Etana Insurance Company Limited

South Africa Insurance Analysis **December 2009**

Security class	Rating scale	Currency	Rating	Rating watch	Expiry date
Claims paying ability	National	Rand	A+	No	12/2010

Financial data:

(US$'m Comparative)

	30/06/08	30/06/09
R/US$ (avg.)	7.31	9.05
R/US$ (close)	7.96	7.88
Total assets	69.5	85.9
Total capital	15.0	25.2
Cash & equiv.	31.2	45.3
GPI	89.0	104.6
U/w result	4.4	1.9
NPAT	5.1	4.8
Op. cash flow	n.a.	7.3
Market cap	n.a.	
Market share*	1.7%	

*Based on GCR's sample group in 2008 and calculated in terms of total GPI.

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:

- The highly regarded management team, which comprises former Hollard group senior executives and experienced technical managers.
- Etana is a continuation of an established book of business with a demonstrated track record of technical profitability. Furthermore, the insurer leverages off long standing broker relationships and has been well accepted by the market, supporting strong new business growth in F09 and for the year to date.
- The international solvency margin was considered strong relative to the industry average, and is expected to remain at comfortable levels over the next two years. In this regard, cognisance is taken of the support provided by Hollard Insurance and other shareholders, including large capital injections and solvency reinsurance protection.
- Note is taken of the conservative investment mix, with liquidity measures projected to remain sound over the next two years.
- The high reliance on proportional reinsurance to support solvency has resulted in a loss of cost efficiencies and lower degree of operating flexibility.

Solvency & liquidity

Following a R40m capital injection and R37m rise in retained earnings, shareholders funds advanced by 67% to R199m in F09. Combined with significantly lower premium retention, this underpinned an increase in the international solvency margin, to 73% in F09 (F08: 29%). The statutory solvency margin was posted at 35% in F09 and remained above the minimum regulatory requirement. A R109m net cash inflow and reduction in claims underpinned a substantial increase in the claims cash coverage ratio, to 27 months in F09 (F08: 14 months). This is expected to remain above 15 months over the next two years, supported by a conservative investment mix. The highest net retention per event amounts to R15m under the Hollard group treaties, and this is bought down to R3m for Etana (2% of capital), through an XOL treaty.

Industry overview

The year 2008 proved challenging for the industry, beginning with electricity shortages that constrained productive capacity and culminating in the global downturn that saw insurers realise outright investment losses. Given the soft market and deterioration in the economic climate, GPI growth is estimated to have declined to 9% from 13% in 2007, with growth emanating from sum insured adjustments and a degree of re-pricing rather than volume growth.

Underwriting margins have narrowed significantly since 2004 (industry average of 12%) and registered at approximately 7% in 2007 and 5% in 2008. This has been a function of competitive pricing and rising claims volumes, particularly in the motor and property portfolios. The overall loss ratio increased to approximately 66% in 2008 (2007: 64%). Adverse weather conditions and a higher incidence of industrial accidents and fires (partly ascribed to weaker risk management) have exerted upward pressure on property claims. Furthermore, the motor book has been impacted by higher claims frequency and the impact of higher replacement costs. These factors are viewed as systemic and imply a longer term challenge.

The capital erosion experienced by insurers with large listed equity exposures suggests that re-pricing will need to take place to compensate for investment losses. Furthermore, the deterioration in economic growth, increasing unemployment and a reduction in disposable income levels are expected to place pressure on volume growth and lead to higher policyholder churn in the near term. Accordingly, pricing adjustments are likely to be on a selective basis and will be more successfully realised by insurers with strong brand affinity, and those that have captive distribution channels.

Background

Etana evolved from Hollard Commercial and General (Pty) Limited ("HC&G"), which Hollard acquired from Fedsure General Insurance Company Limited in 2001. The book was run under a separate division that focused on the commercial and industrial segments of the market. In light of the need to enhance its BEE status, Hollard Insurance sold 50.1% of HC&G to investment holding company Etana Holdings Proprietary Limited, which is 50.1% black owned. Following the change in shareholding, the company was re-branded as Etana and began to operate under its own short term insurance licence from 1st April 2008. Subsequently, new business was directly written by Etana, while existing policies were transferred to Etana paper (along with associated reserves) as they came up for renewal. During this process, no significant loss of business occurred.

