INDIA

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Why India shouldn’t repeat IRCTC’s valuation misstep with LIC’s IPO

The government is counting on life insurance behemoth LIC’s listing to raise $13.4 billion. And it cannot afford to undersell one of its crown jewels in what will be India’s largest-ever IPO

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The government has to be careful not to leave too much money on the table in LIC’s eagerly awaited IPO—India’s largest by a distance

The Centre was slammed for valuing IRCTC at just $700 mn when it listed at more than 2X of that in 2019. Its market cap now is $5 bn

Based on The Ken’s back-on-the-envelope calculation, LIC could be worth between $121 bn and $215 bn

While LIC still sells three in every four life insurance policies in India, it may have to make changes to its product and distribution mix

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As the euphoria over Zomato’s $1.3 billion listing fades, anticipation is building for another eventful initial public offering (IPO). One so large that it will make the foodtech major’s share sale look like a blip.

State-owned leviathan Life Insurance Corporation of India (LIC) is set to go public by March 2022. And the government has indicated that it plans to raise a staggering Rs 1,00,000 crore ($13.4 billion) from the flotation.

Even half that number would make it India's largest-ever listing by a distance.

This IPO's significance derives not merely from its size. The company is India's largest life insurer, controlling two-thirds of the market by premium on new policies. As a result, it is a brand like none other, immediately familiar to all sections of society. "LIC is a machine. Its sales team doesn't have to hard-sell," says a fund manager with one of India's largest mutual fund houses. "The brand has been around for so long that you will see heavy retail subscription to the IPO."

The fund manager and several others *The Ken* spoke to requested anonymity as they either cannot comment on the listing or do not want to be seen publicly talking about the company.

The 65-year-old insurer is also among India's biggest state-run companies and its largest equity investor, with sizeable holdings in companies such as cigarette and FMCG giant ITC Ltd and engineering and construction conglomerate Larsen & Toubro.

But above all, the success of the IPO is paramount in shoring up the government's shaky finances. After all, the Centre plans to raise Rs 1,75,000 crore ($23.5 billion) by selling its stakes in companies in the year ending March 2022.

And that is why the government cannot afford to do with the LIC what it did with another of its consumer-facing entities when it took it public in 2019. The government valued the Indian Railway Catering and Tourism Corporation (IRCTC) at under Rs 5,200 crore ($700 million). Amid criticism that the government had been way too conservative, IRCTC listed at more than twice that valuation, and is now worth Rs 37,340 crore ($5 billion).

The LIC IPO will be considerably larger than IRCTC's Rs 645 crore ($87 million issue), which means the government ought to be a lot more careful not to leave too much money on the table. Any such perception could result in the Centre getting skewered, inviting charges it had undersold another one of its crown jewels.

But valuing any IPO-bound company is tricky, and it is even more so for LIC, given the complexities of the life insurance business.

One of the most important valuation metrics for the sector is embedded value (EV). LIC will reportedly arrive at its EV this month. But according to *The Ken's* back-of-the-envelope calculation based on the EV and assets under management (AUM) of LIC's three largest listed peers, the company could be worth anywhere between Rs 9,00,000 crore ($121 billion) and Rs 16,00,000 crore ($215 billion).

At the lower end, LIC would be India's third-most valuable listed company, behind Reliance Industries and Tata Consultancy Services. And at the upper end, it would eclipse them both.

The IPO will invite closer scrutiny of its business. While there may be no immediate threat to its dominance in life insurance, LIC may still have to change its ways.

Take its distribution model, for instance. Almost 95% of its individual new business comes from agents—a more expensive sales channel than bank branches—while the figure is less than 25% for private life insurers, according to the Insurance Regulatory and Development Authority of India (IRDAI). Banks, on the other hand, bring in more than half of private insurers' business. For LIC, it's under 3%. "LIC can do miracles if they build on this (banking channel)," says a senior executive with a rival life insurer.

Given its might and track record, there may be little LIC can't pull off.

Not high enough

India's life insurance premium income in the year ended March 2020 was Rs 5,72,910 crore ($77 billion). Life insurance penetration—premium as a percentage of GDP—was 2.82% in 2019, lower than the global average of 3.35%.

High stakes

If loss-making Zomato's IPO was about narrative over numbers, the LIC listing will be about stats and story.

