

Financial review

Key financial highlights

The Group recorded another significant increase in pre-tax profit in 2005 - a rise of 14% from £104.9m in 2004 to £119.5m. Core profit was also significantly higher - a jump of 21% from £100.6m to £122.1m.

Core profit is used as an effective measure of the three key elements of the Group's business: 1) underwriting profits, 2) profit commissions and 3) net other income (most notably ancillary income). Each element is discussed below.

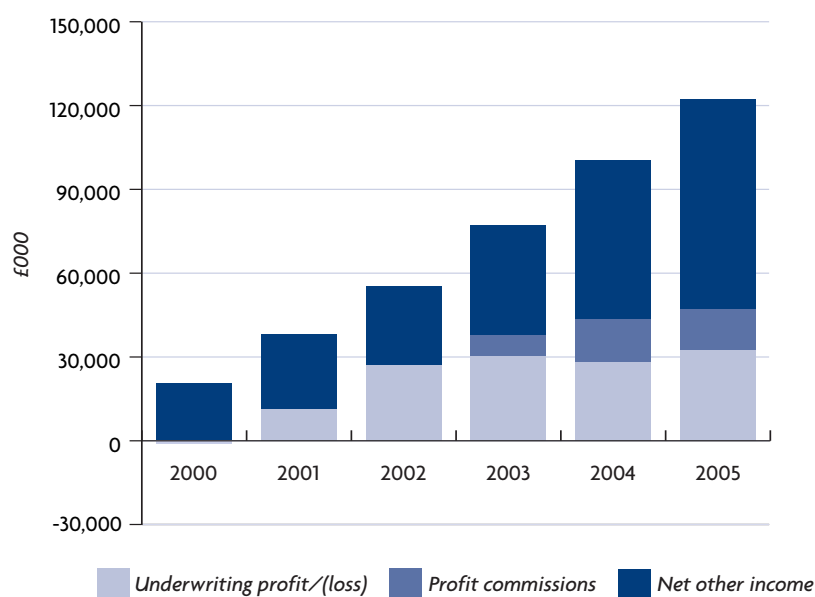
	2005 £000	2004 £000
Underwriting profit	32,361	27,969
Profit commissions ¹	14,735	15,679
Net other income	74,998	56,916
Adjusted Group core profit	122,094	100,564

¹During 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 comparisons and it has been deducted above.

A reconciliation of core profit to figures reported in the income statement is set out later in this section. Since 2000, the Group has returned substantial core profit increases year-on-year, and the compounded annual rate of growth since 2000 is over 44%.

The proportion of the Group's core profits earned from non-underwriting increased again during 2005 - with 73% now arising from intermediary activities and profit commissions (72% in 2004).

Core profit growth



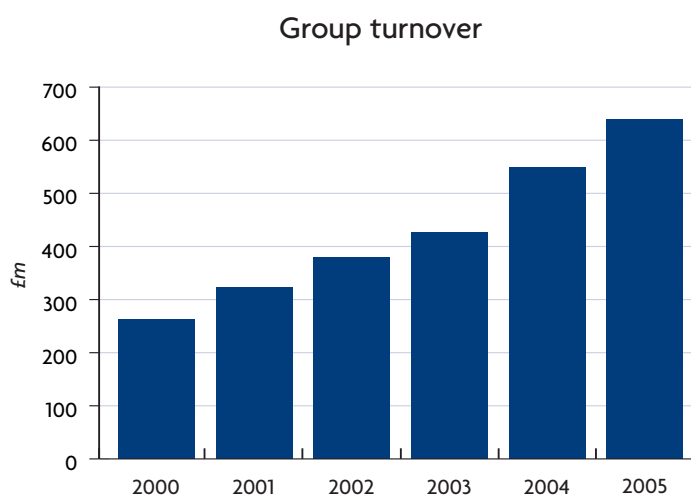
The hybrid nature of the business significantly reduces the volatility of earnings inherent in motor insurance and has some important advantages. Firstly, the Group currently only underwrites 25% of the motor insurance it sells. The Group therefore, materially limits its downside exposure, whilst retaining 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. (Refer to the underwriting structure section below for further detail.)

