

FITCH AFFIRMS ADRIATIC SLOVENICA AT IFS 'BBB-'; KD GROUP AT IDR 'BB'; OUTLOOKS STABLE

Fitch Ratings-London/Frankfurt-17 November 2016: Fitch Ratings has affirmed Slovenian composite insurer Adriatic Slovenica Zavarovalna druzba d.d.'s (Adriatic Slovenica) 'BBB-' Insurer Financial Strength (IFS) Rating and holding company, KD Group financna druzba, d.d.'s (KD Group) 'BB' Issuer Default Rating (IDR). The Outlooks on both ratings are Stable.

KEY RATING DRIVERS

The ratings reflect KD Group's high financial leverage, historically weak profitability and fairly small size by global standards. However, KD Group has a strong market position in the Slovenian insurance and asset management market.

KD Group's high financial leverage remains a negative rating driver. Adriatic Slovenica issued EUR50m of subordinated Tier 2 notes in May 2016 and used EUR27.6m of the proceeds to repay existing bank debt at KD Group level. This caused KD Group's financial leverage to increase to 43% at end-1H16 from 40% at end-2015 (2014: 47%, 2013: 51%). However, the group plans to reduce leverage over the medium term, which Fitch views as a positive for the ratings.

Fitch views KD Group's capitalisation as "adequate" on a consolidated basis as measured by the agency's Prism factor-based capital model (Prism FBM), based on end-2015 financials. While Adriatic Slovenica reported a strong regulatory solvency ratio of 172% on a Solvency I basis and its Solvency Capital Requirement (SCR) ratio under Solvency II was 124% at end-2015, KD Group's consolidated Prism FBM score is negatively affected by a high amount of goodwill on the holding company's consolidated balance sheet, which Fitch does not give credit for in its capital assessment.

Fitch expects Adriatic Slovenica's Solvency II SCR ratio and KD Group's Prism FBM score to improve in 2016, benefiting from the subordinated notes issued in May 2016 and additional reinsurance cover.

KD Group reported a small net loss of EUR0.2m in 1H16 after a profit of EUR2m in 1H15 (2015: EUR0.8m profit; 2014: EUR4.7m profit). The deterioration in 1H16 was mainly the result of lower investment returns and lower health insurance premiums in combination with adverse loss events in the health insurance segment. Adriatic Slovenica has been consistently profitable, reporting annual net income of over EUR10m for each of the past five years and an average return on equity of 18%.

KD Group's market position and scale are small, based on global benchmarks, with gross written premium of EUR298m in 2015 (2014: EUR302m), total assets of EUR0.8bn and shareholders' funds of EUR123m at end-1H16. Nevertheless, it is one of the largest financial service providers in the Balkan region, with Adriatic Slovenica being the second-largest insurer in Slovenia and the group's asset management operations being the third-largest in the Slovenian mutual fund market by assets under management. Fitch views this strong position in the local market as a rating-positive.

KD Group is in the process of divesting most non-core assets to focus on its core insurance and asset management businesses. Fitch expects this to improve the group's performance and generate extra cash flow over the next three years.

As around two thirds of the group's invested assets are held in Slovenian investments and 98% of the group's revenue is in Slovenia (A-/Stable), the group's performance is exposed to the local economy. This exposure includes the risk of losses on its EUR347m of non-unit linked investments as of end-1H16, and the risk of lapses on its EUR268m of unit-linked liabilities. For example, write-downs on Slovenian banks led to investment losses of EUR16m in 2013, EUR2m in 2014 and EUR2m in 2015 for Adriatic Slovenica.

RATING SENSITIVITIES

KD Group's leverage improving to below 40%, in combination with stabilised profitability, could lead to an upgrade.

The ratings could be downgraded if the group's consolidated capital position weakens to a Prism FBM score of below "adequate" for a sustained period. Financial leverage in excess of 50% could also lead to a downgrade.

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Applicable Criteria

Insurance Rating Methodology (pub. 15 Sep 2016)
<https://www.fitchratings.com/site/re/887191>

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