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BRIDGING THE GAP

PERSPECTIVES ON THE INDIAN LIFE INSURANCE SECTOR

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23rd December, 2019

Executive Summary

A compelling play on market gaps

In India, life insurance is perceived more as a savings product and people park their financial savings in it with an eye on earning a bonus (returns) on their investment. Over the years, this perception along with a lack of awareness regarding protecting ones cash flows in case of unfavourable events has led to a significant gap in terms of insured and insurable risks. Referred to as 'Protection Gap', the quantum of this parameter places India at the highest spot among regional peers. This, along with under-penetration of pension and health insurance, offers a huge opportunity landscape to Indian life insurance players.

Insurers are capitalising on the opportunity size

In this report, we analyse India's life insurance sector, delving deeper into the performance of the top two listed life insurers in terms of market capitalisation—HDFC Life and SBI Life.

Our analysis suggests that the two companies are adequately equipped to capitalise on this huge opportunity, underpinned by product innovation, scaling up of distribution channels and sharpened focus on customer service & harnessing technology. Strategies of these companies have evolved over the last few years as they continue to grow using their unique strengths. While on one hand HDFC Life is capturing market share through a diversified product and distribution mix, on the other, SBI Life is leveraging its expansive distribution channel to sell higher-margin products and maintain efficiency.

Leading insurers are playing to their strengths

A long growth runway for well managed insurance companies and an evolving product mix have triggered a surge in stock prices of these players post listing. While valuations appear rich for some, it is largely due to the growth potential or quality premium associated with the superior business models and competitive advantages of these companies. To summarise, we expect the industry and leading players to enjoy a good run going forward, led by the tailwinds we highlight in this report.

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Industry Overview

Roller Coaster Ride Over Past Two Decades Now Culminating Into Solid Growth

India's life insurance industry has clocked solid growth over the past few years and is poised to grow at a higher clip going forward. Over FY12-19, new business premium posted 8% CAGR, almost doubling premiums to INR ~2 lakh cr in FY18 and is estimated to grow by another ~40% over FY20-22 (12% p.a.) to ~INR 3 lakh cr as per industry reports. In terms of total premium, the jump is expected to be higher at 16% CAGR over FY20-22E to INR 8 lakh cr compared to ~INR 5 lakh cr in FY19 (Refer charts 1 and 2). A large part of this growth from private players, who have come off age since their existence in early 2000. Charts 3 and 4 show the contribution of industry premiums from LIC and private players.

Life Insurance Corporation (LIC) was the sole player in the industry during 1956-2000. Privatisation of the sector saw entry of ten players in FY00-01, with HDFC Life (HDFCL), ICICI Prudential (IPRU) and Max Life (MAX) being the first to register. SBI Life (SBIL) and Bajaj Allianz Life (BALIC) entered in FY02. Though LIC continues to be the leading player currently, it is losing share to private insurers in the individual business.

It has not been a smooth sailing for the industry as its journey was characterised by shifts in product propositions, regulatory changes and evolution of distribution channels.

Chart 1: Life Insurance Total Premium expectations (INR bn)

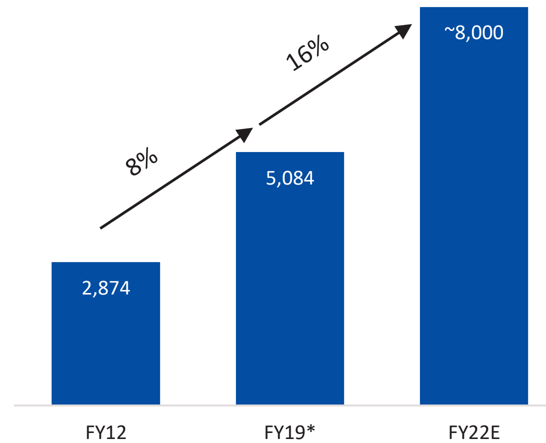


Chart 2: Life Insurance NBP expectations (INR bn)

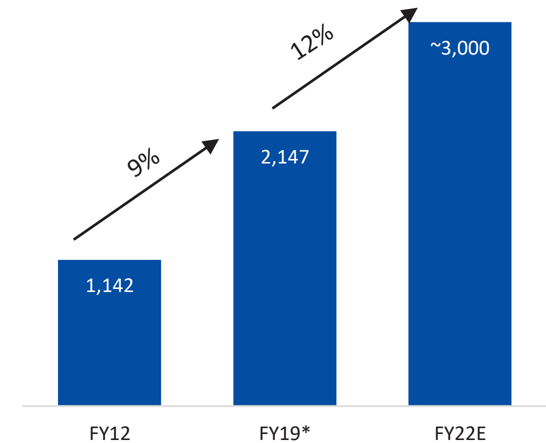


Chart 3: Total Premium of Life Insurers (INR bn)

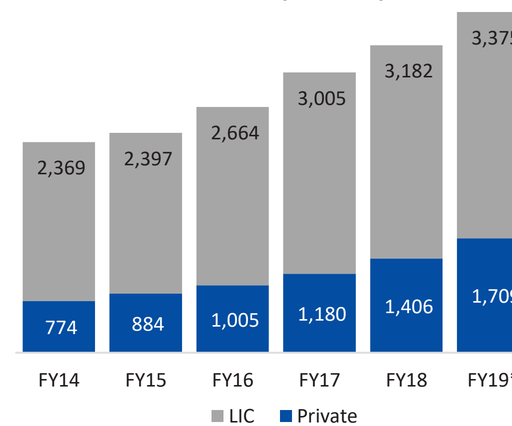
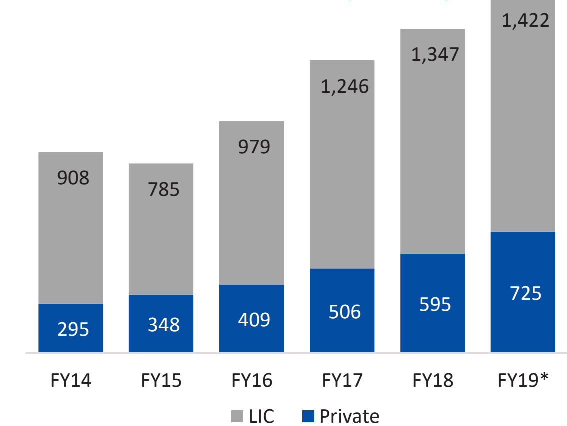


Chart 4: New Business Premium of Life Insurers (INR bn)



Source: IRDAI, Life Insurance Council, CRISIL, IPO Prospectuses, Edelweiss Professional Investor Research

Roller Coaster Ride Over Past Two Decades Now Culminating Into Solid Growth

Phase I (FY01–10): The first phase, starting with privatisation of the sector, which coincided with positive capital market performance, was marked by strong growth of private players, spearheaded by spurt in linked products. Private players gained market share and ULIPs (more profitable because of their structure) constituted a sizeable proportion of their product portfolios. Growth in total premium posted 32% CAGR over FY04-08 as insurers aggressively marketed their products.

Phase II (FY11–14): However, regulatory reforms in ULIPs in FY11 and further changes in traditional products (refer to Appendix A) led to a resetting of business models of private insurers. Growth remained low during this phase as the cap on commissions and surrender norms for ULIPs made them unviable in the prevalent form. With fall in sales of ULIPs post the new regulations, insurers focused on bringing stability to business models through reorientation of their product mix and distribution channels. Lower premium volumes also saw insurance penetrations to come down during this period. This phase also coincided with weak economic growth and underperformance of the stock market amidst aftermath of the global financial crisis and Euro crisis, which dented demand for savings products. We have shown the premium development over the three phases in Charts 5 and 6.

Chart 5: New business premiums for industry and private insurers (INR bn)

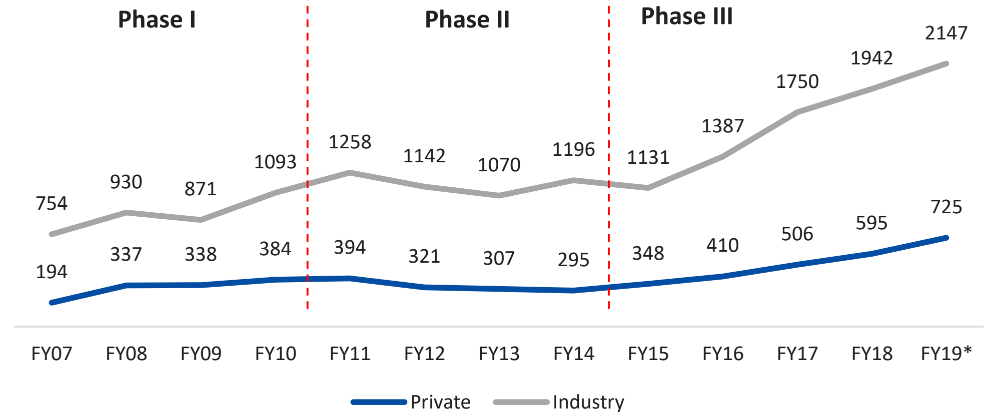
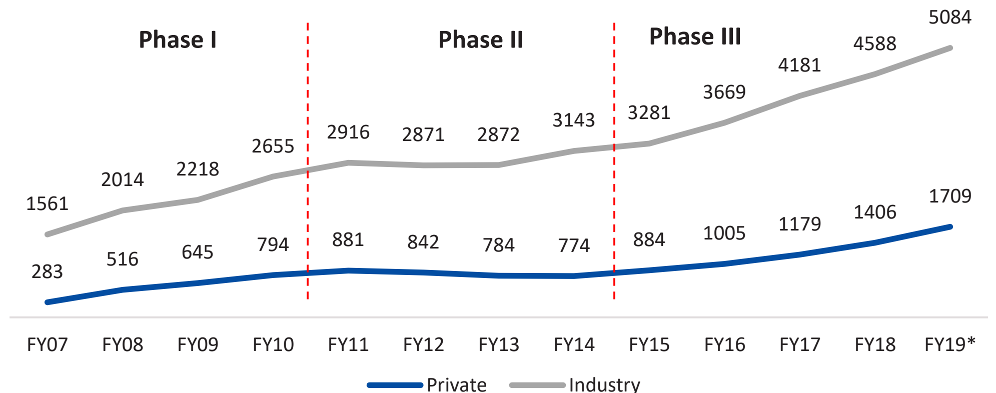


Chart 6: Total premium for industry and private insurers (INR bn)



Source: IRDAI, Life Insurance Council, CRISIL, IPO Prospectuses, Edelweiss Professional Investor Research

Roller Coaster Ride Over Past Two Decades Now Culminating Into Solid Growth

Hence, Phase II saw single-digit growth in total premium (from INR 2.9 lakh cr to INR 3.1 lakh cr), while new business premium contracted (from INR 1.3 lakh cr to INR 1.1 lakh cr). The contraction was starker among private players, with 3% fall in total and new business premiums. Share of linked products plummeted to 45% for the private industry from and 12% for the overall industry. Consequently, growth in average premium per policy in retail business remained muted during this period with LIC regaining market share (refer to chart 7; refer to Appendix A for a summary of life insurance regulations).

Phase III (FY15 onwards): FY15 marked the start of phase III during which private life insurers started regaining growth. They shifted focus to: a) traditional savings products; b) innovative protection offerings; c) sale of new ULIP products via low-cost channel like bancassurance; d) cost control; and e) off late on protection products.

These initiatives have so far resulted in growth coupled with improvement in profitability and private players have managed to gain traction in ULIP in its new form as well as traditional policies. Moreover, revamp of FDI norms and investments by private equity players in the industry have bolstered the outlook for the industry.

Chart 7: Average Premium for Private Players and Industry for Individual Business (in INR)

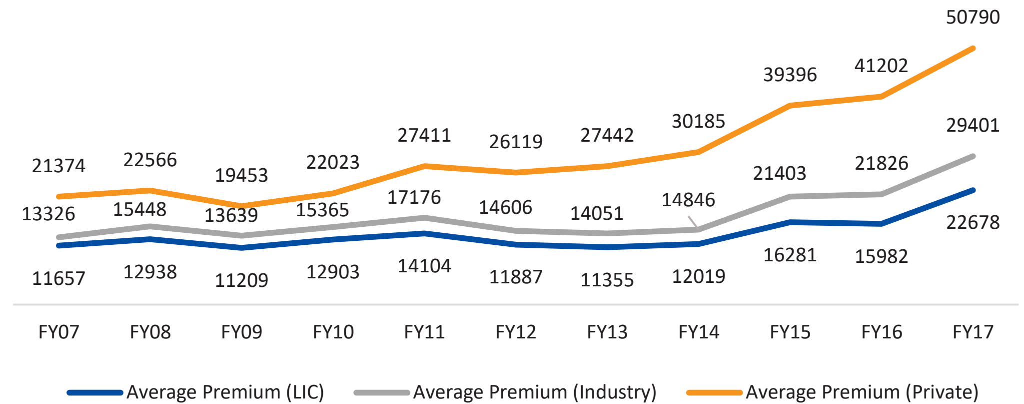
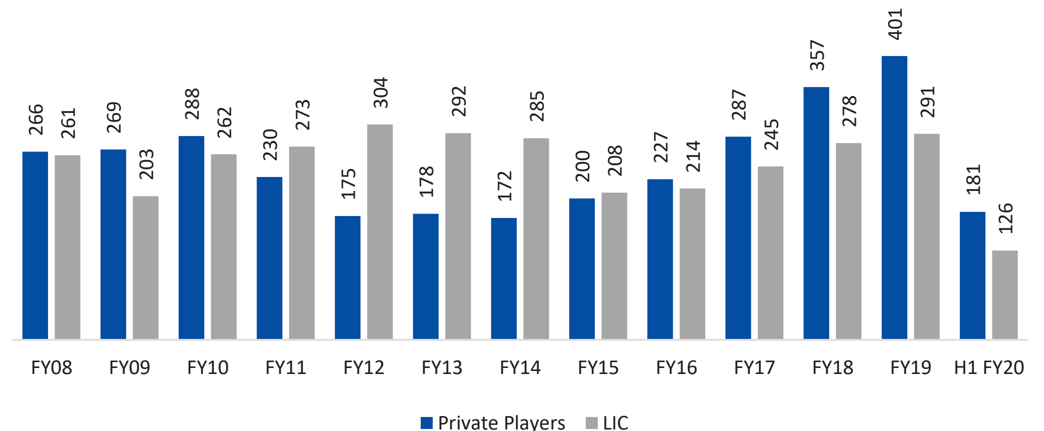


Chart 8: Market Share of LIC and private insurers on the basis of Individual WRP (in INR bn)



Source: IRDAI, LI Council, Company, Edelweiss Professional Investor Research

Under-penetration, Mortality Gap And Retail Credit Growth Entail Structural Opportunity

Under-penetration of insurance in India provides headroom for growth for insurers operating in this space. Insurance penetration in India, defined as premiums as a percentage of GDP, was 2.8% in FY18. Penetration levels normalised from a high of 4.6% in FY10 during the phase II of growth (refer Chart 9), owing to multiple factors impacting sales like changes in product regulations, downturn in capital markets, etc, as we have highlighted in the previous section.

In comparison, Asian economies like Taiwan, Hong Kong and South Korea had insurance penetration of 17.5%, 16.8% and 6.2%, respectively, in FY18. Even emerging economies like Thailand and Malaysia recorded penetration levels of 3.5% and 3.3%, respectively, in FY18, as we show in Chart 10. The global average in FY18 stood at 3.3% with average penetration in advanced Asia-Pacific economies at 6.8%. While the current penetration levels are not dramatically lower than those in a few of India's regional peers, we perceive significant scope for growth if insurance products gain popularity (similar to FY11) compared to other investment products like mutual funds/ELSS (which would be a tailwind for linked and traditional savings products) and awareness related to risk coverage improves among customers (an enablers for growth of protection products).

Chart 9: India Life Insurance penetration (in %)

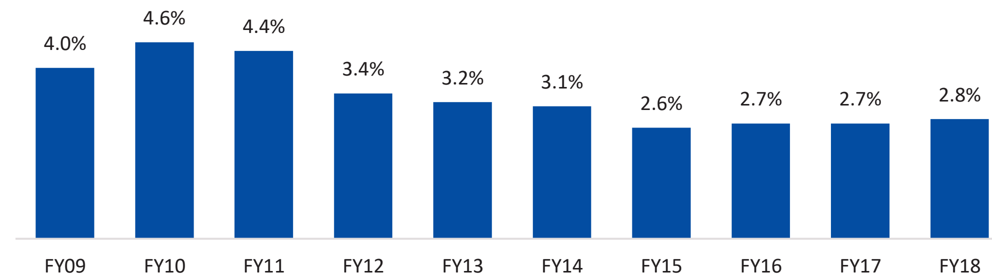


Chart 10: Life Insurance penetration of Asian countries (2018)

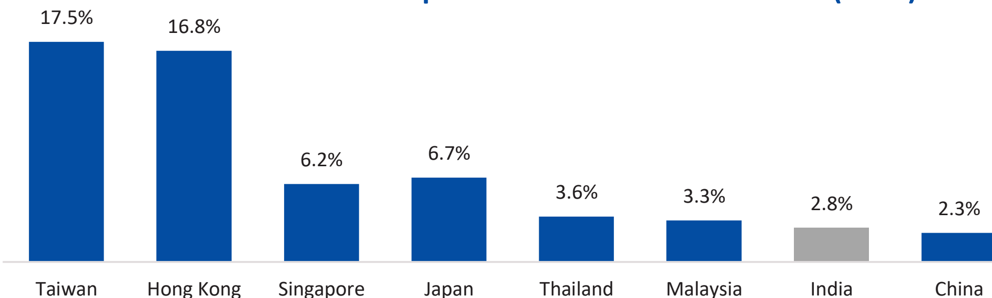
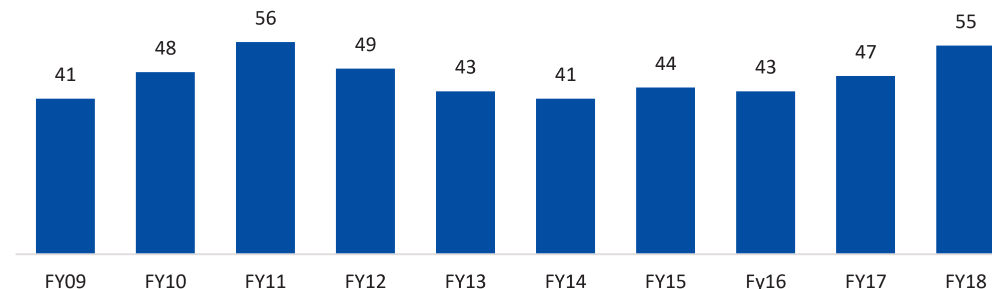


Chart 11: India Life Insurance Density (in USD)



Source: Swiss Re Sigma, Edelweiss Professional Investor Research

Under-penetration, Mortality Gap And Retail Credit Growth Entail Structural Opportunity

India scores low in terms of insurance density, which is the absolute value of premium paid per capita. Compared to global average of USD 370 and average for Emerging Asia-Pacific of USD 115, India's insurance density is at a paltry USD 55. Insurance density has, however, picked up since FY14. On this front also we perceive strong possibility of improvement as premium volumes surge at the industry level and ticket size improves in the sector with rise in awareness related to the mortality protection gap among individuals. Charts 11 and 12 show India's trends in insurance density and comparison with Asian peers respectively.

Given that a large proportion of products sold in India are savings oriented, (share of term products in Industry APE is at ~2% as shown in Chart 13), sales of pure-protection products gaining traction in recent times enhances the scope. Indian customers have traditionally perceived life insurance products as an alternative investment product as opposed to products for risk coverage owing to popularity of LIC's savings-oriented product mix prior to privatisation. We see the shift in customer appetite from traditional savings towards ULIP and term products as shown in Chart 13. Rising per capital GDP is also expected to be a driving factor of growth for the life insurance industry due to a strong correlation (refer to chart 14).

Chart 12: Life Insurance Density of Asian countries in 2018 (in USD)

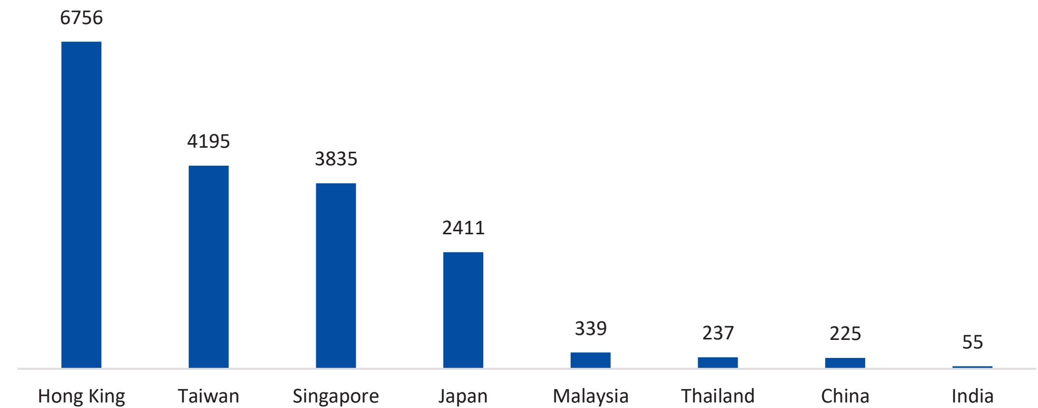


Chart 13: Share of term products very low but improving in new business mix

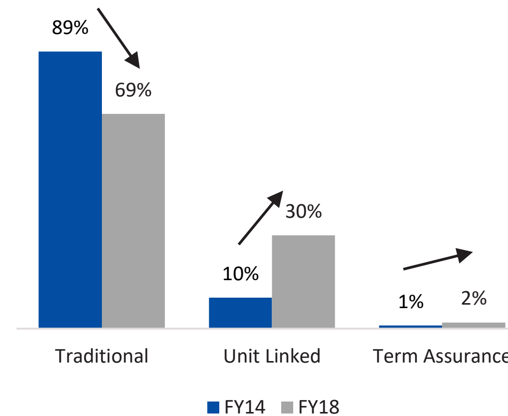
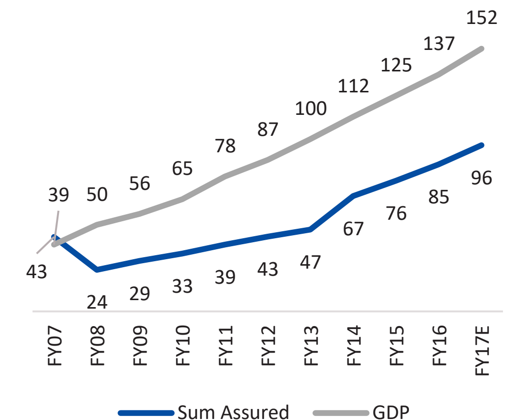


Chart 14: Correlation Between Sum Assured and India's GDP is high (in INR trn)



Source: Swiss Re Sigma, IRDAI, IIB, Edelweiss Professional Investor Research

Under-penetration, Mortality Gap And Retail Credit Growth Entail Structural Opportunity

India ranks the highest among Asian countries in terms of mortality protection gap at 92% in 2014, as per a study by Swiss Re. This implies that of USD 100 risks to be insured, only USD 8 is insured as at 2014, which indicates a staggering inadequacy in terms of a pure protection cover through products like term insurance.

This is significantly higher than other Asian countries where it has been mostly in the 70-80% range (refer to chart 15). This implies significant opportunity for protection products (term life insurance) which was at USD 8.5 tn in 2014, second only to China in absolute terms. While insurance penetration is not dramatically low primarily because a large share of life insurance premium in India is for savings products, it hardly addresses the protection gap.

Mortality protection gap per working person has continuously increased—clocked 10% CAGR to USD 35,181 per working person with dependents over FY00-14, with sum assured at around USD 2,100 per working person with dependents in FY14. We believe this gap has widened over the past five years and the addressable opportunity has catapulted for life insurers since then. Insurers have already started addressing this gap by focusing on sales of protection-oriented products in individual, group and lending products.

Chart 15: Mortality Protection Gap (2014)

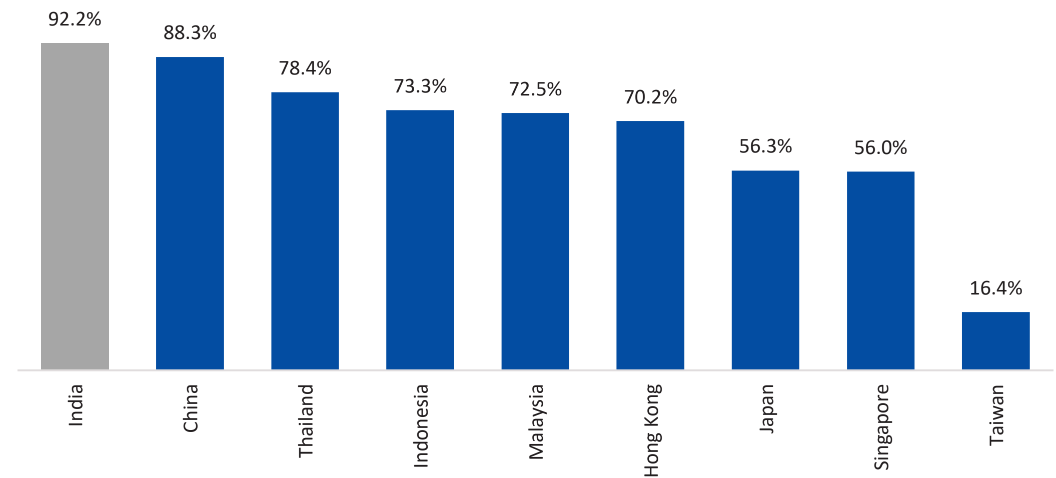
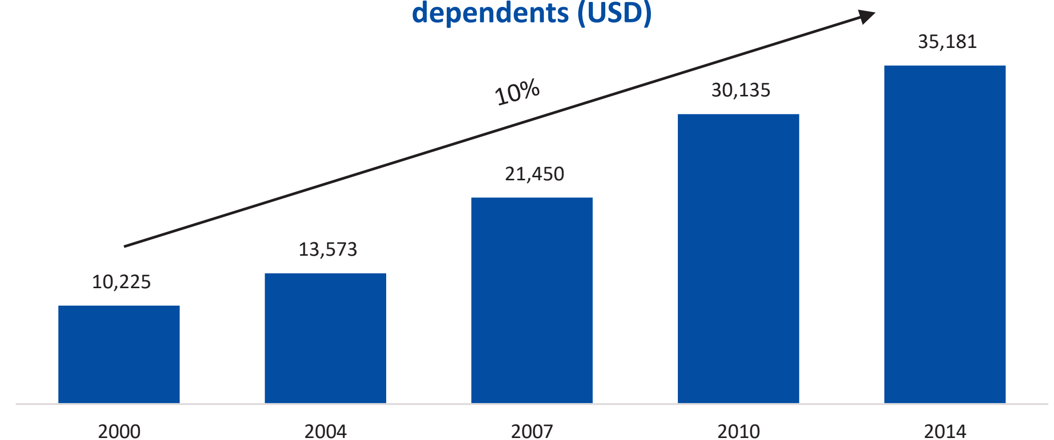


Chart 16: Mortality protection gap per working person with dependents (USD)



Source: Swiss Re Sigma, Edelweiss Professional Investor Research

Under-penetration, Mortality Gap And Retail Credit Growth Entail Structural Opportunity

Credit protect policies on retail loans could further enhance surge in protection products. Retail credit is on a consistent uptrend with a CAGR of 16.3% over FY13-19 driven by NBFCs (refer Chart 17), which capitalised on the large opportunity pie (e.g. India's mortgage is hugely untapped – Chart 18) aided by a low interest rate environment in India. Further, we believe with challenging corporate credit scenario, financiers will sharpen focus on retail credit, resulting in higher growth for life insurance players over a long-term horizon.

With increased penetration of credit protect policies among retail financiers and higher attachment rates, this segment is poised to be a key driver of protection premiums, given that there is significant housing shortage (Chart 19). These products cover losses arising due to customer defaults on credit products like home loans, vehicle financing, microfinance, etc. Among listed life insurers, while HDFCL was an early mover in this segment, SBI Life has now caught up and credit protect now forms a sizeable portion of its group protection sales mix. As we highlight later in this report, insurance on retail credit has been a key driver of growth and profitability of life insurers given its high margin nature. However, it is pertinent to note that these are higher margin products and costlier than term insurance products and significant uptick could attract regulatory attention.

Chart 17: Growth in Retail Credit (INR Bn)

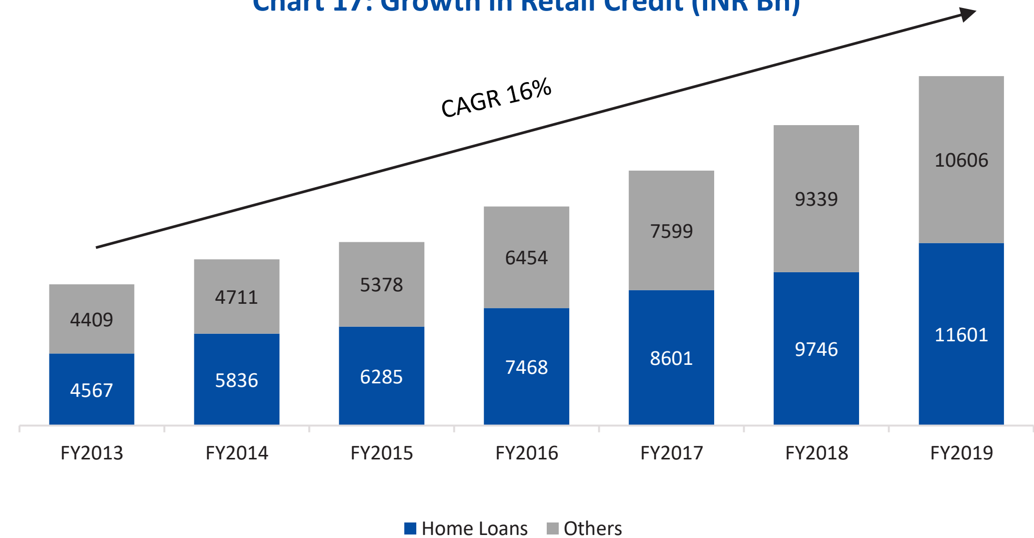


Chart 18: Low Penetration in Mortgage Market (Mortgage as a % of Nominal GDP)

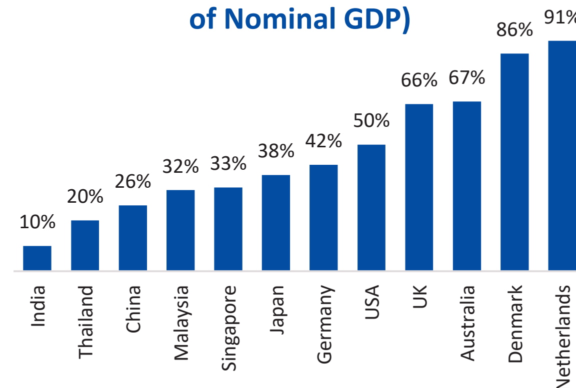
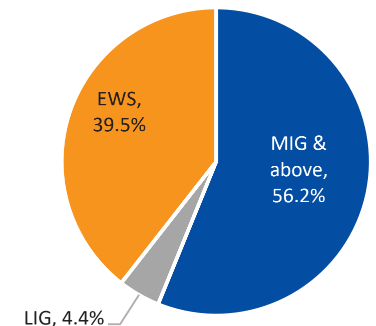


Chart 19: Shortage in Urban Housing (FY12 split %)



Source: MoHUPA, ICRA, IPRU, HDFC, PNB HF, Edelweiss Professional Investor Research

Favourable Demographics And Financialisation of Savings: Key Tailwinds

India's favourable demographics ensure a long growth runway for life insurers. India provides a mix of young population, rising affluence & income levels of the middle class and burgeoning urbanisation. These tailwinds are expected to eventually lead to higher allocation towards financial products. Urbanisation has a correlation with rising GDP per capita (refer to charts 20 and 21).

