Financial review

Key financial highlights

Profit before tax increased significantly during 2004, up from £57.2m to £101.0m.

The Group also achieved significant core profit growth – of over 30% during 2004, as shown in the table below.

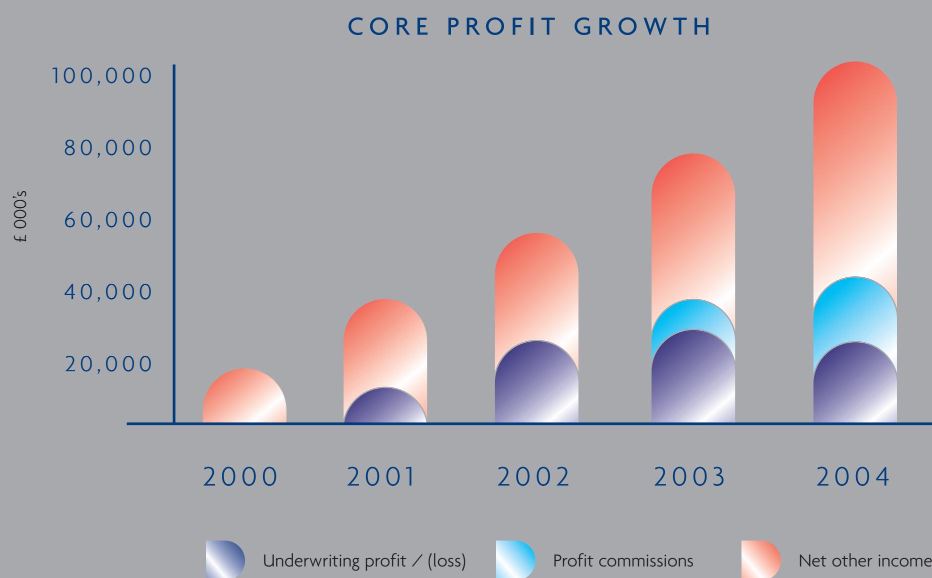
The directors use core profit as an effective assessment of the underlying profitability of the Group. This measure can be split into the three key elements of the Group's business model – 1) underwriting profits, 2) profit commissions and 3) net other income (in particular ancillary income).

Analysis of core profit

	2004 £000	2003 £000
Underwriting profit	27,969	31,048
Profit commissions	21,673	1,447
Net other income	56,916	38,701
Unadjusted total	106,558	71,196
Profit commission adjustment[1]	(5,994)	5,994
Adjusted Group core profit	**100,564**	**77,190**

(1) During 2004 £5,994,000 of profit commission relating to the 2003 financial year became recognisable in accordance with the Group's accounting policy for such commissions and is, therefore, included in the 2004 results in the statutory accounts. The directors believe this amount should be reallocated back to 2003 for the purposes of comparing 2004 against 2003.

2004's core profit of £100.6m (a reconciliation to which is set out later in this section on page 19), equates to a growth rate of over 30% on 2003, and compounded annual growth of almost 51% since 2000 – the first year in which consolidated accounts were drawn up for the Group.

