

Etana Insurance Company Limited

South Africa Insurance Analysis

December 2010

Security class	Rating scale	Currency	Rating	Rating watch	Expiry date
Claims paying ability	National	Rand	A+	No	12/2011

Financial data:

(US\$m Comparative)

	30/06/09	30/06/10
R/US\$ (avg.)	9.05	7.61
R/US\$ (close)	7.88	7.65
Total assets	85.9	149.2
Total capital	25.2	33.2
Cash & equiv.	45.3	90.5
GWP	104.8	172.5
U/w result	1.9	4.7
NPAT	4.7	6.3
Op. cash flow	7.3	50.4
Market cap		n.a.
Market share*		2.1%

*Estimate based on GCR's sample group in 2009 and calculated in terms of total GWP.

Fundamentals:

Etana Insurance Company Limited ("Etana") evolved from Hollard Commercial and General (Pty) Limited ("HC&G (Pty) Limited"), the 100% owned commercial arm of Hollard Insurance Company Limited ("Hollard Insurance"). In February 2008, Hollard Insurance sold 50.1% of HC&G (Pty) Limited to enhance the BEE credentials of the Hollard group. HC&G was rebranded as Etana under a new licence, with ultimate shareholders including Hollard Insurance (49.9%), management (25%) and BEE shareholders (25.1%). Etana primarily focuses on the business related segment of the insurance market.

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Rating rationale

The rating is based on the following key factors:

- Etana has achieved robust organic growth over the past two years, leveraging off established broker relationships and its strong reputation in the market. This is supported by the highly regarded management team, which comprises former Hollard group senior executives and experienced technical managers.
- The insurer has a demonstrated track record of technical profitability, facilitated by selective underwriting and appropriate pricing of risks. However, the reliance on proportional reinsurance to support solvency has resulted in a loss of cost efficiencies and a lower degree of operating flexibility.
- Despite the decline in F10, solvency remained comfortable relative to the industry and GCR's minimum level for the current rating. In this regard, cognisance is taken of the reinsurance arrangement with Hollard Insurance, which is expected to support solvency during the medium term growth phase.
- The conservative investment approach is supportive of sound liquidity levels and an appropriate asset / liability matching profile.
- Note is taken of the large concentration to the property class, which substantially increases the insurer's exposure to underwriting volatility. However, conservative reinsurance should limit the extent of this volatility.

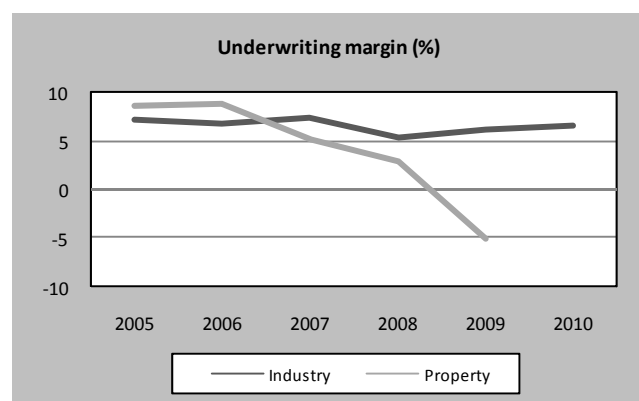
Solvency & liquidity

Shareholders funds increased by 28% to R254m at FYE10, on the back of stable retained earnings. However, strong NWP growth of 80% drove a contraction in the international solvency margin, to 52% from 73% in F09. The statutory solvency margin registered at 32% in F10 (F09: 35%) and was above the minimum regulatory requirement. Reinsurance cover limits the highest net retention per risk and event to 1% of capital. A breakdown of the largest exposures by value and class indicates that all were within the treaty net retention level at FYE10. Excluding cash backing reinsurance liabilities, claims cash coverage remained stable at 11 months in F10, and continued to compare favourably with the unadjusted industry average of around 8 months. Cash coverage of net technical liabilities strengthened to an adjusted 0.9x at FYE10 (FYE09: 0.8x).



