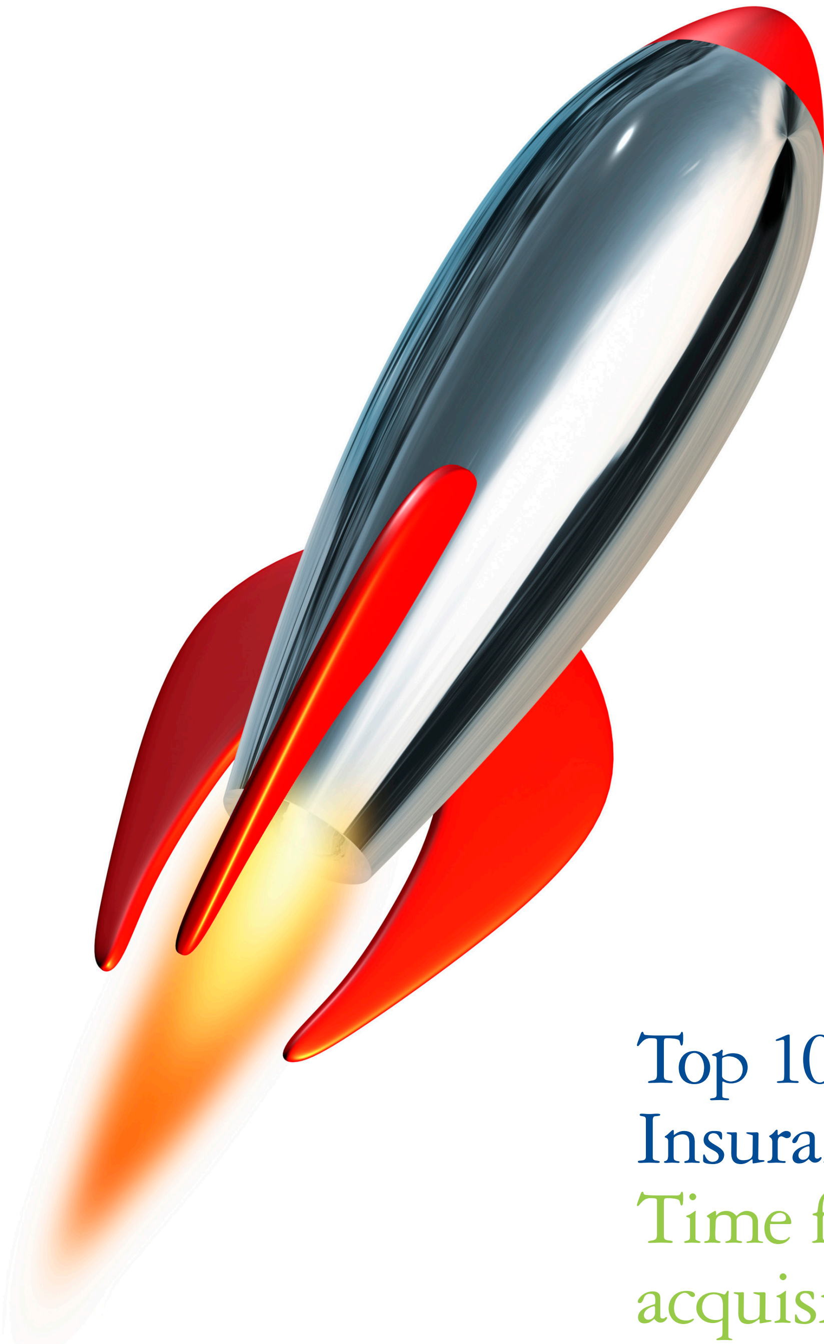
Deloitte.



Top 10 Issues for Insurance M&A in 2013

Time for mergers and acquisitions to take off?

Contents

Overview

Will 2013 be the year that insurance industry mergers and acquisitions (M&A) take off again after a prolonged period of stagnation? A flurry of activity by insurance companies (underwriters) to rebuild internal M&A capabilities may herald an uptick in M&A during 2013 as organizations seek to expand market share, distribution capabilities, product/service offerings, and economies of scale in the face of limited organic growth opportunities.

