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Menora Mivtachim Insurance Ltd.[1]

Monitoring | June 2018

This credit rating report is a translation of a report that was written in Hebrew for a debt issued in Israel.

The binding version is the one in the original language.

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1 Ms. Avital Stein is an external Board member of Menora Mivtachim Holdings Ltd., the parent company of Menora Mivtachim Insurance Ltd., and is also an external Board member of Midroog Ltd. Ms. Stein has no bearing on ratings set by Midroog Ltd.

Menora Mivtachim Insurance Ltd.

Insurer financial strength (IFS) rating	**Aa2.il**	**Rating outlook: Stable**
Subordinated Tier II and Tier III capital	**Aa3.il (hyb)**	**Rating outlook: Stable**
Hybrid Tier II capital/Tier II capital [2]	**A1.il (hyb)**	**Rating outlook: Stable**

Midroog affirms Aa2.il Insurer financial strength (IFS) rating of Menora Mivtachim Insurance Ltd. ("Menora Insurance" or "the Company") rating for subordinated notes (subordinated Tier II and Tier III capital) and affirm A1.il(hyb) rating for subordinated notes (Hybrid Tier II capital/Tier II capital[2]) issued by the Company and by its subsidiary, Menora Mivtachim Insurance Capital Issuance Ltd. Rating outlook – Stable.

Outstanding debentures rated by Midroog:

Debenture series	Securities ID	Rating	Rating outlook	Type of regulatory approved capital[3]	Final maturity
A	1103670	Aa3.il(hyb)	Stable	Subordinated Tier II	July 1, 2022
B	1124759	A1.il(hyb)	Stable	Hybrid Tier II	October 14, 2024
C	1131911	A1.il(hyb)	Stable	Hybrid Tier II	October 1, 2030
D	1135920	Aa3.il(hyb)	Stable	Hybrid Tier III	July 1, 2027
–	Non-tradeable	A1.il(hyb)	Stable	Hybrid Tier II	July 1, 2034
E	1143411	A1.il(hyb)	Stable	Tier II capital	June 30, 2032

Summary of rating rationale

The Company rating reflects its appropriate business profile, as reflected in its size and in diversified business lines which support its revenue generation ability, as well as a risk profile that is positive for the rating, involving relatively low product risk along with relatively moderate exposure to major clients. The Company's financial profile is limited by asset quality and financial flexibility which are not an outstanding positive for the rating, as well as low profitability. The Company's capital adequacy is appropriate for the rating and has good loss absorption capacity under Midroog's stress scenarios. Conversely, expected improvement in the capital cushion is limited over the short term, due to low and volatile potential profitability and given our assessment of dividend distribution of up to 50% of net earnings. The liquidity profile is reasonable for the rating and is supported by relatively long maturities of liabilities.

According to Midroog's capital model, the Company has risk-adjusted capital surplus that is appropriate for the current rating (under the third most severe stress scenario out of five, near the limit for the second most severe stress scenario), with a capital adequacy of 121% under this scenario. The main risks to which the Company is exposed, as perceived in the model, derive from insurance risks and in particular life expectancy risks in policies

2 Tier II recognized under the Solvency II Directive, issued as from June 2017

3 In conformity with the Solvency II Directive, subordinated Tier II capital, Hybrid Tier III capital and Hybrid Tier II capital are recognized as Tier II capital.

with guaranteed annuity and from market risks in the nostro portfolio (guaranteed-return life insurance, P&C and equity). The Company's Solvency Capital Ratio (SCR) in conformity with the new directives as of December 31, 2016 was 124% (without accounting for provisions for the transition period). The regulatory capital adequacy for the Solvency II Directive is outstandingly positive compared to the peer group, supporting the business flexibility and hence the rating and allows the Company to execute strategic moves and to take benefit from its relative advantages over the competition. Midroog expects the Company to act to maintain a safety margin from the regulatory barrier, given the higher volatility relative the current regime, where significant dividend distribution that would erode capital may have a negative impact on the rating.

In our forecast base scenario for 2018-2019, we expect a continuation of the challenging business environment, similar to previous years, which would continue to over-shadow the insurance industry, especially the potential for generating profits and the ability to build up the capital cushion from current earnings. This would continue to be positively affected, in our estimate, by relatively stable GDP growth (3.4%-3.5% in 2018-2019) and low, stable unemployment rate which support further improvement in real wages. Conversely, the low interest and inflation environment, some stability in curve slope, along with volatile returns on the capital market and exposure to regulatory burden, which promotes competition and causes additional costs in certain segments, are a continuing challenge for the insurance industry. We note that we expect further improvement in penetration rates, in particular in the healthcare segment, to somewhat moderate competition in the market.

