GLOBAL CREDIT RATING CO.

GCR | GLOBAL CREDIT RATING CO.
Local Expertise • Global Presence

Guardrisk Insurance Company Limited

South Africa Insurance Analysis **October 2010**

Security class	Rating scale	Currency	Rating	Rating watch	Expiry date
Claims paying ability	National	Rand	AA	No	10/2011

Financial data:
(US$'m Comparative)

	31/03/09	31/03/10
R/US$ (avg.)	8.87	7.85
R/US$ (close)	9.72	7.39
Total assets	380.2	542.7
Total capital	7.2	16.3
Cash & equiv.	292.1	409.3
GWP	279.7	385.8
U/w result	52.9	103.5
NPAT	4.5	5.3
Op. cash flow	21.2	20.2
Market cap	n.a.	
Market share*	50%	

*Estimate based on FSB statistics relating to total cell captive NWP for F10.

Fundamentals:

Guardrisk Insurance Company Limited ("Guardrisk") is a 100% held subsidiary of Guardrisk Holdings Limited, which in turn is wholly owned by Alexander Forbes Equity Holdings (Pty) Ltd ("Alexander Forbes"). This relationship provides the insurer with technical support and access to a secure distribution channel. Guardrisk was established in 1992 and was the first insurer to introduce the cell captive insurance concept in South Africa. The company had a substantial base of around 90 active cells in F10.

GCR contacts:

Susan Andrews
+27 11 784-1771
andrews@globalratings.net

Melanie Brown
+2711 784-1771
brown@globalratings.net

Website: www.globalratings.net

Rating rationale

The rating is based on the following key factors:

- Guardrisk's position as the leading cell captive provider in the market was considered, complemented by management's high level of expertise and track record.
- Cognisance was taken of the increase in capital levels over the past two years, which has supported a marked strengthening in promoter solvency levels. Going forward, the shareholder has committed to maintaining capital at a level that covers the risk based capital requirement at least 1.3x, with core capital coverage (excluding holding company loans) to be maintained at a minimum of 1x.
- The highly conservative investment composition and strong liquidity levels were favourably viewed.
- The large component of fee income lends stability to shareholders earnings, with NPAT having increased consistently over the review period. While the growth in direct business written is expected to increase exposure to underwriting volatility, note is taken of the diversification benefits associated with the new business lines.
- Subdued economic growth is likely to place pressure on volumes in Guardrisk's traditional business lines.

Solvency & liquidity

On the back of retained income of R51m, capital backing promoter activities increased to a review period high of R121m at FYE10 (FYE09: R70m). Subsequent to year-end, Guardrisk paid a dividend of R39m. Of this amount, R28m was offset against the holding company loan, which decreased to R32m at August F11. Core capital covered the risk based capital requirement 1.3x at August F11 (FYE10: 1.1x) and remained above the 1x cover that is viewed by GCR as a minimum for the current rating. Strong NWP growth drove a contraction in the statutory solvency margin, to 32% from 43% in F09. This nonetheless remained in line with management's target level, and was above the minimum regulatory requirement of 15%. The conservative investment mix continued to support very strong liquidity levels, with the claims cash coverage ratio registering at 25 months in F10 (F09: 21 months). Guardrisk uses XOL cover to protect promoter capital, with the highest net retention per risk and event equating to less than 2% of FYE10 shareholders funds.

Business mix

Guardrisk is the leading alternative risk transfer provider in South Africa, having operated in this segment for more than 15 years. The insurer provides structured insurance products in the form of contingency policies and traditional cell captive facilities, which accounted for a combined 81% of statutory GWP in F10. On the back of the conclusion of a new agreement with a UMA that focuses on the hospitality sector (previously underwritten by Compass), direct business increased in prominence in F09, representing 19% of total revenue (F08: 11%). Going forward, Guardrisk aims to continue growing its direct business line, with the aim of increasing the underwriting component of promoter profits. In particular, Guardrisk began to participate in a substantial portfolio of general commercial business (GWP of around R507m) at the beginning of F11. Guardrisk retains 25% of the gross book and then cedes 60% of this to other large South African insurers. Net of proportional reinsurance, Guardrisk's exposure equates to 10%, with further protection provided under the promoter XOL treaty.

