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Centriq Insurance Company Limited

South Africa Insurance Analysis — **September 2010**

Security class	Rating scale	Currency	Rating	Rating watch	Expiry date
Claims paying ability	National	Rand	A+	No	07/2011

Financial data:

(US$'m Comparative)

	31/12/08	31/12/09
R/US$ (avg.)	8.28	8.44
R/US$ (close)	9.46	7.42
Total assets	290.4	350.1
Total capital	18.5	24.7
Cash & equiv.	193.8	265.4
GWP	216.2	231.5
U/w result	-1.6	1.2
NPAT	3.8	5.8
Op. cash flow	19.2	16.3
Market cap	n.a.	
Market share*	23.0%	

*Based on FSB statistics relating to total cell captive NWP for calendar year 2009.

Fundamentals:

Centriq Insurance Company Limited ("Centriq") specialises in alternative risk financing solutions and provision of underwriting facilities through a UMA partnership model. This is mostly achieved through contingency policies and cell captive facilities respectively. The insurer is a wholly owned subsidiary of Centriq Insurance Holdings Limited. Following the acquisition of the outstanding 33% shareholding in early 2010, Santam now owns 100% of the Centriq group.

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Rating rationale

The rating is based on the following key factors:

- Centriq's position as a top tier player in the cell captive and alternative risk transfer space was considered. Furthermore, the reinsurance capacity provided by Santam is expected to sustain growth in its targeted market segment going forward.
- The company has been consistently profitable at the promoter level, supported by a large component of fee-based income and selective participation in underwriting risk.
- Cognisance was taken of the insurer's highly conservative investment approach and sound liquidity levels.
- Centriq has implemented a tiered approach to promoter solvency, with capital to be allocated based on the risk characteristics of underlying portfolios of business. Including the draw down facility from Santam, promoter solvency is expected to remain adequate, albeit below historical levels.
- The company is exposed to solvency and credit risk relating to its third party sponsored cells, with the aggregate shortfall of undercapitalised cells amounting to R33m at 1H F10 (net of collateral). Note is, however, taken of the corrective measures implemented by management, including a call for capital injections from certain cell owners and the more stringent imposition of solvency fees.
- Centriq plans to increase its participation in the underwriting performance of certain cells going forward. While this will take place selectively, it does increase the insurer's exposure to earnings volatility, particularly in the currently challenging operating environment.

Solvency & liquidity

Statutory net surplus assets increased by 44% to R405m at FYE09, on the back of improved profitability at the cell and promoter level. Accordingly, the statutory solvency ratio increased to 33% from 23% in F08. Shareholders funds covered the internally calculated promoter capital requirement a stable 1.7x at FYE09, although this is expected to decline below historical levels in the near term. In this regard, promoter capital will be supplemented by a R20m draw down facility from Santam. Reinsurance is arranged on a case by case basis, bringing Centriq's highest net retention per risk and event below R2m (1% of FYE09 capital) as at August 2010.

Business mix

Table 1: Business mix	F07		F08		F09	
	R'm	%	R'm	%	R'm	%
Cells	862.8	63.1	1,532.9	83.1	1,424.8	64.8
Conting.	469.1	34.3	187.7	10.2	485.2	22.1
MiWay	0.0	0.0	74.1	4.0	238.3	10.8
Direct	35.4	2.6	49.5	2.7	49.3	2.2
GWP - stat	**1,367.3**	**100.0**	**1,844.2**	**100.0**	**2,197.6**	**100.0**

Centriq specialises in the provision of cell captive facilities and alternative risk transfer ("ART") vehicles, with the latter mainly comprising contingency policies. Following a large premium rebate in F08 relating to a discontinued arrangement, premiums derived from contingency policies stabilised at R485m in F09. Furthermore, strong growth in the MiWay book and the cancellation of a few relatively large cell facilities saw the cell division's contribution to total revenue decrease to 65% from an average of 75% in the prior two years. Notwithstanding, the cell captive division is expected to increase in prominence going forward, in view of certain growth opportunities in the UMA segment The MiWay book began to operate under its own licence from 2H F10. This book was previously 100% reinsured with Santam, and as such, the cancellation will not have any impact on the risk premium base.

In the case of contingency policies, clients are usually corporate entities who wish to self-insure part of their risk exposure (first party risks), and the underlying insured risks usually have a high degree of predictability. For example, this type of structure is often used to cover the aggregate deductibles on a company's primary insurance programme, which are defined in terms of the respective insurance policies. As such, pricing can be determined fairly accurately, and the contract is structured in such a way that there is a remote chance of breaching the total premium or accumulated reserves over the period of the contract.

