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2015 Insurance M&A Outlook

Continuing acceleration

Contents

Overview

We believe that 2015 will see continuing acceleration of activity in the insurance M&A market, building upon the growth experienced from 2013 to 2014. Among the indicators supporting a positive forward-looking view are strengthening macroeconomic conditions (including the possibility of a rising interest rate); continued organic growth challenges; historic levels of excess capital; pressure to put that capital to work as stock buybacks become a less-favored capital management vehicle; structural factors and competitive dynamics driving the consolidation of the reinsurance sub-sector; increased interest in insurance M&A from strategic, private equity (PE), and foreign buyers; and several large, late-2014 transactions which may stimulate conversations about M&A among company boards and C-suite executives.

About 12 months ago, we posited that the insurance M&A environment would accelerate from 2013 to 2014, and it did. By historical standards, activity remained modest on an absolute basis; however, an increased number of large M&A announcements helped to drive the aggregate deal value for the year, offsetting a decline in smaller deals.[1] There is clear evidence to suggest that momentum will continue to build in 2015, with activity gaining traction as the year progresses. Yet, this does not mean that 2015 will be without challenges. Europe's economy remains on shaky ground; numerous regions are experiencing geopolitical turmoil; the regulatory landscape for insurance is likely to remain in flux – any number of developments could rattle the market and put a damper on M&A.

In this report, Deloitte highlights the current state of insurance industry M&A and examines the top issues facing companies in 2015.[2] These issues include strengthening macro conditions, regulatory developments, investment activity by PE firms, capital management balancing act, new entrants in the M&A game, and heightened demand by foreign insurers to enter the US market.

2014 in review

With the exception of underwriter deal volume (which decreased modestly), 2014 insurance M&A activity increased significantly by most measures in all segments from 2013 – in some cases, dramatically (Figure 1).

Figure 1: Insurance Sector M&A Activity, 2013-2014

	Number of Deals			Aggregate Deal Value			Average Deal Value		
Sector	2013	2014	YOY Change	2013 ($B)	2014 ($B)	YOY Change	2013 ($M)	2014 ($M)	YOY Change
Underwriters	86	78	(9%)	$6.2	$18.3	195%	$124	$359	190%
L&A	21	15	(29%)	$1.5	$9.8	553%	$107	$818	664%
P&C	52	51	(2%)	$4.7	$7.0	49%	$135	$218	61%
Other	13	12	(8%)	NMF	$1.5	NMF	N/A	N/A	N/A
Brokers	229	321	40%	$3.0	$3.4	13%	$107	$76	(29%)
Total	315	399	27%	$9.2	$21.7	136%	N/A	N/A	N/A

Source: Deloitte analysis utilizing SNL Financial M&A database

2014 activity was highlighted by several new dynamics in the M&A market:

1. **The emergence of the large, transformative deal** – There were eight $1billion+ deals announced in 2014, as many as had been announced in the past several years.

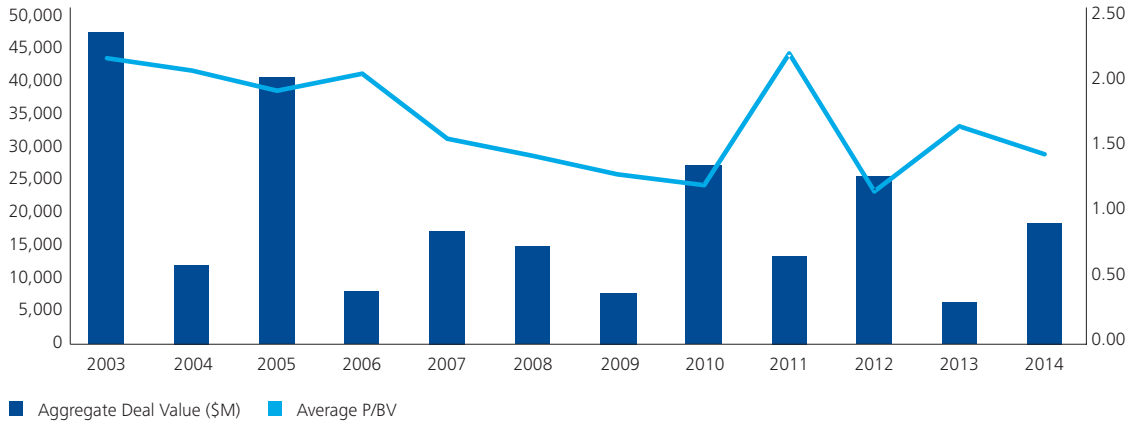
2. **The emergence of the foreign buyer** – Widespread interest from foreign buyers (particularly from the Asia-Pacific region) was on display in 2014, with a focus on identifying companies that could serve as strong market entry vehicles. The acquisitions of Protective Life Corporation by Dai-ichi Life Insurance Company[3] and Meadowbrook Insurance Group by Fosun International[4] were the most prominent examples of this dynamic.

