China / Hong Kong Company Update

AIA Group

Bloomberg: 1299 HK Equity | Reuters: 1299.HK

Refer to important disclosures at the end of this report

DBS Group Research . Equity

18 Feb 2022

BUY

Last Traded Price (17 Feb 2022): HK$89.30 (HSI : 24,793)
Price Target 12-mth: HK$127 (42% upside) (Prev HK$125)

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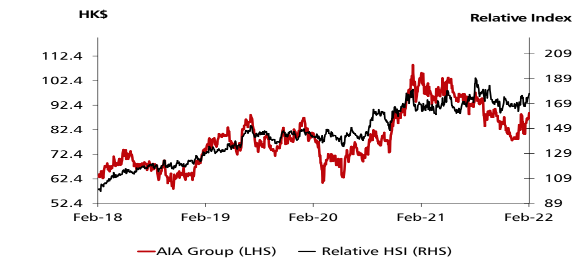
What's New

- We estimate the increase in US 10-year bond yield spot rate will push up AIA's long-term investment return curve by 26bps h-o-h and enhances its interest rate sensitivity
- Outperformed most of its insurers/banking peers in previous US rate cycles, and we expect déjà vu
- AIA China to see moderate start in 1Q22F on a high base, while HK and Thailand to see continuous growth from domestic segment and protection product migration
- Revise up FY21/22 VONB growth assumption by 3%-4% to +17%/+15% y-o-y, and lift TP to HK$127. Reiterate BUY

Price Relative



Forecasts and Valuation

FY Dec (US$ m)	2020A	2021F	2022F	2023F
Net earned premiums	33,666	36,093	38,388	41,255
Net investment income	9,398	10,529	11,218	11,954
Net Profit	5,959	6,579	7,095	7,598
EPS (US$)	0.44	0.61	0.67	0.74
EPS (HK$)	3.41	4.76	5.21	5.75
EPS Gth (%)	*(20.8)*	*39.6*	*9.4*	*10.5*
PE (X)	26.2	18.8	17.1	15.5
DPS (HK$)	1.35	1.47	1.59	1.70
Net Div Yield (%)	1.5	1.6	1.8	1.9
BV Per Share (HK$)	40.75	42.42	46.03	50.07
P/Book Value (X)	2.2	2.1	1.9	1.8
P/EV (X)	2.1	2.0	1.8	1.7
ROAE (%)	8.7	11.4	11.7	11.9
Earnings Rev (%):		0	0	New
Consensus EPS (US$)		0.53	0.61	0.68
Other Broker Recs:		B:37	S:0	H:3

Source of all data on this page: Company, DBS Bank (Hong Kong) Limited ("DBS HK"), Thomson Reuters

Stands to gain most from the US rate hike

Investment Thesis

Well positioned for next expansion. Targeting 12 new provinces/municipalities by FY30F with an addressable market 4x larger than the current footprint offers a grand secular opportunity. The recent investment in China Post Life (non-listed) also helps to capture growth from the mass market segment.

VONB to expand fivefold by FY30F. The additional value of new business (VONB) contribution from the China expansion, under a 10-year view, is estimated to result in a 5x and 27% increase in VONB and EV, respectively. The value of China Post Life's investment is equivalent to US$3.9bn.

Embrace the next US interest rate upcycle. The mounting US rate hike and tapering expectation has led the US 10-year bond yield to reach 1.9% in February 2022, the highest level since 2019. The market currently expects the US Fed to start raising its rate in March and anticipates three interest rate hikes in FY22F. The upward shift in the US bond yield is considered a positive for AIA.

Valuation:

Our TP is based on a two-stage EV growth model, with a) the first stage to factor in existing organic growth and b) the second stage to include the present value (PV) of the additional VONB from the China expansion by FY30F and terminal value. This is pegged to a 2.1x FY22F P/EV multiple. We also included a US$3.9bn valuation from the China Post Life investment.

Where we differ:

We believe the street has yet to factor in the additional value from the China Post Life investment, where we estimate the investment will bring in an additional HK$5/share to AIA.

