India: Financial Services

Life insurance: Negative implications from cap on pricing; prefer SBI

Negative implications from regulatory changes

The Insurance Regulatory and Development Authority (IRDA) has proposed a **cap on fees chargeable** by life insurers from policyholders through a directive released on July 22 for all new contracts. We believe the proposed changes will likely have negative implications for life insurers' business. Judging from the performance of ICICIB, HDFC and SBI stocks since the above change, we believe they do not yet reflect the negative implications from the regulatory changes.

Downside likely to sales and new NBM

In our view, the negative implications for the valuation of life insurers issue from 2 sources: 1) negative impact on EV arising from re-pricing in-force policies, and 2) adverse impact on new business sales in the medium term. We think life insurers will try to minimize the adverse impact on NBM through cost rationalization and change in product mix. However, visibility on such moves remains limited for now.

Valuation impairment risk significant

We estimate that the proposed regulatory changes could lead to a 25%-38% fall in life insurers' valuations. We see further downside to of 6%-13% should NBM contract more severely. The implications for ICICIB, HDFC and SBI are threefold: 1) SOTP valuation of these companies could fall by 2%-9%. 2) The upside the market may expect from improved growth outlook over the medium term and or from higher NBV multiple would not likely be realized. 3) Incentive to unlock value of the business stands reduced for now.

Prefer SBI over HDFC and ICICIB

We prefer SBI given the high leverage of its banking business to favorable changes in the environment but lower sensitivity to changes in valuation of life insurance business. We fine-tune our 12-m TPs down 2%-4% for SBI, HDFC and ICICIB to reflect likely impact to valuation from the new pricing norm. We retain a negative bias until visibility on growth and margin outlook improves. We believe the new pricing norm will dampen market expectations in the medium term.

SUMMARY OF RATINGS AND TARGET PRICES

Reuters Ticker	Rating	Price (Rs) 5-Aug-09	12-month TP (Rs)	Total return potential (%)
SBI.BO	Buy*	1,845	2,230	21.9
HDFC.BO	Neutral	2,469	2,370	(2.7)
ICBK.BO	Neutral	773	700	(8.2)

Note: *This stock is on our regional Conviction list
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SUMMARY OFTARGET PRICE CHANGES

Reuters	12-month TP (Rs)		
Ticker	Old	New	Change
SBI.BO	2,280	2,230	-2.2%
HDFC.BO	2,460	2,370	-3.7%
ICBK.BO	730	700	-4.1%

VALUATION SUMMARY

Reuters	P/E (x)		P/B (x)	
Ticker	2009E	2010E	2009E	2010E
SBI.BO	10.8	7.5	1.45	1.25
HDFC.BO	25.9	21.0	4.70	4.20
ICBK.BO	23.1	17.3	1.65	1.55

Note: 2009E for Indian banks refers to FY2010.
Source: Datastream, Goldman Sachs Research estimates

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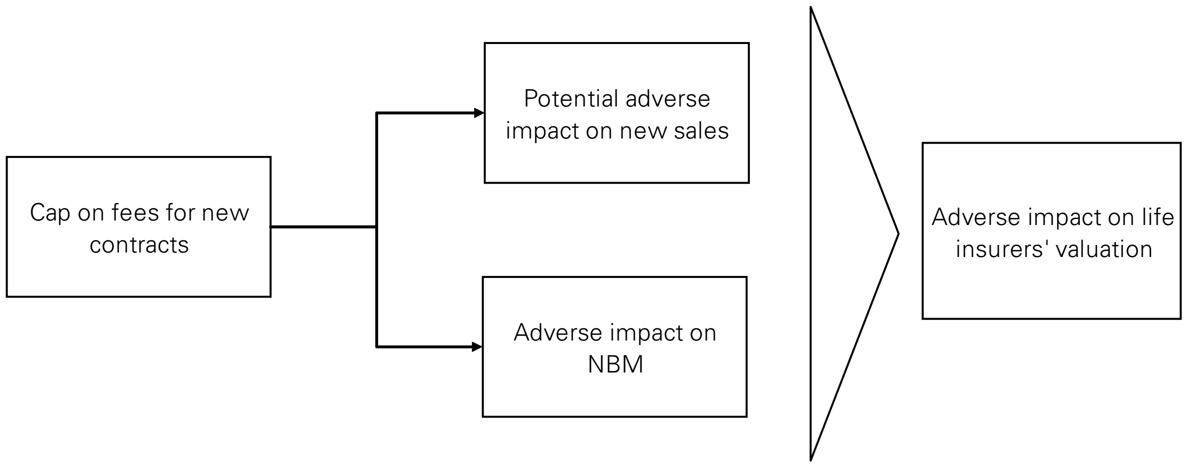
Negative implications for life insurers from cap on fees

