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Liberty Group Ltd.

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Liberty Group Ltd.

Rationale

Operating Company Covered By This Report
Financial Strength Rating
None

Business Risk Profile
• Strong competitive position, reflecting its dominant position in South African life insurance particularly in the "middle-affluent" market. • In common with local peers, heightened economic risk in South Africa weighs negatively on Liberty's revenues and earnings.

Financial Risk Profile
• The Liberty Group enjoys strong capital adequacy with a significant level of capital buffer relative to balance sheet risks. • Favorable risk profile supported by a material amount of business with profit/loss sharing features with policyholders. • Sufficient financial flexibility, demonstrated by its proven access to debt markets.

Other Factors
• Material exposure to products offering guaranteed investment return is mitigated by strong risk controls around asset liability matching through active hedging. • In our view, Liberty is unlikely to default on its liabilities under a foreign currency sovereign stress scenario thanks to its significant level of available capital and robust levels of liquidity. • We consider Liberty group to be strategically important to Standard Bank of South Africa (SBSA), mostly reflecting SBSA's controlling stake in the group, its commitment to provide support, and its strong performance. • We deem Liberty to be somewhat insulated from credit risk relating to its parent, SBSA, due to an independent board of directors, sizable minority shareholders, and Liberty's balance sheet independence from its parent.

Base-Case Scenario

Macroeconomic Assumptions

- Lower South African real GDP growth likely to be 1.4% and 1.8% in 2017 and 2018.
- Interest rates likely to remain around 10% over the same period.
- Liberty will continue to pass our F/C sovereign stress test.

Company-Specific Assumptions

- Group capital adequacy to be at least strong over 2017-2018.
- Return on equity (ROE) for 2017-2018 to be about 15%.
- Financial leverage to remain stable at about 15% and fixed-charge to remain well above 8x.

Key Metrics

	2018f	2017f	2016	2015	2014
Gross premiums written (ZAR mil)	45,431	43,268	41,288	39,245	42,139
Operating income (ZAR mil)	4,276	3,654	2,626	4,287	4,283
Fixed-charge coverage	>8	>8	>8	>8	>8
Financial leverage (%)	~15	~15	13	13	12.9
Return on shareholders' equity (%)	~15	~15	9.5	17.3	19.0

F--forecast.

Company Description: Dominant Position In South Africa With Material Non-Insurance Providing Earnings Diversification

The Liberty Group, which launched in 1957, is one of the largest providers of life insurance (with about 20% market share in terms of annual premium equivalent) and investment solutions domiciled in South Africa (SA). Its main risk carrier Liberty Group Ltd. (LGL) operates alongside its asset management operation, STANLIB (not rated). In addition, the group created the Liberty Financial Solution (LibFin) platform, which manages explicit promises made to policyholders (guarantees etc.) and shareholders' funds. Although small, the group generates a modest amount of premium in the rest of Africa.

The nonoperating holding company Liberty Holdings Ltd. is listed on the Johannesburg Stock Exchange (JSE) and is controlled by SBSA (not rated), which owns 53.6% of the issued ordinary share capital. The remainder is well spread, primarily owned by large asset managers.

STANLIB reported total assets under management (AUM) of near ZAR600 billion, of which about 60% was third-party AUM. STANLIB, as a provider of investment management solutions to retail and institutional investors, contributed nearly 15% of the group's operating profit before tax. The LibFin platform contributes about 40% to headline earnings.

We consider LGL to be core to Liberty group's credit profile, reflecting that it contributes a significant majority of earnings, capital, and business, and is the main risk carrier.

The majority of Liberty's business is in South African, with a customer base of 2.5 million. A small part of its business is written outside South Africa (16 countries), mainly in short-term health insurance. Liberty's retail business accounts for about 90% of total indexed new premiums. We use this index to measure overall new business because it removes the potentially volatile effect of single-premium business by recognizing 10% of new single premiums.

The majority of the business is written through a direct channel. Tied agents account for 37% of new business, explicit bancassurance arrangements with Standard Bank account for 32%, direct sales 2%, and brokers 28%.

Business Risk Profile

Insurance industry and country risk: Moderate

South Africa's country risk weighs on Liberty's business profile. Equity and credit-markets volatility, triggered by the country's weaker economic prospects, is dampening life insurers' sales and profitability. In particular, weak economic growth prospects means lower consumer spending and therefore life insurers are likely to find top-line growth more challenging.

Liberty benefits from the oligopolistic nature of South Africa's life sector as one of the five players that control a significant market share. Other players find it challenging to gain market share. Liberty and the other major players (Sanlam, Old Mutual, MMI, and Discovery) benefit from economies of scale and generally post strong results despite the challenging operating conditions.

