

**Initiation of Coverage**

**Slovenia Insurance**

**BUY**

**Share Price (10 August 2011)**

**EUR6.60**

**Current fair value**

**EUR8.08**

**Upside/Downside**

**22%**

Key figures	2010	2011E	2012E	2013E
GWP reinsurance (EURm)	142.9	137.5	139.8	143.9
GWP non-life (EURm)	125.8	131.8	139.0	146.7
GWP life (EURm)	12.5	14.4	17.3	20.8
Net investment income (EURm)	11.4	12.7	16.6	18.2
SRF est net income (EURm)	7.5	7.9	10.6	11.8
EPS (EUR)	0.80	0.84	1.13	1.26
ROE %	4.93	5.11	6.47	6.80
Combined Ratio (reinsurance) %	95.0	98.0	97.0	97.0
Combined Ratio (non-life) %	105.5	102.0	99.5	98.5

Source: Bloomberg, SRF Research

Valuation multiples	2010	2011E	2012E	2013E
EPS (EUR)	0.80	0.84	1.13	1.26
PER	11.7	7.8	5.8	5.3
Peers average		10.2	7.2	
BVPS (EUR)	16.05	16.89	18.02	18.96
P/BV	0.5	0.4	0.4	0.3
Peers average		0.9	0.8	

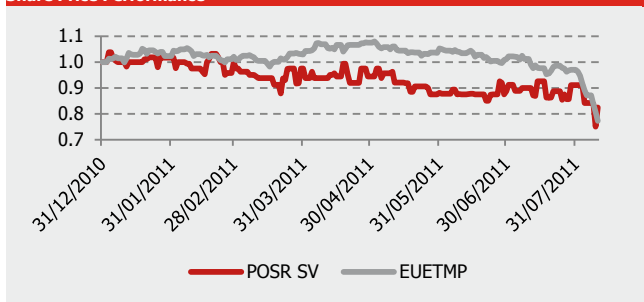
Source: Bloomberg, SRF Research

**Stock information**

Bloomberg code	POSR SV	Key shareholdings	
Reuters code	N.A.	State	25%
Shares outstanding (m)	9.4	Free float	75%
Market cap (EURm)	61.8	Value of float (EURm)	46.3
Market cap (US\$m)	88.0	Value of float (US\$m)	66.0

Source: Bloomberg, SRF Research

**Share Price Performance**



Source: Bloomberg, SRF Research

**Sava Re Group**

**A viable business model offers controlled growth, improved profits**

**We initiate coverage on the shares with a BUY recommendation, based on our EUR 8.08 target price. This implies a 22% premium to its current trading levels, and a 0.5x multiple to its 2011 Book Value per share. The shares are currently trading on a 2011 Book of 0.4x, and at a significant discount to other European insurers and global reinsurers.**

Sava Re Group is the leading reinsurer in Slovenia, and an important primary insurer in both life and non-life segments. Outside of Slovenia, it underwrites the global reinsurance product, as well as the primary insurance in five other markets of former Yugoslavia, being Serbia, Croatia, Montenegro, Macedonia, and Kosovo.

The insurance sector in Slovenia is more mature compared to other former Yugoslav and Central European countries, with a penetration (premiums as % of GDP) of 5.8% in 2010, compared to 3.8% in Poland and to 1.3% in Turkey. However, it is still lagging the developed Europe average penetration of 7.5%. Slovenian overall GWP rose at a 7% compound annual growth rate (CAGR) between 2002 and 2010. We expect it to grow by 3.7% this year, and by 5.1% and 5.4% in 2012 and in 2013 respectively, as the economy continues to recover.

We are impressed with the Group's diversified business mix, and believe that it has a strong reinsurance platform in selected global markets, and a robust primary insurance franchise in Slovenia. Although its non-Slovenian primary insurance operations provide a strong growth potential, we are concerned about their lack of profitability and the resulting strain on the Group's capital. We also believe that Sava Re Group will have to recapitalize in order to support any potential acquisitions in Slovenia or beyond.

We forecast that Sava Re Group's net earnings will grow by 5.7% this year, and at a three-year CAGR of 16.4% between 2010 and 2013. This growth should be driven by the improving profitability in the primary insurance segment, and by stronger premium growth in the life segment, leading to a higher investment income.

We have valued the Group using a DCF to equity model and our proprietary LEFALC methodology, which produces a fair value of EUR 8.08 per share. This implies a 0.5 multiple to 2011 BVPS, and a 9.6x PER multiple to 2011 earnings. This valuation represents a sizeable discount to other European insurers, as well as to other global reinsurers. While this discount is justified by their relative size, liquidity and profitability, we believe that the Group's superior growth potential has not been fully priced in. However, the realization of this potential would largely depend on the availability of capital.

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## Slovenian Insurance Industry

### The insurance sector in Slovenia is more mature compared to other former Yugoslav and Central European countries

In 2010 the ratio of Slovenian gross written premiums (GWP) to GDP, or the penetration, was 5.8%, higher than, for example, 3.8% for Poland, although still below the European average of 7.5%. This translates into a 4.0% penetration for non-life insurance and a 1.8% penetration for life insurance. The market appears even more mature in terms of insurance density, as measured by GWP per capita. In 2009, Slovenian GWP per capita was €1,023 compared to €356 in Poland.

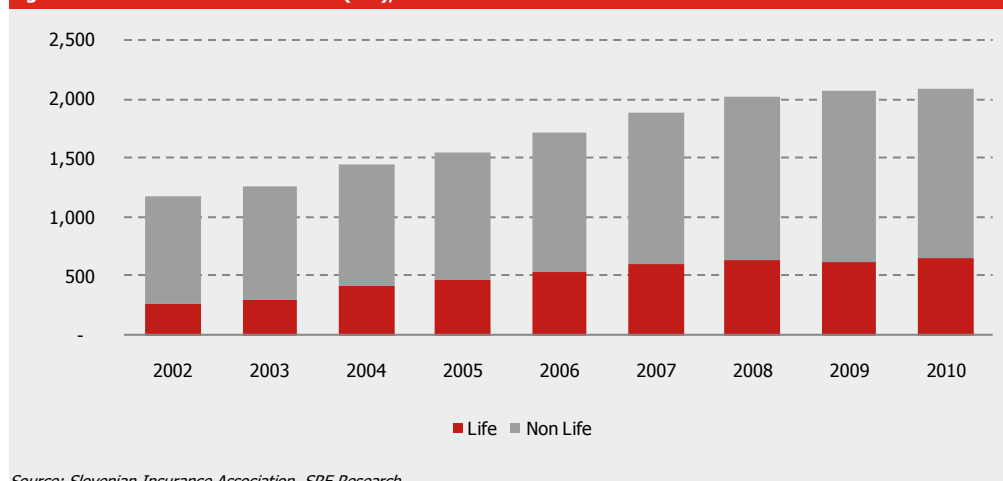
There are 20 insurance companies in Slovenia, of which ten write both the life and the non-life products, two are reinsurers, four write non-life insurance only, and the remaining four write life insurance only.

Slovenian overall GWP rose from €1.2bn in 2002 to €2.1bn in 2010, at a 7% compound annual growth rate (CAGR). Except for 2008-2009, when the financial crisis ravaged the Slovenian economy, life insurance was growing faster than non-life, driven by much lower penetration and the growing awareness of the Slovenian population of tax-free savings vehicles, such as life insurance.

Life and non-life premiums grew at CAGRs of 12% and 6% respectively between 2002 and 2010. In 2010 life premiums were up 4%, while non-life premiums were marginally down. In absolute terms, however, life premiums represented only 31% of total insurance premiums in 2010.

The chart below shows the growth in both life and non-life premiums in Slovenia.

**Figure 1: Slovenian insurance GWP (€m), 2002 to 2010**



Source: Slovenian Insurance Association, SRF Research

### Life insurance segment is still under-penetrated

We expect non-life insurance premiums to increase in line with nominal GDP, by 3.6% in 2011 and by 4.9% in 2012. Life insurance in Slovenia, in our opinion, has better growth potential. We expect life premiums to increase by 4.0% in 2011 and by 5.5% in 2012, ahead of GDP.

Currently, the life insurance segment in Slovenia is dominated by two major business lines: unit-linked products, accounting for 60% of total life insurance premiums in 2009, and traditional life (37% of total life premium in 2009). The remaining 3% is represented by marriage and birth insurance, as well as less popular savings products.

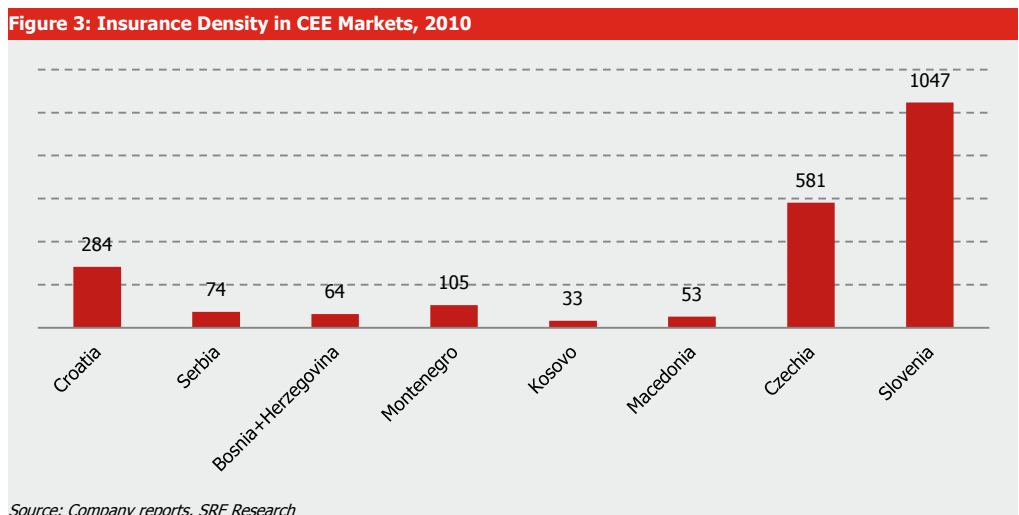
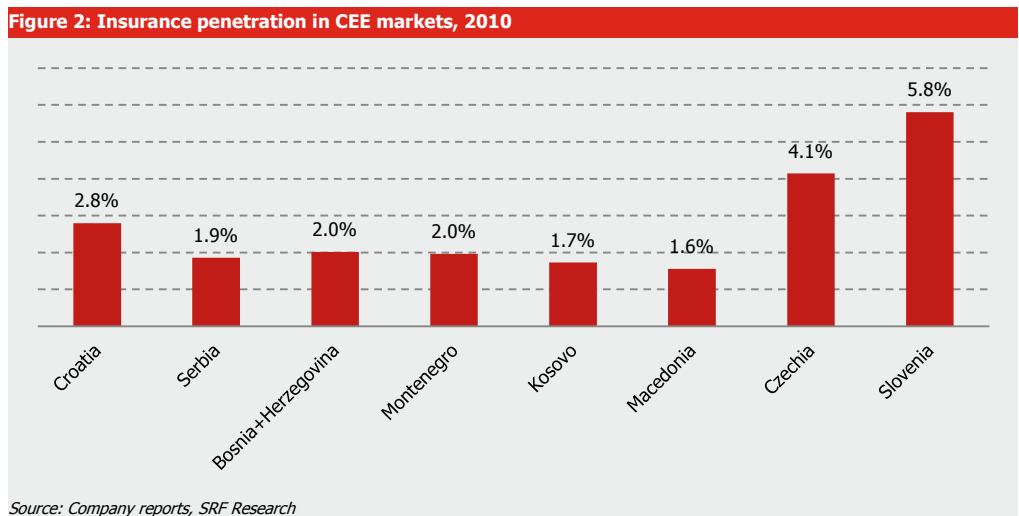
We believe that Slovenian consumers are looking for more sophisticated life insurance products, similar to those offered in developed Europe. While we expect to see more demand for credit-linked life insurance products in Slovenia, any growth in this product line has been restricted so far by the credit insurance sold to banks, thus protecting them from any defaults on the retail loans, including mortgages.

**Private pension sector is dormant**

The second and third pillar pension markets, which are still dormant in Slovenia, would potentially represent another growth opportunity for insurers – pending government reform that would make such plans more advantageous to the population. However, we do not expect this to happen in the next two years.

