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2016 Insurance M&A Outlook

A year of continuing exuberance

Contents

Overview and outlook

2015 was the most active year ever for mergers and acquisitions (M&A) across all insurance industry sectors. By early December, a slew of transactions, large and small, pushed deal volume to a record $5.03 trillion, up 37 percent from 2014 ($3.67 trillion) to surpass the $5 trillion mark for the first time.[1] An improving economy, sustained low interest rates, and the pursuit of new technologies, enhanced capabilities, and increased scale primed the pump for companies' pursuit of high-quality domestic and international assets. Will M&A activity keep pace in 2016 or might economic, operational, and regulatory factors temper buyers' and sellers' enthusiasm? In this report, we highlight the current state of insurance industry M&A; examine key drivers and trends for 2016; and suggest what leading insurance organizations should consider doing to help them identify and capitalize on M&A opportunities as they move forward.

2015 in review

Insurance was one of many industries that enthusiastically embraced M&A in 2015 as a way to boost revenue growth, enter new markets, and improve operating efficiencies. The year was highlighted by several transformative transactions, led by ACE Limited's (ACE) announced acquisition of The Chubb Corp. (Chubb) for $28.3 billion[2]—the Property & Casualty (P&C) segment's largest-ever deal.[3]

Foreign buyers—especially from Asia—went on an insurance company buying spree in 2015, as they continued to invest in US and Bermuda assets to bolster their presence in the world's largest insurance market.[4] Three Japanese deals were particularly noteworthy: Tokio Marine Holdings announced it would acquire HCC Insurance Holdings for $7.5 billion in cash;[5] Meiji Yasuda Life Insurance Co. agreed to acquire StanCorp Financial for $5.0 billion;[6] and the Sumitomo Life Insurance Company of Japan announced its acquisition of Symetra Financial for $3.8 billion.[7]

Meanwhile, two cash-rich Chinese companies, Anbang Insurance Group Co., Ltd. (Anbang) and Fosun International Group, Ltd. (Fosun), made a number of high-profile acquisitions in 2015 across different sectors, including insurance.[8] Anbang announced it would acquire US annuities and life insurer, Fidelity & Guaranty Life, in an all-cash deal valued at about $1.57 billion.[9] Fosun agreed to buy Meadowbrook Insurance Group for $433 million[10] and completed its acquisition of Bermuda-based insurer Ironshore Inc. by buying the $1.84 billion in shares it didn't already own.[11]

European companies also invested in M&A. Italy's Exor S.p.A., a diversified investment group controlled by the Agnelli family, agreed to buy Bermuda reinsurer, PartnerRe Ltd, for $6.9 billion. The move supports Exor's strategy of making long-term investments in global companies in the US and Europe, and will help it further diversify away from industrials.[12]

Fueled by the ACE/Chubb insurance deal, significant foreign investment, continued restructuring within the reinsurance sector, and numerous other transactions, aggregate deal value in the underwriter space in 2015 increased 280 percent over 2014. Deal volume in brokerage set a new record, increasing 11 percent over the previous record set in 2014, although aggregate brokerage deal value decreased by 17 percent (Figure 1).[13]

Figure 1: Insurance sector M&A activity, 2014–2015

	Number of deals			Aggregate deal value			Average deal value		
	2014	2015	YOY change	2014	2015	YOY change	2014	2015	YOY change
Underwriters	82	70	(15%)	$17.2b	$65.3b	280%	$277m	$1,814m	555%
L&H	17	19	12%	$7.6b	$11.8b	55%	$545m	$1,177m	116%
P&C	65	51	(22%)	$9.6b	$53.5b	457%	$199m	$2,058m	934%
Brokers	351	390	11%	$2.8b	$2.3b	(17%)	$49.1m	$41.8m	(15%)
Total	433	460	6%	$20.0b	$67.6b	238%			

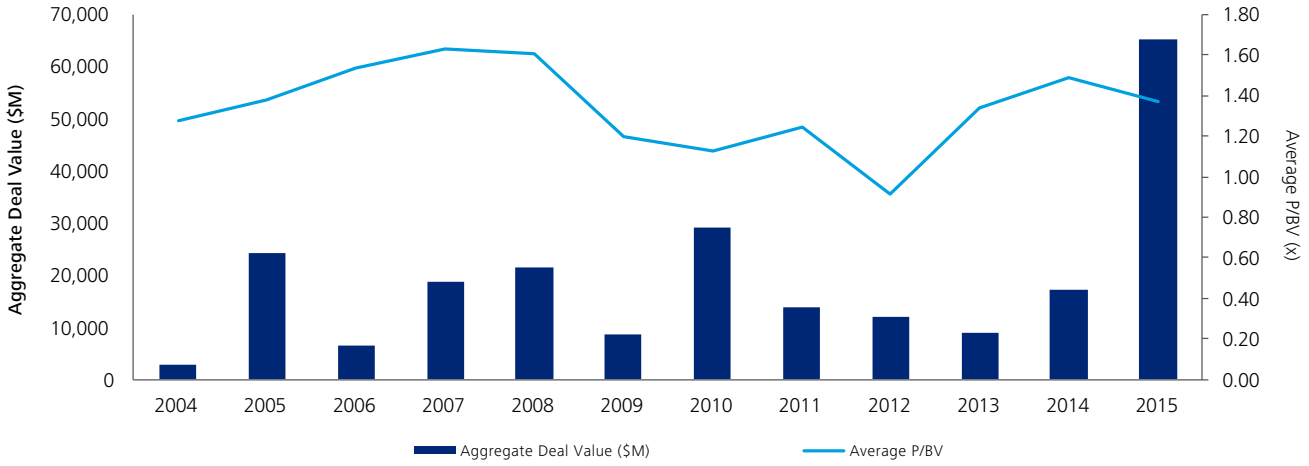
Source: Deloitte analysis utilizing SNL Financial M&A database

Insurance underwriters

In terms of the multiples observed in the insurance underwriters segment, Figure 2 indicates a slight decrease (approximately seven percent) in the average Price/Book (P/B) multiple between 2014 and 2015, adjusting for certain outliers. In addition, as can be observed in the graph, the average deal value in 2015 increased significantly over the 2014 level primarily due to the re-emergence of the transformative deal. This re-emergence is also evident, as mentioned above, by the significant aggregate deal value, which reached a level not approached by any year examined.