3. **The emergence of meaningful consolidation activity in the reinsurance sub-sector** – This long-anticipated consolidation was initiated during the final six weeks of 2014, with Renaissance Re's acquisition of Platinum Underwriters Holdings[5] and XL Group's acquisition of Catlin Group.[6] We believe that the consolidation of reinsurance and a diversification of these organizations into primary specialty insurance (with a particular emphasis on obtaining access to the Lloyd's market) may be a sea-changing event for the industry.

Insurance Underwriters

In terms of the multiples observed in the Insurance Underwriters segment,[7] Figure 2 indicates a slight decrease (a bit more than 10 percent) in the average Price/Book multiple (P/B) between 2013 and 2014, adjusting for certain outliers. In addition, as can be observed in the graph, the average deal value in 2014 increased significantly over the 2013 level, a result of the re-emergence of the transformative deal. A concern with relying on these figures as a barometer of a stabilizing or recovering market, however, is the limited number of transactions and the influence of a couple of deals that were concluded at higher multiples.

Figure 2: Insurance Underwriter Transactions
Price to Book Value Multiples



	Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
	Number of Deals	78	61	89	102	99	102	78	111	110	109	86	78
Size of Deals ($M)	Low	1.3	0.5	0.7	0.4	0.4	0.8	0.0	<$100K	0.5	0.1	0.3	0.8
	High	17,595.4	5,002.1	11,500.0	1,120.9	2,744.0	6,225.0	1,715.8	15,545.1	3,824.9	5,726.4	1,125.0	5,579.6
	Average	761.1	249.8	671.4	93.6	206.3	184.7	148.2	371.9	209.2	377.0	123.9	359.0
Observed P/BV Deal Multiples	Low	0.54x	0.55x	0.87x	0.88x	0.79x	0.49x	0.73x	0.57x	0.12x	0.29x	0.68x	0.14x
	High	7.41x	5.49x	3.46x	6.19x	2.19x	1.96x	2.98x	3.06x	5.98x	3.17x	4.11x	1.77x
	Average	2.13x	2.03x	1.88x	2.01x	1.52x	1.40x	1.26x	1.18x	2.16x	1.13x	1.62x	1.41x

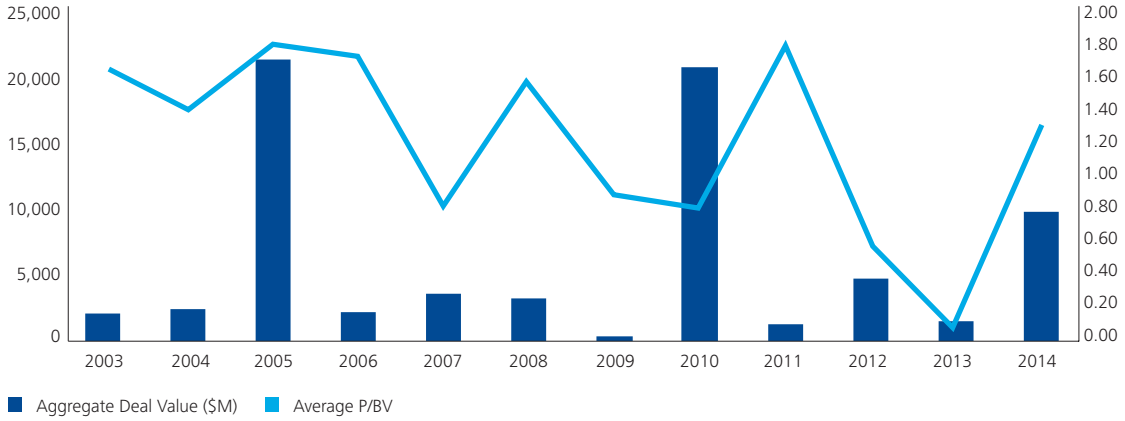
Source: SNL Financial
- Transactions represent US and Bermuda companies making acquisitions on a global basis. Insurance Underwriters include P&C, L&H, Multiline, Managed Care, Title, Mortgage Guaranty and Finance Guaranty sectors covered by SNL Financial.
- Transactions grouped by the year they were announced.
- Deal multiples represent closed multiples, unless the transaction is still pending close.
- The following deals were excluded from the average deal multiples as they skew the data: in 2014, Apollo Global Management's acquisition of Companhia de Seguros Tranquilidade SA for 0.14x P/B, and in 2012, Cigna Corporation's acquisition of Finans Emeklilik for 6.2x P/B and UnitedHealth Group Incorporated's acquisition of Amil Participações S.A. for 6.7x P/B.
- Analysis as of 12/31/2014