**Growth outside Slovenia**

Unlike Slovenia, most other former Yugoslav and CEE insurance markets are significantly less developed. As follows from the table below, in 2010 the insurance penetration (GWP % GDP) and the insurance density (GWP per capita) of all of these markets were below Slovenia's, despite, in many cases, much higher population (in Czechia, Serbia and Croatia). This includes even better developed markets like Czechia and Croatia, where the penetration was 4.1% and 2.8% respectively, compared to 6% in Slovenia; while the density was EUR581 and EUR284 per capita, respectively, versus EUR1,023 for Slovenia.



While premiums in Serbia, Croatia and Montenegro were down by 4%, 3% and 5% respectively in 2010 following the economic crisis, other markets have been recovering. Premiums in Czechia, Bosnia and Herzegovina, Kosovo, and Macedonia grew by 8%, 4%, 6% and 5% respectively in 2010.

Most of these markets are dominated by non-life insurance (73-99% of total the GWP), except for Czechia where non-life insurance was only 53% of the total GWP.

Needless to say, most of these markets are not as rigorously regulated compared to Slovenia, and the business practices there are not yet as transparent as in Slovenia. These practices, among other things, include accounting for impaired insurance receivable, dealing with commissions and contingent bonuses to distribution channels, and determining sufficient reserves against future losses. Besides, most of these markets are subject to irrational pricing especially in the Motor segment where the competition remains fierce. As a result, the underwriting performance in all former Yugoslav markets except Slovenia has been negative so far.

Slovenian insurers such as Triglav and Sava Re Group have been important players in these markets: Triglav has #1 market share in Montenegro and in Kosovo, and #3 market shares in Bosnia and Herzegovina, while Sava Re Group is #2 in Montenegro and in Macedonia. Both Triglav and Sava Re Group target to grow their operations in former Yugoslavia, despite negative underwriting results. Triglav is also present in the Czech Republic. Both companies have recapitalized some of their subsidiaries in the region in 2010 and in 2011, which will be explained in more detail later.

**Figure 4: Insurance Sector in CEE Countries**

	GWP 2010, EURm	YOY%	GDP, EURm	Penetration, %	Population, m	Density, EUR	% non-life	Competition
Croatia	1249	-3%	44,714	2.8%	4.4	284	73.40%	Croatia Os 31.4%, Euroherc 10.8%, Allianz Zagreb 10.6%, Zadransko 6.9%, Kvarner VIG 5.5%
Serbia	550	-4%	29,525	1.9%	7.4	74	83.50%	Dunav 25.9%, Delta Generali 18.5%, DDOR 18.5%, Wiener 8.7%, Uniga 4.9%
Bosnia+Herzegovina	244	4%	12,104	2.0%	3.8	64	84.40%	Sarajevo Os 12.3%, Bosna Sunce 9.7%, Triglav 8.7%, Euroherc 8.1%, Coratia Os 7.9%
Montenegro	63	-5%	3,201	2.0%	0.6	105	86.50%	Lozven (Triglav) 53.1%, Sava 15.1%, Uniga 9.6%, Delta Generali 9.3%, Grawe 7.8%
Kosovo	72	6%	4,163	1.7%	2.2	33	99%	Ilyria (Triglav) 21.8%, Sigma 13.2%, SigalDini 8.9%, Siguria 11.2%, Belg 11.2%
Macedonia	105	5%	6,778	1.6%	2.0	53	94.50%	Vardar 20.6%, Sava Tabak 14.4%, QBE 12.7%, Eurolnk 10.3%, Os Polisa 8.5%
Czechia	6044	8%	145,846	4.1%	10.4	581	53.30%	Ceska poj 28.2%, Kooperativa poj 28%, Allianz poj 8.7%, Generali poj 7.6%, Ceska podnikatelska poj 5.6%

Source: Company Reports, SRF Financial

However, the regional focus and, more importantly, scarcity of capital, remain barriers to entry into non-Slovenian markets for other Slovenian insurers.

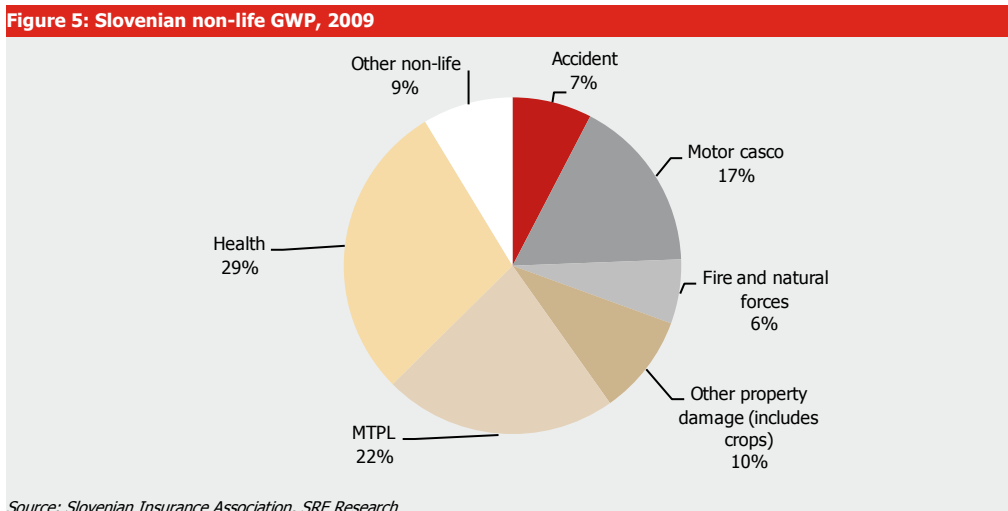
**Slovenian insurers are thinly capitalized**

This is, in our view, the major issue that all local Slovenian insurers face. While they remain adequately capitalized to continue with the existing businesses, most of Slovenian insurance companies would need very material capital infusions in order to grow substantially – be it outside of Slovenia, or into new businesses. Further capital is likely to be required after 2013, when Solvency II rules will become reality.

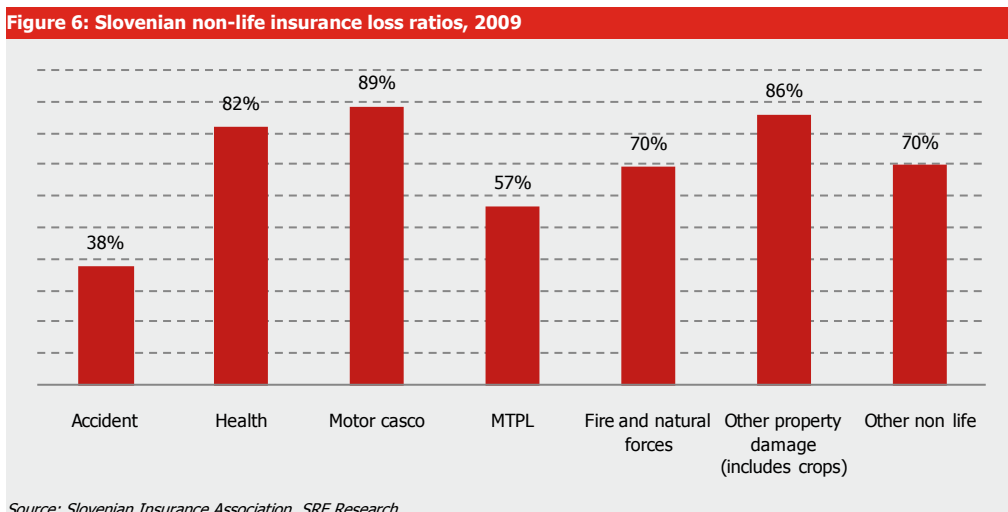
Even now, most Slovenian insurers are highly dependent on reinsurance. In 2009, 14% of non-life GWP in aggregate has been ceded to reinsurance, but the ceding ratio was much higher for property damage insurance – 28%, and fire insurance – 44%.

**The product mix points to lower profitability of the non-life segment**

On the non-life side, the market is dominated by health and motor insurance – the latter is typical for most emerging markets where increasing consumer wealth is immediately translated into growth in car ownership. As of 2010, Slovenian insurers have sharply reduced the underwriting of the agricultural crop insurance (part of "Other Property") due to consistently high claim ratios which seriously hurt this segment in 2008-2009.



In 2009, the gross claim ratio for the non-life insurance sector was 73%. However, it differed greatly from line to line, with health, Casco and other property being the most unprofitable – and coincidentally the largest, and most competitive, lines in Slovenia.



While the overhaul of voluntary (as well as compulsory) health insurance is coming (to be described in more detail later in this report), we do not see any clear signs as to when the profitability of the Casco and other property lines will turn around. We believe that the loss ratios have somewhat improved in 2010, which was generally catastrophe-free, and not subject to any crop insurance losses. However, we do not expect such improvement to be dramatic, as Casco and property still remain unprofitable, or irrationally priced, insurance lines.

While MTPL remains a profitable business for the Slovenian insurance sector, we believe that this might also change once clients begin to better understand the high coverage that is currently available on bodily injury claims. Whereas claims for such “nuisance” injuries as whiplash have been disallowed since 2004 to discourage fraud and reduce claims frequency, it is possible, in our view, that there will be an increase in severity of future claims in the years to come.

**Health insurance in Slovenia**

On average, the life expectancy in Slovenia is now 78.5 years, with 16% of population of retirement age.

The current healthcare system in Slovenia has been in effect since 1992, following some major post-communist reforms. Today, all Slovenes are entitled to healthcare. However, the major problem remains the limited supply of healthcare providers, including hospitals, doctors, dentists etc. This results in longer waiting lists to see the specialists, and other deficiencies such as no uniform long term care program (LTC) for the elderly or chronically ill, insufficient palliative care and others. According to a Health Systems in

Transition report on Slovenia (published in 2009), in 2006 there was a shortage of physicians per capita of population compared to other EU and even CEE countries. Based on most metrics, Slovenian health care system was behind the rest of EU in 2006, and according to the industry experts, that has not changed since then:

- There were 383.4 in-patient hospital beds per 100,000 population, below the EU average of 410.1
- There were 237 physicians per 100,000 population, below the EU average of 332;
- However, there were 756 nurses per 100,000 population, above the EU average of 746.
- There were 47 pharmacists per 100,000 population, below the EU average of 71
- There were 60 dentists per 100,000 population, in line with the EU average.

The healthcare system is managed by the Ministry of Health, under the Health Care and Health Insurance Act.

In 2006, there were 29 hospitals in Slovenia (of which 26 were public), mainly built in the 70's and then refurbished, 64 primary healthcare out-patient centres, and 12 other public health care centres. There are 2 major hospitals (in Ljubljana and in Maribor) for 2,700 beds and for 1,700 beds respectively, the other hospitals have 300-500 beds each, while 3 smaller hospitals are for 120 beds each. There were also 6 psychiatric hospitals, 5 facilities for adults with special needs, and 7 mixed facilities, that included both the elderly and adults with special needs. In 2004, there were 18 CAT scanners, 12 gamma cameras, 9 RAD units, 8 DSA units, and 1 PET scanner in Slovenia.

Currently the health insurance segment in Slovenia consists of three pillars. Pillar 1 is the compulsory health (HIIS) provided by the government, while Pillar 2 is the Voluntary Health (VHI) which includes a co-payment system to pay for the non-covered portion of the compulsory healthcare, as well as the private, or supplementary, health insurance for the services which are not covered by HIIS at all. The VHI pillar has been run by four health insurers: Vzajemna (a mutual non-profit company), Adriatic Slovenia, Triglav, and Merkur. Another important source of health care spending in Slovenia comes out of pocket, and this is the Pillar 3.

HIIS is responsible for 67.1% of total healthcare spent in 2006, it operates through 55 branches of which 10 are regional, and are responsible for contacting health care providers. In 2009 the compulsory health was funded through mandatory payroll deductions from gross income, distributed as follows: 6.56% came from employers, 6.36% from employees, and 5.96% from pensioners.

Co-payment pillar was introduced in 1992 as an attempt to curb some unnecessary healthcare spending. Only the children, and some low-income citizens are exempt from co-payments. By definition, it pays for the non-covered share of HIIS. HIIS coverage varies greatly depending on the service provided, from 25% for non-generic medications, to 50% for ophthalmology and orthodontics for adults, to 75% for generic medications, to 85% for fertility treatments, and to 95% for organ transplants and treatment outside of Slovenia). The co-payment insurance is presently very important, as it amounted to EUR 420m in 2009, and represents the bulk of VHI, as 95% of insured by HIIS would normally buy it. As a result, when an insured patient undergoes a treatment, a provider would bill the insurance company directly, and not the patient, for the co-payment portion.

