

Stock Market Review

Edward Rizzo

Mr Rizzo is director of Rizzo, Farrugia & Co. (Stockbrokers) Ltd.



Middlesea's first loss in 27 years has been mostly due to the Italian subsidiary.

The Italian job

Although the title to this week's article refers to the American movie released in 2003, I am not attempting to write a film review but I am reviewing the results of Malta's largest insurance company, Middlesea Insurance plc. Many might wonder why I chose this title. In my view this gives an immediate insight into the main reason behind the substantial loss of €20.6 million incurred by this insurance group of companies in the last financial year.

While many observers would have rightly expected the Middlesea Group to suffer during 2008 due to the dependence of an insurance company's financial results on the performance of global stock markets, the extent of this year's loss (the first in Middlesea's 27-year history) is mostly due to the Italian subsidiary, Progress Assicurazioni SpA. The initial investment in the Italian insurance company through an acquisition of shares from Corporation Mapfre was made in August 2000 and was completed five years later. In the interim, Mapfre acquired a 21 per cent shareholding in Middlesea Insurance.

During a meeting convened for stockbrokers shortly after the publication of the full-year results on April 28, Middlesea's chairman and CEO Mario Grech together with the heads of the main operating companies delved into great detail on the 2008 performance and strategy going forward. Although Mr Grech initially explained that the fact that Progress had registered a loss was not a surprise to the company and this had also been reiterated to shareholders during the Annual General Meeting held in June 2008, the extent of the loss was unexpected and surely much larger than anticipated by the market and the various shareholders of Middlesea.

The reason for the sharp deterioration within Progress is mainly due to the changes introduced by the Italian government (the 'Card system') with the ultimate objective of creating a more efficient system for third parties. Although this new system was introduced in 2007 and the Middlesea Board of Directors was

aware that this would lead to a negative impact on the Italian company (hence the warning during the June 2008 AGM), the extent of the losses suffered by the new system seem to have caught everyone by surprise. As a result of the introduction of the Card system, Progress suffered a loss of €9 million. Moreover, during the second half of the year a detailed exercise was undertaken by Progress on all large outstanding claims and this exercise revealed that the company's reserves needed to be increased by €8 million.

Also, in view of the loss ratio which amounted to 114 per cent, Progress was required to set aside a further €4.6 million. The Italian insurance company incurred an overall loss of €19.1 million during the year, even though it took advan-



Middlesea Insurance p.l.c.

tage of the Anti-Crisis Decree enacted in Italy which enabled it to value its investment portfolio as at June 30, 2008 rather than December 31. The change in the date of valuation helped the company not to account for €4.9 million in unrealised losses on its investment portfolio. These unrealised losses in Progress' investment portfolio were mostly as a result of its small overall exposure to international equities. The head of the Italian company confirmed that Progress holds a very conservative portfolio with an 89% exposure to fixed income securities.

Following the serious setbacks suffered in Italy, Mr Grech announced to stockbrokers that Progress is conducting a management restructuring exercise and creating five business units as well as effecting a number of changes to the business strategy. Since the new recovery system put in force had a very negative effect on the motorcycle business, Progress is seeking

to remove the motorcycle class of business from its portfolio and has also taken steps to significantly downsize the agency network of the company, especially the activities of two of the largest agents in the most problematic region. Apart from the setback following implementation of the new system, the Italian insurance market is currently entering a downturn and in this respect both Middlesea's chairman and CEO as well as the head of Progress hinted that the performance of Progress is unlikely to return to the levels seen in recent years, despite a number of hikes in premium rates which started in November 2008 and expected to follow in June 2009 and in the final quarter of the year. Apart from the serious issues within the Italian

the company's international base. The head of IIMS reported during the meeting that 30 per cent of the company's revenue is from third-party business.

In reply to questions from the floor, Mr Grech argued against the need for a fresh capital injection into Middlesea as a result of the excess capital retained over the years. Instead, he re-iterated the intention to conduct an overall restructuring exercise with the ultimate aim of segregating the operational activity of Middlesea from the current public company.

Essentially, the holding company of the Group will be listed on the Malta Stock Exchange and in turn this will hold the shares in a new operating company conducting the insurance activities in Malta and Gibraltar (which are currently being conducted by Middlesea Insurance plc), together with the investments in the Italian company as well as the life company. This will enable Middlesea to consolidate the Maltese market by partnering some of the established companies without bringing MSV and Progress into the equation.

The change in fortunes for the Middlesea Group from operating within a very controlled and dominant position on the local market to seeking international business opportunities outside Malta shows the risk being undertaken by some companies which seek to branch out into other territories (sometimes complex and relatively unknown).

While maintaining a local presence may not achieve the desired objective of improving shareholders' returns over the medium to long term, the potential losses that may be suffered from companies operating in larger markets may often be very meaningful and difficult to absorb by a local company.

This is not only true for the few listed companies which have ventured outside our shores but also for the many private companies and individuals that have moved in that direction, some with almost fatal consequences.

“
The reason for the sharp deterioration within Progress is mainly due to the changes introduced by the Italian government.
 ”

Rizzo, Farrugia & Co. (Stockbrokers) Ltd, RFC, is a member of the Malta Stock Exchange and licensed by the Malta Financial Services Authority. This report has been prepared in accordance with legal requirements. It has not been disclosed to the issuer/s herein mentioned before its publication. It is based on public information only and is published solely for informational purposes and is not to be construed as a solicitation or an

offer to buy or sell any securities or related financial instruments. The author and other relevant persons may not trade in the securities to which this report relates (other than executing unsolicited client orders) until such time as the recipients of this report have had a reasonable opportunity to act thereon. RFC, its directors, the author of this report, other employees or RFC on behalf of its clients have holdings in the securities herein mentioned

and may at any time make purchases and/or sales in them as principal or agent. Stock markets are volatile and subject to fluctuations which cannot be reasonably foreseen. Past performance is not necessarily indicative of future results. Neither RFC nor any of its directors or employees accept any liability for any loss or damage arising out of the use of all or any part thereof and no representation or warranty is provided in respect of

the reliability of the information contained in this report.

© 2009 Rizzo, Farrugia & Co. (Stockbrokers) Ltd. All rights reserved.
www.rfstockbrokers.com

