Bupa Arabia Company

Insurance
Bupa AB: Saudi Arabia
18 April 2019

Rating	**NEUTRAL**
Target price	**SAR93.00 (3.5% upside)**
Current price	**SAR89.90**

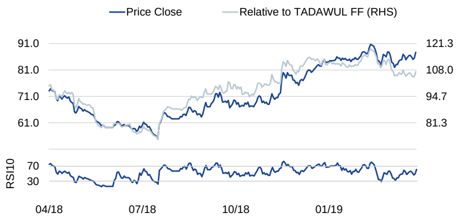
Research Department
Yazeed Alsaqaaby
Tel +966 11 2119398, alsaqaaby@alrajhi-capital.com

Share information

Market cap (SAR/US$)	10.52bn / 2.806bn
52-week range	54.80 - 90.70
Daily avg volume (US$)	2.4mn
Shares outstanding	120.0mn
Free float (est)	50%

Performance	1M	3M	12M
Absolute	4.5%	4.4%	27.9%
TASI	4.7%	10.2%	11.2%

Performance



Source: **Bloomberg, Company data, Al Rajhi Capital**

Valuation

	2017A	2018A	2019E
P/E (x)	17.7	21.8	16.9
P/B (x)	3.2	3.8	3.7
DPS	2.00	2.75	3.25
Dividend Yield (%)	2.2%	3.7%	4.3%

Source: Company data, Al Rajhi Capital * 2018 DPS is Expected

BUPA Arabia
Initiating coverage

We initiate coverage on Bupa Arabia with a Neutral rating and a target price of SAR93 per share. Bupa is the largest health insurer in Saudi Arabia with a solid track record and strong underwriting experience. Key investment themes include:

- *Bupa has a superior pricing power given its dominant position among medical insurers as compared to an overcrowded motor insurance segment.*
- *The company boasts of premium and resilient client base which has the ability to absorb cost increases as seen recently when CCHI changed its table of benefits. Also, this stickiness of Bupa's client base, resulted in strong earnings performance despite expat exodus.*
- *Other structural triggers are mandatory insurance for Saudis working in private sector, increasing number of Saudis working for private sector, women employment etc. each contributing to Bupa's growth story.*
- *Outstanding performance of investment portfolio, resulting in SAR184mn (+21% y-o-y) of investment income, representing ~32% of 2018 total income, yet maintaining a conservative allocation (figure 13) .*

Key forecasts: *It has a consistent track record growing faster than the industry (2018 growth at 10.8% y-o-y vs 5.2% industry), thereby gaining market share of 43% in 2018 from 18% in 2009, coupled with maintaining pricing discipline and stable loss ratios. We expect this performance to continue. We forecast a GWP CAGR of ~5% during 2018-2023E and stable loss ratio of ~80% in our model, mainly due to price leadership and increase in Saudis working in private sector even as expat exodus effect fades.*

Valuation and risks: *We set a TP of SAR93/sh on BUPA in the context of ~7% net income CAGR 2018-23e, and leadership position in less fragmented health segment with stable clientele. Given its healthy profitability ratios with stable risk profile and gearing towards structural growth opportunities in the Kingdom, the premium valuation is justified (implied multiple of 3.3x PB and 18xPE at target price). However, possible risks to the downside include market size decline amid expat levy and stagnant population.*

