Consolidation of Indian life insurance industry – to be or not to be?

Background

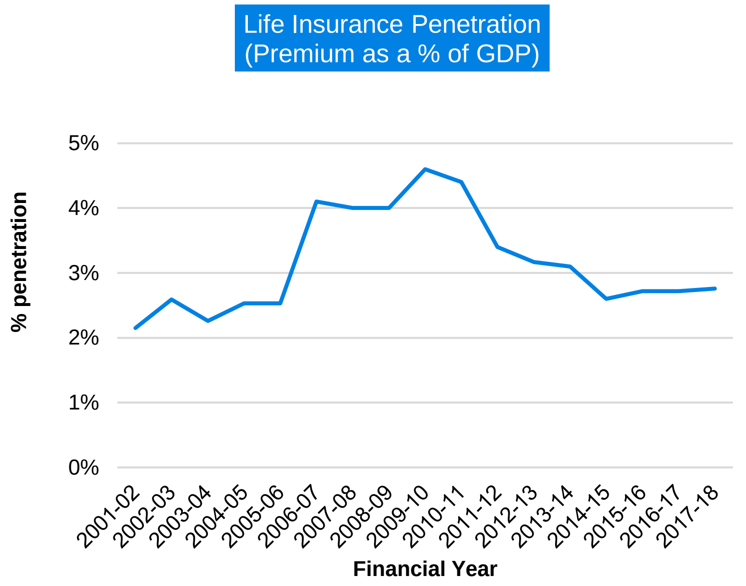
It has been more than 19 years since private sector companies were allowed to enter the Indian life insurance sector. In addition to the Life Insurance Corporation of India (LIC), there are now 23 private sector life insurers operating in the market. The sector has grown significantly over the years, achieving new business APE[1] CAGR of approximately 13% from FY2001–2002 to FY2018–2019. Life insurance penetration has also increased from approximately 1.4% of GDP in FY1999–2000 to 2.8% of GDP in FY2017–2018. The marketing activities of insurers have also led to increased consumer awareness about the need for life insurance.

Key points of discussion:

- Areas in which the insurance sector can improve and enhance its performance
- How many promoters are considering alternative options to divest part or all of their investments in the industry
- Issues to consider before taking the private equity (PE), initial public offering (IPO), or merger route for divestment

The sector has also been successful in:

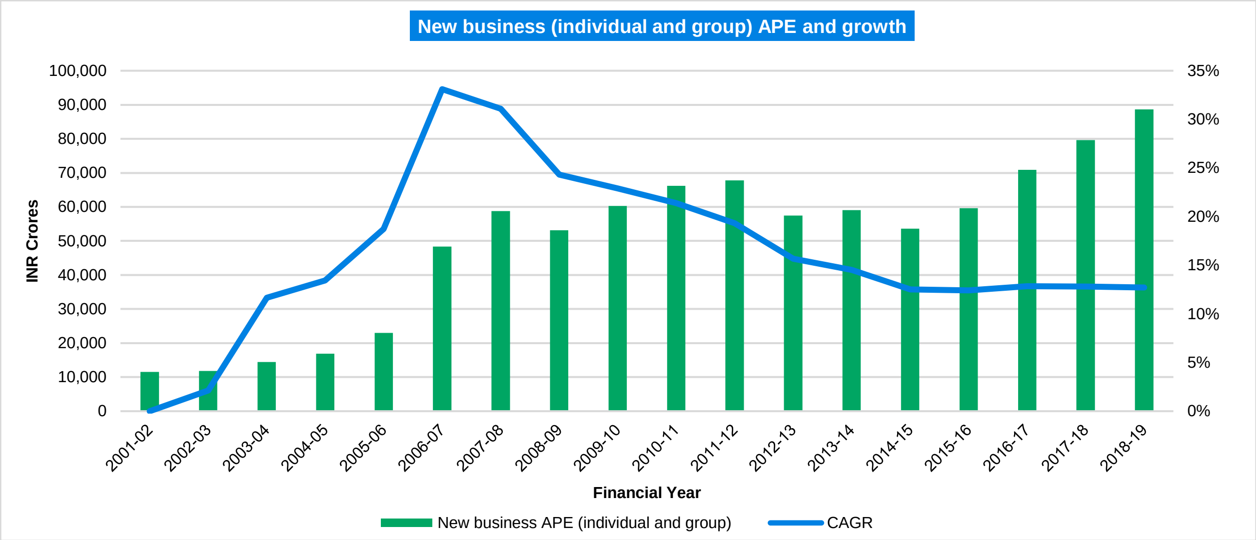
- The introduction of a variety of products including unit-linked (ULIPs), universal life (known as VIP), critical illness, and health products
- Making protection products more accessible to the consumer by simplifying the on-boarding process and reducing term assurance rates materially (by more than 60%–70% since the opening up of the sector)
- Diversifying distribution channels from tied agency to include the use of banks, corporate agencies, and brokers, as well as direct, with the application of online models or web-aggregators
- Creating large numbers of jobs across the country, with the private sector insurers accounting for an estimated 125,000 employees and approximately 950,000 individual agents



