Shikhar Insurance Company Limited: Ratings upgraded to [ICRANP-IR] A+

December 5, 2022

Facility/Instrument	Rated Amount (NPR Million)	Rating Action (December 2022)
Issuer Rating	NA	[ICRANP-IR] A+; upgraded from [ICRANP-IR] A

Rating action

ICRA Nepal has upgraded the issuer rating of Shikhar Insurance Company Limited (SICL) from [ICRANP-IR] A (pronounced ICRA NP Issuer Rating A) to [ICRANP-IR] A+ (pronounced ICRA NP Issuer Rating A plus). 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.

Rationale

The rating upgrade factors in the relatively stable underwriting profitability of SICL despite the impact of the Covid-19 pandemic. Although the company's return indicators have moderated marginally on account of an increased asset base/net worth the company continues to maintain a strong solvency and liquidity profile. ICRA Nepal also takes note of the company's strong competitive positioning as reflected in the highest gross premium written (GPW) in the industry, its wide network of branches, seasoned management team, conservative risk retention policy, strong reinsurance arrangement with catastrophic provision and good financial profile of the lead reinsurer (Hannover Re[1], Germany); which is likely to support its future growth and solvency aspects. Future growth prospects of the company also remain supported by low penetration of insurance business in Nepal. ICRA Nepal also notes the favourable economies of scale available to SICL as the largest player in the industry.

However, rating concerns arise from the steady decline in the premium retention ratio, affecting its net premium written (NPW) and subduing its profitability. The company's rising claims ratio also remains a rating concern, partly aided by lower net premium written volume. Although adequate support from ceding commission (income) has supported its combined ratio and overall underwriting profitability while support from investment income is supporting its profitability, the company's long-term profitability will depend on the ability to maintain/improve the NPW levels and generate economies of scale. The falling premium retention is also affecting SICLs market share (in terms of NPW) and poses as a threat to its market leadership status and volume profitability as well. Rating concerns also continue to arise from the intense industry competition and uncertainties posed from introduction of new/changed insurance laws/regulations as mandated by the IB from time to time- especially with regards to the tariffs and risk coverage impacting insurance profitability and also from the intensifying competition amidst the industry players.

ICRA Nepal also takes note of the unsettled covid insurance claims which remain pending due to delayed receipt of the related claims from the government of Nepal (GoN). This could affect the profile and brand image of the insurer. Nonetheless, gradual release of fund from the GoN and the strong counterparty profile remains a major comfort.

Key rating drivers

Credit strengths

Long track record, strong market position and seasoned management team – Operating since 2004, SICL has a long track record of operations in the Nepalese general insurance industry and stands as the largest player in terms of asset base, capital fund and gross premium earnings (notwithstanding the moderation in net premium earnings because of the

[1] Hannover Re's rating has been affirmed at AA during the latest exercise by AM Best. (Published January 2022)

decline in premium retention from FY2019 onwards). 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. Its management team comprises seasoned professionals with long industry experience, which is a positive factor incorporated in the rating.

Strong reinsurance arrangements – SICL's lead reinsurer –'Hannover Re'[2], Germany (for FY2023) has a strong credit profile which comforts the claims paying ability of the company. SICL's reinsurance arrangement has remained among the strongest in the industry and continues to remain strong till date. SICL's adequate 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 FY2023, which is likely to support the company's solvency during similar catastrophic events as evidenced during the FY2015 earthquake.

Strong solvency and improved liquidity – On the solvency front, SICL's solvency margin as of mid-July 2021 (Actuarial Valuation based), calculated as per the regulatory directive, stood at ~4.31 times (versus a regulatory minimum of 1.5 times) against ~6.8 times as of mid-July 2020, marginal moderation in solvency ratio caused by spike in unpaid claims reserves (partly aided by slow-release of Covid-19 related claims amid its delayed receipt from the exchequer). Also, SICL has been maintaining the mandatory technical reserves and restricted reserves[3] as prescribed by the regulatory authority (Insurance Board of Nepal). As on mid-July 2022, the said reserves accounted for ~20% of its net worth (~23% as of mid-July 2021 vs 26% as of mid-July 2020). In terms of liquidity profile, SICL's cash accruals have been improving in recent years as compared to FY2019 and FY2020 which was characterised by pressure from higher outflows in claims and other operating expenses. Moreover, SICL's liquidity position remains adequate as the company maintains a cash and liquid assets to the technical reserve ratio of 4.72 times as at mid-July 2022 vs.4.10 times as at mid-July 2021.