Life & Health

Among market segments, 2014 M&A activity in Life & Health (L&H) insurance was sluggish, reaching a low point in terms of the number of transactions over the past dozen years, and a decrease of approximately 30 percent from 2013. One factor in the decrease in deal number could be that this segment continues to be adversely impacted by the low interest rate environment, which is expected to remain a governor on the number of deals. Although the multiples related to many of these transactions were not publicly reported, when examining the average deal size from 2013 to 2014 it appears that there was a significant increase in transaction size as well as aggregate deal volume (Figure 3), which was driven by several transformative deals which occurred in this space, including the Dai-ichi Life Insurance Company's acquisition of Protective Life Corp. These large deals drove the average deal value to heights not experienced since 2010.

The pace of M&A in Life & Annuities has been slow – buyers are looking but supply is limited. 2014 activity slumped from a low level in 2013, with some deals being driven by life insurers either buying or selling asset management companies to take on or reduce their exposure to mortality risk, respectively.

Figure 3: Life and Health Transactions
Price to Book Value Multiples



	Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
	Number of Deals	19	21	23	28	25	27	16	28	28	27	21	15
Size of Deals ($M)	Low	1.3	0.5	0.7	1.8	0.4	0.8	0.5	0.1	0.5	0.1	0.1	3.0
	High	500.0	1,350.0	11,500.0	893.0	2,400.0	2,470.7	126.5	15,545.1	440.0	1,550.0	1,056.0	5,579.6
	Average	133.5	150.2	1,423.9	89.5	168.5	159.5	36.1	1,037.5	80.2	311.2	106.5	818.0
Observed P/BV Deal Multiples	Low	1.44x	0.55x	1.39x	1.17x	0.79x	1.12x	0.87x	0.50x	0.58x	0.31x	NA	1.29x
	High	1.72x	3.00x	2.01x	2.32x	0.79x	1.86x	0.87x	1.09x	4.53x	6.67x	NA	1.29x
	Average	1.58x	1.39x	1.79x	1.74x	0.79x	1.57x	0.87x	0.80x	1.78x	0.56x	NA	1.29x

Source: SNL Financial
- Transactions represent US and Bermuda Life & Health Insurance Underwriters making acquisitions on a global basis.
- Transactions grouped by the year they were announced.
- Deal multiples represent closed multiples, unless the transaction is still pending close.
- Where multiples show as "NA", there was not enough publicly available information.
- For 2013, while the data sources indicated the deal size for most of the transactions, information for the P/LTM Earnings for the individual transactions was not available.
- For years 2007, 2009 and 2014 there is only 1 deal with data, respectively.
- Analysis as of 12/31/2014

