The Nigerian Insurance Sector: Diamonds in the Rough

This report takes an in-depth look at 13 of the 26 Insurance companies listed on the NSE, and considers IGI and Leadway, 2 key players who are yet to be listed.

EXECUTIVE SUMMARY

• The Nigerian macro-economy overview is a compelling story of progression and advancement, attributable mostly to a stable political environment and the successful implementation of socio-economic and financial reforms. Though Nigeria has previously been extremely dependent on Oil & Gas revenues, recent statistics show a change in this trend. Militant unrests affecting oil producing regions have resulted in significant reductions in oil contribution to GDP. On the flip side, increasing focus on developing the non-oil sector, combined with growth in key sectors such as Telecoms and Building Construction have boosted non-oil sector earnings and growth.

• The significance sector is a key part of the financial services sector. In other emerging economies, it has been identified as being critical to the ability of those markets to grow and develop, simultaneously providing an opportunity to hedge against possible risks of private, social and economic investments. Insurance companies also serve as a base for collecting relatively small premiums from millions of policy holders, into a pool to support term financing for economic growth.

• A look at the growth patterns and trend of the insurance industry in various developing markets (we examined Brazil, Russia, India, China and Kazakhstan) showed some underlying similarities; as well as other key factors, which have aided strong for the Insurance Sector in these countries.

• The Nigerian Insurance Industry has evolved over the past two years following the announcement of new capitalization requirements for companies operating the sector. With the conclusion of the consolidation exercise, the number of players dropped from 103 to 49. Activities in the sector have, however, noticeably increased; with enhanced public awareness of the sector and their operations, rapid expansion and strategic business acquisitions, improved visibility and strict supervisory regulation.

• Following the announcement of the recapitalization guidelines in 2005, we carried out an in-depth analysis into the implications of the then proposed recapitalization and expressed our opinions on how it would play out. At that time, we came to the following conclusions(i) the insurance industry was large, fast growing and at the start of a predictable growth curve, (ii) it was ripe for consolidation, as there were too many fragmented players; and (iii) it was high performing with huge potentials, but had still largely undervalued companies. The main conclusions of our 2006 report have played out, and in this report, attempt to crystal ball some of the progress that will be made going forward.
We examined 2 key pointers namely; (i) the transformation cycle for the banking sector following its recapitalization; and developmental trends of the insurance sector in other emerging markets. We are of the opinion that in the short to medium term, the same pattern of profitability and growth, as experienced in the Insurance sector. Though most of them are trading at relatively high PEs now.(compared to the average market PE), we believe some select few, who will be able to implement an optimal insurance business model will in the very near future, start to post earnings that will justify these market valuations.

We also believe that in the longer term, an in-depth look at past and current trends in emerging/developing markets will provide a close enough road map for the Nigerian Insurance Sector, in the near to medium term. Some of the trends identified include the following: (i) similar capitalization evolution patterns; (ii) use of technology as a major means of increasing public access to insurance products; (iii) the eventual entry of foreign players into the market, barring any entry restrictions and (iv) life insurance having the higher proportion of total premiums.

This report takes an in-depth look at 15 insurance companies. There are quite a few other key players in the market, for whom we have not provided coverage in this report, due mostly to inaccessibility of adequate data on them. They are by no means of any less significance than those, which are covered herein.

As at August 2005, prior to the announcement of the recapitalization directives, there were 22 insurance companies with a market capitalization of #28.94 billion listed on the Nigerian Stock Exchange. Now there are 26 active companies with a market capitalization of #683.1 billion, a 2,260% growth over two and a half years, with quite a few still expected to be listed this year.

A quick ranking of the companies in our insurance sector report universe, based mainly on key operating ratios, rank Custodian & Allied, Crusader, Sovereign Trust and STACO as premium performers on a majority of the operating ratios. Our analysis looked at company operating ratios (based on available data), cost trends, growth trends and resulting valuations. We, however, note that the analysis was based on 2006 audited results; which is currently the most recent information available for many insurance companies. We look forward excitedly to the release of their 2007 results, and an update to this report.

**THE INVESTMENT CASE FOR THE INSURANCE SECTOR**

The insurance sector is a very key part of the financial sector. In developed markets, the insurance sector accounts for a significant portion of the total economy. In collecting relatively small premiums from many individuals in the economy, insurers are able to pull together, like no other institution, a large pool of funds that could be invested for short or long term periods. Insurance businesses are split mainly into Non-life and Life; Non-Life Insurance representing short term funds and Life Insurance representing
longer term funds. As so many insurers could serve as a means of long term financing, the sector is therefore important for sustained economic growth. This will in turn deepen and broaden the domestic financial services universe, as well as generate higher savings rates and therefore greater economic development.

We believe that the Insurance sector is critical to the ability of emerging and transitional economies like Nigeria to grow and develop, as well as provide a reliable cover for risk to the citizens. Insurance provides stability by allowing large and small businesses operate with a lesser risk of volatility or failure. Insurance is also seen as a compliment to government’s security programmes and it privatization processes.

Our views on the prospects for the industry are hinged on some key factors namely:

1. Recent macro-economic growth especially growth in the real sector and how this affected the industry;
2. Government’s legislations in the insurance sector, and how they have impacted on growth in the sector so far, as well as the prospects for the sector as a result of these legislators; and
3. The recapitalization exercise as a separate regulatory induced activity, and how it opened up the sector for growth, as well as what the prospects of new capital raisings and mergers are.

Real Sector Growth

The Nigerian economy has recorded significant growth over the last five years. This growth has been mostly attributed to the successful implementation of some key reforms including: Fiscal Policy Reforms, Budgetary reforms, Monetary Reforms, Debt Management Reforms and Financial Sector Reforms over this period. GDP growth has averaged 6.95 over the past 5 years (see Table 1).