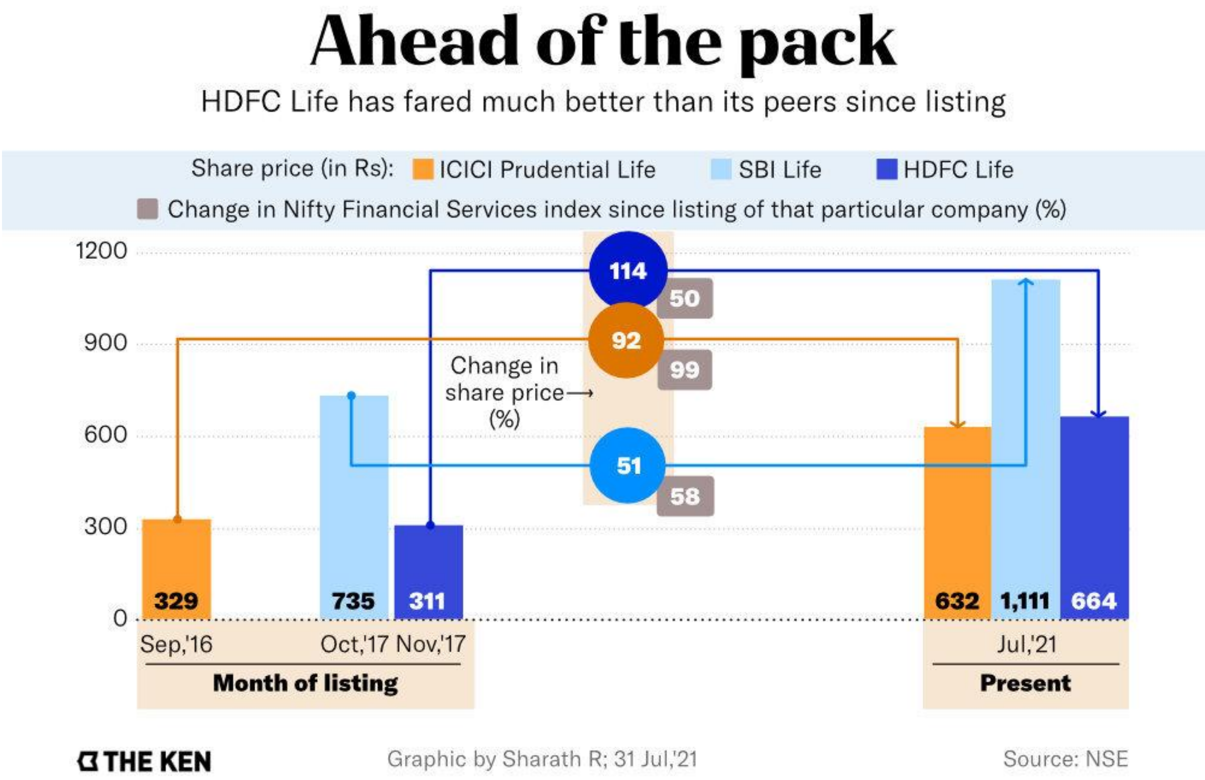
LIC's AUM of over Rs 34,70,000 crore ($466 billion) is more than the size of India's entire mutual fund industry. Two decades after the sector was opened up to private players, LIC still sells three in every four life insurance policies in India. But the average retail investor wouldn't have the desire or ability to parse LIC's financials.

It doesn't matter, though.

There will be a mad scramble to own a piece of LIC simply because every middle-class family is likely to have more than one LIC policy. Even if there are 23 other life insurers in the country, it's as if they don't exist to many. LIC is life insurance. Period.
The government is well aware of this. That's why it plans to keep aside up to 10% of the LIC issue size for LIC policyholders.

"The LIC IPO is also significant because listing would result in greater transparency and better disclosures," says Pranav Haldea, managing director of capital markets data provider Prime Database. "For instance, now we don't have any disclosure of LIC's corporate bond holdings."

As crucial as the LIC issue is for investors, the government has a lot more riding on it. The listing is the linchpin of its disinvestment target of Rs 1,75,000 crore ($23.5 billion) for the year ending March 2022—5X of what the government managed to raise in the previous year.



There are reports that the government could sell 5-6% in the IPO and then sell another 4-5% through a follow-on public offer instead of selling 10% during the listing. This is owing to fears that such a large issue may diminish investors' appetite for other IPOs. But just as crucial is making sure the government and its investment bankers value LIC right and avoid a repeat of IRCTC.

Despite its monopoly in online booking of train tickets and in catering on trains, IRCTC was believed to have been valued quite conservatively. "The government didn't know how to value an internet company," says the fund manager quoted earlier. "There were no realistic domestic benchmarks to compare it against."

The government wanted to raise Rs 645 crore ($87 million) through the IRCTC IPO, and it got bids worth Rs 72,200 crore ($9.7 billion). Its current market capitalisation of Rs 37,340 crore ($5 billion) is more than 7X of its IPO valuation. The government, which divested roughly 12.5% of its stake in IRCTC during the IPO, sold another 20% in December 2020.