Under this scenario, we estimate that the Company would maintain its business positioning, while increasing the gross earned premiums from organic operations by a cumulative 5%-8% compared to 2017, with potential growth arising primarily from the life insurance and healthcare insurance sectors.

We believe that the Company's profit margins should remain low for the rating, given the expense ratio (operating efficiency) that is not an outstanding positive; ROC and ROA ratios should range between 0.5%-2.0% and 0.0%-0.2%, respectively, over the forecast range.

The stable rating outlook reflects our expectation that the company would maintain key ratios in the range of our base scenario.

Menora Mivtachim Insurance Ltd. - Key financial data (NIS in millions)

	March 31, 2018	March 31, 2017	December 31, 2017	December 31, 2016	December 31, 2015
Total assets	**43,316**	**39,660**	**42,153**	**38,860**	**36,424**
Total equity attributable to equity holders of the Company	**1,599**	**1,593**	**1,690**	**1,569**	**1,475**
Total comprehensive income (loss) attributable to equity holders of the Company	**(31)**	**24**	**121**	**94**	**(14)**
Total Earned premiums, gross	**1,791**	**1,500**	**6,155**	**5,870**	**5,079**
Of which: life insurance and long-term savings	1,002	738	3,014	2,884	2,318
Of which: healthcare insurance	192	168	705	627	566
Of which: P&C insurance	596	594	2,436	2,360	2,195
Total premiums earned in residual	**1,600**	**1,307**	**5,393**	**5,136**	**4,363**
Total investment gain (loss)	**162**	**363**	**2,223**	**1,159**	**913**

Midroog's adjusted ratios

Intangible assets and long-term deferred acquisition costs to shareholder equity	67%	64%	63%	64%	66%
Return on capital (ROC) [1]	-3.9%	3.3%	4.1%	3.3%	-0.5%
Return on assets (ROA) [2]	-0.3%	0.2%	0.3%	0.2%	0.0%
Adjusted debt to adjusted debt and shareholder equity [3]	53%	48%	47%	49%	50%
Adjusted earnings before interest and tax (EBIT) to interest expenses	-1.0x	14.1x	3.4x	-0.1x	1.8x

[1] Comprehensive income to average financial liabilities and equity attributable to shareholders for the period, annualized

[2] Comprehensive income to average assets in the period, annualized

[3] Adjusted debt including financial liabilities and liabilities in respect of employee benefits, net

Detailed rating considerations

Appropriate business profile, reflected in Company size and diversified business lines, supporting its revenue generation capacity

Menora Insurance has a relatively strong brand, also reflected in an appropriate renewal rate in some sectors, an extensive, diversified client base and a diversified operating mix, which support its business positioning. The Company is the fifth largest insurer in Israel as of December 31, 2017, in terms of gross premiums, with total assets under management amounting to NIS 38 billion. The Company size is also reflected by relatively significant market shares over time (10% on average in recent years), primarily in P&C insurance.

Despite its relatively strong positioning, we believe the Company has only reasonable control over distribution, as reflected in its expense structure, which primarily relies on external insurance agencies. We believe that similar to other companies in this industry, the Company would act in coming years to diversify the distribution model, reinforcing the direct distribution channel. However, we believe that its share of the marketing channel mix would not be material over the short term.

The Company has appropriately diversified business lines, which include a wide range of insurance products and support the revenue generation capacity across the cycle. This diversification is reflected by three significant components: Life insurance (50% of total gross premiums on average for the past three years), P&C insurance, which is diversified by its nature (40% of total gross premiums on average for the same period) and healthcare insurance (10% of total gross premiums on average for the same period), which also provides future growth potential for the industry and for the Company, given the relatively low penetration rates. On the other hand, we note that revenue diversification is not properly reflected in earnings, due to the expense rate that is not outstandingly positive.

Under Midroog's base scenario for 2018-2019, we estimate that the Company would maintain its business positioning, while increasing the gross earned premiums from organic operations by a cumulative 5%-8% compared to 2017, with potential growth arising primarily from the life insurance and healthcare insurance sectors.

