

APA Insurance Limited

Kenyan Insurance Analysis

May 2007

Security Class	Rating scale	Currency	Rating	Rating outlook	Expiry date
Claims paying ability	National	KShs	A	Positive	05/2008

Financial data:

(USD'm Comparative)

	31/12/05	31/12/06
Ave KShs/USD	75.7	72.6
KShs/USD-close	72.8	69.9
Total assets	36.4	53.4
Total capital	11.9	23.8
GPI	19.9	27.7
U/w result	(0.3)	0.1
NPAT	0.6	1.6

Market share* 5.9%

*Based on general business GPI for year ended December 2005.

Fundamentals:

APA Insurance Limited ("APA") is a 60% held subsidiary of the life assurer Apollo Insurance Company Limited ("Apollo"). The insurer officially commenced operations in 2004 and transacts an array of classes in short-term business within Kenya. More recently the company has taken steps to expand its operations into Tanzania (through its stake in Reliance Insurance Company) as well as Uganda, whilst actively seeking opportunities in Rwanda and Sudan.

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Rating rationale

The rating is based on the following key factors:

- The significant strengthening in the international solvency margin to a review period high of 98% in F06 lent support to the rating. However cognisance was given to the fact that a large portion of the company's capital was in the form of unrealised gains.
- The successive improvements in underwriting profitability were positively viewed, with further strengthening anticipated in F07.
- Cognisance was taken of the company's relationship with its parent company Apollo, which has a 60% stake in the insurer. As such this enables it to leverage off long established relationships and group expertise.
- Cognisance was given to the increased level of risk implied, as a result of the heavy weighting towards equities within the investment portfolio (64%) and in particular the concentration of exposure.
- The insurer remains exposed to the challenging operating conditions in the Kenyan market as a result of the highly fragmented industry, although the regulatory reforms expected in 2007 should have positive implications for the industry as a whole in the longer term.

Solvency and liquidity

Underpinned by the significant increase in profitability (and especially unrealised gains) shareholder funds increased by a robust 92%, outpacing growth in net premium income. As such, this translated into the solvency margin reaching a review period high of 98% (F05: 65%). In line with this, shareholder funds to policyholder liabilities displayed a significant increase to 197% (F05: 150%). However, of the KShs1.6bn in capital, at least 39% related to unrealised gains on equities. Furthermore, capital is exposed to the company's sizeable investment in a single counter, amounting to KShs467m, equating to 28% of shareholders interest. Cash holdings increased by 335% to amount to KShs134m in F06. As such, cash claims coverage increased from a review period low of 0.4 months to 1.6 months recorded in F06, which is still below the industry average. However, KShs295m of total investments is in the form of government securities and when these are incorporated within total cash holdings, cash covered claims by a stronger 5.2 months.



Background

APA Insurance Limited (“APA”) was incorporated in 2003 and commenced operations on 1 January 2004. The insurer was born from the merger of the general business of Apollo Insurance Company Limited (“Apollo”) and Pan Africa Insurance Company Limited, thus forming a 60% held subsidiary of Apollo. As such the company is able to draw from a wealth of experience from its parent organisation.

APA underwrites an array of classes including Health, Marine and Aviation. Through its parent company, the insurer has long established relationships with highly reputable reinsurers who are all rated in the AA (double A) band. In this regard, APA has the capability of underwriting bigger risks due to substantial treaty capacities.

Industry overview

Whilst the strong economic performance in 2006 (estimated GDP growth of 6%) supported growth in industry gross premiums, aggressive rates pressure continued to undermine underwriting profitability. This is a function of the highly fragmented insurance market (incorporating in excess of 45 participants), and is particularly evidenced in the commercial and government sectors. Participants compete relatively aggressively for commercial lines, due to the more stringent risk management measures adopted by the insured clients, as well as the scale efficiencies associated with these large accounts. In terms of public sector business, government policy requires that public service institutions and government entities allocate insurance business based on the lowest rates, which has now been formalised through the Procurement Act (effective January 2007). With state business contributing an estimated 20% of market premiums, this is placing increased pressure on rates.

Underwriting profitability has come under further pressure from the high level of claims, particularly relating to individual motor, which forms a large component of the overall market. Motor claims are exacerbated by inadequate road infrastructure, high traffic volumes and poor driving standards. Furthermore, there is a prevalence of ageing second hand vehicles on the roads, for which parts are not always readily available. However, intense competition for this business (typically as part of a more comprehensive product offering) has led to a resistance to rate increases, with pricing not necessarily being commensurate with claims levels.

