

ZEP-Re (PTA Reinsurance Company) Limited

Kenya Reinsurance Analysis

June 2008

Security class	Rating scale	Currency	Rating	Rating watch	Expiry date
Claims paying ability	National	KShs	AA	No	07/2009
Claims paying ability	International	US\$	BBB-	No	07/2009

Financial data:

(US\$m)

	31/12/06	31/12/07
Total assets	43.9	53.4
Total capital	17.6	23.4
Cash and equiv.	17.5	21.8
GPI	32.5	37.9
U/w result	1.0	1.0
NPAT	2.1	4.4
Op. cash flow	10.7	10.0
Market cap		n.a.
Market share		n.a.

Fundamentals:

ZEP-Re (PTA Reinsurance Company) Limited is a COMESA constituted and supported reinsurance company. The company is exempt from tax in the member states in which it operates. The company is headquartered in Nairobi, Kenya and operates regional offices in Sudan, Zambia and Cameroon. The Board of the company is comprised of 10 non-executive members elected every three years. ZEP-Re underwrites a small amount of business from Asia and the Middle East.

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Rating rationale

The rating is based on the following key factors:

- ZEP-Re's favourable strategic position given its legal mandatory cessions and diversified sovereign equity participation, which reduces sovereign interference risk.
- The highly experienced management team and conservative risk policies.
- The international solvency ratio has improved over the review period, as the rate of capital accumulation has outpaced the rate of net premium growth.
- The improvement in the debtors position of the company.
- The successful capital raising initiatives with an additional US\$3.4m raised post year-end 2007.
- The company has a high level of dependence on the Kenyan market, although this is declining as penetration rates improve in certain other markets.
- However, the ability to price and accept risk in other regions is constrained by the size of the balance sheet and its limited market participation. The company leads a number of programmes and cession percentages have increased its capacity.
- High competitive threat from minority shareholder Kenya Re, which has successfully listed and shows good inward retro prospects.

Solvency and liquidity

Shareholders' funds increased by 33% during 2007 to total US\$24m, stemming from a subscription offer to share capital (as part of a broader capital call programme) and high internal profit generation, with an ROaE of 25% (compared to 15% in 2006). The international solvency ratio increased to 79% (2006: 70%), and is expected to increase to 92% in 2008. The company does not explicitly reserve to underwriting loss years, but to claims notification, whilst the UPR is at a conservative 37% of net earned premium. The company has a high property investment exposure, representing 23% of investable assets. Cash and liquid assets account for over 50%, and are mostly invested with highly rated banks on a short-dated basis, covering 16 months of claims. The company holds most of its cash investments in US\$.



Industry overview

Over the past 5 years, the Kenyan economy has witnessed accelerating GDP growth, estimated to have reached 6.2% in 2007 (F06: 6%). Tourism and agriculture have been at the forefront of this economic expansion, but strong performances from the financial and the growing telecoms sectors have contributed to GDP growth. Robust corporate activity has supported rising income levels amongst the economically active population, further boosted by rising asset prices (particularly equity and property). This has fueled strong consumptive expenditure, spurred by lenient credit criteria. Also evident has been the increasing mobility of skilled workers, with the retention of qualified personnel becoming a significant issue within the corporate environment.

Post election violence in January 2008 has added significant uncertainty to the Kenyan economy. Although the direct disruptions to business were relatively short lived and largely limited to the west of the country, the long term impact is yet to be ascertained. Most notably, the agricultural sector continues to be affected by lingering violence and the displacement of workers. As such, crop yields in 2008 will fall below previous levels, fuelling food price increases and higher inflation. The tourism industry has also experienced a downturn, with arrivals declining markedly year-on-year. Over the longer term, the economy will have to contend with many unquantifiable risks that were unearthed by the unrest. These include an apprehension by businesses to re-establish in areas susceptible to future violence and underlying ethnic tensions that may have surfaced between companies or amongst employees.

The impact on the insurance sector is more difficult to quantify. Insurers have been affected by the violence to varying degrees. Those with greater exposure to the Western regions of the country face far higher levels of claims, while claims in the urban areas have been limited largely to property damage and looting. Despite many claims having been submitted, most fall under the exclusionary clauses for political unrest and as such the insurers are not obligated to make restitution. Nevertheless, in an effort to create goodwill in the market, most insurers intend paying claims on an *ex gratia* basis, with claims considered on a case-by-case basis.

