

October 19, 2017

High returns attract investors to Russian insurance sector

Russian insurance sector RoE analysis

M&As prove investor appeal2

Life insurance and motor hull insurance drive returns3

Larger companies earn more.....4

Rosgosstrakh suffered most in the OMTPLI segment5

Insurers' RoE will decline ...6

— **Insurance sector's RoE is among the highest in the Russian economy.** Insurers' return on equity (RoE) before tax was 24% in 2016 and 28% in 2015. For comparison: banks showed 14% and 3%, respectively, while the economy average was 13% and 11%.

— **Insurers benefit from the moderately strict monetary policy of the Bank of Russia.** High sector returns are supported by growth in new insurance segments and high effective interest rates that generate income from investments. Net loss ratio in the non-life segment declined down to 53% from 61% in 2014–2015. Coupled with the limited growth of administrative costs, the above factors were also positive for the financial results in 2016.

— **On average, major insurers are more profitable than minor companies.** This boosts M&A transactions, as companies strive to increase business efficiency by way of consolidation.

— **Rosgosstrakh absorbed most losses in the OMTPLI segment.** While holding the largest OMTPLI market share (24% in 2016 and 35% in 2015), Rosgosstrakh, one of the largest insurers in Russia, paid out the largest average loss per insured event.

— **ACRA expects insurers' RoE to decline in the upcoming years** in view of the persistent growth of losses in the OMTPLI segment and the declining interest rates. Insurers' RoE will be positively influenced by the growing life insurance segment. The 2017 RoE is expected to be high enough (around 20%), for the sector to remain appealing to investors.

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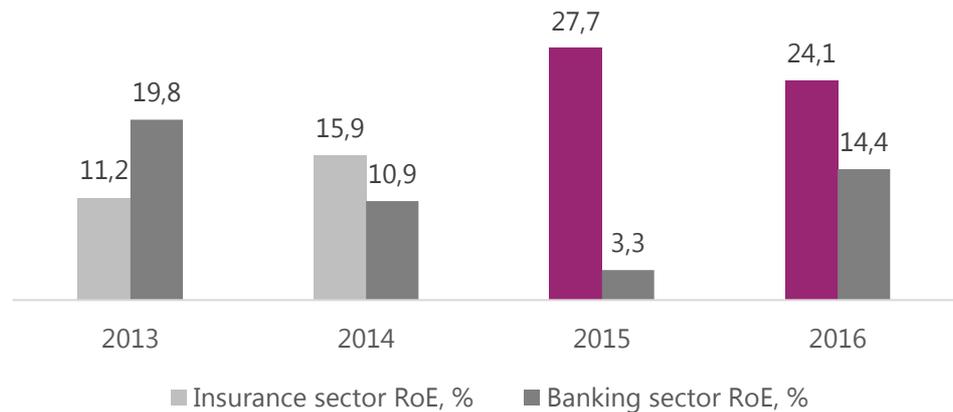
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In this paper, RoE means a ratio of income before tax to average equity for a specific period.

M&As prove investor appeal

According to the Bank of Russia, RoE calculated in respect of all insurance companies amounted to 24.1% in 2016. It is somewhat lower than 27.7% recorded in 2015 but remains high enough to arise interest in both investors and analysts focused on this market segment.

Figure 1. Insurers outperformed banks in terms of RoE in 2015-2016.



Source: the Bank of Russia, ACRA estimates

Strong performance drove the insurer capital market: a number of large M&A transactions took place in 2016–2017, including:

- VSK acquired B&N Insurance and Insurance Company Europlan;
- Renaissance Insurance Group Limited, Renaissance Life Insurance Company Limited, JSC Intouch Insurance, JSIC Blagosostoyaniye and Blagosostoyaniye GI JSC merged into a single insurance group;
- Otkritie insurance company came under control of Rosgosstrakh Life;
- SOGAZ acquired ZHASO and Regionarant.

In the above transactions, former shareholders for whom insurance is a non-core business decided to hand their companies over to stronger insurance market players. In the first two cases, they received minority stakes in the merged businesses.