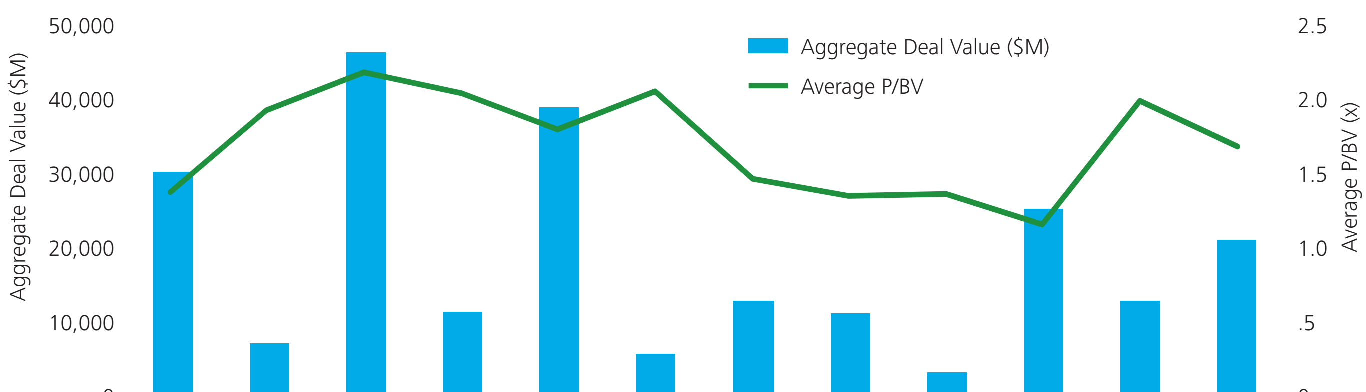
2012 saw an approximate 20 percent decrease in the number of insurance industry M&A deals versus 2011; average price/book value multiples (Figure 1) and average price/LTM earnings multiples (last 12 months) (Figure 2) decreased, as well. M&A activity remained at historically low levels, hampered by widespread concerns about the U.S. and global economies, uncertainty surrounding regulatory and tax reform, low valuations, and other issues. There were few large, transformative deals in 2012; many transactions involved investments in emerging markets and smaller, bolt-on acquisitions of additional distribution channels and niche business lines, a trend that is anticipated to continue in 2013.

Figure 1: M&A Trends for Insurance Underwriters

Price/Book Value Multiples

Insurance Underwriter Transactions

Price to Book Value Multiples



	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Number of deals	80	59	73	60	81	88	83	79	66	93	100	79
Size of Deals ($M)												
Low	0.0	0.5	1.3	0.5	0.7	0.4	0.4	0.8	0.0	0.3	0.5	0.1
High	23,400.8	3,980.8	17,595.4	5,002.1	11,500.0	893.0	2,744.0	6,225.0	1,380.0	15,545.1	3,824.9	5,674.1
Average	572.8	197.5	825.0	254.7	763.9	85.8	199.8	209.9	93.1	425.9	230.6	576.8
Observed P/BV Deal Multiples												
Low	0.46x	0.51x	0.54x	0.55x	0.87x	0.88x	0.79x	0.49x	0.73x	0.57x	0.12x	1.01x
High	3.80x	3.99x	7.41x	5.49x	3.46x	6.19x	2.19x	1.86x	2.98x	3.06x	5.98x	6.71x
Average	1.39x	1.92x	2.16x	2.03x	1.80x	2.04x	1.47x	1.37x	1.38x	1.19x	1.98x	1.68x

Source: SNL Financial, December 31, 2012

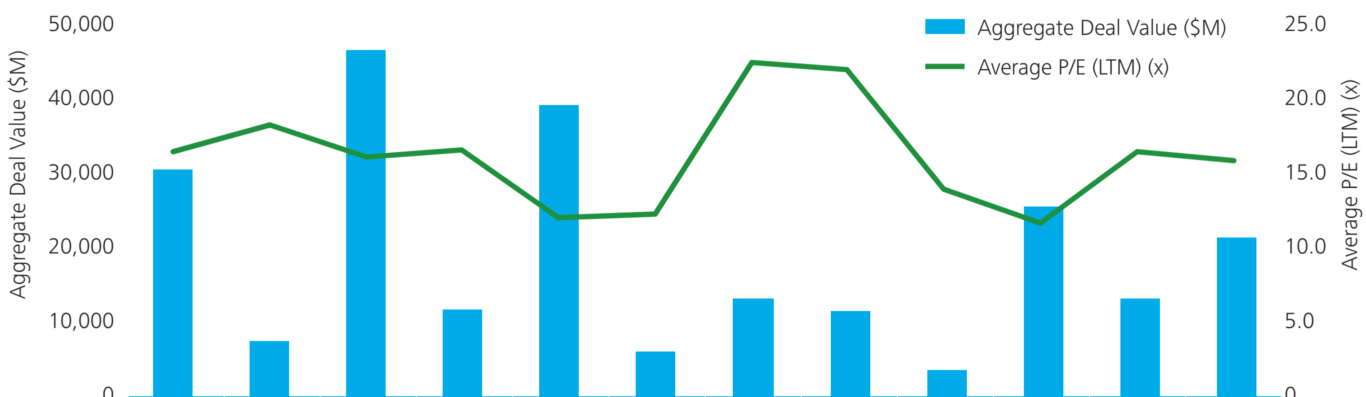
- Transactions represent U.S. companies making acquisitions on a global basis. Insurance Underwriters include P&C, L&H, Multiline, Managed Care, Title, Mortgage Guaranty and Finance Guaranty sectors covered by SNL Financial
- 2012 P/B multiple average excludes the UnitedHealth Group Incorporated/Amil Participações S.A. multiple of 6.7x and the Cigna Corporation/Finans Emeklilik multiple of 6.2x as they skew the data
- Transactions grouped by the year they were announced. 2012 captures the YTD period as of 12/31/2012
- Deal multiples represent closed multiples, unless the transaction is still pending close