Adequate profitability profile – SICL has reported stable profit after tax (PAT) in the recent years, even as its underwriting profits moderated since FY2018, notwithstanding the performance during FY2020 and FY2021 as the years were abnormally impacted by the pandemic. The company reported an underwriting surplus of NPR 306 million in FY2022 (corresponding to a combined ratio and retention of 76% and 28%, respectively), surpassing the same during FY2020 and FY2021, which indicates the gradual ebbing of the impact of the pandemic and remains a rating positive.

Some profitability concerns arise from steadily falling premium retention of SICL. So far, the decline in retention and NPW levels is partly compensated by increase in ceding commission (net ceding commission income to net premium earned-NPE stands ~51%, ~45%, and ~42% respectively for FY2022, FY2021 and FY2020 each). Also, SICL's profitability continues to be supported by its investment income; despite the moderation in investment yield during FY2022 (FY2022 yield stood at 7.8% vs ~9.3% for FY2021 and 8% for FY2020). Nonetheless, the ratio of investment income to underwriting surplus has remained stable at ~1:1 during FY2019–FY2022. Further, the incremental yield on investment is also likely to remain supported by the high-interest rates prevailing in the banking industry at present.

Credit challenges

Declining retention ratio and high claims and management expense ratio could affect long-term underwriting profitability – SICL's claims ratio is registering a gradual growth in the recent years, party aided by declining NPW levels. Along with the rising claims ratio, the gradual uptick in the management expense ratio is also supressing the underwriting profits for the company. Although the GPW of SICL has grown by 13.40% (CAGR) since FY2019 until FY2022, its NPW has only grown by 3% (CAGR) during the same period; affecting the economies of the scale and profitability for the company. Although the increasing ceding commission income partly offsets the impact of increasing management cost to result in

[2] *Rated "Superior" by AM Best in terms of its Financial Strength Rating and Issuer Credit Rating*

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

a relatively stable combined ratio for the company; the sustained decline in retention could lead to further moderation in profitability over the longer term vis-à-vis peers.

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, which remains a positive for the future growth of the sector. However, the competition in the already crowded industry had further increased since FY2018, following the licensing of three new players.

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.

Analytical approach: For arriving at the ratings, ICRA Nepal has applied its rating methodology as indicated below.

Links to applicable criteria:
Issuer Rating Methodology

Links to previous detailed rating rationale:
Issuer Rationale Shikhar Insurance Company Limited-May 2021

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-FY2022. As of mid-July 2022, the company is in operation with 110 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-July 2022 is ~NPR 2,286 million and NPR 4,679 million, respectively. SICL has a 60:40 promoter–public shareholding ratio. The major shareholders as on mid-July 2021[4] include Mr. Gaurav Agarwal (11.1%), Buddha Air Pvt. Ltd. (8.03%), Mr. Bikas J.B. Rana (6.89%), Mrs. Chanda Sherpa (7.17%), Mr. Shashikant Agrawal (4.44%) and Mr. Kailash Prasad Sirohiya (3.79%), among others.

SICL reported a PAT of NPR ~401 million in FY2022 (NPR 311 million in FY2021) over an asset base of NPR 6,557 million as of mid-July 2022 (NPR 5,396 million in mid-July 2021).

[4] Based on latest available information.

December 2022

Key Financial Indicators

Amount in NPR Million	FY2018	FY2019	FY2020	FY2021	FY2022
	Audited				Unaudited
Gross premium written (GPW)	3,336.8	3,434.9	3,385.4	3,921.2	5,009.2
Net premium written (NPW)	1,592.0	1,286.2	1,143.6	1,173.8	1,391.0
Net premium earned (NPE)	1,494.7	1,456.7	1,207.7	1,155.3	1,282.4
Premium retention (NPW/GPW)	47.7%	37.4%	33.8%	29.9%	27.8%
Claims ratio (Net claims incurred/NPE)- A	66.3%	76.7%	66.1%	78.7%	76.6%
Management expense ratio (Management expense/NPE)-B	30.4%	39.5%	50.7%	52.8%	50.2%
Commission expense ratio (Commission expense/NPE)-C	-22.3%	-35.5%	-42.1%	-44.6%	-50.6%
Combined ratio (A+B+C)	74.4%	80.7%	74.7%	87.0%	76.1%
Underwriting surplus	383	282	305	151	306
Investment earnings	219.6	288.9	279.7	333.2	284.6
Average yield on investments	8.3%	9.2%	8.0%	9.3%	7.8%
Profit after tax (PAT)	399.3	401.4	407.6	311.4	401.4
Return on equity	18.4%	15.6%	12.9%	8.4%	8.6%
Return on assets	11.0%	9.4%	8.7%	6.2%	7.8%

Source: Company data

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About ICRA Nepal Limited:

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