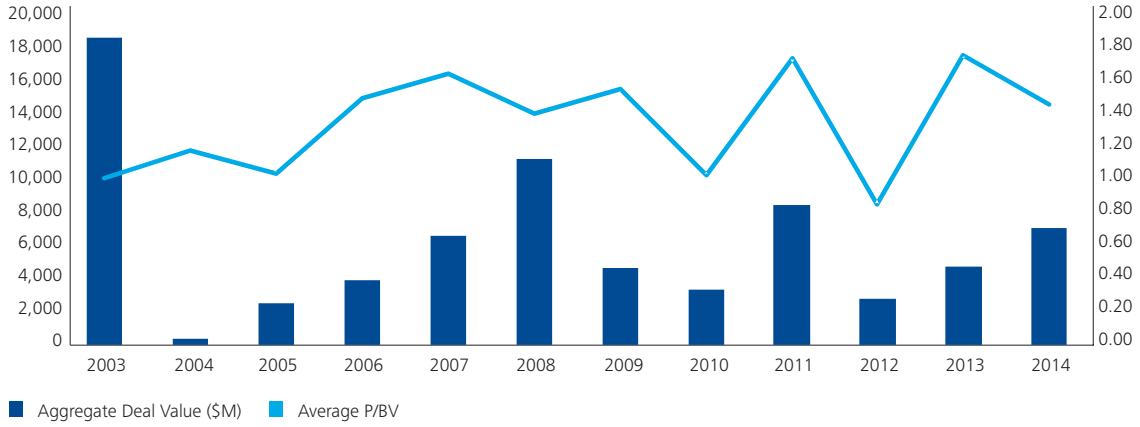
Property & Casualty

The aggregate deal volume of Property & Casualty (P&C) transactions continued an upward trend in 2014, with the average deal size growing in excess of 60 percent from 2013 (Figure 4, next page). Examining the data for transactions with published announced deal value, there were five transactions in 2014 that were in excess of $500 million, compared to four such transactions disclosed in 2013. While the percentage of deals in excess of $500 million increased slightly as a percentage of total 2014 announced transactions, a majority of the transactions were of the bolt-on type. However, as can be observed by the average deal value,[8] while companies continue to look towards bolt-on transactions as a mechanism to drive growth, the price point is beginning to rise. The average P/B multiple, after adjusting for outliers, did pull back from the gain experienced in 2013; but, similar to the overall Insurance Underwriter segment (which includes P&C), caution should be exercised before indicating the market recovered based on the P/B multiple, given the low number of transactions.

In the P&C market, buyers have been seeking scale, diversification and/or market access. P&C accounted for a couple of billion-dollar-plus deals announced in 2014, including TPG Capital Management LP's purchase of Warranty Group Inc., a provider of extended warranty contracts, for an enterprise value of $1.5 billion[9] and RenaissanceRe Holdings Ltd. announced acquisition of Platinum Underwriters Holdings, Ltd.[10] 2014 also saw evidence of deals in the specialty space (e.g., crop insurance), indicative of broader consolidation in certain lines of business.

Where P&C insurers have found themselves dealing with increased competition for a limited number of acquisition targets, companies with more capital are becoming more aggressive. Some have diversified from balance sheet risk to do bolt-on transactions with fee-driven businesses (e.g., claims processors, appraisal firms) to counter the effects that aggressive underwriting conditions have had on their ratios.

Figure 4: Property and Casualty Transactions
Price to Book Value Multiples



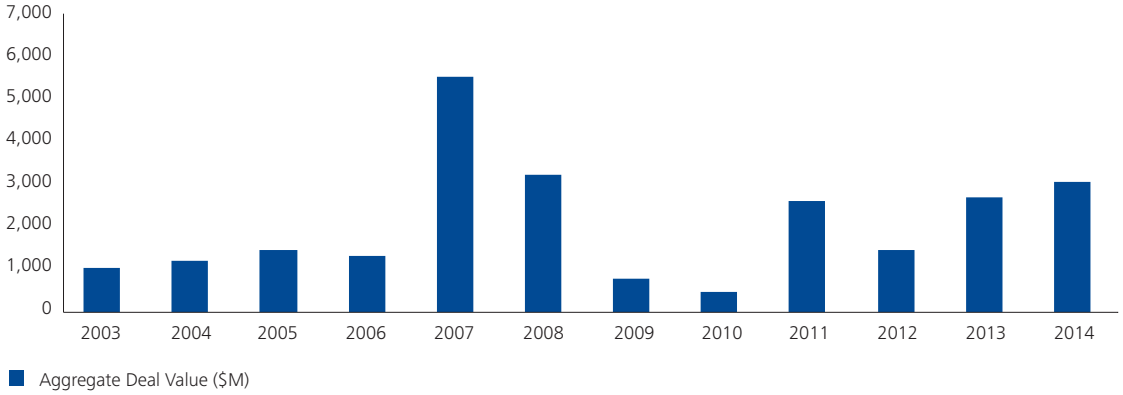
	Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
	Number of Deals	41	16	46	48	55	60	48	69	68	58	52	51
Size of Deals ($M)	Low	5.0	3.0	1.2	0.4	1.0	1.8	0.0	<$100K	0.5	0.8	0.8	3.1
	High	16,138.5	78.0	825.0	1,120.9	2,744.0	6,225.0	1,665.9	396.4	3,534.7	622.9	1,125.0	1,671.3
	Average	594.0	29.5	80.4	94.3	148.3	232.2	136.3	74.0	274.0	77.4	134.5	217.7
Observed P/BV Deal Multiples	Low	0.54x	0.76x	0.87x	0.88x	1.13x	0.49x	0.73x	0.57x	0.12x	0.57x	0.68x	0.14x
	High	7.41x	1.57x	1.15x	6.19x	2.19x	1.96x	2.98x	1.65x	5.87x	1.52x	4.11x	1.77x
	Average	1.00x	1.17x	1.03x	1.48x	1.63x	1.39x	1.53x	1.02x	1.72x	0.84x	1.74x	1.44x