Figure 2: M&A trends for insurance underwriters

Price/Book Value Multiples



	Year	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
	Number of deals	39	74	84	99	95	83	107	99	98	88	82	70
Size of deals ($M)	Low	0.5	0.7	0.4	0.4	1.3	0.02	0.3	0.5	0.1	0.1	1.3	7.5
	High	1,350.0	11,500.0	1,120.9	2,744.0	6.225.0	1,900.0	15,545.1	3,534.6	3,100.2	1,125.0	5,579.6	28,240.3
	Average	98.6	473.8	94.1	229.5	288.9	162.0	395.6	222.5	195.5	136.4	277.3	1,813.5
Observed P/BV deal multiples	Low	0.53x	0.87x	0.75x	0.79x	0.48x	0.77x	0.55x	0.54x	0.31x	0.68x	0.14x	0.003x
	High	0.286x	2.12x	6.19x	2.34x	2.81x	2.98x	1.70x	5.81x	5.99x	4.11x	2.83x	2.17x
	Average	1.28x	1.38x	1.54x	1.63x	1.60x	1.20x	1.12x	1.24x	0.91x	1.34x	1.48x	1.37x
	Median	1.23x	1.24x	1.65x	1.65x	1.59x	0.89x	1.06x	1.01x	0.81x	1.55x	1.39x	1.16x

Source: SNL Financial

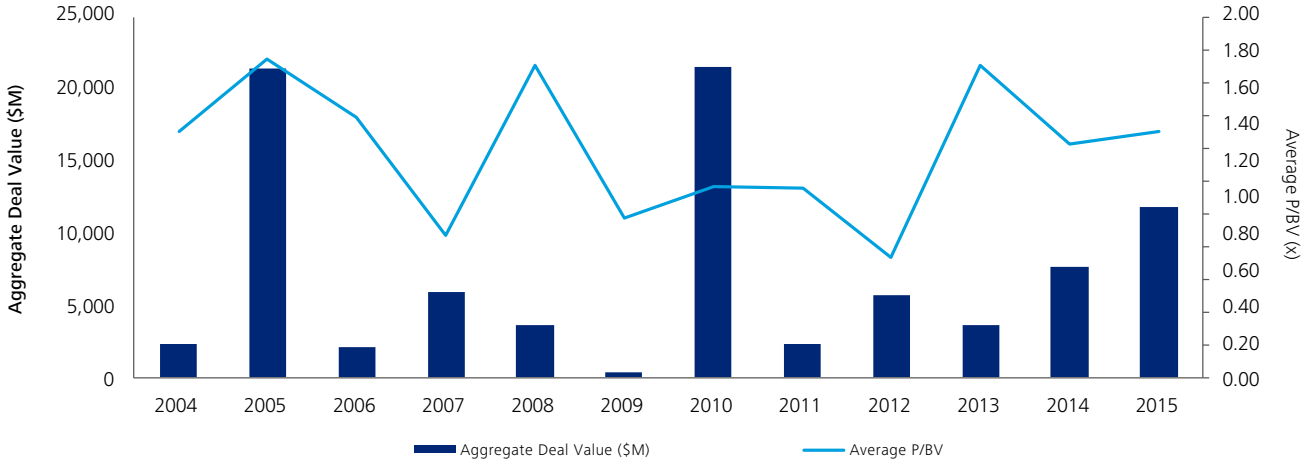
- Transactions represent US and Bermuda companies making acquisitions on a global basis and international buyers making acquisitions in US and Bermuda. Insurance Underwriters include P&C, L&H, Multiline, Title, Mortgage Guaranty and Finance Guaranty sectors covered by SNL Financial. Does not include Managed Care.
- Transactions grouped by the year they were announced.
- Deal multiples represent closed multiples, unless the transaction is still pending close.
- Outliers have been removed from the average deal multiples. Outliers include all deals with a P/BV multiple smaller than 0.5x or greater than 3.0x.
- Analysis as of 12/31/2015.

Overview and outlook (cont.)

Life & Health

Among market segments, 2015 M&A activity in life & health (L&H) insurance continued to be sluggish in terms of the number of deals. With the benefit of hindsight, will 2014 be seen as the long-term nadir for L&H M&A deal volume? It appears that the low interest rate environment continued to adversely impact activity in this segment. In looking at the data, however, the aggregate deal value in this space continued its upward trajectory, reaching a level surpassed only by the peak years of 2005 and 2010. Average deal value was nearly $1.2 billion, topped only in 2005 (Figure 3). This was driven by five prominent deals which occurred in the L&H space, including Dai-ichi Life Insurance Company's acquisition of Protective Life Corp. Collectively, these deals may represent an inflection point for L&H M&A, creating momentum for the sector that could continue into 2016. Average valuations increased modestly from 2014, but remained only slightly above long-term averages.

Figure 3: M&A trends for Life & Health
Price/Book Value Multiples



	Year	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
	Number of deals	20	22	26	33	25	21	28	27	30	25	17	19
Size of deals ($M)	Low	0.5	0.7	1.8	0.4	1.3	0.5	0.3	0.5	0.1	0.1	3.0	14.0
	High	1,350.0	11,500.0	893.0	2,400.0	2,400.0	126.5	15,545.1	917.3	1,550.0	1,056.0	5,579.6	5,001.9
	Average	155.9	1,338.9	92.2	227.1	188.8	28.7	1,026.2	122.3	299.6	204.6	544.5	1,177.4
Observed P/BV deal multiples	Low	0.53x	1.33x	0.75x	0.79x	1.21x	0.88x	1.06x	0.54x	0.31x	1.73x	1.29x	0.10x
	High	2.86x	2.12x	2.41x	0.79x	2.28x	0.88x	1.06x	5.81x	5.99x	1.73x	1.29x	2.17x
	Average	1.36x	1.76x	1.44x	0.79x	1.73x	0.88x	1.06x	1.05x	0.67x	1.73x	1.29x	1.36x
	Median	1.27x	1.84x	1.17x	0.79x	1.71x	0.88x	1.06x	0.94x	0.67x	1.73x	1.29x	1.07x

