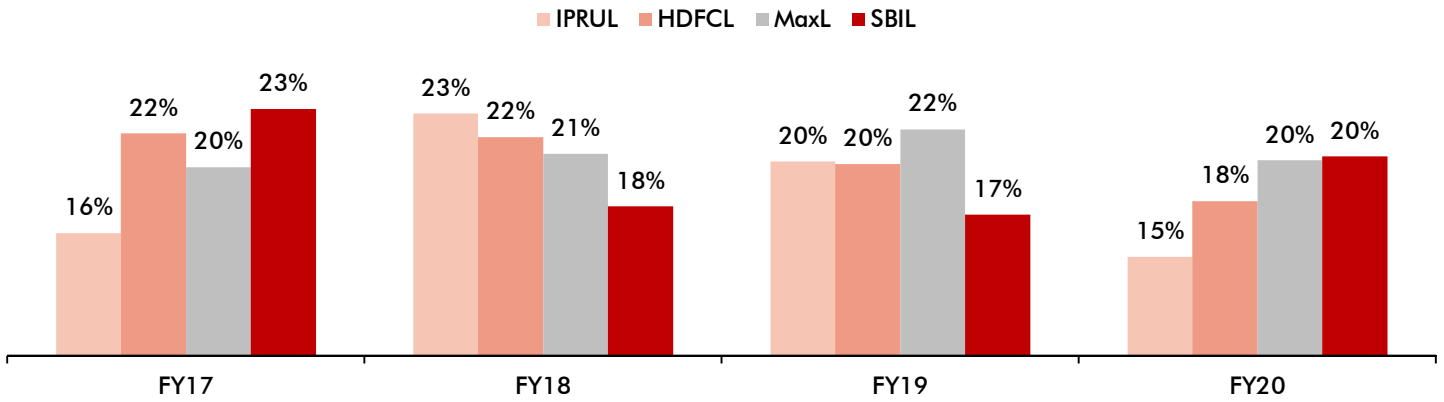
Exhibit 18: Lower than peers but with higher expenses



Source: Company, Ambit Capital research

This led to steady RoEV (average of 21%) between FY17-20 which stacks up well when compared to peers.

Exhibit 19: RoEV for MaxL has been steady and tracks well compared to peers



Source: Company, Ambit Capital research

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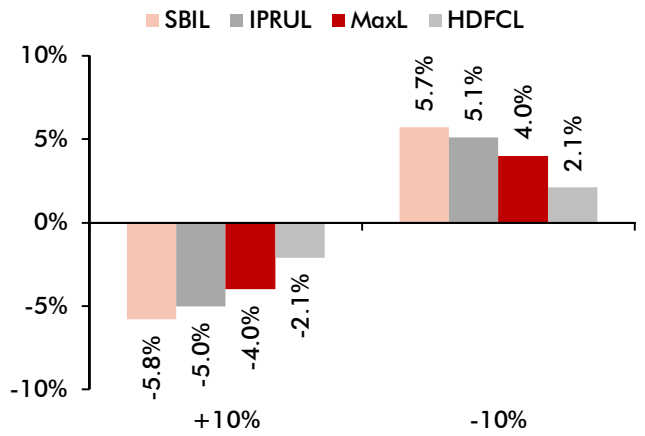
Given MaxL's lower dependence on ULIPs (~38% of APE vs average of 52% for large peers) we expect persistency to remain stable over FY20-23. This is also captured well in its low sensitivity to the discontinuance rate. Some dip may be expected in FY21 but should not adversely affect margins in a meaningful way.

Exhibit 20: Persistency for MaxL has been stable aided by lower share of ULIPs...

Persistency	FY15	FY16	FY17	FY18	FY19	FY20
13th month	77.0%	78.8%	80.4%	81.0%	83.0%	87.0%
25th month	64.0%	66.6%	70.4%	72.0%	71.0%	73.0%
37th month	60.0%	58.0%	59.7%	62.0%	64.0%	64.0%
49th month	49.0%	55.6%	54.9%	57.0%	58.0%	60.0%
61st month	32.0%	42.7%	53.0%	53.0%	53.0%	53.0%

Source: Company (public disclosure), Ambit Capital research

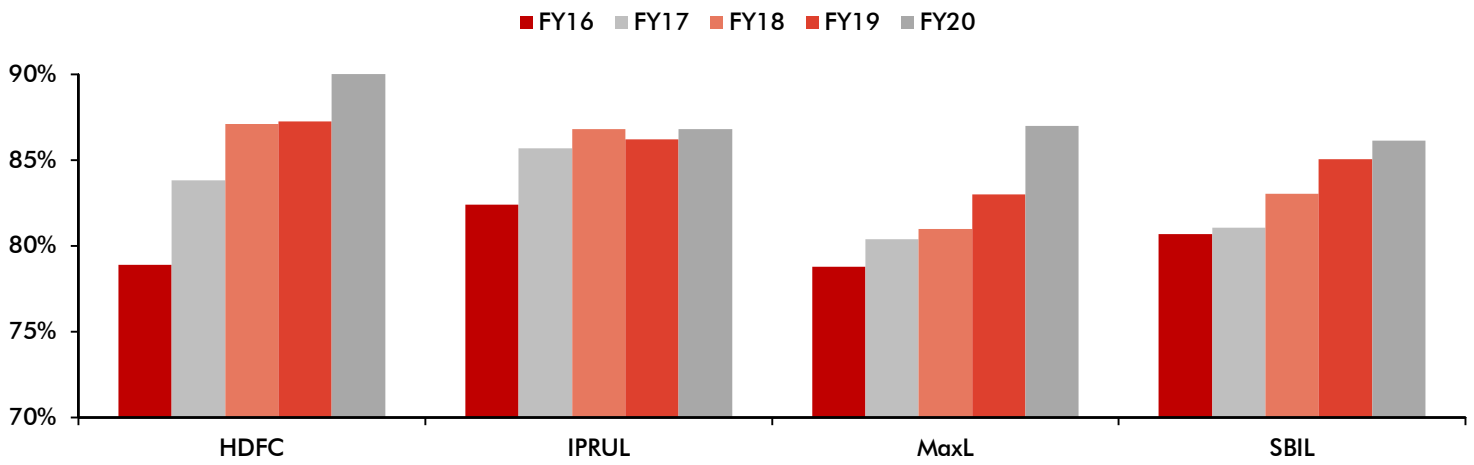
Exhibit 21: ... well-reflected in lower sensitivity of VNB to discontinuance rate when compared to most peers



*Source: Company, Ambit Capital research; *data as at end FY20*

Persistency for MaxL has consistently moved up and stacks well when compared to peers. Consummation of deal with Axis will further strengthen it.

Exhibit 22: Persistency (13th month) for MaxL has consistently moved up over last five years



Source: Company; Ambit Capital research

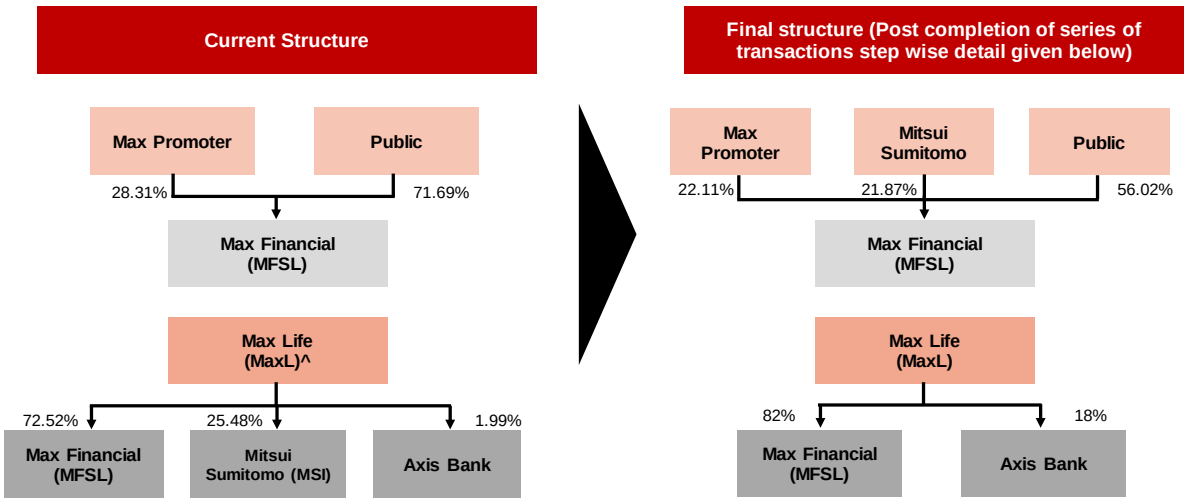
Axis-Max JV - Pursuit to panacea

We believe the deal with Axis Bank will consummate given Axis's deep-rooted intent to manufacture life insurance and MaxL's over-dependence. Even Axis Bank's recent onboarding of Bajaj Allianz heightens this possibility. Axis-MaxL JV would mean lower impact of open architecture vs distribution-only arrangement. We believe MaxL could eventually rebrand with Axis branding. Thus deal is important not only to maintain market share (~3.5% basis APE) but also expand presence in the more profitable protection and annuity segments. Moreover, MaxL will benefit from higher customer retention and the deal would aid in bringing down promotor leverage, a sentiment dampener. Break-up of all partnerships with Axis could mean VNB over the long term (10 years) could contract to 1/3rd.

Contours of proposed deal structure with Axis Bank

MaxL has entered into an agreement with Axis Bank to offer 18% stake in MaxL. The following regulatory approvals are awaited; i) RBI's approval for Axis Bank owning 18% in MaxL, and ii) IRDAI's approval on reverse merger of MFSL (listed) into MaxL (this will help Axis Bank exhibit value of its stake). Multiple options are being worked out in case IRDAI doesn't approve the merger given discomfort around Section-35 of Insurance Act 1938 which only deals with merger between pure play life insurance companies. Option-2 would involve offering MaxL shares to MFSL shareholders which can lead to indirect listing of the life insurance business. A share swap option is also available in which Axis Bank will be offered MFSL shares for their stake in MaxL. Option-3 (put option with Axis Bank) would involve MFSL paying Axis Bank ₹294 per share (current implied price of ~₹115 per share) for 18% stake in MaxL, implying net outflow of ~₹101bn in ~7 years.

Exhibit 23: Max – Axis Bank proposed transaction structure



- **Step 1 :** MSI to hold 21.87% stake of MFSL stake in exchange of 20.57% of Max Life through a Share SWAP transaction
- **Step 2 :** MFSL-MSI to acquire 1% stake in Max Life from Axis in the ratio of 74:26
- **Step 3 :** MFSL to sell 17% stake in Max Life to Axis at Tax Book Value
- **Step 4 :** MFSL to acquire balance 5.17% stake from MSI

*Source: Company. Ambit Capital research *MaxL shareholding on undiluted basis*

Why do we believe the deal will go through?

In our view, ultimately the deal would go through with a possibility of some modifications in the proposed contours. We say so given the deal is important for both parties involved. A look at various parameters reveals so.

Exhibit 24: Proposed deal is a win-win proposition

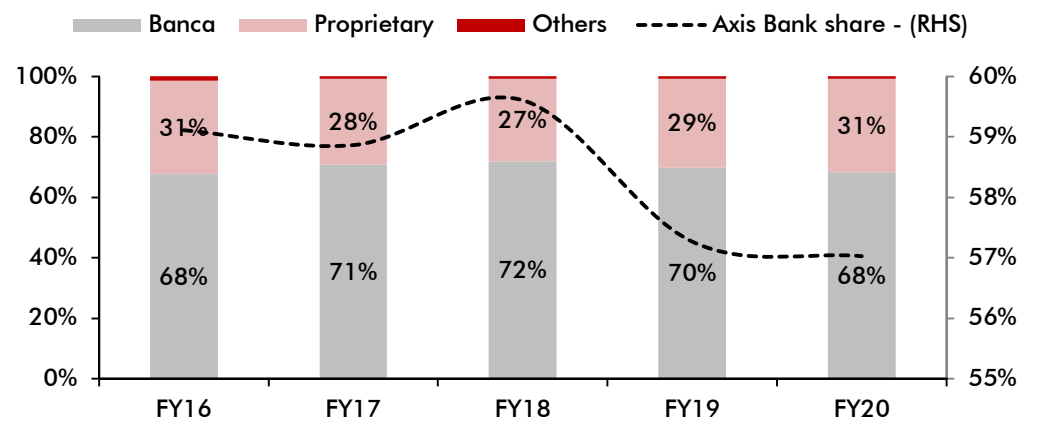
Sr. No.	Importance for Axis Bank	Importance for Max Life
1	Need to establish presence in insurance business (value accretive). Lags when compared to peers in having built industry-leading ancillary businesses/subsidiaries.	Bancassurance deal with Axis Bank to end in Sept'21. Important to extend partnership for a long term as Axis Bank contributes 55-60% of Max Life's new premiums and >40% to its profits (VNB).
2	Partnering with Max Life makes sense given; i) long-standing partnership of almost a decade, ii) Max Life contributes >90% of Axis Bank's fee income from insurance, and iii) Max Life is the 4th largest private life insurer in the country with top-3 already being bank-sponsored.	Axis Bank is the 3rd largest private bank in the country with entrenched pan-India distribution of ~4,528 branches (July'20). All other large private banks directly/indirectly manufacture life insurance.
3	Organically building a life insurance business at this point will not be viable given; i) RBI's preference for holding company structure with other businesses being held parallel to the bank, ii) long gestation period of life insurance businesses (>10 years), and iii) stiff competition from existing life insurers given established large presence and mind share.	Association with Axis Bank will also improve perceived safety. In our view, even brand recall will enhance given Axis Bank is a superior brand when compared to Max Life.

Source: Ambit Capital research

Axis embracing open architecture heightens possibility of acquisition

In Nov'19, Axis Bank partnered with Bajaj Allianz Life Insurance to sell its policies. Though this increases competition for share within Axis Bank, it also indicates reduced possibility of Axis Bank starting its own insurance operations or even buying a stake in another insurer. This implies heightened possibility of Axis Bank distributing MaxL's products for the longer term. JV partnership would mean lower impact of open architecture vs distribution-only arrangement. MaxL has also been investing in proprietary channels to reduce dependence on the bancassurance channel.

Exhibit 25: Share of proprietary channel in APE has moved up between FY18-20; given increased focus



Source: Company, Ambit Capital research

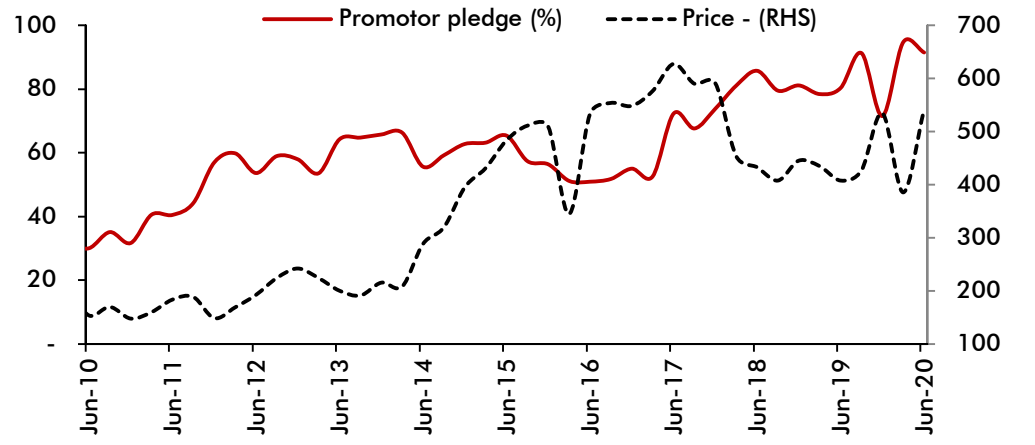
MaxL could get rebranded with Axis branding

Having established high probability of deal fructifying, we believe this could eventually result in MaxL getting rebranded with Axis branding. For Axis, organic build-up would not be viable at the same time it has deep-rooted intent to manufacture life insurance. Hence, from Axis' perspective it's a matter of time that MaxL gets rebranded with Axis branding in entirety. Even the current deal construct highlights usage of Axis' name in the tagline. From, MaxL's perspective also, once the promoter stake reduces (post Axis deal and eventual demerger/share swap) there is higher incentive to rebrand. Current Max brand is owned by Max India Limited which has allowed royalty free usage to Max Financial Services. Rebranding with Axis branding will result in superior brand recognition and help scaling up of protection and annuity franchises the most in the long run.

Deal with Axis Bank could aid in bringing down promotor pledge

High ratio of pledged shares to promoter holding (~92% as of June'20) has been a sentiment dampener over the last three years given it adds uncertainty around potential share sale in the market. Management has articulated reduction of promoter pledge to 50-60% from existing 90-95% by the end of the current fiscal backed by the promoter group's ongoing efforts to monetize some combination of stake sale in Max Financials and healthcare assets. Recently (Sept'20) Analjit Singh (promoter) sold 4.6% stake out of his total 7% stake in Max Healthcare Institute for ~₹5.2bn. Listing of Max Healthcare Institute has also paved way to monetize any part of the remaining stake with ease. Cementing of the deal with Axis Bank would be a catalyst for MaxL's share price to move up. This could help bring down pledge ratios in the short term and aid in structurally bringing down promoter leverage over the longer term.

Exhibit 26: Promoter leverage has been an overhang

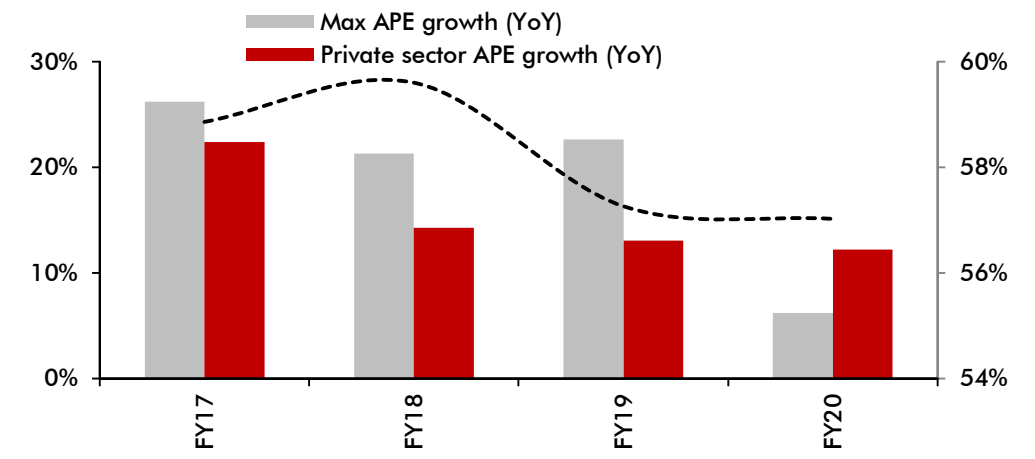


Source: BSE, Ambit Capital research

Can MaxL retain its position in absence of Axis Bank?

Axis Bank contributes 55-60% of MaxL's new retail premiums (basis APE) and >40% to its VNB. Backed by Axis Bank's distribution network MaxL has delivered APE CAGR of 19% over FY16-20, which is higher than private sector growth of 15%. Thus the distribution tie-up is important to maintain existing growth trajectory. With Axis Bank continuing to distribute MaxL's products, we expect APE CAGR of 6% between FY20-23. Given our belief that the deal with Axis Bank will consummate, our estimates factor in sales of Bajaj products are largely incremental and do not take existing share from MaxL.