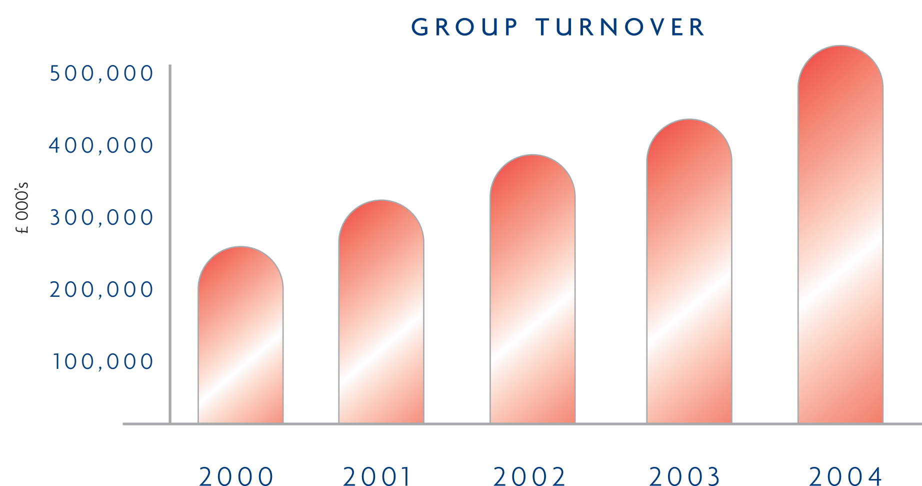


A further measure used by the directors to assess the growth in the size of the business is 'Group turnover' – which includes total premiums written, gross other income and net investment return, all as reported on the face of the profit and loss account. The Group has also achieved substantial growth in this measure, as shown below:

Analysis of group turnover

	2004 £000	2003 £000
Total premium	470,400	371,600
Gross other income	69,457	50,783
Net investment return	8,135	4,881
Group turnover	**547,992**	**427,264**

Turnover has increased by 28% in 2004 with compounded growth over the five years of over 20%.



As noted, the Group generates profits from three principal sources:

- the share of the motor insurance business it retains and underwrites itself
- profit commission earned from the Group's co-insurance and reinsurance partners
- intermediary activities – primarily the selling of ancillary motor products, but also from Gladiator Commercial and Confused.com

The hybrid nature of the business significantly reduces the volatility of earnings inherent in motor insurance and has some important advantages. Firstly, the Group currently only underwrites 25% of the motor insurance it sells. The Group therefore, materially limits its downside exposure, whilst retaining the potential, through the profit commission arrangements in place, to generate potentially significant income from the other 75% of the business depending upon the underwriting results achieved.

The second key advantage comes from retaining ownership of the entire customer base. This means the Group is able to generate substantial non-insurance income from all policyholders.

Underwriting

Underwriting structure

The underwriting arrangements in place for 2004 were unchanged on the previous year. 65% of the total business was underwritten by Great Lakes Reinsurance (UK) Plc (Great Lakes – a UK subsidiary of Munich Re currently rated A+ by A M Best) under a co-insurance arrangement. (This is in contrast to a reinsurance contract and means Great Lakes is the primary risk carrier on this portion of the book.)

The remaining 35% is underwritten through two Admiral Group entities – Admiral Insurance Company Limited (AICL) and Admiral Insurance (Gibraltar) Limited (AIGL), both of which commenced trading in 2003. 10% of the total business was reinsured to Converium Re (Converium) under a proportional quota share contract through AIGL (as in 2003) on a funds withheld basis. The net effect of this is that the Group retained a net share of 25% of the total book.

The quota share contract with Converium was terminated at the end of 2004 and has been replaced with two new contracts (each for 5% of the total book) – with Gen Re (part of the Berkshire Hathaway Group and rated AAA by Standard & Poors) and Axis Re (rated A by Standard & Poors).

As well as proportional reinsurance, the Group has also arranged an excess of loss reinsurance programme with a number of reinsurers to protect itself (along with its co-insurance and reinsurance partners) against very large claims.

For the 2000 to 2002 underwriting years, the Group's retained share of the motor business was underwritten through the Group's Syndicate (Syndicate 2004) at Lloyd's of London. The Group is currently managing the run-off of Syndicate 2004, and the last year of account (2002) remained open at the end of 2004. A decision is to be made during 2005 as to the closure of the 2002 year, and the release of any remaining capital held at Lloyd's.

Underwriting results

In 2004, the Group has again generated significant underwriting profits, reflecting both superior loss and expense ratios. The aggregate of these – the combined ratio – is again expected to rank highly in the UK motor market and has led to an underwriting profit of £28.0m (before reinsurance profit commissions), compared to £31.0m in 2003. This decrease is due to a combination of the higher loss ratios experienced on the more recent underwriting years (a factor of the motor insurance cycle) and the higher level of reserve releases realised in 2003 following the favourable development of the earlier underwriting years.