In terms of the cell captive business, Centriq divides its operations into two business channels, which are managed separately. The largest business channel relates to UMA derived business, where Centriq requires most of its UMA partners to operate a third party cell facility, ensuring that the UMAs' interests are aligned with those of Centriq and other reinsurance providers. In terms of these cell structures, Centriq sometimes chooses to participate in the reinsurance programme of the cells, which exposes the company to underwriting risk. The other type of cell arrangement relates to affinity business. In this instance, cell facilities are provided to business partners that sell complementary insurance products alongside their primary product offering, and the business partners choose to participate in all or a portion of the underwriting risk. Centriq is not directly exposed to underwriting risk in terms of these arrangements. However, with regard to both of the cell structures, the underlying liabilities are to third parties and Centriq 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 financial soundness of each of the cells and the cell owners in managing credit risk.

The number of active cell facilities was relatively stable, at 32 in F09, including new arrangements with four very small cells. Aside from two large cells, most of Centriq's key clients are UMAs that offer traditional insurance products to third parties. The proportion of GWP relating to UMA owned cells increased to 72% in F09 (F08: 67%), on the back of the inclusion of a full year of premiums from one large book (previously only 9 months were included) and strong organic growth in this cell. Gross premiums relating to the five largest cell arrangements increased to a combined 64% from 54% in F08, implying a higher degree of client concentration. This was partly attributed to the fact that three fairly sizeable cells were in run-off during the year, with their GWP reducing to 7% of segmental revenue, from almost 20% in F08 (F07: 40%). Going forward, the company is planning to adopt a more selective approach to new business, with emphasis placed on organic growth and reducing exposure to under-performing cells. Accordingly, further consolidation is expected in the cell division client base in F10.

The average earned loss ratio for the cell division decreased from 62% in F08 to 54% in F09. However, cognisance is taken of the impact of large reserve releases in three cells that were in run-off. Excluding these cells, the earned loss ratio amounted to 59% for the year (F08: 61%), while the underwriting profit registered at R84m, versus R80m in F08. The consolidated underwriting profit in 1H F10 was roughly in line with F09 levels in relative terms, supported by two corporate accounts, as well as improved performance in three UMA books.

In total, 12 clients registered underwriting losses in F09, although the combined deficit of loss making cells decreased to R11m from R20m in F08 (1H F10: R12.5m). Centriq cancelled its arrangement with one loss making cell in 2H F10, following successive underwriting losses.

Competitive positioning

The following table compares some of the key performance measures of Centriq with those of Guardrisk, the market leader in the cell captive segment. Notwithstanding the slowdown in growth in F09, Centriq increased its market share slightly, to 23% of cell captive NWP (F08: 22%). The insurer reflected solid net profitability and sound credit protection measures relative its competitor in F09. However, the capital rationalisation exercise that is expected to take place in F10 is likely to drive a reduction in Centriq's solvency ratios going forward.

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 March 2010.
**Including unrealised movements.

Asset management

The preference shareholders' funds are largely invested in liquid assets, to limit counterparty and market risk and ensure that Centriq would be able to meet its obligations to the preference shareholders in the event that they cancelled their contracts. Following the sale of investments in preference shares and debt securities (combined value of R66m in F08), the promoter investment portfolio was also exclusively invested in liquid investments at FYE09. Cash and equivalents covered policyholder and preference shareholder liabilities 1.1x at FYE09 (roughly unchanged from F08). Excluding cash held on behalf of preference shareholders, the claims cash coverage ratio amounted to a comfortable 35 months in F09 (F08: 31 months). More than 99% of liquid funds were placed with the five largest South African banks at FYE09.

Solvency

The cell owners' consolidated international solvency margin strengthened to 60% from 43% in F08, on the back of a R98m increase in cell owners' capital (largely underpinned by retained income of R70m). However, cell captive business differs from traditional insurance, as the capital held by the cell owners is not intended to be used to cross-subsidise the risks written into other cells or at the promoter level. As such, it is assumed that each cell needs to be solvent on a standalone basis. In the absence of an approved risk based assessment of economic capital requirements, it is prudent to assume that each cell should hold the minimum regulatory requirement of 25% of NWP.

