

Lion of Africa Insurance Company Limited

South Africa Insurance Analysis

March 2008

Security class	Rating scale	Currency	Rating	Rating watch	Expiry date
Claims paying ability	National	Rand	A	No	03/2009
Long term subordinated debt	National	Rand	BBB	No	03/2009

Financial data:

(US\$m Comparative)

	31/12/06	31/12/07
R/US\$ (avg)	6.79	7.07
R/US\$ (close)	7.06	6.85
Total assets	62.4	78.3
Total capital	19.0	19.9
Cash & equiv.	33.9	36.1
GPI	92.6	109.0
U/w result	5.1	(3.2)
NPAT	5.4	(0.1)
Op. cash flow	7.8	1.0

Market cap n.a.

Market share* 1.6

*Estimated share of market GPI in 2006.

Fundamentals:

Lion of Africa Insurance Company Limited ("Lion") commenced operations as a short term insurance company in August 1999. It provides a variety of risk solutions, mainly to the commercial and corporate market, as well as the government sector. Lion is a wholly owned subsidiary of Lion of Africa Holdings (Pty) Limited, which in turn is 39% owned by Brimstone Investments Ltd, 35% by Santam Ltd and 26% by Comlife Holdings (Pty) Ltd.

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Rating rationale

The rating is based on the following key factors:

- Cognisance was taken of the letters of comfort provided to GCR by all three shareholders stating that they remain committed to providing financial and other support to Lion as and when required.
- The tier-I (R15m) and tier-II (R50m) capital injections made prior to year-end F07 increased solvency measures, although the statutory solvency ratio remains below the industry average.
- The insurer has in place a robust reinsurance programme, which is largely led by highly rated international counterparties. Furthermore, Lion has maintained a conservative investment portfolio, supportive of strong cash coverage ratios.
- Lion remains strategically well placed, given its position as one of the largest BEE accredited insurers.
- However, note was taken of the significant deterioration in underwriting profitability in F07. This was attributed to the run-off of a poorly performing book of UMA business (with essentially four policies remaining on-risk for the month of April 2008) and the loss of operating efficiency. This was compounded by the implementation of a new IT system, which presented a number of challenges, although these have subsequently been addressed.

Solvency & liquidity

Following a capital injection of R15m and the bond issue of R50m, total capital (including 75% of tier-II capital) increased by 29% to R173m at year-end F07. Combined with the significantly lower retention level, this supported an increase in the international solvency margin from 36% to 49% in F07. Likewise, the statutory funding ratio amounted to a noticeably improved 30% (F06: 22%). Reinsurance protection provides a further level of comfort, with high capacity limits and low retention. Given the large cash component of the investment portfolio, key liquidity measures remained sound, with the claims cash coverage ratio equating to 13 months in F07 (F06: 15 months).



Background

In the last quarter of 2007, GCR placed Lion's rating on rating watch, after the following concerns were raised:

Claims settlement

After a thorough due diligence (at a cost of R14m), the company awarded a five-year IT contract to SSP (previously known as CSC in South Africa), with related support provided out of the UK and through HP in South Africa. The total cost of the contract, which is GBP denominated, is partly hedged (30%, in respect of licence and maintenance fees). Lion migrated onto the new IT platform in April 2007, which resulted in a number of system difficulties. Of particular concern was the failure of automatic settlement of claims and creditor accounts via EFT transfers. When this issue was brought to Lion's attention, the insurer implemented manual procedures and hired additional contracted staff to alleviate the administrative burden. However, reputation damage has been suffered as a result of the delay in corrective action and lower service standards over this period.

The IT service provider (SSP) has corrected the EFT and claims payment issues and to date, management is not aware of any valid claims that have not been duly paid. GCR has perused claims settlement ratios for the months between March 2007 and May 2008, which show a consistently improving trend, whilst management confirms that the ratios are expected to increase sharply as staff become more proficient with the new IT system. Other IT issues have been or are being addressed and progress in this regard is being audited by KPMG and Deloitte. Two priority issues relating to security controls have not yet been corrected in the new system. A manual alert system has been instituted in the interim.