Notwithstanding the amended shareholding structure, Etana is essentially a continuation of the HC&G business, which has a long track record of profitable underwriting. Furthermore, the management team includes former Hollard group senior executives, and the company has retained most of the former HC&G technical managers.

In line with its strategic focus, Etana sources a substantial portion of its book from the commercial and industrial segment, with personal lines provided solely on an accommodation basis (representing approximately 4% of GWP in F09). During early 2009 Etana added a number of specialised divisions to provide a comprehensive range of insurance products to the business sector. These include corporate, marine, specialist liabilities and commercial trucking. Retention in these new areas has been limited to 10% in most cases until the portfolios achieve sustainable size. The insurer sources its business through a broad network of regional, national and multinational brokers, leveraging off existing relationships that have been built up over many years. The four largest intermediaries accounted for a combined 28% of gross premiums, and no other entity represented more than 4% of GWP in F09. Furthermore, premiums were well diversified amongst policyholders, each of which accounted for less than 4% of the gross book.

Table 1: Premium mix (%)	**Gross premiums**	**Net premiums**	**Retention**
Property	48.2	60.2	35.8
Transport	4.1	4.7	33.4
Motor	28.8	1.9	1.8
Accident	0.4	0.7	45.8
Guarantee	0.2	0.5	63.4
Liability	10.4	17.6	48.4
Engineering	7.9	14.4	52.5
Total	**100.0**	**100.0**	**28.7**

Given the insurer's traditional area of expertise, the property class represents the largest share of GWP, at 48% in F09 (F08: approximately 47%). The motor book largely constitutes HCV business, which is heavily reinsured through quota share arrangements. Accordingly, despite its 29% contribution to gross premiums, exposure to the motor class was limited to only 2% on a risk premium basis. This raised the property account NWP contribution to 60% in F09. The insurer was relatively successful in terms of realising targeted growth in the engineering and liability classes, which represented a combined 18% of GWP in F09, from historical levels of approximately 13%. These two classes are subject to higher retention, and together accounted for 32% of the net book (F08: approximately 16%). In addition to several external proportional treaties, Etana entered into a 65% quota share agreement on its fire and motor portfolios with Hollard at the beginning of

F09, prompted by stronger than anticipated growth and associated capacity constraints. Furthermore, additional XOL cover was used by the insurer to limit capital risk. Accordingly, the retention ratio decreased significantly, to 29% from 63% previously. This reduction in retention levels was necessitated by the transfer of the HC&G portfolio to the Etana licence in April 2008. The first 9 months of F08 were underwritten against the Hollard licence, which has much greater retention capacity than Etana. This has influenced a number of the comparisons between F08 and F09 that appear in this report.

Table 2: Loss ratios (%)	Gross	Net	Earned	
			Etana	Industry
Property	40.9	64.0	54.4	66.0
Transport	16.8	31.9	45.7	60.3
Motor	62.8	n.a.	51.7	72.8
Accident	13.3	7.2	8.8	30.1
Guarantee	355.6	19.7	(33.2)	38.5
Liability	20.6	24.5	46.8	55.3
Engineering	37.5	24.0	35.7	53.3
Total	**44.4**	**74.5**	**50.7**	**65.7**

Source: ST return & management accounts.

As reflected in the preceding table, Etana registered very low gross claims ratios for most classes of business in F09. This is a function of the company's experience and technical expertise in the commercial market, and its thorough surveying and risk assessment practices, which allow for more accurate rating of risk exposures on an individual basis. Furthermore, Etana adopts a highly selective approach to corporate business (projected at a maximum of 15% of GWP in F10), which limited its exposure to the larger sized fire claims that impacted the industry in 2008. The cession of profitable books of business to reinsurers resulted in a higher net loss ratio of 75% in F09. Including reserve releases relating to the higher reinsurers share of provisions, the earned loss ratio was below the industry average for all classes of business in F09.

