

Medical Securities Ltd.

Rationale

The rating on Medical Securities Ltd. (MSL) reflects the company's position as a core operating subsidiary and financial services provider of Medical Assurance Society New Zealand Ltd. (MAS; not rated), a group servicing healthcare professionals in New Zealand. MAS services a loyal high-net-worth customer base of medical practitioners and other health professionals, and has successfully captured a stable share of this niche market by providing a diverse range of adequately priced products. MSL shares this customer base with rated insurer, Medical Insurance Society Ltd. (MIS; A-/Stable/-). Since MAS already has a high penetration of its niche market, the group is targeting other members with a high-quality profession like lawyers, architects, engineers, and accountants. As a consequence, cross-selling opportunities exist, which can support MSL's ability to pursue business growth.

On a stand-alone basis, MSL's financial profile is modest, reflecting its limited business-growth potential for its niche; good capital ratios, although small absolute capital base; and modest but satisfactory profitability. A good credit loss record and adequate funding and liquidity position support the rating. Given its niche focus, MSL is not a significantly large participant in the New Zealand finance-company industry, with a total asset base of NZ\$236 million at year ended March 2008.

Standard & Poor's Ratings Services assesses the rating on MSL from a group perspective, taking into account MAS' strong business franchise and good financial position. MSL is considered a core subsidiary of MAS under Standard & Poor's criteria for group entities. In addition to full ownership, MSL's core status is based on MSL operating in a line of business and servicing a customer base that are of significant importance to its parent. MSL accounted for a material 38% share of group consolidated capital at fiscal 2008. The 'core' status is also supported by MSL's integration with the group's risk-management framework.

The finance company market in New Zealand continues to face very difficult conditions, with more than 20 debenture-funded finance companies defaulting since early 2006. Together with increased volatility in global credit markets, industry defaults have

Counterparty Credit Rating

A-/Stable/—

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contributed to material investor uncertainty among debenture-holders and to a significantly more-challenging funding environment. Investor uncertainty is expected to continue for some time, leading to funding pressures for a number of market participants. MSL has not been immune to the increased investor uncertainty but is better placed, compared to many competitors, to contend with these conditions. This is because of its higher-quality member base compared with many other New Zealand financial-services providers', and investors' loyalty to the group. MSL investors currently are restricted to only members of MAS. Moreover, with committed bank facilities, there is less reliance on debenture funding than many peers.

Asset quality is considered strong, and is expected to benefit from well-controlled underwriting standards and a good-quality customer base. MSL has a low charge-off history, and a low ratio of nonperforming assets (NPA) to gross loans. Management's growth strategy is conservative, highlighted by MSL's decision to not relax underwriting standards while writing new business. Although this has caused a contraction of the loan book, it reflects management's lower risk appetite.

The company's profitability is satisfactory, benefiting from sound net interest margins (NIM) and operating efficiency, and low credit costs. Earnings growth has been affected by a contraction of the loan book by an average of 3% over the past three years. Standard & Poor's believes that the company's earnings base is susceptible to the competition in the industry, particularly if MSL were unable to match competitors' pricing levels and continued to experience significant contraction in its loan book.

The adjusted total equity of NZ\$39.7 million at fiscal 2008 is small in absolute size, and hence more sensitive to one-off losses. However, the contraction of the loan portfolio over the past four years has improved the risk-based capitalization level for the company. The currently strong level of capital within the group, and Standard & Poor's expectation that MSL has access to these funds, alleviate some concern about the small size of MSL's capital. MAS' financial flexibility, however, is moderate, given its mutual status.

Liquidity

MSL's funding position is sound, comprising retail debentures, unsecured notes, and committed credit lines. Funding is adequate for MSL's risk profile with 35% of funds sourced from the retail debenture market, and 65% sourced from banks.

The funding profile is supported by access to a NZ\$155 million bank facility, which is backed by strong financial covenants. MSL's syndicated credit facility is led by ANZ National Bank Ltd. (AA/Stable/A-1+), and supported by Westpac Banking Corp. (AA/Stable/A-1+). Management has a conservative attitude toward liquidity management. Generally, MSL prefers to rely on undrawn committed credit lines rather than to hold liquid assets on-balance sheet. However, with recent investor uncertainty in the industry, management has opted to draw down on its credit line and maintain NZ\$36 million in cash (about 15% of total assets).

Outlook

The stable outlook reflects MSL's ability to continue to leverage off MAS' strong business franchise, underpinned by a niche-market focus. A lower rating could occur from a weakened commitment by MAS as it would lessen MSL's importance to the group.

An improvement in MSL's stand-alone credit profile could occur if it were able to generate strong business-growth momentum, while managing interest margins and asset quality, and increasing its penetration of the group's existing membership base. Conversely, significant

deterioration in funding and liquidity levels with heightened industry pressures can result in a lower rating. The rating could also be lowered due to a deteriorating membership retention rate and material dilution of its franchise.

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