INDIA RESEARCH

IDFC-SSKI FINANCIALS DAY

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IDFC-SSKI Financials Day 2008

IDFC-SSKI Securities hosted a Financials Day on 29 May 2008 in Singapore, showcasing top managements across private banks, NBFCs and insurance companies. We gather that investor interest in the financials sector remains high. This assumes significance in the context of a difficult operating environment propelled by the vicious cycle of spiraling inflation and hardening interest rates (and thereby slowing credit off-take). On the other hand, the prevailing volatility in the capital market and widening international spreads (as also exchange rates) continue to cloud growth visibility for insurance companies. Evidently, the dynamics of the sector are changing; however, consensus view is that the long-term story is intact given the low penetration levels. The managements at the conference were largely from the private space, and exuded confidence that they would continue to gain market share from their PSU counterparts.

INDUSTRY OUTLOOK

FINANCIALS

Tip of the iceberg: India is an under-banked economy, with loans to GDP at ~40% as against 80-150% for other Asian countries. Bank managements believe that favourable demographics would continue to drive growth, with increasing expansion in Tier-II and III towns and cities. However, managements opine that credit growth would likely be subdued during FY09 due to higher interest rates and slowdown in industrial production (~8% against 11% last year). Managements of private banks are confident of gaining market share as geographic coverage increases.

Interest rates to play spoilsport: Managements acknowledged that with interest rates ruling firm, the operating environment for banks has turned challenging. However, private sector banks are confident of protecting their margins. Consensus emerged that with domestic inflation at over 9%, there are no signs of interest rates relenting in the short term. The 75bp CRR hike and the ensuing repo rate hike have resulted in deposit costs being under pressure. But PSU banks have shied away from increasing lending rates, which would impact their near-term margins.

INSURANCE

Volatile markets mute flows, but growth rates still robust: Volatile markets mute flows, but growth rates still robust: In the context of the prevailing volatility in the capital market, performance of insurance companies has taken a beating. Premium growth for private insurers has slowed to 40-45% yoy in May 2008 as against a high of over 80% in the preceding months. Notably, existing ULIP funds of insurance companies remain invested in equity despite the market volatility, with no evidence of accelerated switching to debt.

Investment in distribution continues unabated: The consensus view was that the long-term story remains intact (driven by India's demographic profile, low social security cover and untapped household savings). Therefore, all the private insurers continue to invest in strengthening their distribution franchise. All private insurers at the conference have guided for a CAGR of more than 40% over FY08-10, though increased competition could moderate margins by 150-200bp.

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HOUSING DEVELOPMENT FINANCE CORPORATION (HDFC)

❑ Growth momentum appears sustainable

- The management emphasized that more than higher interest rates, higher property prices have impacted HDFC's growth trajectory. Nonetheless, disbursements grew by 26% yoy to Rs329bn for FY08.
- Improving affordability make the growth rates sustainable, with disbursements expected to grow at 20-25% per annum (past 5-year CAGR is 27%).
- India's favourable demographic profile, along with HDFC's structural competitive advantage over banks (no SLR and CRR requirement), would continue to drive growth.

❑ Business mix and robust asset quality

- HDFC aims to maintain its lending mix at 70% to individuals and 30% to corporates (includes rental discounting and loans to developers).
- Tax incentives (Rs150,000 – maximum deduction for interest allowed and Rs100,000 – deduction on principal) continue to be favourable for small borrowers.
- HDFC's loan-loss is a mere US$16m on disbursements of $16bn.
- The low average loan to value of 65% continues to help HDFC maintain a firm grip on asset quality, with 6-month gross NPAs at 0.68% as of March 2008 (as against 0.77% as of March 2007). Several other mortgage players, specifically banks, succumbed to asset quality problems (delinquency levels for public sector banks stood at 4.6% and that of private sector banks at 2.7% in FY07).
- In addition, HDFC is able to maintain its asset quality on the back of greater control over distribution network, as 40% of the business is sourced from its distribution subsidiary and 27% from HDFC Bank (for 1% fee on business sourced).

❑ Spreads to normalize

- In FY08, HDFC reported high spreads of 2.32% as interest rates increased due to a monetary tightening.
- The management expects spreads to normalize to 2.05-2.1% over FY09.