Table 3: Performance by class (% of EPI)	Mgmt expenses	Commission	U/w margin
Property	34.6	6.7	4.3
Transport	50.8	3.4	0.1
Motor	80.7	(27.8)	(4.6)
Accident	35.9	9.8	45.5
Guarantee	28.6	6.8	97.8
Liability	32.4	9.7	11.1
Engineering	30.0	16.6	17.7
Total	**40.7**	**3.0**	**5.6**

Source: ST return and management accounts.

The very low retention level resulted in a reduction in efficiencies, with the management expense ratio exceeding 30% across most of the book in F09. The impact was most pronounced for the motor class, given its 2% retention ratio. Despite the substantial reinsurance commission recoveries (including a profit share element), this pushed the delivery cost ratio up to 44% from 36% in F08. Overall, the underwriting margin narrowed to 6% from 8% in F08, with the more heavily reinsured books reflecting margins that were below the 2008 industry average.

Competitive positioning

The following table compares Etana's key ratios with the averages for the overall industry and the property sub-segment. Etana has an approximate 2% share of overall industry GWP and a slightly higher market share in the property class. The insurer reflects a very low earned loss ratio relative to the industry and the property class. However, the reduction in retention translated into a loss of efficiencies, which lowered the underwriting margin to a level that was more comparable with the industry average. The insurer's key credit protection measures compared favourably with the industry average, supported by reinsurance and a conservative investment mix.

Table 4: Key ratios (%)	Etana	Industry	Property avg.
GWP growth	45.5	6.6	8.0
Retention	28.7	75.5	72.3
Earned loss ratio	50.7	65.7	66.0
Mgmt. expense ratio	40.7	16.7	14.6
Commission ratio	3.0	12.3	16.5
U/w margin	5.6	5.4	2.9
Cash coverage (mnths)	27.4	7.5	-
International solvency	73.1	48.2	-
Statutory solvency	35.0	37.6	-

Reinsurance

Table 5: Reinsurance (R'm)	Retention	Limit
Proportional		
Property surplus	20	220
Corporate QS	8%	250
Commercial crime QS	40%	50
Special liabilities QS	13%	150
Municipality QS	13%	150
Marine cargo surplus	20	40
Marine QS	2	20
HCV QS	10%	5
Bonds	8%	30
Fire & motor net QS**	35%	-
Non-proportional		
Fire, eng & motor CAT**	3	15
Misc accident	12*	-
Personal property	1	2.5
Commercial property**	5	7.5
Liability & PA**	2.5	5
Special liab & crime	2.5	21.5
Marine	2	10

*Total annual aggregate.
**Reinsured with Hollard.

Where group reinsurance buying power is effective, Etana is covered under the Hollard group treaties, and also utilises a comprehensive range of separate proportional treaties to lower its gross retention level while it accumulates capital in the medium term. The insurer cedes 35% of property and motor premiums to Hollard (after their respective external quota share cessions), and earns 100% profit share on these books, net of an agreed administration fee percentage. In addition, the XOL net retention is reduced below the group treaty level using XOL cover placed with Hollard. The highest net retention per event amounts to R15m under the external group XOL treaty (8% of year end capital) and decreases to R3m (2% of capital) after accounting for the non-proportional cover provided by Hollard. The main reinsurers on both the Hollard group and Etana treaties include Munich Re, SCOR and Everset Re.

Asset management

Operating cash flow generation was underpinned by investment income and a R59m working capital release, and amounted to R66m in F09. After accounting for R40m in share issue proceeds, Etana posted a net cash inflow of R109m for the year. Accordingly, cash and equivalents increased by 44% to R357m, and accounted for 89% of the investment portfolio (budget: 57%). The claims cash coverage ratio was posted at a comfortable 27 months in F09 (F08: 14 months). Going forward, management aims to maintain a highly conservative investment mix, with liquidity measures projected to remain above 15 months in the short to medium term. The more conservative investment stance was ascribed to a strategy of "de-risking" the balance sheet and improving earnings stability during the current highly turbulent period. Accordingly, management does not expect to significantly increase its exposure to non-cash investments in the near term.

