

MERISTEM EQUITY RESEARCH REPORT

CUSTODIAN AND ALLIED INSURANCE PLC

Report Date: November 30, 2007

EXECUTIVE SUMMARY & INVESTMENT RATIONALE

- Custodian and Allied Insurance, an indigenous and new generation insurance company in Nigeria, was incorporated on August 22, 1991 under the name **Accident and General Insurance Company Limited** and commenced operations in July 1995 to transact general insurance businesses only with an initial paid up capital of N5m. In 2001, the Company qualified as a composite insurer having secured license to transact Life Assurance business. It became a quoted Company on the floor of the Nigerian Stock Exchange on June 12, with total shares outstanding of 4 billion units and market capitalisation of N14.9bn as at date, Friday November 30, 2007.
- The company has successfully weathered the storm of regulations and the changing landscape of insurance business in the country. It seamlessly consummated a merger arrangement with Signal Insurance Limited on May 2, 2006 in order to meet the prescribed minimum capital base of N3bn for general insurance business in Nigeria as specified by the National Insurance Commission (NAICOM). Prior to the conclusion of the consolidation exercise in February 2007, the company also concluded another merger talks with Fire, Equity and General Insurance Company (FEGIC) on February 14, 2007. This is expected to crystallize into substantial synergy for the **enlarged Custodian** in terms of capital base, robust clientele network, technical and managerial competence among others.
- Custodian recently undertook a strategic decision to strengthen its core competencies in General Insurance business which saw it ceded its Life Insurance business to Leadway Life Assurance Limited as an investment. This is also expected to consolidate the company's previous investments in Leadway Pension PFA.
- In line with best international practices, Custodian and Allied Insurance has subsisting Re-insurance agreements with prominent Re-insurance companies with sound capital base. These companies are: Munich Re.; African Reinsurance Corporation; WAICA Reinsurance Pool; Continental Reinsurance Co Ltd; Universe Reinsurance Co Ltd and Globe Reinsurance Plc. Similarly, the company enjoys both technical and advisory correspondent relationship with HSBC Insurance

Brokers of London. This is intended to enhance its aptitude in handling special risks (Including Oil and Gas) in both local and international markets.

- Custodian Insurance has evolved as a big contender in the insurance industry in Nigeria. The company has recorded monumental growth in all performance indices over the years. Gross Premiums income rose by over 295 per cent within 5 years (5-yr CAGR: 41 per cent) to N1.609bn in 2006 while pre tax profit hopped significantly by 440 per cent to N641.41m between 2002 and 2006 (5-yr CAGR: 52.4 per cent) and after tax profit increased by over 465 per cent to N576.15m (5-yr CAGR: 54.2 per cent).
- To attest to the company's sterling performance records and future prospects among top players in the insurance industry, Custodian Insurance was recently awarded an A+ rating by the Nigerian foremost rating agency-Agusto & Co. This indicates a good financial condition and ability to meet claims as and when due.
- Our forecasts for Net Premium and After Tax Profit are N2.003bn and N864m based on conservative annual growth rate of 45 per cent and 50 per cent respectively. This translates to FY EPS of 22k, representing a growth of 27 per cent over prior year's feat of 17k. We also project a dividend Per Share (DPS) of 15k for the FYE December 31, 2007 given an average payout of 68 per cent.
- Our analysis takes cognisance of industry risks exposure which threaten sustainable profitability. Prominent amongst these are cut throat competition, exposure to fluctuations in money and capital markets, large scale catastrophe/ natural disasters. The recent growth in insurance industry induced by favourable macro economic policies and institutional reforms are veritable means of creating a **'hard' insurance market** environment characterised by low competition and increased premium rates. Further efforts directed towards consolidating the present feat will help to mitigate likely competition in all respect.
- We make a **BUY** recommendation on **CUSTODIAN** as the stock is currently trading at a discount of 33 per cent to its fair price. We also anticipate a rally for insurance stocks generally in the next couple of weeks up to second quarter 2008. This is premised on anticipated bumper results for the FYE December 31, 2007 as well as the accompanied benefits declarations which may lead to a 'rat race' among competing firms.

