Prudential

Oftentimes, bringing similar businesses together can result in measurable benefits such as greater scale, reduced costs or incremental revenue opportunities. The result is that the earnings and share price of the combined entity are higher than the individual parts.

On the other hand, when several disparate businesses are grouped together with limited monetary benefits to the combination, investors often assign a “conglomerate discount”. This results in the combined entity trading at a share price lower than the sum of its individual parts. The separation of these businesses can unlock this discount, realising the true value for shareholders.

Despite long being seen as one of the major British insurers, Prudential was actually the combination of 3 separate businesses: M&G in the UK, Jackson National in the US and Prudential in Asia, operating across multiple jurisdictions such as Hong Kong, Singapore, Malaysia and China. Prudential was a prime example of a business trading at a discount to the sum of its parts. The Asian business was the jewel in their crown; however, its value was not reflected due to it being lumped together with the less attractive US and UK businesses.

Over the past 2 years, Prudential has separated into 3 parts. First, in October 2019, Prudential de-merged M&G, leaving a business which was focussed on the US and Asia. However, this failed to unlock the full discount and the lower growth profile of Jackson resulted in Prudential continuing to trade at a discount to the sum of its parts.

For a company to be able to sustainably grow its earnings, two factors are required. Firstly, it must generate attractive returns on capital. Secondly, the opportunity must exist to continue to reinvest this capital at attractive returns, thereby compounding earnings. Jackson and Prudential differ both in their profitability and opportunities to re-invest. Asia represents an extremely attractive region for insurers. Low but rising levels of insurance protection in the region combine with large populations which are becoming wealthier and living longer. As both life expectancy and wealth increase, higher levels of insurance are required. In addition, high levels of out-of-pocket health care spend and, in some cases, poor state health care options have been brought front of mind by Covid-19. Given these demographic factors, Prudential Asia has significant opportunities to re-invest the cash generated and grow the business over the long term.

In September 2021, Prudential de-merged Jackson Financial leaving Prudential as a pure play, Asian focused business. Although pursuing a de-merger has resulted in the company needing to raise a small amount of capital to strengthen its balance sheet and support greater growth opportunities going forward, it also significantly accelerated the process for the separation of Jackson. Since the equity raise will take place in Hong Kong, it will boost liquidity for local investors and make the counter “investable” for institutions, making it a direct comparable to AIA. Moreover, any share dilution will be almost entirely offset by savings made on interest payments due to redeeming high-cost debt, resulting in a minimal impact on earnings per share. Hence, we believe the Asian capital raise is actually a net positive. ▶▶

Prudential's closest peer is AIA which we also own in both the BIP and DGP portfolios and CGEF. When calculating the fair value of Prudential, we have previously used AIA as a comparator for the Asian portion of the business. Since the split we have seen a raft of broker notes comparing the two businesses and pointing out this excessive discount. We see Prudential's Asian listing as a catalyst for a re-rating given the similarity of the two businesses.

However, within the portfolios, we recognise that we now have exposure to two Asian insurance pure plays. Whilst we continue to believe in the attractiveness of the sector over the long term, we do see risks building given the current news flow coming out of China. Therefore, mindful of managing our risk exposure, we may look to reduce our concentration in this area of the market and sell one of these positions. ■

Important notice