Figure 1 Bupa: Summary of key ratios

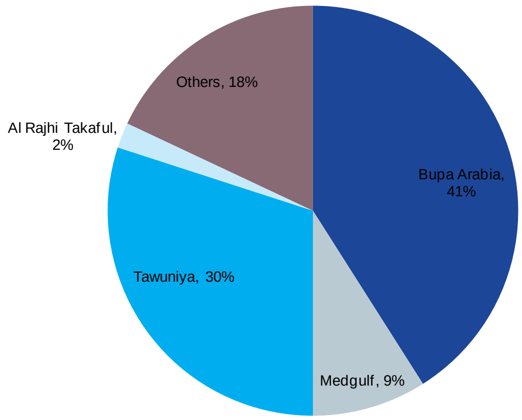
Key ratios	2017	2018	2019E	2020E	2021E
GWP(mn)	7,733	8,567	9,088	9,547	10,030
Net earned premiums (mn)	7,672	8,150	8,810	9,278	9,748
Expense ratio	15.9%	16.3%	16.5%	16.5%	16.5%
Loss ratio	83%	82%	81%	81%	81%
Combined ratio	99.2%	98.0%	98.0%	97.7%	97.2%
Net margin	7.2%	7.0%	7.1%	7.2%	7.2%
Return on Average Assets	6.9%	6.6%	6.6%	6.6%	6.5%
Return on Average Equity	25.3%	23.5%	22.9%	22.1%	21.6%
EPS	4.6	4.8	5.2	5.5	5.9
DPS	2.0	2.8	3.3	3.8	4.0
BVPS	19.3	21.5	23.9	26.2	28.3

Source: Company data, Al Rajhi Capital

BUPA – a leading player in Saudi health insurance sector

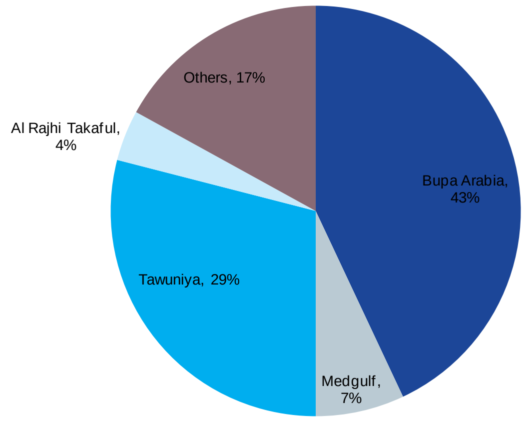
BUPA Arabia continues to be the single largest health insurer with 43% market share in 2018. The company has consistently maintained its market share over the past several years despite the disruptions in market dynamics, owing to various challenges faced which has put breaks in the overall growth of the industry. In 2018, BUPA GWPs increased 10.8% y-o-y, compared to the industry GWPs rise of 5.2% y-o-y. Further, BUPA's market share increased to 43% in 2018 from 41% during the same period. We think that BUPA will continue to show resilience and will gain further market share as it out paces the overall health insurance market. Also, the company, being the largest and only single line health insurer in the market will directly benefit from the structural growth opportunity that arises in the industry. However, that being said, there are few challenges which we believe are short-lived in our view.

Figure 2 BUPA Market share - 2017



Source: Company data, Al Rajhi Capital

Figure 3 BUPA Market share - 2018

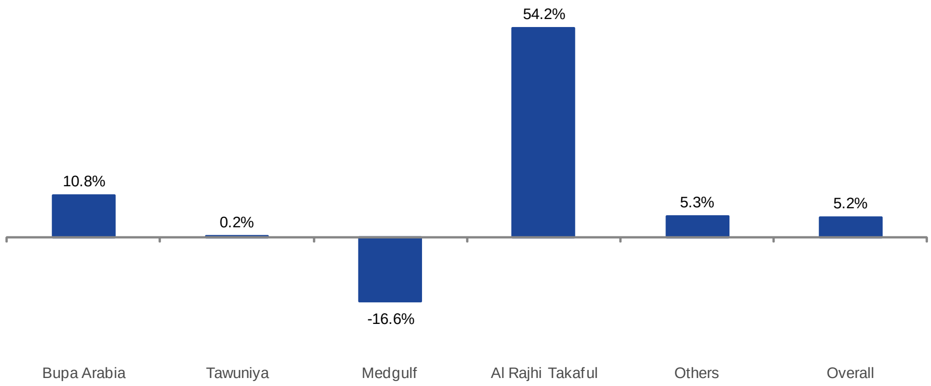


Source: Company data, Al Rajhi Capital

BUPA to benefit from the structural tailwinds

BUPA being the market leader should benefit from the structural tailwinds that should continue to support the industry. These are: 1) rise in Saudisation, 2) improved macroeconomic environment translating into higher insurance spending 3) mandatory insurance for Saudis working in private sector and higher participation expected from private sector in the economy 4) government's focus on increasing religious tourism, 5) dwindling effect of expat exodus . In addition, BUPA should continue to gain market share as the industry consolidates and weak players disappear in an industry that is highly fragmented. This is likely to result in a more favorable competitive landscape for the company as it will enable it to command higher pricing power over the peers.

