Top Ten Issues for Insurance M&A in 2012

Despite being challenged by their ability to grow organically in a struggling economy, insurance companies (underwriters) have been hesitant of late to use mergers and acquisitions ("M&A") as a way to expand. In 2009, industry M&A came to a standstill as companies looked to build capital to survive the recession. 2010 saw an increase in deal volume, but a continued deterioration of Price/Book ratios; and while there was a slight uptick in industry M&A during 2011, activity was quite low by historical standards (Figure 1). It also was more episodic than expected, with buyers looking to acquire specific capabilities (new products, distribution channels) or extend their geographic reach (especially in emerging markets), rather than striving for scale and cost-savings.

In general, insurance company M&A activity during 2011 was hamstrung by widespread uncertainty about the U.S. and global economies, regulatory reform, tax reform, accounting reform and other concerns. However, some insurance segments were more active than others.

Property and Casualty ("P&C") deal activity suffered from low valuations, concerns about the prolonged soft pricing market and reserve adequacy. As a result, the number of P&C deals was down as compared to 2010. The data indicates that average deal size and average price to book value increased; however, further analysis shows this increase was driven by a few large and rather richly priced transactions. In analyzing a sample of the P&C transactions from 2008–2011, based on data obtained from SNL and CapitalIQ, it appears that, on average, there was minimal movement in the acquiring entity's stock price when the average stock price 30 days prior to the announcement of the transaction is compared to the average stock price 30 days after the announcement. Because, historically, P&C deals have not been good for the buyer's stock performance; this has led to increased scrutiny by Boards of Directors and an even greater reluctance to transact deals in an uncertain environment.

Figure 1: Insurance Underwriter Transactions (as of November 30, 2011)

Global Insurance Underwriter Transactions
Price to Book Value Multiples

Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Number of deals	10	82	93	75	105	113	115	114	98	125	103
Size of Deals ($M)											
Low	<$100K	<$100K	<$100K	0.5	0.3	0.4	0.4	0.8	<$100K	<$100K	3.2
High	23,400.8	3,980.8	17,595.4	5,002.1	11,500.0	2,740.1	2,744.0	6,225.0	1,900.0	15,545.1	28,901.6
Average	547.3	150.8	861.7	232.5	692.8	144.8	258.8	247.0	165.2	374.5	403.6
Observed P/BV Deal Multiples											
Low	0.46x	0.51x	0.54x	0.55x	0.85x	0.88x	0.79x	0.49x	0.73x	0.27x	0.54x
High	3.80x	3.99x	7.20x	5.49x	3.46x	6.19x	2.19x	2.75x	2.98x	3.06x	5.98x
Average	1.31x	1.60x	1.91x	1.81x	1.70x	2.02x	1.60x	1.45x	1.16x	1.10x	1.95x

Source: SNL Financial

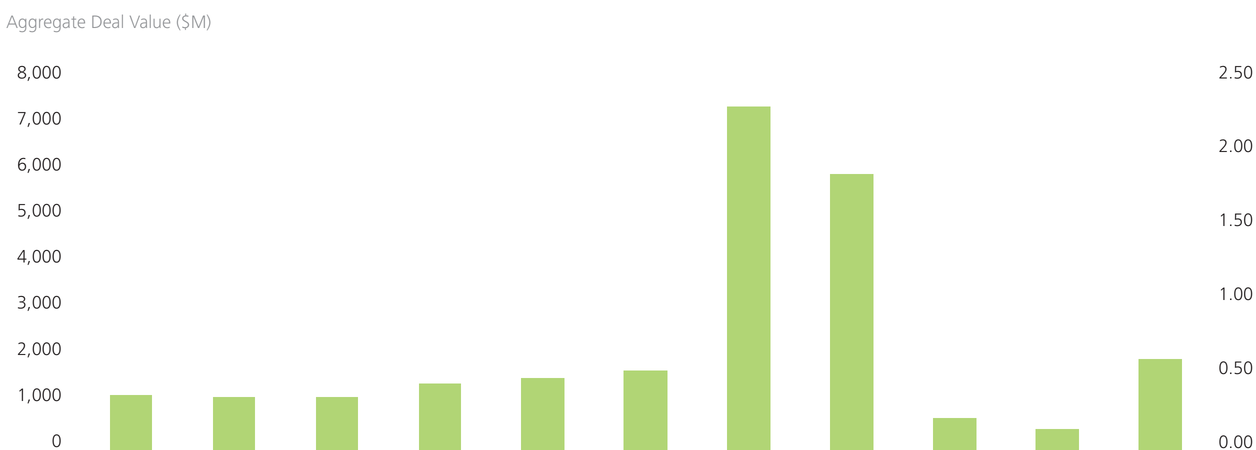
- Transactions represent whole company deals of global Insurance Underwriters within the P&C, L&H, Multiline, Managed Care, Tit le, Mortgage Guaranty and Finance Guaranty sectors covered by SNL Financial Note that Reinsurance companies are included within the aforementioned sectors.
- 2011 average deal size data excludes the Express Scripts Inc/Medco Health Solutions merger valued at approximately $29BN as t hisskews the data.
- Transactions grouped by the year they were announced. 2011 captures the YTD period as of 11/30/2011.
- Deal multiples represent closed multiples, unless the transaction is still pending close

