04 July 2016 | Sector Update

Insurance/Takaful Sector

***Maintain* POSITIVE**

A transitional phase begins

INVESTMENT HIGHLIGHTS

- **First phase of detariffication of motor and fire tariffs likely to financially benefit insurance players as new products are allowed to be priced at market rates**
- **The aggregate earnings of insurance companies under our coverage is expected to continue to be on the bright side in the next 12 months**
- **We reiterate our POSITIVE stance on the sector**

The detariffication of motor and fire tariffs is now a reality. The potential winners are arguably those who deploy the best pricing strategies and focus on tactical flexibility. These players have been investing in technologies to develop premium pricing models, and to improve process and delivery channels to sustain profitability growth from 3Q2016 onwards. Our investment merits are as follow:

A. BENEFITTING FROM THE 1ST PHASE OF DETARIFFICATION

First phase of detariffication has begun. As previously announced, insurance and Takaful markets are adjusting to the changes in the pricing of motor and fire insurance products which will take place gradually, shifting from a tariff based pricing to a risk based pricing methodology. During the phased liberalisation period, the first phase allows insurers to offer new products/coverage at market rates with effect from 1 July 2016 to 30 June 2017. As detariffication will lead to a paradigm shift in insurance business activities, the overall impact to the industry is still too pre-mature to be determined at this stage.

Figure 1: Phased Liberalisation of Motor and Fire Class

Timeline	Motor Business	Fire Business
Prior to 1 July 2016	▪ All available products are defined in the Tariffs and are subject to tariff rates ▪ Gradual adjustments to tariff rates for identified risk groups	
Effective from 1 July 2016 onwards	**Flexibility in product offering** ▪ A licensed person shall continue to offer the same products at the same prices that were being offered as at 30 June 2016. Such products shall be offered in accordance with the Tariffs ▪ A licensed person may introduce new products at premium or takaful contribution rates as determined by the licensed person (market rates)	
Effective from 1 July 2017 onwards	**Gradual Tariffs adjustments** ▪ The pricing for Third Party products[1] shall be in accordance with the Motor Tariff and any pricing adjustments which the Bank may specify for identified classes of vehicles **Flexibility in product pricing** ▪ The pricing for Comprehensive and Third Party Fire and Theft products[1] will be liberalised. Licensed persons will be able to determine the premium or takaful contribution rates for such products	▪ The pricing of fire products[1] shall be in accordance with the Fire Tariff and any pricing adjustments which the Bank may specify for identified categories of risks
From 2019 onwards	▪ The progress and impact of the phased liberalisation will be evaluated to determine the readiness of consumers and the industry for further liberalisation	

Source: BNM, MIDFR

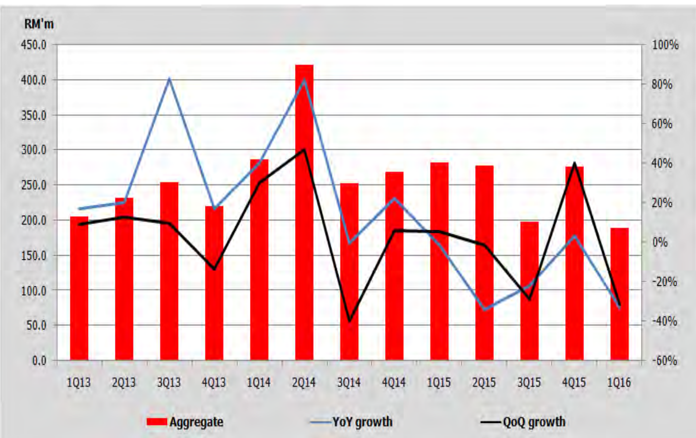
Detarrification not necessarily a worse off overall impact for insurers. Although it is widely expected that the detariffication may literally lead to free competition market and subsequently, price wars for motor and fire tariffs, we opine that this will not happen. This is in view pricing of insurance products is still required to fall within the risk based capital framework issued by BNM. Thus, it is immensely important for an insurer to invest in technology to build sophisticated pricing mechanisms and to improve its operational capabilities. Those lacking in capital to invest to improve their pricing models are likely to face an adverse impact from under-pricing for risk of insurance policies underwritten.