Key Risks to Our View:

Slower VONB growth, sharp deterioration of investment performance, slower economic growth in China, and any interest rate downcycle.

At A Glance

Issued Capital (m shrs)	12,095
Mkt Cap (HK$m/US$m)	1,080,084 / 138,488
Major Shareholders (%)	
Capital Research Global Investors	6.2
Free Float (%)	93.8
3m Avg. Daily Val. (US$m)	229.73
GICS Industry: Financials / Insurance	

WHAT'S NEW

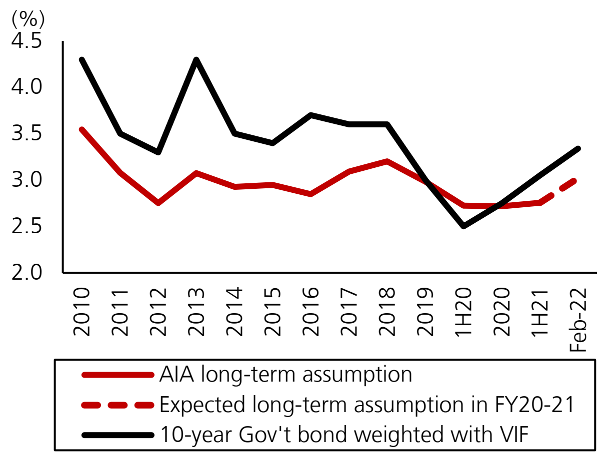
The US rate hike beneficiary

AIA to benefit from the US-China interest rate divergence. We expect AIA to benefit from the divergence of the US and China interest rate cycles, with the US interest rate expected to enter an upcycle while the interest rate in China remains on a downward cycle in the near term. The divergence in the US and China interest rate cycles will enhance the interest rate sensitivity of AIA's embedded value (EV), given that two types of rate assumptions will impact the calculation of EV, namely 1) the long-term investment return assumption, which will impact the numerator of the EV calculation; and 2) the risk discount rate assumption, which is the discount rate of the EV calculation.

Long-term investment return tends to be more sensitive to spot rate movements, while the risk discount rate reflects the risk-free rate plus risk premium and is considered less sensitive to spot rate movements. As AIA conducts business in several markets in the Pan-Asia region, each market uses its respective long-term investment return and risk discount rates and the insurer also provides a weighted average long-term investment return based on its top five VIF (value-in-force) contributing markets – including Hong Kong, China, Thailand, Singapore, and Malaysia – to better gauge the impact at the group level.

Long-term investment return expands with spot rate. Benefiting from the mounting expectation of the US interest rate hike, the US 10-year government bond yield has reached 1.92% as of 7 February 2022, a new high since 2019. This has also provided an upward lift to the 10-year bond yield in Thailand, Singapore, and Malaysia, as interest rate cycles in these markets tend to benchmark the movement of the US interest rate cycle. With AIA's top five VIF contributing markets, our estimate suggests the 10-year government bond weighted average with VIF may reach the 3.34% level, up by nearly 30bps (Fig. 1). As AIA's long-term investment assumption highly correlates with the VIF weighted average 10-year bond yield curve, we also expect that its long-term investment assumption may also trend upward by 26bps, compared to 1H21. With the US bond yield continuing its upward shift, we expect a further upside in its long-term investment return movements.