Centriq is exposed to solvency strain when a cell owner is undercapitalised relative to the 25% benchmark ratio, in which case Centriq needs to allocate the shortfall in capital from its promoter capital pool. The insurer is also exposed to credit risk when the cell is in a net liability position and Centriq would be unable to recover amounts due from the cell owner in the event of insolvency. The capital shortfall decreased significantly in F09, albeit mainly as a result of the cancellation of one cell, which had a shortfall of R21m at FYE08. In an effort to encourage further improvements in capitalisation levels within the cells, Centriq has called for capital injections from certain cell owners and begun to impose penalties more stringently in 2H F10. Solvency fees are charged on the capital shortfall at a percentage that roughly matches the company's targeted return on equity of around 20%.

Table 3: Capital shortfall – cells (R'm)	F08	F09	1H F10
Total	**91.9**	**69.1**	**57.6**
Total net of collateral	**n.a.**	**40.5**	**33.1**

In early F10, Santam acquired Kagiso Risk Solutions' 33% stake in the Centriq group, to increase its effective shareholding in Centriq to 100%. A subsequent review of capital efficiency has resulted in Centriq adopting a tiered solvency approach, with capital allocated according to the nature of risks in the respective business lines. The underwriting risk relating to contingency business is considered remote and the company is of the view that a solvency ratio of between 5% and 7.5% of GWP is adequate for this type of business. In terms of risk accepted for Centriq's own account (comprising risk participation on cell business and direct business) a solvency margin of 25% is viewed as appropriate. Including solvency support provided to under-capitalised cells (net of collateral), the F09 promoter capital requirement would amount to approximately R108m, which was covered 1.7x by shareholders funds. The insurer paid a special dividend of R58m in 2H F10 and ultimately aims to reduce capital to between 15% and 20% of promoter NWP. Assuming similar business volumes in terms of risk acceptance and contingency policies, this implies a reduction in shareholders funds to approximately R90m. However, capital will be supplemented by a draw-down facility of R20m from Santam. Centriq will have access to these funds if growth in risk assumption exceeds expectations or if one large client withdraws its funds. Including this amount, capital would cover the promoter solvency requirement approximately 1.1x in F10.

Table 4: Promoter solvency (R'm)	F09
Contingency policies	36.4
Risk assumption	30.6
Cell shortfall	40.5
Capital requirement	**107.5**
Promoter solvency	*1.7x*

The statutory solvency ratio includes cell owner's capital (net of related technical reserves) and is calculated against total net written premiums, before notional reinsurance outwards relating to the cells. Statutory net surplus assets increased by R124m to

R405m at FYE09, on the back of a R90m increase in preference shareholders' capital (largely profit driven). This underpinned a noticeable strengthening in the statutory solvency margin, to 33% from 23% in F08. Going forward, the insurer aims to maintain statutory solvency between 25% and 35%.

Reinsurance

Centriq participates selectively on the proportional reinsurance programmes of certain cells. XOL cover is usually purchased to protect Centriq and the cell owner, with the limits aligned with both parties' combined proportional retention. On this basis, the highest net retention is R2m per risk, with Centriq's share decreasing to less than R1m in most cases. The company has in the past been exposed to certain high value risks that were placed facultatively by one UMA. The largest related to a commercial property that had a gross sum insured of R2bn. Notwithstanding the credit quality of the facultative insurers (ACE, Chartis and Lloyd's syndicates), Centriq has discontinued this type of arrangement, given the associated operational and liquidity risk. The insurer is in the process of formulating a risk appetite framework, and gross exposures will in most instances be managed in line with the treaty limits going forward.

Centriq only places reinsurance with counterparties (or groups) that have a minimum international rating of A-. Furthermore, the insurer is able to leverage off Santam's large balance sheet, and places a substantial portion of its reinsurance with the holding company. This should assist in supporting ongoing growth in the longer term.

Financial performance

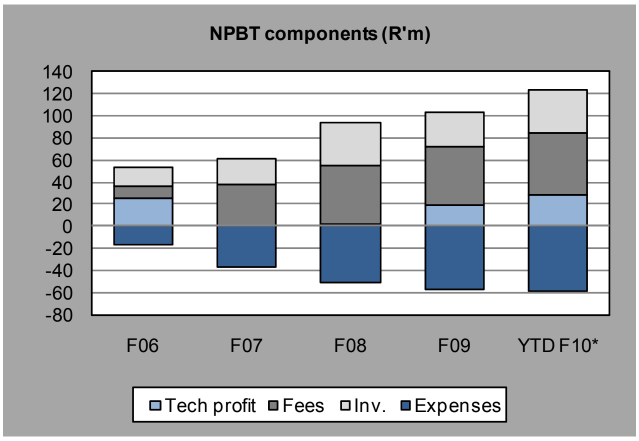
A 5 year synopsis of Centriq's financial performance (IFRS format) is reflected at the back of this report. However, cognisance is taken of the distortions that arise as a result of the notional reinsurance transactions relating to third party cells. Table 5 provides a summary of profitability in the promoter format (excluding amounts accruing to cell owners), with brief commentary following below.