Table 6: Investments	Actual F09		Budget F09 (%)
	R'm	%	
Cash	357.3	88.9	56.8
Listed shares	34.8	8.7	34.5
Unlisted inv.	9.7	2.4	8.7
Subsidiaries	0.1	0.0	n.a.
Total	**401.9**	**100.0**	**100.0**

Solvency and reserving

The business was capitalised with R125m from Hollard Insurance at the beginning of 2008. The other shareholders will repay Hollard for their proportional shareholdings, with the loans ring fenced within the BEE entity and private trusts (management shareholders). These obligations have no impact on the balance sheet or obligations of Etana. In F09, the shareholders injected an additional R40m into the business, to bolster Etana's underwriting capacity. After accounting for retained income of R37m, shareholders funds advanced by 67% to R199m (net of R6m in intangibles that relate to future profit commissions). Given the significant reduction in retention, this bolstered the international solvency margin to 73% from 29% in F08. Assuming a similar retention level to F08 (and no difference in the net result), the international solvency margin would have amounted to 33% in F09. The statutory funding ratio was posted at a noticeably lower 35% in F09, with the difference relating to debtor impairments (R26m) and non-admitted reinsurance assets (R47m, or 10% of total reinsurance assets). The insurer has subsequently included a loss reserve clause in its treaties, which requires reinsurers to pay claims when notified, rather than on settlement. This will enable Etana to include the foreign portion of technical assets for future statutory reporting purposes. No further capital injections are planned. The international solvency margin is expected to decrease to 59% in F10 and to 49% in F11, as the insurer gradually increases its retention under the proportional treaties. Management is targeting a minimum international solvency margin of 35% in the longer term.

The substantial increase in reinsurance cessions resulted in a rise in the reinsurers' share of technical reserves, translating into net reserve releases in terms of both outstanding claims and UPR. However, as a percentage of risk premiums, the ratios increased relative to F08, while the financial base ratio rose to 123% in F09 from 119% previously.

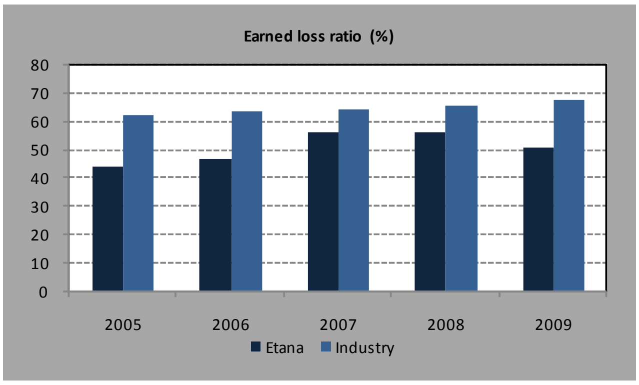
Financial performance

Table 7: Income statement F09 (R'm)	Actual	Budget	Actual as % of budget
GWP	946.9	758.3	124.9
NWP	271.4	500.8	54.2
EPI	**308.9**	**469.8**	**65.7**
Claims	(156.5)	(272.5)	57.4
Commission	(9.4)	(62.3)	15.1
Mgmt expenses	(125.7)	(95.2)	132.1
U/w result	**17.3**	**39.8**	**43.4**
Key ratios (%)			
Retention	28.7	66.0	
Earned loss	50.7	58.0	
Mgmt exp	40.7	20.3	
Comm	3.0	13.3	
U/w margin	5.6	8.5	
Solvency	73.1	34.7	

A summary of Etana's first full year of operation in F09, together with management accounts for F08 and budgets for F10 and F11, is presented at the back of this report and brief comment follows. Etana significantly exceeded its premium growth forecasts in F09, which necessitated the use of additional proportional reinsurance to prevent solvency strain. The associated loss of efficiency resulted in a shortfall in underwriting profitability relative to expectations.