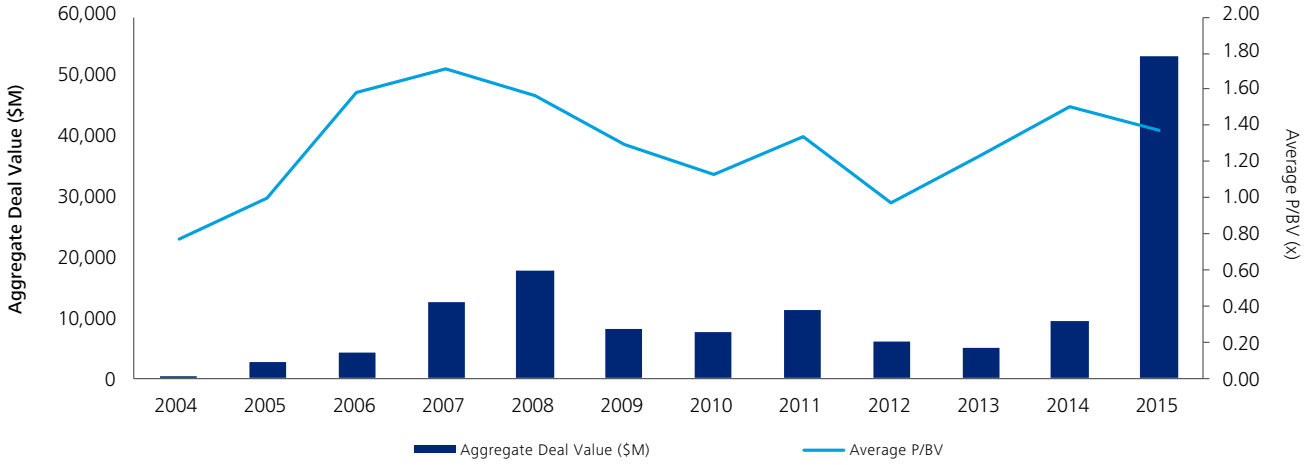
Source: SNL Financial

- Transactions represent US and Bermuda companies making acquisitions on a global basis and international buyers making acquisitions in US and Bermuda. Does not include Managed Care.
- Transactions grouped by the year they were announced.
- Deal multiples represent closed multiples, unless the transaction is still pending close.
- For years 2007, 2009, 2010, 2013 and 2014 there is only one deal with data, respectively.
- Outliers have been removed from the average deal multiples. Outliers include all deals with a P/BV multiple smaller than 0.5x or greater than 3.0x.
- Analysis as of 12/31/2015.

Property & Casualty

The aggregate deal value of P&C transactions in 2015 reached a level not observed over the examined period despite the approximately 20 percent drop in the number of deals (Figure 4). In looking at the data, the number of deals in excess of $500 million continued an upward trajectory, with seven such deals announced in 2015 compared to five in 2014 and four in 2013. This was a significant increase in large deals as a percentage of the overall population. The data also indicates that while the P/B multiple decreased slightly from 2014, it continues to show an upward trend since 2012. The average valuation level in 2014 was consistent with the long-run average of 1.35.

Figure 4: M&A trends for Property & Casualty
Price/Book Value Multiples



	Year	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
	Number of deals	19	52	58	66	70	62	79	72	68	63	65	51
Size of deals ($M)	Low	3.0	1.2	0.4	1.0	1.8	0.02	1.2	0.5	0.8	0.4	1.3	7.5
	High	79.5	825.0	1,120.9	2,744.0	6,225.0	1,900.0	1,318.5	3,534.6	3,100.2	1,125.0	1,671.3	28,240.3
	Average	32.4	78.3	95.1	230.6	323.5	196.9	145.7	266.8	148.5	110.3	199.4	2,058.2
Observed P/BV deal multiples	Low	0.77x	0.87x	0.92x	1.23x	0.48x	0.77x	0.55x	0.73x	0.57x	0.68x	0.14x	0.003x
	High	0.77x	1.15x	6.19x	2.34x	2.81x	2.98x	1.70x	2.69x	1.52x	4.11x	2.83x	1.90x
	Average	0.77x	1.00x	1.58x	1.72x	1.56x	1.30x	1.13x	1.34x	0.97x	1.24x	1.50x	1.37x
	Median	0.77x	0.97x	1.66x	1.73x	1.51x	0.99x	1.06x	1.16x	0.90x	1.38x	1.43x	1.24x

Source: SNL Financial

- Transactions represent US and Bermuda companies making acquisitions on a global basis and international buyers making acquisitions in US and Bermuda. Property & Casualty includes P&C, Multiline, Title, Mortgage Guaranty and Finance Guaranty sectors covered by SNL Financial.
- Transactions grouped by the year they were announced.
- Deal multiples represent closed multiples, unless the transaction is still pending close.
- For 2004, there is only one deal with data.
- Outliers have been removed from the average deal multiples. Outliers include all deals with a P/BV multiple smaller than 0.5x or greater than 3.0x.
- Analysis as of 12/11/2015.

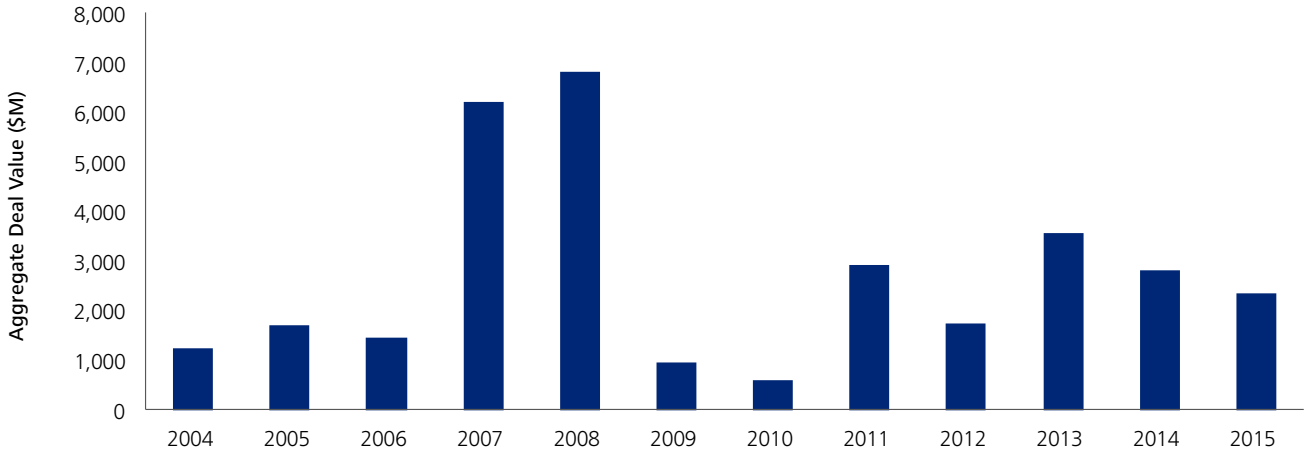
Overview and outlook (cont.)

Insurance Brokers

The Insurance Broker segment continued to be the most active in terms of 2015 deal volume, setting a new record with 390 announced deals, up from the record of 351 achieved in 2014 (Figure 5). Aggregate deal volume, meanwhile, decreased by 17 percent in the same period.

Approximately 50 percent of the deals were purchases of small and/or regional brokers by serial acquirers, the five most active being Hub International, AssuredPartners, Inc., Arthur J. Gallagher & Co., Confie Seguros California, Inc., and Acrisure, LLC.

Figure 5: M&A trends for Insurance Brokers
Price/Book Value Multiples



Year	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Number of deals	229	201	220	267	293	183	240	304	344	239	351	390

Source: SNL Financial

- Transactions represent US and Bermuda companies making acquisitions on a global basis and international buyers making acquisitions in US and Bermuda.
- Transactions grouped by the year they were announced.
- Analysis as of 12/31/2015.