❑ Dynamic funding mix

- In the 1990s, about 45% of HDFC's total funds accrued from retail deposits (with interest rates being high and deposits relatively less expensive). HDFC continues to tailor funding mix to changing macro variables with deposits down to 17% of total borrowings as of March 2008.
- At 51% of total funds, bonds and debentures are the primary sources of borrowings as of Mar '08, while domestic term loans make up for another 29% of the total.

❑ Core business adequately capitalized, value-unlock in subsidiary businesses

- As of March 2008, capital adequacy for HDFC stands at 16.8% (Tier-I at 14.6%).
- HDFC recently raised about US $710m of capital, of which $350m was infused in HDFC Bank (HDFC's current stake at 23.27%). The remaining would be channelized into the life insurance business.
- Value unlocking in subsidiary businesses is in the offing. Specifically, the life insurance business (HDFC holds ~73% of the outstanding share capital) is expected to be listed by December 2009, and subsequently the asset management business (HDFC stake at 60%).

SHRIRAM TRANSPORT FINANCE (STFC)

❑ Key triggers

- Deepening penetration

The management attributes the company's success partly to its expanding network as also the tie-ups with private financiers.

- Improving funding profile

In the initial phase, STFC had little access to attractive funding from banks which, due to the inherently risky nature of the business, were reluctant lenders. Since then, the improvement in credit ratings, coupled with its loan portfolio being treated as priority sector advances by banks, have tilted the balance in favour of STFC. An improving funding profile has facilitated availability of institutional funding at a cheaper cost, which translates into lower cost of funds. Along the way, STFC has been able to attract reputed private equity and institutional investors as equity partners, which has lent further financial flexibility.

- Slowdown in the new truck market

The management considers the slowdown in new truck sales to be the key factor for rising disbursements in the used truck segment.

❑ New growth engines

- With STFC being the only organized player with a 20-25% market share and process-driven constraints on growth, the company considers it prudent to use the private financier network for the near term. Currently, around 400 private financiers contribute ~15% of the disbursements. STFC intends to expand the private financier network to 1,000 in the next couple of years.
- STFC is expanding its product portfolio to emerge as a one-stop shop for small truck operators needing finance. To achieve its objective, the company is focusing on developing a vertically integrated business model. STFC plans to add the following products/ services to its portfolio:
  - Financing of multi-axle trucks, passenger commercial vehicles and multi-utility vehicles, tractors and agriculture equipment
  - Planning value-added services such as finance for re-conditioned trucks, truck exchange programmes, tyre finance and engine replacement finance
  - Commercial three-wheeler segment
  - The lucrative construction equipment segment, which offers a huge potential in the backdrop of a positive outlook on infrastructure in the country.

❑ Wide network providing competitive edge

STFC has built a low-cost network encompassing 6 regional, 85 divisional and over 430 branch offices and a team of more than 7,000 employees including 2,400 field officers. Its branch network is concentrated in "relevant" freight centers having widespread coverage of semi-urban and rural areas.

❑ Well capitalized till 2010

STFC has recently raised Rs6bn (Rs2.4bn via warrants) by issuance of warrants to promoters as also a preferential allotment. The management believes that this should help sustain the growth momentum till 2010.

❑ Unique competencies act as formidable entry barriers

Ground level relationships with small truck operators and first time buyers of old CVs is the key strength behind STFC's competencies in sourcing as well as collection. A large customer base providing valuable market references and expertise in valuation of old trucks are other strengths that have enabled STFC to manage its credit quality effectively.

Authority and accountability for loan origination and collection is delegated to branches, and field officers are recruited at very low fixed costs but incentivized for collection efficiencies.

❑ Key challenges

- The management fears that recovery agent guidelines could have some impact on the asset quality.
- Work force accretion at ground level remains a key challenge.
- Increasing fuel price impacting the economics of truck operators.

SHRIRAM CITY UNION FINANCE (SCUF)

❑ Robust business model… rein on NPA levels

- SCUF's business model revolves around strong customer intelligence developed on the back of regular field level interaction. Consequently, SCUF has been able to compete and grow profitability in remote locations often found unviable by peers:

  (1) Mono-line financiers (banks or manufacturer-backed finance companies) usually find remote locations unviable due to high operating costs not justified by the low single product volumes.

  (2) Aggressive product-driven targets often result in higher LTVs, which are detrimental to asset quality.

- In addition, locally hired executives with strong understanding of the customer base are better able to assess customer needs. Further, the existing Shriram Chit customer database provides SCUF a head-start and better control over asset quality. As a policy, SCUF continues to disburse personal loans to Chit customers only.