Global Insurance Industry Overview

The integration of financial markets all over the world has had profound influence on the insurance industry which is typically subdivided into life and non-life insurance. According to a survey of world insurance, conducted by Swiss Re, world insurance premium volume in 2005, for both sectors combined totaled USD3.4 trillion up 2.5 per cent from 2004. In 2006, worldwide insurance premiums amounted to USD3.72 billion. This translates into 7.7 per cent of global economic value generation (GDP),

unchanged to 2005. According to the Swiss Re sigma study, growth in total premium volume accelerated further to 5 per cent (adjusted for inflation). Both life and non-life premiums increased over prior year by 7.7 per cent and 1.5 per cent respectively.

Despite this impressive performance, the developed countries have continued to dominate the market at the expense of the developing economies. The United States alone accounted for over 31 percent of the world's life and non life insurance premiums in 2006 while Japan and the U.K accounted for about 12.4 and 11.4 percent respectively. Companies like **Alliance AG, ING Group, AIG, AX and Nippon Life Insurance** have maintained dominance in the market. Considering insurance spendings, the industrialized countries spent about 9 per cent of their gross domestic product (GDP) on insurance in 2006, while in the emerging markets; this ratio varies from 1.4 per cent in the Middle East and Central Asia to 4.7 per cent in Africa.

The Nigerian Insurance Industry Overview

The insurance industry in Nigeria, just like most developing countries, is largely underdeveloped and fragile. With only about USD716m share of world life and non-life premiums in 2006, Nigeria accounts for a meager 0.02 per cent of total volume of insurance premium in the world. Prior to 2007, the total market capitalization of insurance sector in Nigeria was N34 billion spread among 103 direct insurers and 4 re-insurers. This was grossly inadequate to propel the much needed economic growth that the sector is expected to generate. Generally, the industry suffers from poor risk management capability and low credit rating. As a result, insurance companies in Nigeria continue to lose major underwriting deals and most unfortunately, giving rooms to foreign carriers to dominate insurance coverage especially in the oil industry.

The Nigerian insurance industry is still budding with abounding opportunities for growth and operational expansion. In the recent times, there is a sharp departure from the orthodox practice of insurance business ranging from the development of the insurance products to the administration of the policy of claims made under the insurance as well as the long term investment of the asset supporting the insurance liabilities. Insurance companies are now delving into areas such mortgage/real estate financing and aggressive assets management, project finance, consumer credit finance and a host of others.

There is no gainsaying that the Nigerian insurance market has the potentials of playing dominant roles in the whole of Africa. Future prospects are bright especially with the promulgations of the cabotage

reform law and the pension reform law which will lead to expansion in the oil and gas/marine insurance policies as well as the group life and annuity portfolio. With increased capital base and current institutional/legal reforms, insurance companies are attracting foreign partnerships. One of the obvious examples of this is the recent strategic partnership agreement of AIICO Insurance Plc with AIG, one of the largest insurance companies in the world. Also, as a means of inducing rapid growth in insurance industry in Nigeria, the local content policy of the oil and gas sector was introduced. This will have the insurance companies handle 40 per cent of the underwriting business in Nigeria. This is expected to increase to 70 per cent in 2010 as stipulated by the Federal Government.

However, wide gap still exists in terms of capital base and manpower requirements to undertake big ticket transactions by the local players. Underwriting businesses in oil and gas, energy and telecoms require a great deal of technical competence and huge capital which most of the local insurance firms lack. This poses a great challenge to all local operators as there are lots of untapped fortunes provided by recent regulations with a view to growing this important segment of the financial services sector. Experts express strong opinion that strategic alliances with foreign technical partners may be a panacea to exploit these opportunities. Others also profess that further recapitalisation exercise (regulatory or market induced) may be the antidote.

