Specialisation and scale at Santam

Justin Floor - Portfolio Manager

"The *'Suid-Afrikaanse Nasionale Trust en Assuransie Maatskappy Beperk'* (Santam) was established in Cape Town in 1918. Just shy of 100 years on, it is the largest short-term insurance company in South Africa, with a market share of 22% (roughly double that of its nearest competitor) and a R28 billion market value. It provides cover to more than 1 million policyholders in the corporate, commercial and personal markets - with 80 of the top 100 companies listed on the JSE Securities Exchange currently insured with Santam."

Specialisation and scale at Santam

Competition within the South African short-term insurance market is stiff, and current local economic headwinds and significant regulatory reforms place further pressure on the sector. We believe that Santam's scale, diversified risk exposures and portfolio of high quality specialist businesses position the company to navigate these challenges well and achieve continued growth.

Under the umbrella

The Santam Group is 60%-owned by respected financial services conglomerate Sanlam and benefits from a strong partnership with its parent company. Santam comprises an unrivalled portfolio of diverse insurance businesses offering products broadly grouped into: motor, property and specialist lines (pie chart below).

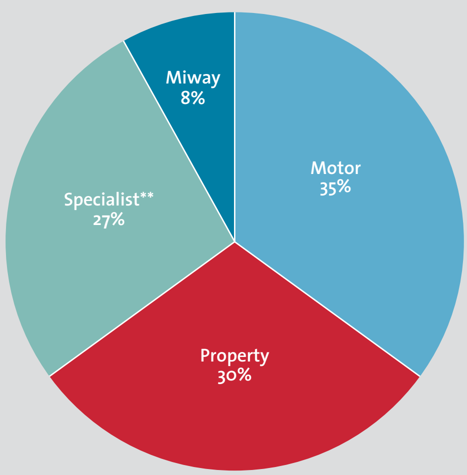
The Santam Commercial and Personal division provides motor and property cover to individuals and institutions through a national network of more than 2 700 intermediaries. The Santam brand is well-recognised in these markets and attracts loyal business.

Wholly-owned subsidiary, Miway, offers primarily motor and property cover to individuals. The business gives Santam exposure to the fast-growing 'direct' insurance market, selling policies straight to customers through its call centre and online platform. Launched in 2008, Miway has successfully carved out a place in a highly competitive market, holding its own against competitors such as Outsurance and the Telesure Group brands (which include Dial Direct and First for Women). Well run direct insurance businesses can offer sustainably higher margins and cost efficiencies (often due to their emphasis on new technology) once scale is reached. Miway has achieved consistently above-average profitability and strong growth, and we expect these trends to continue.

Included under the Santam Specialist division are a variety of highly-skilled underwriting management agencies. These are specialised insurance businesses with the deep technical expertise to underwrite niche risks. Whether it's the engineering on the construction of a complex infrastructure project, a cargo ship or sailing yacht, a fleet of heavy commercial vehicles or the indemnity cover for a medical professional, there's a highly-skilled team within the Santam fold, equipped to insure the risk.

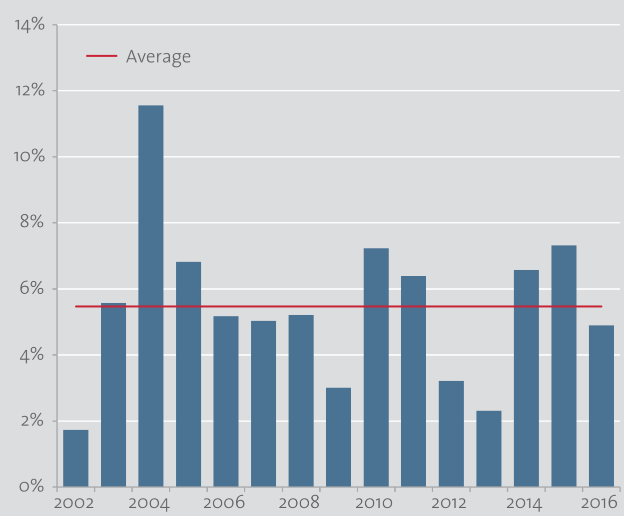
These high quality businesses are the jewel beneath the yellow umbrella and have contributed disproportionately to Santam's profitability over time. They have demonstrated sustainable, superior profitability in the form of higher and more consistent margins than any other division of the business. Relatively low competition in these specialist niches, and the critical importance of data and risk evaluation and pricing skills, results in excellent pricing power for the division.