Fig 1. AIA's long-term investment return assumption

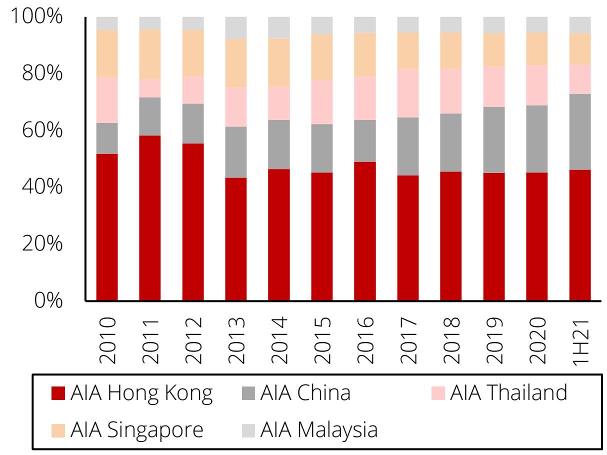


Source: Company data, DBS HK

Slower expansion in risk discount rate, as it is suppressed by the decline in China's risk discount rate. On the other hand, with the increasing VIF contribution from AIA China, the VIF weighted average of China's market has increased from 11% in 2010 to 27% as of 1H21 (Fig. 2). We believe the decline in China's interest rate, along with the low sensitivity of the risk discount rate toward the spot rate, will result in a slower expansion of AIA's weighted average risk discount rate, if any. In 1H21, the risk discount rates of AIA China and AIA Thailand were moderately revised down by 2bps and 5bps (Fig. 3), respectively, while the assumptions of other major markets remained intact. As AIA China's risk discount rate remains relatively high, at 9.73%, as the market further develops, we also see room for the risk discount rate (composite of risk-free rate plus risk premium) in China to further decline in the long term, like the trend we've seen in Thailand.

Overall, we believe the compounded effect from both, the movement in AIA's long-term investment return and risk discount rate, amid the US-China interest rate cycle divergence, will enhance its interest rate sensitivity and stand to be favourable to its embedded value growth.

Fig 2. Weighted average on AIA's top 5 VIF markets



Source: Company data, DBS HK

Fig 3. AIA's risk discount rate in major markets

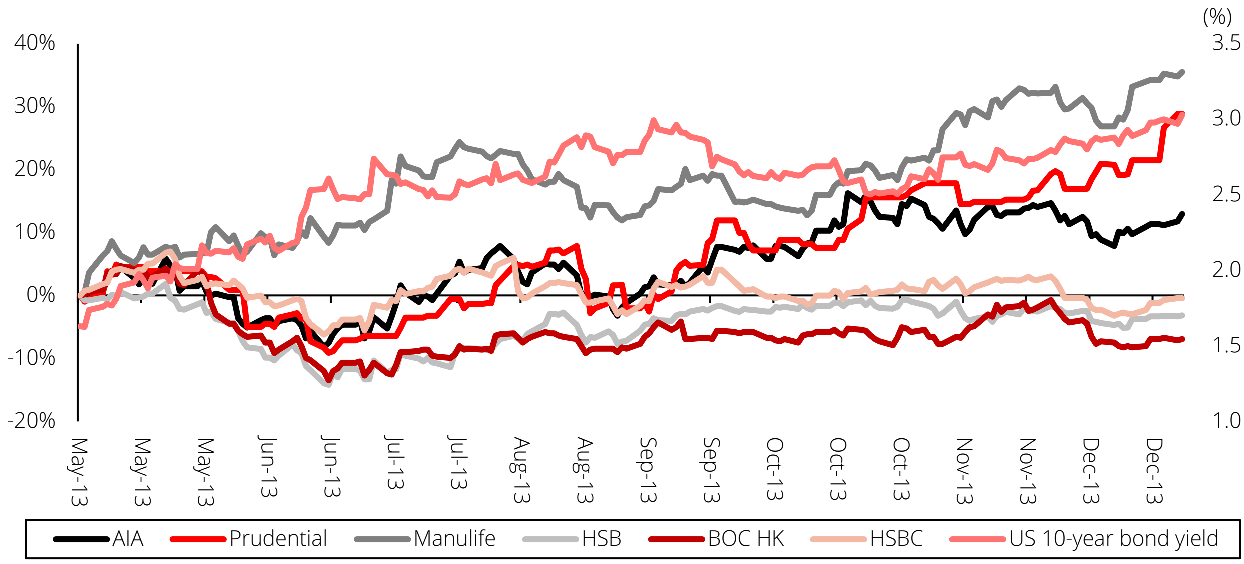
Country	2014	2015	2016	2017	2018	2019	2020	1H21
AIA Hong Kong	7.00	7.00	7.00	7.30	7.50	7.20	7.00	7.00
AIA China	9.75	9.75	9.55	9.75	9.75	9.75	9.75	9.73
AIA Thailand	9.00	8.80	8.60	8.60	8.60	7.90	7.80	7.75
AIA Singapore	6.75	6.90	6.90	6.90	7.10	6.90	6.60	6.60
AIA Malaysia	8.75	8.75	8.75	8.75	8.75	8.55	8.55	8.55
VIF weighted average	7.84	7.70	7.70	8.05	8.15	7.93	7.77	7.85