In 2006, the total health expenditure amounted to 8.3% of GDP, or EUR 2.6b, and was below 8.9% EU average. It was funded 67.1% through HIIS, 12.8% through out of pocket expenses, 15% through VHI, and 5.2% through taxes. The public health expenditure (HIIS and taxation) in 2006 was 72.4% of the total health care expenditure, which is below the EU average of 75.5%.

There are several major problems with co-payment system from the insurers' viewpoint:

- At the moment, all negotiations with healthcare providers are carried out by HIIS. Insurers are not allowed to participate in such negotiations. As a result, insurers have to pay the price quoted by providers without any input/control over it.
- Health insurers are not allowed to own hospitals, or any other medical providers. As a result, it is impossible for them to control the cost of claims.
- A risk equalization scheme for VHI introduced in 2005 basically requires that all four health insurers earn the same returns regardless of any variations in their cost structures. This system

was introduced to avoid skimming, however it currently penalizes the three listed, or for-profit insurers versus the non-profit mutual Vzajemna.

- Currently there is a unified flat premium charged of all insured for co-payments, regardless of their age, gender, and previous health history.

Finally, the supplementary insurance is the smallest health care component in Slovenia at the moment. It is mainly a corporate product, which covers only 3-5% of the total population. However, the most opportunities for the profitable growth come from this segment. They include, for example, the introduction of the Long-Term Care insurance (LTC), and the dental insurance (currently paid out of pocket).

So far, both HIIS and VHI pillars have been very unprofitable on the technical level, with a loss ratio of over 90%. Some reasons for that include insurers' inability to control costs as they cannot negotiate the cost of services with medical providers, nor outright own hospitals and clinics, a shortage of supply of medical services and providers, the flat premium charged to all insured (which is not a function of age, or health conditions). At the moment, insurers cannot determine the pricing for co-payments, however if their claims exceed premiums by more than 5%, they can file for a premium rate increase with the government.

At the moment, the government has prepared a draft law for the new health care system. According to the Health Care System Upgrade published by the Ministry of Health in February 2011, the main suggestion would be to merge HIIS and co-payment systems together into one public system, or basically to eliminate the co-payments. This also implies reducing the list of services covered by public insurers, and increasing the mandatory employee payroll deductions by 1.65 percentage points (from 6.36% to 8.01% of gross wages). For health insurers, this proposal means that more services, no longer covered by the public health, will have to be covered by the private insurance. Following the 2013 harmonization of EU health care market, we expect a sharp increase in the supply of health care providers available to Slovenes. We expect this to boost the private health insurance premium in Slovenia, mainly because of the Directive of the European Parliament and the Council on patients' rights in cross-border health care. The latter states that the costs of treatment received in another Member State are reimbursed only for those health services which are included in the compulsory insurance basic benefit package of the home Member State.

The insurance industry proposal for the reform includes the introduction of the compulsory LTC insurance, the ability to negotiate pricing of health services directly with providers, and the ability to own and operate hospitals and clinics. Other plans include offering of the bundled products such as life and health, or health and Casco, or health and MTPL.

### High concentration in the insurance segment

In 2010, the Slovenian non-life insurance sector was led by five top players, which in total were responsible for 87.5% of the total GWP, while in the life insurance sector the top five players generated 82% of the total GWP.

Triglav, the market leader, dominates the insurance market with leading shares of both the non-life (35.6%) and the life (31.7%) segments.

**Figure 7: Non-life market share by GWP as of December, 2010**

Name	Market share, %
Triglav	35.6
Adriatic Slovenia	17.2
Vzajemna	16.6
ZM	13.1
Triglav Zdravstvena	5.1
<b>Big 5</b>	<b>87.6</b>
Other	12.4
<b>Total</b>	<b>100.0</b>

Source: Slovenian Insurance Association, SRF Research

**Figure 8: Life market share by GWP as of December, 2010**

Name	Market share, %
Triglav	31.7
Kapitalska Druzba	22.5
ZM	10.9
KD Zivljenje	10.7
Merkur	6.1
<b>Big 5</b>	<b>81.8</b>
Other	18.2
<b>Total</b>	<b>100.0</b>

Source: Slovenian Insurance Association, SRF Research

### Competition intensifies, driven by foreign players

Capital constraints, in our opinion, are the main reason for the Slovenian insurers to remain very regionally-focused.

At the same time, the industry has become more competitive, mainly because of the number of foreign players entering the market. According to the Slovenian insurance association, in 2009 (not a good year for the Slovenian insurance), the eight insurance companies with majority foreign capital (Allianz Hungaria, ARAG, Generali, GRAWE, Merkur, Victoria-Volksbanken, Wiener and NLB Vita), grew their premium income by 33%, versus the total market growth of 2.7%. In 2010 their premium grew by 15%, compared to 1% for the total market. Although they only controlled 10.65% of the total insurance market in 2010, their market share has been growing, especially in the promising life insurance segment where they account for 20% market share (up from 18% in 2009). In the non-life insurance they controlled a 7% share of the market, up from 5% in 2009.

More intense, or rather more focused, competition in the MTPL business by foreign players (such as Generali) also led to declining profitability in this segment. However, MTPL still remains profitable, and, according to industry insiders, has been subsidising the loss-making Casco. While Slovenian insurers are not allowed by law to exchange information on drivers, some foreign insurers (like Generali) believe in segmentation and a targeted approach to the client selection. However, other local insurers do not follow segmentation models as they are concerned about losing market share. While we believe that segmentation is the way to go in motor insurance, the small size of the Slovenian market would lead to even more price competition for more desirable segments of the population.

### The distribution mix is dominated by agents

Insurance products in Slovenia are sold mainly by agents (both tied and untied), as well as by employees of the insurance companies. Because of the capital constraints, many insurers cannot afford to hire the best agents on an exclusive basis. The *bancassurance* channel is not yet well developed in Slovenia, and is responsible for only 1% of total life premiums.

### Conclusion

Slovenia is a small yet prosperous nation which after suffering miserably in the wake of the global crisis is now starting to show signs of recovery. Having withstood a tumultuous history at the hands of the Nazis and the Communists, Slovenia has rather impressively emerged from Eastern Europe as the model of economic and political stability.

Two decades after independence, Slovenia has undergone immense social and economic modernisation. The banking system and insurance markets are both relatively mature but, despite showing high levels of penetration by CEE standards, continue to present opportunities for growth, for example in the personal sector for banking and in life insurance.

### Sava Re Group: strong business model driven by reinsurance and domestic operations, but marred by the unprofitable non-Slovenian primary insurance business

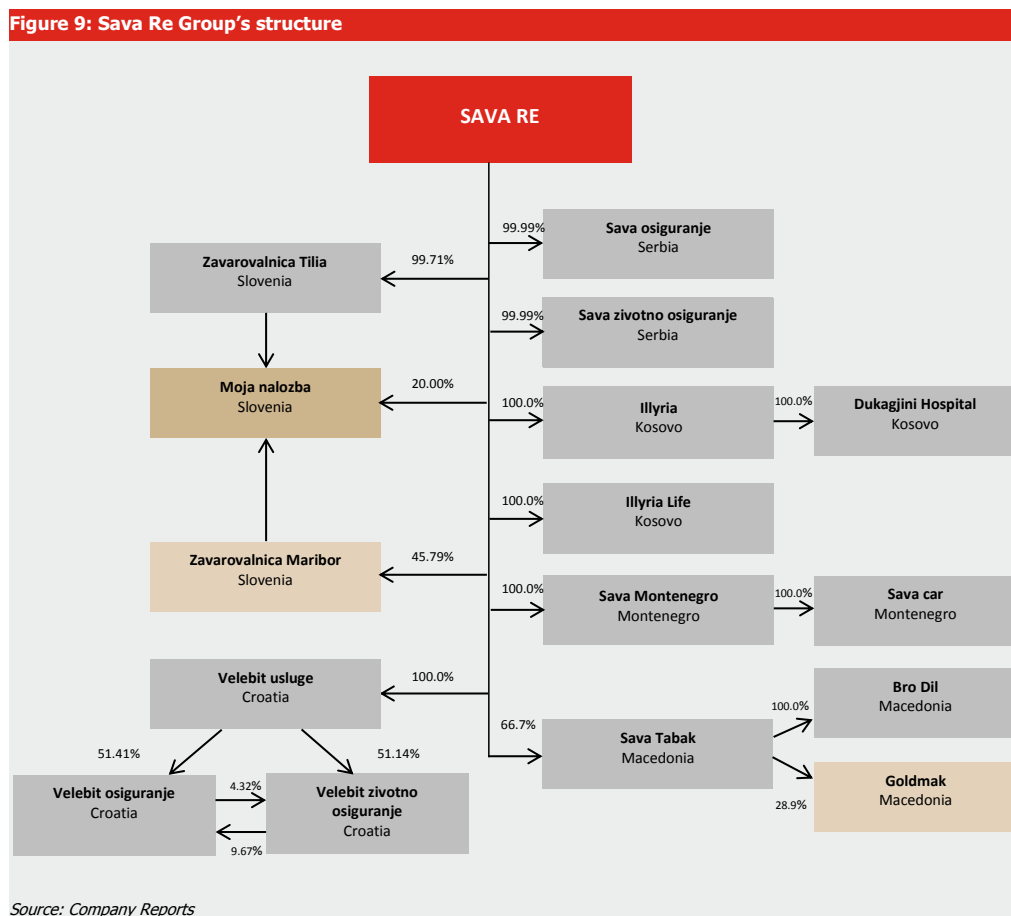
Founded in 1973, Sava Re Group, with EUR 578m in assets, is a well-established global reinsurance company, and a leading reinsurer in Slovenia. Following the strategic management decision to expand into

the primary insurance business in 2007, the Group now also counts nine insurance companies in the Western Balkans area. It is also an important primary insurer in Slovenia through its wholly-owned subsidiary Tilia, and through an equity stake in ZM, the second-biggest insurer in Slovenia. The company also has an equity stake in Moja Naložba (a pension fund in Slovenia).

The stock is currently trading on a 2012 P/BV of 0.4x, and on a 6.5 PER to 2012 earnings. Our proprietary LEFALC-based DCF valuation model generates a EUR 8.66 target price, suggesting that the stock is currently trading at a 18.7% discount to fair value. As such, we initiate coverage of Sava Re Group with a BUY recommendation.

**Positioning and Strategy**

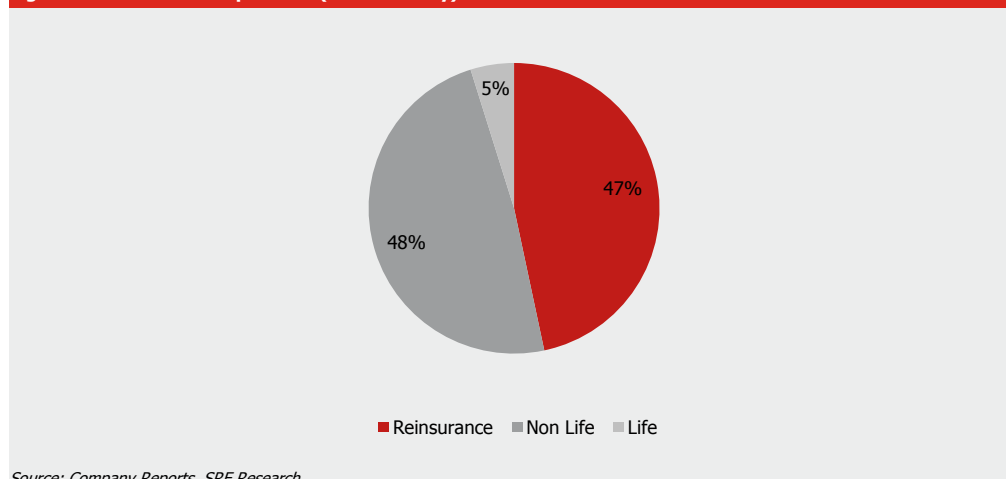
The composition of the Group is shown below.