Industry overview

The global recession exacerbated pricing pressure in the South African insurance market, and led to a higher incidence of policyholder cancellations and under-insurance in 2009. This constrained industry gross premium growth, which is estimated to have softened to a five year low of around 6% for the year (2008: 7%). This notwithstanding, a strengthening in the exchange rate alleviated some of the claims pressure previously experienced in the motor class, which left the earned loss ratio stable at approximately 65% in 2009. Furthermore, a reduction in the average commission ratio (a function of the increasing share of direct business) underpinned a strengthening in the industry underwriting margin, to 6% in 2009 (2008: 5%). Cognisance is, however, taken of the systemic nature of claims drivers in the motor class and the potential for further underwriting strain in this area going forward. Moreover, a deterioration in risk management in the business environment has contributed to a higher incidence of industrial fire and accident claims. The property underwriting margin has declined consistently since 2006, following an increase in claims frequency and subdued demand. Furthermore, a decline in building cost inflation has made it difficult for insurers to push through price increases.



Competitive positioning

	Etana	Industry*	Property avg.*
GWP growth	38.6	5.9	4.8
Retention	37.3	75.5	70.8
Earned loss ratio	54.2	65.4	73.4
Mgmt. expense ratio	39.0	16.9	15.9
Mgmt exp / GWP	13.4	12.7	10.9
Commission ratio	(1.1)	11.5	15.7
U/w margin	7.9	6.2	(5.0)
Cash coverage (mnths)	34.1	8.3	-
International solvency	51.8	48.7	-
Statutory solvency	32.2	37.6	-

*Based on 2009 averages.

Etana has an approximate 2% share of overall industry GWP and more than 3% in the property class. Table 1 compares Etana's key ratios with the averages for the overall industry and the industry property book. On a gross basis, Etana registered a significantly higher loss

ratio of 74% in F10 (F09: 42%), which was entirely driven by one large property claim. Excluding this claim, the gross loss ratio would amount to approximately 49%, compared to an estimated industry average of 63% in 2009. After accounting for reinsurance claims recoveries, Etana's earned loss ratio remained below the industry average, underpinning a comparatively strong underwriting margin. The insurer reflects a comfortable international solvency margin and sound liquidity measures, supported by reinsurance and a conservative investment approach.

Risk diversification

Etana was initially a continuation of the Hollard Commercial & General business, which had a long track record of profitable underwriting. However, Etana has since diversified into a number of areas focused on the specific insurance requirements of the business sector. The core management team includes former Hollard group senior executives and the company has leveraged off an experienced underwriting team to achieve profitable growth into its core business lines. Given its historical area of expertise, Etana remains focused on the commercial segment, which accounted for 61% of GWP in F10 (F09: 69%). Personal lines is mainly written as a means of securing the more profitable commercial portfolios via its broker relationships, and represented a stable 24% of GWP in F10. The corporate portfolio has gained in prominence in recent years, and represented a higher 15% of GWP in F10 (F09: 8%). This business is pursued selectively and mainly comprises specialist lines classes that are not as susceptible to pricing pressure. Etana has invested heavily in developing a risk management team of qualified professionals, and all material risks are surveyed prior to acceptance. Etana delivers its products through a broad network of regional, national and multi-national brokers. The five largest intermediaries accounted for a combined 35% of GWP in F10, with the largest representing 9%. In terms of policyholders, the book is well diversified, with no single entity contributing more than 3% of GWP in F10.

Premium mix	GWP		NWP		Retention	
	F09	F10	F09	F10	F09	F10
Property	48.2	51.6	60.2	51.7	35.8	37.3
Transport	4.1	6.2	4.7	3.4	33.4	20.8
Motor	28.8	24.6	1.9	21.9	1.8	33.2
Accident	0.4	0.4	0.7	0.1	45.8	5.9
Guarantee	0.2	0.4	0.5	(0.1)	63.4	(14.6)
Liability	10.4	9.0	17.6	10.9	48.4	45.3
Engineering	7.9	7.9	14.4	12.2	52.5	57.8
Total	100.0	100.0	100.0	100.0	28.8	37.3

Source: ST return.

