



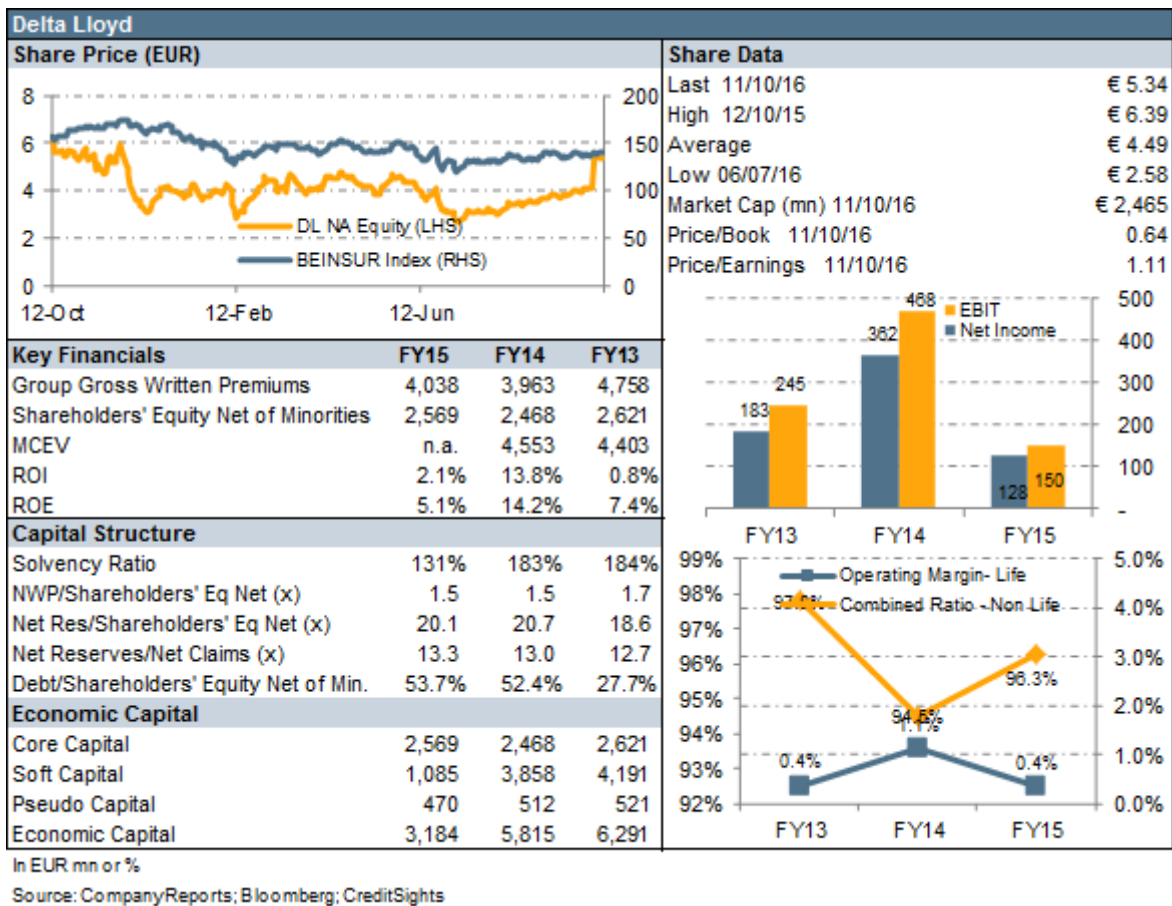
Delta Lloyd: Cut to Underperform. Deal in Smoke

HY NOTE: 11 OCT 2016, 11:53 AM ET

Executive Summary

- **We lower our recommendation to Underperform from Market perform for Delta Lloyd and maintain our Market perform recommendation for NN Group.**
- **We find the gap in the valuation between NN's bid and Delta Lloyd's fair value to be too wide to reach an agreement.** Considering the average price at which some of Delta Lloyd's significant shareholders entered into their investment, it is unlikely that the deal will occur with the present terms and conditions that do not propose any upside such as the inclusion of a share exchange in the offer.
- **We can articulate two reasons for NN's low valuation: either Delta Lloyd is presently facing severe financial difficulties and/or NN has taken an opportunistic approach in its strategy to acquire Delta Lloyd.**
- **Under the former reason, we have not seen any signs of difficulties from Delta Lloyd at present.** In fact, the insurer benefited from a relatively solid Solvency II ratio of 173 % as of June 2016 and rating agencies have not lowered Delta Lloyd's ratings recently.
- **In the latter rationale, we do not know how NN's management could articulate a sharp increase in its initial bid of €2.4 bn to any level close to Delta Lloyd's fair value.** The storyboard would be difficult to fill...
- **So, the deal seems to have gone up in smoke.**
- **At present, Delta Lloyd's bonds trade too tight; 586 bp and 437 bp for the 4.375% €750 mn bond and 9% €500 mn respectively.**
- **Assuming we are right, we expect their spreads to widen to a level similar to prior to NN's bid (i.e. 800 bp and 500 bp).** Hence, our downgrade in the recommendation of Delta Lloyd.