Figure 2: M&A Trends for Insurance Underwriters

Price/LTM Earnings Multiples

Insurance Underwriter Transactions

Price to LTM Earnings Multiples



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Average	572.8	197.5	825.0	254.7	763.9	85.8	199.8	209.9	93.1	425.9	230.6	576.8
Observed P/E (LTM) Deal Multiples												
Low	5.85x	8.12x	3.45x	12.81x	4.93x	2.00x	4.19x	9.93x	3.34x	3.59x	5.43x	5.86x
High	35.76x	30.96x	34.91x	24.09x	23.68x	26.48x	42.75x	45.24x	22.40x	22.53x	39.59x	50.34x
Average	16.37x	18.26x	15.97x	16.49x	11.80x	12.04x	22.54x	22.04x	13.75x	11.45x	16.35x	15.72x

Source: SNL Financial, December 31, 2012

- Transactions represent U.S. companies making acquisitions on a global basis. Insurance Underwriters include P&C, L&H, Multiline, Managed Care, Title, Mortgage Guaranty and Finance Guaranty sectors covered by SNL Financial
- 2012 P/E multiple average excludes the UnitedHealth Group Incorporated/Amil Participações S.A. multiple of 50.34x as it skews the data
- Transactions grouped by the year they were announced. 2012 captures the YTD period as of 12/31/2012
- Deal multiples represent closed multiples, unless the transaction is still pending close

Among market segments, Property and Casualty (P&C) deal activity in 2012 decreased compared to 2011. While deal volume slowed toward the end of 2012 as P&C companies sought to determine their exposure from Superstorm Sandy, it is expected to pick up in 2013 — albeit sporadically — as Sandy's impacts are absorbed and companies desiring to improve their performance or revenue expectations push for specialty line acquisitions that hold value better. Some P&C companies could also likely seek to broaden their scope in faster-growing markets outside of the U.S.

Life and Health (L&H) insurance M&A activity has been lackluster, and many of 2012's deals were seemingly done out of necessity: Companies trying to exit the annuity business — which has been plagued by extended, historically low interest rates — sold blocks of businesses at bargain prices to opportunistic buyers, including private equity (PE) firms; some European companies in survival mode or shoring up their balance sheets in advance of Solvency II capital requirements sold their U.S. counterparts. 2013 may see life insurers continuing to evaluate which businesses to remain in and spinning off non-core or underperforming pieces.

The broker and agent segment continues to be an industry bright spot. Bid-ask spread is not an issue and large brokers continue to make acquisitions and have robust pipelines. To drive growth, these organizations have been focusing on acquisitions that can provide additional clients and revenue sources. In addition, some large brokers have strategies to help penetrate the regional and middle-market space. Also, PE firms have long been interested in this segment of the insurance industry because it is cash-flow based with no balance sheet risk. This trend is expected to continue, as evidenced by Onex's acquisition of USI at the end of 2012.

Within the reinsurance sector, there were a couple of large deals: Alleghany Corp.'s acquisition of Transatlantic Holdings and Validus Holdings Ltd.'s acquisition of Flagstone Reinsurance Holdings SA. There appeared to be a market perception that these deals might be the impetus for consolidation in the reinsurance sector, especially within the Bermuda marketplace; however, this has not occurred. There may have been a few reasons for this. Similar to the P&C industry, as referenced above, many players in the reinsurance market are trading at discounts to their book value. For example, according to Fitch Ratings, 15 of the 17 publicly traded reinsurance companies located in Bermuda are trading below their book value. This disconnect tends to add to the complexity of transactions — the buyer may likely need to issue more shares than contemplated and the seller may likely need to accept an offer below book value. In addition, alternative risk vehicles, e.g., side cars and catastrophe bonds (CAT bonds), continue to gain momentum, adding to the capacity in this market segment. This, coupled with a low CAT year, is hindering price firming.

Entering 2013, the environment seems more conducive to accelerating M&A activity than a year ago: organic growth opportunities appear limited; insurance companies and PE firms are holding large amounts of excess capital that need to be deployed; and the stock market is doing well overall, which generates confidence. Indeed, more insurance companies appear to be engaging in the preliminary stages of M&A — developing strategies and playbooks, and engaging in targeting and selection — although many look as if they are waiting for a market catalyst to move to the subsequent stages of due diligence and transaction execution.

Congress' agreement to avoid the immediate impacts of the so-called "fiscal cliff" and continued improvements in the U.S. economy might encourage companies that have been holding back on M&A to pull the trigger. This could create a synergistic effect: As companies see others move ahead, they may think that they may miss out on opportunities or targets if they don't do likewise. As a result, the industry could see activity of significance that it hasn't for the past several years. In the meantime, insurance companies across many market segments should consider the following top 10 issues when developing their 2013 M&A strategies.

Top 10 Issues for Insurance M&A in 2013

1 Economic and regulatory uncertainty

2012 insurance industry M&A was stunted by widespread economic stress and regulatory uncertainty. Entering 2013 great uncertainty remains, with many regulations yet to be promulgated and the Federal Insurance Office (FIO) report yet to be released. Although a last-minute deal averted the "fiscal cliff," insurance industry observers are closely monitoring the potential impacts on M&A activity of a continued slow U.S. economic recovery, the Eurozone sovereign debt crisis, and post-election implications of the Dodd-Frank Act, Financial Stability Oversight Council (FSOC) initiatives, International Association of Insurance Supervisors (IAIS) framework, and other U.S. and international regulations.