Sava Re Group operates in three distinct lines of business.

1. Reinsurance: it is the largest regional non-captive reinsurer in CEE, operating both in Slovenia and world-wide.
2. Primary non-life insurance: the Group underwrites the primary non-life insurance in Slovenia (through Tilia and through its stake in ZM), and in 5 other markets of former Yugoslavia, such as Serbia, Croatia, Montenegro, Macedonia, and Kosovo.
3. Primary life insurance: it also underwrites the primary life insurance in Slovenia.

**Figure 10: Sava Re Group's GWP (external only)**



Source: Company Reports, SRF Research

Currently, the Group holds 4.4% and 1.6% of primary non-life and life insurance markets in Slovenia, respectively.

- The reinsurance business generated EUR 142.9m in GWP in 2010 (of which EUR 121m was external), 47% of the total premium for the Group. Sava Re writes the reinsurance in Slovenia, and globally. In 2010, 50% of the GWP came from Slovenia, followed by Europe (20%), Asia (18%), CEE (11%) and other (1%). In Slovenia, there are two reinsurance companies: Sava Re with a 54.3% market share, and Triglav Re with a 45.7% market share. The management made a strategic decision to reduce the share of business in Slovenia and focus more on the global markets. Sava Re generated the underwriting profit of EUR 6.2m and the net profit of 7.2m in 2010, a strong reversal from respective losses of EUR 7.7m and 12.6m in 2009.
- The non-life insurance business generated EUR 125.7 in GWP in 2010, or 48% of the total premium for the Group. Of this, EUR 63.7m, or 50.7% came from Slovenia (through Tilia, the domestic insurer). In 2010 Tilia had a 4.4% market share in Slovenia, up from 4.3% in 2009. In other regions, the Group had the following non-life market shares: 21.8% in Kosovo, 17.5% in Montenegro, 15.3% in Macedonia, 3.4% in Serbia, and 0.9% in Croatia.

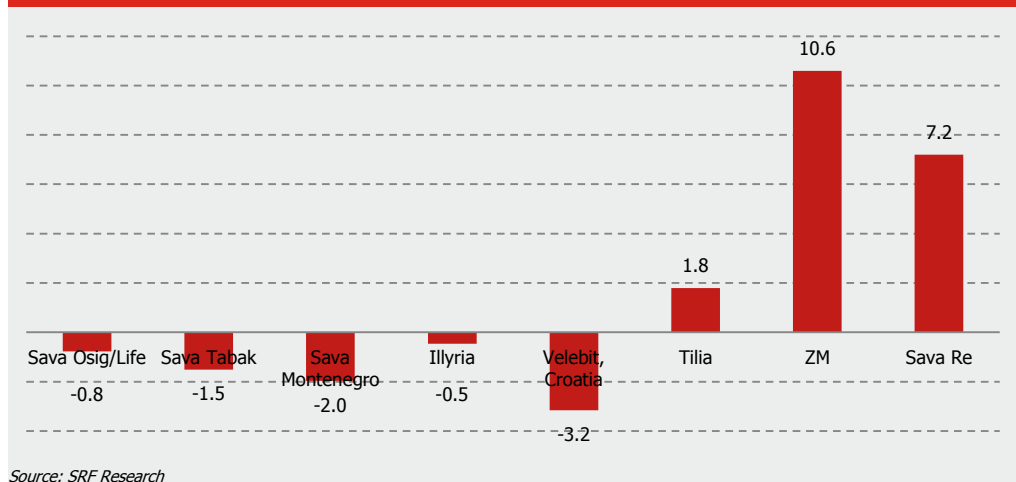
The non-life business produced an underwriting loss of EUR 5.3m and a net loss of 4.8m in 2010, which was an improvement from respective losses of 8.7m and 14.6m in 2009. However, Tilia, the domestic insurer was profitable in 2010, whereas the loss was caused by non-Slovenian operations.

- The life insurance, the smallest of the three businesses, generated EUR 12.5m in GWP in 2010, adding 5% to the total premium of the Group. This translated into a 1.6% market share in Slovenia held by Tilia, unchanged from 2009. Outside of Slovenia, the Group has greenfield operations in Croatia (with EUR1.3m in GWP), in Kosovo (with EUR0.7m in GWP), and in Serbia (with EUR0.3m in GWP). The life insurance generated a loss of EUR 1.6m in 2010, from a loss of EUR 0.7m in 2009.
- Additionally, Zavarovalnica Maribor (ZM), of which Sava Re Group owns 45.79%, contributed EUR 4.9m to the Group's net income. It is accounted for as an investment in associate.

**Income Statement**

In 2010, Sava Re Group generated EUR 7.5m in net income, a strong rebound from a loss of EUR 25.1m in 2009. The profit was driven by strong reinsurance operations, and by healthy domestic primary insurance operations of Tilia and ZM (the latter accounted for as an investment in associates), partly offset by unprofitable primary insurance operations in other former Yugoslav countries. The major reason for this return to profitability in domestic non-life and reinsurance operations was a more prudent approach to pricing, including the restructuring of the crop insurance product in 2010.

**Figure 12: Profitability of Sava Re Group members in 2010, EURm**



Source: SRF Research

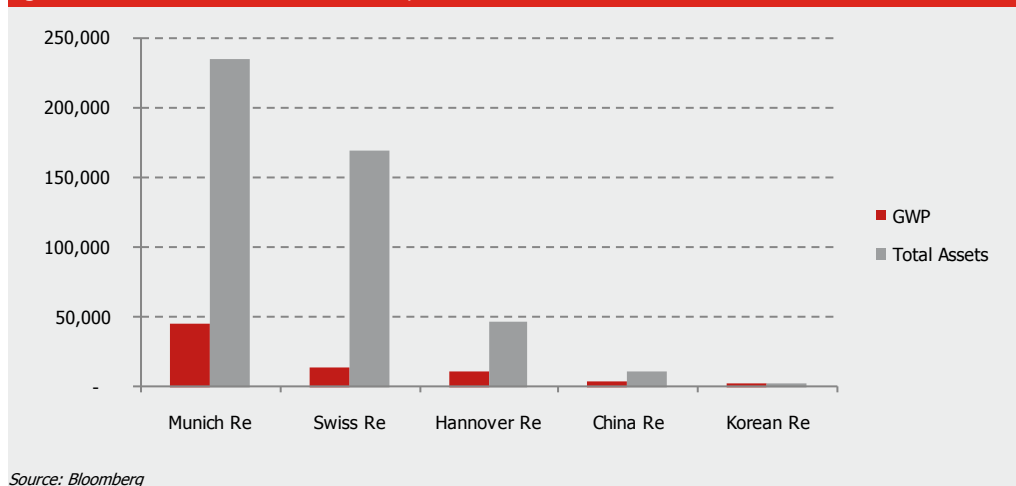
For reinsurance operations, the combined ratio (CR) reached 95% in 2010, strongly improved from 106.4% in 2009. As for the still unprofitable non-life insurance segment, the combined ratio improved to 105.5% in 2010 from 109.9% in 2009.

**Reinsurance**

This segment generated EUR 142.9m in GWP in 2010, 47% of the total premium for the Group. 50% of this came from Slovenia, and 50% from the global markets. Sava Re generated an underwriting profit of EUR 6.2m and a net profit of EUR 7.2m in 2010, a strong reversal from losses in 2009 of EUR 7.7m and 12.6m respectively.

Sava Re is an important player in the global reinsurance business. However, it is quite small compared to the major global reinsurers, such as Munich Re or Swiss Re. The chart below compares the leading global reinsurance companies by GWP and by assets. In 2010, Sava Re's GWP and total assets of EUR 259m and EUR 578m respectively represented only a small fraction of the global reinsurance picture.

**Figure 13: Global Reinsurance Sector 2010, EURm**



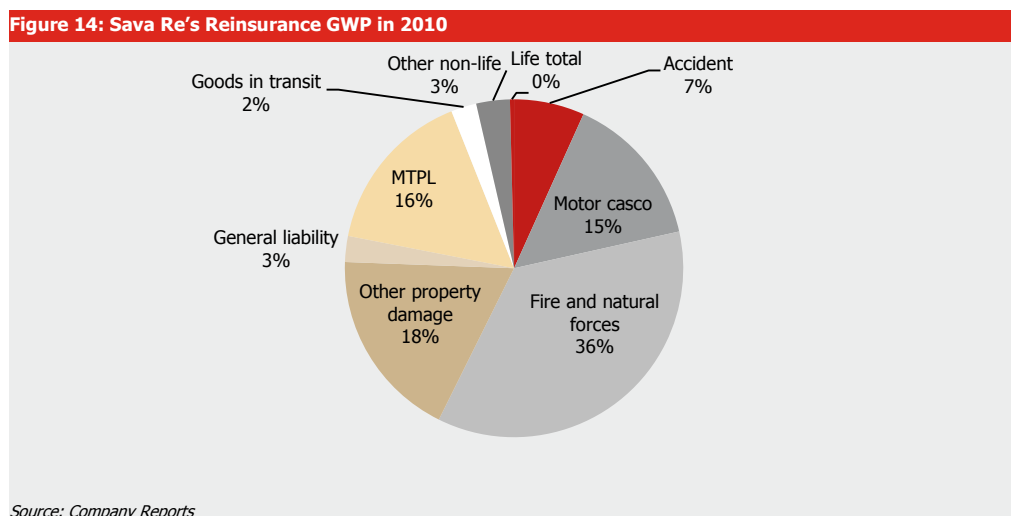
Source: Bloomberg

The reinsurance sector, when compared to the primary insurance sector, has higher appetite for risk, and requires more capital - hence it has fewer players. The period of 2009-2010 could be described as soft for reinsurance markets, with declining price premiums and an excess capacity. However, the earthquake in Japan in the beginning of 2011 seemed to halt the decline in prices. In the first six months of 2011, the industry incurred ~\$70bn in losses from natural disasters (including over \$4bn from tornadoes and severe weather in the US), according to Marsh & McLennan Cos. While it is still unclear whether there will be any price increases for 2012 (normally dependant on the US hurricane season and the magnitude of typhoons in the Western Pacific in September-November), the industry is not expected to soften any more.

In 2010, the global non-life reinsurance premium grew by 1.3% from 2009, driven by emerging Asia (up 17.7%), the Middle East (up 7.7%), and Africa (up 4.4%), while the Western Europe's reinsurance premium declined by 0.5%. The overall ROE in the global reinsurance sector was ~10% in 2010, down from ~12% in 2009 as the markets continue to soften.

In Slovenia, there are two reinsurance companies: Sava Re, the #1 with a 54.3% market share, and Triglav Re with a 45.7% market share. Sava Re's management made a strategic decision to reduce its share of business in Slovenia and focus more on the global markets. While the global reinsurance GWP grew by 16% in 2010, the Slovenian-based reinsurance GWP was down 13%.

Sava Re's strategy is to grow its global reinsurance premium faster than the Slovenian one. The main growth engines in 2010 were Malaysia, South Korea, China, Sweden, and Japan. The company performs extensive market research on geographies where it writes reinsurance to avoid entering softer markets (which at present include Romania, Bulgaria, India and China). It also partners with other reinsurers that have expertise in local markets.

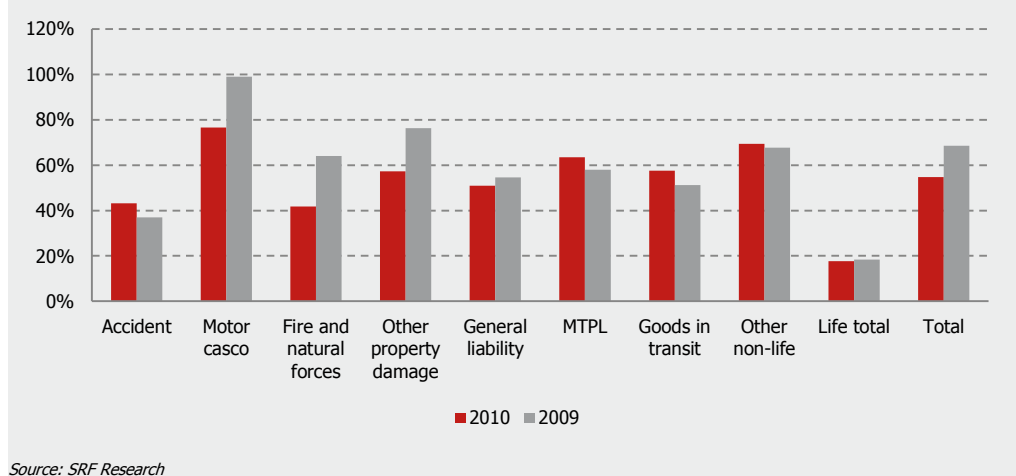


The major reinsurance lines in 2010 were fire and CAT, property damage, MTPL, and Casco, which contributed 36%, 18%, 16% and 15% to Sava Re's reinsurance GWP respectively. While the company writes all kinds of reinsurance products, proportionate reinsurance (quota-share) represented 83.7% of the total premium in 2010, while non-proportionate lines (CAT excess of loss and Risk excess of loss) added 14.1%, and the facultative insurance added 2.2%. The share of excess loss reinsurance was up from 2009 due to gradual and anticipated decline in the usage of the proportionate reinsurance in Slovenia.