Exhibit 27: MaxL's APE growth has been strong led by Axis Bank's partnership

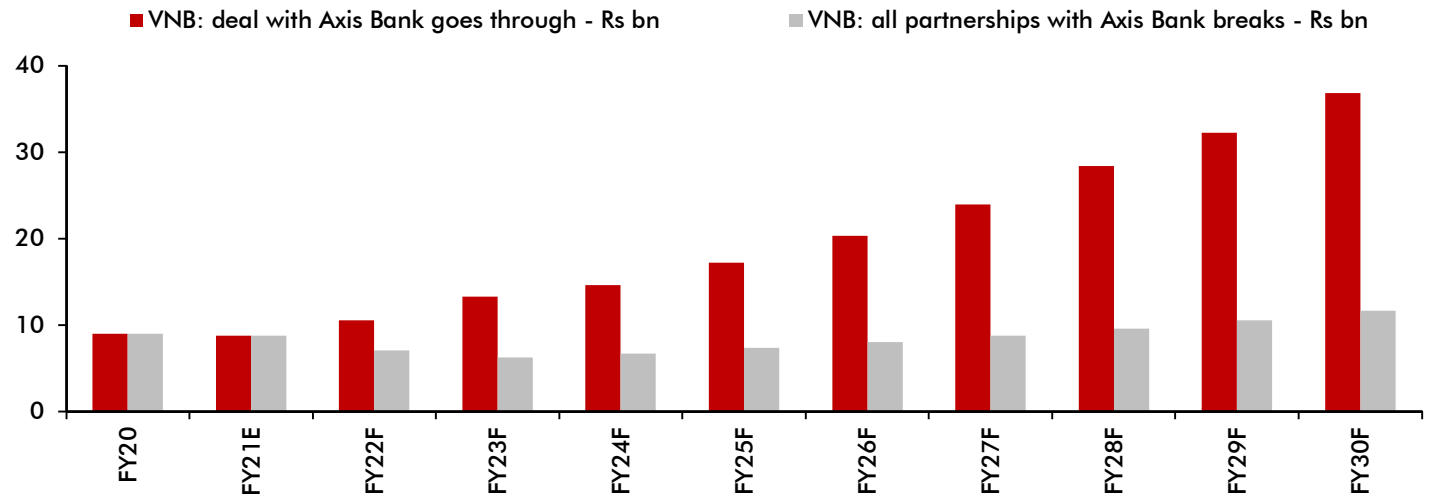


Source: IRDAI, Company, Ambit Capital research

Break-up of all partnerships could contract VNB to 1/3rd over long term

In addition to Axis' current contribution to APE/VNB of 55-60%/>40%, failure of the deal would materially dent protection and annuity growth estimates over the long term (10 years). Both these product offerings have higher margins than the company and hence could contract VNB to 1/3rd over the long term compared to estimates factoring the deal going through. Our estimates also account for the belief that eventually MaxL could get completely rebranded with Axis branding, improving brand recognition. This is why our VNB estimates are 1/3rd in a break-up scenario.

Exhibit 28: Break-up of all partnerships with Axis could hurt development of protection and annuity franchise, resulting in muted VNB trajectory



Source: Ambit Capital research estimates

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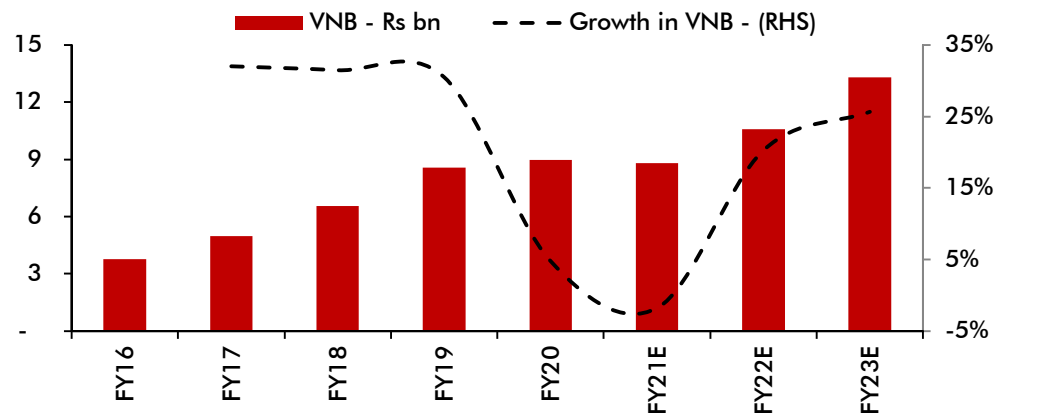
VNB growth to outpace premium growth

We expect RoEV of 17-19% (FY20-23) backed by margin expansion-led VNB CAGR of 14% and APE of ~6%. VNB growth would be back-ended despite slowdown. Protection would grow fastest (~32% CAGR), enabling margin to expand to ~26% in FY23 vs ~21% in FY20. Rising demand for protection and possible tie-up with Axis would aid in propelling faster protection growth. We do expect protection market share to go up in the medium term (2-3 years) but eventual complete rebranding with Axis branding could help gain market share over larger peers in the long run. MaxL is adequately capitalized (solvency 212%) to grow the protection segment over the next 2 years. Expected protection growth will require a capital raise subsequently; we expect sub-debt to be the preferred route.

VNB to grow at 14% between FY20-23

We estimate VNB to grow at 14% between FY20-23 with a large part of expansion being back-ended. This is on account of expectation of marginal decline in VNB of ~2% in FY21 on the back of the pandemic-led slowdown.

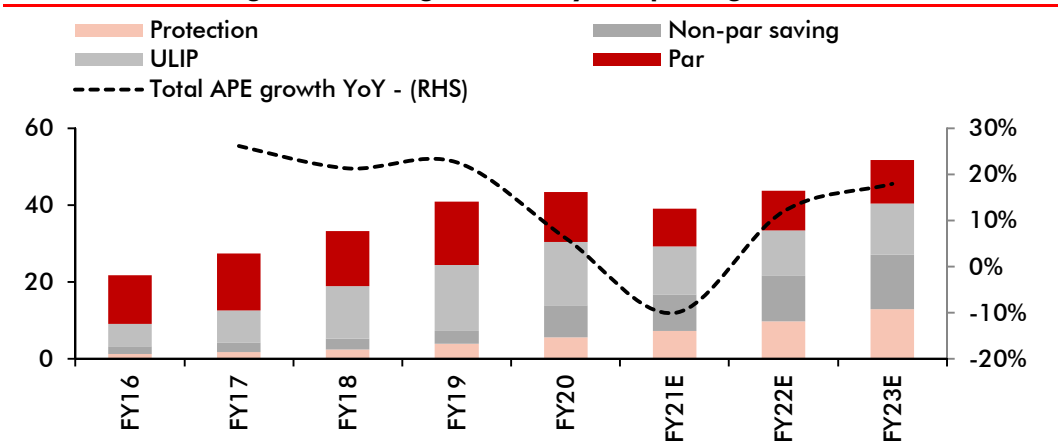
Exhibit 29: VNB growth to be strong through FY23 though back-ended



Source: Company; Ambit Capital estimates

We build in modest APE CAGR of 6% between FY20-23 with 10% APE decline in FY21. This implies a large part of VNB expansion would come through margin expansion. We expect protection to grow fastest at ~32% CAGR followed by non-par savings, which could grow at ~20% CAGR. We build in decline in ULIPs/par at ~7.1%/4.7%.

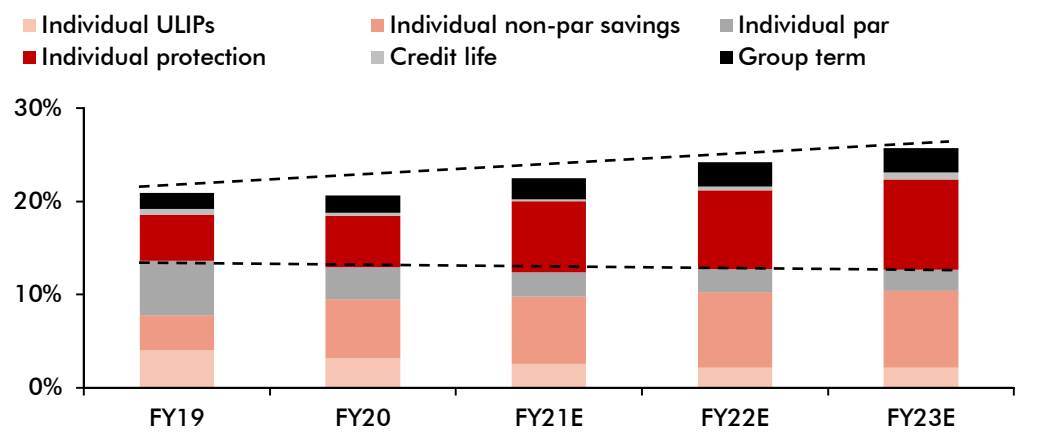
Exhibit 30: Factoring modest APE growth led by non-par segment



Source: Company; Ambit Capital estimates

Sharp growth in protection would lead to protection mix (basis APE) increasing to ~25% by FY23 from ~13% in FY20. This would drive margins from ~21% in FY20 to ~26% in FY23. By FY23, we estimate the protection segment to contribute ~50% to VNB margin vs ~37% in FY20.

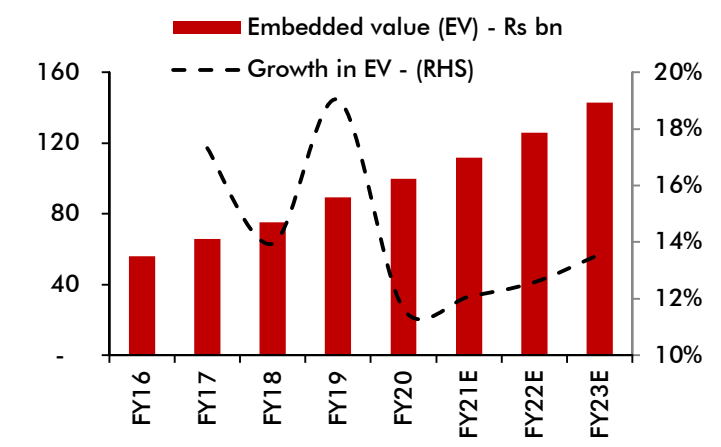
Exhibit 31: VNB margin break-up - Protection to contribute ~50% to margins by FY23



Source: Company, Ambit Capital research

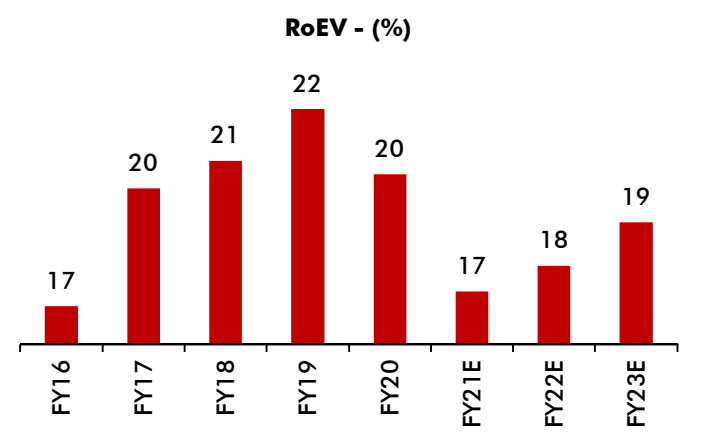
VNB CAGR of 14% would drive EV to expand at a CAGR of ~13% between FY20-23. This would imply strong RoEV between 17-19%.

Exhibit 32: EV expansion to remain strong through FY23...



Source: Company; Ambit Capital estimates

Exhibit 33: ... resulting in healthy RoEV

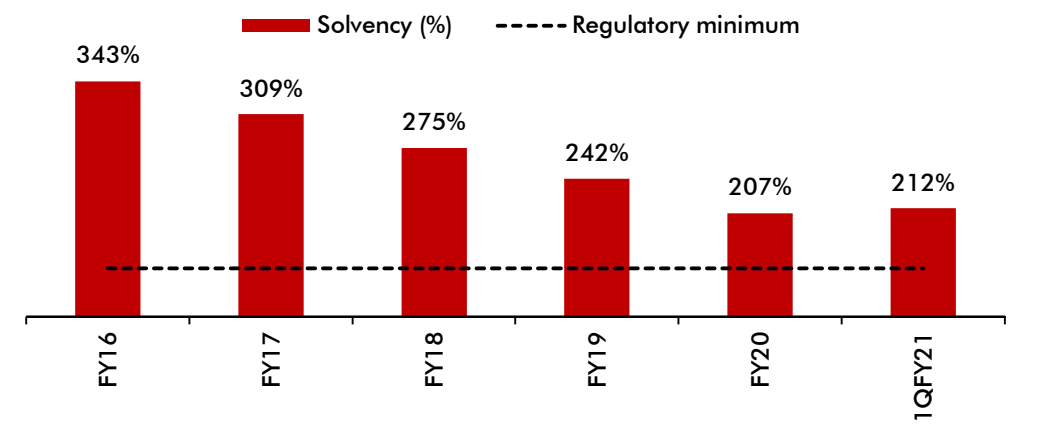


Source: Company; Ambit Capital estimates

Expect sub-debt issuance in FY22 to boost solvency

Though solvency for MaxL is strong at 212% as of 1QFY21, robust growth in the capital-guzzling protection segment (~32% CAGR between FY20-23) would require MaxL to raise capital to keep its solvency sufficiently above the regulatory minimum of 150%. We expect MaxL to use the sub-debt instrument to improve solvency in the medium term given low negative carry albeit low interest rates and non-occurrence of any shareholder dilution.

Exhibit 34: Solvency for MaxL remains comfortable



Source: Company; Ambit Capital estimates

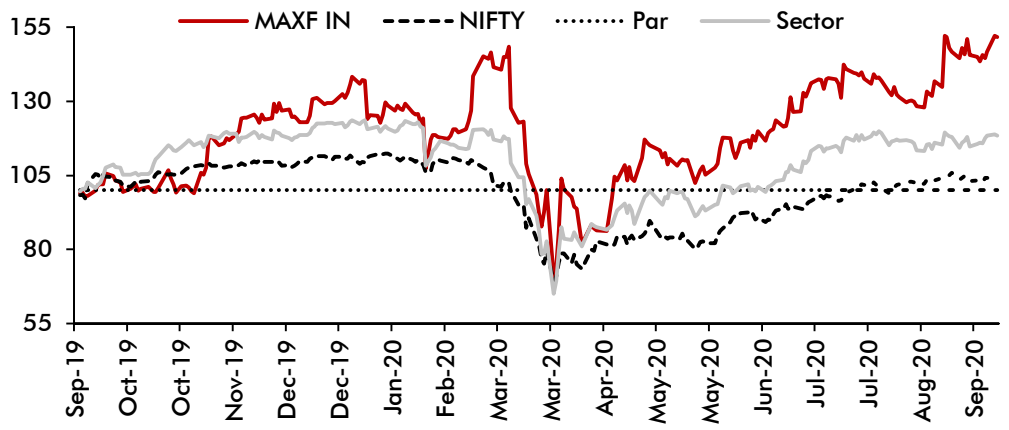
Valuation appears skewed to the upside

MaxL's bancassurance partnership with Axis Bank ends in Sept'21. It's important to extend this partnership for the long term to maintain existing market share (~3.5% basis APE) as Axis contributes 55-60% of its retail premiums and >40% of its VNB. We believe eventually MaxL could get completely rebranded with Axis branding, improving brand recognition. This would aid in uplifting the protection and annuity franchises. Hence, cementing the deal would be cardinal to drive valuation; transaction price would not be a game changer. Greater visibility around distribution would result in the stock trading at fair valuation, more in line with peers rather than at a discount (12-50%). We estimate 42% upside for articulated 18% stake sale to Axis at tax book value.

MaxL has been volatile amid new flow and overhang of promoter leverage

MaxL's stock price has moved by 52% since Sept'19 backed by news flow on the proposed JV deal with Axis Bank. Sharp rise in price led to reduction in promoter leverage to 92% in this period. Subsequent lockdown led to decline in price of broader markets but life insurance stocks took a sharper beating given March is typically is a sales-heavy month for life insurers. Given increase in promoter leverage, adverse impact on MaxL was higher. Recovery since then has been sharp for both the life insurance sector and MaxL in particular supported by emerging visibility around the deal with Axis Bank. The promotor group has already monetized some assets to reduce debt and could further sell some assets, implying lowering of the pledge ratio. Management has guided to bring down the pledge ratio to 50-60% from existing 90% plus by Mar'21. Led by news flow around the JV deal with Axis Bank, MaxL has delivered 52% returns, which is higher than both the broader markets (NIFTY 5%) and life insurance sector (19%).

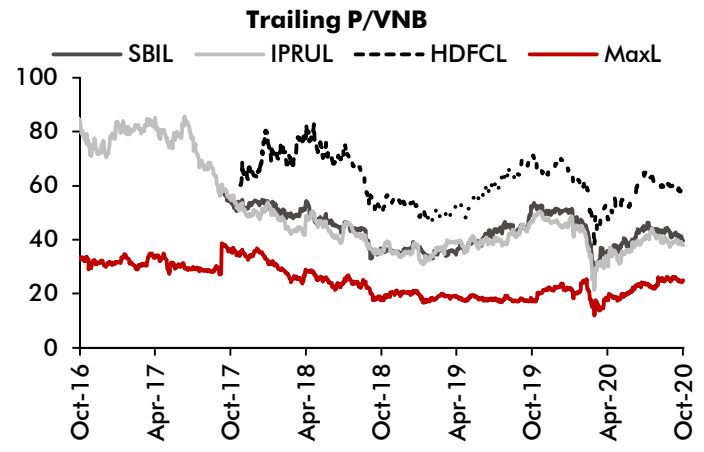
Exhibit 35: Insurance stocks beat benchmark; MaxL has given maximum returns



*Source: Bloomberg, Ambit Capital research *Sector is average of SBIL, HDFCL, IPRUL and MaxL*

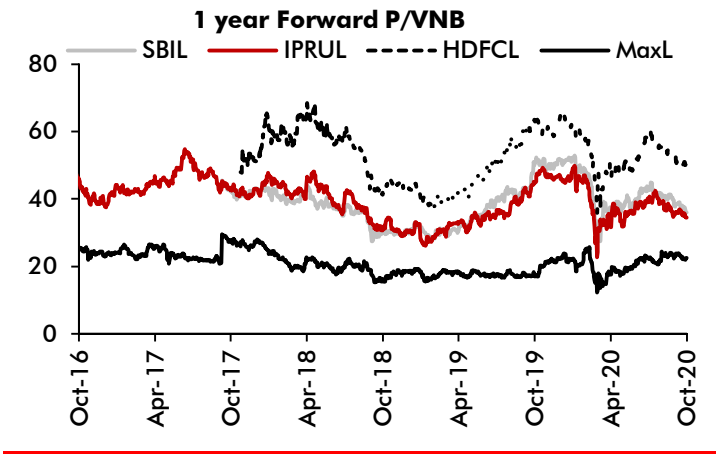
We value MaxL using the appraisal value methodology, wherein we have added NPV of VNB profits over FY23-43 to EV at FY22E to arrive at Max Financial's target price of ₹751 (implied MaxL valuation of FY22EV + 22x 1-year forward VNB and 2.2x FY22 EV). Our new business multiple of 2.2x FY22 EV is based on two growth phases over the next 20 years – a ten-year high growth period with average growth rate of 14%, a ten-year matured period of moderate growth with average growth rate of 9.7% and terminal period. We assume terminal growth of 5% similar to other financials in our coverage. Factoring that the deal with Axis Bank will consummate, we estimate MaxL will grow in line with our estimate of private sector growth pegged at ~1.3x of long-term nominal GDP growth estimate.

Exhibit 36: MaxL has been trading at lower multiples compared to large peers (basis P/EV)...



Source: Bloomberg, Ambit Capital research

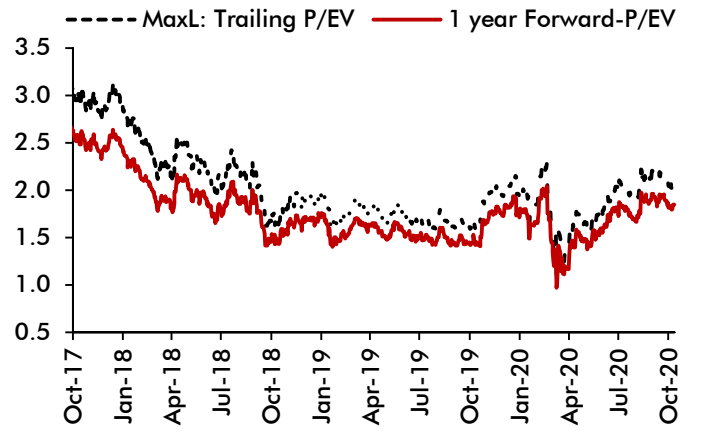
Exhibit 37: ...in addition to not being bank-sponsored; promoter leverage has also been an overhang



Source: Bloomberg, Ambit Capital research

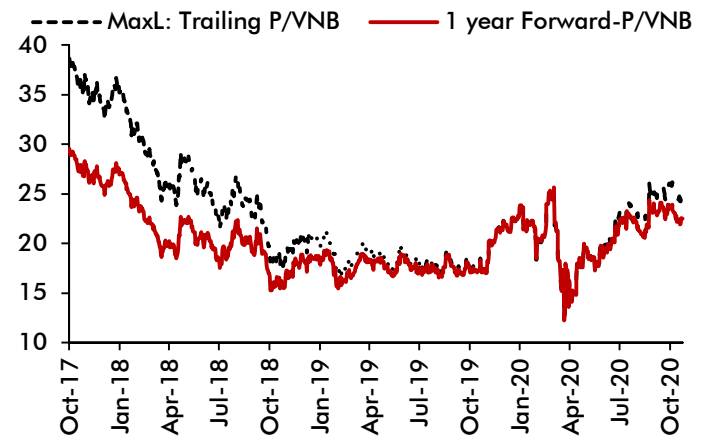
Cementing of the deal with Axis Bank will add visibility on long-term distribution tie-up, which would drive share price rerating. This could also help in reducing promoter pledge ratio to less concerning levels.