Business Model:

Custodian and Allied Insurance Plc is principally involved in non-life business to provide general insurance and specific risks services/products to its classy clientele base ranging from private individuals to corporate entities. The company has a wholly owned subsidiary- Custodian and Allied Insurance Trustees which provides a leasing business amongst other services/ functions. Hitherto, Custodian operated a Life Business Unit through its subsidiary- Custodian Assurance Life Limited but this unit was recently excised and strategically transferred to Leadway Assurance Company Limited. The Company also has an equity stake of 21.53 per cent in Leadway Pensure PFA Limited, a subsidiary of Leadway Assurance Company Limited. The Company has its core competence in the general insurance business which informed its decision to undertake expunge its life Business Unit. Part of the core strategic initiative of the company is the structure of its balance sheet components in such way that income generating assets constitute a big chunk of its entire assets portfolio with a view to making appreciable contributions to its bottom lines.

Recent Developments:

- Custodian and Allied Insurance was assigned an **A+ rating** by the foremost Nigerian ratings agency, **Agusto & Co.** in July 2007. By this rating, it implies that the company is in good financial condition and also possesses good ability to meet its obligations to policyholders. This adjudged the company with positive outlook.
- The Q3-2007 results of the company re-affirm its performance potency among top players in the industry as well as its strong future strategic prospects. Gross Premium and After Tax Profit rose by 55.3 per cent and 39.7 per cent respectively while Total Assets and Shareholders Fund hopped by 38.4 per cent and 40.4 per cent correspondingly over same period. Similarly, the company's net margin stood at 38.7 per cent while return on equity was 16.2 per cent.
- Following the recent re-certification exercise concluded in November 2007, Custodian and Allied Insurance is among the 47 insurance companies (apart from 2 other Re-insurance companies) that finally scaled the hurdle after a long waiting period post consolidation exercise in February 28, 2007.

Future Strategic Growth, Prospects and Challenges:

Given the feat recorded in the past one decade, especially in less than 2 years post consolidation, there is no reason to doubt the assertion that the Custodian and Allied Insurance is strategically positioned to compete favourably well in the evolving insurance industry in Nigeria. The company has a good Brand in the marketplace and this has earned it appreciable market share within short spate of time. Custodian and Allied Insurance plans to consolidate on existing technical and business relationships with local and international firms in insurance and re-insurance business with the strategic intent of leveraging on its core competencies in oil and gas sector to harness more possibilities. The company also promises to undertake strategic expansion in information communication technology (ICT) infrastructure and asset management with a view to meeting the dynamism of the market demands.

However, the enormous challenges before **Custodian and Allied Insurance** as well as other players in the industry are: the ability to innovate and develop products that will meet the needs of their budding consumers, capability to develop formidable ICT infrastructural support required to serve the demands of the sophisticated consumers in the oil and gas, energy and telecommunications sectors in order to compete favourably with foreign rivals.

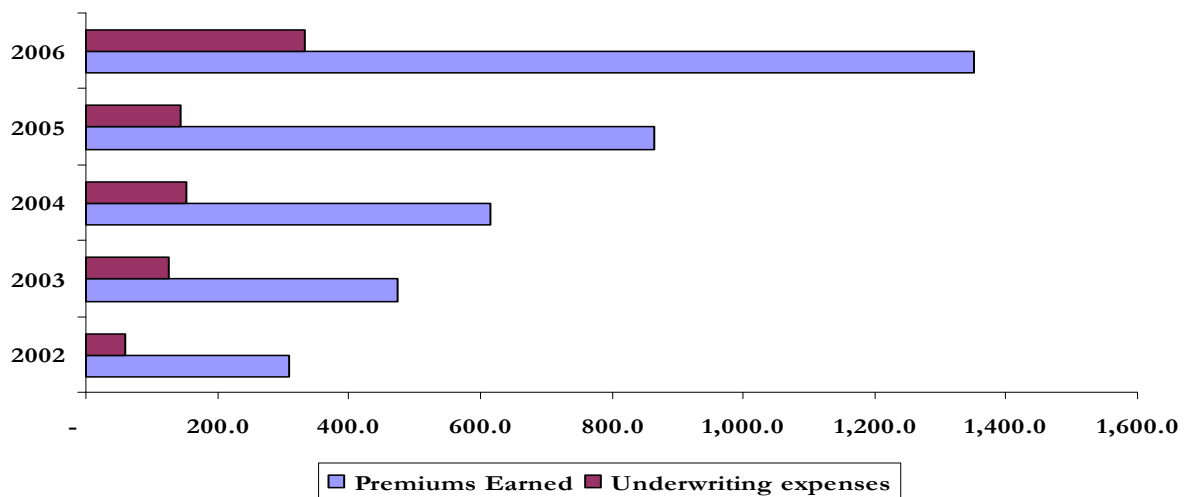
Performance Overview:

Premium Growth, Profitability and Efficiency

Custodian has grown its Net Premium by nearly 295 per cent to N1.61bn from 2002 to 2006 (CAGR: 41 per cent) while Earned Premium rose by over 336 per cent (CAGR: 44.5 per cent) and commission received increased by over 254 per cent (CAGR: 37.2 per cent) over same period. In the same vein, the Company's Earned Premiums as a proportion of Gross Premium has witnessed an impressive and consistent growth over the years at an average rate of 80.3 per cent annually.

The company has a sterling record of strong **retention rate** (Net Premium written to Gross Premium) which measures the extent of cushion an insurer has in case of risk. This ratio has also grown at an annual average rate of 87 per cent from 2002 till date however, the recent Q3-2007 results reveal that a slight decline to 81 per cent compared to 82 per cent growth recorded in the similar quarter of prior year. However, this feat in performance is well above the industry average of about 75 per cent.

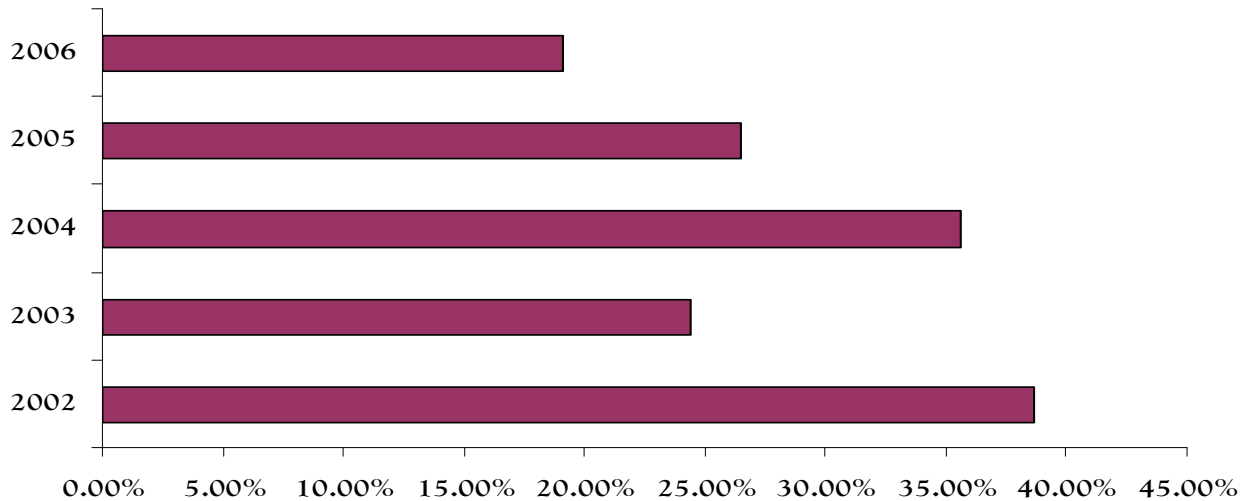
CUSTODIAN AND ALLIED INSURANCE
TRENDS IN EARNED PREMIUM & UNDERWRITING EXP (million)
2002-2006



Custodian has maintained above average performance in key profitability metrics. Underwriting Expenses to Gross Premium averaged 18 per cent over the past 5 years. This stood at 21 per cent as at 2006 compared **LASACO** (11 per cent); **SOVEREIGN TRUST** (13 per cent) **CORNERSTONE** (22 per cent) and **LAW UNION & ROCK** (22 per cent) over the same period. The industry average in 2006 is 18 per cent. Custodian's Net Margin averaged 30 per cent over the past 5 years. For the FYE December 31, 2006, its net margin was 42 per cent far above the industry average of 22 per cent in the same year. Moreover, the company's combined ratio- a metric for determining the effect of claims losses and other operating expenses on revenue stood at 47 per cent in 2006 (industry average:40 per cent) compared to notable peers.

