Initiation Report

June 20 2019

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Saudi Re

Brightening outlook for KSA's only reinsurer

- **RoE to improve from 0.5% in FY 18A to 6.5% in FY 23e on domestic (CAGR of 11.3% FY 18-22e in health, motor and P&C) and international growth (CAGR of 5.7% FY 18-22e), better underwriting margins (3.9% in FY 20e) and resilient investment yields.**
- **Competitive advantage domestically (compulsory cessions, 30% local retention rate). Low exposure to NatCat losses in region shield combined ratios (<95%). Loss ratios to improve on retrocessions.**
- **Share of regional markets increasing from 14% to 20% of GWP from FY 18A to FY 22e), after i) credit rating downgrade of Trust Re, ii) closure of ARIG and iii) closure of ACR's Dubai branch.**
- **Stock trades at 44% P/B discount to local and international reinsurance peers. We initiate with a BUY and TP of SAR 10.3.**

Domestic growth opportunities via strong domestic competitive advantage. Saudi Re continues to hold a preferential position in its home market, thanks to a 30% compulsory retention in the local market and having the first right of refusal on a portion of premiums retained. This allows the reinsurer to protect its profitability and reduce its concentration risk. The reinsurer had been steadily improving its share of local ceded premiums from 1.0% in FY 08A to a peak of 11.7% in FY 16A, but has since scaled back to 6.7% by YE 18A due to its strong focus on underwriting profitability. From that lowered base, we expect Saudi Re's local market share to improve to c.8-10%, as the company continues to cherry pick the most profitable exposures while also seeking to diversify its business mix/geographic concentration. International expansion and new products provide diversification and lower concentration risks.

Underwriting margins can reach c.4% by FY 20e, having already improved from -31.1% in FY 13A to +0.8% in FY 18A as the reinsurer reduced its net loss ratio from 103.6% in FY 13A to 65.8% in FY 18A on the back of i) reduced geographic concentration, ii) increased product line diversification, iii) non-renewal of loss-making accounts, and iv) higher utilization of retrocessions. Expense ratios have benefited from increased efficiency and improved distribution channels, coupled with higher commissions thanks to retrocessions.

Investment yields to add 3.1ppt to RoE. We expect the blended investment yield to increase to c.4%, due to its investment mix and reclassification of all investments as FVTPL. Business growth should increase the investment book from 1.0x of NAV in FY 18A to 1.4x by FY 24e.

Valuation does not reflect RoE improvement potential. Stock trades at 44% discount to domestic peers on P/E 20e and 82% on P/tNAV 19e, which we find unwarranted for the anticipated upward trajectory in RoE. We expect RoE to increase by 5.5ppts to 6.5% in the medium term helped by higher GWP/NAV (increasing from 86.7% in FY 18A to 105.4% by FY 26e), reduction in combined ratio and resilient investment yields (2.1% in FY 18A to 4.2% in FY 19-22e).

BUY SAR 10.3

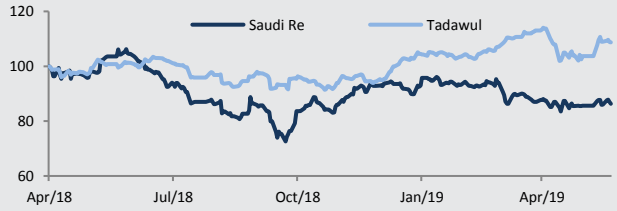
Insurance/KSA

Bloomberg code	SAUDIRE AB
Market index	KSA
Target Price	10.3
Upside (%)	41.3

Market data 13-Jun-19	
Last closing price	7.3
52 Week range	6.1-9.1
Market cap (SAR m)	592
Market cap (USD m)	158
Average Daily Traded Value (SAR m)	3.0
Average Daily Traded Value (USD m)	0.9
Free float (%)	95%

Year-end (local m)	2018	2019e	2020e	2021e
Gross Written Premiums	722	757	809	887
Underwriting Profit	52	57	80	86
EPS	0.05	0.27	0.55	0.60
P/E (x) (market price)	152.0	27.3	13.3	12.2
BVPS	10.28	10.55	11.10	11.70
Tangible BVPS	9.05	9.07	9.66	10.16
P/B (x) (market price)	0.7	0.7	0.7	0.6
P/TBVPS (x) (market price)	0.8	0.8	0.8	0.7
DPS	-	-	-	-
Div. yield (%)	-	-	-	-
RoAA (%)	0.2	0.9	1.8	1.9
RoAE (%)	0.5	2.6	5.1	5.3
Investments/Assets (%)	23.5	26.2	27.8	29.4
Investment Yield (%)	1.8	4.6	4.4	4.3
Net Loss Ratio	65.8	64.9	64.6	65.4
Combined Ratio	100.4	99.2	96.0	96.1
Underwriting Profit Margin	0.8	1.3	3.9	3.8
Net Profit Margin	0.5	2.9	5.5	5.5
Policy Reserves/Equity	164.9	158.1	157.5	157.0

Price Performance



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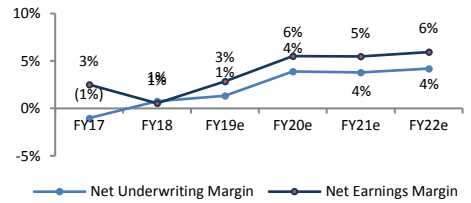
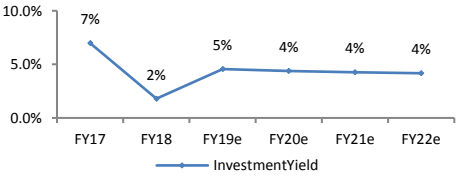
Abacus *Arqaam Capital Fundamental Data*

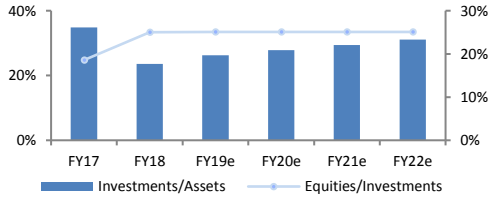
Profitability



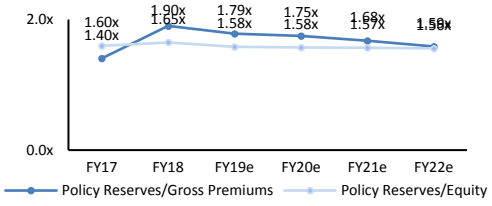
Investment Yield



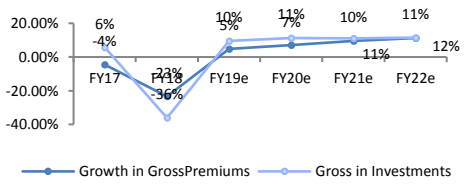
Investment Exposure



Solvency ratios & reserve adequacy



Growth



SAUDI RE

Year-end	2017	2018	2019e	2020e	2021e	2022e
Performance analysis						
Cession Ratio	29.1	10.1	10.3	10.3	10.1	9.9
Net Loss Ratio	70.3	65.8	64.9	64.6	65.4	65.5
Expense Ratio	32.8	34.5	34.3	31.5	30.7	30.1
Combined Ratio	103.1	100.4	99.2	96.0	96.1	95.6
Underwriting Profit Margin	(1.0)	0.8	1.3	3.9	3.8	4.2
Investment Yield	7.0	1.8	4.6	4.4	4.3	4.2
Net Margin	2.5	0.5	2.9	5.5	5.5	5.9
RoAE	2.9	0.5	2.6	5.1	5.3	6.0
RoAA	0.9	0.2	0.9	1.8	1.9	2.2
Net Premiums/Equity	0.7	0.7	0.7	0.7	0.8	0.8
Gross Premiums/Equity	1.1	0.9	0.9	0.9	0.9	1.0
Claims Reserve/NPE	1.4	1.6	1.5	1.5	1.4	1.3
Investment Income/Total Income	61.3	19.8	31.7	25.8	26.1	25.1

Year-end	2017	2018	2019e	2020e	2021e	2022e
Investment Exposure						
Investments/Assets	34.8	23.5	26.2	27.8	29.4	31.1
Equities/Investments	18.6	25.0	25.1	25.1	25.1	25.1
Equity/Assets (%)	33.4	35.5	37.0	37.2	37.3	37.5

Year-end	2017	2018	2019e	2020e	2021e	2022e
Liquidity/Leverage						
Policy Reserves/Gross Premiums	1.4	1.9	1.8	1.7	1.7	1.6
Policy Reserves/Net Earned Premiums	2.2	2.2	2.2	2.1	2.1	1.9
Policy Reserves/Equity	1.6	1.6	1.6	1.6	1.6	1.6
Debt/Capital	-	-	-	-	-	-
Debt/Equity (x)	-	-	-	-	-	-

Year-end	2017	2018	2019e	2020e	2021e	2022e
Growth						
Gross Premiums	(4.4)	(23.4)	4.8	7.0	9.6	11.3
Net Earned Premiums	(47.3)	3.0	0.2	7.3	9.9	11.6
Investments	5.8	(36.1)	9.6	11.3	11.1	11.5
Assets	19.4	(5.5)	(1.7)	4.8	5.1	5.6
Total Reserves	34.1	3.8	(1.6)	4.8	5.1	5.4
Equity	2.9	0.5	2.6	5.2	5.4	6.2

Year-end	2017	2018	2019e	2020e	2021e	2022e
Valuation						
P/B(x) (current price)	0.7	0.7	0.7	0.7	0.6	0.6
P/B(x) (target price)	1.0	1.0	1.0	0.9	0.9	0.8
P/E(x) (current price)	25.1	152.0	27.3	13.3	12.2	10.1
P/E(x) (target price)	35.5	214.8	38.6	18.8	17.2	14.3

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Abacus *Arqaam Capital Fundamental Data*

Investment thesis

Saudi Re was established in Riyadh in 2008 and is currently the only Saudi Arabia-based reinsurer, and it is regulated by the Saudi Arabian Monetary Agency (SAMA) in Riyadh. The company is listed on the Riyadh stock exchange with a diversified investors base. It writes most lines of general, life, and health inwards reinsurance on a predominantly proportional treaty basis, with some non-proportional and facultative business.

Saudi Re has a A3 rating from Moody's and AA rating from Tasneef (local rating agency). Its portfolio is now well diversified geographically and across all lines of business.

Key Drivers:

- Strong brand and market position in Saudi Arabia as the sole Saudi professional reinsurer as well as a growing presence in its target markets of Asia, Africa and Lloyd's
- Preferential position in Saudi market due to a right of first refusal on a portion of premiums ceded by primary carriers in the Saudi market,
- Strong asset quality exemplified by its conservative investment portfolio
- Good capital adequacy, both in terms of capital levels, with gross underwriting leverage (GUL) of 2.2x, and relatively modest exposure to natural catastrophe risk
- Strong financial flexibility with non-existent leverage and good access to capital markets in Saudi Arabia given its listing on the Saudi stock exchange, and broad investor base.

Key Shareholder's	
Ahmad H Al Qusaibi	5.0%

Total Foreign Ownership	
% of foreign ownershi	3.6%

SAUDI RE

Year-end	2017	2018	2019e	2020e	2021e	2022e
Income statement (mn)						
Gross Written Premiums	**942.0**	**721.6**	**756.5**	**809.4**	**887.1**	**987.1**
Ceded Premiums	305.1	104.7	112.2	120.0	129.8	141.9
Retained Premiums	636.9	616.9	644.4	689.4	757.2	845.3
Movement in Unearned Premiums	41.1	3.3	31.5	31.7	34.6	38.4
Net Premiums Earned	**595.8**	**613.6**	**612.9**	**657.7**	**722.6**	**806.8**
Commissions paid	146.1	172.5	170.8	166.0	178.2	195.2
Net commissions	(134.9)	(156.0)	(154.8)	(148.8)	(159.6)	(175.1)
Other underwriting expenses	4.7	2.0	2.3	2.4	2.7	3.0
Changes in technical reserves	-	-	-	-	-	-
Net Claims	419.1	404.1	399.1	426.2	474.3	530.2
Underwriting Profit	**37.1**	**51.6**	**56.7**	**80.3**	**86.0**	**98.5**
Investment Income	62.4	18.6	36.3	39.0	42.6	46.7
Other operating income	-	0.9	0.9	1.0	1.0	1.0
Investment & other income	**-**	**-**	**-**	**-**	**-**	**-**
Interest Expense	-	-	-	-	-	-
General & Administrative	46.7	46.0	46.7	48.9	52.4	57.1
Operating Profit	**52.8**	**25.0**	**47.3**	**71.4**	**77.2**	**89.2**
Distribution of surplus	(0.4)	(1.4)	-	-	-	-
Other income/(loss)	(13.6)	(9.9)	(8.6)	(9.2)	(9.8)	(10.6)
Tax	13.4	12.9	17.0	17.6	18.7	20.0
Minority Interest	-	-	-	-	-	-
Net Income	**25.9**	**2.2**	**21.7**	**44.6**	**48.6**	**58.6**
Reported EPS	0.29	0.05	0.27	0.55	0.60	0.72

Year-end	2017	2018	2019e	2020e	2021e	2022e
Balance sheet (mn)						
Cash	33.5	31.9	(19.3)	(117.4)	(219.6)	(365.6)
Intangible Assets	-	-	-	-	-	-
Reinsurance Contract Assets	283.5	291.5	209.6	217.5	226.4	236.3
Investment Properties	-	-	-	-	-	-
Investments	865.1	552.6	605.5	673.8	748.6	835.0
Associates	92.0	97.3	97.3	97.3	97.3	97.3
Insurance Receivables	845.6	721.1	826.8	922.1	1,019.9	1,159.2
Fixed Assets	33.5	32.6	31.4	30.3	28.9	27.4
Other Assets	331.8	620.9	556.7	596.0	641.6	695.7
Total Assets	**2,484.9**	**2,347.8**	**2,308.0**	**2,419.6**	**2,543.1**	**2,685.3**
Short-term Insurance Contract Liabilities	861.1	992.9	953.1	985.1	1,020.7	1,060.4
Long-term Policyholder Liabilities	461.5	380.2	397.5	430.7	467.1	507.5
Debt	-	-	-	-	-	-
Insurance Payables	264.5	69.1	30.1	31.9	34.8	38.2
Other Liabilities	69.1	72.9	72.9	72.9	72.9	72.9
Total Liabilities	**1,656.1**	**1,515.2**	**1,453.7**	**1,520.7**	**1,595.6**	**1,679.1**
Shareholders Equity	**828.8**	**832.6**	**854.3**	**898.9**	**947.6**	**1,006.2**
Minority Interest	-	-	-	-	-	-
Total Equity	**828.8**	**832.6**	**854.3**	**898.9**	**947.6**	**1,006.2**
BVPS	10.23	10.28	10.55	11.10	11.70	12.42

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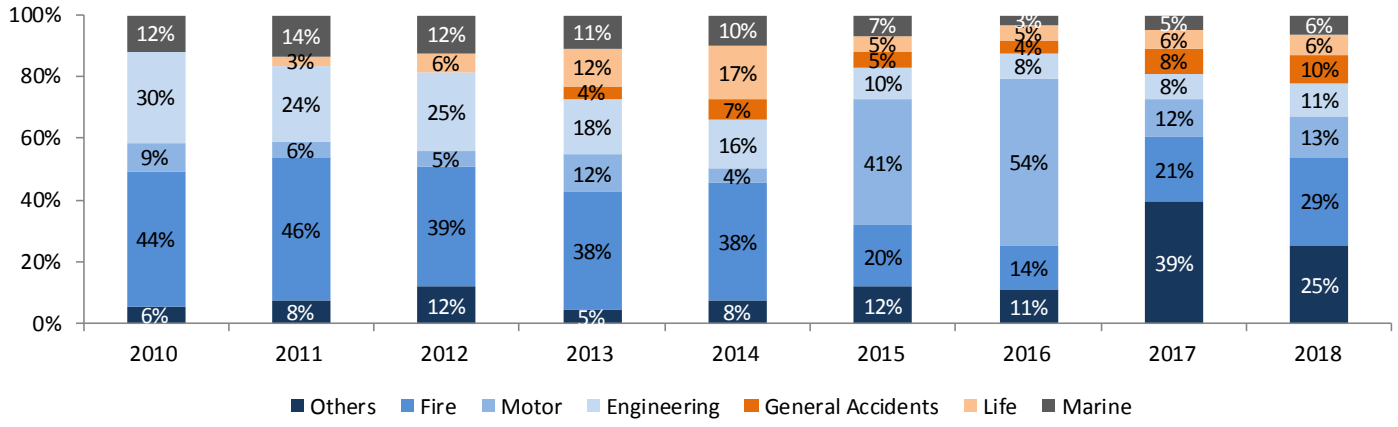
Saudi Re has gone through a transformation from a domestically focused institution towards a diversified multi-line insurance company

- **A well-diversified portfolio both geographically and by product segment; allowing the reinsurer to capitalize on the high-growth segments.**
- **Local regulatory cessions, albeit loosely implemented, have granted Saudi Re a free ticket to the primary insurance markets. Catalysts in-sight remain in both motor and medical due to their lower enforcement rates.**
- **Saudi Re has enhanced its underwriting metrics, by improving both its loss and expense ratios to 65% and 34%, respectively, in FY 19e.**

Saudi Re has diversified its portfolio across most lines of general, life and health, mostly on a proportional treaty basis. The evolution of Saudi Re's concentration risk within its lines of business is built on strong relationships and detailed knowledge of the local/regional markets. Today, Saudi Re's business mix is well-diversified, spread across property, short-tail casualty and specialty, with only a modest uptake of life and medical businesses.

