Financial Services
China

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Ping An Insurance (Group) of China (2318 HK)

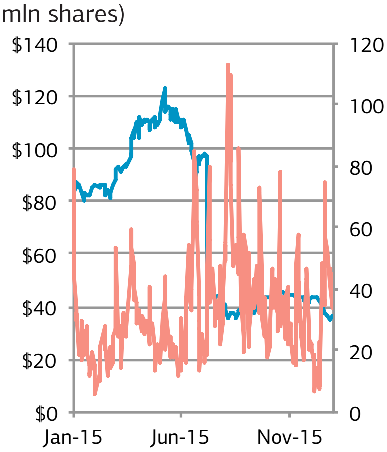
Hiding Troubled Assets?

- **We think Lufax,** in which Ping An holds a 47% interest, has taken on liabilities that will could drag down Ping An results once Lufax's new financing has been used up.
- **Slowing car sales** are likely to be damaging to Ping An Insurance, which derives 89% of its P&C income from auto insurance.
- **The operating metrics** of Ping An's life insurance business are deteriorating.
- **We reiterate our SELL rating** and lower our target price to HKD 29.42.

Ping An Insurance (2318 HK)

Price	HKD 36.55
Rating	**SELL**
Price Target	**HKD 29.42**
Difference	24%
Market Cap	HKD 655.85 bln
Avg. Volume	29.9 mln
P/E	12x
P/B	1.58

Ping An (2318 HK) last share price in HKD (blue) and volume (pink, in mln shares)



Source: Wind

A Lack of Trust

Ping An may have stuffed money-losing assets into the trust asset pool.

Our work on Ping An suggests that the assets in the bank are of unusually low quality, and yet Ping An Bank boasts the lowest NPL ratio of any bank in China. We believe Ping An carries this off by using its Lufax subsidiary to dispose of non-performing assets from Ping An Bank. Our interviews with experts in the industry have corroborated this view.

Some proof comes from a 2012 bond prospectus for Ping An. Chinese bond prospectuses are generally more detailed than disclosures for equities. The (Chinese language) bond prospectus details one third the assets in the trust that were reported by Ping An Insurance in 2012 and three times the income, meaning ROA of trust unit reported in Ping An Insurance is only one fifth of that in bond prospectus. In other words, Ping An may have been stuffing money-losing assets into the trust asset pool.

Table 1. 2012 Bond Prospectus and Annual Report Data

2012 Data from Bond Prospectus (RMB mln)

	Total assets	Total income	Net profit	ROA	Net margin
Life Insurance	1,036,933	161,536	7,558	15.58%	4.70%
P&C Insurance	134,934	82,492	4,635	61.14%	5.60%
Banking	1,606,537	39,749	13,511	2.47%	34.00%
Trust	73,897	15,141	2,929	20.49%	19.30%
Securities	32,328	2,711	845	8.39%	31.20%

2012 Data from Annual Report (RMB mln)

	Total assets	Total income	Net profit	ROA	Net margin
Life Insurance	1,036,933	161,012	6,457	15.53%	4.00%
P&C Insurance	134,93W	86,863	4,648	64.37%	5.40%
Banking	1,606,537	33,243	13,232	2.07%	39.80%
Trust	212,025	3,031	1,524	1.43%	50.30%
Securities	N.A.	2,897	845	N.A.	29.20%

Source: Company reports

Stuffing bad assets into the trust could help Ping An Bank, and indeed, Ping An reports the lowest NPL ratios in the business despite lending practices that we view as risky, especially compared with those of the big five SOE banks. This may be topping out now. Ping showed high growth in NPLs in H1 2015 from commercial, manufacturing, and retail companies,[1] all of which are vulnerable to the continuing downturn in the Chinese economy.

Table 2. NPL Comparison—Ping An and Peers

	NPL 2014	NPL 1H 2015	Increase in NPLs
Ping An Bank	1.02	1.32	0.3
ICBC	1.13	1.4	0.27
China Construction Bank	1.19	1.42	0.23
China Everbright Bank	1.19	1.42	0.23
Bank of Communication	1.25	1.35	0.1
China Citic Bank	1.3	1.32	0.02
China Merchant Bank	1.1	1.5	0.4

Source: Google Finance and company data. P/E and P/B ratios are as of December 9, 2015.

What Does Lufax Really Do?

Lufax, the Shanghai Lujiazui Financial Asset Exchange, was founded in 2012 and had 1.43 mln registered users by the end of Q3 2015 and transaction volumes of RMB 926.4 bln for the first three quarters of 2015. Lufax's P2P business, or loans between individuals, accounted for just 3.23% of the business, while institutional transactions amounted to RMB 609 bln or 66% of the volume.[2] The balance of transactions consists of sales of financial products to individuals.

Our checks with experts in the P2P industry revealed that most of the institutions working with Ping An are commercial banks. They say they think Ping An sells credit card receivables to them via the Lufax platform at a very thin profit. The retail products, P2P and B2C loans, are more profitable. Yet Lufax chooses to dedicate the bulk of its business to institutional transactions. We believe that is because the main role of Lufax is to assist Ping An Group in disposing of its NPLs.

