BARRON'S MONDAY, MARCH 13, 2006

Winning Policies

OF THE VAST POTENTIAL MARKETS THAT EXIST in China, one of the most treacherous in recent years has been insurance, buffeted by nimble foreign competition and precariously low interest rates that have curbed income from investments in domestic bonds. China's insurers are radically restructuring, and none has done so more successfully than Ping An Insurance.

Ping An (which means "peace and safety") is China's second-largest life insurer, after China Life, and third-biggest nonlife insurance company. Life insurance accounts for some 90% of its revenue.

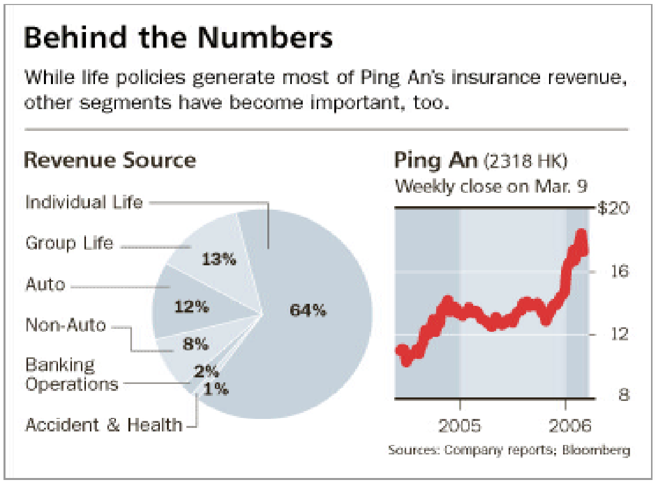
Fans of Ping An, whose shares trade in Hong Kong (ticker: 2318.HK), are impressed by its potential. Says Christopher Smart, manager of Pioneer Emerging Markets Fund in Boston: "The compelling case is a demographic one: China is a country of a billion people, with a story of rising incomes and savings. This is a secular growth story."

Unfortunately for investors thinking of buying the shares, they've jumped almost 23% this year, to HK$17.55, versus 4.3% for the Hang Seng Index, partly on renewed enthusiasm for Chinese stocks and, particularly, Chinese domestic plays. So, while they look like an outstanding long-term value, waiting for a pullback in the share price would make sense.

COO Louis Cheung says that Ping An has big ambitions -- and a realistic plan to realize them.

The company is well-known to international portfolio managers and soon may become better-known to investors abroad, as it invests more outside its homeland. The nonconvertibility of China's currency, called the renminbi or yuan, precludes most domestic investors from plunking down any money overseas. However, Beijing is relaxing those limits, partly because insurers need yield to make up for absurdly low government-bond rates.

Ping An has been investing in initial public offerings of Chinese companies overseas. "It's a natural hedge against the renminbi," Louis Cheung, the insurer's chief operating and financial officer, said in an interview. "We are buying such stocks very selectively." That's likely to increase as more Chinese stocks become available -- China is set to offer billions of dollars of stock in new companies this year -- and may even extend to other foreign shares. Cheung won't specify which companies Ping An owns, but the



company is thought to be invested in China Construction Bank (939.HK) and PetroChina (whose American depositary receipts trade in New York under the ticker symbol PTR).

Eventually, Ping An's investments abroad will expand even more when the company starts selling foreign-currency-denominated life-insurance products, which Cheung expects could happen in the next year or two. These should be popular, particularly among parents who want to send their children overseas for schooling. U.S.-dollar-denominated policies are widespread in Hong Kong for precisely that purpose.

True, investing outside China has its hazards for the Chinese: It's subject to taxes (Chinese bonds aren't) and currency risk. Morgan Stanley figures that, assuming a 3.5% coupon on Chinese government bonds, a 33% corporate tax rate, and 3% renminbi appreciation, a foreign investment would have to return 8.5% to merely break even. However, for an insurer in need of a steady income screen, the potential rewards easily outweigh the risks.