Saudi Re has halved its property risk (fire and engineering) exposure since FY 10A to c.40%. We view the group's diversification towards motor, general accidents, and life positively. Property risk continued to be affected the high frequency of single-event losses, specifically in fire, due to large commercial establishments in Saudi and high-rise buildings in the UAE. This was previously the result of i) the 30% compulsory cession in Saudi and ii) the higher retention of personal lines by primary insurers in the region.

Exhibit 1: GWP concentration by line of business – management have effectively diversified portfolio the past decade



Source: Company Data, Arqaam Capital Research

Local regulatory cession has granted Saudi Re a 'free ticket' to the primary markets. Supported by its strong presence in the region and regulatory protectionist measures (30% compulsory cession – though loosely enforced), Saudi Re writes the bulk of its premiums directly, with access to the primary motor and medical segments in Saudi as well. While retention rates remain high, Saudi Re today underwrites only 16% of the motor ceded business and 6% of the medical business. We believe this is due to the challenging competitive landscape and deteriorating profitability of those two segments.

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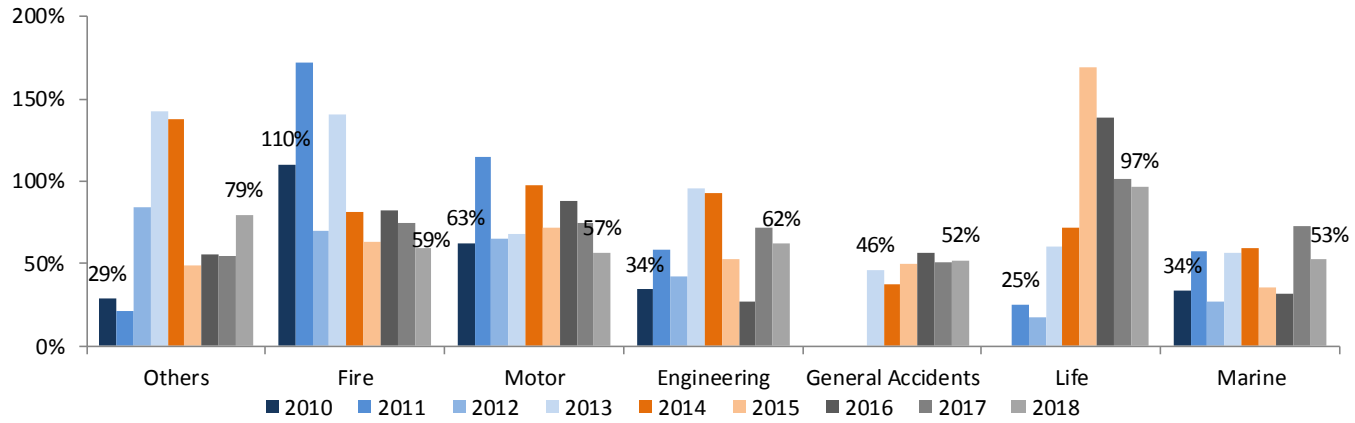
Saudi Re has enhanced its international footing to diversify risk and optimize net loss ratios. Despite the surge in premiums for the KSA insurance sector (12.1% CAGR FY 08-18A) and the favorable protectionist measures, Saudi Re has increased its foreign underwriting since FY 10A. We welcome this strategy, having strengthened its capital and underwriting expertise in the local markets (primarily through local protectionist measures) prior to treading international markets.

It has already begun to reap the results of its 'early strategy' for geographic diversification. Saudi Re has halved its share of local premiums to 40% over FY 10-18A, while sustaining a 27% GWP CAGR, identifying lucrative growth opportunities abroad, mainly in Asia and other ME countries (which now account for 45% of total). It has avoided some of the costly man-made losses in the GCC by diversifying its concentration risk and increasing share of retrocessions.

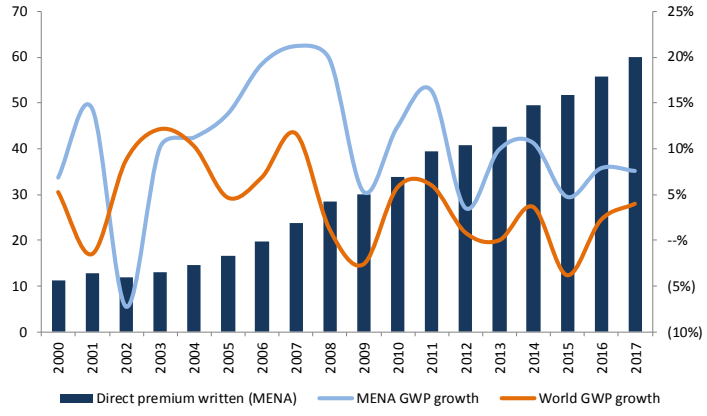
Exhibit 2: Evolution of Net Loss Ratios per segment – Saudi Re managed to optimize its NLR through product line and international diversification



Source: Company Data, Arqaam Capital Research

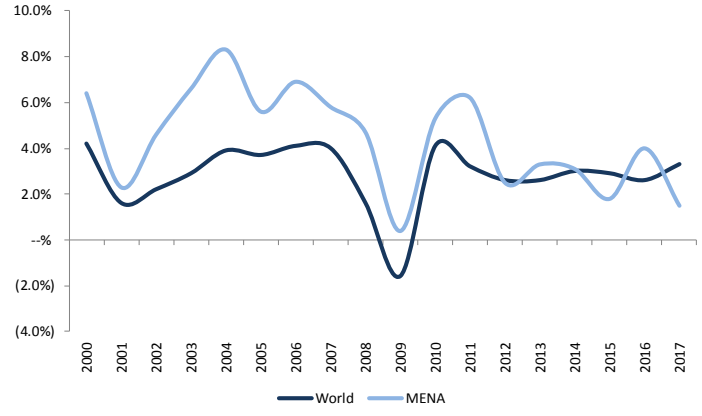
Saudi Re has improved its expense ratio from 28.7% in FY 13A to 25.4% in FY 18A. Reinsurance companies specializing in the non-life have elevated expense ratios of on average c.28% (10yr avg - A.M Best, link), as they to invest in underwriting expertise and pay for agency commissions. Still it has reduced its expense ratio below the average through staff training (reducing its SG&A/GWP from 8.0% in FY 13A to 6.1% in FY 18A), while also increasing its share of retrocessions and proportional treaty businesses.

Exhibit 3: GWP in MENA has consistently outperformed



Source: Swiss Re Sigma, Arqaam Capital Research

Exhibit 4: MENA offers higher GWPs growth in reinsurance



Source: Swiss Re Sigma, Arqaam Capital Research

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Growth and profitability is promising: 2019-26e GWP 9.9% CAGR

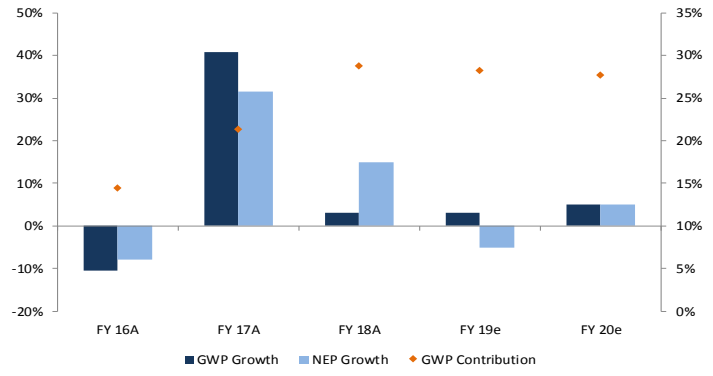
- **Ample room for growth in Saudi and EM markets, owing to the low penetration rates and improving cession ratios (Exhibit 46:, Exhibit 47:).**
- **GWP FY 19-26e CAGR of 9.9%, driven by growth in both fire (+9.7%) and motor segments (+15.8%); GWP/equity to increase from 87% in FY 18A to 111% in FY 26e.**
- **Underwriting margins should improve to 1.3% in FY 19e, benefitting from diversified product mix, reduced geographic concentration, and higher share of retrocession.**
- **Structural cost growth (in-line with Saudi sector) is a drag on expense ratios in the short term, but gradual M/S expansion should continue to drive economies of scale.**
- **We pencil in an RoE improvement to 6.5% by FY 26e.**

Fire/property segment – Remains dominant in the EM, but is a volatile line

Fire/property segment should remain a dominant contributor to GWP growth, at c.26% on average (FY 10-18A), though slow domestic GDP growth may weigh on the segment in FY 19e. Saudi is impacted by a rise in urbanization and a requirement by businesses to comply with regulations on insurance coverage. Saudi Re has capitalized on this growth in the GCC by leveraging its deep market knowledge to underwrite treaty reinsurance contracts. Nonetheless, we model for just 3.0% growth in FY 19e as we expect the weaker GDP growth in the GCC to keep growth contained in the ST (Exhibit 48:). Appendix I: Saudi Market Overview, Exhibit 36: for correlation analysis on property/fire premiums to GDP and public spending,

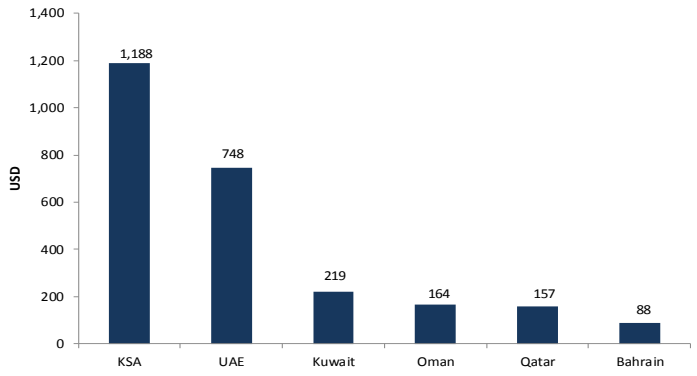
Vision 2030 and government projects are the main catalysts for growth. The Saudi government has embarked on a bold reform program to wane off its dependence on oil revenues. With large and new mega projects announced by the Saudi and UAE government (i.e. Neom, *Exhibit 49:)*, we expect growth in the property/fire to pick up in FY 20e to 5.0% and even 11.0% in FY 22e (*Income elasticity* section p.21 – {*Exhibit 36:* & *Exhibit 37:}*).

Exhibit 5: Fire/property GWP growth vs. NEP



Source: Company Data, Arqaam Capital Research

Exhibit 6: Value of planned and unwarded GCC projects



Source: MEED, Company Data, Arqaam Capital Research

Profitability has been volatile in the fire/property segment. Underwriting income has fluctuated between -68.7% to +8.4% through FY 10-17A, though has now begun to exhibit signs of normalization. Since its onset Saudi Re has adhered to a selective risk growth model, where it

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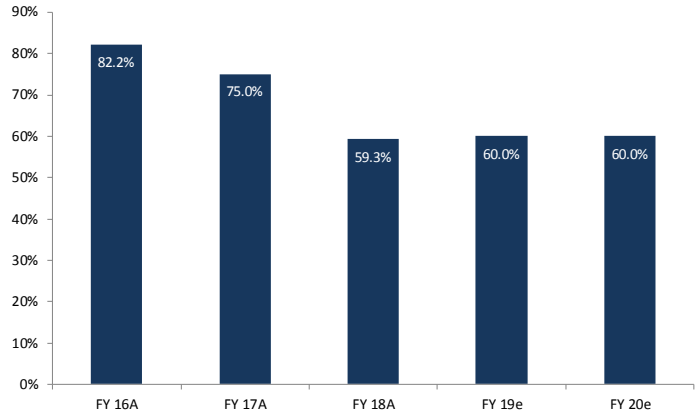
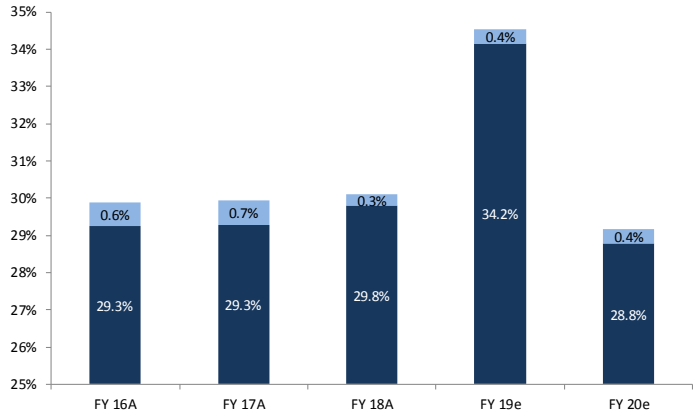
successfully reduced its net loss ratio from 171.7% in FY 10A to 71.8% FY 14-18A average. Nonetheless, due to the high frequency of losses in the GCC region, large single account exposures induced a deterioration in FY 13A to 140.2% and in FY 16A to 82.2%. Having said that, we see signs of normalization post FY 17A, and expect net loss ratios to remain at c.60% thereafter and combined ratios to remain just below 90%.

Exhibit 7: Breakdown of net loss ratio



Source: Company Data, Arqaam Capital Research

Exhibit 8: Breakdown of expense ratio



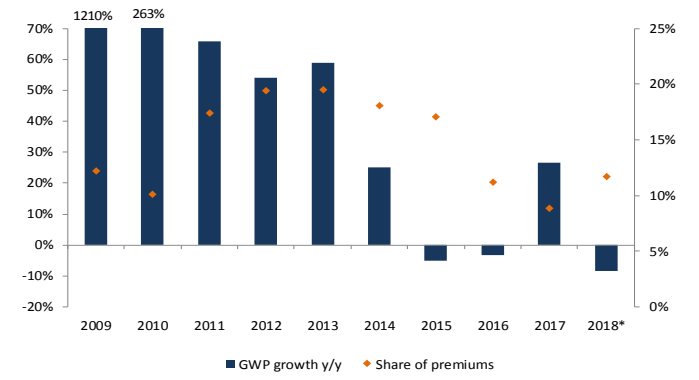
Source: A.M. B est Company, Company Data, Arqaam Capital Research

Motor segment – Holds the most lucrative opportunities for LT growth

Saudi Re has been able to improve its motor market share, despite the low cession and enforcement rates, as it benefits from the regulatory measures in Saudi. Motor GWPs have grown at 32.4% FY 10-18A CAGR, contributing c.13% of gross GWPs in FY 18A. Nonetheless, underwriting risk in the Saudi motor segment is challenging when considering the muted cession ratios (c.4%) and lower profitability.