Santam's business mix*



*2016 gross written premium
** includes Liability, Engineering, Crop, Transport, Accident, Guarantee and Alternative risk transfer.
Sources: company reports, FSB and Kagiso Asset Management research

Santam's underwriting margin history



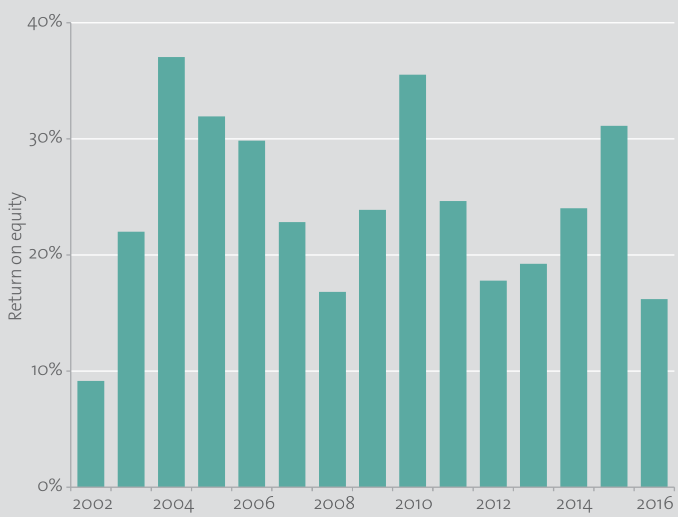
Source: company reports

Attractive characteristics

The Santam business offers a number of key positive attributes which strengthen its competitive position:

- **Scale:** Scale is critical for insurance companies, providing increased access to data (enabling improved risk analysis to inform accurate pricing) and an ability to diversify across different risks. In addition, economies of scale on fixed overhead costs result in higher margins.
- **Diversification:** Santam insures risks that are diversified across type, customer and geography. This diversification enables the group portfolio to consistently deliver stable, positive margins, despite the cycles and volatility of different businesses and risks over time.
- **Stable and high returns on capital:** These strong returns over time indicate the high quality of the group and its robust business model with demonstrable pricing power (see chart below).
- **Consistent profitability and free cash flow growth:** This is evidenced in the consistent dividend over time, offering shareholders a 12% compounded annual growth rate in the dividend per share since 2002, including special dividends (see chart over page).
- **Shareholder-centric philosophy:** Santam has consistently managed the company with shareholders in mind. Its dividend growth illustrates capital allocation decisions over time, and it is evident that most cashflows find their way to shareholders, with minimal amounts of debt issuance along the way. The business generates sufficient cashflow over time to finance its growth ambitions without recourse to external capital injections which would dilute existing shareholders - a further significant attribute.

Santam's consistent returns over time



Source: company reports

A capital change

Following the Global Financial Crisis, risk management across the entire financial services industry came under the magnifying glass. In line with the reformed insurance capital management regulations implemented in the European Union, South Africa has introduced Solvency Assessment and Management (SAM), due for implementation in 2018.

SAM is aimed at protecting policyholders by ensuring that insurers are able to meet their financial obligations and introduces a 'risk-based' approach to capital management. Previous regulation required that short-term insurers held a fixed percentage of all premium income as capital. SAM will now require that capital requirements are calculated according to a standard formula, or internal model, which takes into account the riskiness of the underlying liabilities, nature of the backing assets and diversification of the entity.

For many local competitors, the change is likely to mean a substantial increase in the amount of capital they are required to hold, with mono-line players in commercial lines being worst affected because they have no diversification to offset their risk. For Santam, however, we expect the change to be negligible as the group's size and diversified portfolio will significantly reduce its risk.

The effect of this differential in capital requirements will benefit Santam. As competitors' businesses become more capital intensive, they will be forced to increase their pricing to earn an adequate return on capital, or, ultimately, will have to close or dispose of their businesses. This is an opportunity for Santam which has capital to make acquisitions and can use its scale and lower cost of capital to run these businesses more profitably. The group has demonstrated its capacity for opportunistic consolidation in two recent deals: its acquisitions of Rand Merchant Investment Holdings' specialist insurance business, and a book of commercial business from Absa.

