GCR RATINGS

CREDIT RATING ANNOUNCEMENT

GCR affirms Lombard's South Africa financial strength and long term issuer ratings of A+$_{(ZA)}$ and A$_{(ZA)}$ respectively; Outlook Stable

Rating Action

Johannesburg, 31 October 2022 - GCR Ratings ("GCR") has affirmed Lombard Insurance Company Limited's ("Lombard") national scale financial strength rating of A+$_{(ZA)}$ with a Stable Outlook. At the same time, GCR has affirmed Lombard's national scale long term issuer rating of A$_{(ZA)}$; with the Outlook maintained on 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

Rating Rationale

The ratings on Lombard consider its position as the core operating entity within Lomhold Proprietary Limited ("Lomhold" or "the group") and reflect the group's sound liquidity and an expected strengthening in capitalisation on the back of two corporate initiatives. These factors are counterbalanced by less competitive earnings and the insurer's small market share. 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.

Lombard's market share has increased gradually on the back of its ongoing diversification strategy, although it remains low at around 2%. We view this to be somewhat offset by the insurer's positioning and brand in the guarantee segment and growing presence in other specialist lines. Diversification by line of business is very healthy, supported by a multi-channel distribution network and the insurer's ongoing expansion in the Partnership business. As a result, four classes contribute materially to revenue, while there is high policyholder granularity and good diversification between product sub-segments. The insurer remains concentrated to South Africa, although expansion into Australia could enhance its business profile over the longer term.

Lombard has reflected positive cross cycle earnings, although underwriting profitability has been volatile given the linkage of the guarantee book's performance with the credit cycle. In this regard, after the large claims recoveries recorded in the prior year, the insurer raised reserves for some large guarantee claims in FY22 and was also adversely impacted by the KZN floods, resulting in a small underwriting loss in FY22. Cross cycle underwriting performance has been positive, but slightly lags the industry average with the five-year average combined ratio equating to about 98%. This is partly a result of the higher costs associated with its Partnership business model, which offsets its competitive claims experience. Group earnings have also been slightly below peer averages, with return on revenue averaging around 8%. Looking ahead, we see potential for the earnings profile to strengthen supported by strong growth in the commercial lines portfolio, which could improve economies of scale.

The group reflected sufficient capitalisation, and regulatory risk is viewed to have reduced after a refinement of the Solvency Capital Requirement ("SCR") coverage ratio calculation. The GCR capital adequacy ratio ("CAR") equated to 1.2x at FY22 and SCR coverage is projected to be similar at group and company level. The assessment considered relatively high leverage and upcoming refinancing risk as slightly offsetting factors. Going forward, an expected corporate transaction along with some investment restructuring could be positive for our capitalisation assessment if concluded in line with the anticipated terms and timeframes.

Strong operational cash flows supported higher liquidity, with stressed coverage of expected liquidity requirements registering at 1.4x at FY22 (FY21: 1.2x). This is expected to remain at similar levels as cash flows are expected to be positive in FY23 and the portfolio is conservatively invested. However, over the longer term there could be some dilution given the strong growth trajectory.

Outlook Statement

The Stable Outlook factors in the expected corporate transactions that are likely to support the strong growth trajectory, resulting in strengthened capitalisation and sustained strong liquidity. In this regard, the liquidity ratio is expected to be maintained at around 1.4x and GCR CAR is expected to increase to around 1.5x over the next 12 to 18 months. We expect the business profile to be stable over the near term, although there is potential for a more positive assessment beyond the outlook horizon as the insurer delivers on its growth strategy.

Rating Triggers

The ratings could be upgraded if GCR CAR strengthens above 1.5x on a sustainable basis. Furthermore, an improvement in earnings (combined ratio in the 90% to 95% range) that feeds into sustained liquidity strength could be positive for the ratings. Downward rating action could follow if underwriting profitability remains comparatively suppressed, resulting in a reduction in capitalisation and liquidity ratios below 1.2x and 1.4x respectively.

Analytical Contacts

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Related Criteria and Research

Criteria for the GCR Ratings Framework, January 2022
Criteria for Rating Insurance Companies, July 2022
GCR Ratings Scales, Symbols & Definitions, May 2022
GCR Country Risk Scores, August 2022
GCR Insurance Sector Risk Scores, September 2022

Ratings History

Lombard Insurance Company Limited					
Rating class	Review	Rating scale	Rating	Outlook/Watch	Date
Financial strength*	Initial	National	A(ZA)	Stable Outlook	March 2004
	Last	National	A+(ZA)	Stable Outlook	October 2021
Long term issuer	Initial	National	A(ZA)	Stable Outlook	October 2019
	Last	National	A(ZA)	Stable Outlook	October 2021

*Formerly claims paying ability

Risk Score Summary

Rating Components & Factors	Score
Operating environment	**14.50**
Country risk score	7.00
Sector risk score	7.50
Business profile	**(0.75)**
Competitive position	(0.75)
Management and governance	0.00
Financial profile	**0.50**
Earnings	0.00
Capitalisation	(0.25)
Liquidity	0.75
Comparative profile	**0.00**
Group support	0.00
Peer comparison	0.00
Total Risk Score	**14.25**

Glossary

Capital Adequacy	A measure of the adequacy of an entity's capital resources in relation to its risks.
Capitalisation	The provision of capital for a company, or the conversion of income or assets into capital.
Cash Flow	The inflow and outflow of cash and cash equivalents. Such flows arise from operating, investing and financing activities.
Cash	Funds that can be readily spent or used to meet current obligations.
Commercial Lines	Insurance for businesses, professionals, and commercial establishments.
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.
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.
Economies Of Scale	Economies of scale are the cost advantages of an increase in output if the fixed costs of doing so, such as those for plant and equipment, remain the same. The marginal cost, or the cost of the last unit of production, falls as output is raised.
Guarantee	An undertaking in writing by one person (the guarantor) given to another, usually a bank (the creditor) to be answerable for the debt of a third person (the debtor) to the creditor, upon default of the debtor.
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.
Refinancing	The issue of new debt to replace maturing debt. New debt may be provided by existing or new lenders, with a new set of terms in place.
Reserve	An amount representing actual or potential liabilities kept by an insurer to cover debts to policyholders
Reserves	A portion of funds allocated for an eventuality.
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.
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.

For a detailed glossary of terms please click here

SALIENT POINTS OF ACCORDED RATING

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 were based solely on the merits of the rated entity, security or financial instrument being rated; and c.) such ratings were 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 entities.

The ratings above were solicited by, or on behalf of, the rated entities, and therefore, GCR has been compensated for the provision of the ratings.

The rated entities participated in the rating process via face-to-face management meetings, as well as 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:

- Draft audited annual financial statements for Lombard and Lomhold to 30 June 2022;
- Four years of comparative audited financial statements to 30 June;
- Lombard budgeted financial accounts to 30 June 2027;
- Other relevant documents

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