Special attention should be paid to a transaction in shares of Rosgosstrakh, the largest insurer in terms of client base. Otkritie Financial Corporation acquired a controlling stake in Rosgosstrakh, regardless of losses Rosgosstrakh suffered in the OMTPLI segment. The parties planned to form the largest private financial holding in the country operating in all financial market sectors. However, difficult financial situation of the acquiring entity ruined these plans and resulted in that Rosgosstrakh fell under control of the Banking Sector Consolidation Fund established by the Bank of Russia.

Life insurance and motor hull insurance drive returns

"Net" indicators represent the result of subtracting amounts under outward reinsurance agreements.

Example:

Net insurance premium = Gross insurance premium less Outward reinsurance premium

In this paper, the "Underwriting result" means a balance of non-life insurance income and expenses excluding investment income.

For the purposes of quantitative analysis of indicators, ACRA used RAS financial statements of 299 insurance companies for 2014–2016. All other companies generated less than 3% of the total insurance premiums in the market. Table 1 shows consolidated financials of such insurers for 2014–2016 under the Russian accounting standards.

Table 1. Non-life segment remains a key component of insurers' income

	2014	2015	2016
Net insurance premiums	107.7	128.5	215.0
Life insurance	-3.5	24.4	38.4
Net earned premiums,	717.4	771.5	839.0
Net claims incurred	440.5	468.9	447.4
Underwriting result	76.7	105.3	148.1
Investment income	29.3	49.5	46.8
Non-life insurance	106.0	154.8	194.9
Administrative costs	-78.8	-85.0	-87.4
Other income	35.5	23.5	-40.6
Income (loss) before tax	59.2	117.7	105.3

Source: ACRA estimates

In the period under consideration, the key driver of the total financial performance of insurers has consistently been the non-life insurance segment that grew by 46% in 2015 and 26% in 2016. Such trend is rather unexpected in view of a limited growth of earned premiums (by 7.5% in 2015 and 8.8% in 2016) and a loss surge in the OMTPLI segment.

ACRA is of the opinion that the growth in the non-life insurance segment in 2015–2016 was driven by:

- 1) **Lower losses in the motor hull insurance segment.** Before 2014, motor hull insurance was characterized by low tariffs and high commissions, which led to low earnings in the segment. Subsequent amendments introduced in tariff policies and, most importantly, expansion of franchise insurance resulted in lower motor hull losses.
- 2) **Increased interest rates.** A surge in the Bank of Russia's key rate from 8% to 17% in late 2014 allowed the insurers to earn more from investments of actuarial reserves. Amid a comparatively low growth of insurance premiums, investment income (included in the non-life insurance result) grew over 1.5 times.

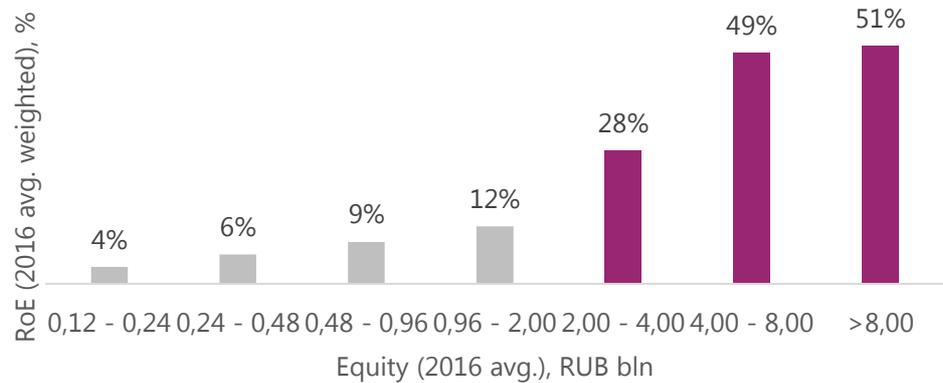
A rapid expansion of the life insurance segment was another contributor to the insurance sector growth seen in the above period. The segment flourished on the growing sales of investment life insurance, which led to strong financial results from life insurance operations.