The life insurance sector has enjoyed, over the past year, a higher average contribution rate as percentage of wages, due to the low unemployment environment. While we do not expect further growth in the contribution rate in 2018, we expect the supportive macro-economic environment to continue, including stable growth (3.4% and 3.5% for 2018-2019) and stable unemployment, which should contribute to further, slow real wage growth. Therefore, in the life insurance and LTS sector, we expect the Company would grow at a rate higher than GDP growth, primarily due to current contributions and our estimate of a certain continued increase in real wages, without a significant addition of non-recurring premiums, compared to recent years. In the healthcare sector, further to our aforementioned estimates, we assume some moderation in premium growth compared to recent years, while maintaining market share and continued focus on individual insurance, which should remain high and supported by the relatively low penetration rate for the market and, conversely, continued competition in this sector should continue to generate some price pressure in this sector. In the P&C insurance sector, we expect stability or a moderate increase in premiums, given the continued growth in competition in this sector and limited pricing flexibility, due to underwriting margins (net combined ratio) relatively low.

The risk profile is good for the rating, with relatively low product risk and relatively moderate exposure to major policy holders

The Company is characterized by relatively low product risk, which supports its underwriting capacity and reduces insurance risk, due to the higher level of certainty. In P&C insurance and short-term healthcare insurance, some 68% of total gross premiums in the past 12 months and over time are with respect to "short-tail" insurance contracts, which in our opinion are characterized by lower insurance risk than "long-tail" contracts, due to higher uncertainty and lower business flexibility due to change in the business environment. Furthermore, the Company hedges insurance risk in the P&C insurance segment through highly-rated re-insurers, with relatively stable exposure in residual given a catastrophic event, at 3% of regulatory approved capital as of December 31, 2017.

The rate of "low risk" reserves, as per our definition, in long-term life and healthcare insurance is an outstanding positive over time, at 54% as of December 31, 2017. This ratio reflects the good risk profile, given the relatively low exposure to return-guaranteed provisions (excluding HETZ debentures) which expose insurers to significant external change, including change to the interest curve and capital market volatility, in addition to demographic risk. In the short and medium term, we do not anticipate material change in the reserve mix, given the expected operating mix.

Moreover, the risk profile is supported by relatively moderate exposure to major collectives and policy holders, which exposure may enhance the insurance risk, credit risk and sector risk across the cycle and limit the risk-adjusted pricing, given the clients' economies of scale. Total exposure to major clients was at 10% of gross earned premiums as of December 31, 2017, which is supportive of the rating and typical for the Company over time. Note that most of this exposure is in the P&C insurance sector, accounting for 20% of total gross premiums in this sector in recent years.

We believe that the Company's risk management policy and controls are appropriate for the rating and supported by regulatory requirements, with the Company having started to implement and report its Solvency II ratios. Complete implementation of this Directive should further improve the risk management processes at the Company (as well as in the industry) and should support improvement in the risk profile over time and in measurement of economic capital, albeit this capital should be more volatile. The Company's relatively good preparedness for capital requirements under the new capital regime further supports the Company's good risk management practice and its business flexibility. We note that the Company has set its target capital for dividend distribution (expected distribution of up to 50% of net earnings) at 10% above the required capital as of December 31, 2017, with gradual growth to a 15% margin over the required capital in 2024. The Company's Solvency Capital Ratio (SCR) in conformity with the new directives as of December 31, 2016 was 124% (without accounting for provisions for the transition period). The Company has already conducted a first distribution in early 2018. We assume that the Company would continue to distribute earnings to the parent company, Menora Mivtachim Holdings Ltd. (hereinafter: "**the Parent Company**"), which is rated Aa3.il / Stable outlook over the forecast range. Should such distribution erode the capital base and not be adjusted for current earnings generation capacity, as was the case in the first quarter of 2018, Midroog would consider this a burden on the Company's risk profile. We note, however, that the Parent Company is not dependent on dividends distributed by the Company for its debt service over the short to medium term and relies on other sources (Menora Mivtachim Pension and Provident Funds Ltd.), which reduces the pressure on distributions by the Company. We note that the Company is still the main focal point of the consolidated operations of the Parent Company and has business connections to other Group companies.

Asset quality is not an outstanding positive for the rating, with a relatively high ratio of intangible assets to shareholder equity

We believe that the Company's nostro investment profile indicates a risk appetite that is reasonable for the rating, as reflected by the ratio of adjusted "assets at risk"[4] to regulatory approved capital at 60% as of March 31, 2018, which has been growing over the past two years (2016: 50%), concurrently with the increase of their share of the nostro portfolio to 30% of this portfolio (excluding guaranteed-return life insurance) (2016: 22%), which indicates a certain increase in risk appetite.