Underwriting performance

The insurer terminated its relationship with an underperforming UMA on 30 April 2007. When the account was in run-off it came to management's attention that the UMA had extended cover to an agency without Lion's knowledge. The agency built a motor book with high exposure to inexperienced drivers and sourced from the motor retail trade. This action was prohibited under the provisions of its contract. As a result of poor management by the agency, claims were still outstanding and provisions (and accordingly loss ratios) had been understated between September 2006 and April 2007. Accordingly, there were delays in settling these claims, while the actual loss ratio was noticeably higher than management initially anticipated. The UMA contributed around R21m to the underwriting

loss in F07. According to management, they intend instituting legal proceedings against this entity.

Solvency

The unexpectedly poor underwriting result led to concerns that Lion's solvency margin would be adversely impacted. The possible deterioration in solvency was, however, addressed with a capital injection, effected to alleviate stakeholder concerns. The insurer had attained a statutory funding ratio of 30% by the end of F07.

Efficiencies

The estimated total cost of implementing the IT system was revised upwards to R101m from R85m initially, including unforeseen expenses and the cost of second phase system enhancements (to take place in 2H F08). This cost will be expensed over five years beginning in F07, adding around R15m (net of amounts previously paid to Santam for IT services) to annual management expenses. Most temporary staff members have already left the business or will leave during F08, with no further costs of this nature anticipated. The management reporting (on a real time basis) and rating capabilities are expected to be significantly enhanced relative to the previous system that was used. In addition to being a large contributor to value uplift, the new system will also facilitate new product roll out for the company.

Earnings diversification

Lion primarily focuses on the commercial and corporate markets, which represented 51% and 26% of GPI respectively in F07. The remainder of business was sourced from the personal lines (at around 10%) and municipal buying segments. The insurer largely utilises brokers, with premium relatively well spread amongst the various intermediaries (top five accounted for 26% of GPI in F07).

Three UMAs wrote business on behalf of Lion in F07. One contract was discontinued effective 30 April 2007, with only four related policies remaining on Lion's books for the month of April 2008 (as well as unexpired liability risks). Only one UMA (specialising in engineering risks) will be retained in F08, given its history of highly profitable performance (underwriting profit of R12m in F07).

The motor class surpassed property as the largest contributor to GPI in F07, which was ascribed to strong consumer demand and the re-rating of existing business. However, in terms of risk premiums, this decreased to just 15% of NPI, from 41% previously, following increased use of quota share cover. Conversely, the retention levels for property and engineering increased and these accounts continued

to be the largest contributors to NPI, at a combined 57% in F07 (F06: 47%). The ART portion of business decreased to R7m (F06: R31m) and the reinsurer's outstanding liabilities (R42m at year-end F07) were paid subsequent to year-end F07.

	GPI		NPI		Retention	
	F06	F07	F06	F07	F06	F07
Property *	36.2	31.6	31.0	36.6	50.2	53.1
Transport	5.0	4.0	5.1	6.5	59.4	74.2
Motor *	29.8	32.6	41.4	15.1	81.5	21.1
Accident	2.2	10.5	3.1	17.6	83.5	76.5
Liability	2.4	2.1	3.9	3.7	93.8	81.3
Engineering	19.4	18.3	15.6	20.5	47.2	51.1
Misc.**	4.9	0.9	0.0	0.0	0.0	0.0
Total	100.0	100.0	100.0	100.0	58.7	45.8

* Includes personal lines

**Relates to ART business, which was fully reinsured in F07.

A significant deterioration in loss experience was evidenced in F07, with the overall earned loss ratio having increased by nine percentage points to 65%. In particular, the motor book was adversely impacted by higher claims volumes (estimated to have increased by 30%), exacerbated by the aforementioned difficulties with a UMA. Moreover, the earned loss ratio for the property account rose to 73%, which was attributed to four large fire claims.

