

Rating-Agentur Expert RA GmbH assigned 'BB' reliability rating to Balcia Insurance SE according to the international scale. The rating outlook is stable.

Rating-Agentur Expert RA GmbH assigned 'BB' (Sufficient level of reliability) reliability rating according to the international scale to Balcia Insurance SE. The rating outlook is stable which means that in the mid-term perspective there is a high probability of maintaining the rating score.

MAJOR FACTORS THAT INFLUENCED THE RATING:

Positive factors:

- Positive macro profile as the company operates in markets with solid macroeconomic and institutional indicators (as reflected by investment grade credit ratings) and, on average, a good insurance market penetration and density;
- Gross written premiums (GWP) grew constantly throughout 2016 (average of 69% from 1Q 2016 to 4Q 2016). The yearly growth was 44% as of December 2016 due to a strong increase of GWP from motor insurance, mainly in the Polish market;
- There is a number of financial risk management procedures in place with clear quantitative tests such as sensitivity analyses and defined coverage ratios;
- The structure of the customer base is positive with low concentration on the main clients: while the company's 10 largest clients (all government entities) are located in France and all of them are insured for Property Insurance, they only represent 9,2% of the total GWP;
- The highest paid claim by the company was back in mid-2015 and it represented around 2,7% of the 2015 equity, signaling a good reinsurance policy. Additionally, the 10 highest current risk exposures are all reinsured;
- Good quality of reinsurers as 98% of the reinsurer's share in GWP is transferred to companies with an international credit rating above A-. Furthermore, the reinsurance diversification is positive as only 22% of the reinsurer's share in GWP is concentrated in one company (Barents RE, rated A by A.M. Best);
- Satisfactory liquidity metrics (mainly due to the sale of the Latvian subsidiary) as the ratio of liquid assets to total liabilities was above 100% and the ratio of liquid assets to net reserves stood at 135% as of end-2016. In 2015, before the sale of the subsidiary, these ratios were 73,1% and 90,6% respectively;
- Adequate levels of accounts payable and receivable to total assets (5,1% and 3,9% respectively in 2016) indicating low indebtedness and reduced credit risk;
- The company's solvency capital requirement has been constantly over the minimum Solvency II requirement in 2016 (2Q: 150,4%, 3Q: 463%, and 4Q: 146%);
- Strong investment portfolio. As of end-2016 we calculate that around 85% of the investment portfolio was highly liquid, over 82% of investments were rated above investment grade and the concentration was acceptable as the share of largest investment was 27% in Polish sovereign bonds (rated BBB+ by S&P).

Restricting factors:

- We assess the business development strategy as moderately positive given the degree of projected diversification, underwriting growth and profitability in its main operating markets, cost optimization focus and conservative investment approach. However, we

also consider it challenging given the lack of a positive track record of market position sustainability and the competitive structure of the targeted markets which, we expect, will exert pressure on product pricing;

- Geographical diversification is considered as limited. The operations of Balcia measured as a percentage of total GWP by end-2016, were mostly concentrated in Poland (67,8%) and France (28,1%). The rest of the operations were allocated in Italy (2%), Spain (1%), Germany (0,8%) and Latvia (0,2%);
- The company has promoted the cooperation with insurance brokers and other sales channels in France, Poland, Italy and Spain. However, the estimated underwriting expenses as a percentage of earned premiums were around 45% in 2015 and 41% in 2016; moreover, client acquisition costs to earned premiums in 2015 were 27% and 33% in 2016, while the average for Poland was 30% and for France 21% in 2015, showing areas of opportunity regarding cost management;
- Profitability indicators were negative in 2015, ROA equaled -1,7% and ROE was -6,4%. In 2016, these ratios improved dramatically, as ROA and ROE were equivalent to 64,1% and 173,9% respectively. However, the high profit before tax was driven by the sale of the Latvian subsidiary in mid-2016.