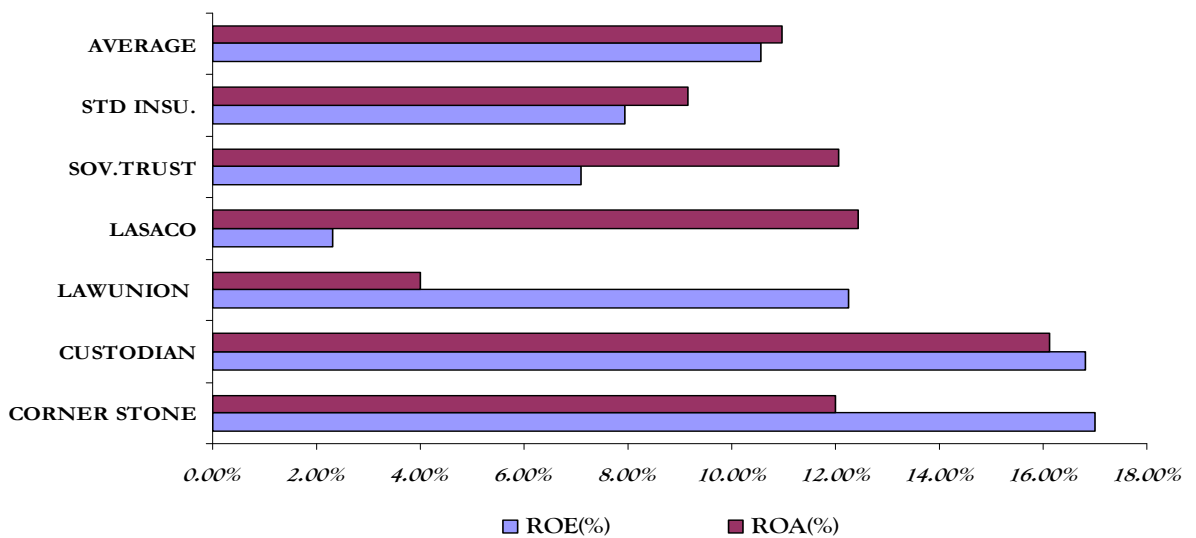
The company has also strengthened its investment income base in last couple of years. It has made appreciable returns from its income generating assets. Investments income soared by over 510 per cent to N265.97m between 2005 and 2006. This constituted over 46 per cent of the company's bottom line in 2006. As at Q3-2007, Custodian's investment income was over N470m (Q3-2006:N222m).

Return on Equity (ROE): 2002-2006



Custodian's ROE and ROA were 18.8 per cent and 16.6 per cent respectively FYE December 2006 compared to the industry average of 15.2 per cent and 11 per cent in that order.

Peer Performance Review Returns on Equity & Returns on Asset



Asset Growth, Liquidity & Capital Adequacy:

Custodian has recorded phenomenal growth in balance sheet size over the past years especially post consolidation. Total assets soared by nearly 82 per cent between 2005 and 2006. As at Q3-2007, Total assets stood at N5.37bn while Shareholders Fund rose to N4.33bn. Moreover, the company's proportion of Equity to Total assets- a measure of the extent of cushion the company has from equity holders' funds stood at 76.5 per cent as at FYE 2006. However, this has risen to about 81 per cent as at Q3-2007. This was due to additional funds from equity contributors, consolidation of its books with Fire, Equity and General Insurance (FEGIC). This provides more resources for the company to leverage on in growing market share and achieving commendable returns on assets.