The sector is also adapting to new regulatory challenges, notably the prudential regime Solvency Assessment and Management (SAM) and conduct-of-business rules such as those of the Retail Distribution Review (RDR). While we recognise the short-term challenges, we believe that these new rules are positive for the sector (see "Insurance Industry And Country Risk Assessment: South Africa Life," published Feb. 17, 2017).

Table 1

Liberty Holdings -- Industry And Country Risk

Insurance sector	IICRA	Business mix*
South AfricaP/C	4	5
South Africa life	4	95
	--	100
Weighted-average IICRA	Moderate risk	--

*IICRA--Insurance industry and country risk assessment.

Competitive position: A dominant player in sales to affluent clients

Our assessment of Liberty's strong competitive position reflects Liberty's competitive strengths in South Africa's life insurance sector, coupled with its asset management platform.

A strong competitive position in the middle-affluent market segment. As one of the largest players in South African life insurance, Liberty's competitive position benefits from its well-established position in the middle-affluent market, where it is ranked number one. Liberty lags its major peers in the institutional sector, which has resulted in Liberty placing greater focus on this segment in recent years. Liberty does not actively focus on the entry level market, which it perceives to be highly competitive.

The group has been actively expanding its operations in the rest of Africa--facilitated by Standard Bank's network--primarily by acquiring or launching new subsidiaries. We expect the business outside South Africa will remain limited over the next two years, mostly reflecting the small size of this market.

While we recognize that the challenging economic environment in South Africa slows growth and increases competition, we believe that Liberty's product innovation and sound technology platform will enable it to defend its market share.

The South African life sector is currently subject to significant regulatory and legislative changes. In aggregate, we believe that Liberty is well positioned for these changes, given its strength in capital management, sound distribution network, and solid market position. We believe Liberty, like its peers, is well prepared for SAM--scheduled for implementation over the short term (see capital and earnings).

The proposed introduction of the RDR is likely to change the compensation structure of intermediaries. Liberty has been actively reviewing its commission structures and providing the necessary support such that they comply with the new requirements.

Given the reduced GDP growth forecast, we now believe Liberty's premium income will grow by about 5% (similar to the 2016 level), compared with the double-digit growth it achieved prior to 2014.

Liberty's new business margins (NBM) have suffered partly due to delayed repricing; they were at 1.1% for the first half of 2016, down from 1.8% in 2015. NBM is generally lower than peers because it does not include the profit generated by the LibFin platform as part of NBM profit (including this would bring it in line with peers). NBM is likely to be lower than historic levels (of around 1.5%) over 2017-2018. This is partly due to the phased introduction of RDR, which will result in lower new business volumes relative to the fixed-cost base. Liberty had a strong ROE track record, with a five-year average of 19% to the end of 2015. However, in 2016 Liberty's ROE reduced significantly primarily due to various one-off reasons, which led to material reduction in 2016 earnings. We expect the group's ROE to recover to a level similar to its peers (around 15%-20%) over 2017-2018.

Table 2

Liberty Holdings -- Competitive Position					
	--Year-ended Dec. 31--				
	2016	**2015**	**2014**	**2013**	**2012**
Gross premiums written (mil. ZAR)	41,288	39,245	42,139	35,782	30,720
Change in gross premiums written (%)	5.2	(6.9)	17.8	16.5	12.5
Net premiums written (mil. ZAR)	39,366	37,572	40,724	34,466	29,631
Change in net premiums written (%)	4.8	(7.7)	18.2	16.3	12.3
Total assets on balance sheet (mil. ZAR)	397,014	401,421	361,602	336,166	293,537
Reinsurance utilization (%)	4.7	4.3	3.4	3.7	3.5
Business segment (% of GPW)					
Life	95.0	95.6	96.6	96.4	96.7
P/C	5.0	4.4	3.4	3.6	3.3

Financial Risk Profile

Liberty benefits from a significant level of capital relative to its balance sheet risks. Many of its products have profit/loss sharing features with policyholders. Therefore, the group has the ability to pass on some of the losses to its policy holders under severe stress scenarios.

The average credit quality of Liberty's asset portfolio is at the lower end of 'BBB' primarily because a significant majority of its assets are held as bank deposits and local currency sovereign bonds. A drop in average credit quality to 'BB' could trigger downward pressure on its financial profile.

Capital and earnings: Key strength albeit some reliance on softer forms of capital

Liberty's capital and earnings is a key strength supporting its overall ratings, in our view. This is supported by a significant level of excess capital (including shareholder and policyholder) relative to its risks. We expect Liberty to retain at least a strong level of risk-based capital (measured using our model) over 2017-2018. That said, we do recognize that the group relies on material levels of weaker forms of capital relative to total capital, notably value in force (VIF).

Table 3

Liberty Holdings -- Capital					
	--Year-ended Dec. 31--				
(mil. ZAR)	**2016**	**2015**	**2014**	**2013**	**2012**
Shareholders equity	29,006	25,993	23,634	21,356	18,511
Change in shareholders equity (%)	12	10	11	15	14

We view Liberty's underlying operating performance as sound, demonstrated by its high ROE.

