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## Research Update:

# Quálitás Controladora 'BB+' Rating, And Subsidiaries 'BBB-' And 'mxA+/mxA-1+' Ratings Affirmed; Outlook Remains Stable

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## Research Update:

# Quálitas Controladora 'BB+' Rating, And Subsidiaries 'BBB-' And 'mxAA+/mxA-1+' Ratings Affirmed; Outlook Remains Stable

## Overview

- Our rating on QualCon, the Mexico-based non-operating holding company, reflects the strong brand recognition and solid operating performance compared with those of industry peers. However QualCon's business concentration partly limits our assessment. We continue assessing QualCon's capital redundancy as appropriate, according to our risk-based capital model.
- The rating on QualCon is two notches below its group credit profile (GCP), reflecting the degree of structural subordination to the group's operating subsidiaries. The rating on Quic, the U.S.-based insurer, is one notch below the GCP given its highly strategic subsidiary of QualCon.
- We affirm our global scale long-term credit issuer rating of 'BB+' on QualCon, and our long term issuer credit and financial strength ratings of 'BBB-' on Quic. At the same time, we affirmed our national scale long-term issuer credit and financial strength ratings of 'mxAA+' and short-term issuer credit rating of 'mxA-1+' on Mexico-based Quálitas, a core subsidiary of QualCon.
- All rating outlooks remain stable.

## Rating Action

On Feb. 20, 2019, S&P Global Ratings affirmed its global scale rating of 'BB+' on Quálitas Controladora S.A.B. de C.V. (QualCon). Also, we affirmed our national scale long-term issuer credit and financial strength ratings of 'mxAA+' and our short-term issuer credit rating of 'mxA-1+' on Qualitas Compania de Seguros, S.A. de C.V. y Subsidiarias (Quálitas). At the same time, we affirmed our 'BBB-' issuer credit and financial strength ratings on Qualitas Insurance Company (Quic). The outlook on all these companies remains stable.

## Rationale

Our ratings on Quálitas reflect our opinion of its business and financial risk profiles as solid. Our assessment on the former reflects Quálitas' sound competitive position thanks to its strong brand recognition, solid operating performance, and effective product distribution through various channels. During 2018, Quálitas reported satisfactory net income by implementing new

sales through its more efficient distribution channel and with better risk selection. With these changes, Quálitas reduced its acquisition cost and loss ratios. At the end of 2018, its capitalization level was below our 'BBB' rating category threshold. Nevertheless, our base-case scenario assumes a higher net income, which could allow the company's capital to exceed that threshold. However, our base-case scenario also considers some likely deviations stemming from the multiannual year policies (which represent 26% of Quálitas' policies) or from higher-than-expected dividend payments, given the company's capital management or dividend payout track record. These factors partly limit our financial risk profile assessment. We consider Quálitas has an experienced senior management, a suitable management and governance structure, and an appropriate risk management framework for its underwritten risks.

QualCon is the non-operating holding company and parent of Quálitas and Quic. The latter is the U.S.-based insurer focusing on the Mexico-U.S. cross-border auto insurance business. The group also has smaller operations in El Salvador, Costa Rica, and soon in Peru.

We consider Quálitas' business risk profile as satisfactory. The company faces an intermediate insurance industry and country risk, because its operations are mainly in Mexico (see "Insurance Industry and Country Risk Assessment: Mexico P/C And Health," June 7, 2018). We believe Quálitas' competitive position as satisfactory. The company benefits from strong brand recognition, leadership in Mexico's auto insurance segment (29% of market share as of September 2018), and solid operating performance, which is in line with those of the top auto insurance market participants. Quálitas' five-year average combined ratio (CR) was 97% and return on equity (ROE) was 22%. However, its high concentration in multiannual year policies partly limits our competitive position assessment. In 2018, Quálitas' gross premiums written rose 2%, because of a shift in its new sales distribution channels mix. This strategy enabled Quálitas to decrease the share of its financial institution distribution channel and to expand its individual and fleet channels. The multiannual policies were typically sold through the financial institutions channel, which we consider as riskier, given the recent widening in losses in the Mexican insurance industry. Therefore, Quálitas reduced its loss and acquisition cost ratios, and increased its operating efficiency in the last year, with a CR of 93% and an ROE of 28%. Nevertheless, the concentration in multiannual policies remains significant, in our opinion. We believe that the widening loss ratio of these policies, without the option to adjust their pricing until time to maturity, could offset the profit of healthier contracts and compromise the net income in the next three years. Our base-case scenario considers that the company will gradually reduce this exposure by increasing the share of annually renewable policies.