2016 outlook

Hindsight and insight enable foresight, a critical capability for insurance companies seeking to incorporate M&A into their growth strategies. Yet, acquiring and appropriately using this capability can be a challenge for executives across the L&H, P&C, and Insurance Broker segments.

The members of Deloitte's insurance M&A leadership team have produced this 2016 Outlook to provide insurance industry executives with insights for consideration in their M&A planning and implementation efforts. Leveraging hindsight accrued from our industry experience, and insight gleaned from our analysis of market conditions and trends, we hope to equip executives with foresight to help them to better anticipate and address potential M&A opportunities and challenges in the coming year. To that end, we believe 2016 could be a year of continuing exuberance, including the following:

- Overall sector-wide transaction volume in 2016 may be no less than what we've seen in 2015. Aggregate deal value, however, could be less since 2015's total is impacted by "mega" transactions that may not reoccur.
- Current valuations, the need to stimulate growth inorganically, foreign buyers, and divestiture of non-core operations due to ongoing regulatory scrutiny could drive M&A.
- L&H could produce notably more M&A volume, both in terms of stock purchase agreements and acquisitions of closed blocks. A series of five high-profile deals during the second half of 2015 may have created a sea change for this sub-sector that could build upon itself. Active interest by foreign buyers may amplify this trend into 2016.
- P&C could see a similar level of transaction volume in 2016 as in 2015. Specialty lines organizations with unique franchises, strong management teams and/or strong underwriting performance may attract particular interest. Small and middle-market companies may continue to focus on building much-needed scale.
- While P&C claim activity from natural catastrophes dropped from $31 billion in 2014 to $27 billion in 2015, its lowest level since 2009,[14] the El Niño effect might be reversed in the coming year, possibly bolstering hurricane activity, increasing insured and uninsured losses, negatively impacting P&C company valuations, and producing a chilling influence on M&A.[15]
- M&A could remain central to Insurance Broker segment growth strategy, with deal volume potentially on par with the record levels achieved in 2015.
- M&A could continue to be a key mechanism in the ongoing restructuring of the global reinsurance segment.
- If reinsurance pricing does not improve in 2016, smaller players may struggle to remain profitable under increased capital requirements, and could become distressed targets for acquirers looking to pick up new books of business to build scale.
- There could be numerous $1 billion-$5 billion deals in 2016 (there were 10 in 2015), but only a handful of large deals in the $5 billion-$10+ billion range.
- Foreign companies, especially those from China and Japan, may continue to invest in the US and Bermuda. Many of the potential buyers from Japan are established insurers that have been encouraged by the government to put capital to work outside the country. The potential buyers from China likely include both established insurers as well as organizations that have accumulated substantial wealth/assets in real estate but are now looking to diversify their portfolio holdings.
- Insurance financial technology ("fintech") transactions could increase in both number and strategic significance. While most fintech activity may be in the form of financial investments as part of insurers' venture investment portfolios, we could increasingly see fintech acquisitions being integrated into legacy operations to help insurers accelerate their efforts to become more digitally enabled.
- Private Equity (PE) firms may continue to be active shoppers, but may also be challenged to become the successful bidder given the often superior value proposition a strategic buyer can offer. Other forms of "alternative capital" could take the lead.
- Acquisition integration may emerge as a common theme across the insurance industry in 2016 for at least three reasons: (1) A majority of deals announced in 2015 require some degree of integration; (2) Strategic buyers (who have an advantage in this environment) are more likely than financial buyers to execute deals that require integration; and (3) Asian parent companies will be looking to M&A to quickly expand their new US growth platforms, potentially triggering the need to integrate.

Insurance company executives contemplating M&A in 2016 should consider hindsight, insight, and foresight to help identify and capitalize on potential growth opportunities. We suggest they consider planning for and addressing six marketplace drivers and trends discussed below that could help or hinder their plans.

Drivers for insurance M&A in 2016

1. Environment of high confidence

2015 was a banner year for M&A around the world, surpassing $5 trillion in aggregate deal value for the first time in history[16] and besting 2007's previous record of $4.296 trillion.[17] Deal-making was fueled, in part, by an environment of high confidence. Positive macro conditions, including an improving economy and low interest rates, encouraged company boards and executives in insurance, health care, technology, food & beverage, transportation, and other industries to look for ways to put accumulated capital to work. M&A is often an effective way to spur growth and expand market share, and it proved to be a popular choice for companies of all sizes.

Despite generally positive market conditions entering 2016, potential cross-currents and areas of uncertainty that might impede inbound and outbound M&A typically exist. In the US, insurance executives should be mindful of potential impacts from fluctuating economic conditions, volatility in the US equity markets, rising interest rates, and the 2016 Presidential election.

The US insurance sector's performance is generally not as highly correlated as other industries to the general economy's ebb and flow, so modest up-or-down movements in the gross domestic product (GDP) or stock market during 2016 typically have little-to-no effect on insurance M&A. There could be possible downside impacts if the economy or stock market experiences an unexpected, major and/or sustained pullback, because fewer consumers may be able to afford buying insurance, and there may be less commercial exposure that needs to be insured.

Interest rates may prove to be a double-edged sword for 2016 insurance industry M&A. The sustained low interest rate environment can make financing deals affordable but can also create conditions—especially in the L&H segment—under which a key source of revenue generation for insurance companies can be dampened significantly as a result. Returns and organic growth are generally poor today and a primary reason why inorganic growth via M&A has been so active.

The environment changed somewhat on December 16, 2015, when the US Federal Reserve, citing the nation's ongoing economic recovery, hiked its benchmark interest rate by 25 basis points—to between 0.25 percent and 0.50 percent—the central bank's first rate increase in nearly a decade.[18] Financial markets, which had long expected the December hike, appeared fairly muted in their immediate reaction.[19] The impact on insurance M&A could be muted as well, given the size of the initial increase, the fact that it was widely anticipated, and the sense that future increases, if any, may be modest and occur only gradually.

Increasing interest rates may improve insurance company profitability, which could make insurers more attractive to potential acquirers. However, rising rates may siphon-off capital from the insurance space if investors conclude that they can obtain better risk-adjusted returns elsewhere. While it may be marginally more difficult to raise money for M&A with slightly higher interest rates, the industry appears to have plenty of capital right now.

Ultimately, rising rates' impact on insurance M&A may not depend on the increase itself—a quarter-point change may not be considered significant by many—but when the next rate hike is believed to take place. Fed Chairman, Janet Yellen, said that subsequent rate increases will be gradual so the Fed can gauge the effect on financial conditions and spending. She also added that the Fed intends "to communicate as clearly as we could about our policy intentions to avoid spillovers that might result from abrupt or unanticipated policy moves."[20]

Finally, the political uncertainty that accompanies presidential election years could go either way in terms of its impact on M&A. Depending on the winds of change in the political process, companies either try to get in front of it—"let's get this deal done before things change"—or they delay M&A plans until uncertainties about the implications of the November elections—including the new Administration's stance on corporate tax policy (inversions) and regulatory oversight—dissipate.