GPI growth registered at a robust 46% in F09, on the back of new business of around R124m (including around R42m from acquired Hollard subsidiary FGA) and an approximate 26% increase in premiums relating to existing portfolios. Following the significant reduction in retention, earned premiums decreased by 21% to R309m for the year.

Net of reinsurance recoveries and a R46m claims reserve release, claims incurred declined by 28% to R157m in F09. Accordingly, the earned loss ratio decreased to 51% from 56% in F08 and continued to compare favourably with the projected 2009 industry estimate of 68%. The following graph reflects Etana's consistently favourable earned loss ratio relative to the industry average over the past five years. Management aims to maintain the loss ratio below 60% over the long term.



Note: Etana ratios sourced from HC&G management accounts prior to F09. Industry estimate was used for 2009.

As a percentage of gross premiums, management expenses decreased from 15% in F08 to 13% in F09, versus an industry average of around 12%. However, the decline in retained risk premiums resulted in a loss of efficiencies, which saw the management expense ratio rise to 41% from 24% in F08. Notwithstanding the impact of reinsurance commission receipts, this drove an eight percentage point increase in the delivery cost ratio, to 44% in F09. This offset the improvement in relative claims, resulting in a 46% decline in the underwriting profit, to R17m. This translated into an underwriting margin of 6% for the year (F08: 8%).

Following an increase in cash holdings in absolute terms, investment income rose by 71% to R43m in F09. As such, despite the decline in the underwriting profit, NPAT increased by 18% to R44m in F09. After accounting for R7m in fair value losses on listed equity investments, R37m was transferred to retained earnings in F09.

Future prospects

Etana is targeting robust gross premium growth of at least 20% in the next two years, as it increases its penetration into the commercial segment. Premium retention is expected to increase by about ten percentage points in each of the next two years, while associated efficiency gains should see an improvement in the delivery cost ratio, which is forecast to decrease by seven percentage points by F11. Accordingly, the underwriting margin is projected to increase slightly, to 6.4% in F10 and 7.1% in the following year.

Actual performance for 1Q F10 reflects strong gross premium growth in proportional premiums. The earned loss ratio was slightly higher than expectations for the full year, which was influenced by weather related construction losses and a large industrial property claim. The net commission ratio equated to a low 2% in 1Q F10, relative to projections of around 7% for the year. This was bolstered by profit related reinsurance commission receipts, and is unlikely to be maintained at this level for the full year. Accordingly, the underwriting margin of 9% was above the full year forecast of 6%. Shareholders funds increased to R214m as at September F10 (F09: R199m). The rise in premium retention (36% versus 29% in F09) resulted in a contraction in the international solvency margin, to an annualised 61% (F09: 73%), albeit remaining comfortable relative to management's target ratio and forecasts for the full year.

Table 8: Income statement (R'm)	**Actual 1Q F10**	**Budget F10**	**Actual as % of budget**
GWP	325.6	1,203.0	27.1
NWP	117.4	427.0	27.5
EPI	**92.6**	**451.0**	**20.5**
Claims	(49.0)	(231.0)	21.2
Commission	(2.1)	(32.0)	6.6
Mgmt expenses	(33.3)	(159.0)	21.0
U/w result	**8.2**	**29.0**	**28.4**
Key ratios (%)			
GPI growth*	37.5	27.1	
Retention	36.1	35.5	
Earned loss ratio	52.9	51.2	
Commission ratio	2.3	7.1	
Mgmt expense ratio	36.0	35.3	
U/w margin	8.9	6.4	
Solvency*	60.7	59.1	

*Year to date is annualised.

