

APA Insurance Limited

Kenya Insurance Analysis

June 2008

Security class	Rating scale	Currency	Rating	Rating watch	Expiry date
Claims paying ability	National	Kshs	A	No	06/2009

Financial data:

(US\$m Comparative)

	31/12/06	31/12/07
Kshs/US\$ (ave)	72.6	67.8
Kshs/US\$ (close)	69.9	64.0
Total assets	52.8	62.3
Total capital	23.1	25.0
Cash & equiv.	1.6	4.9
GPI	27.7	34.7
U/w result	(0.1)	(0.2)
NPAT	1.0	1.2
Op cash flow	2.6	3.9
Market cap.	n.a.	
Market share*	6.88%	

*Based on industry GPI in 2006.

Fundamentals:

APA Insurance Limited ("APA") is a 60% held subsidiary of the life assurer Apollo Insurance Company Limited ("Apollo"). The company transacts an array of classes in short-term insurance within Kenya and was formed out of the non life business of Pan Africa and Apollo in 2004. 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:

- APA's growth in the fragmented Kenyan insurance industry, which has seen it rise to become the second largest short term insurer in the market.
- Management has successfully brought the management expense ratio down over the recent past.
- The company continues to invest heavily in the equity market, significantly more so relative to its peers, reflecting its higher risk appetite.
- APA's exposure to the medical insurance class, which has reflected significant losses over the review period and constrained underwriting performance.
- Intense rates pressure and the highly fragmented nature of the market will continue to constrain underwriting profitability. This may be exacerbated by the anticipated slower economic performance in the country.

Solvency and liquidity

Notwithstanding underwriting profitability and trading gains, shareholders interest remained flat at Kshs1.6bn. This is due to the retracing of the Nairobi Stock Exchange on unrealised gains. This, together with the faster paced growth in net premiums saw the international solvency margin decline to 84% in F07 (F06: 95%). APA's unearned premium reserve has been maintained above industry averages, having remained above 40% of NPI over the review period, although it declined to 48% in F07 (F06: 49%). The insurer's cash holdings strengthened significantly in F07 and despite the 35% higher claims, supported a rise in the cash claims cover to 2.8 months (F06: 1.4 months). Inclusive of government securities that are redeemable in less than a year, this ratio improves to 5 months (F06: 3 months).



Industry overview

Over the past 5 years, the Kenyan economy has witnessed accelerating GDP growth, estimated to have reached 6.2% in 2007 (2006: 6.0%). Tourism and agriculture have been at the forefront of this economic expansion, with strong performances from the financial, manufacturing and growing telecoms sectors also contributing to GDP growth.

However, post election violence in January 2008 has added significant uncertainty to the Kenyan economy in 2008. The direct disruptions to business were relatively short lived (3 weeks) and largely limited to the rural areas in the West of the country. The longer term impact is yet to be ascertained. Most notably, the agricultural sector continues to be affected by lingering violence in the rural areas and the displacement of workers. As such, crop yields in 2008 are unlikely to reach the levels of previous years, fuelling food price increases and in turn higher inflation. Tourism also experienced a severe downturn, with arrivals having fallen markedly year-on-year. Given the importance of these two sectors in the Kenyan economy, a slowdown in growth is expected in 2008.

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 agricultural regions of the country face far higher levels of claims, whilst claims in the urban areas have been limited largely to property damage and looting. Although many claims have 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 payments considered on a case-by-case basis.

The insurance sector is quite fragmented, with just over 40 licensed insurers at present. The Commissioner of Insurance in Kenya has proposed increased capital requirements for both life and non-life insurers. The new legislation will see the capital requirements triple for all classes of insurance. Non-life requirements will increase to Kshs300m from Kshs100m, life to Kshs150m from Kshs50m and composite insurers to Kshs450m from Kshs150m at present. For many insurers retained earnings are unlikely to be sufficient to meet the minimum capital levels by the 2010 deadline. Moreover, investors may be hesitant to commit additional capital given the low historical returns in the sector. As such consolidation will be inevitable, enhancing the capacity and financial soundness of the remaining insurers.

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 competing for few large contracts. As these contracts are almost entirely cost driven, insurers have been forced to undercut competitors to obtain new business, often pricing premiums at barely economical rates. Exacerbating the situation was the introduction of legislation requiring government institutions to place insurance based on the lowest rates. With government accounting for around 20% of market premiums, this places significant pressure on profitability. While there has been an attempt by some of the more established insurers to attract new business through improved service offerings, price remains the major determining factor for many clients.