What's new for 2013

A bipartisan Senate agreement and subsequent House approval helped the U.S. narrowly avoid going over the fiscal cliff on January 1, 2013.[1] Yet the political wrangling and uncertainty around more substantive cuts to government programs, the debt ceiling, and comprehensive tax reform — which can hold significant implications for insurance companies, such as a potential change in the unique tax benefits of annuities and other products — is expected to continue well into 2013.

Fortunately, clarity around other legislation and regulations of importance to the insurance industry could help to instill some confidence and reignite interest in strategic M&A, even if some outcomes may include increased oversight, higher compliance costs, and a movement away from exotic financial products and back to core business operations. For example, Dodd-Frank implementation is expected in first or second quarter 2013 and includes creation of the FIO, the federal government's first foray into insurance supervision. Also, it is hoped that the Financial Stability Oversight Council (FSOC) may soon finalize its Systemically Important Financial Institution (SIFI) criteria. The unresolved criteria have been perceived by some as dampening the appetite of large insurance companies for M&A, as a substantial acquisition might put a company on the FSOC's radar. Conversely, some think that to avoid being a SIFI some companies may divest assets so they become smaller and less connected. Finally, a new global initiative by the IAIS to institute a common framework for the group-wide supervision of internationally active insurance groups, or IAIGs,[2] may give U.S. companies pause but is not expected to appreciably inhibit the growth of M&A in emerging markets.

While the Eurozone sovereign debt crisis continues to hold the global economy hostage, there are signs that the United States' "iffy" economic recovery may be gaining momentum, as evidenced by increased manufacturing activity, an improving housing market, and greater consumer spending — factors which may prompt banks to open-up lending. One vulnerable area is continued low interest rates, which reduces the attractiveness of annuity-heavy life insurance companies as potential acquisitions; it also leaves many organizations' balance sheets exposed should the Federal Reserve signal interest rate increases. As rates go up, bond prices go down; that could be a major problem, especially for life and annuity companies whose products tend to be on the books for 40, 50, or 60 years; their bonds could be hammered if their instruments are sensitive to the bond rate.

Bottom line

Assuming the economy continues to improve in 2013, growth in the insurance space should accelerate as consumers seek to protect valuable assets such as autos and homes. Industry M&A also should perk up, although low interest rates could continue to be a drag on activity. As the year progresses, insurance companies contemplating M&A transactions should engage in scenario planning and stress testing that takes into account varying economic conditions and the changing domestic and international regulatory landscape, particularly with an eye to those products or lines of business that are highly dependent on interest rate changes or involve multi-jurisdiction supervision.

1 "In last-minute vote, Senate approves fiscal bill," MSNBC News.com, January 1, 2013. http://firstread.nbcnews.com/_news/2013/01/01/16280618-in-last-minute-vote-senate-approves-fiscal-deal?lite. Accessed January 1, 2013
2 International Association of Insurance Supervisors, http://www.iaisweb.org/Supervisory-Material-765. Accessed January 1, 2013

2 Increasing deal complexity

Many of 2012's insurance industry M&A deals were complex, highly structured transactions; among them, companies unwinding themselves by selling subsidiaries or lines of business, joint ventures, restructurings, and cross-border deals subject to multi-country tax regulations. Increasing deal complexity may lengthen the M&A process, require more stringent due diligence, and increase the need for external support from attorneys, tax advisors, and other M&A experts.

What's new for 2013

During the financial crisis of the past few years it was not uncommon for a company to be a buyer one month and a target a few months later. When dealing with a seller in crisis mode, potential buyers were sometimes willing to forego rigorous due diligence on the target's current and future viability if they could quickly execute the deal at a low price.

Entering 2013, fewer sellers are in crisis and prepared to sell their entire company at a bargain price. Rather, they may assess regulatory and market conditions and decide to selectively exit countries and/or shed business lines and use the resulting capital to strengthen their balance sheets. Offloading existing books of business can involve complex reinsurance arrangements to make a deal work so that both the buyer and seller walk away with the assets, capital, and tax benefits they want and need. As part of the process, buyers may need to do more thorough due diligence than they did for financial crisis-era transactions to make sure the price they pay is solid.

When conducting due diligence on niche opportunities outside their core business or in new geographic regions, companies may find themselves in unfamiliar waters which, in turn, may prompt them to hire consultants to provide the necessary insights and expertise. Internal and external stakeholders are scrutinizing today's complex deals closely; if company management makes an acquisition and intends a certain amount/level of synergies/return on equity (ROE), board members and investors may likely want reassurance that the deal was an appropriate use of capital given the alternatives (e.g., share buybacks).

Bottom line

Insurance products, businesses, and the industry in general are growing more complex, so expect that M&A deals may take longer to structure, negotiate, and execute. Yet potential acquirers still need to be prepared to move quickly when they identify viable candidates. One suggestion is to conduct due diligence during the target screening process on a handful of targets the company might be interested in if they came on the market. Usually, any target may have three-to-five gating issues; focus on analyzing those risks first. If the necessary experience to assess the risks does not reside in-house, consider hiring advisors for these specialties. Also, when given the choice, consider opting for a simpler deal structure, one that includes an exit strategy if the deal doesn't come to fruition or has to be unraveled later.