For now, Ping An can invest up to $1.75 billion abroad, the amount of the foreign-currency reserves it raised in its 2004 initial public offering. Some 10% of that, or $175 million, can go into stocks of Chinese companies listed overseas, including Hong Kong-listed H shares and red chips. It can put the remainder in foreign government bonds and domestic mortgage bonds rated single-A or above.

Widening the scope of Ping An's investments, to areas like real estate and infrastructure, would go a long way toward making up for a mismatch of assets and liabilities at Ping An, which, like other Chinese insurers, which, like other Chinese insurers suffered as rates plunged to a nadir of 2.25% in June 1999. While the government at about that time capped payouts on policies at a maximum 2.5%, about 40% of Ping An's policies still have average liability rates of 4.3%, versus the insurer's average investment return of 4.1%. And even though insurers have been allowed to own domestic A shares, that market has been a dismal performer, too.

Yields slid again in 2005, with that of the seven-year Chinese government bond dropping by 0.92 of a percentage point, to 3.46%. SHK Financial Group reckons that Ping An's earnings slip 5.3% for every 0.5-percentage-point decline in bond yields.

Chinese regulators want to ensure that its insurers can compete with the small but nimble foreign joint-ventures that are scarfing up market share. Ping An has 17% of China's life-insurance market -- the world's eighth largest, at about RMB300 billion-plus. That's well behind China Life 48%, but significantly ahead of No. 3

China Pacific's 11%. American International Group (AIG), the big American insurer that has done well in many parts of the Far East, has just 1.8%.

Ping An's share had been 30% before, but in an effort to boost efficiency and profitability, it slashed its sales force over several years to 200,000 from 300,000 and retrained the people it kept on. Its market share is reviving, however, even as the company's profitability remains superior to its chief rivals'. (Ping An also has 9.5% of the property and casualty market.).

In the past few years, China has relaxed rules on a number of investments. Insurers, which had been severely constrained from investing in equities, now have more latitude to do so. Today, Ping An can place 5% of its total assets in stocks, 15% in stock funds, and 30% in convertible bonds. Some 4% of Ping An's assets are now in stocks, versus 5% for China Life and 8% for PICC Property & Casualty, another big insurer.

Ping An, founded in 1988 by now chairman and CEO Mingzhe "Peter" Ma, is certainly up to the challenge of revamping its business. Since 1999, it has radically restructured to address declining yields, sacrificing volume growth to write more profitable universal-life policies. The company is due to report 2005 earnings on March 30; Morgan Stanley expects earnings of RMB4.2billion, or RMB0.68 per share, on revenue of RMB65.3 billion, up from profits of RMB3.1 billion in 2004 on revenues of RMB63.3 billion.

How They Stack Up

While Ping An, by some measures, trades at a premium to its rivals, bulls on the stock say this is justified, because its prospects are brighter and that its links to HSBC should ensure that it follows better corporate-governance standards than do many Chinese companies.

Company	Recent Price	Market Value (bils)	Price/Earnings 05E	Price/Earnings 06E	Price/ Book	Return on Equity	Dividend Yield
China Life	HK$8.50	HK$227.5	23.6	18.7	3.6	11.12%	N/A
Ping An	17.55	108.7	26.4	21.0	4.0	15.12	0.75%
PICC Property & Casualty	2.45	27.3	19.3	13.6	1.7	1.25	2.82

E=Estimated

Source: Bloomberg

For 2006, the consensus among analysts is for profit of RMB0.87 per share. CSFB reckons that Ping An's profit will advance 25% annually for the next three years, as net premiums climb 11% a year.

Today, more than half of Ping An's first-year premiums come from regular policies, on which premiums are paid periodically, versus 20% for China Life, whose 600,000 salespeople have focused on lower-margin single-premium coverage. "With regular long-term products, you get 10 to 20 times better margins," says Cheung.

In fact, Ping An's margin on new policies has snapped to 30%-plus from 20%, estimates HSBC Global Research. In contrast, China Life's margin is less than 15%, HSBC says. And that leaves lots of room for profitability to improve. Cheung reckons that each agent brings in RMB100 for each policy. That can at least double.

