Credit Rating Announcement

GCR affirms Lombard's national scale financial strength rating of A+$_{(ZA)}$; Outlook Stable

Rating action

Johannesburg, 30 October 2020 - GCR Ratings ("GCR") has affirmed Lombard Insurance Company Limited's ("Lombard") national scale financial strength rating of A+$_{(ZA)}$; Outlook Stable. At the same time, GCR has affirmed Lombard's national scale long term issuer and issue ratings (notes LOM02, LOM03 and LOM04) of A$_{(ZA)}$ and BBB+$_{(ZA)}$ respectively. The Outlooks are Stable.

Rated Entity / Issue	Rating class	Rating scale	Rating	Outlook/Watch
Lombard Insurance Company Limited	Financial strength	National	A+$_{(ZA)}$	Stable Outlook
	Long term issuer	National	A$_{(ZA)}$	Stable Outlook
LOM02		National	BBB+$_{(ZA)}$	Stable Outlook
LOM03	Long term issue	National	BBB+$_{(ZA)}$	Stable Outlook
LOM04		National	BBB+$_{(ZA)}$	Stable Outlook

Rating rationale

The ratings on Lombard consider the insurer's position as the core operating entity within Lomhold Proprietary Limited ("Lomhold" or "the group") as well as strong liquidity and intermediate earnings and capitalisation. These factors are somewhat counterbalanced by a limited business profile, given low market share and geographic concentration to South Africa. Despite the very challenging operating environment and its adverse impact on the guarantee portfolio in FY20, earnings are expected to rebound in FY21, supported by a large net claim recovery, along with improved performance of other operating entities within the group. This is expected to continue to support capitalisation and liquidity at rating appropriate levels. The national scale long-term issuer credit rating is one notch lower than the financial strength rating because GCR views policyholder obligations to be senior to those of senior unsecured creditors. The ratings on the notes reflect the subordinated status and the mandatory deferability (if there is a solvency event or if the regulator requires) of the instruments.

Lombard has reflected sound cross cycle earnings, although underwriting profitability is susceptible to variability given the correlation between the performance of the guarantee book and the credit cycle. The economic impact of the COVID-19 pandemic lockdown resulted in elevated reserving in the trade credit portfolio, while construction was also impacted by higher claims experience in FY20. As a result, Lombard posted its first underwriting loss of the review period, with the underwriting margin registering at -5% versus a prior four year average of 4%. This in turn exerted pressure on net earnings, with Lombard's return on revenue reducing to 5% from an average of 9% between FY16 and FY19. Nevertheless, underwriting profitability is expected to improve in FY21, supported by a large claim recovery in the construction guarantee portfolio, offsetting potential ongoing pressure in the trade credit book and some normalisation in claims frequency for the rest of the book post-lockdown (although remaining competitive). Furthermore, Lomhold has reflected a strengthened earnings trend since FY18, following improved performance of other group operating entities. Accordingly, we expect the short term business underwriting margin to register within positive lower single digits in FY21 and the group operating margin to align with the prior cross cycle average of between 7% and 10% (FY20: 6%).

Liquidity strengthened in FY20 on the back of operational cash inflows, additional subordinated debt issue and net proceeds on investment sales. Stressed investment assets coverage of net technical provisions and operational cash requirements registered at 1.9x and 18 months respectively at FY20 (FY19: 1.2x and 12 months) after adjusting for collateral owing to reinsurers. Conservative asset allocation and improved earnings are expected to maintain liquidity at stronger levels over the outlook horizon, although the timing of claims settlements and recoveries could result in some fluctuation around the current level.

Risk adjusted capitalisation has been sustained at an intermediate level, supported by full profit retention and additional subordinated debt issuances. Including admissible subordinated debt, Solvency Capital Requirement ("SCR") coverage equated to 1.29x at FY20 (FY19: 1.26x) and is expected to remain at a similar level over the outlook horizon, supported by positive earnings and potentially reduced claims reserving risk charges. The capitalisation assessment considered the increase in leverage post the issuance of the new subordinated notes, which saw Tier-II capital rise to 39% of shareholders' equity from 29% previously.

Lombard's business profile is viewed to be moderate, with a limited (albeit gradually increasing) share of total industry gross premiums somewhat offset by the insurer's strong position in the construction guarantee sub-segment and brand recognition in other specialist classes. Diversification by line of business is healthy, with four to five classes contributing materially to revenue, while high policyholder granularity and good diversification between risk exposures is evident. However, the negative assessment for premium diversification stems from concentration to South Africa, which still accounts for more than 90% of GWP. Nevertheless, GCR notes strategic targets to diversify geographically, which could contribute positively to the business profile over the medium term.

Outlook statement

The Stable Outlook considers expectations that earnings will improve in FY21, with Lombard's cross cycle underwriting margin projected to range between 0% and 5% over the next 12 to 18 months. Furthermore, we expect liquidity to be maintained at strengthened levels (net technical reserve coverage above 1.5x) and SCR coverage to continue to register above 1.25x. The business profile is expected to be fairly stable over the near term, although there is potential for a more positive assessment beyond the outlook horizon as the insurer delivers on its geographic expansion strategy.

Rating triggers

We could raise the ratings over the longer term if liquidity and capitalisation strengthen on a sustainable basis, with coverage ratios above 2x and 1.5x respectively. Conversely, we could lower the ratings if the projected improvement in earnings does not materialise, particularly if this leads to reduced liquidity and/or capitalisation (with ratios falling below 1.5x and 1.2x respectively). A further increase in leverage could also contribute towards downward ratings pressure.

