

Global Credit Research - 24 Nov 2011

London, United Kingdom

### Ratings

Category	Moody's Rating
Rating Outlook	NEG
Senior Unsecured	Baa1
Senior Unsecured MTN	(P)Baa1
Commercial Paper	P-2
LT Issuer Rating	Baa1
Subordinate	Baa3 (hyb)
Junior Subordinate	Baa3 (hyb)
Pref. Stock	Baa3 (hyb)
<b>Old Mutual Capital Funding LP</b>	
Rating Outlook	NEG

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### Key Indicators

#### Old Mutual Plc[1]

	2010	[2]2009	2008	2007	2006
Total Assets (GBP Mil.)	193,552	163,806	144,283	142,740	128,575
Shareholders' Equity (GBP Mil.)	11,474	10,711	9,577	9,597	8,763
Net Income (GBP Mil.)	(24)	(118)	683	1,246	1,093
Gross Premiums Earned (GBP Mil.)	3,582	3,020	5,156	5,566	4,713
Goodwill & Intangibles % Shareholders' Equity	56.6%	77.5%	94.8%	80.4%	71.4%
Adjusted Financial Leverage	18.8%	20.6%	20.1%	20.9%	21.4%
Total Leverage	29.1%	29.4%	30.7%	25.9%	26.9%
Earnings Coverage (1 yr.)	6.5x	1.8x	4.8x	10.5x	10.1x

[1] Information based on IFRS financial statements [2] Restated to reflect US Life as discontinued operation

### Opinion

#### SUMMARY RATING RATIONALE

Based in London, Old Mutual plc (senior debt Baa1, negative outlook) is the holding company of a diversified group operating in the fields of life assurance, asset management, banking, non-life insurance and other financial services. The group has a particularly strong franchise in South Africa, occupying top market positions in life assurance (Old Mutual Life Assurance Company (South Africa), "OMLACSA", A1 IFSR negative outlook) and asset management and solid positions in banking (Nedbank, rated C- for Bank Financial Strength) and in non-life insurance (Mutual & Federal).

Old Mutual also has a significant presence in the UK and Swedish markets through its ownership of Skandia (A2 IFSR stable outlook for both Skandia Insurance Company Ltd and Skandia Life Assurance Company Ltd). Additionally, the group has a presence in the US market through various asset management operations.

On 23rd November 2011, Moody's affirmed the Group's debt ratings and IFSRs of OMLAC(SA) and Skandia, following the announcement of the outlook change in South Africa's sovereign rating from stable to negative. As part of this rating action, the outlook on the principal rated South African entity, OMLACSA, and the Group's debt ratings were changed from stable to negative (see relevant press release for further details). Prior to this, Moody's latest rating action was on 10 August 2011 when the outlook was revised to stable, from negative, following the announcement of the sale of the US Life operations, which concluded in the first half of 2011.. Notwithstanding the deterioration within the South African sovereign rating, Moody's considers the Group to have made good recent progress re its adjusted operating performance and capitalisation, whilst risk management controls have been improving in recent years and the good business and financial fundamentals of

Skandia and OMLAC(SA) continue.

Moody's rating approach to its Baa1 senior unsecured rating on Old Mutual plc reflects the intrinsic financial strength of its various operating units. The rating is also reflective of the material proportion of earnings derived from South Africa (A1 country ceiling for foreign currency bonds, negative outlook), presenting an element of sovereign risk. However, following the Skandia acquisition, Moody's views the group's profit profile as more diverse, such diversification being reflected in the rating.

#### **Credit Profile of Significant Subsidiaries (please also refer to separate Moody's credit opinions on the relevant entities)**

##### South African Life

The A1 Insurance Financial Strength Rating ("IFSR") at Old Mutual Life Assurance Company (South Africa), ("OMLAC(SA)") applies to the company's policyholders liabilities in South African rand and is assigned on a global scale. The rating reflects the company's very strong and resilient, though less dominant, franchise maintained over many years, its solid financial fundamentals in terms of efficiency, capitalisation, and its expertise in the fields of information technology, asset management and product design. Off-setting this to an extent is the non-linked equities exposure, which remains high and is one of the most significant risks for OMLAC(SA), although we note that the flexible liability profile mitigates the effect somewhat. Furthermore, the South African economic environment presents a number of potential challenges to profitability, sales growth, and policy surrenders, together with the political environment, as cited in the recent sovereign rating action from 09 November 2011.

OMLAC(SA) is Old Mutual's fully owned South African life assurance subsidiary and the group's largest operation in the country by asset size.

##### South African Banking

Nedbank Limited (Nedbank) is a wholly owned subsidiary of Nedbank Group Limited (Nedbank Group). Nedbank Group is listed on the Johannesburg Stock Exchange, and is majority owned (54.7%) by Old Mutual Life Assurance Company (South Africa) Limited and Old Mutual associates. Nedbank Group is one of the four largest banking groups in South Africa, with total assets of ZAR609.8 billion (US\$89.1 billion) as of June 2011, while Nedbank's total assets were ZAR580.1 billion, comprising 95% of Nedbank Group's assets.