Life and Health deal activity also suffered from the malaise of 2011 as poor investment yields took a toll on earnings and surplus. Based on data obtained from SNL, it appears that the number of deals and the average deal size decreased from 2010 as the large, transformation transactions of 2010 closed. The data indicates that price to book increased; however, analysis shows that this was skewed by two deals.

Broker and Agency deal activity was, once again, the insurance market's most active segment. The number of deals in 2011 was up slightly compared to 2010, as was the average deal size, as buyers competed for the larger targets (Figure 2). Note that there was not sufficient publicly available data related to deal multiples to calculate meaningful results. The most active buyers include several serial acquirers of agencies embarked on a roll-up strategy of large and small brokers and agencies.

Figure 2: Insurance Broker Transactions (as of November 30, 2011)

Global insurance underwriter transactions
Aggregate deal value



Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Number of deals	194	206	196	240	210	227	262	294	186	234	238
Size of Deals ($M)											
Low	<$100K	<$100K	<$100K	0.2	0.3	0.2	<$100K	<$100K	<$100K	0.1	<$100K
High	200.5	404.1	481.9	118.3	394.0	314.1	1,758.8	1,706.9	217.7	85.6	1,235.1
Average	19.9	22.6	21.6	19.0	24.1	25.7	86.5	64.9	18.1	12.5	43.7

Source: SNL Financial

- Transactions represent whole company deals of global Insurance Brokers within the P&C, L&H, Multiline, Managed Care, Title, Mortgage Guaranty and Finance Guaranty sectors covered by SNL Financial.
- Transactions grouped by the year they were announced. 2011 captures the YTD period as of 11/30/2011.
- Transaction multiples are not presented due to lack of sufficient publicly available information.

Although Reinsurance deal activity in 2011 was minimal, this may have been one of the most interesting segments to watch. With many reinsurers trading at discounts to book value and concerns lingering about reserve adequacy, it was challenging to get deals done and negotiations seemed to play out in the public spotlight. However, pressure to execute transactions remains, as several investors in the class of 2005 appear determined to cash out and redeploy their capital elsewhere.

Unfortunately, many of the challenges stunting M&A activity during 2011 are likely to remain unresolved in the coming year, as detailed in the following top ten issues for insurance M&A in 2012.

1 Economic uncertainty

The current economic climate is not perceived as being conducive to increased insurance M&A activity. Entering 2012, the United States ("U.S.") and global economies remain defined by low growth, high unemployment, a widely fluctuating stock market, and a European debt crisis. A sustained low interest rate environment is stunting investment returns for life insurance companies; P&C companies have increased interest rate exposure on the liability side of their balance sheet. In addition, low real estate valuations and continued defaults could create a drag on life company investment returns and surplus cash, while creeping inflation may have an adverse impact on future claim costs. It is an unhealthy economic mix for companies already demonstrating their hesitancy to engage in M&A activity.

2 Regulatory uncertainty

A number of provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and the Patient Protection and Affordable Care Act ("PPACA") concern insurance company operations and, thus, could impact 2012 M&A activity and strategies. For example, a company's designation as a systemic risk company will likely increase capital requirements and information reporting and the creation of the Federal Insurance Office will likely create increased data demands. In order to meet these new demands, some insurance companies may have to significantly upgrade their IT systems, which they may not be able to afford. Also, insurance companies that own thrifts will face higher capital requirements and regulation by the Fed, which may result in insurance companies selling their thrifts. Similarly, insurance companies may sell any business units that create systemic risk.

3 Solvency II Directive

The Solvency II Directive that aligns European Union ("EU") insurance regulation and codifies the amount of capital that EU insurance companies must hold to reduce their risk of insolvency, could impact the U.S. subsidiaries of parent companies located in the EU. Because of the legislation's capital requirements, certain lines of business that attract the higher capital requirement, such as long-term guaranteed products, may become unattractive. Also, compliance with the Solvency II Directive may require a significant investment in IT systems and enterprise risk management ("ERM"). As a result, the industry could see an increase in M&A activity as companies seek to achieve the preferred scale and diversity of risk under the Solvency II Directive calculations.