Table 1: Business mix – statutory GWP	F09		F10	
	R'm	%	R'm	%
First party cells	718.6	22.5	797.1	20.8
Third party cells	1,091.5	34.1	1,156.2	30.2
Contingency policies	1,024.3	32.0	1,148.5	30.0
Direct business	365.5	11.4	723.4	18.9
Total revenue	**3,199.9**	**100.0**	**3,825.3**	**100.0**

Contingency policies

A contingency policy is a contract that allows the policyholder to participate in the underwriting performance of a predefined insured risk or set of risks. The insurable interest relates to first party risks, meaning the risks are associated with the client's own business or operations within the same group. Premiums are charged upfront and are calculated in terms of the policyholder's expected risk exposure over the period of the contract. In addition, Guardrisk provides an excess layer of cover over and above this retained portion, usually limited to 20% of the total gross premium. In effect, Guardrisk's claims exposure is limited to 120% of the premium over the term of the contract. It is noted that contingency policies rarely breech the predicted layer. The net surplus of the contingency policyholder's account (after Guardrisk's management fee and a provision for unexpired risk) accrues to the client as a policyholder bonus at the end of the contract period. This may be used to provide for part of the new premium payments in the following period, or retained on expiry of the contract. GWP from contingency policies increased by 12% to R1.1bn in F10. A policyholder bonus of R954m was transferred to contingency policyholders, equating to a net surplus of 83% of combined premiums (F09: 64%).

Cells

A cell arrangement is governed by a contract between Guardrisk and a cell shareholder, which transfers the economic benefits and risks relating to insurance and investment activities to the cell shareholder. Cells are fully or partially capitalised by the client, through the acquisition of "A" ordinary shares. In terms of the "A" shareholders agreement, Guardrisk has a contractual right to call for additional capital in the event that solvency of the cell falls below the agreed minimum level. In determining a solvency benchmark for the cell, Guardrisk uses a risk based model that considers the underlying risk characteristics of the business, with underwriting risk modelled at a 99.5th percentile level of certainty. On this basis, cells that are adequately capitalised may withdraw a portion of their funds in the form of a dividend.

First party cell arrangements refer to the insurance of risks that relate to the cell owner's own business. The premium is charged upfront on an annual basis and the contract includes an aggregate claims limit, usually set at the total premium plus accumulated surpluses and capital in the cell. The company bears no underwriting or credit risk on first party cell arrangements. Guardrisk provided first party cell facilities to 32 clients in F10 (F09: 34), with associated GWP increasing by 11% to R797m for the year. The five largest first party cell owners together accounted for a stable 58% of GWP in F10 (F09: 57%).

In terms of third party cell arrangements, Guardrisk divides its operations into two sub-segments, which are managed under separate divisions. The affinity segment relates to cell facilities provided to corporate entities (mainly retailers) that sell ancillary insurance products alongside their primary product offering. The cell owner participates in a portion of the underwriting risk by writing the insurance business into the cell. The UMA segment includes business derived via underwriting agencies that wish to retain a portion of risk for their own accounts. This usually relates to more market-wide risks and, as such, is subject to a higher level of underwriting volatility. In terms of both third party cell structures, underwriting risk accrues to Guardrisk through direct participation in the reinsurance programme of the cells and/or where the underlying liabilities are to third parties and Guardrisk would ultimately be responsible for claims in the event that the cell owner was unable to meet its obligations to policyholders. Accordingly, it is important to consider the track record and financial soundness of each of the cells, which can have a direct impact on Guardrisk's profitability and capital requirements.

Including 11 new cell arrangements and net of 5 cancellations, Guardrisk operated close to 60 third party cell facilities in F10. In terms of gross premiums, there was an approximate 60/40 split between corporate and UMA owned cells respectively. The five largest cell owners accounted for a combined 42% of GWP in F10 (F09: 44%), indicating a fair degree of concentration risk. Retention levels vary substantially from one cell to the next, depending on the nature of the underlying risks and the extent to which cell owners have built up their own underwriting capacity. On average, the cell division's retention level increased marginally, to 61% from 58% in F09, primarily on the back of restructuring of one cell's reinsurance programme.