Growth in total premium written was 27% in 2004, up from £371.6m to £470.4m. This was due to targeted increases in marketing spend, and the continuing, highly successful development of elephant.co.uk – the Group's internet-only brand. This growth generated an increase in the Group's market share, and an even more notable increase in its share of the internet motor market.

Premium rates were on average around 3% lower in 2004 than in 2003. This reduction was implemented as a strategy to take advantage of the Group's superior combined ratio to help achieve the substantial growth in both policies and premiums written while delivering attractive combined ratios, both for the Group and our reinsurers.

2004's loss ratio (excluding claims handling expenses – which are allocated to net claims incurred but are included in expenses for this analysis) is 67.0%, up from 52.1% in 2003. The 2003 ratio was flattered by substantial reserve releases (£16.1m) resulting from the favourable development of earlier underwriting years. The 2003 releases accounted for a reduction of over 20 points in the reported loss ratio, compared to £9.2m of releases, or an 8.5 point reduction in the loss ratio in 2004.

A full understanding of the impact of reserve releases on the Group's results is important. The table below sets out net reserve releases (by underwriting year) included in the financial statements since the 2001 financial year (no releases were included in the 2000 financial statements as this was the first year the Group underwrote premiums and prepared consolidated accounts):

Analysis of reserve releases

	2004 £000	2003 £000	2002 £000	2001 £000
Underwriting year				
2000	1,480	5,176	6,188	3,923
2001	2,967	7,938	2,490	-
2002	3,229	2,975	-	-
2003	1,513	-	-	-
Total net release	9,189	16,089	8,678	3,923
Net earned premium	107,501	79,327	81,336	84,135
Releases as % of premium	8.5%	20.3%	10.7%	4.7%

This pattern of releases reflects consistent downward revision of loss ratios across all underwriting years, in response to consistently favourable development of these years.

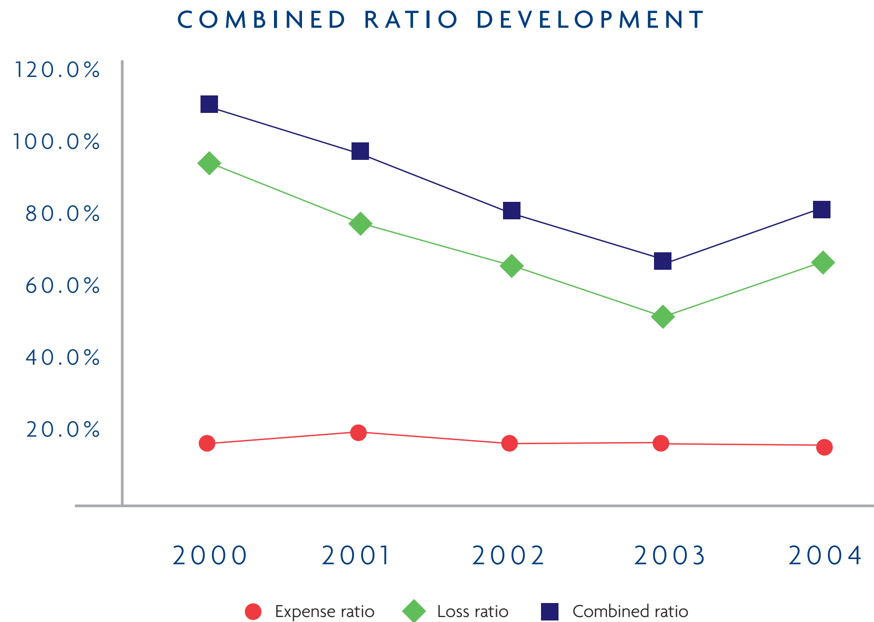
The Chief Executive's Statement refers to this development in some detail and presents a graph which sets out the development of the loss ratios by underwriting year over the past five years.