Positive on the first phase of liberalisation. We see the 1st phase of detariffication as able to encourage the increase in number of new insurance products with the introduction of variation in product features. Insurers can freely tailor their new products and price them according to risk profile and customer preferences. Correspondingly, this may result in higher premium income and lower claims ratio, which will be beneficial to insurance companies' bottom line. We understand that some opportunists have already made their move to introduce their new products, pending the review by PIAM/MTA and BNM's approval.

B. PUBLIC LISTED INSURERS' EARNINGS PERFORMANCE

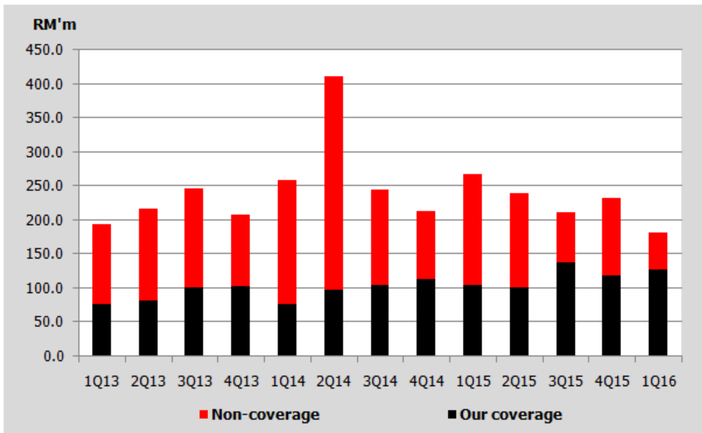
Slow start to the year. The aggregate earnings of current eight public listed insurance companies (after excluding MAA Group) totalled RM189.9m, thus far in 1QCY16 (see chart 1). The figure was lower both on-year by -33.1%yoy and -31%qoq respectively. The decline of aggregate earnings was mainly dragged by insurance companies which were not in our coverage (see chart 2). We note that it was due to the increase in provision for claim liabilities and lower investment income.