The assets sold on Lufax are not of high quality. In recent interviews, we learned that a large proportion of Lufax assets are from Gem Alliance, its new P2P subsidiary, and consist of unsecured loans to individuals and small businesses. These loans traditionally have default rates as high as

[1] Source here

[2] Source here

20-30%, sometimes even reaching 70%.

The Lufax IPO Plan

Lufax only just raised USD 1.216 bln in mezzanine financing, and this cash helps Ping An create a cushion to delay recognition of deteriorating asset values. Lufax separated from Ping An Holdings in order to seek an IPO later this year. Lufax spun off its P2P business into a new company called Gem Alliance Limited then repurchased Gem Alliance in August by issuing a USD 2 bln convertible bond. On January 8, Lufax completed the new, USD 1.216 bln round, which values the company at USD 18 bln,[3] or almost twice the USD 10 bln valuation of April 2015.[4] The higher valuation and spare cash in Lufax will give Ping An more leeway to move NPLs off balance sheet.

We expect that the Lufax assets could default in high volume, and that will impact Ping An's earnings. Disclosures are weak. But if we assume that Lufax provides returns of 8% to investors, it would need borrowers to pay about 24%. These would be fairly standard numbers in the market. In that case, Lufax would make money only with default rates under 16%. But average defaults are 10-20% for P2P loans and 30% for unsecured consumer loans on P2P platforms. With these numbers, Lufax would have very thin margins.

Another liability comes to Ping An via its guarantees for Lufax assets. Ping An has provided loan guarantees to Lufax through Ping An Financial Guarantee (Tianjin) Co. Ltd. The Ping An Financial Guarantee assets, however, are likely insufficient to backstop the P2P loans. Ping An Financial Guarantee has RMB 1.25 bln in registered capital,[5] which under Chinese regulation is deemed sufficient for RMB 12.5 bln in guarantees. But Lufax P2P loans amount to RMB 200 bln, and nearly all products are guaranteed by Ping An Financial.

Property & Casualty

Auto insurance accounts for 89% of the group's P&C insurance, making it the second-largest business segment, accounting for 21% of group revenue and 22% of net income in H1 2015. We forecast a 6% decline in auto sales in 2016. We believe the slowdown in auto sales will have a negative impact

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3 Source here

4 Source here

5 Source here

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on this business.

Table 3. Share of Auto Insurance Among the Top P&C Insurers

People's Insurance Company of China	33.46%
Ping An	18.94%
China Pacific Insurance	12.31%
China Life	5.35%
China Insurance	4.62%
China Continent Insurance	2.96%
Sunshine Insurance Group	2.81%
China Export and Credit Insurance Corporation	2.40%
China Taiping	1.76%
Tianan Property Insurance	1.48%
Top 10 Property Insurance Companies	86.09%

Source: Bond prospectuses

Table 4. Contribution of Auto Insurance to P&C

Total income (RMB mln)	2012	2013	2014
P&C Insurance	86,863	103,160	124,152
Auto Insurance	76,159	89,952	110,530
Auto insurance contribution	87.7%	87.2%	89.0%

Source: Bond prospectus

Life Insurance

Ping An is losing in this competitive market. From 2011 to 2013, Ping An was more than 30% less efficient yet had higher net margins than China Life measured by sales per agent. This changed in 2014, when China Life's net margin surpassed Ping An's by 0.9%.

In 2014, China Life's net margin surpassed Ping An's.

Table 5. Net Margin (Life Insurance Business)

	2011	2012	2013	2014
Ping An (Life insurance)	6.5%	4.0%	6.1%	6.5%
China Life	5.8%	3.5%	6.0%	7.4%

Source: Company data

Table 6. Net Margin (P&C Insurance Business)

	2011	2012	2013	2014
Ping An (P&C insurance)	7.1%	5.4%	5.7%	7.1%
PICC	4.6%	5.4%	4.7%	6.0%

Source: Company data

Table 7. Sales Per Agent RMB/ppl (Life Insurance Business)

	2011	2012	2013	2014
Ping An	337,737	365,066	358,161	345,146
Life Insurance	464,636	464,828	494,433	444,287

Source: Company data

Table 8. Solvency Ratio Life Insurance

	2011	2012	2013	2014
Ping An	156.1%	190.6%	171.9%	219.9%
China Life	211.9%	170.1%	226.0%	294.0%

Source: Company data

The solvency ratio of Ping An's life insurance business is 74.1% lower than that of China Life, meaning that Ping An has less cushion for the clients' claims. This may be because Ping An uses money for higher-risk, higher-yield wealth management products.

Table 9. Solvency Ratio P&C Insurance

	2011	2012	2013	2014
Ping An	166.1%	178.4%	167.1%	164.5%
PICC	184.0%	175.0%	180.0%	239.0%

Source: Company data

In addition, Ping An's insurance mix is heavily weighted toward investment products similar to universal life policies. Some 89% of Ping An's life insurance products are "participating products," which have higher premiums and guarantee a minimum return of 2.5%. By contrast, China Life has only 19% of its portfolio in these investment products. Given declining market returns, surrender ratios are rising. Ping An's surrender ratio rose from 2.3% in 2010 to 4% in 2014.