While the gross claim ratio (before retrocessions) was 55% in 2010, lower than 69% in 2009, there were significant variances between different lines. As follows from the chart below, Motor Casco was the most unprofitable line with a claim ratio of 77% (improved from 99% in 2009), followed by MTPL with a claim ratio of 63% (deteriorated from 58% in 2009). The loss ratios for fire and CAT, and other property businesses were much improved in 2010.

The chart below compares gross claim ratio for various reinsurance lines in 2010 and in 2009.

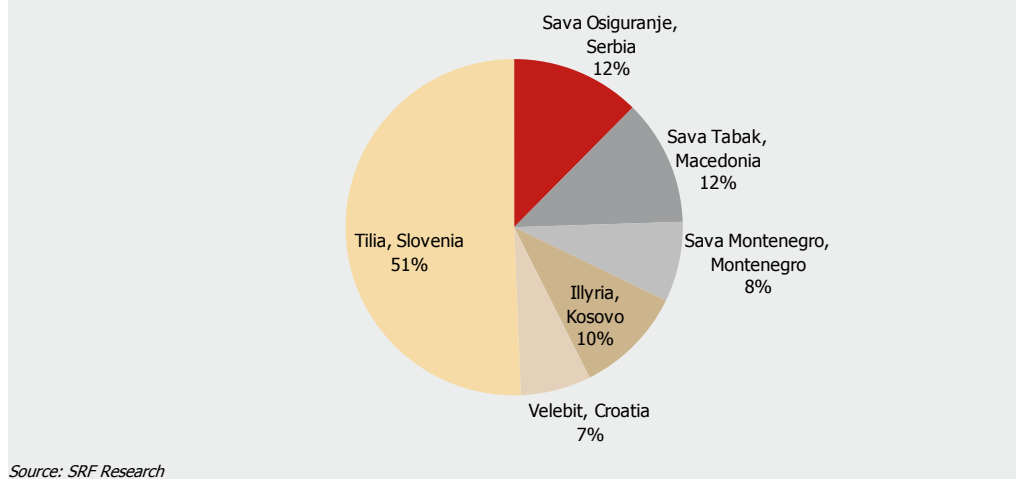
**Figure 14: Sava Re's Gross Claim Ratios, Reinsurance 2009-2010**



**Primary non-life insurance**

The Group generated EUR 125.8m in non-life GWP in 2010, up 5% from 2009 (not including the contribution from ZM). Tilia, the Group's insurance arm in Slovenia, contributed 51% of it.

**Figure 15: Sava Re Group's non-life GWP in 2010**



The non-life business produced an underwriting loss of EUR 5.3m and a net loss of 4.8m in 2010, which was an improvement from respective losses of 8.7m and 14.6m in 2009. However, Tilia, the domestic insurer was profitable in 2010, whereas the loss was caused by non-Slovenian operations.

**Slovenian operations**

Tilia, a Slovenian multi-line insurer, 99.7% owned by Sava Re Group, generated EUR 63.7m in GWP in 2010, up 2.8% from 2009. This contributed 51% to the Group's total non-life GWP of EUR 125.8m. Tilia was profitable in 2010, and produced a net income of EUR 1.2m for its non-life business.

**Non-Slovenian operations**

The non-Slovenian primary non-life insurance premium was EUR 62.1m in 2010, or 49% of the Group's total primary non-life GWP. However, the profitability remained poor for most of Group members in the region, as follows from the chart below. Combined, non-Slovenian operations generated a loss of EUR 5.9m.

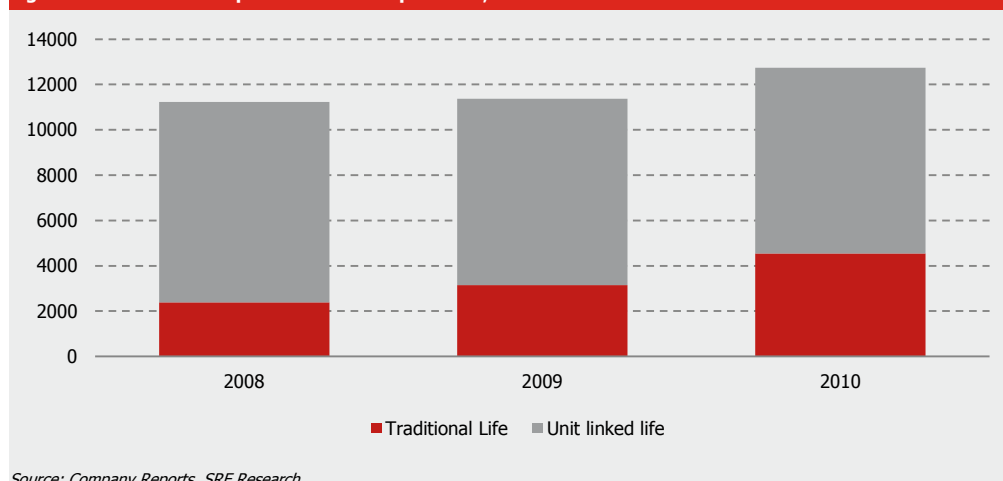
However, Sava Re Group expects higher growth and gradually improved profitability from the markets where it is currently present as the insurance penetration and density there are much lower compared to

Slovenia. On the flip side, Slovenian insurers face more aggressive competition in these markets, and have to deal with less transparent accounting and business practices.

### Life insurance

The Group's primary life insurance premium reached EUR 12.5m in 2010, up 10% from 2009. 80% of it was generated domestically, by Tilia, Sava Re's subsidiary in Slovenia, which provides both traditional life and unit-linked products.

**Figure 16: Sava Re Group's life insurance premium, EUR 000's**



Source: Company Reports, SRF Research

**Traditional life/endowment** is an interest-sensitive product, but current guaranteed crediting rates of 2.75% are well below market rates.

**Unit-linked life** product is a lower margin product compared to the traditional life, but it represents no investment or interest rate risk to the insurer as it does not offer any investment guarantees (a policyholder bears all the investment risk). The product offers a tax-effective investment with a life insurance cover. For these products, clients normally assume all investment risk. However, the unit-linked product has always been "fickle": as it has a highly volatile redemption profile that reflects investors' sentiment towards the capital markets. The major risk on this product is the higher level of commissions (presently ~16%) compared to other life insurance products. At the same time and for the same reason, this product tends to be a gold mine for an intermediary. The return for the insurer includes asset management fees (1-2.5% of AUM) that it shares with external asset managers, as well as administration fees of ~10% of the premium.

The life segment generated a loss of EUR 1.6m in 2010, from a loss of EUR 0.7m in 2009 mainly due to unprofitable operations in Croatia (Velebit Life) and in Serbia (Sava Life) which lost EUR 1.2m and 0.8m respectively. Tilia Life, however, generated EUR 0.3m in profits, while Illyria Life remained marginally profitable.

Similar to other Slovenian insurers, Tilia plans to grow the life insurance business, especially the traditional life segment.

The Serbian, Kosovan and Croatian life insurance operations are greenfields. In 2010, they generated EUR 2.4m in GWP, or 19% of the Group's total primary life premium.

### ZM

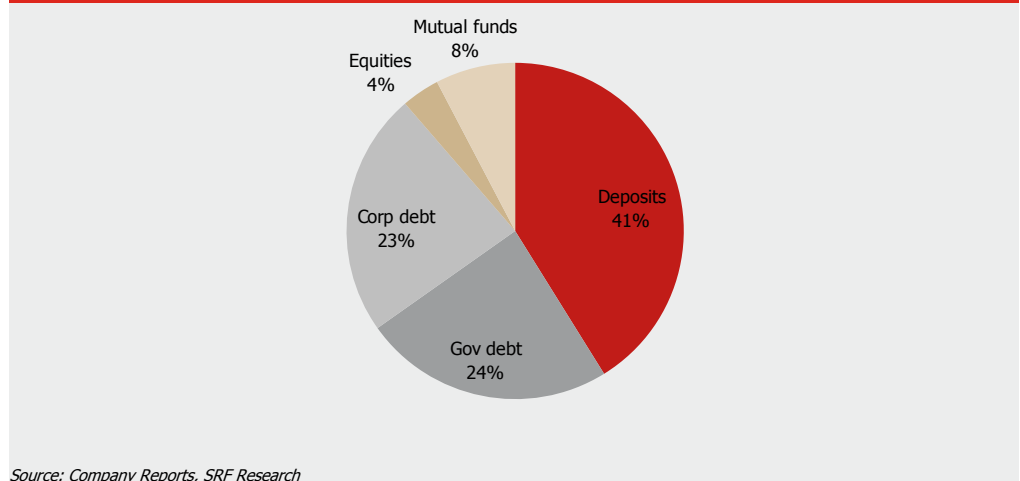
Sava Re Group holds a 45.79% stake in Zavarovalnica Maribor, or ZM, the #2 insurance company in Slovenia by market share. ZM is a multi-line insurer, and as of 31 December 2010 it had €734m in assets, with 219 exclusive agents selling its products. In 1Q 2011, it had the second largest overall market share in Slovenia (15.2%), following the market leader Triglav with a 33.5% market share. Segment wise, it has a 16.8% market share in non-life insurance (#2), and an 11.1% market share in life insurance (#3) in Slovenia. However, excluding voluntary health insurance, which is not part of ZM's business mix, ZM's market share of non-life insurance is ~20%.

In 2010, ZM generated EUR 259.6m in total GWP, which translated into a net profit of EUR 10.6m, thus adding EUR 4.9m to the Group's net income.

**The Balance Sheet Snapshot shows good reserve coverage, material past-due receivables, while the leverage remains adequate**

The composition of Sava Re Group's investment portfolio has been dominated by bonds and deposits. In 2010, the portfolio was restructured to reduce the proportion of equities and corporate bonds, and to increase the allocation to government debt. The inevitable consequence of this approach will be a reduction in the investment yield. However the strong growth in life insurance premium should result in a longer investment horizon, and therefore will push the investment yield up.

**Figure 17: Investment portfolio, 2010**



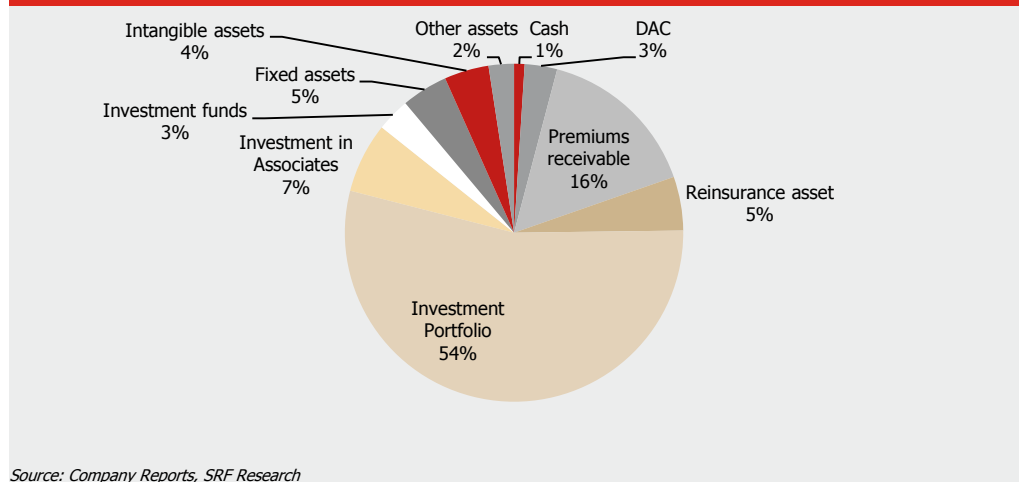
Source: Company Reports, SRF Research

The investment portfolio is expected to provide a comfortable level of coverage to insurance reserves, in line with the current 110% coverage level. We expect insurance reserves to grow at a three year CAGR of 6.9%, slightly behind the growth in investments.