Source: Company data, DBS HK

Insurers' share prices to outperform that of banks. During the previous US interest rate hike cycles in FY13 and 2H15-2H18, AIA's share price, in general, had outperformed, if compared to either its regional insurer peers or banking peers. From a business model standpoint, an insurance company is considered more sensitive to interest rates than a bank, given that the balance sheet leverage for insurers is higher, at 15-20x, while the balance sheet leverage for banks is somewhat limited by the minimum capital requirement (i.e., if CAR ratio is 8%, this implies leverage at 12.5x). As such, an insurance company is considered more sensitive to interest rate movements.

The US Fed's tapering actions during 2H13 were considered relatively short-lived, while no interest rate hike actions were taken. Backed by the tapering expectations and the continuous tapering signals from the FOMC (Federal Open Market Committee) during the time (Fig. 5), the US 10-year bond yield increased from 1.63% to 3.03% (up 140bps, Fig. 4). Regional insurers' share prices, including AIA, Prudential (2378 HK, NR), and Manulife (945 HK, BUY), on average, were up 26% during the period. On the other hand, the average share prices of regional/HK banks, which are considered more sensitive to the US interest rate, such as HSB (11 HK, BUY), BOC HK (2388 HK, BUY), and HSBC (5 HK, BUY), moderately declined by 4%.

Fig 4. Relative share price performance – FY13 cycle



Source: Company data, DBS HK

AIA outperformed its peers amid US rate hike cycles. During the US interest rate cycles in 2H15 to 2H18 (first rate hike was initiated in December 2015, but the second rate hike was delayed until December 2016), the US 10-year bond yield increased from 2.21% to 3.24%, or up 103bps, if tracking from May 2015 to December 2018, when the US Fed signaled an interest rate hike for the first time amid this cycle and until the end of the rate hike cycle (Fig. 6). If tracking from trough to the end of the rate cycle, the US 10-year bond yield increased from 1.36% (recorded in July 2016) to 3.24% or was up 188bps.

If referring to the full cycle (from May 2015 to December 2018), AIA's share price was up 23% compared to its regional insurers' average share price, which was down 1%, and regional/HK banks' average share price, which was down 3% (Fig. 6). If referring to the trough level to the end of the rate cycle, AIA's share price was up 38%, compared to the regional insurers' average share price, which was up 35%, and regional/HK banks' average share price, which was up 36%; the insurers also moderately outperformed its peers. As such, we believe we will experience déjà vu, and hence see AIA as the best play to benefit from the expectation of the upcoming US interest rate hike.

Fig 5. US interest rate hike and tapering signals released from FOMC for previous interest rate cycles

