

Santam Limited

South Africa Insurance Analysis

July 2011

Security class	Rating scale	Currency	Rating	Rating watch	Expiry date
Claims paying ability	National	Rand	AAA	No	07/2012
Long term subordinated debt	National	Rand	AA-		07/2012

Financial data:

(US\$m Comparative)

	31/12/09	31/12/10
R/US\$ (avg.)	8.44	7.34
R/US\$ (close)	7.42	6.65
Total assets	1,708.0	1,955.2
Total capital	743.2	892.2
Cash & equiv.	466.5	350.5
GWP	1,551.1	1,900.5
U/w result	32.5	131.1
NPAT	68.4	139.6
Op. cash flow	168.4	181.8
Market cap**	US\$2.25bn	
Market share*	22%	
*Estimated share of total GWP in 2010.		
**As at June 2011.		

Fundamentals:

Santam Limited ("Santam") is the leading short term insurer in the South African market, with an estimated 22% share of gross premiums in 2010. The insurer is listed on the JSE, with major shareholders including Sanlam Limited (53.5%) and members of the public (31.6%). Sanlam had a market cap of R56.8bn as at June 2011 (Santam: R15.6bn).

GCR contacts:

Trevor Barsdorf
+27 11 784-1771
barsdorf@globalratings.net

Susan Andrews
+2711 784-1771
andrews@globalratings.net

Website: www.globalratings.net

Rating rationale

The rating is based on the following key factors:

- Santam is the market leader in the short term insurance industry, with an estimated 22% share of GWP. In this regard, the insurer's strong brand and substantial underwriting capacity are expected to sustain its market leadership position.
- Santam continues to outperform its peers in terms of underwriting profitability, supported by the high degree of risk diversification and economies of scale, as well as strong representation in certain profitable specialist segments.
- The insurer uses a well developed risk based capital model to determine appropriate economic capital levels and manage risks within clearly defined risk appetite criteria. The international solvency margin remains well above the internally calculated economic risk capital requirement and is in line with GCR's comfort level for the current rating.
- The insurer's investment portfolio remains large and diversified with adequate liquidity. The total listed equity portfolio constitutes 53% of total capital, although risk is mitigated by the use of derivative instruments, with the unhedged portfolio representing 25% of capital.
- The funds from the debt issue are ring-fenced in a separate portfolio and invested in cash and fixed interest bearing investments, with a minimum benchmark return equivalent to Santam's bond performance. Debt serviceability measures remain sound.
- The high level of competition in the insurance industry is likely to persist in the near term. Furthermore, recent new entrants could introduce a greater degree of pricing pressure.

Solvency & liquidity

Total capital (including Tier II capital) increased to R5.9bn at FYE10 (F09: R5.5bn). After accounting for 6% growth in NWP, the international solvency margin rose to 47% (F09: 46%). The statutory funding ratio amounted to 30% in F10 (F09: 33%), well above the minimum regulatory requirement. XOL reinsurance limits the highest net retention per risk and event to R50m before reinstatement premiums (less than 1% of total capital). The claims cash coverage ratio decreased to 3.4 months in F10 (F09: 4.9 months). However, liquidity is supported by a large portfolio of liquid money market and fixed income securities, which together with cash holdings, covered net technical liabilities 1.2x at FYE10 (FYE09: 1.1x).

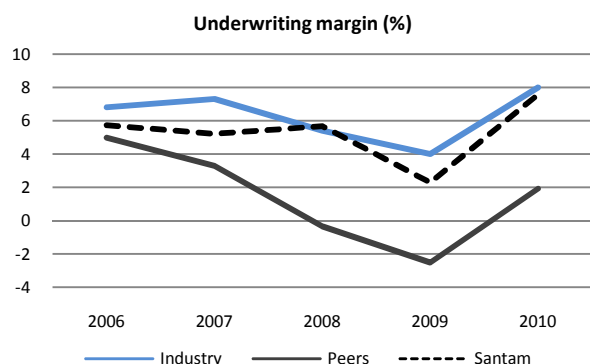


Introduction

The analysis in this report relates to Santam Limited (company only) and is based on company numbers sourced from the Annual Financial Statements, as well as the ST returns submitted to the FSB.