We continue to view Quálitas' financial risk profile as less than adequate. Based on the 2018 figures, the company had the highest net income in the last five years, and it reduced its capital deficiency, with respect to our 'BBB' rating category threshold, to 10% from 13%. Our base-case scenario for 2019-2021 assumes that Quálitas' internal capital generation will remain in

line with 2018 results, as long as its loss and total expense ratios stay below 68% and 27%, respectively. If factors materialize, Quálitas would be able to surpass the 'BBB' threshold category in the next two years. Our projections consider dividend payments of MXN1.4 per share, or nearly MXN600 million, for the same period.

However, the volatility stems from higher dividends, the share repurchase program, and widening of the loss ratio of multiannual policies, all of which are not captured in our model or projections. Therefore, we keep our financial risk profile assessment unchanged until we see evidence that the three factors behind volatility remain modest. On the other hand, we don't expect Quálitas' regulatory capital adequacy to fall below the 1.5x the minimum required. As of September 2018, its regulatory ratio was 1.84x, according to the domestic insurance regulator, Comision Nacional de Seguros y Fianzas.

The ratings on Quic reflect its highly strategic subsidiary status. Therefore, the rating is one notch below the GCP. The rating on QualCon is two notches below the GCP, reflecting the degree of structural subordination to the operating subsidiaries. The rating on Quálitas reflects its core subsidiary status, given that it's the group's main operating subsidiary. In addition, the rating on Quálitas is at the same level as the GCP.

## **Outlook**

The stable outlook on Quálitas reflects our expectation that it will remain as the leading player in Mexico's auto insurance market, and its credit fundamentals--including its operating performance and capital redundancy--as adequate. We also expect Quálitas to reduce its exposure to multiannual policies gradually in the next two years. The stable outlook on QualCon and Quic mirrors the one on Quálitas.

### **Downside scenario**

We could downgrade Quálitas and its subsidiaries in the next two years if capital redundancy is below our 'BBB' rating category threshold by 15% or more, according to our risk-based capital model. This could happen if Quálitas' dividend payments were higher than we expect and/or its operating performance deteriorates, resulting in CR above 100%. We could also lower ratings if there are significant threats to its market leadership, an erosion in operating performance or brand recognition; however, we consider these as unlikely in the next two years.

### **Upside scenario**

We could upgrade Quálitas and its subsidiaries if capital redundancy is consistently above the 'BBB' rating category threshold, the share of multiannual policies drops significantly, the internal capital generation rises, and dividend payment are lower than expected.

## Ratings Score Snapshot

	To	From
Holding Company Rating	BB+/Stable/--	BB+/Stable/--
Business Risk Profile IICRA*	Satisfactory Intermediate Risk	Satisfactory Intermediate Risk
Competitive Position	Adequate	Adequate
Financial Risk Profile Capital & Earnings Risk Position	Lower Adequate Upper Adequate Moderate Risk	Lower Adequate Lower Adequate Intermediate Risk
Financial Flexibility	Adequate	Adequate
Modifiers	0	0
ERM and Management	0	0
Enterprise Risk Management	Adequate	Adequate
Management & Governance	Fair	Fair
Holistic Analysis	0	0
Liquidity	Strong	Strong
Support	0	0
Group Support	0	0
Government Support	0	0

## Related Criteria

- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Insurance - General: Enterprise Risk Management, May 7, 2013
- Criteria - Insurance - General: Insurers: Rating Methodology, May 7, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- 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

### Ratings Affirmed

Qualitas Controladora S.A.B. de C.V.

Issuer Credit Rating

Global Scale BB+/Stable/--

Qualitas Compania de Seguros, S.A. de C.V. y Subsidiarias

Issuer Credit Rating

CaVal (Mexico) National Scale mxAA+/Stable/mxA-1+

Financial Strength Rating

CaVal (Mexico) National Scale mxAA+/Stable/--

Qualitas Insurance Company

Issuer Credit Rating

Local Currency BBB-/Stable/--

Financial Strength Rating

Local Currency BBB-/Stable/--

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](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column.

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