

Insurance: M&A – From famine to feast? We're not that optimistic.

In 2009 M&A was at its lowest level since 2004. Will 2010 bring more – especially in the insurance sector.

2009 was an unusual year from an M&A perspective. According to Dealogic, global M&A volume for the year, totalling \$2.4 trillion for all sectors combined, was at its lowest level since 2004.

Notably though, global restructuring M&A, through bankruptcy or distressed situations, reached \$320 billion in 2009 for all sectors combined, the highest annual volume on record and government backed acquisitions accounted for 15% of all global volume during the year.

Contributions to the number for global restructuring M&A from the insurance sector included US insurance group AIG disposing of some US\$3 billion of its Asian operations.

Overall though, M&A activity in the insurance sector was somewhat subdued, with most deals closing at much lower prices versus book value than were being achieved before the onset of the financial crisis.

Outlook for 2010

This week Brave Partners looks back at some of the insurance-related M&A talking points of 2009 which were largely confined to the second half of the year. We then look forward to 2010 and ask ourselves the following four questions:

- Will M&A volume increase in the insurance sector in 2010?
- What are the arguments for an increase in M&A volume?
- Where will we see M&A deals?
- Will deals ever again close at the prices versus book value that were being achieved before the onset of the financial crisis?

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Review of 2009

Despite the lack of overall activity, 2009 did see some deals and a few hard fought transactions in Bermuda.

December 2009

Just before Christmas, the insurance broker and risk adviser, Marsh Inc., announced it had reached an agreement to acquire HSBC Insurance Brokers Ltd (HIBL), a wholly owned subsidiary of HSBC Bank.

Under the terms of the agreement, Marsh will acquire HIBL for £135 million. The transaction is expected to close in the first quarter of 2010.

The deal will allow Marsh to leverage HSBC's global network and banking relationships to generate new business. HIBL holds prominent market positions in countries where Marsh has both a significant presence and major plans to grow, including the UAE, Saudi Arabia, Qatar, China, Hong Kong, India, Singapore, South Korea and Taiwan. In short, this deal appears to represent a strong complementary fit which will deepen Marsh's global presence in high growth areas and it is therefore a text book example of delivering value to shareholders, assuming integration is achieved smoothly.

Meanwhile, Bermuda became something of a focus for deal watchers, with various combinations deemed possible. The two most talked about possible M&A deals were an Aspen acquisition of Ariel Re and a HarborPoint tie-up with Max Capital, with the former deemed more likely than the latter.

However there are barriers to overcome before any of the Bermuda-based rumours become a reality. In particular, whilst property-and-casualty (P&C) insurers might, in many cases, have strong balance sheets, their stocks trailed the market in 2009 and many expect P&C stocks to be flat in 2010. This clearly makes it more of a buyer's than a seller's market.

An Aspen/Ariel merger would create a \$4 billion diversified company with US platforms, operations at Lloyd's and a strong Bermudian presence. And scale of this nature is certainly considered important amongst Bermudian reinsurers in order to gain investor interest.

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November 2009

On 5 November 2009, UK life insurer Friends Provident Group PLC was acquired by Resolution Limited. This probably wins the prize for being the most controversial insurance market deal of 2009 as the companies involved are apparently poles apart in terms of their raison d'être. Friends Provident was set up by Quakers in the early 19th century and has trod a conservative, ethical path ever since. Resolution, a fund registered in the tax haven of Guernsey, buys insurers and gives them the private equity treatment. It's hard to know what to make of this deal until Resolution's next moves become apparent. Only as subsequent Resolution deals become known will we be able to evaluate possible cost, outsourcing and asset management synergies.

September 2009

In September we saw London-listed Tawa plc acquire Swiss Re's UK P&C legacy business, Pro Group. Meanwhile, Bermudian-domiciled Enstar bought RSA Group's legacy portfolio, British Engine which includes long-tail liabilities such as UK asbestos exposures.

July 2009

In July, Bermudian PartnerRe bought its smaller Swiss-domiciled competitor, Paris Re in a deal valued at \$2 billion. The deal has created the fifth largest global reinsurer by gross written premium.

Observers of the deal commented that it would bring greater market presence, risk diversification, capital strength and scale as well as providing more balance and stability. In general the deal was well liked as a marriage of two quality franchises. But the pricing at 0.98x price/book value was thought to represent a low valuation.

Looking ahead to 2010

BRAVE Partners addresses the significant questions for 2010.

Will M&A volume increase in the insurance sector in 2010?

Most observers of this market seem to believe that we will see an increase in M&A activity in 2010 as companies look for growth through either diversification or specialization.

However an increase in M&A will require a stabilization of markets, a boost of confidence in valuations – or an acceptance that one time valuation levels may no longer be achievable – as well as an improvement in financing capacity and terms. It is Brave Partners' expectation that funding will continue to be challenging for some time to come.