However, the jury is still out on whether one can question a company's IPO valuation based on how it fares during the listing. Even Zomato is now trading at nearly twice its issue price.

Unlike IRCTC, LIC may no longer be the monopoly it was till 2000, but it is still in pole position. "Private-sector life insurers are more agile," says Nitin Aggarwal, an analyst with brokerage Motilal Oswal. "But LIC has held on to its turf, unlike the banking sector where private banks have gained significant market share over the years."

The government has begun the process of choosing investment bankers and legal advisors for the IPO. But the most critical component in LIC's valuation is its embedded value. The figure is likely to be made available this month; the government had appointed actuarial firm Milliman Advisors in December 2020 to determine LIC's EV.

What is LIC really worth?

Valuing LIC without its EV is tricky. But the government has dropped some hints. Last year, its chief economic advisor KV Subramanian said that a 6-7% stake dilution in LIC would be enough to mop up Rs 90,000 crore ($12.1 billion) based on back-of-the-envelope calculations that he had done. Going by this estimate, LIC would be valued at Rs 13,00,000-15,00,000 crore ($175-202 billion).

In March, Subramanian said that divesting its stake in LIC would fetch the government Rs 1,00,000 crore ($13.4 billion), though he did not specify how much of its stake it would divest.

Unlike IRCTC, which is a monopoly with no peers, LIC has large listed competitors that it can be benchmarked against—SBI Life Insurance, HDFC Life Insurance, and ICICI Life Insurance. According to a person who tracks the sector, LIC's valuation metrics might be at a discount to that of the listed private players due to its product mix and business model.

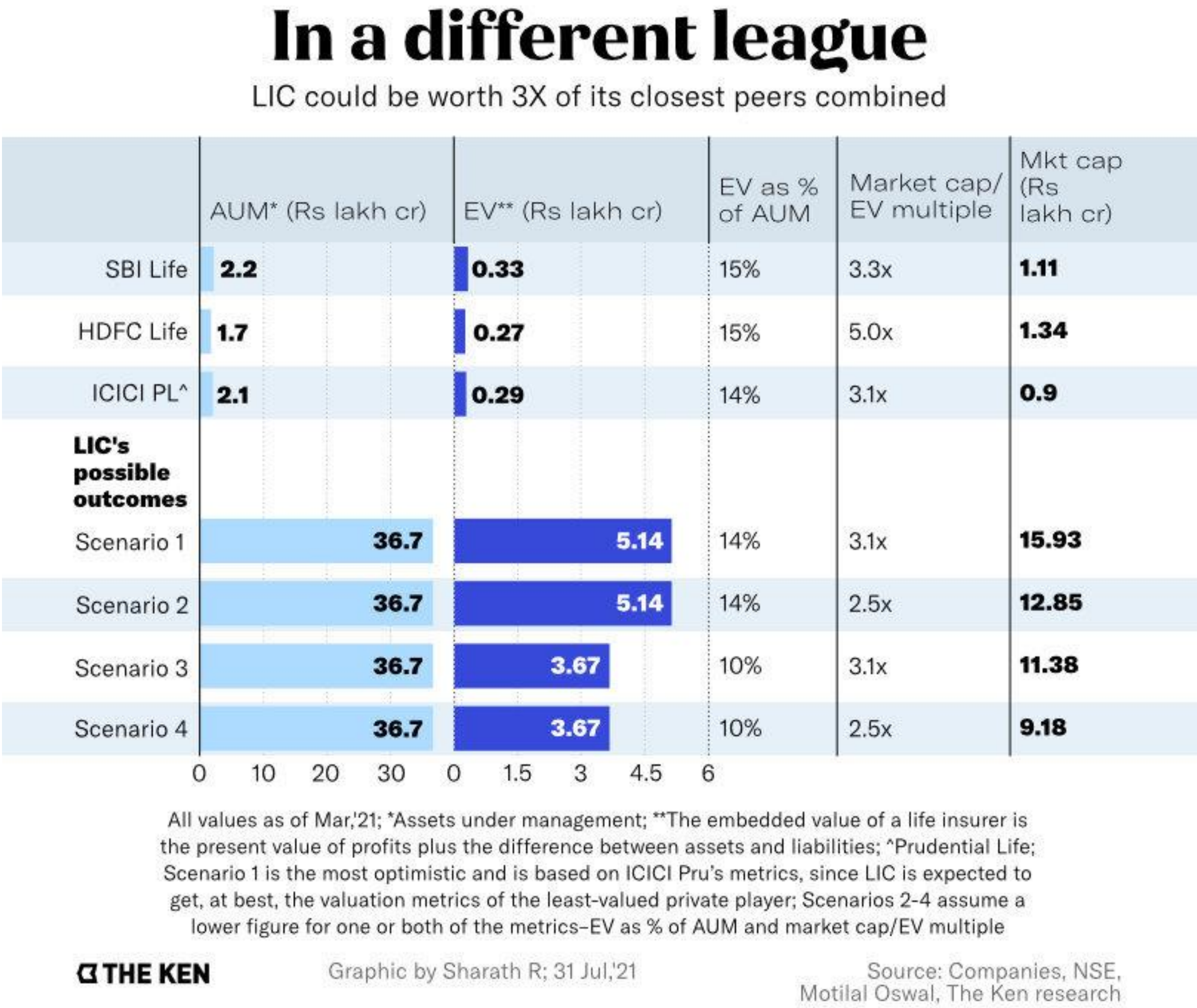
For instance, when compared to private players, LIC has a higher share of traditional savings schemes—such as endowment and money-back policies—than protection products like term policies, which just offer a life cover. Savings schemes have lower profitability than protection policies. LIC also has a higher share of group insurance and single-premium products, which have lower predictability/profitability than individual insurance and recurring-premium products.