Adverse impact to growth and margins likely in the medium term

Insurance Regulatory and Development Authority (IRDA) imposed a cap on fees recoverable by life insurers from policy holders through a directive issued on July 22. This will be applicable to all new contracts effective from October 31, 2009. Previously, there was no such regulation/cap on fees recovered by the insurers. The new regulation is likely to have wide ramifications on profitability of the life insurance business, capital allocation, efficiency and medium-term growth prospects. Potentially, this could alter the industry structure depending on the efficiency and capital strength of the players.

Exhibit 1: We believe there are negative implications to the valuations of life insurers arising from the regulatory change
Factors affecting the profitability and valuation of life insurers



Source: Goldman Sachs Research estimates.

We believe there are two potential sources of negative implications for life insurers from the above changes:

1. **Adverse impact on NBM**—Life insurers might have to cut fees by up to 25% in order to comply with the new regulation. While we expect life insurance companies to rationalize costs including distribution expenses, it appears that the negative impact arising from the new regulation would likely be borne by the originator as well as the distributor. New business margin (NBM) is likely to decline under this scenario.

2. **Adverse impact on new sales**—Given the likely changes to product structure and incentives for distributors, we foresee disruption in the near to medium term on new premium income. The distribution channels will need to be motivated to deliver higher productivity for the same pool of distribution fees; originators would need to submit their products for regulatory scrutiny and approval. All of the above would likely lead to disruption to new sales, in our view.

Risk of negative impact to stock valuations significant

Significant erosion in NBM, a muted outlook for growth over the medium term and lower multiple for NBV could lead to significant downside to the current valuations of the life insurers, although sensitivity to these factors for the parent could be less severe (see Exhibit 2). The severity would also vary depending on the range of value attributed by the market to various players.

Exhibit 2: Downside risk to valuation could be significant for the life insurers under the new pricing norm, even after accounting for improvement in operating efficiency

Sensitivity of valuation to growth, NBM and NBV multiples

	ICICI Prudential Life	HDFC Standard Life	SBI Life
Valuation of business (Rs bn) - before the new pricing norm	264	187	114
Value per share of the parent company (Rs)	174	520	180
Assumed NBM	18%	25%	20%
Assumed 2010E NBV (X)	15	15	15
Valuation of business (Rs bn) - base case scenario under new pricing norm			
Assumed NBM under the new scenario	16%	21%	17%
@ 12X 2010E NBV	155	107	115
Value per share	111	320	135
Decline in value attributable to the change in pricing norm	**36%**	**38%**	**25%**
Value per share assuming further decline in NBM	99	290	112
Potential downside risk from further NBM decline	**7%**	**6%**	**13%**
Potential impact to our SOTP valuation of the parent (base case scenario)	**ICICIB**	**HDFC**	**SBI**
Current SOTP valuation	730	2460	2280
Potential downside risk based on worst case scenario	**9%**	**8%**	**2%**

Source: Goldman Sachs Research estimates.