Sava Re Group has been building up its subsidiaries' reserves to be in line with EU reserving standards, and to account for prior period reserves that had to be strengthened.

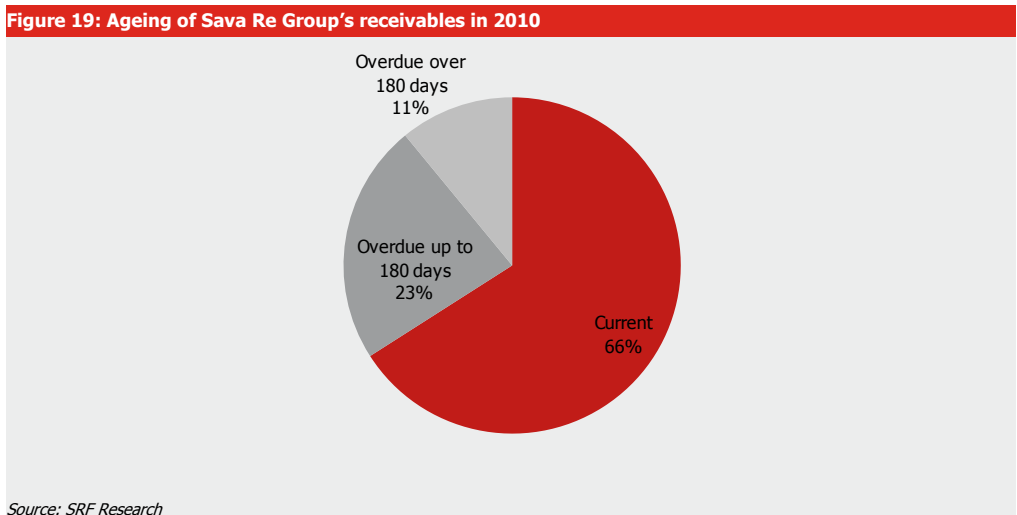
The chart below provides the structure of the Group's assets at the end of 2010.

**Figure 18: Sava Re Group's Asset Composition**



Source: Company Reports, SRF Research

As follows from the chart, cash and investments represented 55.2% of total assets. The second biggest item was accounts receivables, which represented 15.5% of total assets (while accounts payable represented only 7%). The allowance for doubtful receivables was 2.4% of total assets, and 26% of total accounts receivables, consistent with 2009. The overdue accounts represented 34% of total receivables in 2010.



Most of the impaired receivables have been incurred in primary non-life insurance operations, but not in the reinsurance business. The cost of past-due receivables is the foregone investment income, and therefore a strain on the profitability.

Sava Re Group has a subordinated variable rate debt of EUR 31.2m on its books, on which it pays at 3-months Euribor + 3.35%. This debt represents 18% of the total capital, and 22.5% of the equity in 2010. Although the company has no immediate plans to reduce its debt level, we consider its leverage to be sustainable.

As we mentioned earlier, capital constraints represent the greatest challenge for the insurance sector in Slovenia. The good news is that the Group was adequately capitalized in 2010, with NPW to Equity of 1.5x (below the rule-of-thumb threshold of 2x), and the Solvency I margin of over 200%. Our proxy for capital, the equity to assets ratio, was above 25%, and is expected to stay at a 25% level in 2011-2013. While the Group paid no dividend in 2010, the management plans to introduce a modest dividend beginning in 2013. Our dividend pay-out forecast is 25% of the net earnings for 2013 and beyond. On the flip side, with upcoming Solvency II the Group may face some extra challenges, as it is currently in negotiations with the regulator about the right formula to calculate the required capital. In 2010-2011 the Group had to recapitalize some of its subsidiaries in Serbia, Croatia, Macedonia and Montenegro for the total of EUR 10.7m, and may need to recapitalize them even more going forward.

**Figure 20: Sava Re Group's Capital, EUR m, 2009-2010**

EURm	2009	2010
Available Solvency margin	57.3	41.8
Required solvency margin	18.7	20.2
Surplus	38.6	21.6
Solvency margin	306.5%	207.1%
NPW to Average Equity	1.4	1.5
Equity % Assets	27.2%	26.0%
Equity % Insurance Reserves	52.9%	49.5%

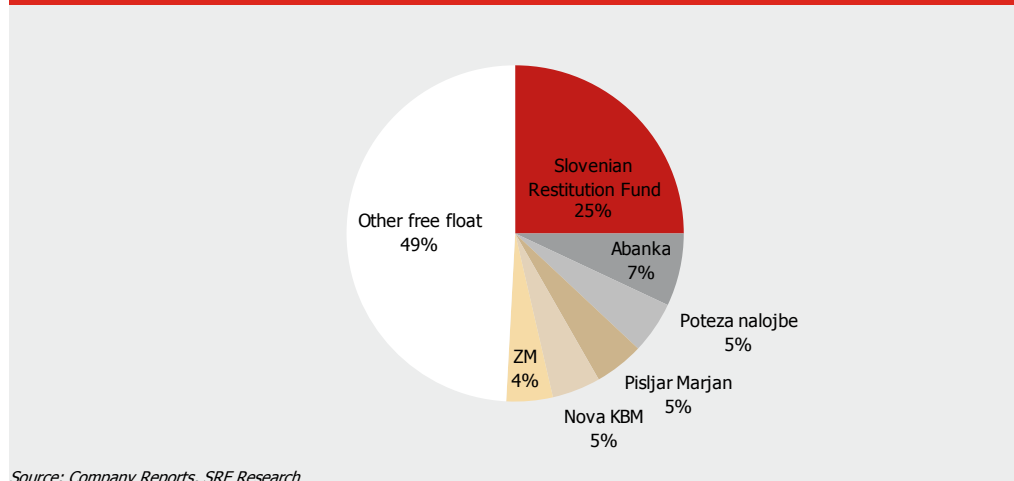
Source: Company Reports, SRF Research

### Ownership

Sava Re Group is a small-cap story by market capitalization, which was USD 88mn as of 10<sup>th</sup> of August 2011, of which 75% is public float. The shares have been listed on Ljubljana Stock Exchange since the company's IPO in November 2008.

The Slovenian Government remains the main shareholder in Sava Re Group, with a 25% stake.

Figure 21: Sava Re Group's Ownership structure, 2010



### Strategy: Strong and growing presence in the global reinsurance business with a robust domestic insurance franchise

We believe that Sava Re Group's investment story is driven primarily by its strong and growing global reinsurance platform, as well as by the robust primary insurance franchise in Slovenia.

#### Strong and growing presence in the global reinsurance

Not only is Sava Re the market leader in Slovenia, it continues to grow its presence in the global reinsurance. We believe that the global reinsurance should be the main driver of Sava Re's earnings going forward.

#### Improved results in domestic non-life insurance

We believe that the overall profitability of the non-life insurance segment in Slovenia has been improving. Although it is not a fast-growing market compared to other CEE economies, it can achieve sustainable underwriting profits and stable investment results. Although Sava Re Group is only a price-taker in this segment, we believe that it can significantly grow its primary business through acquisitions to further strengthen its domestic franchise. While we are not explicitly forecasting a take-over of a minority stake in ZM, we believe that Sava Re will be growing its domestic non-life franchise. However it may need to raise some extra capital to accomplish this.

#### In the long run, the life insurance business has a better growth and profitability profile compared to the non-life

While the life insurance segment in Slovenia is less penetrated, and potentially more profitable than the non-life, there is also more competition for this segment. Most foreign insurers wish to increase their market share there, whereas the market leaders (Triglav and ZM) want to expand even further. Under these conditions, we believe it would be hard for Sava Re Group to grow its modest market share in the life insurance unless through a major acquisition – for which, again, it would need to raise some extra capital.

There are a number of risks to the Group's investment story, including:

#### The primary business outside of Slovenia remains unprofitable

While the primary insurance business remained unprofitable outside of Slovenia, Sava Re Group still intends to increase its presence in these regions. While this approach may be justified given a much higher growth potential in countries like Croatia, Serbia or Kosovo, such growth strategy requires yet more capital. Sava Re Group had to recapitalize its non-Slovenian subsidiaries for EUR 10.7m 2010-2011, and there may be more capital infusions coming. Another threat comes from foreign insurers, which have deeper pockets compared to Sava Re Group, and want to grow their market shares aggressively in the

region by pricing the product irrationally. You snooze you lose is the name of the game when it comes to price-dumping in order to gain market share, and normally the winners would be the ones with the strongest balance sheets. We are not sure about Sava Re Group in this respect.

**Sava Re Group has a rather high level of overdue receivables**

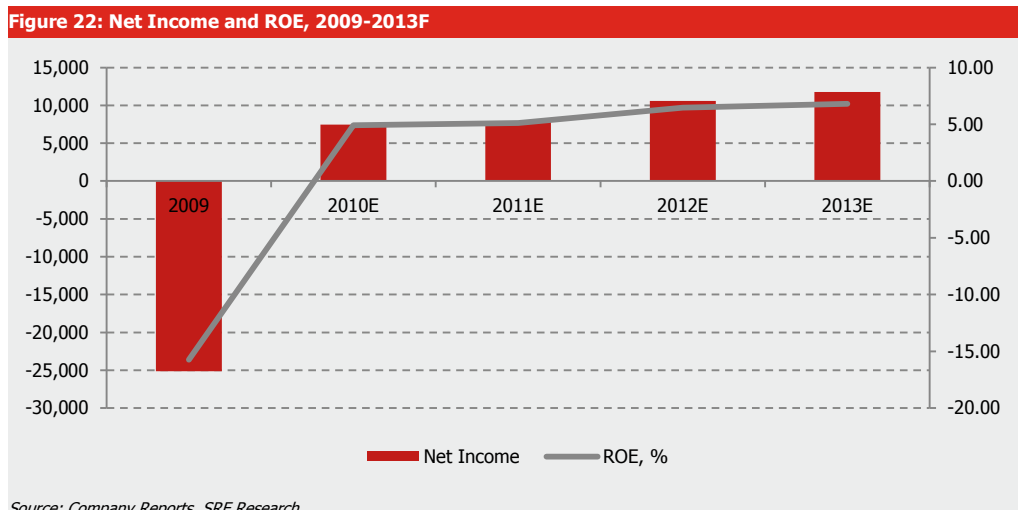
The overdue accounts receivable represented 34% of total receivables in 2010, while the allowance for doubtful receivables was 2.3% of total assets, and 26% of total accounts receivables. The cost of past-due receivables is the foregone investment income, and therefore a strain on profitability.

**Capital may be under pressure**

We have two major concerns about Sava Re Group’s capital. The first one is to do with the upcoming Solvency II: the company may face some extra challenges, as it is currently in negotiations with the regulator about the right formula for calculating the required capital. The other concern is its non-Slovenian primary insurance business. As these operations continue to lose money, the Group may have to recapitalize them even further, thus putting an additional strain on capital.

**Earnings Outlook**

We forecast that Sava Re Group’s net earnings will grow by 5.7% this year, and at a three-year CAGR of 16% between 2010 and 2013.



This should be driven by a strong growth in life premium, and consequently, in the investment income, as well as by modestly improved profits in the primary insurance. On the flip side, we expect the commission rates to remain sticky both for the Group, and for the whole industry. We also expect a considerable drop in income from associates once the situation with ZM’s ownership has been resolved, likely in 2011, as will be explained in more detail later in this report.