The Commissioner of Insurance in Kenya has introduced an increase in the capital requirement for both life and non-life insurers. As per the legislation, non-life requirements will triple to KShs300m from KShs100m, life to KShs150m from KShs50m and composite insurers to KShs450m from KShs150m. For many insurers, retained earnings are unlikely to be sufficient to meet the minimum capital levels by the 2010 deadline. Investors may also be hesitant to commit additional capital given the low historical returns in the sector.

The listing of government owned Kenya Re in 2007 has unlocked significant value in the Kenyan market. Supported by the compulsory 18% cession from the local market, the company has focused on expanding its presence regionally and in the Middle East. This in turn will have a positive affect on the long-term capacity bearing nature of the cedents, enabling progress towards the 2010 recapitalisation. Falling yields across all maturities will have the effect of increasing property values (given the high 33% asset weighting to property), but the increase in long tail liabilities (i.e. 3rd party motor) could potentially have a large negative impact on equity.

General insurance

Total industry premiums continued to increase moderately in 2007, in line with the growing economy. Despite this, underwriting profitability remained constrained by the large number of insurers and continued premium pricing pressures. In response, there has been some attempt by established insurers to attract new business through improved service and benefit offerings. Nevertheless, price remains the determining factor for many clients.

Compounding the pressure on industry underwriting profitability is the substantial concentration of motor and personal accident business (cumulatively representing almost three quarters of industry GPI) and the high loss ratios prevalent in both. Industry participants have thus taken steps to minimise losses. In the motor class these include the establishment of a network of approved panel beaters and utilisation of independent assessors. In this way, fraudulent claims are being addressed and recurring claims limited.

Medical cover has continued to be a major driver of GPI growth, supported by rising employment levels and the introduction of new members to employer group medical schemes. However, persistent underwriting losses and the cumbersome administrative capacity required, has led many companies to discontinue such policies despite medical's importance to the overall insurance offering. Losses have been driven by rising medical inflation, aggravated by member abuse and supplier over-servicing. In addition, the failure of 3 health maintenance organizations ("HMOs") has enhanced calls for greater regulation of these organisations (including proposals to impose similar capital requirements to the insurance sector). Such issues have led employers to approach reputable insurers to service their healthcare funding requirements. The resultant consolidation has led to the emergence of 5 primary medical insurers UAP, Jubilee, CFC, APA and Heritage.

Life insurance

Demand for life assurance in Kenya has remained relatively subdued, constrained by the historically high unemployment levels and low disposable income. In addition, group life business has historically been subject to high rates pressure (priced to one year loss horizon, in some cases lengthened to two years), which continues to undermine the development of individual life policies where employed members are not prompted to buy outside the scheme.

Competitive positioning

There are significant impulses from the European reinsurance market in regard to the shortening loss horizon scenarios from 1/100 to between 1/50 to 1/30, due to global warming. Whether or not emerging economies would be as adversely impacted on (with the exception being the agricultural arena) as the developed world must be considered. Notwithstanding, the price signaling effect has been historically successful at placing security with European reinsurers. This message contrasts the huge underwriting profits made by the incumbant reinsurers (due to a number of disaster free years). Exposures to the sub-prime crisis are not well understood, although it is understood that a significant amount of investments were made into reinsurance companies/instruments by hedge funds - absorbing some of the worldwide liquidity. This combination of high capital growth and concomitant high demand for investment in US sub-prime mortgages resulted in high success rates for insurance of credit risks. The breakdown in risk drivers in the market emerged in mid-2007, initially punishing investors directly exposed to the transactions but this quickly lead to second order effects of the liquidity crisis, whereby companies were forced to liquidate investment holdings in unaffected areas by covenants in order to meet the liquidity demands. This has led to the reduction in reinsurance capacities, more so in the exotic/smaller boutique reinsurers where capital was flowing prior to the crisis. Whether this will translate into a larger capacity issue with well capitalised insurers, will more likely be the result of insurer and reinsurers themselves owning sub-prime stock, in which write downs are inevitable. The downgrading of AIG International Issuer Default Rating to AA- is testimony to the malaise. A number of reinsurers (i.e. Swiss Re) had significant underwriting exposure, which would affect overall loss ratios.

Competitive threats/opportunities considered for ZEP-Re are as follows:

- East Africa Re shareholding change with GIC of India purchasing Jubilee's stake.