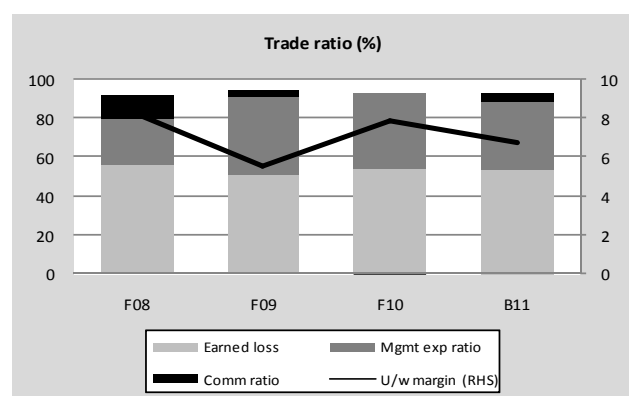
Etana registered GWP growth of 39% in F10, which was supported by double digit growth across all classes of business. The portfolio mix remained

geared towards property, however, which represented 52% of gross and net premiums in F10. The motor class accounted for a substantially higher 22% of NWP from only 2% in F09. This was attributed to a decline in average cessions to the Hollard Insurance net quota share treaty (to 65% from 80% in F09). The remainder of the book largely constituted liability and engineering risks, which together represented 23% of NWP in F10 (F09: 32%).

	F09	F10
Fire	38.5	66.5
Accident	53.9	46.9
Motor	52.0	72.3
Engineering	42.2	49.1
Marine	(262.5)	30.6
Total	50.7	54.2

Source: Management accounts.

Etana's business model focuses on selective underwriting and appropriate pricing of risks on an individual basis. This assists in containing attritional claims experience and maintaining a favourable gross loss ratio. However, in F10, Etana was impacted by one of the largest property claims in its history (Etana's gross portion was R300m, including business interruption). Accordingly, the property class gross loss ratio increased to 93% (F09: 41%), which was well above the industry average. After accounting for substantial reinsurance claims recoveries, the property earned loss ratio amounted to 67% versus 39% in F09. Notwithstanding the increase, this still compared favourably with the estimated industry average of around 73%. The motor account gross loss ratio increased to 68% in F10 from 63% in F09, although was below the industry average of 75% (excluding direct players). However, the earned loss ratio was significantly higher than in F09, as a result of a reduction in relative claims recoveries under the net quota share treaty. Overall, the earned loss ratio increased to 54% in F10 (F09: 51%).



Note: F08 ratios are based on management accounts.

Most classes benefitted from higher reinsurance commission in F10 (profit commission driven), supporting a slight increase in the technical margin, to 47% (F09: 46%). Etana significantly increased its staff complement during the year (to 260 employees from 218 in F09) to enhance growth capacity and

technical expertise in some of the niche areas. Due to strong earned premium growth, the management expense ratio declined to 39% from 41% in F09. Accordingly, the underwriting margin strengthened to 8% in F10 (F09: 6%).

Reinsurance

Etana has an extensive reinsurance programme that covers all classes and sub-segments of business written. Where group reinsurance buying power is effective, Etana is covered under the Hollard group treaties. The insurer placed its primary reinsurance treaties with 25 counterparties in F10, all of which were S&P A or better rated. The quota share agreement with Hollard Insurance is intended as a solvency support mechanism and covers the fire and motor accounts (after cessions to the primary reinsurance treaties). The proportion of related premiums ceded under this treaty decreased to 65% in F10 from 80% in F09.

XOL treaties limit Etana's maximum net retention per risk and event to R2.5m and R3m respectively (1% of FYE10 capital). Etana is covered under the Hollard group catastrophe programme. The limit on this treaty is determined using a DFA model (1 in 200 year event), which is verified by the reinsurance brokers. A breakdown of the largest exposures by value and class indicates that all were within the prevailing treaty limits, with net retention in line with that under the XOL treaties.

Etana uses facultative reinsurance to increase capacity for property, marine, guarantee and engineering risks, with related premiums accounting for 25% of total premiums ceded to reinsurers in F10. Facultative placements are subject to approval by the reinsurance committee and underlying counterparties must be A rated. Etana requires all foreign facultative reinsurers to provide a letter of guarantee or to pay their share of technical liabilities upfront when notified. At FYE10, the largest facultative exposures were to ACE, Chartis, Africa Re, Lloyd's, RSA group (AM Best rating of A), CGIC, Munich Re and RMBSI.

Including provisions, the reinsurance loss ratio increased to 85% from 38% in F09, as a result of the aforementioned fire claim. Accordingly, Etana received a net recovery of R104m from reinsurers in F10, versus a R207m net cession in F09. Following 2010 renewals, the commission ratio was lowered on the property proportional treaties, although this was partly a result of a general tightening following a deterioration in market claims experience. Other treaty terms were renewed at the same or better rates. The net quota share treaty generated a technical profit of R85m in F10 (F09: R63m), most of which accrues to Etana in terms of a profit share arrangement (net of a 1.75% administration fee).

