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Research Update:

Vienna Insurance Group Wiener Staedtische Versicherung Affirmed At 'A+' On Demerger Of Austrian Business; Outlook Stable

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Overview

- Austria-based composite insurer Vienna Insurance Group Wiener Staedtische Versicherung AG's (VIG AG's) financial strength is unaffected by the demerger of its Austrian business.
- We are affirming our counterparty credit and debt ratings on VIG AG.
- We apply zero-notch gapping between the restructured parent company VIG AG, and the group's overall financial strength.
- We maintain a two-notch differential between the counterparty credit rating on VIG AG and the rating assigned to the €500 million undated subordinated notes.
- We maintain a three-notch differential on the two subordinated notes issued in 2005.
- The stable outlook reflects our view that management will continue to successfully develop the group's CEE businesses, despite a weakened economic outlook.

Rating Action

On Jan. 26, 2010, Standard & Poor's Rating Services affirmed its 'A+' long-term counterparty credit and insurer financial strength ratings on Austria-based composite insurer Vienna Insurance Group Wiener Staedtische Versicherung AG (VIG AG). The outlook is stable. At the same time we affirmed the 'A-' junior subordinated long-term debt rating on the €500 million undated, subordinated notes issued by the company in 2008 and 2009, as well as the 'BBB+' junior subordinated debt ratings on the total €300 million subordinated fixed-to-floating-rate notes and on the perpetual subordinated bonds.

Rationale

The affirmation follows today's announcement by group management that it intends to separate the holding function and demerge its Austrian insurance business into a newly founded operating insurance subsidiary. After the demerger, VIG AG plans to focus on the strategic management and optimization of the financial and earnings profile of the group's sizable primary insurance operations, which hold leading market positions in Austria and Central and Eastern Europe (CEE). As part of its role as the group's parent company with strategic management responsibilities, VIG AG will also steer and underwrite group reinsurance and commercial business with international clients centrally.

The proposed restructuring, which represents a group-internal reallocation of business, will, in our opinion, not negatively affect the strength of the Vienna Insurance Group's (VIG's) business, earnings, and financial profile. The ratings on VIG AG are derived from its ownership in and the financial strength of its primary insurance operations.

We would apply a zero-notching gapping between VIG AG and the group's overall financial strength given that, after the demerger, we expect VIG AG to primarily act as a regulated reinsurer for several of VIG's core insurance businesses. In addition, the company is likely to have access to significant own liquid assets of at least €400 million and unrestricted access to substantial free reserves of the newly founded Austrian subsidiary. Furthermore, it is our belief that financial leverage and fixed-charge coverage will remain at a very conservative level of below 20% and 7X, respectively.

In our opinion, VIG AG be able to generate its own sustainable cash flows from a variety of dividend-independent sources, such as regular yields from own high quality and low-risk assets, group reinsurance, and direct insurance business with commercial customers. In addition, we expect VIG AG to continue to hold the bulk of the group's excess capital and reserves and act as the main vehicle for all financing transactions, allowing efficient and flexible capital allocation.

We also continue to apply the two-notch differential between the counterparty credit rating on VIG AG and the rating assigned to the €500 million undated subordinated notes, reflecting the level of subordination and the interest deferral terms. Because of the company's largely unchanged financial strength continuing to carry most of the group's financial resources after the merger, we consider it highly unlikely that mandatory deferral, which is linked to a combined capital and earnings test, would be triggered.

The ratings on VIG AG reflect the group's very strong competitive position in Austria and CEE, our positive view of management, the group's very strong capitalization, and resilient operating performance. These strengths are partly offset by concerns about lower growth and earnings prospects, owing to the difficult economic and financial market conditions and relative overexposure to credit risk through investment in CEE.

Outlook

The stable outlook reflects our view that management will continue to successfully develop the group's CEE businesses, despite a weakened economic outlook. The focus on CEE and the relative immaturity of the region should allow the group's growth to surpass that of similarly rated peers. We expect the group's operating earnings to remain in excess of €400 million in 2009 and 2010, supported by a net combined ratio of about 96% and life new business margins of more than 4%. Capitalization should remain very strong and regulatory group solvency at about 150%. Non-Austrian operations are likely to contribute about 50% of the group's profits by 2011.

We expect VIG AG to maintain its high liquidity, very conservative financial leverage and fixed-charge coverage, as well as its access to group internal reserves, at least at the current levels. Its own flexibility should, therefore, in our view, remain sufficient to fund its interest payments in order to support the zero notching.

We could revise the outlook to positive if economic and financial market conditions stabilize and reduce the risks from the group's credit exposures and potential earnings volatility, clearing the way for VIG AG and the group as a whole to continue on the path of positive underlying growth and earnings.

We might lower the ratings if further deterioration of economic or financial market conditions were to significantly challenge our operating profit expectations for VIG AG and the group over a sustained period or if unexpectedly high investment losses were to lead to marginal net income and were large enough to erode the group's very strong capital base.

Related Research

- Vienna Insurance Group Wiener Staedtische Versicherung AG Full Analysis, June 30, 2009
- Wiener Staedtische Versicherung AG's Perpetual Junior Subordinated Notes 'A-' Rating Affirmed, June 5, 2008

Ratings List

Ratings Affirmed

Vienna Insurance Group Wiener Staedtische Versicherung AG

Counterparty credit rating	A+/Stable/--
Financial strength rating	A+/Stable/--

NB: This list does not include all ratings affected.

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