Source: IRDAI disclosures

[1] *APE (annualised premium equivalent) is a measure of new business performance commonly used by life insurers and is defined as 100% of premiums from regular premium policies and 10% of single premiums.*

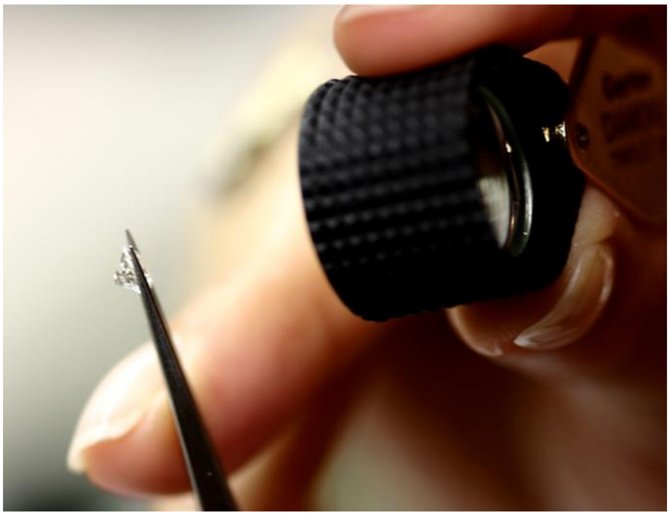
- Increasing rural penetration of life insurance
- Enhancing industry service standards, including a reduction in turnaround times for key policyholder services, with the development and application of new technologies and processes



Source: IRDAI disclosures

However, despite these noteworthy achievements, there remain many areas for the life insurance industry to improve and enhance its performance. These include:

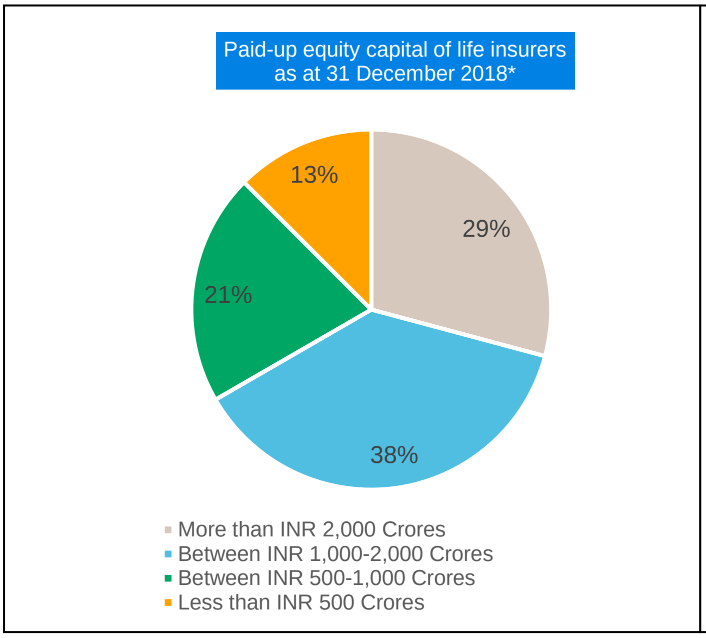
- Addressing the high policy lapse rates that are prevalent in the industry
- Improving the productivity levels of some of the distribution channels (especially the tied individual agency channel)
- Achieving greater insurance penetration, especially within the lower socio-economic groups
- Writing a greater proportion of ‘protection’ business in order to narrow the large protection gap in India
- Developing the ‘pensions’ and ‘annuities’ market opportunities further, thereby helping to close the retirement savings gap
- Further product innovation with structured products, health and wellness products, products tailored to the rural markets with volatile income and savings patterns, propositions such as hospitalisation/major medical, long-term-care products, etc.