The investment mix in the nostro portfolio primarily consists of government debentures, at 35%, private loans (primarily mortgages) at 15%, corporate debentures (across the rating scale) at 20% and bank deposits at 10%, with other investments being relatively diversified. We expect no material change in the investment mix over the short term, hence in the risk appetite as well, with further focus on non-negotiable assets, given the current interest environment which poses a challenge to maintaining potential returns.

The ratio of intangible assets and deferred acquisition costs (DAC) in life insurance, with typically a "softer" valuation, to shareholder equity is still high and is not an outstanding positive for the rating, at 67% as of March 31, 2018. We expect no material change in this ratio over the short and medium terms, given our expectation of some stability in the operating mix and in particular, in new origination in the life insurance sector and potential build-up of the capital cushion.

The Company's capital adequacy is appropriate for the rating; the potential for improvement in the capital cushion is limited over the short term

In accordance with Midroog's capital model, the Company has risk-adjusted capital surplus that is appropriate for the current rating (under the third most severe stress scenario out of five, near the limit for the second most severe stress scenario), with capital adequacy ratio of 121% under this scenario. The main risks to which the Company is exposed, as perceived in the model, derive from insurance risks and in particular life expectancy risks in policies with guaranteed annuity and from market risks in the nostro portfolio (guaranteed-return life insurance, P&C and equity), with diversification of operations and correlations between operations reducing the required capital by 23%. Against these risks, the Company has an economic capital cushion with adjusted shareholder equity as of March 31, 2018 amounting to NIS 1.7 billion and adjusted VIF amounting to NIS 2.0 billion.

As a complementary test, not based on risk weighting for insurer leverage, we consider the ratio of equity to total assets (excluding assets for return-dependent contracts) excluding 10% of assets at risk, which reflect the expected erosion in asset value under more stringent scenarios. This ratio has been eroding in recent years, to 8% as of March 31, 2018 – a level that is not an outstanding positive for the rating. We believe that over the short and medium terms, this ratio should continue to be marginally eroded, primarily due to increase in operations without

[4] High risk assets generally include all financial investment assets other than cash, Government debentures and investment-grade corporate debentures, with the weighting of the latter based on partial reliance reflecting risk of potential impairment over the credit cycle due to credit, market or liquidity risk.

concurrent increase in capital. We expect that build-up of the capital cushion over the short and medium terms would be limited, given the challenging business environment, which we believe results in relatively low and volatile potential for earnings accumulation, as set forth below, as well as our expectation of dividend distributions at up to 50% of net earnings in this period.

In June 2017, updated directives were published for implementation of an economic solvency regime for insurers, based on Solvency II ("the new directives"), whereby insurers would maintain an economic solvency regime in accordance with the directives and concurrently comply with existing capital regulations pending approval by the Commissioner of an audit of implementation of the new directives on the financial statements. Given the elimination of the old capital regulations, the Company has transitioned exclusively to an economic solvency regime. The Company's Solvency Capital Ratio (SCR) in conformity with the new directives as of December 31, 2016 was 124% (without accounting for provisions for the transition period[5]). The regulatory capital adequacy for the Solvency II Directive is outstandingly positive compared to the peer group, supporting the business flexibility and hence the rating and allows the Company to execute strategic moves and to take benefit from its relative advantages over the competition. Midroog expects the Company to act to maintain a safety margin from the regulatory barrier, given the higher volatility relative the current regime, where significant dividend distribution that would erode the capital base may have a negative impact on the rating.

Low profitability relative to the rating; Expected further pressure on profitability due to the challenging business environment

The Company's profitability has been weak for the rating and by comparison to the industry in recent years, further limited by low underwriting profitability and an expense ratio which is not an outstanding positive. The industry exposure and the Company exposure to external factors, particularly to the capital market, the interest rate curve and the lack of significant underwriting profitability, result in volatility in profitability, as reflected in the Company's ROC and ROA ratios ranging between 0.5%-4.2% and 0.0%-0.4%, respectively, in 2014-2017. Profitability in this period was due to the need to supplement reserves in light of the continuing decline in the interest rate curve, volatility in the capital market, which impacted collection of variable management fees and investment gains, as well as impact of the Vinograd Commission on the capitalization interest rate for Social Security claims, which have affected and may continue to affect the underwriting profitability in mandatory motor liability insurance and liability insurance.