3 Investment activity by private equity firms

The insurance industry is becoming a favored investment focus for several PE firms as well as industry/strategic buyers. For example, PE firms made over 100 acquisitions in the insurance industry in the 24-month period ending December 31, 2012.[3] A continued softening in sale price makes the segment attractive for financial investors who are looking for cash flows which they can manage aggressively and sell.

What's new for 2013

In general, PE firms have been more focused on insurance brokers than traditional insurance underwriting for M&A. The traditional market is risk- and balance-sheet intensive and, therefore, it can be hard for PE firms to leverage their investment. However, a recent uptick in insurance industry M&A by PE firms is expected to continue into 2013, for a number of reasons. First, many PE firms are sitting on ready cash and looking for investment options in a low-return marketplace in which good deals can be difficult to find. Current discount-to-book values may make a stock deal challenging; however, it is relatively easy for PE firms to offer cash when they locate solid companies that are trading inexpensively and need to do deals. Second, many life insurance companies are trying to sell-off their volatile variable annuity business; however, PE firms may be able to sit on the block until interest rates recover without worrying about short-term profit and loss volatility. Third, PE firms generally like to invest in niche insurance markets, such as reinsurance and fee-based businesses that provide services to insurance companies and the reinsurance market, because they can offer quicker return on investment (ROI). They also view the insurance broker sector as a good avenue to achieve steady cash flow.

Bottom line

PE firms' appetite for insurance M&A appears to be increasing, especially in the variable annuities space. The industry is in the early innings of a general rebound: volume, pricing power, and economic activity are moving in the right direction, which can offer a good entry point for a financial investor that is looking to buy an insurance company or selected assets at a low price, aggressively manage and clean up the business, and quickly sell it to reap appropriate rewards.

3 Deloitte analysis of FactSet Mergers data, 2012

4 Capital requirements

Evolving — and sometimes conflicting — regulations on capital requirements may hold implications for insurance industry M&A in 2013. Of particular note for European insurance companies that own U.S. entities is the Solvency II Directive, which aligns EU insurance regulations and codifies the amount of capital that EU insurance companies must hold to reduce their risk of insolvency. In the U.S., the Solvency Modernization Initiative (SMI) and the National Association of Insurance Commissioners's (NAIC)'s adoption of principles-based reserving (PBR) by life insurance companies may likewise herald an era of increased risk-based supervision for the industry.

What's new for 2013

European insurance companies are getting ready for Solvency II by assessing where they are against the new risk-based regulations, drafting implementation plans, and putting appropriate processes in place — most companies will be required to develop their own internal capital model. Even though the required adoption date for Solvency II is being delayed, efforts by European companies to demonstrate to regulators that they are well-capitalized may reduce their appetite to engage in M&A, as regulators are expected to pay close attention to the capital implications of any acquisition. Also, if a company has to put more capital into the business it may reduce ROE and keep the organization from reaching its hurdle rate, which also could discourage M&A.

Solvency II is not expected to impact domestic U.S. insurance companies' capital requirements — and, by extension, their M&A activities. It has, however, had an impact on European insurers, some of which have divested (or are in the process of divesting) their U.S. operations since many insurance products common in the U.S. fare poorly in a Solvency II regime. Capital requirements in the U.S. have been risk-based for more than a decade, with the initial life insurance risk-based capital (RBC) formula implemented in 1993 and updated numerous times since.[4] The new Solvency Modernization Initiative aims to update the United States' insurance solvency regulation framework by focusing on specific issues such as capital requirements, governance and risk management, group supervision, statutory accounting and financial reporting, and reinsurance;[5] it may lead to refinements of the risk-based formula. The Own Solvency Risk Assessment (ORSA) regulations that are part of the SMI may come into effect on January 1, 2015; in the meantime, pending implementation of the modernization formula is prompting U.S. companies to develop self-assessments of their capital requirements and how they make business decisions based on that.

Other capital-requirement developments of note for U.S. insurance companies are the NAIC's December 2012 vote to approve a new Valuation Manual that allows for the movement of the new Standard Valuation Law (SVL) to state legislatures and the adoption of PBR, which may change and likely lower reserve requirements for life insurance companies;[6] and the approaching January 1, 2015, effective date for the NAIC's ORSA Model Act, a major step in U.S. solvency regulation modernization. The ORSA is an integrated framework using several tools to give a current and forward-looking vision of the risk and solvency position of an insurer. With the ORSA, companies bear significant responsibility for determining their capital standing and adequacy. As envisioned, the ORSA is expected to be a key part of an organization's enterprise risk management (ERM) framework and of the supervisory review process.[7] The ORSA concept is becoming an international requirement and is an important element of the Solvency II framework currently being implemented in Europe.

Bottom line

If they are not already doing so, European insurance companies that own U.S. entities should ramp-up preparations for Solvency II's implementation date and consider the impacts of more stringent capital requirements on their business models. Already, requirements emanating from Solvency II have been prompting organizations like HSBC to divest unattractive businesses; Aviva to exit the U.S. market; and ING to exit Asia. The U.S. is not changing its capital requirements to the same extent as Europe. However, U.S. insurers should begin planning their responses to ORSA and PBR. Finally, when evaluating the impacts of new capital requirements on potential M&A in 2013, both European and U.S. insurance companies should look at a potential acquisition's capital availability as well as their own capital availability under the new standards.

