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Hannover Reinsurance Africa Limited

South Africa Reinsurance Analysis **November 2008**

Security class	Rating scale	Currency	Rating	Rating watch	Expiry date
Claims paying ability	National	Rand	AA+	No	07/2009
Claims paying ability	International	US$	A		

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	252.0	269.5
Total capital	78.6	81.4
Cash & equiv.	59.6	36.5
GPI	137.0	136.9
U/w result	4.0	0.9
NPAT	14.2	16.1
Op. cash flow	19.3	28.0
Market cap	n.a.	
Market share*	33.5%	

**Based on FSB statistics relating to total reinsurance NPI in 2007, excluding Lloyd's.*

Fundamentals:

Hannover Reinsurance Africa Limited ("Hannover Re') is a 100% owned subsidiary of Hannover Rückversicherung AG ("Hannover Re Germany"). Hannover Re Germany is one of the five largest international reinsurers, with Eur3.1bn in capital as at September 2008. Hannover Re has been operating in South Africa for more than 50 years and has been a large investor in the financial services arena, with a 20 year track record in funding and developing start up UMAs.

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Rating rationale

The rating is based on the following key factors:

- Hannover Re's strong position in the South African reinsurance market, supported by the significant amount of business sourced from its subsidiaries. Furthermore, its focus on niche sub segments within the traditional insurer classes of business enhances the diversification of the portfolio.
- The high level of management expertise, complemented by access to Hannover Re Germany's technical support and risk modelling.
- The reinsurer continues to display sound solvency measures, supported by access to retrocession from its parent company, which is rated AA- internationally (reaffirmed in October 2008).
- Key liquidity measures remained comfortable, with investment market risk considered low given the large weighting in cash and government securities.
- Hannover Re is exposed to cyclical claims experience in the cedent market, given its relatively high retention level. Cognisance is, however, taken of the high level of provisioning, as well as the anticipated correction in pricing in reinsurance and underlying insurance markets.
- The international scale rating has pierced the sovereign risk ceiling due to the level of support provided by Hannover Re's highly rated parent company, including a letter of credit to the value of R275m and retrocession protection.

Solvency & liquidity

The reinsurer paid a R125m dividend, with shareholders funds remaining stable at R558m in F07. Taking into account a 5% increase in net written premiums, the international solvency margin decreased to 88% from 91% in F06. Hannover Re displays a high level of provisioning, with the financial base ratio equating to 234% in F07 (F06: 241%). The statutory funding ratio was posted at 63% (F06: 70%) and remained comfortably above the minimum regulatory requirement. Statutory solvency is expected to remain above 60% in the next two years. A move into fixed income securities, combined with a 10% rise in claims, saw the claims cash coverage ratio contract to 8 months from 15 months previously, albeit remaining comfortable.

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Operating environment

Reinsurance market

Internationally, reinsurance rates began to soften in the middle of 2006 and this continued into 1H 2008. This was a function of relatively few large catastrophe incidents, as well as intensive competition from well-capitalised players, following consolidation and the accumulation of profits in prior years. Furthermore, the growing popularity of capital market products as alternatives to traditional reinsurance manifested in excess capacity, particularly in the catastrophe market. The South African market has followed a similar trend, with rates constrained by internationally soft retrocession pricing and higher cedent retention. Competition from new entrants and internationally domiciled reinsurers has also been a constraining factor, as these players have increasingly sought to achieve geographical diversification in emerging markets.

The impact of the sub-prime crisis, however, has seen an erosion in capital levels, as a result of equity investment write-downs and in some instances, direct exposure to sub-prime investments or associated liability claims. Furthermore, two large catastrophe events occurred in 3Q 2008, namely hurricanes Gustav in July (estimated cost of US$18bn) and Ike in September (US$31.5bn). This is expected to compound the impact of investment losses on capital accumulation. Accordingly, reinsurance capacity is likely to become scarcer in the near term, whilst an increase in demand from the cedent market (also subject to capital depletion) is expected. This has begun to underpin a hardening of rates in the latter part of 2008, which is likely to persist in the 2009 renewal period.