Bottom line:
If the US economy continues to improve in 2016, the equity markets remain stable, and interest rates remain low, the current environment of high confidence will likely continue, and insurance industry M&A along with it. Substantially more difficult to anticipate are those unforeseen or unexpected factors that, either individually or in some combination, could have the ability to dampen confidence. These include equity market volatility in the US, China, or other major markets; regulatory changes that impede acquisitions in the US; major acts of terrorism; a spike in incurred losses; further declines in the price of oil; or a change in the pace or magnitude of interest rate increases.

2. Regulatory developments cut both ways

Regulatory uncertainty is generally viewed as much less of an impediment to insurance industry M&A than it once was, for an interesting reason: Uncertainty has persisted for so long that it has effectively become "business as usual"—just one more factor for companies to incorporate into their growth and M&A strategies. It helps that there is now clarity about what regulators are focused on; namely, capital, risk management, corporate governance, taxation, and consumer protection. Still, the trend of more stringent regulation continues and insurance companies should take note of several regulatory developments that may impact their 2016 M&A planning:

Capital requirements: Many large US insurance companies' concerns about being designated a Systemically Important Financial Institution (SIFI)—and bearing the significant regulatory burden that accompanies that designation—could dampen potential plans for "mega" M&A deals in 2016. Even getting close to being a SIFI brings increased regulatory scrutiny, so some large insurers—often at the urging of shareholders—may decide to sell or spin off non-core assets and avoid acquiring anything of significance. (On January 12, 2016, MetLife announced its plan to pursue the separation of a substantial portion of its US Retail segment,[21] driven, in part, by the competitive disadvantages it sees associated with SIFI capital requirements.) Internationally, in November 2015, the Financial Stability Board updated its list of nine Global Systemically Important Insurers (G-SIIs), adding Aegon N.V.[22] and removing Assicurazioni Generali after Generali made a number of divestitures and dropped below the global SIFI level. The move appears to be prompting early calls by US insurance industry lobbyists and members of Congress for the Financial Stability Oversight Council (FSOC) to develop a SIFI exit strategy.

On the flip side, Solvency II in Europe could create opportunities for M&A as smaller players may be unable to achieve the scale necessary to remain profitable under the greater capital requirements and heavier compliance and reporting burdens. In 2016, such players may continue seeking scale through M&A to leverage existing frameworks or relocate their operations.

DOL and CFPB rule package on retirement asset management: On April 20, 2015, the US Department of Labor (DOL) and the Consumer Financial Protection Bureau (CFPB) proposed the "Definition of the Term 'Fiduciary'; Conflict of Interest Rule—Retirement Investment Advice, Proposed Rule[23] ("Rule Package"), which could make it difficult for insurance broker-dealers and L&H companies to present an offer to a customer. As written, the Rule Package could have major structural implications on businesses that use exclusive agents and customer service models including call centers and wholesalers. In addition, creating the systems, processes, and oversight functions to comply with the ruling would likely be costly and time-intensive. The proposed ruling is still being discussed and debated but, if implemented, could be a major stimulus for divestitures or other forms of restructuring/business model changes.

Inversion regulations: The IRS Inversion Notice 2014-52, which targets the tax benefits of corporate inversions, continues to have implications for insurance industry M&A. The notice introduces an anti-abuse rule that alters the 80 percent ownership test for companies that have disproportionately large passive holdings (the "cash box rule").[24] The notice equates foreign insurers and reinsurers with cash boxes by offering only limited exclusion for assets that those companies hold in the ordinary course or conduct of their insurance businesses. On the other hand, the notice offers foreign banks and finance companies much broader exclusions for assets that those companies hold in the ordinary conduct of their banking and finance businesses. Many in the insurance industry believe that the notice may have a chilling effect on inbound foreign insurers or reinsurer transactions because: 1) The cash box rule may skew the statutory (IRC section 7874) ownership fraction towards domestic corporation shareholders; and 2) For the same reason, a large foreign insurance company could inadvertently become a US corporation by acquiring a small US entity in whole or in part with its stock.

Drivers for insurance M&A in 2016 (cont.)

Proposed PFIC regulations on hedge funds: On April 23, 2015, the IRS issued proposed regulations under 1.1297-4 *Exception from the definition of passive income for certain foreign insurance company income*,[25] partially as a response to concerns expressed by the Senate Finance Committee over US hedge funds' use of offshore insurance companies as a means of deferring taxation. Many hedge funds, or their investors, have been investing in an offshore insurance company in low- or no-tax jurisdictions, with the insurance company then agreeing to have its investment portfolio managed by the hedge fund or directly investing in the same hedge fund. Such investors have typically relied on an exception from current taxation under the passive foreign investment company (PFIC) regime specifically applicable to companies engaged in the active conduct of an insurance business. The IRS and Senate Finance Committee are directly targeting this deferral by issuing the regulations. If they are finalized as proposed, they will likely serve to shut down an income deferral strategy that some hedge funds and other investors have historically used when partnering with insurance companies to use certain investment structures. Industry comments and criticisms that the proposed regulations are overly broad are making many observers believe that they may not be finalized as proposed.

Bottom line:
Regulators are focused on capital and risk management, which insurance companies—no matter their size—can find challenging to address. Big players concerned about becoming SIFIs likely will not seek to bulk-up via M&A; conversely, the industry could see divestments from SIFIs looking to lose that designation. Because more regulations typically require companies to devote more financial and personnel resources to meet compliance requirements, smaller organizations may seek to improve efficiencies and gain economies of scale through M&A.

3. Current valuation environment may lead to an increased supply of acquisition targets

According to many insurance industry observers, a major impediment to more M&A activity has been a scarcity of available targets. This supply/demand imbalance may improve in 2016, thanks, in part, to a current valuation environment that could help to increase the supply of available targets and, consequently, drive even more demand—buyers could have the implicit "currency" to consummate the deals, and sellers could be enticed to cash out of their positions.

Although overall average P/B multiples paid for insurance underwriters decreased slightly from 2014 to 2015 (see Figure 2), P/B multiple have strengthened notably from the lows seen in 2012 and now sit at, or slightly above, long-term averages. For P&C, the 2015 P/B multiple of 1.37 is nearly identical to the 15-year average of 1.35. For L&H, the 2015 P/B multiple of 1.36 is slightly higher than the 12-year average of 1.26. Current valuations combined with continued foreign interest in US properties may provide powerful incentives for sellers to divest non-core assets or consolidate with a similar-sized or larger player.