Exhibit 38: Valuations have come off the peaks...



Source: Bloomberg, Ambit Capital research

Exhibit 39: ...factoring more negatives than positives



Source: Bloomberg, Ambit Capital research

Key appraisal value assumptions

- We expect no significant negative operating variances over FY20-23. Even interest rate sensitivity for MaxL is low at ~2%. Hence we value EV at 1x.
- To derive value of future business, we discount our estimates of future VNB at a rate of 14.5% (CoE=14.5%) over a 20-year period and calculate terminal value assuming 5% terminal growth rate. Our CoE for MaxL is higher by 50bps compared to other life insurers under our coverage given lower perceived safety on the back of weaker sponsor backing.
- Since under IEV insurers are obligated to set the investment return and discounting rate at the risk free rate irrespective of the investment mix, we do not adjust the unwind component of the reported EV.
- We factor in VNB CAGR of ~14% between FY20-23 on the back of margin improvement from ~21% in FY20 to ~26% in FY23 led by strong protection growth of ~32%.
- We factor in 5-10% margin compression in the individual retail protection and credit life segments over the next 5-7 years, factoring in higher competition and possibility of regulatory tightening in the credit protect segment.

Exhibit 40: Key valuation parameters

₹ bn	FY20	FY21E	FY22E	FY23E
APE	43	39	44	52
Growth in APE	6%	-10%	12%	18%
VNB margin	20.6%	22.5%	24.2%	25.7%
VNB	9	9	11	13
Growth in VNB	5%	-2%	20%	26%
EVOP	18	17	20	24
Growth in EVOP	10%	-5%	16%	19%
Embedded value	100	112	126	143
Growth in Embedded value	12%	12%	13%	14%
ROEV	20.3%	17.3%	18.0%	19.1%

Source: Ambit Capital research estimates

Exhibit 41: Max Life - Valuation summary

CoE	**14.5%**
Period of high growth	10 years
Period of moderate growth	10 years
Terminal growth	5%
APE high growth - FY23-33F (CAGR)	14.0%
APE moderate growth - FY33 - 43F (CAGR)	9.7%
VNB high growth - FY23-33F (CAGR)	15%
VNB moderate growth - FY33-43F (CAGR)	10%
Embedded Value (in bn), F22E - (A)	126
VNB (FY23E) - 1-in ₹ bn	13
VNB multiple (FY23E) - 2	21.9x
Structural value = (1*2) - (B)- in ₹ bn	291
Appraisal Value- (A+B) - in ₹ bn	**417**

Source: Ambit Capital research

Analysis suggests meaningful upside even in case of sharper dilution

Even after factoring the transaction at the low price (tax book value), visibility around long-term distribution arrangement could help the stock to rerate. The stock could trade at fair valuation, more in line with peers, rather than at a discount. **Our implied valuation factors 90% probability of the deal with Axis consummating.** At 90% probability we estimate fair value of Max Financials to be **₹202bn, implying 28% upside over the next 12 months.** Thus, the valuation hereon appears skewed to the upside. To get a holistic perspective, we also ran a sensitivity analysis on valuations for prices lower than and higher than those suggested by management. We also build in a valuation scenario in case the deal with Axis Bank falls off to understand downside. This would imply either Axis Bank deciding to continue only as an insurance distributor (in this case impact of open architecture would be more pronounced) without any equity participation or Axis Bank deciding to start its own insurance arm or acquire a stake in any other life insurer. This would have adverse consequences on MaxL's market positioning not just in the short term but also over the medium term.

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Exhibit 42: Cementing of the deal would be cardinal to drive valuations; price of dilution not a game changer

Particulars (₹ bn)	10% stake in MaxL sold to Axis			18% stake in MaxL sold to Axis			30% stake in MaxL sold to Axis			Scenario where all partnerships with Axis Bank breaks
	for free	at tax book value	at FY20 EV	for free	at tax book value	at FY20 EV	for free	at tax book value	at FY20 EV	
Value - (A)	0	28.6	52.0	0	28.6	52.0	0	28.6	52.0	
Embedded value, F22E - (B)	126	126	126	126	126	126	126	126	126	122
VNB, F23E - (C)	13	13	13	13	13	13	13	13	13	6
VNB multiple - (D)	21.9x	21.9x	21.9x	21.9x	21.9x	21.9x	21.9x	21.9x	21.9x	13.5x
MaxL valuation - [E] = [B+C*D]	417	417	417	417	417	417	417	417	417	207
MFSL stake post transaction - (F)	65%	65%	65%	57%	57%	57%	45%	45%	45%	73%
Proposed post transaction Axis Bank shareholding - (G)	10%	10%	10%	18%	18%	18%	30%	30%	30%	0%
Existing stake of Axis Bank -(H)	2%	2%	2%	2%	2%	2%	2%	2%	2%	0%
Stake to be bought by Axis Bank - (I)	8%	8%	8%	16%	16%	16%	28%	28%	28%	0%
No. of Shares of MaxL - (J)	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Cash received by MaxL from Axis Bank - [K] = [A*I*J]	0	4.4	8.0	0.0	8.8	16.0	0.0	15.4	27.9	0.0
Estimated NPV of Max Financial expenses and debt if any - (L)	8	8	8	8	8	8	8	8	8	12
Holding company discount - (M)	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%
Probability of deal happening - (N)	90%	90%	90%	90%	90%	90%	90%	90%	90%	
MFSL valuation - [O] = [(E*F)+K-L]*(1-M)*N	223	227	230	195	202	208	152	165	176	131
No. of Shares of MFSL - (P)	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
MFSL per share target price - [Q] = [O/P]	828	842	854	722	751	773	564	612	652	487
Current market price of MFSL shares - (R)	589	589	589	589	589	589	589	589	589	589
% of upside/downside - ('S)	**41%**	**43%**	**45%**	**23%**	**28%**	**31%**	**-4%**	**4%**	**11%**	**-17%**

Source: Company, Ambit Capital research estimates

Exhibit 43: Rationale for assumptions around growth and margins

Parameter	Growth	Rationale
APE growth FY20-23	6.0%	APE growth to be driven by; i) robust growth in the retail protection segment on the back of severe under-penetration and pandemic-led latent demand, and ii) non-par savings (guaranteed return products) backed by muted credit growth in the bank system.
Margin expansion by FY23	~510 bps	We estimate protection share to increase to 25% of APE by FY23 from 13% in FY20. This would aid in lifting margins to 26% in FY23 from ~21% in FY20.

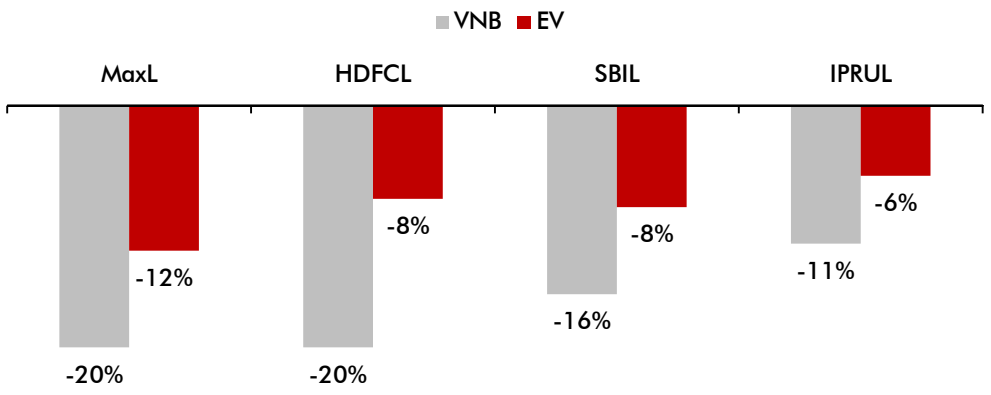
Source: Ambit Capital research

Catalysts & risks

Key risks

Tax normalization to 25%: Based on sensitivity disclosures, MaxL is relatively more sensitive compared most peers to an increase in tax rate.

Exhibit 44: MaxL is most sensitive to tax rate increasing to 25%



*Source: Company, Ambit Capital research *sensitivity numbers are for FY20*

Drop in persistency: While persistency for MaxL is expected to remain stable, a prolonged weakness in the equity markets could impair persistency for ULIP offering, resulting in some adverse impact on margins.

Key catalysts

Consummation of deal with Axis Bank: Axis Bank contributes 55-60% of MaxL's new retail premiums (basis APE) and >40% of its VNB. Backed by Axis Bank's distribution network, MaxL has delivered APE CAGR of 19% over FY16-20, higher than private sector growth of 15%. Thus, the distribution tie-up is important to maintain existing premium growth trajectory.

Margin expansion: Expect protection APE growth to be >25% in FY21 for margins to improve enough to realize estimated VNB growth.

Exhibit 45: Explanation for our flags on the cover page

Segment	Score	Comments
Accounting	GREEN	We did not find anything unusual in accounting practices of Max Life.
Predictability	AMBER	With pandemic-led slowdown, we expect uncertainty around premium growth and profitability.
Earnings Momentum	RED	In the past 12 months, VNB growth has been materially lower than in the past.

Source: Ambit Capital research

Financials

Policyholders Account

(₹ mn)	FY19	FY20	FY21E	FY22E	FY23E
First year premium	38,731	40,885	36,796	41,212	48,630
Renewal premium	94,148	106,002	122,352	132,548	144,701
Single premium	12,873	14,950	13,455	15,069	17,782
Gross Written Premiums	145,752	161,836	172,603	188,830	211,113
Net Premiums Earned	144,184	159,788	170,418	186,439	208,441
Investment Income	48,955	21,589	62,904	72,293	83,356
Total Income	**193,578**	**181,989**	**233,793**	**259,247**	**292,373**
Commission Expenses	9,901	10,244	9,953	10,998	10,998
Operating expenses	19,261	23,441	23,342	26,386	30,269
Benefits paid (Net)	57,165	66,205	70,053	82,607	95,859
Change in valuation of policy liabilities	97,365	66,394	106,429	112,024	124,089
Total Expenses	**185,334**	**169,073**	**212,363**	**234,754**	**264,209**
Surplus/(deficit) after tax	**8,244**	**12,916**	**21,430**	**24,493**	**28,163**
Transfer to Shareholders' account	4,402	4,690	12,965	16,029	19,699

Source: Ambit Capital research

Shareholders Account

(₹ mn)	FY19	FY20	FY21E	FY22E	FY23E
Amounts transferred from Policyholders' account	4,402	4,690	12,965	16,029	19,699
Income from investments	2,227	2,074	1,920	2,676	3,531
Total Income	**6,654**	**6,781**	**14,902**	**18,722**	**23,247**
Total Expenses	**427**	**802**	**863**	**1,084**	**1,346**
Profit before Tax	6,226	5,978	14,039	17,638	21,901
PAT	**5,564**	**5,394**	**12,666**	**15,913**	**19,759**

Source: Ambit Capital research

Balance Sheet

(₹ mn)	FY19	FY20	FY21E	FY22E	FY23E
Sources of Funds					
Share capital	19,188	19,188	19,188	19,188	19,188
Reserve and surplus	8,478	6,806	11,174	17,220	25,280
Net worth	27,609	25,739	30,362	36,408	44,468
Policyholders' funds	585,765	640,747	757,135	873,074	1,001,446
Funds For Future Appropriations	22,498	30,962	39,427	47,891	56,356
Total Liabilities	**635,872**	**697,448**	**826,924**	**957,373**	**1,102,271**
Applications of Funds					
Shareholders' investments	35,187	32,581	45,414	59,924	76,449
Policyholders' investments	394,173	460,484	535,826	608,091	688,635
Total Investments	429,360	493,065	581,240	668,016	765,084
Asset held to cover linked liabilities	198,619	191,642	232,153	275,193	322,288
Total Assets	**635,872**	**697,448**	**826,924**	**957,373**	**1,102,271**

Source: Ambit Capital research

Premium Flows

Particulars	FY19	FY20	FY21E	FY22E	FY23E
NBP (₹ mn)	51,604	55,835	50,251	56,281	66,412
APE (₹ mn)	40,930	43,480	39,132	43,828	51,717
NBP Growth (%)	18.7	8.2	(10.0)	12.0	18.0
APE Growth (%)	22.7	6.2	(10.0)	12.0	18.0
Conservation Ratio (%)	83.0	79.8	82.0	82.0	82.0
Commission ratio (%)	6.8	6.3	5.8	5.8	5.2

Source: Ambit Capital research

Product Mix

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Individual ULIPs	42%	38%	32%	27%	26%
Individual Par	40%	30%	25%	23%	22%
Individual Protection	6%	8%	12%	14%	16%
Individual Non Par Savings	8%	19%	24%	27%	27%
Total Individual	**96%**	**95%**	**93%**	**92%**	**91%**
Group Protection	4%	5%	7%	8%	9%
Group Savings	0%	0%	0%	0%	0%
Total Group	**4%**	**5%**	**7%**	**8%**	**9%**

Source: Ambit Capital research

Valuation

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Embedded Value (₹ mn)	89,380	99,780	111,828	125,898	142,978
VNB (in ₹ Mn)	8,560	8,970	8,811	10,596	13,313
VNB Margin	20.9%	20.6%	22.5%	24.2%	25.7%
RoEV (%)	21.9%	20.3%	17.3%	18.0%	19.1%
EPS (₹.)	20.6	20.0	47.0	59.0	73.3
BPS (₹.)	102.4	95.5	112.6	135.1	165.0
P/EV	2.5	2.2	2.0	1.8	1.5
ROA (%)	1.0%	0.81%	1.66%	1.78%	1.92%
ROE (%)	20.4%	20.2%	45.2%	47.7%	48.9%

Source: Ambit Capital research

AMBIT
Acumen at work

HDFC Life

BUY

INITIATING COVERAGE	HDFCLIFE IN EQUITY	October 26, 2020

Create. Execute. Prosper

HDFCL is the most valued life insurer given industry leading profitability, ability to identify opportunities and distribution might. Protection and annuity are largest opportunities with >20% CAGR for sector through FY30, with HDFCL best-suited to capitalize. Strong brand, high propensity to cross-sell given access to affluent customer base and established presence across protection products will help retain protection leadership. Admirable execution led by ingenious marketing and innovation DNA enables it to capture lion's share (private) of new retirement opportunities. These attributes should help sustain premium valuations given faster VNB compounding of ~19% vs 13-14% for peers over next decade. Even if HDFCL's 1-year fwd P/VNB multiple de-rates 40-45% by FY30, exit multiple of 32-35x implies 14-15% IRR at current valuations. Risks: Capping of charges for credit life; paucity of hedging instruments with sharp non-parallel fall in yields.

Competitive position: STRONG Changes to this position: STABLE

Superior franchise with entrenched and diversified distribution mix

HDCFL is the most profitable insurer with 25.9% VNB margin vs ~21% for peers. High protection APE share (17% vs 12% for peers) and balanced savings mix drive profitability. Market dynamics require distribution muscle to scale up. Strong brand with access to large affluent customer base (>5.4k HDFCB branches) adds teeth to distribution. Industry-high (300+) under-leveraged banca tie-ups and best-in-class direct channel render distribution diversity.

Complementing business mix; ability to create markets and capitalize

Complementary product suite makes HDFCL stand out vs competition. Protection APE (17%) renders hedging comfort to annuity business (4%) whilst non-par savings (34%) compliments ULIPs (23%) to extend cross-cycle stability. It's been at forefront of product innovation (e.g. first to enter credit life, high rider usage). Combination of innovative DNA, ingenious marketing and exceptional execution will propel it to capture new opportunities.

VNB growth to be highest amongst peers; help drive RoEV of 17-20%

Expect RoEV of 17-20% (FY20-23) backed by margin expansion-led VNB CAGR of 19% (peer high). VNB growth would be back-ended given slowdown. Protection would grow fastest (~21% CAGR), enabling margin to expand to ~32% in FY23 vs ~26% in FY20. Fast growing protection would require capital over next 2-3 years. Given strong performance and pedigree, growth capital won't be constraint. Interest rate risk at this point appears adequately hedged.

Valuations reflect opportunity, longevity and exceptional execution

HDFCL posted VNB CAGR of 28% in FY17-20 at average margin of 24% vs 27% VNB CAGR at 18% margin for peers, justifying ~85% valuation premium. We value HDFCL using appraisal value, implying valuation of 4.8x FY22E EV. Valuations reflect: i) faster VNB compounding (~19% vs 13-14% for peers till FY30); ii) complementing business mix aiding secular premium growth and risk management, and iii) ability to identify and capitalize on opportunities.

Key metrics

Year to March	FY19	FY20	FY21E	FY22E	FY23E
APE (₹ bn)	63	74	72	85	102
VNB margins (%)	24.6	25.9	27.6	29.2	31.8
VNB (₹ bn)	15	19	20	25	32
Embedded Value (₹ bn)	183	207	245	287	339
P/EV (x)	6.2	5.5	4.7	4.0	3.4
RoEV (%)	20.1	18.1	17.1	18.6	19.7

Source: Company, Ambit Capital research

BFSI – Insurance

Recommendation

Mcap (bn):	₹1140/US$15.5
3M ADV (mn):	₹2237/US$30.4
CMP:	₹565
TP (12 mths):	₹677
Upside (%):	20

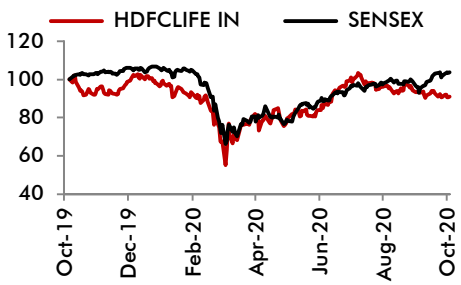
Flags

Accounting:	GREEN
Predictability:	GREEN
Earnings Momentum:	AMBER

Catalysts

- VNB in FY21 to sustain at FY20 levels and grow by at least 20% in FY22
- Persistency to not decline >2% of FY20 levels in FY21 and FY22

Performance (%)



Source: Bloomberg, Ambit Capital research

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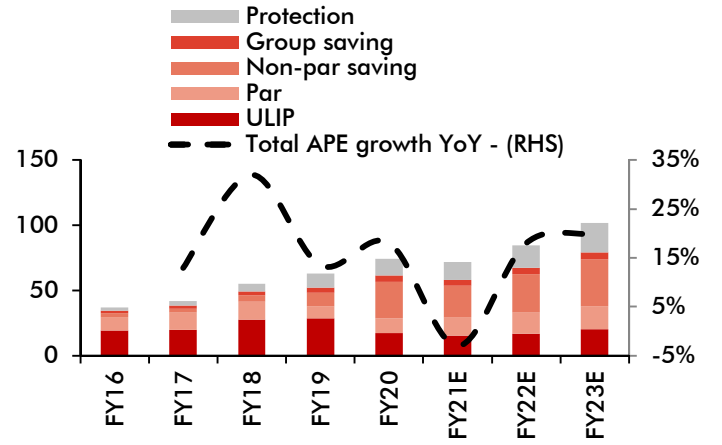
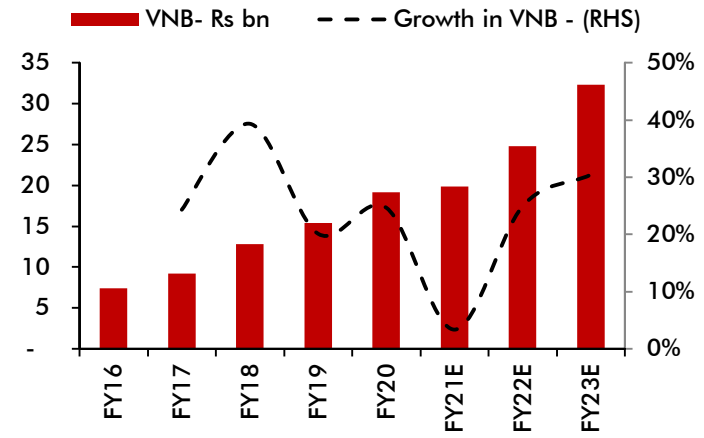
The Narrative in Charts

Building in modest APE CAGR of ~11% through FY23; increasing share of protection to drive margin expansion



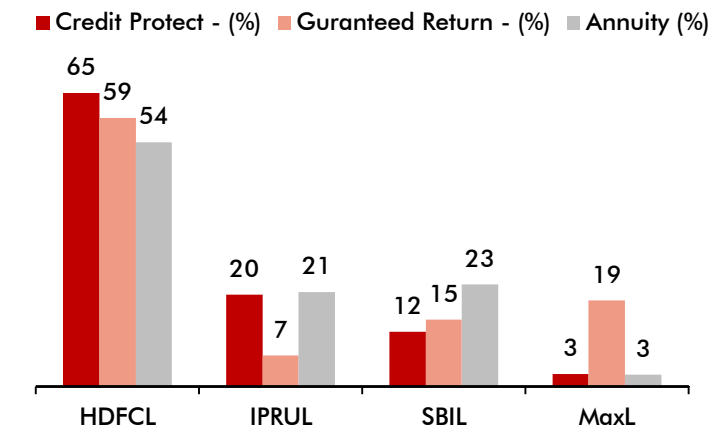
Source: Company, Ambit Capital research estimates

VNB to grow at ~19% CAGR over 20-23 largely led by margin expansion



Source: Company, Ambit Capital research estimates

Has achieved market leadership in various segments with its ability to innovate and create markets



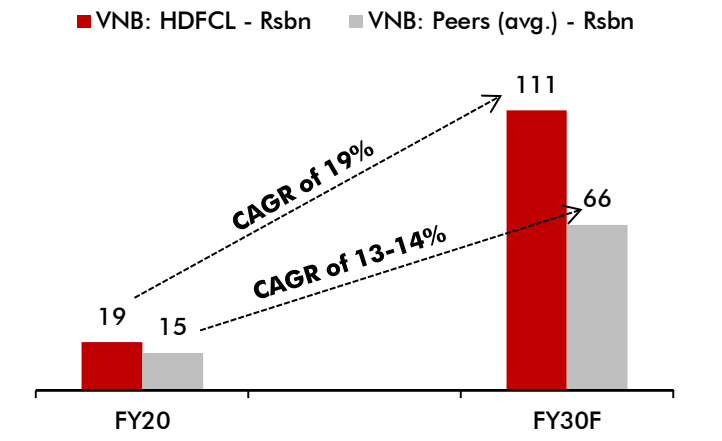
*Source: Company, Ambit Capital research estimates; *market share is calculated basis total of HDFCL, IPRUL, SBIL and MaxL and not industry **market share numbers are as of FY20*

Innovation DNA/ingenious marketing to help maintain leadership/capture larger share of new opportunities ...