Cedent market

The South African short term insurance market continued to report double digit growth in 2007, with GPI increasing by 12.7% (2006: 12.2%). Volume growth has been underpinned by demand factors, successfully tapped into by the move into alternative distribution channels, including affinity marketing and partnering with banks and motor dealerships to capture business at the point of sale. The UMA model has also achieved strong success, as insurers have sought to diversify earnings and access the typically more profitable niche sub-segments. However, rate pressure continued in 2007, as a result of intensive competition. Combined with higher claims, this has exerted pressure on underwriting profitability. The motor book has experienced a marked increase in claims volumes, exacerbated by imported price inflation and its effect on the cost of replacement parts. Furthermore, the property account has come under pressure from changing weather patterns and a higher incidence of larger sized fire losses. The worsening claims environment, combined with a continued softening of rates, has seen successive contractions in the underwriting margin, from 12% in 2004 to 7% in 2007. However, it is expected that the cycle has bottomed out and rates will begin to normalise, particularly in light of the capital erosion experienced by insurers with large listed equity exposures. In this regard, the anticipated hardening of reinsurance rates will serve as a catalyst to accelerate the return to more sustainable pricing levels in the cedent market. However, a strong correction in economic growth, together with a reduction in real disposable income levels (due to elevated inflation), is expected to place pressure on volume growth and lead to higher policyholder churn. Accordingly, pricing adjustments may be effected more successfully by participants with strong bargaining power and brand affinity, and those that have captive distribution channels.

Competitive positioning

Table 1: Peer comparison 2007 (R'm)	**Hannover Re**	**Swiss Re**	**Munich Re**	**Africa Re**	**Peer avg.**
GPI	967.8	1,221.3	1,878.5	1,067.4	-
NPI	636.6	460.5	522.4	253.0	-
Surplus assets	306.3	216.9	630.2	96.3	-
Ratios (%)					
GPI growth	4.0	51.3	31.1	43.0	31.1
Retention	65.8	37.7	27.8	23.7	36.5
Earned loss ratio	62.3	32.9	66.9	76.9	58.5
Mgmt exp ratio	7.2	21.3	3.0	10.1	9.8
Comm. ratio	29.5	15.6	21.7	20.4	22.7
U/w margin	1.0	30.1	8.4	(7.4)	9.0
Stat. solvency	63.1	62.1	135.6	53.1	50.4

Source: STAR return, including foreign business.

The preceding table presents a comparison of key statistics for the four leading reinsurers in South Africa. Notwithstanding its smaller size in terms of gross premiums, Hannover Re had a noticeably higher retention ratio, reporting net premiums that surpassed its closest competitor by 22% in F07. This is facilitated by the high degree of autonomy afforded by the holding company, which has provided it with a full regional underwriting mandate subject to high treaty limits for most classes. Hannover Re's higher participation on a net level exposes the reinsurer to underlying market claiming patterns (high frequency low severity) to a greater degree than its competitors. Accordingly, the reinsurer attempts to manage the cycle by adopting a more conservative approach to growth when prices are softening. Risk is further mitigated by its relationship with a large number of its cedents. Despite its large portion of direct business, Hannover Re displays a comparatively high commission ratio, as a result of lower commission receipts from retrocessionnaires. This offsets its low management expense ratio, translating to a delivery cost ratio that is slightly above the average for its competitors. Furthermore, an increase in the earned loss ratio constrained Hannover Re's underwriting profitability in F07. This should, however, be viewed in the context of differing claims reserving. In particular, Swiss Re previously had significantly higher claims reserves as a percentage of NPI, prompting a release of reserves in 2007, which reduced its earned loss ratio by approximately nine percentage points. Hannover Re displayed a comfortable solvency margin, complemented by sound liquidity measures.