❑ In-house employee force

- SCUF's business model is differentiated as it has not opted for the DSA (direct sales agents) model, popular with other competitors. Instead, SCUF has an in-house team for all functions – origination, servicing and collection.
- Currently, there are ~2,000 personnel on SCUF's payrolls (senior management is rarely laterally hired) and 6,000 Chit employees. In line with a bilateral agreement, SCUF pays 5% of the business sourced as the operating cost to Shriram Chits.
- Majority of SCUF's business is conducted at the customer's doorstep. Monthly interaction of field executives with customers aids collection (20% in cash) and enables the company to maintain updated credit records.

❑ Growth drivers

- Currently, 80-85% of SCUF's network is in rural areas, with 70-80% of the total being in the South. Management has indicated that increased penetration in existing locations would be the key top-line driver in the near term.
- Locally hired executives continue to be intrinsic to SCUF's growth strategy, enabling faster quality growth. The Chits customer base is a ready target pool, lending accelerated scalability to SCUF.

❑ Capital requirement

- At the current growth rates, SCUF is sufficiently capitalized for the next two years. SCUF recently raised about Rs4bn through a preferential allotment.

INFRASTRUCTURE DEVELOPMENT FINANCE COMPANY (IDFC)

❑ Energy and transportation – the focus segments

- Energy and transportation are the key growth drivers for IDFC. As of March 2008, ~37% of the loan book is exposed to the energy sector (across generation, transmission and distribution) and ~23% to transportation.
- In the energy segment, the potential is huge. However, IDFC steers clear of UMPPs and state-sponsored projects. The focus for IDFC is captive power projects, which offer more predictable revenue streams.
- Further, the energy segment is expected to grow at a healthy 25-30% yoy given the 12% peak deficit indicated by the government.

❑ A strong pipeline

- The order pipeline is hot, on the back of sanctions of ~US $7bn and outstanding disbursements of $5.8bn.
- Disbursements and sanctions are expected to clock 25-30% CAGR over FY08-10.
- In FY08, disbursements increased by ~49% yoy and total exposure grew by over 50% yoy.

❑ Diversified non-interest income

- IDFC has steadily diversified its offerings in the infrastructure financing space, and is now present across the spectrum from project finance to asset management to principal investments.
- In March 2008, principal investments income registered an increase of 63% yoy and constituted about 35% of the non-interest income (with carry kicking in). Another 30% of non-interest income for IDFC was attributable to the investment banking and broking business brought into the fold through the stake purchased in SSKI Securities.
- Standard Chartered's AMC business was recently acquired by IDFC, and is expected to add debt offerings to an otherwise equity biased business.

❑ Strong portfolio…access to low-cost funds

- IDFC's loan portfolio is diversified across credit categories, with BBB category being a large proportion as all Greenfield projects are classified under this category.
- Given the high credit ratings, IDFC's cost of money stands at 9-9.5%, as it benefits from lower cost of funds availed of from banks.
- About 87% of IDFC's borrowings are long-term, of which ~50% are through bonds and debentures.

ING VYSYA BANK (ING VYSYA)

❑ Retail strategy…

- The management articulated a differentiated strategy to grow ING Vysya's consumer assets business (about Rs31bn book as of March 2008). In the South (which has about 75% of the bank's current network), the focus is on increasing productivity. In the North, the bank's emphasis is to scale up its presence.
- SME business (classified as retail at ING Vysya) is also set to witness traction with emphasis on: a) leveraging the bank's historic relationships; and b) accelerating customer acquisition on the back of improved productivity and expanding geographical coverage.

❑ …to be deposit-driven

- Retail growth would be preceded by expansion in CASA deposits, driven by a) increasing coverage; and b) differentiated product offerings.
- CASA deposits grew at ~45% yoy in March 2008, taking the proportion in total deposits up to 31.5%. The management indicated a target to increase CASA ratio to 34-35% over the next two years.

❑ Turnaround strategy orchestrated

- ING Vysya's turnaround revolves around: a) rejig in top management; b) product consolidation and rationalization; and c) creating a performance culture aided by a robust technology platform

  a) Out of the 19 top management team, 17 members have been changed.

  b) Non-core areas/ High risk verticals, such as auto-loans and two-wheelers, have been exited. Private banking has been hived off into a separate vertical with huge opportunity to manage NRI inflows and manage portfolios of an expanding SME customer base.

  c) A new culture is being institutionalized with performance linked targets for unionized and CTC employees; key metrics (including CASA) are being monitored at the branch level on a monthly basis.