We see three implications for the holding companies arising from downside risk to valuation of life insurers:

- Adverse impact on SOTP valuation— we estimate 2%-9% downside risk to our SOTP valuation. In reality, the adverse impact on valuation will depend on the range attributed by the market to various players. The impact could be greater if the market were to attribute much higher relative values to the companies' life insurance businesses.
- Upside to valuation from improved growth outlook over the medium term and/or from higher NBV multiple would likely be capped.
- Prospects of unlocking value through an offer for sale is likely to diminish in the near to medium term, as we believe the Government of India is likely to raise foreign ownership in insurance through legislative changes as proposed earlier this year. Without the change in pricing norm, holding companies could have unlocked the value of their investments by simply listing the insurance venture.

In our base-case scenario, we have assumed that life insurance companies would likely minimize the adverse impact arising from the pricing cap by cutting costs and improving operating efficiency. However, there could be further downside to our base-case scenario—we estimate 6%-13% for our coverage universe—if such efforts fall short.

Prefer SBI over ICICIB and HDFC

We reiterate our preference for SBI, as we believe it is more leveraged to the improving operating environment for the banking business and at the same time less sensitive to adverse changes in the valuation of its life insurance business. We reiterate our Buy rating (on Conviction list), but decrease our SOTP-based 12-month target price to Rs2,230 (from Rs2,280) for three reasons. 1) at the macro level, we believe SBI will be a key beneficiary of the economy if it gets back on track with 8% growth over the medium term—we estimate 33% CAGR in earnings for SBI during 2009E-2011E. 2) At a bank-specific level, we see SBI as a long-term player with a sustainable advantage due to its strengthening competitive position, given its solid and stable deposit franchise, higher and rising productivity compared with its peer group of state-owned banks with prospects of further improvement through potential mergers with its subsidiary banks in the long term. 3) Likely positive valuation change relative to peers, reflecting potential cyclical upside to earnings and strengthening competitive position in the long term.

Lower HDFC and ICICIB target prices by 4%; maintain Neutral rating on both

ICICB and HDFC have outperformed the broad market indices since March 2009 lows, suggesting to us that current market expectations are building in robust growth prospects for their core business as well as benefits from favorable changes in the regulatory framework on foreign ownership. However, we believe expectations will likely be dampened arising from the negative implications of the regulatory changes and valuations that are at or above their historical median P/Bs.

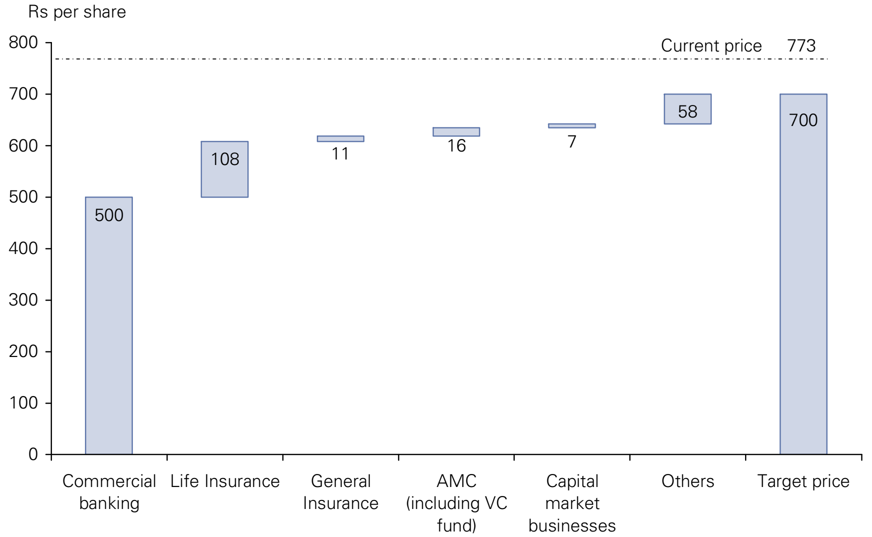
As such, we fine-tune our SOTP-based 12-month target prices for HDFC and ICICIB down by 4% as a result of the above changes. The reductions in our target prices for HDFC and ICICIB are muted compared to the potential downside risk shown in Exhibit 2 for the following reasons:

- For HDFC, while we have cut the value attributable to life insurance business in our SOTP analysis by 6%, we have simultaneously raised the value attributable to its investment in banking, with a likely increase in its interest from 19% to over 23% by December 2009. Reflecting these changes, our 12-month target price decreases to Rs2,370 from Rs2,460.
- For ICICIB, we lowered our 12-month price target to Rs730 after 1Q09 results to reflect a weaker growth outlook for its life insurance business. We are now cutting our target price further to Rs700 to reflect the downside risk to NBM as a result of the new pricing norm.

Risks

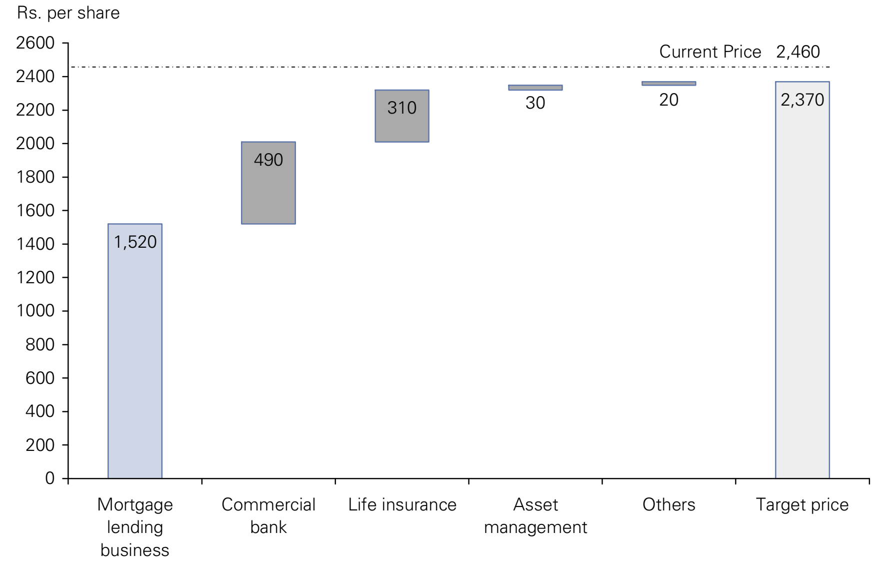
- **SBI:** Key risks to our target price and investment view include 1) increase in interest rates and 2) deterioration in SBI's asset quality outlook.
- **ICICIB:** Downside risks include further deterioration in asset quality, execution risk in consumer banking. Upside risk: Higher FDI ceiling for life insurance.
- **HDFC:** Downside risks: Significant deterioration in the outlook for mortgage business and asset quality of loan exposure to property developers. Upside risk: Higher FDI ceiling for life insurance.

Exhibit 3: SOTP valuation of ICICIB



Source: Goldman Sachs Research estimates.

Exhibit 4: SOTP valuation of HDFC



Source: Goldman Sachs Research estimates.

More pain to the growth outlook likely over the medium term

Exhibit 5: The new regulation from IRDA seeks to impose cap on fees recoverable from policyholders
New pricing norm to be implemented effective October 31, 2009

Tenor of contract	Existing cap	New regulation
Less than or equal to 10 years	None	Fees capped at 300 bp being the difference between gross and net yield on
		policies and applicable for all new
		Fund management fees capped at 150 bp within the
		overall ceiling of 300 bp prescribed above.
Greater than 10 years	None	Fees capped at 300 bp being the difference between gross and net yield on
		policies and applicable for all new
		Fund management fees capped at 125 bp within the
		overall ceiling of 225 bp prescribed above.

Note: IRDA has not clearly specified whether fees recoverable from policy holders will be inclusive of mortality charges. We have assumed that mortality charges will be excluded based on our discussion with the companies.

Source: IRDA.