For Cheung & Co., the holy grail is top-line growth. Today, Ping An is a favorite insurance brand, and the firm serves some 30 million customers. Growth in nonlife insurance will pace China's blistering economy, but life insurance is much more promising as China's population grows older and richer. Ping An figures that Chinese households are amassing wealth at an 11% annual clip, to an estimated average of RMB92,600 in 2010 from RMB 32,500 in 2001.

To prepare, Chairman Ma hired a slew of foreigners to upgrade systems and strategies at Ping An. One was Cheung, a former McKinsey Consulting partner who joined the firm in 2000, after McKinsey did a lengthy study to improve Ping An's systems.

One of Ping An's key aims is to get into banking and asset management. China saves 50% of its gross domestic product, and the single largest asset class for individuals remains bank deposits.

Thus, giant HSBC Holdings (HBC in the U.S.), the London-based banking organization, owns 20% of Ping An (foreigners are limited to a 25% stake under current law) and is helping improve the insurer's risk management and auditing practices. The two also have a joint venture -- Ping An Bank. "The sales capability of Ping An with the back office of HSBC is a most powerful combination," says Cheung. (HSBC also owns 20% of publicly traded Bank of Communications, China's fifth largest bank.)

Currently, Ping An is in the running to buy Guangdong Development Bank in a consortium with ABN Amro (ABN); Cheung says that Ping An is looking for small "accretive" deals. He adds that Ping An's business will rest on three legs over the next decade.

The first is life insurance -- including policies to cover specific major diseases, and new pension-planning products for individuals.

The second is fee-based asset accumulation, mostly for pensions, some through mutual funds. One big product will be corporate pensions. Now, there are $14 billion of assets in these plans, and Ping An has a 27% market share; the plans will be rolled out fully in 2009. "Insurance companies should be one of the biggest pension managers in Asia," says Cheung. "A good 20% to 30% share of the 15 to 20 trillion renminbi in savings will go into pensions. The potential there is huge -- tens of trillions of RMB."

The third sector is consumer finance, "lending a small amount of money to a lot of people," as Cheung puts it. "Our 30 million-plus customers will become 100 million-plus in 10 years. In retail banking, liabilities are long-dated and assets are short-dated. In life insurance, liabilities are short-dated, but assets are long-dated. It's a perfect match."

One caveat: HSBC's lead insurance analyst, John Russell, thinks that Ping An's balance sheet could be squeezed as it seeks new business while dealing with the burden of old policies that have been yielding more than the company has been able to generate from investments. However, Cheung says that Ping An has plenty of capital. In addition, Russell notes that the company could free up some capital by securitizing policies, as U.K. insurers have done, or selling more shares.

For now, Ping An is handling this problem by diversifying its assets swiftly, writing new policies and controlling costs. Maintenance expenses as a percentage of renewal premiums are 10%, versus 14% or so for China Life. And eventually, yields will rise; interest rates in China -- in fact, across Asia -- are unsustainably low.

The Bottom Line

With a cogent blueprint for growth, Ping An is a long-term buy, but only after its stock retreats from its current level.

Lately, brokers have taken fright at Ping An's sharp advance as the stock blew through their price targets. The shares now trade at 4 times book and 32 times trailing 12-month earnings, according to Bloomberg, versus 1.9 and 18 for American International Group, 1.3 and 12 for MetLife, and 1.6 and 13.2 for Allianz. Since its 2004 listing, Ping An stock is up 70%.

The premium valuation could cap the shares in the short term. Cautions David Zhang, manager of the Dynasty Fund in Shanghai: "You can't widen the P/E by much more." Yet Zhang plans to hang on to his Ping An shares, which he's had since the 2004 IPO, because he thinks they're a sound long-term investment.

Another fan is Patrick Lemmens, who steers the ABN Amro Financials fund in Amsterdam. "The advantage of Ping An is they're ahead in terms of management, accounting and distribution. What's the worth of long-term growth? For a select group of international life insurance companies that are managed very well, it makes sense to pay a relatively high price."

Cheung certainly agrees. "We are a great franchise, a strong brand, a 30-million-plus customer base with huge room for improvement and high growth in retail financial services," he says. "Growth of 10 times what we have is not implausible."