	Earned loss ratio		Delivery cost ratio		U/w result (R'm)	
	F06	F07	F06	F07	F06	F07
Property	47.7	72.9	51.1	48.8	1.3	(27.0)
Transport	39.7	40.0	37.9	45.0	3.7	3.0
Motor	73.0	90.3	28.9	50.0	(2.9)	(29.7)
Accident	31.5	47.9	28.4	35.4	4.2	8.0
Guarantee*	(7.7)	-	(30.8)	-	(0.1)	0.0
Liability	9.0	23.1	35.2	38.5	7.1	5.0
Engineering	37.6	49.2	17.4	23.1	21.5	18.0
Misc.**	38.5	0.0	(438.5)	0.0	(0.1)	0.0
Total	55.1	64.5	34.9	42.0	34.8	(22.7)

*Runoff of discontinued business.

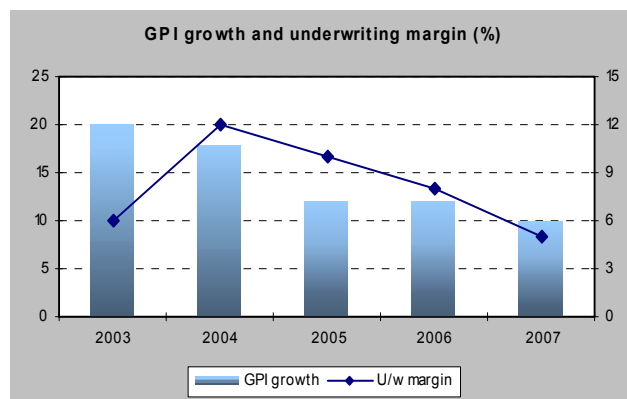
**Relates to ART business, which was fully reinsured in F07.

The company elected to hedge its exposure to the motor book at last renewal, entering into a 90/10 quota share treaty with Africa Re. Considering the worsening claims inflation scenarios, this is considered prudent. This significantly reduces the risk to the company, whilst retaining high exposure to more profitable classes of business (with the exception of personal lines - property).

The underwriting result was further eroded by the cost of implementing the IT system, which added around R15m to management expenses. Against relatively flat EPI, this resulted in a rise in the delivery cost ratio, to 42% (F06: 35%). Accordingly, most classes showed a weaker underwriting

performance, with property and motor in particular posting a combined underwriting loss of R57m in F07. Overall, despite the strong performances of the accident and engineering accounts, the insurer recorded an underwriting loss of R23m, versus a R35m profit in F06.

Competitive environment



The underwriting cycle has softened in recent years, with GPI growth estimated to have slowed further in 2007 to 10%, from 12% in 2006 (2003: 20%). This is ascribed to an intensification of competition, stemming from new entrants and increased pricing pressure. Softening rates have been accompanied by a deterioration in claims, as a result of volatile weather patterns and fundamental changes in motor claims volumes and costs. In this regard, the earned loss ratio is estimated to have risen to 66% in 2007 (2006: 64%), the highest level in four years. This has placed pressure on underwriting profitability, with the underwriting margin forecast at a lower 5% in 2007 from 8% previously, representing the third consecutive decline.

	Lion	Santam	M&F	Zurich
GPI	770	13,173	9,323	4,401
NPI	353	10,919	8,003	3,573
Total capital*	173.3	5,086	3,348	1,902
Ratios (%)				
GPI growth	22.5	8.7	9.1	12.5
Retention	45.8	82.9	85.8	81.2
Earned loss ratio	64.5	68.1	65.9	73.3
Delivery cost ratio	42.0	25.7	29.5	24.1
U/w margin	(6.5)	6.2	4.6	2.6
International solvency*	49.2	46.6	41.8	53.2
Cash cover (months)	13.2	5.7	2.6	7.3

*Including subordinated bonds.

The preceding table compares Lion's performance with that of some of the largest players in the corporate and commercial arenas. Lion's

underwriting performance was undermined by its high delivery cost structure and deterioration in claims, being the only one of its competitors to report an underwriting loss in F07. However, cognisance is taken of the fact that the international solvency margin was at least comparable with that of its competitors, whilst it maintained a stronger liquidity position.

Asset management

The investment portfolio is managed by Lion of Africa Capital Management. During F07, the insurer acquired unit trusts to the value of R50m (actively managed by Trident), comprising a mix of security classes (on a AA mandate). Despite the volatility in 1Q F08, the portfolio was valued at R54m at 28 March F08. The balance of the investment portfolio relates to preference shares (R26m) in the five largest South African banks. The value of cash holdings remained largely unchanged, at R248m at year-end F07. Notwithstanding the 17% increase in claims, the claims cash coverage ratio, at 13 months (F06: 15 months), remained comfortable.