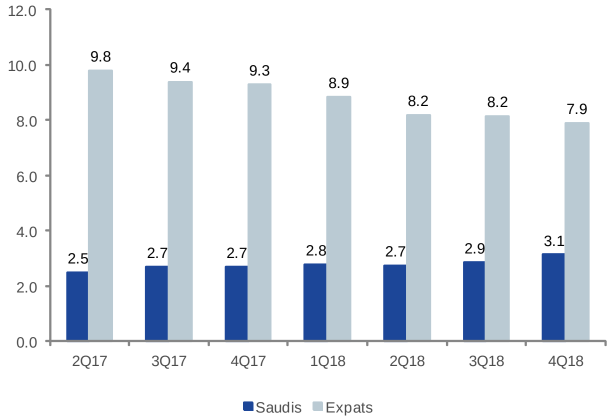
Figure 4 GWP - Bupa Arabia vs Peers growth rate (2018 vs 2017)



Source: Company data, Al Rajhi Capital

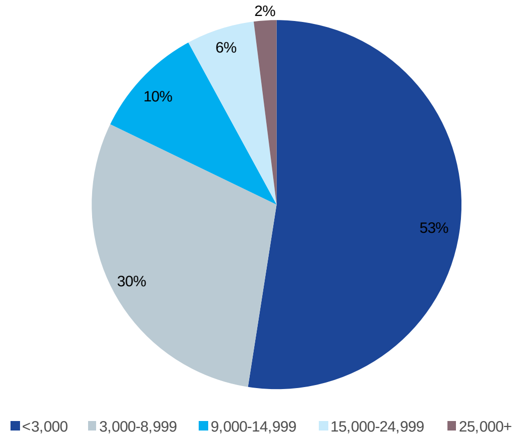
During the early part of 2018, expat exodus was the concern for the insurance companies, though BUPA was relatively better positioned vs peers given it operates in premium corporate segment where the impact of expat exodus has been minimal. Most of the expats who left were related to construction sector with low income, whereas Bupa's clients are premium. However, the company compensated for this negative impact by raising prices in 2018. We noted that expat exodus has slowed down during the second half of the year and we expect pace of it to stabilize, helping Bupa and the insurance industry as a whole. On the other hand, the number of policy coming from Saudi enforcement as CCHI has mandated the electronic insurance for all Saudis working in the private sector and their family members is increasing and will play important role in revenue. Additionally, Bupa will also benefit from the increase of prices happened as a result of CCHI increase of table of content, which was the main reason of GWP growth last year and will remain there till end of H1 2019.

Figure 5 Insured lives (mn)



Source: BUPA Presentations

Figure 6 % Non-Saudi Household expenditure distribution (SAR)