- TAN-Re increasing its mandatory legal cession in Tanzania. Note is, however, taken of the participation of ZEP-Re on the retro.
- Minority shareholder Kenya Re successfully listed in 2007 and is showing good inward retro prospects.
- The company needs to win risk contracts in order to dilute risk (by spreading its footprint), through representative branch offices (typically staffed with one or two people), along with opportunistic contracts from the unrepresented markets, a hurdle easily met by competitors Munich Re, Swiss Re and Africa Re.
- With the successful penetration into the Sudan market, the company is well positioned to advise clients on rates derived from dominant ceding books, reducing the risk premia, thereby reinforcing market share.
- The company has branch offices in Lusaka and Douala.

		ROA	ROE	Assets*	Capital*
Kenya Re	2005	7.2	13.5	--	--
	2006	4.8	8.8	12.9	6.3
	2007	5.0	10.1	14.7	7.2
Africa Re	2005	3.8	11.2	--	--
	2006	4.5	12.8	38.1	13.4
	2007	5.1	14.7	40.8	13.8
ZEP-Re	2005	4.9	12.2	--	--
	2006	5.6	14.0	3.4	1.2
	2007	14.6	29.1	3.4	1.5

* Kshs bn

Note: Returns include unrealised gains

Fundamentals

The largest component of the reinsurer's business is sourced from Kenya, accounting for 37% in 2007. The company has a high cedent participation of over 40% on two portfolios from Sudan, which is expected to increase the country exposure from 12% in 2007 to 16% in 2008. The exposure to the Zambian market is high, with participation percentages of 35% in three of the leading insurers. In respect of lead positions, the company has increased shares by between 15% to 50% on some programmes, with 2007 participation ranging from a low of 5% to a high 40%. As evidenced in the table below, no single cedent comprises more than 7% of premium written.

Gross premium income (%)	F06	F07
Cedent 1	8.0	6.6
Cedent 2	4.6	6.1
Cedent 3	4.0	4.2
Cedent 4	3.7	3.4
Cedent 5	2.2	2.9
Cedants 6-10	7.4	7.2
Sub-total	29.9	30.4

In terms of loss ratio experience, the proportional business was better performing in F07, whilst a continued deterioration was noted with non-proportional, increasing to 99% from 63% in F06.

Table 3: Risk layering	Gross premium income (US\$m)		Earned loss ratio (%)	
	F06	F07	F06	F07
Proportional	21.2	20.6	61	53
Non-proportional	8.3	6.7	63	99
Other	3.1	2.2	59	27
Total	32.5	29.5	61	61

Fire and accident represented the bulk of gross premium income, at 76%, with marine contributing 14% and life 10%. The overall loss ratio was unchanged at 61% in 2007.

The company wrote US\$3.8m in premium for group life in 2007, or 8.5% above the prior year production.

Table 4: Performance indicators (US\$m)	Gross Earned loss ratio		Net Earned loss ratio	
	F06	F07	F06	F07
Fire & accident	44.4	47.1	62.3	69.5
Marine & aviation	43.2	18.4	55.1	23.4
Life	63.6	51.5	62.0	54.0
Total	44.8	44.6	61.3	61.1

With respect to the underwriting result by division, fire and accident levered from 1.6% profit in 2006 to 6.2% underwriting loss in 2007. In respect of marine and aviation, the underwriting profit increased from 6.5% to 33.6%.

Solvency and actuarial valuation

Authorised share capital has increased from US\$27.2m to US\$50m, with paid up capital increasing from US\$11.8m to US\$12.8m. Post year end 2007, the company issued shares resulting in an additional US\$3.4m being raised.

Following a 33% increase in shareholders interest to US\$23.4m, the solvency margin improved from 70% in 2006 to 79%. The company does not explicitly reserve to underwriting loss years, but to claims notification, whilst the UPR is at a conservative 37% of net earned premium.

Retrocession

The retrocession trade-off is tabled below. As evidenced, the company effected a net transfer of US\$2m or 9% of capital to the retro market in 2007.

Table 5: Retrocession account (US\$000)	F05	F06	F07
Premium ceded	(7,379)	(7,311)	(8,386)
Commission recovered	2,037	1,912	2,992
Claims recovered	6,587	3,197	3,049
Net result	1,245	(2,202)	(2,346)

Retro programme

Inward proportional and non-proportional treaty capacity on fire is US\$6.75m (retention US\$750,000 except for Kenya US\$600,000), with marine up to US\$3.6m. In respect of facultative business the following capacities are provided; fire US\$9m capacity, with US\$3m retention and marine US\$3.6m capacity with US\$600,000 retention. The accident class capacity limit is US\$1.6m (retention US\$400,000).