Risk diversification

Hannover Re's strategy focuses on reinsuring niche sub-segments of the traditional insurance market, with its investments in subsidiaries forming an integral part of this business model. In this regard, the reinsurer owns 51% of investment company Lireas Holdings Pty Limited, which has strategic shareholdings in several UMAs and in MUA Insurance Company Limited. In addition, Hannover Re owns 100% of Compass Insurance Company Limited, which operates under a short-term licence and exclusively derives business via UMAs (including, but not limited to, Lireas subsidiaries and associates). The largest reinsurance broker accounted for a high 33% of GPI in F07, including broker intermediated business underwritten by Compass. The balance of the gross book was largely sourced from four other prominent reinsurance brokers.

Table 2: Diversification by class (%)	GPI		NPI		Retention	
	F06	F07	F06	F07	F06	F07
Property	41.3	40.2	37.7	36.5	59.6	59.8
Transport	2.2	2.0	2.3	1.9	69.1	60.0
Motor	29.1	30.4	30.5	32.0	68.4	69.2
Accident	4.5	3.8	4.7	4.1	68.2	70.9
Guarantee	3.7	3.4	4.0	3.8	70.1	74.1
Liability	12.4	11.0	12.2	11.1	64.5	66.5
Engineering	2.6	5.7	2.7	6.9	68.7	79.7
Miscellaneous	4.2	3.5	5.8	3.7	90.7	69.5
Total	**100.0**	**100.0**	**100.0**	**100.0**	**65.3**	**65.8**

Proportional business continued to represent more than 80% of gross premiums in F07, which is in line with the business mix of the peer group. The company is, however, focusing on growing its non-proportional book, particularly in terms of business sourced outside of the group. This should alleviate exposure to attritional claims in the South African market. Facultative business represented only 4% of GPI and is expected to remain under pressure, given an increase in treaty capacity provided to underlying insurers (and associated higher retention), as well as competition from international reinsurers. The premium spread by class of business was stable in terms of both gross and net premiums, with the property and motor accounts dominating the risk premium spread, contributing a combined 69% in F07 (F06: 68%) in net premium terms.

Most classes displayed higher earned loss ratios in F07. In particular, the property account claims ratio elevated to 83% from 60% in F06, on the back of a greater number of medium sized weather related claims, which fell below the XOL net retention. This saw the property account post a large underwriting loss of R40m for the year (F06: R6m profit). The underwriting loss in the liability account increased to R24m from R3m in F06, largely on the back of a R43m upward adjustment of net outstanding claims provisions. This was ascribed to new business underwritten and the prudent claims reserving applied in the open underwriting year. Notwithstanding a marked improvement in motor claims experience, the aforementioned losses resulted in a contraction in the overall underwriting surplus, to R6m from R28m in F06.

Table 3: Performance by class	Earned loss (%)		Comm / EPI (%)		U/w result (R'm)	
	F06	F07	F06	F07	F06	F07
Property	60.1	83.4	28.8	27.1	5.6	(40.4)
Transport	(44.3)	77.9	31.8	35.7	13.9	(2.8)
Motor	68.0	45.4	27.8	26.1	(4.5)	43.8
Accident	56.7	64.1	41.9	31.0	(1.6)	(0.3)
Guarantee	54.8	(47.9)	41.0	38.3	(0.6)	22.2
Liability	63.4	95.0	34.1	30.3	(3.1)	(24.3)
Engineering	17.6	49.1	41.3	34.7	5.1	1.2
Miscellaneous	16.8	4.9	43.6	59.8	12.6	6.7
Total	**56.8**	**62.3**	**31.6**	**29.5**	**27.5**	**6.1**

Risk management

Hannover Re evolved from a group with a strong risk management culture and has several procedures in place to monitor risk on an enterprise wide basis. Where possible, risks are quantified and monitored using models developed and tested at group level and adapted to South African circumstances. Quarterly risk assessments take place through discussions with the relevant managers or stakeholders. Controls are both preventative and responsive and are subject to external and internal audits annually.