Table 5: Promoter (R'm)	F08 Actual**	F09		
		Actual	Budget	% of budget
GWP - statutory	***1,844.3***	***2,197.6***	***2,396.6***	***91.7***
Technical result	2.4	18.7	13.7	136.5
Fee income	52.0	52.8	53.1	99.3
Inv. Income*	39.0	31.5	30.0	105.0
Total income	**93.3**	**103.0**	**96.8**	**106.3**
Expenses	(51.0)	(57.5)	(63.3)	90.9
Tax	(11.6)	(11.9)	(9.4)	126.7
NPAT	**30.7**	**33.5**	**24.1**	**138.9**

*Including unrealised investment movements.
**After management account adjustments made subsequent to year end.

Statutory GWP increased by 19% to R2.2bn in F09. However, this included R238m in premiums from MiWay (fully reinsured back to Santam), which began to operate under its own licence from 2H F10. Excluding the MiWay business, gross premium growth softened to 11% (F08: 29%), following consolidation in the third party cell business.

The technical profit increased substantially, to R19m from R2m in F08, and exceeded budget by 37%. Note is, however, taken of the impact of reserve releases posted by cells that were in run-off in F09. Furthermore, the insurer derived a non-recurring administration fee of R2.8m from MiWay in F09, which was captured as a technical profit. Following relatively flat volumes in the core business lines, fee income remained stable at R53m, and was in line with expectations for the year. Net of a R15m fair value loss (realised on the sale of preference shares), investment income declined to R32m from R39m in F08, albeit on par with budget. Overall, shareholders earnings increased by 9% to R34m (including unrealised gains), translating into a stable ROaE of 19% in F09.



Centriq's net profitability has been supported by a stable component of fee income and interest driven investment returns. However, note is taken of the more prominent role of underwriting profits recently, which could introduce a higher degree of earnings volatility. In particular, Centriq plans to increase its participation in the underwriting performance of certain third party cells, which would have a direct impact on promoter profits.

Future prospects

Going forward, Centriq views the UMA segment as a strong potential growth area, in view of the more stringent compliance regulations and solvency regime, which will make it difficult to run this business model without advanced systems capabilities. The insurer aims to strengthen its relationships with key clients by acquiring minority shareholdings in profitable UMAs, which will also assist in standardising reporting and information systems. The company has restructured its operations to consolidate each product line into specialist business units. This should enhance risk management in each of the business lines, and is viewed as an integral part of Centriq's capital allocation model.

Table 6: Promoter (R'm)	**Actual 5 mnths to May F10**	**Budget full year F10**	**Actual YTD as % of full year budget**
GWP - statutory	***988.8***	***2,472.5***	***40.0***
Technical result	11.7	13.3	87.6
Fee income	23.1	66.8	34.6
Inv income*	16.4	19.7	83.7
Total income	**51.2**	**99.7**	**51.3**
Expenses	(24.0)	(67.0)	35.8
Tax	(7.7)	(10.6)	72.2
NPAT	**19.5**	**22.1**	**88.5**

*Including unrealised investment movements.

Actual performance for the five months to May F10 was ahead of budget in proportional terms. This was supported by further technical reserve releases, as well as solid investment income. Accordingly, after tax profits of R20m equated to 89% of expectations for the full year.

Centriq Insurance Company Limited

(R in Millions except as noted)