Industry overview

An improved economic environment, coupled with re-pricing, prompted a rise in industry GWP growth to approximately 9% from around 6% in F09. The motor loss ratio benefited from the firmer Rand, which lowered the cost of imported replacement components. There was also a reduction in claims frequency, although this was not specific to the motor class and also extended to the corporate and commercial property segment. As such, the overall earned loss ratio fell to around 62%, from 66% in 2009. The industry underwriting margin strengthened further from 6% to approximately 8% in 2010, which marks a level last achieved in 2005. However, GCR is of the view that the motor class remains exposed to systemic challenges, while any increase in weather related and corporate property claims would dampen underwriting profitability. There is also an increasing threat being posed by alternative insurance models and recent new entrants to the market.



Note: 2010 industry estimates.

Santam continues to hold a dominant position in the domestic short term insurance market, with an estimated 22% share of GWP, compared to a combined 25% for its three closest rivals. This allows the company to realise underwriting profitability margins in excess of its peers, which is achieved through diversification and economies of scale. However, the direct insurers continue to reflect underwriting margins that are well above those of the traditional broker intermediated players, with Santam slightly lagging the overall industry average over the past five years.

Santam displays adequate liquidity levels, supported by the large portfolio of longer dated money market and fixed income instruments. The international solvency margin was below the peer average in F10,

although this is viewed in the context of the company's stronger growth, diversified business mix and track record of underwriting profitability over more than 16 years. Furthermore, Santam uses a well developed risk based capital model to determine appropriate economic capital levels, and to proactively manage risk at all levels of the business. The company's large capital base provides it with substantial underwriting capacity, which is expected to sustain its market leadership position.

Table 1: Key ratios F10 (%)	Santam	Peer avg.*
GWP growth	6.6	(2.7)
Retention	91.0	86.9
Earned loss	64.1	64.3
Deliv. cost	28.3	33.7
U/w margin	7.6	1.9
Solvency**	46.7	63.2
Cash cover (months)	3.4	7.7
Cash & fixed int. / tech liabs (x)	1.3	1.2

* Includes Hollard, M&F and Zurich. Hollard has a June year-end.

**Including admissible Tier-II capital.

Earnings diversification

Santam primarily generates business from the commercial and personal lines segments, which represented 51% and 45% of GWP respectively in F10. The insurer operates through nine business units, each of which is differentiated in terms of target market and buying segments. The performance of the key divisions over the past two years is outlined below.

Broker services is the largest division, and is split across both commercial and personal lines. The improved motor claims experience and a lower incidence of weather related claims supported a pronounced strengthening in the division's underwriting margin in F10. In view of the relatively competitive rate environment and atypically low claims frequency in F10, Santam expects the underwriting margin to normalise within a band of 4% to 6% in the short to medium term.

The portfolio management division includes a substantial component of personal lines motor business, which has been a loss leader in the broker intermediated market. This is compounded by the fact that administration is outsourced to third parties, which has historically limited Santam's ability to segment the risks and implement pricing adjustments where necessary. During F10, the insurer re-rated the entire portfolio using its internal underwriting systems, and imposed more stringent mandates to limit discounting and improve its access to policyholder data. Furthermore, measures were taken to contain claims costs by leveraging off Santam's centralised claims management process and procurement channel. Following these initiatives and

the industry wide improvement in motor claims experience, this division returned to underwriting profitability in F10, following the loss posted in F09. Santam continues to move forward with its IT integration strategy, which will improve data transfer between the company and its outsourced administration partners. This is aimed at enhancing information accuracy and the ability to monitor underwriting performance on a more granular level. These initiatives are expected to sustain underwriting profitability in this book going forward, albeit at a lower margin than the more traditional broker services portfolio.

With respect to the corporate division, the acquisition of Emerald Underwriting Management (“EUM”) introduced a revised approach to underwriting corporate property risk. This involved a “de-risking” of the book and move to a more cost effective reinsurance structure, as well as the shedding of poorly performing portfolios. Furthermore, the absence of large claims resulted in a significant decrease in the corporate loss ratio in F10, with this division reverting to underwriting profitability for the year. The loss ratio has increased in the current financial year, which management attributes to a large claim that was incurred in Mauritius and relatively conservative reserving. This is expected to move in line with the longer term targeted loss ratio by the end of F11, as volumes increase post June renewals and a portion of reserves is unwound.

The niche segment includes the specialist classes and reflected a stable earned loss ratio in F10. The largest contributor to this segment was the liability class, which despite a reduction in turnover and aggressive pricing by competitors, recorded a healthy underwriting margin in F10. Within the engineering class, the acquisition of Mirabilis and consolidation of the CEU portfolio with this UMA is expected to introduce synergies and diversification benefits. The Mirabilis book has historically run at a low loss ratio compared to the industry average for engineering. Together with the strong performance in the transport class, these business lines continued to support overall underwriting profitability in F10, registering a margin that was well in excess of the industry average.