On the surplus treaty, the larger cessions are placed with international investment grade counterparties Best Re (12.5%) and Africa Re (10%), although non-investment grade counterparties GIC (12.5%), Kenya Re (7%), Sen Re (5%) and Continental Re (6%) take up smaller cessions. Fire and engineering XOL placements of 55% are with Lloyds (marine XOL 65%), whilst 80% of the miscellaneous accident XOL is with Brit Insurance, both rated in the A band. The company will look to increasing retentions in the 2009 programme.

Asset management

The Kenyan bond market has in the last quarter of 2007 reflected large portfolio activity, with the long term interest rate pricing dominating the auction, with government introducing 15 yr paper. With the turn of events in January, short term rate weakness would have fed into the market causing unrealised losses on such positions. However, this is not expected to substantially change the long term expectations, which signal further strengthening of yields.

The balance sheet reflects a high level of liquidity, with cash and equivalents representing 51% of investment assets, with government securities accounting for an additional 26%.

Table 6: Investment portfolio	2006		2007	
	US\$000	%	US\$000	%
Cash & equivalents	17,489	51.3	21,829	51.3
Govt. securities	7,576	22.2	10,995	25.8
Equity	961	2.8	1,023	2.4
Investment property	8,068	23.7	8,705	20.6
Total	34,094	100.0	42,552	100.0

Counterparty risk

Cash investments are largely invested with Lloyds Bank plc (US\$8.0m or 36% of total cash), and Barclays Kenya (US\$6.2m or 28% of total cash).

Currency risk

Over 90% of cash and liquid assets are in hard currencies. The KShs has more than 50% probability of not depreciating against the dollar in the next year.

Asset conversion risk

Property assets and debtors comprise a high 37% of total assets. A positive trend has resulted in a markedly improved aging profile (debtors days) of under 90 days from pre-2006's 180 days average, due to corrective measures implemented by the company.

Financial performance

A 5-year financial synopsis of the company is reflected at the back of this report and brief comment follows.

Table 7: 2007 comparison to budget (US\$000)	Actual	Budget	% of budget
GPI	37,923	36,000	105.3
EPI	27,721	26,674	103.9
Claims incurred	(16,927)	(14,400)	117.5
Commission	(7,172)	(7,344)	97.7
Management expenses	(2,649)	(3,849)	68.8
Underwriting margin	971	1,081	89.9

Gross premium income advanced by a high 16.8% in 2007, to US\$37.9m. Net of retrocession premium, net premium income increased by 17.4% to US\$29.5m notwithstanding higher cessions than forecast. Against earned premiums of US\$27.7m, the unchanged earned loss ratio (of 61%) and net commission ratio (of 25%) supported the technical result of US\$3.8m, which was 20% up on 2007. The management cost ratio increased from 8.8% to 9.6%, effecting a relatively unchanged underwriting profit of US\$1.1m. The gains from foreign exchange have increased from US\$0.9m in 2006 to US\$2.7m in 2007, significantly supporting the net result. The higher investment income, partly reflective of the higher cash generation and net rental receipts, net of the doubling of the bad debt provision for reinsurance premium receivables to US\$1m, has resulted in a 31% increase in NPAT to US\$2.6m. This coupled with unrealised gains (mostly property) of US\$3.3m, resulted in the company reporting an impressive ROE of 29%, compared to 19% in 2006.

Future prospects

The year to date performance against the full year budget for 2008 is tabled below. The company is budgeting for a high 20% growth in gross premium in 2008 to US\$46m, not significantly different from the 3 year budget put forward in 2007, of growth in 2008 (16.6% to US\$42m) and 2009 (19% to US\$50m). The performance for the year to date reflects the positive underwriting result of US\$553,000 against 48% of full year budgeted written premiums. Solvency is expected to increase to 92% in 2008 due to capital raising initiatives.

Table 8: 2008 YTD and budget (US\$000) *	Jan-May Actual	Full year Budget	% of budget
GPI	21,855	45,500	48.0
EPI	16,360	33,472	48.9
Claims incurred	(9,979)	(19,748)	50.5
Commission	(4,384)	(8,463)	51.8
Management expenses	(1,444)	(3,302)	43.7
Underwriting margin	553	1,959	28.2
Solvency margin (%)**	79	92	

* excludes non-underwriting expenses.