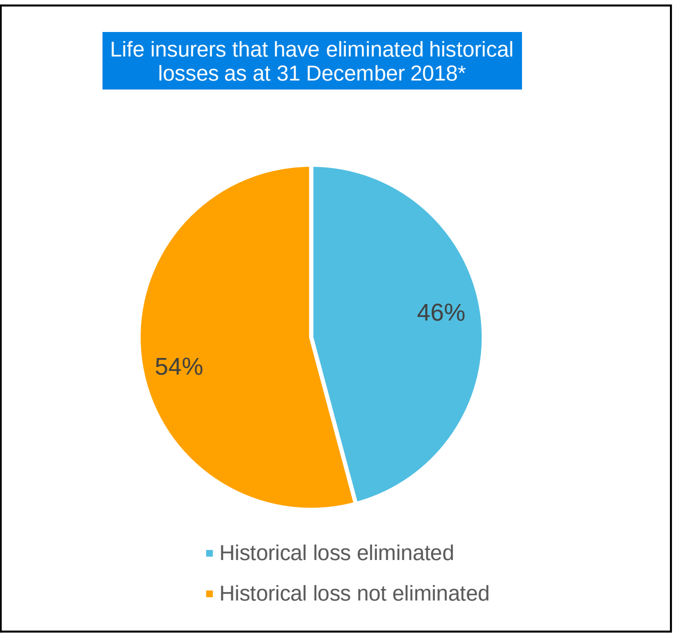


- Creating a more cost-efficient distribution model to improve profitability and return on equity for shareholders

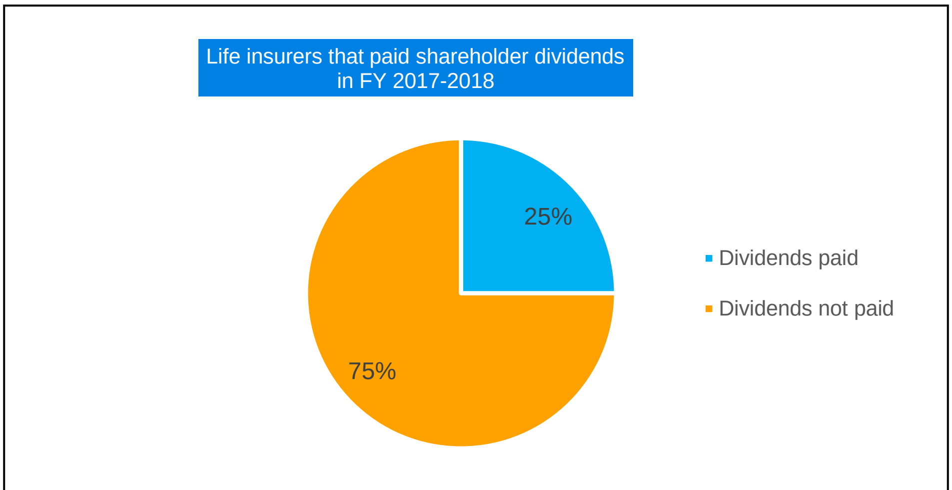
With a strong macro-economic outlook for the Indian economy, the young population, the large emerging middle class with high savings potential and the low penetration of life insurance business, the longer term outlook for the Indian life insurance industry continues to be positive. In many respects, even after 19 years, the privatised life insurance industry in India is still considered to be at a nascent stage.