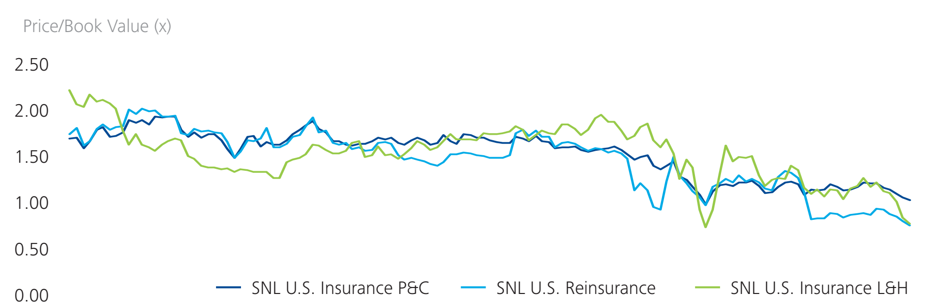
4 Valuations

The insurance industry continues to see historically low valuations in P&C, Life and Health (L&H), and Reinsurance companies. Many insurers are trading at a discount to book value (Figure 3). The discount to book value has potentially created a discrepancy between management's and board of directors' perceptions of their company's worth and that which is being indicated by the market, causing a decrease in deal activity.

The bright side is that valuations are at attractive levels for acquirers. At these levels, very little value, if any, is given to goodwill or infrastructure; the value is mostly the embedded value of the book of business. However, unrealistic expectations could remain an impediment to deal-making: bid-ask spreads are still large, although spreads appear to be narrowing. On the buy side, potential bidders have been hesitant to offer prices that are significantly above that which the market is indicating, as they would then experience pressure to quantify this control premium through potential synergies.

Figure 3: Historical Price-to-Book Ratios for Insurance Underwriters

Price/Book Value
Historically between 2001 and YTD 2011



	Jan 1	Jan 1	Jan 1	Jan 1	Jan 1	Jan 1	Jan 1	Jan 1	Jan 1	Jan 1	Jan 1
Median P/BV (x) Values	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
SNL U.S. Insurance L&H	2.02	1.50	1.32	1.54	1.57	1.75	1.79	1.65	1.28	1.12	1.09
SNL U.S. Insurance P&C	1.71	1.75	1.61	1.64	1.64	1.67	1.57	1.40	1.15	1.13	1.13
SNL U.S. Reinsurance	1.78	1.76	1.63	1.62	1.45	1.49	1.57	1.18	1.18	0.85	0.85
Average	19.9	22.6	21.6	19.0	24.1	25.7	86.5	64.9	18.1	12.5	43.7

Source: SNL Financial

- SNL U.S. Insurance P&C : Includes all publicly traded Insurance Underwriters in SNL's coverage universe in the Property & Casualty sector.
- SNL U.S. Reinsurance : Reinsurance
- SNL U.S. Insurance L&H : Includes all publicly traded Insurance Underwriters in SNL's coverage universe in the Life & Health sector
- YTD as of November 30, 2011

5 Alternative use of capital

A prolonged soft pricing market and low return on equity is making the insurance industry unattractive to new entrants, existing insurers and many investors. Even though takeover targets are selling below book value, potential acquirers, especially stock companies, are getting tremendous pressure from their investors for dividends and buybacks to return capital rather than devote it to M&A. As a result, many insurance companies are engaging in share buy-backs of their own and increasing shareholder dividends rather than reinvesting excess capital in their core insurance business.

6 Emerging markets

The U.S. has become a slow premium growth market. As a result, foreign insurers have less interest in the U.S. insurance market; M&A activity is moving to Asian and Latin American emerging market economies, which are seen as more attractive in terms of premium growth opportunities. This trend may accelerate as a result of the Euro debt crisis. Because of the higher capital requirements placed on European financial institutions, some financial institutions are beginning to sell their crown jewels in Latin America and Asia, which could lead to more M&A activity and some transformational deals for financial institutions in these markets.

7 Catastrophes

The U.S. in 2011 has seen more weather catastrophes that caused at least $1 billion in damage than it had in the 1980s, even after adjusting those earlier dollars for inflation.[1] As of early December 2011, the National Oceanic and Atmospheric Administration ("NOAA") identified a dozen such disasters, including twisters, floods, snow, drought, heat, and wildfire.[2] As a result of these catastrophes, P&C company income statements have absorbed some large hits to earnings and capital; which has adversely impacted earnings and surplus. Unfortunately, increasing numbers of extreme weather events are generating concerns that we are entering into a period of higher catastrophic losses.