Figure 23: Sava Re Group's earnings outlook, 2009-2013E

EUR 000's	2010	2011F	Change, %	2012F	Change, %	2013F	Change, %	CAGR
NPE - reinsurance	123,497	122,728	-0.6%	124,247	1.2%	126,088	1.5%	0.7%
NPE - non Life	96,085	102,667	6.9%	110,594	7.7%	117,880	6.6%	7.1%
NPE - Life	12,394	14,197	14.6%	17,037	20.0%	20,444	20.0%	18.2%
<b>NPE - total</b>	<b>231,976</b>	<b>239,592</b>	<b>3.3%</b>	<b>251,878</b>	<b>5.1%</b>	<b>264,412</b>	<b>5.0%</b>	<b>4.5%</b>
Net Fnl Income and Gains	11,417	12,710	11.3%	16,647	31.0%	18,175	9.2%	16.8%
Income from associates	5,055	6,348	25.6%	2,291	-63.9%	500	-78.2%	-53.8%
<b>Net revenue</b>	<b>248,449</b>	<b>258,651</b>	<b>4.1%</b>	<b>270,816</b>	<b>4.7%</b>	<b>283,087</b>	<b>4.5%</b>	<b>4.4%</b>
Underwriting profit, Reinsurance	6,188	2,455		3,727		3,783		
Underwriting profit, Non-Life	-5,331	-2,053		553		1,768		
Underwriting profit, Life	-4,568	-5,280		-5,632		-5,241		
Pre-tax income	8,840	10,920	23.5%	14,344	31.3%	15,841	10.4%	21.5%
Taxes	-3,320	-2,293		-3,012		-3,327		
<b>Net income</b>	<b>7,453</b>	<b>7,877</b>	<b>5.7%</b>	<b>10,582</b>	<b>34.3%</b>	<b>11,764</b>	<b>11.2%</b>	<b>16.4%</b>
EPS	0.80	0.84	5.7%	1.13	34.3%	1.26	11.2%	16.4%
ROE, %	4.9%	5.1%		6.5%		6.8%		

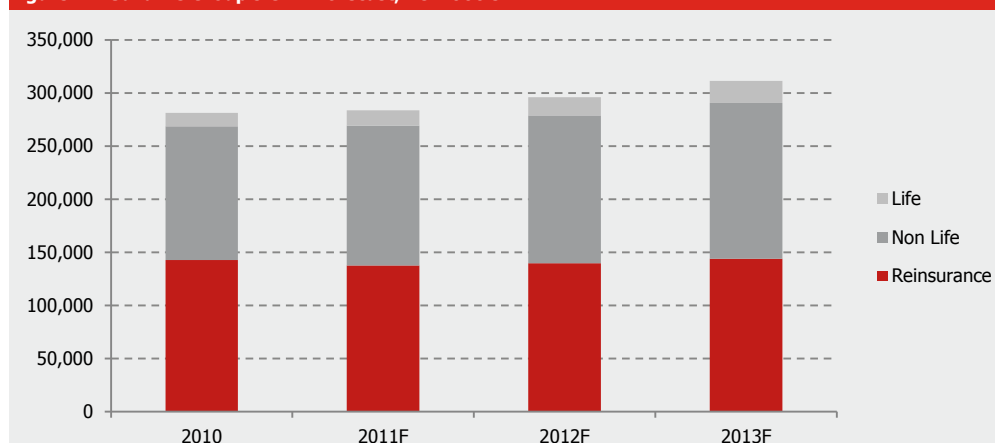
Source: Company Reports, SRF Research

As we are not forecasting any new equity issues, we expect the ROE to improve to 5.1% in 2011, and to 6.8% in 2013 (from 4.9% in 2009). Our long-term sustainable ROE forecast for the Sava Re Group is 7.5%.

### Revenue growth

We expect Sava Re Group's GWP to grow by 3.6% in the current year, and at a three year CAGR of 5.3% between 2010 and 2013. The net revenues are forecast to increase by 4.1% in the current year and by a three year CAGR of 4.4% between 2010 and 2013, driven by the net premium earned (NPE), especially in the primary insurance segment, as well as by the net investment income.

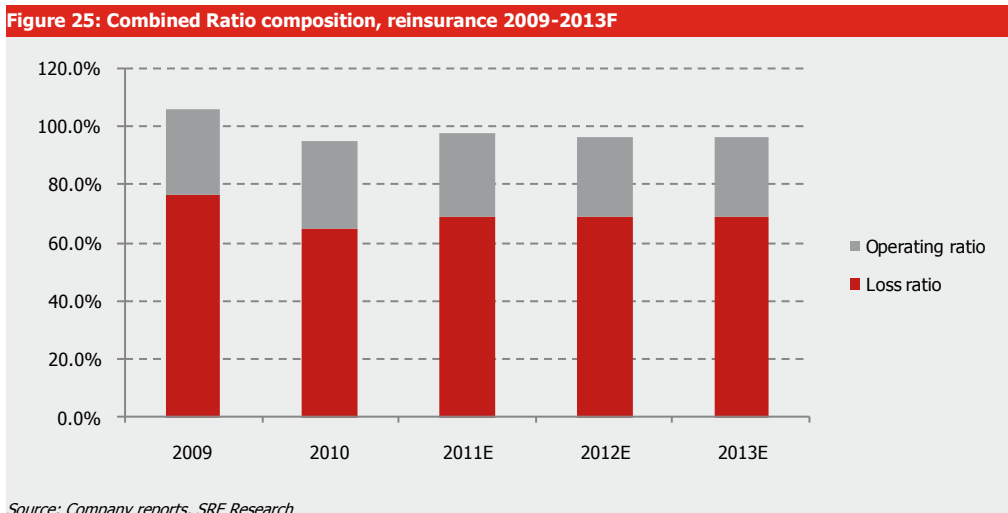
Figure 24: Sava Re Group's GWP forecast, EUR 000's



Source: Company Reports, SRF Research

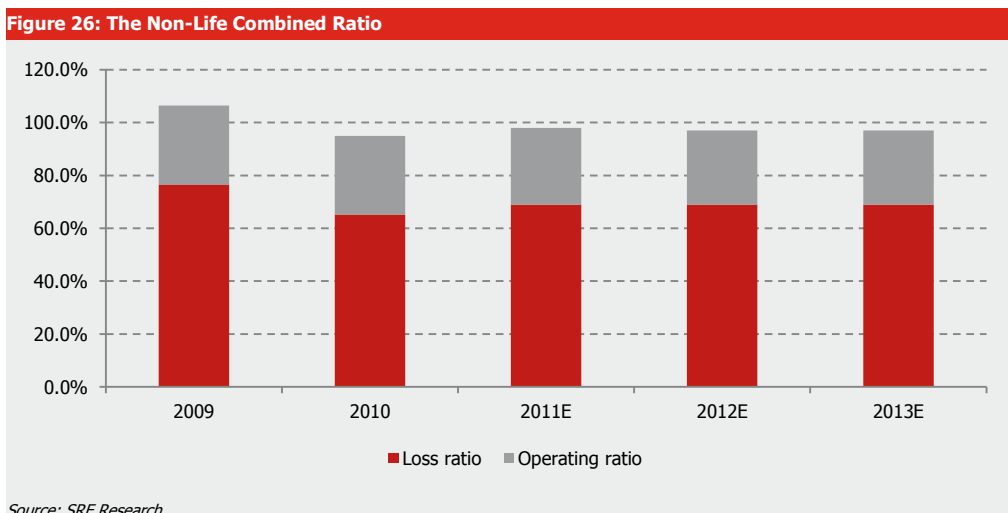
### Reinsurance

We expect the reinsurance GWP to remain flat between 2010 and 2013, as any growth in its global product will be offset by declining reinsurance premiums in Slovenia. Retrocession rates are expected to decline to 11.5% in 2013 from 15.1% in 2010 mainly due to the lower use of quota-share reinsurance by domestic non-life insurers. We expect the reinsurance combined ratio to actually pull back to a more sustainable level of 97% in 2013 and beyond, from 95% in 2010. In the long run, the sustainable loss ratio for this segment is expected to stabilize at 69% (from 65%), while operating ratio is expected to improve to 28% (from 29.8%).



**Non-life insurance**

We expect the Group’s primary non-life GWP to grow at a CAGR of 5.3% between 2010 and 2013, while underwriting results should turn to profitability in 2012, mainly driven by strong domestic operations. We expect the non-life combined ratio to improve to 98.5% in 2013 from 105.5% in 2010 driven by consistent, albeit modest, improvements in both claim and operating ratios.



**Life insurance**

We forecast the life GWP to grow faster than in other segments, at a 18.3% CAGR between 2010 and 2013, off a relatively low base. We therefore expect the Sava Re Group to increase its market share in life insurance to 2.7% in 2013 from 1.9% in 2010. We expect the loss ratio to reach 76% in 2013 from 82% in 2010. Even more importantly, the strong growth in longer tail life products should result in a higher investment yield going forward.

**Investment income**

We expect the investment portfolio to grow at a CAGR of 8.7% between 2010 and 2013. The composition of the investment portfolio is expected to include more government bonds and term deposits, and less corporate bonds and equities, thus producing a lower investment yield. On the other hand, the expected growth in life premiums implies more long-term investments, and therefore some pick up in yields. Overall, we expect investment income to grow at a three year CAGR of 16.8%, while the investment yield is forecast to increase to 4.0% in 2013 from 3.5% in 2010, to reflect the higher level of expected interest rates in Slovenia and the rest of the Eurozone.

**Equity income to decline following the resolution of ZM's control**

For now, the equity income is a very important contributor to Sava Re Group's net earnings, mainly due to ZM. We expect ZM's net profit to increase by 79% in 2011 and by 18% in 2012 driven mainly by the operational gearing through cost efficiencies. That would potentially add EUR 6.4m to the Group's earnings in 2011. However we do not expect the status quo over the control of ZM to continue beyond 2011. Recently NKBM (another part-owner of ZM) announced a bid to buy out the Group's stake in ZM. While the final outcome is yet unknown, the logic is as follows: if NKBM buys out the Sava Re Group's stake, it will much increase the Group's capital and allow it to grow faster in its target areas. If the Group makes a counter-offer and buys out NKBM's stake, it will boost its market share in both life and non-life insurance sectors in Slovenia. In both cases, we will see some strong growth in Sava Re's GWP, while the profitability is also expected to improve, especially on the non-life side. We are modelling in these positive changes. However, we expect the investment in associates to decline to EUR 10m after 2011, and the equity income should therefore become less material going forward.

**VALUATION**

We value the company using a DCF model based on the following assumptions: 7.5% for the long-term sustainable ROE, 2.5% for the long-term sustainable earnings growth, and 10.7% for the cost of capital.

We determine the cost of capital, or the required return, using our own proprietary "LEFALC" approach:

LEFALC is a scoring system that we use to calculate the appropriate risk premium for valuing Sava Re Group's shares. It stands for:

**L = Liquidity.**

Sava Re Group shares are trading at the Ljubljana Stock Exchange, under the ticker of POSR. We measure the liquidity by the stock turnover on the basis of the 50 day average volume multiplied by the average stock price. POSR's average turnover was USD0.03m, which puts it among the illiquid stocks, although such level of liquidity is typical for the Ljubljana Stock Exchange. However, POSR shares have a free float of 75%. We therefore assign the Sava Re Group a 5 for liquidity.

**E=Earnings Quality.**

First, we estimate core earnings as a percentage of total insurance revenue. As Sava Re Group is a multi-line insurer, we define core earnings as the sum of net premiums earned (NPE) and the investment income (excluding gains). On average, core earnings contributed 98% to the total revenue between 2007 and 2010, which deserves the highest score of 1.

**Figure 27: Net operating revenue to total revenue, 2007-2010**

	2007	2008	2009	2010	Average	Score
NPE	157,736	194,114	217,428	231,874		
Investment Income	9,982	12,348	10,401	12,123		
Investment Gains	19,444	-14,763	-9,925	-706		
Net operating revenue	167,718	206,462	227,829	243,997		
Total revenue	192,944	195,745	218,553	253,880		
Net to total operating revenue	87%	105%	104%	96%	98%	1

Source: SRF Research

We also look at the volatility of insurance reserves which we measure as the absolute change in total insurance reserves as a percentage of NPE. In addition, in order to illustrate the volatility, we have deducted the lowest figure from the highest. Sava Re Group's reserves volatility is calculated as 19% (of NPE) minus 7% - giving an answer of 12%. This deserves a score of 2.

**Figure 28: Reserve size and volatility, 2007-2010**

	2007	2008	2009	2010	Average	Score
Change in insurance reserves	16,342	13,816	41,371	30,149		
% NPE	10%	7%	19%	13%	12%	2

Source: Company Reports, SRF Research

Additionally, as write-downs of late insurance receivables and interest costs represented a material expense for Sava Re Group, we evaluate the size of these items relative to pre-tax earnings. On average,

such items represented 40% of the pre-tax income between 2007 and 2010. We therefore assign it a lower ranking of 4.