Financial Metrics



NN Group recently made an offer to acquire Delta Lloyd (see [Delta Lloyd: Is NN Bidding Too Low?](#)). We believe that the initial offer was too low as NN valued Delta Lloyd at €2.4 bn only. Not surprisingly, the offer was rejected by Delta Lloyd's management who argued in summary that (i) following the management recent actions, Delta Lloyd had a strategy and a plan for the medium-to-long term and (ii) the valuation of Delta Lloyd by NN was far too low (see [Delta Lloyd: Management Rejects Offer from NN](#)).

The Dutch insurance market is clearly fragmented so we did expect mergers and acquisitions. The six largest Life insurers represent c.80% of the market. According to Bloomberg, Aegon enjoys the leading position in terms of market share (23%), followed by NN (19%), SRLEV and Achmea (13% each), Delta Lloyd (12%) and ASR (9%). Indeed the low interest rate environment and the change in the solvency regulatory framework (effective 1 January 2016) do not help matters. Life insurers are caught in a vicious cycle where they are penalised by the prolonged low interest rates (the demand for Life products and ROI) which in turn requires higher levels of capital under Solvency II.

In our view, NN Group has a very opportunistic approach in its desire to acquire Delta Lloyd. We can't articulate the rationale for such a low valuation. In fact, either Delta Lloyd is facing severe financial difficulties and hence is worth €2.4 bn only or NN Group has taken an aggressive strategy in order to acquire Delta Lloyd.

While we believe that Delta Lloyd's risk profile is weak and the company is very sensitive to the low interest rate environment considering the long-tailed nature of its liabilities, we do not think that the insurer is near a state of bankruptcy. Our justification lies in the absence of signals such as rating downgrades or the sharp drop in the Solvency margin of the insurer that management would have disclosed. As of June 2016, Delta Lloyd reported a Solvency II ratio of 173% on the Standard formula; this level of Solvency ratio is acceptable due to the limited use of transitional rules by the insurers (see [Delta Lloyd: 1H16 In Progress but Still at Risk](#)). We continue to believe that the insurer lacks core capital even with two rights issues (see [Delta Lloyd: All Right! But For How Long?](#)).

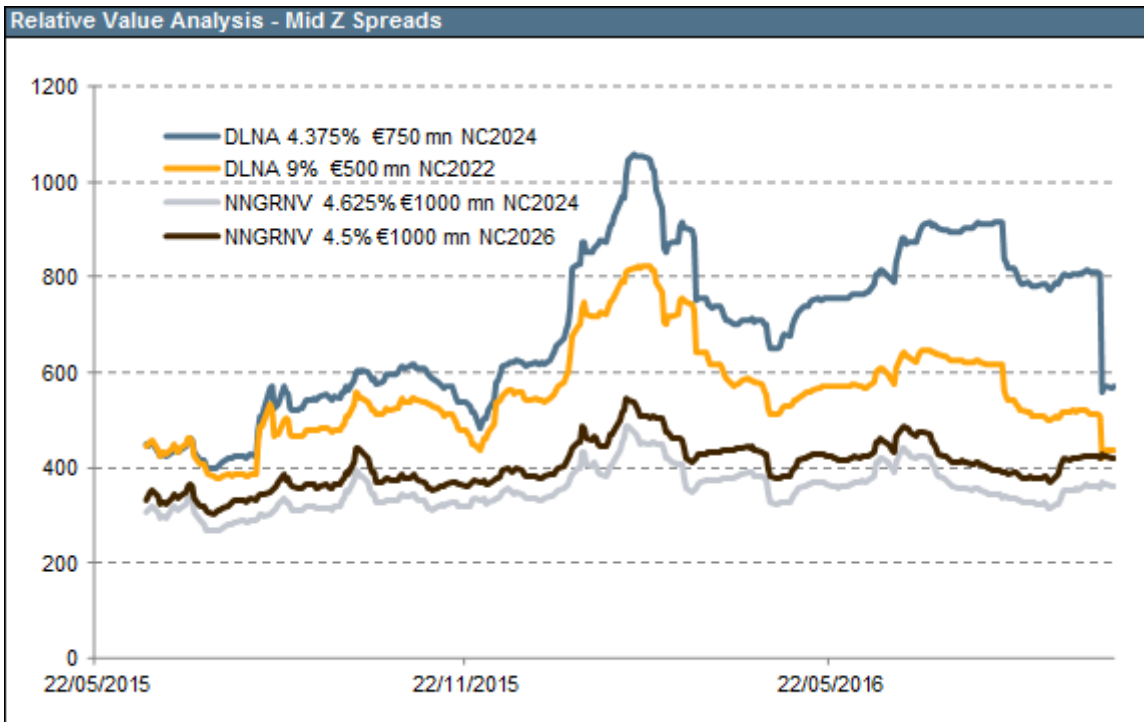
So, this leaves us with the second argument, i.e. an opportunistic bid from NN Group. We value Delta Lloyd in the range of €4 bn to €5 bn, i.e. more than 50% higher than NN's bid of €2.4 bn. Considering the significant gap between NN's bid and our valuation, we do not foresee an increase in the bid from NN. How would NN's group rationalise doubling its existing bid? This is certainly something that NN's management is unwilling to do.

