

Research Update:

DRAFT: Qualitas Outlook Revised To Positive On Stronger Financial Risk Profile, Ratings Affirmed

January 16, 2020

Overview

- We revised the outlook on our global and national scale ratings on Qualitas to positive from stable. This reflects our expectation that it will continue building its capital buffer through strong earnings. Predictability in capital management and stability of its capital adequacy above our 'BBB' category benchmark, according to our capital model, could lead to an upgrade in the next two years.
- We're revising our rating methodologies for insurers and their holding companies, which don't affect our ratings on Quálitas.
- Our ratings on Qualitas continue reflecting its solid business position and adequate capital levels. Thus, the insurer's group credit profile (GCP) remains at 'bbb'.
- We affirmed our global scale 'BB+' long-term credit issuer rating on the non-operating holding company, QualCon, and our long-term 'BBB-' issuer credit and financial strength ratings on its U.S.-based insurance subsidiary, Quic. At the same time, we affirmed our long-term 'mxAA+' national scale issuer credit and financial strength ratings, and short-term 'mxA-1+' issuer credit rating on Quálitas.

Rating Action

On Jan. 16, 2020, S&P Global Ratings revised its outlook on the global and national scale ratings on the three entities (together, Quálitas): Quálitas Controladora S.A.B. de C.V. (QualCon), Quálitas Compañía de Seguros S.A. de C.V. y Subsidiarias (Qualitas Compañía), and Quálitas Insurance Co. (Quic).

We also affirmed our global scale 'BB+' issuer credit rating on QualCon. In addition, we affirmed our national scale 'mxAA+' long-term issuer credit and financial strength ratings, and short-term 'mxA-1+' issuer credit rating on Quálitas. At the same time, we affirmed our 'BBB-' issuer credit and financial strength ratings on Quic.

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Outlook

Our positive outlook on all three entities reflects the possibility of an upgrade in the next two years if Qualitas' capitalization levels remain consistently above our 'BBB' benchmark category and its operating performance continues strengthening. We also expect Quálitas to limit exposures that could increase volatility to its capital and earnings, for example, by restraining growth in multiyear policies.

Downside scenario

We could revise the outlook to stable if Qualitas engages in aggressive capital management strategies, posing risks to capitalization levels remaining above our 'BBB' category benchmark. For example, if the company's dividend policy or share repurchases deviates significantly from its capital management strategy in the past two years. Also, aggressive growth in multiyear policies could prompt us to revise the outlook to stable in the absence of risk mitigation strategies to, for example, counter foreign exchange volatility.

A downgrade is unlikely in the next 12-24 months given the positive outlook and because it would require a deterioration in Quálitas' capital base or a major business disruption which is not in our base-case scenario.

Rationale

Our ratings on Quálitas reflect our opinion of its strong brand recognition, leading position in the Mexican auto insurance market, as well as its solid profitability. However, its operations are based mostly in a single country, Mexico, and single line of business limit the ratings. Our ratings also reflect our expectation that Quálitas' net income for the next two years will be similar to 2019 (measured as of September 2019), which will support its capitalization above our 'BBB' benchmark, according to our capital model. The company's record of somewhat aggressive capital management, including high dividend payouts, limit our assessment, although consistency of earnings and stability of its capital adequacy could lead to an upgrade.

QualCon is the non-operating holding company and parent of Quálitas Compañía de Seguros, its main operating entity, and Quic, which focuses on the Mexico-U.S. cross-border auto insurance business. QualCon also has smaller size operations in El Salvador, Costa Rica, and Peru.

Quálitas' satisfactory business risk profile is based on its sound competitive advantages in the Mexican marketplace. The company faces an intermediate insurance industry and country risk, because its operations are mostly in Mexico (see "Insurance Industry and Country Risk Assessment: P/C Mexico," June 7, 2018).

In our view, Quálitas' strong brand recognition among customers and agents support its competitive advantage in the Mexican marketplace. Quálitas remains the leading auto insurer in Mexico with a 28% market share as of September 2019, while its closest competitor has 12%. In addition, the company continues to report sound operating performance, which is in line with the country's top auto insurance competitors. Quálitas' five-year average property and casualty (P/C) combined ratio (CR) was 97% and return on equity (ROE) 27%, compared with 101% and 15%, respectively, among its top five market peers. During 2019, Quálitas' continues to prioritize new sales through its individual agents distribution channel, its profitable sales channel, doubling net income despite slower premium growth. As of September 2019, Quálitas kept its loss and

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acquisition cost ratios low, and increased its operating efficiency, resulting in a CR of 93% and ROE of 70%. The expansion of the agents channel offset the contraction of the company's financial entities channel. The latter was due to lower demand for auto insurance, amid the falling new car sales in Mexico, and diminished appetite for multiyear business through financial entities due to tighter margins and the challenges for pricing multiyear policies. The proportion of these policies in the portfolio decreased to 19% from 27%. Quálitas is planning to start a new health insurance business. However, the ratings don't reflect yet the possibility of Quálitas diversifying into new segments.

In our view, the contraction of multiyear policies benefits Quálitas' financial risk profile by reducing its risk exposure. In our view, fixing a price for multiyear contracts amid uncertainties over future claims expose auto insurers to volatile claim trends. In Mexico, for example, auto parts and repairs priced in foreign currency have increased the domestic insurers' loss ratios as the peso slid against the dollar in past years. Therefore, limiting Quálitas' exposure to multiyear policies reduces potential earnings and capital volatility.

The company continues to report strong earnings. Based on September 2019 figures, Quálitas is likely to report the higher net income for that year than in the past five years. This further supports our view of Quálitas' strengthening capital. Therefore, we consider its capital adequacy will be redundant with respect to our 'BBB' rating category threshold in the next two years. In recent years, Quálitas operated with relatively thin capitalization levels. In particular, we consider dividend payments have become more predictable, and we expect them to be about 85 cents per share for our forecast period. However, the company's capital management strategy would more likely center on its stock repurchase program in the future. We also consider that Quálitas will keep its regulatory capital ratio at least at 1.5x the minimum required. As of September 2019, its regulatory ratio was 4.49x, according to the company's figures. In addition, Quálitas maintains sound liquidity. We expect its liquidity ratio will remain above 120% in the next two years.

Our rating on Quic reflects its highly strategic subsidiary status. Therefore, the rating is one notch below the GCP. Our rating on QualCon is two notches below the GCP, reflecting the degree of structural subordination to policyholders' obligations. Quálitas Compañía is the main operating subsidiary; therefore, its national scale ratings reflect creditworthiness of Quálitas' core subsidiaries.

Finally, we consider that Quálitas has a skilled senior management. In addition, the company's corporate governance, apart from complying with regulatory requirements, includes board members with significant experience in insurance and other relevant areas, as well as independent directors.

Ratings Score Snapshot

Holding Company Rating	BB+/Positive
Business Risk Profile	Satisfactory
IICRA*	Intermediate Risk
Competitive Position	Satisfactory
Financial Risk Profile	Satisfactory
Capital & Earnings	Satisfactory
Risk Exposure	Moderately low
Funding Structure	Neutral

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Modifiers	0
Governance	0
Liquidity	Adequate
Comparable Ratings Analysis	Neutral
Support	0
Group Support	0
Government Support	0

*Insurance Industry And Country Risk Assessment. NB: Support does not consider Ratings Above Sovereign criteria.

Related Criteria

- Criteria | Insurance | General: Insurers Rating Methodology, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria | Insurance | General: Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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