Nepal Reinsurance Company Limited

ICRA Nepal assigns [ICRANP] IPO Grade 2 to the proposed IPO of Nepal Reinsurance Company Limited

INSTRUMENT/FACILITY	ISSUE SIZE	RATING ACTION (JUNE 2019)
Rights issue (Equity)	NPR 1,600 million	[ICRANP] IPO Grade 2 (Assigned)

ICRA Nepal has assigned **[ICRANP] IPO Grade 2**, indicating above-average fundamentals to the proposed Initial Public Offering (IPO) of equity shares amounting to NPR 1,600 million of Nepal Reinsurance Company Limited (Nepal Re). ICRA Nepal assigns IPO[1] grading on a scale of IPO Grade 1 through IPO Grade 5, with Grade 1 indicating strong fundamentals and Grade 5 indicating poor fundamentals. For the grading categories 2, 3 and 4, the sign of + (plus) appended to the grading symbols indicate their relative positioning within the grading categories concerned. Thus, the grading of 2+, 3+ and 4+ is one notch higher than 2, 3, and 4 respectively. Nepal Re has proposed an IPO of 16,000,000 numbers of equity shares, of face value NPR 100 each, to be issued to the general public including the staffs of Nepal Re.

The above average fundamental grading factors in the strong ownership profile of Nepal Re with 100% institutional holding (including ~44% stake by the Government of Nepal - GoN) coupled with regulatory and policy-level support accorded to it by the GoN, given its status as the only domestic reinsurer. The grading also factors in Nepal Re's strong solvency profile, adequate reinsurance (retrocession) arrangements and good underwriting performance of the company so far. Regulatory provision requiring all domestic insurers to cede 20% of their business to Nepal Re remains a strong positive, which is expected to support the business growth and profitability of the insurer going forward. Moreover, its increasing acceptability from foreign insurance companies, including a cross border reinsurance licence from the Insurance Regulatory and Development Authority of India (IRDAI) also remains a positive from the future growth perspective. Nepal Re is also expected to benefit from the policy level changes and the mechanism proposed to be introduced[2] by the GoN for supporting reinsurance sector growth in Nepal.

However, the grading remains constrained by the limited track record of Nepal Re as a full-fledged reinsurer. The grading also remains constrained by high business concentration (~62% of gross premium written in FY2018 from its top ten customers); albeit partly contributed by the provision of mandatory cession, which signifies reinsuring a fixed percentage of the total risks with the reinsurer. Being a regulation-supported business, Nepal Re also remains exposed to the change in regulatory norms, especially regarding the provision of mandatory cession by local insurers. With over 90% of its business coming from the domestic market, the company also remains exposed to the geographical concentration risk; albeit partly mitigated by adequate reinsurance coverage, including catastrophic coverage taken by Nepal Re. The grading also remains constrained by the competition Nepal Re faces from other established foreign reinsurers offering their services in Nepal.

Nepal Re was established as a government-promoted reinsurance pool in 2003, created to provide cover against the losses arising from riots, sabotage and terrorism risk (RSTMD[3]), after foreign reinsurers declined to provide cover against those losses during insurgency in Nepal. The pool had equity participation from the GoN and general insurers of Nepal but was subsequently converted into Nepal Re in November 2014 with a mandate to operate as a reinsurer. For FY2015 and FY2016, Nepal Re's business was largely restricted to the RSTMD cover. Through the budgetary announcement for FY2017, the GoN encouraged all domestic insurers to reinsure a portion of their risk with Nepal Re. From FY2019, the GoN, through the insurance board, has directed all domestic insurers to mandatorily reinsure 20% of their risk with Nepal Re. This is expected to solidify the revenue profile of Nepal Re going forward.

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[1] Includes rights and further public issue of equity shares

[2] as declared during the budgetary announcement for FY2020.

[3] Riot, Sabotage, Terrorism & Malicious Damage

During the last two to three years, Nepal Re's gross premium written (GPW) has reported a healthy growth, albeit on a low base and remains supported by the regulatory changes. Its GPW grew by 91% in FY2017 after the GoN encouraged domestic insurers to reinsure with Nepal Re. The premium growth moderated to 23% in FY2018 before spiking to ~52%, annualised during H1 FY2019 after the GoN made 20% cession to Nepal Re mandatory for all domestic insurers. For FY2018, ~90% of Nepal Re's gross premium written (GPW) was accounted for by general insurance businesses with the balance 10% coming from life insurers (entirely comprised of term life policies). Over the last three years ending FY2018, 90-95% of the GPW for Nepal Re has come from general insurance companies. Regulatory support remains the key revenue driver for Nepal Re with ~92% of the GPW in FY2018 coming from direct cession and treaty insurance with the rest coming through facultative insurance. Similarly, ~93% of the GPW in FY2018 came from domestic companies, indicating a strong domestic base to Nepal Re's business.