From a cell owner perspective, underwriting results are impacted by fees paid to Guardrisk, which bolsters profitability at the promoter level. Furthermore, Guardrisk's overall profitability is supported by diversification amongst the various cells. Following corrective measures that were implemented in F10, the average earned loss ratio for the ten largest third party cells decreased to 42% from 48% in F09. However, this was offset by a deterioration in claims experience in several smaller sized cells, with the overall earned loss ratio registering at a higher 39% from 35% previously. This nonetheless compared very favourably with the estimated industry average of around 68%, facilitated by Guardrisk's scientific underwriting approach and the large component of affinity business, which is not as sensitive to competitive pressures.

In total, 14 cells registered underwriting losses in F10, with the combined deficit of loss making cells amounting to R43m (F09: R33m). The actuarial division is working on various measures to restore these books to profitability in the near term.

Competitive positioning

Table 2: Peer comparison – IFRS (R'm)	Centriq*	Guardrisk
GWP	1,953.7	3,027.4
NWP	488.3	1,537.6
NPAT**	33.4	51.1
S/h funds	183.4	120.5
Key ratios (%)		
GWP growth	9.2	22.0
Statutory solvency margin	32.9	32.0
Claims cash cover (months)	34.5	25.2

*Year ended December 2009.
**Including unrealised movements.

The strong growth in direct business saw Guardrisk's share of the cell captive sub-segment increase substantially, to 50% of NWP in F10, from 41% in F09. Following robust volume growth, Guardrisk's statutory solvency margin decreased to 32% from an atypically high 43% in the previous year, and was in line with that of its competitor (regulatory minimum: 15%). Both companies continued to reflect liquidity levels that were well above the industry average.

Reinsurance

Guardrisk arranges appropriate reinsurance cover for all of the third party cells, to ensure that cell owners are not retaining risks in excess of their available capacity. The third party reinsurance programme was placed with 18 insurance and reinsurance counterparties in 2010, all of which had a minimum international rating (or GCR domestic currency rating in the case of local insurance companies) of A-.

In terms of its own risk assumption, Guardrisk uses XOL treaties to protect its net account, which are placed with Africa Re and Hannover Re. The highest net retention amounts to R1m per risk and R1.5m per event on third party business, and to R2m per risk on direct business written (1.7% of FYE10 shareholders funds).

Asset management

Table 3: Investment portfolio	F08		F09	
	R'm	%	R'm	%
Cash & equiv	***2,839.0***	***84.4***	***3,025.0***	***85.2***
Preference shares	390.6	11.6	374.7	10.6
Unit trusts	127.3	3.8	143.9	4.1
Unlisted equities & subsidiary	8.5	0.3	6.8	0.2
Total investments	**3,365.5**	**100.0**	**3,550.4**	**100.0**

Funds backing the "A" shareholders' capital are invested in accordance with a mandate provided by the cell owner, which indemnifies Guardrisk from responsibility for adverse market movements. The investment portfolio primarily comprises cash and money market instruments, 96% of which were placed with the five largest South African banks at FYE10. Cash and equivalents covered cell owners' capital and policyholder liabilities 0.8x at FYE10 (unchanged from FYE09). Excluding amounts due to cell owners, the claims cash coverage ratio increased to 25 months from 21 months in F09.