Specialisation and scale at Santam

International expansion

Santam has partnered with Sanlam's international division, Sanlam Emerging Markets, to pursue further opportunities for growth in emerging markets in Africa and Asia. In terms of the partnership, Santam takes a 35% shareholding in all short-term insurance business outside of South Africa.

The recent downturn in the commodity supercycle has resulted in economic and currency weakness in Santam's emerging market businesses, dampening their near term prospects. However, this is not reflective of their underlying potential and a return to a normalised environment will highlight their strong positioning, above average profitability and higher growth trajectory over time. We believe them currently to be an undervalued and underappreciated component of the Santam investment case.

The insurance industry in these markets is underdeveloped and penetration is low. As incomes rise and urbanisation continues, Santam can harness the skills of its specialist businesses to provide cover for large-scale infrastructure projects. Its personal lines offerings in these markets are also positioned to benefit from trends towards rising incomes and ongoing rapid urbanisation.

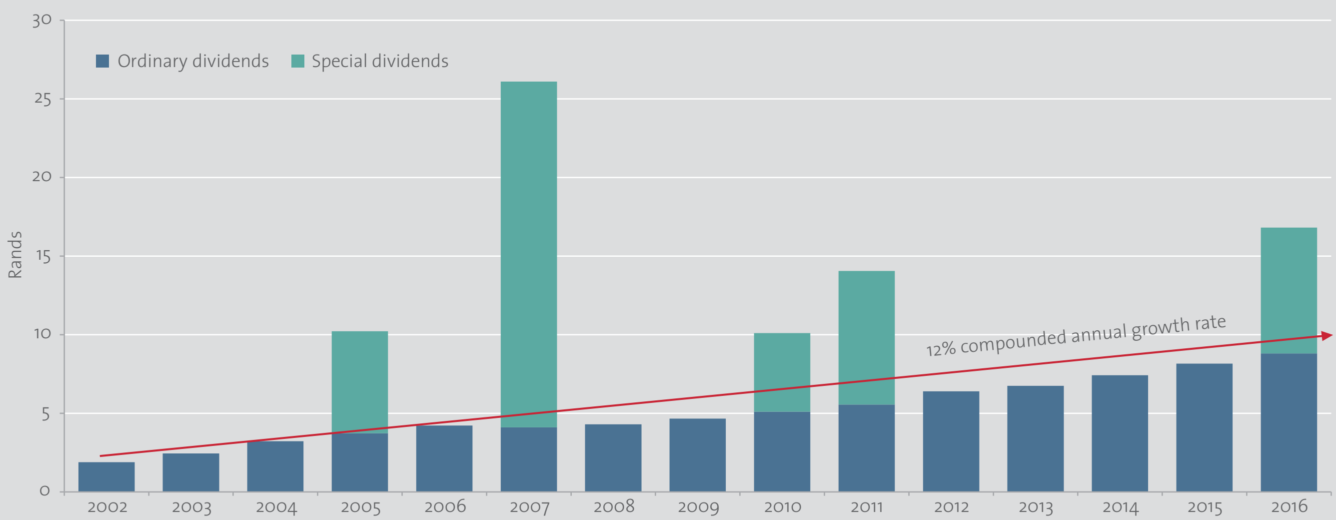
Conclusion

Santam is in an extremely strong competitive position with its scale, diversified portfolio and cost efficiency allowing it to be a net beneficiary of upcoming regulatory changes. As competitors experience an increased cost burden, it is well placed to profitably deploy capital into highly accretive consolidation activity in the years ahead.

It earns high returns on capital and has a long runway of profitable growth ahead. We expect growth in South Africa to be reasonably steady (nominal GDP growth is a useful starting point) with incremental benefits from market share gains and the faster-growing Miway business. The group's international exposure remains under-appreciated and over time will add significant value to its financial statements.

Ultimately, Santam meets all the criteria of an enduring, appreciating business and we expect our clients to continue to enjoy the benefits of owning such a high quality business over time. UP

Santam's growing dividends per share



Source: company reports

KAGISO
Asset Management

Kagiso Asset Management (Pty) Limited

Fifth Floor MontClare Place
Cnr Campground and Main Roads
Claremont 7708

PO Box 1016 Cape Town 8000

Tel +27 21 673 6300 Fax +27 86 675 8501

Email info@kagisoam.com

Website www.kagisoam.com