As a result of the new regulation, insurers may have to cut fees recoverable significantly

Our analysis of the charge structure of various products suggests that insurers may need to cut fees recoverable from policy holders by up to 25% (refer Exhibit 6–8 for details). We have chosen products at random from different players and hence may not be representative of the average fees earned by the companies. However, our analysis indicates that potential downside to fees could be as high as 25%, if not beyond that.

Exhibit 6: Fees earned by the life insurers could be up to 4% for a 10-year contract
Analysis of fee earned on a product by insurer A

1. Premium allocation to units: 83% and 91% in year 1 and year 2 respectively. 99% from year 3 onwards.
2. Administration charges Rs 40/m and fund management charges @ 1.5%.
3. Assumed return is 10%. IRR for the policyholders is 6% based on the charge structure.
4. **Fees charged by the insurer (difference between assumed return and IRR) is 3.5%.**

Year	Premium payable	Allocation charge	Unit allocation	Admin charge	Net funds allocated	Returns 10%	NAV	FM charge 1.50%	Funds end bal
1	30,000	17%	24,900	480	24,420	1,221	25,641	385	25,256
2	30,000	9%	27,300	480	26,820	3,867	55,943	839	55,104
3	30,000	1%	29,700	480	29,220	6,971	91,295	1,369	89,926
4	30,000	1%	29,700	480	29,220	10,454	129,599	1,944	127,655
5	30,000	1%	29,700	480	29,220	14,227	171,102	2,567	168,535
6	30,000	1%	29,700	480	29,220	18,315	216,070	3,241	212,829
7	30,000	1%	29,700	480	29,220	22,744	264,793	3,972	260,821
8	30,000	1%	29,700	480	29,220	27,543	317,584	4,764	312,820
9	30,000	1%	29,700	480	29,220	32,743	374,783	5,622	369,162
10	30,000	1%	29,700	480	29,220	38,377	436,759	6,551	430,207

Source: Company data, Goldman Sachs Research estimates.

Exhibit 7: Analysis of fees earned on a product by insurer B

1. Premium allocation to units: 60% and 85% in year 1 and year 2 respectively. 98% from year 3 onwards.
2. Administration charges Rs 60/m and fund management charges @ 1.25%.
3. Assumed return is 10%. IRR for the policyholders is 5% based on the charge structure.
4. **Fees charged by the insurer (difference between assumed return and IRR) is 4.6%.**

Year	Premium payable	Allocation charge	Unit allocation	Admin charge	Net funds allocated	Returns 10%	NAV	FM charge 1.25%	Funds end bal
1	30,000	40%	18,000	720	17,280	864	18,144	227	17,917
2	30,000	15%	25,500	720	24,780	3,031	45,728	686	45,042
3	30,000	2%	29,400	720	28,680	5,938	79,660	1,195	78,465
4	30,000	2%	29,400	720	28,680	9,281	116,426	1,746	114,679
5	30,000	2%	29,400	720	28,680	12,902	156,261	2,344	153,917
6	30,000	2%	29,400	720	28,680	16,826	199,423	2,991	196,432
7	30,000	2%	29,400	720	28,680	21,077	246,189	3,693	242,496
8	30,000	2%	29,400	720	28,680	25,684	296,860	4,453	292,407
9	30,000	2%	29,400	720	28,680	30,675	351,762	5,276	346,485
10	30,000	2%	29,400	720	28,680	36,083	411,248	6,169	405,079

Source: Company data, Goldman Sachs Research estimates.

