Shikhar Insurance Company Limited: [ICRANP-IR] A (reaffirmed)

May 10, 2021

Facility/Instrument	Rated Amount (NPR Million)	Rating Action (May 2021)
Issuer Rating	NA	[ICRANP-IR] A (reaffirmed)

Rating action

ICRA Nepal has reaffirmed the issuer rating of [ICRANP-IR] A (pronounced ICRA NP Issuer Rating A) to Shikhar Insurance Company Limited (SICL). Issuers with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such issuers carry low credit risk. The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument. The sign of + (plus) or – (minus) appended to the rating symbols indicate their relative position within the rating categories concerned. Thus, the rating of A is one notch higher than A-.

Rationale

The rating reaffirmation continues to draw comfort from SICL's adequate track record in the industry (operating since 2004) and its strong market position (largest company in terms of gross premium written (GPW) for FY2020 and H1 FY2021). The rating also factors in SICL's strong branch network, its seasoned management team and its comfortable solvency profile. These remain positive for the company's future growth, given the low penetration of insurance business in Nepal. Further, the company's adequate reinsurance arrangements with low-risk retention level vis-à-vis its net worth (per risk retention within 1% of net worth) and strong catastrophic coverage provisions, provides comfort to its claims-paying ability and its ability to maintain solvency in the event of catastrophic events. ICRA Nepal also notes the favourable economies of scale available to SICL, being the largest player in the industry.

Nonetheless, rating concerns arise from the expected impact of the ongoing Covid-19 pandemic on SICL's business growth and its underwriting profitability. The company's return indicators (return on assets and return on net worth) have moderated in the recent years because of the decline in net premium (because of mandatory cession towards Nepal Reinsurance starting from FY2019 over and above SICL's regular reinsurance arrangements) and increase in claims ratio. This has supressed its net profits, despite being supported by the increase in ceding commission. The recent softening of banking sector deposit rates also remains a concern as a major portion of SICL's investment portfolio remains concentrated in bank deposits. This could further subdue the investment earnings and therefore, the overall profitability of the company over the near term.

ICRA Nepal takes note of the recent deterioration in the financial profile of the lead reinsurer (GIC-Re, India). Although there has been no material deterioration in the recovery from reinsurers so far, sustained deterioration in the lead reinsurer's financial capability could result in delayed recovery/non-recovery of claims from reinsurers which could erode the claims paying ability of SICL. This remains a key rating sensitivity.

Key rating drivers

Credit strengths

Adequate track record, strong market position and seasoned management team – Operating since 2004, SICL has an adequate track record of operations in the Nepalese general insurance industry, remaining the largest player in terms of asset base, capital fund and gross premium earnings (notwithstanding the moderation in net premium earnings because of the decline in premium retention from FY2019). The company's market position remains stable and strong, supported by the largest branch network in the country, which is likely to help in the long-term growth and diversification of business. SICL's seasoned management team, with long-experience in the industry, has also been positively factored into the rating action.

Adequate reinsurance arrangements; notwithstanding the recent deterioration in the financial profile of lead reinsurer – SICL's strong catastrophic reinsurance arrangement at the time of the April 2015 earthquake not only supported its claims-paying ability but also helped its branding, enabling it to become the largest player in the years following. The company continues to maintain adequate reinsurance arrangements, including a strong catastrophic risk coverage for FY2021, which is likely to support the company's solvency during similar catastrophic events. Although there has been deterioration in the credit profile of the lead reinsurer in the recent years, SICL continues to maintain healthy recovery against the reinsurance treaty, which remains a comfort. However, sustained deterioration in the financial position of the lead reinsurer could challenge the timely recovery and affect the claims-paying ability of the company, which is a key rating sensitivity.

Adequate solvency and liquidity – On the solvency front, SICL's solvency margin as of mid-July 2020, calculated as per the regulatory directive, stood at ~3 times (versus a regulatory minimum of 1.5 times) against ~2.5 times as of mid-July 2019. The solvency profile can be expected to improve after the capitalisation of the proposed rights issue (assuming full subscription). SICL has been maintaining the mandatory technical reserves and restricted reserves[1] as prescribed by the regulatory authority (Insurance Board of Nepal). As on mid-January 2021, the said reserves accounted for ~61% of its net worth (~60% as of mid-July 2020). In terms of liquidity profile, SICL's cash accruals came under pressure in the recent years because of higher outflows in claims and other operating expenses. Despite the adverse average cash flow to net premium written (NPW) ratio in the recent times (at -20% and -3% for FY2020 and H1 FY2021 respectively; previously it stood at 12% in FY2019 amid a declining trend commencing from FY2018), the company maintains adequate liquidity as evidenced by cash and liquid assets to the technical reserve ratio of 4.45 times as at mid-July 2020 and 3.37 times as at mid-January 2021.

Stable profitability profile – SICL reported progressive profit after tax (PAT) in the recent years, even as its underwriting profits moderated since FY2018. The company reported an underwriting surplus of NPR 305 million in FY2020 (corresponding to a combined ratio and retention of 75% and 34%, respectively) higher than NPR 282 million in FY2019 (combined ratio of 81%, retention of 38%) but lower than NPR 383 million in FY2018 (combined ratio of 74%, retention of 48%). The underwriting surplus for SICL in H1 FY2021 stood at NPR 146 million (combined ratio of 69%, retention of 35%) amid rising claims ratio and declining retention. Despite an impact on underwriting profitability from the lower premium retention, it remained supported by rise in ceding commissions after FY2019 (net commission income to NPE stood at 42% for FY2020 and 57% for H1 FY2021 compared with 36% for FY2018 and 23% for FY2017).