❑ Plan to double deposits every three years

- With turnaround catalysts being gradually put in place, the management aims to double the deposit base every three years.
- As the bank invests in growth, return ratios may be subdued in the near term with RoA expected to hover around 1%.
- With service levels honed, the bank is investing in brand building which, in turn, would provide impetus to growth in the retail segment.

❑ Continued momentum in fee income

- The management has identified trade finance and cash management services as growth drivers for the fee income business, which is gaining scale. In addition, treasury income is expected to remain healthy despite the current market volatility.

❑ Capital raising considered a non-issue

- Through a QIP (at Rs310 per share), the bank raised ~Rs3.5m in November 2007. Capital adequacy ratio stood at 10.2% as of March 2008.
- The management has indicated preference to raise upper Tier-II capital (with Tier-I CRAR at 6.8%) if the need arises in the near term. With deep pockets of the ING Group, the bank does not foresee any problem in raising capital.

YES BANK

❑ Changing fee income mix

- The management reiterated that dynamics of the forex business are changing towards the plain-vanilla forex business (high volume-low margin) vis-à-vis exotic structures (high margin-low turnover). To that extent, the operating environment has become more difficult.
- In line with market volatility, financial advisory has also evidenced a slowdown. However, the bank expects traction in transaction banking and third party distribution.
- According to management, the overall intensity in fee income (50% yoy growth estimated) would persist, while fee income mix would undergo a change.

Fee income mix and growth rates

	% of total non-interest income		(Rs m)		(%)
	FY07	FY08	FY07	FY08	yoy growth
Financial Markets	42	41	818	1,459	78.4
Financial Advisory	33	27	649	956	47.3
Trade / Guarantee	11	14	206	483	134.5
Third Party Distribution	10	12	203	439	116.3
Others	4	6	69	208	201.4
Total	100	100	1,946	3,545	82.2

Source: Company, IDFC-SSKI Research

❑ Whole-sale funded bank…cautious retail strategy

- While on an improving trend, share of CASA remains low for Yes Bank at 8.5% as of March 2008.
- As per management, the expedited rollout of branches (with lease rentals easing-off) would trigger an increase in CASA deposits.
- In the context of tight liquidity conditions and high interest rates prevailing, margins could evidence some volatility in the near term.
- As of March 2008, large corporate advances form 54% of advances while SME clients constitute ~44% of the total.
- Consumer lending would continue to be a non-focus segment for the bank, given the low cost competition from NBFCs and increase in system delinquencies.

❑ Differentiating from competition

- Yes Bank has differentiated offerings on the back of sector knowledge.
- The bank has invested in a state-of-the-art technology platform, which would enable better service levels and innovative product offerings for customers.

❑ Capital raising

- Yes Bank has raised US $84m through a QIP with Orient Global during the third quarter. Post the issue, 4.99% of the stake has been diluted.
- As of March 2008, capital adequacy ratio stood at 13.7% with Tier-I Capital at 8.5%. The management plans to raise capital in the near term.

RELIANCE LIFE

❑ Distribution – a key differentiator

- After a late entry in the life insurance space in July 2005, Reliance Life has been the fastest growing life insurance company and the No. 5 private insurer on the back of aggressive distribution expansion.
- Despite concerns on growth moderation in ULIPs, the management intends to continue investing heavily into distribution. The company is proceeding with the ambitious plan of doubling its network from 744 branches currently to ~1,400 and agent force from 184,201 to ~350,000 by March 2009. In FY08, ~15,000 employees were retrenched due to lower productivity. In the absence of a suitable banc assurance partner (as it was a late entrant), agency force continues to be the dominant distribution channel.
- After being reasonably networked in the western and southern states on the back of the AMP Sanmar foothold, Reliance Life intends to extend its geographical coverage to the eastern states as well.
- Along with expanding its agent force, Reliance Life would retain emphasis on alternate channels. The company is increasingly leveraging its arrangements with distribution partners such as Reliance Money (R-Money; a group company) and cooperative banks.