As regards expense ratios, the Group's direct distribution model, focussed on the internet and telesales, is highly cost effective – especially in terms of the cost of acquiring new business. Passing on a share of these costs to its co-insurance and reinsurance partners also means the Group is able to benefit from economies of scale.

Continued growth of internet sourced business has, along with tight control of costs within the Group, led to a further improvement in the expense ratio (including claims handling costs) to 15.0% in 2004, down from 15.6% in 2003. These ratios are derived as follows:

Adjusted expense ratio

	2004 £000	2003 £000
Net earned premium	107,501	79,327
Net operating expenses per technical account	13,796	10,308
add back: claims handling costs	2,352	2,230
deduct: non-recurring Lloyd's charges	-	(193)
Adjusted net technical expenses	16,148	12,345
Adjusted expense ratio	**15.0%**	**15.6%**



The Group's adjusted combined ratio (being the aggregation of the loss and expense ratios above) for 2004 is 82.0%, compared to 67.7% in 2003. The increase is primarily due to the reserve releases in 2003 as discussed above. Once again it is expected that the combined ratio will rank the Group towards the top of the UK market.

Profit Commission

The Group receives profit commission through both its proportional co-insurance and reinsurance arrangements. The amount of commission receivable is dependent on the volume and profitability of the insurance business, measured by reference to loss and expense ratios.

Profit commission – Quota share reinsurance

For the 2003 and 2004 underwriting years, the Group earned profit commission from Converium, depending on the loss ratio returned on these underwriting years. During 2004, £3.1m of commission was recognised, compared to £1.2m in 2003. This contract is operated on a funds withheld basis.

The new quota share contracts that came into effect on 1 January 2005 have similar profit commission arrangements.

Profit commission – Co-insurance

The Group also receives profit commission from Great Lakes, based on the size and profitability of the business written. £16.7m of commission has been recognised in the 2004 results, although, as referred to in the financial highlights section above, £6.0m of this commission relates to premium earned in 2003.

A further £1.9m of profit commission was recognised during 2004 (£0.3m in 2003) under co-insurance arrangements relating to earlier underwriting year contracts with Swiss Re. An additional £1.2m should become due (based on current reported loss ratios) from Swiss Re when the 2002 year of account within the Syndicate is closed or the profit commission is received from Swiss Re. This did not occur at the end of 2004 as the Board of the Managing Agent, Admiral Syndicate Management Limited felt that a number of opportunities were still to be examined for closing the 2002 year.

Net other income

This figure can be further analysed as follows:

	2004		2003	
	£000	£000	£000	£000
Ancillary contribution		48,493		35,856
Instalment income		2,603		1,257
Gladiator contribution		1,756		1,575
Gross Inspop.com contribution	2,033		322	
Net Inspop.com consolidation adjustments*	(750)		(721)	
Net Inspop.com contribution / (deficit)		1,283		(399)
Aggregate interest receipts		3,348		1,166
Other Group / central overheads		(567)		(754)
Net other income		56,916		38,701

* adjustments relate to intra-group sales. Confused.com is a trading name of Inspop.com Limited.

As noted above, the Group is able to use its direct customer contact model to generate significant intermediary revenue through sales of ancillary products to the customer base. This represents the majority of net other income. The products involved are primarily insurance products that complement the motor policy, but which are underwritten by external parties. The contribution above is largely commission earned on such sales. Net contribution from ancillary sales grew by over 35% during the year, with average gross income per motor policy amounting to £51.20 (2003: £50.70).

Financial investments, cash and indebtedness

All aspects of the Group's business generate significant operating cash inflows. At 31 December 2004, the Group held a total of £322.6m in cash and financial investments (2003: £239.0m) – an increase of 35% on 2003:

	2004		2003	
	£000	£000	£000	£000
Non-regulated cash	50,096		30,035	
Regulated cash	38,515		40,040	
Total cash		88,611		70,075
Deposits with credit institutions	30,590		24,464	
Government and sovereign bond holdings	42,980		63,525	
Corporate bonds and similar instruments	160,438		80,936	
Total financial investments		234,008		168,925
Grand total cash plus investments		**322,619**		**239,000**

Financial investments, cash and indebtedness (cont.)