Asset management

Following a shift into fixed income securities and a large dividend payment, cash and equivalents decreased by 40% to R251m in F07. Combined with a 10% increase in claims, this resulted in a contraction in the claims cash coverage ratio, to 8 months from 15 months in F06. Fixed income securities predominantly comprised listed government (63%) and semi-government (20%) stocks. Including government securities, cash coverage would amount to 29 months in F07. Liquidity is significantly bolstered by the fact that the holding company has provided a letter of credit to Hannover Re to the value of R275m.

Hannover Re's long term investment mandate limits listed equity exposure to 25% of the portfolio, with a minimum fixed income security component of 60%. Given prevailing market conditions, the current mix is more conservative, with 98% placed in cash and fixed income investments and less than 1% in listed equities as at October F08 at amortised cost.

Table 4: Investment portfolio	**F06**		**F07**	
	R'm	**%**	**R'm**	**%**
Cash & equivalents	420.3	27.2	250.5	15.3
Listed equities	179.7	11.6	170.2	10.4
Fixed inc. securities	834.0	53.9	1,049.8	64.3
Inv in subsidiaries	113.7	7.3	163.3	10.0
Total investments	**1,547.7**	**100.0**	**1,633.8**	**100.0**

Currency and counterparty

Hannover Re has a low exposure to currency risk, with only 4% of gross premiums derived from foreign sources in F07 (gross retrocession claims recovery of R8m). Foreign currency denominated funds represented a higher 16% of cash and equivalents in F07 (F06: 5%), and were predominantly US$ denominated. Investment counterparties were internationally rated BBB and above.

Solvency and reserving

Hannover Re assesses its capital requirement using underwriting and reserving models that take into account the projected scale and mix of business and accumulation of exposures, to determine a minimum risk based capital requirement. Management considers the current level of capital to be comfortable on this basis. If further capital is required, this will be accumulated from retained earnings, while additional capacity would be sought through increased retrocession, if required. The company paid a dividend of R125m in F07 (F06: R25m), which offset net profit of R114m for the year. Accordingly, shareholders funds remained relatively flat at R558m at year-end F07. Against NPI growth of 5%, this resulted in a contraction in the international solvency margin to 88% from a review period high of 91% in F06. The statutory funding ratio was posted at 63% in F07 (F06: 70%), remaining well above the minimum regulatory requirement. The solvency ratio is expected to remain above 60% in F08 and F09. A risk based capital model is being developed internationally using the group's models as a base and adjusting this to incorporate FCR requirements in South Africa.

Hannover Re displays a high level of claims reserving, with the net outstanding claims (including IBNR) to NPI ratio posted at more than 140% over the past three years.

Retrocession

The company primarily retrocedes to its parent company, Hannover Re Germany or to other companies within the Hannover Group. These counterparties each have an international rating of AA- from S&P. In addition, Hannover Re may participate in the group retrocession programme, which is subject to stringent head office vetting protocols. 30% of the gross proportional book is retroceded in terms of a quota share treaty. A stop loss is also in place. Whole account catastrophe excess of loss cover is used to limit the maximum net retention per event.

On the back of an increase in claims recoveries in relative terms (40% of premium ceded, versus 32% in F06), the transfer to retrocessionnaires decreased to R99m from R119m in F06.

Table 5: Reinsurance account (R'm)	**F05**	**F06**	**F07**
Premium ceded	(256.9)	(322.6)	(331.2)
Claims recovered	97.0	104.2	133.8
Commission recovered	79.7	99.4	98.9
Net transfer / recovery	**(80.2)**	**(119.0)**	**(98.5)**

Note: Cash basis.

Financial performance

A 5-year financial synopsis of the company is reflected at the end of this report and brief comment follows. Hannover Re's actual performance was in line with expectations in terms of all key line items in F07.