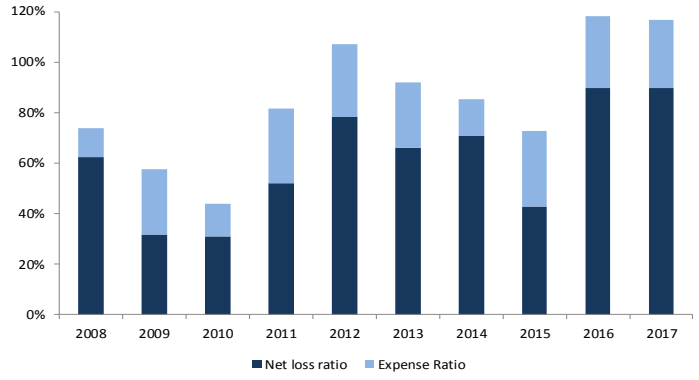
FY 19-26e CAGR of 15.8% as share of local ceded premiums increases by 4.5ppts to 20.1%. Saudi Re has been selectively writing local motor risk, reducing compulsory cessions (30%) to just 15.6% (FY 18A) of local ceded premiums, due to the sector's weak underwriting metrics and large losses. Nonetheless, this represents a marked improvement of 5.6ppts from FY 10-14A averages (FY 15 & 16A M/S were inflated by one-offs), as technical expertise and underwriting metrics began to improve in line with the stricter regulatory oversight. Net Loss Ratio is penciled in at 65% in FY 21e and beyond, up from 56.8% in FY 18A.

Exhibit 9: Motor GWP growth vs. Market share



Source: A.M. Best Company, Arqaam Capital Research

Exhibit 10: Evolution of combined ratios



Source: A.M. Best Company, Company Data, Arqaam Capital Research

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'Others' segment – Potential boost for Saudi enforcement in the PMI

Unclassified portion has increased to c.25% of GWPs in FY 18A from just 5% in FY 13A. Nonetheless, its share has decreased by 14ppts last year as FY 17A premiums were inflated by a one-off facultative contract with SABIC of c.SAR 200m. Besides large facultative contracts, Saudi Re bundles its premiums from Lloyd's and the medical segment (c.4.6%) into that segment as well, which we expect to grow at a 12% CAGR in FY 19-26e.

Medical segment – Provides ST relief in FY 19e through Saudi enforcement

Saudi Re has reduced its premiums to a negligible exposure (too volatile and low margins). The medical segment has been mired by different price wars from FY 11-18A, increasing the sector's combined ratio to >98%. It had reduced its exposure to just 2.7% by YE 17A, but increased it again to 5.5% in FY 18A.

Saudi enforcement and improved underwriting metrics provide potential for increasing share ceded of premiums. The medical segment should exhibit robust growth of +19.8% y/y as crackdown on uninsured Saudis stiffens this year (please check enforcement section). We expect the tightening underwriting cycle which commenced from YE 17A, to start improving the sector's underwriting margins, and increase its share of locally ceded premiums to 13.4% in FY 26e, 2x.

Probitas Acquisition – Provides entry to Latin American markets

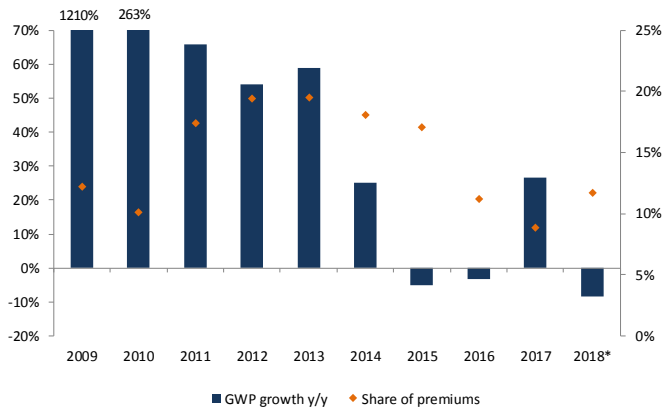
Acquistion of Probitas Holding Bermuda provides Saudi Re a foothold in South America, through Lloyd's syndicate 1492. Post its acquisition of Bermuda Holdings (for more details check *Probitas*) Saudi Re indirectly contributes part of the third party capital (TPC) to Lloyd's syndicate 1492, with underwriting exposure limited to the amount of TPC.

Life segment – low penetration levels

Life insurance in the ME remains limited; Saudi expat exodus weighs (CAGR of 6% FY 19-26e). At present, we believe that expats dominate the lion's share of life premiums in the GCC. Furthermore, life insurance remains a taboo in the region as its broadly forbidden under Islam, though its mandated by mortgage providers to the outstanding amount of the home loan. However, the North Africa region has enjoyed stronger growth from middle-income population.

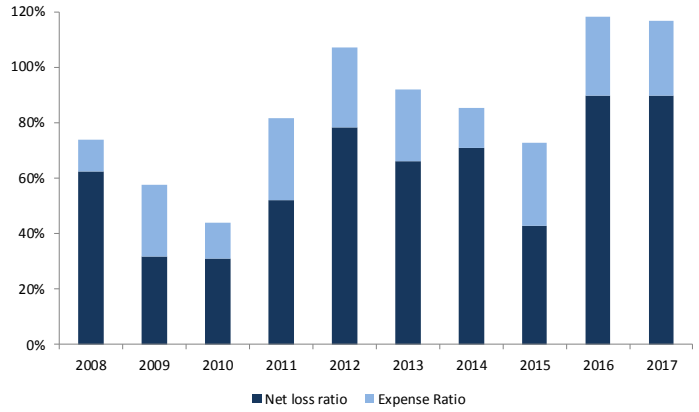
Saudi Re still managed a healthy growth of 19.3% FY 12-18A CAGR from a low base. It has been affected by loss making accounts in FY 14A to FY 18A. Even though Saudi Re had immediately terminated those accounts in FY 14A, the longer tail-risks of that segment have impacted its profitability and NLRs. We expect the bulk of those legacy claims to have filtered through by now and this should reduce NLRs in that segment to 85% by FY 19e. It writes the bulk of that business on a net written basis, allowing it to maintain an expense ratio of c.10%.

Exhibit 11: Life GWP growth



Source: A.M. Best Company, Arqaam Capital Research

Exhibit 12: Evolution of combined ratios



Source: A.M. Best Company, Company Data, Arqaam Capital Research

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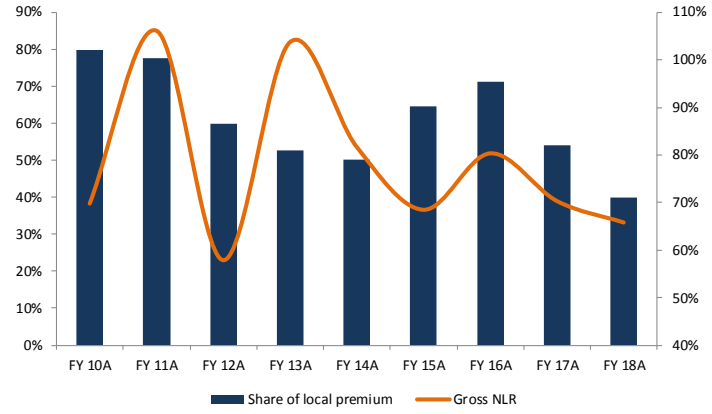
Profitability outlook – A turnaround story in a persistently soft market

New entrants in the reinsurance sector burdened by i) prudent risk selection vs. cost of idle capital, to ii) higher expenses from diseconomies of scale. Saudi Re was no exception. However, Saudi Re has stabilized its net loss ratio through: i) reduced geographic concentration (Exhibit 13:), ii) increased product line diversification, iii) non-renewal of loss-making accounts, and iv) increased utilization of retrocessions.

Expense ratio improved from 47.5% in FY 12A to 30.3% in FY 18e.

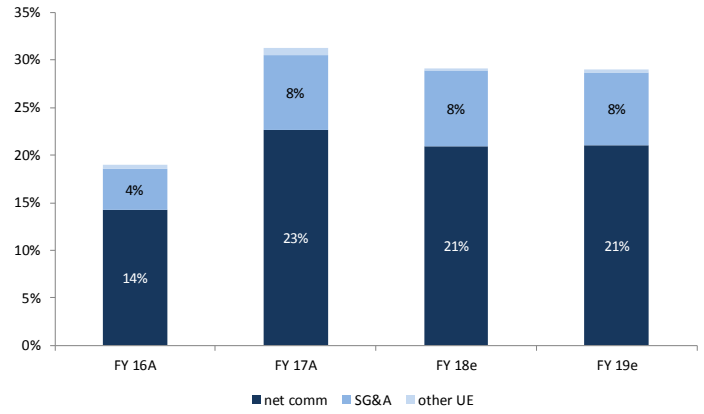
- Saudi Re has effectively reduced its share of SG&A as % of GWPs from 22% in FY 11A to 6.1% in FY 18A, despite the structural cost growth, due to economies of scale and enhanced efficiency.
- Net commission charges have dropped from a peak of 28.7% in FY 13A to 25.4% in FY 18A, through effective diversification of the distribution channels, and increased share of retrocession business, even though reinsurers are bound to higher expense ratios due to their expensive acquisition costs when compared with primary insurers

Exhibit 13: Geographic diversification vs. NLRs



Source: Company Data, Arqaam Capital Research

Exhibit 14: Breakdown of expense ratios



Source: Company Data, Arqaam Capital Research

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Investment income: Driving RoE to 6.5%

- **SAMA has mandated stricter limits on investment activity, leading to more prudent investment allocations. However, investment risk for Saudi Re is already lower than the rest of the MENA, due to its focus on time deposits and fixed income, though also benefitting from increasing local interest rates due to short average duration.**
- **We expect investment yields to pick up to 4.2% by FY 19e from 2.1% last year, improving its contribution to RoE from 1.0% in FY 15A to 3.1% in FY 19e driven by a higher allocation to the fixed income markets (54% of portfolio, average yield ~3.5%) and local equities (17% of portfolio, average dividend yield ~2.0%, to TRS of 10-12%).**

Investments are all booked under FVTPL, which enhances its RoE, but also leads to volatility. Due to the high contribution of investment income, Saudi Re's sought to better reflect its performance as part of the company's core earnings generator, and pass it through the P&L. As a result, investment yields spiked to 6.3% in FY 17A and dropped back to 2.1% last year, as the company reallocated part of its HTM investments to the higher rates, dragging both its realized/unrealized income. Having said that, we expect investment yields to increase +4.6% in FY 19e before gradually normalizing to +3.9% by FY 26e, supported by a stronger contribution from the i) fixed income, ii) equity, and iii) Probitas acquisition. Investment income has already increased by 349% y/y Q1 19e, with an annualized yield of 10.7% vs. 2.3% last year.

Rebalancing of the investment book and the stabilizing evolution of the fixed income markets should reduce volatility in the future. We assume the reinsurer to have transitioned c.9% of its fixed income portfolio to the time and money market accounts in FY 18A, as it waits out the volatility in the fixed income markets. We expect the reinsurer to revert its allocation to 27% fixed income, 54% time and money market funds, and 17% equities.

Investment returns have seen increased volatility since FY 15A with all income through PL. Saudi Re manages its investments fairly and dynamically, in our view, having a larger allocation to fixed income with lower duration. Albeit, investment yields have been volatile since FY 15A, in-line with Saibor, and primarily due to heavy un/realized losses of its fixed income and equity market portfolios. Nonetheless, the reinsurer has now increased its allocation to time deposits, and stabilized its yields at c.4%.

MENA re/insurers generally have concentrated investment books. Investment portfolios are generally weighted towards the equities and real estate, which are inherently riskier and relatively illiquid. Compounding that problem is the usage of credit facilities by some re/insurers to settle their claims and cover the illiquidity gap from their investments. Nonetheless, the Saudi regulator has always adhered to a more prudent investment approach with a 40% minimal allocation to deposits and bonds. The drive towards a risk-based supervision in the UAE and Saudi should result in further de-risking of investment books.

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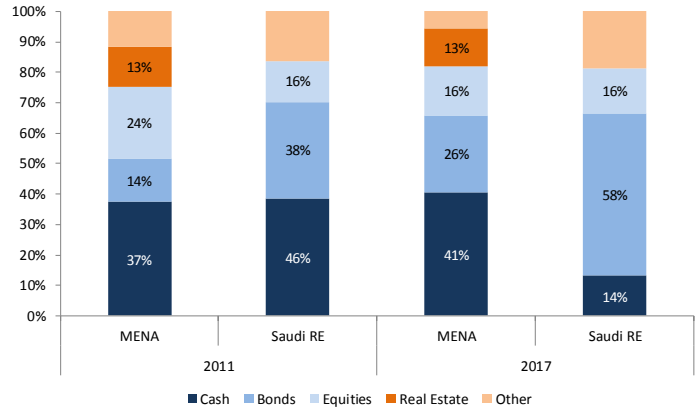
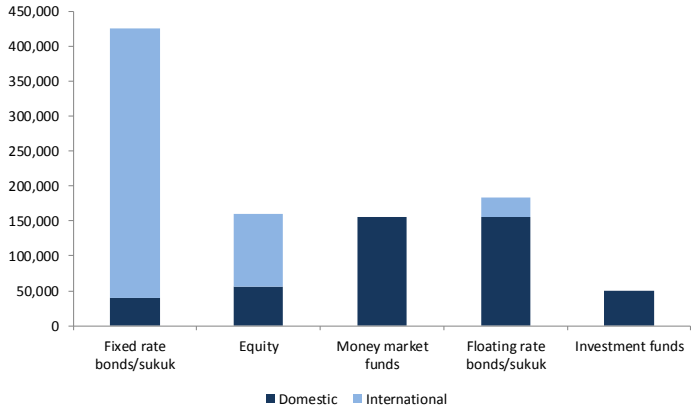
Exhibit 15: Asset allocation – Saudi Re vs. MENA re/insurers



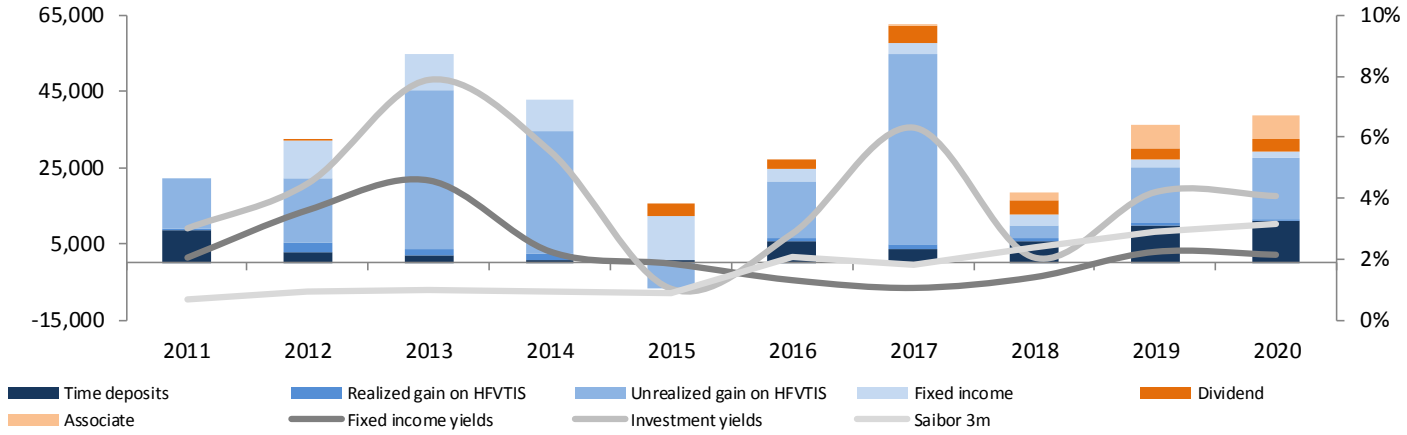
Source: A.M. Best Company, Arqaam Capital Research