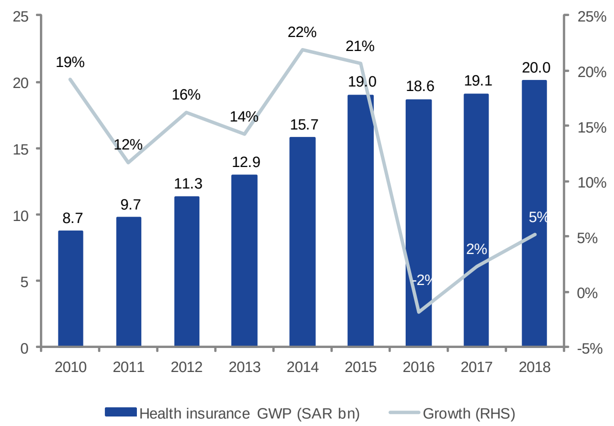


Source: GASTAT

Health insurance market

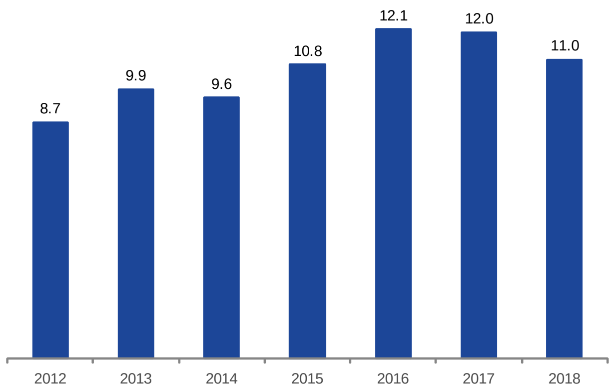
The health insurance market in the kingdom has seen a period of structural growth from 2010-2015. This significant growth reflected fast catching up of the health insurance in Saudi where the penetration rate remained low as compared with the rest of the world. However, in 2016 (+2% y-o-y) and 2017 (-2% y-o-y), GWP growth became subdued, largely due to weakness in labor markets and down trading to lower priced insurance with fewer benefits. In 2018, GWP growth showed some signs of pick up, though still remained weak as compared to the historical standards. We believe that 2018 was affected by the decline in insured lives and expat exodus which was partially offset by the insurance companies increasing their prices as a result of higher CCHI table of benefits (July 2018). As we step into 2019, we expect health insurance growth to normalize as structural factors such as enforcement of insurance for Saudis and government's initiatives overshadow the exodus of expats, the pace of which is expected to slow down in coming years. All that will lead to a growth in the sector which will be higher than the growth of Saudi economy.

Figure 7 Health insurance market GWP



Source: Company data, Al Rajhi Capital

Figure 8 Total insured lives (mn)



Source: Company data, Al Rajhi Capital

Key investment themes – opportunities

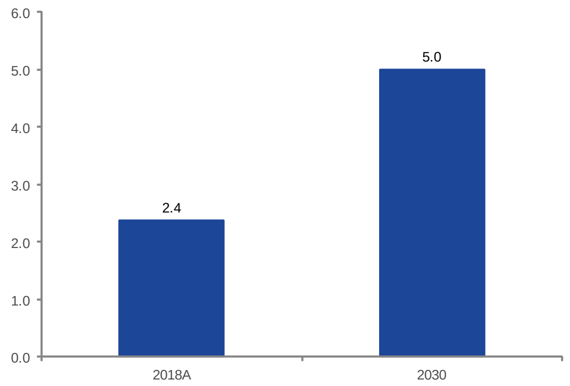
Increase in adoption rate of health insurance for Saudis working in private sector The health insurance adoption rate for Saudis working in the private sector is still low as compared to the expats (54% for Saudis compared to 80% for expats). We think that, going forward the adoption rate for Saudis will improve from the current levels which will lead to the narrowing of this gap. The country's health regulator CCHI has mandated the electronic insurance for all Saudis working in the private sector and their family members. This is likely to add 2mn number of insured lives by 2020 end. Growth in the health market is directly linked to the adoption rate of health insurance by the Saudis. In fact, the increase started as of the first quarter of 2019, number of Saudi citizens covered with medical insurance rose by 16.6 percent to reach 1.25 million as announced by CCHI. Further, this is likely to benefit Bupa and the health insurance sector as a whole.

Better performance and cash flow from corporates As the Kingdom's economy improves, better performance from corporates with higher cash flows will translate into higher spending by the individuals towards the health cover, directly benefitting insurance companies. In the past two years, insurance companies were struggling with high costs and were constrained from raising premiums due to weak market dynamics. However, as the macroeconomic environment improves in the longer-run, insurance companies are likely to command higher pricing power with their clients likely to upgrade insurance towards more premium product.

More and more Saudis work in private sector Under vision 2030, Saudi government aims to increase the private sector contribution to GDP from 40% to 65%. Also, the mid-term National Transformation Programme, has tasked the private sector to create 450,000 new jobs for Saudis to reduce unemployment for locals. We believe that one of the most important objectives of government initiatives to encourage private sector participation is to increase the weight of private sector jobs to locals to relieve the pressure on the public sector weight which is around ~60% in Saudi compare to average of ~23% in OECD average .This will lead to increased demand for medical insurance, particularly benefitting Bupa.