Etana Insurance Company Limited

(R in millions except as noted)

Year ended : 30 June		2008#	2009	Budgets F2010	Budgets F2011
Income Statement					
Gross written premium (GWP)		650.6	946.9	1,203.0	1,457.0
Reinsurance premiums		(239.4)	(675.4)	(776.0)	(789.0)
Net written premium (NWP)		**411.2**	**271.4**	**427.0**	**668.0**
(Increase) / Decrease in insurance funds		(21.3)	37.4	24.0	(6.0)
Net premiums earned		**389.9**	**308.9**	**451.0**	**662.0**
Claims incurred		(217.3)	(156.5)	(231.0)	(371.0)
Commission		(45.6)	(9.4)	(32.0)	(68.0)
Management expenses		(94.9)	(125.7)	(159.0)	(176.0)
Underwriting profit / (loss)		**32.1**	**17.3**	**29.0**	**47.0**
Investment income - total used for budget		24.9	42.6	42.0	52.0
Other income / (expenses)		(7.0)	(3.2)	0.0	0.0
NPBT		**50.0**	**56.6**	**71.0**	**99.0**
Taxation		(13.0)	(12.9)	n.a.	n.a.
Net income after tax		**37.0**	**43.7**	**n.a.**	**n.a.**
Dividends		0.0	0.0	n.a.	n.a.
Fair value gains / losses		(1.5)	(6.9)	n.a.	n.a.
Capital profits after tax		**35.5**	**36.9**	**53.9**	**73.5**
Cash Flow Statement					
Cash generated by operations		n.a.	(20.8)	n.a.	n.a.
Cash flow from investment income		n.a.	39.5	n.a.	n.a.
Working capital decrease / (increase)		n.a.	58.8	n.a.	n.a.
Tax paid		n.a.	(11.7)	n.a.	n.a.
Cash available from operating activities		**n.a.**	**65.9**		
Dividends paid		n.a.	0.0	n.a.	n.a.
Cash flow from operating activities		**n.a.**	**65.9**	**n.a.**	**n.a.**
Cash flow from investing activities		**n.a.**	**0.3**	**n.a.**	**n.a.**
Cash flow from financing activities		**n.a.**	**42.7**	**n.a.**	**n.a.**
Net cash inflow / (outflow)		**n.a.**	**108.9**	**n.a.**	**n.a.**
Balance Sheet					
Shareholders interest*		**119.1**	**198.5**	**252.4**	**325.9**
Net UPR		134.0	90.8	66.8	72.8
Net outstanding claims reserve		127.0	81.3	128.0	200.0
Other liabilities		173.5	306.3	308.8	318.3
Total capital & liabilities		**553.6**	**676.9**	**756.0**	**917.0**
Fixed assets		0.1	3.0	n.a.	n.a.
Investments		50.5	44.7	45.0	45.0
Cash and short term deposits		248.4	357.3	445.0	529.0
Other assets		254.5	272.0	266.0	343.0
Total assets		**553.6**	**676.9**	**756.0**	**917.0**
Key Ratios					
Solvency / Liquidity					
Shareholders funds / NWP	%	29.0	73.1	59.1	48.8
Solvency margin (Act)	%	n.a.	35.0	n.a.	n.a.
Financial base	%	119.1	123.4	n.a.	n.a.
Net outstanding claims / NWP	%	15.5	30.2	30.0	29.9
Net UPR / NWP	%	18.9	33.5	15.6	10.9
Claims cash coverage	months	13.7	27.4	23.1	17.1
Profitability					
ROaE (before unrealised gains / losses)	%	n.a.	27.5	n.a.	n.a.
ROaE (after unrealised gains / losses)	%	n.a.	23.2	n.a.	n.a.
Investment yield (including unrealised gains / losses)	%	n.a.	10.2	9.4	9.8
Investment yield (excluding unrealised investment movements)	%	n.a.	12.1	n.a.	n.a.
Efficiency / Growth					
GPI Growth	%	n.a.	45.5	27.1	21.1
Premiums reinsured / GWP	%	36.8	71.3	64.5	54.2
Earned loss ratio	%	55.7	50.7	51.2	56.0
Commissions / Earned premiums	%	11.7	3.0	7.1	10.3
Management expenses / Earned premiums	%	24.3	40.7	35.3	26.6
Underwriting result / Earned premium	%	8.2	5.6	6.4	7.1
Trade Ratio	%	91.8	94.4	93.6	92.9
Total investment yield	%	n.a.	10.2	9.4	9.8

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

*Budgets assume that intangible assets will be amortised on a straight line basis over five years.