Nepal Re's portfolio remains largely similar to that of the Nepalese general insurance companies from which it derives most of its business. For FY2018, ~39% of Nepal Re GPW came from the motor business, followed by 23% from fire, 11% from its engineering business and ~10% from the term life business. The rest was accounted for by marine, miscellaneous and cattle/agro insurance. Premium retention remains high across all major portfolios like fire and motor, mainly due to the granularity in the portfolio insured[4]. For FY2018, Nepal Re's premium retention ratio stood at 78% vs. 83% in FY2017. Adequate capitalisation and solvency profile coupled with adequate retrocession arrangements provide comfort on Nepal Re claims' paying ability, despite the company's high premium retention. For fixed property insurance, Nepal Re has ceded risk above NPR 40 million per insured property (NPR 15 million for motor business) to its reinsurer through back-end retrocession treaty. This effectively reduces the liability of Nepal Re towards individual risks across all portfolios. For multiple losses arising from catastrophic events, net liability of Nepal Re is limited to NPR 350 million per events, through catastrophic provision in the retrocession arrangements. Catastrophic provision enables Nepal Re to recover catastrophic losses up to NPR 11,150 million from its reinsurers by retaining NPR 350 million on its account.

Underwriting performance of Nepal Re remains healthy so far, supported by higher premium retention and low claims ratio (~35% in FY2018 vs. ~47% in FY2017). For Nepal Re this ratio stems from the industry-wide moderate claims ratio and sizeable RSTMD portfolio (~38% of GPW in FY2018) of Nepal Re, wherein the claims ratio has come down significantly over the years. The underwriting performance also remains aided by the very low management expense ratio of the company, on account of the lean organisational structure. This has supported the company's underwriting surplus, despite the recent increase in the commission expense on inward business. Nepal Re reported a combined ratio of 70% for FY2018 vs. ~87% in FY2017 corresponding to an underwriting surplus of NPR 900 million and NPR 235 million. The improvement in the combined ratio on a growing premium base augurs well for incremental return prospects to the equity holders.

Profitability indicators of Nepal Re remain adequate despite being in the early years of its operation. This stems from the good underwriting performance of the company. With the mandatory 20% cession to Nepal Re implemented from FY2019, incremental profitability outlook for Nepal Re remains good. Nepal Re has reported a return on assets of 7-9% over the last two to three years, corresponding to the return on net worth of 9-10%. Return indicators remain moderate given the sizeable capital base of the company and the early stage of the company's operation. This is expected to improve going forward, as the business stabilises and the economies of scale kick in.

The profitability of Nepal Re is also supported by its investment income, given the sizeable investment portfolio of ~NPR 11 billion as of mid-January 2019 and its improving yield thereon. Over 90% of the investment portfolio of Nepal Re is concentrated in the fixed deposit accounts with banks and financial institutions, in line with the regulatory requirement. Tight liquidity in the banking sector and the resulting

[4] *Automatic direct cession to Nepal Re can only be made up to a certain ceiling. Beyond that the risk has to be offered facultatively to Nepal Re. In FY2018, overall facultative business was less than 10% which indicates higher granularity of the portfolio.*

hardening of the deposit rates have, therefore, benefitted large institutional depositors like Nepal Re. The average yield on investment for Nepal Re stood at ~10% in FY2018 vs. ~7% in FY2017 and ~6% in FY2016. Nepal Re has been maintaining the mandatory technical reserves and restricted reserves[5] as prescribed by the regulatory authority (Insurance Board of Nepal). As on mid-Jan 2019, the said reserves accounted for 57% of the net worth of Nepal Re. The regulator has not prescribed any solvency guidelines for Nepal Re. However, the solvency margin calculated based on 20% of the net premium written (NPW) stands adequate at ~10 times as on mid-January 2019.

Company Profile

Nepal Re-Insurance Company Ltd. (Nepal Re) is the successor of the insurance pool that was set up in 2003 with the aim to cover the losses arising from situations like riot, sabotage, or terrorism and malicious damage (RSTMD), during the insurgency in Nepal. Nepal Re was incorporated on November 7, 2014, under the Companies Act, 2006 as per the decision of the Council of Ministers to convert the pool to that of a reinsurance company. The company came into operation from December 2014. This is the first and only Nepalese reinsurance company.

The paid-up capital and the net worth of Nepal Re as of mid-Jan 2019 stood at NPR 8,400 million and ~NPR 11,686 million respectively. At present, the entire equity shares of Nepal Re are held by promoter shareholders. The shareholding is divided among the Government of Nepal (GoN) (~44%), 17 non-life insurance companies (~38%) and eight life insurance companies (~8%) and other public institutions (~10%).

During FY2018, Nepal Re reported a profit after tax of ~NPR 1,017 million (NPR 560 million in FY2017) over an asset base of NPR 13,026 million as of mid-July 2018 (NPR 10,021 million as of mid-July 2017). During H1 FY2019, Nepal Re reported a profit after tax of ~NPR 558 million.

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About ICRA Nepal Limited:

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[5] *Technical reserve includes (reserve towards unpaid claims & unexpired risk); restricted reserves include Insurance reserve and Insurance fund appropriated from annual profits.*

For more information, visit www.icranepal.com

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