1 "Weather disasters smash U.S. Record," Associated Press, December 7, 2011. http://www.foxnews.com/us/2011/12/07/billion-dollar-weather-disasters-smash-us-record/. Accessed December 8, 2011

2 Ibid

8 Capital adequacy

The life insurance industry is becoming increasingly concerned about statutory surplus/capital adequacy — in part, due to the move towards international accounting standards and potential changes in statutory accounting that impact surplus cash requirements — resulting in a general reluctance to conduct M&A transactions. Companies that experience a decrease in surplus as a result of the changes in accounting methodologies may be forced to seek additional capital, or a higher capitalized merger partner.

Cash is king in making deals. In the case of competing offers, the one with cash tends to get precedence over an even better economic deal where more volatile stock is concerned. Also, many of the deals being transacted are driven by restructurings, as sellers carve out non-core or underperforming subsidiaries or try to exit lines of business to shore up their bottom line.

9 Tax reform

Tax reform typically creates M&A uncertainty, as taxes can have a significant impact on deal value. In the past year, there have been suggested changes in the taxation of life insurance products, offshore reinsurance and offshore insurance companies, as well as taxation issues resulting from health care reform. Each of these proposed changes could have a significant impact on insurance company earnings and deal value. Certain tax reforms appear inevitable in 2012; however, these reforms may impact various segments of the insurance industry differently. For example, P&C insurers may be affected by proposed changes in the taxation of premiums ceded to offshore entities. Life and Health insurers may be impacted by proposed changes in the taxation of life insurance products. Reinsurance companies may be affected by proposed changes in international taxation, and privately held brokers and agents may be impacted by changes in individual and capital gains tax rates.

10 Lack of accretion

Historically, many insurance M&A deals have failed to be accretive to earnings. In fact, some have resulted in a decrease in earnings per share even after company management and analysts have predicted otherwise. There are many reasons for this, including failures in M&A strategy, due diligence and integration; many of which could have been prevented. However, this lack of accretion has made some CEOs and Boards of Directors opposed to M&A under any circumstances. In other cases, Boards have required a much higher discount rate and internal rate of return to compensate for the M&A risk factor, which makes agreeing on valuation more difficult. In either case, accretion is a factor impacting today's deal environment.

Outlook for 2012

The time for an uptick in insurance industry M&A appears to be ripe and we are beginning to see an uptick in small company and emerging market M&A. It appears the soft pricing market has shifted in some lines and rates have begun to stabilize. However, it is highly unlikely that insurance companies can achieve significant organic growth in this environment. For those companies focused on growth, acquisitions may continue to present the most viable option, particularly in a buyer's market filled with compelling values.

We expect the strong Broker and Agency M&A market to continue, as this industry segment proceeds down its path of consolidation. P&C M&A is likely to be stagnate, as low valuations and reserve concerns may constrain deal-making. We anticipate that Life and Health insurance M&A activity may increase, as the low interest rate environment and surplus concerns begin to drive consolidation in mid-size public companies and mutual insurers.

Although there remains much interest in Reinsurance company M&A, as witnessed by events in 2011, we expect limited activity until (and unless) a "game-changing" event occurs such as a catastrophe or significant change in the interest rate, regulatory or tax environment which serves as a catalyst for renewed deal making.

Among general industry M&A trends that are anticipated to continue in 2012:

- Emerging markets remain a focus for the larger players. In particular, Latin America, Asia, Eastern Europe and the Middle East are areas where insurers with limited growth opportunities in the U.S. remain interested in potential targets.
- Cross-border activity appears to be a growing theme. This is due, in part, to regulations changing in different countries at different times; for example, the impact of the Solvency II Directive on spread products, and the impact of IFRS on long-tail, interest-sensitive life products. Another driver is the need for companies that received government aid to sell portions of their companies to pay back their governments.