Exhibit 8: Analysis of fee earned on a product by insurer C

1. Premium allocation to units: 83% in year 1, 95% for year 2 & 3, 96% for year 4 & 5. 98% from year 6 onwards.
2. Administration charges Rs 50/m with annual increase of 5% on the same; fund management charges @ 1.75%.
3. Assumed return is 10%. IRR for the policyholders is 6% based on the charge structure.
4. **Fees charged by the insurer (difference between assumed return and IRR) is 3.9%.**

Year	Premium payable	Allocation charge	Unit allocation	Admin charge	Net funds allocated	Returns 10%	NAV	FM charge 1.75%	Funds end bal
1	30,000	17%	24,900	600	24,300	1,215	25,515	447	25,068
2	30,000	5%	28,500	630	27,870	3,900	56,839	853	55,986
3	30,000	5%	28,500	662	27,839	6,991	90,815	1,362	89,453
4	30,000	4%	28,800	695	28,105	10,351	127,909	1,919	125,990
5	30,000	4%	28,800	729	28,071	14,003	168,064	2,521	165,543
6	30,000	2%	29,400	766	28,634	17,986	212,163	3,182	208,981
7	30,000	2%	29,400	804	28,596	22,328	259,904	3,899	256,006
8	30,000	2%	29,400	844	28,556	27,028	311,590	4,674	306,916
9	30,000	2%	29,400	886	28,514	32,117	367,547	5,513	362,034
10	30,000	2%	29,400	931	28,469	37,627	428,130	6,422	421,708

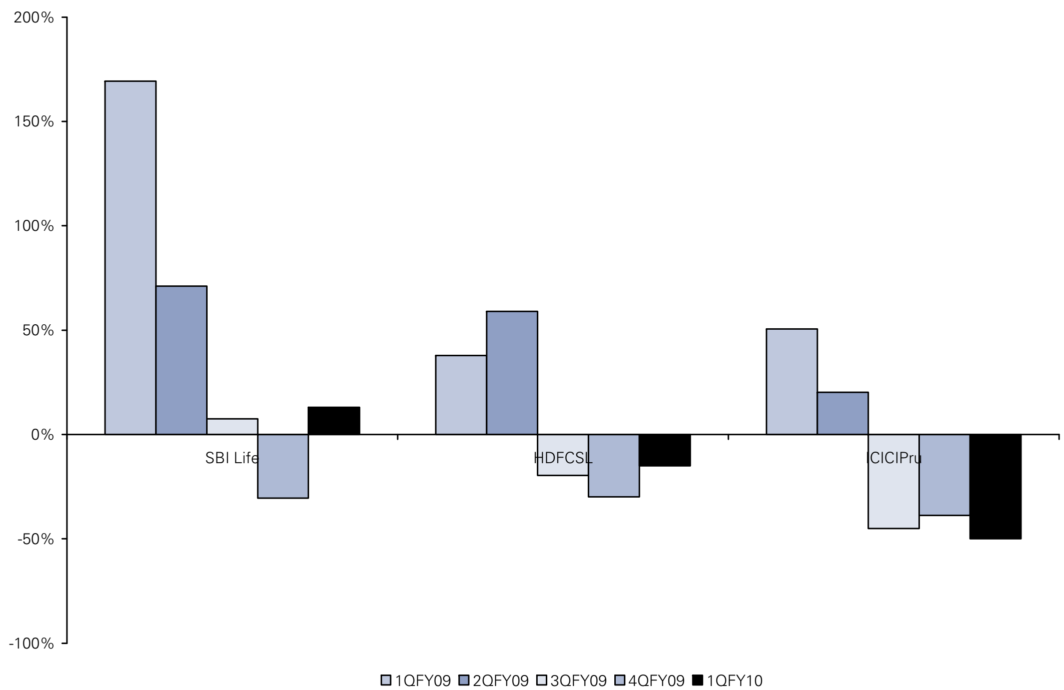
Source: Company data, Goldman Sachs Research estimates.

As we see it, life insurers could respond in three ways:

- Option 1: Absorb the potential adverse impact on NBM without cutting distribution expenses but rationalize administration cost gradually. This would likely result in significant drag on NBM and ROE in the medium term and could constrain the ability of the company to invest for future growth.
- Option 2: Cut overall costs aggressively—this could help protect NBM in large measure.
- Option 3: Life insurers could share the burden through lower NBM, while cutting/rationalizing distribution expenses at the same time.