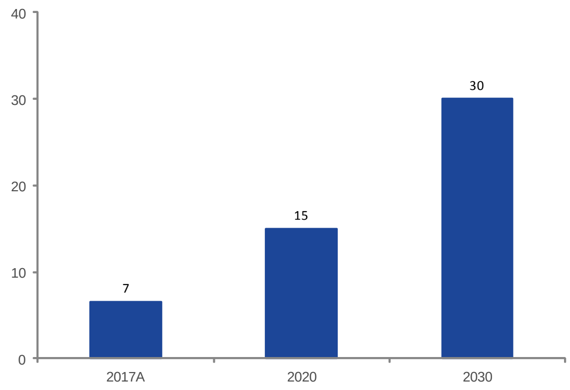
Mandatory health insurance in religious tourism The country's health insurance regulator is exploring the possibility of mandatory health cover for the pilgrims visiting the country. As the government aims to increase the Umrah number to 15mn by 2020 and 30mn by 2030 by simplifying the visa application process, the mandatory health cover will further benefit the insurers. On the other hand, government wants to reduce the costs of medical treatment for pilgrims. Umrah Host program (Umrat almudeef) is one of the initiatives to facilitate and improve the visa application process which has just been approved at the beginning of 2019 . CCHI is exploring the possibility of imposing mandatory health cover for pilgrims, however still in early stages and the premiums could be low but loss ratios will likely be profitable. We estimate that inclusion of pilgrims could add SAR 1.0-1.5bn to total GWP by 2020.

Figure 9 Target- number (mn) of Hajj Visitors by Govt



Source: GASTAT, Al Rajhi Capital

Figure 10 Target- number (mn) of Umrah Visitors by Govt



Source: GASTAT, Al Rajhi Capital

Possible challenges

CCHI increased table of benefits The recent (as of July 2018) increase in table of benefits such as obesity treatment, dental issues and vaccines for children among others, for new/renewed policies mandated by the CCHI, is likely to push amount of claims and lift the loss ratios of the insurance companies. However, in our opinion, the insurance players, especially the big ones like Bupa can limit the rise in loss ratios by passing on the higher costs to insurers through re-pricing the renewal policies.

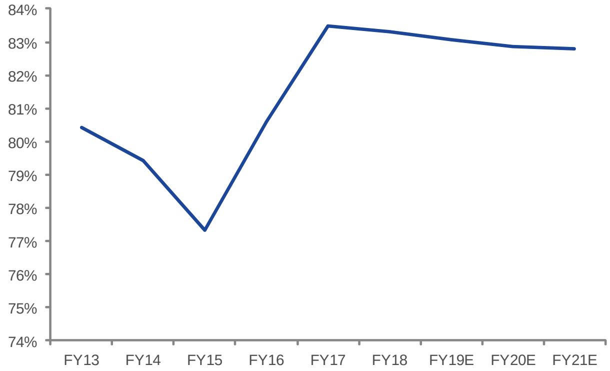
Expat will keep leaving but with slower trend in 2019 The overall market size of the insurance sector has declined significantly due to exodus of expat population from the Kingdom. According to Bupa, nearly 1.8mn expats have left Saudi Arabia since June 2017. While the pace of decline has slowed down in the second half of 2018, there is a risk that expat exodus will continue which can lead to contraction of the health insurance market size.

Modest long run growth, unless new regulation has been announced The highly penetrated insurance segment in private/SME segment in the Kingdom leaves limited headroom for growth unless regulatory changes require insurance companies to expand in other markets as well.