Source: SNL Financial
- Transactions represent US and Bermuda Property & Casualty Insurance Underwriters making acquisitions on a global basis.
- Transactions grouped by the year they were announced.
- Deal multiples represent closed multiples, unless the transaction is still pending close
- The following deals were excluded from the average deal multiples as they skew the data: in 2014, Apollo Global Management's acquisition of Companhia de Seguros Tranquilidade SA for 0.14x P/B, in 2006, Berkshire Hathaway Inc.'s acquisition of Applied Underwriters, Inc. for 6.2x P/B, and in 2003, Liberte Investors's acquisition of USAuto Holdings, Inc. for 7.4x P/B.
- Analysis as of 12/31/2014

Broker/Agent

In terms of deal volume, brokerage was, by far, the insurance market's most active sub-sector. With 321 announced deals, 2014 fell just short of 2012 as the most active year in the past decade (Figure 5). Serial acquisitions have been the core driver of brokerage growth for many years and that dynamic remained firmly in place in 2014. In fact, due to a soft P&C rate environment and very low exposure growth, brokers relied on M&A-driven growth even more than is typical.

Figure 5: Insurance Broker Transactions
Aggregate Deal Value



Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Number of Deals	190	231	200	219	259	284	178	234	300	336	229	321

Source: SNL Financial
• Transactions represent US and Bermuda Insurance Brokers making acquisitions on a global basis.
• Transactions grouped by the year they were announced.
• Analysis as of 12/31/2014

Adding further fuel to the fire was intensifying interest in the brokerage segment by PE buyers. These firms have been drawn to the brokerage business due to its steady cash flow, ability to generate strong return on equity (ROE), and relative lack of correlation to the performance of the broader market. As an example, following its 2013 acquisition by a PE firm, HUB International increased its pace of acquisitions, announcing a total of 28 in 2014.[11]

The most active acquirers in the sub-sector were Arthur J. Gallagher & Co. (38 deals), AssuredPartners, Inc. (23 deals) and, as previously mentioned, HUB International Ltd. (28 deals). Gallagher drove two of the three largest acquisitions in the segment in 2014: the cross-border acquisitions of both Westfarmers Insurance Brokerage (Australia) and Noraxis Capital (Canada).[12]

As the market continues to consolidate, we expect to see increased broker influence within the insurance value chain. Those brokers with the broadest, deepest, most efficient platforms will continue to win, and effective M&A programs will be a central component of their success.

Top Issues for Insurance M&A in 2015

Now that the insurance sector has come through the financial crisis and many companies are on better financial footing, C-suites and boards of directors are placing renewed attention on the quest for profitable growth. Most find that growing organically is very difficult; one strategic option is to deploy available capital to M&A. Facing opportunities as well as challenges in 2015, insurance companies across market segments should consider the following issues that may influence their M&A activities.

1. Strengthening macro conditions

The trifecta of low US interest rates, high capital reserve levels, and stagnant organic growth, along with an intensely competitive marketplace, continued to depress insurance company ROE in 2014. Even as many publicly traded insurance companies used their excess capital to fund stock buybacks, issue dividends, or invest in low-yielding bonds, activist investors increased their pressure on management and boards of directors to consider M&A as a way to stimulate ROE. Fortunately, strengthening macro conditions, strong balance sheets, improved insurance company earnings, and a recent uptick in billion-dollar deals may prove self-reinforcing for insurance industry M&A in 2015.