Non-oil sector contribution to GDP growth has grown significantly over the years from an all time low of 45% in 1992 to 69% in 2007. Considering the setbacks from production in the oil sector (0.3% growth in 2005 and -5% in 2006), the non-oil sector has mostly been responsible for propelling overall growth in the economy.

Growth in the non-oil sector has meant a wider distribution of wealth in the economy, as the focus is no longer solely on oil. This has also supported the growth of an emerging middle class.

An in-depth analysis which involved a regression of Gross Premiums of several countries to their GDP per capita figures shows a very strong correlation of 0.90 between GDP growth and Gross Premium growth. This strengthens the basis of our reliance on GDP growth as a key driver and support of growth in Gross premiums.
We believe that as Nigeria continues to experience growth (forecast at an average of 6% for the next 5 years, according to the Economist Intelligence Unit of The Economist), Gross Premiums and the insurance Sector will also experience significant growth.

**Implications of Government Legislation**

Government legislation have also supported the prospects of growth for the industry. Regulations that have been propagated by the Government in recent times in support of growth in the industry include the following:

1. Compulsory insurance of all public buildings as well as those under construction;
2. Compulsion of all private sector organizations operating in Nigeria to enroll their employees in the National Health Insurance Scheme to boost the resource base of the scheme;
3. The National Insurance Commission ensuring that any inhibitions to local Insurers participating in the oil % Gas business are removed. It has also worked to ensure that “consortium bidding” is strongly considered by the Oil and Gas companies in selecting insurers for participation in the Oil and Gas business. This is also as to achieve a wider spread in participation by local insurance companies;
4. Introduction of the Local Content Policy for the Oil and Gas industry, and an increase in the applicable rate from 10% to 45% in 2007 and 70% in 2010;
5. The regulatory authorities also plan to address a tax law, which places a separate tax on Gross Premiums. Discussions are on with the Federal Inland Revenue Service to work out ways and means of ameliorating the effect of this policy on the insurance companies;
6. The Central Bank is also currently considering an upward review of interest rates that are currently earned on the Statutory Deposits of insurance companies which are placed with the CBN; and
7. There is also a planned reactivation of the VISER sticker, an initiative which is meant to increase the coverage of motor vehicle insurance, and increase the premiums earned by insurance companies, based on number of policies.

Further to the implementation of these legislations, we have witnessed growth in the activities of Insurance companies left in the market. One example of this is the formation of some Insurance Consortia; with several insurers pooling funds together to enable them underwrite significantly large risks, especially in the Oil and Gas sector.
Evolution of capital Requirements in the Insurance Sector

The sector has undergone 2 rounds of recapitalization over the past 6 years; and in our opinion, is additional proof that the insurance industry is closely linked to general economic growth over this same time period, the sector has had to increase capacity to draw level with economic development and expectations. Even with this, there were clear indications that the new capitalization levels were inadequate at each point. Industry statistics reveal that insurance companies lose the opportunity of earning N70 billion in premiums annually from the oil and gas sector as a result of premium flight. Many companies, especially multinational ones, have resorted to insuring their assets overseas; as the capital base of the local insurance companies are inadequate to carry the risks of insuring thee assets.

The first of the two rounds of recapitalization occurred in 2003, where inline with the passing of the 2003 Insurance Act, Insurance Companies were required to increase their capital bases from N20 million to N150 million for Life businesses, N70 million to N300 million for Non-Life businesses, and N150 million to N350 million for Reinsurance businesses.

There were 117 insurance companies before the recapitalization in December 2002, 14 of them did not make it and were liquidated.

In September 2005, a new capitalization requirement was announced, increasing the capital base to N2 billion for Life Insurance businesses, N3 billion for Non-Life insurance businesses and N10 billion for Reinsurance businesses. Following the completion of the 2005/6 recapitalization exercise, which also involved quite a number of consolidations, the number of insurance companies dropped from 103 to 49.

Pre-Recapitalization/Consolidation

The insurance industry before the regulatory induced recapitalization/consolidation was one confronted with many challenges.

These challenged were mostly responsible for the sector’s inability to attract sufficient businesses both locally and internally. It also affected its ability to retain a significant proportion of risk emanating from assets domiciled in Nigeria. Insurance premium flight was a key challenge for the sector, as the underwriting capacity of the existing companies was low.

The industry at that time had 103 Insurance companies, 4 Reinsurers, 527 Brokers and 28 Loss Adjusting companies.

The industry at this point in time was characterized by the following:

- Under capitalization of existing industry players;
- Dearth of appropriate human capital and professional skills;
- Poor returns on capital;
- Existence of too many fringe players;
Poor asset quality;
Prominence of unethical practices;
Significant corporate governance issues;
Insurance Premium Flight;
Poor business infrastructural facilities especially in the area of ICT;
Lack of Innovation in product development;
Lack of awareness on the part of consumers on the uses/suitability of insurance products;
Low GDP per capita figures; and
Poor Corporate governance structures.

These factors proved significant in restricting the companies from achieving any potential development. In 2006, Nigeria’s total premiums as a percent of world premiums was put at 0.82% (Source: IIA), as World premiums totaled $3.72 trillion (N446.4 trillion) for that year, a pale comparison to other emerging markets such as South Africa, India and Brazil, which contributed 1.09%, 1.16% and 0.82% respectively. The United States had the largest contribution with 31.43%.

Total premiums for Nigeria in 2001 were N33.1 billion ($283.7 million), and have grown to an estimated N82.3 billion ($705.4 million) as at 2006 representing a 20% AAGR over the past six years.