	FY20		Cummulative through FY30F	
	Protection	Annuity	Protection	Annuity
Market share of HDFCL amongst top 4 private players (basis APE)	~33%	~54%	~31%	~60%

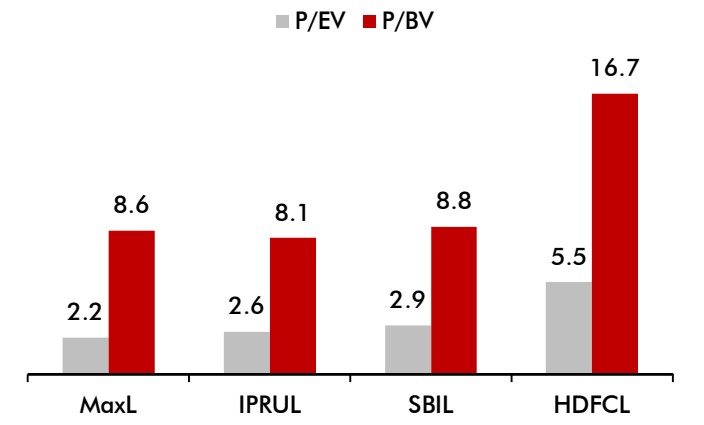
Source: Company, Ambit Capital research estimates

... which would aid in faster VNB compounding of 19% vs 13-14% for peers



Source: Company, Ambit Capital research estimates

Valuation premium of 85% over peers justified and sustainable given ability to outgrow peers (basis VNB)



Source: Company, Bloomberg, Ambit Capital research

HDFCL: Agile and innovative franchise

Established in 2000, HDFC Life Insurance Company Limited (formerly HDFC Standard Life Insurance Company Limited) is a joint venture between Housing Development Finance Corporation Limited (HDFC – 51.4% stake), one of India's leading housing finance institutions, and Standard Life Mauritius (12.3% stake), a wholly-owned subsidiary of Standard Life Aberdeen (a global investment company). It was the first private life insurer to launch operations in India. It's one of the most profitable life insurers having a balanced product mix with leadership in the group protection segment. Product and distribution innovation has been a key differentiator. As of 1QFY21, it's the second-largest private life insurer with APE market share of 14.2% (~6% including Life Insurance Corporation of India).

Exhibit 1: HDFC Life is one of the most profitable life insurers in India

Year	Event
2001	First private life insurer to obtain registration from the IRDAI
2003	Crossed 100,000 policies and 10,000 individual agents; distribution tie-ups with HDFC Bank
2004	Launch of unit linked funds
2007	Crossed the 500,000 policy milestone
2010	AUM crossed ₹200bn
2011	Subsidiary, HDFC Pension incorporated on June 20, 2011
2012	Turned profitable, total premium for the year crossed ₹100bn
2014	AUM crossed ₹500bn; dividend was declared for the first time in December, 2013
2016	Subsidiary, HDFC International Life & Re incorporated in Dubai Standard Life Mauritius increased its stake from 26% to 35%
2018	Listed on NSE Ltd and BSE Ltd w.e.f. November 17, 2017; AUM crossed ₹1tn
2020	Embedded value crossed ₹200bn mark

Source: Company, Ambit Capital research

Execution – A cut above peers

HDFCL is amongst India's highest quality and most profitable life insurers given its well-poised business model and ability to tap large protection profit pool. It has been an early mover in the credit life product, something which the other insurers have started focusing on only recently. Its well-diversified product mix, with the highest share of protection mix (~17% of APE vs average of ~12% for large peers), has enabled it to report VNB growth of 28% between FY16-20, resulting in RoEV of 18-22% during the period. In 2018, HDFC Bank, the primary bancassurance partner (contributes 57% to overall APE) of HDFCL; decided to sell life insurance policies of other insurers. Resultantly, it partnered with Aditya Birla Sun Life Insurance and Tata AIA Life Insurance to additionally sell their policies. Even after this, HDFCL has managed to do well. Its focus on building its proprietary channels and broadens its distribution base has further strengthened its well-diversified business model.

Exhibit 2: HDFCL: SWOT analysis; well-placed to benefit from both protection and annuity opportunities

STRENGTH	WEAKNESS
Strong brand & distribution franchise: Strong and reputed brand which gives the company a distinct edge over others. Access (non-exclusive) to a large customer base through >5.4k branch network of HDFC Bank having entrenched pan-India presence spread across 2,848 cities. **Amongst India's most profitable franchise**: HDFC Life is the most profitable franchise among all life insurers with VNB margin of 25.9% vs average of ~21% for peers. **Best-in-class execution with a balanced product mix:** Product and distribution innovation has been a key differentiator. Has a well-diversified product mix, with the highest share of protection mix (17% of APE vs average of 9-15% for large peers.	**Absence of distribution exclusivity:** In 2018, HDFC Bank (primary bancassurance partner) adopted open architecture ending exclusive distribution arrangement with HDFC Life. Though HDFC Life continues to have largest wallet share amongst all life insurance partners of HDFC Bank, absence of distribution exclusivity is a weakness when compared to other large peers. **High cost structure:** Costs are dependent on sales channel. For bank-sponsored insurers, bancassurance channel stacks cheaper given large sales volume through parent. Given HDFC Bank (largest partner) is a sister concern and not a parent; commission arrangements are aligned to an open market. Hence, compared to peers, HDFC Life stacks up as a high-cost player (FY20 total cost ratio of 17.6% vs peer average of ~15%).
OPPORTUNITIES	**THREATS**
Well-placed to build a larger retail protection franchise: In our framework (exhibit 20 of thematic), HDFC Life stacks second only to IPRU Life to build a larger protection franchise. HDFC Life benefits from a strong brand, an able direct channel and affluent customer profile of HDFC Bank. **Annuities a big opportunity:** As highlighted in our thematic (exhibit 34), annuities is the next big opportunity after protection for the sector. HDFC Life with a strong brand, balanced product mix and a nimble risk & investments team is best suited to capture this opportunity amongst all private players.	**Regulatory intervention in the high-margin credit life offering:** We estimate credit life (margin 70-100%) contributes 23% to HDFCL's VNB vs 2-12% for peers. High margins (channel exclusivity) make credit life an expensive offering for the end customer. In addition, high attachment rates could attract regulatory attention as distributors are using this as a fee generator than a risk management tool. Regulatory intervention could be a margin dampener and affect HDFC Life disproportionately. **Tax normalisation to 25%:** Insurance companies at present pay effective tax of 14.4% on income from life insurance business vs corporate tax of 25%. As per FY20 disclosures, an increase in tax rate to 25% would shave off HDFC Life's reported EV by ~7.7% and reported VNB by ~20%. This risk exists for all life insurers in the country.

Source: Company, Ambit Capital research

Diversified APE mix (ULIP/Par/non-par savings/Protection/Group savings – 23/16/38/17/6), strong position to become a larger protection franchise (strong brand and an able direct channel) and an entrenched distribution network will enable HDFCL to sustain its existing growth trajectory over the long term. HDFCL has been able to profitably grow its APE at ~19% CAGR over FY16-20 (vs industry average of 19%, private average of 15%) while also growing VNB at 28% CAGR during the period. HDFCL recently raised sub-debt of ₹6bn which helped its solvency in 2QFY21 to improve to 203% vs 190% in 1QFY21. Solvency is adequate vs regulatory requirement of 150%, sufficient to take care of growth over next 1-2 years.

Longevity of profitable growth should drive constant compounding

Protection and annuity are the largest opportunities with >20% CAGR for the sector through FY30. HDFCL is best suited to capitalize. Strong brand, high propensity to cross-sell given access to affluent customer base, best-in-class direct sales channel and established presence across protection products will help retain protection leadership. Admirable execution led by ingenious marketing and innovation DNA enable it to capture the lion's share (private) of new retirement opportunities. HDFCL trades at 4.0x FY22 P/EV, which is at a 98% premium to peer group. Factors that justify premium valuations are: i) faster VNB compounding (~19% vs 13-14% for peers over the next decade); ii) complementing business mix aiding in secular premium growth/risk management and iii) ability to identify and capitalize on opportunities. Backing from the HDFC group and acceptance of open architecture by HDFC Bank are now behind, which is an added comfort.

.

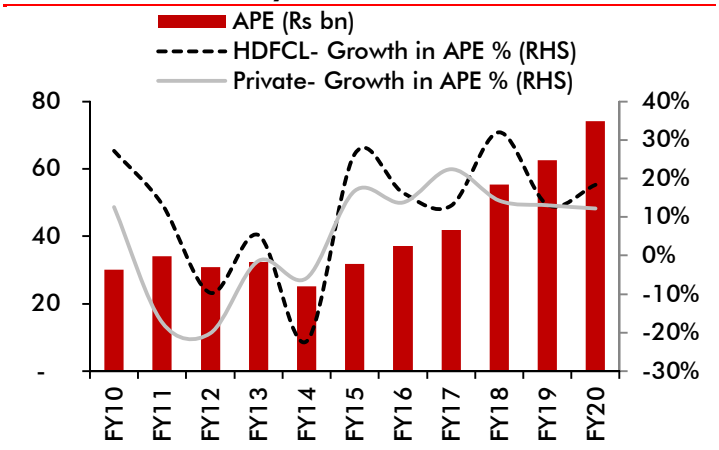
Most profitable life insurer

VNB grew at a CAGR of 28% between FY16-20, resulting in average RoEV of ~20%. Expansion was driven by 19% APE growth (15% for peers) led by guaranteed return which grew faster at a CAGR of 73%. In the same period, protection APE grew at a CAGR of 47% led by credit life which expanded at a CAGR of 68%. This helped improve margin from ~20% in FY16 to ~26% in FY20. In addition to focus on protection, better utilization of riders and improving persistency helped HDFCL achieve industry leading profitability despite high cost structure. Complementary product suite makes HDFCL stand out vis-a-vis competition. Protection APE (17%) renders hedging comfort to annuity business (4%) whilst non-par savings (34%) compliment ULIPs (23%) to extend cross-cycle stability.

Delivered industry-leading premium growth...

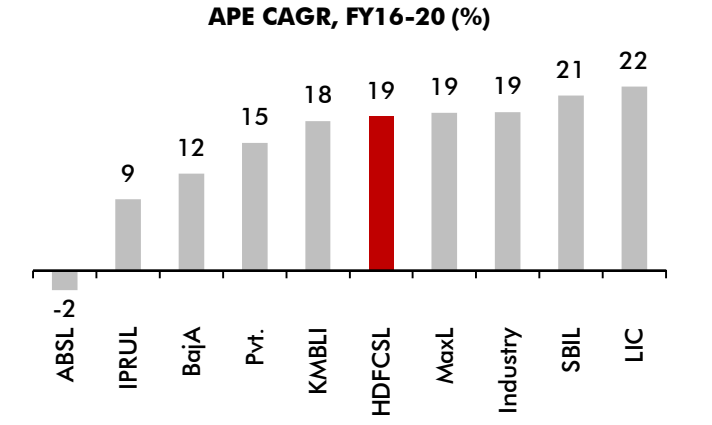
HDFCL's APE grew at a CAGR of 19% vs 15% for peers between FY16-20. Growth was driven by guaranteed return offering (Sanchay Plus), which grew faster at a CAGR of 73% between FY16-20.

Exhibit 3: Premium growth (basis APE) has been strong for HDFCL; second only to SBIL



Source: Company, Ambit Capital research

Exhibit 4: APE grew faster at CAGR of 19% in FY16-20 vs 15% for private peers

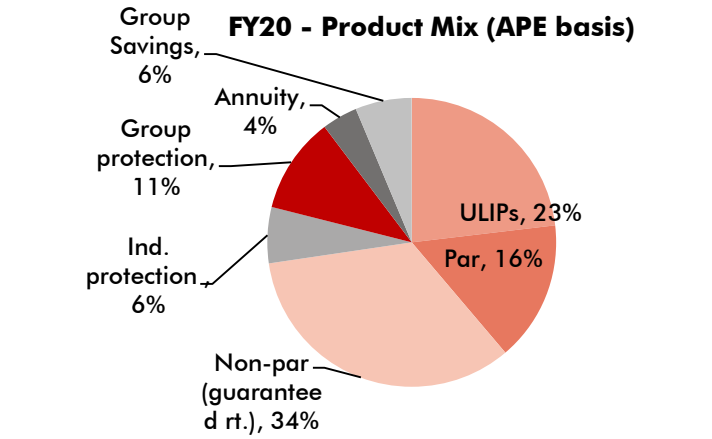


Source: Company, Ambit Capital research

...led by non-par guaranteed offering

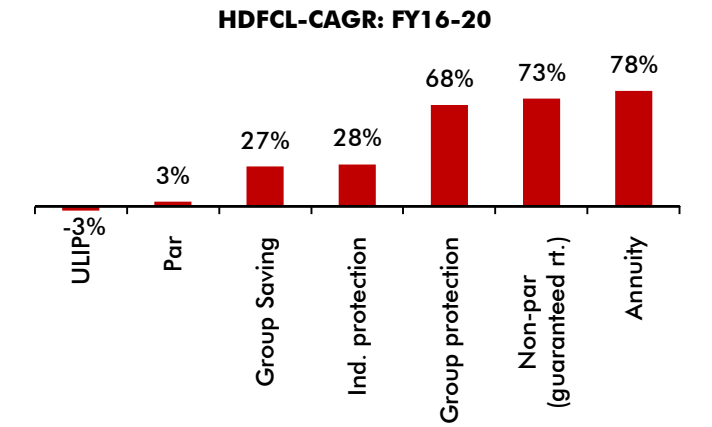
This led to share of non-par guaranteed offering in overall APE increasing to 34% in FY20 vs 8% in FY16. APE growth was also aided by 47% CAGR in protection APE. ULIP declined by a CAGR of 3% during the period.

Exhibit 5: Guaranteed return contributes ~34% to APE...



Source: IRDAI, Company, Ambit Capital research

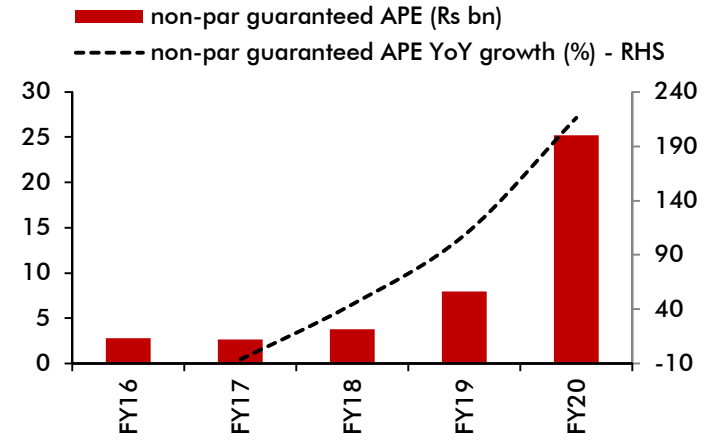
Exhibit 6: ...led by robust CAGR of 73% in FY16-20



Source: Company, Ambit Capital research

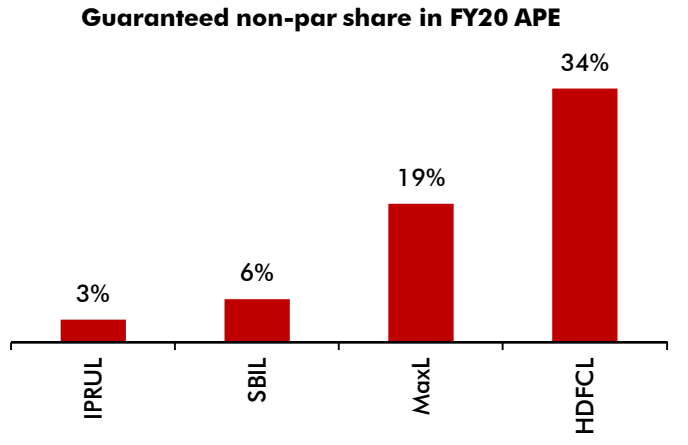
Growth of guaranteed return products between FY16-20 was highest among peers. Large part of this growth was back-ended with premiums in this segment almost tripling in FY20 to ₹25bn post launch of Sanchay Plus. Guaranteed returns offered by HDFCL were attractive (5-6%) and higher than most peers. This product was also heavily marketed by the company and was also a beneficiary of the low banking sector credit offtake. Muted credit offtake led banks to cut deposit rates, which made relative return on this product attractive. In our view, growth of this product would be volatile with periods of high growth (low credit offtake and low bank deposit rates) followed by periods of muted growth.

Exhibit 7: Launch of Sanchay Plus led to premiums almost tripling in FY20



*Source: Company, Ambit Capital research estimates *Sanchay Plus is a non-par guaranteed product*

Exhibit 8: Growth in this segment was highest for HDFCL across peers

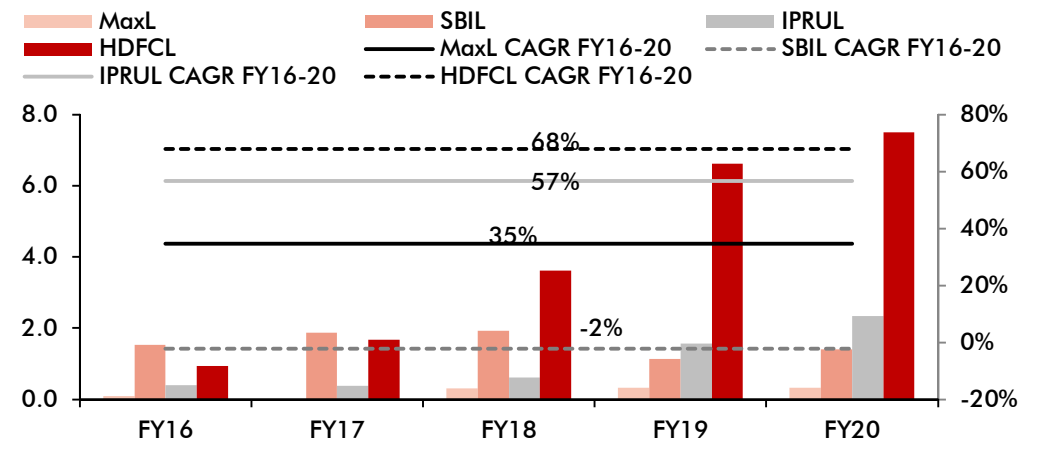


Source: Company, Ambit Capital research

Industry-leading protection share led by credit life

HDFCL has a well-diversified product mix, with the highest share of protection mix among peers at ~17% of APE vs average of ~12% for peers. This is driven by leadership position in the credit life segment, which contributes ~10% to overall APE vs ~2% for peers. HDFCL has been an early mover in the credit protect product, something which the other players have started focusing on only recently. Leadership was established and maintained by undertaking multiple bancassurance tie-ups (300+ as of 2QFY21 versus 31 in FY15). In FY20, HDFC group contributed ~30% to overall credit protect premiums basis APE.