Although the US remains in a prolonged low interest rate environment, the market is seeing signs that monetary policy is starting to come into play, which could favor a modest interest rate increase. In October 2014, the Federal Reserve (the Fed) ended its long-running bond purchase program (quantitative easing) that has stimulated growth since the 2008 financial crisis.[13] And while the Fed declined to raise rates at its December 17, 2014, meeting, most officials still see the first increase taking place sometime in 2015.[14]

An increasingly robust US economy bolstered by rising interest rates, relatively stable stock market, and flush corporate balance sheets may encourage growth-oriented insurance companies to consider strategic acquisitions as a way to augment organic growth. Deal types could range from a portfolio "tuck-in," in which a company adds a component from an adjacency to round out its capabilities or markets (e.g., as when Progressive Insurance announced its acquisition of property insurer ARX Holding Corporation to drive incremental growth in homeowners' premium volume[15]); to a "need for scale" play, in which two or more small- to mid-market insurers consolidate books and/or businesses; to a large, transformational deal in which a domestic insurance carrier ties up with an international player.

Several large transactions announced in 2014 may trigger boardroom discussions and follow-on insurance sector deals in 2015. Chief among these was June's announced sale of Protective Life Corp. to Dai-ichi Life Insurance Co. Ltd., for $5.58 billion.[16] Other notable deals included RenaissanceRe Holdings Ltd.'s November agreement to buy fellow Bermuda-based reinsurer Platinum Underwriters Holdings Ltd. in a stock-and-cash deal worth more than $1.9 billion;[17] and TPG Capital Management LP's third-quarter 2014 purchase of Warranty Group Inc. from Onex Corp. for an enterprise value of nearly $1.5 billion.[18]

One potential fly in the ointment: valuations. There may be a desire on the part of C-suites to do deals, but valuations – which have been somewhat irrational as of late – don't necessarily align with the businesses they want to buy. Fortunately, buyer/seller expectations appear to be moving closer to alignment. Stock prices in general have continued to rise and with them many sellers' confidence that the offered price for an acquisition is more realistic. Meanwhile, many buyers are concluding that it may be time to move on desirable targets, especially before interest rates begin to climb.[19]

Bottom line

Many of the "big picture" factors that combined to dampen insurance sector M&A over the past few years remained in place during 2014: sluggish economic growth; low interest rates; keen investor attention on ROE; the rise the rise of activist investors; and sector fragmentation. Entering 2015, however, some macro conditions may be strengthening. For example, the prospect of rising interest rates could spur on-the-fence acquirers. Also, GDP growth will likely remain too low to easily support organic growth strategies, making M&A more attractive. In addition, pent-up demand for transactions has intensified, due to high levels of excess capital with significant additional inflows. The supply of available targets also appears to have increased, as evidenced by recent large deals.

2. Regulatory developments

The unsettled regulatory environment will remain a net impediment to the insurance M&A marketplace in 2015. Top issues include systemically important financial institution (SIFI) designation; risk-based capital frameworks; principal-based reserving; focus on consumer protection; governance and risk; and a greater emphasis on the board's role in compliance. In addition, increases in both the scope and pace of regulatory change will continue to drive up costs for the risk and regulatory functions in the insurance business.[20]

As was the case in 2014, companies can expect to face increasing scrutiny from US and international regulators, as well as new rules and modified requirements that could significantly affect how they operate, including M&A. Among trends to watch:

Expanding regulatory oversight – States have traditionally handled US insurance industry regulation; now, however, oversight is moving to a hybrid system, with the federal government playing an ever-increasing role. The Federal Insurance Office (FIO) has broad responsibility for monitoring the insurance industry, although it does not have statutory regulatory authority over insurance companies. The Federal Reserve (Fed) also has a growing role in insurance regulation, with official responsibility for overseeing insurance companies that operate banks or thrifts, as well as those designated as Systemically Important Financial Institutions (SIFIs) by the Financial Stability Oversight Counsel (FSOC). Initially, only three insurance companies will carry this designation. Going forward, one potential consideration is that a significant M&A deal may draw attention to companies not now on the FSOC's radar, given its charge to monitor changing market conditions.

The exact roles of state and federal regulators continue to evolve. In the meantime, most regulators are reacting to what other regulators are doing – states are emulating the Fed and international regulators, for example – which is leading to greater regulatory rigor, higher compliance costs, and the need for improved controls, governance, and information technology.[21] While the new Republican-controlled Senate and House of Representatives in 2015 may be less likely to give the FIO and other federal agencies more power in 2015, their mere existence is impacting state agencies.