4 *Solvency Modernization Initiative Roadmap*, National Association of Insurance Commissioners, August 31, 2012
5 Ibid
6 Mais, Andrew N. "NAIC Adopts Life Principles-Based Reserving in Close Vote," Deloitte Insurance Blog, December 2, 2012
7 *Forward Focus: The Own Risk and Solvency Assessment (ORSA): A regulatory guidepost to the future*, Deloitte Development LLC, 2012

5 Valuations

Many companies in the insurance segment are still trading well below historical book value (Figure 3). Entering 2013, the bid-ask spread is narrowing, but disconnects often remain between a company's view of its value and Wall Street's view. If the stock market experiences a major drop in the coming year, it could exacerbate the situation and dampen future M&A activity, as the due diligence process may prompt preemptive questions and concerns about company assets and future profitability of its business platform.

What's new for 2013

The three-to-four-year trend of certain major players in the insurance industry trading below book value is anticipated to continue in 2013, making stock-based M&A deals more difficult to transact. However, the bid-ask spread is narrowing as the industry begins to recognize that lower valuations may represent a "new normal."

A prime factor depressing valuation — particularly that of variable annuities — is the prolonged low interest rate environment; the Federal Reserve keeps extending it, and there are indications that the current near-zero rate may remain in effect until 2015. The overhang of low interest rates is causing ongoing stagnation in life insurance M&A, where a block of annuities has the potential to derail a deal. However, the sector may see some deals transacted if seller-buyer geographic, product, or distribution challenges are synergistic.

The P&C sector could see some price hardening in 2013 as Superstorm Sandy claims make their way through the system. If P&C companies have to pay significant losses, they may need to increase rates which, in turn, could generate revenue and likely push analysts to raise valuations, although P&C companies are still likely to trade at below book value for a period of time.

Bottom line

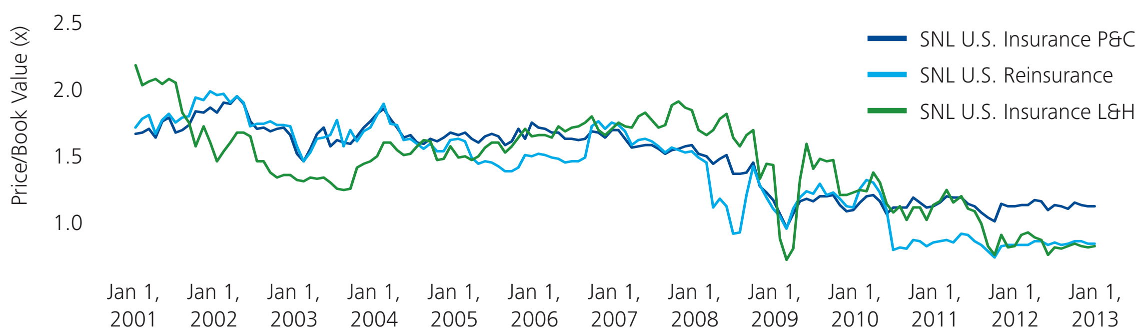
2013 may be a good year for strategic buyers and PE firms to pursue bolt-on transactions or niche market opportunities. Even though overall valuations are depressed, specialty or niche carriers may provide decent ROE. Many companies are anticipated to focus on acquiring new or expanded distribution channels versus products, to better differentiate themselves in an increasingly homogenized marketplace.

Figure 3: Indices — Insurance Underwriters

Price/Book Value Multiples between 2001 and YTD 2012

Performance of U.S. P&C Insurance, U.S. Reinsurance and U.S L&H Insurance companies between 2001 and 2012

Insurance Underwriter Transactions
Price to Book Value Multiples



Median P/BV (x) Values	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
SNL U.S. Insurance L&H	1.46	1.32	1.56	1.57	1.70	1.79	1.66	1.27	1.12	1.03	0.81
SNL U.S. Insurance P&C	1.74	1.61	1.65	1.65	1.68	1.57	1.40	1.14	1.13	1.12	1.12
SNL U.S. Reinsurance	1.76	1.64	1.62	1.45	1.50	1.57	1.17	1.18	0.85	0.83	0.83

Source: SNL Financial, December 31, 2012

- 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

6 Alternative use of capital

Due to the ongoing discount-to-book issue, many insurance companies with excess capital have been buying back stock rather than transacting M&A deals. Also, some companies have been exiting certain lines of business or markets and using that capital to shore up remaining operations and older acquisitions, comply with capital adequacy requirements, or pay back shareholders. These practices can't continue indefinitely, though, because companies may be unable to meet shareholders' and analysts' growth expectations. 2013 may be the year that insurance companies refocus their excess capital on M&A.