The central government is also focusing on financial inclusion, which includes insurance schemes like Pradhan Mantri Jeevan Jyoti Bima Yojana (PMJJBY). These schemes are likely to create awareness regarding the need for protection products.

A higher share of young working individuals in the population is also expected to be a tailwind for financial products, and consequently for insurance companies as the share of population in the accumulation age group rises (from 56% in 2015 to estimated 61% in 2035; refer to Chart 22). Increasing life expectancy, shown in Chart 23, will also promulgate the need for pension, which is an additional source of growth for life insurers.

Chart 20: Trend in urbanization of population

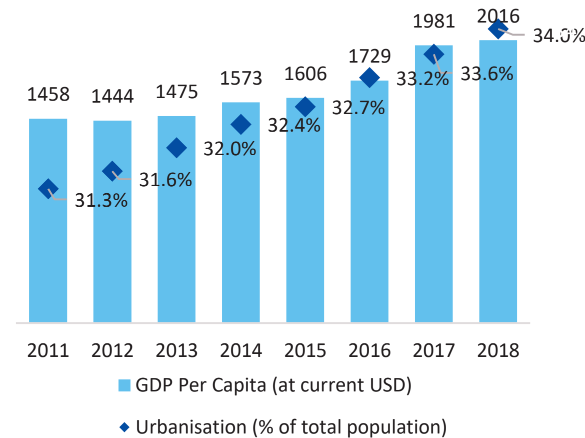


Chart 21: Growth in Urbanisation Rate and GDP Per Capita

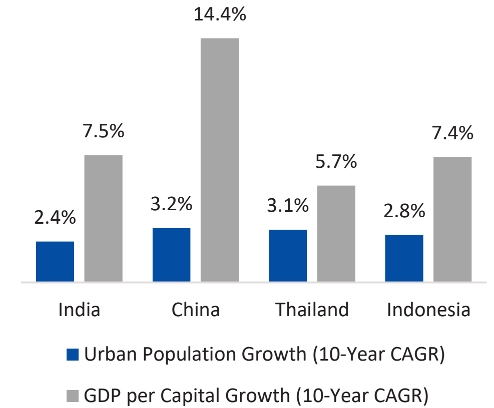


Chart 22: Population Composition (in billion)

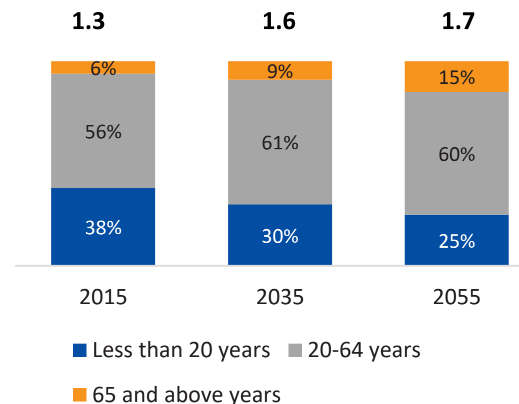
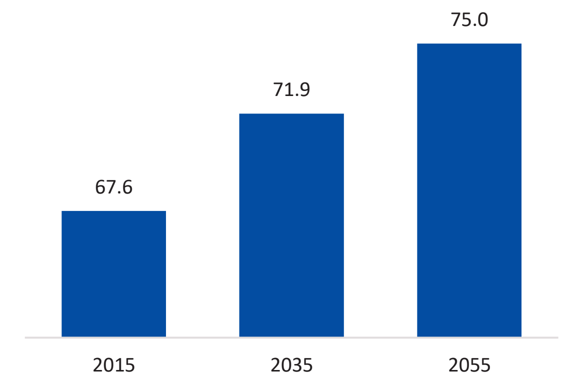


Chart 23: Life Expectancy (Years)



Source: WHO, UN, IMF, Edelweiss Professional Investor Research

Favourable Demographics And Financialisation of Savings: Key Tailwinds

Insurers have been actively working to improve awareness regarding need of a risk cover. We believe better awareness, easier access (through distribution channels like online sales), innovative products (including additional riders or bundling of health insurance) and better rates for term insurance premium (led by larger underwriting experience) will boost off take of life insurance products. In a low interest rate environment, traditional savings products are also evincing consumers' interest. On the other hand, better financial market scenario should boost sales of ULIPs, which have become a transparent and competitive product post regulatory changes and pose strong competition to mutual funds along with tax advantages. ULIPs generally see higher allocation as capital market conditions improve.

Table 1: Comparing ULIP vs Equity Linked Saving Scheme (ELSS) products

	ULIP	ELSS
Lock-in	5 years	3 years
Tax benefits	Both investment and return exempted	Investments exempted, returns over INR 1 lakh taxed
Switching	Allowed between asset classes	Not allowed
Charges	Capped at 2.25% for 10+ years policies, 3% for others	Fund management charges (~2%)
Life cover	Yes	No

Chart 24: Financial Savings and Household Savings

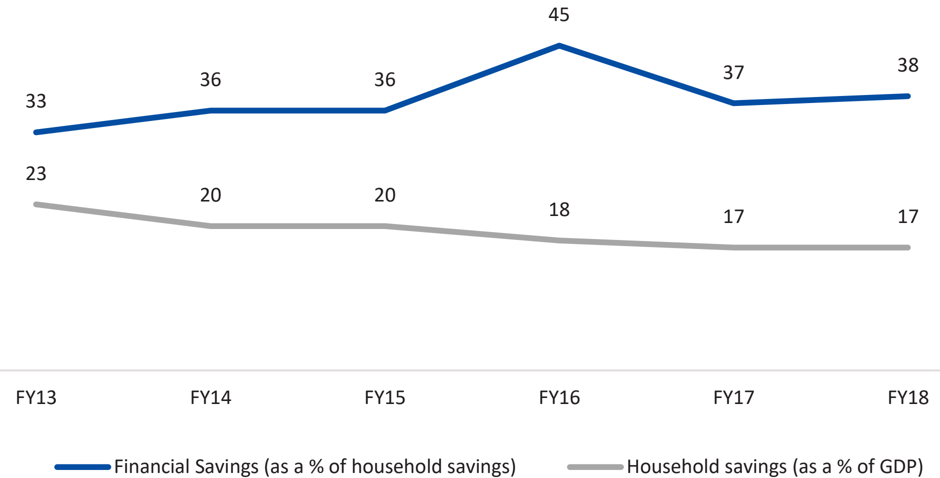
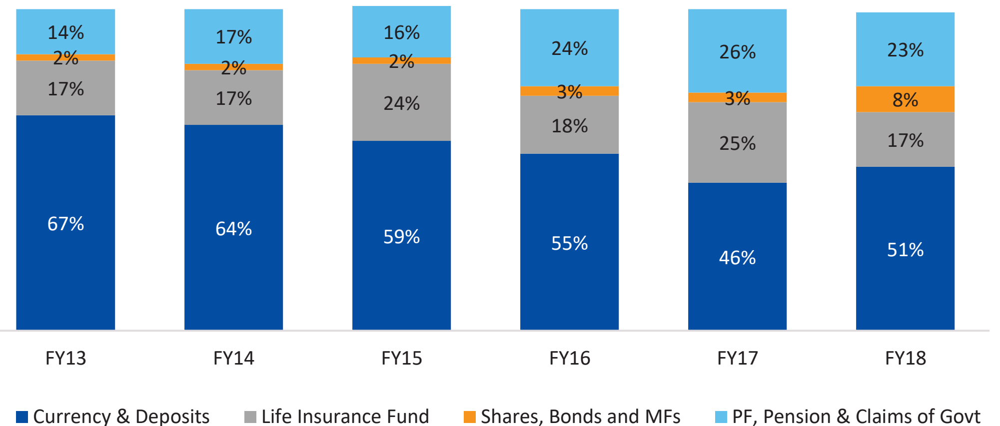


Chart 25: Rising Share of Insurance in Financial Savings



Source: RBI, Industry, Edelweiss Professional Investor Research

Pension And Health Insurance: Emerging Opportunities

We believe, apart from the opportunity in the protection and savings segment, life insurers can capitalise on the significant gap in the pension and health insurance space.

India's pension assets as a proportion of GDP are at a low level compared to global peers (refer to chart 26). Given the young population, as old age dependency ratio remains low at 14% currently, it is expected to cross the 25% mark over the next few decades (refer Charts 27 and 28). This, coupled with rising life expectancy, smaller family size and an inadequate existing pension system, will be a tailwind for life insurers.

With over 15% of the population, or 25 crore individuals over the age of 60 by 2055, a large chunk will have no pension income and hence will be financially insecure. A current estimate pegs only 8% of retirees in the private sector receive pension, while a complete coverage of private sector workforce over 60 years will imply assets equivalent to 38% of GDP by 2030 and 74% of GDP by 2050 (refer Table 2).

Chart 26: Pension Assets as a % of GDP (%)

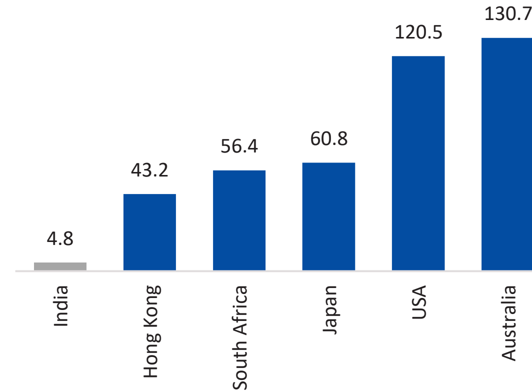


Chart 27: Old Age Dependency Ratio Per Thousand

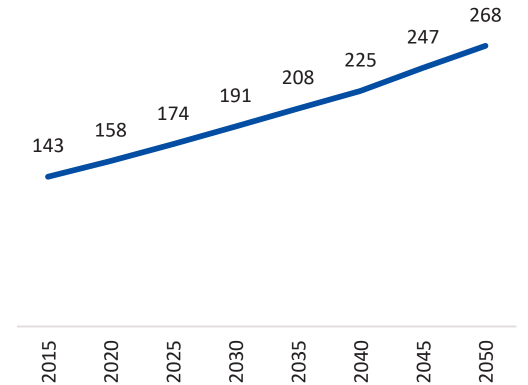
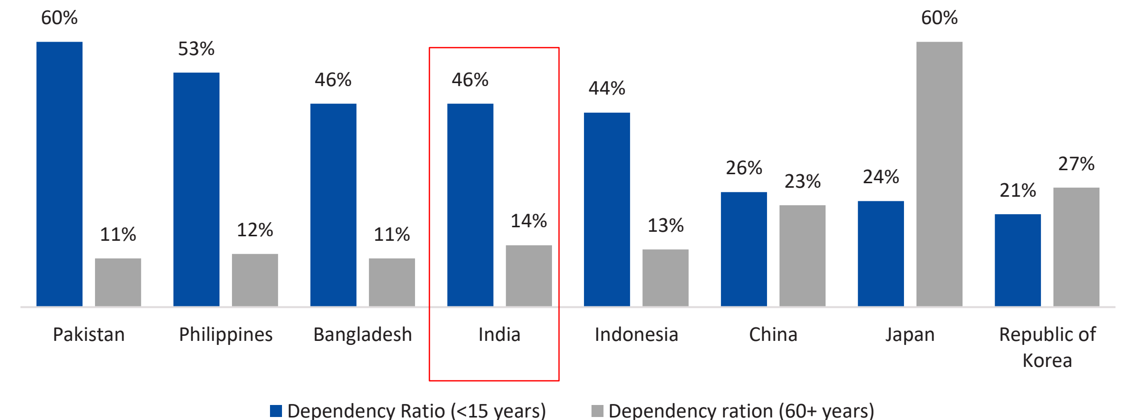


Chart 28: Old Age Dependency Ratio in South and Southeast Asia



Source: HDFCL, CRISIL, PFRDA, Edelweiss Professional Investor Research

Pension And Health Insurance: Emerging Opportunities

While IRDAI pegs India's health insurance opportunity size at INR 3 lakh crore, current market size of the health insurance business is under INR 50,000 crore (Chart 29). This highlights the industry's strong growth potential going forward. Life insurers mostly provide benefit policies for health protection, attached as riders to the base policy, although standalone policies have also been offered.

As per IRDAI only 36 crore individuals had health insurance coverage, of which only 20% was via commercial insurance providers in life and non-life space as bulk of it comes from central and state government sponsored schemes. Private health expenditure is expected to rise significantly as life expectancy continues to increase, and till now, the lion's share of healthcare expenditure has come from out-of-pocket expenditure (~62%). Share of out-of-pocket expenses for healthcare is highest in India compared to regional peers (refer to charts 30 and 31).

A multitude of factors—under-penetration, low government share of expenditure, rising life expectancy and rising cost of healthcare—will be key drivers of growth in these segments. As we show in Chart 32, life insurers, particularly private ones, have started to see traction from health insurance related products, although size of business is small.

Chart 29: Health insurance premiums in India (INR cr)

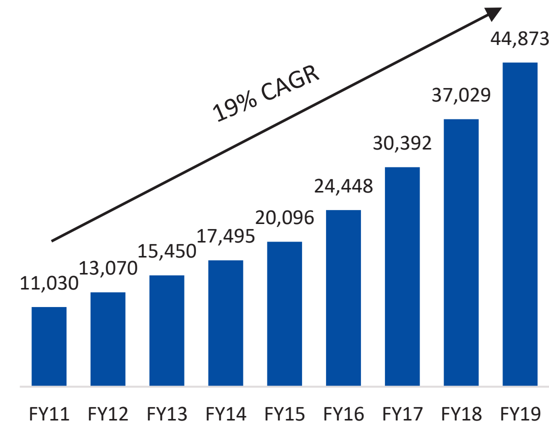


Chart 30: Mix of Medical expenses - Private Expenditure (2014)

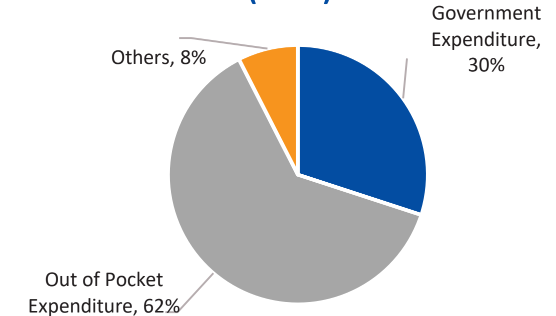


Chart 31: Share of Out of Pocket Expenditure (As % of Total Health Expenditure) for Asian Peers

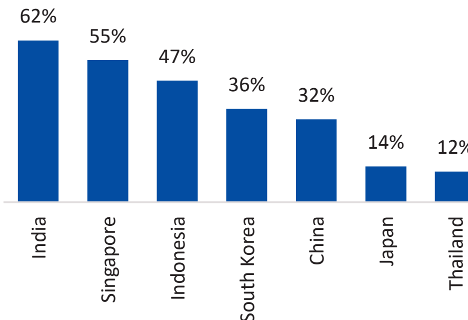
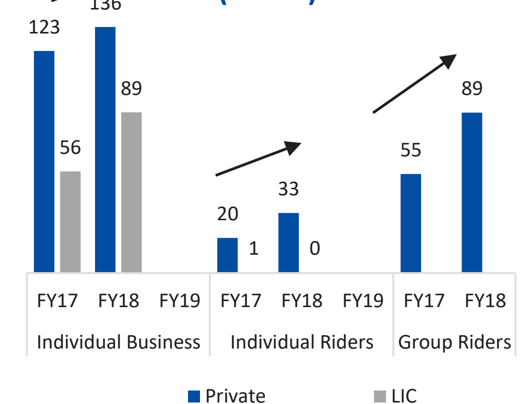


Chart 32: Health insurance premiums by life insurers (INR cr)



Source: IIB, GI Council, IPO Prospectus, IRDAI, Edelweiss Professional Investor Research

Pension And Health Insurance: Emerging Opportunities

A few players, particularly among the larger ones, have already entered this space by providing annuity products, participating in the National Pension System (HDFCL, SBIL and IPRU are leading fund managers) and providing health protection products (like Cancer Care/Cardiac Care by HDFCL). In Chart 33, we depict the robust growth posted by HDFC Life's pension fund management arm, while Table 2 highlights the massive gap that India sees in terms of pension coverage currently.

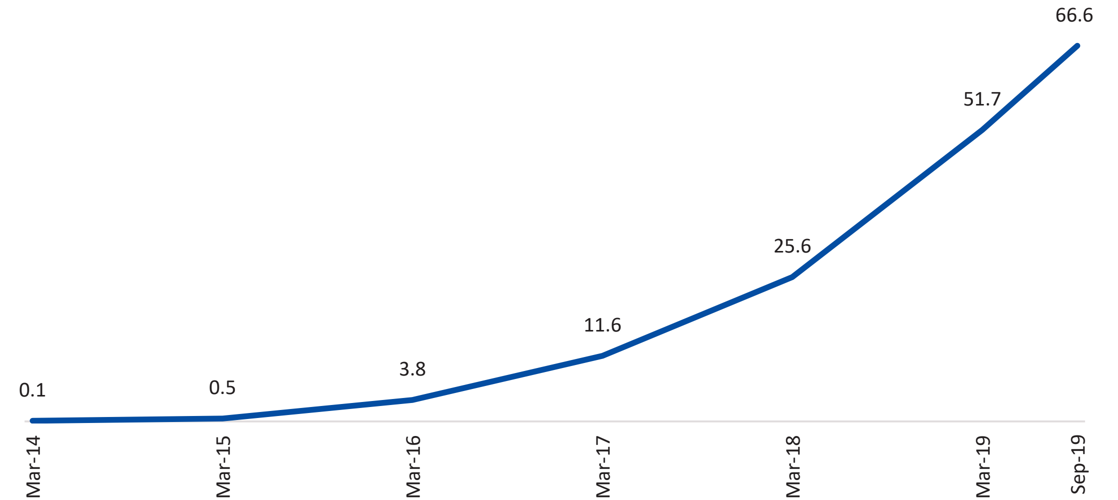
To conclude, we believe, a host of tailwinds boost the possibility of long-term growth for life insurers, not only in terms of volume, but also profitability as new opportunities are generally higher margin in nature.

We see clear trend of leading players capitalising on these opportunities, reflected in their robust and improving financial performance, as we highlight in the next section. We believe, these segments will materially boost valuations of these companies over the long term as the trends play out.

Table 2: Pension coverage ratio - Scenarios

Pension Coverage Ratio	2030		2050	
	In trillions	% of GDP	In trillions	% of GDP
8%	21	3	281	6
30%	83	11	1,088	22
50%	138	19	1,813	37
70%	193	26	2,538	52
100%	276	38	3,626	74

Chart 33: HDFC Pension Fund AUM (in INR bn)



Source: PFRDA, CRISIL, Company, Edelweiss Professional Investor Research

Listed Life Insurers: Cashing in On Huge Opportunity

Listed life insurers have been at the forefront of capturing this large opportunity pie, reflected in their strong YoY growth rates. Growth for listed life insurers has been consistently 10% plus in terms of total premium outlining balanced growth in new business and renewals. This has resulted in private players' market share rising over FY15-19, when the current growth phase commenced.

On total premium basis, growth has been strongest for SBIL despite it being one of the largest insurers—21% CAGR over FY13-19. This has been led by healthy growth in both regular and renewal premiums. HDFCL has also posted robust growth in its premium since FY13, which has spurred total premiums almost 2x (or 17% CAGR over FY13-19). ICICI Prudential (IPRU) has also grown strongly with 15% CAGR over FY13-19.

Chart 34: FY15-19 Total Premium CAGR implies strong growth in Phase III

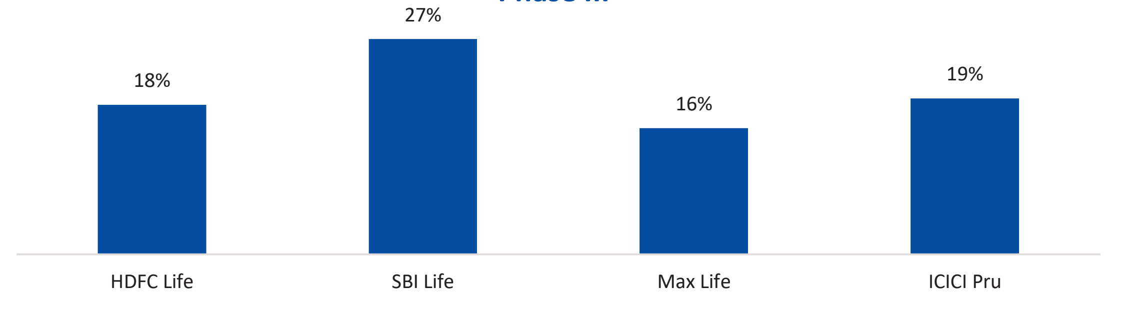
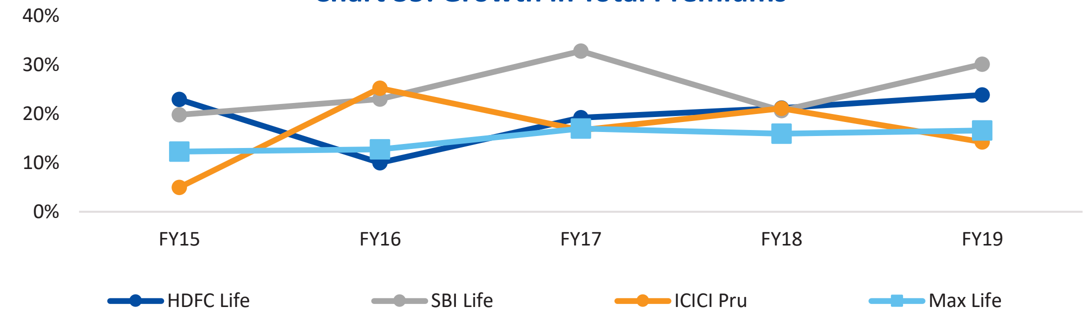


Chart 35: Growth in Total Premiums



Source: Company, Edelweiss Professional Investor Research

Glossary: Insurance Premiums (Refer Appendix C for detailed terminologies)

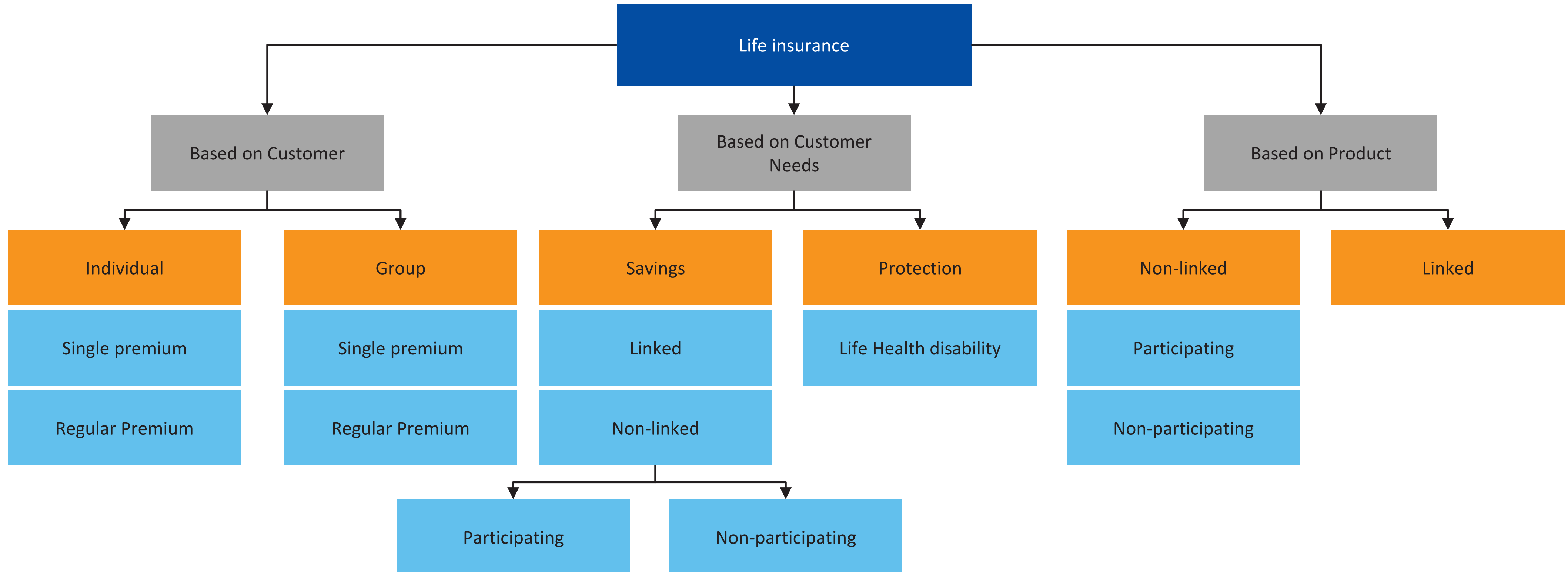
Insurance premiums (**Total Premium**) constitute of **Renewal Premium** (renewal payments received from policies underwritten in prior years) and **New Business Premiums** (premiums for policies written in the current year and constitute **Single Premium** and **First Year Premium**). **Annual Premium Equivalent** (APE) is calculated as the sum of First Year Premium and ten percent of Single Premium. Hence,

$$\textit{Total Premium} = \textit{Single Premium} + \textit{First Year Premium} + \textit{Renewal Premium}$$

$$APE = \textit{First Year Premium} + 0.1 \times \textit{Single Premium}$$

Life Insurance: Product Types

Chart 36: Classifications of life insurance products



Insurance products can be classified in several ways. Products can be traditional (include participating, non-participating, protection) and unit linked. While traditional products used to have the largest share in India, ULIPs have gained popularity owing to encouraging capital market conditions. ULIPs are generally instrumental in terms of premium volume growth, although impact on profitability remains relatively less than other products (as we explain in the next section).

Another classification of protection products can be in terms of savings (unit-linked, participating, non-participating savings products) and protection. Historically, India has had a higher share of savings products, primarily as LIC used to sell a large proportion of participating policies. However, protection policies are gaining traction as insurers have focused on selling these, identifying the large opportunity size and as protection products have higher profitability than savings products (refer to Appendix B for detailed life insurance product descriptions).

LIC And Private Players Continue To Focus On Different Products

ULIPs continue to remain the most popular among life insurance products and constituted more than half of overall WRP during the past three years for private players; however, they have dipped marginally in FY19 due to lower ULIP sales on account of underperforming equity market. Clearly, private life insurers have, on aggregate level, continued to focus on ULIPs after industry growth recovered in FY15 and Indian equities were also in a bull run. This led to share of ULIPs catapulting from a third of product mix to 54% in FY18.

The divergence between life insurance products sold by LIC and private insurers still remains significant. While LIC's product mix contains largely traditional products (of which participating products are significant), private players have moved away from participating products and are selling unit-linked, non-participating savings, protection and annuity products. This is the reason why even though the share of linked products was just above a quarter for the industry in terms of overall weighted rated premium basis, the same for the private industry was more than 50%. Given the current capital market scenario, the share of non-linked products can increase for private insurers. On the other hand, a recovery in the market will boost ULIPs volume.

Chart 37: Private insurers product mix by Overall WRP

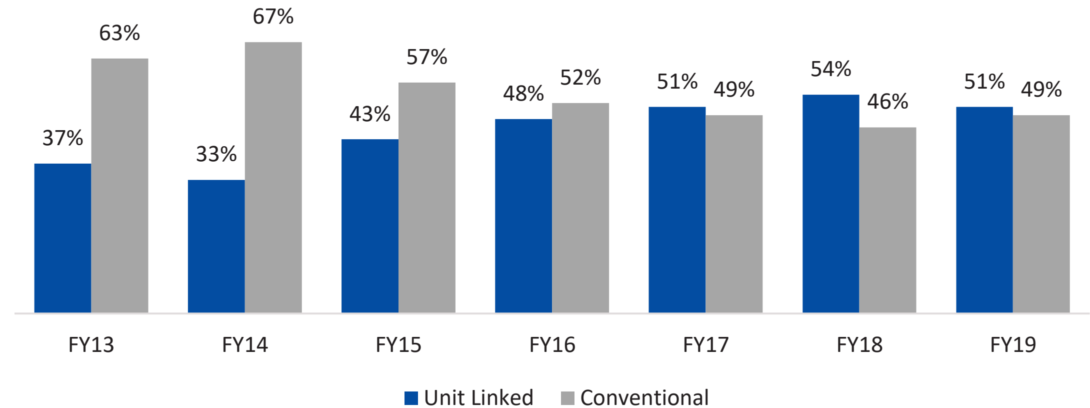
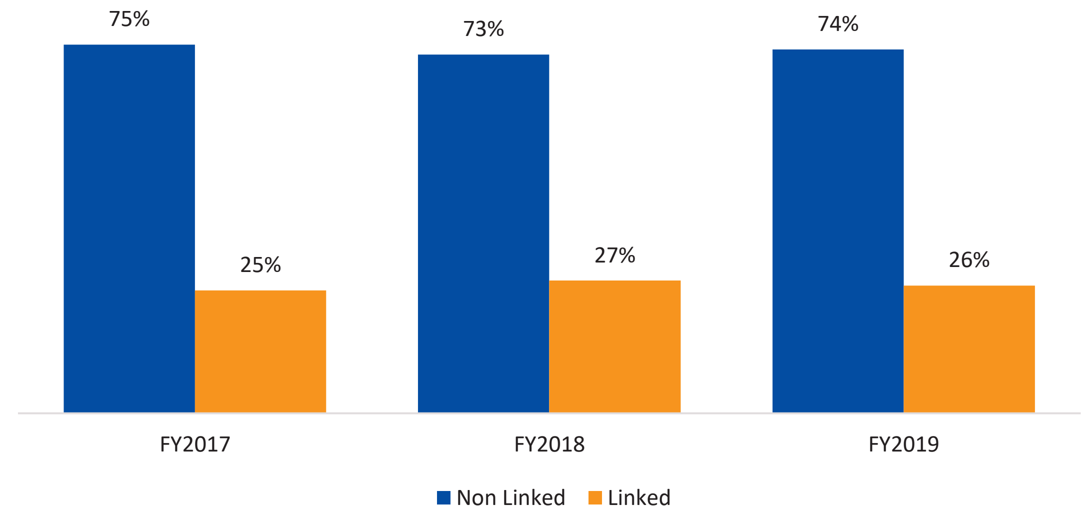


Chart 38: Industry product mix by Overall WRP basis



Source: Company, Edelweiss Professional Investor Research

LIC And Private Players Continue To Focus On Different Products

While protection products entail higher margins, ULIPs have the lowest. This is because only a small proportion of ULIP premium goes towards risk cover, while the balance is invested after deducting charges, the investment risk of which is borne by the policyholder. Hence, profitability generated from risk premiums is much smaller compared to the premium volume. On the other hand, for protection as well as non-participating products, policyholders are entitled to pre-determined benefits (sum assured for life cover and guaranteed benefit for non-par savings products) and do not bear the risk of underlying fund performance. Participating or "with profits" are products with a risk cover and a share of profit from the underlying fund performance (90% share as per IRDAI regulations). In terms of profitability, participating products are in between ULIPs and non-participating products.