The agriculture portfolio was impacted by a higher incidence of weather related claims, and posted an underwriting loss in F10. This class is subject to a higher degree of volatility and has experienced strong competition, resulting in subsequent rates pressure. On the back of a stronger maize price and improved renewal rates, underwriting profitability is budgeted to improve in F11, although remaining below historical levels.

Table 2: Performance by class (%)	GWP weighting		Earned loss ratio		U/w result (R'm)	
	F09	F10	F09	F10	F09	F10
Property	35.5	37.0	85.3	63.3	(595.2)	227.8
Transport	3.0	2.6	50.8	39.2	82.3	100.2
Motor	45.6	45.6	78.4	69.4	(153.0)	341.7
Accident	2.8	2.7	64.1	64.3	0.1	0.3
Guarantee	0.1	0.1	(4.5)	0.9	7.7	7.5
Liability	8.7	7.7	10.1	46.2	683.0	260.8
Engineering	4.2	4.1	48.9	34.6	93.0	150.3
Miscellaneous	0.1	0.1	96.4	34.6	(4.3)	7.3
Total	100.0	100.0	72.0	63.2	113.6	1,095.9

Note: Sourced from ST return. Excludes the non-approved reinsurers' share of technical provisions.

In terms of the class breakdown, there was little change in the composition, with property and motor accounting for 37% and 46% respectively in F10, which is in line with industry averages. Given that Santam retains most of the risk, there was a similar spread on a NWP basis. The table above reflects the substantial turnaround in underwriting profitability in the motor and property classes, as well as the strong contribution of specialist lines to the overall underwriting result.

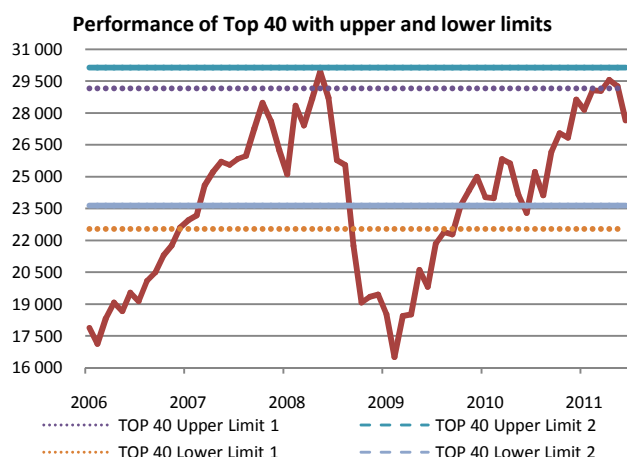
Asset management

Table 3: Investments	F09		F10	
	R'm	%	R'm	%
Cash & equiv.	3,460.0	32.7	2,330.0	20.8
Subsidiaries	1,503.0	14.2	1,843.0	16.4
Associates	133.0	1.3	133.0	1.2
Listed equity	2,659.0	25.1	3,166.0	28.2
Unlisted equity	14.0	0.1	12.0	0.1
Bonds & M. mkt	2,187.0	20.7	3,145.0	28.0
Pref. shares	747.0	7.1	670.0	6.0
Derivatives	(117.0)	(1.1)	(75.0)	(0.7)
Total	10,586.0	100.0	11,224.0	100.0

Santam has contracted with Sanlam Investment Management to manage the bulk of the investment portfolio. Each investment class is managed under strict portfolio mandates, with any change needing board approval. In addition, Santam manages credit risk by limiting exposure to various counterparties and specifying minimum credit ratings. As at FYE10, the insurer's largest exposure was to Absa, which at group level accounted for 14% of invested assets (including non-portfolio cash). Santam backs policyholder liabilities with cash and fixed income securities, with the latter mainly comprising bonds and longer dated money market instruments. On a combined basis, these asset classes constituted 49% of the overall investment portfolio (FYE09: 53%) and covered net technical liabilities 1.2x at FYE10 (FYE09: 1.1x). More than 80% of cash and fixed income holdings were invested in securities with ratings of AA- or higher. Including only the government bond component, the coverage factor amounted to 0.8x at FYE10 (FYE09: 0.9x).