	F09	F10
Premium ceded	(575.4)	(748.0)
Claims recovered	218.5	637.2
Comm. recovered	150.1	214.3
Net result	(206.8)	103.5
RI ratios (%)		
Claims ratio	38.0	85.2
Commission ratio	26.1	28.7
Technical margin	35.9	(13.8)

Asset management

Etana posted a working capital release of R292m in F10, on the back of an increase in reinsurance payables, to R465m from R220m at FYE09. These included deposits held on behalf of foreign reinsurers (R250m at FYE10) and premiums payable under the Hollard treaty. Accordingly, total cash and equivalents almost doubled to R693m at FYE10. Excluding cash backing the reinsurance liabilities, claims cash coverage remained stable at 11 months in F10, which continued to compare favourably with the unadjusted industry average of around 8 months. On the same basis, cash coverage of net technical liabilities strengthened to 0.9x (F09: 0.8x) at FYE10, which was in line with the unadjusted industry average. The value of unlisted investments increased to R58m at FYE10 from R10m previously, mainly on the back of a R45m investment in preference shares issued by a group investment holding company. This investment is secured by a put option from Hollard Insurance. The company does not plan to change the investment mix in the immediate future.

	F09		F10	
	R'm	%	R'm	%
Cash	357.3	88.9	692.5	87.9
Listed shares	34.8	8.7	36.5	4.6
Unlisted shares	9.7	2.4	58.4	7.4
Subsidiaries	0.1	0.0	0.0	0.0
Total	402.0	100.0	787.4	100.0

Solvency and reserving

Since F08, Etana has generated cumulative net profits of R126m, which have been retained in the business to support growth. Together with a R40m capital injection in F09, this has seen shareholders funds more than double to R254m at FYE10 from R119m at FYE08. Following an 80% increase in NWP and a rise in average retention (to 37% from 29% in F09), the international solvency margin contracted to 52% in F10 from 73% previously. Forecasts for F11 indicate that premium retention is expected to remain stable, with the international solvency margin projected at 53%. This is within GCR's adjusted capital adequacy requirement for the current rating. Management aims to maintain the international solvency margin above 40% in the longer term, although this would need to be accompanied by increased risk diversification to maintain the rating. Excluding the Hollard quota share treaty,

international solvency amounted to approximately 35% in F10 (B11: 36%).

The statutory solvency margin contracted to 32% in F10 from 35% in F09. The difference between the international and statutory solvency ratios narrowed noticeably in F10, largely as a result of a decline in the value of non-approved reinsurance balances (to 6% of NWP from 17% in F09).

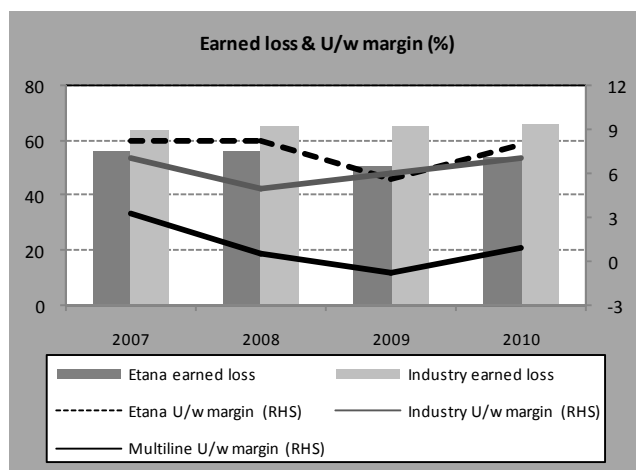
Etana uses a DFA model to determine a risk based capital requirement for underwriting risk, which indicates that capital of approximately R95m is adequate at current premium volumes. Given the low risk investment portfolio and high credit quality of reinsurers, management does not expect the capital requirement to be heavily influenced by asset or credit risk factors. However, there is some uncertainty regarding the impact of operational risk factors and the appropriate way in which to quantify these. Etana's internal actuaries assess reserving adequacy on a semi annual basis and deem balance sheet reserves to be at least sufficient relative to estimates of future claims liabilities.