Table 6: Key statistics (R'm)	**Forecast F07**	**Actual F07**	**Actual as % of budget**
GPI	960.5	967.8	100.8
U/w result	7.4	6.1	82.8
NPAT	122.0	114.1	93.5
Int. solvency (%)*	87.0	87.7	-

*Forecast was estimated assuming a constant retention ratio.

GPI growth softened to 4% from 19% in F06, with gross premiums totalling R968m for the year. This was nonetheless slightly ahead of expectations (budgeted growth of 3%). Premium retention was stable at 66%, with net premiums rising by 5% to R637m. After accounting for a higher transfer to UPR, earned premiums of R605m were in line with the level in F06.

Claims incurred rose by a comparatively high 10% to R377m, on the back of an increase in reserving and the higher incidence of fire losses. This translated to an earned loss ratio of 62% (F06: 57%), representing a four year high. Management expenses were well controlled and rose by 2%, translating to an unchanged 7% of earned premium. The net commission charge decreased to R178m from R191m in F06, facilitated by lower profit commissions paid to cedents. This resulted in a reduction in the delivery cost ratio, to 37% from 39% in F06. Overall, the increase in relative claims drove a reduction in the underwriting profit, to R6m from R28m in F06. This was more or less comparable with budget of R7m. The underwriting margin contracted to 1% (F06: 4.5%) versus a peer group average of 9% in 2007.

Taking into account higher investment income of R151m (F06: R121m), net profit after tax advanced by 18% to R114m in F07. Including unrealised investment gains of R14m, ROaE was posted at a sound 23% in F07 (F06: 25%).

Future prospects

Table 7: Income statement (R'm)	**Forecast F08**	**Actual 9 mnths to Sept F08**
GPI	1,149.3	918.8
NPI	773.9	608.3
EPI	**790.0**	**620.4**
Claims	(514.9)	(398.5)
Commission	(213.0)	(169.7)
Mgmt expenses	(48.4)	(33.9)
U/w result	**13.7**	**18.4**
Key ratios (%)		
GPI growth*	18.8	26.6
Earned loss ratio	65.2	64.2
Commission ratio	27.0	27.3
Management exp. ratio	6.1	5.5
U/w margin	1.7	3.0
International solvency*	78.6	74.3

*Year to date is annualised.

Gross premiums advanced by a robust 27% (annualised) in the nine months to September F08. Facilitated by a four percentage point reduction in the delivery cost ratio, the underwriting margin increased to 3% from 1% in F07. The full year forecasts were prepared in November F08 and incorporated adjusted assumptions regarding investment performance. The reinsurer sold its investments in listed equity counters during 4Q F08, given the adverse outlook following the severe market downturn. A realised loss of R73m was incurred, which was factored into the investment income line in the full year forecasts. Overall, after tax profits are expected to be lower than in F07, as a direct result of investment markets. Notwithstanding the adverse investment performance, the international solvency margin is expected to remain strong, at 79% in F08. Furthermore, cognisance is taken of the absence of further exposure to equity market movements, following the sale of these investments in F08.

Hannover Reinsurance Africa Limited

(R in Millions except as noted)