Date	Key meeting takeaway of unveiling tapering and rate hike signal
1-May-13	Some Fed policymakers were coming around to the idea that the June 18-19 meeting would be a good time to start tapering the boind purchase
22-May-13	Chairman of FOMC, Ben Bernanke, mentioned of wrapping up bond purchase program in testimony before Congress
19-Jun-13	FOMC is prepared to increase or reduce the pace of bond purchases to maintain appropriate polocy aoomodatiion as the outlook for the labot narket or inflation changes
18-Jul-13	Chairman of FOMC, Ben Bernanke, told the congress the Fed remained committed to an accomodative policy even after it slowed its bond purchases
31-Jul-13	Policymakers continued to discuss how best to comminicate any decision to trim asset purchases
18-Dec-13	FOMC decide to reduce its monthly pace of asset purchases to US$75bn, from US$85bn, beginning January 2014 and added it would continue to reduce the bond purchases if the economy continued to perform as expected
29-Jan-14	FOMC decided to reduce its monthly pace of asset purchase to US$65bn, beginning Feburary 2014
19-Mar-14	FOMC decided to reduce its monthly pace of asset purchase to US$55bn, beginning April 2014
30-Apr-14	FOMC decided to reduce its monthly pace of asset purchase to US$45bn, beginning May 2014
18-Jun-14	FOMC decided to reduce its monthly pace of asset purchase to US$35bn, beginning July 2014
30-Jul-14	FOMC decided to reduce its monthly pace of asset purchase to US$25bn, beginning August 2014
17-Sep-14	FOMC decided to reduce its monthly pace of asset purchase to US$15bn, beginning August 2014
29-Oct-14	FOMC decided to conclude its asset purchase program this month
22-May-15	Fed Chairwoman, Janet Yellen, indicate that if US economy continues to strengthen, it would be appropriate at some point this year to take the initial step to raise the federal funds rate
10-Jul-15	Fed Chairwoman, Janet Yellen, reaffirmed that the central bank's plan to start raising short-term US interest rate later this year
4-Nov-15	Fed Chairwoman, Janet Yellen, indicated a December rate hike is still on the table despite the continued low inflation rate
16-Dec-15	FOMC decided to raise the target range for the federal funds rate to 1/4 to 1/2 percentage (by 25bps, first rate hike since 2006), despite the shortfall of inflation from 2%
27-Jan-16	FOMC expects that economic conditions will evolve in a manner that will warrant only gradual increases in federal funds rate
16-Mar-16	FOMC inidcated global economic and financial developments continue to pose risks and inflation remains below the 2% long-term objective
7-Jun-16	Fed Chairwoman, Janet Yellen, indicated that Fed funds rate probably needs to raise gradually over time despite recent mix of countervailing forces
26-Aug-16	Fed Chairwoman, Janet Yellen, indicated the case for an interest rate hike has strenghtened
17-Nov-16	Fed Chairwoman, Janet Yellen, signaled the U.S. central bank is close to lifting interest rates as the economy continues to create jobs at a healthy clip and inflation inches higher
14-Dec-16	FOMC decided to raise the target range for the federal funds rate to 1/2 to 3/4 percent (25bps)

Source: FOMC, DBS HK

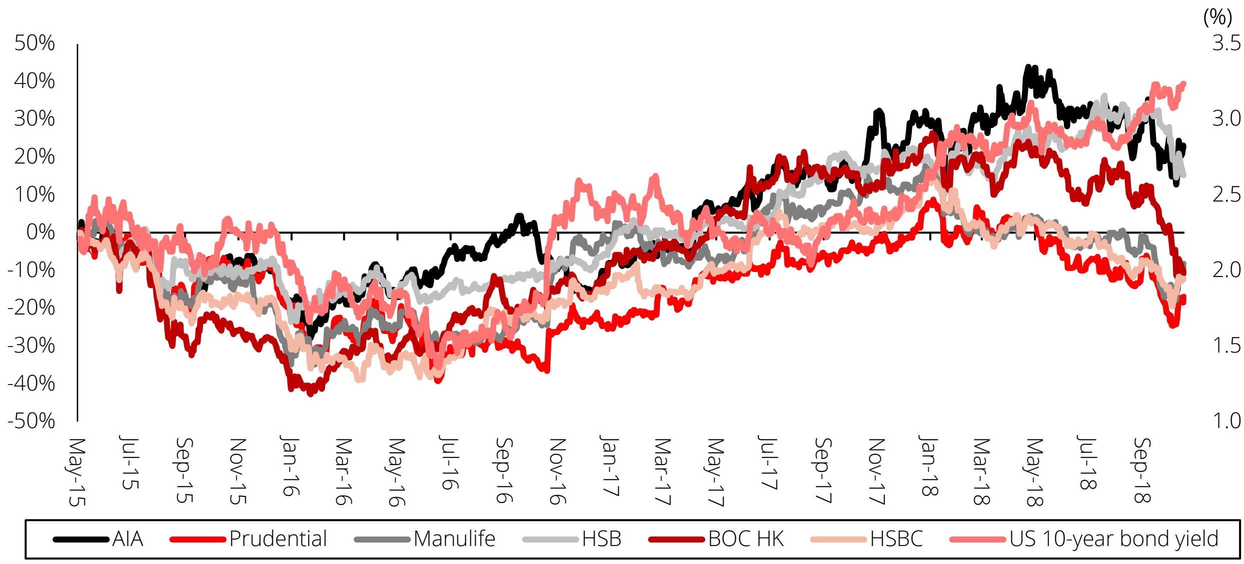
Fig 5. US interest rate hike and tapering signals released from FOMC for previous interest rate cycles (continued)