Analytical contacts

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Related criteria and research

Criteria for the GCR Ratings Framework, May 2019
Criteria for Rating Insurance Companies, May 2019
GCR Ratings Scales, Symbols & Definitions, May 2019
GCR Country Risk Scores, May 2020
GCR Insurance Sector Risk Scores, July 2020

Ratings history

Lombard Insurance Company Limited

Rated Entity / Issue	Rating class	Review	Rating	Rating	Outlook/Watch	Date
Lombard Insurance Company Limited	Financial strength*	Initial	National	A(ZA)	Stable Outlook	March 2004
		Last	National	A+(ZA)	Stable Outlook	October 2019
	Long term issuer	Initial/last	National	A(ZA)	Stable Outlook	October 2019
LOM02	Long term issue	Initial	National	BBB+(ZA)	Stable Outlook	October 2019
		Last		BBB+(ZA)	Stable Outlook	December 2019
LOM03	Long term issue	Initial/last	National	BBB+(ZA)	Stable Outlook	December 2019
LOM04	Long term issue	Initial/last	National	BBB+(ZA)	Stable Outlook	December 2019

*Formerly claims paying ability.

Risk score summary

Rating components & factors	Risk scores
Operating environment	**15.00**
Country risk score	7.00
Sector risk score	8.00
Business profile	**(1.50)**
Competitive position	(0.75)
Premium diversification	(0.75)
Management and governance	0.00
Financial profile	**0.75**
Earnings	0.25
Capitalisation	0.00
Liquidity	0.50
Comparative profile	**0.00**
Group support	0.00
Government support	0.00
Peer analysis	0.00
Total score	**14.25**

Glossary

Admissible	Values that are permitted by law to be included for regulatory purposes.
Asset	A resource with economic value that a company owns or controls with the expectation that it will provide future benefit.
Capital	The sum of money that is invested to generate proceeds.
Capitalisation	The provision of capital for a company, or the conversion of income or assets into capital.
Cash	Funds that can be readily spent or used to meet current obligations.
Credit Rating	An opinion regarding the creditworthiness of an entity, a security or financial instrument, or an issuer of securities or financial instruments, using an established and defined ranking system of rating categories.
Credit	A contractual agreement in which a borrower receives something of value now, and agrees to repay the lender at some date in the future, generally with interest. The term also refers to the borrowing capacity of an individual or company
Debt	An obligation to repay a sum of money. More specifically, it is funds passed from a creditor to a debtor in exchange for interest and a commitment to repay the principal in full on a specified date or over a specified period.
Diversification	Spreading risk by constructing a portfolio that contains different exposures whose returns are relatively uncorrelated. The term also refers to companies which move into markets or products that bear little relation to ones they already operate in.
Equity	Equity is the holding or stake that shareholders have in a company. Equity capital is raised by the issue of new shares or by retaining profit.
Issue Ratings	See GCR Rating Scales, Symbols and Definitions.
Issuer	The party indebted or the person making repayments for its borrowings.
Leverage	With regard to corporate analysis, leverage (or gearing) refers to the extent to which a company is funded by debt.
Liquidity	The speed at which assets can be converted to cash. It can also refer to the ability of a company to service its debt obligations due to the presence of liquid assets such as cash and its equivalents. Market liquidity refers to the ease with which a security can be bought or sold quickly and in large volumes without substantially affecting the market price.

Operating Margin	Operating margin is operating profit expressed as a percentage of a company's sales over a given period.
Proceeds	Funds from issuance of debt securities or sale of assets.
Rating Outlook	See GCR Rating Scales, Symbols and Definitions.
Reserve	An amount representing actual or potential liabilities kept by an insurer to cover debts to policyholders.
Senior	A security that has a higher repayment priority than junior securities.
Solvency	With regard to insurers, having sufficient assets (capital, surplus, reserves) and being able to satisfy financial requirements (investments, annual reports, examinations) to be eligible to transact insurance business and meet liabilities.
Subordinated Debt	Debt that in the event of a default is repaid only after senior obligations have been repaid. It is higher risk than senior debt.
Underwriting Margin	Measures efficiency of underwriting and expense management processes.
Underwriting	The process of selecting risks and classifying them according to their degrees of insurability so that the appropriate rates may be assigned. The process also includes rejection of those risks that do not qualify.

SALIENT POINTS OF ACCORDED RATINGS

GCR affirms that a.) no part of the rating process was influenced by any other business activities of the credit rating agency; b.) the ratings are based solely on the merits of the rated entity, security or financial instrument being rated; and c.) such ratings are an independent evaluation of the risks and merits of the rated entity, security or financial instrument.

The credit ratings have been disclosed to the rated entity. The ratings were solicited by, or on behalf of, the rated entity, and therefore, GCR has been compensated for the provision of the ratings. The rated entity participated in the rating process via virtual management meetings, and other written correspondence. Furthermore, the quality of information received was considered adequate and has been independently verified where possible.

The information received from the rated entity and other reliable third parties to accord the credit ratings included:

- Audited annual financial statements for Lombard and Lomhold to 30 June 2020;
- Four years of comparative audited financial statements to 30 June;
- Lombard budgeted financial summary to 30 June 2025;
- Other relevant documents