Exhibit 9: HDFCL has ramped up credit life well and maintains its leadership position



Source: Company, Ambit Capital research

It also has a strong presence in individual protection, contributing ~6.3% to APE. Growth of individual protection has been strong though slower than peers. It grew at a CAGR of 28% over FY16-20 vs average of 56% for peers.

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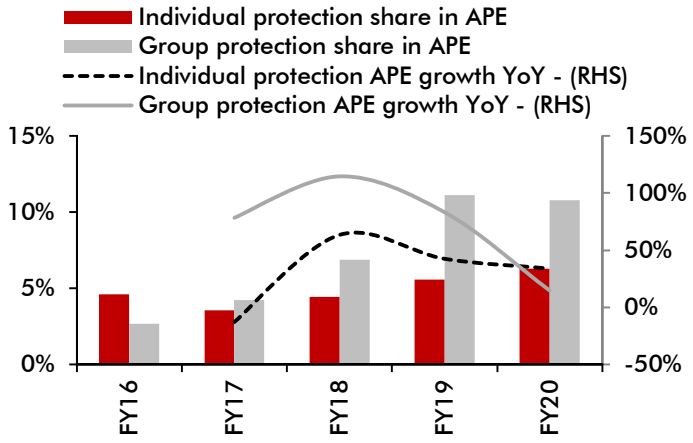
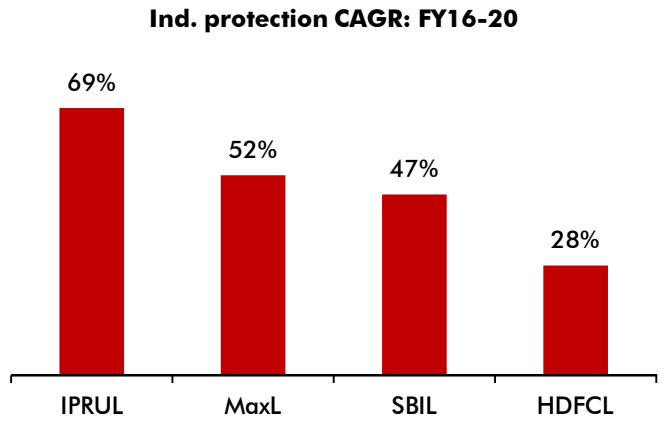
Exhibit 10: Even growth in individual protection has been strong



Source: Company, Ambit Capital research

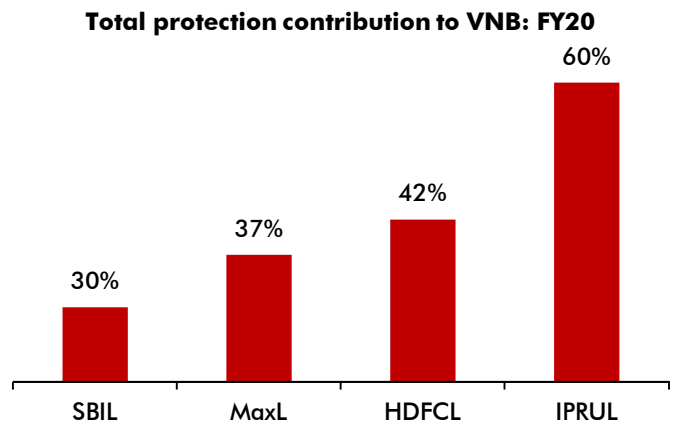
Exhibit 11: Individual protection APE growth has been strong but lags peers



Source: Company, Ambit Capital research

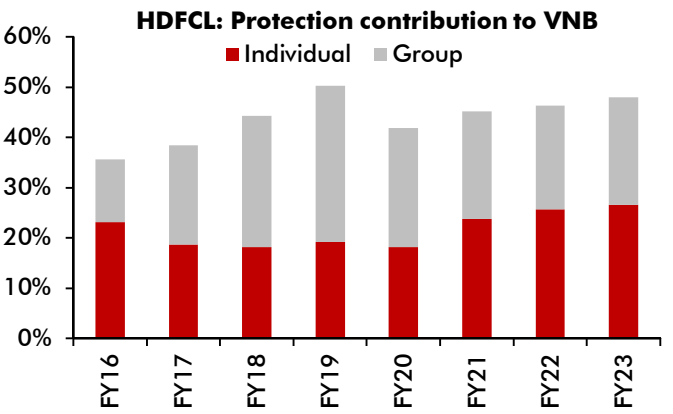
We estimate protection contributed ~42% to VNB as of FY20 with individual protection contributing ~18%. By FY23, we expect protection to contribute ~48% to total VNB. Given strong brand recall, entrenched distribution and an evolved direct channel, we believe HDFCL can continue to grow fast in the protection segment.

Exhibit 12: Protection segment has scope to contribute more to VNB...



Source: Company, Ambit Capital research

Exhibit 13: ...driven by higher potential in the individual segment

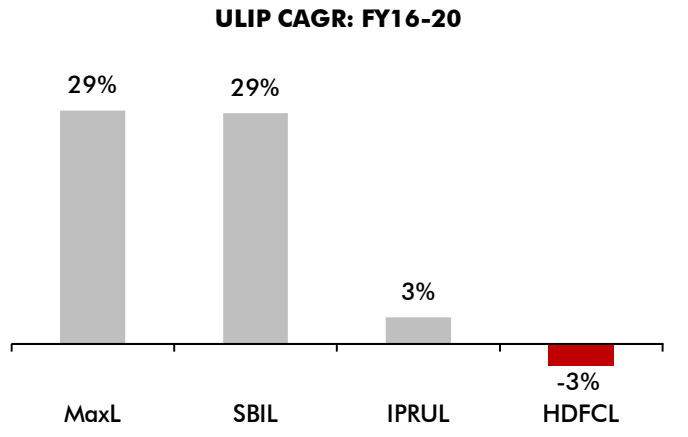


Source: Company, Ambit Capital research

ULIP premium have been disappointing

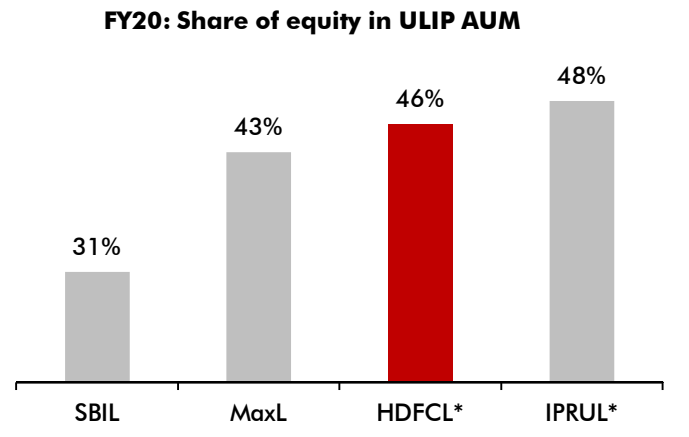
Volatile equity markets over the last 24 months and focus on the affluent customer segment to drive equity ULIPs have resulted in muted ULIP flows. Affluent customers tend to be financially savvier and hence more sensitive to equity market volatility. HDFCL/IPRUL predominantly have been focusing on equity ULIPs with 46%/48% AUM parked in equities while SBIL and MaxL focus on debt ULIPs. Between FY16-20, ULIP APE declined 3% for HDFCL. Over the next 12-18 months we expect ULIP premiums to remain muted given market volatility. Nevertheless, rising demand for individual protection products would help maintain VNB and also aid in margin expansion.

Exhibit 14: ULIP premiums have been under pressure for HDFCL and IPRUL...



*Source: Company, Ambit Capital research *APE premiums considered*

Exhibit 15: ... predominantly on account of higher focus on equity ULIPs and tilt towards an affluent customer mix

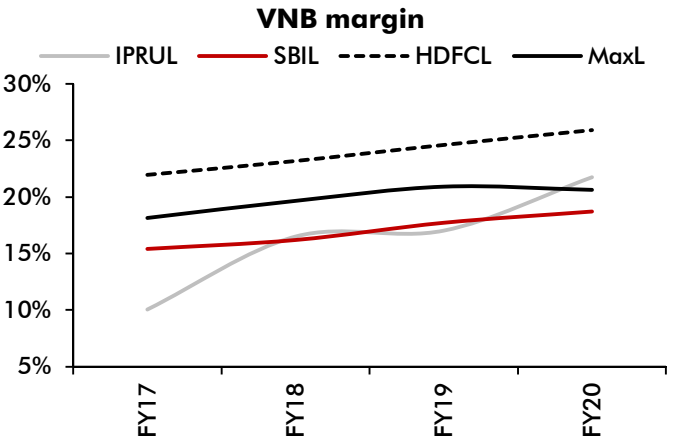


*Source: Company, Ambit Capital research estimates * calculated numbers*

Profitability better than peers

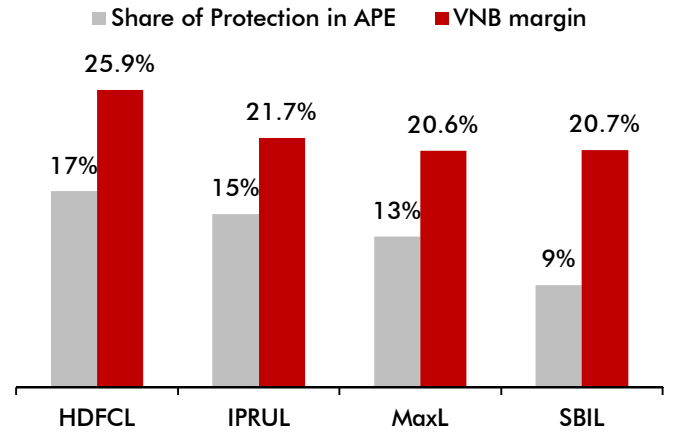
HDFCL is among the most profitable insurers. Its 25.9% VNB margin compares well with 21.7% of IPRUL and 20.7% of SBIL. Higher share of protection (~17% of overall APE) and an improving persistency have enabled HDFCL to enjoy an industry-leading margin profile despite having a high cost structure.

Exhibit 16: Margin profile has been best in class...



Source: Company, Ambit Capital research

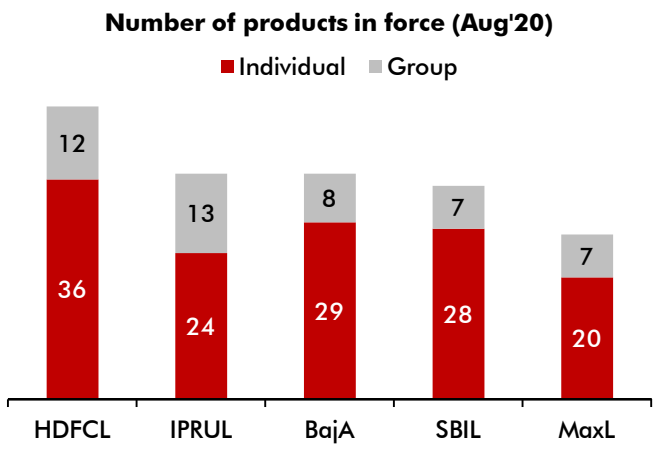
Exhibit 17: ...led by high share of protection APE mix



Source: Company, Ambit Capital research FY20 numbers*

In addition to product mix, better utilization of riders and improving persistency helped HDFCL achieve an industry-leading margin profile. It used innovation well to drive protection sales. It was one of the first life insurers in the country to push online protection sales along with introducing health and cancer care products. On an average, its products are feature-rich compared to peers and its use of riders (higher margins) has been well ahead of that of other life insurers.

Exhibit 18: HDFCL has a wide product offering



Source: Company, Ambit Capital research

Exhibit 19: HDFC Life's persistency has been improving

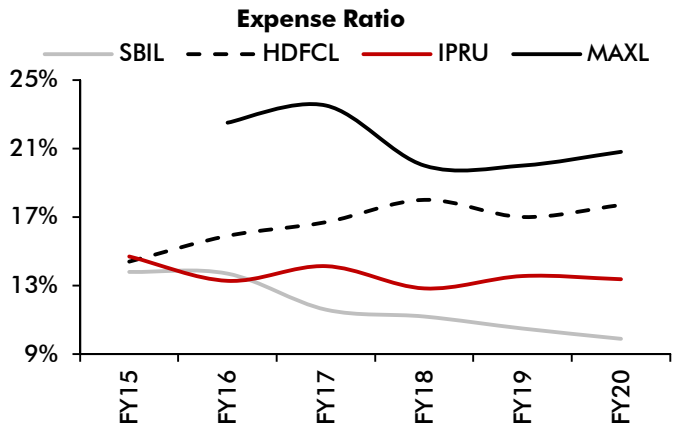
Persistency	FY15	FY16	FY17	FY18	FY19	FY20
13th month	73.3%	78.9%	83.8%	87.1%	87.2%	90.1%
25th month	64.0%	67.4%	75.3%	77.4%	80.5%	80.2%
37th month	65.1%	60.1%	64.7%	70.9%	72.0%	73.8%
49th month	64.2%	63.4%	59.5%	62.2%	67.7%	67.2%
61st month	37.4%	50.1%	58.8%	51.0%	52.3%	55.1%

Source: Company, Ambit Capital research

Opex ratios high led by higher bancassurance commissions

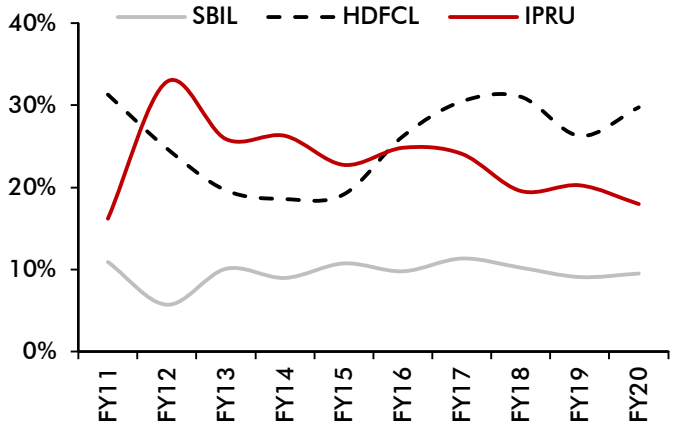
HDFCL's expense ratio is high at 17.6% vs 13.3%/9.9% for IPRUL/SBIL; the primary reason being higher commissions paid to primary bancassurance partner. Group bancassurance ratio is highest for HDFCL at 30% vs 18%/10% for IPRUL/SBIL.

Exhibit 20: Expense ratio amongst bank-sponsored insurers has been highest for HDFCL ...



Source: Company, Ambit Capital research

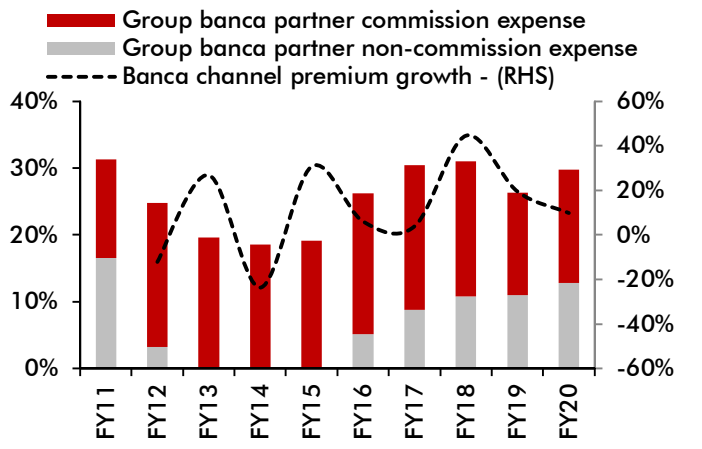
Exhibit 21: ... prime reason being higher commission to primary bancassurance partner



Source: Company, Ambit Capital research

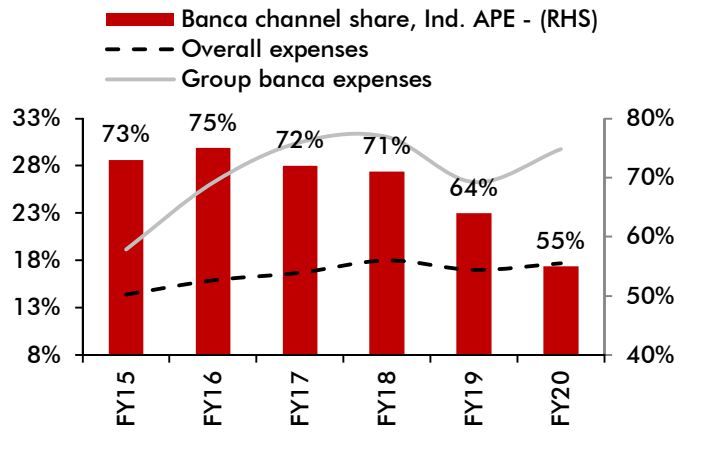
This is well explained by the ownership structure. In the cases of SBIL and IPRUL, the banks are holding companies of the life insurance subsidiaries. HDFCL is a sister entity of HDFC Bank, and both are held by HDFC Limited. This means that, while the shareholders of SBI and ICICI Bank also benefit from higher valuations of subsidiaries, shareholders of HDFC Bank do not.

Exhibit 22: Non-commission related expenses have been on the rise for HDFCL



Source: Company, Ambit Capital research

Exhibit 23: Though the overall bancassurance channel share is reducing, expenses are not

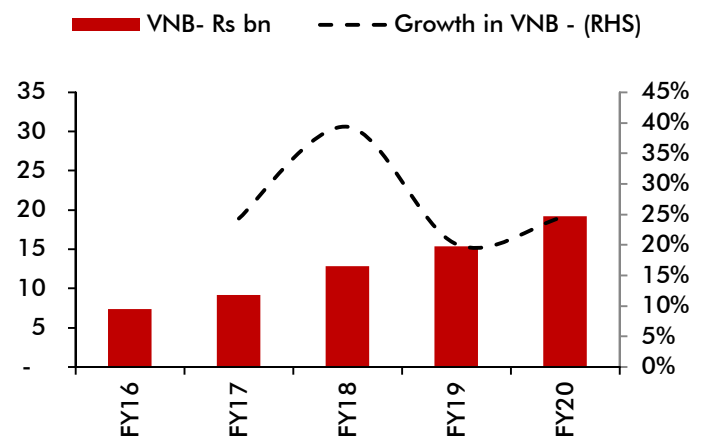


Source: Company, Ambit Capital research

Strong VNB growth led by both margin expansion and APE growth

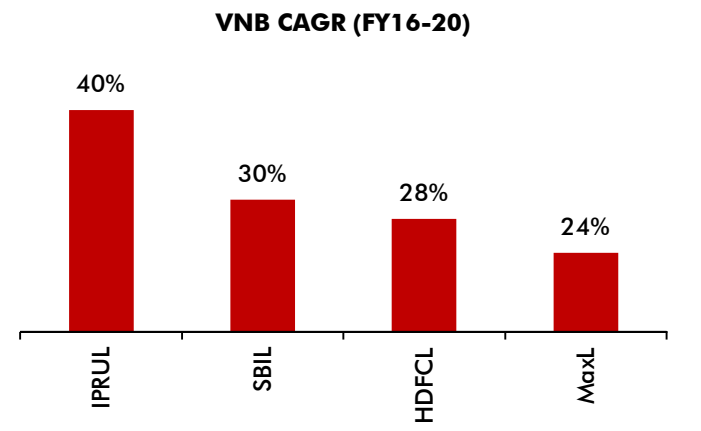
APE growth of 19% and margin expansion by 596bps between FY16-20 led to VNB CAGR of 28%. For IPRUL, historical low VNB (driven by ULIP-heavy book) and now focus on protection drove higher VNB expansion. In the case of SBIL, premium growth during the period was the highest (APE CAGR of 21% vs 9% for IPRUL and 19% for HDFCL.