**Figure 29: Interest costs and costs of unpaid receivables to pre-tax income, 2007-2010**

	2007	2008	2009	2010	Average	Score
Interest costs	3,935	2,818	1,740	1,757		
Cost of unpaid receivables	1,330	3,064	5,766	1,790		
% pretax income	30%	-67%	-26%	40%	-40%	4
Pretax income	17,835	-8,794	-28,345	8,840		

Source: Company Reports, SRF Research

We then summarize all 3 factors to arrive at a final Earnings Quality Score of B, or 2.

**Figure 30: Earnings Quality Summary**

	Core earnings	Reserves scale & volatility	Financing costs and w/downs to pre-tax	Average ranking	Rating	Score
Sava Re Group	1	2	4	2.3	B	2.3

Source: SRF Research

**F=Franchise**

Sava Re Group is 20% owned by the Government which does not generally allow the management a lot of flexibility or independence for adopting more innovative business practices, or for implementing major changes. The company is not a price-setter in its target markets, including the reinsurance segment where it remains one of the minor players world-wide. Neither is it a price-setter in the primary insurance business in Slovenia where it has less than 5% market share. While its international primary business mix allows for a stronger growth potential given the low level of insurance penetration in ex-Yugoslav countries, it is also subject to multiple risks over which Sava Re Group has little control. Additionally, compared to other foreign insurers which operate in those markets, Sava Re Group is not the strongest in terms of capitalization.

As such, we conclude that Sava Re Group has an average-quality overall franchise, and assign it a rating of C, or 3.

**A=Asset Quality**

Sava Re Group's portfolio is invested mainly in Slovenian government bonds, so not much diversification there. However, the investment portfolio provides a comfortable coverage to investment reserves, which was 108.5% at the end of 2010.

Additionally, in 2010 the value of goodwill and intangibles represented 4% of total assets and 16% of the equity, as the company has been growing through acquisitions, mainly outside of Slovenia. Although we are not forecasting any write-downs to goodwill in the next two years, they might still happen if the company's primary operations outside of Slovenia remain unprofitable. Lastly, the investment in associate (mainly the stake in ZM) represented 7% of total assets and 28% of the equity, generating a very significant contribution to earnings (57% of pre-tax earnings in 2010). While we are very optimistic about the quality of this investment, we are uncertain about the final outcome over ZM's control. If Sava Re Group's stake in ZM is to be sold, it may not be replaced with the same quality assets. We therefore assign its asset quality a rating of 3.

**Figure 31: Sava Re Group's Asset Quality (EUR 000's)**

	2007	2008	2009	2010
Goodwill and intangibles	25,393	24,795	23,847	23,290
% total assets	5%	5%	4%	4%
% equity	15%	15%	16%	16%
Investment in associates	31,005	31,581	37,646	42,322
% total assets	6%	6%	7%	7%
% equity	19%	19%	25%	28%
Total assets	478,960	535,347	560,712	578,385

Source: SRF Research

**L=Liabilities Quality**

Sava Re Group insurance reserves have been strengthened to be in line with EU standards, and we expect this strengthening to continue into 2011. In addition, as any reinsurer, the company faces higher reserving requirements compared to the primary business. However based on the loss development triangle of the reinsurance company, there have been consistent albeit declining redundancies of prior periods reserves for 2005-2009 accident years, representing 24%, 24%, 4%, 6% and 7% of originally estimated reserves, pointing to conservative reserving practices. We are also concerned about the pricing environment and reserving practices in former Yugoslav countries, and therefore the risk of further strengthening of prior period reserves associated with these businesses. According to the loss development triangles of the subsidiary companies, there was a reserve strengthening for 2005 accident year, followed by reserve redundancies for 2006-2009 accident years. Lastly, on the consolidated level, Incurred by Not Reported (IBNR) reserves stood at 42.2% of total claims reserves in 2010, which we consider to be conservative.

We therefore assign the Group's liabilities a quality rating of 2.

**C=Capital**

Capital, in our opinion, represents somewhat of a challenge for Sava Re Group, as is the case with other Slovenian insurers. On the one hand, the company was adequately capitalized in 2010, with NPW to Equity of 1.5x (below the rule-of-thumb threshold of 2x), and the Solvency I margin of over 200%. However with the upcoming Solvency II the company may face some extra challenges, as it is currently in negotiations with the regulator about the right formula for calculating the required capital. In 2010-2011 Sava Re Group had to recapitalize some of its subsidiaries in Serbia, Croatia, Macedonia and Montenegro for the total of EUR 10.7m, and may need to recapitalize them even more going forward.

We are less concerned about the company's leverage: it has the subordinated variable rate debt of EUR 31.2m on its books, on which it pays a 3-months Euribor + 3.35%. This debt represents 18% of the total capital, and 22.5% of the equity in 2010. The cost of interest represented 20% of pre-tax income in 2010, which is a sizeable strain on earnings.

Based on the above considerations we assign the capital a rating of 4.

So what does this boil down to?

We calculate the risk premium, based on the resulting average risk score of 3.05, as 100.7% of the expected risk-free rate of 5.2%, or another 5.2%.

**Figure 32: LEFALC Summary**

LEFALC Scores	L	E	F	A	L	C	Average Score
Sava Re Group	F	B	C	C	B	D	3.2

Source: SRF Research

We then apply that risk premium of 5.2% to expected risk-free rate of 5.2%, and arrive at the required return (RR) of 10.4%. We use this required return for our DCF model, and arrive at the fair value of **EUR75.6m, or EUR8.08 per share**. This fair value implies a 0.5x to 2011 and to 2012 book value respectively.

As follows from the charts below, Sava Re Group shares are trading at a sizeable discount to its European peers, as well as to its global reinsurance peers. While this discount is justified by their relative size, liquidity and profitability, we believe that the Group's superior growth potential has not been fully priced in. However, the realization of this potential would largely depend on the availability of capital.

**Figure 33: Sava Re Group and other European Insurers**

		2011	2012
<b>Price-to-Earnings (x)</b>	<b>Sava Re Group</b>	<b>7.8</b>	<b>5.8</b>
	Allianz SE - Germany	6.3	7.1
	AXA SA - France	6.2	6.0
	Aviva - UK	7.7	6.9
	Aragon - Germany	12.7	8.4
	Vienna Insurance - Ai	10.8	9.5
	Generali	9.1	7.9
	<b>Average peers</b>	<b>8.8</b>	<b>7.6</b>
	<b>Price-to-Book value (x)</b>	<b>Sava Re Group</b>	<b>0.4</b>
Allianz SE - Germany		0.9	0.8
AXA SA - France		0.6	0.6
Aviva - UK		0.8	0.8
Aragon - Germany		0.9	0.8
Vienna Insurance - Ai		1.0	1.0
Generali		1.0	0.9
<b>Average peers</b>		<b>0.9</b>	<b>0.8</b>
<b>ROE (%)</b>		<b>Sava Re Group</b>	<b>5.1</b>
	Allianz SE - Germany	11.4	12.1
	AXA SA - France	11.6	10.7
	Aviva - UK	14.2	14.3
	Aragon - Germany	7.8	10.5
	Vienna Insurance - Ai	10.1	11.1
	Generali	11.7	12.6
	<b>Average peers</b>	<b>11.1</b>	<b>11.9</b>

*Source: Bloomberg, SRF Research*

**Figure 34: Sava Re Group and other global reinsurers**

		2011	2012
<b>Price-to-Earnings (x)</b>	<b>Sava Re Group</b>	<b>7.1</b>	<b>5.3</b>
	Munich Re	18.0	6.8
	Swiss Re	15.1	6.1
	Hannover Re	8.1	6.2
	Korean Re	8.2	7.3
	<b>Average peers</b>	<b>12.3</b>	<b>6.6</b>
<b>Price-to-Book value (x)</b>	<b>Sava Re Group</b>	<b>0.4</b>	<b>0.3</b>
	Munich Re	0.8	0.8
	Swiss Re	0.6	0.5
	Hannover Re	0.9	0.8
	Korean Re	1.3	1.1
	<b>Average peers</b>	<b>0.9</b>	<b>0.8</b>
<b>ROE (%)</b>	<b>Sava Re Group</b>	<b>5.1</b>	<b>6.5</b>
	Munich Re	4.3	12.0
	Swiss Re	3.1	9.3
	Hannover Re	11.0	14.0
	Korean Re	16.2	15.9
	<b>Average peers</b>	<b>8.6</b>	<b>12.8</b>

*Source: Bloomberg, SRF Research*

**Figure 34: Sava Re Group's Financial Information, 2010-2013E**

<b>INCOME STATEMENT, EURm</b>	<b>2010</b>	<b>2011E</b>	<b>2012E</b>	<b>2013E</b>
Total Gross Written Premium	259	268	285	302
Premiums Ceded To Reinsurance	-25	-26	-30	-34
<b>Total Net Written Premium</b>	<b>234</b>	<b>243</b>	<b>254</b>	<b>268</b>
Change in unearned premium	-2	-3	-2	-4
<b>Total Net Premiums Earned</b>	<b>232</b>	<b>240</b>	<b>252</b>	<b>264</b>
Claims and benefits paid	-118	-129	-134	-138
Change in policy reserves, total	-24	-23	-24	-25
Change in provision for investment	-6	-7	-8	-9
<b>Insurance profit (loss)</b>	<b>84</b>	<b>81</b>	<b>86</b>	<b>93</b>
Acquisition costs	-45	-47	-50	-53
Administrative expense (net of fee)	-43	-39	-37	-40
<b>Net underwriting income</b>	<b>-5</b>	<b>-5</b>	<b>-1</b>	<b>0</b>
<b>NET INVESTMENT INCOME AND GAINS</b>				
Dividend and interest income	12	13	17	18
Investment gains/losses	-1	-1	0	0
<b>Net investment income</b>	<b>11</b>	<b>13</b>	<b>17</b>	<b>18</b>
Finance costs	-2	-2	-2	-2
Other operating income, net	0	0	0	1
Other operating expense (allowance)	-2	-2	-2	-2
<b>Operating Income</b>	<b>4</b>	<b>5</b>	<b>12</b>	<b>15</b>
Income from associates	5	6	2	1
<b>Income Before Income Tax</b>	<b>9</b>	<b>11</b>	<b>14</b>	<b>16</b>
Income tax	-3	-2	-3	-3
<b>Income before minority interest</b>	<b>6</b>	<b>9</b>	<b>11</b>	<b>13</b>
Minority income	2	-1	-1	-1
<b>Net income</b>	<b>7</b>	<b>8</b>	<b>11</b>	<b>12</b>
Common dividends declared	0	0	0	-3
EPS (EUR)	0.80	0.84	1.13	1.26
Wgt. Avg. Shares Outstanding (ml)	9.36	9.36	9.36	9.36
<b>BALANCE SHEET, EURm</b>				
Cash and cash equivalents	4	5	5	6
DAC	17	19	25	26
Insurance and reinsurance receivables	82	84	88	93
Reinsurance asset	20	21	30	34
Total Investment Portfolio	329	363	391	422
Investment in Associates	42	46	10	10
Seg assets - Inv Funds	24	30	38	46
Fixed assets	27	27	28	28
Intangible assets	23	23	23	23
Other assets	10	12	13	13
<b>Total assets</b>	<b>578</b>	<b>629</b>	<b>651</b>	<b>701</b>
<b>LIABILITIES &amp; SHAREHOLDERS' EQUITY</b>				
Insurance and reinsurance payable	31	34	35	37
Unearned premium reserve	87	90	92	96
Claim and Policy reserves	216	240	263	288
Total Insurance Reserves	303	330	356	384
Seg funds: Investment reserves (Liabilities)	24	30	38	46
Borrowings	34	30	30	30
New financing (unrealized gains on debt)	0	0	0	1
Other liabilities	32	42	19	20
Total liabilities	424	466	477	519
Minority Interest	4	5	5	5
Equity	150	158	169	178
<b>Total liabilities &amp; equity</b>	<b>578</b>	<b>629</b>	<b>651</b>	<b>701</b>

Source: SRF Research

Figure 35: Sava Re Group snapshot



Source: Company, SRF Research

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