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 the customer base.

Group turnover, which comprises total premiums written, gross other income and net investment return (and measures the combined size of the Group's businesses) also returned significant growth:

	2005 £000	2004 £000
Total premium written	533,616	470,400
Gross other income	93,405	69,457
Net investment return	11,342	8,135
Group turnover	638,363	547,992

The growth of 16% in the year contributes to compounded average annual growth since 2000 of around 20% shown by the steady growth trend in the graph below. Gross other income, which is made up predominantly of ancillary revenue (before allocation of overhead) and Confused.com income, demonstrated an especially high increase (over 34%) in the year - both are discussed further below.



Underwriting

Underwriting structure

The Group's underwriting structure is as follows:

65% of the business written continues to be underwritten by Great Lakes under a long-term co-insurance contract.

35% of the business is underwritten by the Group through Admiral Insurance (Gibraltar) Limited (AIGL) and Admiral Insurance Company Limited (AICL). 10% (of the total business) is ceded via quota share contracts that qualify for deductions in required solvency capital.

Of the 10%, 5% is ceded to Axis Re Europe under a contract covering 2005 and 2006 and 5% to Cologne Reinsurance Company (Dublin) Limited (part of Gen Re) for 2005 only.

The Gen Re contract was commuted with effect from 31 December 2005, and in line with accounting guidelines, has not been treated as reinsurance in the financial statements. This has the effect (for contracts incepted in 2005 only) of grossing-up premiums, claims and expenses retained by the Group to a net 30%.

A new quota share contract with Swiss Reinsurance Company UK Limited (Swiss Re) replaces the Gen Re contract for 2006 only.

As well as proportional reinsurance, the Group has also arranged an excess of loss reinsurance programme with a number of reinsurers to protect itself 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 2005.

The Group is currently pursuing the option of a transfer of the remaining liabilities for the 2000-2002 underwriting years into AICL under the provisions of Part VII to the Financial Services and Markets Act 2000. Should this project complete successfully, it is estimated that not less than £20m of funds currently maintained in the Syndicate would be released.

Underwriting results

Total premium written increased by 13.4% from £470m to £534m during the year. This has once again resulted from targeted marketing spend increases and the continued growth of elephant.co.uk, the Group's principal internet offering and largest brand. All Group brands increased in size during 2005. Note that whilst premium increased by 13.4%, the Group's closing policy base increased by around 10%. The differential consists of the overall rate increases effected over 2005, combined with a change in the mix of business which also led to higher average premiums.

Motor insurance quotes rose significantly from 6.2m in 2004 to 9.7m in 2005 (an increase of 56%). This growth has partly come about as a result of the notable increase in volume generated by Confused.com in the year - further analysis of which is set out below. Although selective rate changes have been implemented throughout the year, on average, premium levels at the end of 2005 are around 1% higher than those at the start of the year.

The accounting treatment adopted for the commutation of the Gen Re contract has meant that for contracts incepted in 2005, the Group effectively underwrites 30% of the total motor business. For this reason, net insurance premium revenue has increased by almost 30% in the year - although on a like for like basis (that is, had the Group underwrote 25% as opposed to 30% of 2005 business), the increase is 16% - much more in line with the written premium increase noted above.