The Group has four managed investment funds in which the majority of the insurance funds are invested. Three of these (one each for Syndicate 2004, AICL and AIGL) are managed by Alliance Capital Management, whilst the fourth (another AIGL fund) is managed by Lloyds TSB International.

Investment strategy is set by the Group Investment Committee (and approved by the Boards of directors of the relevant entity). The strategy is conservative, with much of the funds invested in high quality corporate or government bonds. No investments are made in equity shares.

Group cash holdings earn interest at just below the UK base interest rate.

At 31 December 2004, the Group had £33.1m (2003: £35.4m) of debt in respect of a commercial loan facility drawn down in 2002. £4.3m in capital and interest was repaid during the year with a further £4.1m on 3 January 2005. The original arrangement included a £10m revolving credit facility that the directors cancelled in 2004 as it was unlikely to be required.

Refer to note 21 to the accounts for further details on the Group's debt.

Dividends

The directors have established a dividend policy based on the principle of returning excess cash to shareholders. In accordance with this principle they would expect to make a normal distribution of at least 45% of post-tax profits, and to review regularly the Group's available cash to determine whether it is appropriate for the Company to pay a further special dividend.

The directors have, therefore, declared final dividends totalling 9.3p per share on 18 March 2005. These comprise a normal dividend of 3.1p per share and a special dividend of 6.2p per share. The normal dividend took into account our listing part way through the financial year and is based on a 45% pay-out ratio, adjusted for the exceptional tax credit. The special dividend reflected the abnormally low tax charge in the 2004 accounts resulting from relief for the cost of the ESOT distribution on listing which will reduce the Group's tax payment in 2005.

In addition dividends of £52.0m were paid during 2004 prior to the Company's listing.

Taxation

The total taxation charge reported in the profit and loss account is £14.4m (2003: £18.0m) representing 14.3% (2003: 31.5%) of pre-tax profits. The significant decrease in the effective tax rate is mostly due to the impact of the ESOT share awards made during the year, which attracted a significant deduction for corporation tax purposes.

A charge for the employer's National Insurance contributions arising from the share provision (£7.2m) has been included in the profit and loss account. The tax deduction on this charge was accrued in previous years.

Refer to notes 8 and 20 to the accounts for further detail on taxation and the ESOT.

International Financial Reporting Standards (IFRS)

From 1 January 2005, EU regulations require companies listed on regulated markets in the EU to prepare their consolidated accounts under IFRS. The Admiral Group consolidated accounts for 2005 will, therefore be prepared under IFRS, as opposed to UK GAAP. 2004 comparative information must also be restated.

Reconciliations of profit and shareholders' equity will be provided in order to set out the major differences between the 2004 UK GAAP and IFRS numbers.

The Group has considered the impact of the 'stable platform' of IFRS standards on the financial results to 31 December 2004 and the position at the balance sheet date. The directors are confident that, based on the guidance currently in existence, no material reconciling items (other than in respect of accounting for dividends and goodwill amortisation) will be required when the 2004 figures are restated and reconciled in 2005.

Employee share schemes

This section is split into two – the first covers the Admiral Employee Share Ownership Trust (ESOT) established in 2000, and under which no further grants are to be made. The second section deals with the new schemes that will take effect in 2005, under which no awards have yet been made.

1. Admiral ESOT

The Group established an ESOT during 2000, under which a specified number of Admiral Group Limited shares were to be made available for issue to the Trust if the Group listed or if it was subject to take-over. Staff have been granted units since 2000, which gave them a proportional entitlement (at no cost) in the shares to be issued.

The listing in September 2004 triggered an issue of shares to the Trust immediately prior to the listing. Full details of the associated transaction (and the impact of share reorganisation) are set out in note 20 to the accounts. The effect of the listing on the Trust was that staff who held units became holders of shares in Admiral Group plc equating to an 8% stake worth £57m at listing.