Moody's assigns a bank financial strength rating (BFSR) of C- to Nedbank, mapping to Baa1 on the long-term scale. The rating reflects Nedbank's strong market presence in the South African banking sector as one of the four largest banks, with a share of approximately 18% of total assets. The C- BFSR also takes into account Nedbank's strengthened risk and capital management capabilities, moderate market-risk appetite and good capitalisation metrics, with a Tier 1 ratio of 12.4% as of June 2011. In addition, the bank's 33.3% increase in profit to ZAR2.4 billion for the period to June 2011 driven by an improved margin, strong non-interest revenue growth and lower specific provisioning charges are supportive to its BFSR. We also recognise the bank's improved retail banking franchise in terms of customer penetration, transactional banking market share, and earnings-generating capabilities.

However, these strengths are partially counterbalanced by Nedbank's high proportion of wholesale deposit funding and credit risk concentrations - issues faced by all major South African banks. The BFSR also incorporates the relatively weak asset quality of its retail residential mortgages portfolio and the impact that this has on its retail financial performance. Concurrently, the bank's relatively good asset quality in its other business lines restricts any negative rating pressure exerted from its retail residential mortgages portfolio.

Following the sovereign rating action, Nedbank Limited's A2/P-1 GLC deposit ratings and Aa2.za long-term national-scale deposit rating have been placed on review for downgrade. With regards to the bank's EMTN programme, the (P)A2 rating for senior unsecured debt and the (P)A3 rating for subordinated debt have also been placed on review for downgrade. With regards to the bank's domestic MTN programme, the Aa2.za national-scale rating for senior unsecured debt and Aa3.za national scale rating for subordinated debt have been placed on review for downgrade. The A3 long-term foreign-currency deposit rating has been assigned a negative outlook, in line with the outlook of the corresponding sovereign ceiling, whilst the P-2 short-term foreign-currency deposit rating remains unchanged. Finally, the C- BFSR (stable outlook), the P-1.za national-scale short-term deposit rating and the national-scale hybrid Tier 1 rating of A3.za (stable outlook) remain unaffected (see 10 November press release for further details).

##### US Asset Management

The Group's US asset management business provides central and back office support to a range of smaller investment management subsidiaries, enabling experienced managers to focus on their area of expertise whilst achieving the economies of scale of a large asset management group. In Moody's view this strategy has been relatively successful, although net client cash flows were minus \$10.4bn for the first half of 2011 (years ending 31 December 2010 and 2009 respectively minus \$18.0bn and \$7.1bn but positive \$1.5bn in 2009 excluding securities lending at Dwight Asset Management), reflecting the challenging environment for asset management business. In Moody's opinion, the boutique structure of Old Mutual's US asset management business leads to a somewhat different set of operational risks than those seen in more traditional asset manager structures, generating a need for particularly strong governance and management systems. Furthermore, profits continue to be pressurised since 2008. Old Mutual remains, in Moody's view, committed to a potential IPO of the USAM business, although the timing remains uncertain due to the ongoing market volatility.

##### Skandia

Moody's A2 insurance financial strength ratings on Skandia Insurance Company Ltd (SICL) and Skandia Life Assurance Company Ltd (SLAC) reflect Skandia's good market position, being a leading Swedish life player with a growing unit-linked franchise in the UK, low product risk and good capitalisation.

These strengths are off-set by the continued challenge of rebuilding the market share of its Swedish unit-linked market business which has been experiencing margin pressure in recent years. In 2010 sales and profitability dropped, with Nordic Life new business sales (on an APE basis) down 21% at SEK 2,238m (2009: SEK 2,819m) as a result of the discontinuance of an unprofitable product. However APE post tax margin continued improving to 21% in 2010 (2009: 19%, 2008: 15%) and further improved to 23% for the first six months of 2011. In addition, distribution of products is predominantly via unaffiliated third party independent financial advisors (IFAs), although the Nordic division is less reliant on the IFA channel than, for example, the UK business and the tied agent channel is increasing in terms of size and importance. Skandia's performance has been mixed in recent years as demonstrated by its earnings volatility, driven in part by legacy issues. Skandia has settled all the remaining legacy issues in relation to the sale of American Skandia.

For Skandia's UK operations (which represented around 53% of the Wealth Management segment at H1 11, as measured on an APE basis), whilst sales initially grew rapidly following the acquisition, 2008 witnessed an 18% decline in life new business APE sales, followed by a 7% reduction in 2009 across the wealth management division as a whole (of which the UK is the largest component), driven by the recessionary environment and a combination of the tough competitive environment and the relatively high per policy expenses of Skandia. However, Moody's noted in 2010 a trend reversal, with APE sales increasing 28% to GBP 352m. More negatively, margins in the wealth management division remain pressurised in 2010, at 9% APE margin (post-tax) (2009: 8%) and, specifically, UK margins were only 3% (2009: 2%), well below the Group's longer-term target for the UK of 11-12%. More recently however, we note an improvement in the UK margins, to 6% at H1 2011, and in the wealth management division generally, to 11% at H1 2011. Net Client Cash Flows decreased to £1.8bn at H1 11 (H1 10: £2.3bn), although this reflects a boost in 2010 sales in Italy due to a special taxation scheme.