Exhibit 16: Geographic split vs asset class



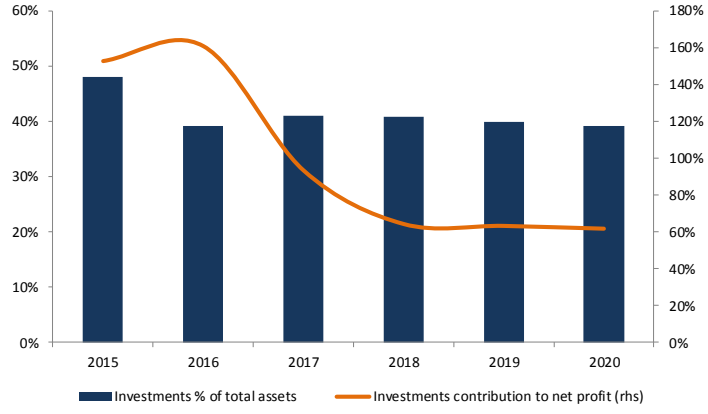
Source: Company Data, Arqaam Capital Research

Exhibit 17: Investment returns by line of business increasing after MtM losses in FY 15A



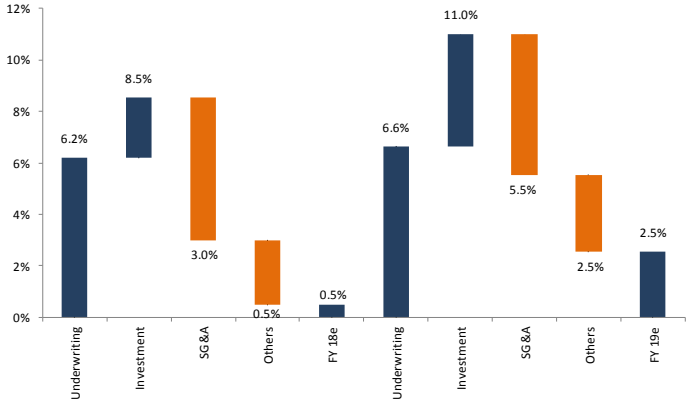
Source: Company Data, Arqaam Capital Research

Exhibit 18: Investment contribution



Source: A.M. Best Company, Arqaam Capital Research

Exhibit 19: RoE breakdown



Source: Company Data, Arqaam Capital Research

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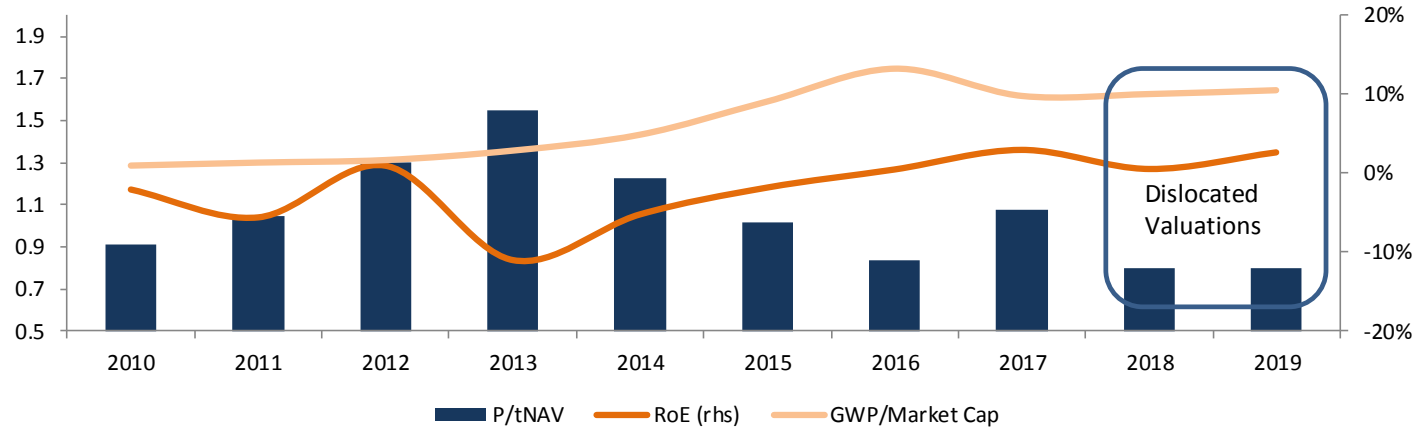
Valuation – stock price performance lagged behind the improvement in earnings

- **Share price has yet to catch up with the improvement in profitability, with current trading multiples overly punitive given the sustainability of its underwriting margins.**
- **Saudi Re is now trading at 44% and 82% discount to local primary insurers on PE 20e and P/tNAV 19e basis, respectively**
- **We initiate coverage on the reinsurer with a Buy recommendation.**

The market has yet to price in the improvement in RoE, despite the preemptive measures the company has taken. Saudi Re has steadily improved its RoE on the back of i) increased retrocessions, ii) more prudence in risk selection, and iii) improving investment yields. In that regard, we believe those actions should normalize its RoE 19e and beyond at c.6%; creating a dislocated valuation gap until the market readjusts to its newer profitability metrics.

Exhibit 20: P/tNAV vs. RoE and GWP/Market Cap



Source: Company Data, Arqaam Capital Research

Exhibit 21: Valuation Table – KSA Insurance

Company	Rating	Share Price	Target Price	Upside %	Mkt. Cap. USDm	Curr	Mkt Cap. (m)	ADTV6M USDm	PE (x) 19e	PE (x) 20e	P/tNAV (x) 18A	P/tNAV (x) 19e	MC % of GWP 17A	MC % of GWP 18A	UW margins 18A	UW margins 19e	NP Margin (%) 18A	NP Margin (%) 19e	RoTE (%) 18A	RoTE (%) 19e	RoTE (%) 20e
Tawuniya	HOLD	71.9	75.5	5.0	2,396	SAR	8,988	4.1	(53.4)	19.4	5.4	6.0	140.4	117.6	0.5	0.5	(3.4)	(2.0)	(13.2)	(9.8)	25.2
Bupa	BUY	94.4	99.8	5.7	3,020	SAR	11,328	4.2	22.3	19.0	4.9	4.4	96.2	132.2	12.2	12.1	5.1	5.2	17.8	18.6	19.2
MedGulf	HOLD	15.2	10.7	(29.9)	324	SAR	1,216	2.4	na	na	6.7	na	103.9	65.2	3.8	2.5	(8.7)	(9.3)	(26.4)	(41.2)	(37.7)
Malath	BUY	10.5	14.8	40.7	141	SAR	527	2.4	na	50.1	1.2	1.2	109.6	72.3	(0.6)	(3.9)	(0.3)	(0.3)	(0.4)	(0.4)	2.4
AlRajhi	BUY	52.9	58.7	11.0	564	SAR	2,116	4.8	35.7	17.8	3.0	2.8	74.0	71.2	13.3	7.2	7.3	2.2	31.6	7.4	13.4
AXA	BUY	25.7	21.6	(15.7)	308	SAR	1,154	1.0	15.0	16.0	2.2	2.1	59.6	79.8	2.7	3.5	4.4	5.7	11.2	12.2	10.3
Walaa	HOLD	17.1	23.1	35.0	241	SAR	905	1.0	17.2	15.8	1.1	1.0	117.0	-	21.6	14.8	7.7	3.9	13.8	5.8	5.9
Saudi Re	BUY	7.4	10.3	40.1	159	SAR	597	0.9	27.5	13.4	0.8	0.8	67.3	82.7	7.1	7.5	0.5	2.9	0.5	2.6	5.1
SAICO	HOLD	10.3	12.1	17.7	82	SAR	309	1.0	na	170.2	0.8	0.8	55.2	37.5	14.6	11.8	1.5	(0.5)	3.5	(1.1)	0.4
Buruj	HOLD	20.2	20.8	3.0	162	SAR	606	1.0	24.2	158.8	1.1	1.1	87.1	189.4	38.9	22.6	18.7	6.4	14.0	4.5	0.7
Sector				**6.1**	**7,997**		**29,995**	**6.1**	**116.7**	**26.4**	**5.0**	**5.1**	**136.5**	**124.5**	**7.1**	**6.3**	**1.3**	**1.0**	**4.3**	**3.5**	**13.9**

Source: Company Data, Arqaam Capital Research

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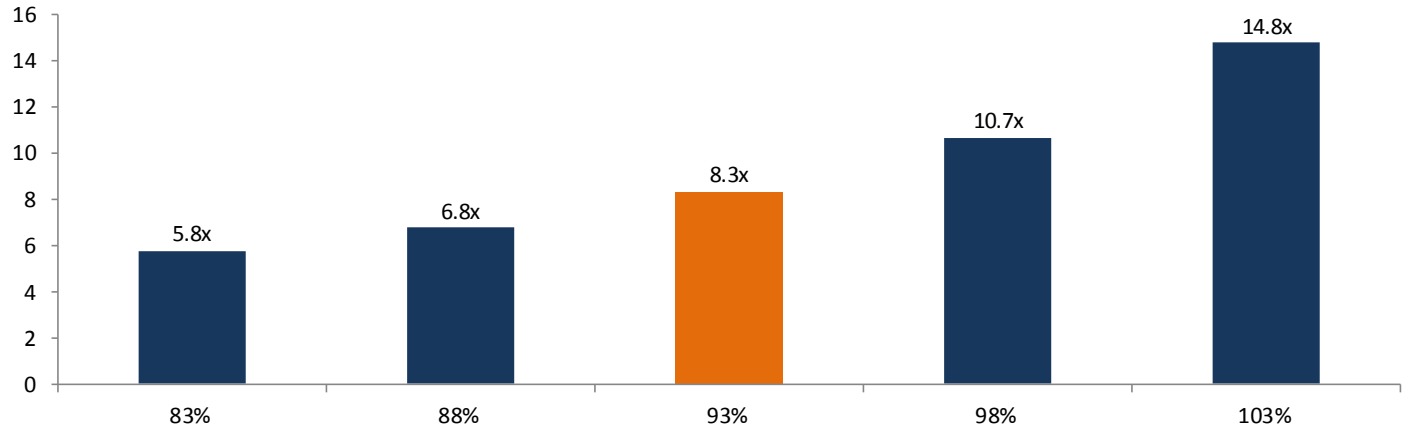
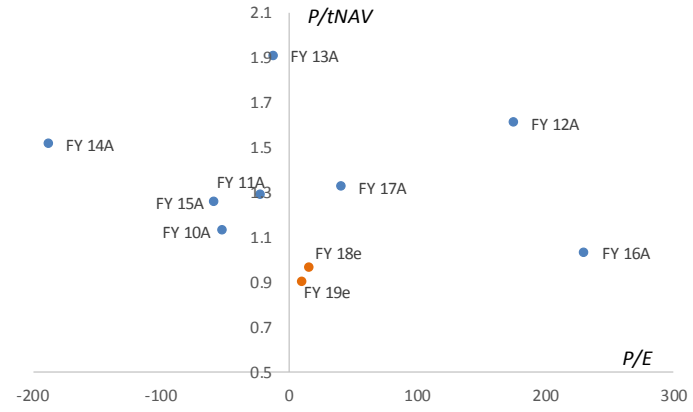
Exhibit 22: Sensitivity of P/E 20e to deviations in Combined Ratios



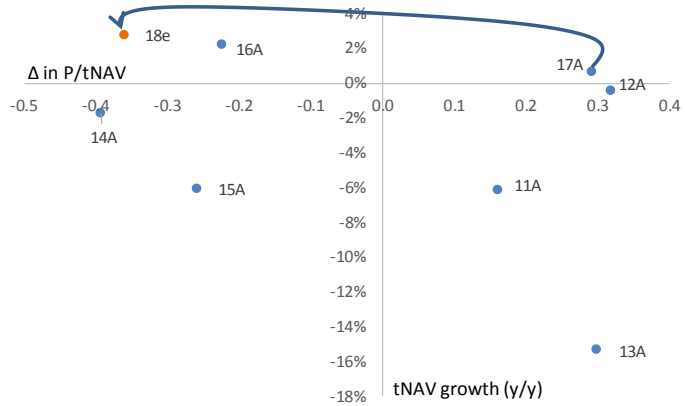
Source: Company Data, Arqaam Capital Research

Exhibit 23: P/E vs. P/tNAV – EPS turns positive in FY 16A but P/tNAV continues to lag



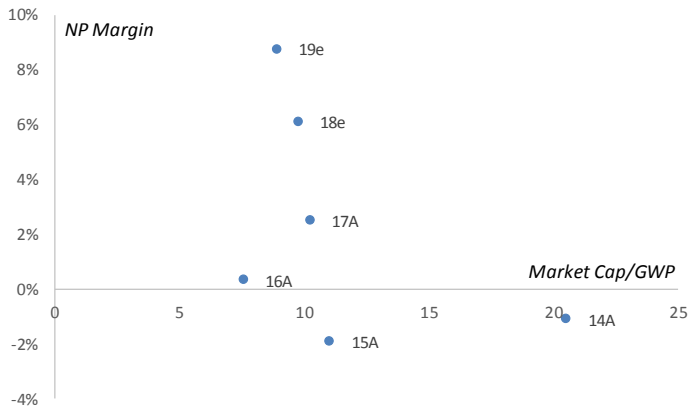
Source: A.M. Best Company, Arqaam Capital Research

Exhibit 24: Δ in P/tNAV vs. tNAV growth – improvement in price has lagged the growth in NAV



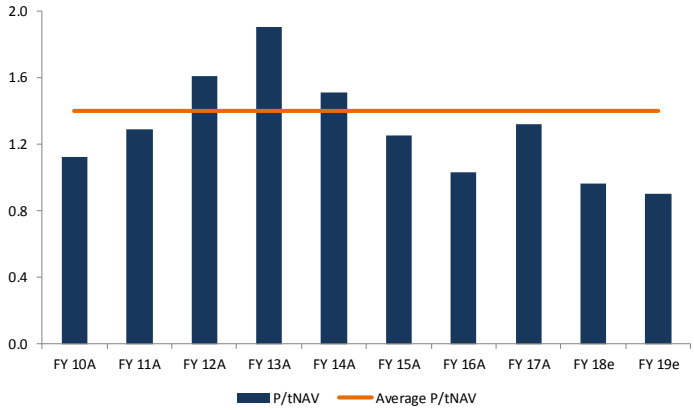
Source: Company Data, Arqaam Capital Research

Exhibit 25: Market Cap/GWP vs. Net Profit Margin



Source: A.M. Best Company, Arqaam Capital Research

Exhibit 26: P/tNAV vs. five-year avg. P/tNAV



Source: Company Data, Arqaam Capital Research

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Exhibit 27: Saudi Re' Valuation Table