We have shown indicative VNB margins for products in Chart 40. Given that VNB margins are computed using first year annualised premium along with VNB of the entire life-cycle, margins can look higher and those for protection products can be as high as 100%. A more apples-to-apples comparison is VNB with present value of new business premiums (or PVNBP), which is not disclosed in India. PVNBP margins of AIA (Chinese insurer) is shown in Chart 41, which shows that margins are in the range of 8-15% for various products.

Chart 39: The high profitability of protection adds significantly to VNB – IPRU (FY19)

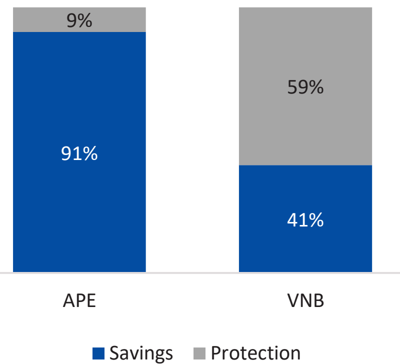


Chart 40: Indicative VNB margin ranges of life insurance products

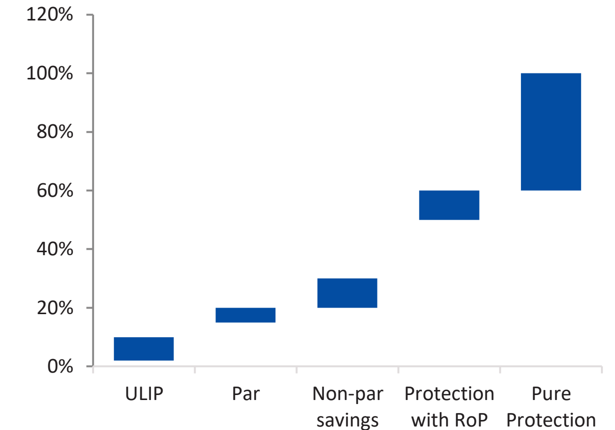
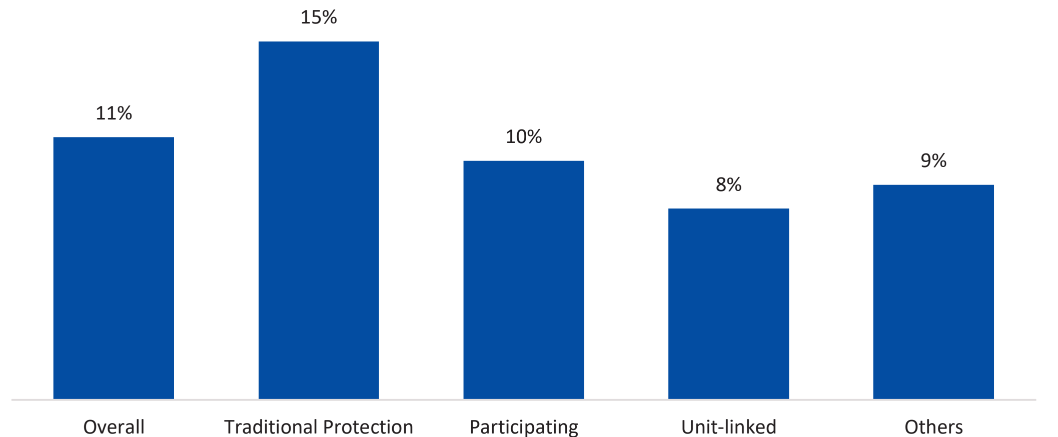


Chart 41: Product margins on PVNBP basis – AIA (1H19)



Source: Company, Edelweiss Professional Investor Research

Protection And Annuity Sales: Key Margin Drivers

In terms of shifting the product mix towards higher-margin products, HDFCL is ahead of other competitors. In terms of new business premium (NBP), protection products (term and annuity together) now constitute the largest chunk (~44% of NBP in FY19), while savings products contributed the balance in FY19 (refer Chart 42). This has been fueled by strong growth in term life and credit life products, both in individual and group businesses, as well as traction in annuities (which is now 17% of NBP vs 6% in FY15). Similarly, we see in Chart 43 that SBIL's product mix also gaining traction in terms of protection products. While SBIL writes individual term life policies, it is focused more on group life and credit life products. However, the company continues to maintain a sizeable share of ULIPs in its product mix aided by its large bancassurance network owing to access to parent SBI's large branch network.

Alongside protection, insurers are also focusing on guaranteed savings type products like non-par savings and annuities. Non-participating products, owing to their margin (higher than participating yet lower than protection), are also instrumental in bumping up the VNB margins of HDFCL and SBIL (as we show in the next section). We believe, VNB margins can expand further as we compare those of neighbouring economies—40% plus for South East Asian peers, as highlighted in Chart 44.

Chart 42: HDFCL's Product mix in terms of new business premium

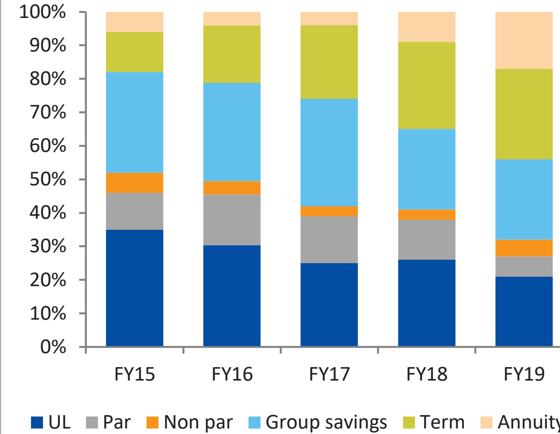
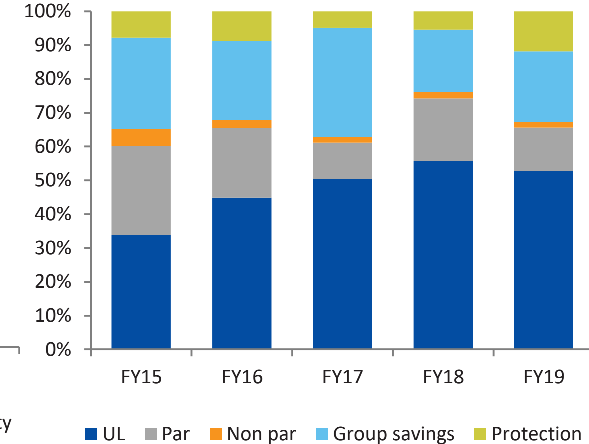
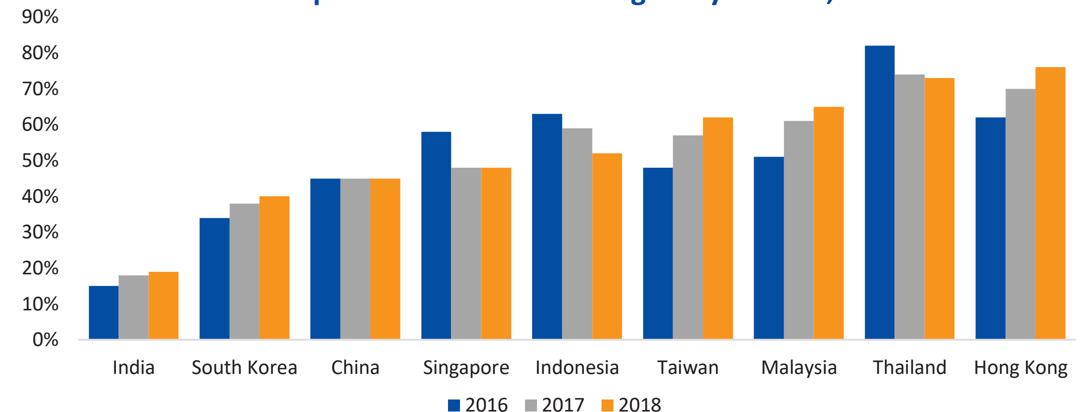


Chart 43: SBIL's Product mix in terms of new business premium



Source: Company, Edelweiss Professional Investor Research

Chart 44: Implied New Business Margins by Market, 2016-18



Source: Milliman, Edelweiss Professional Investor Research

Protection And Annuity Sales: Key Margin Drivers

VNB margins of HDFCL and SBIL have jumped due to a change in mix towards higher margin products like term life, credit life, group life and non-participating guaranteed products (refer to charts 45 and 46).

HDFCL's VNB margin has risen consistently from 13% in FY13 to 25% in FY19. Similarly, that of SBIL has improved from 14% in FY16 to 18% in FY19. They rose further in H1FY20—27.5% and 20.2% for HDFCL and SBIL, respectively. While strong demand for non-par savings product 'Sanchay Plus' was instrumental in the jump of HDFCL's VNB margin in H1FY20 (with operating leverage playing out as we will highlight later on in this note), 74% YoY increase in protection premiums and 3x YoY surge in annuity business spurred SBIL's margin.

Glossary: Value of New Business and VNB margin (refer to Appendix C)

In order to take a long-term view of life insurance profitability, value of new business (VNB) is calculated as net present value of expected after-tax profit from the new business written over a particular period. VNB margin is a measure of the profitability of life insurance business. It is calculated as

VNB margin = VNB / APE.

VNB margin will be representative of the product mix.

Chart 45: HDFCL's margin expansion has been driven by increasing share of high margin products

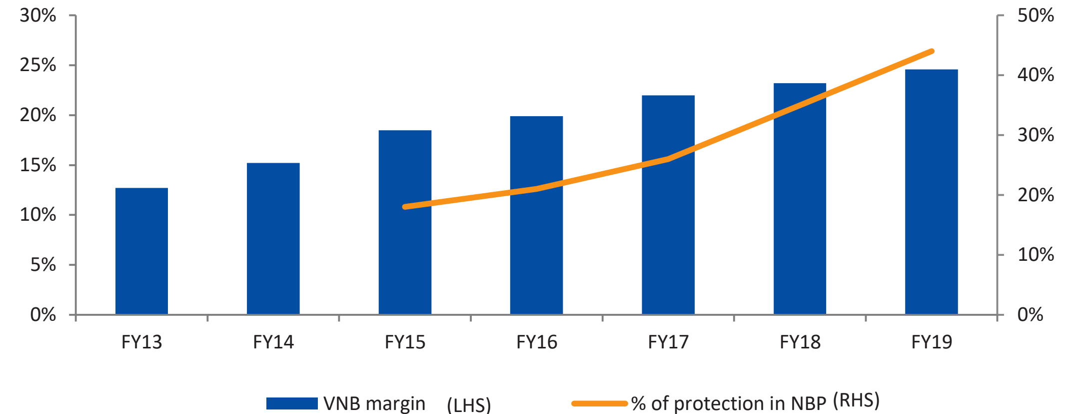
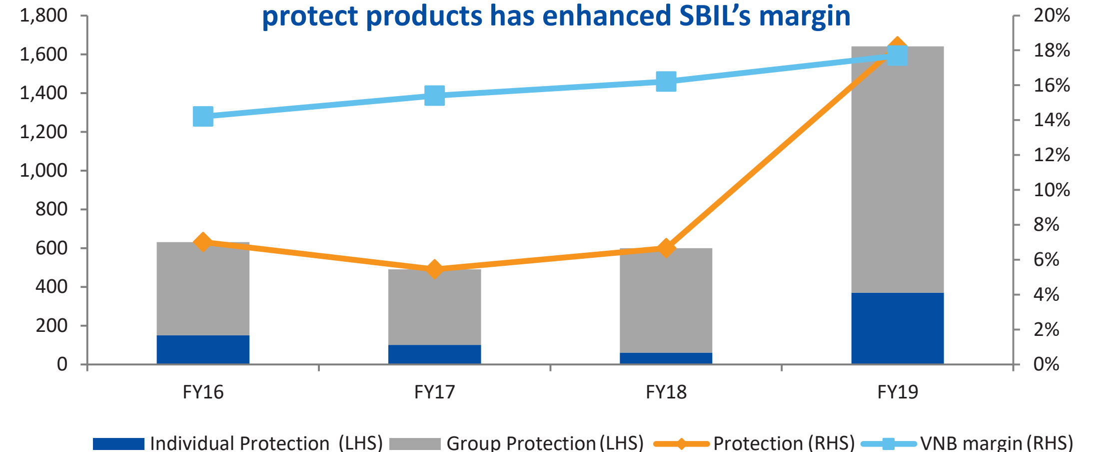


Chart 46: Increase in protection business driven by credit protect products has enhanced SBIL's margin



Source: Company, Edelweiss Professional Investor Research

Life Insurance Distribution: Banca Dominating Channel For Bank-promoted Insurers

Currently, bancassurance is the leading channel through which insurers sell their products, although this was not the case earlier. LIC, which had a much larger market share a few years ago (62% share of individual WRP in FY13), was predominantly an agency-driven business. Consequently, individual agents contributed ~40% to premiums among insurance channels. However, with the growth in market share of private insurers, among which the larger ones were promoted by banks (or have banks in their overall group structure), bancassurance became the dominant channel (contributing ~55% to individual NBP in FY19), as IRDAI permitted banks to sell insurance products under the corporate agency structure.

The low-cost nature of the banca channel was useful in selling ULIPs, which had become a low-margin product post regulatory changes and was a key driver of industry premium growth as capital markets boomed. Of late, insurers have also started focusing on the direct channel, whose share has increased to 14% of individual NBP. We believe, this is a step in the right direction given that an insurer's sales depend significantly on the relationship with channel partners (case in point: Max Life Insurance with Axis Bank) and diversification is not only necessary within the bancassurance channel (given its large proportion), but also across various channels as it shields an insurer from any regulatory changes that get effected on a channel (like cap on commissions).

Chart 47: Distribution mix of private life insurers based on Individual NBP

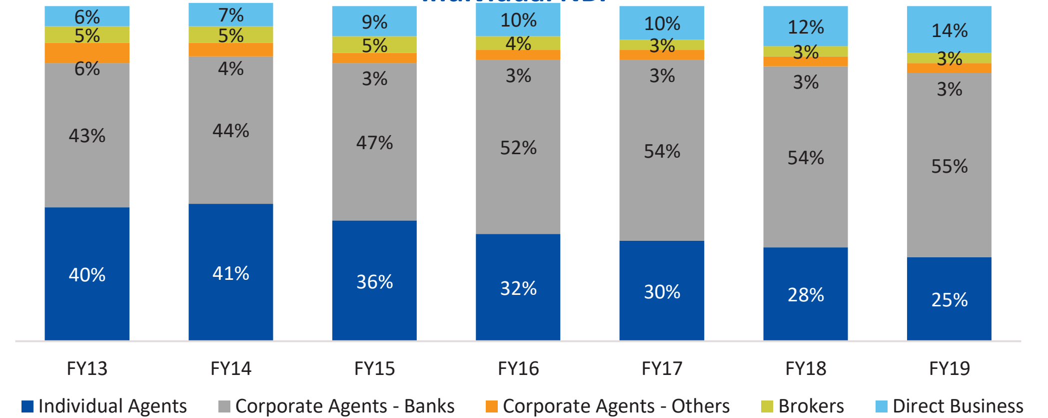


Table 3: Depth of Bancassurance channel for HDFCL and SBIL

	Bancassurance partners	Distribution
HDFC Life	220+ partners - 54 banks - HDFC Bank, Saraswat Bank, RBL Bank, IDFC First, Bandhan Bank, United Bank of India; 165 NBFCs/MFIs - Bajaj Finance, PNB HF; 8 SFBs - Equitus, Ujjivan, Suryodoy, CSFB	5,500 bank branches
SBI Life	SBI, South Indian Bank, Punjab & Sind Bank, Syndicate Bank, Allahabad Bank, Indian Bank, Repco Home Finance	34,000 bank branches

Source: Company, Edelweiss Professional Investor Research

Life Insurance Distribution: Banca Dominating Channel For Bank-promoted Insurers

Bancassurance is the leading channel for HDFCL and SBIL. It contributed ~65% to HDFCL's individual APE in FY19. However, we believe, the share will fall in the near to medium term, in line with the current trend, driven by lower growth in ULIPs and higher growth in alternate channels like agency and direct sales, in which HDFCL is investing. On the group front, relationships with bancassurance partners, NBFCs and MFIs have also helped HDFCL grow its credit protect business.

SBIL, however, continues to see higher sales through its bancassurance channel owing to access to SBI's large branch network which is 4-6x that of competitors, which has enabled it to maintain volumes in the ULIP business. While a third of the company's total branches make sizeable business (SBIL's branch productivity is on the rise), SBIL's credit protect business is almost entirely sourced from SBI's credit portfolio. SBIL has also tied up with other banks and MFIs. Additionally, it has a agency network which is best in class in terms of agent productivity in India.

As mentioned earlier, share of direct business is increasing for life insurers, with focus on online sales. HDFCL has been successful in selling 'Click2' series through online and SBIL has also used SBI's YONO mobile app for protection sales.

Chart 48: Bancassurance is the leading channel for HDFCL, but Direct channel gaining ground (basis Individual APE)

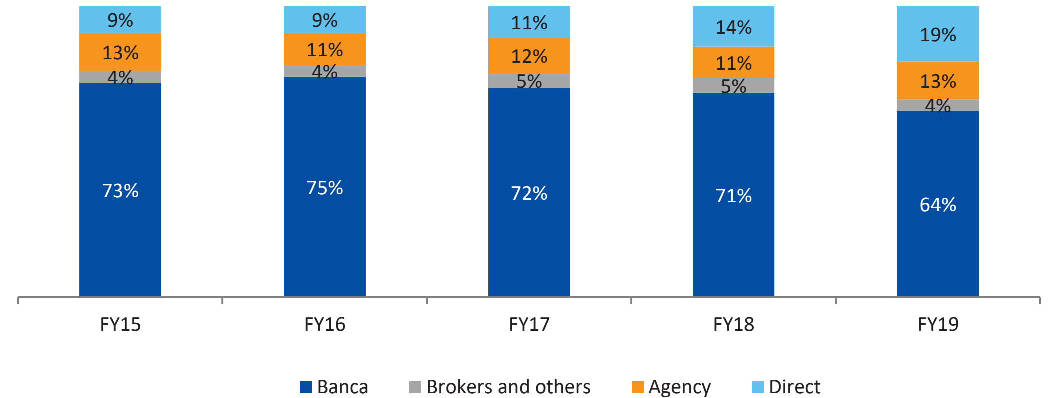
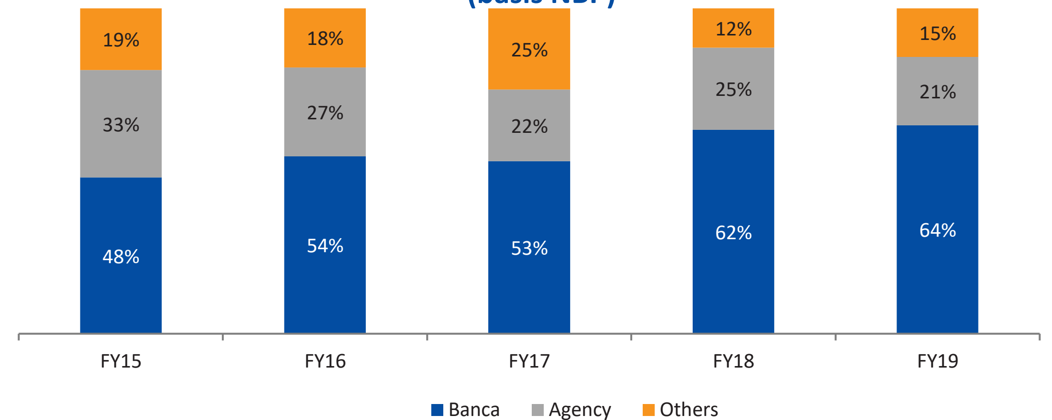


Chart 49: Bancassurance has been a dominant channel for SBIL (basis NBP)



Source: Company, Edelweiss Professional Investor Research

Digitisation of Insurance Value Chain: From Online Sales To Automated Processing

Insurers have consistently embedded technology in their value chain, addressing challenges in areas like underwriting, delays in policy issuance, mis-selling, etc. Additionally, adoption of a digital culture enables insurers integrate themselves with new sales ecosystems.

The deepening of insurance penetration in India and consequent rise in financial transactions has been harnessed by life insurers to create digital channels of sales, helping customers make informed decisions and reduce mis-selling and operating costs. Further, use of predictive analysis has been instrumental in improving underwriting, fraud detection and customer targeting. Straight through processing without manual intervention by companies reduces lead time for policy issuance and helps improve customer satisfaction.

Both HDFCL and SBIL have been harnessing digitisation in operations as well as sales channels. They have also tied up with new ecosystem partners like Paytm & Airtel for HDFCL and YONO app for SBIL, which will enable them access the lion share of internet users (who use through mobile, refer Chart 51). We believe, helping consumers make informed decisions and improving their experience in terms of turnaround time will boost persistency of policies and cut operating costs.

Chart 50: Internet subscriber base in India (in cr)

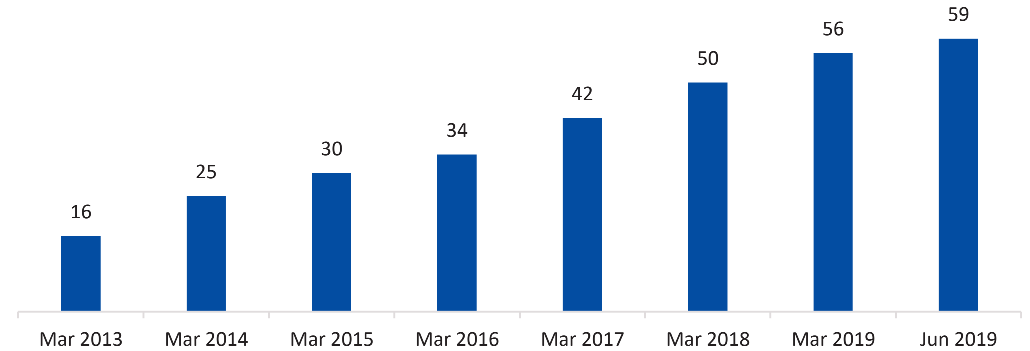
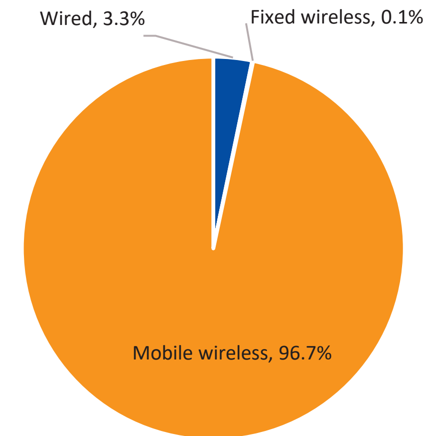


Chart 51: Composition of Internet Subscription



Source: TRAI, Edelweiss Professional Investor Research

Cost Structures For Private Life Insurers

The industry's commission ratio has declined consistently, particularly post FY11. Prior to this, commissions were quite high (6.5-8.0% of total premium for the industry), especially as private insurers paid higher commissions (7.5-11.0% of total premium) as they aggressively gained market share. However, regulatory changes in FY11 capped the commission structure for distribution channel and resulted in sharp fall in commissions paid as a percentage of total premium. Currently, commissions paid by listed private insurers have come under 5% of total premiums paid with LIC's commission rate being higher by around a percentage point as it remains an agent-driven business—a channel which has a higher commission structure.

On the other hand, operating expenses for private insurers have been much higher than that of LIC as the newer players, unlike LIC which has a mature infrastructure and does not incur much upfront operating costs on business acquisition, has to continue investing in the business for growth. Private players are also investing in developing digital infrastructure, which will payoff in the long term through better persistency and cost economics. SBIL, however, rivals LIC in terms of operating costs as we highlight in the next section. We expect private players' cost structures to normalise over the medium term.

Chart 52: Commission Expense Ratio (as % of total premium)

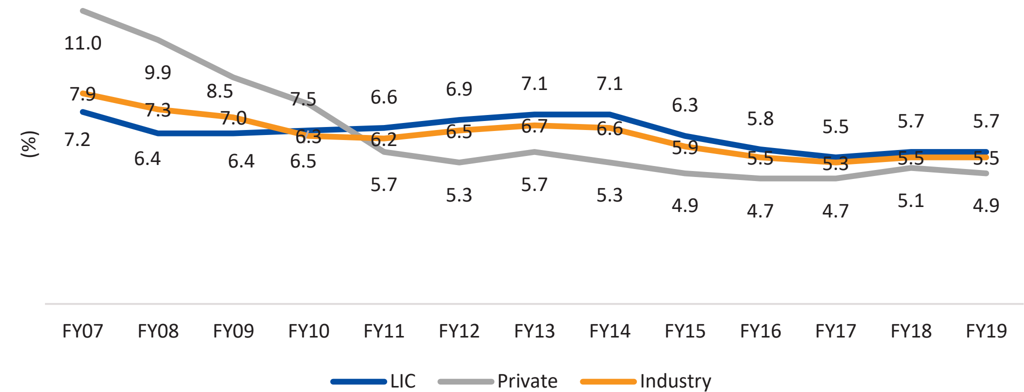
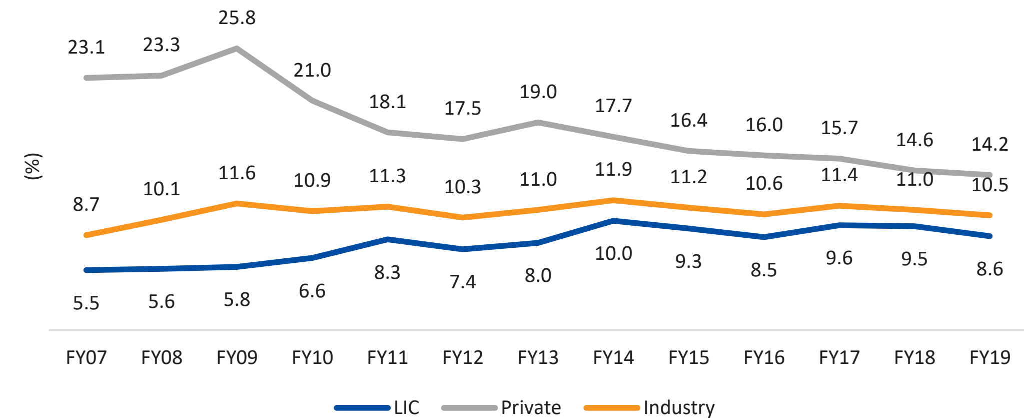


Chart 53: Operating Expense Ratio (as % of Total Premium)



Source: Company, Edelweiss Professional Investor Research

SBIL Has Best Cost Structure; HDFCL's Cost Ratios To Normalise

SBIL has the best cost structure in the industry, which has consistently improved over FY14-19 (refer to chart 54). This has been primarily driven by improvement in the company's operating expense ratio, which is the lowest as peers continue to record operating expense ratios in the 10-13% range. SBIL is able to achieve such low cost structure because of access to SBI's large bancassurance network, which generally is a low-cost one among insurance channels and also a very productive agent network.

In comparison, HDFCL's operating expense ratio remains elevated as the company continues to invest in the business in terms of developing distribution channels and technology (Chart 56) . Consequently, the company's expense ratio is one of the highest among listed peers. We believe, this will normalise over the medium term as investments fructify.

Commission ratio has remained ~4% for both these companies (refer Chart 55 and 56), which is slightly lower than the broader private industry. We believe, bigger scale enables these companies to bargain better commission terms from their channel partners.

Chart 54: SBIL's operating expense ratio has seen continuous improvement

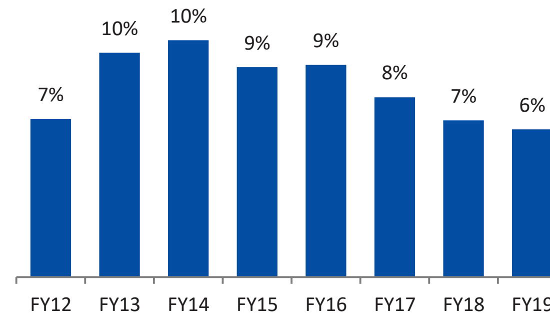


Chart 55: SBIL's Commission ratio remains in a tight range

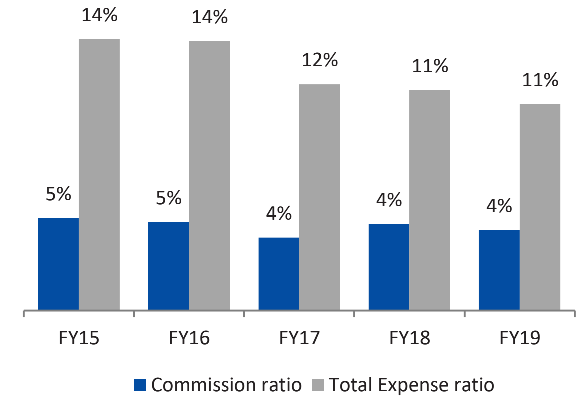
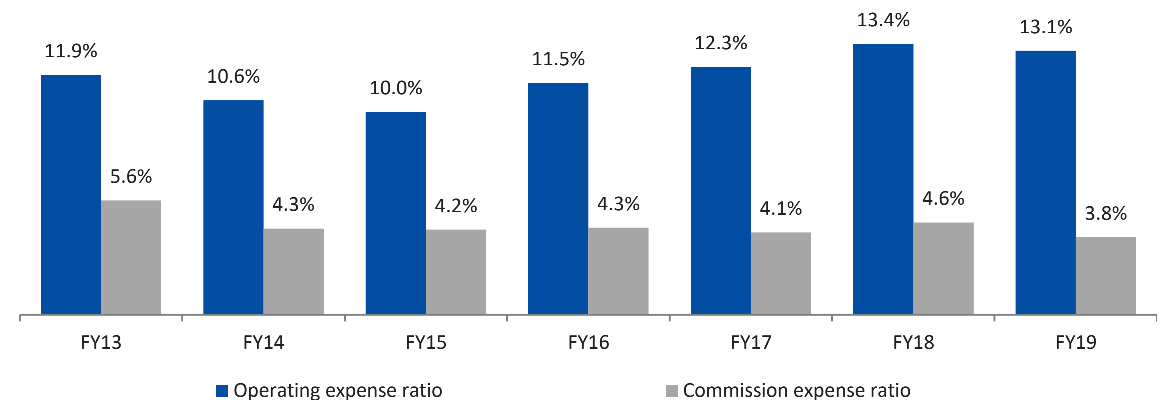


Chart 56: HDFCL's operating expense ratio has increased on the back of investments into the business



Source: Company, Edelweiss Professional Investor Research

Accounting Profits For Insurers Do Not Paint The Whole Picture

Life insurance is a long-term business and as a result looking at an annual snapshot of any life insurance company's performance could be myopic. A GAAP statement will have divergent revenue and expense streams (claims arising in a particular year may not necessarily be for premiums received in that year). Additionally, costs related to customer acquisition are expensed upfront in India (known as new business strain), whose benefits arise later on in the life-cycle of the product.

Ergo, particularly in the growth phase, accounting profit underperforms economic profit (which can be computed using embedded value methodology in life insurance). Hence, we believe, using accounting profit to measure the performance of a life insurer may not be meaningful at growth stage and using valuation parameters depending on accounting profit (like price/earnings ratio) will yield optically high multiples.

We highlight this in the adjacent chart for HDFCL, where we see that EV earnings are much higher than PAT, around 2-3x in recent times. As a result, in order to better understand the profitability, we need to have a longer-term view (net present value approach) in our profitability calculations. We elaborate on the embedded value methodology in further detail in the following section.