Exhibit 24: VNB growth has been consistent...



Source: Company, Ambit Capital research

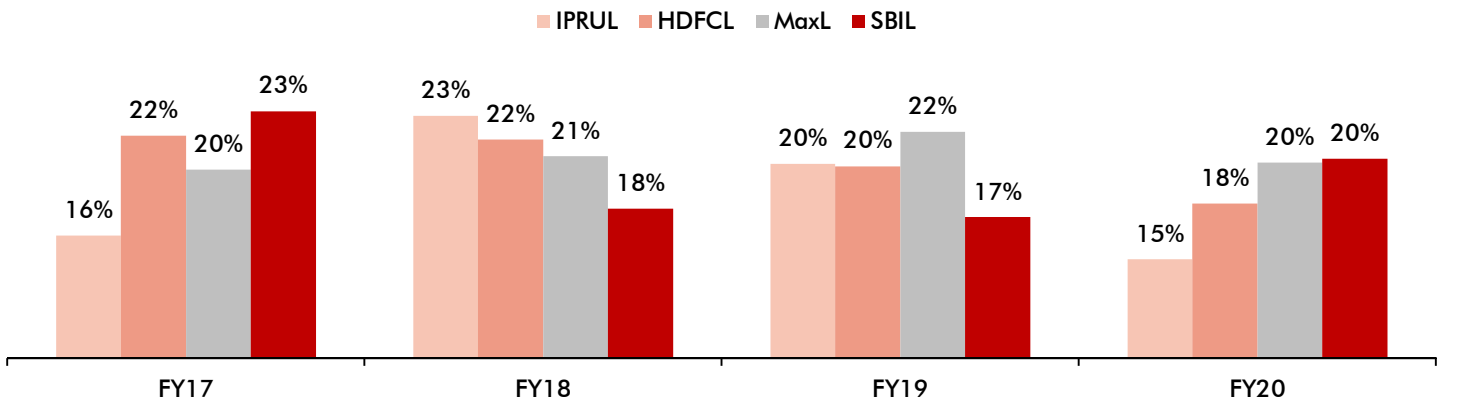
Exhibit 25: ...and strong at ~28% for HDFCL



Source: Company, Ambit Capital research

This led to steady RoEV (average of 20%) between FY17-20, which stacks up well compared to peers. Embedded value during this period grew at a CAGR of 18%.

Exhibit 26: RoEV for HDFCL has been steady and tracks well compared to peers



Source: Company, Ambit Capital research

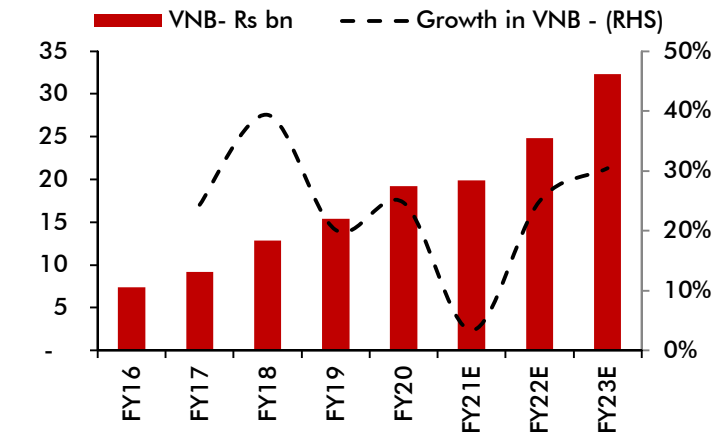
Versatile franchise - one for the long haul

Expect RoEV to remain strong at 17-20% between FY20-23 led by strong VNB CAGR of 19%. Albeit pandemic-led slowdown, we expect expansion to be back-ended. We build in modest APE CAGR of 11.2% between FY20-23, implying a large part of VNB growth would come through margin expansion. Protection would grow fastest (~21% CAGR), driving margins to expand from ~26% in FY20 to ~32% in FY23. HDFCL recently raised sub-debt of ₹6bn which helped its solvency in 2QFY21 to improve to 203% vs 190% in 1QFY21. Solvency is adequate vs regulatory requirement of 150%, sufficient to take care of growth over the next 1-2 years.

Expect VNB to grow at 19% between FY20-23 led by margin expansion

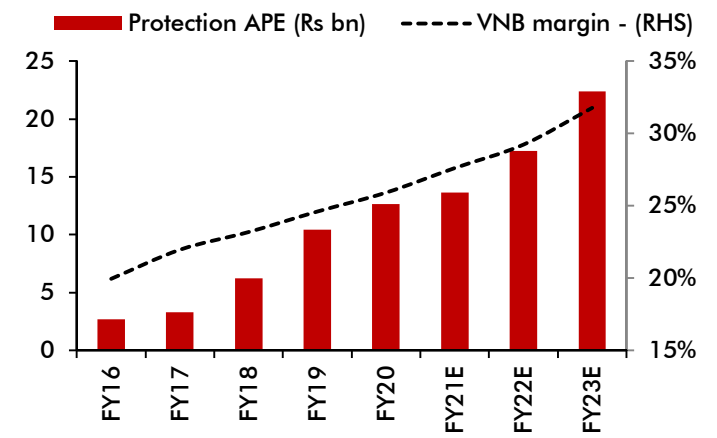
We estimate VNB to grow at 19% (vs 13-14% for peers) between FY20-23. Expansion would be back-ended as VNB growth in FY21 would remain subdued at ~3% despite pandemic-led slowdown. Protection-led margin expansion would drive VNB growth; expect margins to expand by ~600bps to ~32% in FY23.

Exhibit 27: Expect VNB to grow at 19% (highest among peers) through FY23...



Source: Company; Ambit Capital estimates

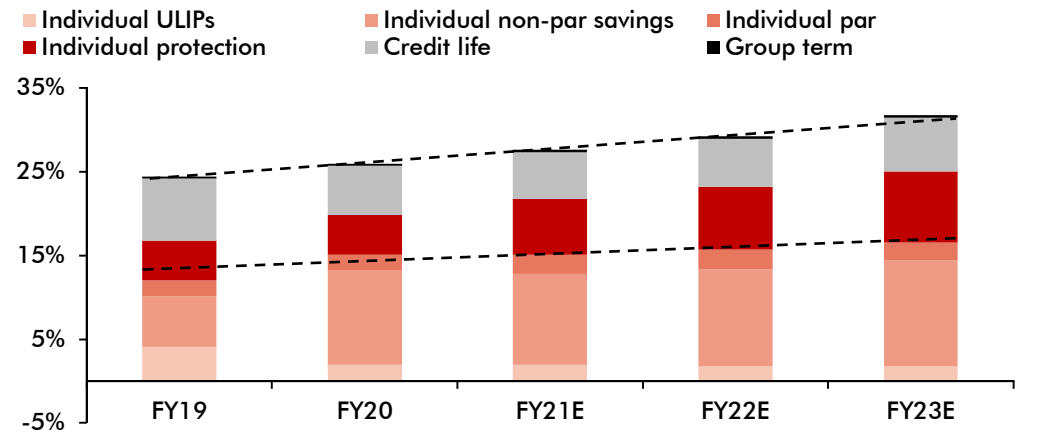
Exhibit 28: ... due to protection-led margin expansion; expect protection to contribute ~50% to VNB by FY23



Source: Company; Ambit Capital estimates

Sharp growth in protection would lead to protection mix (basis APE) increasing to 22% by FY23 from 17% in FY20. This would imply contribution of protection to VNB increases to ~50% by FY23 vs ~42% in FY20. Backed by new product launches and thrust on distribution, we expect non-par savings to be the second-largest contributor with ~40% contribution to VNB by FY23.

Exhibit 29: VNB margin break-up - Protection to contribute ~50% to margins by FY23



Source: Company, Ambit Capital research

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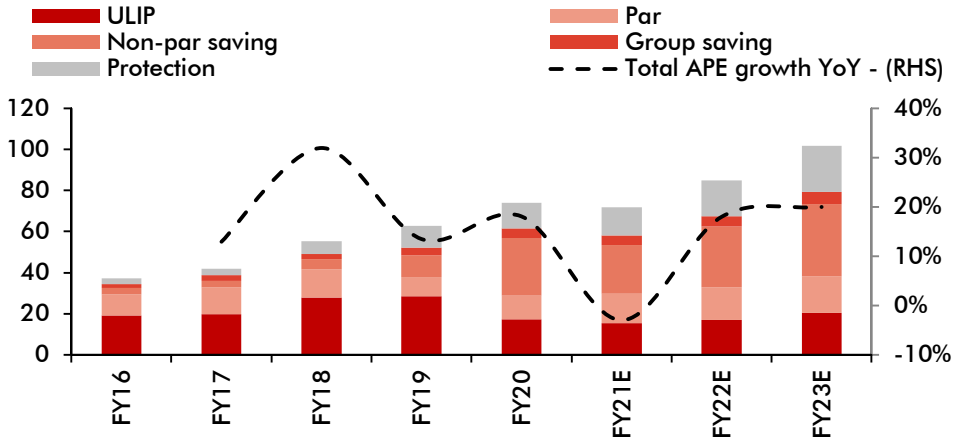
We build in modest APE CAGR of 11.2% between FY20-23 with 3% APE decline in FY21. Our modest APE growth assumptions are driven by muted growth expectation of ~6% for higher ticket size ULIPs given rising competition from mutual funds and volatile markets. Benefiting from rising demand, protection would grow fastest at ~21%.

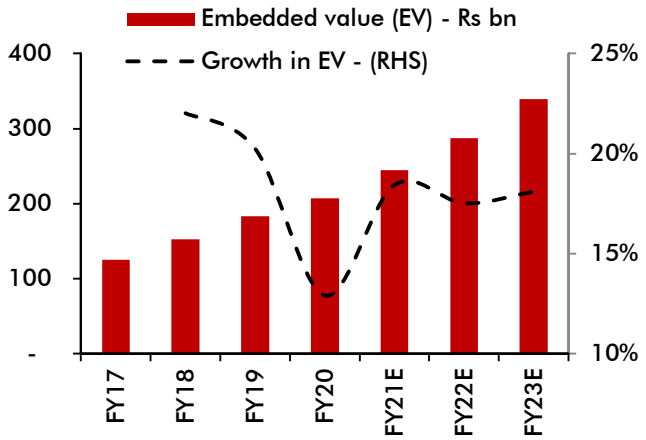
Exhibit 30: Factoring modest APE growth led by protection



Source: Company; Ambit Capital estimates

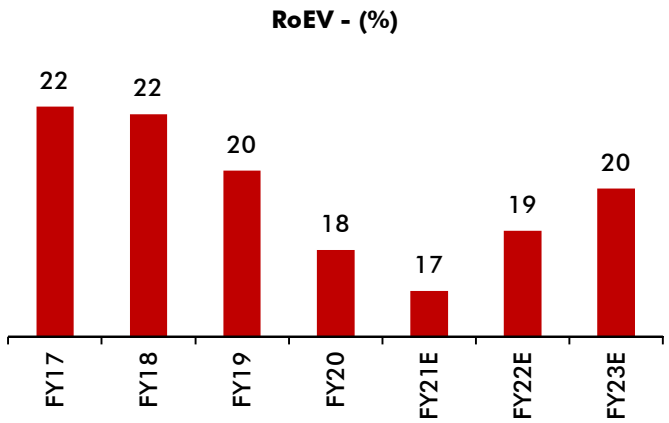
VNB CAGR of ~19% would drive EV to expand at a CAGR of ~18% between FY20-23, resulting in RoEV of 17-20%.

Exhibit 31: EV expansion to remain strong through FY23...



Source: Company; Ambit Capital estimates

Exhibit 32: ... resulting in healthy RoEV



Source: Company; Ambit Capital estimates

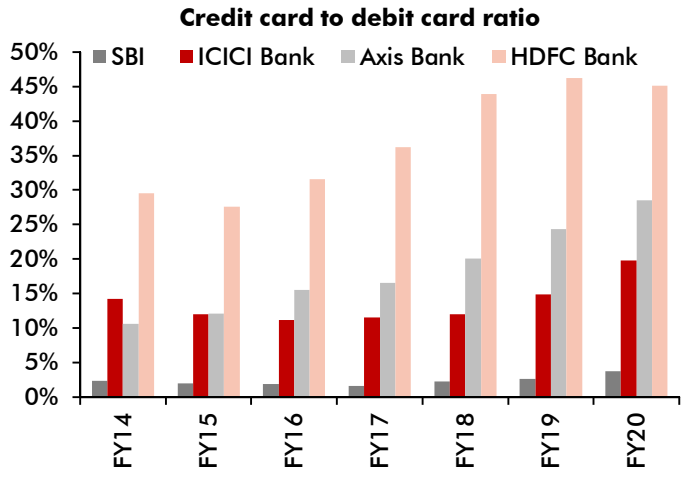
Our expectation of peer-high VNB growth is driven by:

- **Benefit of a superior cross-sell franchise of HDFC Bank**

  HDFC Bank (primary bancassurance partner) is best-placed among large banks to provide a robust platform to grow ULIPs, non-par guaranteed return and credit life offering. This partnership gives HDFCL access to mass affluent customer segment (entrenched reach of >5.4k branches and ~33mn customers). Even in retail mortgages, the key segment to bundle credit life, HDFCL benefits from scale and reach of HDFC group. HDFCL has been at the forefront of product innovations, especially investment products (e.g. Sanchay Plus both par and non-par variants). HDFC Bank has responded well to all the new product launches backed by its strong focus and ability to cross-sell. This has enabled HDFCL to achieve market leadership position time and again in many segments.

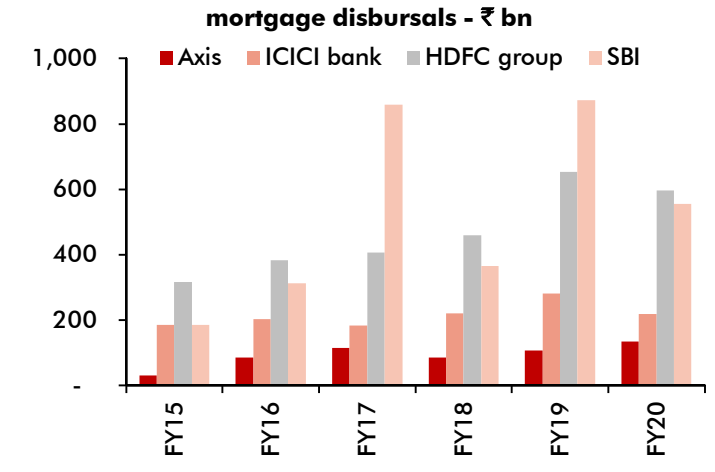
Bancassurance is an apt channel to sell investment products given its fits well with bank's investment management mandate.

Exhibit 33: HDFC Bank has the highest cross-sell ratio (ratio of number of credit cards to debit cards used as a proxy)



Source: Company; Ambit Capital estimates

Exhibit 34: HDFCL benefits from group's scale in retail mortgages (yearly mortgage disbursals net of repayments)

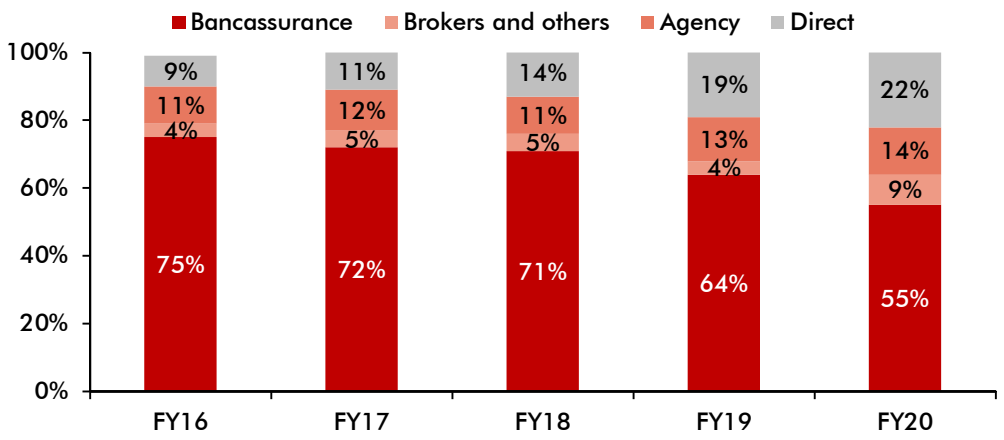


Source: Company; Ambit Capital estimates; Note: HDFC group = HDFC bank plus HDFC Limited

- **Well-balanced distribution infrastructure to support growth**

  Bancassurance remains a significant channel, contributing ~55% of its individual APE. In 2018, HDFC Bank opened up to sell polices of other insurance players (Tata AIA and Aditya Birla Sun Life) breaking its earlier exclusive arrangement with HDFCL. This led to decline in bancassurance APE share in FY19 and FY20.

Exhibit 35: Share of bancassurance reducing but remains a key distribution channel

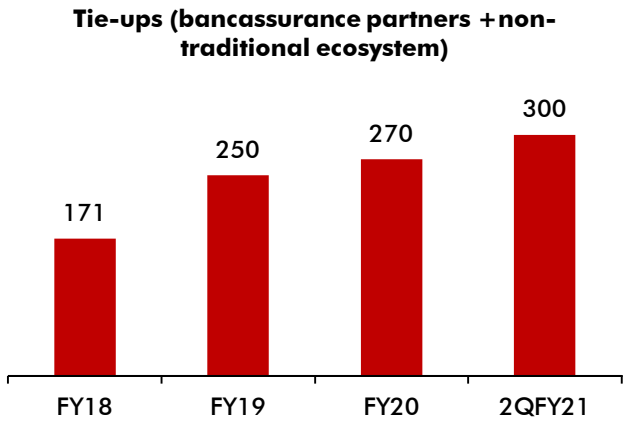


*Source: Company, Ambit Capital research; *chart basis Individual APE*

Nevertheless, HDFCL responded well by increasing non-HDFC partnerships (>300, highest amongst peers) and developing the direct channel. Contribution of the direct channel to individual NBP increased to 24% in FY20 (peer high) from 19% in FY18. This is well reflected in peer-high APE CAGR of 21% between FY17-20, resulting in VNB CAGR of 28%.

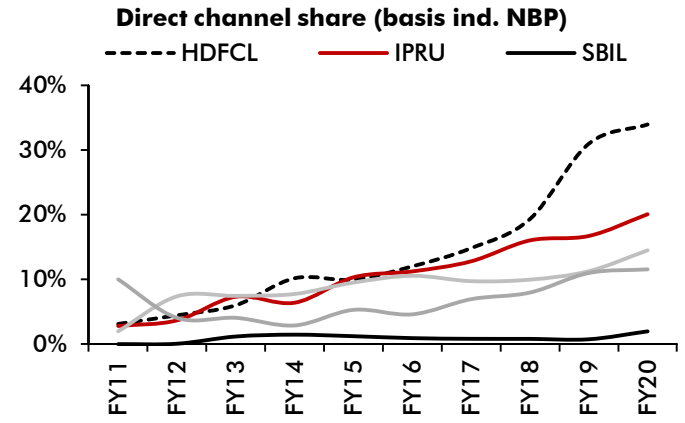
Development of direct channel is key to grow individual protection as bancassurance and agency channels are more suited to sell investment products given wealth management focus and small ticket size of retail protection offering (typically 1/10th of investment products).