In addition, LIC distributes its surplus in the ratio of 95:5 between policyholders and shareholders across the board. Private-sector insurers, on the other hand, distribute their surplus in the ratio of 90:10 for some policies, while for the rest, all the profits go to shareholders. A lower share of the surplus puts shareholders of LIC at a disadvantage relative to those of private insurance companies. This is one reason why even though LIC's AUM is nearly 17X of SBI Life's, its net profit for shareholders in the year ended March 2021–Rs 2,900 crore ($390 million)–is only 2X of SBI Life's.

The government is said to be mulling gradual tweaks to bring the surplus distribution of LIC in line with the private players.

Analysts *The Ken* spoke to say that the changes to the surplus distribution, if and when they happen, are likely to be prospective and not retrospective, considering the interests of policyholders and the fact that past obligations cannot be tampered with.

Even if LIC commands lower valuation metrics than its private sector peers, it would still be among India's top companies by market cap.



The Ken has considered four scenarios to arrive at a broad valuation range for LIC. In the absence of LIC's EV, these estimates can only be considered as an indicative proxy for the company's actual worth.

In the most optimistic of scenarios, we have assigned the AUM and EV multiples of ICICI Prudential—the least valuable of the top three private players—to LIC since it is not expected to command the best valuation metrics of the listed insurers.

With its EV at 14% of its AUM and its market cap/EV multiple at 3.1X, LIC could have a valuation of nearly Rs 16,00,000 crore ($215 billion). Assuming a lower figure for either of these metrics, LIC could be worth Rs 11,00,000-13,00,000 crore ($148-175 billion).

In the most conservative scenario, assuming LIC's EV to be 10% of its AUM and its market cap/EV multiple to be 2.5X, LIC's valuation could still be over Rs 9,00,000 crore ($121 billion).

Where on the valuation spectrum investors will place LIC depends partly on how they view LIC's traditional product and distribution mix.

Old habits die hard

A large part of LIC's success can be chalked up to that unmissable character across the country: the LIC agent. Persuasive and desperate in equal measure, she is in high demand between January and March—the last month of the financial year—when taxpayers hasten to buy insurance as a tax-saving measure.