Chart 57: PAT development from Backbook unwind and strain – HDFC Life (INR cr)

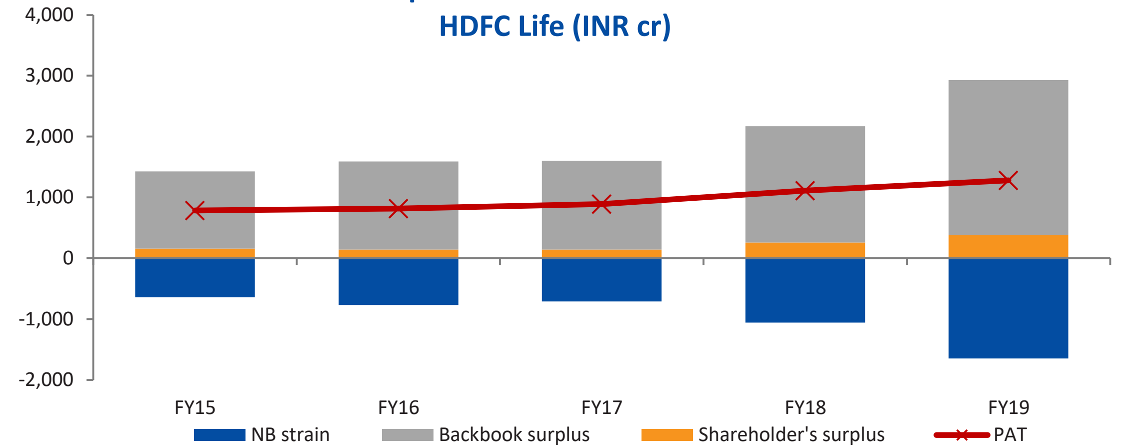
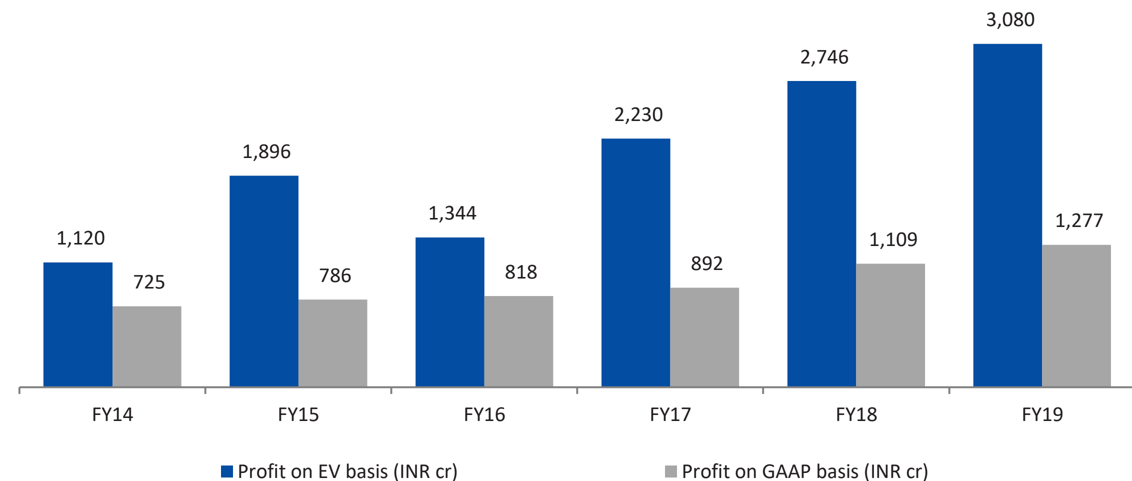


Chart 58: GAAP profits underperform EV profits – HDFC Life



Source: Company, Edelweiss Professional Investor Research

Persistency Ratio: Improving Trend

Maintaining persistency of policies remains key in an insurance business, as post the initial period of higher costs, larger share of profits unwinds. Persistency is defined as the proportion of business that is renewed and is measured at the end of every year.

Persistency levels in the industry have been on the rise for most listed players and HDFCL and SBIL have posted consistent improvement. All listed players have strong persistency levels (refer to charts 59 and 60). This was post a period of high surrenders in FY11-14.

We expect the industry's persistency ratio to improve going forward. HDFCL has better persistency, both in term and non-par savings products, which are key focus areas for the company, and as their share improves in the mix, persistency will rise.

Further, higher sales through the direct channel, which generally has better persistency over the long term, will boost numbers. SBIL has best-in-class persistency at the 61st month period, primarily because of its strong renewals.

Chart 59: 13th month persistency on an improving trend for all the listed players (%)

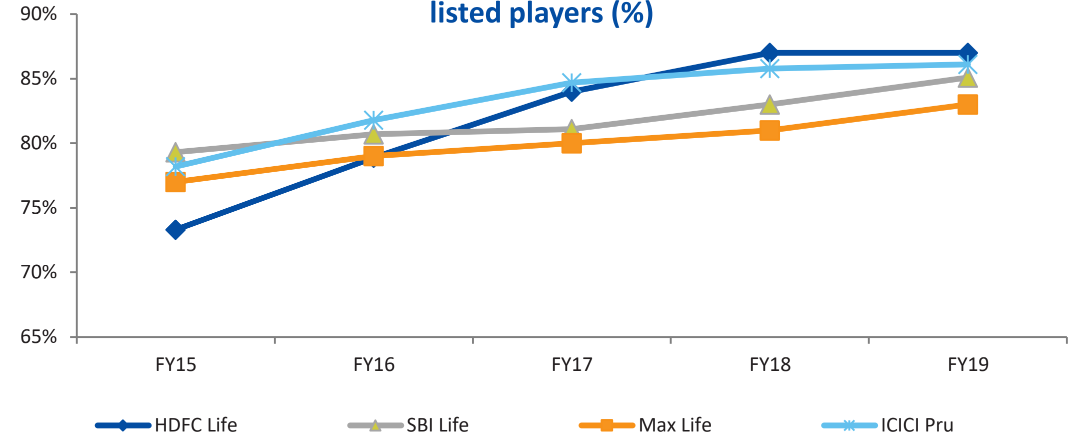
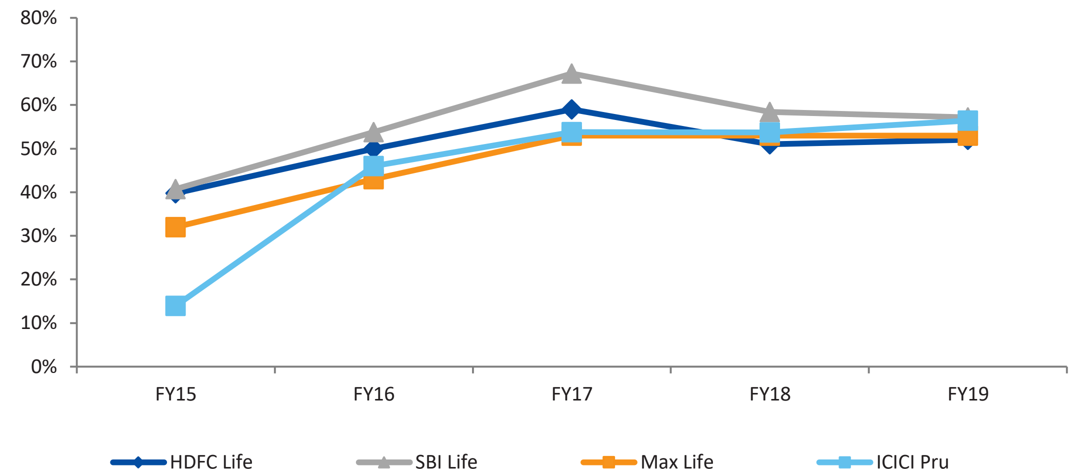


Chart 60: SBIL has industry leading 60th month persistency (%)



Source: Company, Edelweiss Professional Investor Research

Embedded Value: Taking A Longer-term View

Embedded value is the net present value of future profits from the existing book of business. We illustrate the estimation of this metric in Chart 61. It gives an estimate of the value of the book of business already written, net of risks assumed, also known as **Value of In-force (VIF)** plus the **adjusted networth (ANW)**, which is the shareholder's networth on a market consistent basis (which will be higher than net-worth reported in GAAP balance sheet as we show in Chart 62 which is not fully marked-to-market). It gives a picture of what the business is worth, without accounting for any value that will be derived from new business to be written henceforth.

Hence, we can equate EV as: EV = ANW + VIF. ANW comprises regulatory capital required to be maintained (**required capital**) and any surplus capital (**free surplus**). VIF comprises present value of future profits from in-force business (**PVFP**) net of risks/costs (like frictional costs of holding required capital like investment expenses/tax, time value of financial options and guarantees embedded in the insurance contracts, and cost of non-hedgeable risks). We have included definitions of these terminologies in Appendix C. Advantage of the EV framework is that we assess an insurer on a net present value basis as opposed to looking at its performance in a particular accounting year, which does not give the correct picture.

Chart 61: Components of Embedded Value Estimation

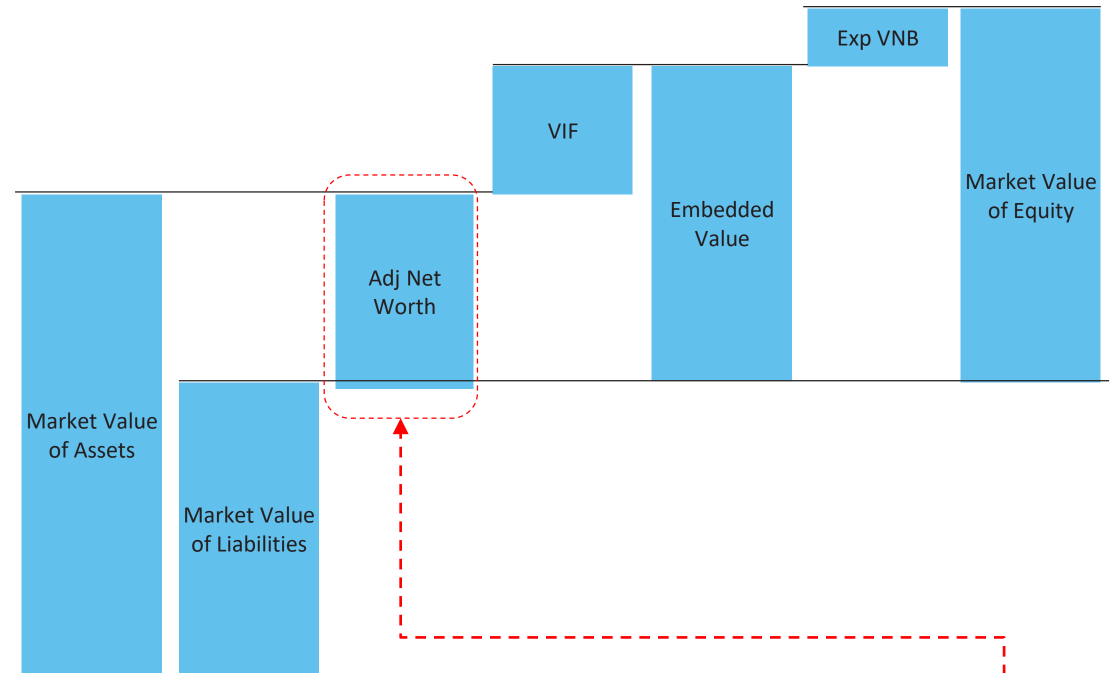
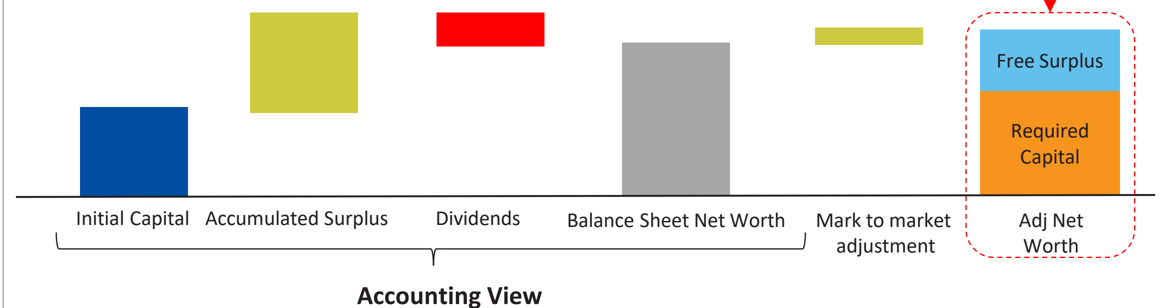
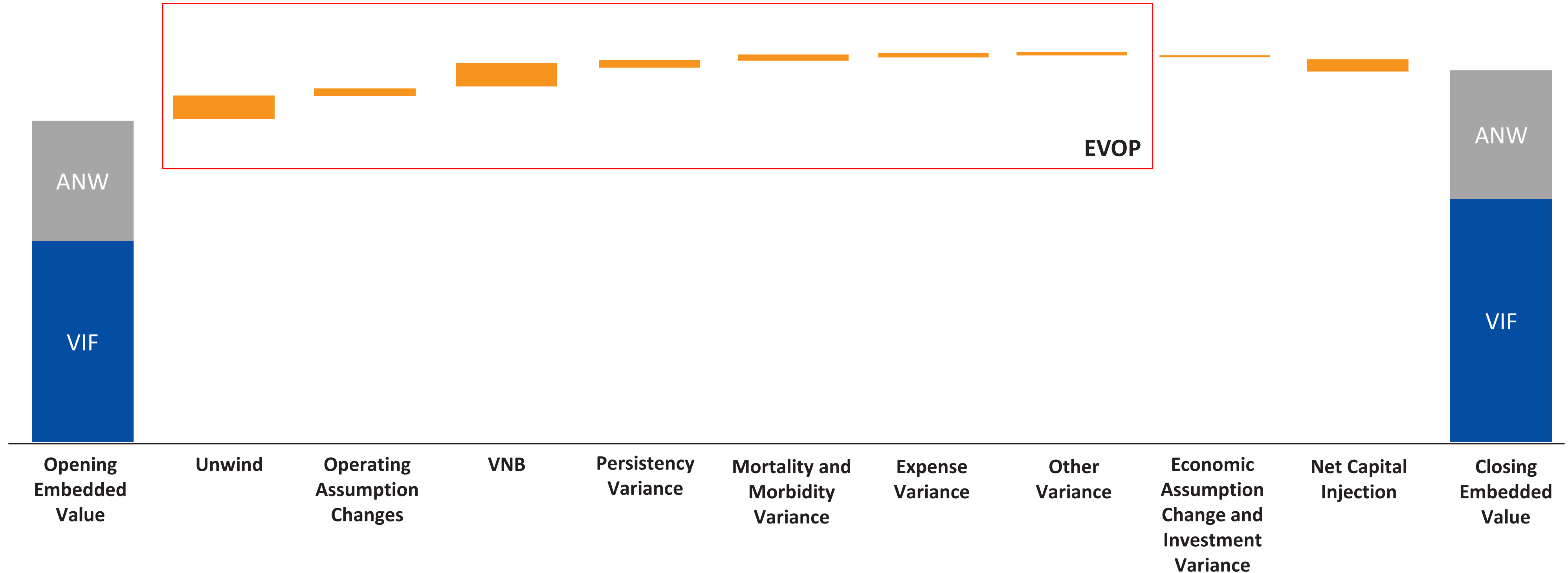


Chart 62: Reconciling GAAP and EV statements



Embedded Value: How Embedded Value Rolls Forward Between Periods

Chart 63: Embedded value roll-forward between periods



The movement of embedded value between periods occurs from multiple factors like unwinding of VIF, addition of new business (VNB) and assumption changes. Factors impacting VIF form two major components of EV—Embedded Value Operating Profit (EVOP) and Economic Variances. EVOP has three major components: expected return from existing business or unwind, value of new business and changes/variances in operating assumptions. While movement in EV between periods is also impacted by changes in market variables (and reflected in economic assumption changes/variances), it is not in the control of the business and hence not counted in EVOP. Other factors include movements in capital like capital injections, dividends and ESOPs. The difference between EV of two periods is referred to as embedded value earnings or EVE.

Embedded Value: Compounding To Continue

Historically, HDFCL's EV has compounded at a strong rate—20% CAGR over the past five years with EV of INR 20,120 crore at H1FY20 end. Primary drivers of this growth have been strong spurt in value of new businesses and expected returns from business (refer to chart 64).

EVOP for HDFCL can remain strong as VNB continues to grow strongly riding higher-margin product sales. Further, operating variances have historically remained positive for HDFCL given its conservative assumptions on mortality, persistency and expenses.

SBIL's EV has grown around 15-17% over the past two financial years. Though solid, it is a tad lower than 32% in FY17 on a smaller base and a large variance in operating assumptions for the year. SBIL's EV can grow at a faster clip going forward as it increases the share of higher-margin products, which will boost VNB. We have highlighted the trend of SBIL's strong growth in EV in Chart 65.

As we discuss in a later section, VNB growth can be a key driver of EV growth for SBIL.

Chart 64: HDFCL to continue to experience strong EV growth

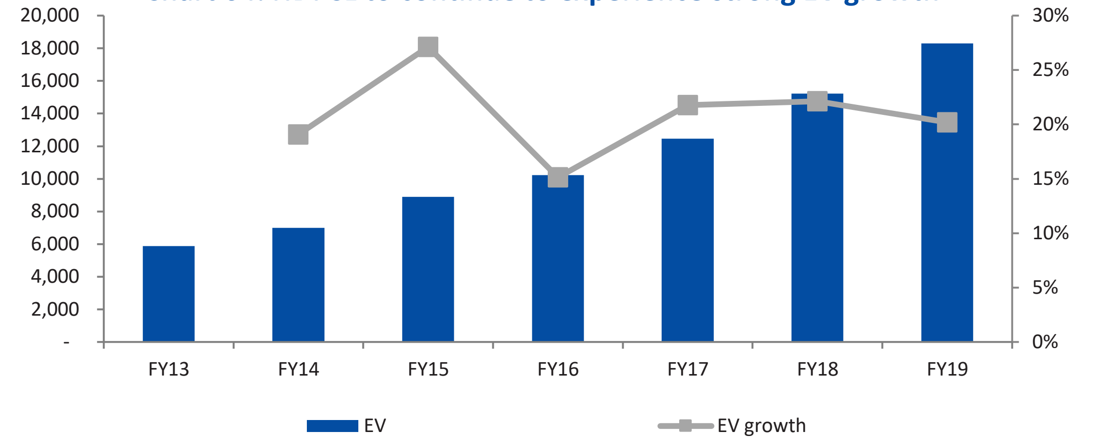
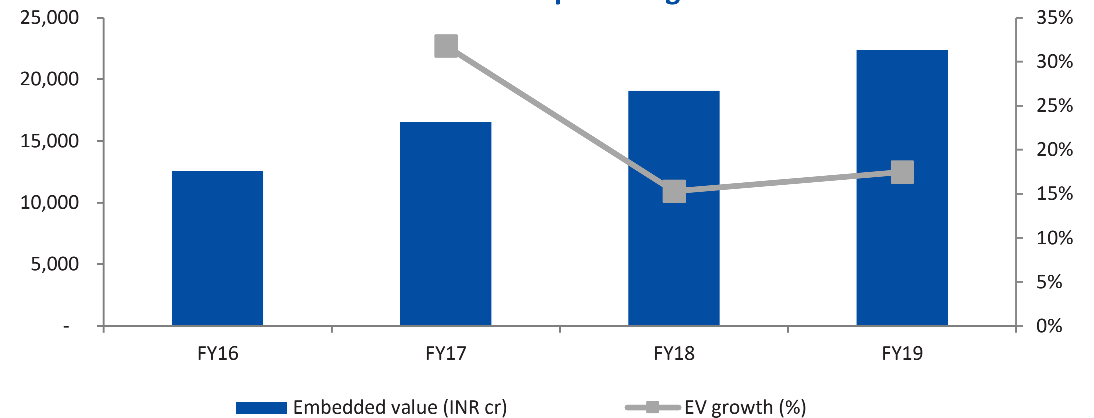


Chart 65: SBIL's EV compounding to continue



Source: Company, Edelweiss Professional Investor Research

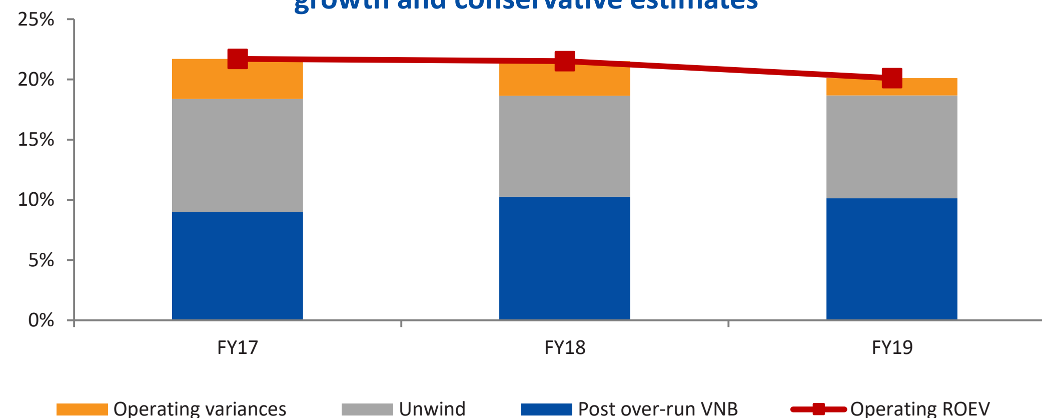
Embedded Value: Robust Operating ROEVs

We plot HDFCL's and SBIL's operating ROEV and its components in adjacent charts. While HDFCL's operating ROEV has been robust at 20-22% consistently, SBIL's is in the 17-23% range. Operating ROEV is a measure of profitability of life insurers calculated as EVOP as a percentage of opening EV and consists of unwind of VIF, VNB and assumptions for mortality, morbidity, expenses and persistency (operating assumptions).

Unwind and VNB as a proportion of operating ROEV has been stable over the years for both the companies (refer to charts 66 and 67). We believe, as these companies are increasing share of protection products at a fast pace, it can boost contribution of VNB to EV growth.

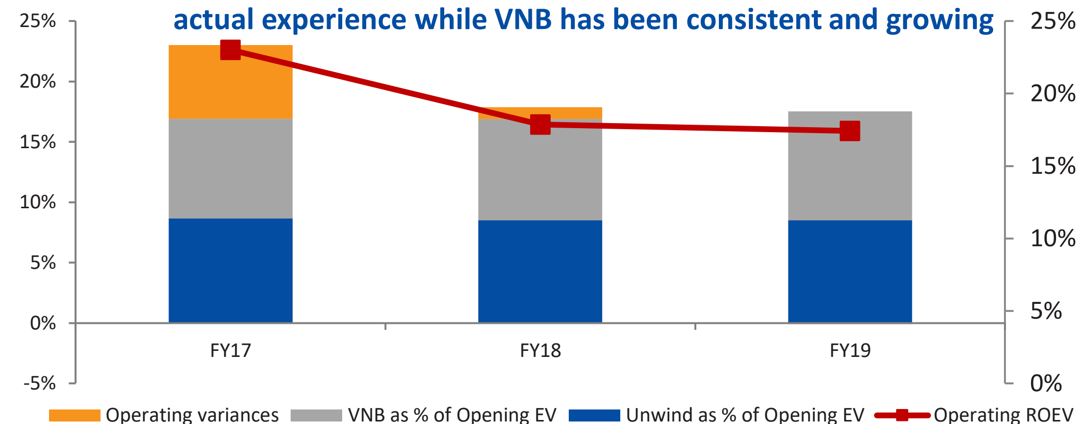
However, one needs to pay attention to operating variances/assumption changes as it reflects the conservatism in a company's estimates. HDFCL's assumption has been more conservative (hence operating variances better than estimates have resulted in positive variances), while SBIL's has seen divergences in the past, but has been quite close to experience off late.

Chart 66: HDFCL's operating ROEV has been driven by stable VNB growth and conservative estimates



Source: Company, Edelweiss Professional Investor Research

Chart 67: SBIL's operating assumptions have inched closer to actual experience while VNB has been consistent and growing



Source: Company, Edelweiss Professional Investor Research

Embedded Value Sensitivities

Insurers mandatorily report the sensitivity of the EV estimate to changes in various assumptions (which insurers generally undertake annually taking into account the experience of the year).

These include sensitivities of changes to economic (reference rates and equity market movements) and operational parameters (persistency, mortality and expenses). Sensitivities depend highly on the product mix of an insurer and hedging in place for these sensitivities.

We benchmark a few sensitivities for HDFCL and SBIL in the adjacent chart. Sensitivities differ within insurers owing to their product mix, where we see these industry leaders mostly at comparable levels.

Sensitivities of HDFCL and SBIL have been mostly at a similar level owing to their prudent underwriting. SBIL's interest rate sensitivity has been higher than its peers, although reducing, probably due to sensitivity of the group fund management business. However this is on a reducing trend, and has come down to ~3.5% to 100 bps movement in interest rates in H1FY20.

Chart 68: EV sensitivity for 1% increase in reference rate

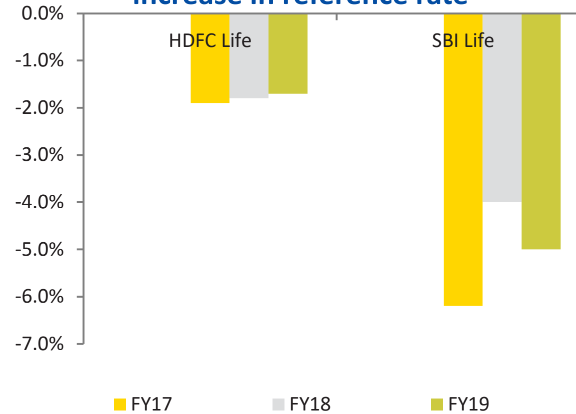


Chart 69: EV sensitivity for 10% fall in equity markets

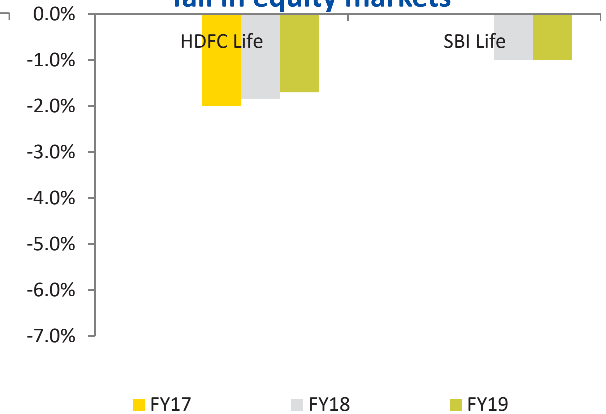


Chart 70: EV sensitivity for 10% increase in Lapse Rate

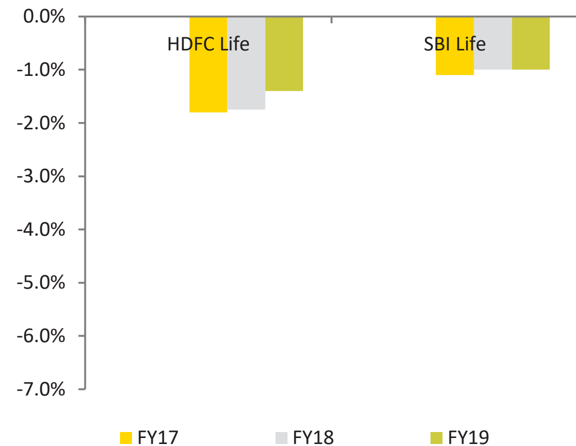
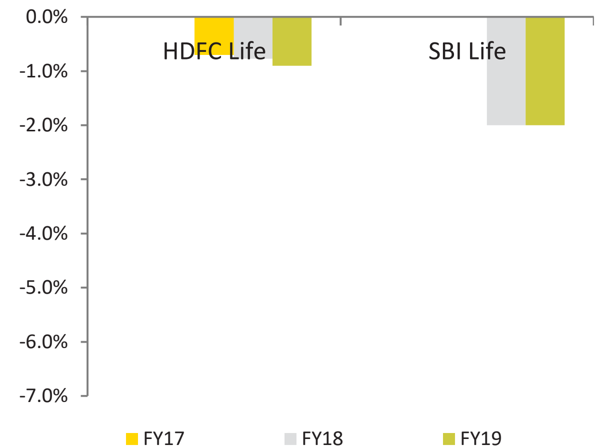


Chart 71: EV sensitivity for 5% increase in Mortality/Morbidity



Source: Company, Edelweiss Professional Investor Research

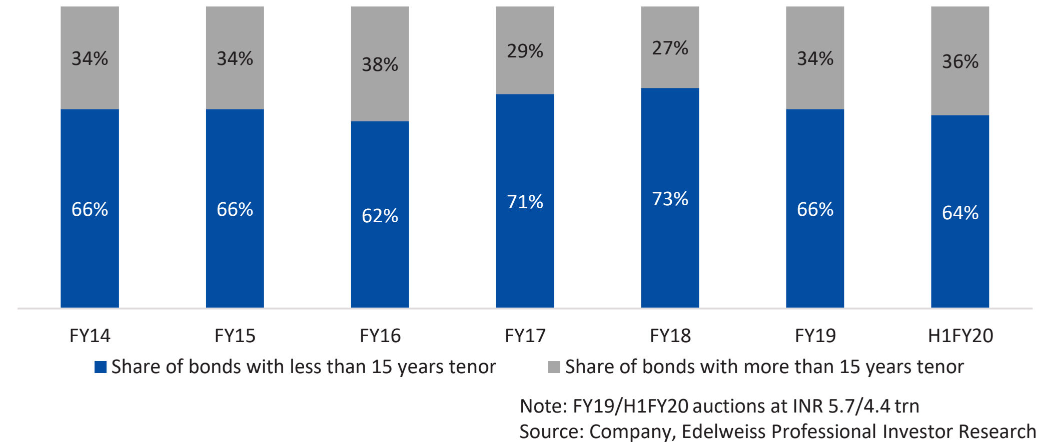
Non-par Products With Interest Rate Risks

Non-participating products with a guaranteed rate of return have been very popular. In addition to the guaranteed rate of return, these products also provide a risk cover. This primarily results in two types of risks for an insurer—mortality risks and interest rate risks. In case of annuities, instead of mortality risk, there is longevity risk along with interest rate risk. While mortality and longevity risks may hedge each other out, at least partially, depending on the nature of the products, insurers need to hedge the interest rate risk.

Techniques used to undertake such hedges are through duration matching (for parallel yield curve shifts) and cash flow matching (for non-parallel shifts). Instruments predominantly used for such matching are longer duration bonds (mostly government bonds which have deep markets), partly paid bonds and derivative instruments like interest rate futures, swaps and recently approved Forward Rate Agreements.

Both HDFCL and SBIL have undertaken such hedging and disclosed their interest rate sensitivities, which remain reasonable. HDFCL has disclosed that it plans to use shorter duration credit life cash flows to match longer duration non-par savings products, particularly Sanchay Plus.

Chart 72: Depth of India's fixed income markets – Split of government bond auctions across tenors (%)



Note: FY19/H1FY20 auctions at INR 5.7/4.4 trn
Source: Company, Edelweiss Professional Investor Research

HDFCL has also been underwriting deferred annuities, which can be an additional source of interest risk. Given that the deferment period on an average is at 3-4 years and a small proportion of these products in the mix, we do not see a significant risk on the balance sheet from these products.

SBIL management, during a recent interaction, highlighted that it uses G-Secs and partly paid bonds for hedging purposes and is planning to undertake Forward Rate Agreements with a few banks for hedging. Additionally, management has caps on product sales in place to limit their interest rate risk.