Date	Key meeting takeaway of unveiling tapering and rate hike signal
14-Feb-17	Fed Chairwoman, Janet Yellen, indicate it would be unwise to wait too long to hike rates and it may be appropriate for the central bank to raise interest rate at one of its upcoming meetings
15-Mar-17	FOMC decided to raise the target range for the federal funds rate to 3/4 to 1 percent (25bps)
14-Jun-17	FOMC decided to raise the target range for the federal funds rate to 1 to 1-1/4 percent (25bps) and set plan for balance sheet reduction
26-Sep-17	Fed Chairwoman, Janet Yellen, indicate Fed plans to keep raising its benchmark interest rate depsite the mysterious weakness of inflation
13-Dec-17	FOMC decided to raise the target range for the federal funds rate to 1-1/4 to 1-1/2 percent (25bps)
21-Mar-18	FOMC decided to raise the target range for the federal funds rate to 1-1/2 to 1-3/4 percent (25bps)
13-Jun-18	FOMC decided to raise the target range for the federal funds rate to 1-3/4 to 2 percent (25bps)
26-Sep-18	FOMC decided to raise the target range for the federal funds rate to 2 to 2-1/4 percent (25bps)
19-Dec-18	FOMC decided to raise the target range for the federal funds rate to 2-1/4 to 2-1/2 percent (25bps)
22-Sep-21	Moderation in the pace of asset purchases may soon be warranted (monthly purchase of US$80bn/US$40bn of Treasury/MBS)
3-Nov-21	Decide to begin reducing the monthly pace of its net asset purchases by US$10bn/US$20bn of Treasury and US$5bn/US$10bn of MBS from the beginning of November/December 2021
15-Dec-21	Decide to reduce monthly pace of its net asset purchase by US$20bn/US$bn of Treasury/MBS from the beginning of January 2022, in light of inflation and improvement in the labor market,

Source: FOMC, DBS HK

What about the current cycle?
The FOMC first signaled the intention to taper and reduce its monthly asset purchase of treasury and MBS (mortgage back securities) during its meeting in September 2021 and signalled, for the first time amid the current cycle, an interest rate hike. During the time, regional/HK banks' share prices were up 40%, buoyed by the commence in the Cross-boundary Wealth Management Connect scheme in the Greater Bay Area. On the other hand, AIA and regional insurers' share prices were down 3% and 0%, respectively. Hence, we believe the positive effect of the US interest rate hike is yet to be factored in the regional insurers' share prices and continue to see AIA as the best play to benefit from the US interest rate hike cycle.

Fig 6. Relative share price performance – FY15-18 cycle



Source: Company data, DBS HK

AIA China to see moderate start in 1Q22F on a high base. The streamlining exercise among the virtually newly recruited life agents in 1H20, due to the impact of the pandemic, has come to an end in 3Q21, with the life agent headcount stabilising. We believe the temporary impact on new business growth should be over and growth is likely to resume at a moderate pace in 4Q21F. 1Q22F will likely see a moderate start due mainly to high base as driven by the front-end loaded sales of critical illness product in January 2020. Nonetheless, we expect growth to normalize as we move into Q2.