We believe life insurers are likely to face a significant challenge in cutting distribution costs and motivating the distribution channels to raise productivity for the same pool of incentives that they have been paid in the past. This could appear daunting, particularly in the face of growth challenges that companies faced over the last 2-3 quarters.

Exhibit 9: Most insurers have seen de-growth in their new business premiums, mainly due to reliance on investment-linked products; the outlook for these products have remained challenged by weak capital market conditions over the past 2-3 quarters
Growth in new business premiums, group and individual segments included



Source: Company data, IRDA.

Of the many approaches that companies could choose, we think that option 2 would likely be very disruptive to the companies' growth outlook. Option 1 would likely be least disruptive; however, it could result in significant expense overruns resulting in deterioration in long-term profitability of the company. In our view, the market is unlikely to reward such an approach, even if it were employed for a limited period of time by a company.

We believe many companies are likely to choose option 3 over others, i.e., cut distribution-related expenses and at the same time absorb some of the pricing pressures through lower NBM in the near to medium term. Companies could seek higher efficiency from their infrastructure and improve NBM over the long term through this approach, in our view. This approach may not prevent the potential downside to growth in the near term but nevertheless we think it would be less disruptive for growth as well as profitability over the medium term.

Finally, we believe the regulatory action could bring about change to the industry landscape over the long term. Currently, the industry has many players with the top six players (including the state-owned enterprise, Life Insurance Corporation (LIC)) accounting for 80%-85% of the new business premium underwritten market share according to IRDA. There are a number of players that lack economies of scale in their operations. The new regulation could spark consolidation, as smaller players would likely seek consolidation as a way to gain economies of scale. Larger players may be incentivized to consider the consolidation prospects, assuming scope for merger synergies through cost rationalization.

Reg AC

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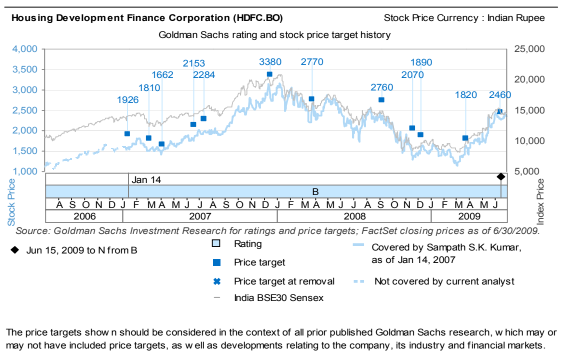
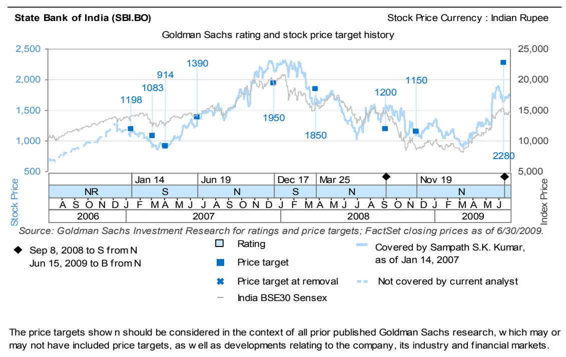
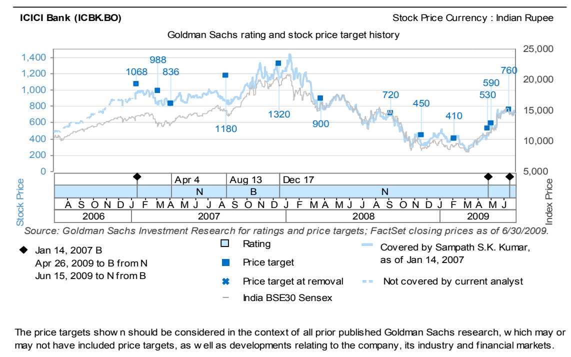
Price target and rating history chart(s)







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