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Old Mutual Life Assurance Co. (South Africa) Ltd.

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Old Mutual Life Assurance Co. (South Africa) Ltd.

Major Rating Factors

Operating Company Covered By This Report
Financial Strength Rating
Local Currency
BB+/Stable/--

Strengths

- Strong footing as a leading, fully-fledged life and saving products provider in South Africa, complemented by promising, albeit small and fragmented, market positions abroad.
- A resilient balance sheet, thanks to prudent capital and reserve buffers and product structures, the majority of which allow flexible guarantees and include mechanisms to share profits and losses with policyholders. Should a severe default stress occur--such as our hypothetical sovereign stress scenario--we expect policyholder funds to share the bulk of losses.
- Adequate financial flexibility due to low financial leverage and healthy fixed-charge coverage.

Weaknesses

- Elevated levels of economic risk in South Africa, which weighs negatively on revenues and earnings, in common with peers.
- Economic conditions in South Africa lead to a weaker asset quality on the balance sheet, given the majority of locally denominated assets.
- Whilst largely complete, potential for operational disruption following the completion of the managed separation of the broader Old Mutual group.

Rationale

S&P Global Ratings' financial strength ratings on Old Mutual Life Assurance Co. (South Africa) Ltd. (OMLACSA) reflects the company's very strong domestic franchise and the significant flexibility provided by the nature of the products and the policyholder loss sharing mechanisms therein. These strengths are mitigated by both the challenging economic conditions in South Africa as well as the weaker asset quality given the majority of OMLACSA's liabilities (and therefore its assets) are held in South Africa.

Outlook

The stable outlook on Old Mutual Life Assurance Co. (South Africa) Ltd. (OMLACSA) reflects S&P Global Ratings' stable outlook on South Africa. The downgrade in November 2017 reflects the downgrade of the sovereign at that time. We rate OMLACSA one notch above the 'BB' foreign currency rating on the sovereign. This reflects our belief that OMLACSA's largely loss-absorbing liability profile allows it to withstand the stress associated with a foreign currency sovereign default. We use our South African national scale tables to derive our 'zaAAA' national scale rating on OMLACSA.

We limit our global scale ratings on OMLACSA to the 'BB+' local currency ratings on South Africa. This is because, in our view, OMLACSA's asset and liability concentration in the domestic economy makes it susceptible to the financial and macroeconomic stresses associated with a local currency sovereign default.

Downside Scenario

We consider the company's relatively robust SACP as unlikely to trigger negative rating actions in the coming 12 months, at the current rating level. However, we could lower the rating on OMLACSA over the same timeframe if:

- We were to lower our local currency sovereign credit ratings on South Africa; or
- If we saw exceptional dividends impacting capital; unexpected negative consequences of the dismantling of Old Mutual PLC (OM PLC, although this is now largely completed); earnings fundamentals deteriorating (e.g. the new business margin sustainably fell below 2.5%); or deterioration in the credit quality of assets; or a weakened balance sheet to the extent that OMLACSA failed to pass our sovereign foreign currency default stress scenario.

Upside Scenario

We could raise the rating on OMLACSA over the next 12 months if:

- We were to raise our local currency sovereign credit ratings on South Africa.

Given the linkages between the sovereign credit rating and that of OMLACSA, it is unlikely that an improvement in the stand-alone characteristics of OMLACSA would, by itself, lead to a rating upgrade.

Base-Case Scenario

Macroeconomic Assumptions

- Real GDP growth in South Africa of 0.8-2.3% per year over 2018-2021.
- Savings to remain above 16% of GDP over 2018-2020.

Table 1

Economic Forecast Summary | South Africa

	2014	2015	2016	2017	2018F	2019F	2020F	2021F
Key Indicators								
GDP (Real, YOY%)	1.8	1.3	0.6	1.3	0.8	1.8	2.3	2.3
CPI (Avg, YOY%)	6.1	4.6	6.3	5.3	4.8	5.3	5.4	5.4
CPI (Q4 Avg, YOY%)	5.7	4.9	6.6	4.7	5.4	5.3	5.4	5.4
Unemployment (%)	25.1	25.4	26.7	27.5	27.3	27.3	27.0	26.5

Source: S&P Global Economics, S&P Global Ratings, Oxford Economics.

Company-Specific Assumptions

- Gross premiums earned to rise by 0%-5% per year.
- Funds under management to increase by 0%-5% per year.
- Inorganic growth to remain muted, with a focus on consolidating existing sub-Saharan positions.