Overall, we maintain our upbeat view on AIA China's long-term business outlook, given the grand opportunity to expand outside the previously restricted five geographical locations due to policy deregulation since 2020. The relaxation will enable AIA China to expand its addressable market by fourfold by 2030F, according to the management. With the latest geographical expansion effort of obtaining operating approval in the Hubei province in October 2021 (since 2020, AIA has obtained approval for Sichuan and Hubei) underway, we also see its expansion pace, where AIA China targets to expand in 12 new provinces by 2030F, as being on track.

Outside AIA China, we continue to see sequential growth and good business growth momentum from the domestic segment in the Hong Kong market. Despite the possibilities that the delay in the reopening of the Hong Kong-Mainland China border due to the recent COVID-19 surge may mildly impact the anticipated MCV (Mainland Chinese Visitor) segment recovery in FY22F, the reopening of the Macau-Mainland China border has resulted in better-than-expected MCV segment recovery in AIA Macau, as one-third of Macau's annual premium equivalent (APE) is now being contributed by the MCV segment. We also expect AIA HK to follow suit after the border reopens. In addition, we also see continuous product migration demand for the "unit-linked with protection rider" product in AIA Thailand. We believe this will continue to help drive APE growth from the Thai market; most importantly, to benefit from a VONB margin expansion due to the product mix.

Manageable impact from C-ROSS II Phase 2 adoption. According to the management, the impact from the C-ROSS II Phase 2 adoption in China is considered manageable. Despite a substantial drop in AIA China's core solvency ratio being expected (in line with the market), the insurer expects its core solvency ratio to remain above the 200% level after the adoption, down from above 400% previously. The level should remain comfortably above its peers in the Chinese market.

Lift TP to HK$127. Reiterate BUY. We revise up AIA's VONB growth assumption by 3%-4%, and now expect its VONB to post +17%/+15% y-o-y in

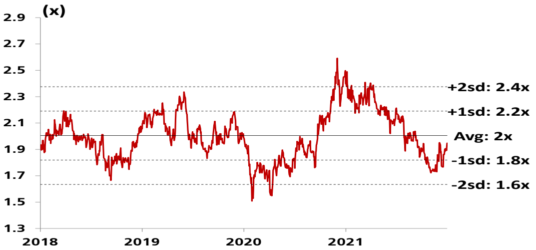
FY21/22F, respectively, on better-than-expected APE sales, margin expansion, and business outlook. As such, we moderately lift the TP to HK$127. With a 46% share price upside, we reiterate BUY on AIA.

Company Background

AIA Group Limited (AIA) is the largest independent publicly listed Pan-Asian life insurance group that was first established in Shanghai in 1919. It is a market leader in the Asia-Pacific region (ex-Japan), based on life insurance premiums, and holds leading positions across the majority of its markets. AIA meets the long-term savings and protection needs of individuals by offering a range of products and services, including life insurance, accident and health insurance, and savings plans. The group also provides employee benefits, credit life, and pension services to corporate clients.

Historical PEV and PB band

Forward PEV band (x)



PB band (x)

Source: Bloomberg Finance L.P. DBS HK

Key Assumptions

FY Dec	2019A	2020A	2021F	2022F	2023F
Total weighted premium growth	11.3	4.1	7.3	6.2	7.3
VNB growth	5.8	(33.4)	17.3	15.4	15.4
VNB margin	63.6	53.4	55.8	57.0	58.0
Net investment return	4.6	4.1	3.6	3.5	3.4
Total investment return	4.6	4.1	3.6	3.5	3.4
EV growth	13.7	5.3	7.8	8.1	8.4
Solvency ratio	362.3	489.0	475.5	482.4	490.2

Source: Company, DBS HK

Income Statement (US$ m)