Network expansion

	FY07	FY08	FY09
Agents	95,711	184,201	~350,000
Branches	156	744	~1400

Source: Company

- The unprecedented growth in distribution network vis-à-vis competition has been coming on the back of:
  - Ability to commit capital given the deep pockets of the Reliance ADA Group.
  - The in-house training institute (NIS Sparta) enables Reliance Life to expand its agent force efficiently.
  - Fast growth in Tier-II and III cities by leveraging infrastructure of Reliance Communications and R-Money.
- Increasing the stickiness of agents (average life cycle of ~3 years currently) and expanding distribution depth are the key challenges for Reliance Life.

❑ Business mix – set to change

- ULIP products form ~92% of premiums.
- Against expectations, the share of single premium policies in total premium has gone up significantly from 24% in FY07 to 33% in FY08, pulling down the overall APE numbers. A new plan – "Total Investment Plan", which was filed with the IRDA as a single premium product, was introduced in March 2008. The plan garnered a whopping Rs2.5bn in March though it also impacted the APE number. According to the management, though the policy is reported as a single premium, it offers an incentive to holders in case of renewal as it lowers the premium allocation charges. Given this, the management is confident of converting some of these single premium policies into regular premium ones. Aware of the spike in the share of single premium policies, the management seeks to correct the situation.
- More than 88% of the portfolio has a tenor above 12 years.
- Pension products constituted ~50% of the business in FY08, and health remains a key focus segment.

❑ New initiatives…offering value-added services

- **Innovation:** A point system has been launched for policyholders, wherein points are awarded for the number of years premium is paid/ any top-ups on child plans.
- **Leveraging group strengths:** Reliance Communications' technological platform is being used to provide prompt acknowledgement letters and receipts for the premium received to policyholders.

❑ Growth estimates

- Given the inherent strengths of Reliance Life and driven by aggressive expansion efforts, the management is confident of achieving 80-100% yoy growth for the next two years (2x private industry growth rate of 35-40%).
- The sponsor is committed to invest Rs20bn in the business over the next few years.
- The management reiterated its stance of placing a small stake with financial investors as and when capital market conditions improve.

HDFC STANDARD LIFE

❑ HDFC SL focuses on selling processes

- The management reiterated that the strategy was initially concentrated on building the company's backbone, i.e. workflow processes across functions (policy sales, complaint status and claim handling). It was the first life insurer in India to have achieved Automated Workflow processes. Growth is being managed within a centralized virtual organization.
- HDFC SL is focused on assessing customers' financial needs and offering well-aligned solutions; the strategy is yielding growth in a tough market environment.
- Though the strategy constricted growth in the initial years, results are now evident in the form of a high persistency ratio and higher average premium.

Emphasis on financial need assessment…translates into higher average premium

March '08	LIC	Pvt. companies	HDFC SL
Average premium (Rs)	8,100	21,000	36,000

Source: Company

❑ Agency to remain the dominant distribution channel

- The management has highlighted that in FY08, 40% of the individual business was procured through alternate channels, 59% through tied agency (56%), and ~1% from direct selling agents (DSAs). HDFC Bank contributed around 22% of the total sales.

Rapid distribution ramp-up – presence in 700 locations

Nos.	Mar'06	Mar'07	Sept'07
Agents	33,288	74,000	99,312
Branches	169	276	300

Source: Company

- By 2012, the management expects the share of alternate channels to reduce to 25% and that of DSAs to increase to 12%. This tilt towards agency and DSAs is fallout of the management expecting all large public sector banks to have their own insurance companies.

❑ ULIP products…still the leader

- Around 96% of new sales are of ULIP products.
- During the recent correction, the company has observed an interesting trend of money being switched from equity to debt as against the trend seen during the earlier corrections wherein exposure to equity had increased. The share of debt increased from around 43% in December 2007 to 46% in March 2008.

❑ Increasing focus on pension and health products

- The management indicated that pension products contribute ~ 39% of the total premium, up from 14% in FY05.
- The increased focus on pension products is a function of the encouraging demographic profile:
  - An independent survey indicates that majority of the 50-year+ age group has not undertaken any retirement planning. Population in this age bracket is estimated to increase from 11% in 2005 to 26% (i.e. 423m additional people) by 2050.
- According to the management, the average premium for pension products is relatively higher at Rs40,000.
- HDFC SL is entering the health pure-protection space to capitalize on the huge underlying potential in India.