There was a large cash outflow of R1.1bn reported in F10, compared to an inflow of R701m in F09. This was mainly as a result of a R1bn investment in bonds and the sizeable dividend payment of R1.2bn. Accordingly, cash and cash equivalents declined by 33% and accounted for 21% of the portfolio in F10 (F09: 33%). This drove a deterioration in the claims cash coverage ratio, to 3.4 months from 4.9 months in F09. Cognisance is, however, taken of the large portfolio of bonds and money market instruments, which further support overall liquidity levels.

The proportion of capital exposed to total equities rose to 53% from 48% in F09, buoyed by the gains seen in the equity market. In this regard, in the last third of the financial year Santam entered into derivative fence structures covering R1bn and R750m of listed equities respectively. The first structure (R1bn) offers upside participation of 18% and the second structure provides for 16%, while both structures offer downside protection of 9%. The attachment points on the SWIX index are 5,311 and 5,589 respectively. The graph below reflects the upper and lower limits of the two tranches, adjusted to the ALSI Top 40 index. At 1H F11, on average there was 6.1% and 9.6% remaining upside (downside: 18.5% and 14.5%) in each structure respectively. The remaining R1.4bn unhedged equity investments, or 45% of the equity portfolio, constitutes 25% of capital. A 10% decline in the total equity portfolio (excluding the protection afforded by the hedge) would lower profit before tax by approximately R320m (5% of capital at FYE10).



Note: Top 40 upper and lower limits have been calculated using the same upside and downside protection percentages as on SWIX index

During F10, Santam acquired 100% of Emerald Risk Transfer and increased its shareholding to 100% in Centriq (from 66.6%), Indwe Broker Holdings (from 37.8%) and MiWay (from 31.3%). Fair value was determined using internal valuations on a fair and reasonable basis, as well as external valuations from a major auditing firm. Goodwill attributed to Indwe Broker Holdings and MiWay amounted to R356m

and R319m respectively, although the MiWay purchase consideration has been deferred, as it is dependent on future returns over the next three years. This led to a subsequent increase in subsidiary investments to R1.8bn, from R1.5bn previously.

Reinsurance

Unless specifically approved by the board, Santam does not accept any net exposure of greater than R50m (0.8% of capital), before the cost of reinstatement premiums. The insurer was within this specified limit across the board under its 2011 reinsurance programme.

Santam utilises a broad base of reinsurer participants, with the largest counterparty exposure being to Lloyds, and other large reinsurers including Munich Re, Gen Re, Swiss Re and Hannover Re. Only reinsurers with an international rating of A- or greater will be used. In F10, there was a R604m net transfer to the reinsurers (F09: R157m), which was a function of the softer claims experience. Over the past five years, Santam has ceded a total of R1.8bn to reinsurers, with the reinsurer loss ratio averaging 47%.

Solvency and reserving

Including unrealised gains, NPAT increased by 69% to R1.4bn in F10, supported by the substantially stronger underwriting profit. After accounting for R1.2bn in dividends (including a special dividend of approximately R620m), retained income increased by R264m for the year. Including the subordinated debt (which is permissible for solvency purposes), total capital amounted to R5.9bn at FYE10 (FYE09: R5.5bn). Following NWP growth of 6%, the international solvency margin rose to 46.7% from 45.9% previously, which was comfortable relative to management's target band for the group of 35% to 45%. The insurer plans to review the capital position in 4Q F11, and a formal dividend decision will be taken in conjunction with a review of the investment strategy on expiry of the equity derivatives. In view of the uncertainty surrounding developments under SAM, the company does not plan to significantly reduce solvency or increase investment risk in the near term. However, the longer term objective is to allocate capital efficiently after factoring in growth and acquisition opportunities. The statutory funding ratio decreased to 30%, from 33% in F09. This was mainly driven by an increase in the disallowed portion of investment in subsidiaries and associates, following the acquisitions in F10.

Santam has been using a risk based capital model to guide management decisions and capital allocation since 2007. The model was independently reviewed by Tillinghast in 2008 and is scheduled for another

review in 2012. The model continues to be developed in line with the Solvency II framework, which requires an insurer to remain solvent at a 99.5th percentile level of certainty over a one year time horizon. On this basis, Santam's internal capital model indicates that the insurer's solvency ratios were comfortably above the risk based capital requirement at a company and group level.

Santam assesses reserving requirements based on actuarial modelling, and holds a margin in excess of the best estimate and the more conservative 75th percentile level of reserves.