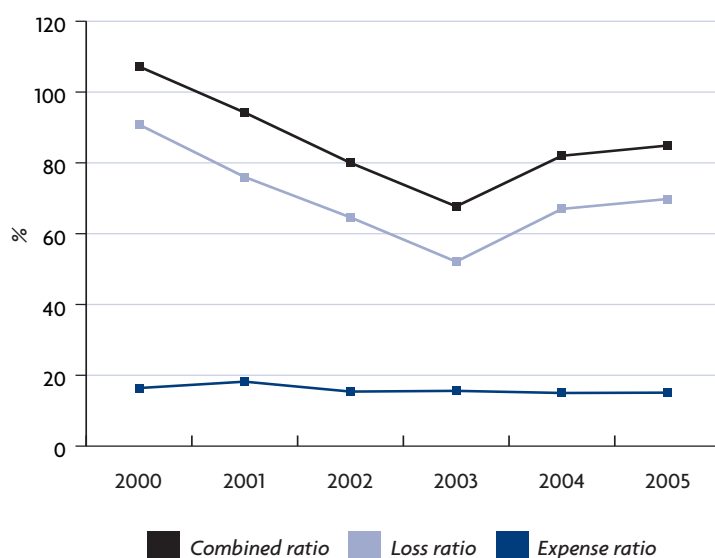
There was an increase in the underwriting result of around £4.4m in the year (£28.0m to £32.4m), although almost £3m of this is due to increased investment return (which in turn primarily resulted from higher levels of invested funds). 2005's reported loss ratio (excluding claims handling expenses) was 69.8%, up from 67.0% in 2004. Movements in loss ratios are discussed in the Chief Executive's statement.

Positive development of prior year claims provisions has continued, and the 2005 income statement contains £17.3m of net releases (up significantly from £9.2m in 2004). 2005's releases effectively reduce the reported loss ratio by 12.4 percentage points (8.5 points in 2004). Note 19 to the financial statements includes further detail on claims provision development.

The Group's expense ratio continues to run at competitive levels – 15.1% (including claims handling expenses) in 2005, relatively unchanged from 15.0% in 2004. Excluding regulatory levies, the figures are 12.3% in 2005 and 12.5% in 2004.

The expense ratio is reconciled to the figures included in the income statement in note 9 to the financial statements, whilst the underwriting result is reconciled later in this review.

Combined ratio development



The Group's combined ratio (being the aggregation of the loss and expense ratios above) is 84.9% up from 82.0% in 2004. The increase is due to the loss ratio move noted above. The Group's 85% compares to an expected market combined ratio in 2005 of around 105% (source – Deloitte) – an outperformance, consistent with previous years of around 20 points. Further detail on market combined ratios is set out in the Chief Executive's statement.

Some additional ratios are noted in the Chief Executive's statement – firstly the ratio of total outgoings to net income at 60% (2004: 58%) and secondly the ratio of core profit to net income at 52% (2004: 57%). Reconciliations to the figures in the accounts are set out at the end of this review.

Profit commission

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

Profit commission – co-insurance

The principal source of profit commission is the long-term co-insurance contract with Great Lakes. £11.2m has been recognised in 2005, compared to £10.7m in 2004 (after adjusting for the £6m noted above).

An additional £0.5m of profit commission relating to earlier underwriting year contracts with Hibernian Re (100% reinsured into Swiss Re) has been recognised in 2005 (£1.9m in 2004). It is expected that further amounts will be recognised when the Group closes the final year of account of Syndicate 2004.

Profit commission – quota share reinsurance

The Group earns profit commission from Converium (relating to 2003 and 2004 underwriting years) and Axis Re (on the 2005 year). A total of £3.1m has been recognised during 2005 (2004: £3.1m).

No commission will be earned on the Gen Re contract as this has been commuted. The new 2006 quota share contract with Swiss Re has similar profit commission arrangements to the current deals.

Net other income

This figure can be broken down as follows:

	2005		2004
	£000	£000	£000
Ancillary contribution		59,092	48,493
Gross Confused.com contribution	8,823		2,033
Intra-group adjustment*	(1,941)		(750)
Confused.com contribution		6,882	1,283
Aggregate interest receipts		4,176	3,348
Instalment income		3,768	2,603
Gladiator contribution		1,871	1,756
Other Group/central overheads		(791)	(567)
Net other income		<u>74,998</u>	<u>56,916</u>

**Confused.com adjustment:*

Confused.com earns a proportion of its income from Admiral Group brands and hence an adjustment is made to the gross contribution. This is to reflect the fact that a proportion of Confused.com's costs are incurred in acquiring insurance business for the Group. The opposite side of the adjustment appears in the costs of acquiring insurance contracts.