When we looked at the investors with significant holdings of Delta Lloyd's shares and the average cost of their investments, we do not see how most shareholders would accept NN's bid. Furthermore, considering the existing cash only offer does not include a share exchange, Delta Lloyd's shareholders will not receive any future upside to offset their existing unrealised losses.

Shareholdings of Delta Lloyd			
Holders	No. of Shares	% of O/S	Average Cost per share (€)
FUBON FINANCIAL HOLDING CO LTD	44,705,891	9.69	11.66
OLD MUTUAL PLC	24,411,251	5.29	6.16
MAJEDIE ASSET MANAGEMENT LTD	15,805,226	3.43	4.26
DIMENSIONAL FUND ADVISORS LP	15,256,222	3.31	5.71
HIGHFIELDS CAPITAL MANAGEMENT	12,761,651	2.77	7.92
DE MOL J H H	11,982,063	2.6	3.87
NORGES BANK	11,021,876	2.39	7.34
FONDS NUTSOHRA	10,021,495	2.17	4.02
VANGUARD GROUP	8,673,993	1.88	5.92
TRANSAMERICA INVESTMENT SERVICES	7,563,160	1.64	5.77
MARSHALL WACE LLP	7,125,982	1.54	4.57
UBS	7,071,808	1.53	9.33
NEUFLIZE OBC ASSET MANAGEMENT	6,995,412	1.52	6.33
EINHORN DAVID MICHAEL	6,960,000	1.51	12.05
WELLINGTON MANAGEMENT GROUP LLP	6,834,834	1.48	9.81
STATE STREET CORP	6,604,221	1.43	11.59
AQR CAPITAL MANAGEMENT LLC	6,333,870	1.37	8.22
BLACKROCK	5,682,061	1.23	12.12
HIGHBRIDGE CAPITAL MANAGEMENT	-1,383,997	-0.3	n.a.
CAPITAL FUND MANAGEMENT SA	-2,007,203	-0.44	n.a.
BLUECREST CAPITAL MANAGEMENT	-2,052,822	-0.44	n.a.
CITADEL ADVISORS II LLC	-2,214,396	-0.48	n.a.
MARSHALL WACE LLP	-2,260,529	-0.49	n.a.

Source: Bloomberg, CreditSights

On this basis, we lower our recommendation on Delta Lloyd to Underperform from Market perform as we find that its bonds trade too tight. Assuming we are right, we would expect the bonds to return to the levels prior to NN's bid i.e. c. 800 bp for the 4.375% €750 mn NC2024 bond and c.500 bp for the 9% €500 mn NC2022 bond. **We maintain our Market perform recommendation for NN Group.**



Delta Lloyd (DL NA)

Underperform

In our view, NN Group's proposed acquisition of Delta Lloyd is unlikely to be successful. We believe that the gap in valuations as well as the considerable losses that some investors of Delta Lloyd will have to realise by accepting the bid mean that the deal is unrealistic. At present, Delta Lloyd's bonds trade too tight. Assuming we are right, we would expect the bonds to return to the levels prior to NN's bid i.e. c. 800 bp for the 4.375% €750 mn NC2024 bond and c.500 bp for the 9% €500 mn NC2022 bond. (11 Oct 2016)

Last Reviewed: 11 Oct 2016

Last Changed: 11 Oct 2016

NN Group (NN NA)

Market perform

From a credit perspective, we find that NN is prone to adverse one-off effects that could weaken its profitability in the near term. Nevertheless, its lack of leverage, low insurance ratios and a strong economic capital profile are strong positives for its credit profile. (28 Mar 2016)

Last Reviewed: 11 Oct 2016

Last Changed: 15 Jul 2014

Philippe Picagne

Raymond Tam

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