Further undermining industry underwriting profits are the high claims levels experienced. These claims ratios are particularly prevalent in the motor and personal accident (including medical) classes, which cumulatively account for around 60% of short term insurance GPI (NPI: 70%). Insurers are required to continue writing policies in these classes even if profitability does not justify such business. Many industry participants have thus begun taking steps to minimise these losses. Strategies in the motor class include the establishment of a network of approved panel beaters and the utilisation of independent assessors.

Medical cover has continued to be one of the major drivers of GPI growth. The class has been supported by rising employment levels and the accompanying introduction of new members to employer group medical schemes. However, persistent underwriting losses and the cumbersome administrative requirement have led many companies to discontinue such cover despite medical's importance to the overall insurance offering. Aggravated by the relatively unregulated private medical sector, medical inflation and large losses have driven particularly high earned loss ratios (73% in 2006).

Operations

APA is a general insurer, with the company's main focus being the corporate market, which contributed 78% of gross premium income in F07 (F06: 71%). The insurer's exposure to its top 5 clients in F07, although lower at 21% of net premiums (F06: 27%), remained high. Given that the broker market in Kenya is quite influential, broker business increased to 70% of total premiums in F07 (F06: 64%). Direct sales increased by 49% to Kshs659m, which saw them account for 28% of total premiums (F06: 22%), with the company anticipating this to fall to 23% in F08.

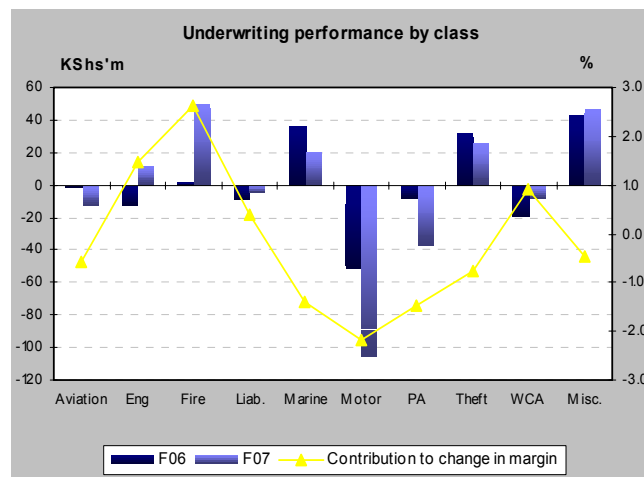
Income (%)	GPI		NPI	
	F06	F07	F06	F07
Aviation	3.4	6.6	0.3	0.3
Engineering	2.4	2.2	1.7	1.0
Fire	10.8	8.4	6.7	3.8
Liability	4.4	7.4	2.3	6.3
Marine	3.6	3.3	3.3	2.4
Motor	23.2	23.1	26.0	27.8
PA	40.9	37.2	46.8	45.0
Theft	4.4	3.0	4.8	3.2
WCA	3.5	4.4	4.1	5.3
Miscellaneous	3.5	4.3	3.9	4.9
Total	100.0	100.0	100.0	100.0

Historically, APA's largest gross premium earner has been the personal accident class (which mainly comprises medical insurance). This class recorded a 7% increase in premiums in F07 to account for a lower 37% of total premium income. Despite the motor class' 17% growth to Kshs543m, the class contributed a flat 23% of GPI in F07. It is noted that the motor class' growth has been driven by personal lines, with the increasing wealth in the market seeing a higher average value of vehicles due to the "buying up" trend evidenced. Notwithstanding the significant growth evidenced in the liability class (increasing its share of premiums to 7%), APA increased its premium retention to 68% in F07 (F06: 46%).

Underwriting expenses (%)	Earned loss		Delivery cost ratio	
	F06	F07	F06	F07
Aviation	2.9	49.4	116.1	143.7
Engineering	118.4	26.6	59.5	42.8
Fire	41.1	25.3	57.6	23.6
Liability	59.2	18.0	77.1	91.1
Marine	(9.3)	29.5	34.9	30.4
Motor	83.0	89.5	29.7	31.7
PA	79.4	85.6	21.8	18.9
Theft	9.5	40.4	36.0	26.3
WCA	94.0	68.1	36.1	42.1
Miscellaneous	0.2	4.6	29.9	32.7
Total	68.7	72.6	31.6	28.2