FY Dec	2019A	2020A	2021F	2022F	2023F
Total weighted premium income	34,002	35,408	37,986	40,328	43,272
Gross written premiums	0	0	0	0	0
Net earned premium	32,896	33,666	36,093	38,388	41,255
Investment income	8,899	9,398	10,529	11,218	11,954
Other operating income	0	0	0	0	0
Total income	41,795	43,064	46,622	49,606	53,208
Benefits and claims	(27,624)	(28,346)	(30,460)	(32,290)	(34,615)
Underwriting and policy acquisition costs	(4,297)	(4,402)	(4,741)	(5,039)	(5,406)
Finance cost	(582)	(658)	(685)	(702)	(720)
Other expenses	(2,468)	(2,695)	(3,094)	(3,345)	(3,663)
Total expenses	(34,971)	(36,101)	(38,981)	(41,376)	(44,403)
Share of profit of associated and JVs	0	0	0	0	0
Profit before tax	6,824	6,963	7,641	8,230	8,805
Income tax expense	(1,030)	(960)	(1,019)	(1,091)	(1,163)
Minority interest	(45)	(44)	(44)	(44)	(44)
Preferred dividend	0	N/A	N/A	N/A	N/A
Net income attributable to shareholders	5,749	5,959	6,579	7,095	7,598

Source: Company, DBS HK

Balance Sheet (US$ m)

FY Dec	2019A	2020A	2021F	2022F	2023F
Total Investment	212,776	247,461	261,438	278,273	296,642
Segregated funds net assets	N/A	N/A	N/A	N/A	N/A
Property, plant and equipment	2,865	2,722	2,722	2,722	2,722
Other assets	68,491	75,938	81,053	87,214	93,937
Total assets	284,132	326,121	345,213	368,209	393,301
Net life reserves - traditional	189,597	223,071	238,854	255,474	273,462
Net life reserves - investment contracts	12,273	12,881	12,881	12,881	12,881
Other Liabilities	24,306	26,501	27,186	27,925	28,724
Total liabilities	226,176	262,453	278,921	296,280	315,067
Shareholder's equity	57,508	63,160	65,756	71,349	77,610
Minority interest	448	492	536	580	624
Total equity	57,956	63,652	66,292	71,929	78,234

Source: Company, DBS HK

Key Financials & Ratios

FY Dec	2019A	2020A	2021F	2022F	2023F
Du Pont analysis (%)					
Net profit / premium income	20.2	15.7	20.4	21.0	21.6
Premium income / total asset	11.6	10.3	10.5	10.4	10.5
Total asset / total equity	5	5	5	5	5
Return on equity	13.8	8.7	11.4	11.7	11.9
Embedded value (US$ m)					
Book value	57,508	63,160	65,756	71,349	77,610
Adjusted items	(29,267)	(34,657)	(35,173)	(36,283)	(37,527)
Adjusted book value	28,241	28,503	30,584	35,065	40,083
Value-in-force	33,744	36,744	39,727	40,913	42,280
Group embedded value	61,985	65,247	70,311	75,978	82,363
Per share analysis(US$)					
EPS	0.55	0.44	0.61	0.67	0.74
BPS	4.76	5.22	5.44	5.90	6.42
DPS	0.16	0.17	0.19	0.20	0.22
EVPS	5.13	5.40	5.82	6.28	6.81
Capital Strength (%)					
Leverage ratio	0	0	0	0	0
Solvency ratio	362.3	489.0	475.5	482.4	490.2

Source: Company, DBS HK

Target Price & Ratings History

S.No.	Date	Closing Price	12-mth Target Price	Rating
1:	7-Jul-21	HK$96.55	HK$125.00	Buy
2:	23-Nov-21	HK$85.60	HK$125.00	Buy

Source: DBS HK

Analyst: *Ken Shih*

Sam Lu

DBS HK recommendations are based on an Absolute Total Return* Rating system, defined as follows:
STRONG BUY (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)
BUY (>15% total return over the next 12 months for small caps, >10% for large caps)
HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)
FULLY VALUED (negative total return, i.e., > -10% over the next 12 months)
SELL (negative total return of > -20% over the next 3 months, with identifiable share price catalysts within this time frame)

**Share price appreciation + dividends*

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Sources for all charts and tables are DBS HK unless otherwise specified.

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