What's new for 2013

There has been a recent slowdown in insurance company stock buybacks and more interest in plowing capital back into the business to drive organic growth in a thoughtful manner. After several years of limited capital investment, companies are beginning to upgrade their core infrastructure, information technology platforms, and other back-office systems. Some companies are making bold technology investments in an effort to create market differentiation: one emerging trend that is being leveraged by Progressive and other carriers is telematics, which uses actual driving data to make underwriting decisions. Other market developments that are driving investment and creating a destination for excess capital are the shift to multichannel distribution and the use of data analytics to create a better customer experience.

Bottom line

Generally, a company can only buy back shares so long; analysts eventually grow tired of the practice and require other forms of ROE. Strategic M&A via niche acquisitions could improve an insurer's bottom line to the extent that it easily outshines stock buybacks or organic growth initiatives and is expected to clear the company's ROE hurdle. In the end, determining the better use of excess capital in the coming year should be based on a company's detailed analysis of where it and the market are heading, as well as the optimal mix of organic and inorganic growth for that organization.

7 Emerging markets

As an alternative to investing in organic growth or domestic businesses, some large insurance companies with the financial wherewithal are making focused M&A investments in Latin America, Asia, and other emerging markets, where they can achieve higher returns than in the U.S. Acquiring companies typically are looking for existing organizations with solid underwriting capability in a country with attractive demographics (especially a burgeoning middle class that is interested in protecting its health, homes, and cars); democratic ideals (which can foster intellectual property rights, legislative transparency, and lower civil unrest); and a strong local presence to help quickly grow market share.

What's new for 2013

Continued, focused insurance industry M&A in non-U.S. markets during 2013 is anticipated, as companies seek to expand their products or distribution channels in regions with demonstrable or perceived high growth. While Eastern Europe is less active than in recent years, China, Japan, India and Brazil are likely to remain attractive options. Asia's insurance industry, in particular, is generating interest from investors and insurers looking for acquisitions. Strong economic growth, especially in Southeast Asia, has increased demand for insurance; yet, to date, few companies have established a major presence in these emerging markets. Also, European banks in need of capital are withdrawing from the sector.[8] Also of interest are next-tier countries such as Mexico, Chile, and other Latin American nations, where insurance companies are making a case that they can handle the financial management of mandatory pension programs as well as banks do.

Regulatory and compliance considerations are likely to figure prominently in any cross-border M&A deal. Current insurance industry regulation has a global aspect that was lacking 10-15 years ago; this can add expense, complexity, and time to a transaction. Also, regulations viewed as limiting or onerous may prompt a potential buyer to downsize or forego a deal in a specific market. For example, many U.S. companies want to avoid being under Solvency II's capital requirements, so when they consider making an acquisition in a jurisdiction that falls under Solvency II, they may look for smaller companies that may likely not be material to their bottom line.

Bottom line

While U.S. insurance companies may likely continue to explore domestic M&A opportunities in 2013, particularly bolt-on acquisitions such as supplemental distribution channels for e-commerce, many are also expected to invest in emerging markets where there is a propensity for higher growth, higher profits, and less competition. When considering investments in such markets, however, companies should first assess whether growth prospects there hold long-term promise, especially when weighed against potential regulatory and operational challenges. If the outlook is favorable, considerable due diligence should then be conducted to identify targets that have a strong management team and a distinct competitive advantage that can be leveraged for growth, such as underwriting capability or a unique distribution platform.

8 Koons, Cynthia. "Insurance Becomes M&A Powerhouse in Asia," WSJ Blogs, January 16, 2013. http://blogs.wsj.com/deals/2013/01/16/insurance-becomes-ma-powerhouse. Accessed January 23, 2013

8 Catastrophes

2012 had been a relatively quiet year for catastrophes until Superstorm Sandy struck the East Coast on October 29. Fourth-quarter catastrophe activity, including Superstorm Sandy, can likely impact P&C companies' financial results and could prompt M&A activity in 2013.

What's new for 2013

The combination of Superstorm Sandy, the Midwest drought, and tornado/severe weather will likely make 2012 the United States' second-costliest year (after 2005) for weather and climate disasters on record, according to data from the National Oceanic and Atmospheric Administration (NOAA).[9] Moody's Analytics and Eqecat estimated that economic damages from Sandy alone could top $50 billion, branding it one of the top five most expensive U.S. disasters.[10] RMS estimated that insured losses from Sandy would fall between $20 billion and $25 billion;[11] while this amount is far less than the total damages incurred it is substantial, nonetheless. Sandy's classification as a storm rather than a hurricane eliminates the higher deductibles to homeowners and increases losses for the insurance industry.[12] Also, some P&C insurers were left in a weakened position due to 2011's catastrophe-related losses (Flagstone Reinsurance Holdings' acquisition by Validus Holdings, Ltd.,[13] is an example of a company that was impacted by worldwide storms in 2011 and acquired in 2012). Sandy-related claims may create a need for additional capital and require some insurers to merge or sell certain lines of business.

Bottom line

Only time will reveal the full financial impact of Superstorm Sandy on the insurance industry, as P&C companies — especially those that do business in the Northeast — continue to process claims. In the short term, Sandy may have a dampening effect on M&A. While the storm is not expected to have a significant impact on the worldwide capital position of the insurance-reinsurance industry, it may have an impact on individual companies. Also, it may be difficult to quantify Sandy losses due to the number of business interruption claims sustained by the insured. However, it is anticipated that insurers could finalize estimates for Sandy-related pay-outs by late first quarter/early second quarter 2013; this may spur M&A activity as some P&C companies look to diversify into other types of insurance and those organizations whose capital strength allowed them to absorb Sandy-related losses seek to acquire assets from competitors who did not fare as well.