Current valuations appear to favor strategic over PE firms. To justify 30+ percent premiums over book value, the successful bidder will likely need to formulate a strategy that offers the potential for synergies (both revenue and expenses) that add significant incremental value through the business combination. This may make it more difficult for PE firms to make an acquisition in the underwriting space, given their relative lack of synergy generation. One possible exception to this rule could be in the broker market, where some PE firms may have existing platforms to which to add bolt-on transactions. Some foreign buyers also may be an exception. Certain Chinese and Japanese companies appear to be demonstrating willingness to bid-up prices and pay a significant premium over book (usually in cash) for a US target that can help establish or notably expand their market presence. (Note that this practice, combined with foreign buyers' long-term investment horizon, has produced certain deal multiples that have been called "sky-high" by some and have led other observers to call the market "frothy." Overall deal valuations, however, do not appear to support these positions.)

Even if 2016 valuations continue to climb from the lows of 2012, we could see the robust deal environment continue given a slow organic growth environment, the presence of some buyers willing to accept a longer payback horizon, and the emergence of fintech transactions that can provide buyers with access to high-payback markets and/or capabilities. In this environment, some buyers with robust balance sheets may be more willing to put their money to work now, before valuations rise further and make it harder for them to cover their hurdle rate, in an effort to present a more compelling story to Wall Street.

Bottom line:
Demand for acquisitions in the insurance industry appears to have surpassed the supply of available targets for a number of years. Given market fundamentals, most organizations today will likely remain very open to—and many are, in fact, seeking—acquisitions. With current valuations, the supply side of the equation could improve—it may be a good time to sell. However, with valuations on the rise, there is a counterweight. More financially conservative companies believe that valuations are too high and have indicated that they have no buying appetite at these levels. At what point will valuations bid up to levels that take out most prudent buyers?

4. Continued demand by foreign buyers to invest in the US market

Foreign companies—especially those from China and Japan—investing in US and other international assets was one of the most important insurance M&A drivers in 2015. Insurers may be attractive targets for companies seeking to grow outside their home country because they typically generate ample cash flows, which can be used for further expansion.[26]

Deep-pocketed Chinese conglomerates, Anbang and Fosun, continued to grow their global financial sector footprint in 2015 by acquiring US and Bermuda-based insurance companies. Fosun agreed to buy Meadowbrook Insurance Group for $433 million[27] and completed its acquisition of Bermuda-based insurer Ironshore Inc. after buying the $1.84 billion in shares it didn't already own.[28] Meanwhile, Beijing-based Anbang announced a merger agreement with Fidelity & Guaranty Life, an annuities and life insurance provider in the US[29]—the first L&H acquisition by a Chinese company. According to SNL Financial, of the 11 full or partial ownership deals for financial firms made by Chinese companies in 2015, Anbang and Fosun together signed four of them, all for insurers, totaling almost $5 billion.[30] Among other Chinese-originated activity, China Minsheng Investment Corp agreed to acquire Bermuda reinsurer International Insurance Group Ltd. for about $2.2 billion.[31]

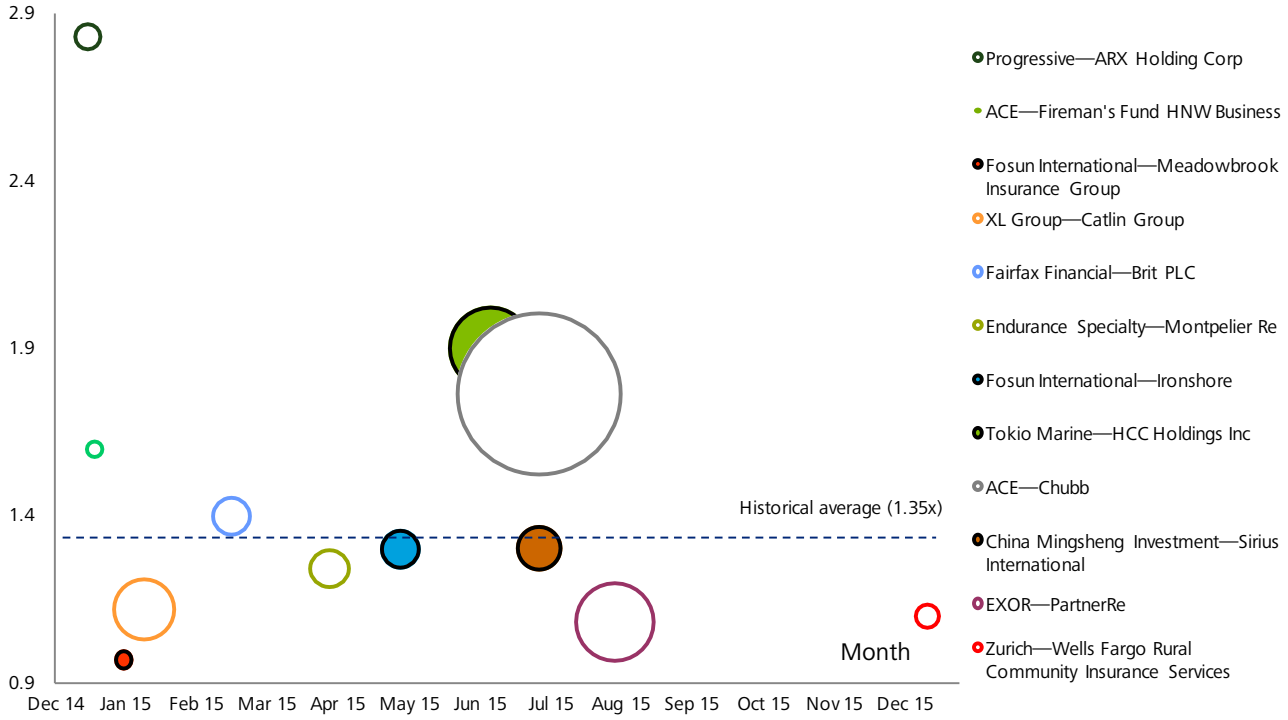
Meanwhile, a summer trifecta of overseas purchases by Japanese insurers generated considerable industry and media attention: In June, Tokio Marine Holdings announced it would acquire HCC Insurance Holdings for $7.5 billion in cash;[32] in July, Meiji Yasuda Life Insurance Co. agreed to acquire Oregon-based StanCorp Financial for $5.0 billion;[33] and in August the Sumitomo Life Insurance Company of Japan announced its acquisition of Symetra Financial, based in Bellevue, Washington, for $3.8 billion.[34]

Three attributes have helped to facilitate Asian companies' forays into the US insurance market: In general, they don't mind navigating the complex US regulatory environment, as they believe that it levels the playing field. In addition, they are generally patient, and willing to balance the risk of not-as-robust, short-term financial returns against longer-term gains. Finally, they are often willing to pay a premium to establish a foothold in a new market, leading some industry observers to complain that these buyers have driven up valuations. To consider this assertion within the

Drivers for insurance M&A in 2016 (cont.)