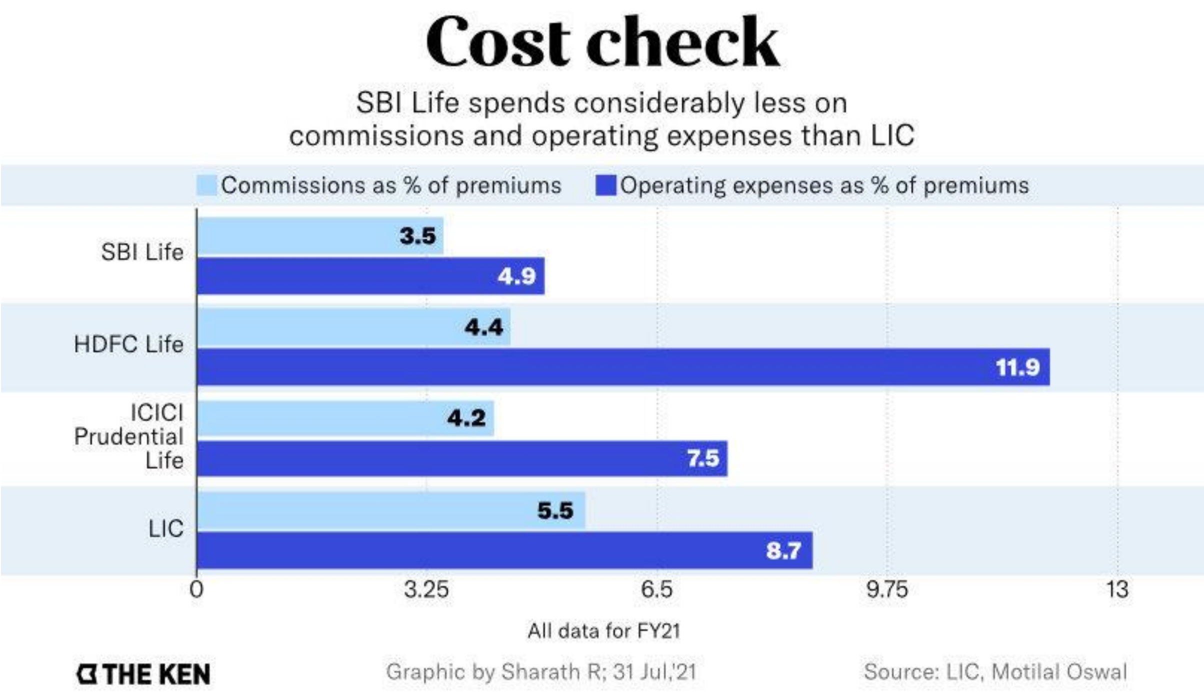
As of March 2020, the latest year for which this data is available, India had 2.3 million life insurance agents. And more than half of them worked with LIC.

These agents brought in nearly 95% of the premium paid on LIC's new individual policies in the year ended March 2020. For its peers, agents contributed under 25%. "Private players have been able to leverage the reach of banks. It allows you to scale rapidly," says Saurabh Bhalerao, associate director of Care Ratings. (Disclosure: LIC owns nearly 10% of Care.)

Incidentally, LIC is a shareholder in most major banks, including State Bank of India (SBI), ICICI Bank, Punjab National Bank, and Bank of Baroda. But they all have their own life insurance ventures.

LIC is also the largest investor in IDBI Bank, owning a shade under 50%, and has tie-ups with the likes of Axis Bank and Union Bank of India. But it's about time LIC stepped on the gas on this distribution channel, says the senior executive with an LIC rival quoted earlier. "The agency model is expensive. It costs 25-30% more than selling through banks."

Questions sent to LIC went unanswered.



An even bigger problem for LIC is its dependence on group and single-premium policies. About 70% of LIC's new business in the year ended March 2021 came from group policies, and almost all of it was single-premium, according to IRDAI. For the private sector, group insurance accounted for less than 40% of its new business.

Even with LIC's individual policies, 43% were single-premium, while for private players, it's just 18%.

Sustaining growth in single-premium policies year after year requires a lot of effort, which is why private life insurers focus more on products with recurring premiums. "They (LIC) have the capability to repeat their single-premium business every year," says the senior executive with a rival insurer mentioned above. "But if they fail for a couple of years, there will be a problem."

The persistency problem

Around 54% of LIC policies, calculated by premium, are renewed after the fifth year, compared to 62% for SBI Life, 58% for ICICI Prudential, and 53% for HDFC Life.

Breaking with the past is not merely to do with LIC's business.

LIC's massive investment book will certainly help its valuation. But LIC, thanks to its balance sheet, has had to help the government out in many a sticky situation. A state-owned company's share sale, if met with a poor response from the market, is rescued by LIC. The IPOs of general insurance company New India Assurance Company and defence company Hindustan Aeronautics Ltd in 2017 and 2018, respectively, are cases in point. And in 2019, LIC once again came to the government's aid by buying into bad debt-afflicted IDBI Bank. Investors will want to know "how heavy the government's hand will continue to be" in LIC, says the fund manager quoted earlier.

It's one thing for the government to get LIC to do its bidding when it owns 100% of it. But for it to do the same after LIC is listed will only detract from its appeal as an otherwise shrewd and contrarian investor that buys big when the market is down, like the initial months of the pandemic. LIC booked a record Rs 10,000 crore ($1.3 billion) profit in the quarter ended June by selling some of its holdings.

Relying on LIC is an addiction the government may not be able to kick anytime soon. And investors may well factor this vulnerability into LIC's valuation. But, regardless of apprehensions over the Centre's meddling, LIC's listing will be a pivotal moment in the history of India's capital markets.