Solid underwriting track record

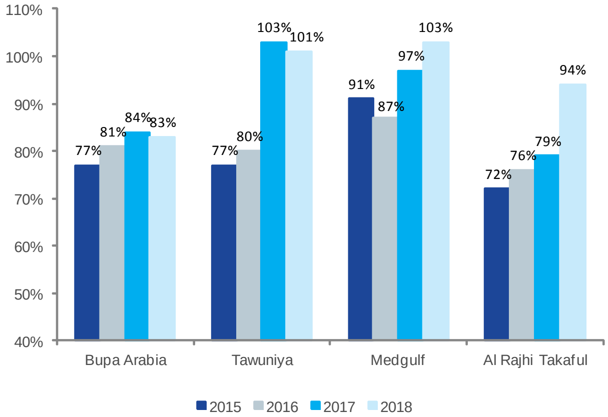
Bupa's pricing power and better clientele ensures that its loss ratio has remained largely stable close to 80%, even in the period of stress. In addition, Bupa benefited from the huge discount recognized from the newly opened/expansion of number of private hospitals (e.g. Dallah Namar , Hammadi Nuzha). While the company expects slight pressure on the loss-ratio as a result of increased CCHI table of benefits in the near-term, we expect company to maintain stable loss ratios as most of the increase in claims is already priced in the policy premium. Further, we believe that Bupa's big clients will not be affected by the rise in prices as insurance cost is considered minimal to them.

Figure 11 Loss-ratio trend



Source: Company data, Al Rajhi Capital

Figure 12 Low Loss Ratio vs Peers

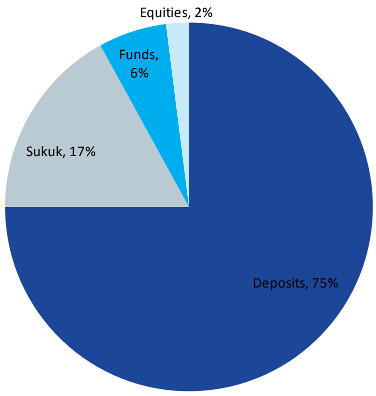


Source: Company data, Al Rajhi Capital

Rising contribution from investment income

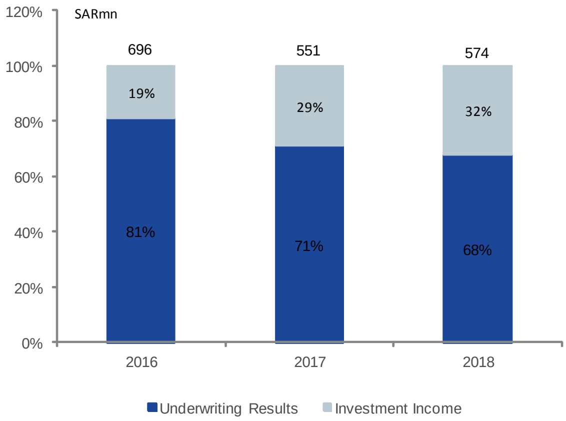
Bupa's investment income has been growing at a modest rate over the past few years, supporting the underwriting income. Also, this has resulted in the investment income taking a larger contribution in the total income. Further this has helped Bupa in decreasing the reliance on the its core underwriting income. In terms of investment approach, Bupa is fairly conservative with 75% of total investments invested in deposits, 17% in sukuk markets, 6% in funds and 2% in equities.

Figure 13 Asset Allocation



Source: Company data, Al Rajhi Capital

Figure 14 Income mix



Source: Company data, Al Rajhi Capital

BUPA financials and forecasts

We forecast a GWP CAGR of ~5% in 2018-2023E and stable loss ratio of ~80% in our model, mainly due to price leadership and growth in Saudis working in private sector even as expat exodus effect fades.