Against this background, and despite investing a significant amount of capital (in excess of Rs. 36,000 Crores[2]), many life insurers are not yet achieving their desired level of profitability. Following the regulatory intervention in 2010, which resulted in capping charges on ULIPs, almost all life insurance companies were forced to re-look at their product, distribution, and operational strategies. Although a few companies have managed to make significant positive operational changes in response to the new environment (by cost rationalisation, changing product and distribution channel mix, improving persistency, etc.), many players continue to face headwinds on future growth prospects and profitability.





*Data for Sahara Life is as at 30 June 2018 Source: Public disclosures



Source: Public disclosures

Looking at the macro-economic potential and the significant untapped potential for life insurance business in India, one may argue that taking a longer term view will pay rich dividends, given the opportunity to grow and prospects to achieve a high return on capital invested.

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[2] *Crore = 10 Million*

However, in spite of this, in recent years, we have seen a lot of interest from several promoters looking to divest either fully or a part of their stakes in the life insurance businesses. We estimate that currently, as many as 15 promoters in 11 companies may be interested in some form of divestment. However, to date, such attempts have not proved to be easy.

What's driving the promoter appetite for divestment?

The main reasons commonly cited for the promoters' appetite for divestment can be summarised as follows:

a. **Promoter level capital requirements** – For many, there is a need for capital at the promoter level to fund other businesses.
b. **"Indian management control"** – When increasing the foreign equity limits in the life insurance sector to 49%, the Insurance (Amendment) Act 2015 stated that life insurers still need to have Indian management control. This condition is less palatable to many foreign promoters. Many argue that their level of management control as a 26% promoter was higher than what is possible under the current regime. Although most foreign promoters are keen to remain in the market, this point may persuade some to exit, should they not feel comfortable with how the business is being managed.
c. **Lack of meaningful future returns** – Some promoters feel that the life insurance sector provides lower margins and returns than other sectors. Given this, they may wish to divert investment to these sectors.
d. **Need to cash-in on the value built** – Some promoters that have invested in life insurance companies for the past 19+ years, feel that it is time to redeem some or all of the business value that has been created. Recent successful life insurance company listings have been analysed very closely in this regard.
e. **"Life insurance is not for me"** – Some domestic promoters may not be keen to stay invested in the life insurance sector. This is because they may not be keen to wait for the long-term profitability to materialise and/or have the appetite to continue to provide further capital to support growth.
f. **Regulatory driven** – Although rare, the industry has seen one potential transaction in the past that was driven by regulatory intervention.

Role of private equity (PE) investors and issues to consider

Given the promoters' appetite for divestment, PE investors may provide an avenue for divestment in some cases. PE firms can be attracted to the life insurance assets, especially if they see prospect for high returns over the next three to five years (which is typically the investment horizon of PE firms), followed by a clear exit route for themselves.

In companies where foreign promoters have not increased their stake to 49% (the maximum permitted), PE investors (most of whom are classified as 'foreign'), typically provide a route to the domestic promoter for partial / full divestment of its stake. PE investors have also acted as 'pre-IPO' investors in some of the listed life insurers, assisting in the price discovery process.

Naturally, PE investors have been looking at the sector, attracted by the prospect of long-term profitable growth and because life insurance companies can potentially command significant IPO valuations. A few existing financial investors in the listed life insurance companies may also be considering realising their returns by selling off their investments, thus providing PE firms additional opportunities to invest.

A list of successful investments by PE firms in recent years is set out below:

Date of publication	Insurer	Buyer	Seller	Stakes sold	Implied approximate valuation of the insurer (INR Cr)
October 2016	SBI Life	KKR / Temasek	State Bank of India (SBI)	3.90%	46,000

Date of publication	Insurer	Buyer	Seller	Stakes sold	Implied approximate valuation of the insurer (INR Cr)
November 2018	IndiaFirst Life	Warburg Pincus	Legal and General (UK)	26.00%	2,730
March 2019	SBI Life	Carlyle	BNP Paribas Assurance S.A.	9.00%	51,501
March 2019	PNB MetLife	Oman India Joint Investment Fund	Jammu and Kashmir Bank	2.04%	9,000

Source: Press reports

However, before such an investment, PE firms would consider a number of aspects:

1. What is the exit route? If the PE firms' focus is on generating high returns over a period of three to five years, they need to be clear about the planned exit route.
   - Are there likely to be a large number of new investors to whom the PE investors can sell their stakes in three to five years? If so, would the likely valuation then provide the desired level of return to the PE investor?
   - Is IPO an option? Are all other promoters in a given life insurance company on board for a potential IPO in the future? What is the likely level of valuations that can be achieved through an IPO? Would that deliver the desired level of returns to the PE investor?
2. What is the likelihood that the insurer is able to deliver on its stated business strategy having regard to the track record of its management, the regulatory environment in India, and possible changes in the future?
   - Would the PE firm want to/have any influence on management of the business? How would that work in practice for 'foreign' PE firms given the 'Indian management control' requirements?
3. Valuations, profitability and capital
   - How confident are the PE firms of the 'embedded value' (EV) and 'value of new business' (VONB) numbers disclosed by the insurer? How do they expect these values to change under different scenarios, given different product, distribution, and business strategies?
   - How does the overall valuation of the insurer compare against its recent EV and VONB results, e.g., the multiples against those found in other markets? Are the PE investors comfortable with the reasons for the valuation multiples demanded by the existing promoters? Would this deliver the required IRR on their investment?
   - Does the projected capital requirement for the business look appropriate given the business strategy? What is the dividend policy of the insurer and how is that likely to change in the future?
   - Taxation implications – What are the tax implications including any dividend distribution tax, withholding tax, capital gains tax, etc., on the investments by the PE firms? What are the taxation implications of the 'special purpose vehicle' (SPV) requirement by IRDAI?

Depending on the level of stake involved, a PE firm may or may not gain access to the management and detailed company-specific information and time that may be necessary for it to carry out a thorough due diligence. In the absence of this, it may be difficult for the PE firm to carry out a detailed assessment of the potential investment opportunity.

Although several discussions with PE firms in the past have not resulted in successful transactions, PE investors continue to display interest and engage with the sector given its long-term growth potential.

Is IPO a possibility?

Although many promoters/insurers have also considered IPO as a possible route to divest/exit, given the nascent stage of their businesses, we do not believe that this would be a suitable route for most of the players in the immediate future. The attraction for IPO seems to be more from the point of view of maximising the valuation (thanks to the valuations achieved by the listed life insurers) rather than the businesses themselves being ready for the IPO.

In our view, before considering an IPO, the insurers need to consider the following:

1. **Compelling strategic outlook for the business** – In order to achieve a high valuation, the insurer needs to have a well thought out strategy. This would depend not just on the product, distribution, and operational strategies adopted by the insurer, but also on the executional track record of its management.
2. **Scale and growth of business** – Although it is difficult to specify a number, life insurance companies should have achieved the scale necessary for the markets to find them attractive. In the past, IRDAI had specified a requirement (although this has since been removed) that life insurers have to have an embedded value of at least twice their paid-up capital as one of the conditions for approving the IPO plans. Also, it is important for insurers to be demonstrating a high and sustained growth in their new business volumes – it may be difficult to successfully IPO and command a high valuation if the new business growth has been low or erratic.
3. **Track record on profitability, VONB and embedded value growth –** Although it is not an absolute pre-condition, the businesses may find it very difficult to attract high valuations, if there is no track record of profitability. Apart from statutory profitability and elimination of historically accumulated losses, the businesses may also be required to demonstrate high VONB margins and VONB growth, as well as high returns on embedded value to support their expected IPO valuation prices.
4. **Track record on disclosures –** Thanks to the disclosures from currently listed insurers, investors have gradually started to unravel the complexities of life insurance business. In order to achieve an attractive valuation, it is important for the insurers to have a track record of disclosure of information for at least two to three years prior to the IPO. The disclosures may also need to be robust and comparable with those provided by the listed players in order to command the investor interest and secure attractive valuations.
5. **Operational readiness for post-IPO disclosures and scrutiny requires detailed planning –** Insurers may also need to carefully consider their ability to produce the detailed and robust disclosures and accurate management information required by the investors post listing, within a short time span after each quarter-end. This may require detailed planning preceding the actual IPO for at least a couple of years.