Debt rating factors

Santam issued R600m in subordinated callable notes in May 2007, at an effective fixed interest rate of 8.6%, and a further R400m in November 2007, at an interest rate of 9.6%. At FYE10, the gross gearing ratio amounted to 18.5% (FYE09: 18%). The funds from the debt issue are ring-fenced in a separate portfolio and invested in cash and fixed interest bearing investments, with a minimum benchmark return equivalent to Santam's bond performance. Interest rate swaps are used to hedge interest rate risk. The interest charge remained unchanged at R83m in F10, and was covered 12x by after tax profits and 16x by operating cash flow (F09: 7x and 17x respectively).

Financial performance

A five-year financial synopsis is reflected at the end of this report and brief comment follows.

GWP growth moderated to 7% in F10 (F09: 8%), with a soft rates environment resulting in a number of core divisions underperforming budget. Furthermore, corrective measures on certain books curtailed new business and in some instances saw a shedding of poorly performing portfolios, specifically within the broker services and portfolio management divisions.

from 70% in F09 (five year average: 67%). Accordingly, the earned loss ratio registered at a review period low of 64% in F10, having fluctuated within a fairly narrow band of between 67% and 71% in the prior four years. In this regard, cognisance is taken of the favourable industry performance over the past year, which is expected to normalise in the short to medium term.

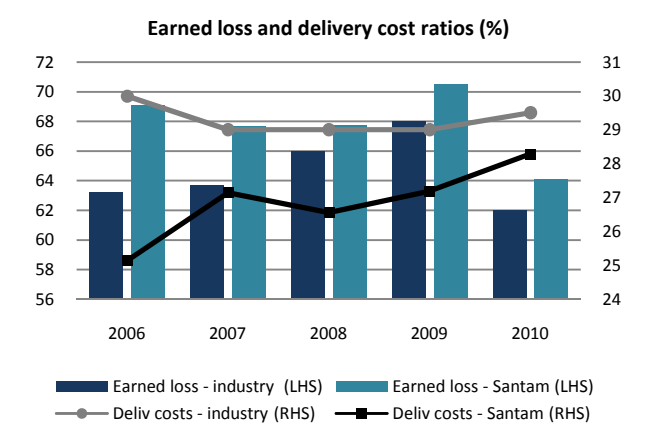
Santam's relative size and economies of scale have translated into a comparatively low delivery cost ratio, which has supported underwriting profitability in higher claiming years. However, the differential has narrowed over the past two years, which is ascribed to an increase in expenditure on strategic projects, technology and process improvements. The delivery cost ratio increased by a percentage point to 28% in F10 (budget: 26%), although improved cost efficiencies are expected to be realised in the near term.

Overall, the underwriting margin strengthened to 8%, which is double the projected margin, and compares to a low of 2% in F09. After accounting for unrealised gains on listed equities, the total investment yield was relatively stable at 9.4% in F10. Overall, ROaE registered at 30%, compared to 19% in F09.

Future prospects

GWP growth is expected to increase slightly in F11, supported by new corporate business and the acquisition of the Mirabilis portfolio, as well as an increase in personal lines volumes. Cost efficiencies are expected to be realised following systems improvements and operational streamlining in recent years. However, following the very low loss experience in F10, Santam expects to see a correction in the earned loss ratio. As such, underwriting profitability is expected to return to Santam's longer term target band of 4% to 6% over the short to medium term.

The international solvency margin is expected to moderate to within the group target range of 35% to 45%. Assuming that 100% of NPAT is paid as a dividend in F11, the international solvency margin would equate to roughly 43%.



The significant improvement in claims experience drove a contraction in the gross loss ratio, to 61%

Santam Limited
(R in millions except as noted)

Year ended : 31 December

	2006	2007	2008	2009	2010
Income Statement					
Gross written premium (GWP)	10,233.0	11,135.0	12,172.0	13,091.0	13,957.0
Reinsurance premiums	(1,040.0)	(1,019.0)	(1,036.0)	(1,085.0)	(1,261.0)
Net written premium income (NWP)	9,193.0	10,116.0	11,136.0	12,006.0	12,696.0
(Increase) / Decrease in insurance funds	(295.0)	(253.0)	(236.0)	0.0	16.0
Net premiums earned	8,898.0	9,863.0	10,900.0	12,006.0	12,712.0
Claims incurred	(6,151.0)	(6,672.0)	(7,386.0)	(8,468.0)	(8,153.0)
Commission	(1,283.0)	(1,435.0)	(1,598.0)	(1,821.0)	(1,964.0)
Management expenses	(954.0)	(1,242.0)	(1,297.0)	(1,443.0)	(1,632.0)
Underwriting profit / (loss)	510.0	514.0	619.0	274.0	963.0
Investment income	1,518.0	2,698.0	795.0	622.0	603.0
Taxation	(538.0)	(479.0)	22.0	(319.0)	(541.0)
Net income after tax	1,490.0	2,733.0	1,436.0	577.0	1,025.0
Dividends declared / paid	(1,165.0)	(3,129.0)	(489.0)	(513.0)	(1,176.0)
Unrealised investment movements	158.0	(1,269.0)	(786.0)	277.0	418.0