	2016A	2017A	2018e	2019e	2020e	2026e	perp	subtotal	% of total
1. DCF									
Net profit	3,235	23,565	3,894	21,669	44,602	95,176	95,176		
Minus: return excess capital	12,791	12,305	12,708	12,809	13,363	17,891	17,891		
Return on excess capital	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%		
Tax shelter	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%		
Adjusted net profit	(9,557)	11,260	(8,814)	8,860	31,239	77,285	77,285		
Capital requirements	336,391	352,143	342,203	358,400	379,987	614,531	614,531		
RoEcC	-2.8%	3.2%	-2.6%	2.5%	8.2%	12.6%	12.6%		
Cost of capital	10.5%	10.5%	10.5%	10.5%	10.5%	10.5%	10.5%		
Capital charge	35,321	36,975	35,931	37,632	39,899	64,526	64,526		
Economic profit	(44,878)	(25,715)	(44,745)	(28,772)	(8,660)	12,759	12,759		
Discount factor	0.00	0.00	0.00	1.00	0.90	0.50	0.50		
NPV of economic profit	--	--	--	(28,772)	(7,837)	6,343	12,759		
DCF EVA forecast period							(30,759)		
Perpetual growth rate (GDP)							3.5%		
Terminal Value							182,275		
Terminal value discounted								90,613	
Required Capital								342,203	
Value of the reinsurance operations								**402,057**	**48.1%**
2. Capital surplus/deficit									
Available capital:									
Shareholders' equity	805,301	828,793	832,648	854,316	898,919	1,327,409			
Less Goodwill & intangibles	31,594	55,975	55,975	58,003	62,060	101,211			
Less dividends									
Tangible equity	773,707	772,817	776,672	796,314	836,859	1,226,198			
Capital needs									
Net Written Premium (NWP)	891,953	582,629	572,550	598,270	640,561	1,193,008			
Technical reserves	19,720	24,971	28,795	27,641	28,568	36,771			
Equity investments	142,975	160,595	138,270	151,896	169,013	324,680			
Claims provision	569,364	695,213	734,578	762,516	788,088	1,014,380			
Associates	--	91,954	97,294	97,294	97,294	97,294			
Equity as % of NEP	27.1%	32.9%	33.5%	33.9%	34.0%	33.6%			
Equity as % of technical reserves	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%			
Equity as % of investments	50.0%	50.0%	50.0%	50.0%	50.0%	50.0%			
Equity as % of claims reserves	33.9%	33.9%	33.9%	33.9%	33.9%	33.9%			
Equity as % of associates	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%			
Capital requirements	336,391	352,143	342,203	358,400	379,987	614,531			
Surplus capital	**437,316**	**420,675**	**434,470**	**437,913**	**456,872**	**611,667**		**434,470**	**51.9%**
3. Other adjustments									
Total adjustments									
4. Dividends								**--**	**0.0%**
Total Fair Value								**836,527**	
Fair value per share								**10.3**	
Current share price								7.3	
Upside								**41.3%**	
Implied P/E	258.6x	35.5x	214.8x	38.6x	18.8x	8.8x			
Implied P/B	1.0x	1.0x	1.0x	1.0x	0.9x	0.6x			

Source: Company Data, Arqaam Capital Research

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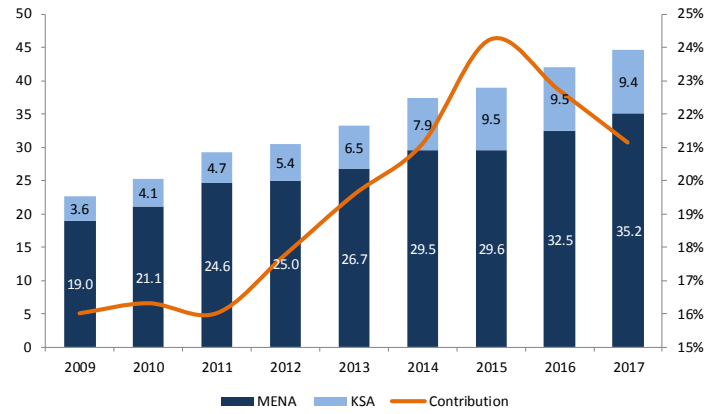
Appendix I: Saudi Market Overview– ample room for growth despite the low cession rates

- **Ample room for growth in Saudi, as exposure remains well below the regulatory limit.**
- **GDP elasticity of P&C premiums has materially dropped from 5.1x in FY 05-10A to 0.9x, due to high cessation rates and oversupply of foreign capital.**
- **Growth catalysts insight are both in the motor and medical segments, as enforcement rates remain relatively low at just 50% and 80%, respectively. Crackdown on Saudi employees this year should boost medical GWPs by +13% y/y.**
- **Implementation of Risk Based Supervision (RBS) framework in FY 18A should significantly improve underwriting standards and expertise, providing the opportunity for Saudi Re to write more local risk.**

Saudi market is now considered a major reinsurance hub in the MENA region, constituting 21% of MENA GWPs (vs. 16% in FY 09A) and 38% of GCC GWPs, with renewed growth in health. Supported by its government-fueled growth and larger population, premium growth in Saudi has outpaced the rest of the GCC region (prior to 2015) for the past five years. The medical segment is benefitting from a price hardening cycle, and with significant growth potential after the CCHI declared the start of its Saudi crackdown as of January 2019 (*Link*).

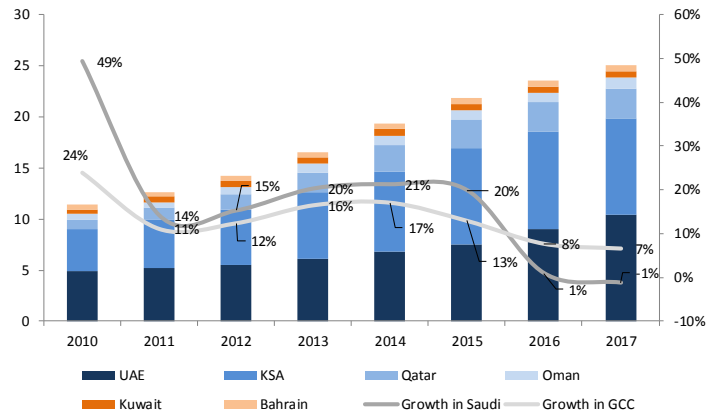
However, average rate/policies (ex. medical) have been declining for the past two years, though have finally begun to tighten this year. Primary insurers are compounding the problem by leveraging their ratings and capacity to increase their retention and/or write inward facultative business. Concurrently, foreign reinsurance capital and expertise continue to flood the market and further suppress P&C rates (Exhibit 39: & Exhibit 40:). Nonetheless, a larger share of insured losses over the past two years have finally begun to harden the P&C market.

Exhibit 28: Non-life premiums – MENA vs. Saudi – Saudi growth rates have outpaced the MENA region by FY 11A



Source: SAMA, Swiss Re Sigma, Arqaam Capital Research

Exhibit 29: Direct premiums GCC – Saudi to become the largest insurance hug in the GCC by FY 20e



Source: Company Data, Swiss Re sigma, Arqaam Capital Research

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Sector outlook: Some juice left in motor and medical segments

We expect growth in the P&C sector (ex. motor) to slow in FY 19-24e to a CAGR of 2%, which is primarily a reflection of the slower GDP growth. The P&C sector has enjoyed a FY 10-17A CAGR of 3.5%, providing the bulk of reinsurance activity to the market (70%), as primary insurers still lack the necessary technical expertise to underwrite these risks. Nonetheless, and in-line with the falling oil prices, growth has significantly decelerated since FY 14A, as the Saudi government has tightened its fiscal policy; reigning in spending as well as raising revenues. However, fiscal policy has started to loosen as of late.

The on-going battle in the motor segment and tightening regulatory requirements should induce a sector consolidation and improve the B/S strength and underwriting practices for the rest. Faced with a toxic trifecta of i) lower car sales, ii) reduced policy rates, and iii) and stiff competition, the resilience of motor franchises was tested last year as sector GWPs contracted by -14.5% y/y. Nonetheless, some aggressive seekers of growth in FY 16-18A (ie. Salama, Gulf Union, etc.) have already begun to see slight margin erosions, which is only expected to worsen by YE 19e. Furthermore, new CB regulations stipulating an increase of regulatory capital to SAR 500 from SAR 100, should force the weakest sector participants to drop out.

Lucrative growth opportunities remain in motor, once enforcement rates pick up and underwriting expertise improves. Profitability of the primary motor insurers in Saudi has been very volatile, which was initially due to lack of underwriting expertise, and inadequate insurance databases to effectively price claims. Nonetheless, SAMA took multiple measures to correct the sector's underwriting from: i) compulsory actuarial pricing, ii) unified pricing policies and iii) centralized databases at Najm, all of which hardened the market rates in FY 16A and bounced the sector back to the green. Nonetheless, steep price discounts followed right after in FY 17A, which was primarily due to SAMA's No Claim Discount initiative. Currently the motor segment is still experiencing a price war, with average claim/policy have dropped back to FY 15A levels (SAR 1,500), and with some insurers underwriting TPL policies for <SAR 300.

Exhibit 30: GWP evolution motor segment

(000's)	2016	2017	2018e	2019e	2020e	2021e	2022e	2023e	2024e	2025e	2026e
Vehicles with accidents	1,564	1,542	1,523	1,538	1,692	2,030	2,538	2,843	2,914	2,987	3,061
Vehicles accident free	4,580	4,722	4,663	4,709	5,180	6,216	7,770	8,703	8,920	9,143	9,372
Total insured vehicles	6,144	6,264	6,186	6,247	6,872	8,247	10,308	11,545	11,834	12,130	12,433
Total vehicles	13,653	13,920	14,113	14,385	14,649	14,925	15,211	15,591	15,981	16,381	16,790
Rate/Policy (accident history)	1,854	1,917	1,725	1,777	1,688	1,604	1,555	1,587	1,618	1,651	1,684
Rate/Policy (accident free history)	1,854	1,669	1,316	1,277	1,239	1,177	1,141	1,164	1,188	1,211	1,236
GWP (SARm)	**11,392**	**10,835**	**9,337**	**8,747**	**9,273**	**10,571**	**12,817**	**14,642**	**15,309**	**16,005**	**16,733**
Enforcement rate	45%	45%	44%	43%	47%	55%	68%	74%	74%	74%	74%
Insured vehicles growth	(10.7%)	2.0%	(1.2%)	1.0%	10.0%	20.0%	25.0%	12.0%	2.5%	2.5%	2.5%
GWP/Policy (clean slate)	24.2%	3.4%	(10.0%)	3.0%	(5.0%)	(5.0%	(3.0%)	2.0%	2.0%	2.0%	2.0%
GWP/Policy (accident history)	24.2%	(10.0%)	(21.1%)	(3.0%)	(3.0%)	(5.0%)	(3.0%)	2.0%	2.0%	2.0%	2.0%
GWP growth rate	**10.9%**	**(4.9%)**	**(13.8%)**	**(6.3%)**	**6.0%**	**14.0%**	**21.3%**	**14.2%**	**4.5%**	**4.5%**	**4.5%**

Source: Company Data, Najm, Arqaam Capital Research

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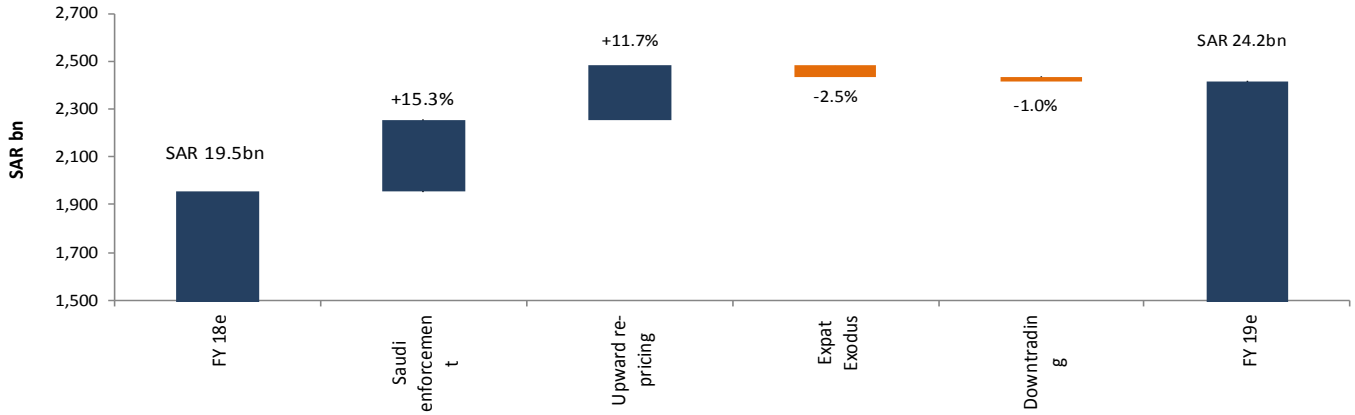
The Council of Cooperative Health Insurance announced the finalization of e-connection for all Saudi workforce in the private sector and their families. All private sector entities that have not provided health insurance coverage yet, are now forced to comply (check, link).

75% enforcement rate by FY 19e should boost volumes in the private sector by c.1m. Saudi enforcement will now be phased-in over two years, with 1.5m additional lives expected by YE 19e and 3.2m by YE 23e, reducing our growth forecasts to 11.2% from 16.3% earlier.

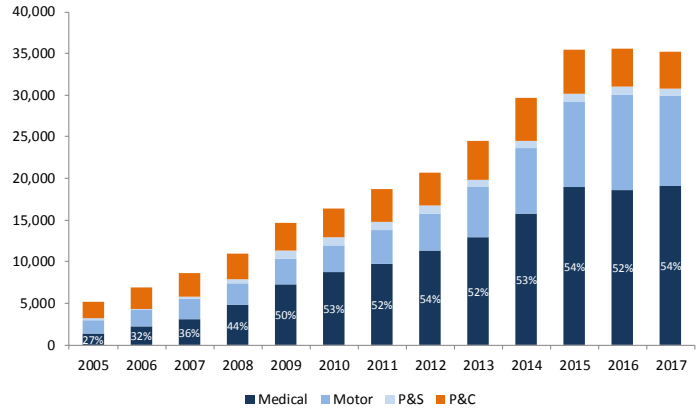
Saudi enforcement should cater for new growth opportunities in FY 19e. We expect Saudi enforcement to boost the medical segment by +11.2% y/y in FY 19e and 11.8% in FY 20e, increasing ceded premiums to SAR 680m and SAR 760m, respectively, at the current run rate.

Exhibit 31: Evolution of Medical GWPs in FY 19e – Saudi enforcement to override the exodus of expats in FY 20e



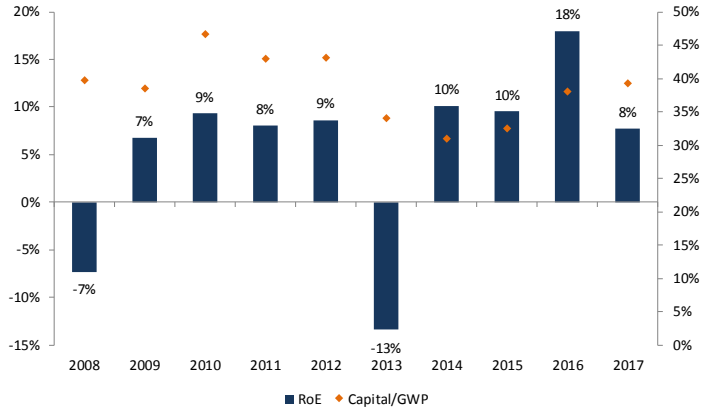
Source: Company Data, Arqaam Capital Research

Exhibit 32: Evolution of premiums in Saudi – medical coverage was the primary driver since FY 08A



Source: A.M. Best Company, Arqaam Capital Research

Exhibit 33: Capital GWP vs. RoE – improving profitability at primary insurers reduced the need for reinsurance



Source: A.M. Best Company, Company Data, Arqaam Capital Research

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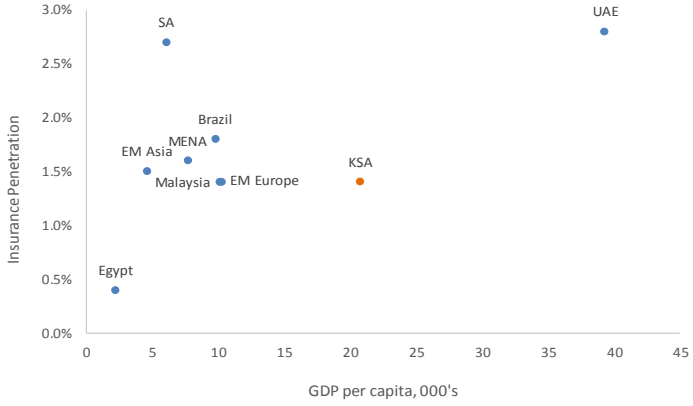
Income elasticity of premiums – KSA significantly lags other EMs

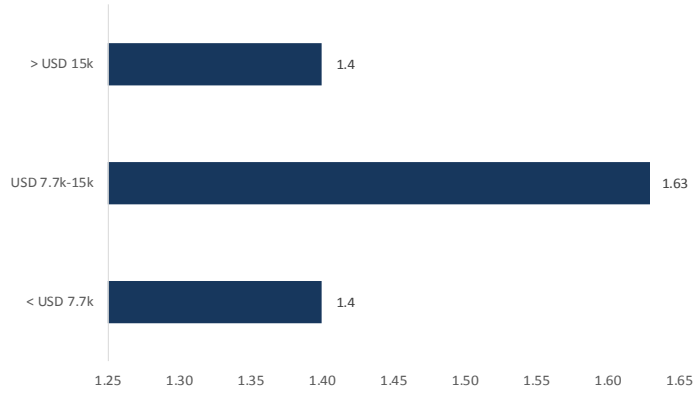
We expect consumer welfare and confidence to improve as KSA moves towards EM status, rendering vehicles and homes the first insurable assets. Commercial insurance coverage dominates the industry in the prelim stages of economic development, due to a rise in urbanization and the need for businesses to comply with regulatory coverages. Subsequently, as individuals purchasing power improves, demand for vehicles and home coverages increases. In fact, non-life insurance tends to have comparatively higher penetration rates in the earlier phases of development, with motor insurance typically being the largest line of business. Individuals then begin to place a larger value on their health and well-being; increasing the demand for both medical and life coverages. Nonetheless, if compulsory medical coverages exist, then medical and motor tend to dominate the non-life insurance sector at the early stages.