Negative factors:

- The market position of the company is assessed as moderately weak. The company's size, as measured by GWP at EUR 72 m by end-2016, is small in absolute terms and also relative to its non-life insurance peers in the main markets where it operates: we estimate that the market share for non-life insurance in Poland and France, where the company's share of total GWP was 67,8%, and 28,1% respectively, was as low as 0,7% in the Polish market and 0,03% in the French market. However, the market share for CMTPL, Balcia's main product, is higher and close to 2% of total CMTPL gross written premiums in Poland. Finally, Poland has a very concentrated market where the top three insurance companies accounted for 60% of the total market's GWP in 2015;
- The insurance portfolio is mostly concentrated on Compulsory Motor Third Party Liability Insurance (CMTPL) amounting to 66% of Balcia's GWP followed by 24% of property insurance in 2016;
- The technical result has been increasingly negative since 2Q 2016 due to one-off events which caused an increase in incurred claims and technical reserves;
- The total net loss ratio stood at 60,5% in 2015 and deteriorated up to 75,1% in 2016, while the expense ratio went from 46,6% to 42,9%, which resulted in a combined loss ratio 107% and 118% in the same periods. The above shows the steep increase in claims as compared to the growth in GWP;
- The net loss ratios for the main type of products were moderately high at 84,1% for Property Insurance and 67% for CMTPL by end 2016. While the loss ratio for Property Insurance has been constantly increasing (only 25% by 1Q 2016), the same ratio for CMTPL has been decreasing (73% in 1Q 2016).

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Substantial increase in geographic and product diversification alongside a stable consolidation of the market position in one or several of the markets where the company operates;
- Sustained improvement in underwriting results which would translate in solid declines on the loss and expense ratios, especially for the Balcia's main products.

The following developments could lead to a downgrade:

- Continued increase in incurred claims and operating expenses which would further increase technical losses;
- Constant deterioration of the main liquidity and solvency metrics.

JUSTIFICATION OF THE RATING:

The agency assigned a reliability rating of 'BB' to Balcia Insurance SE with a stable outlook. The rating mainly reflects the positive macro profile in the markets where the company operates, as well as the satisfactory reinsurance policy, the strong liquidity and solvency metrics and favorable risk management practices. However, the rating also shows the weak market position of the company as a fairly new player outside Latvia, the concentration of the insurance portfolio and the negative financial results in regard to underwriting activities.

The company operates in countries which, on average, we have assessed with a positive macro profile and acceptable non-life insurance market penetration and density. This means that the stability of the insurance business, its growth and reliable regulatory conditions are likely to persist in those countries. However, the market position of the company is weak mainly due to its low market share, especially in, Poland and France, where its operations are concentrated. In addition, the size of the client base is also assessed as weak since the total amount of GWP is well below the average in Poland, Balcia's largest market in terms of operations. Moreover, we also consider that the concentration in regard to product lines is high as both, Compulsory Motor Third Party Liability Insurance (CMTPL) and Property Insurance account for 90% of total GWP, concentration which has been constant throughout 2016. As a result, the lack of consolidation and strong market presence in these regions along with the moderately high levels of concentration, could harm future profitability in case of adverse market conditions.

Despite the positive and constant increase in the amount of GWP throughout 2016, which we assessed as positive, Balcia has posted negative figures in regard to underwriting results, loss ratios and expense ratios. All of these metrics have been deteriorating in 2016, as shown in the previous section, due to an increase in claims and reserves. Nonetheless, the increase has been due to one-off events such as, the earthquake in Italy, floods in France, and build-up of reserves in Poland. For this reason, we expect the levels of claims to normalize in 2017; however, based on the numbers shown by this metric in 2015 (without one-off events), we still anticipate slightly negative figures for the technical result in the short term.

The future development strategy of the company is satisfactory but at the same time moderately challenging. We believe the adequate risk management procedures in place, the positive structure of the customer base, the very good quality of the reinsurance policy and above average liquidity indicators, can support a favourable realization of the proposed strategy. A successful implementation of the strategy should slightly increase the underwriting results in the mid-term perspective; however, the investment result is poised to remain modest given the conservative approach combined with a low-rate market environment. Additionally, the regulatory assessment, mainly based on Balcia's regulatory capital metrics, influenced the rating positively. The company's Own Risk and Solvency Assessment (ORSA) Report shows the capital coverage will be strong in the mid-term perspective.