Certain regulatory reforms are expected to take place in 2007, which should have positive implications for the industry as a whole. The Office of the Commissioner, previously part of the Ministry of

Finance, will be established as an independent body, thus ensuring political autonomy and access to its own resources. Furthermore, a potential increase in the minimum capital requirement could see consolidation amongst industry participants in the medium term, thus enhancing capacity and financial soundness of the remaining entities. Furthermore, changes to the Insurance Act are anticipated, including limiting third party injury claims to KShs3m and enforcing “cash and carry” underwriting for theft and motor risks (whereby cover is withheld until premiums are received). These changes, if implemented, should benefit insurers in terms of controlling claims and improving cash flow management.

Competitive positioning

Table 1 provides a comparison of APA’s general business performance with most recently available statistics for its competitors. As evidenced below, the insurer displayed relatively high levels of retention in comparison to that of its peers (F06: 85%) facilitated by a comparatively high level of solvency at 98%. Furthermore, APA’s management expenses were relatively low compared to that of its competitors, which is indicative of tighter cost controls implemented within the company, which translated into an expense ratio of 21% in F06 (F05: 22%). As such, the insurer recorded its first year of underwriting profitability, demonstrating a significant improvement from the KShs21m underwriting deficit recorded in the previous year.

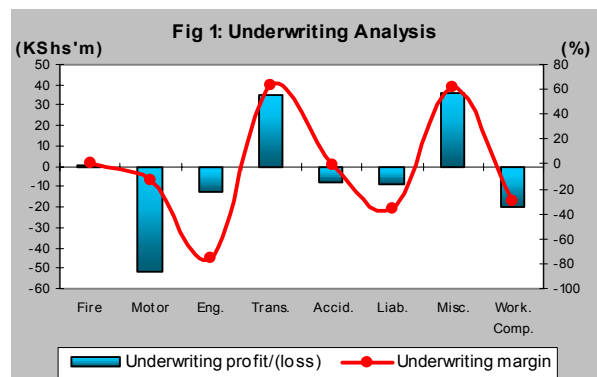
Table 1: General business F06	APA	Blue Shield*	Jubilee	UAP
NPI (KShs’m)	1,704	1,790	1,612	1,605
Capital (KShs’m)	1,662	373.1	1,397	4,434
Solvency (%)	97.5	22.2	86.7	276.2
NPI/GPI (%)	84.8	105.7	83.9	74.6
Cash cover (mnths)	1.6	10.5	1.0	7.6
Loss ratio (%)	68.7	40.2	73.5	43.2
Commission ratio (%)	10.4	10.2	11.6	10.2
Expense ratio (%)	21.3	28.4	20.8	33.0
U/W margin (%)	0.7	21.2	(5.9)	13.6
Trade ratio (%)	100.2	78.8	105.9	86.3

*Based on F05 results.

Operations

APA sources the majority of its business from the commercial market, which contributed 71% (F05: 72%) of gross premiums garnered in F06. Despite the commercial market typically being serviced by a few large brokers, APA’s largest broker sourced a relatively low 17% of total GPI in F06, whilst on a cumulative basis the five largest brokers only contributed 38% of total gross premiums, indicating relative diversity in terms of intermediary contributions. Conversely, 22% (F05: 29%) of

business was sourced directly, whilst the balance of the business (39%) was generated by various other channels. In terms of its five largest clients, net premium income evidenced a slight increase in concentration from the 17% recorded in F05 to 27% for the year under review (although this remains well diversified).



APA derives the majority of its premium income from its motor and accident lines, which collectively accounted for 64% of gross premiums garnered for the year. As indicated in figure 1, from an underwriting perspective, the insurer's transport and miscellaneous classes were by far the most profitable, achieving margins in excess of 60% in F06. Supported by improved efficiencies the miscellaneous account posted a solid underwriting profit of KShs36m in F06, whilst the transport class posted a net surplus of KShs35m. Notwithstanding the aforementioned, the overall impact on the cumulative underwriting margin was negligible since this was offset by the considerable loss in the motor account (of KShs52m). Despite posting a small contribution, APA's fire class also displayed slight profitability (KShs1m surplus) in F06, which can be ascribed to the relatively low number of claims reported in the year. Within the insurer's personal accident class gross premiums increased by 37% to KShs821m (or 41% of total GPI), whilst the earned loss ratio was notably above the average for the industry (of around 65%) at 79% in F06.