The company has also maintained a good liquidity record over the years. This is a potent measure of determining the extent of ability of an insurer to pay claims as and when due. Custodian's ratio of Liquid assets to Total assets was about 56 per cent in 2006 (FY 2005:62 per cent) while Liquid assets to Insurance funds was 603 per cent (FY 2005:448 per cent).

Table 2: Industry Peer Performance Review

INSURANCE INDUSTRY PEER PERFORMANCE REVIEW							
	Ind. Avg	CORNERSTONE	LAW UNION & ROCK	LASACO	SOV.TRUST	STD INSU.	CUSTODIAN
Shares Outstanding	3.64	3.39	1.34	7.32	3.24	3.15	4.00
Market Capitalisation (N'bn)	13.25	14.08	5.94	22.04	12.12	12.90	12.45
Market Price (Nov.26, 2007)	3.85	4.15	4.44	3.01	3.74	4.09	3.67
Shareholders Funds	1.66	1.11	1.21	1.52	1.47	1.64	3.03
EPS(N)	0.16	0.21	0.16	0.13	0.12	0.17	0.17
DPS(N)	0.04	0.10	0.00	0.00	0.06	0.00	0.10
ROE (%)	15.2%	17.0%	13.6%	11.2%	15.6%	15.2%	18.8%
ROA (%)	11.0%	12.0%	4.0%	12.4%	12.1%	9.1%	16.1%
Book Value Per Share (N)	0.65	0.51	0.90	0.17	0.68	0.77	0.89
Earnings Yield (%)	4.15%	5.1%	3.6%	4.3%	3.2%	4.2%	4.6%
Dividend Yield (%)	2.2%	2.4%	0%	0%	1.6%	0%	2.7%
Dividend Payout	52.1%	47.6%	0.0%	0.0%	50.0%	0.0%	58.8%
Trailing EPS	0.25	0.40	0.56	0.11	0.16	0.16	0.11
Price/Earning Ratio (Nov. 26, 2007)	24.57	19.61	27.78	23.25	31.25	23.78	21.74
Price to Book Value	8.33	3.73	4.93	17.71	5.50	5.31	4.11
Price-to-Net Premium	17.89	51.88	5.67	20.07	10.68	8.52	10.49

Net Premium Per Share (N)	0.34	0.08	0.78	0.15	0.35	0.48	0.35
Gross Premium (N'bn)	1.44	1.29	1.33	1.6	1.42	1.37	1.60
Net Premium (N'bn)	1.07	0.28	1.05	1.08	1.14	1.51	1.38
Underwriting Exp (N'bn)	0.26	0.28	0.29	0.18	0.18	0.304	0.33
Underwriting Exp/Gross Premium (N'bn)	18.4%	21.7%	21.8%	11.3%	12.7%	22.2%	20.6%
Stock Volatility (β)	0.17	0.14	0.04	0.16		0.09	0.41