Strong Balance Sheets Alleviate Concerns

Being a regulated sector, life insurance companies have to mandatorily park large portions of their AUM in debt securities, as per IRDAI rules. As we show in the adjacent chart, only around a quarter of the book of the industry is in equity securities, with the balance being in debt (Refer Chart 73). Limits for traditional products have a floor for 50% of debt (of which government securities not less than 25%) and a cap on equities at 50%. Such restrictions on asset allocation are also applicable to unit linked, pension and annuity funds with government security exposure not less than 20%, debt exposure not less than 40% and exposure to riskier assets capped at 60% (refer Appendix A).

For HDFCL, the current INR 1.3 lakh crore AUM consists of 63% debt and 37% equity (at September 2019 end). SBIL's INR 1.55 lakh cr AUM is split 77:23 between debt:equity. Splits for linked and non-linked assets are 65:35 and 88:12, respectively. Exposure to AAA assets remains at 90%+ for both the companies and hence they have been largely unaffected by the recent defaults in papers of a few financiers. We highlight this in Chart 74. Solvency levels remain robust for both, higher than the IRDAI recommended level of 150% (refer to chart 75). We do not see requirement of additional capital infusion for players in the near future; however, as insurers write more and more capital intensive products, this may be required over the medium term.

Chart 73: Industry asset mix contains predominantly debt securities (%)

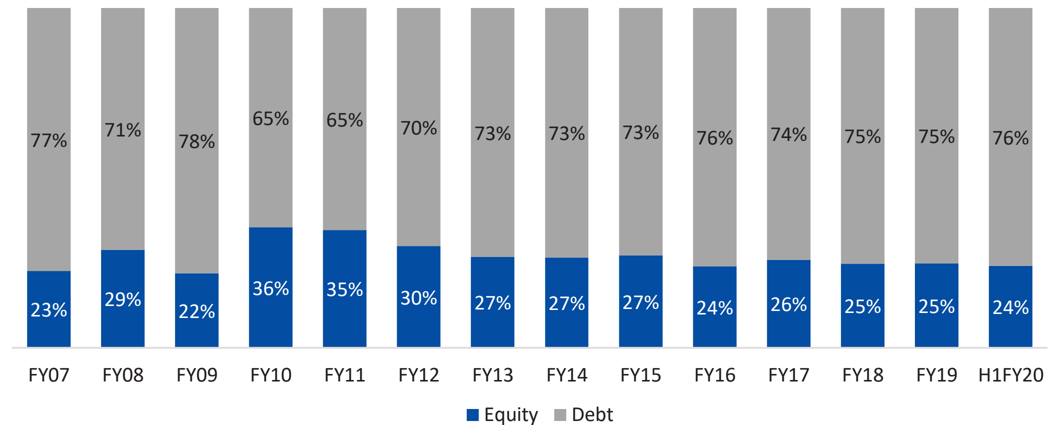


Chart 74: HDFCL and SBIL's AUM have a large share of Debt

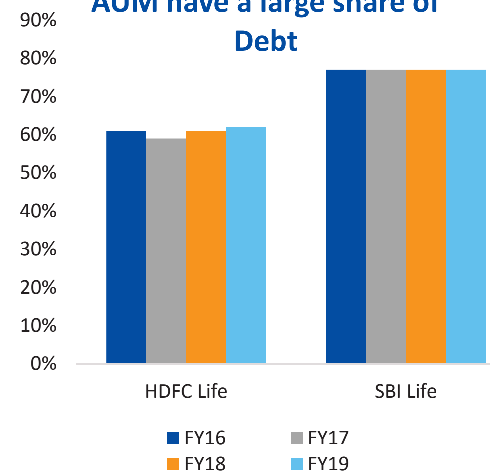
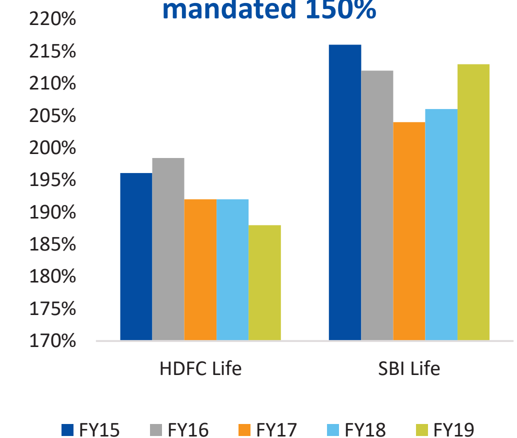


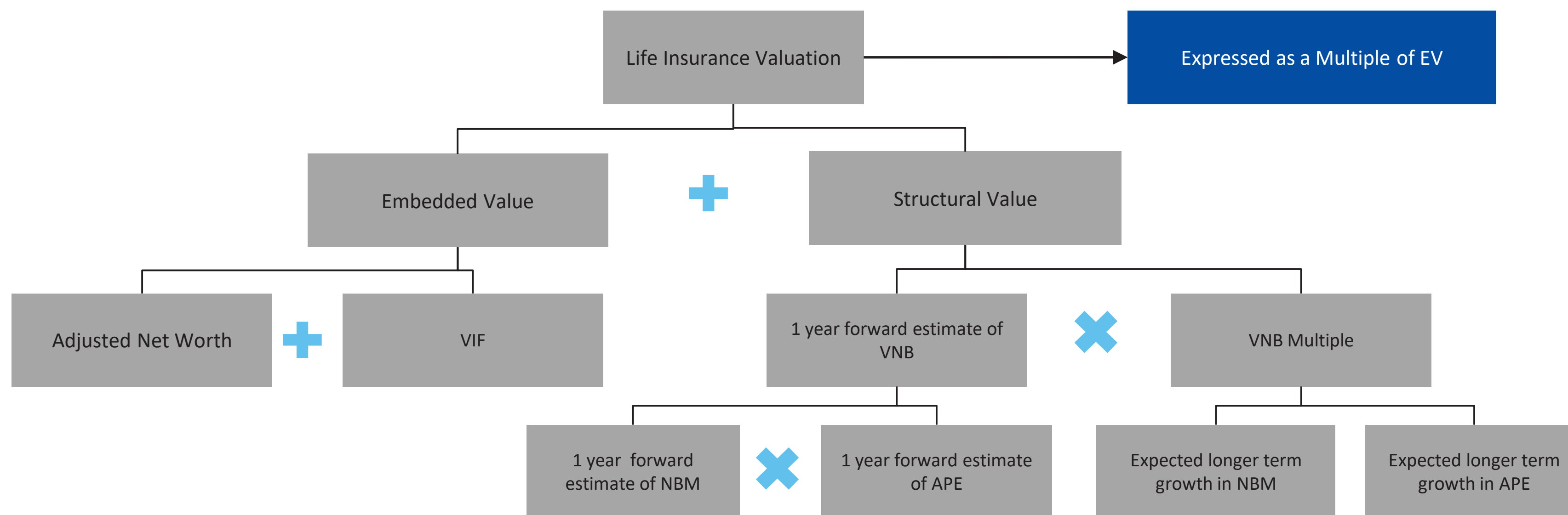
Chart 75: Solvency margins well over the IRDA mandated 150%



Source: Life Insurance Council, Company, Edelweiss Professional Investor Research

Embedded Value: Assessing Value of A Life Insurer

Chart 76: Valuation of life insurance companies



The EV framework is used to value an insurance company (as shown in the above schematic). The exercise is undertaken to arrive at the value of the life insurer, which is the sum total of the EV and an estimate of the value to be accrued from new businesses written in future (structural value). This is normally estimated by using a capitalisation factor on a forward estimate of new business value (which is done by estimating next year's new business margin and APE). Capitalisation factor is chosen based on expected pace of margin expansion and expected growth in APE. Alternatively, structural value can be calculated by forecasting future VNBs and taking their present value. Valuation of the life insurance business is generally expressed in terms of P/EV multiple.

The current valuation of insurance companies has been a topic of much discussion with listed peers trading at 3-6x trailing EV. This looks high in comparison to valuations of insurers in some other countries, which have been trading at 1-2x trailing EV. We, however, do not believe that the current valuations overestimate the growth in future new business, characterised by a large opportunity size, shift towards untapped high-margin protection/annuity segments and possibility of a surprise on margin expansion front as the headroom remains large.

Company Section

HDFC Life Insurance Company Ltd.

HDFC Life (HDFCL) is one of the leading private players in Indian life insurance space. We believe, the company will capitalise on the industry tailwinds of under-penetration across sectors, mortality gap and demographic advantages owing to its: a) execution capabilities underpinned by a balanced product mix (shifting to higher margin products); b) diversified distribution channels; c) product innovation; and d) investment in digital capabilities, which will aid prudent underwriting and help lower cost distribution.

HDFCL aims to grow each of the businesses at an optimal rate with a goal of all-round growth across product categories. Capital is generally allocated on the basis of new business value generation, while risk management starts at the time of conceptualising a product. HDFCL's product innovation has helped it build a solid track record and resulted in improvement in profitability as the product mix changes towards more protection and annuity products.

We believe, ability to identify niches and deliver blockbuster products, coupled with its diversified distribution network, will promote all-round growth for the insurer.

At the current price, the stock trades at ~6x the latest disclosed EV.

Swarnabha Mukherjee
Research Analyst
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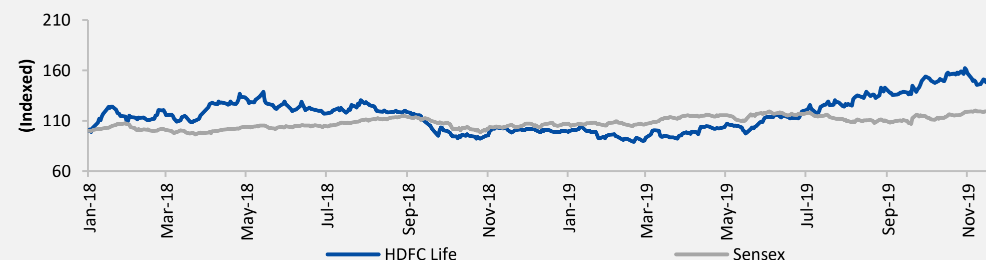
CMP INR: 617

RATING: Not Rated

Relative Price Performance



Bloomberg:	HDFCLIFE:IN
52-week range (INR):	646 / 344
M cap (INR cr):	1,18,851
Average Daily Volume (BSE/NSE)	

Share Holding Pattern	(%)
Promoter	71.16
Public	28.81
Others	0.03

Year to March (INR Cr)	FY17	FY18	FY19
Total Premium	19,445	23,564	29,186
APE	4,190	5,530	6,260
Embedded Value	12,470	15,220	18,300
Profit after tax	890	1,110	1,280
P/EV	10.0	8.2	6.8
New Business Margins	22.0%	23.2%	24.6%
RoEV	21.7%	21.5%	20.1%
RoE (%)	25.7%	26.0%	24.6%

Date: 23rd December 2019

I. Consistent Premium Growth And Market Share Gain Riding Booming Group Business

HDFCL has consistently gained market share in the private market as well as overall industry bolstered by sustained robust pace (refer Chart 77). Gross premiums jumped 17% p.a. over FY13-19, with significant surge in growth in recent years (FY17 onwards) fueled by single-premium products like credit protect and annuities (as we show in Chart 78 and 80). Credit protect is sold as a group insurance product, resulting in group new business premium growing at a much faster clip than individual new business premium (36%/8% p.a. CAGR in FY13-19). Owing to this stellar growth, HDFCL's market share in the group business has catapulted from 14% in FY14 to 28% in FY19, driving overall private market share to 21% compared to 14% in FY14, as shown in Chart 79.

This has further propelled driven by robust sales of popular products in the non-participating savings segment. Management, in recent interviews, has guided for new products to be released in Q3/Q4FY20, which, if gains traction, should be instrumental in driving up market share going forward. Another factor that could accelerate sales is focus on higher productivity across channels, like the agency channel, which has headroom to improve compared to its peers as we highlight in our discussion on HDFCL's distribution channels in this note.

Chart 77: Consistent growth has aided in almost trebling the total premium

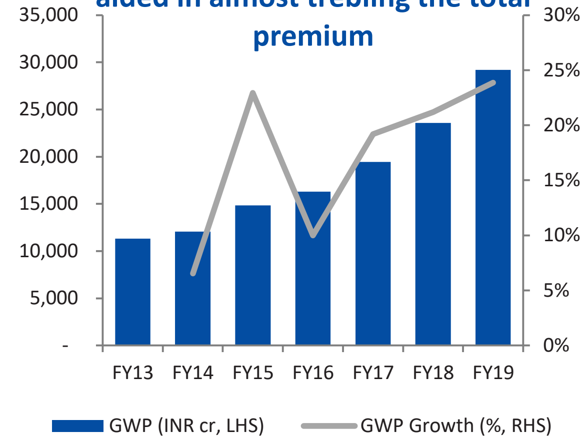


Chart 78: Single premium policies saw the strongest growth

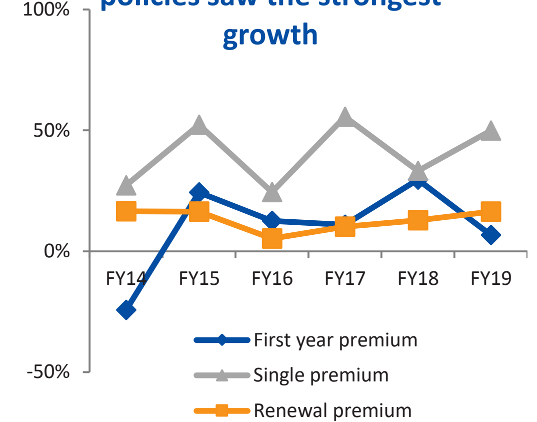


Chart 79: Consistent gain in overall market share, aided by group business

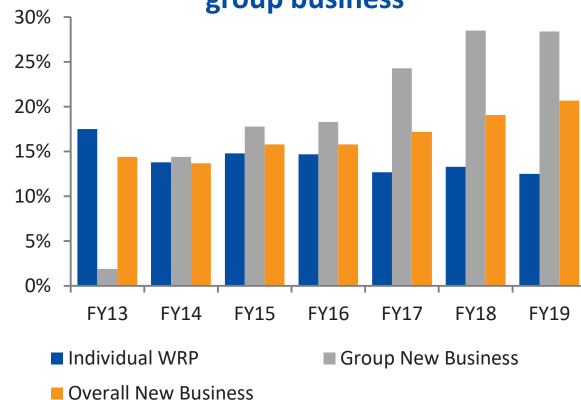
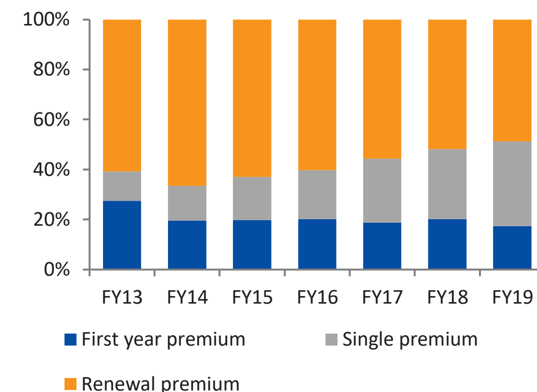


Chart 80: Contribution of single premium policies have increased in the mix



Source: Company, Edelweiss Professional Investor Research

II. Group Protection And Annuities Clocking Stellar Growth

HDFCL is present in all the three segments of the insurance business—risk (covering mortality/morbidity risk – protection), fee (ULIPs) and spread (non-participating savings and annuities). The company's mix is balanced across product types (refer to chart 81), particularly on an overall NBP basis. In terms of NBP, while protection products (term and annuity together) constituted the largest chunk (~44% in FY19), savings products contributed the balance in FY19. Share of ULIPs is dipping in the mix as annuity and term insurance businesses ramp up.

Growth in the protection business has primarily been fueled by robust spurt in credit life products, part of the group businesses. HDFCL is a leader in credit life products, starting prior to FY14, and now consists over 50% of the group premium. These products provide cover for default of loan repayments in the event of death of the borrower. The book and sourcing remain fairly diversified (refer Charts 82 and 83) and the company remains focused on risk management, including repricing/exiting deals where expectations and experience mismatch. Credit protect policies generally become profitable quickly compared to other term products as more than half of the cover is towards shorter-duration products. Management is also focusing on increasing the value as well as attachment ratios.

Chart 81: Product-wise mix of new business premium

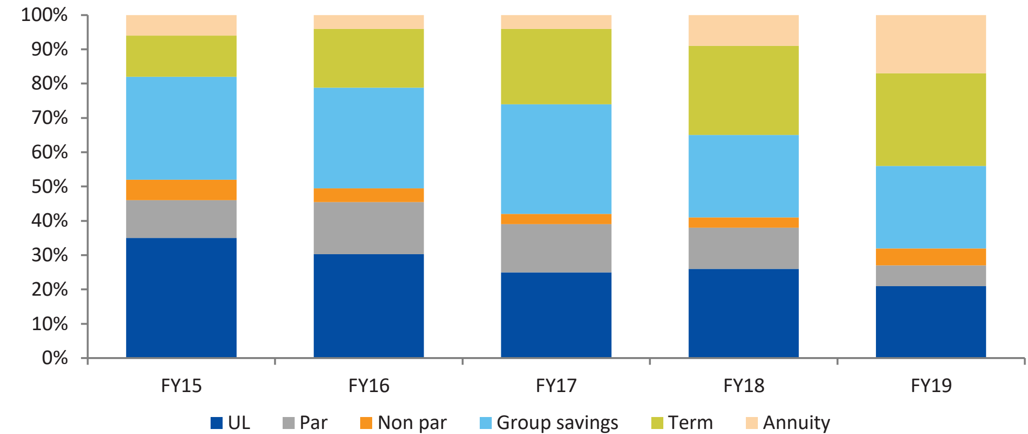


Chart 82: HDFCL's Credit Protect book is fairly diversified

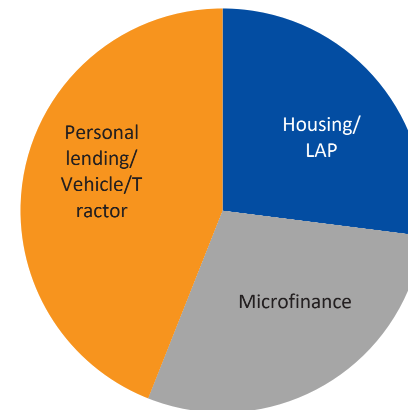
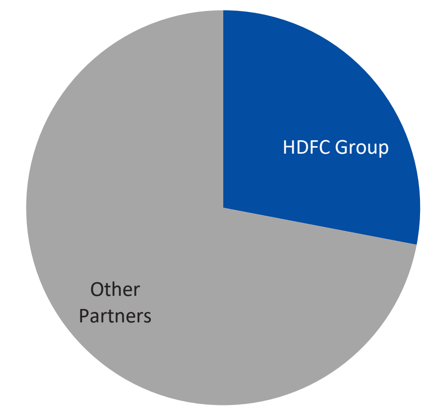


Chart 83: Distribution channel for CP is also diversified with no partner other than HDFC Group having >10% share



Source: Company, Edelweiss Professional Investor Research

III. Share of Protection And Non-participating Savings Rising in Product Mix

In terms of individual business, the share of ULIPs was ~55% in FY19. Since ULIPs are popular in India, their proportion is expected to remain between 50% and 60%, according to management. However, HDFCL is focusing on expanding the protection business, whose share in the product mix has jumped from 5% in FY15 to 12% in FY19 (7% from term insurance and 5% from annuities). Share of protection and non-par savings policies in the mix has increased at the expense of participating policies.

The company is not targeting any particular product mix and will allow each product line to grow within the ambit of manageable risk. However, the recent traction in non-participating products could tilt the mix in favour of saving products to some extent in the near term, although management has guided for an exit rate of 35-38% of non-par savings products in the mix at FY20 end.

These products carry interest rate risk, which the company has highlighted is well managed as HDFCL continues to reprice products with movement of interest rates and hedge interest rates using fixed income instruments/derivatives like G-Secs, bonds, FRAs, IRFs and swaps.

Chart 84: Product mix of Individual APE (%)

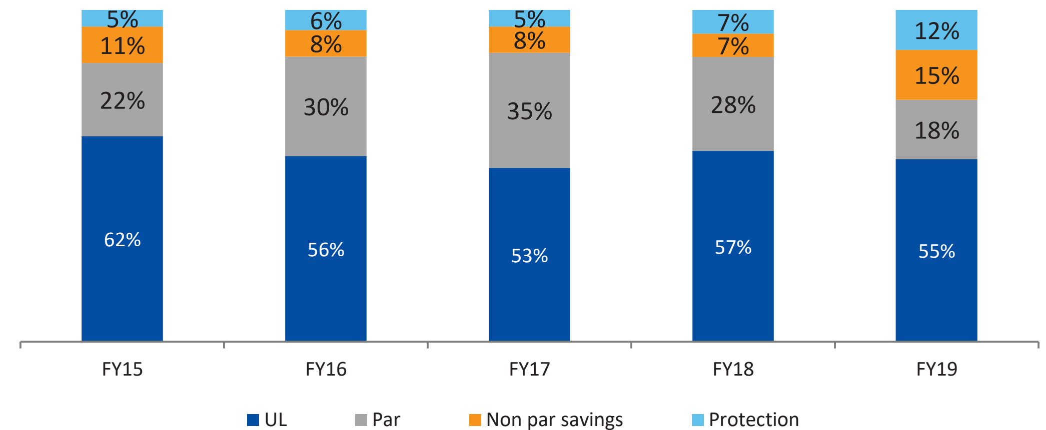
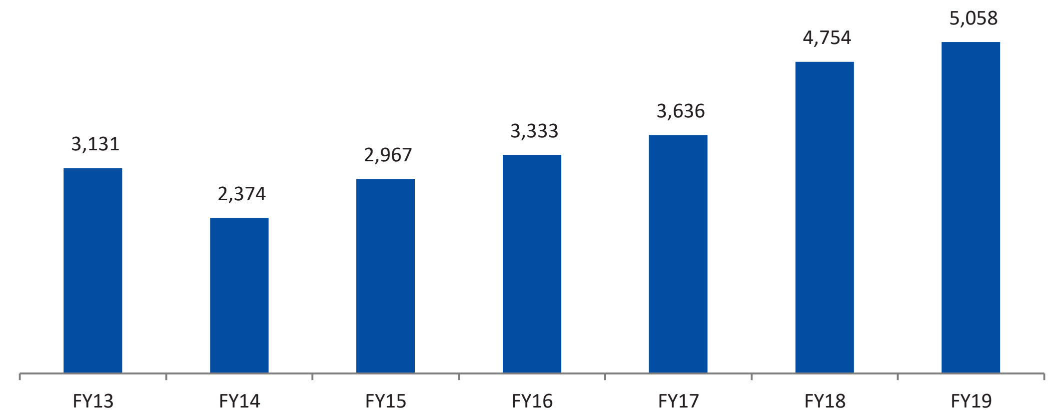


Chart 85: Individual business WRP has seen solid growth (INR cr)



Source: Company, Edelweiss Professional Investor Research

IV. Shifting To Higher-margin Products

Spurt in HDFCL's VNB has been aided by higher volumes and change in product mix in FY19, with operating leverage starting to play out riding robust sales of non-par savings products in H1FY20. Consequently, the company has posted industry-leading new business margin (or VNB margin). Change in the product mix was the key driver of margin improvement. Going ahead, along with growth in protection products, annuities are also expected to see strong growth.

We expect this shift towards protection products to continue at an industry level as it undergoes a long-term structural shift led by customer awareness and focus of insurance companies on ramping up the share of protection products (individual protection, group protection and annuities). This should result in strong VNB growth and margin expansion for players.

While this can be a consistent trend going forward, HDFCL's near-term margin will probably normalise led by changes in the product mix (normalization in sales of Sanchay Plus from the record levels seen since launch). Management had, in one of the earlier interactions, guided for a floor of 22% in VNB margin and the company is currently operating substantially above it.

Chart 86: Consistent VNB margin expansion driven by solid growth in VNB (INR cr)

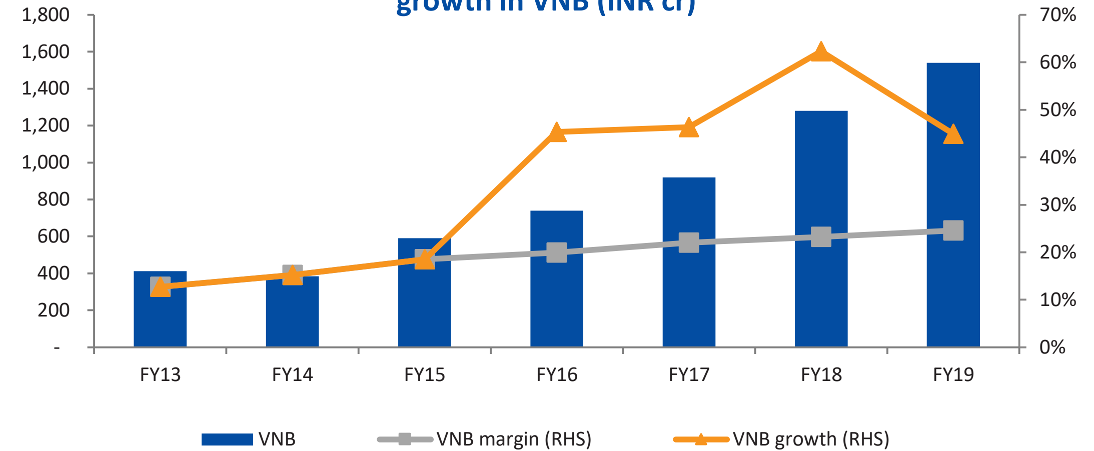
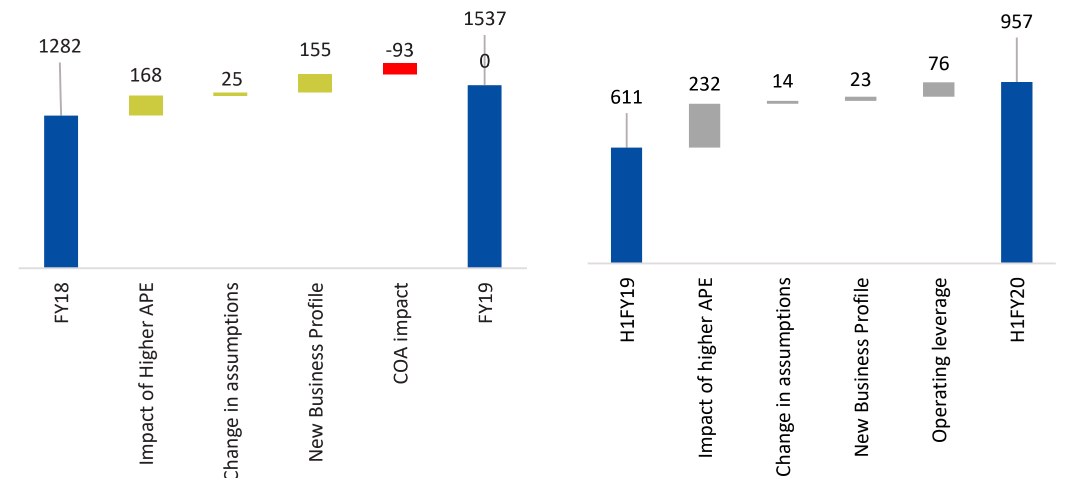


Chart 87: VNB growth aided by volumes and changes in product profile (INR cr)



Source: Company, Edelweiss Professional Investor Research

V. Spearheading Innovation Drive

HDFCL has been at the forefront of product innovation, which has helped the company gain industry-leading margin coupled with strong volume growth. Identifying the niche of credit protect insurance and expanding on it has helped the company achieve strong growth in its group premium as well as overall VNB margin considering it is a higher-margin product.

Additionally, HDFCL's *Click2* series products have also gained good traction. The series was started with *Click2Protect* online term insurance in FY12, followed by ULIP offerings *Click2Invest* and *Click2Retire*. Leveraging the online channel, these products targeted younger customers with average age of 36 years.

Health policies like *Cancer Care* & *Cardiac Care* and small-ticket products through new ecosystems have been recent innovations in the protection space. In savings, recent products launched are Sanchay Plus (a guaranteed income product) and Classic One (joint-life single premium ULIP product). Given its track record, we believe HDFCL will continue to come up with innovative products. Management had earlier mentioned in an interview that HDFCL is likely to launch new products in Q3/Q4FY20.

Chart 88: Innovative products launched by HDFC Life

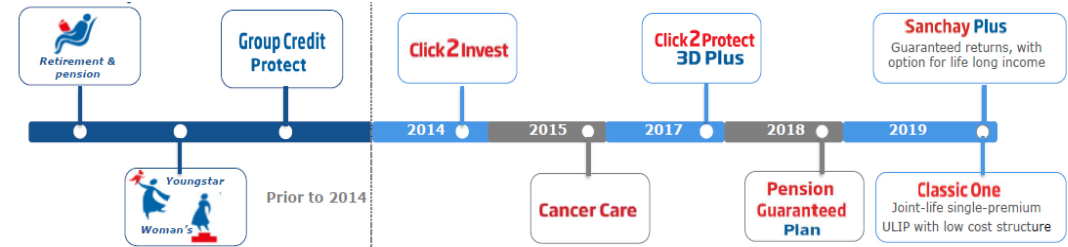
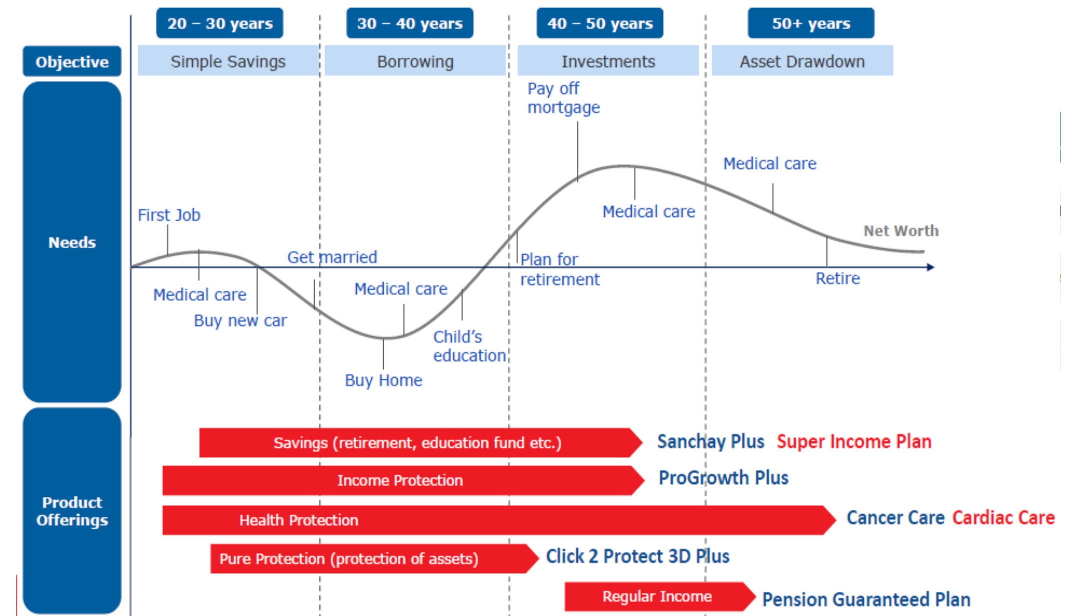


Chart 89: Presence across customer life-cycle



Source: Company

VI. Diversified Distribution Channels Fuelling Balanced Product Mix

A diversified distribution mix has ably supported HDFCL's balanced product mix. Bancassurance is one of the leading channels, which contributed ~65% to individual APE in FY19 (dipped to 56% in Q1FY20 owing to higher non-par sales).