Driven by Kshs682m in medical claims in F07, the personal accident class recorded a significant rise in its earned loss ratio which, notwithstanding perceptible improvement in cost management, saw the class' underwriting loss widen to Kshs38m (F06: Kshs8m loss). APA's medical insurance portfolio has been managed by Amini (a joint venture between APA and Momentum Africa (PTY) Ltd) since 2005. Given the losses that have been evidenced over the period (the class' underwriting margin has reversed from a profit of 3.2% in F05 to a deficit of 4.4% in F07), management intend reviewing the contract as of F08. The rising motor earned loss ratio and increased expenses in the class (largely a factor of increased commercial motor claims) together with the increased

losses in the PA class, saw the company's underwriting deficit widen to Kshs14m (F06: Kshs4m). The fire class recorded significant profits of Kshs50m in F07 (F06: Kshs 1m), with overall profitability ascribed to the reduction in costs. In this regard, the growth in APA's book has seen the company benefit from economies of scale, which together with tighter expense management has resulted in a declining management expense ratio since F05.



Solvency and reserving

APA's share capital rose to Kshs400m in F07 placing the insurer in an advantageous position given the new capital requirements to be met by 2010. APA's shareholders funds have, in the past, been significantly augmented by the company's unrealised investment gains, which cumulatively amounted to Kshs1.1bn at F06. However, the investment markets have retraced part of the gains made over the past three years. In addition, the adverse political situation at the end of 2007 saw APA make unrealised investment losses of Kshs84m. Shareholders interests at F07 were recorded at Kshs1.6bn, which together with the higher net premiums saw the international solvency margin fall to 84% (F06: 95%), which is below the industry average. Going forward, the solvency margin will be increasingly a function of the investment markets. The company adopts an aggressive listed equity investment mandate with basket share transactions of Kshs100m at regular intervals (in order to take advantage of excess market liquidity).

APA reflected an unearned premium reserve of Kshs914m, amounting to 48% of net premiums in F07 (F06: 49%). Together with the declining international solvency margin, this saw the financial base ratio decrease to 137% (F06: 144%). APA has reserved in excess of 40% of its net premiums since inception, which is above the industry average.

Following the lower retentions of 81% and the 17% rise in the claims reserve to Kshs1.3bn, the insurer's

ratio of outstanding claims reserves to NPI increased to 67% in F07 (F06: 64%). It is noted that the IBNR component of this ratio has been maintained at around 5% over the review period.

Reinsurance

APA's reinsurance programme is led by Swiss Re, with participation from Africa Re, East Africa Re, Kenya Re and PTA Re. The insurer utilises excess of loss and surplus treaties on the marine, fire, motor, personal accident and bond classes, whilst medical insurance is reinsured through a stop loss contract led by Africa Re. Under the stop loss, the reinsurer will pay claims between 103% and 200% of GPI. The company's XOL programme supports the surplus treaties protecting the insurer's renewal success on its proportional programme.

Table 4: Reinsurance XOL (Kshs'm) (Layers)	Net retention	Limit per event	
Fire & allied perils/engineering CAT (5)	10	750	
Marine (2)	5	40	
Motor, liability, accident (5)*	5	400	
Personal accident (4)	5	300	
Bonds (4)	7.5	300	
Surplus treaties (Kshs'm)(lines)	Net retention	Capacity	CAT
Marine cargo (5)	20	100	
Marine hull (12)	5	60	
CAR, EAR & engineering (10)	60	600	2,400
Fire (24)	60	1440	10,000

* XOL layer 5 pertains to motor 3rd party bodily injury of Kshs200m in excess of Kshs200m

The insurer ceded 47% higher premiums to reinsurers. Despite the increased recoveries, the net transfer to reinsurers was reflected at a higher Kshs172m. This equates to 11% of the capital base in F07 (F06: 9%).

Table 6: Reinsurance account (Kshs'm)	F05	F06	F07
Premiums ceded	(165.2)	(304.5)	(446.3)
Claims recovered	107.0	86.6	189.0
Commission recovered	41.6	77.3	85.2
Net result	(16.6)	(140.6)	(172.1)

Asset management

APA's investment portfolio is internally managed by the investment committee, which comprises directors and senior staff. Despite the adverse price movement in the Kenya Airways stock holding (18%), the overall investment portfolio reflected growth of 6% to Kshs2.9bn. The increase was supported by the increased cash component (following the realised capital gains of Kshs256m), reflective of the active trading mandate. Cash and equivalents accounted for 11% of the portfolio in F07 from 4% in F06, equating to a claims cash coverage ratio of 2.8 months (F06:

1.4 months). Notwithstanding this, coverage remains low compared to the industry average of around 4.2 months. Cognisance is taken of the low interest rate environment, with the company preferring to earn coupon interest from fixed interest stock (13% of the portfolio).