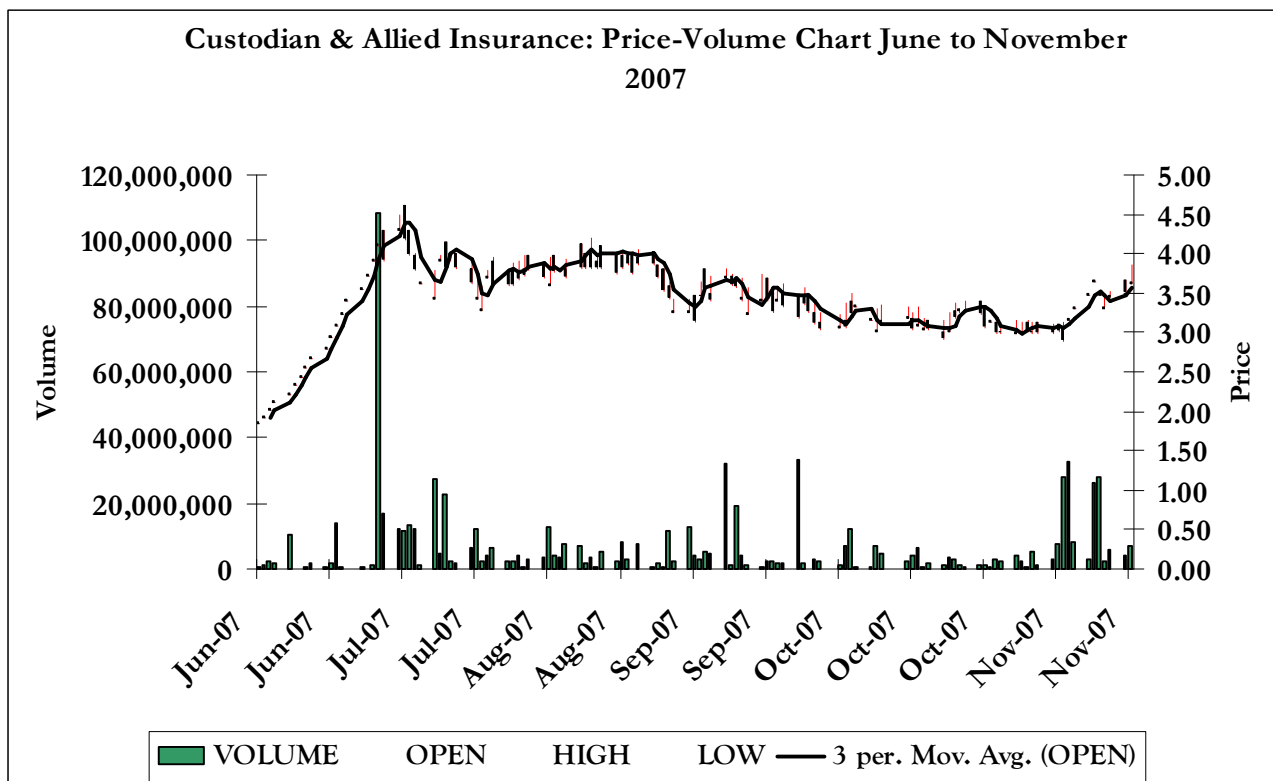
Technical Analysis and Stock Performance Review:

Custodian and Allied Insurance barely 6 months old on the floor of the Nigerian Stock Exchange (NSE) as its shares were listed on the floor of the Exchange on June 12, 2007 at N1.84k. Sequel to its listing, stock of immediately went on bid (in tandem with the general market trend of newly listed equities with promising future) for approximately one month within which the stock returned over 139% to investors to close at the all time high of N4.40k on June 9, 2007.

Following the bearish regime that laid siege on the market in the second and third quarters of 2007, the stock price descended slightly to a support level of above N3.01. The stock has enjoyed impressive patronage from investors since its listing with an average volume of about 6.6million shares traded on daily basis. By the close of market on November 28, 2007, the stock has returned 104 per cent and out performed the entire market which returned 65 per cent over same period.

Custodian has a volatility index of 0.40 (6 months) much lower than the market's of 1.0. This may not be reflective of the true price behaviour of the stock relative to the market since the time interval is rather too short. Meanwhile, performance trends of the stock as highlighted in the above paragraph may indicate that the stock is much more volatile than the market. However, there is a strong indication that the stock will hit its previous all time high of N4.40 and possibly surpass it in the weeks ahead as activity level in the insurance industry garners stronger momentum towards the year end.

Technical Chart:



Valuation Summary & Recommendation:

Two different valuation metrics were used in arriving at a fair value for CUSTODIAN AND ALLIED INSURANCE Plc. The first metric was based on trading multiples relative to prices of peers in the insurance industry. The second valuation method was based on the Present Value of Custodian's future cash flows, measured by discounting the company's future projected dividend payment into the present

From our Discounted Cash Flow Approach (DCF), we used a discount rate of 10.75 per cent and a perpetual growth rate of 9 per cent. We arrived at a final valuation of N4.91k after attaching appropriate weights to various valuation metrics we employed.

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