HDFCL has 120+ bancassurance relationships (of which HDFC Bank contributes significantly – 80%+) through which it predominantly sells ULIPs and par products (non-par savings products have also grown through this channel off late). Bancassurance, being a lower-cost distribution channel due to lower overheads, is best suited to sell products with lower profitability. However, HDFC Bank has adopted the open architecture model and has tied up with other insurers (Aditya Birla Sunlife/Tata AIA) as well.

Since ULIPs have been one of the popular products in the Indian market, life insurers with a expansive bancassurance network have gained scale. For HDFCL, the share of bancassurance will reduce in the near to medium term driven by lacklustre growth in ULIPs and higher growth in alternate channels like agency and direct sales, which remain a focus area for the insurer. Higher sales via proprietary channel will result in economies of scale in the channel.

Chart 90: Share of direct sales has been increasing in the channel mix

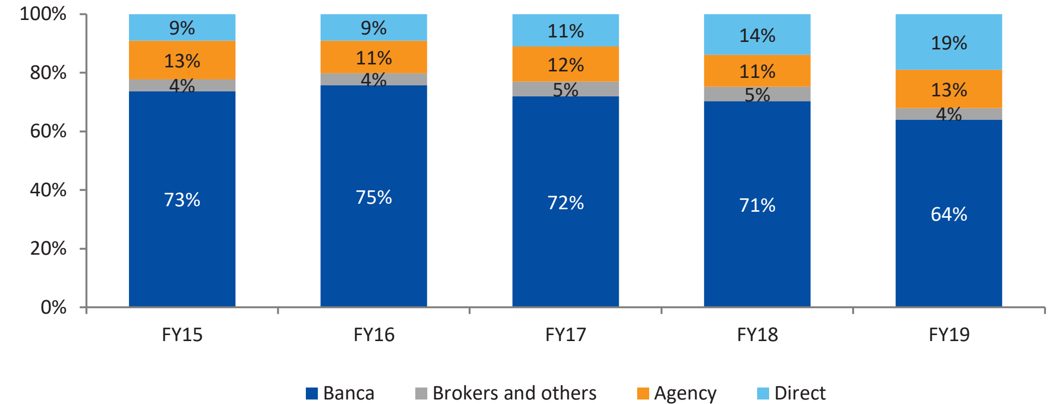
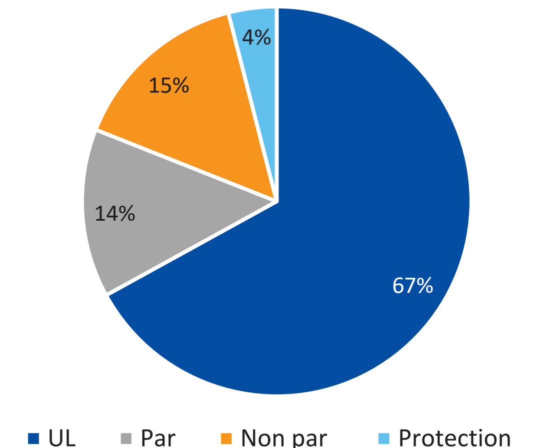


Chart 91: HDFCL's key banca partners

Chart 92: ULIPs, Par and Non-par are products sold through Banca



Source: Company, Edelweiss Professional Investor Research

VII. Productivity Booming Across Distribution Channels

HDFCL has been investing in developing its agency and direct distribution channels. The agency channel is generally fixed cost heavy and requires high productivity to be profitable. It generally sells considerable portion of non-linked policies and this is probably the key reason for management's focus on it.

We see these initiatives bearing fruit as the share of direct sales in the channel mix has jumped (19% in FY19 from 9% in FY15) and productivity of agents has increased (15% of H1FY20 APE vs 11-12% in FY16-18 and higher agent productivity due to segmented agent recruitment strategy, refer Chart 93), although lower than listed peers. The agency channel has posted solid growth (80%+) in H1FY20 driven by robust sales of Sanchay Plus. The channel has best-in-class persistency ratio across cohorts (we highlight later).

Direct and online are the fastest-growing channels (we highlight the strong growth in these segments in Chart 94) and have been one of the key enablers of individual protection and non-par sales (refer to Chart 95). They have improved productivity through use of technology and cross-selling opportunities. While direct channel has seen strong sales in annuity, online sales have a large share of term insurance and ULIPs.

Chart 93: Agent productivity on a rise (in '000)

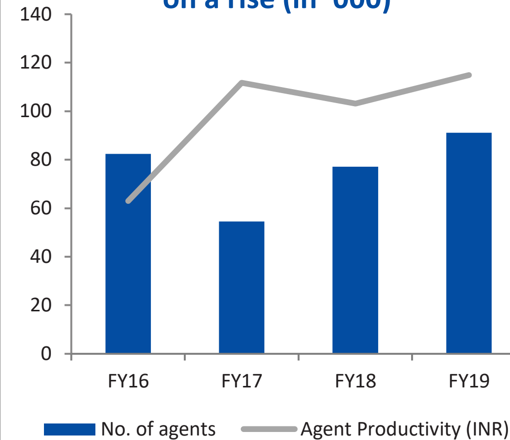


Chart 94: Agency and Direct channels have seen solid growth (INR cr)

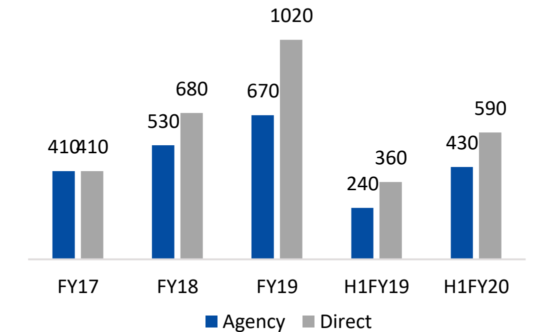
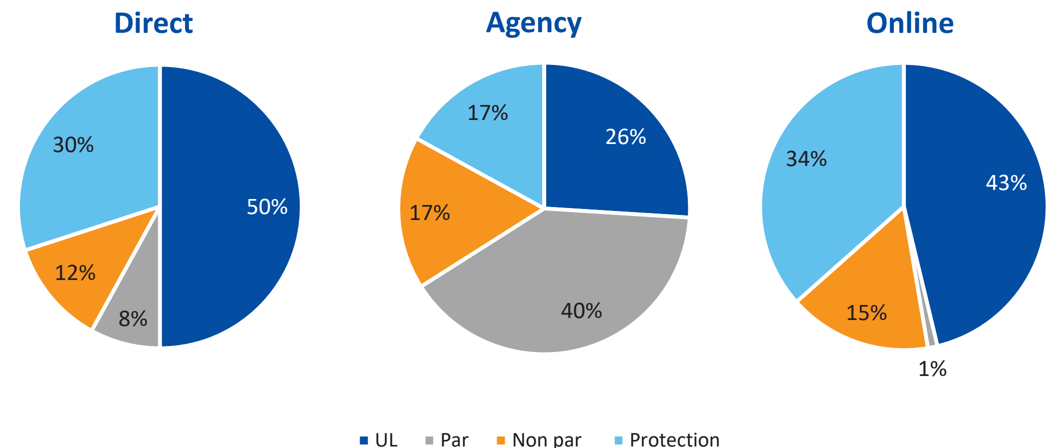


Chart 95: Agency, Direct and Online channels – FY19 sales mix



Source: Company, Edelweiss Professional Investor Research

VIII. Higher Expense Ratios To Normalise And Benefits Of Investments In Technology To Materialis

HDFCL's operating expense ratio has increased over the past few years as the company has continued to invest in the business for developing distribution channels and technology. Consequently, the company's expense ratio is one of the highest among listed players. We believe, operating expense ratio has peaked out and should normalise to slightly lower level and fall gradually as operating leverage plays out.

This will be further aided by initiatives like machine learning, which will reduce customer acquisition costs and improve operating & search efficiencies in the business. Over the long -term, benefits of these initiatives should flow into the profitability of the company. According to management, these initiatives have resulted in 84% incremental leads and 46% reduction in the cost per lead in the direct channel.

Commission ratio has remained around 4% for HDFCL (3.8% in FY19) driven by a larger share of group business from the direct channel. This should broadly remain at similar level, albeit rise marginally from FY19 level, due to higher sales of individual protection and non-participating guaranteed products (H1FY20 commission at 4.9%).

Chart 96: Operating Expense Ratio high owing to investments in business

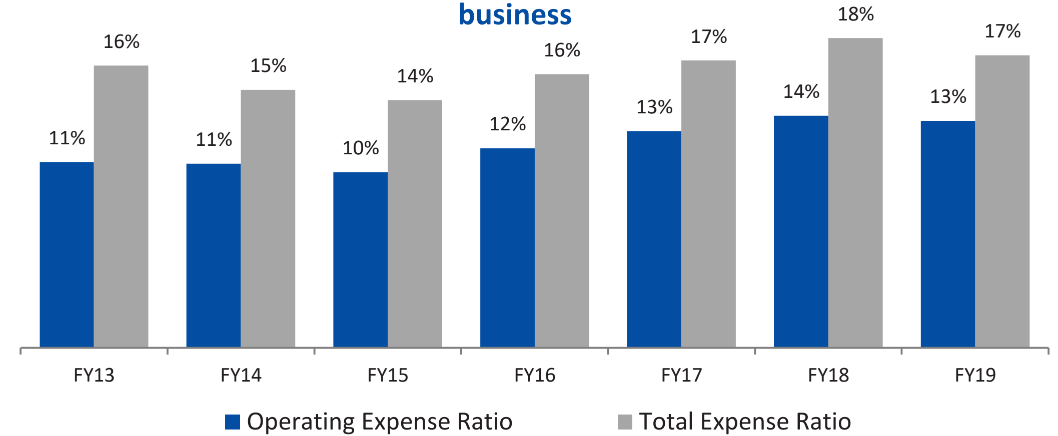
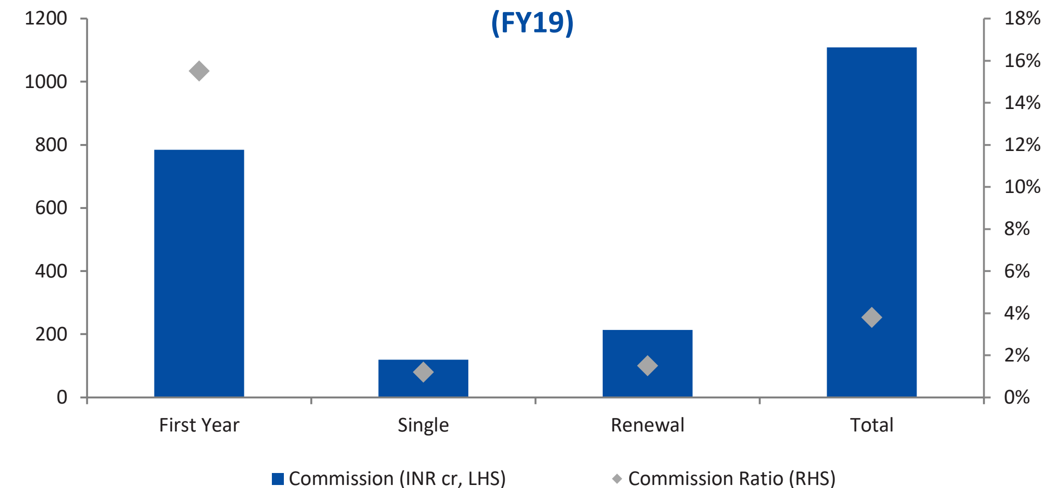


Chart 97: Commission paid for various types of premium (FY19)



Source: Company, Edelweiss Professional Investor Research

IX. Persistency Ratio Continues To Improve

Maintaining persistency of policies remains key in insurance business as post initial period of higher costs, larger share of profits unwind. Persistency is defined as the proportion of business that is renewed and is measured at the end of every year. Persistency levels in the industry have been on the rise for most listed players.

HDFCL has also consistently improved its persistency level and has been mostly on the higher side among peers. While persistency in the 13-month cohort has increased from 73% to 89%, that of the 61-month cohort improved from 40% to 54% (from FY15 to H1FY20; refer to chart 98).

HDFCL experiences better persistency in both term and non-par savings products (refer to chart 100), which are key focus areas for the company. And, as their share improves in the mix, persistency will also improve. Non-par saving policies do not see much lapse third year onwards. Further, larger sales through the direct channel, which generally have better persistency over the long term, will also boost numbers (refer to HDFCL's persistency across channels in chart 99).

Chart 98: Persistency is consistently on the rise

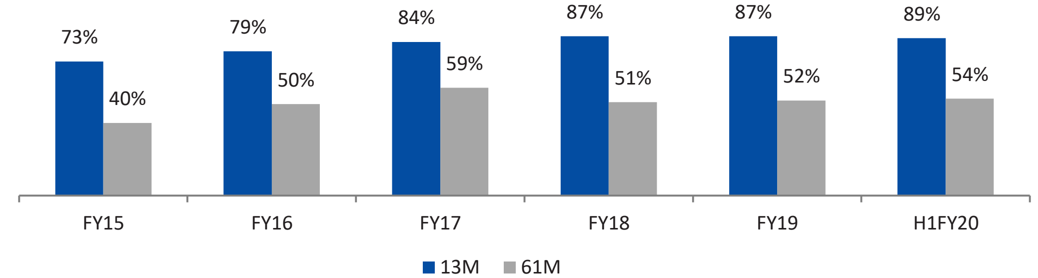


Chart 99: Persistency across distribution channels (FY19)

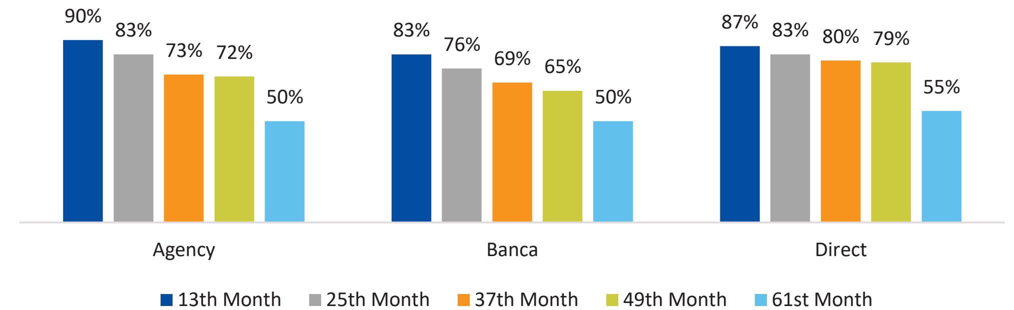
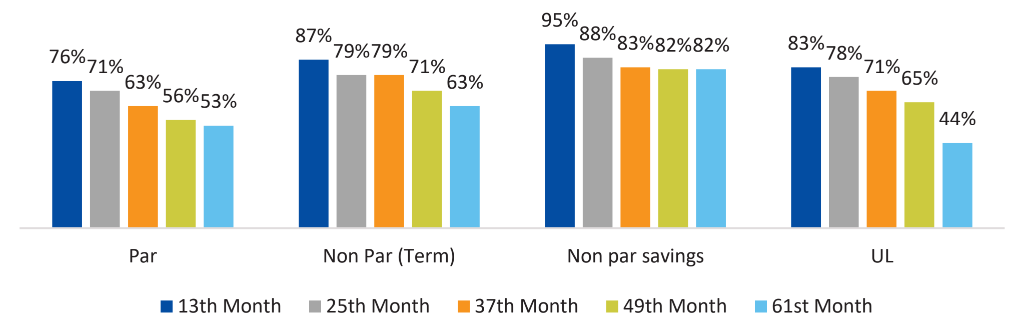


Chart 100: Persistency across product segments (FY19)



X. Embedded Value: Compounding To Sustain

Historically, HDFCL's EV has compounded at a strong rate—21% CAGR over FY13-19 with EV of INR 20,120 cr at H1FY20 end. Primary drivers of this growth have been robust surge in value of new businesses and expected returns from business (refer to chart 101).

The company's EVOP growth can remain robust (Refer Chart 102) as VNB continues to grow strongly riding sales of higher-margin product. EVOP has grown consistently at 20%+ over FY16-18; some slowdown owing to a larger base (FY19 growth at ~14%). However, it has picked up to ~20% in H1FY20 owing to strong new business development.

EVOP growth should sustain as improving new business margins/higher sales result in new business value be a leading contributor to EVOP growth and ROEV. VNB as a percentage of opening EV has consistently improved over the years—from 7% in FY14 to 10% in FY19, as we highlight in Chart 103. This may not to be materially lower than the current level in the medium term as improving profitability (due to adoption of more higher-margin products) compensates for a larger base.

Chart 101: HDFCL to continue to experience strong EV growth (INR cr)

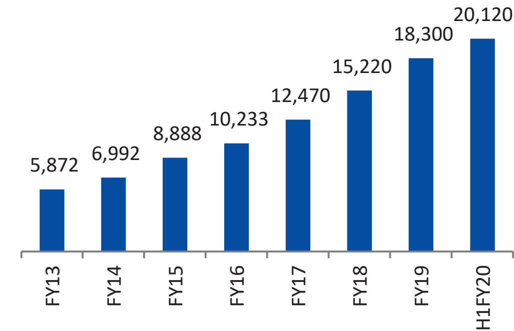


Chart 102: EVOP growth has remained robust resulting in solid ROEV

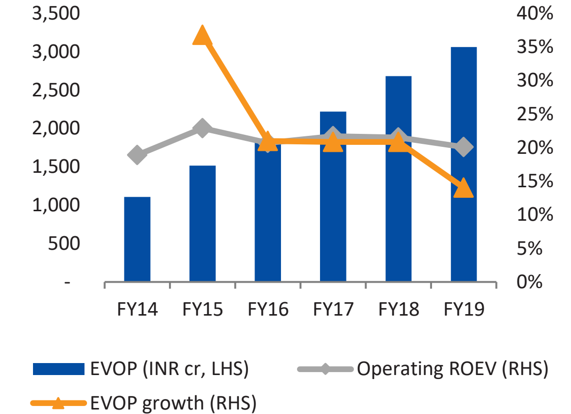
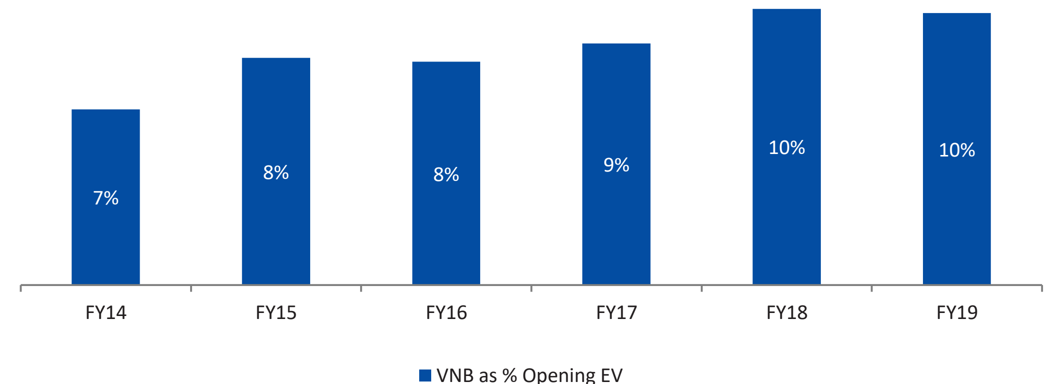


Chart 103: VNB has been a leading driver of EV growth as margins improve coupled with APE growth



Source: Company, Edelweiss Professional Investor Research

XI. Embedded Value: Conservative Assumptions Ensure Top-notch Reporting Qualit

A view on the quality of EV reporting of an insurer can be taken from the assumption variances that impacts the roll-over of EV. While economic assumptions hinge on financial markets (bond yields and market movements), positive variances in operating assumptions related to mortality, morbidity, persistency and cost highlight that a management has been conservative in estimating EV and actual experiences have been better than expected. HDFCL reviews assumptions annually.

Operating variances have historically remained positive for HDFCL given management's conservative assumptions on mortality, persistency and expenses. Operating ROEV can remain broadly at a similar level going forward as a larger base can be compensated by improving profitability of new business. For HDFCL, the boost to EV owing to variances/changes in operating assumptions has been 1-3% in FY17-19 (refer to charts 104 and 105), which resulted in INR 220-360 crore addition to the EV.

During our recent interaction, management stated that the experience has been small positive variances under these heads. Given the company's track record, we expect such a trend to continue. Operating variance in H1FY20 was ~INR 60 crore.

Chart 104: HDFCL's operating ROEV has been driven by stable VNB growth and conservative estimates

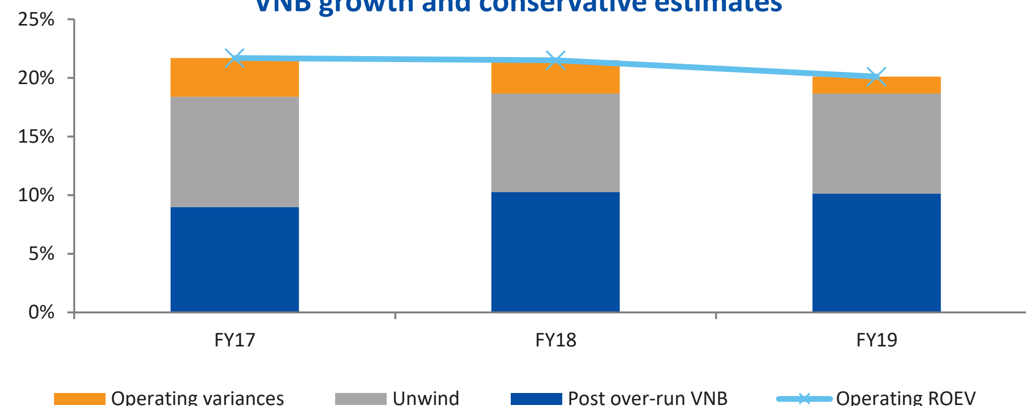
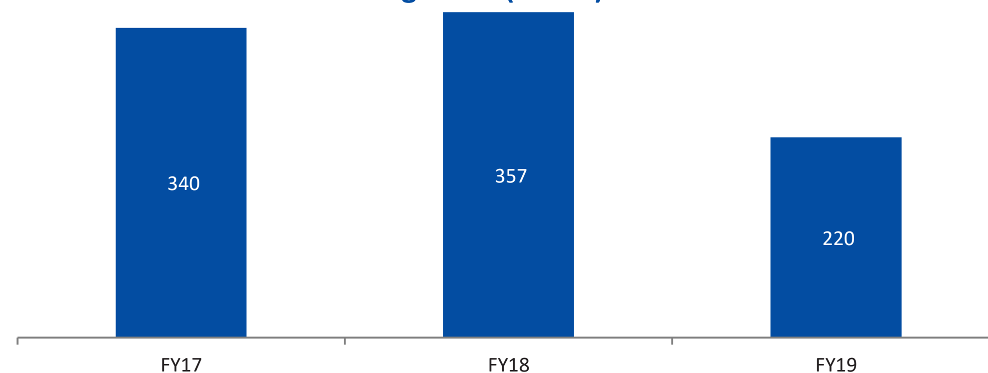


Chart 105: Operating variances has consistently aided EV growth (INR cr)



Source: Company, Edelweiss Professional Investor Research

XII. Strong Balance Sheet With Comfortable Solvency Position

HDFCL is a leading asset manager with INR 1.3 lakh crore assets under management as at H1FY20 end. AUM growth has been robust over the past few years (refer to Chart 106), with annual growth in the 15-20% range, despite a fairly large base.

HDFCL has a strong balance sheet with predominant investments in debt, even in ULIP books owing to strict regulations on the same (refer to Appendix A). Debt generally has been upwards of 60% of the asset mix with equity comprising the balance. In terms of individual mandates, ULIP books remained more geared towards equities than others. Most of the assets are in AAA rated papers and government bonds (~96% as at H1FY20) resulting in the company being largely immune to recent corporate bond defaults.

Due to strong back book generation, HDFCL's solvency margins have remained stable despite strong pick up in share of capital-intensive products. It has posted margin of ~190% over the past few years with a minor fall in solvency level due to capital infusion in subsidiaries (pensions and GCC reinsurance subsidiaries). Owing to this, we do not see capital infusion to be a necessity any time soon.

Chart 106: AUM growth remains stable

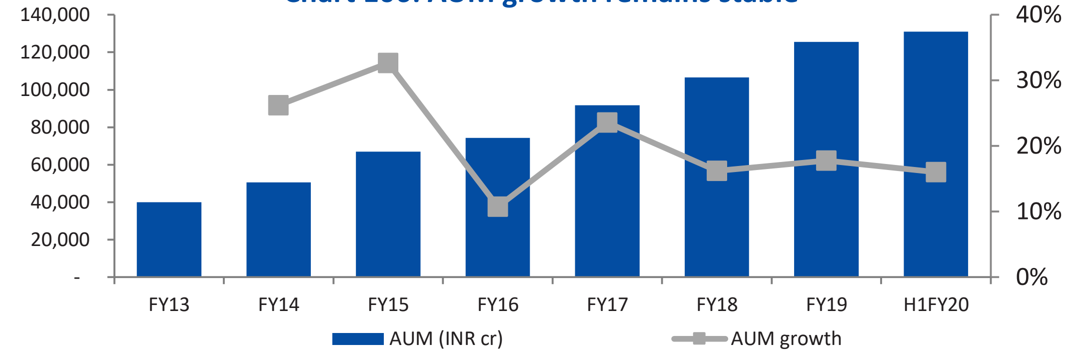


Chart 107: Debt comprises of major portion of AUM

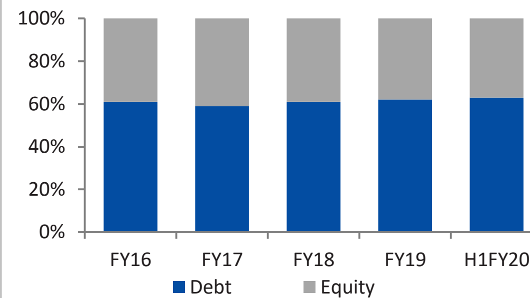


Chart 108: Capital required as a % of NBP (INR cr)

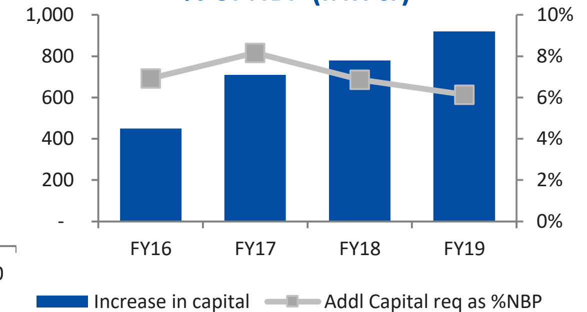
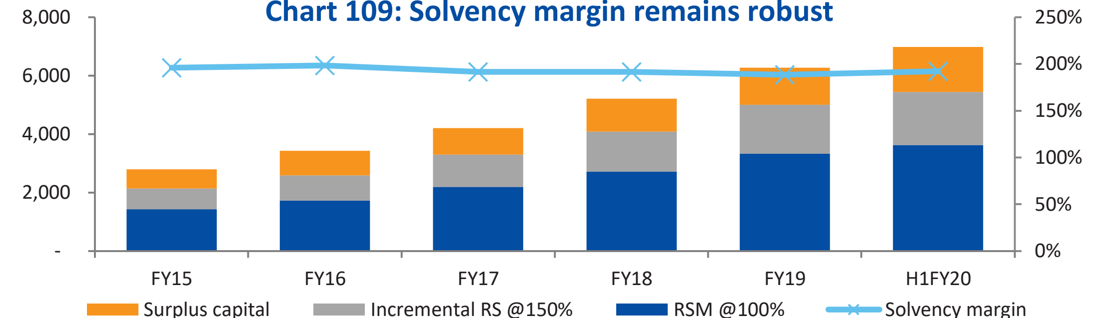


Chart 109: Solvency margin remains robust



Source: Company, Edelweiss Professional Investor Research

XIII. Senior Management Team: Overview

Name	Designation	Experience
Ms. Vibha Padalkar	*Managing Director & Chief Executive Officer*	Associated with HDFCL since August 2008, Ms. Padalkar qualified as a member of the Institute of Chartered Accountants of England and Wales in 1992 and is also a member of the Institute of Chartered Accountants of India. Prior to HDFCL, she has been associated with WNS Global Services, Colgate Palmolive and PricewaterhouseCoopers.
Mr. Suresh Badami	*Executive Director*	Mr. Badami has been associated with HDFCL since October 2013. Previously, he was associated with Dunlop India Limited, ICI India Limited, Cogensis Networks Private Limited, Max Ateev Limited and ICICI Bank Limited. He holds a Bachelor's degree in Science from Bangalore University and a Post Graduate Diploma in Management from Xavier Institute of Management, Bhubaneswar.
Mr. Niraj Shah	*Chief Financial Officer*	Mr. Shah has been associated with HDFCL since February 2019 and heads Finance, Audit, Risk Management and Investor Relations. Prior to joining HDFCL, he was associated with PNB MetLife, ICICI Prudential Life, EY and BNP Paribas. He holds a Post Graduate Diploma in Management from Indian Institute of Management, Bangalore, and is a member of ICAI.
Mr. Parvez Mulla	*Chief Operating Officer*	Mr. Mulla has been associated with the company since January 2018. Prior to joining HDFCL, he was the MD at True North Managers LLP and before that he was the Chief Executive of Retail at L&T Financial Services. He was also associated with ICICI Bank, ANZ Grindlays Bank and Bajaj Auto. He holds a Bachelor's degree in Mechanical Engineering and also a Post Graduate Diploma in Management from Indian Institute of Management, Bangalore.
Mr. Srinivasan Parthasarathy	*Senior Executive Vice President, Chief Actuary & Appointed Actuary*	He is associated with HDFCL since December 2011 and heads Actuarial and Products. Prior to joining the company, he was associated with LIC of India, Watson Wyatt (UK), AVIVA Life (UK), York (Norwich Union), AVIVA India, and Canara HSBC. He holds a Bachelor's degree in Science (Mathematics) from Loyola College, University of Madras, and is also a Fellow of the Institute of Actuaries of India (2008) and Institute of Actuaries, UK (2004).
Mr. Prasun Gajri	*Chief Investment Officer*	Mr. Gajri has been associated with HDFCL since April 2009. Prior to joining HDFCL, he was associated with Citibank and Tata AIA Life Insurance Company Limited. He holds a Bachelor's degree in Engineering from Punjab Engineering College, Chandigarh and a Post Graduate Diploma in Management from Indian Institute of Management, Ahmedabad. He is also a CFA charter holder.

