**Disclaimer :- This was originally published on 2nd October 2019 and is part of our Q2FY20 letter. Link to the letter here**

**Max Financials**

- Life Insurance is a decadal and more growth opportunity. India's Insurance penetration is very low and as awareness increases, more people will buy Life Insurance (penetration) and people will enhance their cover as Incomes increase (consume more). In an industry that offers long term growth prospects, there can be many winners as there is space for many players.
- Max is a well-run franchise reflected in high persistency (renewal) ratios and amongst the most productive Agency channels (own sales force) in the country. Max Life is distributed by Axis Bank with ~57% of its business originated by Axis Bank. However, its partnership with Axis Bank expires in Sep 2021 and uncertainty of whether the partnership will be renewed hangs heavily over the stock price. Bank led distribution is a key success factor in an Insurance company's growth.
- The market tends to place a huge premium on certainty. However, what is key is to understand what expectations are embedded in the stock price. The current stock price implies a complete termination of business from Axis Bank. That is a plausible, but a low probability scenario
    - The RBI is discouraging Banks from owning a majority stake in Insurance companies. Even if that hurdle is surmounted, building an Insurance company from scratch for Axis Bank will be very tough, especially when Banking is becoming a tougher business by the day and Axis as a franchise has struggled in the last few years. If Axis wants to buy an Insurance company, no real Asset of the scale of Max is readily available.
    - Exiting the Max relationship completely to sign up a preferential agreement with another Insurance partner will be detrimental to Axis Bank interests as Max provides significant Fee Income from renewal commissions and customer satisfaction will be at stake. Max has invested heavily in the relationship with integration of technology, trained employees stationed at Axis Branches, all of which will have to be replicated afresh. And employee/branch productivity takes time to build.
- Our base case assumption is that Axis Bank will
    - Either stay with "open architecture ".Max Life will continue to be a partner, but without exclusivity. Axis will on-board other Insurance company to offer more choice to its customers and also negotiate better terms with Max Life. Hence, Max Life new business and new business margin from the Axis Bank channel may see some volume de growth/flat growth for a while as new partners gain share of the Axis Bank relationship
    - Negotiate a high minority equity stake in Max Life and look to drive more Max Life business through its branches to maximize the Equity value of its stake
- Insurance companies are valued based on "Embedded Value" (Net Worth + Present value of future Profits of policies in force) plus a multiple of "New Business Margin" (NBM: present value of future profits from Insurance policies sold in the current year).
- The current Market Cap of Max Life is ~15000 Cr of which about ~9300 Cr comes from Embedded Value. EV remains un-impacted by future uncertainty as long as renewals are unimpacted. The Balance valuation from "NBM" is at present ~7X NBM vs ~35-67X FY 19 for its larger peers (perhaps reflecting the stable distribution partnerships the larger peers have).

- In our base case scenario, we believe that the NBM from the Axis Channel will be impacted. However, after an initial drop/no growth phase, Max should be able to grow its New Business Margin by 15-18% long term and hence valuations should re rate to ~15-25X NBM of the new NBM base by FY 23 to reflect the long term growth potential and lifting of the uncertainty around the distribution partnership. In this scenario, Max should trade between 1000- 1200/share by FY23 (compared to ~420/share today), based on different scenarios of how much volume and NBM it drives from the Axis Bank channel
- In the worst case scenario (the Axis Bank distribution agreement is not renewed), we believe Max Life would be adversely affected. Max Life has a strong proprietary channel as well as Bank distribution partnership with other Banks. However, a loss of the Axis Bank relationship would mean that fixed costs would need to be absorbed over a lower base and hence aggregate NBM will take a hit. However, we estimate the value of the franchise will still be close to 550/share by FY 23 due to its strong proprietary channel which is delivering very strong growth in the last few years. In this eventuality, we will exit as the competitive position of the franchise will be impaired without a strong distribution partner.
- Given it is rational for Axis Bank to continue with Max life, the upside/downside risk is very strongly in favour at present and merits the initial position we have taken.