** annualised

ZEP RE (PTA Reinsurance Company) Limited

(US\$ in thousands except as noted)

Year ended : 31 December

	2003	2004	2005	2006	2007	
Income Statement						
Gross premium income (GPI)	25,638.5	24,373.1	26,900.0	32,474.9	37,923.0	
Retrocession premiums	(6,254.4)	(5,539.0)	(7,379.5)	(7,311.7)	(8,386.0)	
Net Premium income (NPI)	19,384.1	18,834.1	19,520.5	25,163.2	29,537.0	
(Increase) / Decrease in insurance funds	(2,972.2)	220.0	(422.2)	(1,403.5)	(1,816.7)	
Net premiums earned	16,411.9	19,054.1	19,098.3	23,759.7	27,720.3	
Claims incurred	(7,390.1)	(9,943.5)	(10,181.6)	(14,562.7)	(16,927.0)	
Commission	(5,440.4)	(4,971.9)	(5,365.0)	(6,118.1)	(7,172.4)	
Management expenses	(1,784.4)	(1,781.0)	(1,822.2)	(2,098.5)	(2,649.0)	
Underwriting profit / (loss)	1,796.9	2,357.7	1,729.5	980.4	971.9	
Investment income	263.4	427.8	948.7	1,423.8	2,587.0	
Other income / (expenses)	(693.0)	(748.5)	(841.1)	(229.7)	922.4	
Taxation	0.0	0.0	0.0	0.0	0.0	
Net income after tax	1,367.3	2,036.9	1,837.0	2,174.5	4,481.3	
Dividends	0.0	(315.6)	(300.0)	(500.0)	(750.0)	
Retained income	1,367.3	1,721.3	1,537.0	1,674.5	3,731.3	
Unrealised gains / (losses)	0.0	0.0	0.0	230.0	637.0	
Check						
Cash Flow Statement						
Cash available from operating activities	3,246.0	2,793.1	3,833.1	10,724.5	10,067.2	
Dividends paid	0.0	0.0	(298.8)	(294.7)	(513.0)	
Cash flow from operating activities	3,246.0	2,793.1	3,534.3	10,429.8	9,554.2	
Cash flow from investing activities	(2,245.8)	(2,339.6)	(7,400.0)	(4,537.7)	(6,250.0)	
Cash flow from financing activities	732.8	2,433.6	841.8	410.1	1,036.5	
Net cash inflow / (outflow)	1,733.0	2,887.1	(3,023.9)	6,302.2	4,340.7	
Balance Sheet						
Shareholders interest	9,277.5	12,431.1	15,044.6	17,641.0	23,389.8	
Insurance funds	7,753.6	7,184.2	7,606.4	9,009.8	10,827.0	
Other liabilities	5,650.1	12,689.0	14,959.4	17,314.3	19,157.3	
Total capital & liabilities	22,681.2	32,304.2	37,610.3	43,965.1	53,374.1	
Fixed assets	2,140.3	4,779.6	1,683.9	1,587.0	1,482.0	
Investments	843.8	848.8	11,422.5	16,605.7	20,723.7	
Cash and short term deposits	11,308.6	14,196.4	11,181.9	17,488.7	21,829.1	
Other current assets	8,388.5	12,479.4	13,321.9	8,283.7	9,339.3	
Total assets	22,681.2	32,304.2	37,610.3	43,965.1	53,374.1	
Key Ratios						
Solvency / Liquidity						
Shareholders funds / NPI	%	47.9	66.0	77.1	70.1	79.2
Cash claims cover	months	18.4	17.1	13.2	14.4	15.5
Debtors days	days	115.2	181.3	171.6	88.5	85.5
Operating cash flow / NPI	%	16.7	14.8	18.1	41.4	32.3
Reserve adequacy						
Net outstanding claims/NPI	%	15.1	32.6	41.5	34.5	42.4
Insurance funds/NPI	%	40.0	38.1	39.0	35.8	36.7
Profitability						
ROaE (after unrealised gains / losses)	%	16.8	18.8	13.4	14.7	24.9
Investment yield (including unrealised gains / losses)	%	2.4	3.1	5.0	5.9	8.5
Cash investment yield (average)	%	2.4	3.1	5.0	5.1	6.8
Efficiency / Growth						
GPI Growth	%	64.9	(4.9)	10.4	20.7	16.8
Premiums reinsured / GPI	%	24.4	22.7	27.4	22.5	22.1
Earned loss ratio	%	45.0	52.2	53.3	61.3	61.1
Commissions / Earned premiums	%	33.1	26.1	28.1	25.7	25.9
Management expenses / Earned premiums	%	10.9	9.3	9.5	8.8	9.6
Underwriting result / Earned premium	%	10.9	12.4	9.1	4.1	3.5
Operating						
Effective tax rate	%	0.0	0.0	0.0	0.0	0.0
Dividend cover	X	n.a.	6	6.1	4.3	6.0