Finally, it is worth noting that insurers were successful in managing their administrative costs, which only grew by 11% in two years, while accrued insurance premiums went up 24%.

Larger companies earn more

Larger insurance companies (including top ten insurers with over RUB 8 bln in equity capital) showed higher RoE as compared to insurers with less capital reserves (starting from RUB 120 mln). Rosgosstrakh was an exception, showing the largest historical loss in 2016.

Figure 2. Average-weighted RoE grows with the capital



Source: ACRA estimates

RoE growth is especially high when the equity surpasses the threshold amount of RUB 2 bln (as at end-2016, 30 insurers had equity exceeding RUB 2 bln). The analysis of pre-tax income allows pinpointing the following factors that determine the competitive advantage of large companies:

- 1) **Underwriting results to average capital ratio grows consistently if capital increases.** Larger capital apparently enables the company to attract larger clients and retain larger share of insurance risk (and, therefore, financial results).
- 2) **Focus on the mass segment.** Large insurers are in a position to work on the mass life insurance market including life insurance of borrowers and investment life insurance: these insurance classes demonstrated high margin in 2016.
- 3) **Significantly higher non-life investment income to average capital ratio.** Larger amounts of cash insurers with capital over RUB 8 bln deposit with banks presumably allow them to secure better financial terms.

The above trend represents another factor driving consolidation, including by way of mergers and acquisitions, in the Russian insurance market.

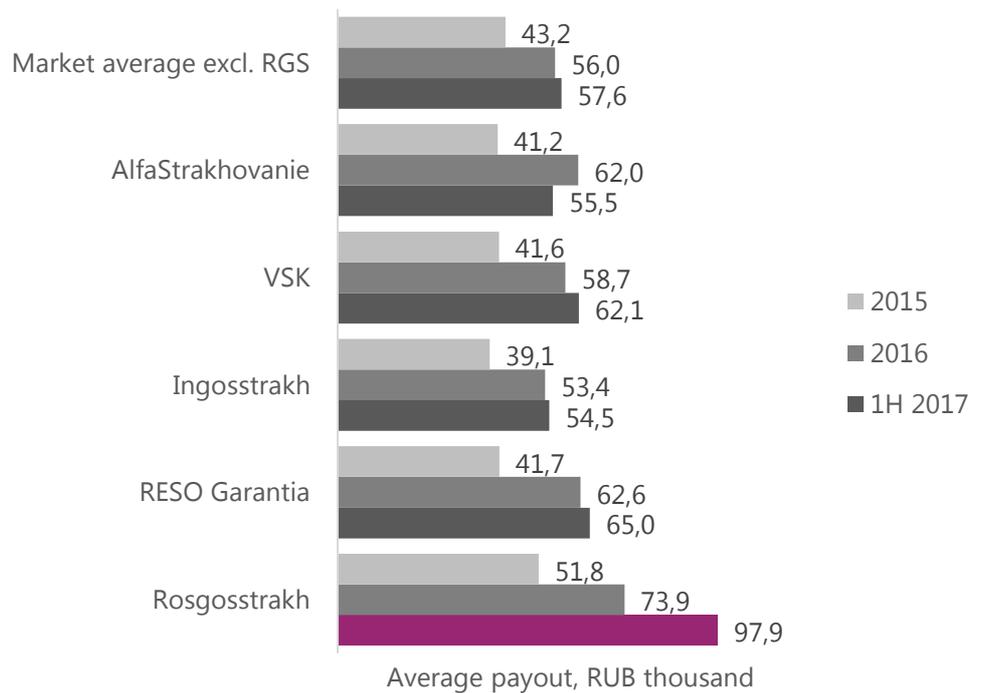
Rosgosstrakh suffered most in the OMTPLI segment

On the back of strong results of the overall market, performance by Rosgosstrakh - one of the largest insurers in Russia - stand out particularly. Following 2016 results, the company generated a loss of RUB 20.6 bln, which is around 20% of the total sector earnings. Excluding Rosgosstrakh figures, the average-weighted RoE of insurers exceeded 31%.