In our forecast base scenario for 2018-2019, we expect a continuation of the challenging business environment, similar to previous years, which would continue to over-shadow the insurance industry, especially the potential for generating profits and the ability to build up the capital cushion from current earnings. This should continue to be affected by relatively stable GDP growth (3.4% to 3.5% in 2018-2019), the low interest, low inflation

[5] The capital required for solvency of an insurer in the period from June 30, 2017 to December 31, 2024 would gradually increase by 5% annually, from 60% of SCR to 100% of SCR.

environment, some stability in the steepness of the curve along with volatile returns on the capital market and exposure to the regulatory burden, which promotes competition and generates additional costs in certain segments. Conversely, penetration rates should continue to grow, in our opinion, which would somewhat moderate market competition.

In the life insurance and LTS sector, we expect continued earnings volatility over the forecast period, given significant exposure to external factors, including volatility in the interest rate curve and in market returns. Moreover, the healthcare sector is also exposed to the interest rate curve and we assume some profitability erosion, given our estimated deterioration in claim volume and severity, due inter alia to the increased penetration rate in this sector. Furthermore, recent regulatory changes in the industry, including the creation of a uniform insurance policy structure, are expected to increase price competition and to pressure profitability. In the P&C insurance sector, we assume some stability in underwriting performance compared to 2017, while competition should remain relatively high, especially in the motor Casco segment, which saw some tariff increases over the past year. We believe that underwriting profitability should remain low and limited due, inter alia, to regulatory involvement. Under Midroog's base scenario, the Company's profit margins should be low for the rating, with ROC and ROA ratios should range between 0.5%-2.0% and 0.0%-0.2%, respectively, over the forecast range.

Liquidity profile is reasonable for the rating, supported by relatively long maturities of liabilities and financial flexibility that is not an outstanding positive

We believe that the Company's liquidity profile is reasonable for the rating, as reflected by a stable current ratio of X1.9 for weighted liquid assets to short-term expected insurance and financial liabilities. Given the Company's diversified business mix, some liabilities should mature over the long term (life insurance and LTS) and some over the short term (P&C insurance); we do not assume any significant repayment of financial liabilities in the forecast range, other than further regular repayment of debentures (Series A).

We note that Company liabilities have a relatively long duration, which strongly supports its liquidity profile and rating. In our opinion, insurers characterized by a long duration of liabilities and no put options for policyholders to call for money, are less exposed to liquidity risk and are better capable of responding to them over a longer period of time, which supports their survivability and rating. Moreover, the volatility that may result from marking to market of assets (MTM) sometimes does not reflect the economic value of insurers with a long duration of liabilities, given their ability to hold the relevant assets to maturity, therefore the economic capital of these insurers may be less exposed to short-term market volatility in our opinion.

The Company's financial flexibility is not an outstanding positive for the rating, with a balance sheet leverage ratio (debt to CAP) that is relatively high at 53% as of March 31, 2018, which we believe would not materially change over the short to medium term. On the other hand, financial and business flexibility is supported by relatively good Solvency II ratios at present, relative to the final directives and relative to the peer group.

Rating outlook

Factors that could lead to a rating upgrade:

- Significant improvement in business scope and in earnings generation capacity
- Significant improvement and stability over time in earnings cushion

Factors that could lead to a rating downgrade:

- Continued erosion of retained earnings according to Midroog's capital model
- Continued deterioration in underwriting results in core segments and/or significant, prolonged erosion in overall earnings
- Dividend distributions which may impact the Company's financial robustness