2. New share scheme arrangements

The Board is strongly of the view that actual or prospective share ownership plays a key role in staff incentivisation (across all levels – not restricted to executives or senior management). Given that no further awards are possible under the ESOT, new arrangements have, therefore, been established in its place.

As noted above, the current executive directors, with the support of the Board, are of the opinion that their shareholdings provide appropriate incentivisation to maximise shareholder return. For this reason, none of the current executive directors will participate in the new share schemes (nor did they in the ESOT).

Two new schemes have been put in place under which awards will be made with effect from the 2005 financial year. The maximum annual award under these schemes will be no more than 1% of the issued share capital.

The Approved Share Incentive Plan (SIP)

This scheme is intended to replace the previous staff profit share scheme, and is open to all staff, (excluding current executive directors) of Admiral Group plc.

The maximum to be awarded under the SIP will be £3,000 per employee per annum, with the awards being subject to a three-year vesting period. As the scheme is Inland Revenue approved, the awards will be free of income tax after 5 years. The £3,000 limit will be based on the market value of the shares at the date of award.

Awards will be made twice a year, based on the stand-alone results of each half-year. Inland Revenue rules dictate that staff must hold the shares for three years before being able to sell them, but dividends will be payable during the vesting period. If a member of staff leaves the Group before the end of the three year period, without being a 'good leaver', they get no benefit from the shares not yet vested.

A linear relationship will exist between the size of the award and the percentage over the Group's budgeted core profit achieved. Awards will start to be made if the Group achieves over 90% of its budgeted core profit and full award will be made if the Group exceeds 111.5% of its budgeted core profit.

Admiral Group Senior Executive Restricted Share Plan

This scheme is not Inland Revenue approved, and is open to Group employees of a certain level of seniority, excluding the current executive directors of the Group.

The main performance criteria will be the growth in earnings per share (EPS) in excess of a risk free return (RFR), defined as average 3-month LIBOR, over a three year period. The Board feels that this is a good indicator of long-term shareholder return and aligns senior staff incentivisation with total shareholder return.

For any shares to vest, the Group's Total Shareholder Return (TSR) must at least match the TSR of the FTSE 350 over the three year vesting period.

If the Group's TSR matches or exceeds that produced by the FTSE 350, the following measures will be applied to the Group's growth in EPS to calculate the amount of shares to vest:

- if the Group's EPS growth over the vesting period equals the RFR then each individual will receive 10% of their maximum award
- to obtain the maximum award, the Group's EPS growth would have to average 10 percentage points better than the return available for a cash investment – the RFR

For the purposes of calculating EPS for 2004 as the base value for the computation of the awards, the tax credit resulting from the ESOT will be adjusted to reflect a more normalised tax charge. The 2004 EPS will also be adjusted to reflect changes arising from International Accounting Standards, specifically the goodwill write-off.

Approximately 250 staff will be included within the plan, commensurate with the Group's philosophy that real difference can be achieved by incentivising staff that have direct control over customer interaction as well as the Group's most senior managers.

Award proposals are submitted to the Remuneration Committee by the executive directors. Individual awards in excess of 100% of salary require individual discussion and justification to the Committee.

The plan includes provision for a maximum individual award equal to the lower of £400,000 or 600% of salary. Such an amount is included to provide flexibility for future succession planning in the most senior positions.

Reconciliation of profit before tax to adjusted core profit

	2004 £000	2003 £000
Profit before tax	101,000	57,244
Add back: interest payable	2,451	3,146
Add back: goodwill amortisation	3,906	3,906
(Deduct) / add back: share scheme (credit) / charges	(4,144)	6,900
Add back: bonuses paid in lieu of dividends	3,345	-
Core profit	106,558	71,196
Profit commission adjustment	(5,994)	5,994
Adjusted core profit	100,564	77,190