❑ Among the lowest expense ratios in the industry…supported by growth

- HDFC SL has managed to pare its expense ratio to 20% in FY08 from 34% in FY05. However, due to significant investment in building up the distribution network, expense ratio was stagnant on yoy basis. The target is to reduce the expense ratio to 10% in the next two years, aided by a 50-60% CAGR in top-line over the same period.

A declining expense ratio on the back of higher volumes

March '08	FY06	FY08	2-year target
Operating expense ratio (%)	26	20	10

Source: Company

❑ Growth targets

- Despite the market being in a phase of consolidation, the management is confident of achieving 80% growth in APE in FY09 on the back of a focused selling approach and by leveraging the distribution network.
- The company plans to add around 100 branches to the network in FY09.

❑ Key trends witnessed during the market consolidation phase

- Growth has moderated during the recent market correction phase. The management feels that a focused selling approach and movement towards longer-term policy should help sustain the growth momentum.

❑ Moderate drop in persistency

- During FY08, persistency ratio marginally came down to 86% from 90% in FY07 as the company – under pressure from the sales force – introduced flexible premium pay products. The company, however, managed to arrest the decline by quickly withdrawing the product.

❑ Capital requirement could necessitate an IPO in the next 12-18 months

- The management specified capital requirement of about Rs4.5bn per annum for the next two years.
- The management hinted at coming out with an IPO in the next 12-18 months, subject to the IRDA formulating uniform disclosure norms by then.

ICICI-PRUDENTIAL LIFE

❑ Deepening penetration

- Over the last few years, ICICI-Pru has aggressively expanded its distribution network, supported by the Indian promoter's extensive reach. The faster pace of distribution penetration has been one of the key differentiators, enabling ICICI-Pru to sustain its leadership (share of 24.5% in the private space and 10.5% in the total market in FY08). Going forward, the company intends to adopt a calibrated approach in its branch expansion strategy. It will continue to expand to smaller towns to take advantage of the huge underlying potential and rising affluence.

Distribution network ramp-up…bolstered by high promoter penetration

Nos.	FY05	FY06	FY08
Locations	74	132	1669
Branches	107	177	1965
Advisors	57,000	72,000	290,000
Non-agency share (%)	30	37	39

Source: Company

❑ Channel mix unlikely to change

- Over 60% of the business is attributable to agency force, while the remainder is contributed by alternate channels. ICICI Bank is the largest banc assurance partner.
- Going forward, the management does not expect any material change in the distribution mix.

❑ Stable product portfolio

- **Predominantly ULIP:** The management maintained that the product portfolio is primarily ULIP-biased with single premium products (a relatively shorter tenure of 5-10 years) constituting 15% of the total book.
- **Reinsurance book to remain stable:** The management indicated that reinsurance is currently ~1% of the total premium, and is likely to remain so. The proportion of reinsurance varies with the risk of a product; health products, for instance, require higher reinsurance against pure protection products.

❑ Focus segments identified

- **Pension products:** With only 10% of the industry premium accruing from pension products, the management is bullish on the segment, more so in anticipation of the changing dynamics with PFRDA pushing the reform process by opening pension funds to private management. To capitalize on the potential opportunity, ICICI-Pru has introduced a few retirement plans like 'Jeetey Raho' and 'Plan Your Number with Us'. Pension policies currently account for 35-40% of the total premium.
- **Health products:** The management forecasts the current spend on healthcare to be abysmally low at ~2% of GDP, which would make the segment attractive. Health is a key focus area for the company and it has launched eight health products in the market. Currently, health contributes a meager 2% of the total premium but the share is expected to move up to double-digits in the next few years.

❑ NBAP margin controversy

- Prudential UK reported NBAP margins of 12% for the Indian operations as against 19% reported by the company – ICICI Prudential (I-PRU). The difference in margins has arisen on account of the following:

  A} Treatment of expense overruns

  - While calculating NBAP margins, companies build in a certain level of productivity improvement which is expected to be realized from the current expense outgo. The difference in NBAP has stemmed from this variation:
  - Prudential UK has been conservative in its assumption for productivity improvement, thereby using a higher expense ratio. This has led to a lower NBAP margin.

- o ICICI-PRU works on a long-term assumptions model, which provides sufficient room for productivity improvement as it is still in the investment phase. Hence, the expense ratio is comparatively lower and has led to a higher NBAP margin.

B} Permanent difference due to a varied set of economic assumptions

- o The management maintains its stance of 19% NBAP margins and believes that as the company moves closer to break-even, the margin stated by Prudential UK would converge towards the company's estimates.