Exhibit 34: Scatter: GDP/capita vs. Insurance penetration



Source: Swiss Re - SIGMA, Arqaam Capital Research

Exhibit 35: GDP/capita and income elasticities – EM markets



Source: Swiss Re - SIGMA, Company Data, Arqaam Capital Research

GDP elasticity of insurance premiums has materially dropped from 5.1x in FY 05-10A to 0.9x. GDP elasticity dropped in FY 10-17A (Exhibit 36:), as foreign capital continues to flood the market (Exhibit 40:) and due to lower rates (Exhibit 41:). The combination of high cession rates in the P&C sector, coupled with the oversupply of foreign capital (**Error! Reference source not found.**), a nd subdued global rates (Exhibit 61:), have all contributed to suppressing P&C rates in Saudi, and reversing the income elasticity. Nonetheless, public sector spending in Saudi remains the main driver of GDP growth, which is projected to grow by +8% this year, after +19% the prior year, driving a recovery in the P&C segment from -2.6% last year to +0.5% this year.

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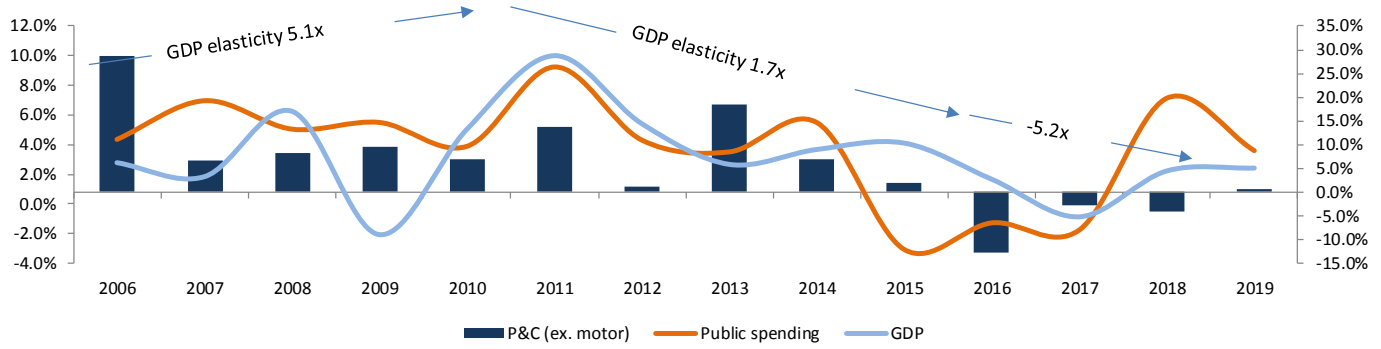
Exhibit 36: Correlation of P&C GWPs to public spending and GDP growth



**The income elasticity of insurance demand measures changes in insurance premiums as % of changes to GDP. Source: SAMA, Arqaam Capital Research*

Higher retention of risk by primary insurers is a drag on the local reinsurance market

Sound profitability supported capital formation and increased retention rates. Primary insurers capitalized on the growth in the medical segment, especially at the early stages, in which market inefficiencies resulted in net loss ratios below 50% for many of the smaller players. Furthermore, the Saudi insurance sector underwent a complete overhaul in FY 13A, which improved underwriting cycles once SAMA introduced actuarial practices to the market (for more info, download link). Capital levels were healthy, with shareholders' equity/GWP at around 30-40% range for the period FY 08-17A. Risk retention levels increased in the medical segment from 78% in FY 08A to 96% in FY 17A. As a result, the bulk of reinsurance business in Saudi is driven by the P&C segment (ex. motor), where retention rates are still low at 26%.

Retention in P&C has been steadily increasing, but we expect this to stabilize at current levels. Primary insurers have shied away from onboarding P&C risk (ex. motor) due to its volatile nature**.** Furthermore, insurers focused their capital towards the larger motor and medical segments, as they sought to stabilize their bottom line and cede away their P&C risk. While retention levels have gradually increased in the P&C segment from 20% in FY 10A to 26% by FY 17A, we expect them to normalize at current levels, due to the stronger growth expectations for both the medical and motor segments.

Headwinds – better underwriting standards and enhanced capital levels for primary insurers.

- Primary insurers have been heavily investing to improve their underwriting metrics in the medical and motor segments, coupled with regulatory developments like the unified policy format, and actuarial pricing, which have boosted insurers profitability.
- SAMA has inaugurated a new valuation center for claims in the motor segment, reducing market malpractices, while unifying the database at Najm to improve pricing.
- SAMA is expected to increase the min. capital requirement for primary insurers by FY 20e from SAR 100m to SAR 500m, and further strengthening their B/S.

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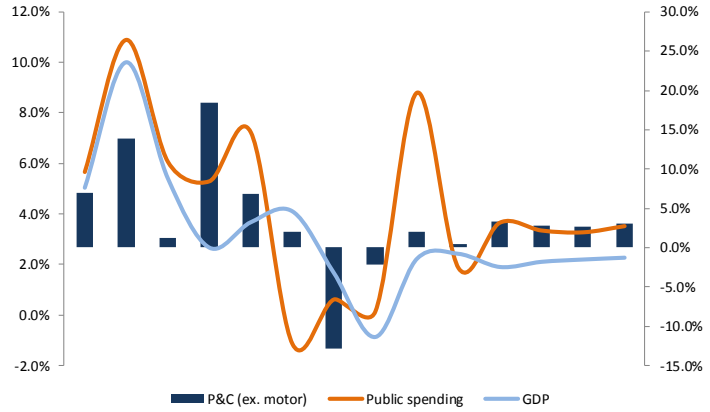
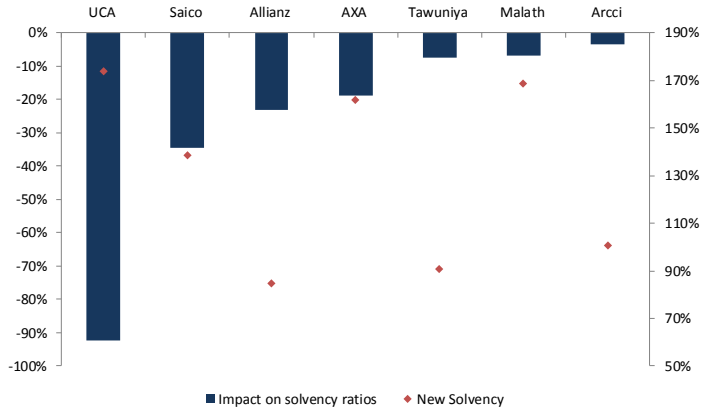
Exhibit 37: Regression analysis – P&C growth vs. government spending and real GDP growth



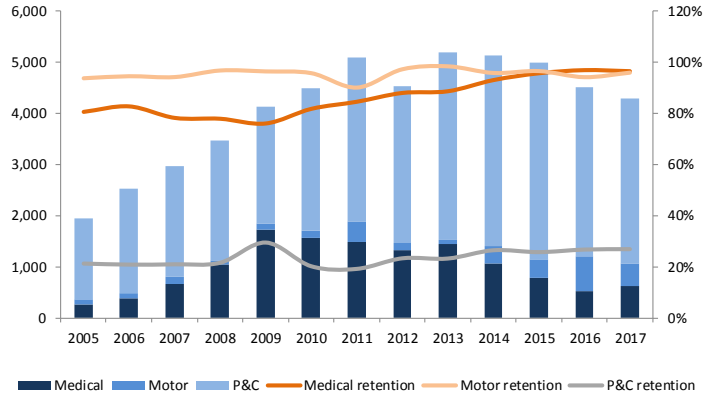
Source: A.M. Best Company, Arqaam Capital Research

Exhibit 38: Solvency ratios FY 17A – Full P&C retention could melt away solvency at select insurers



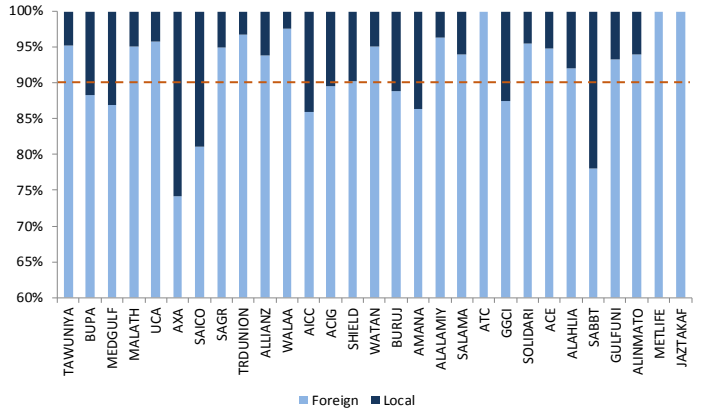
Source: A.M. Best Company, Company Data, Arqaam Capital Research

Exhibit 39: Ceded premiums vs. retention rates by segment – P&C remains the main driver of growth



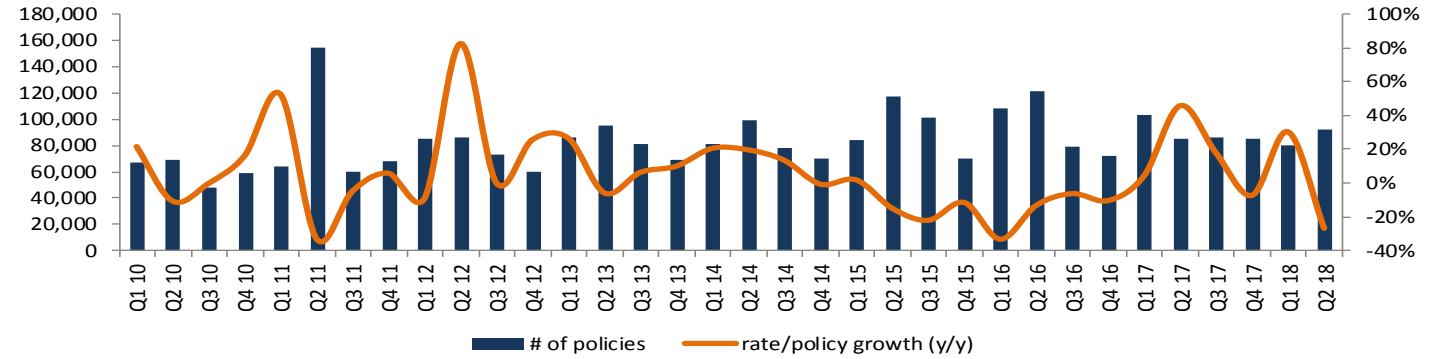
Source: A.M. Best Company, Arqaam Capital Research

Exhibit 40: Local vs. Foreign reinsurance cessions – foreign capital absorbs c.90% of the reinsurance risk in KSA



Source: Company Data, Arqaam Capital Research

Exhibit 41: Number of P&C (ex. motor) policies vs. rate/policy growth – Softening cycle which extended from Q1 14 - Q1 16, was only partially offset by the hardening cycle in Q1 16 – Q2 17



Source: SAMA, Arqaam Capital Research

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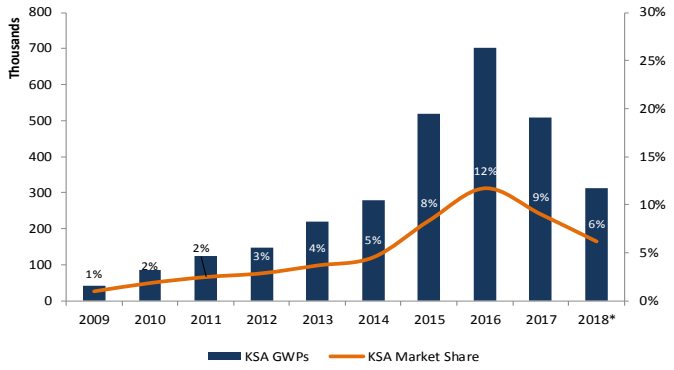
Protectionist measures and macro fundamentals bode well for growth

Regulatory protectionist measures in Saudi boding well for growth. Saudi Re continues to hold a preferential position in its home market, as companies are incentivized by SAMA to adhere to a 30% compulsory-part retention to the local market, while Saudi Re retains the right of first refusal on a portion of premiums retained, allowing the reinsurer to protect its profitability and reduce its concentration risk.

Saudi Re's local market share has fallen from 13.3% in FY 16A to 6.7% in FY 18A, due to its focus on profitability but from that base we see some room for market share expansion. The reinsurer has been steadily improving its share of local ceded premiums from 1.0% in FY 08A to a peak of 11.7% in FY 16A, though retracing back to 6.7% by YE 18A.

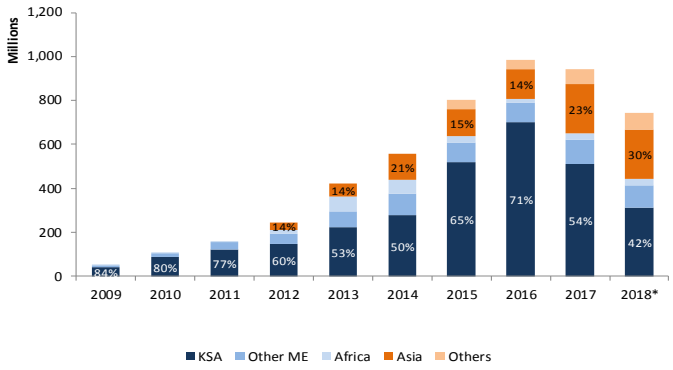
We model for a recovery in Saudi Re's local market share to c.8-10%, as management continues to prioritize profitability by cherry picking the most profitable exposures, while also seeking to diversify their business mix and geographic concentration. Good client relationships allow for continued growth in the P&C and medical segments, mainly as Saudi Re continues to benefit from smaller B/S sizes for the smaller players.