Figure 15 Financials

Year Ending 31 DEC (SAR mn)	2018A	2019E	2020E	2021E	2022E	2023E
Income Statement						
Gross premiums written(mn)	8,567	9,088	9,547	10,030	10,486	10,856
Net premiums earned	8,150	8,810	9,278	9,748	10,210	10,611
Gross claims paid	(6,709)	(7,225)	(7,590)	(7,924)	(8,253)	(8,522)
Total Underwriting Cost& Expenses	(6,986)	(7,534)	(7,926)	(8,319)	(8,704)	(9,037)
Net Underwriting result	1,164	1,277	1,352	1,429	1,506	1,574
Total Other Operating Expenses	(590)	(652)	(687)	(723)	(756)	(781)
Net Incom	574	624	665	707	750	793
EPS	4.8	5.2	5.5	5.9	6.3	6.6
DPS	2.8	3.3	3.8	4.0	4.3	4.8
Balance sheet						
Total Assets	8,272	8,922	9,498	10,189	10,936	11,688
Total Liabilities	5,706	6,062	6,363	6,797	7,274	7,743
Equity	2,574	2,868	3,144	3,400	3,671	3,954
Cash Flow						
Cash from Operation Activities	972	926	859	1,004	1,073	1,088
Cash Flow From Investing Activities	(760)	(278)	(291)	(304)	(317)	(332)
Cash Flow From Financing Activities	(151)	(330)	(390)	(450)	(480)	(510)
Growth YoY in percentage terms						
Gross written premiums	10.0%	6.1%	5.1%	5.1%	4.5%	3.5%
Net premiums earned	6.0%	8.1%	5.3%	5.1%	4.7%	3.9%
Net underwriting result	7.2%	9.7%	5.9%	5.7%	5.4%	4.5%
Total Other Operating Expenses	10.4%	10.6%	5.2%	5.2%	4.6%	3.3%
EPS	4.0%	8.7%	6.6%	6.2%	6.2%	5.7%

Source: Company data, Al Rajhi Capital

Valuation

We set a TP of SAR93/sh on BUPA in the context of ~7% net income CAGR 2018-23e, and leadership position in less fragmented health segment with stable clientele. Our TP of SAR93 per share is derived using the average of residual income method yielding fair value of SAR96.7 per share and the relative valuation method, resulting in SAR90 per share. Our forecasted terminal value stands it 3% and we used 9.3% as the cost of equity.

Figure 16 Bupa-Residual income valuation

SARmn	2017	2018	2019E	2020E	2021E	2022E	2023E
Net income	483	519	565	612	638	676	717
Equity charge	188	216	239	267	292	316	341
Residual income	295	303	326	345	346	360	375
PV of FCFE			306	297	272	259	247

Aggregate of PV of residual income	1,381
Add: Current Book Value	2,574
Terminal Value	8,223
Add: Discounted Terminal Value	7,651
Equity value	11,606
Shares outstanding(000's)	120
Share Price	96.7
CMP	89.9
Upside	8%

CoE calculation:	
Risk Free Rate	2.5%
Beta	1.03
Market Risk Premium	5.4%
Country risk premium	1.2%
Cost of Equity	9.3%
Terminal Growth Rate	3.1%

Source: Company data, Al Rajhi Capital

Figure 17 Bupa-Relative valuation

Relative Valuation	PB	PE
Multiple	3.3	18.0
BVPS	25.1	5.4
Fair Value (SAR)	82.7	96.7
Relative Valuation share price (average)	**89.7**	

Source: Company data, Al Rajhi Capital

Figure 18 BUPA Target Price

	Target Price	Weight
DCF	96.7	50%
Relative Valuation	89.7	50%
Target Price	**93**	
CMP	89.9	
Upside	**3.5%**	

Source: Company data, Al Rajhi Capital

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"Overweight": Our target price is more than 10% above the current share price, and we expect the share price to reach the target on a 12 month time horizon.

"Neutral": We expect the share price to settle at a level between 10% below the current share price and 10% above the current share price on a 12 month time horizon.

"Underweight": Our target price is more than 10% below the current share price, and we expect the share price to reach the target on a 12 month time horizon.

"Target price": We estimate target value per share for every stock we cover. This is normally based on widely accepted methods appropriate to the stock or sector under consideration, e.g. DCF (discounted cash flow) or SoTP (sum of the parts) analysis.

Please note that the achievement of any price target may be impeded by general market and economic trends and other external factors, or if a company's profits or operating performance exceed or fall short of our expectations.

Contact us

Mazen AlSudairi
Head of Research
Tel : +966 1 211 9449
Email: alsudairim@alrajhi-capital.com

Al Rajhi Capital
Research Department
Head Office, King Fahad Road
P.O. Box 5561, Riyadh 11432
Kingdom of Saudi Arabia
Email: research@alrajhi-capital.com

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