Financial performance

A summary of Etana's first two full years of operation, together with management accounts for F08 and the budget for F11, is presented at the back of this report and brief comment follows. Underwriting profitability compared favourably with budget in F10, supported by net commission recoveries. In this regard, note is taken of the impact of profit commissions from prior years, which are only recognised when actually received. In terms of the net quota share treaty, profit commission is calculated as the net technical profit on the treaty, less a 1.75% administration cost.

	Actual	Budget	Actual as % of budget
GWP	1,313.4	1,203.0	109.2
NWP	489.9	427.0	114.7
NPE	449.8	451.0	99.7
Claims	(243.7)	(231.0)	105.5
Commission	4.8	(32.0)	n.a.
Mgmt expenses	(175.4)	(159.0)	110.3
U/w result	35.6	29.0	122.7
Key ratios (%)			
Retention	37.3	35.5	-
Earned loss	54.2	51.2	-
Mgmt exp	39.0	35.3	-
Comm	(1.1)	7.1	-
U/w margin	7.9	6.4	-
Solvency	51.8	59.1	-

Gross premiums advanced by a robust 39% to R1.3bn in F10, on the back of new specialist lines business and organic growth in existing broker portfolios. After accounting for an increase in average premium retention and a R40m net UPR transfer (F09: R36m release), NPE grew by 46% to R450m.



Note: Etana ratios based on management accounts prior to 2009.

On the back of one large property claim in F10, the gross incurred loss ratio rose sharply, to 74% from 42% in F09. After accounting for reinsurance recoveries (72% of gross claims incurred versus 58% in F09), the earned loss ratio registered at 54% in F10 (F09: 51%). The management expense ratio decreased slightly, to 39% from 41% in F09, although was well above the industry average of around 17% in 2009. The high cost ratio is a function of Etana's low NWP volumes, given the significant reinsurance support. As a percentage of GWP, management expenses amounted to a stable 13% in F10, which was in line with the industry average and suggests an efficient cost structure. Net commission receipts of R5m (F09: R9m cost) lowered the delivery cost ratio to 38% in F10 from 44% previously. As reflected in the above chart, Etana's earned loss ratio has consistently registered well below the average for the industry over the past four years. This has supported above average underwriting profitability, particularly when compared to the multi-line sub-segment.

Following a reduction in interest income (given the declining interest rate environment), realised investment income contracted by 7% to R38m in F09, translating to an investment yield of 6% (F09: 12%). A strengthening in the underwriting profit supported a 46% rise in NPAT, to R54m for the year (including unrealised gains). It is noted that the insurer has reported a consistent increase in net profits since inception. Including fair value gains on listed equities, ROaE registered at 24% in F10 (F09: 23%).

Future prospects

Etana has forecast a 21% increase in GWP in F11, on the back of organic growth in existing business lines. New initiatives include cautious expansion into other African countries, as well as an extension of the liability offering to include a broader range of risk types. Both of these business lines will initially be heavily reinsured. The company has also begun to expand into the agricultural assets sub-segment (excluding crop).

The reinsurance structure was not changed substantially in 2010 and, given a relatively stable business mix, premium retention is projected to remain at around 37%. The earned loss ratio is expected to decrease marginally to 53% in F11 (F10: 54%). Despite improved volume efficiencies, the underwriting margin is forecast to soften to 7% in F11 (F10: 8%), as a result of a net commission cost of R26m (F10: R5m net recovery).

Table 7: Income statement (R'm)	Actual 1Q F11	Budget F11	Actual as % of budget
GWP	364.8	1,588.0	23.0
NWP	111.3	590.0	18.9
NPE	118.7	548.0	21.7
Claims	(62.9)	(291.0)	21.6
Commission	17.3	(26.0)	n.a.
Mgmt expenses	(53.9)	(194.0)	27.8
U/w result	19.2	37.0	51.9
Key ratios (%)			
GWP growth*	11.1	20.9	
Retention	30.5	37.2	
Earned loss ratio	53.0	53.1	
Commission ratio	(14.6)	4.7	
Mgmt expense ratio	45.4	35.4	
U/w margin	16.2	6.8	
Solvency*	61.1	52.5	

*Year to date is annualised.

Underwriting profitability for the year to date was supported by substantial reinsurance commission recoveries. This was partly attributed to profit commissions that accrued from previous years, and net commissions are expected to be more in line with budget as the year progresses. Premium growth was below expectations, which was attributed to a transition to monthly premiums on certain policies that renewed in July. Combined with lower premium retention, this supported an increase in the international solvency margin, to an annualised 61% as at September F11 (F10: 52%).

