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Research

Research Update: German Insurer KarstadtQuelle Lebensversicherung AG Ratings Raised To BBB+; Outlook Stable

Publication date: 11-Oct-2005
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Local Currency

Credit Rating: BBB+/Stable/--

■ Rationale

On Oct. 11, 2005, Standard & Poor's Ratings Services raised its long-term counterparty credit and insurer financial strength ratings on Germany-based direct life insurance writer KarstadtQuelle Lebensversicherung AG (KQL) to 'BBB+' from 'BBB'. The outlook is stable.

The ratings reflect KQL's successful, unique business model initially founded on KarstadtQuelle's customer base, sound operating performance, and good capitalization. This is partly offset by the need to further promote its franchise diversification and its reliance on a narrow simple product range in the direct writer framework.

Major rating factors:

- Successful, unique business model. Building on its access to KarstadtQuelle's extensive 19 million customer base, KQL has reached critical mass and gradually managed to diversify away from this distribution concentration, for example through cross-selling among existing clientele or cooperations with statutory health insurers and corporate customers. However, KQL is expected to take the initiative to further diversify its franchise to become less dependent on the KarstadtQuelle brand, which had raised high management attention and may have somewhat restrained business prospects in recent years. KQL's strong ability to segment its client base, particularly focusing on the "45 years plus" clientele, allows it to effectively channel distribution efforts. This creates a unique business model, providing KQL with a defensible niche position.
- Sound operating performance. KQL continues to focus on very efficient processes. Combined with its conservative bonus policy, this enabled the company to report an operating return on embedded value and net return on shareholder capital well in excess of 15% in 2004. New business margins reached 7%. However, these figures are partly supported by the parent's decision to run the company on a moderate, though economically sensible equity capital base. KQL has a clear focus on profitability, controlled via appropriate monitoring systems. Sound business margins should remain largely stable over the medium term, despite an expected increase of competition among the '45 plus clientele' and a moderate bond yield environment. Stronger sales in the high-margin funeral expense business should support underlying profits against the sales pick-up in the low margin capital accumulation product.

- Capitalization is good and was further strengthened in 2004 both in terms of risk-based capital adequacy and quality of capital. Capital is mainly built through policyholder capital.
- Reliance on narrow and simple product range. KQL's direct selling approach with limited customer advice necessitates selling products that are easily understood. This low volume niche product focus is likely to challenge KQL to keep pace with the business growth of other players that are better able to promote sales in the strongly expanding group life field. Instead, KQL is expected to continuously focus on leveraging its niche product range. It is essential for KQL to keep the number of different products within limits to maintain its efficient processing and an appropriate level of complexity.

■ Outlook

The stable outlook reflects Standard & Poor's view that the continued restructuring at KarstadtQuelle will present limited risks to KQL's competitive position. Furthermore, Standard & Poor's expects ERGO Versicherungsgruppe AG (A-/Stable/--), KQL's majority shareholder, to remain committed to support KQL if a financial stress scenario were to arise, although KQL remains, in Standard & Poor's view, a nonstrategic company to the ultimate owner Munich Reinsurance Co. (A+/Stable/--). KQL is expected to further leverage its business model, translating into successful cross-selling and new cooperation agreements to further reduce its reliance on the retailer's clientele. This should result in at least market-average growth rates. Capitalization is expected to remain securely in the 'BBB' range. Operating return on embedded value and return on shareholder capital should remain at least in excess of 10%. New business margins are expected to remain largely stable.

■ Ratings List

	To	From
KarstadtQuelle Lebensversicherung AG		
Counterparty credit rating	BBB+/Stable/--	BBB/Stable/--
Insurer financial strength rating	BBB+/Stable	BBB/Stable

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