Exhibit 42: Evolution of Saudi Re's market share – reducing focus on local market and diversifying risk



Source: A.M. Best Company, Arqaam Capital Research

Exhibit 43: Boost to GWP growth if Saudi Re's market share was to climb to the compulsory limit



Source: A.M. Best Company, Company Data, Arqaam Capital Research

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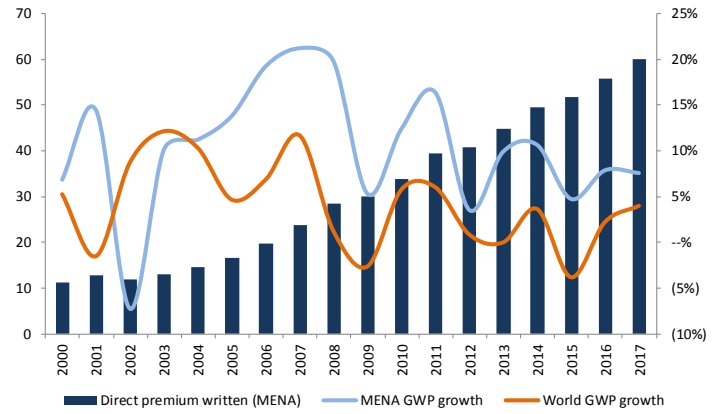
Appendix II: MENA Reinsurance – Saudi Re standing out amongst new entrants

- **The persistent flow of alternative capital has stymied rates globally (Exhibit 46: and Exhibit 47:) and induced an increasingly more challenging operating environment in the MENA region. Nonetheless, Saudi Re stands out amongst the new entrants with stronger profitability and larger diversification**
- **MENA is characterized by its low penetration rates, providing room for future re/insurance growth. Demand for P&C segment has been high, as primary insurers struggle with the profitability of retained business – primarily motor and medical.**
- **Low exposure to NatCat losses in the region has shielded regional insurers balance sheets, though fires in high rise building in recent years has dented their profitability.**
- **Int'l reinsurers play an integral part of this industry in the MENA providing primary insurance with technical expertise and increased underwriting scale.**

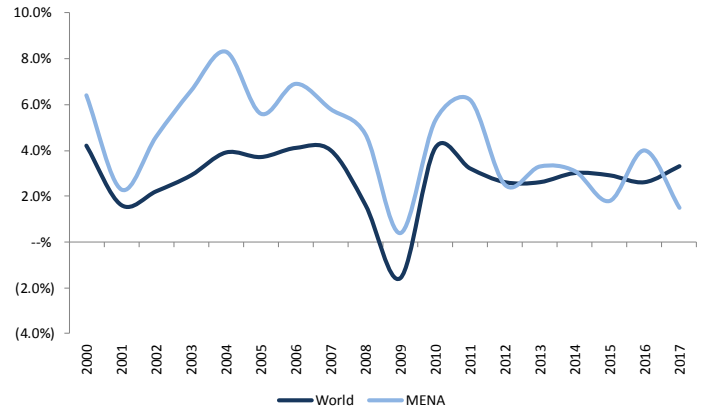
MENA has emerged as a major hub for regional and international reinsurers, attracting an influx of foreign capital and further suppressing local rates. The market continues to be characterized by its public spending-fueled growth, low penetration rates, and continued pressure on profitability of its primary insurers. These distinct characteristics, coupled with a lower exposure to NatCat losses and slower growth in DM markets, has attracted an influx of foreign capital. The UAE and Saudi markets represents c.80% of the reinsurance business in the GCC with c.USD 6.6bn in ceded premiums.

Exhibit 44: Premium growth vs. real GDP growth – MENA region now contributes 1.2% to global GWPs



Source: Swiss Re Sigma, Arqaam Capital Research

Exhibit 45: Real GDP growth rates – MENA region growth has outpaced the world average for the past 17 years



Source: Swiss Re Sigma, Arqaam Capital Research

Low penetration and retention rates to cater for further growth opportunities, though short term challenges remain in place. There are opportunities for growth owing to the low penetration rates compared to global averages. Cession rates have been increasing in the GCC, due to both regulatory changes and prudent risk management by the primary insurers. Retention rates are likely to fall to 70% from the current 84%, offering further scope for growth. Nonetheless ST growth opportunities remain challenging, but Saudi Re continues to leverage on its expertise and deep market knowledge to advance its market share in MENA.

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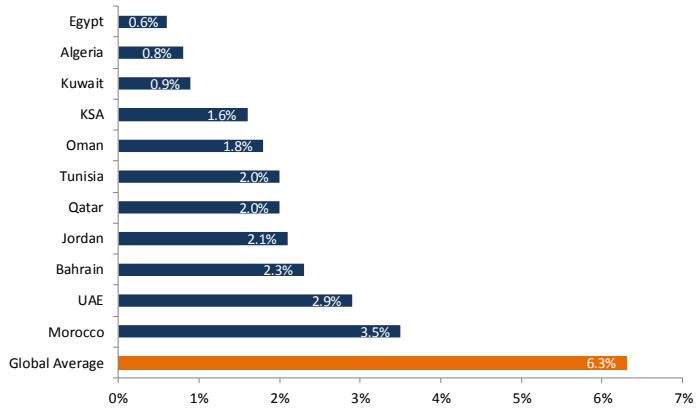
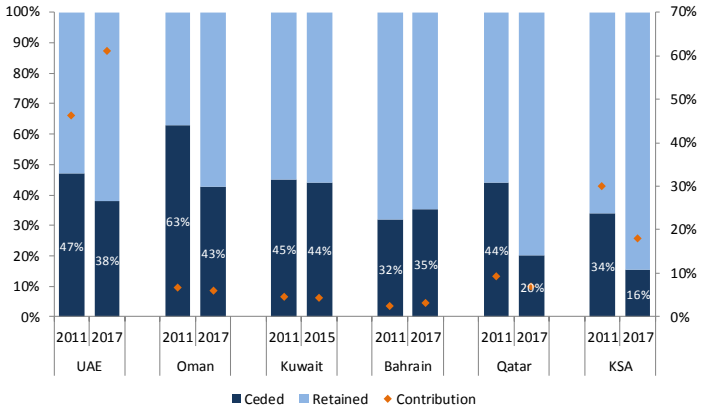
Exhibit 46: MENA penetration rates – providing ample room for future growth



Source: Swiss Re Institute, Arqaam Capital Research

Exhibit 47: Cession rates – UAE & Saudi provide c.80% of the reinsurance business in the GCC

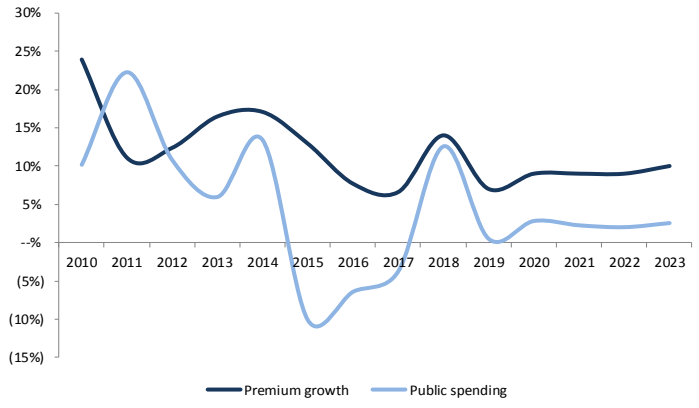


Source: CMA Oman, QFCRA, SAMA, UAE Insurance Authority, Arqaam Capital Research

GDP growth in the GCC is unlikely to accelerate in FY 19e as production increase is likely to be reversed, but fiscal policy continues to slightly loosen for most GCC countries.

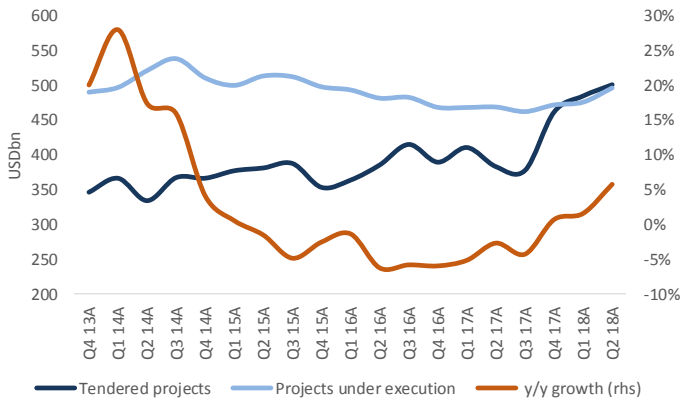
Market structure remains fragmented in MENA, owing to many insurers chasing relatively smaller markets. Currently there are +60 insurers in the UAE, +30 in KSA, and +20 in Jordan, while top 5 insurers in each market continue to dominate >50% of the market share. The result is a large number of insurers continue to compete for the scraps while breeding an unhealthy pricing competition.

Exhibit 48: Premium growth vs. government spending



Source: IMF, Swiss Re Sigma, Arqaam Capital Research

Exhibit 49: Projects in Saudi – projects under execution picks up for the first time in three years



Source: MEED Data, Arqaam Capital Research

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Exhibit 50: Summary of market developments in the MENA region

Acquisitions
First Insurance (Jordan) – Yarmouk Insurance (Jordan)
Bahrain Kuwait (Bahrain) – Takaful International (Bahrain)
Solidarity (Bahrain) – Al Ahleia (Bahrain)
Al Madina (Oman) – Watania (UAE)
Al Ahleia (Kuwait) – Kuwait Reinsurance (Kuwait)
Gulf Insurance Group (Kuwait) – AIG Sigorta (Turkey)
Saudi Re (Saudi Arabia) – 49.9% stake purchased in Probitas Bermuda Holding Limited (Bermuda)
Takaful Emarat (UAE) – Al Hilal Takaful (UAE)
Mergers
Malath (Saudi Arabia) & Allied (Saudi Arabia)
Gulf Union (Saudi Arabia) & Al Ahlia (Saudi Arabia)
New Entrants
Orient UNB Takaful (UAE)
Medgulf UAE
Conversion to Takaful
Al Madina (Oman)
Solidarity General Takaful (formed from the merger of Solidarity General Takaful with Al Ahlia) (Bahrain)
Arab Scandinavian (UAE)
Run-offs/Closures
Arab German (Jordan)
Takaful Re (UAE)
Al Barakah (Jordan)
Gulf Re (UAE)
Weqaya Takaful Insurance and Reinsurance (Saudi Arabia)
Sanad (Saudi Arabia)

Source: A.M Best, Arqaam Capital Research

Amongst the newly established reinsurers, Saudi Re is the only one benefiting from local regulatory cessions. In the MENA region established reinsurers were classically formed through government affiliation over 20 years ago. On the other hand, new formed reinsurers entered the market in the last 15 years, solely looking to benefit from the regions robust growth profile and low NatCat exposure. Saudi Re is the only "new entrant" benefiting from compulsory cessions in its regional market, due to SAMAs delayed regulation of the re/insurance sector.

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Exhibit 51: Established vs. New Entrants – Saudi Re established in 2008

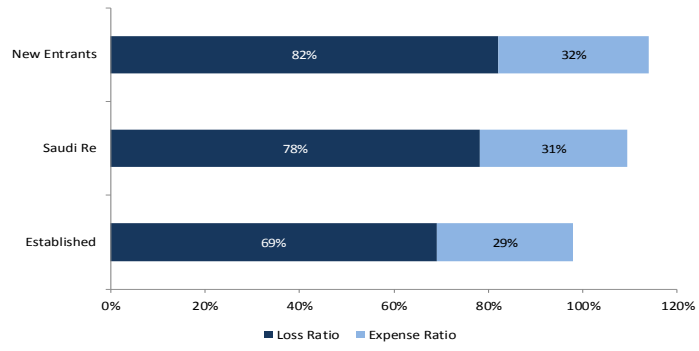
Established Participants			New Entrants		
Established	**Reinsurer**	**Domicile**	**Established**	**Reinsurer**	**Domicile**
1929	Milli Re	Turkey	2003	Amin Re	Iran
1957	Egypt Re	Egypt	2005	Takaful Re	UAE
1960	SCR Morocco	Morocco	2006	Hannover Re	Bahrain
1971	Bimeh Markazi Iran	Iran	**2008**	**Saudi Re**	**Saudi Arabia**
1972	Kuwait Re	Kuwait	2008	Emirates Re	UAE
1972	Arab Re	Lebanon	2008	Gulf Re	UAE
1973	CCR Algeria	Algeria	2008	ACR ReTakaful	Bahrain
1974	Arab Union Re	Syria	2009	Qatar Re	Qatar
1980	ARIG	Bahrain	2009	Oman Re	Oman
1981	Tunis Re	Tunisia	2010	Iranian Re	Iran
1989	Trust Re	Bahrain			

Source: A.M. Best Company, Company Data, Arqaam Capital Research

Considerable variance in underwriting performance of established entities vs. new entrants. Primarily, this a reflection of the higher competition in the region which has forced new entrants to penetrate the market through attractive pricing, while also battling with higher expense ratios due to their lower scale.

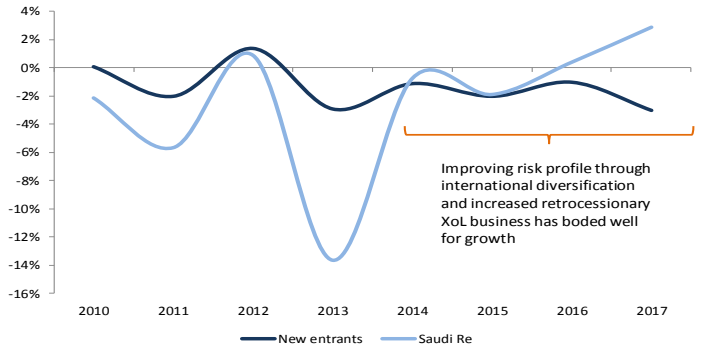
Trust Re's rating downgrade coupled with the cession of operations for both Arab Insurance Group (ARIG) and Asia Capital Reinsurance (ACR) provides new opportunities for growth. Three of the regions more established reinsurers have been downgraded/terminated this year due to their deteriorating profitability profile. Trust Re has withdrawn its rating from both AM Best and S&P, while ARIG has been downgraded by AM Best. Furthermore, ARIG has been notified by the Central Bank of Bahrain (CBB) to cease its underwriting activities as of May 2019, while ACR has deregistered its DIFC branch, and will now operate solely from Singapore.

Exhibit 52: 2010-2017 average combined ratio breakdown – Saudi Re stands out amongst the new entrants



Source: A.M. Best Company, Arqaam Capital Research

Exhibit 53: RoE – New entrants vs. Saudi Re – Saudi Re's profitability profile has markedly improved



Source: A.M. Best Company, Company Data, Arqaam Capital Research

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Appendix III: International diversification – Capitalizing on growth in EMs

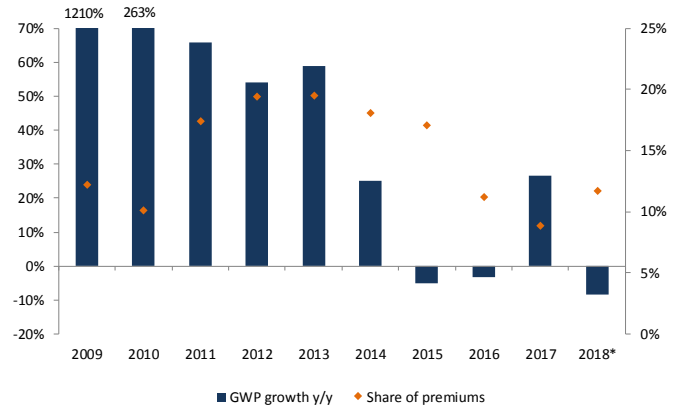
- **Saud Re has diversified and improved its international footing, with more opportunities mainly in MENA (mostly GCC, followed by Levant) and Asian markets. 40% comes from KSA, 31% from Asia, 14% in other ME countries, and 5% in Africa.**
- **Acquisition of 49.9% stake in Probitas provides further diversification, while limiting the maximum loss exposure to the amount of invested capital.**
- **Saudi Re successfully entered the Asian markets in FY 12A through the inauguration of its Malaysian branch, and enjoyed sound GWP growth of 36.3% FY 12-18A CAGR.**

GCC Markets – Challenging operating environment

Reinsurance markets in the Middle East are bound by i) pressure on pricing, ii) oversupply of capital, and iii) a large number of losses in recent years. Similar to the Saudi market, competition continues to be driven by the oversupply of foreign capital and exasperated by the increased underwriting of inward facultative business by primary insurers. Nonetheless, Saudi Re has leveraged its rating and B/S strength to underwrite c.SAR 100m in GWPs.