❑ Estimated growth rates…sustained by capital infusion

- The management expects to report accounting profits in 2-3 years.
- The business is expected to grow 30-40% yoy over the next few years. At least US $600m-650m is proposed to be injected over the next 2-3 years to fund growth. The management's estimates factor in stable capital market conditions towards the second half of the current fiscal.

❑ Value unlocking – not likely in the near term

- With the holding company structure not finding favor with the RBI, ICICI-PRU was looking to unlock value via an IPO. However, the plans have been put on hold as the apex bank has recently provided relief to a parent company towards investment limit in subsidiaries (investment in banking subsidiary not to be considered for the 20% limit). The relief will allow the parent to continue funding the business requirement of the insurance company without compromising on growth.

ICICI LOMBARD

❑ Under-penetration, short-term underwriting contracts and technology to drive growth

- Post de-tariffing, ICICI Lombard had consciously moderated its growth targets considering the irrationality in pricing experienced in the market. The strategy has paid off as the company has managed to keep its economic combined ratio within 100% as against other private players, which were bleeding. The management stated that rationality is returning to pricing with increased rates in the marine and group health business.
- The management expects to grow the business by 25-30% in the next couple of years on the back of geographical penetration, increasing business through the web-platform and stable pricing.
- The management reiterated that the industry potential is immense in view of the low penetration (0.6% of GDP). Further, the retail opportunity is magnified as less than 2% of the US $30bn of health spend is through insurance. Also, only ~1% homes are currently insured and penetration levels are abysmally low in rural India.
- ICICI Lombard has achieved a market share of 30% among private insurers and an industry market share of 12%. The sophisticated technology platform, which enables the company to cross-sell products, is another growth trigger.

❑ Going retail…health and accident `key focus segments'

- Customer base has grown from 1.5bn in FY05 to 45bn in FY08, with a sea change in the Group : Retail business mix from 90:10 to 43: 57 (post de-tariffing).
- The management stated that backing of the country's largest consumer financing company (ICICI Bank) gives ICICI Lombard a head-start over competition.
- Going forward, health and accident are the two focus segments with special emphasis on the rural market.

❑ A differentiated distribution model

- Despite slower growth of 12% in FY08, investments in building scale continue unabated. The game plan is to penetrate the Tier-II and Tier-III cities and capture the first mover advantage. The company plans to expand the total branch network to 600 branches in the near term.

Building distribution muscle

	FY07	FY08	% of premium
Employees (direct)	4,800	5,600	41
Banc assurance	5	5	38
Intermediaries	8,200	11,200	21
Branches	220	340	

Source: Company

- As opposed to the industry norm of agency business contributing 75% of the premium, ICICI Lombard relies on its direct sales force (accounting for -41% of premium).
- The banc assurance channel, currently with five partners, contributes about 3x business vis-à-vis competitors, and currently accounts for 38% of the business as against 10% for the industry.
- The management shared that the low-ticket size in the health insurance segment makes it less cost-effective due to higher channel and administrative costs. Therefore, tele-sales and web-enabled platforms have been identified as key channels for servicing the health segment (70-75% of sales to this segment are now through these channels).

❑ Robust technology back-bone

- Over the years, ICICI Lombard has invested heavily in building a strong technological base.
- Given the low-ticket size of policies, especially in the travel and two-wheeler segments, policy issuance cost needs to be much lower in comparison to other countries. The company has developed strong technology solutions, which has brought down the policy issuance cost to about USD 1 per policy.

❑ New business model

- To keep a check on the claim ratio in the motor segment, ICICI Lombard has around 400 motor engineers (handling ~90% of the claims) on its rolls.
- The company is replicating a similar model for health, wherein it is in the process of setting up its own third party administrator (TPA).

❑ Monitoring the risk profile…alliances with the best

- The changed business mix in favour of retail has de-risked the portfolio against clustered revenues from corporate business.
- Deregulation has enabled closer monitoring of bad risk probability and mis-pricing.
- In addition, alliances with the best in the industry have been forged to manage claims and losses across products.
- The management stated that the combined ratio is currently at ~99%, and is targeted to be brought down to the level of 95%.

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Explanation of Ratings:

1. Outperformer: More than 10% to Index
2. Neutral: Within 0-10% to Index
3. Underperformer: Less than 10% to Index

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