SICL's profitability continues to be well supported by its investment income. However, the incremental yield on investment remains challenged by the softening of interest rates on bank deposits. In H1 FY2021, the company's average yield (annualised, not considering capital gains) stood at 7.7% (compared with ~9.3% for FY2020 and FY2019). Still, the ratio of investment income to underwriting surplus remained stable at ~1:1 during FY2019–H1 FY2021, mainly because of the growth in investment portfolio base.

Credit challenges

Slowdown in premium growth, declining retention and increasing claims ratio – Between FY2018 and FY2020, SICL's GPW witnessed a CAGR of ~0.50% compared to the industry average of ~5%. The company's GPW growth moderated because of the screening of less profitable businesses. Further, the recent decline in economic activities because of Covid-19 and possibility of premium waivers during the lockdown period are also likely to supress the premium growth over the near term. Net premium earnings of SICL declined in the last two to three years because of increased premium cession towards reinsurers (including Nepal Re). The premium retention (NPW/GPW) declined from 48% in FY2018 to 38% in FY2019 and further to 34% in FY2020 after the start of additional cession towards Nepal Re from FY2019. With the reduction in net premium base, the net claims ratio also remained elevated in the recent years (66%, 78% and 66% in FY2018, FY2019 and FY2020 respectively). The claims ratio of SICL remains above industry average due to higher retention

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

under the motor segment, which is the main revenue driver for the company. The increase in ceding commission after FY2019 supported the underwriting surplus to some extent.

Low penetration of insurance sector, fragmented industry and intense competition – Even with increase in the businesses and asset base of insurance companies, the penetration of insurance in the country remains low because of low insurance awareness. The competition in the already crowded industry has further increased since FY2018, following the licensing of three new players. Moreover, the expected slowdown in economic activities over the near term is likely to further intensify the competition among players for the relatively lower volume of fresh business.

Changes in operating environment because of new regulations – The players in the general insurance industry have been facing frequent changes in regulatory environment, especially those related to tariff and risk cover. An increase in third-party motor insurance cover, starting FY2017, has led to an industry-wide rise in motor claims, pressurising the segment's profitability. The new 'property insurance directive' introduced with effect from FY2019 has increased the claims ratio for the companies because of the comprehensive risk coverage at relatively lower premium tariff. The Insurance Board mandated companies to waive off renewal fees in major segments for Q4 FY2020 (during the period of Covid-19 lockdowns), impacting the overall profit margins. Further, with effect from January 2021, the regulator has subdued the prospects of third-party motor business by limiting the number of offices of Department of Transportation that can be catered to by a single player. While all these changes are likely to increase the insurance sector penetration and eventually aid in industry growth, these could impact the underwriting profits of all players over short to medium term, including SICL.

High sectoral concentration in motor segment – The motor segment accounted for 41% of GPW and 76% of NPW in FY2020, making it the largest business segment for SICL, in line with the industry trend. Although the motor portfolio is highly granular, which minimises the chances of any large loss from the motor segment, this exposes the company to sectoral-concentration risk. Any regulation changes affecting the motor portfolio profitability has a correspondingly high impact on the overall business of SICL.

Company Profile

Established in March 2004, Shikhar Insurance Company Limited (SICL) is the 13th private sector general insurer in Nepal. SICL is a large-sized company with ~13% of the market share in terms of the general insurance industry's gross premium written in FY2020. As of mid-January 2021, the company is in operation with 108 branches spread across the nation for procuring business and extending after-sales services.

The paid-up capital and the net worth of the company as of mid-January 2021 was ~NPR 1,375 million and NPR 3,683 million, respectively. SICL has a 60:40 promoter–public shareholding ratio. The major shareholders as on mid-July 2020 include Mr. Gaurav Agarwal (12.89%), Buddha Air Pvt. Ltd. (8.03%), Mr. Bikas J.B. Rana (7.32%), Mrs. Chanda Sherpa (7.08%), Mr. Shashikant Agrawal (4.94%) and Mr. Kailash Prasad Sirohiya (4.05%), among others.

SICL reported a PAT of NPR ~408 million in FY2020 (NPR 401 million in FY2019) over an asset base of NPR 5,062 million as of mid-July 2020 (NPR 4,729 million in mid-July 2019). In H1 FY2021, SICL reported a PAT of ~NPR 182 million.

Key Financial Indicators

Amount in NPR million	FY2017	FY2018	FY2019	FY2020	H1FY2021
	Audited				Provisional
Gross premium written (GPW)	2,745.0	3,336.8	3,434.9	3,385.4	2,116.9
Net premium written (NPW)	1,415.3	1,592.0	1,286.2	1,143.6	744.5
Net premium earned (NPE)	1,208.0	1,494.7	1,456.7	1,207.7	472.0
Premium retention (NPW/GPW)	51.6%	47.7%	37.4%	33.8%	35.2%
Claims ratio (Net claims incurred/NPE)- A	58.8%	66.3%	76.7%	66.1%	80.2%
Management expense ratio (Management expense/NPE)-B	29.1%	30.4%	39.5%	50.7%	46.3%
Commission expense ratio (Commission expense/NPE)-C	-19.8%	-22.3%	-35.5%	-42.1%	-57.3%
Combined ratio (A+B+C)	68.1%	74.4%	80.7%	74.7%	69.2%
Underwriting surplus	386	383	282	305	146
Investment earnings	143.1	219.6	288.9	279.7	102.9
Average yield on investments	7.0%	8.3%	9.2%	9.3%	7.7%
Profit after tax (PAT)	360.0	399.3	401.4	407.6	182.1
Return on equity	20.3%	18.4%	15.6%	12.9%	9.9%
Return on assets	12.7%	11.0%	9.4%	10.1%	9.7%

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About ICRA Nepal Limited:

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Our parent company, ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment information and credit rating agency. Today, ICRA and its subsidiaries together form the ICRA Group of Companies.

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