Table 7:	F06		F07	
Investments	Kshs'm	%	Kshs'm	%
Cash	29.5	1.1	114.9	3.8
Short term deposits	104.0	3.7	220.6	7.5
Overdraft	(20.5)	(0.7)	(19.0)	(0.6)
Cash and equivalent	113.0	4.1	316.5	10.7
Investment properties	471.5	17.0	486.0	16.5
Investment in associates	24.0	0.9	106.0	3.6
Unlisted shares	8.1	0.3	8.1	0.3
Listed shares	1,795.3	64.7	1,618.6	54.9
Mortgages	46.0	1.6	38.6	1.3
Fixed interest stock	317.3	11.4	375.5	12.7
Total	2,775.2	100.0	2,949.3	100.0

Despite the aforementioned disposal of equities in F07, APA's listed shares remained the bulk of the investment portfolio at 55% in F07. Given the quality of the stocks, the losses made on the portfolio during F07's end of year market fall were minimised at Kshs99m. However, note is taken of the fact that the downturn in the markets saw a significant reduction in the insurer's investment returns, with the ratio of investment income to average invested assets plummeting to 1% in F07, from a review period high of 36% in F06. Note is taken of the fact that APA's exposure to listed equities is contrary to Kenyan insurance industry trends, which point to an affinity towards the more "safer" government securities. Management has motioned that the high weighting to equity markets is expected to continue.

The Kshs82m higher investment in associate was on the back of the company's investment in Gordon Court Limited, in which it holds a 40% stake. Associate investments also include the company's foray into the Tanzanian insurance market, through a 34% shareholding of Reliance Insurance Company (T) Limited. APA's share of after tax profits from associates that has not been included in the financial statements amounted to a significant Kshs24m (F06: Kshs4m).

Financial performance

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

Supported by the growth in the aviation, engineering and miscellaneous classes, APA reflected GPI growth of 17% in F07. The insurer retained more than the budget of 82% of premiums, with net premium

income recorded at 4% more than anticipated, at Kshs2bn.

Table 8: Income statement (Kshs'm)	F07		Actual vs. budget variance (%)
	Actual	Budget	
GPI	2,355.6	2,232.0	5.5
NPI	1,909.2	1,831.0	4.3
Transfers	(71.3)	(51.0)	39.8
Net earned premiums	1,837.9	1,780.0	3.3
Claims incurred	(1,333.5)	(1,264.0)	5.5
Commission	(178.6)	(132.0)	35.3
Management expenses	(339.6)	(348.0)	(2.4)
Underwriting result	(13.8)	36.0	(138.3)
Realised investment income	123.8	0.0	n.a

Driven by the significant rise in medical (personal accident) and motor claims in F07, overall claims rose by 35% to Kshs1.3bn. Responsive to the high claiming pattern in the market, the company is undergoing a process of internal risk assessment. In the interim, an internal loss assessor has been appointed and current outsourced management contracts are being reviewed.

The continued decline in the management expense ratio, together with lower relative acquisition costs (a function of the change in the reinsurance programme), saw the insurer's delivery cost ratio fall to 28% (F06: 32%). Despite improved cost control measures, APA's underwriting deficit widened to KShs14 (compared to budgeted profit of Kshs36m). This saw the underwriting margin amount to -0.7% (F06: -0.3%).

During F07 APA's investment income declined by 20% to Kshs124m. Together with other income and expenses, and following significantly lower tax of Kshs6m (effective tax rate of 7.3% from 39.1% previously due to the unrealised investment losses), the company increased its net profit after tax to Kshs81m (F06: Kshs76m). Notwithstanding, the return on equity decreased to 5% from a previous 6%.

Future prospects

Going forward, the Kenyan Insurance industry is set to benefit from the new "Cash and Carry" law, which stipulates that cover is only effective when premiums have been paid. This is likely to see an improvement in the industry's cash flow management, liquidity and investment returns.

Internally, APA's newly implemented internal audit function (which is headed by an auditor with 12 years experience in the industry) is anticipated to streamline various processes in the company, with stricter underwriting controls expected. In addition, the company will be partnering with a financial institution to offer the X-account, which has a

medical rider benefit. The financial institution has a high exposure to the retail market (who may not necessarily be company employed), thus giving APA access to individuals who may not have medical cover. APA is confident of underwriting senior citizens with the appropriate rate mark up in an effort to retain medically insured members post retirement.