Performance by class F06 (%)	Earned loss ratio		Mng. Expense ratio	
	F05	F06	F05	F06
Fire	(6.4)	40.9	34.3	34.5
Motor	90.3	83.0	21.8	20.4
Engineering	59.5	118.8	72.9	56.3
Transport	42.7	(7.1)	28.0	44.6
Accident	74.7	79.4	12.6	12.7
Guarantee	36.4	n.a	25.0	n.a
Liability	165.2	20.0	28.1	64.0
Miscellaneous	0.0	36.6	22.3	21.5

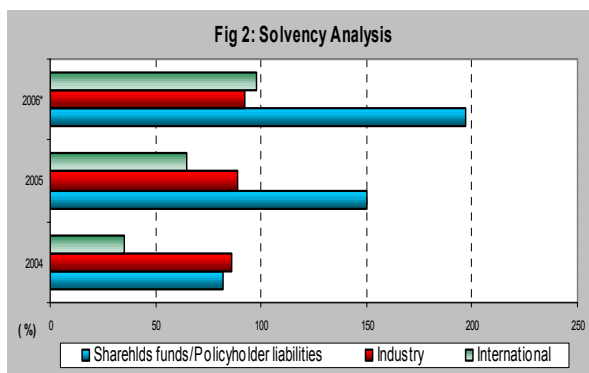
Following increased focus on the tightening of management expenses (through managing staff

numbers and the implementation of tighter procurement policies) and improving economies of scale, management expenses evidenced a slight decrease to amount to a review period low of 21.3% (F05: 22.1%).

In addition to the improvement in management expenses, on a cumulative basis the insurer's loss ratio has also displayed an improving trend, contracting to 69% from 78% two years ago (although it still remains above industry averages).

Solvency and reserving

Underpinned by the significant increase in profitability and unrealised gains of KShs698m, shareholder funds increased by a robust 92% to KShs1.6bn, whilst net premiums increased by 27% to amount to KShs1.7bn in F06. As such, this resulted in the solvency margin reaching a review period high of 98% (F05: 65%), which was slightly above the local industry averages. Similarly, shareholder funds to policyholder liabilities displayed a significant increase to 197% (F05: 150%). Analysis of forecasts, suggest that international solvency is expected to reduce to around 75% in F07, on the back of anticipated growth, although this is expected to stabilise at around 81% by F08. It is noted that 68% of shareholders funds relates to unrealised gains (mostly on equity investments), which is atypical of the industry. This implies variability of the capital base, given the potential fluctuation of values.



Reinsurance

The insurer ceded KShs305m in premiums to reinsurers within the year, translating into 15% of total gross premiums written, whilst overall retention reduced from 89% to 85% in F06. In line with the increased cedece, claims recovered increased by 77% to amount to KShs190m, which equated to a sizeable 62% of premiums ceded. Overall the company ceded KShs37m in profits to reinsurers for the year under review.

	F05	F06
Premium Paid	(165.2)	(304.5)
Commission recovered	41.6	77.3
Claims recovered	107.0	189.8
Net result	(16.5)	(37.4)

APA predominantly utilises proportional reinsurance for its fire, marine and engineering classes, which is led by Swiss Re and Munich Re, whilst Africa Re provides non-proportional cover on its respective accident, motor, liability and miscellaneous books. The surplus treaty in place has a limit of KShs50m, with XOL under this to keep the maximum retention at KShs6m per event (which equates to 0.4% of the insurer's capital base). Looking ahead the insurer will look to steadily move towards XOL and stop loss arrangements to limit the impact of low frequency large claims, whilst increasing retention to accommodate a change in product mix towards higher retained risks, as well as higher volumes written.