Key Metrics

Table 2

Key Metrics

		--Fiscal year end Dec. 31--			
(Mil. ZAR)	**2019F**	**2018F**	**2017**	**2016**	**2015**
Gross premiums earned	>50,000	>50,000	48,320	50,224	43,523
Net income	~9,000	~9,000	7,188	8,014	3,050
Total assets under management	~660,000	~640,000	639,121	605,080	588,912
Return on shareholders' equity (reported) (%)	>15.0	>15.0	14.2	16.3	6.3
Net investment yield (%)	~4	~4	4.2	4.2	4.0
EBITDA Interest coverage (x)	>8.0x	>8.0x	10.0	22.9	8.2
Financial leverage (%)	<15	<15	12.0	6.9	7.0

ZAR--South African rand. f--Forecast data reflects S&P Global Ratings' base-case assumption. Net income forecasts excluding mark-to-market impact. Figures relate to OMLACSA, the rated South African company, not OMEM/OML consolidated figures. EBITDA Interest Coverage is calculated excluding collateral held.

In addition, we highlight the following expectations over the next two years:

- Capital adequacy to remain at least in the upper adequate range, that is in the upper 'BBB'/lower 'A' capital adequacy range.
- Life new business margin to remain above 3% (first-half 2018: 3.3%).

Business Risk Profile: Strong Market Position In South Africa Partially Mitigates Challenging Operating Conditions

OMLACSA is the leading player in the life and saving insurance industry in South Africa, with South African rand (ZAR) 48 billion of gross premiums earned and ZAR639 billion of assets under management at year-end 2017. OMLACSA holds a leading position in both the retail ("Mass and Foundation Cluster") and corporate segments. Following the completion of the managed separation of Old Mutual Plc's various business units during the second half of 2018, Old Mutual Limited ('OML'), of which OMLACSA is by far and away the largest component, is now a separate, listed entity on the Johannesburg Stock Market.

Diversified and majority-controlled distribution capabilities add to OMLACSA's competitive strengths, including employee sales, tied agents, agency franchise distribution, and personal finance advice. OM Insure's ('OMI') number 2 position in the South African P/C market complements OMLACSA's footprint and product offering in South Africa. The Rest of Africa business for OMLACSA, whilst small in absolute terms, does provide some geographic diversification into East and West Africa as well as Southern African Development Countries (SADC).

Reflecting the ongoing challenging macroeconomic environment in South Africa, we anticipate revenue growth (i.e. gross earned premiums) to be no more than 5% for each of the next two years, as compared to our prior expectations of 5%-10%.

OMLACSA's domestic life insurance franchise is complemented by Old Mutual Insure (formerly known as Mutual & Federal), the second-largest non-life insurer in South Africa. After a challenging period from a profitability perspective, we anticipate further improvements in the underlying performance of this business, with the underwriting result improving to ZAR270 million as at first-half 2018 (first-half 2017: ZAR96 million).

In the retail market, OMLACSA is leading the traditional players in the low-income segment ("Mass and Foundation Cluster"), while it holds top-3 positions in most of the middle-income segments. OMLACSA's is a top-3 player in the high-net-worth business, and is the market leader in the corporate segment. OMLACSA draws its strength from its large product offering in both the with-profit segment, where it leads the market, and in unit-linked offers.

Financial Risk Profile: Notwithstanding Flexible Product Nature, Asset Risk Constrains Capital Adequacy

OMLACSA's balance-sheet resilience is supported by substantial buffers within its with-profit policyholder funds (WPF). Such buffers, in particular the bonus-smoothing reserves and the non-vested part of the bonuses, could offset the potentially high volatility due to substantial investment in equities within the WPF (60%-70% of invested assets). Smoothed-bonus reserves comprise nearly half of OMLACSA's reserves, while unit-linked funds, mostly without investment guarantees, make up a similar level and non-profit reserves the remainder (less than 10%).

This liability profile, which includes significant mechanisms for sharing profits and losses with policyholders (including the ability to make negative bonus declarations, as well as market risk hedging programmes), contributes to our view of the balance sheet's resilience to investment market volatility. In addition, most products pay market value on termination. That said, the highly competitive nature of the savings market and high policyholder expectations might discourage OMLACSA from making full use of the loss-sharing mechanisms in all bar the most extreme of stress events. We therefore view OMLACSA's capital adequacy as being healthy, but constrained by the asset risk borne by the balance sheet.