The US insurance industry also faces increasing pressure to follow international regulatory standards. Bodies such as the International Monetary Fund (IMF) and the Financial Stability Board (FSB) are seeking a central supervisory point for US insurance, which is the norm in most other countries. The International Association of Insurance Supervisors' (IAIS) global regulatory framework – under which Globally Systemically Important Insurers (G-SIIs) and internationally active insurance groups will be subject to international capital standards – will be taking full effect in 2019. As globally accepted insurance supervisory standards are agreed upon, state regulators are under growing pressure to conform to how insurance is regulated in other parts of the world.

Own Risk and Solvency Assessment (ORSA) – The ORSA model developed by the National Association of Insurance Commissioners (NAIC) goes into effect in 2015. Under ORSA, many US insurers and insurance groups are required to subject themselves at least once a year to a confidential internal assessment of material and relevant risks associated with their current business plans, and sufficiency of capital resources to support those risks. Beginning on January 1, 2015, affected companies must submit their initial summary findings within the year; however, regulators are strongly encouraging organizations to get in touch early for an informal discussion so there are no surprises about the agreed ORSA reporting expectations.[22]

Corporate governance – Regulators are increasingly interested in corporate governance, risk management, and ownership by the board of directors. In 2014, the NAIC approved a framework for corporate governance, which requires the annual collection of information about an insurer's corporate governance practices. The framework, which is now being considered by the states for adoption and is intended to go into effect in 2016, would require every insurer to file an annual report about its corporate governance practices, including its governance framework, management policies and practices, and the policies and practices of its board of directors and committees. States may use the model act as a foundation, layering on additional requirements as they see fit. Confidentiality issues are likely to be the industry's primary concern as states adjust the model to the requirements of state law.[23]

Use of captives – The NAIC has moved to address concerns about how US commercial life insurers may use captives and similar alternative risk-bearing entities[24] in ways that might enable them to evade accounting rules and reserve requirements. While regulators in New York and California remain among those opposed, the NAIC recently accepted the new rules recommended by its consultant in the modified Rector Report. These new rules, aimed at providing more uniformity and clarity around the quality of assets, are prospective -- affiliated captives that already exist are unaffected. The NAIC in August 2014 adopted the XXX/AXXX Reinsurance Framework, furthering an action plan to develop proposed changes to the insurer/captive regulations specific to XXX/AXXX transactions.[25] However, the FIO, which identified use of captives as a gap in state regulation, has not weighed in since the modified Rector Report was adopted. However in its annual report to Congress on systemic risks, the Office of Financial Research (OFR), the office within Treasury tasked with providing research support for FSOC, named this use of captives as among the major emerging systemic risks.

Principle-based reserving (PBR) – Life insurers argue that the traditional formula-based approach to determine reserve requirements is outdated and produces reserve requirements that are excessively high. They favor a principle-based approach that could enable companies to profitably offer a different mix of products. The NAIC agrees, and has approved the shift to principle-based reserving. However, the change can't take effect without approval from a supermajority of states representing 75 percent of the life premium – and that goal remains elusive. New York and California have already expressed strong opposition, and the issue is expected to play out in 2016-2018. The industry might see a partial move towards PBR, even if New York, California, and a few other states retain the traditional approach.[26]

Inversion regulations – In Notice 2014-52, 2014-42 IRB 712 (the "Notice"), the IRS described additions it will make to the Treasury regulations under section 7874 of the Internal Revenue Code, in order to curb further corporate inversions. As a result, insurance industry M&A may be adversely impacted by such future regulations if they are promulgated as envisioned in the Notice. This is because the Notice targets the use of foreign "cash boxes" to complete inversions that otherwise would fall outside the purview of section 7874. That is, 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. Unfortunately, however, the Notice does not clarify the policy justifications for the disparate treatment afforded foreign insurers and reinsurers vis-à-vis the banking and finance industry, and many in the insurance industry believe that the absence of further clarification may have a chilling effect on acquisitions of domestic corporations (insurance companies or otherwise) by foreign insurers or reinsurers at a time when M&A activity would otherwise seem to be accelerating.