9 "Severe weather makes 2012 a costly year for U.S.," *USA Today*, December 21, 2012

10 "Superstorm Sandy costs rise to $50 billion," *On The Money*, November 1, 2012. http://thehill.com/blogs/on-the-money/economy/265461-superstorm-sandy-costs-up-to-50-billion

11 "The Anatomy of a Loss Estimate: Superstorm Sandy," Property Casualty 360°, February 26, 2013. http://www.propertycasualty360.com/2013/02/26/the-anatomy-of-a-loss-estimate-superstorm

12 "Wind Deductibles and Sandy: What it Means for Total Insured Losses," *Insurance Journal*, November 28, 2012. http://www.insurancejournal.com/news/national/2012/11/28/271738.htm. Accessed January 14, 2013

13 "Validus completes Acquisition of Flagstone Reinsurance Holdings, S.A.," Yahoo Finance, November 30, 2012. http://finance.yahoo.com/news/validus-completes-acquisition-flagstone-reinsurance-133000705.html. Accessed January 14, 2013

9 Tax reform

The insurance industry has enjoyed a long history of favorable tax legislation (e.g., the tax-free accretion of value in a whole life policy); however, as Congress searches for increased revenue, it may review the treatment that certain industries and individuals traditionally have received and change applicable tax models and/or increase tax rates. In the near term, stopgap measures as part of a fiscal cliff solution may be precursors to more substantive U.S. tax reform, although comprehensive legislation is not anticipated to be enacted in 2013.

What's new for 2013

There appears to be pent-up demand among the public and on both sides of Congress for general tax reform — which could likely include the financial services sector — although what shape it may take is as yet unclear. The insurance industry is considering the potential impacts of reform elements that could include capital gains and dividend rate increases; changes in U.S. taxation of foreign entities; the closure of certain tax loopholes; and limitations on the tax-free benefits of life policies and the tax-free increase in value of whole life policies. Strong lobbying may mitigate legislative actions somewhat, but changes in insurance taxation should be anticipated.

Bottom line

In the absence of specific tax legislation or even general agreement on the shape that legislation could take, it may not yet be prudent for insurers to make tax reform a key consideration in their 2013 M&A strategy. The insurance industry should stay tuned, monitor and influence the situation, and start scenario planning upon hearing of specific bills or legislative changes that could change tax laws.

10 Talent management

For years, insurance industry M&A was primarily focused on bolstering a company's scale, geographic presence, or products/capabilities. Many of today's acquisitions, however, are driven by the industry's need to secure high-quality talent, especially in the broker space. Insurance industry employee demographics skew older; companies need to bring in new talent but are stymied on two fronts: Current employees are delaying retirement (many to preserve health care benefits), which limits openings for new hires. Also, insurance is not typically viewed by younger people as an attractive career choice; the industry is not as "flashy" or well-paying as, say, investment banking and the career path can be arduous.

What's new for 2013

Attracting, retaining, and developing talent may continue to be a top-of-mind issue for insurance executives who are looking to grow their organization and position it for the future. M&A deals have the potential to bring together the best people, products, and operations to create more value in months than a start-up can produce in years. Yet delivering on post-deal opportunities requires that company leaders create a compelling vision for the combined organization and effectively transition current and new employees to establish a culture that cultivates cohesion and commitment.[14]

Bottom line

Acquiring top talent can likely continue to be a key consideration for insurance M&A in 2013 and beyond. Once an acquisition is made, elevating talent retention to talent engagement can incentivize existing employees to stay and encourage new employees to contribute fully and candidly in a newly combined organization. Effective post-deal integration hinges on a smooth transition: Company leaders should use transparent and synchronized integration planning to build commitment and consensus; discuss specifically how employees can contribute to the new organization's goals and how they will be rewarded; establish a positive tone that's inspiring and uplifting; and pave clear career paths to help maintain employee commitment and enthusiasm.

14 "High stakes M&A: Seven bets that matter," Deloitte Development LLC, 2012

Moving forward

The overall market appears ripe for accelerated insurance industry M&A in 2013. Companies should prepare by affirming the role M&A can play in their overall growth strategy, strengthening their internal M&A capabilities and staff, conducting scenario planning, and becoming more active in proactive targeting and selection. For companies that have not been historically or recently active in M&A, management should engage with their boards of directors and reach an understanding about board involvement in M&A decisions going forward. Also, developing an M&A playbook with different scenarios that have been vetted and aligned to by the board and management may help companies react quickly when plum entities become available, smooth transaction execution, and support integration preparedness.

As a number of industry-specific regulations come into effect in the near future, insurance companies should begin educating themselves about requirements; assessing the state of their current ERM framework (as well as that of potential acquisitions); determining organizational readiness for increased oversight; and formulating appropriate response plans. Proactively connecting with trade associations and government affairs staff and leveraging leading practices may help companies move forward with more confidence.

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