Cash Flow Statement

Cash generated by operations	588.0	632.0	679.0	352.0	1,048.0
Cash flow from investment income	429.0	918.0	791.0	568.0	599.0
Working capital decrease / (increase)	327.0	63.0	174.0	564.0	304.0
Tax paid	(513.0)	(200.0)	(593.0)	(63.0)	(616.0)
Cash available from operating activities	831.0	1,413.0	1,051.0	1,421.0	1,335.0
Dividends paid	(1,165.0)	(3,129.0)	(489.0)	(513.0)	(1,176.0)
Cash flow from operating activities	(334.0)	(1,716.0)	562.0	908.0	159.0
Cash flow from investing activities	(418.0)	(29.0)	847.0	(207.0)	(1,289.0)
Cash flow from financing activities	29.0	998.0	2.0	0.0	0.0
Net cash inflow / (outflow)	(723.0)	(747.0)	1,411.0	701.0	(1,130.0)

Balance Sheet

Shareholders interest	5,980.0	4,352.0	4,276.0	4,673.0	5,005.0
Debt securities	0.0	908.0	972.0	839.0	925.0
Total capital	5,980.0	5,260.0	5,248.0	5,512.0	5,930.0
Net unearned premium reserve	861.0	1,114.0	1,351.0	1,350.0	1,334.0
Net OCR and IBNR	2,486.0	3,017.0	3,278.0	3,557.0	3,511.0
Other liabilities	2,383.0	2,300.0	1,831.0	2,249.0	2,221.0
Total capital & liabilities	11,710.0	11,691.0	11,708.0	12,668.0	12,996.0
Fixed assets	37.0	31.0	36.0	39.0	40.0
Investments	7,985.0	8,362.0	6,734.0	7,126.0	8,894.0
Cash and short term deposits	2,095.0	1,347.0	2,759.0	3,460.0	2,330.0
Other current assets	1,593.0	1,951.0	2,179.0	2,043.0	1,732.0
Total assets	11,710.0	11,691.0	11,708.0	12,668.0	12,996.0

Key Ratios

Solvency / Liquidity

Shareholders funds / NWP	%	65.0	43.0	38.4	38.9	39.4
Total capital / NWP	%	65.0	52.0	47.1	45.9	46.7
Group capital / NWP	%	65.6	45.4	43.0	42.7	45.4
Solvency margin (Act)	%	51.8	39.4	35.3	33.2	30.2
Financial base (IFRS)	%	101.5	92.8	88.7	86.8	84.9
Net outstanding claims / NWP	%	27.0	29.8	29.4	29.6	27.7
Net UPR / NWP	%	9.4	11.0	12.1	11.2	10.5
Cash flow from operating activities / Liabilities	%	8.7	(27.0)	8.7	12.9	2.3
Claims cash coverage	months	4.1	2.4	4.5	4.9	3.4

Profitability

ROaE (before unrealised gains / losses)	%	33.3	52.9	33.3	8.6	14.1
ROaE (after unrealised gains / losses)	%	28.8	28.3	15.1	19.1	29.8
ROaE (incl. unrealised investment gains)	%	55.1	28.3	15.1	19.1	29.8
Investment yield (incl. unrealised investment gains / losses)	%	19.2	14.4	0.1	9.0	9.4

Efficiency / Growth

GWP Growth	%	9.1	8.8	9.3	7.6	6.6
Premiums reinsured / GWP	%	10.2	9.2	8.5	8.3	9.0
Earned loss ratio	%	69.1	67.6	67.8	70.5	64.1
Commissions / Earned premiums	%	14.4	14.5	14.7	15.2	15.4
Management expenses / Earned premiums	%	10.7	12.6	11.9	12.0	12.8
U/w margin	%	5.7	5.2	5.7	2.3	7.6
Trade ratio	%	94.3	94.8	94.3	97.7	92.4
Operating ratio	%	77.2	67.4	87.0	92.5	87.7

Debt rating ratios*

Gross gearing	%	n.a.	20.9	22.7	18.0	18.5
NPAT / debt servicing costs	X	n.a.	30.5	17.3	7.0	12.3