The stable outlook is supported by our view that the main rating drivers will remain unchanged in the mid-term perspective.

COMPANY PROFILE:

Balcia Insurance SE is an insurance company based in Latvia which is currently focused on non-life insurance product, mainly CMTPL and Property Insurance. The main operations, measured by GWP, are in Poland and France with a smaller amount of operations in Italy, Spain, Germany and Latvia. The GWP of the company as of end-2016 amounted to EUR 72 m, its assets were equal to EUR 173 m and equity was EUR 59 m.

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Minute's summary:

The rating committee for Balcia Insurance SE was held on 5 May 2017. The quorum for the rating committee was present. After the responsible expert presented the factors which influenced the rating assessment, the members of the committee expressed their opinions and suggestions within the framework of the Insurance methodology. The chairman of the rating committee ensured that every member of the committee expressed his/her opinion before proceeding to the rating class voting.

The rating was disclosed to the rated entity prior to the publication and was not changed during the process of coordination.

The following methodology was used for the rating assessment: Methodology for Assigning Reliability Ratings to Insurance Companies – Short Public Version (from January 2017) can be found under the following link: http://raexpert.eu/files/methodology/Methodology_Short_Reliability_Ratings_Insurance_2017_v2.pdf. Descriptions and definitions of all rating categories can be found under the following link: <http://www.raexpert.eu/insurance/> under the "Rating scale" section. The user of the rating shall read the methodology in order to have a full understanding of the rating procedure.

This rating is solicited. The rated entity participated in the rating assignment process.

No other third party participated in the preparation of the rating.

Main sources of information:

- Questionnaire from Balcia Insurance SE based on the form provided by the Agency;
- IFRS Quarterly reports for 2016;
- Audited IFRS Annual reports for 2014, 2015 and 2016;
- Answer for additional request based on the form provided by the Agency;
- Information from media and other public sources.

Limits of the Credit Rating

During the rating assignment process, Rating-Agentur Expert RA GmbH (the Agency) used publicly available information as well as non-public information (obtained from the rated entity and/or other third parties) which was considered to be reliable, complete and non-biased. The responsible expert performed rating assessment of the insurance company with information considered as the most reliable and up to date in accordance to the overall position of the insurance company and the Agency's internal criteria for selecting data providers. The information and data used for this specific assessment can be considered as of sufficient quality.

Conflict of interest

The responsible expert was neither influenced nor biased by third parties during the rating assessment. The experts involved in the rating assessment and revision of the rated entity showed no conflict of interests before initiation of the rating assessment.

Rating-Agentur Expert RA GmbH is completely independent from the activities of other agencies from RAEX group.

Risk warning

The Agency disclaims all liability in connection with any consequences, interpretations, conclusions, recommendations and other actions directly or indirectly related to the conclusions and opinions contained in the Agency's press-release.

This press-release represents the opinion of Rating-Agentur Expert RA GmbH and is not a recommendation to buy, hold or sell any securities or assets, or to make investment decisions.

Office responsible for preparing the rating

The office responsible for the preparation and issuance of this credit rating is the office of Rating-Agentur Expert RA GmbH in Frankfurt am Main, Germany.

Rating-Agentur Expert RA GmbH is a credit rating agency established in Germany and therefore shall comply with all applicable regulations currently in force in the European Union.

The European Securities and Markets Authority (ESMA), the EU's direct supervisor of credit rating agencies (CRAs), has registered Rating-Agentur Expert RA GmbH as a CRA under Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, with effect from 1 December 2015.

Rating-Agentur Expert RA GmbH applies the Code of Conduct Fundamentals for credit rating agencies issued by the International Organization of Securities Commissions (IOSCO Code) and includes the basic principles of IOSCO Code in its Code of Conduct.