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Encouragingly though we've already seen reports of M&A activity in 2010. Bermuda-headquartered Armour Re has completed its acquisition of PMA Capital Insurance Company.

Meanwhile, in a recent European Union ruling on state aid it became clear that RBS will be divesting its insurance businesses (which include the Churchill and the Direct Line brands) over coming years.

Indeed as banking groups in general seek to release capital and sharpen their strategic focus in the wake of the credit crisis, some others may choose to sell their insurance subsidiaries.

Other opportunities include life insurance buyouts, which could increase as the move to Solvency II heightens the spotlight on capital-intensive run-off business.

What are the arguments for an increase in M&A volume?

It is clearly imperative for risk management to be ever stronger in the wake of the financial crisis. Insurance companies may find the challenges in this respect easier to achieve with certain critical mass. Huge scale (e.g. AIG) is clearly not a paradigm here. But a certain scale may indeed be helpful. Indeed

the size and scale of insurance companies is becoming increasingly important for rating agencies, investors and clients.

Well executed integrations may well lead to cost reductions which would of course be positive. At the same time sales and distribution efforts may benefit from scale, and investment management may benefit from the depth of experience resident in larger firms.

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Where will we see insurance M&A deals?

First of all, where are we less likely to see deals? Clearly the answer here relates to where the industry is already well concentrated which it is in geographies such as the Netherlands, Japan and Australia.

Areas with more deal potential are as follows:

EUROPE

It is understood that UK insurers are looking to explore acquisitions, particularly in high growth markets such as emerging Asian and emerging European markets.

There is some expectation that Resolution Ltd might mount a bid for another life insurer after buying Friends Provident Group PLC.

Aviva is understood to be looking at potential targets overseas rather than in the UK.

Meanwhile in Spain, whilst the health insurance sector is consolidated, other areas of the industry are fragmented and thus M&A opportunities could be in the offing.

THE AMERICAS

More consolidation is expected over the coming years in fragmented Mexico and more global players are expected to enter this market, possibly through M&A.

Whilst M&A activity in the US has been relatively quiet over recent years, there has been activity in Bermuda – and further activity here is anticipated given the nature of the market.

BERMUDA

Bermuda is a special case for 2010. The market has seen little M&A over its history apart from a period of acquisitive growth when Ace and XL vied for the top spot on The Island.

■ The troubles at XL Capital, although sliding into the rear view mirror have reminded the next generation (eg Axis, Ironshore, Validus) that there is room for more large, international players to compete with Ace and XL.

■ Pricing, particularly in the core Bermuda business of property catastrophe risk, will be under severe pressure in 2010. Property catastrophe players need:

- To lower cost bases
- To boost capital bases
- To find diversified business under less price pressure

The particular position of the senior executive making the issue of management of a merged entity less of an issue than it might otherwise be.

“There is murmur of a four way merger in Bermuda. A tough call, but it shows how favourable the current M&A conditions are on The Island.”

Richard Enos
Partner
BRAVE Partners LLP

Recent events have made Bermuda a breeding ground for M&A as the two deals closed in 2009 demonstrate. Drivers for M&A in Bermuda include:

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In fact BRAVE Partners has heard murmurs of a four way merger deal. A tough call, but it shows the favourability of conditions.

ASIA PACIFIC

China is one of the key markets to watch here. In China global players have entered the market and formed joint ventures with local partners. M&A is expected to increase as regulation relating to foreign ownership of local insurers is relaxed.

Will deals ever again close at the prices versus book value that were being achieved before the onset of the financial crisis?

The small number of 2009 deals were done at low price to book multiples. This was partly responsible for discouraging additional logical combinations.

Despite this background, where the industry is running out of time to consolidate, some deals will start to be done with a view to generating longer term, rather than immediate term shareholder gain.

Ironically such an increase in “necessity” deals will likely increase the levels of closing prices in general over time, because as deals start to get done, confidence will increase – especially if deals are done with strategic logic and are implemented with skill in areas such as integration. However it still seems a long way off before pre financial crisis level prices on a price to book value basis will be commonplace again.

So the question smaller companies in particular need to ask themselves is: can they afford to wait, or do they need immediate scale to survive?

BRAVE Partners services

BRAVE Partners can advise companies on their business and capital strategy to enhance their position in the M&A market.

Within Europe BRAVE Partners believes that Solvency II will drive M&A activity. The firm believes that a solid capital plan that includes Solvency II is a critical component for a European firm’s M&A strategy in 2010.

Interaction

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- BRAVE Partners believes that M&A activity will increase in 2010, but will not become an avalanche.
- Most M&A activity will be within the mid tier and driven by capital and revenue needs.
- Firms will need to prepare themselves well for the 2010 M&A environment. A poor business or capital strategy could make a firm a laggard and a target for a predatory bid.
- BRAVE Partners can advise on the state of the markets, particularly in Bermuda and Europe.
- BRAVE Partners can advise on optimal capital and Solvency II strategies for M&A.

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