Asset management

	F05 (KShs'm)	F06 (KShs'm)	F05 (% of total)	F06 (% of total)
Cash and equivalents	30.7	133.5	1.6	4.8
Equity instruments				
- Listed	1,086.4	1,795.3	57.1	64.1
- Unlisted	0.0	8.1	0.0	0.3
Investments in JV & Associates	30.0	30.9	1.6	1.1
Government securities	250.8	294.5	13.2	10.5
Commercial paper	22.3	22.8	1.2	0.8
Investment properties	426.5	471.5	22.4	16.8
Mortgage Loans	54.6	46.1	2.9	1.6
Total	1,901.3	2,802.6	100.0	100

APA's investment portfolio has grown by a sizeable 47% for the year under review. This was largely underpinned by the robust performance of the insurer's equity portfolio, which increased by 65% in F06. In this regard, the higher weighting of the total investment portfolio towards equities (64%) implies increased risk and was duly noted. The high weighting of equities in the portfolio is atypical for the industry, with management of the view that there is significant upside to be gained on the back of the increased liquidity and the emergence of new IPO activity within the local market. Notwithstanding the aforementioned, cognisance was taken of the fact that equity holdings, are invested in relatively high quality corporates. Further analysis indicates that the insurer's top five equity holdings in terms of market value comprised 85% of the total portfolio in F06, as indicated in the table.

	F05	F06
Kenya Airways Ltd	308.0	467.0
Barclays Bank Ltd	162.0	283.0
CMC Holdings Ltd	82.0	268.0
Kenya Commercial Bank	122.0	293.0
East African Breweries Ltd	202.0	216.0
Sub total	876.0	1527.0
Other	209.0	268.0
Total	1085.0	1795.0

On the back of the higher weighting of equities within the portfolio, holdings in government securities and corporate bonds evidenced a slight reduction and cumulatively contributed to 11% of investments in F06 (F05: 14%).

Primarily supported by the strong cash flows evidenced in F06, consolidated cash holdings increased to amount to KShs134m, contributing 5% of total investments. As such, cash claims coverage increased from a review period low of 0.4 months to 1.6 months recorded in F06, albeit relatively low in comparison to its peers. However, KShs295m of total investments is in the form of government securities (which can be easily liquidated) and when these are incorporated within total cash holdings, cash covers claims by a stronger 5.2 months.

The property portion of the portfolio, which accounts for 17% of the company's investments, comprises of three commercial and three residential properties within Kenya. These properties collectively garnered around KShs35m in rental income and a further KShs45m in fair value gains in F06.

Financial performance

A summary of the financial performance of the insurer is reflected at the end of this report and brief commentary follows hereafter.

	Actual F05	% Δ	Actual F06
GPI	1,504.40	33.50	2,008.40
NPI	1,339.20	27.20	1,703.90
EPI	1,264.50	13.80	1,438.50
Claims	(900.5)	9.7	(987.7)
Commission	(128.5)	16	(149.0)
Management expenses	(257.0)	13.4	(291.5)
U/W result	(21.4)	148.1	10.3
Investment income	115.6	33.7	154.6

APA recorded strong growth in F06, with gross premiums increasing by 34% to amount to just over KShs2bn. A slight decrease in premium retention from 89% to 84% within the year, combined with the KShs265m increase in insurance funds, translated into earned premiums increasing by a lower 14% to amount to KShs1.4bn. On the back of improved risk

control measures, claims during the year rose by a comparatively low 10% (versus general inflation of 14%), which facilitated an improvement in the earned loss ratio, which contracted to 69% from 71%. Management expenses also grew by a comparatively low 10%, which can be ascribed to a stricter cost culture within the company and improved economies of scale. Accordingly the management expense ratio displayed a modest improvement, reducing to a review period low of 21% (F05: 22%). This compares favourably with the industry, with the company effectively having a 6% margin advantage over the rest of the market. The advantage is, however, given back in terms of the higher commission ratio, as well as the underwriting quality of the book, particularly in light of the performance in the accident class. This is reflected in table 7.

Table 7: Industry comparative	Industry F05	Actual F05	Actual F06
EPI	100.0	100.0	100.0
Claims	(61.5)	(71.2)	(68.7)
Commission	(6.7)	(10.2)	(10.4)
Expenses	(28.6)	(20.3)	(20.2)
U/W result	3.2	(1.7)	0.7

The company displayed a marked improvement with regards to its underwriting performance, posting a KShs10.3m surplus from the previous KShs88m deficit during its first year of operation in F04. As such, underwriting margins evidenced a notable improvement to 0.7% (F05: -1.7%).

Future prospects

Looking ahead, the company is entering a period of consolidation with respect to its local operations – with management anticipating growth in Kenya of around 11% in F07. From a group perspective the strategy revolves around the international growth set to take place, as the insurer looks to extend its presence into Tanzania (through its stake in Reliance Insurance Company) and Uganda, whilst actively seeking opportunities in Rwanda and Sudan.