Given the large cash component, the investment yield has largely been determined by prevailing interest rates and, accordingly, increased slightly to 7.5% in F07, from 6.9% previously.

Reinsurance

Lion's reinsurance programme is placed with a range of counterparties, with lead positions generally taken by Swiss Re and Munich Re, while Africa Re is the lead on the motor treaties. The fire surplus treaty provides high capacity limits, whilst facultative cover is in place in the event that the sum insured exceeds this level.

	F05	F06	F07
Premium ceded	(379.8)	(259.4)	(417.7)
Claims recovered	242.6	183.9	208.8
Commission recovered	67.1	53.8	77.6
Net profit / (loss)	(70.1)	(21.7)	(131.3)

Note: Cash basis, excluding provisions.

Following a 61% increase in premium cession, claims recovered rose by a comparatively low 14%, with the net transfer to reinsurers widening to R131m in F07 (F06: R22m). However, it is noted that given the large fire claims for the year, a sizeable portion of claims incurred is represented as an outstanding claims provision (R62m, which was fully covered by the reinsurers' share of provisions). Accordingly, on an earned basis (taking into account provisions), the

cession to reinsurers equated to a noticeably lower R27m, or 15% of capital (F06: 25%).

Solvency and reserving

Lion raised a R50m bond in June 2007 and paid out a R12m dividend in March 2007. Taking 75% of the proceeds of the bond issue as capital (as per FSB allowance) changed the mix of Tier 1 capital to total capital, from 100% to 79% at year-end F07. Cognisance is taken of the fact that intangible assets of R17m have been excluded from equity in terms of GCR's methodology. NPI contracted by 5%, following increased utilisation of reinsurance cover. Accordingly, the international solvency margin strengthened to 49%, from 36% in F06, representing a review period high. The statutory funding ratio increased by eight percentage points, to 30% at year-end F07, which was above the statutory requirement. Management views a statutory solvency ratio of between 30% and 35% to be optimal, and will structure dividend policy accordingly. Projections are for the international solvency margin to be around 58% at year-end F08.

Both reserving ratios increased in F07, with the net outstanding claims and unearned premium reserves equating to 33% and 24% of NPI respectively (F06: 31% and 22%). Lion received 63% of premium annually in F07, which has reduced from 66% in F06.

Debt rating factors

Lion issued an unsecured subordinated bond to the value of R50m in June 2007. The bond matures on 29 June 2017, but is callable from 29 June 2012. It is shown on the balance sheet at amortised cost (based on discounted cash flow valuation), valued at R49.3m at year-end F07. The security is subject to a fixed interest rate of 12.27% per annum. The gross gearing ratio stood at 36% at year-end F07, whilst the company was un-g geared on a net basis. Notwithstanding the above, 2007 earnings did not cover finance charges (of R6m annualised). Accordingly no dividends have been paid.

Given the size of the callable note programme (agreed to at R100m), this grants the issuer quicker access to market, but in no way guarantees rate and underwriting of script.

Financial performance

A five-year financial synopsis is reflected at the end of this report and brief comment follows. The table below provides a comparison of actual versus budgeted performance in F07. Premium retention was noticeably below the budgeted level, as a result of the utilisation of additional proportional reinsurance (not

factored into the initial budget). As such, each cost component exceeded budget when measured as a percentage of EPI. Ultimately, given the financial impact of the underperforming UMA book, an underwriting loss of R23m compared to a budgeted profit of R41m was reported. Investment income was noticeably higher than budgeted, in line with rising interest rates.