Three life insurers are already listed and investors can also gain exposure to the life insurance sector through investment in the listed holding companies of a few other life insurers. Thus, the ‘scarcity premium’ may no longer be achievable for new life insurance stocks. Nevertheless, an IPO provides an attractive divestment option for promoters in the medium term, provided they fulfil the conditions set out above.

What’s the solution?

While both the IPO and PE investor routes seem difficult in the short term, there are also several alternatives for promoters/insurers to consider. These include:

1. **Maintain status quo and explore avenues to grow the business and the valuation** – Given that the longer term prospects for the life insurance sector continue to be positive, companies may continue to focus on driving profitable future growth. Promoters should be able to achieve a good return on their investment, provided they are patient enough and ensure that the businesses focus on adopting the right strategies to increase the valuation. This may even require ongoing capital investment, which may be worth it if one is convinced about the longer term prospects for the sector.

The promoters may need to take actions to enhance the valuation through the consideration of several measures such as identifying areas of existing business/strategy that can be adjusted to enhance new business growth, margins and valuations; exploring subordinated debt or financial reinsurance type arrangements on attractive terms to finance new initiatives, etc.

2. **Moderation of valuation expectations** – We believe that the high valuation expectations of many promoters continue to be a hindrance for the completion of many transactions. Although past transactions may have happened at a certain level, it may not be appropriate for other insurers to continue to expect such high levels of valuation in the future, particularly if the VONB margins are low, expense overruns are still high, and future growth prospects are restricted. If promoters moderate their valuation expectations this could be a very important first step in facilitating their divestment or exit from the company.

3. **Merger with an existing listed insurer** – This may provide the strategic option that some promoters are looking for and may also add to the overall value of the merged entity due to potential synergies. However, this alternative may not suit all the promoters as it may require them to compromise on several aspects such as becoming a 'financial investor' instead of a 'strategic investor' in a life insurance company; letting go of the brand assigned to the life insurance business; being content with being a smaller stakeholder in a significantly larger insurer, etc. Given this, we believe that this alternative may not be taken up by many insurers.

4. **Aggregation of closed books** – Although several insurers in other countries run their businesses as 'closed book,' this may not be an attractive proposition for the promoters who are looking to exit. However, if there is an existing insurer (or investor) that is prepared to act as a consolidator of several such 'closed books,' this may provide an exit route for some of the promoters. Such models may also benefit participating policyholders given the lower expense ratios likely to result from a consolidation of smaller participating portfolios.

   However, the regulator may need to approve such models so this alternative does not seem to be plausible in the short to medium term.

If the promoters do not consider such steps now, there is a risk that the valuations for some of the smaller insurers may deteriorate over the years especially if:

- The productivity of the distribution channels and new business volumes remain low
- The insurer continues to experience high lapses
- The businesses continue to experience high expense overruns, deteriorating their embedded values

Of course, in the case of the joint ventures, if only one of the promoters is looking to divest, it may be extremely difficult for any type of transaction to progress, which has been the situation faced by several promoters in the recent past. Other issues that have commonly been encountered are:

- The existence of multiple joint venture partners in some insurance companies, each having differing views about the future strategies to be adopted

- The difficulty in finding suitable partners to replace the promoters looking for an exit
- The inherent complexities of a merger (again given the multiplicity of views)

Conclusion

Although the sector provides a significant potential for growth in new business and VONB margins (thanks in part to an enhanced focus on protection business), several promoters are looking to divest for a variety of reasons. However, partly due to the joint venture structure of the business, and partly due to high valuation expectations, many promoters have been finding it difficult to sell their stakes.

While an IPO has been an attractive route for some players in the past, considering the hurdles involved with listing successfully, this may not be a feasible route in the short to medium term for many of the promoters looking to divest.

Divestment to PE firms is certainly one option, provided promoters are willing to moderate their valuation expectations and some of the hurdles in PE investments are ironed out. Other alternatives include merging with an existing listed life insurer or selling the businesses to a consolidator (provided the regulator allows such models).

Promoters should carefully consider the various alternatives for consolidation, exit, or for continuation and the steps necessary to achieve an optimal outcome.

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