Financials

INCOME STATEMENT

INR Cr	FY17	FY18	FY19
Gross Premium Income	19,446	23,564	29,186
Reinsurance (net)	(171)	(193)	(255)
Net Premium Income	**19,275**	**23,371**	**28,931**
Policyholders	11,141	8,595	9,027
Shareholders	230	284	414
Total Income from Investments	**11,371**	**8,879**	**9,442**
Other Income adj	97	122	188
Total Income	**30,743**	**32,372**	**38,561**
Commission	792	1,075	1,118
Operating expenses	2,456	3,175	3,844
GST / Service tax on UL charges	216	297	340
Benefits Paid	10,000	13,111	13,990
Provision for diminution in value of investments	2	(1)	101
Change in Valuation Reserves (net)	16,055	13,323	17,507
Change in funds for future appropriations	161	92	144
Provision for tax	174	193	240
Total Expenses and Outflow	**29,856**	**31,265**	**37,283**
Profit after tax	**887**	**1,107**	**1,278**

KEY INDICATORS (INR Cr)	FY17	FY18	FY19
Premium			
New business premium	8,621	11,350	14,971
New business APE	3,740	4,890	5,200
Renewal Premium	10,824	12,215	14,215
Embedded Value			
Embedded Value	12,470	15,220	18,300
Value of New Business	920	1,280	1,540
Embedded Value Operating Profit	2,220	2,683	3,060
Valuation Ratios			
Price to Embedded Value	10.0	8.2	6.8
Price to Earnings	140.6	112.6	97.6
Price to Book Value	32.6	26.3	22.1

BALANCE SHEET

INR Cr	FY17	FY18	FY19
SOURCES OF FUNDS			
Share Capital	1,999	2,013	2,018
Reserves and Surplus	1,796	2,692	3,628
Fair Value Change in SH account	32	30	(3)
Sub-Total	**3,826**	**4,735**	**5,643**
Policyholders Liabilities	32,383	42,330	53,662
Provision for Linked Liabilities	50,806	54,598	60,521
Funds for discontinued policies	2,994	2,587	2,856
Funds for Future Appropriations	867	959	1,103
Change in fair value account	398	622	1,112
Total	**91,274**	**105,832**	**124,897**
APPLICATION OF FUNDS			
Investments			
Shareholders	3,231	4,057	5,036
Policyholders' assets	34,692	45,347	57,124
Assets held to cover linked liabilities	53,801	57,185	63,377
Loans	48	19	80
Fixed Assets	353	342	334
Cash & Bank Balances	797	1,111	1,244
Advances & Other Assets	2,174	2,422	2,820
Current liabilities	(3,822)	(4,651)	(5,119)
Total	**91,274**	**105,832**	**124,897**

KEY RATIOS (%)	FY17	FY18	FY19
New Business Margins	22.0%	23.2%	24.6%
Operating Return on EV	21.7%	21.5%	20.1%
Return on Equity	25.7%	26.0%	24.6%
Solvency Ratio	192%	192%	188%
Operating Expenses Ratio	12.6%	13.5%	13.2%
Total Expenses Ratio	16.7%	18.0%	17.0%
Persistency - 13M	84%	87%	87%
Persistency - 61M	59%	51%	52%

SBI Life Insurance Company Ltd.

SBI Life (SBIL) is one of the fastest-growing life insurers in India, despite being the largest player in terms of premium volume. This has been possible owing to its strong bancassurance network leveraging on parent SBI's branch network as well as an efficient agency force. We believe, advantages in the distribution channel lend SBIL a competitive edge as it will eventually result in higher premium volume as branch productivity increases and operating leverage plays out.

The company already has the lowest cost structure among listed peers, which, coupled with its focus on increasing the share of protection products will boost margin. SBIL's focus on customer service and productivity of its distribution channels has resulted in very strong renewals, leading to best-in-class persistency and reduced capital requirements. Management is focusing on annuity and protection products, particularly credit life policies.

SBIL is well positioned to benefit from the increasing sales in higher margin insurance products as it leverages its distribution and cost competitiveness.

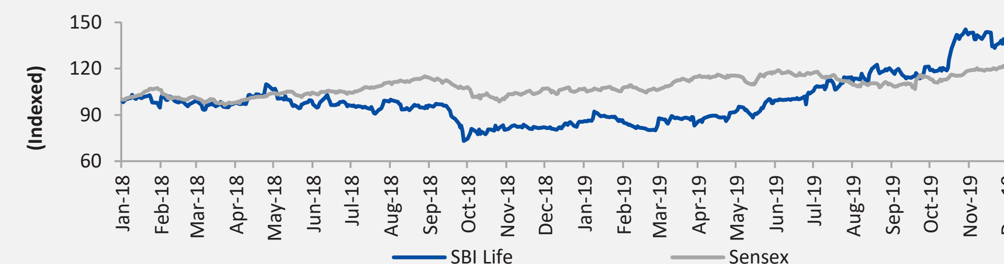
At the current price, the stock is trading at ~4x its latest disclosed EV.

Swarnabha Mukherjee
Research Analyst
swarnabha.mukherjee@edelweissfin.com

CMP INR: 1004

RATING: Not Rated

Relative Price Performance



Bloomberg:	SBILIFE:IN
52-week range (INR):	1,030 / 516
M cap (INR cr):	97,490
Average Daily Volume (BSE/NSE)	

Share Holding Pattern	(%)
Promoter	62.80
Public	37.20
Others	–

Year to March (INR Cr)	FY17	FY18	FY19
Total Premium	21,015	25,354	32,990
APE	6,727	8,540	9,700
Embedded Value	16,540	19,070	22,400
Profit after tax	960	1,150	1,330
P/EV	6.1	5.3	4.5
New Business Margins	15.4%	16.2%	17.7%
RoEV	23.0%	17.9%	17.4%
RoE	19.0%	19.0%	19.0%

Date: 23rd December 2019

I. Strong Growth In Premium Despite Large Base

Despite being one of the largest private insurers in the domestic market in terms of GWP (FY19 GWP at INR 32,990 crore), SBIL has the strongest top-line growth—FY13-19 CAGR of 21%—amongst listed peers. We highlight this strong growth rate in Chart 110.

Over the same period, total APE and individual APE jumped 22% and 23% p.a., respectively, led by regular premium products (highlighted in next section). In terms of absolute number of policies, SBIL has posted ~13-14% growth in the past and management expects to grow at similar rate going forward. In our view, this growth is expected to continue owing to solid traction in product lines in focus – protection and annuities.

This growth has enabled SBIL maintain market, which has risen from ~17% of the private market share in FY13 to ~19% in FY19. In terms of overall market, its share has jumped 140 bps from 4.8% in FY13 to 6.4% in FY19.

The growth was led by traction across product lines in individual and group business, with the exception of participating and group fund management business, the latter being planned to manage at a lower proportion.

Chart 110: Robust growth in Gross Premiums

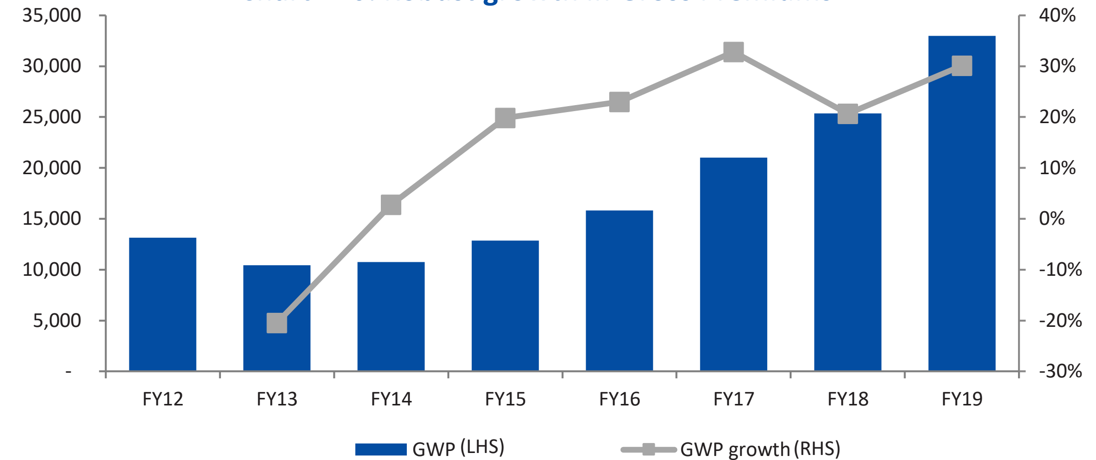
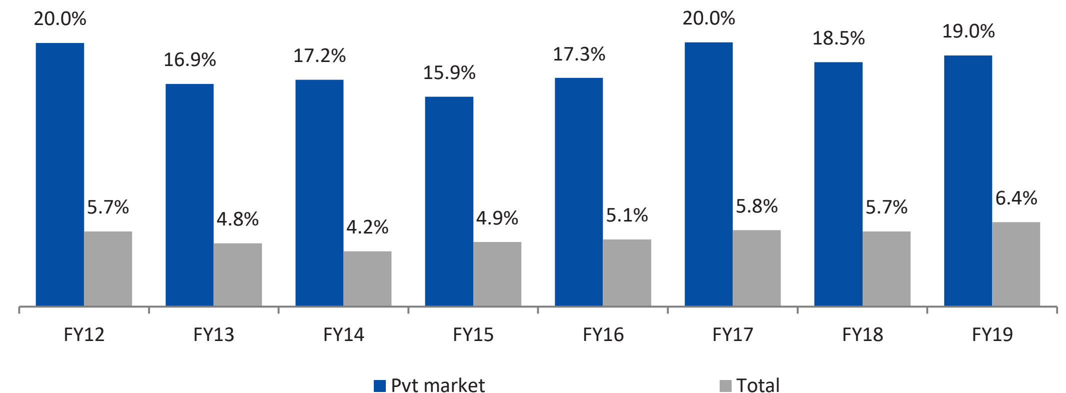


Chart 111: Consistent gain in overall market share, aided by group business



Source: Company, Edelweiss Professional Investor Research

II. Robust Spurt In Renewal And New Business Premiums

SBIL's 21% CAGR in premiums over FY13-19 was driven by solid growth in both first year premiums (or regular premium) and renewal premiums (Refer Chart 112 and 113). The latter clocked CAGR of 24% over FY13-19, which can be attributed to management's focus on it via improving customer awareness on continuation of policies and digitisation of the renewal process (64% renewal premium collected through digital mode), as it aids longer-term profitability.

Additionally, first year premiums have posted robust CAGR of 24% over FY13-19 owing to growth in multiple product streams, particularly in group protection, and ULIPs. While protection and annuities remain a focus area for the company, ULIPs continue to remain popular for SBIL. In the protection space, credit life has been a key driver of growth, while group term insurance has also been a contributor. Individual protection has also gained traction in the recent past. In the savings business, annuity has also posted significant growth due to a lower base.

So far, the share of regular premium policies has increased in the mix at the expense of single premium policies. This could, however, reverse as group credit life—high growth area—is being converted into single premiums, resulting in a jump in growth of single premium products going forward.

Chart 112: Single premium policies saw the strongest growth

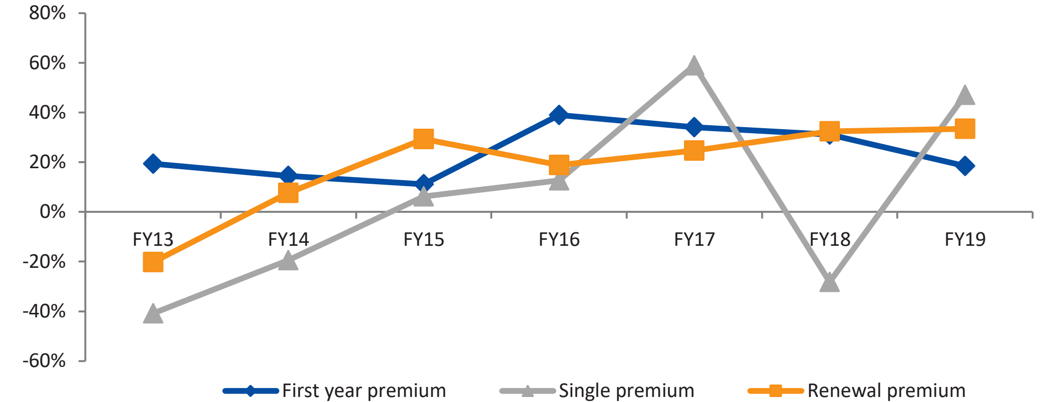
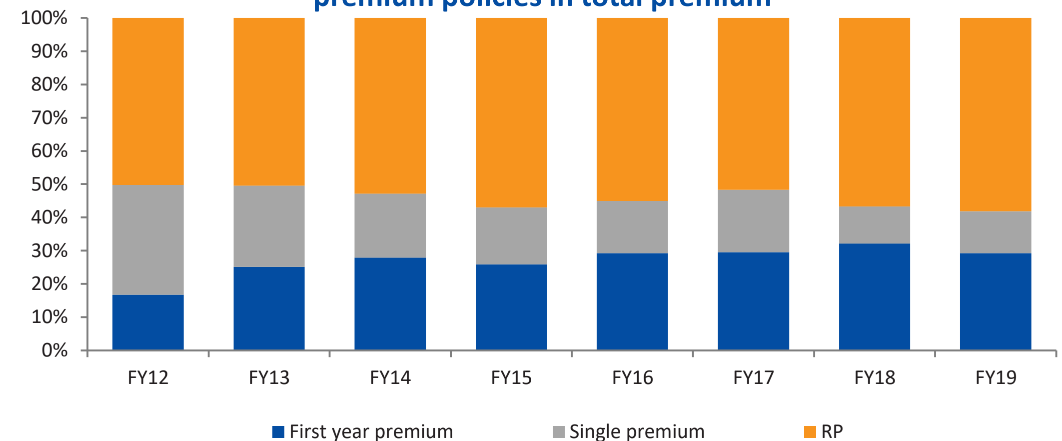


Chart 113: Change in product mix has reduced share of single premium policies in total premium



Source: Company, Edelweiss Professional Investor Research

III.a. Product Mix: ULIP-heavy, But Share Of Higher-margin Products Rising

SBIL had increased the share of ULIPs in its product mix during FY15-18 led by a buoyant capital market, which rendered ULIPs a competitive alternative to mutual funds. Additionally, access to a large and low cost bancassurance network of parent SBI also helped SBIL increase ULIP sales—jumped from 34% of total NBP in FY15 to 56% in FY18. Although ULIP NBP grew 19% in FY19, owing to a stronger surge in protection and group savings products, share of ULIPs in the mix fell to 53%. ULIPs share in individual NBP has been in the 70-80% range in recent years.

We expect this trend to sustain as management focuses on protection sales and should lead to better margin. Management has sharpened focus on protection and annuities, of which credit life policies and annuities are gaining strong traction. With growth in retail credit in India and SBI being a key beneficiary of the trend, growth in credit life is expected to sustain. Management expects the insurer's credit life book to grow slightly faster than SBI's credit book (which is expected to grow 17-20% going forward). Further, SBIL's exposure is across product types, which will help diversify end-sector specific woes (Chart 116). SBIL focuses on increasing penetration within SBI and other credit life tie-ups and leverage its relationships to grow GTI.

Chart 114: Product-wise mix of new business premium

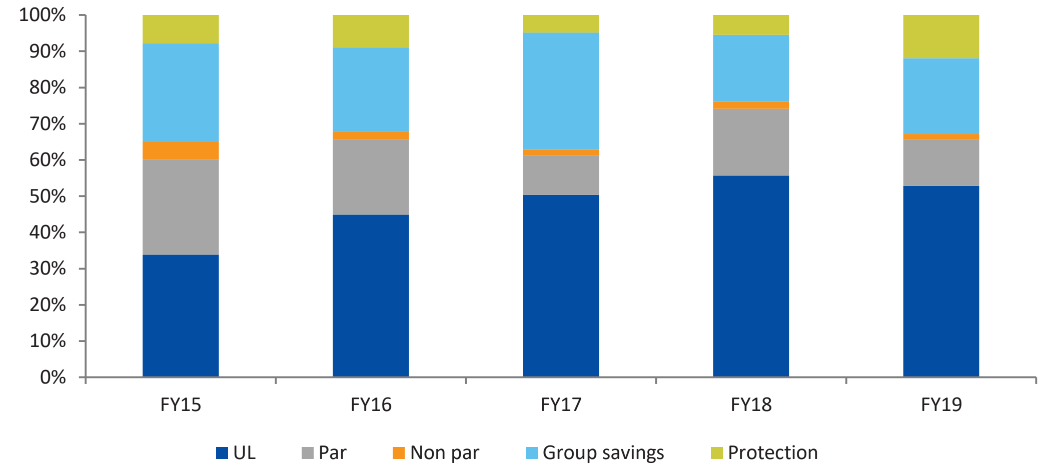


Chart 115: ULIPs have seen strong growth in FY15-19

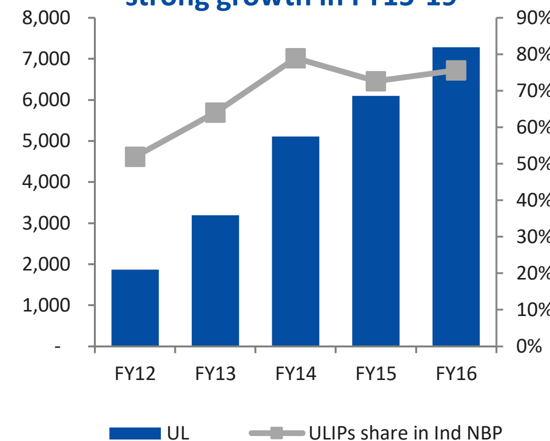
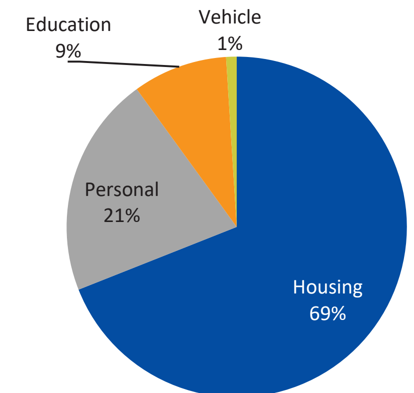


Chart 116: SBIL's Credit Protect book is fairly diversified (H1FY20)



Source: Company, Edelweiss Professional Investor Research

III.b. Product Mix: ULIP-heavy, But Share Of Higher-margin Products Rising

Consequent to SBIL's focus on growing sales in protection products, there has been a jump in share of protection premiums from 7.7% in FY15 to 11.9% in FY19. As highlighted in the previous section, most of this growth came from group products, as share of individual protection products remained stagnant and volatile (3%/1%/1%/4% of individual APE in FY15/16/17/18), due to slow customer demand and lesser incentive from distributors because of a lower commission payout.

SBIL has now focused on Return on Premium protection products, which have been successful. SBIL has evinced good demand in products like non-par savings and annuities, but has budgeted caps on sales in place in view of interest risks that these products bring to balance sheet.

SBIL's value of new business (VNB) has seen consistent growth (CAGR of 35% over FY16-19) driven primarily by increase in higher-margin protection products. During this period, VNB increased from INR 700 cr to INR 1,720 cr. VNB margins have increased at a sustained rate from 14.2% to 17.7% over the same period. Also, share of protection products increased in the mix. With management's focus on increasing protection, annuities and single premium policies, SBIL's margin should improve and boost EV.

Chart 117: VNB margin growth driven by credit life as individual protection business does not show linear growth

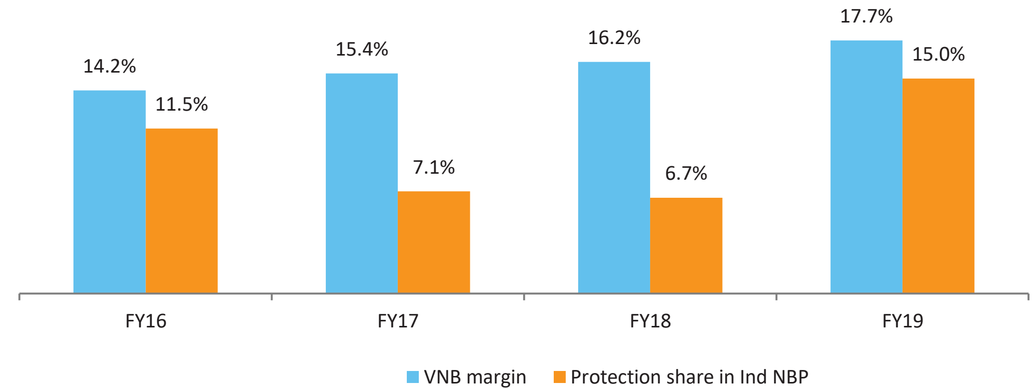


Chart 118: Increase in protection business driven by credit life products

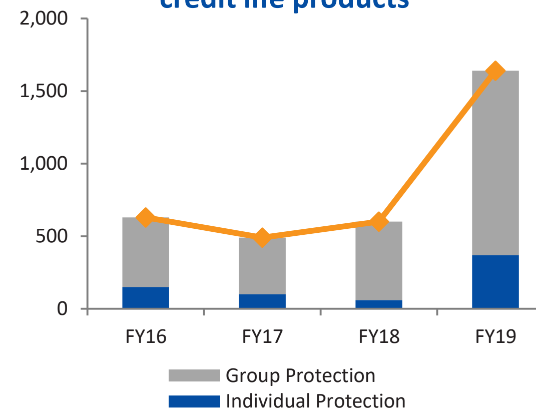
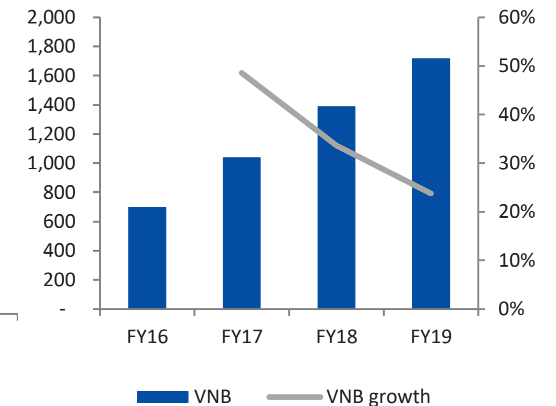


Chart 119: VNB growth remains 20%+ in FY16-19



Source: Company, Edelweiss Professional Investor Research

IV. Robust Distribution Channel: Key Competitive Edge

Bancassurance has become the largest distribution channel for SBIL given: a) large share ULIPs in product mix which are better sold through low-cost bancassurance channels owing to their lower margin nature; and b) access to parent SBI's 22,000+ branches. We believe, this imparts significant competitive advantage, which is difficult for peers to replicate, and helps the company maintain the channel at a lower cost. SBIL has also tied up with other banks and NBFCs, who provide access to another 12,000+ branches.

With SBIL's branch productivity (premium per branch at ~INR 30 lakh) on the rise (refer to chart 122) with ~77% branches registering business of INR 25,000 per month in insurance sales or higher, and given that SBIL is not implementing open architecture, we perceive further headroom for growth. However, in our view, the level of scale-up may be slower than it appears optically as only ~30% of the branches are selling 5-6 policies per month.

Additionally, tie-ups with other banks (Syndicate Bank, Indian Bank and Allahabad Bank) will aid SBIL increase its bancassurance business. Management is now focusing on selling protection and annuity products through bancassurance, resulting in strong growth in these product segments (protection/annuity at 18%/6% of H1FY20 NBP vs 15%/1% of H1FY19 NBP).

Chart 120: Bancassurance has been the dominant channel for SBIL

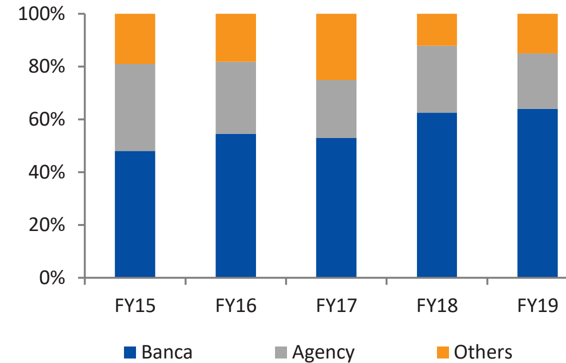


Chart 121: Bancassurance partners provide access to 12k+ branches

Chart 122: SBIL's branch productivity on the rise

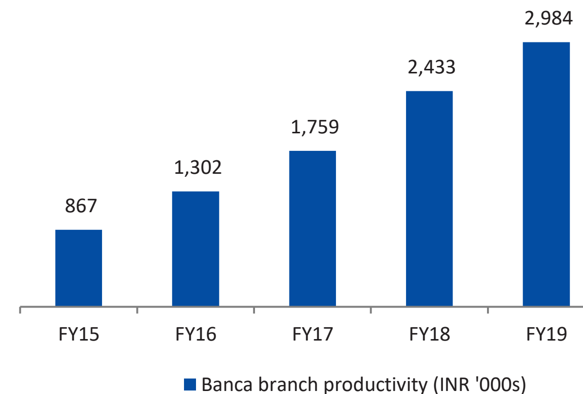
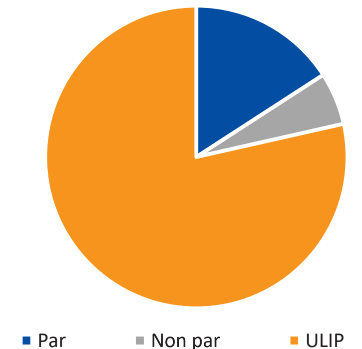


Chart 123: ULIPs, Par and Non-par are products sold through Banca



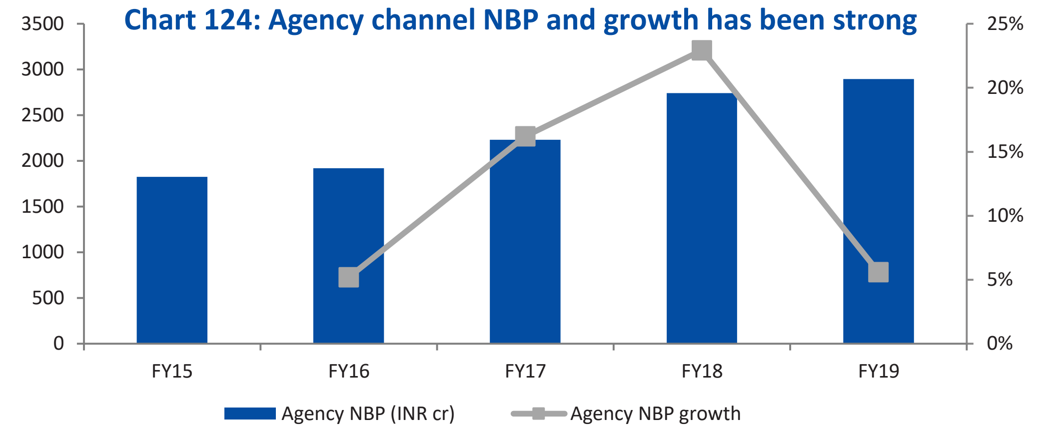
Source: Company, Edelweiss Professional Investor Research

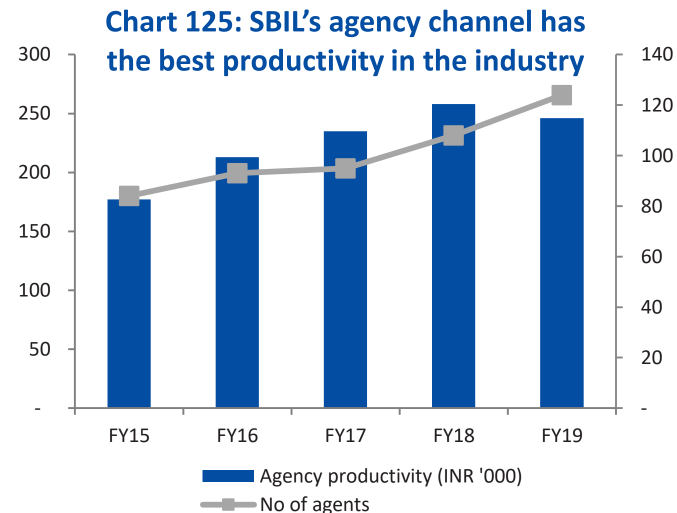
V. Robust Distribution Channel: Key Competitive Edge

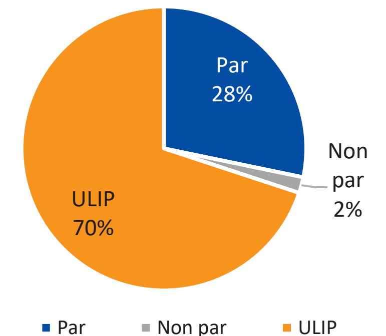
SBIL's agency NBP growth has been robust during FY15-19. Although rising share of bancassurance has come at the expense of agency, owing to high NBP growth, agency channel has continuously grown over FY15-19 with recent FY NBP recorded at cINR 2,900 cr, contributing ~21% to overall NBP.

SBIL's agency channel has one of the highest productivity in the listed space with productivity recorded close to INR 2.5 lakhs in FY19 (INR 2.2 lakhs in H1FY20). As of end-H1FY20, SBIL had 1,21,652 agents and predominantly sold ULIPs and par products. However, management is focusing on higher sales of protection, individual non-par savings and annuity products through this channel, which should result in value accretion through this channel. Share of protection/annuity was at 2%/4% in H1FY20 compared to 1%/2% in the prior period. Additionally, SBIL has partnership with 65 corporate agents and 99 brokers.

SBIL has also seen sales developing through SBI's YONO app, with around 55k lives covered in H1FY20, which are small ticket protection products (ticket size INR 1,000). Traction has been observed more on health products through this channel. Going forward, management also plans to use this channel for other forms of insurance (credit life, health) as ticket size expands.







Source: Company, Edelweiss Professional Investor Research

VI. Best Cost Structure In Industry To Boost Margin

SBIL's cost structure has consistently improved over FY14-19. This has been primarily driven by improvement in operating expense ratio (from ~10% of total premium in FY14 to ~6% in FY19). If benchmarked against other listed peers, this is the lowest as peers continue to record operating expense ratios in the 10 - 13% range .

SBIL is able to achieve such low-cost structure because of access to SBI's large bancassurance network, which generally is low cost among insurance channels, and also a very productive agent network. Commission ratio for SBIL has remained in and around 4% over the past few years, which is comparable to peers. This has remained low as bancassurance has low cost of acquisition and additionally due to a large share of renewals on which commissions remain low and lower expenses due to higher volumes.

Owing to this, SBIL's total expense ratio (as shown in chart 128) has improved consistently. We believe, this is a significant source of competitive advantage for SBIL and will continue to aid margin going forward as the insurer aims to sell more higher-margin products through the bancassurance channel, which was previously used to sell ULIPs.