Table 5: Income statement (R'm)	Actual	Budget	Actual as % of budget
	F07	F07	
GPI	770.2	775.1	99.4
Reinsurance premiums	(417.7)	(280.0)	149.2
Net premium income	352.5	495.0	71.2
Change in insurance funds	(4.3)	(16.0)	26.8
Net premiums earned	348.2	479.1	72.7
Claims incurred	(224.7)	(274.8)	81.8
Net commission	(46.9)	(66.8)	70.2
Management expenses	(99.4)	(96.5)	103.0
Underwriting profit	(22.7)	40.9	n.a.
<i>Total investment income</i>	<i>22.0</i>	<i>16.0</i>	<i>137.6</i>

GPI advanced by a robust 23% to R770m in F07. Following increased use of proportional cover, premium retention decreased by almost 13 percentage points, to 46%. Accordingly, earned premiums were unchanged at R348m in F07. Claims incurred rose by a marked 17% to R225m, with the earned loss ratio increasing by almost ten percentage points, to 65% in F07. In addition, partly driven by the costs of implementing the IT system and the associated challenges in this regard, the management expense ratio rose to a four year high of 29% (F06: 22%) and continued to noticeably exceed the industry average of around 16%. The net commission ratio was posted at a slightly higher 14% (F06: 13%). The full impact of commission inflows will feed though into 2008 assuming loss ratios fall within sliding scale parameters (see future prospects). Overall, the underwriting result deteriorated to a loss of R23m, from a profit of R35m previously. After accounting for investment income of R22m (net of the R3.2m interest expense), Lion recorded a net loss after tax of R1m in F07 (F06: R37m profit).

Future prospects

GPI is expected to be unchanged from the F07 level, with a degree of fall-out anticipated as a result of the difficulties experienced during F07, as well as the impact of corrective pricing (particularly for motor). Management is in the process of implementing improved rating tables to adjust for changing claiming patterns and to enhance underwriting quality across the board. In the absence of the loss-making UMA book discussed earlier, the earned loss ratio is thus forecast to improve to 62% from 65% in F07. Management expenses are projected to decrease slightly, to R93m in F07. Furthermore, commission

income relating to the new proportional treaty will accrue for a full year in F08 (total of R112m versus R78m previously), which, together with a stable commission expense, is expected to see a significant reduction in the net commission charge. Accordingly, the delivery cost ratio is budgeted at a lower 30% compared to 42% in F07. Overall, the insurer expects to post an underwriting margin of 8%, versus 10% in F06. The international solvency margin is forecast to increase to around 58% in F08 (F07: 49%).

Table 6: Income statement (R'm)	Actual 1Q F08	Forecast F08	Actual YTD as % of budget
GPI	100.4	770.0	13.0
Reinsurance premiums	(50.2)	(406.2)	12.4
Net premium income	50.2	363.8	13.8
Change in ins.funds	24.1	3.6	669.6
Net premiums earned	74.3	367.4	20.2
Claims incurred (net)	(42.8)	(229.0)	18.7
Commission (net)	(9.6)	(15.7)	60.8
Management expenses	(20.5)	(93.0)	22.1
Underwriting profit	1.3	29.7	4.5
Key ratios (%)			
GPI growth (annualised)	(47.9)	0.0	-
Earned loss ratio	57.7	62.3	-
Delivery cost ratio	40.5	29.6	-
Underwriting ratio	1.8	8.1	-
Shareholders funds / NPI*	n.a.	57.9	-

*Annualised, assumes no dividends paid and an effective tax rate of 29%.

A summary of year to date accounts reflects an underperformance relative to the full year budget. This was largely due to lower than expected business volumes, which together with a higher net commission charge in proportional terms, resulted in a marked increase in the delivery cost ratio. Cognisance is, however, taken of the fact that the underwriting profit of R1.3m compared favourably with expectations for the year to date (budget 1Q F08: R0.1m).

Lion of Africa Insurance Company Limited

(R in Millions except as noted)