Year ended : 31 December		2005	2006	2007	2008	2009
Income Statement						
Gross written premium (GWP)		807.1	937.7	1,312.4	1,788.7	1,953.7
Reinsurance premiums		(293.8)	(492.8)	(838.3)	(1,364.7)	(1,465.3)
Net written premium (NWP)		513.3	444.9	474.2	424.0	488.3
(Increase) / Decrease in insurance funds		(295.1)	(158.5)	68.0	62.2	(2.5)
Net premiums earned		**218.2**	**286.4**	**542.2**	**486.2**	**485.8**
Claims incurred		(142.7)	(190.2)	(441.9)	(412.4)	(384.8)
Commission		(24.5)	(15.5)	(18.7)	(34.6)	(42.1)
Management expenses		(46.3)	(73.7)	(82.4)	(52.4)	(48.8)
Underwriting profit / (loss)		**4.7**	**7.0**	**(0.9)**	**(13.2)**	**10.1**
Policyholder bonus		(48.7)	(72.8)	(86.9)	(110.3)	(37.8)
Investment income*		92.8	111.6	144.1	226.5	145.1
Fair value adjustment - preference share capital		n.a.	0.0	(29.0)	(61.2)	(56.7)
Fee income		(4.0)	11.7	3.1	0.6	0.0
Taxation		(12.8)	(8.3)	(6.3)	(11.1)	(12.0)
Net income after tax		**32.0**	**49.2**	**24.1**	**31.3**	**48.7**
Dividend paid		0.0	0.0	(16.0)	0.0	0.0
Fair value adjustements - investments		(10.4)	(9.4)	(4.3)	(1.7)	(15.2)
Cash Flow Statement						
Cash generated by operations		92.1	(64.0)	(117.0)	(131.6)	(133.4)
Cash flow from investment income		448.0	100.3	152.4	173.4	180.8
Working capital decrease / (increase)		327.4	289.9	121.8	142.2	58.4
Tax paid		(21.5)	(16.4)	(24.7)	(24.7)	31.9
Cash available from operating activities		**846.1**	**309.8**	**132.5**	**159.3**	**137.7**
Dividends paid		295.6	0.0	(16.0)	0.0	(25.0)
Cash flow from operating activities		**1,141.7**	**309.8**	**116.5**	**159.3**	**112.7**
Cash flow from investing activities		**(66.5)**	**124.2**	**23.8**	**52.0**	**63.9**
Cash flow from financing activities		**0.0**	**(59.7)**	**63.9**	**(99.5)**	**(43.0)**
Net cash inflow / (outflow)		**1,075.2**	**374.2**	**204.1**	**111.8**	**133.6**
Balance Sheet						
Shareholders interest		**115.8**	**143.7**	**146.0**	**175.0**	**183.4**
Preference shares/cell owners' capital		199.6	271.4	504.6	770.6	860.9
Holding company loans		68.0	31.1	0.0	0.0	0.0
Net outstanding claims reserve		0.2	(3.4)	63.5	71.6	75.1
Net unearned premium reserve		898.1	1,056.6	986.6	928.1	930.6
Other liabilities		160.3	238.4	501.6	803.1	546.5
Total capital & liabilities		**1,442.1**	**1,737.7**	**2,202.3**	**2,748.4**	**2,596.4**
Fixed assets		0.0	0.0	0.2	1.2	1.8
Investments		275.9	151.7	121.7	69.1	0.0
Cash and short term deposits		1,124.9	1,518.3	1,722.5	1,834.7	1,968.3
Other assets		41.3	67.7	357.9	843.4	626.3
Total assets		**1,442.1**	**1,737.7**	**2,202.3**	**2,748.4**	**2,596.4**
Key Ratios						
Solvency / Liquidity						
Statutory solvency ratio	%	30.3	25.7	28.7	23.3	32.9
Total capital / NWP	%	61.4	93.3	137.2	223.0	213.8
Shareholders funds / NWP	%	22.6	32.3	30.8	41.3	37.5
Cash claims coverage**	mth	77.8	78.7	33.1	31.0	34.5
Avg premium debtors days	days	n.a.	24.0	19.2	50.2	55.2
Profitability						
ROaE (before unrealised gains / losses)	%	30.5	68.4	16.7	19.5	27.2
ROaE (after unrealised gains / losses)	%	20.6	55.4	13.7	18.5	18.7
Investment yield (including unrealised gains / losses)	%	n.a.	13.4	8.2	12.1	7.5
Efficiency / Growth						
GWP Growth	%	n.a.	16.2	40.0	36.3	9.2
Premiums reinsured / GWP	%	36.4	52.6	63.9	76.3	75.0
Earned loss ratio	%	65.4	66.4	81.5	84.8	79.2
Commissions / Earned premiums	%	11.2	5.4	3.5	7.1	8.7
Management expenses / Earned premiums	%	21.2	25.7	15.2	10.8	10.1
Underwriting result / Earned premium	%	2.1	2.4	(0.2)	(2.7)	2.1
Trade ratio	%	97.9	97.6	100.2	102.7	97.9

*Including foreign exchange movements.

**Excluding preference share capital.