Participating products allow 80% of the premium to be invested in equities. Ping An has been yielding a 5% return on these products. However, those returns generally cannot be achieved without leverage given the 38% drop in the Shanghai Composite. Many insurance companies are using trusts and other asset managers to add leverage to the premium from participating products. A recent high-profile case is that of Baoneng, the company that has made a hostile takeover bid for Vanke. Baoneng borrowed premiums from its subsidiary Qianhai Life to finance its acquisition of 24% of Vanke shares. Baoneng used at least four times leverage for the transaction.

Available public filings indicate that most of the equities in which Ping An has invested are losing money. These are merely indicative: Ping An might have invested its insurance funds in more remunerative securities. But we expect Ping An would be unlikely to lose on its own account and invest the insurance funds at a gain.

Investments made with capital borrowed through trusts and wealth management products are less transparent. Given further slump in A-share market, we suspect that leverage capital that invest in equity market would continue to pressure Ping An's bottom line in the new year.

Table 10. November Return on Participating Ping An Products

Participating Products Accounts	Annual Interest Rate
Individual participating accounts	4.50%
Premium participating accounts	5.00%
Jucaibao Participating accounts	5.00%
Caifubao No.2	6.50%

Source here

Table 11. Publicly Disclosed Ping An Holdings

Ticker	Company Name	Mkt Cap (mln)	Invest-ment (mln)	No. of shares holding '000	Holding Shares %	Value of Invest-ment (mln)	Change in Value
601398. SH	Industrial and Coml Bank of China Ltd	1,466,929	18,570	N.A.	N.A.		N.A.
601939. SH	China Construction Bank Corporation	1,054,435	9,561	N.A.	N.A.		N.A.
601328. SH	Bank of Communications Co Ltd	371,096	3,586	N.A.	N.A.		N.A.
600900. SH	China Yangtze Power	205,260	2,749	N.A.	1.2%	2,463	-10%
601166. SH	Industrial Bank Co., Ltd	299,122	1,984	N.A.	0.7%	2,094	6%
600036. SH	China Merchants Bank	389,433	1,956	N.A.	N.A.	0	N.A.
600887. SH	Inner Mongolia Yili Industrial Group	87,333	1,758	N.A.	1.6%	1,397	-21%

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000538.SZ	Yunnan Baiyao Group	6,711	1,407	N.A.	9.4%	631	-55%
600016.SH	China Minsheng Banking	290,706	351	37,700		319	-9%
002396.SZ	Fujian Star-net Communication	8,895	194	5,200		86	-56%
300232.SZ	Unilumin Group	6,586	108	7,100		204	89%
000501.SZ	Wuhan Department Store Group	8,623	107	4,000		65	-39%
000939.SZ	Kaidi Ecological &Envronmtl Tech	16,279	91	6,500		70	-23%
000915.SZ	Shandong Shanda Wit Scienc& Tech	4,687	77	1,100		29	-63%
002388.SZ	Shenzhen SnysElctrc-MnfctrgHldg	2,857	75	3,900		28	-63%
002289.SZ	Success Electronics	4,166	45	2,300		51	14%
300237.SZ	Shandong Meichen Science & Technology	6,902	40	1,200		10	-74%
000800.SZ	Faw Car Co	19,953	38	1,500		18	-52%

Impairment Loss

Impairment losses are suspiciously volatile.

We find that impairment losses the company reports are suspiciously volatile, and we suspect that this account is used to manipulate the bottom line. According to company filings, impairment losses include declines in the value of property, equity losses, and loan losses. As below table indicates that, the impact of impairment loss to the bottom line fluctuates significantly.

Table 12. Impact of Impairment Loss on the Bottom Line

RMB mln	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Net investment income	18,863	25,343	33,148	41,578	46,488	58,346
Net realized and unrealized gains	12,431	4,372	-961	-9,522	732	5,521
Impairment loss	-392	-540	-2,606	-6,450	-1,253	-8,822
Others	-174	97	-65	74	-	-
Total investment income	30,728	29,272	29,516	25,680	45,967	55,045
Profit for the year	14,482	17,938	22,582	26,750	36,014	47,930
Impairment loss impact on bottom line	3%	3%	12%	24%	3%	18%

Source: Company annual reports

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Valuation

We do not believe that Ping An merits the high valuation assigned to it by the market.

Table 13. Comparative Bank Valuations

	P/E	P/B
Ping An	10.64	1.98
ICBC	4.88	0.91
China Construction Bank	4.72	0.88
China Everbright Bank	4.61	0.76
Bank of Communication	4.96	0.71
China Citic Bank	4.56	0.74
China Merchant Bank	6.33	1.19
Agricultural Bank	4.37	0.81
Bank of China	5.98	0.77

Source: Bloomberg

We reiterate our sell rating with a price target of HKD 29.42 based on 0.57X P/EV2015 and 9.28x P/E 2015 implying a downside of 16%.We believe that plunge in A-share market would impair company's bottom line and be enhance with leverage which we believe is of high likelihood. On the other hand, weakening economy slows down company's main insurance business.

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