Table 10: Budget	YTD*	F08	% YTD of budget
GPI	1,318.0	3,278.0	40.2
NPI	1,148.5	2,900.0	39.6
Transfers	(123.8)	(415.0)	29.8
Net earned premiums	1,024.8	2,485.0	41.2
Claims incurred	(777.3)	(1,754.0)	44.3
Commission	(97.7)	(269.0)	36.3
Management expenses	(185.8)	(412.0)	45.1
Underwriting result	(36.1)	50.0	n.a.
Ratios (%)			
Retention	87.1	88.5	
Earned loss	75.9	70.6	
Delivery costs	27.7	27.4	
Underwriting	(3.5)	2.0	

* Six months to June 30 2008

The changes that have been planned for the year are to see gross premiums rise by 39% to Kshs3.3bn. The rise will mainly be supported by the 60% rise in medical insurance premiums to 38% of the total. The international solvency margin is expected to fall to 60% in F08, due to the larger net book underwritten

Whilst claims are expected to increase by 32%, the earned loss ratio is anticipated to remain relatively flat at 71% (F07: 73%). APA is expected to benefit from continued cost cutting measures, with management expenses falling to 16% of earned premiums. The lower reinsurance and increased business is, however, set to see commissions rise to 11% of the net earned premium, which will see the delivery cost ratio amount to 27%.

APA Insurance Limited

(K'shs in Millions except as noted)

Year ended : 31 December	2004	2005	2006	2007
GENERAL INSURANCE				
Revenue statement				
Gross premium income	1,406.9	1,504.4	2,008.4	2,355.6
Reinsurance premiums	(243.3)	(165.2)	(304.5)	(446.3)
Net premium income	1,163.6	1,339.2	1,703.9	1,909.2
(Increase) / decrease in insurance funds	(101.6)	(74.7)	(265.4)	(71.3)
Net premiums earned	1,062.0	1,264.5	1,438.5	1,837.9
Claims incurred	(823.7)	(900.5)	(987.7)	(1,333.5)
Commission	(94.9)	(128.5)	(149.0)	(178.6)
Management and other expenses	(218.8)	(279.5)	(306.0)	(339.6)
Underwriting profit / (loss)	(75.4)	(43.9)	(4.1)	(13.8)
Investment income	110.0	115.6	154.6	123.8
Other income/ (expenses)	(24.8)	(26.9)	(26.1)	(23.0)
Net profit before tax	9.9	44.8	124.4	87.0
Taxation	19.1	0.7	(48.6)	(6.3)
Dividends	0.0	(15.0)	(18.0)	(21.0)
Retained income	28.9	30.5	57.8	59.6
Unrealised investment movements	34.0	414.6	686.2	(84.2)
Balance Sheet				
Shareholders interest	411.8	867.3	1,615.8	1,597.4
Insurance funds	501.9	576.6	842.0	913.4
Other liabilities	1,136.7	1,119.8	1,233.8	1,472.4
Total capital & liabilities	2,050.4	2,563.7	3,691.7	3,983.2
Fixed assets	89.3	95.0	95.5	108.9
Investments	1,267.5	1,870.6	2,662.2	2,632.8
Cash and equivalent*	43.7	(25.9)	113.0	316.5
Other current assets	649.9	623.9	821.0	925.0
Total assets	2,050.4	2,563.7	3,691.7	3,983.2
Key Ratios				
Operating ratios				
GPI Growth	n.a.	6.9	33.5	17.3
Premiums reinsured / GPI	17.3	11.0	15.2	18.9
Earned loss ratio	77.6	71.2	68.7	72.6
Commissions / Earned premiums	8.9	10.2	10.4	9.7
Management expenses / Earned premiums	20.6	22.1	21.3	18.5
Underwriting result / Earned premiums	(7.1)	(3.5)	(0.3)	(0.7)
Trade ratio	0.6	103.5	100.3	100.7
Solvency & liquidity				
Shareholders funds / NPI	35.4	64.8	94.8	83.7
Shareholders funds / policyholder liabilities (UPR only)	82.0	150.4	191.9	174.9
Outstanding claims/NPI	69.4	73.5	64.3	67.2
Insurance funds/NPI	43.1	43.1	49.4	47.8
Claims cash cover	0.6	(0.3)	1.4	2.8
Investment returns				
Investment income / Average invested assets	22.0	33.6	36.4	1.4
Growth rates				
Total assets	n.a.	25.0	44.0	7.9
Insurance funds	n.a.	14.9	46.0	8.5
Profitability				
ROE	14.1	7.1	6.1	5.0
Dividend cover	n.a.	3.0	4.2	3.8

*Net of bank overdraft.