In our forecast for 2017-2018, we expect Liberty to post a profit. We forecast ROE to remain above the weighted-average cost of capital, which is about 12%.

We note that the group has an appetite for small acquisitions and has set aside a clear budget for funding these. We do not expect prospective acquisitions within the budget to hamper the group's capital.

Our capital adequacy forecast assumes annual dividend payouts broadly in line with recent years. We assume further growth in AUM, as the group executes its growth strategy.

At the end of 2015, Liberty sold a material portion of its equity portfolio (reducing it to 7%, from 15% in 2014) because of the potential for market volatility, as reflected in our capital model outcomes. Our base-case assumption is that this was a tactical move and Liberty will likely re-invest in equities when financial market conditions improve.

LGL is well-capitalized in terms of regulatory requirements, at around 2.95x coverage at December 2016. This is excluding the significant level of discretionary margin (about ZAR16 billion, which is similar to the amount of available capital). This is a voluntary reserve margin set above best estimates and can be released as capital under stress scenarios. We recognise this in our assessment of the group's capitalization.

The new capital regime, SAM, is materially different from the current regime. In particular, it is based on 1-in-200 return periods for stress tests compared with 1-in-20 under current requirements. This, in particular, substantially increases the amount of required capital. Equally, the available capital under the new regime explicitly includes the aforementioned discretionary margin because liabilities must be measured on a best estimate basis in line with Solvency 2. We expect the group's coverage ratio to be good at 1.5x-2.0x under the new regime.

Table 4

Liberty Holdings -- Earnings					
	--Year-ended Dec. 31--				
(mil. ZAR)	**2016**	**2015**	**2014**	**2013**	**2012**
Operating income	2,626	4,287	4,283	4,470	4,118
Life: Prebonus pretax earnings/total assets (%)	1.6	2.3	2.2	2.8	3.0
Life: Net expense ratio (%)	38.2	38.0	33.0	37.4	36.4

Risk position: Favourable thanks to fee-related business and products with profit sharing features that balance the high level of high risk assets

Almost 40% of income from continuing operations was derived from fee revenues through its asset management arm (STANLIB) and insurance products (such as unit-linked). A significant level of exposure to high-risk assets relative to capital is mitigated by the material amount of products with profit- and loss-sharing features.

The group actively hedges its exposure to guarantees offered and its exposure to high-risk assets is primarily through assets backing shareholders' equity.

For the shareholder investments portfolio the group's tolerance for investment risk is reasonable, reflecting its 15-year time horizon. Its strategy is to hold 29% in equities, 13% in property, 7.5% in other risky assets (5% in alternative and 2.5% in preference shares), and the remainder in fixed income.

The group's foreign currency exposure is minimal as its business exposure outside South Africa is small. The staff pension scheme liability is small and is in surplus.

Table 5

Liberty Holdings -- Risk Position					
	--Year-ended Dec. 31--				
(%)	**2016**	**2015**	**2014**	**2013**	**2012**
Investment portfolio composition, including unit-linked business					
Cash and short-term investments	22	22	21	18	19
Bonds	11	11	10	10	10
Equity investments	53	52	54	50	49
Real estate	8	8	8	8	8
Loans	2	2	3	8	8
Investment in affiliates	4	5	5	5	5
Other investments	1	1	1	1	1

Financial flexibility: Adequate, with proven track record of access to debt markets

Liberty's financial flexibility is adequate, in our view, based on its access to the local debt market for short-term debt issuance. As part of its capital management plan, Liberty issued deferrable subordinated notes during second-half 2016. Its financial leverage ratio is about 15% and we expect it to remain similar over 2017-2018. Liberty's fixed-charge coverage is robust at well above 8x and we expect it to remain so. The group's market value to net asset value coverage is near 1.5x currently, indicating sound investor appetite. This is despite the drop in share value following the profit warning relating to 2016 results (see competitive position section).

As part of its securities lending and bond repo agreements Liberty receives collateral, which is primarily used to meet the collateral requirements of its derivative transactions. We understand that under IFRS the interest earned on this collateral cannot be deducted from interest paid. This means the finance cost is gross of interest received from these collaterals. We consider these transactions to be operational leverage because collateral received is kept in the same asset class with the same duration (so, if cash collateral has three months duration then it is kept as cash with three months duration).

Overall finance cost is reduced significantly after reducing the interest paid on the collateral by interest earned.

Other Assessments

We regard Liberty's ERM and management and governance practices as neutral to the ratings. Liquidity is exceptional.