Solvency

Cell captive business differs from traditional insurance, as the surplus capital held by the cell owners is not intended to be used to fund business written by other cells or at the promoter level. Accordingly, each of the cells needs to be adequately capitalised on a standalone basis. When cells do not have adequate surplus funds relative to the internal benchmark solvency level, Guardrisk needs to hold these funds on its own balance sheet. Furthermore, Guardrisk accepts risk for its own account (promoter) by providing an excess layer of protection to contingency policyholders, by participating on a share of the proportional reinsurance programmes of third party cells and by underwriting business directly. Guardrisk uses a risk based capital model to determine the appropriate level of capital to be held at the promoter level, which is actively used in the business to guide management decisions. The model provides for underwriting risk accruing from third party and promoter risks respectively (99.5% level of sufficiency). Credit risk factors are built into the model to account for potential reinsurance failure and the possibility of cell owners defaulting on their obligations to maintain the required risk based solvency level. The model also includes a market risk component and an estimate for catastrophe risk, which management believes is fairly conservative in light of the current reinsurance programme. These two risk components are built into the capital allocation for each business line.

Table 4: Risk based capital requirement (R'm)	
Mining rehabilitation	8.4
Promoter	23.1
First party	2.2
Operational risk	12.6
Standalone total	**46.3**
Correlation adj.	(9.2)
Third party shortfall	20.5
Capital req'm	**57.6**

Guardrisk has retained a greater portion of profits over the past two years, with cash distributions to shareholders largely being in the form of holding company loans. This has supported a strengthening in shareholders funds, to R121m at FYE10 from a review period low of R25m at FYE08. The internally calculated risk based capital requirement increased to R57.6m from R53.8m in F09, which was attributed to the inclusion of the new direct UMA book, which is subject to a degree of underwriting volatility. As at FYE10, shareholders funds covered the risk based capital requirement 2.1x. Excluding holding company loans of R60m at FYE10, core capital covered the risk based capital requirement 1.1x (F09: 0.7x). Subsequent to year-end, Guardrisk paid a dividend of R39m. R28m of this amount was offset against the holding company loan, which decreased to R32m at the end of August F11. The risk based solvency requirement was stable, at R57.6m, with core capital covering this amount 1.3x and total capital coverage amounting to 1.9x as at August F11. These coverage ratios remain above the levels that GCR regards as appropriate for the current rating.

The statutory solvency margin includes cell owners' capital (net of technical reserves) and is calculated against total net written premiums, before notional reinsurance outwards relating to third party cells. Statutory net surplus assets decreased by 7% to R871m in F09, as a result of an increase in insurance liabilities. Furthermore, strong top line growth and an increase in average retention (relating to the higher weighting of direct business) saw statutory NWP rise by 27% to R2.7bn. As such, the statutory solvency margin declined to 32% from 43% in F09. Going forward, Guardrisk does not expect statutory solvency to fall below 30%, which is twice the minimum regulatory level of 15%.

Financial performance

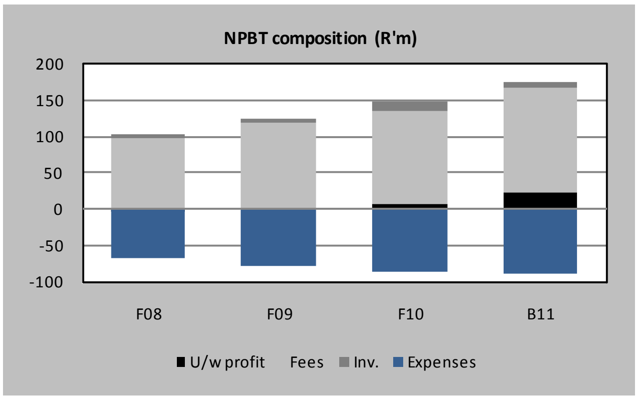
A 5 year synopsis of Guardrisk's IFRS results is reflected at the back of this report. However, cognisance is taken of the distortions that arise as a result of the notional reinsurance transactions relating to third party cells. Table 5 provides a summary of the promoter account, which excludes line items that accrue to the cell owners.

Table 5: Promoter F09 (R'm)	**Actual F09**	**F10**		**Actual F10 as % of budget**
		Actual	**Budget**	
GWP - statutory	***3,199.9***	***3,825.8***	***3,385.6***	***113.0***
U/w result	4.1	8.5	13.7	61.9
Fee income	115.2	128.8	135.1	95.3
Inv income*	6.3	11.1	6.0	185.1
Total income	**125.6**	**148.4**	**154.9**	**95.8**
Expenses	(76.8)	(82.9)	(85.1)	97.5
NPBT	**48.8**	**65.4**	**69.7**	**93.8**

*Including unrealised investment movements.