- Many in the industry see opportunity in strategic "bolt-on" transactions; in particular, to fill geographic or capability/product gaps. Similarly, recent large acquirers may need to dispose of duplicative operations in selected countries, while other insurance companies may wish to divest banks purchased as a means to acquire Troubled Asset Relief Program ("TARP") funds several years ago.
- Many companies are looking for multiple, alternative multi-platform distribution channels (exclusive agents, E-Commerce, independents). While there may be a place for the agent or broker in selling certain large commercial accounts or sophisticated commercial products, many carriers having traditional distribution channels, exclusive agents and independent brokers are now considering an additional e-commerce distribution channel as well, which creates potential insurance M&A demand.
- M&A in the traditional brokerage (distribution) industry segment is expected to remain active in 2012. The reasons for consistent M&A activity include: attractiveness of this segment to private equity, as it is a cash flow-generating business without the capital requirement of an insurer; the need for larger brokers to generate top-line growth in a prolonged soft market; and the ability to drive improved profit margins though economies of scale.
- Vertical acquisitions could lead underwriters to acquire managing general agents ("MGAs"), and managing general underwriters ("MGUs"), or captive agents.
- Analysts are judging potential M&A on their strategic fit (closer to the core is preferred), accretion to earnings per share and return on invested capital, and the degree of difficulty in the M&A undertaking across deal completion, management, achievement of planned synergies, and culture. The margin for error is considered carefully; the bigger the deal, the greater the downside if something goes wrong. This close scrutiny by analysts is driving companies to look at alternative uses for their capital, such as increasing dividends or share buybacks, as the hurdle rates for M&A are very high.

Impediments to wide-scale M&A activity in 2012 remain. Legislative uncertainty until after the general elections will continue to generate hesitancy around tax, financial and health care reform, while the Solvency II Directive could decrease European insurers' appetite for M&A, especially in the U.S. Yields remain low, impacting spread-based business. Also, potential acquirers continue to experience stockholder pressure for alternative use of capital.

What could trigger increased M&A activity?

Despite lingering market uncertainty, certain triggers could increase insurance industry M&A activity in the next 12 months:

Relatively high probability, relatively low impact triggers

1. *Strategic management of business portfolios:* Competitive pressure within specific segments of the industry prompt larger organizations to divest of businesses that are not core and cause organizations of various sizes to acquire capabilities (e.g., channels, technology) that will strengthen their core.
2. *Growth pressure reaches a tipping point:* Triggered by heightened earnings per share ("EPS") growth expectations by the investment community or by further shrinkage in premium or market share by the mutuals, organizations likely turn to inorganic growth strategies.
3. *Bid-ask spreads narrow:* Bidders are able to justify higher multiples to book because clear evidence begins to emerge of a hardening trend in pricing, driven by earthquake and storm-driven balance sheet deterioration, especially in commercial lines.

Relatively low probability, relatively high impact triggers

1. *Emergence of clarity about capital requirements:* Go-forward capital reserve requirements become clear for specific lines of business, triggering both divestitures by organizations seeking to exit businesses that are no longer attractive to them as well as acquisitions by others who seek to grow scale in businesses that have become relatively more attractive.
2. *The U.S. insurance market becomes more attractive:* A hard market similar to 1988-2001 makes the U.S. a much more attractive insurance growth market to foreign investors and could trigger strategic acquisitions designed to enable those acquirers to capitalize on that growth.
3. *Private equity makes a bold play:* Private equity investors, triggered by an ability to raise cheap capital, consolidate a number of midsize organizations (especially P&C) that are selling for less than book value, building a strong organization capable of taking market share.
4. *Major competitive action alters landscape:* The launch of a highly popular new product (e.g., pay-as-you-drive auto or a highly competitive product bundle) or an aggressive price play by a major player with significant capital reserves puts significant pressure on the top lines of weaker players, causing transactions to maintain scale.

Preparing for a potential M&A resurgence

To prepare for an anticipated uptick in industry M&A activity, insurers should develop a strategy comprised of three elements: business portfolio improvement to enhance existing assets, inorganic growth analysis to improve market position and M&A process excellence to embed M&A process knowledge.

Portfolio improvement assesses which business units are adding versus subtracting enterprise value. Insurance companies should evaluate the contribution of individual business units to growth, profitability and the balance sheet; assess each business unit's strategic fit to corporate strategy; and rationalize and/or improve the performance of specific business units.

An inorganic growth analysis focuses on setting priorities and building a preferred-fit acquisition pipeline to help a company become a "prepared acquirer." Insurers should establish a corporate strategy for operating companies; assess capability gaps required to achieve their aspirations; and build a proactive M&A pipeline to close gaps and expand service offerings.

M&A playbooks for each stage of the M&A lifecycle can be a foundation for M&A process excellence. To address both approach and execution, companies should create broad M&A policies and procedures; establish standard operating procedures for transaction execution; and incorporate M&A reviews to evaluate previous acquisitions.

Whatever their rationale for pursuing M&A opportunities in 2012 — acquiring new distribution capabilities, expanding the scale of existing business(es), entering new lines of business (products, customers, geographies), or acquiring enhanced operational capabilities — insurance companies that craft an M&A strategy now should be better-positioned to take advantage of an M&A resurgence.

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