OMLACSA's capital adequacy is constrained by lower asset quality. The average credit quality of OMLACSA's asset portfolio is within the 'BB' range because the significant majority of its assets are held as bank deposits (in local banks) and local currency sovereign bonds. OMLACSA also maintains substantial asset exposure to high-risk assets, such as equities, properties, loans, and speculative-grade and unrated bonds, although the profit-and-loss sharing mechanisms describe above also mitigates this.

OMLACSA's financial leverage is low, even including the recent debt issuances at OM Plc and OM Insure, and its fixed-charge coverage is healthy. Excluding collateral held as at end-2017, this was 10x, with financial leverage of 12%, including the downstreamed €400 million from Old Mutual Plc and the ZAR500 million instrument issued by OMI. In November 2018, Old Mutual Plc announced and completed the redemption of various outstanding hybrids at the Old Mutual Plc level. We view OMLACSA as self-sufficient for capital generation to fund organic growth post the managed separation.

Other Assessments

Enterprise risk management: Adequate

We view the ERM importance to the rating as high, given the substantial market risk in OMEM's assets, and its broad geographic exposures and complex structure. Our adequate ERM assessment is mostly driven by practices in place for OMLACSA that are replicated for its foreign businesses. OML has explicit capital-at-risk and earning-at-risk, cash-at-risk, and operational risk tolerances. OML also has adequate processes in place to maintain its risk positions within tolerances. Furthermore, OML has an extensive key risk identification program where it groups the main risks into different tolerance levels and this complements management actions. Risk reporting is extensive and granular. Management and board awareness of risk taking is high, as evidenced by extensive risk focus in the quarterly board review.

Management and governance: Satisfactory

OML's management has extensive experience and expertise in its chosen markets and risks. It has a clear strategy and adequate structure and skills to be able to execute it. We expect the managed separation to contribute positively to reinforcing OML's management and governance as it had led to the transfer of certain corporate tasks formerly held at OM PLC ahead of the managed separation.

Liquidity: Exceptional

OMLACSA's liability bias toward smoothed with-profit business and the related heavy exposure to equities support heavy charges under our liquidity analysis, versus insurers with asset allocations mostly geared toward investment-grade bonds. Still, OMLACSA and OML boast exceptional liquidity, thanks to the liquid nature of investments backing liabilities, and because of their ability to apply market value adjustments in case of lapse surge in a stressful market environment.

We think that collateral posting risk is manageable and that risks arising from contingent liabilities are unlikely to materially affect liquidity. The current 19.9% Nedbank stake held within OMLACSA does not materially affect liquidity at OMLACSA, in our view.

Rating above the sovereign: OMLACSA passes the foreign currency stress test.

OMLACSA holds approximately 95% of its assets in South Africa. However, the bulk of its life liabilities are with-profit or unit-linked and feature substantial loss-sharing abilities with policyholders. Should a severe default stress occur--such as our hypothetical sovereign stress scenario--we expect OMLACSA's policyholder funds to share the bulk of losses. We would expect shareholder funds to suffer substantially under such a scenario, but not be fully exhausted. Therefore, OMLACSA and OML withstand our foreign currency sovereign default stress test.

However, we limit the ratings on OMLACSA to the level of our local currency sovereign credit ratings on South Africa because we believe the insurer remains susceptible to financial and macroeconomic stresses associated with a local currency sovereign default, given its asset and liability concentration in the domestic economy.

Support

Group support

The company covered by this report is OMLACSA. We view OMLACSA as core to OML.

Accounting Considerations

We base our analysis on the OMLACSA IFRS financial statements.

Related Criteria

- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables, July 27, 2017
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- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Insurance - General: Enterprise Risk Management, May 7, 2013
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- General Criteria: Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions, Oct. 22, 2012
- Criteria - Insurance - General: Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- Criteria - Financial Institutions - General: Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers, Feb. 10, 2010
- Criteria - Financial Institutions - Banks: Assumptions: Clarification Of The Equity Content Categories Used For Bank And Insurance Hybrid Instruments With Restricted Ability To Defer Payments, Feb. 9, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2014
- Criteria – Insurance – General: A New Level of Enterprise Risk Management Analysis: Methodology for Assessing Insurers' Economic Capital Models, Jan. 24, 2011

Ratings Detail (As Of December 5, 2018)
Operating Company Covered By This Report

Ratings Detail (As Of December 5, 2018) (cont.)	
Old Mutual Life Assurance Co. (South Africa) Ltd.	
Financial Strength Rating	
Local Currency	BB+/Stable/--
Issuer Credit Rating	
Local Currency	BB+/Stable/--
South Africa National Scale	zaAAA/--/zaA-1+
Subordinated	
South Africa National Scale	zaAA-
Domicile	South Africa

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.