Chart 127: Operating expense ratio has seen continuous improvement

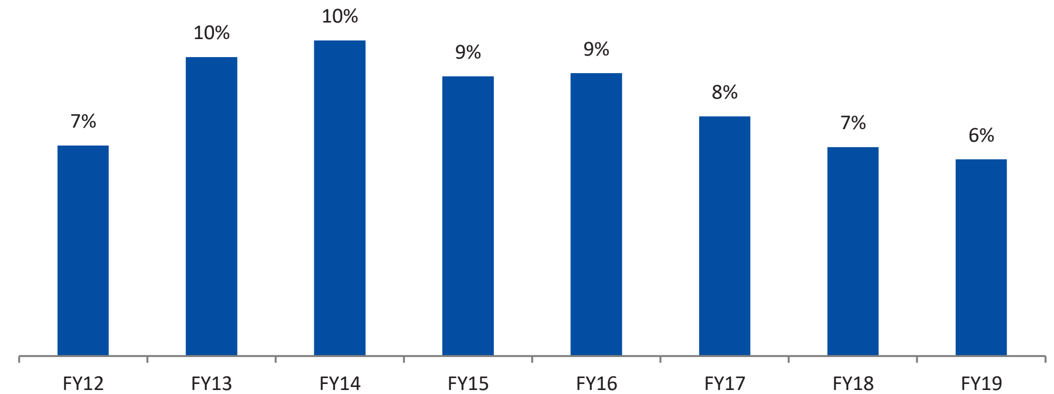
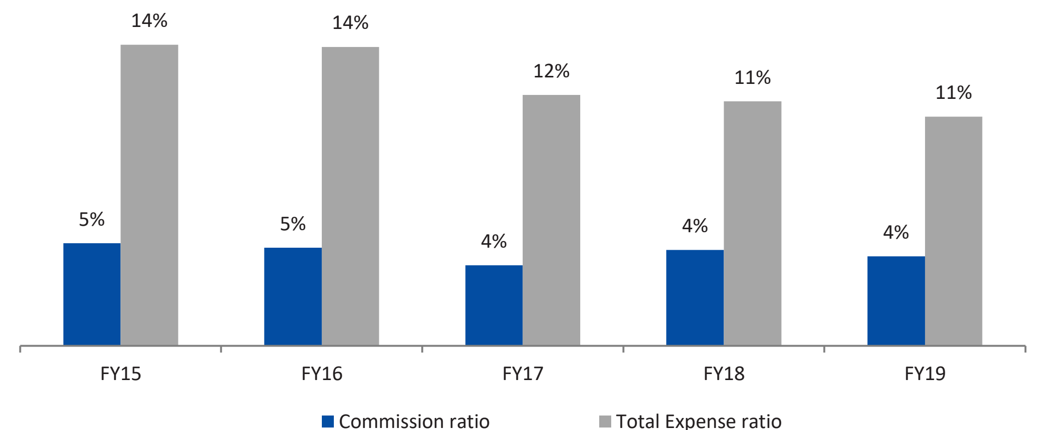


Chart 128: Commission ratio remains in a tight range



Source: Company, Edelweiss Professional Investor Research

VII. Persistency Ratio To Continue To Improve

SBIL has managed to improve its 13-month persistency from 79% to 85%, which is more or less in line with that of peer group. However, the company's 61-month persistency reached a high of 67% in FY17, post which it dipped in FY18/FY19 when it was at 58%/57%. This in part can be due to merger of associate banks with SBI, where persistency ratios were considerably lower, and partly due to decline in single premium policies.

Despite this, SBIL's 61-month persistency is among the best in the industry with IPRU coming a close second. We believe, this stems from SBIL's strong brand and customer service levels, reflected in its robust renewal premiums. Persistency is higher for non-participating products, savings and protections. In terms of distribution channels, the bancassurance channel has the best persistency, followed by individual agents. SBIL has undertaken several initiatives, including use of data and analytics, to improve persistency level.

Key drivers for improvement of persistency going forward can be better customer propositions and a productive agency force. Further, higher sales of non-participating savings and protection products (which tend to have better persistency) should also drive the same.

Chart 129: Persistency is consistently on the rise

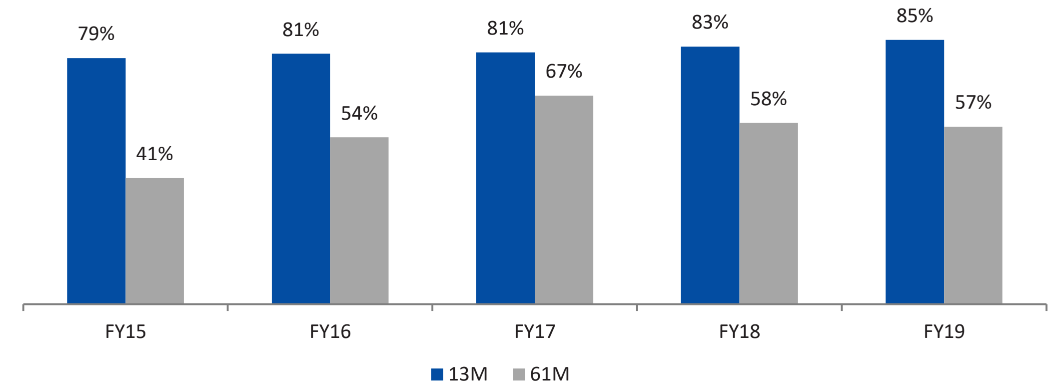
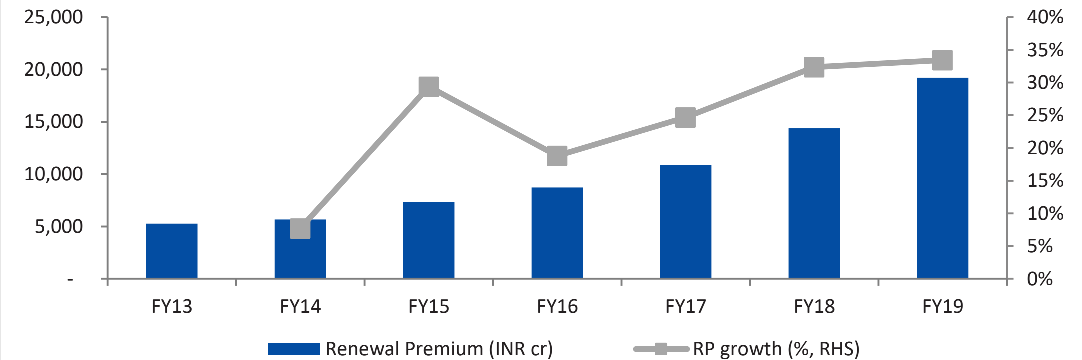


Chart 130: Improving persistency is aiding strong renewals



Source: Company, Edelweiss Professional Investor Research

VIII. Embedded Value: Stable Compounder

SBIL recorded EV of INR 22,400 cr in FY19, 21% CAGR over FY16-19. In H1FY20, it grew further 10% to INR 24,690 cr. Consequently, EVOP was also robust (moving up from INR 2,887cr in FY17 to INR 3,323 cr in FY19) with operating ROEV in the 17-23% range over FY17-19. We highlight this in Charts 131 and 132.

EVOP posted lackluster growth during FY17/FY18 primarily due to a larger base owing to volatility in operating assumption changes and variances which added around INR 764 cr in FY17, implying that initial assumptions were very conservative. In the following fiscals, the assumptions were much closer to the actual experience (around INR 163 cr in FY18 and marginally negative in FY19). Adjusting for that, growth and development of operating RoEV in FY18 would have been significantly strong.

Going forward, improvement in profitability owing to business mix change will aid compounding of EV, in line with observable trend. SBIL has seen strong traction for its protection and savings offerings, which will result in robust VNB and in turn EV growth. In the midst of a dovish interest rate cycle, impact of unwind of back book can be fairly stable.

Chart 131: EV growth has remained strong

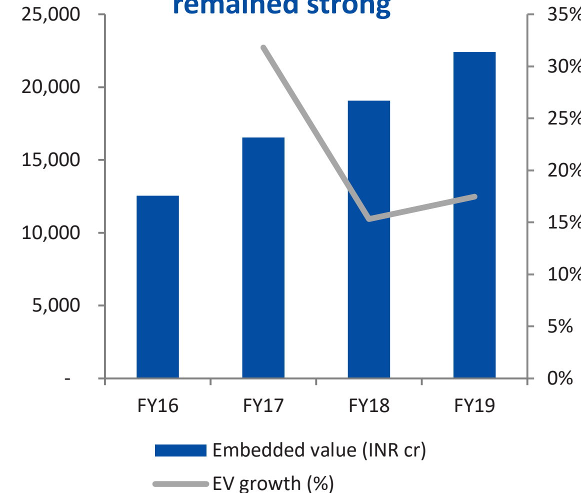


Chart 132: EVOP growth is on an improving trend

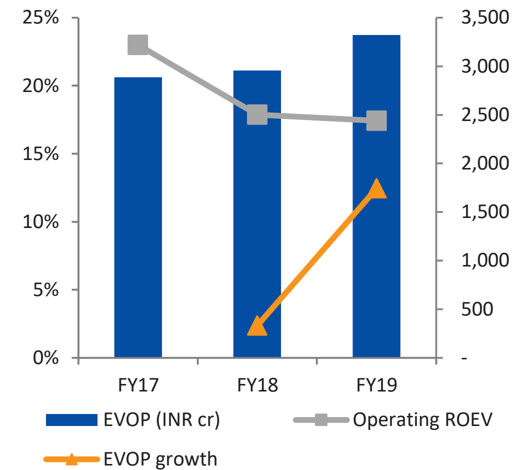


Chart 133: VNB and Unwind driving EV growth

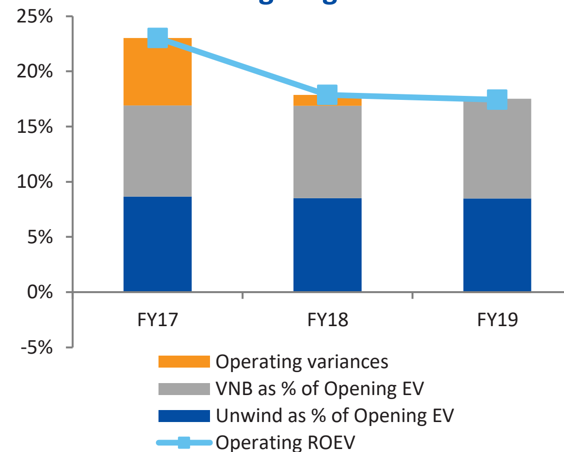
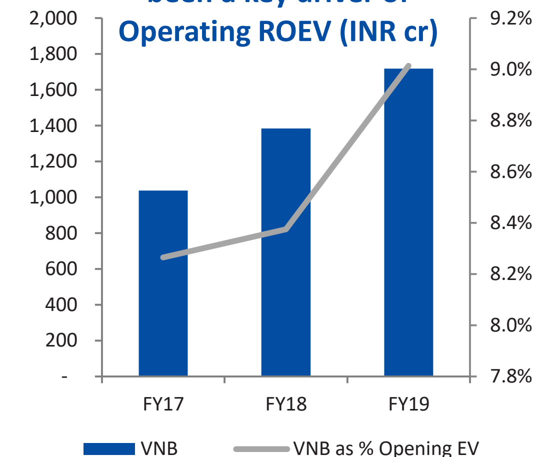


Chart 134: VNB growth has been a key driver of Operating ROEV (INR cr)



Source: Company, Edelweiss Professional Investor Research

IX. Strong And Conservative Balance Sheet

While SBIL has posted stellar growth, reflected in strong spurt in AUM, its balance sheet has remained strong over the years with solvency margin consistently above 200%.

SBIL is one of the largest asset managers in India with total AUM of over INR 1.5 lakh crore. Growth in recent years has been in excess of 20% consistently. This has been driven by new money and investment performance with 5 year CAGR of 8.5-9.0% p.a. In terms of asset classes, debt comprises more than three-quarters of the AUM and equity the balance. Linked and non-linked assets comprise almost half of the AUM each. In the linked portfolio, debt is almost two-thirds of the mix, while it is almost 90% of the assets backing traditional policies. The debt portfolio remains strong in terms of credit quality, with around 91% of assets in AAA papers and G-secs. This has resulted in minuscule impact of the ongoing NBFC crisis in comparison to the overall fixed income portfolio.

Owing to the strong renewals, SBIL's solvency level has consistently remained above 200% (compared to 150% regulatory requirement), despite underwriting more capital-intensive products like protection. We do not perceive the need of capital infusion in the near future to support growth.

Chart 135: AUM growth remains strong

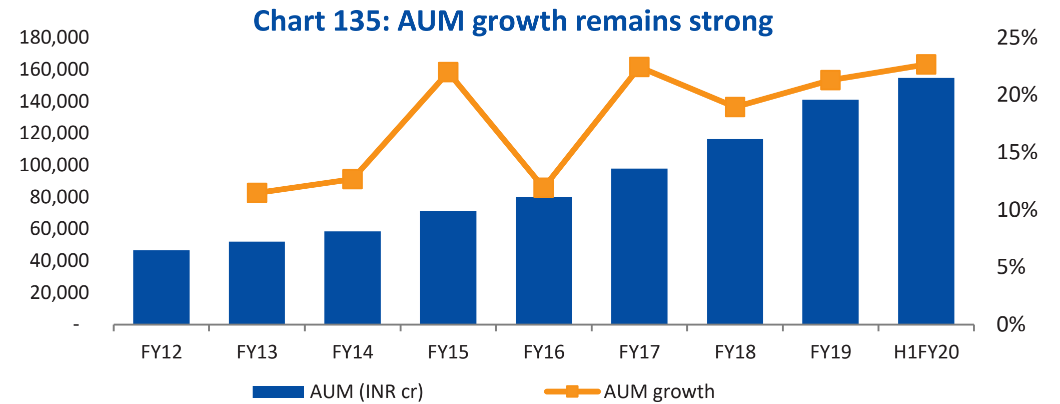


Chart 136: Debt comprises of major portion of AUM

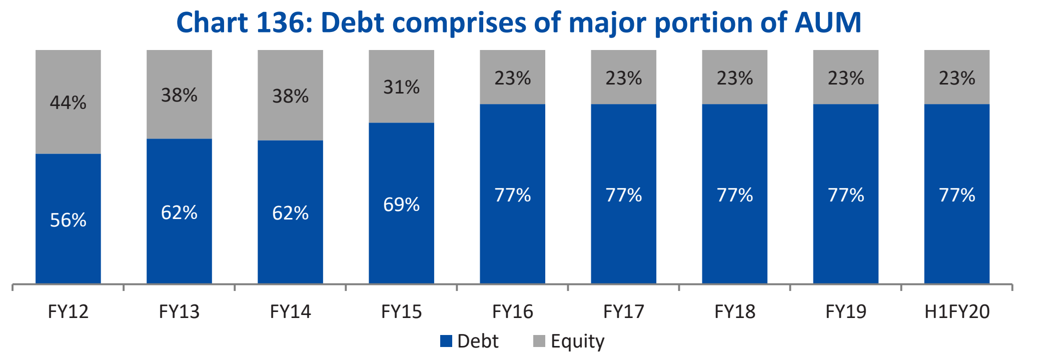
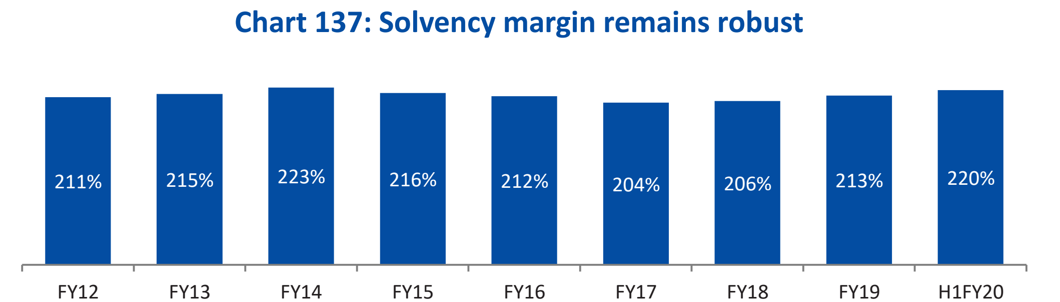


Chart 137: Solvency margin remains robust



Source: Company, Edelweiss Professional Investor Research

X. Senior Management Team: Overview

Name	Designation	Experience
Mr. Sanjeev Nautiyal	*Managing Director and CEO*	Mr. Sanjeev Nautiyal has 33 years of experience in the banking industry. He holds a Bachelor's degree in Arts and a Master's degree in Business Administration. He is also a Certified Associate of the Indian Institute of Bankers.
Mr. Sangramjit Sarangi	*President & Chief Financial Officer*	Mr. Sangramjit Sarangi has 19 years of experience in life insurance and mutual fund businesses. He holds a Bachelor's degree in Commerce and Law and is a Fellow of the Institute of Chartered Accountants of India.
Mr. Sanjeev Pujari	*President Actuarial & Risk Management & Chief Risk Officer*	Mr. Sanjeev Pujari has 33 years of experience in the life insurance business. He has a Bachelor's degree in Science, a Master's degree in Physics, is a Fellow of the Institute of Actuaries of India and holds a diploma from the Faculty of Actuaries, Institute of Actuaries, UK.
Mr. Anand Pejawar	*President Operations, Information Technology and International Business*	Mr. Anand Pejawar has more than 36 years of experience in the life insurance business. He has a Bachelor's degree in Science and holds a diploma in financial management.
Mr. Abhijit Gulanikar	*President - Business Strategy*	Mr. Abhijit Gulanikar has 20 years of experience in life insurance, general insurance, banking and corporate finance businesses. He holds a Bachelor's degree in Commerce, a postgraduate diploma in Management from the Indian Institute of Management, Ahmedabad, and is an associate of the Institute of Chartered Accountants of India.

Financials

INCOME STATEMENT

INR Cr	FY17	FY18	FY19
Premium earned	21,014	25,354	32,989
Reinsurance (net)	(163)	(194)	(99)
Net Premium Income	**20,852**	**25,160**	**32,890**
Investment income	9,695	8,908	11,714
Other income adj	58	(170)	(189)
Total income	**30,605**	**33,899**	**44,415**
Commission paid	783	1,121	1,346
Operating and other expenses	1,672	1,736	2,135
Provision for tax –policyholders	180	238	269
Benefits paid (net)	9,549	11,712	15,294
GST/Service Tax on charges	227	347	453
Change in actuarial liability	17,242	17,595	23,592
Total expenses	**29,650**	**32,748**	**43,088**
Profit before tax	**975**	**1,184**	**1,373**
Provision for tax –shareholders	20	34	46
Profit after tax	**955**	**1,150**	**1,327**

KEY INDICATORS (INR Cr)

KEY INDICATORS (INR Cr)	FY17	FY18	FY19
Premium			
New business premium	10,140	10,970	13,790
New business APE	6,727	8,540	9,700
Renewal Premium	10,871	14,388	19,200
Embedded Value			
Embedded Value	16,540	19,070	22,400
Value of New Business	1,040	1,390	1,720
Embedded Value Operating Profit	2,887	2,961	3,318
Valuation Ratios			
Price to Embedded Value	6.1	5.3	4.5
Price to Earnings	105.2	87.3	75.7
Price to Book Value	18.1	15.4	13.3

BALANCE SHEET

INR Cr	FY17	FY18	FY19
SOURCES OF FUNDS			
Share Capital	1,000	1,000	1,000
Reserves and Surplus	4,465	5,374	6,460
Fair Value Change in SH Account	87	153	116
Sub-Total	**5,552**	**6,528**	**7,576**
Fair Value Change in PH Account	776	943	1,056
Policyholders Liabilities	48,324	55,556	64,954
Provision for Linked Liabilities	38,856	49,558	60,592
Fair Value Change in linked account	3,790	3,110	5,160
Funds for Discontinued Policies	1,927	2,268	3,377
Funds for Future Appropriation	-	193	282
Total	**99,225**	**118,156**	**142,997**
APPLICATION OF FUNDS			
Investments			
Shareholders	4,296	5,014	5,723
Policyholders	46,962	54,486	64,472
Sub-Total	**51,257**	**59,500**	**70,196**
Assets held to cover Linked Liabilities	44,573	54,936	69,129
Loans	178	171	173
Fixed assets	538	581	595
Net Current Assets	2,678	2,968	2,905
Total	**99,225**	**118,156**	**142,997**

KEY RATIOS (%)

KEY RATIOS (%)	FY17	FY18	FY19
New Business Margins	15.4%	16.2%	17.7%
Operating Return on EV	23.0%	17.9%	17.4%
Return on Equity	19.0%	19.0%	18.8%
Solvency Ratio	204%	206%	213%
Operating Expenses Ratio	7.8%	6.8%	6.4%
Total Expenses Ratio	11.5%	11.2%	10.5%
Persistency - 13M	81%	83%	85%
Persistency - 61M	67%	58%	57%

Appendix A: Summary Of Insurance Regulations

Year	Key regulations	Products/Channels affected
FY10	● Fund management charges for ULIPs capped at 135 bps for each segregated fund	Linked
FY11	● Increase in minimum lock-in period and premium paying term for ULIPs from 3 to 5 years Minimum sum assured for regular premium policies defined for ULIP Reduction in investment yield capped between 2.25% and 4.0% per year Surrender charges capped, reducing gradually from first till fifth year	
FY13	● Minimum sum assured for regular premium policies defined Surrender charges capped based on period of discontinuance	Non-linked
FY14	● Cap on commissions dependent on premium payment tenure (PPT), to be defined as 15-40% of first year premium	All products
FY16	● Open architecture framework introduced which enables banks to sell insurance products of up to 3 life insurers	Bancassurance channel
FY17	● Management expenses capped at 60-90% of first year premium	
FY19	● Minimum sum assured for single premium linked policies to be 125% of premium and 7x for regular premium Revival periods have been increased across product types and allowance of withdrawal of 25% of fund value for pension product Allowance to decrease premium after five years Difference between maximum and minimum charges during first five years can vary upto 3x	Linked
	● Minimum sum assured for single premium linked policies to be 125% of premium and 7x for regular premium, death benefits at 105% of premium paid Premium paying term and minimum policy terms at five years for individual savings products and annually renewable for group savings, with surrender rules revised	Non-linked

Source: IRDAI, Edelweiss Professional Investor Research

Appendix A: Insurance Regulations - Commissions

Caps on commission by product type

First year premium

Product type	Cap on commission
Individual Protection	40%
Individual Savings	
PPT 5-11 years based on the tenure	15%-33%
PPT 12 and higher years	35%
Annuity / Pension	7.5%
Group Products	7.5%

Renewal premium

Product type	Cap on commission
Individual Protection	10%
Individual Savings	7.5%
Annuity / Pension	2.0%
Group Products	7.5%

Charges levied on ULIPs

Description	Charge
Premium allocation charge Percentage of premium appropriated towards charges from the premium received	12.5% of Annualized Premium
Fund Management Charge Levied as a percentage of value of assets adjusting NAV	1.35%
Guarantee Charge Levied as a percentage of value of assets adjusting NAV	0.50%
Policy Administration Charge	INR 500 per month
Surrender Charge - levied on Unit fund expressed as percentage of fund/annualized premiums	Details in next section

Source: IRDAI, Edelweiss Professional Investor Research

Appendix A: Insurance Regulations – Surrender Charges For ULIPs

For Annual Premiums

Where the policy is discontinued during the policy year	Maximum Discontinuance Charges for the policies having annualized premium up to INR 50,000/-	Maximum Discontinuance Charges for the policies having annualized premium above INR 50,000/-
1	Lower of 20% * (AP or FV) subject to a maximum of INR 3000	Lower of 6% * (AP or FV) subject to a maximum of INR 6000
2	Lower of 15% * (AP or FV) subject to a maximum of INR 2000	Lower of 4% * (AP or FV) subject to a maximum of INR 5000
3	Lower of 10% * (AP or FV) subject to a maximum of INR 1500	Lower of 3% * (AP or FV) subject to a maximum of INR 4000
4	Lower of 5% * (AP or FV) subject to a maximum of INR 1000	Lower of 2% * (AP or FV) subject maximum of INR 2000
5 and onwards	Nil	Nil

For Single Premiums

Where the policy is discontinued during the policy year	Maximum Discontinuance Charges for the policies having Single Premium up to INR 3,00,000/-	Maximum Discontinuance Charges for the policies having Single Premium above INR 3,00,000/-
1	Lower of 2% *(SP or FV) subject to a maximum of INR 3000	Lower of 1% *(SP or FV) subject to a maximum of INR 6000
2	Lower of 1.5% *(SP or FV) subject to a maximum of INR 2000	Lower of 0.70% *(SP or FV) subject to a maximum of INR 5000
3	Lower of 1% *(SP or FV) subject to a maximum of INR 1500/-	Lower of 0.50%* (SP or FV) subject to a maximum of INR 4000
4	Lower of 0.5% *(SP or FV) subject to a maximum of INR 1000	Lower of 0.35% *(SP or FV) subject to a maximum of INR 2000
5 and onwards	Nil	Nil

Source: IRDAI, Edelweiss Professional Investor Research

Appendix A: Insurance Regulations - Investments

Regulatory requirements for investments by life insurers

	Traditional	Unit linked
Central government securities	Not less than 25%	Not less than 20%
Central, state government, and other approved securities	Not less than 50% incl. Central G-secs	Not less than 40% incl. Central G-secs
Listed equities, preferred equities, debentures, properties etc.	Maximum of 50%	Maximum of 60%
Investment in housing and infrastructure	Not less than 15%	

Difference between gross and net yields for ULIPs

Number of years completed since inception	Maximum Reduction in Yield (Difference between Gross and Net Yield (% p.a)
5	4.00%
6	3.75%
7	3.50%
8	3.30%
9	3.15%
10	3.00%
11 and 12	2.75%
13 and 14	2.50%
15 and thereafter	2.25%

Source: IRDAI, Edelweiss Professional Investor Research

Appendix B: Insurance Product Types

Participating Products or "Par" products are savings oriented products which have a protection component. The features of the products are:

- These products provide long term returns in terms of bonuses from the distributable surplus along with a guaranteed sum assured
- Generally these policies will have higher premium requirements as compared to non-participating products for similar sum-assured
- Policyholder does not have the option to choose the asset allocation of his assets as underlying investments are pooled
- Policyholder participates in the profits of the underlying investment pool during the policy term, received as bonuses, hence these are also called "With Profits"
- Bonuses are not guaranteed as they are profits from the invested pool of assets, but once declared are guaranteed
- Bonuses, upon declaration are accrued to the policy and hence guaranteed for the insured. Distributable bonuses are generated out of sources like favourable mortality experiences and investment yields smoothed for volatility[
- Bonuses are of three types in general – reversionary bonus (paid once a year based on actuarial valuations and vested once declared), interim bonus and terminal bonus (paid at maturity or death)

Non-participating Savings Products or "Non-par savings" or "Non-par" products are savings products with guaranteed returns. The key features are:

- These products provide a guaranteed income stream for a defined period and do not participate in any upside from the underlying fund performance. These include products for savings, pensions and annuities
- Additionally, these products also have a risk cover in the form of a sum assured on death
- Customers do not have a choice of asset allocation and have exit loads on the policy discontinuance, coupled with no fixed cap on the charges
- Savings products are suitable for customers who prefer low yet guaranteed returns while annuity products are useful for retirement funding
- Annuity products come in two forms – immediate annuity (where the payment stream will start on a lumpsum payment for a defined period or till perpetuity) and deferred annuity (where payment stream starts after a period)

Appendix B: Insurance Product Types

Protection Products or are non-participating products with guaranteed benefits. The features of the products are:

- These products offer benefits guaranteed at the inception of the policy in terms of absolute value, dependent on a particular event (which are generally death, permanent disability or critical illness)
- Policyholder do not participate in the underlying fund performance and no bonus is paid during the policy tenure, and the policies generally expire without value if the event does not occur. Discontinuation also results in forfeiture of the premium paid till date
- However, recent product designs include return on premium (ROP) products, which returns the premium paid to customer at the expiry of the policy
- These products are sold to not only individuals and to employers as group term insurance, but also as a master policy to lending institutions for covering credit defaults

Unit Linked Products or "ULIP" are savings products whose returns are linked to the underlying fund performance. The key features of these products are:

- Policyholders bear the risks of underlying investment performance of the fund and have the ability to select the asset classes to invest in depending on the risk appetite of the customer
- Non-investment risks like mortality/morbidity risks are borne by insurers and charges for such services are deducted from the underlying investment funds
- ULIPs are transparent products with clearly defined surrender and discontinuation charges (which we have highlighted in Appendix A)

Group Insurance Products contain mainly **Group Term Insurance (GTI)** and **Group Fund Management (GFM) business**

- GTI provides life insurance covers to a group of individual, and generally are addressed to employers and other informal groups
- GFM products generally address employer's needs of management of employee benefit schemes like gratuity, superannuation and leave encashment

Appendix C: Insurance Terminologies

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Annual Premium Equivalent (APE) – Sum of annualized first year premium and 10% of single premium. It is regarded as an annualized measure of premiums.

Adjusted Net Worth (ANW) - Shareholder's net-worth on a market consistent basis. This is the value of all assets allocated to the covered business but not required to back the liabilities of the covered business.

Administrative Expense – Operating expenses of a life insurance, which include employee benefits and other expense to maintain insurance operations. This does not include costs of acquiring clients.

Acquisition/Commission Expense – These are customer acquisition costs which insurers pay to their distribution partners like banks, agents, brokers etc.

Cost of Residual Non-hedgeable Risks (CNRHR) – An explicit measure as part of the MCEV calculation, that includes costs of risks which are non-hedgeable in nature and has not been allowed elsewhere (i.e. part of PVFP or FCoC).

Embedded Value (EV) – Embedded Value is the measure of the shareholders' interest in the life insurance business. It can be understood as the net present value of future profits from the existing book of business, and gives us an estimate of the value of the book of business already written, net of risks assumed, also known as Value of In-force (VIF) plus the adjusted net-worth (ANW), which is the shareholder's net-worth on a market consistent basis.

Embedded Value Operating Profit (EVOP) – Measures the change in EV during a period due to changes in operating variables , excluding an impact due to non-operating factors like economic variable changes and corporate actions like dividends/capital injections etc.

Expense Ratio – Ratio of Administrative Expense to total premiums. It is taken as a measure of the operating efficiency of an insurer.

Appendix C: Insurance Terminologies

First Year Premium (FYP) – Regular premiums received during the first installment of payment for a policy that has annualized premium structure.

Free Surplus (FS) – Excess capital which is a part of ANW over and above the capital required to cover the liabilities.

Frictional Cost of Capital (FCoC) – Part of the Embedded Value calculations, this head makes allowances for frictional costs – tax, investment expenses, shareholders' fund expenses.

Gross Written Premium (GWP) – Total premium written by an insurer in an year, gross of any reinsurance premium ceded.

Individual Rated Premium (IRP) – The sum of first year premium and 10% weighted single premium for individual business.

New Business Premium (NBP) – Total premium from new businesses written in a particular year, and excludes any premium that has been written for renewal of previously written business. It is a summation of first year premium and single premium.

New Business Strain – Strain on the business created due to revenues received in the first policy year, as upfront expenditure for sourcing of the new business form a considerable portion of the first year premiums.

Operating Expense Ratio – Ratio of Administrative/Operating Expense to total premium.

Persistency – The proportion of business retained from the total business underwritten, measured in terms of both number of policies, as well as premiums underwritten.

Appendix C: Insurance Terminologies

Present Value of Future Profits (PVFP) – Present value of future after-tax shareholder's profits from in-force business. This is calculated as the net present value of profits from best estimate of cash flows business in-force.

Renewal Premium – Regular premium paid for a policy from the second year onwards.

Required Capital (RC) – Regulatory capital that needs to be maintained to cover for existing business, over and above the assets required to back the liabilities.

Return on Embedded Value (ROEV) – Measure of profitability of life insurance business, ROEV is calculated as Embedded Value Profit as a proportion of EV at the start of the year. This is generally looked at operating level and hence the measure Operating ROEV (EVOP/Opening EV) is used.

Solvency Ratio – A measure of financial strength of an insurer, solvency ratio is calculated as available capital divided by required capital, expressed in percentage terms. Required capital for solvency ratio is calculated in India using a two factor model.

Time Value of Financial Options and Guarantees (TVFOG) – Part of the embedded value calculations, allows for impact of financial options and guarantees within the covered business.

Total Expense – Calculated as summation of operating expenses and commission expenses.

Total Expense Ratio – Calculated as a ratio total expense divided by total premiums, expressed as a percentage.

Value of In-force (VIF) – A measure of the value of the book of business that is in-force, i.e. excluding any new business written during the period. This is calculated as PVFP after deducting allowances for TVFOG, CRNHR and FCoC.

Value of New Business (VNB) – VNB reflects the value that is expected to be added to the current embedded value through any new business written during the current period. It is calculated as the present value of expected future profits from the new business written during the period.

Value of New Business margin (VNB margin) – A measure of expected profitability of the new business written, VNB margin is calculated as a ratio of VNB to APE, expressed as a percentage.

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