Year ended : 31 December	2003	2004	2005	2006	2007
Income Statement					
Gross premium income (GPI)	343.9	567.9	665.5	628.6	770.2
Reinsurance premiums	(235.3)	(307.5)	(379.8)	(259.4)	(417.7)
Net Premium income (NPI)	108.7	260.4	285.7	369.2	352.5
(Increase) / Decrease in insurance funds	(7.3)	(36.2)	(5.0)	(21.5)	(4.3)
Net premiums earned	101.3	224.2	280.7	347.7	348.2
Claims incurred	(64.9)	(127.5)	(174.9)	(191.6)	(224.7)
Commission (net)	(1.4)	(12.2)	(28.8)	(45.8)	(46.9)
Management expenses	(36.0)	(49.9)	(59.3)	(75.5)	(99.4)
Underwriting profit / (loss)	(0.9)	34.5	17.7	34.8	(22.7)
Net investment income	11.1	10.1	15.2	17.4	22.1
Net income before taxation	10.2	44.7	32.8	52.1	(0.7)
Taxation*	(3.1)	(13.9)	(10.0)	(15.4)	(0.4)
Net income after taxation	7.1	30.8	22.8	36.7	(1.0)
Unrealised gains / (losses)*	0.0	0.5	2.0	(1.9)	(0.1)
Cash Flow Statement					
Cash generated by operations	4.5	95.3	52.5	74.0	(8.6)
Cash flow from investment income	9.2	10.3	16.2	17.4	19.0
Working capital decrease / (increase)	(6.0)	55.5	(53.9)	(16.9)	15.7
Cash available from operating activities	7.7	161.1	14.9	74.4	26.1
Tax paid	0.0	(1.0)	(22.8)	(14.4)	(7.5)
Dividends paid	(3.9)	(2.6)	(2.1)	(7.0)	(11.5)
Cash flow from operating activities	3.7	157.5	(10.0)	53.0	7.1
Purchases of investments and fixed assets	(0.5)	(12.8)	(10.2)	(26.2)	(63.3)
Proceeds on disposal of investments	8.3	0.0	0.0	0.0	0.0
Other investing activities	0.0	0.0	0.0	0.0	0.0
Cash flow from investing activities	7.8	(12.8)	(10.2)	(26.2)	(63.3)
Cash flow from financing activities	0.0	25.0	0.0	0.0	64.2
Net cash inflow / (outflow)	11.6	169.7	(20.2)	26.8	8.1
Balance Sheet					
Shareholders interest	46.5	100.2	122.9	134.3	136.4
Bond**	0.0	0.0	0.0	0.0	36.9
Total capital**	46.5	100.2	122.9	134.3	173.3
Insurance funds	18.0	54.2	59.2	80.6	84.9
Other liabilities	76.8	165.0	162.4	225.4	278.2
Total capital & liabilities	141.3	319.4	344.5	440.3	536.5
Fixed assets	0.7	1.6	2.6	3.1	6.2
Investments	0.0	11.9	21.3	26.5	77.6
Cash and short term deposits	63.0	232.7	212.6	239.4	247.5
Other assets	77.5	73.2	108.0	171.3	205.2
Total assets	141.3	319.4	344.5	440.3	536.5
Key Ratios					
Solvency / Liquidity					
Total capital / NPI**	%	42.8	38.5	43.0	36.4
Statutory solvency**	%	23.0	25.0	31.0	22.0
Financial base**	%	91.9	80.6	94.4	89.1
Claims cash coverage	mnths	11.7	21.9	14.6	15.0
Operating cash flow / NPI		3.4	60.5	(3.5)	14.4
Reserve adequacy					
Net outstanding claims/NPI	%	28.0	18.4	26.9	30.9
Insurance funds/NPI	%	16.5	20.8	20.7	21.8
Profitability					
ROaE (before unrealised gains / losses)	%	15.7	42.0	20.4	28.5
Investment yield (average)	%	18.2	6.6	6.3	6.9
Efficiency / Growth					
GPI Growth	%	3.8	65.1	17.2	(5.5)
Premiums reinsured / GPI	%	68.4	54.1	57.1	41.3
Earned loss ratio	%	64.1	56.9	62.3	55.1
Commissions / Earned premiums	%	1.3	5.4	10.3	13.2
Management expenses / Earned premiums	%	35.5	22.3	21.1	21.7
Underwriting result / Earned premium	%	(0.9)	15.4	6.3	10.0
Trade ratio	%	100.9	84.6	93.7	90.0
Operating					
Effective tax rate	%	30.4	31.1	30.6	29.6
Dividend cover	X	1.8	12.0	11.1	5.2

*Net of deferred tax on capital gains.

**Including 75% of tier-II capital