Company profile

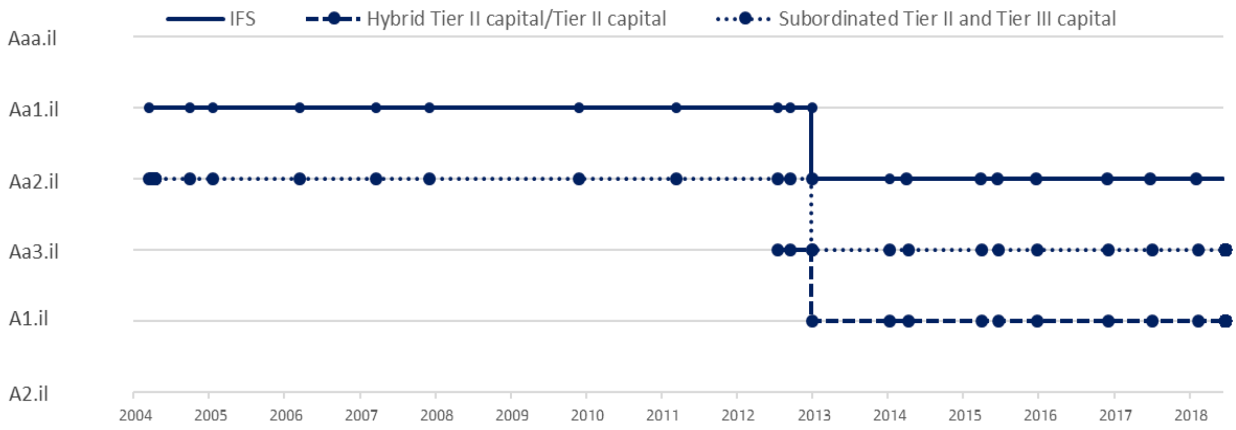
The Company is a private company wholly controlled by Menora Mivtachim Holdings Ltd. (hereinafter: "**Menora Mivtachim Holdings**"), a public company whose shares are traded on the Traded on the Tel Aviv Stock Exchange. The controlling shareholders of Menora Mivtachim Holdings are Palamas Establishment and Najaden Establishment (foreign corporations) held on behalf of Tali Grippel and Niva Gurevich, respectively, which jointly own 61.86% of Company shares. The Chairman of the Company Board of Directors, Mr. Ari Kalman, who also serves as CEO of Menora Menora Mivtachim Holdings, owns, through the Employee Trust Company, as of the report date, 2.72% of shares of Menora Mivtachim Holdings. The remaining shares of Menora Mivtachim Holdings are owned by the public.

The Company is engaged in all major insurance sectors, including life insurance and LTS, P&C insurance (including motor insurance (liability and property) and other P&C insurance) and healthcare insurance. The Company also owns Orot Life Insurance Agency (2005) Ltd.

The Company used to own the management company of New Mivtachim Pension Fund, the largest pension fund in Israel. In 2012, the Company transferred ownership of the pension fund to the Parent Company as dividend in kind. In January 2013, the Company distributed as dividend in kind the shares of Shomera Insurance Company Ltd., which is primarily engaged in auto and property insurance.

Midroog

Rating history



Related reports

[Menora Mivtachim Insurance Ltd.]

[Rating methodology for insurance companies – December 2017]

[Midroog's rating scales and definitions]

These reports are available on the Midroog website at www.midroog.co.il

General information

Rating report date:	June 24, 2018
Most recent rating update date:	February 1, 2018
Initial rating issue date:	March 15, 2004
Rating initiated by:	Menora Mivtachim Insurance Ltd.
Rating paid for by:	Menora Mivtachim Insurance Ltd.

Information from the issuer

In its ratings, Midroog relies, inter alia, on information received from competent organs of the issuer.

Midroog

Long - term local rating scale

Aaa.il	Issuers or issues rated Aaa.il present, in Midroog's judgment, the highest credit repayment capacity relative to other local issuers.
Aa.il	Issuers or issues rated Aa.il present, according to Midroog's judgment, a very high repayment capacity relative to other local issuers.
A.il	Issuers or issues rated A.il present, in Midroog's judgment, a high credit repayment capacity relative to other local issuers.
Baa.il	Issuers or issues rated Baa.il present, according to Midroog's judgment, a medium credit repayment capacity relative to other local issuers and may have certain speculative characteristics.
Ba.il	Issuers or issues rated Ba.il present, in Midroog's judgment, a low credit repayment capacity relative to other local issuers and have speculative characteristics.
B.il	Issuers or issues rated B.il present, in Midroog's judgment, a very low credit repayment capacity relative to other local issuers and have significant speculative characteristics.
Caa.il	Issuers or issues rated Caa.il present, in Midroog's judgment, a significantly low credit repayment capacity relative to other local issuers and have very significant speculative characteristics.
Ca.il	Issuers or issues rated Ca.il present, in Midroog's judgment, an extremely low credit repayment capacity and are very close to default with some chance of repayment of principal and interest.
C.il	Issuers or issues rated C.il present, in Midroog's judgment, the lowest credit repayment capacity and are generally in default with a remote chance of repayment of principal and interest.

Note: Midroog uses numerical values 1,2,3 in each of the rating categories from Aa.il to Caa.il. The value '1' indicates that the debenture is at the upper end of its rating category, as denoted by letters. The variable ‘2’ indicates that it is at the middle of its rating category; while the variable ‘3’ indicates that the debenture is at the bottom part of its rating category, as indicated by letters.

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