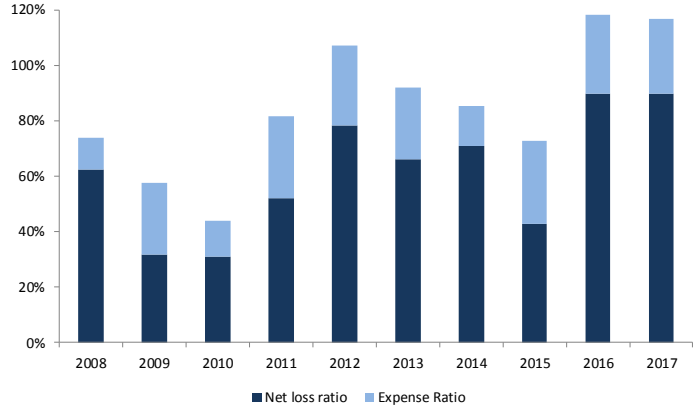
The GCC is known for its low NatCat exposure; however, the most severe losses emanate from commercial risks (mostly fires at high rise buildings). In recent years, there has been significant claims relating to high rise and high-value buildings. These include the fires in Dubai in FY 15A at the Address Hotel and the Torch residential skyscraper. In response, the UAE has updated its version of the country's Fire and Life Safety Code of Practices, making tenants accountable for ensuring fire safety and compliance with specific rules. Nonetheless, Saudi Re has kept a relatively lower exposure to the "other Middle Eastern" countries, hovering around 14% and having peaked in FY 12A at 19%. We expect the reinsurer to maintain its relatively lower exposure to the region, unless prices were to firm.

Exhibit 54: GWP growth in other ME countries – reducing its exposure due to high level of losses



Source: A.M. Best Company, Arqaam Capital Research

Exhibit 55: Combined ratio evolution in other ME countries – high frequency of losses has impacted NLRs



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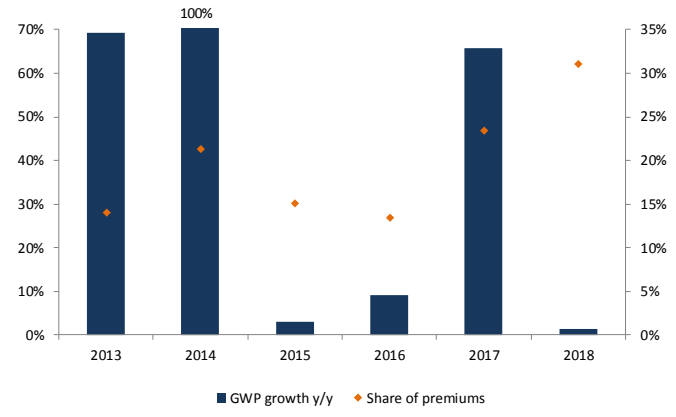
Asian Markets – Testing Saudi Re's adaptability in the future

Saudi Re has successfully penetrated the Asian markets, after growing its GWPs at a FY 12-18A CAGR of 36%, while also improved its underwriting margins from -39% in FY 12A to +7% in FY 18A. Having said that, we expect growth to slow down to a FY 18-22e GWP CAGR of 10%, as we see increased challenges in acquiring profitable business opportunities. Nonetheless, we expect net loss ratios to remain at c.60% for the Asian markets, thanks to the prudent risk selection techniques adopted by Saudi Re's management team, and underwriting margins at c.8%, despite rising acquisition costs.

An influx of foreign capital from reinsurers looking to diversify their concentration from their local markets has dampened rates. As is the case in NE Asia and elsewhere, competition in SE Asia and India is intensified by growing inward reinsurance activity from primary insurers. Furthermore, the robust growth in personal lines and sluggish growth of the commercial lines pose new challenges for the reinsurers operating in the markets. As is the case in Saudi, personal lines typically require less reinsurance, whereas classes of business like the property lines that do require reinsurance have lagged. Furthermore, in major markets like India and Malaysia, regional reinsurers benefit from compulsory cessions that allows them to participate in the primary market, leaving international players to compete for the property segment.

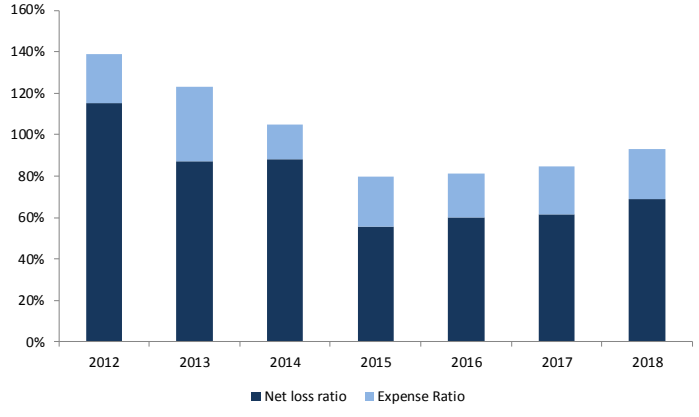
Easing reinsurance protectionist measures in key Asian markets provides a leeway for growth. The compulsory cessions in India and Malaysia are expected to fade over time, in-line with other markets like Vietnam, Thailand, Philippines and Singapore. Furthermore, protectionist measures such as the China Risk-Oriented Solvency System (C-ROSS), where solvency requirements of international players are materially higher than regional one have also begun to ease.

Exhibit 56: GWP growth in Asian countries – Expanding its footprint



Source: A.M. Best Company, Arqaam Capital Research

Exhibit 57: Combined ratio evolution in Asian countries – improving underwriting metrics



Source: A.M. Best Company, Company Data, Arqaam Capital Research

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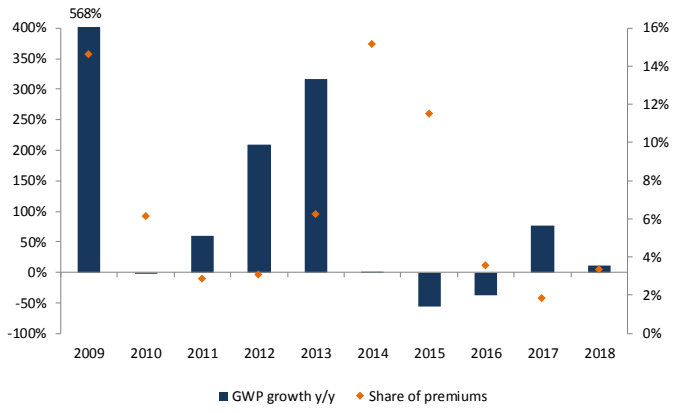
African Markets – Barriers of entry remain high from protectionist measures

A high level of mandatory cessions in SSA, has created a reinsurance sector that's dominated by local and regional players. Many local and regional reinsurers continue to benefit from legal treaty cessions and domestication of policies, this has created an overdominance of the regional and local reinsurers and increased the accumulation of risk. In that regard, Saudi Re's exposure to the African markets is low at just 5% of premiums, which will likely remain the case, unless significant deregulation happens.

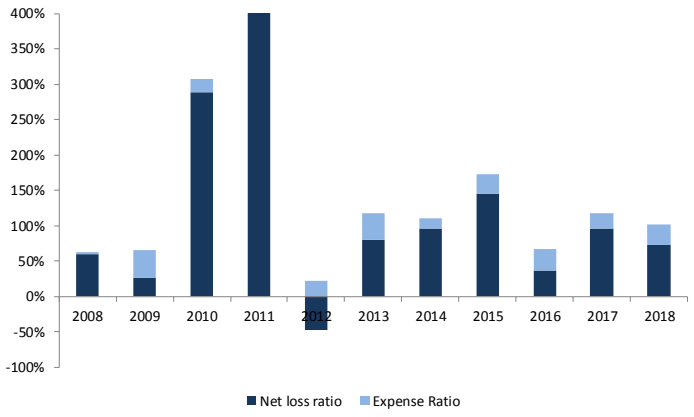
Saudi Re has penetrated the African markets mainly through Egypt, Morocco, Tunisia, and Algeria. Although those markets remain relatively small, they have provided Saudi Re with an opportunity to diversify their concentration and grow their GWPs at FY 09-18A CAGR of 30.8%.

Exhibit 58: GWP growth in African countries – Volatile growth due to high level of losses



Source: A.M. Best Company, Arqaam Capital Research

Exhibit 59: Combined ratio evolution in other African countries – high frequency of losses has impacted NLRs



Source: A.M. Best Company, Company Data, Arqaam Capital Research

Probitas Acquisition – Provides a footing to the Lloyd's market

Saudi Re acquired 49.9% stake at Probitas Holdings Bermuda Ltd. (PHBL) last year for c.SAR 100m, contributing +75% of funds to Lloyds Syndicate 1492. PHBL's fully owned subsidiary Probitas Holdings UK Ltd., owns Probitas Corporate Capital Ltd. (PCC), which currently provides 76.4% of Funds at Lloyds' Syndicate 1492. PCC provides these funds at Lloyds using its own capital as well as funds from Third Party Capital Providers. Currently about 37% of the PCC funds are provided by Third Parties, and hence only 63% of the PCC's share of the Syndicate's Premium will be taken to consolidate with the Holding Company.

Probitas Syndicate 1492 was established in FY 15A to specialize on core classes of direct and facultative business in property, construction, general liability, and financial lines.

Saudi Re has been engaged in Lloyd's since FY 154A as a Third-Party Capital provider. Currently premiums from Lloyd's business is estimated to represent c.10% of Saudi Re's portfolio. Furthermore, Saudi Re further provides TPC to Syndicate 1492 and gets a share of the underwriting exposure (Latin America, etc.), with downside risk capped at the amount of TPC provided.

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Appendix IV: Global Reinsurance – stubbornly "soft" market conditions due to oversupply of capital

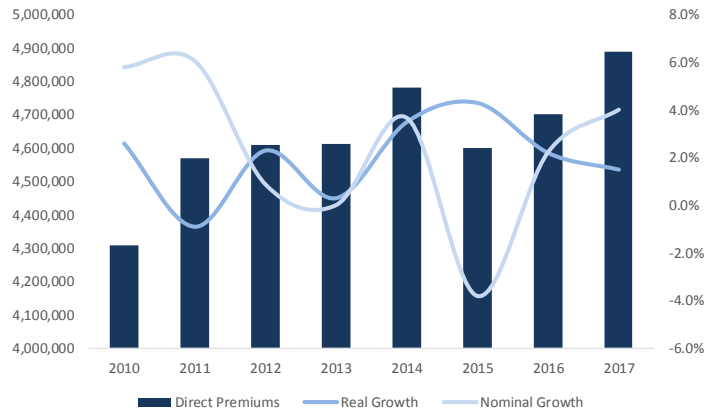
- **The oversupply of capital has stymied re/insurance rates globally, and deteriorated reinsurers profitability to single digit RoEs.**
- **Stiffening competition coupled with challenging operations continue to drive M&A activity in this space.**
- **Despite the large magnitude of NatCat losses in FY 17A (USD 143bn), price hardening remains lackluster as alternative capital has quickly replenished any funding deficits.**

Underlying trends indicate that underwriting cycles are strongly integrated globally and across lines of business. We provide a brief primer on the global market conditions, before diving into Saudi Re's performance.

Global premium growth slows as price softening suppresses the market

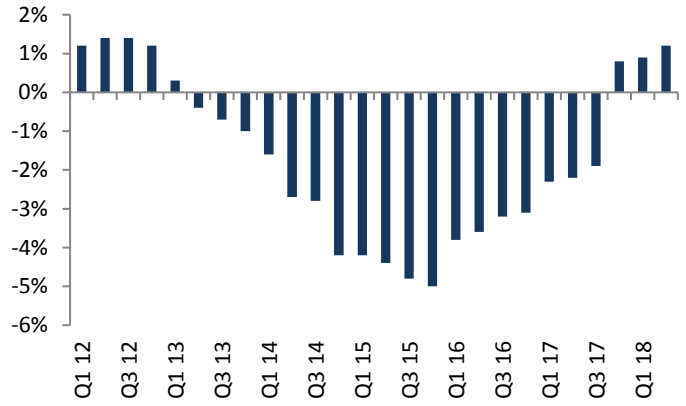
Reinsurers are now bracing with a new reality, one where returns are less impressive and underwriting performance is ever more under the spot light. Prudent risk selection, diversification of product offerings, and extensions of geographic reach, are key to survival. Nonetheless, with key challenges facing the sector, new entrants like Saudi Re have the luxury of cherry picking the fastest growing operating segment.

Exhibit 60: Direct premiums vs. real premium growth



Source: Company Data, Arqaam Capital Research

Exhibit 61: Marsh global re/insurance rates – adj. font



Source: Marsh Global Insurance Composite Index, Arqaam Capital Research

The calm "after" the storm – when USD 143bn of losses fails to harden the reinsurance market

2017 is considered amongst the highest years of NatCat losses (c.USD 143bn), however, the investment linked securities (ILS) market has played a pivotal role in the transfer of overall risk from direct reinsurers to capital investors. ILS created a new liquidity venue in the system for plugging the losses of reinsurers post NatCat.

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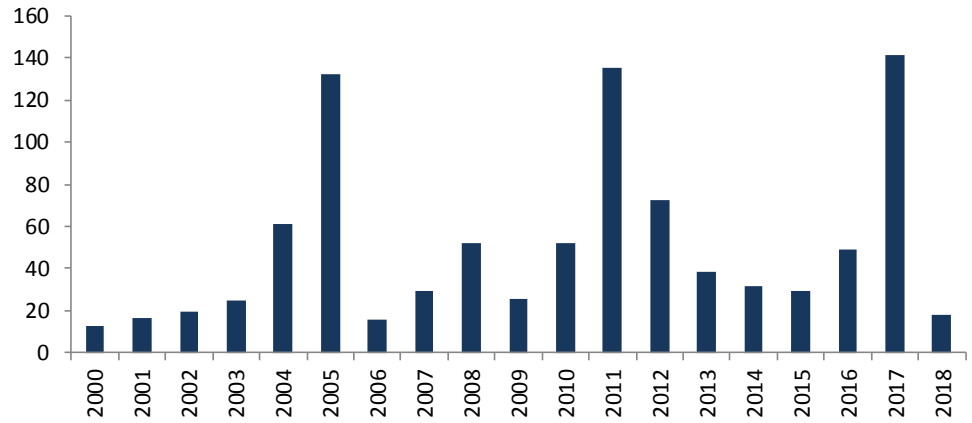
Exhibit 62: Insured losses from Nat Cat events (USDbn)



Source: Company Data, Arqaam Capital Research

ILS segment potentially could bear between 15% and 20% of the HIM insured losses or USD 14-18bn. Based on ILS market estimates of USD 89bn this implies a reduction in capacity of 15% and 20%. The foregone capacity has already been replenished as more ILS funds have increased their AUMs.

In that regard, softer rates, stiffening competition, oversupply of alternative capital solutions, and lower interest rates have formed a toxic mix for eroding reinsurers profitability, with smaller players being most at risk of forceful liquidation. A survey of senior executives in the reinsurance industry reveals that c.40% of them expect natural catastrophe losses of >USD 200bn in-order to harden the market rates.

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