Facilitated by the anticipated increase in quality, coupled with enhanced risk control measures, the insurer expects to reduce its claims on a relative basis, which is reflected in the earned loss ratio forecast to reduce to 63% by F08 from 69% for the year under review. In the mean time, APA is forecasting an underwriting profit of approximately KShs35m in F07, driven mainly by lower acquisition costs, from increasing penetration in the direct market, recruiting tied agents to market its personal lines products and stringent cost controls. As such, the insurer is expecting significant strengthening in its underwriting margin, which is anticipated to increase to 2% in F07 and as high as 10% thereafter.

Notwithstanding the aforementioned improvement in underwriting performance, the overall underwriting environment in Kenya is not expected to materially improve in the short term. This can be ascribed to the high level of fragmentation within the industry, leading to relatively thin underwriting margins (indicative of the competitive environment). However, if current industry initiatives transpire conditions may ease in the medium term.

Table 8: Income statement	Actual F06	Budget F07	Budget F08
GPI	2,008	2,232	2,561
NPI	1,703	2,181	2,394
EPI	1,438	1,780	1,939
Claims	(988)	(1,219)	(1,223)
Commission	(149)	(132)	(148)
Management expenses	(291)	(394)	(375)
U/W result	10	35	193
Investment income	155	174	325
Ratios (%)			
Loss ratio	68.7	68.4	63.1
Commission ratio	10.4	7.4	7.6
Management expense ratio	21.3	22.1	19.3
Underwriting margin	0.7	2.0	10.0

APA Insurance Limited

(K'shs in Millions except as noted)

Year ended : 31 December	2004	2005	2006
GENERAL INSURANCE			
Revenue statement			
Gross premium income	1,406.9	1,504.4	2,008.4
Reinsurance premiums	243.3	165.2	304.5
Net premium income (NPI)	1,163.6	1,339.2	1,703.9
(Increase) / decrease in insurance funds	(101.6)	(74.7)	(265.4)
Net premiums earned	1,062.0	1,264.5	1,438.5
Claims incurred	(823.7)	(900.5)	(987.7)
Commission	(94.9)	(128.5)	(149.0)
Management and other expenses	(231.0)	(257.0)	(291.5)
Underwriting profit / (loss)	(87.5)	(21.4)	10.3
Investment income	57.7	115.6	154.6
Other income (net of expenses)	55.1	59.5	59.5
Taxation	19.6	(0.9)	(0.9)
Dividends	0.0	0.0	0.0
Retained income	44.7	152.8	223.6
Unrealised investment gains/ (losses)	34.0	414.6	689.1
Balance Sheet			
Shareholders interest	411.8	867.3	1,662.2
Insurance funds	501.9	576.6	842.0
Other liabilities	1,168.5	1,205.9	1,228.0
Total capital & liabilities	2,082.2	2,649.8	3,732.2
Fixed assets	89.3	95.0	95.5
Investments	1,176.8	1,870.6	2,669.1
Cash and equivalent	230.0	30.7	133.5
Other current assets	586.1	653.5	834.0
Total assets	2,082.2	2,649.8	3,732.2
Key Operating Ratios			
General business			
GPI Growth	n.a.	6.9	33.5
Premiums reinsured / GPI	(17.3)	(11.0)	(15.2)
Earned loss ratio	% 77.6	71.2	68.7
Commissions / Earned premiums	% 8.9	10.2	10.4
Management expenses / Earned premiums	% 21.7	20.3	20.3
Underwriting result / Earned premiums	% (8.2)	(1.7)	0.7
Shareholders interest/NPI	% 35.4	64.8	97.5
Claims cash cover	months 3.4	0.4	1.6
Debtors days	days 112.5	86.5	90.2
Solvency			
Shareholders funds / NPI	% 35.4	64.8	97.5
Shareholders funds / Policyholder liabilities	% 82.0	150.4	197.4
Investment returns - general business			
Investment income / Average invested assets	% 13.0	32.1	35.9
Growth rates			
Total assets	% n.a.	27.3	40.8
Insurance fund	% n.a.	14.9	46.0
Profitability			
ROE	% 21.7	23.9	17.7
Dividend cover	X n.a.	n.a.	n.a.