### **Credit Strengths**

- Strong mature South African financial services franchise.
- Good business and financial fundamentals of Skandia and, especially, OMLACSA.
- Diversified geographical and business profile.
- Relatively low financial leverage.

### **Credit Challenges**

- Improving Retail Europe and Wealth management profitability.
- Whilst considered unlikely, potential issues arising from the run-off of the Bermudan business.
- Improving interest cover.
- Improving US asset management net client cash flow.

### **Rating Outlook**

The Outlook on OMLACSA and Old Mutual's ratings were affirmed with a negative outlook on 23rd November 2011, following the sovereign rating. The outlook on Skandia Insurance Company Ltd and Skandia Life Assurance Company Limited remain stable.

### **What Could Change the Rating - Down**

Negative rating pressure could arise from the following:

- A further negative rating action on South Africa's sovereign rating
- A deterioration in OMLACSA and Skandia's credit profiles;
- A meaningful reduction in business and geographic diversification;
- Failure to sustain hard interest cover of at least 2x;

### **What Could Change the Rating - Up**

Given the current negative outlook at the Group level, positive rating pressure is considered unlikely in the near-term. However, in the longer term, this could arise if (i) the IFSR of OMLACSA and Skandia were upgraded; (ii) consistently low financial leverage (less than 20%) and sustained earnings coverage above 8x are delivered; and/or (iii) Old Mutual delivers sustained return on capital levels of at least 10%.

Moody's might change the outlook to stable if the outlook on South Africa's sovereign rating stabilises.

### **Recent Results and Company Events**

At H1 11, Old Mutual reported higher adjusted operating profit of £845m (H1 10: £714m), net income post tax and minority interests of £489m (H1 10: £265m), equity of £11.5bn, net client cash flows of -£3.6bn, and Funds Under Management of £303bn. The Group's FGD regulatory capital surplus was stable from year-end 2010, at £2bn with a coverage ratio of 150%.

Following the announcement in March 2010 of a rationalisation of its activities, the Group concluded in April 2011 the sale of its US Life operations to affiliates of Harbinger Capital Partners LLC for a consideration of \$350m. It is also preparing its US asset management business for a potential partial IPO, and remains committed to reducing its debt by at least £1.5 billion by the end of 2012.

### **Capital Structure and Liquidity**

As a significant proportion of the group's principal operating activities are domiciled in South Africa, Old Mutual plc remains somewhat exposed to restrictions on foreign exchange transfers out of South Africa. In Moody's view, this reduces the fungibility of any liquidity available in the South African operations, increasing the need for robust liquidity arrangements at holding company level. The vast majority of external financial debt is issued by the UK holding company, and the main sources for servicing debt and any shareholder dividends are the cash flows arising from the mature South African operations, the US asset management operations and Skandia UK and Nordic.

The group's operating cash-flows have significantly improved in 2010 (£3.6bn versus 1.2bn in 2009). However, holding company operational receipts declined to £433m (2009: £529m). In aggregate, Moody's regards additional liquidity resources which could be drawn upon if necessary as an important rating factor. In Moody's view, these have previously been a little limited but have improved recently with liquid assets held centrally of around £694m at H1 11 (YE 10: £438m). Other borrowing facilities available to the group include a £1,200m revolving credit facility available until April 2016 - utilisation at H1 11 being nil of drawn debt and £174m (YE 10: £499m) of LOCs and a £600m Euro CP program

(rated P-2 which is currently un-drawn).

With regard to financial flexibility, financial leverage remains relatively low at around 19%, and the Group is committed to reducing debt by GBP1.5bn by the end of 2012. This should aid earnings cover which has been under pressure in recent years, although we noted a strong improvement in 2010 at 6.5x. Hard interest cover, which excludes South African earnings, also improved in 2010 to 2.6x and H1 11 to 3.0x in line with Moody's expectations of at least 2x coverage for the current rating level. In Moody's opinion, Old Mutual's overall financial flexibility has improved somewhat as evidenced by its GBP500m subordinated debt issuance of May 2011 and improved holding company liquidity. In addition, the Group called GBP300m subordinated debt securities in January 2011 and realised a tender offer on EUR550m in July 2011, reducing further the level of financial debt.

However, there remains a significant reliance on the Group's revolving credit facility in calculating the holding company's total liquidity headroom of £1.7bn at 1H 11. Old Mutual's debt structure remains a mix of senior, dated subordinated, perpetual subordinated and preferred securities- the profile of debt maturities is well spread across future years. Of particular note is the \$750m preferred security issued in 2003, which has been callable since December 2008. Whilst it is in issue, all other regulatory qualifying securities rank pari-passu with this instrument in liquidation. As a consequence, all such instruments have been rated at the same level (currently Baa3), which in some instances (for example dated subordinated debt) is a notch lower than normal practice. In the event that the preferred securities are no longer in issue, Moody's expects to revert to normal notching practice for all outstanding instruments.



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