On the back of strong growth in direct business written, statutory GWP increased by 20% to R3.8bn and exceeded budget by 13%. However, underwriting performance was adversely impacted by lower underwriting profits in two books of business where Guardrisk participates in a portion of the risk. As such, the underwriting profit of R8.5m equated to only 62% of expectations for the year. Fee income rose by 12% to R129m in F10, although lagged expectations as a result of slower than expected growth in cell business. This was offset by solid investment income of R11m, which was bolstered by comparatively favourable yields on longer term money market instruments. After accounting for an 8% rise in management expenses (56% of total income versus 61% in F09), NPBT advanced by 34% to R65m in F10.

The stability of Guardrisk's after tax profits is attributed to the large component of fee income, which has increased gradually along with higher business volumes. Going forward, the greater proportion of direct business is expected to increase Guardrisk's exposure to underwriting risk. However, cognisance is taken of the diversified nature of the new commercial lines portfolio and the low degree of correlation with the insurer's traditional business lines. This is ultimately expected to have a favourable impact on the risk based capital requirement.



Future prospects

Guardrisk concluded new agreements with several cell owners in early F11. However, in light of the subdued economic environment and associated impact on corporate profits, premium volumes in the cell division are likely to be relatively stable in the near term. New direct business is expected to underpin 7% growth in statutory gross premiums, to R4.1bn in F11. Fee income is forecast to increase by 12% to R144m in F11. Furthermore, the corrective measures implemented in the cell division and the contribution of profits from new business are expected to underpin a marked increase in the underwriting profit, which is budgeted at R25m versus R8.5m in the previous year. However, lower average interest rates are expected to feed through in F11, reducing investment income to R7m from R11m in F10. Management expenses are forecast at a well contained R87m (49% of total income versus 56% in F10), with NPBT budgeted to increase by 37% to R89m for the year.

Table 6: Promoter (R'm)	**Actual 4 mnths to July F11**	**Forecast full year F11**	**Actual YTD as % of full year budget**
GWP - statutory	***1,490.6***	***4,080.4***	***36.5***
U/w result	6.9	24.6	27.8
Fee income	49.4	144.2	34.3
Inv income*	3.7	7.0	52.5
Total income	**59.9**	**175.8**	**34.1**
Expenses	(33.5)	(86.6)	38.7
NPBT	**26.4**	**89.3**	**29.6**

*Including unrealised investment movements.

Actual results for the first four months of F11 indicate that the insurer is reasonably on track relative to full year projections.

Guardrisk Insurance Company Limited

(R in Millions except as noted)