Ancillary contribution & instalment income

This primarily involves commissions earned on sales of insurance products complementing the motor policy, but which are underwritten by external parties. Net contribution from these sales grew by 22% in 2005 - from £48.5m to £59.1m. Average gross income per motor policy sold also increased significantly during the year, from £51 in 2004 to £56 in 2005.

Instalment income represents charges for payment by instalments on motor policies sold which are paid for over the course of the policy life by direct debit.

Confused.com

As the profit figures suggest, Confused.com has seen substantial growth during 2005 - both in terms of volume and profitability. This was driven by efficient increases in marketing spend generating substantial increases in quote activity. Confused.com receives a commission from its partners and has a relatively small fixed cost base.

Gladiator Commercial

Gladiator had another profitable year, with relatively little change in the overall result or level of business. In spite of this, it has been a year of change for Gladiator - with the development of its own interactive quote facility that is expected to make the internet its principal distribution channel.

Taxation

The total taxation charge reported in the income statement is £34.8m (2004: £14.4m), representing 29.1% (2004: 13.7%) of pre-tax profits. The unusually low effective rate in 2004 is due to the impact of the ESOT share awards made during that year, which attracted a significant deduction (£17m) for corporation tax purposes. This tax deduction is the reason why post tax profits in 2004 were higher than in 2005.

Refer to note 13 to the accounts for further detail on taxation.

Earnings per share (EPS)

The tax deduction referred to above also has a distorting impact on the EPS figures presented in the income statement. Note 15 to the accounts sets out a calculation of adjusted EPS, which backs out the impact in the 2004 comparatives. EPS for 2005 is 32.7p, up from the adjusted 2004 figure of 28.4p - an increase of 15%, in line with the increase in pre-tax profits reported on the income statement.

Financial investments, cash and debt

A continuing feature of the Group's business is the significant generation of cash from all operations. At the end of the year, the Group held a total of £406.1m in cash and financial investments - up 26% on the £322.6m held at the end of 2004. This increase is after distributions to shareholders of £49.2m during 2005 (£52.0m in 2004).

The balances making up this total can be analysed as follows:

	2005 £000	2004 £000
<i>Liquid funds in underwriting companies:</i>		
Government and sovereign bond holdings	83,071	42,980
Corporate bonds and similar instruments	172,866	160,438
Deposits with credit institutions	40,646	31,070
Cash at bank	39,824	38,035
	336,407	272,523
<i>Liquid funds held outside underwriting companies:</i>		
Cash at bank	69,682	50,096
	406,089	322,619

The Group maintains four externally 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.

There have been no changes to investment strategy, which is set by the Group Investment Committee and approved by the Board of Directors of the relevant entity. The strategy is conservative, with all of the funds invested in either cash or short dated, high quality corporate or government bonds.

The Group restructured its loan facility during 2005 in order to reduce the interest margin being incurred on the debt and to increase its flexibility.

Refer to note 22 to the accounts for further details on the Group's debt.

Dividends

There has been no change in dividend policy, which is based on the principle of returning excess cash to shareholders. The Directors expect to make a normal distribution of at least 45% of post-tax profits each half-year, and will regularly review the Group's available cash to determine whether it is appropriate for the Company to pay a further special dividend.

In line with this policy, as outlined in the Chairman's statement, the Directors have declared a final dividend for 2005 of 14.9p per share, which is made up of 7.8p per share normal element, plus 7.1p per share special distribution based on the Group's cash resources at the end of the year.

This final payment combines with the interim dividend to make a total distribution for 2005 of 24.6p per share. The final dividend declared in respect of the post-flotation period of 2004 was 9.3p.

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. As such, these financial statements are the first full year accounts to be prepared under IFRS. The 2004 full year accounts were reported under IFRS in the 2005 interim accounts document, reported in September 2005.