Enterprise risk management: Adequate with strong risk controls

The group's risk management culture is strong with a sound governance structure and good awareness of the importance of risk management. Although the group provides guarantees, it has an effective hedging program. Policy persistency risk is the most significant risk as a proportion of the economic capital requirement. Risk tolerance limits are generally based on the approved strategic initiatives per business unit.

The group's internal capital model (covering 95% of the total business), which was first established in 2006, has been evolving in line with SAM requirements (equivalent to S2 in principle). The group is further embedding its strategic risk management across business units.

Management and Governance: Satisfactory, with a clear strategy that suits the market conditions

The group's key strategy is to maintain its dominant position in the middle-affluent market while expanding in the institutional segment. We think Liberty's management has developed a strong track record of executing its strategy to achieve its 2020 vision. The group has very clear short-term (three year) and long-term (six year) strategic plans that feature financial and operational goals geared toward maximizing shareholder value. These are tailored to business units and have been transitioned to customer facing units [CFU] (individual life, group life, and asset management). In common with its peers, the group has a clear acquisition strategy that so far has been in line with its goals and capabilities.

The group's strategy has been consistent in recent years focusing on profitable growth in its key market of South Africa and growing outside the rest of Africa to diversify its earnings stream.

Operations are very tightly linked to goals set at the board level and the group has been meeting shareholder expectations, meaning nearly all of the strategic decisions have been implemented. The group has been able to rapidly adapt to market conditions through tailoring products that fit its risk appetite and customer needs.

Liquidity: Exceptional, thanks to ample amount of liquid assets

We assess Liberty's liquidity as exceptional, owing to the strength of available liquidity sources relative to requirements.

The group holds substantial cash and liquid resources relative to its technical reserves. We believe the group will be able to withstand liquidity stresses and we view any refinancing needs as manageable.

Sovereign risk

Under our sovereign foreign currency default scenario, we believe the group would likely retain positive regulatory capital and a liquidity ratio in excess of 100%. Liberty's excess level of available capital relative of its risks and its discretionary buffers allow it to withstand our foreign currency default scenario. We limit the ratings on Liberty at the level of our local currency sovereign credit ratings on South Africa, as we believe it remains susceptible to financial and macroeconomic stresses, given the company's asset and liability concentration in the domestic economy.

Group status

We consider Liberty to be strategically important to its parent Standard Bank SA (SBSA), primarily reflecting its contribution to the broad wealth management offer of the bank and its meaningful contribution to SBSA's earnings. At the same time, we insulate the ratings on Liberty from those on its parent. This reflects our view of Liberty's financial independence from its majority owner. Additionally, our expectation that the oversight of the South African regulator will safeguard Liberty's balance-sheet independence should SBSA experience financial distress. Our view is also based on LHL's independent board of directors and its sizable minority shareholders. Our view of Liberty as insulated from its parent could change if we reconsider the extent of SBSA's influence on Liberty's management of capital buffers, strategy, or risk-taking.

Accounting Considerations

The 2016 annual financial statements of Liberty Holdings Ltd. have been prepared in accordance with--and contain information required by--International Financial Reporting Standards (IFRS).

Related Criteria And Research

Related Criteria

- General Criteria: Group Rating Methodology - November 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- General Criteria: Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions - October 22, 2012
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition - September 15, 2008
- Criteria - Insurance - General: Methodology For The Classification And Treatment Of Insurance Companies'

Operational Leverage - October 31, 2014
- Criteria - Financial Institutions - Banks: Assumptions: Clarification Of The Equity Content Categories Used For Bank And Insurance Hybrid Instruments With Restricted Ability To Defer Payments - February 09, 2010
- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables - June 01, 2016
- General Criteria: Principles For Rating Debt Issues Based On Imputed Promises - December 19, 2014
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- Criteria - Insurance - General: Enterprise Risk Management - May 07, 2013
- Criteria - Insurance - General: Insurers: Rating Methodology - May 07, 2013
- Criteria - Insurance - General: Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model - June 07, 2010
- Criteria - Financial Institutions - General: Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers - February 10, 2010
- General Criteria: National And Regional Scale Credit Ratings - September 22, 2014
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions - November 19, 2013

Related Research

- Various Rating Actions Taken On South Africa-Based Insurers And Reinsurers Following Sovereign Downgrade, April 7, 2017
- South Africa-Based Liberty Group Ltd.'s Proposed Unsecured Subordinated Notes Rated 'zaAA+', Sept. 13, 2016
- South African Insurers: Clouds And Silver Linings For The Rainbow Nation, Feb. 27, 2017
- Insurance Industry And Country Risk Assessment: South Africa Life, Feb. 17, 2017

Ratings Detail (As Of April 13, 2017)	
Operating Company Covered By This Report	
Liberty Group Ltd.	
Counterparty Credit Rating	
South Africa National Scale	zaAA-/--/zaA-1
Subordinated	
South Africa National Scale	zaA
South Africa National Scale	zaA+
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.

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