Year ended : 31 March		2006	2007	2008	2009	2010
Income Statement						
Gross written premiums (GWP)		1,752.0	2,217.8	2,378.2	2,481.4	3,027.4
Reinsurance premiums		(904.4)	(1,032.5)	(1,104.0)	(1,401.3)	(1,489.8)
Net written premiums (NWP)		**847.6**	**1,185.3**	**1,274.3**	**1,080.1**	**1,537.6**
(Increase) / Decrease in insurance funds		50.1	(204.3)	(124.8)	(158.7)	(141.9)
Net premiums earned		**897.7**	**981.0**	**1,149.5**	**921.3**	**1,395.7**
Claims incurred		(198.0)	(264.1)	(438.2)	(528.2)	(500.7)
Commission		145.1	118.2	143.7	174.1	28.6
Management expenses / performance bonus		(70.9)	(75.6)	(84.6)	(97.7)	(111.5)
Underwriting profit / (loss)		**773.9**	**759.6**	**770.5**	**469.5**	**812.0**
Policyholder bonus		(847.2)	(856.8)	(905.7)	(652.5)	(954.4)
Investment income		143.6	195.4	271.5	360.3	280.5
Fee income		37.6	44.7	59.0	71.5	77.5
Fair value adjustment - financial liabilities		(98.1)	(118.6)	(159.2)	(204.7)	(159.8)
Taxation		(5.6)	(3.2)	(6.8)	(4.0)	(14.4)
Net income after tax		**4.2**	**21.2**	**29.3**	**40.2**	**41.4**
Dividends		(24.0)	(24.0)	(53.5)	0.0	0.0
Unrealised gains / (losses)		21.0	3.3	3.7	4.8	9.7
Cash Flow Statement						
Cash generated by operations		(216.5)	76.7	192.8	157.9	182.0
Cash flow from investment income		143.6	195.6	271.5	361.4	272.6
Working capital decrease / (increase)		(28.5)	(6.4)	(136.0)	(237.6)	(175.3)
Tax paid		(83.9)	(74.8)	(79.7)	(93.5)	(120.9)
Cash available from operating activities		**(185.3)**	**191.1**	**248.6**	**188.2**	**158.4**
Dividends paid		(23.9)	(24.0)	(53.5)	0.0	0.0
Cash flow from operating activities		**(209.2)**	**167.1**	**195.1**	**188.2**	**158.4**
Cash flow from investing activities		**(669.2)**	**416.7**	**(2.4)**	**159.9**	**16.9**
Cash flow from financing activities		**379.9**	**393.6**	**(41.4)**	**108.2**	**10.6**
Net cash inflow / (outflow)		**(498.6)**	**977.5**	**151.4**	**456.3**	**185.9**
Balance Sheet						
Shareholders interest		**46.5**	**46.8**	**25.1**	**70.0**	**120.5**
'A' Shareholders interest		0.0	1,666.0	1,700.8	1,904.6	1,975.2
Net unearned premium reserve		564.6	768.9	893.7	1,052.5	1,194.4
Net outstanding claims and IBNR		219.7	262.4	405.8	514.7	614.1
Other liabilities		1,620.8	280.6	242.9	153.5	106.7
Total capital & liabilities		**2,451.6**	**3,024.6**	**3,268.3**	**3,695.3**	**4,010.9**
Fixed assets		1.0	0.8	1.0	0.9	0.8
Investments		1,092.7	679.6	683.7	526.5	525.4
Cash and short term deposits		1,254.6	2,231.3	2,382.8	2,839.0	3,025.0
Other current assets		103.2	112.9	200.9	328.9	459.7
Total assets		**2,451.6**	**3,024.6**	**3,268.3**	**3,695.3**	**4,010.9**
Key Ratios						
Solvency / Liquidity						
Shareholders funds / NWP*	%	5.5	4.0	135.4	182.8	136.3
Solvency margin (Act)	%	28.8	30.9	32.9	43.0	32.0
Cash flow from operating activities / Liabilities	%	(19.7)	12.7	12.7	10.9	8.3
Claims cash coverage	mths	n.a.	25.7	18.7	21.2	25.2
Profitability						
ROaE (before unrealised gains / losses)	%	n.a.	45.4	81.4	84.4	43.5
ROaE (after unrealised gains / losses)	%	n.a.	52.4	91.8	94.4	53.6
Investment yield (including unrealised gains / losses)	%	n.a.	7.6	9.2	11.4	8.4
Investment yield (excluding unrealised gains / losses)	%	n.a.	7.4	9.1	11.2	8.1
Efficiency / Growth						
GWP growth	%	(16.5)	n.a.	7.2	4.3	22.0
Premiums reinsured / GWP	%	51.6	46.6	46.4	56.5	49.2
Earned loss ratio	%	22.1	26.9	38.1	57.3	35.9
Commissions / Earned premiums	%	(16.2)	(12.1)	(12.5)	(18.9)	(2.0)
Management expenses / Earned premiums	%	7.9	7.7	7.4	10.6	8.0
Underwriting result / Earned premium	%	86.2	77.4	67.0	51.0	58.2
Operating						
Effective tax rate	%	57.2	13.0	18.9	9.0	25.7
Dividend cover	X	1.1	1.0	0.5	n.a.	n.a.

*Total capital (including cell owners' capital) / IFRS net written premiums.