Year ended : 31 December		2003	2004	2005	2006	2007
Income Statement						
Gross premium income (GPI)		1,011.6	847.7	783.3	930.2	967.8
Reinsurance premiums		(257.8)	(266.9)	(257.3)	(322.7)	(331.2)
Net Premium income (NPI)		**753.9**	**580.9**	**526.0**	**607.5**	**636.6**
(Increase) / Decrease in insurance funds		133.1	12.7	2.2	(3.9)	(31.4)
Net premiums earned		**886.9**	**593.6**	**528.2**	**603.6**	**605.2**
Net claims incurred		(627.7)	(363.2)	(272.2)	(342.6)	(376.9)
Commission		(233.1)	(172.1)	(165.2)	(190.7)	(178.4)
Management expenses		(37.9)	(40.1)	(46.3)	(42.8)	(43.8)
Underwriting profit / (loss)		**(11.8)**	**18.1**	**44.5**	**27.5**	**6.1**
Investment income		27.1	51.9	76.4	120.5	150.5
Other income / (expenses)		(31.6)	3.8	(6.0)	(13.0)	(3.4)
Taxation		(13.1)	(14.2)	(36.3)	(38.3)	(39.1)
Net income after tax		**(29.4)**	**59.6**	**78.5**	**96.7**	**114.1**
Unrealised investment movements*		22.5	(25.1)	25.9	27.7	14.3
Cash Flow Statement						
Cash generated by operations		233.2	44.1	40.9	108.9	72.3
Cash flow from investment income		27.1	51.9	79.7	94.3	121.4
Working capital decrease / (increase)		72.5	64.5	33.8	(27.3)	36.7
Tax paid		(10.8)	(11.8)	(38.8)	(45.1)	(32.4)
Cash available from operating activities		**322.0**	**148.7**	**115.7**	**130.9**	**198.1**
Dividends paid		0.0	0.0	(25.0)	(25.0)	(125.0)
Cash flow from operating activities		**322.0**	**148.7**	**90.7**	**105.9**	**73.1**
Cash flow from investing activities		**(188.9)**	**(34.6)**	**(115.9)**	**(252.1)**	**(242.9)**
Cash flow from financing activities		**(20.0)**	**0.0**	**0.0**	**0.0**	**0.0**
Net cash inflow / (outflow)		**113.1**	**114.2**	**(25.2)**	**(146.3)**	**(169.8)**
Balance Sheet						
Shareholders interest		**287.9**	**375.5**	**455.1**	**554.7**	**558.2**
Insurance funds		169.3	136.0	127.7	132.4	160.8
Other liabilities		1,034.4	1,046.7	1,019.9	1,090.4	1,128.1
Total capital & liabilities		**1,491.6**	**1,558.2**	**1,602.7**	**1,777.6**	**1,847.2**
Fixed assets		3.7	3.4	3.0	2.4	2.2
Investments		670.4	695.0	848.1	1,127.5	1,383.3
Cash and short term deposits		477.5	591.7	566.5	420.3	250.5
Other current assets		340.0	268.1	185.1	227.5	211.1
Total assets		**1,491.6**	**1,558.2**	**1,602.7**	**1,777.6**	**1,847.2**
Key Ratios						
Solvency / Liquidity						
Shareholders funds / NPI	%	38.2	64.7	86.5	91.3	87.7
Solvcency margin Act	%	28.0	38.6	65.8	70.1	63.1
Financial base	%	161.7	221.9	255.4	241.0	234.0
Outstanding claims / NPI	%	107.2	138.6	154.7	145.6	142.9
Unearned premium reserve / NPI	%	22.5	23.4	24.3	21.8	25.3
Cash coverage	mnths	9.1	19.5	25.0	14.7	8.0
Profitability						
ROaE (before unrealised gains / losses)	%	(10.1)	18.0	18.9	19.1	20.5
ROaE (after unrealised gains / losses)	%	(2.4)	10.4	25.1	24.6	23.1
Investment yield (including unrealised gains / losses)	%	5.5	2.5	8.3	10.9	10.4
Investment yield (excluding unrealised gains / losses	%	3.0	4.3	5.7	8.1	9.5
Efficiency / Growth						
GPI Growth	%	(15.2)	(16.2)	(7.6)	18.8	4.0
Premiums reinsured / GPI	%	25.5	31.5	32.9	34.7	34.2
Earned loss ratio	%	70.8	61.2	51.5	56.8	62.3
Commissions / Earned premiums	%	26.3	29.0	31.3	31.6	29.5
Management expenses / Earned premiums	%	4.3	6.8	8.8	7.1	7.2
Underwriting result / Earned premium	%	(1.3)	3.1	8.4	4.5	1.0
Operating						
Effective tax rate	%	(81.0)	19.2	31.6	28.4	25.5
Dividend cover	X	n.a.	n.a.	3.1	3.9	0.9

*Represents unrealised investment movements directly recognised in equity.