Reconciliations and explanations are again provided in order to set out the major differences between the 2004 UK GAAP and IFRS numbers. Refer to note 4.

As reported in the interim statements, the only significant impacts on the income statement are the cessation of goodwill amortisation, the valuation of financial investments at bid as opposed to mid-market price, and the inclusion of dividends in the retained profits of the period in which they were declared as opposed to allocated. The changes have no impact on the Group's ability to pay dividends.

Employee share schemes

The Board continues to take the view that actual or prospective share ownership plays a vital role in staff incentivisation across all levels of employee. To this end, two new share schemes were established in late 2004 - an Inland Revenue approved Share Incentive Plan (the SIP) and the Unapproved Free Share Scheme (UFSS) under which the first awards were made during 2005.

1. The Approved Share Incentive Plan (SIP)

This plan is open to all staff of Admiral Group plc (the current Executive Directors have opted not to participate in the Scheme).

The maximum award under the SIP will be £3,000 per employee per annum, those shares being forfeited if staff leave within three years of the award. As the scheme is Inland Revenue approved, awards will be free of income tax after five years. The £3,000 limit is based on the market value of the shares at the date of award.

Awards are made twice a year, based on the results of each half-year. The first awards, in respect of the period to 30 June 2005 were made in September 2005, and the second, based on the second half's results will be made during the first half of 2006.

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.

Further details of the awards – actual and anticipated – are included in note 26 to the financial statements.

2. The Unapproved Free Share Scheme (UFSS)

This scheme is not Inland Revenue approved, and is open to Group employees of a certain level of seniority plus exceptional performers, again excluding the current Executive Directors of the Group.

The main performance criteria in determining awards under the UFSS will be the growth in earnings per share (EPS) in excess of a risk free return, 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 it.

In addition, 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.

Around 270 staff received awards during 2005, demonstrating the Directors' belief that a real difference can be made by incentivising staff that have direct control over customer interaction as well as the Group's most senior managers.

The performance criteria for future awards under the UFSS have been amended by removing the TSR hurdle. The Board considered that it would be demotivational for staff if a structure was in place whereby significant increases in EPS may not be rewarded.

The Board believes that the EPS targets alone provide sufficient incentivisation and align the interests of staff and shareholders. The EPS targets are such that for full vesting of shares to occur, the average EPS growth over the three year performance period would have to be approximately 15% per annum, assuming LIBOR remains at approximately 4.5%. Only 10% of shares vest for matching the growth of LIBOR over the three year period.

Reconciliation of profit before tax to core profit	2005 £000	2004 £000
Profit before tax	119,494	104,906
Add back: finance charges	2,162	2,451
Add back/(deduct): share scheme charges/(credit)	438	(4,144)
Add back: bonuses paid in lieu of dividends	–	3,345
2003 profit commission adjustment	–	(5,994)
Core profit	122,094	100,564

Reconciliation of underwriting profit	2005 £000	2004 £000
Net insurance premium revenue	139,454	107,501
Net insurance claims	(100,526)	(74,272)
Net expenses related to insurance contracts	(17,909)	(13,796)
Investment return	11,342	8,536
Underwriting profit	32,361	27,969

Reconciliation of loss ratios reported	2005 £000	2004 £000
Net insurance claims from income statement	100,526	74,272
Deduct: claims handling costs	(3,202)	(2,352)
Adjusted net insurance claims	97,324	71,920
Net premium revenue	139,454	107,501
Loss ratio	69.8%	67.0%

Reconciliation of alternative operating ratios	2005 £000	2004 £000
<i>Outgoings:</i>		
Net insurance claims	100,526	74,272
Insurance contract expenses	17,909	13,796
Ancillary/Gladiator/Confused expenses	21,792	15,322
	140,227	103,390
<i>Income:</i>		
Net premium revenue	139,454	107,501
Gross other revenue	93,405	69,457
	232,859	176,958

Outgoings to income	60%	58%
Core profit (from above) to income	52%	57%