Exhibit 36: Diversifying risk from open architecture at HDFC Bank by ramping up tie-ups



*Source: Company, Ambit Capital research *partners include banks, NBFCs, SFBs, MFIs, fintech players, ecommerce players and cab aggregators*

Exhibit 37: HDFCL has been at the forefront of developing its direct channel; key to ramp up retail protection

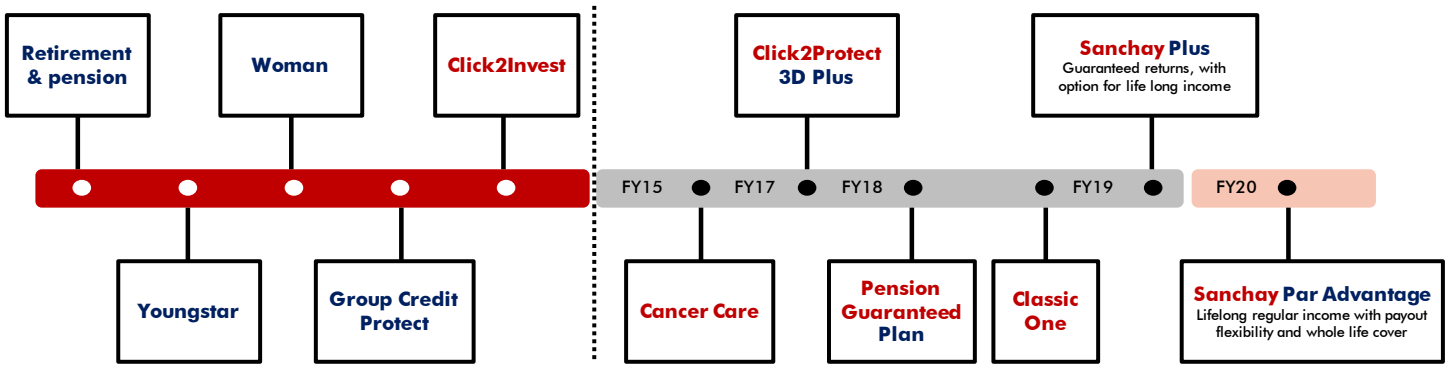


Source: Company, Ambit Capital research

- **Ability to identify opportunities and create markets**

HDFCL launched credit life in 2011 and over the years has expanded the product offering to non-mortgage loans as well. Contribution of mortgage loans/LAP to credit life has now reduced to ~33%. Microfinance and miscellaneous loans (personal, auto, tractor, others) contribute ~33%/33% respectively. HDFCL is the leader in credit life with ~65% market share. It contributed 10% of total APE and ~23% to its VNB in FY20. Rider usage (margin accretive) has also been higher for HDFCL than for peers. The success of Sanchay Plus speaks a lot about its ability to market new launches.

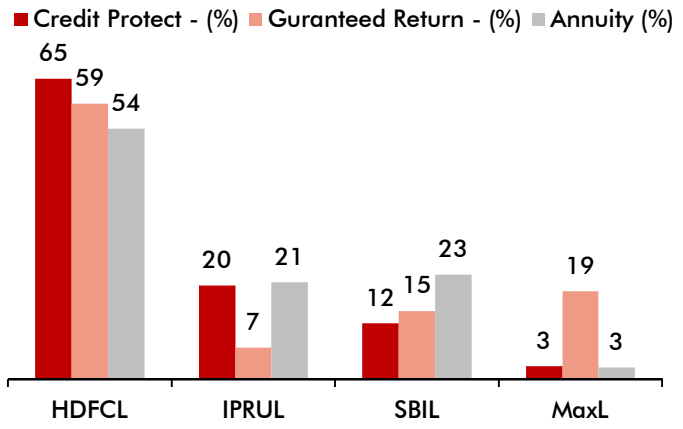
Exhibit 38: Master at product innovation and marketing



Source: Company, Ambit Capital research

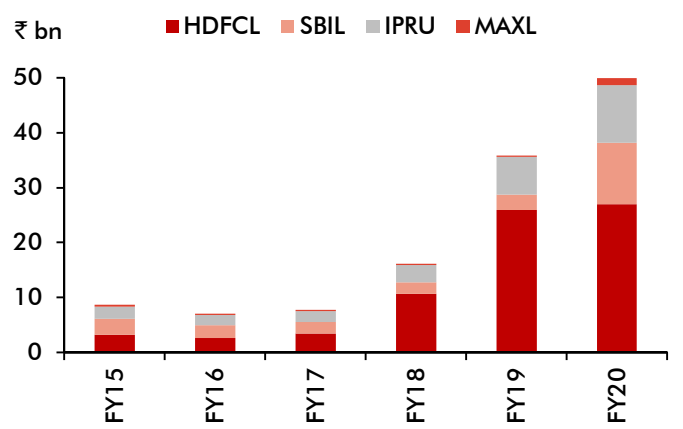
As discussed in the thematic (refer exhibit 34), annuities would be the next big opportunity. HDFCL has been ahead of the curve with peer-high annuity market share of ~7.4% and is amongst very few private insurers selling deferred annuity offerings. Its constant knack to innovate and ingenious marketing ability differentiate it from the rest when it comes to capturing new opportunities.

Exhibit 39: HDFCL has achieved leadership in various segments with its ability to innovate and create markets



*Source: Company, Ambit Capital research; *market share is calculated basis total of HDFCL, IPRUL, SBIL and MaxL and not industry **market share numbers are as of FY20*

Exhibit 40: Within private players, HDFCL has been growing its annuity book fastest over last 4 years

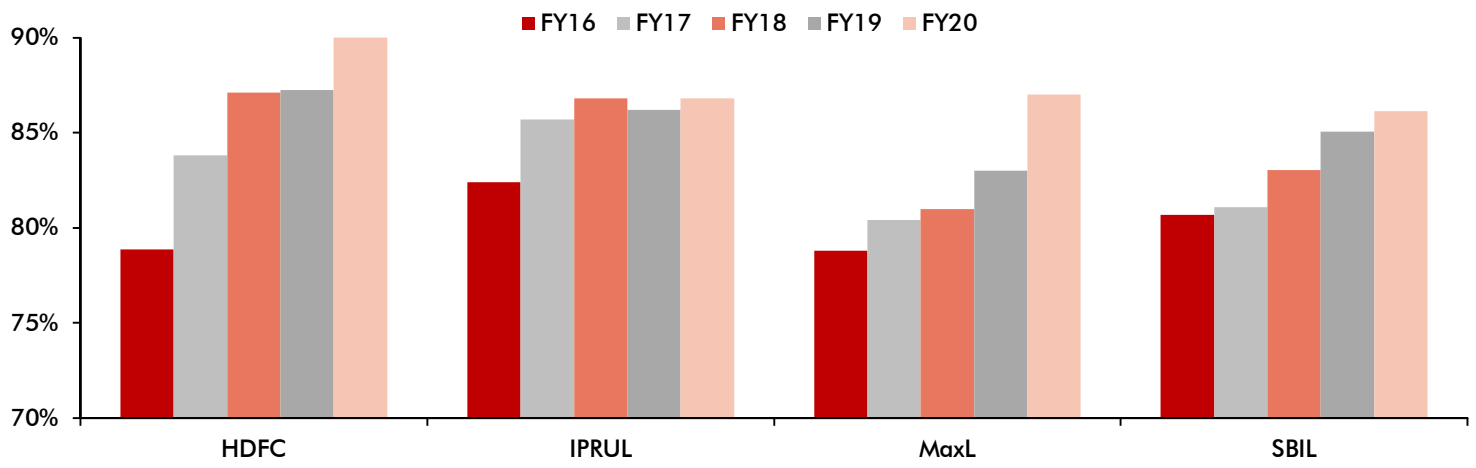


Source: Company, Ambit Capital research

- **Comfort around persistency and on tap ability to raise capital**

  Persistency for HDFCL has consistently moved up and stacks well when compared to peers. Given industry-wide increase in term plan pricing led by upward movement in reinsurance cost, we expect term plan persistency to improve heron over the next 3-4 years. Even its non-par saving products (~38% contribution to individual APE) are expected to have strong persistency over the long term given competitive guaranteed returns offered by these products. ULIP persistency could take a hit in FY21 given volatile equity markets and pandemic-led slowdown; five-year lock-in clause renders some benefit. Overall, we expect persistency to remain stable over the next 3-4 years.

Exhibit 41: Persistency for HDFCL has consistently moved up over the last five years



Source: Company; Ambit Capital research

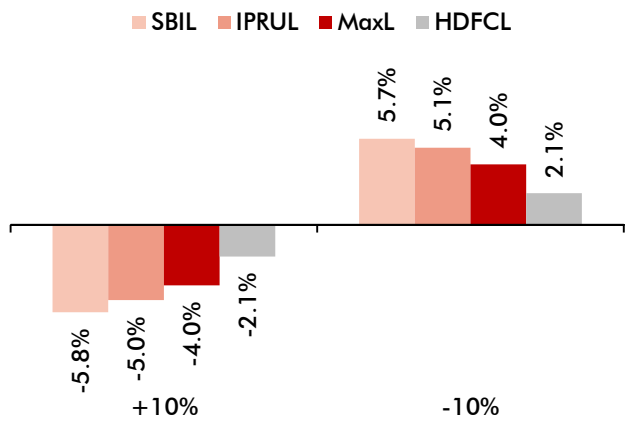
Structural improvement in persistency has helped HDFCL in margin expansion. We also take comfort in HDFCL's well-balanced product mix which has enabled it to have the lowest sensitivity to discontinuance rate amongst peers.

Exhibit 42: Structural improvement in persistency for HDFCL has aided in margin expansion...

Persistency	FY15	FY16	FY17	FY18	FY19	FY20
13th month	73.3%	78.9%	83.8%	87.1%	87.2%	90.1%
25th month	64.0%	67.4%	75.3%	77.4%	80.5%	80.2%
37th month	65.1%	60.1%	64.7%	70.9%	72.0%	73.8%
49th month	64.2%	63.4%	59.5%	62.2%	67.7%	67.2%
61st month	37.4%	50.1%	58.8%	51.0%	52.3%	55.1%

Source: Company (public disclosure), Ambit Capital research

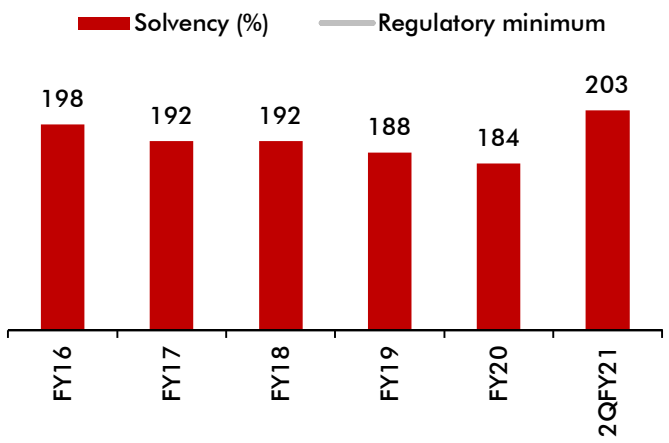
Exhibit 43: ...well-reflected in relatively lower discontinuance sensitivity when compared to peers



Source: Company, Ambit Capital research

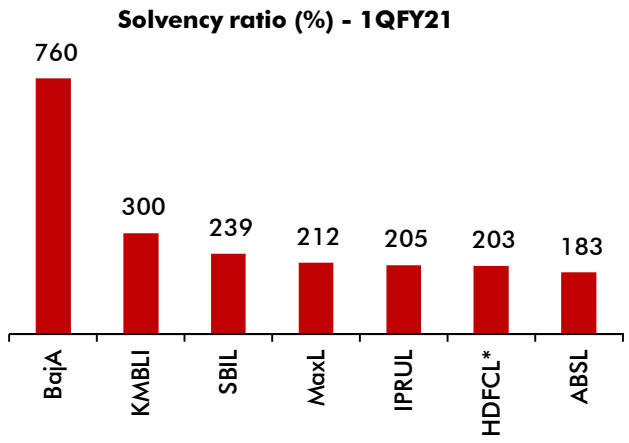
HDFCL's solvency in 2QFY21 improved to 203% from 190% in 1QFY21 with sub-debt issuance of ₹6bn. Estimated protection CAGR of 21% between FY20-23 would require capital raise over the next 2-3 years. Given its strong performance and pedigree, we do not see capital being a constraint for growth.

Exhibit 44: Solvency for HDFCL remains comfortable; gets boost in 2QFY21 with sub-debt issuance of ₹6bn



Source: Company; Ambit Capital estimates

Exhibit 45: Solvency ratio is not best in class though enjoys on-tap ability to raise capital



*Source: Company; Ambit Capital estimates *2QFY21number for HDFCL*

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Valuations are punchy, so are prospects

HDFCL's expensive multiples (absolute and relative) must be read with its ability to drive superior profitability and return ratios in a hugely scalable industry. Current valuations of 4x FY22E P/EV appear rich (98% premium to peers). However, they are justified given i) ability to drive profitable growth (posted similar VNB CAGR of 28% between FY17-20 at 6% higher margin vs peers); ii) high propensity to cross-sell given access to affluent customer base; and iii) admirable execution led by ingenious marketing/innovation DNA. We value HDFCL using appraisal value, implying valuation of 4.8x FY22 EV. Valuations reflect i) faster VNB compounding (~19% vs 13-14% for peers till FY30), ii) complementing business mix aiding secular premium growth/risk management, and iii) ability to identify and capitalize opportunities. Even if HDFCL's one-year forward P/VNB multiple de-rates by 40-45% by FY30, exit multiple of 32-35x implies 14-15% IRR at current valuations.

Our appraisal value-based TP implies ₹677 value...

We value HDFCL using appraisal value, wherein we have added NPV of VNB profits over FY23-43 to EV at FY22E to arrive at a target price of ₹677 (implied valuation of FY22 EV + 33.4x 1-year forward VNB and 4.8 FY22 EV). Our new business multiple of 33.4x is based on two growth phases over the next 20 years – a ten-year high-growth period with average growth rate of 15.8%, a ten-year matured period of moderate growth with average growth rate of 11.8% and terminal growth rate of 5% similar to other financials in our coverage. Margins during this period could amplify by >1.5x in line with our thesis that protection (margin accretive) would grow fastest for the industry at ~23% over the next decade. Backed by its potential to capture the lion's share (private) of new retirement opportunities and complementing business mix, we estimate HDFCL will grow 50-100bps faster than our estimate for the private sector over the next 10 years.

Exhibit 46: Valuations reflect opportunity, longevity and low disruption risk

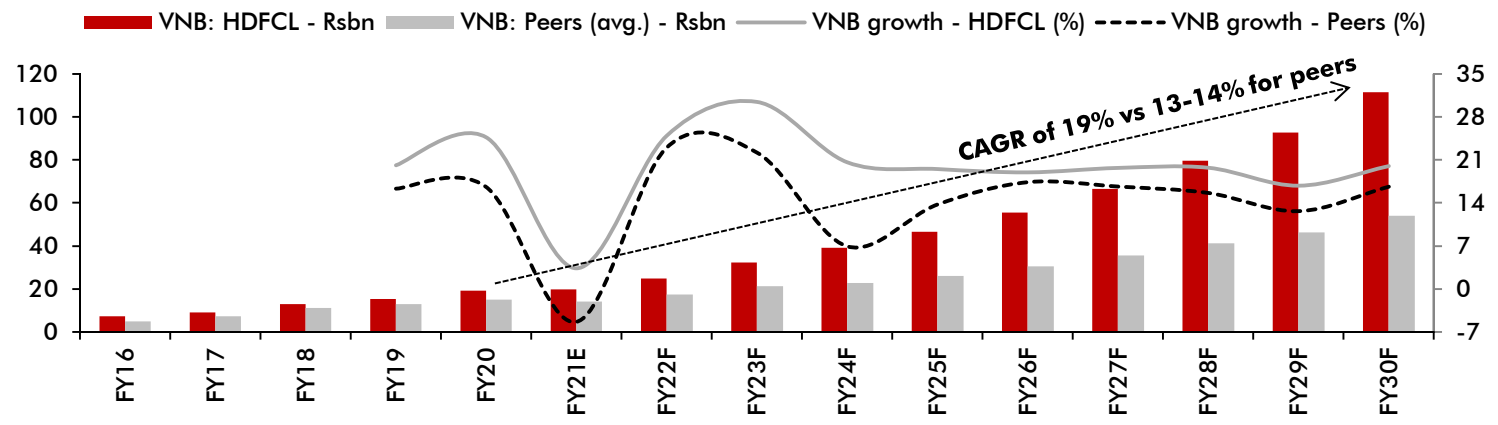
Key valuation drivers	Commentary
Ability to identify opportunities and create markets	HDFC Life has been at the forefront of new product launches, backed by its ingenious marketing. It has been able to attain market leadership in most new segments. Its innovation DNA and existing complementary product mix would enable it to create and capture higher market share in future. Resultantly, we expect HDFC Life to grow 50-100bps faster than our estimate of private sector (14.5%) over next 10 years.
Higher profitability	HDFC Life posted similar VNB CAGR of 28% over FY17-20 at 6% higher margin vs peers. Protection and annuity (higher-margin products than company average) are the big opportunities going forward for the industry (>20% CAGR by FY30); hence, expect profitability to only improve hereon. Its ability to maintain leadership in protection and capture lion's share (private) of new retirement opportunities will help maintain superior profitability over peers.
Lower distribution disruption risk	Distribution is key given life insurance is a push product. Exclusive arrangement with HDFC Bank (primary bancassurance partner) has already ended in 2018 for HDFC Life, but large peers continue to enjoy exclusivity benefits from their primary bancassurance partners. HDFC Life has managed this change well; in fact, it has been able to gain market share. Hence, in our view, distribution infrastructure for HDFC Life is far more evolved compared to peers and is subject to lower disruption risk.
Ability to raise growth capital	HDFC Life benefits from backing of HDFC Group. Its strong performance (both absolute and relative) and pedigree enable it to raise growth capital at ease.

Source: Company, Ambit Capital research

... and fastest VNB compounding amongst peers

In addition to the drivers mentioned above, strong brand and high propensity to cross-sell given access to affluent customer base of HDFC Bank and established presence across a wide range of products should help sustain premium valuations given resultant faster VNB compounding of ~19% vs 13-14% for peers over the next decade.

Exhibit 47: Estimate VNB for HDFCL to compound fastest amongst peers



Source: Company, Ambit Capital research estimates

Even 45-50% discount to FY30 exit multiples implies 14-15% IRR

It would be fair to assume that as insurance penetration in India increases and the market matures, multiples of the sector should contract. Even if HDFCL's one-year forward P/VNB multiple de-rates by 40-45% by FY30, exit multiple of 32-35x implies 14-15% IRR at current valuations. Potential to outpace peers' VNB growth by ~1.5x justifies 32-35x P/VNB exit multiple in FY30.

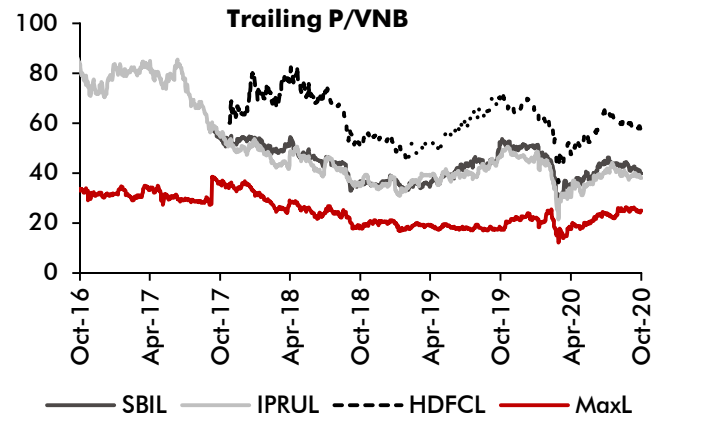
Exhibit 48: HDFC Life could deliver 14-15% IRR over the next few years

Parameters	Current	45% discount		40% discount	
		FY30F	IRR	FY30F	IRR
P/VNB	58x	32x	14%	35x	15%
Price	570	2,106		2,297	

Source: Company, Bloomberg, Ambit Capital research

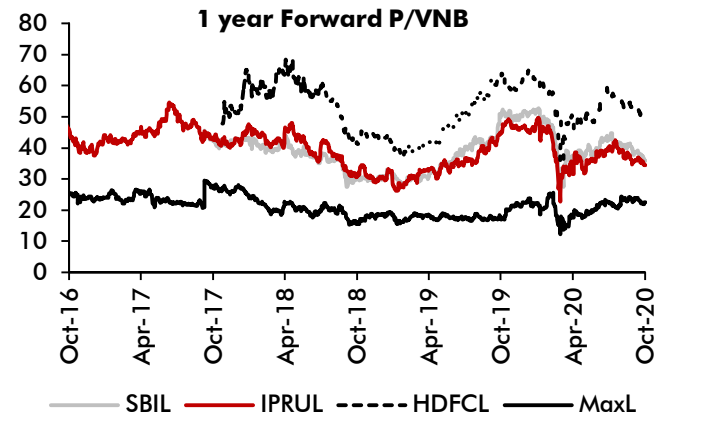
HDFCL's expensive multiples (absolute and relative) must be read with its ability to drive superior profitability and return ratios in a hugely scalable industry. The higher valuations are justified given ability to drive profitable growth. HDFL posted similar VNB CAGR of 28% between FY17-20 at 6% higher margin vs peers and admirable execution led by ingenious marketing/innovation DNA.