P&C sector, Figure 6 contrasts acquisitions made by the Chinese and Japanese with all other deals. In short, the data does not appear to support that claim. In fact, with just a couple of exceptions, most deals have been done at or below the long-term industry average P/B multiple of 1.35.

Figure 6: P&C Valuations Paid by Japanese and Chinese vs. Other Buyers
Price/Book Value Multiples



Notes:

1. Transactions shown are P&C deals valued at $250M+ with either the buyer or target being a US- or Bermuda-based (re)insurer.
2. Average historical P&C P/BV multiple for publicly traded companies computed from 2000 to 2015, Morgan Stanley.
3. Acquisitions by Japanese or Chinese buyers illustrated with colored bubbles with black bubble outline.
4. Size of bubble proportional to transaction value.

Will Chinese and Japanese players hit "pause" on M&A after expending so much capital in 2015? The reverse could be true. Many Asian buyers have been clear about their intent to use each initial US purchase as an entry platform and to grow their market share through ongoing M&A. In fact, Japan's government is encouraging companies of all types to put capital to work outside the country to offset Japan's shrinking population and stalled economy. And companies have been doing just that: The first quarter of 2015 was Japan's second-busiest ever for outbound M&A deals, surpassed only by the fourth quarter of 2012.[35] And Japan's big banks are financing more foreign M&A deals by Japanese companies.[36] China's outbound deal volume hit a record high in 2015 and the momentum appears to be carrying over into 2016; as of mid-January, a total of $12.5 billion in China outbound acquisitions have been announced, the fastest-ever recorded start to a year.[37]

Inbound US M&A may continue in 2016, with the most active foreign buyers potentially being one of two types: 1) established Asian insurers looking to expand their geographic footprint and/or product offerings; and 2) Chinese organizations with substantial accumulated real estate wealth that are looking to diversify their portfolio holdings into other industries and countries, including US insurance. CMI, for example, is among international firms seeking to expand to add premium dollars for investment purposes and gain access to risks that aren't tied to stock and bond markets.[38]

Despite a generally positive outlook for the coming year, the party could end early if Chinese market volatility continues and causes a slowdown in capital flows. If, for example, the Chinese stock market remains highly volatile and/or there is a reduction in China's efforts to liberalize its market, it could dampen organizations' enthusiasm for M&A. Also potentially impacting the trend in 2016, persistent cybersecurity issues and intensified regulatory scrutiny could see increased oversight of Chinese-initiated deals by US federal and state regulators.

Bottom line:
Many Asian companies see US insurance assets as valuable additions to their business portfolios and are buying business-building platforms to enable future growth in the world's largest insurance market. Chinese and Japanese investors are often willing to bid aggressively for US properties but justify doing so because they view M&A through a longer-term lens than many domestic buyers. US markets motivate many publicly-held US insurers to execute transactions that are accretive immediately or in the near term, while many Asian investors are prepared to incorporate a much longer time horizon when evaluating the ROE of a potential acquisition.

5. Fintech-oriented transactions begin to increase in number and strategic significance

Fintech organizations powered by exponential technologies are beginning to become as strategically significant to insurers as traditional underwriters and brokers. Start-up fintech organizations across the insurance value chain may collectively offer significant potential for insurers as venture portfolio investments, components of a broader economic ecosystem, or potential acquisitions that become integrated into existing operations. Recent examples include financial investments by insurance companies (e.g., ACE's investment in CoverHound) and outright acquisitions of fintech firms by insurers (e.g., John Hancock's acquisition of Guide Financial).

Becoming more digital went from not being discussed at all a few years ago to a front-burner topic; in response, fintech deals that enable growth and digital innovation could become a strategically significant component of the overall insurance M&A environment over the next 24–36 months. Insurance companies with old, legacy systems may try to acquire assets that can help them establish or expand their digital capabilities, become more efficient, and appear less stodgy to younger, technically savvy consumers. If fintech entrepreneurs can create a capability to help an insurer's core business become digitized, there will likely be huge revenue/profitability potential.

The surge in insurance M&A has driven up valuations and may attract digital entrepreneurs and venture capital attention. Combined with a poor track record of organic innovation and an often urgent need to more effectively engage customers via digital channels—the new generation of insurance buyers may not visit the local agent around the corner; they often want to research and purchase insurance online—the insurance industry appears primed for transactions enabling direct distribution and digital innovation by leveraging fintech, e-commerce, artificial intelligence (AI), the Internet of Things, big data/analytics, health technology, and wearables.[39]

Fintech organizations can provide differentiated capabilities and business models that may be essential for success in the increasingly digital marketplace. Engaging with these organizations, then, may become an important priority for insurance company business development (BD) teams. BD may be uniquely positioned to understand the evolving landscape and help company leadership evaluate how new and emerging fintech organizations may support business strategy. Delivering on this mission could mean developing the skills needed to design and build complex economic ecosystems; understanding how creating, aggregating, and analyzing digitized information generates value; and developing a much better understanding of insurance operations, as the greatest benefits may come to those organizations which can successfully integrate digital capabilities into their core operations.[40]

Drivers for insurance M&A in 2016 (cont.)

The bulk of fintech deals in 2016 are likely to be small, reflecting the size of most fintech companies. Buyers that intend to operationally integrate their acquisition or make it a part of a broader economic ecosystem may focus their investments on acquisitions that include capabilities/products that help to secure new customers; data and analytics to select, price and manage risk; and offerings that enhance claims experience. In the case of insurers looking to add investments to their venture portfolios, the above list may expand to include fintech organizations that are peer-to-peer insurers; offer telematics, sensors, and connected services; and insure people as asset users (versus owners).

Bottom line:
2016 could be a tipping point for fintech, as these digital, highly scalable organizations continue to multiply and impact competitive dynamics within the insurance industry—especially as Millennials gain more buying power and insurance carriers try to figure out ways to be more attractive to them. M&A among traditional insurance underwriters and brokers is likely to remain top-of-mind for most executives; however, fintech start-ups appear to be emerging as a major opportunity and risk area. The greatest benefits may be realized by those insurers which successfully integrate digital capabilities into their ongoing operations, either through fintech acquisitions or ecosystem partnerships.

6. Investment activity by "alternative capital"

Strategic buyer M&A activity appeared to outpace alternative capital activity in the insurance industry during 2015, with investment activity by PE firms, hedge funds, and other sources of alternative capital limited primarily to annuities and reinsurance companies.

PE firms' interest in insurance acquisitions may have temporarily waned because of concerns that rising interest rates may change their cost of capital to be deal-prohibitive. Maybe they think they can get higher and faster rates of return from other investment areas. Or perhaps they don't want to deal with additional scrutiny by states and other regulators.