For more on the OMTPLI crisis see [OMTPL: Higher Chances for Change](#) dated June 07, 2016 and [OMTPL and investment insurance risks threaten growth stability](#) dated March 30, 2017

The major reason for a loss of that magnitude is losses suffered in the OMTPLI segment. Share of Rosgosstrakh in that segment in 2015 was 35%. After facing accelerating losses in this segment, the company decided to cut its market share. In 2016, it stood at 24%, and for the first six months of 2017, it declined to 20%. However, the cut was accompanied by increase in the average payout. The company significantly outpaced its immediate rivals and the average market figures: the average payout by Rosgosstrakh was 20% higher than the average payout for the rest of the market in 2015; in 2016 it was 32% higher, and in 1H 2017 70% higher.

Figure 3. The average payout by Rosgosstrakh under OMTPLI substantially exceeds payouts by its key competitors



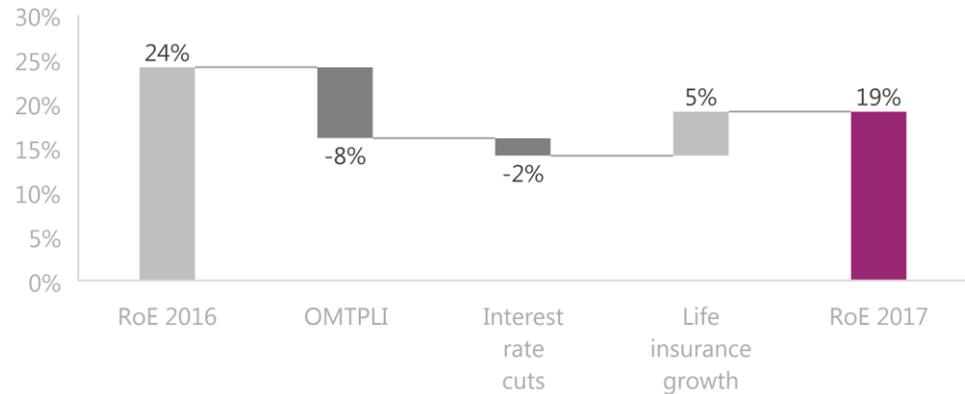
Source: ACRA estimates

Although the reasons for such a substantial gap between the average payout by Rosgosstrakh and the market average figures are unclear, the company's negative financial results can be mostly explained by the above factor. According to ACRA estimates, if the average payout of Rogosstrakh equaled the figures of its competitors, the company would manage to save around RUB 42 bln in payouts.

Insurers' RoE will decline

High RoE of insurers following their performance in 2015 and 2016 was driven by a combination of several factors, with some already being out of steam. Therefore, we expect that, following 2017 results and in subsequent years, RoE of insurers will be lower than in 2015 and 2016 dropping below 20%.

Figure 4. OMTPLI is the key factor for declining returns



Source: ACRA estimates

The continuing growth of losses in the OMTPLI segment will have the largest effect on RoE decline. The average insurance claim payout in 1H 2017 increased by 18% vs the same period last year. At the same time, the average insurance premium amount declined. We believe the total RoE will fall by at least 8% due to this factor.

In addition, interest rate cuts will also affect RoE. From January 2015 to September 2017, the Bank of Russia halved its key rate (from 17% to 8.5%) and is expected to continue rate cuts. The annual average interest rate will be around 9% in 2017, which is substantially lower than 10.6% in 2016 and 12.7% in 2015. A corresponding decline in investment income will result in additional decrease of RoE for insurers by around 2% vs 2016 figures.

Improved results in the life insurance segment may have a positive effect on RoE. Insurance premiums in this segment grow substantially: in 1H 2017, they gained 59% vs 1H 2016. By virtue of this factor, the estimated assessment of life insurance revenues translates into a 5% increase of the aggregate RoE.

Regardless of the decline, RoE remains high and investors will retain their interest in the sector. It is also a positive indicator for assessment of the average creditworthiness of Russian insurance companies.

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