Exhibit 49: HDFCL has been trading at premium valuations (basis P/EV)...



Source: Bloomberg, Ambit Capital research

Exhibit 50: ... and highest amongst all listed life insurers in India

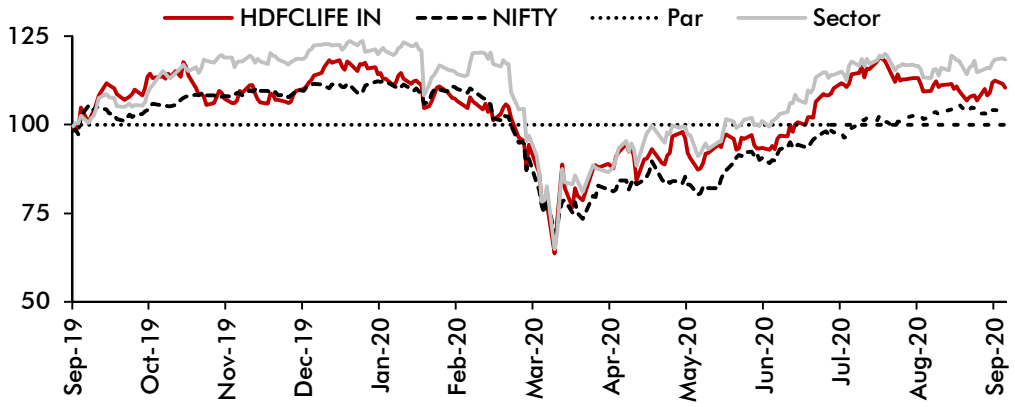


Source: Bloomberg, Ambit Capital research

Market share gain while maintaining profitability led to recent outperformance

In the first five months starting Sept'19 insurance stocks, including HDFCL, performed well before witnessing a sharp fall led by the budget announcement around making the benefit under section 80C optional from FY21. Subsequent to that, the lockdown led to decline in broader markets but life insurance stocks took a sharper beating given March is typically is a sales heavy month for life insurers. Recovery was sharp for the life insurers given challenges were confined to muted growth in 2-3 quarters. In the last two quarters, backed by well-diversified product mix and superior execution, HDFCL was able get a higher incremental market share of ~50bps over the last 12 months while maintaining superior margins (average of 26% vs 21% for peers). This enabled it to outperform most of its peers barring MaxL, which gained more given emerging visibility around the deal with Axis Bank. Over the last 12 months, HDFCL delivered 11% return, beating NIFTY by 6%.

Exhibit 51: Insurance stocks beat benchmark; HDFCL has given 11% returns



*Source: Bloomberg, Ambit Capital research *sector is average return for HDFCL. SBIL, IPRUL and Max Financials*

Key appraisal value assumptions

- We expect no significant negative operating variances over FY20-23. Even interest rate sensitivity for HDFCL is low at ~1.2%. Hence we value EV at 1x.
- To derive value of future business, we discount our estimates of future VNBs at a rate of 14% (CoE=14%) over a 20-year period and calculate terminal value assuming 5% terminal growth rate.
- Since under IEV insurers are obligated to set the investment return and discounting rate at the risk free rate irrespective of the investment mix, we do not adjust the unwind component of the reported EV.
- We factor in VNB CAGR of 19% between FY20-23 on the back of margin improvement from ~26% in FY20 to ~32% in FY23 led by strong protection growth of 21% during the period.
- We factor in 5-10% margin compression in the individual retail protection and credit life segments over the next 5-7 years, factoring in higher competition and possibility of regulatory tightening in the credit protect segment.

Exhibit 52: Key estimates

₹ bn	FY20	FY21E	FY22E	FY23E
APE	74	72	85	102
Growth in APE - %	18%	-3%	18%	20%
VNB margin - %	25.9%	27.6%	29.2%	31.8%
VNB	19	20	25	32
Growth in VNB - %	25%	3%	25%	30%
EVOP	33	35	46	57
Growth in EVOP - %	8%	7%	29%	24%
Embedded value	207	245	287	339
Growth in Embedded value - %	13%	18%	18%	18%
ROEV -%	18.1%	17.1%	18.6%	19.7%

Source: Ambit Capital research estimates

Exhibit 53: HDFC Life – Valuation summary

Parameters	HDFCL	Comments
CoE	14.0%	
Period of high growth	10 years	
Period of moderate growth	10 years	
Terminal growth	5%	
APE high growth - FY23-33F (CAGR)	15.8%	Backed by its potential to capture lion's share (private) of new retirement opportunities and complementing business mix, we estimate HDFC Life to grow 50-100bps faster than our estimate of private sector (14.5%) over next 10 years.
APE moderate growth - FY33 - 43F (CAGR)	11.8%	
VNB high growth - FY23-33F (CAGR)	19.2%	Its ability to maintain leadership in protection and capture lion's share (private) of new retirement opportunities will help maintain superior profitability over peers, resulting in faster VNB growth vs peers.
VNB moderate growth - FY33-43F (CAGR)	11.3%	
Target Price	677	
CMP--as on 25/10/2020	564	
Upside/Downside	20%	
Valuation break-down	21%	
Embedded value	64%	
Value of future business (20 years)	15%	
Terminal value	21%	
Implied target multiples		
VNB multiple (FY23E)	33.4x	
Implied P/EV (FY22E)	4.8	
Implied P/EV (FY23E)	4.0	

Source: Ambit Capital research estimates

Exhibit 54: Rationale for assumptions around growth and margins

Parameter	Growth	Rationale
APE growth FY20-23	11.2%	APE growth to be driven by i) robust growth in the retail protection segment on the back of severe under-penetration and pandemic-led latent demand, and ii) non-par savings (guaranteed return and annuity products) backed by muted credit growth in the bank system and build-up of retirement fund corpus.
Margin expansion by FY23	~586bps	We estimate protection share to increase to 22% of APE by FY23 from 17% in FY20. This would aid in lifting margins to 32% in FY23 from 26% in FY20.

Source: Ambit Capital research

Catalysts & risks

Key risks

Underwriting of guaranteed book: HDFCL has aggressively scaled up its non-par guaranteed book (26% of APE as of 1HFY21). Risks here are from long-term guaranteed returns (premium paying term of 10-15 years and payouts over 10 years). Risks at this point appear to be adequately hedged (opined by Milliman Advisors LLP). Nevertheless, we remain watchful of aggressive build-up of this book and would have discomfort if the mix rises >40% of overall APE as in that case it could face risks in case of non-parallel fall in bond yields and reduced availability of hedging tools like FRA or long-term party paid bonds. Understanding of future liabilities would be the key differentiator beyond the hedge ratio percentage.

Exhibit 55: Book remains adequately hedged at this point

Sensitivity	1HFY21: Overall book		1HFY21: Non-par book	
Scenario	EV	VNB margin	EV	VNB margin
Interest rate +1%	-1.5%	-0.9%	-1.4%	-2.4%
Interest rate -1%	0.7%	0.2%	0.2%	1.3%

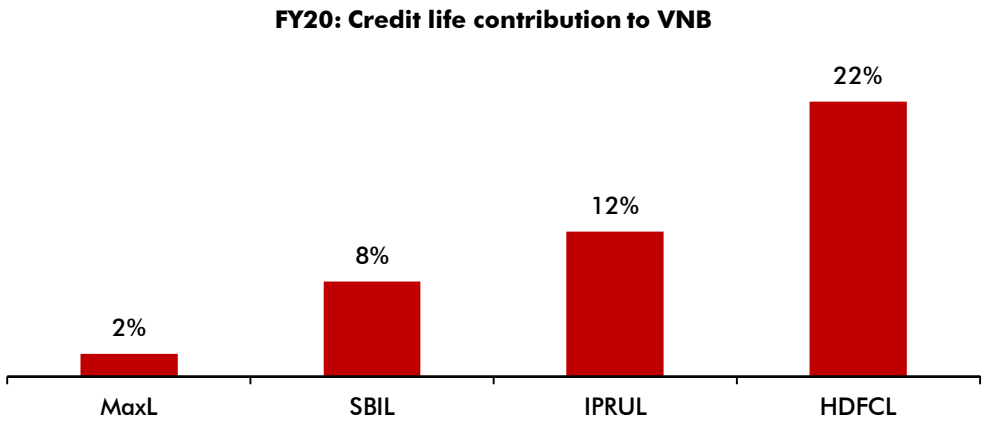
Source: Company, Ambit Capital research

Margins in credit life could erode: High margins and channel exclusivity leave insurers as a price taker with financial institutions commanding large commissions. Given high commission rates, credit life is priced higher (in some cases 2-3 times the cost of a similar feature pure term plan) to maintain margins.

Though regulations don't compel borrowers to purchase credit life policy, attachment rates remain high, especially for mortgage loans. This makes us question whether financial institutions are using this product as a risk management tool or looking it as a quick fee generator. If the case is the latter, then the regulator may take a view and margins for credit protect could come under pressure. Given credit life's high contribution to VNB for HDFCL, it could be disproportionately impacted.

Attachment rates = (number of credit protect policies sold/number of loans disbursed)

Exhibit 56: Contribution from credit protect to VNB is highest for HDFCL



Source: Ambit Capital research, estimated numbers

Tax normalization to 25%: Based on sensitivity disclosures, HDFCL's EV and VNB are highly sensitive to increase in tax rate.

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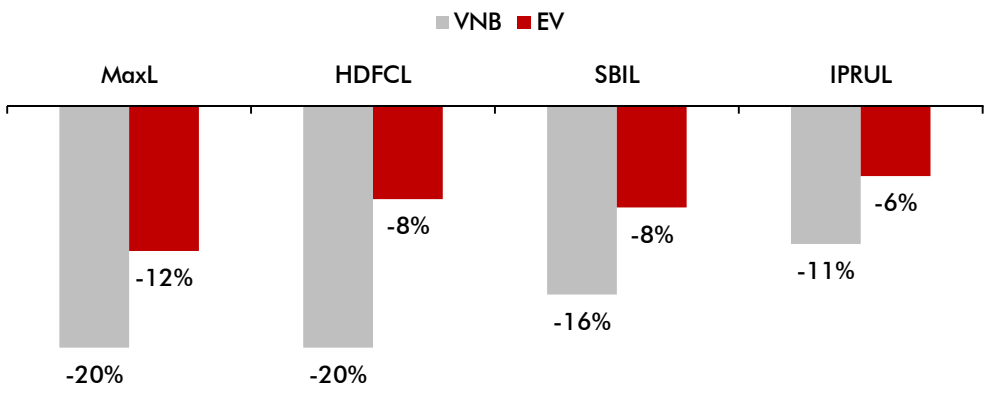
Exhibit 57: Sensitivity to tax rate increasing to 25% is high for HDFCL



*Source: Company, Ambit Capital research *sensitivity numbers are for FY20*

Key catalysts

VNB growth of at-least 20% in FY20: VNB in FY21 to be maintained at FY20 levels and grow by at least 20% in FY22.

Drop in persistency being curtailed: Overall persistency decline to be curtailed at 2% or lower than FY20 level. We expect ULIP persistency to decline amid volatile markets.

Exhibit 58: Explanation for our flags on the cover page

Segment	Score	Comments
Accounting	GREEN	We did not find anything unusual in accounting practices of HDFC Life.
Predictability	GREEN	Complementary business mix and ability to innovate make long-term premium and VNB growth sustainable.
Earnings Momentum	AMBER	In the past 12 months, VNB growth has met expectations.

Source: Ambit Capital research

Financials

Policyholders Account

(₹ mn)	FY19	FY20	FY21E	FY22E	FY23E
First year premium	50,581	60,443	58,629	69,183	83,019
Renewal premium	142,146	154,684	177,829	195,793	219,689
Single premium	99,133	111,942	108,584	128,129	153,754
Gross Written Premiums	291,860	327,069	345,042	393,105	456,463
Net Premiums Earned	289,240	322,236	339,943	387,296	449,718
Investment Income	90,275	(33,109)	(6,722)	6,125	17,951
Total Income	**384,366**	**292,614**	**335,392**	**395,895**	**470,541**
Commission Expenses	11,315	14,912	14,905	17,320	17,320
Operating expenses	38,008	42,669	45,044	51,839	59,997
Benefits paid (Net)	134,146	181,730	183,323	191,023	205,004
Change in valuation of policy liabilities	175,075	24,408	54,864	94,352	140,246
Total Expenses	**368,591**	**281,410**	**308,827**	**366,128**	**435,344**
Surplus/(deficit) after tax	**13,507**	**9,714**	**23,032**	**25,807**	**30,515**
Transfer to Shareholders' account	12,069	11,914	25,231	28,007	32,715

Source: Ambit Capital research

Shareholders Account

(₹ mn)	FY19	FY20	FY21E	FY22E	FY23E
Amounts transferred from Policyholders' account	12,069	11,914	25,231	28,007	32,715
Income from investments	4,084	4,378	5,270	6,650	8,246
Total Income	**16,364**	**16,478**	**30,687**	**34,842**	**41,146**
Total Expenses	**3,465**	**3,360**	**4,307**	**4,890**	**5,775**
Profit before Tax	12,899	13,117	26,380	29,952	35,371
PAT	**12,768**	**12,953**	**26,048**	**29,576**	**34,927**

Source: Ambit Capital research

Balance Sheet

(₹ mn)	FY19	FY20	FY21E	FY22E	FY23E
Sources of Funds					
Share capital	20,174	20,188	20,188	20,188	20,188
Reserve and surplus	36,409	49,675	67,204	87,139	110,558
Net worth	56,556	67,999	87,392	107,327	130,746
Policyholders' funds	1,181,243	1,195,025	1,253,468	1,346,613	1,486,989
Funds For Future Appropriations	11,030	8,830	6,631	4,431	2,231
Total Liabilities	**1,248,829**	**1,271,854**	**1,347,491**	**1,458,371**	**1,619,966**
Applications of Funds					
Shareholders' investments	50,498	58,555	73,884	91,620	112,839
Policyholders' investments	571,245	671,886	771,911	881,175	1,016,234
Total Investments	621,742	730,441	845,796	972,795	1,129,073
Asset held to cover linked liabilities	633,774	541,821	497,861	478,254	480,367
Total Assets	**1,248,829**	**1,271,854**	**1,347,491**	**1,458,371**	**1,619,966**

Source: Ambit Capital research

Premium Flows

Particulars	FY19	FY20	FY21E	FY22E	FY23E
NBP (in ₹ Mn)	149,715	172,385	167,213	197,311	236,774
APE (in ₹ Mn)	62,600	74,100	71,877	84,815	101,778
NBP Growth (%)	31.9	15.1	(3.0)	18.0	20.0
APE Growth (%)	13.2	18.4	(3.0)	18.0	20.0
Conservation Ratio (%)	83.8	80.3	82.0	82.0	82.0
Commission ratio (%)	3.9	4.6	4.3	4.4	3.8

Source: Ambit Capital research

Product Mix

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Individual ULIPs	46%	23%	21%	20%	20%
Individual Par	15%	16%	20%	19%	17%
Individual Protection	6%	6%	9%	10%	11%
Individual Non Par Savings	17%	38%	33%	35%	35%
Total Individual	**83%**	**83%**	**83%**	**84%**	**84%**
Group Protection	11%	11%	10%	10%	11%
Group Savings	6%	6%	7%	6%	6%
Total Group	**17%**	**17%**	**17%**	**16%**	**16%**

Source: Ambit Capital research

Valuation

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Embedded Value (₹ mn)	182,970	206,570	244,631	287,470	339,485
VNB (₹ mn)	15,400	19,200	19,846	24,793	32,340
VNB Margin	24.6%	25.9%	27.6%	29.2%	31.8%
RoEV (%)	20.1%	18.1%	17.1%	18.6%	19.7%
EPS (₹.)	6.3	6.4	12.9	14.7	17.3
BPS (₹.)	28.0	33.7	43.3	53.2	64.8
P/EV	6.2	5.5	4.7	4.0	3.4
ROA (%)	1.1%	1.03%	1.99%	2.11%	2.27%
ROE (%)	24.5%	20.8%	33.5%	30.4%	29.3%

Source: Ambit Capital research

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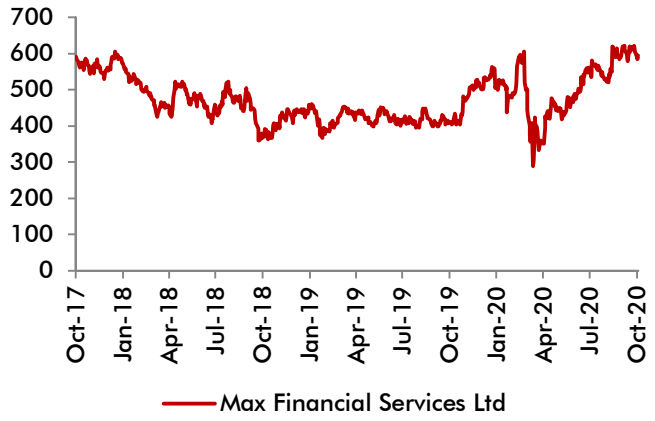
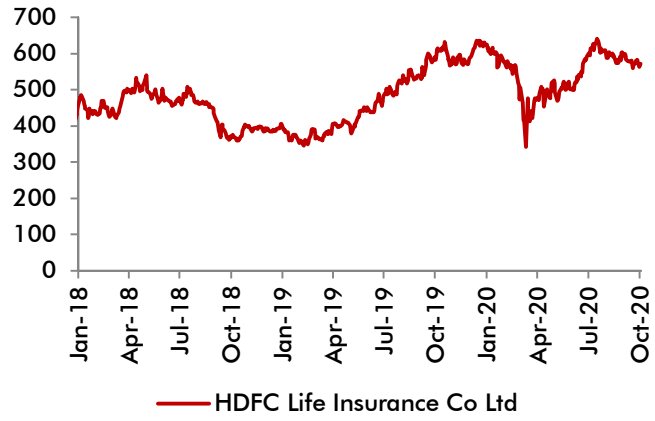
Stock price performance - BFSI

Max Financial Services Ltd (MAXF IN, BUY)



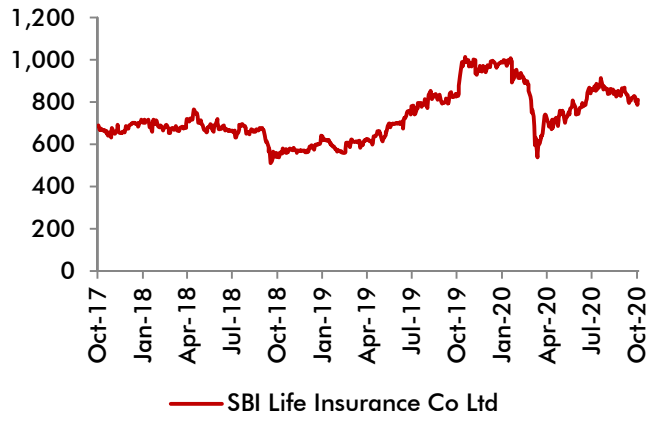
Source: Bloomberg, Ambit Capital research

HDFC Life Insurance (HDFCLIFE IN, BUY)



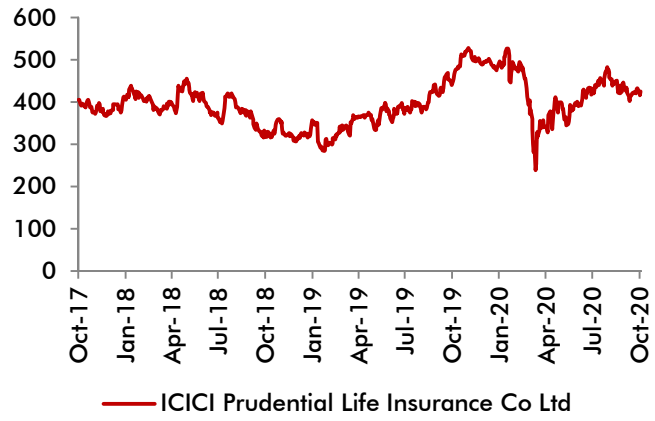
Source: Bloomberg, Ambit Capital research

SBI Life Insurance Co Ltd (SBILIFE IN, BUY)



Source: Bloomberg, Ambit Capital research

ICICI Prudential Life Insurance Co Ltd (IPRU IN, BUY)



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richard.mugutmal@ambit.co 2020-12-07 Monday 13:23:18

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