Despite the recent dip in activity, alternative capital could continue to provide a large supply of funding to drive insurance M&A. Both hedge funds and PE firms may step-up their deal-making activity in 2016. Some PE firms have been showing interest in accessing the returns of reinsurance businesses, and in following a similar model to hedge fund reinsurers in which the investment provides access to permanent capital. For example, San Francisco-based PE firm Golden Gate Capital funded a start-up company, Nassau Reinsurance (NassauRe), with up to $750 million of seed funding.[42] NassauRe, which is focused on acquiring and operating onshore and offshore operations with long-tail liabilities in the life, annuity and long-term care markets,[43] in turn announced three acquisitions in quick succession, including The Phoenix Companies for $217.2 million.[44] Earlier examples of alternative capital flowing into reinsurance start-ups are Third Point Reinsurance in Bermuda and Greenlight Reinsurance in the Cayman Islands.

In 2016 continued activity may come from formations of new hedge fund reinsurance companies in Bermuda, similar to the model pioneered by Watford Re (2014) and ABR Re (2015), both formed by innovative partnerships between reinsurers and investment managers.[45]

2015 saw the first alternative capital vehicle emerging from China in the form of the Panda Re catastrophe (cat) bond. Cat bonds and sidecars may continue to attract the attention of alternative capital investors in 2016, as their risk profile is typically not correlated to traditional markets. These investors could also buy and cobble together some subscale P&C or L&H companies, make a one-time investment to upgrade their infrastructure, and flip the new, larger entity for a quick and profitable return.

The majority of alternative capital has been flowing into property lines of business, but 2016 may see increased investment in casualty lines, as well. Casualty can be more complicated than property lines of business because the long-tailed nature of the liabilities makes it harder to get in and out of the investment; PE firms could be looking for ways to bundle and market casualty risk. Meanwhile, large alternative asset managers may acquire insurance companies, believing that their investment acumen can generate substantial incremental value when applied to the insurer's investable assets.

Bottom line:
PE firms, hedge funds, and other sources of alternative capital may continue to shop for insurance properties in 2016; however, the industry's lower and/or longer-run rates of return may leave the window open for capital-rich strategic buyers that can offer a better price and create synergies that trump PE firms.

Moving forward

What can leading insurance organizations be doing to help identify and capitalize on M&A opportunities as they move forward in 2016?

- **Widen your strategic aperture.** Look forward five to 10 years, model how things may be different within and adjacent to your industry segment, determine where you want to be positioned and how you will win, and adjust your business and growth strategies—including M&A—to support that anticipated future. This process includes evaluating both "old world" and nontraditional acquisition targets in an effort to determine which may best help you grow your top line and become a market leader.
- **Build your M&A capabilities.** Especially in a market where valuations may be rising, you can't afford to make an M&A misstep. Your corporate development function and external advisors should have the capabilities to proactively source and evaluate potential targets; conduct thorough due diligence; and financially/operationally/culturally integrate an acquisition—from bolt-ons and tuck-ins to transformative purchases—with the existing business. Universally viewed by experienced M&A executives as the most challenging part of the M&A lifecycle, integration often stands apart as a capability worthy of developmental emphasis, especially by organizations that expect to execute a number of acquisitions.
- **Establish venture funds to help obtain early-stage access to people and ideas.** Many large companies have created corporate venture funds—some use them as an investment alternative (versus stocks, real estate, etc.), others as a strategic lever: By becoming an early-stage investor or significant equity owner in a start-up enterprise, you may be able to obtain a seat on its board of directors; gain access to innovative entrepreneurs and their ideas; influence the entity's strategic direction/product offerings; and, ultimately, drive up its value as a corporate asset.
- **Engage with market disruptors.** They could be a future competitor that siphons off revenue or customers or, conversely, be a future acquisition or partner that provides much-needed capabilities and/or a foothold in exciting new markets. Case in point: a technology company could help a mainline insurance firm use data and analytics to generate greater insights from customer information. Think strategically about your growth goals, how to reach them, and consider buying or partnering with a disruptor that complements your weaknesses. In addition, consider developing the strategies, networks, data sources, and personal relationships necessary to engage with these organizations.
- **Keep your eye on the regulatory landscape.** Be mindful that foreign and domestic regulations appear to be moving in the direction of more scrutiny. Any deal you transact that increases your capital—especially if your expanded enterprise nears SIFI levels—could increase regulatory scrutiny.

By many measures, the environment appears conducive to continued insurance industry M&A in 2016: many corporate balance sheets are flush with cash, companies have access to debt and equity markets, and the economy appears stable. In addition, M&A activity across many industries was at record levels in 2015. Companies large and small may be looking at transactions to help deliver growth.[46] Those organizations that link business and M&A strategy, that understand and manage the drivers described in this report, and that focus on executing with excellence (especially during the integration phase), are more likely to reap the benefits of successful M&A.

Contacts

Insurance M&A Leadership Team

Boris Lukan
Principal
Insurance M&A Practice Leader
Deloitte Consulting LLP
+1 312 486 3289
blukan@deloitte.com

Matthew Clark
Principal
Deloitte Consulting LLP
+1 312 486 0185
matthewclark@deloitte.com

Liz Cunningham
Partner
Deloitte Ltd.
+1 441 299 1323
liz.cunningham@deloitte.com

Bruce Fell
Principal
Deloitte Consulting LLP
+1 215 446 4337
brucefell@deloitte.com

David Foley
Principal
Deloitte Consulting LLP
+1 212 618 4138
dfoley@deloitte.com

Matt Hutton
Partner
Deloitte & Touche LLP
+1 212 436 3055
mhutton@deloitte.com

John Johnston
Partner
Deloitte Ltd.
+1 441 292 1500
john.johnston@deloitte.com

Robert Kaye
Principal
Deloitte Consulting LLP
+1 312 486 2359
rkaye@deloitte.com

Howard Mills
Global Insurance Regulatory Leader
Deloitte Services LP
+1 212 436 6752
howmills@deloitte.com

Mark Purowitz
Principal
Deloitte Consulting LLP
+1 215 606 1983
mpurowitz@deloitte.com

Douglas Sweeney
Director
Deloitte Financial Advisory Services LLP
+1 617 585 4848
dosweeney@deloitte.com

Christopher Tutoki
Partner
Deloitte Tax LLP
+1 212 436 3375
ctutoki@deloitte.com

Matthew Usdin
Principal
Deloitte Consulting LLP
+1 212 618 4884
musdin@deloitte.com

Thank you to **Rachel Moses**, Lead Marketing Specialist, Deloitte Services LP, and **Joanna Ostaszewski**, Manager, Deloitte Services LP, for their contributions to this report.

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