Chart 1: Calenderised aggregate earnings



Source: Bursa Malaysia, MIDFR

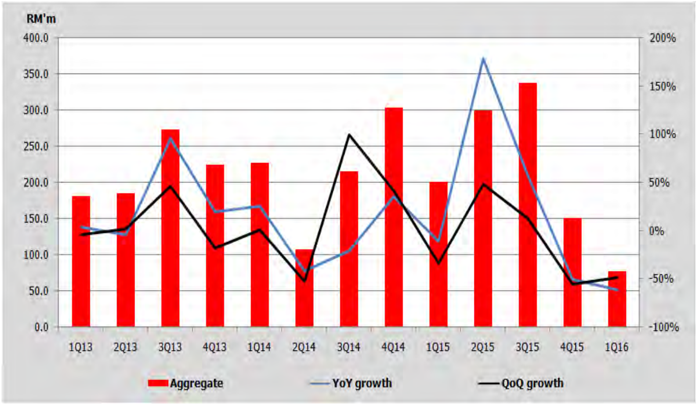
Chart 2: Earnings under our coverage



Source: Bursa Malaysia, MIDFR

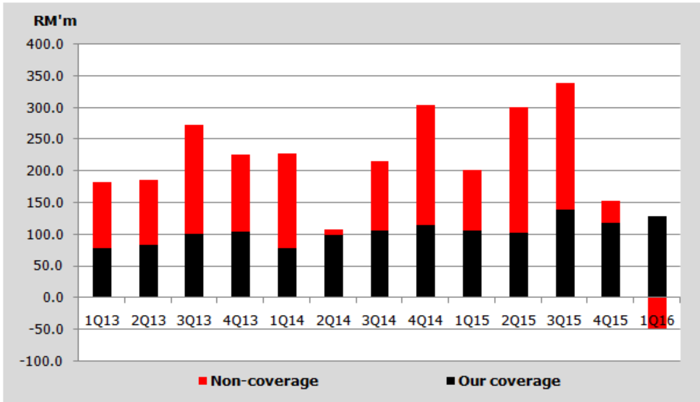
Estimated 1QCY16 core earnings in the same trend. After normalizing the impact of non-recurring items, the adjusted earnings growth in 1QCY16 was RM78.0m, registering higher negative growth of -61%yoy and -49%qoq (see chart 3). Likewise, the spoilers were insurance companies that were not in our coverage. On the contrary, it is noteworthy that 1QCY16 aggregate core earnings of three companies under our coverage (which are Syarikat Takaful Malaysia, LPI Capital and Tune Protect) of RM127.6m have registered solid growths of 21.5%yoy and 7.7%qoq (see chart 4). With 1st phase of detariffication likely to benefit insurance players, we expect the aggregate earnings of our coverage will continue to be on constructive growth path in the next 12 months.

Chart 3: Calenderised aggregate core earnings



Source: Bursa Malaysia, MIDFR

Chart 4: Core earnings under our coverage



Source: Bursa Malaysia, MIDFR

C. VALUATION AND RECOMMENDATION

Maintain POSITIVE. To conclude, we reiterate our **POSITIVE** recommendation on the sector. Our top pick for the sector remains unchanged, **Syarikat Takaful Malaysia (TP: RM4.65)** and for small cap, we continue to like **Tune Protect (TP: RM2.14)**. We advocate investors to hold **LPI Capital (TP: RM16.04)** as the company still possess (i) good forward earnings growth potential, (ii) inherent underwriting profit and margin quality, and (iii) generous dividend payout.

Table 1: Peer Comparison

Stock	Last price (RM)	Recom.	TP (RM)	EPS (sen)		PER (x)		Div. yield (%)		PBV (x)	
				FY16F	FY17F	FY16F	FY17F	FY16F	FY17F	FY16F	FY17F
Insurer/Takaful											
STMB	3.92	BUY	4.65	21.3	23.7	18.4	16.5	2.3	3.1	4.6	4.4
Tune Protect	1.45	BUY	2.14	11.2	13.6	12.9	10.7	2.9	3.0	2.0	1.8
LPI Capital	15.94	NEUTRAL	16.04	78.1	87.1	20.4	18.3	4.4	4.4	2.8	2.7
Allianz Malaysia	10.02	NR	-	-	-	-	-	-	-	-	-
MPHB Capital	1.34	NR	-	-	-	-	-	-	-	-	-
Manulife Holdgs	2.90	NR	-	-	-	-	-	-	-	-	-
Pacific & Orient	1.31	NR	-	-	-	-	-	-	-	-	-
Reinsurer											
MNRB Holdings	2.46	NR	-	-	-	-	-	-	-	-	-

Source: MIDF

Risks. Downside risks to the sector includes: (1) Unfavourable regulatory changes, (2) higher-than-expected claims, (3) interest rate movements that could impact investment returns and discount rate on future contract liabilities and (4) compression of profit margin due to intense competition from the liberalisation of motor and fire tariff.

No direct impact of Brexit. Over the years, our insurance industry has grown and developed with a stringent and robust regulatory framework by Bank Negara Malaysia. Insurers and Takaful operators do not have a direct exposure in overseas insurance market as these underwriters are not allowed to underwrite insurance and reinsurance policies directly in the EU countries. Thus, there is neither a direct benefit of Britain being part of the EU or a negative impact directly from the divorce of Britain from EU on Malaysia's insurance industry.

Hafiz Hassan
mohd.hafiz@midf.com.my
03-2772 1668

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MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS	
STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >15% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >15% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -15% and +15% over the next 12 months.
SELL	Total return is expected to be <-15% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >15% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.
SECTOR RECOMMENDATIONS	
POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.