Etana Insurance Company Limited

(R in millions except as noted)

Year ended : 30 June	2008 [#]	2009	2010	Budget 2011
Income Statement				
Gross written premium (GWP)	650.6	948.0	1,313.4	1,588.0
Reinsurance premiums	(239.4)	(675.4)	(823.5)	(998.0)
Net written premium (NWP)	411.2	272.5	489.9	590.0
(Increase) / Decrease in insurance funds	(21.3)	36.3	(40.1)	(42.0)
Net premiums earned	389.9	308.9	449.8	548.0
Claims incurred	(217.3)	(156.5)	(243.7)	(291.0)
Commission	(45.6)	(9.4)	4.8	(26.0)
Management expenses	(94.9)	(125.7)	(175.4)	(194.0)
Underwriting profit / (loss)	32.1	17.3	35.6	37.0
Investment income - total used for budget	24.9	41.1	38.0	38.0
Other income / (expenses)	(7.0)	(3.2)	(9.3)	(1.0)
NPBT	50.0	55.2	64.4	74.0
Taxation	(13.0)	(12.9)	(16.8)	(19.0)
Net income after tax	37.0	42.2	47.6	55.0
Dividends	0.0	0.0	0.0	0.0
Fair value gains / losses	(1.5)	(5.4)	6.3	0.0
Capital profits after tax	35.5	36.9	53.9	55.0
Cash Flow Statement				
Cash generated by operations	n.a.	(20.8)	81.4	n.a.
Cash flow from investment income	n.a.	39.5	29.0	n.a.
Working capital decrease / (increase)	n.a.	58.8	291.7	n.a.
Tax paid	n.a.	(11.7)	(18.7)	n.a.
Cash available from operating activities	n.a.	65.9	383.3	n.a.
Dividends paid	n.a.	0.0	0.0	n.a.
Cash flow from operating activities	n.a.	65.9	383.3	n.a.
Cash flow from investing activities	n.a.	0.3	(48.7)	n.a.
Cash flow from financing activities	n.a.	42.7	0.6	n.a.
Net cash inflow / (outflow)	n.a.	108.9	335.2	n.a.
Balance Sheet				
Shareholders interest	119.1	198.5	253.9	310.0
Net unearned premium reserve	134.0	91.9	134.0	n.a.
Net outstanding claims reserve	127.0	81.3	118.9	n.a.
Other liabilities	173.5	305.2	634.9	n.a.
Total capital & liabilities	553.6	676.9	1,141.7	2,421.0
Fixed assets	0.1	3.0	4.1	n.a.
Investments	50.5	44.7	94.9	95.0
Cash and short term deposits	248.4	357.3	692.5	1,038.0
Other assets	254.5	272.0	350.2	n.a.
Total assets	553.6	676.9	1,141.7	2,421.0
Key Ratios				
Solvency / Liquidity				
Shareholders funds / NWP	%	29.0	72.8	51.8
Solvency margin (Act)	%	55.5	35.0	32.2
Financial base ratio (audited)	%	92.4	136.4	103.4
Net outstanding claims / NWP	%	15.5	30.0	24.3
Net UPB / NWP	%	18.9	33.7	27.3
Claims cash coverage	months	13.7	27.4	34.1
Average premium collection period	days	n.a.	69.1	55.5
Profitability				
ROaE (before unrealised gains / losses)	%	n.a.	26.6	21.0
ROaE (after unrealised gains / losses)	%	n.a.	23.2	23.8
Investment yield (including unrealised gains / losses)	%	n.a.	10.2	7.5
Investment yield (excluding unrealised investment movements)	%	n.a.	11.7	6.4
Efficiency / Growth				
GWP Growth	%	n.a.	45.7	38.6
Premiums reinsured / GWP	%	36.8	71.2	62.7
Earned loss ratio	%	55.7	50.7	54.2
Commissions / Earned premiums	%	11.7	3.0	(1.1)
Management expenses / Earned premiums	%	24.3	40.7	39.0
Underwriting result / Earned premium	%	8.2	5.6	7.9
Trade Ratio	%	91.8	94.4	92.1
Operating ratio	%	85.4	81.1	83.6

[#]Unaudited management accounts, including 9 months of business that was written against the Hollard Insurance licence.