Bottom line

The insurance regulatory landscape will likely remain challenging and uncertain in 2015, with new rules and modified requirements that could significantly affect how companies operate and engage in M&A. Regulatory bodies in the US and abroad have been expanding their compliance, oversight, and enforcement activities, and that trend is expected to continue. To be effective in this ambiguous environment, insurers will need to plan for potential regulatory changes and their impacts to avoid scrambling to achieve compliance. For an in-depth look at regulatory trends impacting the US insurance sector, read the Deloitte publication, *Forward Look: Top Regulatory Trends for 2015 in Insurance.*[27]

3. Investment activity by private equity firms

Private equity (PE) firms continue to be interested in insurance sector investments. Historically, PE firms have focused on the brokerage/agent segment, attracted by its cash-flow-based business model and the ability to quickly enter and exit the market. However, their activity in the life & annuity space is on the rise. Annuities companies present steady cash flows and the ability for PE shops to reinvest assets at amplified returns, which they are increasingly able to achieve in today's rising market. As a result, there has been an uptick in consolidated blocks of life insurance business going to PE firms.

Another area of PE interest is companies that provide services to insurance businesses. In January 2014, for example, New York investment firm KKR & Co. LP announced its purchase of a majority ownership in third-party administrator Sedgwick Claims Management Services Inc. for $2.4 billion.[28] Sedgwick provides claim management systems specializing in tools that manage workers' compensation, disability, managed care, liability, fraud, and warranty claims.[29] In this PE-to-PE transaction, KKR purchased its stake in Sedgwick from the company's current investors, Stone Point Capital LLC and Hellman & Friedman LLC, which bought Sedgwick for about $1.1 billion in 2010. Analysts described the sale as part of a standard life cycle for PE investments.[30] In a second example of PE firms selling their insurance-sector investments to another PE firm (for their financial versus strategic value), Toronto-based Onex Corporation and its affiliates announced in August 2014 that they completed the sale of The Warranty Group, which provides extended warranty contracts for consumer goods, including cars, electronics, and major home appliances.[31]

Some PE firms, especially in the broker space, are cashing out of investments they made a few years ago. In addition, certain privately held companies with PE backing continue to be very aggressive in certain insurance segments. For example, HUB International, controlled by Hellman & Friedman LLC, announced 28 deals in 2014, per SNL. Confie Seguros Insurance Services, controlled by ABRY Partners, announced 13 transactions in 2014, and Onex Corp's portfolio company, USI Holdings Corporation, announced nine deals.[32] Finally, hedge funds are still very interested in insurance risk, and view insurance float as another investment vehicle to increase their cash flow.

In addition to acquiring reinsurance companies, some hedge funds have established their own strategy reinsurer businesses. Bermuda-based Third Point Reinsurance Ltd., started by activist hedge fund Third Point LLC, wants to form a US subsidiary to originate incremental reinsurance business, better serve its insurance company clients there, and enhance its reinsurance broker relationships.[33] The integration of large amounts of nontraditional capital into the reinsurance market has been accelerating, as investors look to diversify themselves in the market. Until alternative capital from PE firms and other investors suffers a significant loss, the marketplace should continue to grow.

Bottom line

The financial discipline and performance improvement-orientation that PE firms bring to the M&A environment should continue to influence their deal activity in 2015. PE firms typically want outsize returns in a relatively short timeframe, so expect to see continued transactions in the brokerage space. Yet, some PE investors are also taking a longer-term view by acquiring life blocks of businesses, reinsurance companies, and insurance services providers.

4. Capital management balancing act

Insurers often find themselves in a tug-of-war between investor demands for enhanced ROE and rating agencies' requirements for adequate capital reserves. In the process, funding for potential M&A can become an afterthought. As rating agencies continue formulating views on capital reserves in 2015 (there are specific capital challenges in the different segments), insurance companies are assessing how best to deploy tremendous amounts of excess capital in a way that balances the interests of multiple stakeholders. M&A is moving to the forefront as a viable option, amid general consensus that rating agencies and regulators are unlikely to derail a deal in a marketplace where everyone has so much capital.

Robust capital reserves combined with excess underwriting capacity, or policyholder surplus,[34] in the insurance marketplace may create the need for more strategic acquisitions in 2015 and 2016. So may a paucity of organic growth drivers. In the P&C space, for example,

the lack of major catastrophes since Superstorm Sandy has made it difficult for insurers to increase rates. On the flip side, P&C capital in the US is at an all-time high, sellers are getting a premium above market cap from buyers, and stock valuations have improved – all of which should lead to more M&A. In fact, some P&C companies with excess capital are becoming more aggressive about M&A, diversifying from balance sheet risk to do bolt-on transactions (e.g., claims processors, appraisal firms) with businesses that are more fee-driven.

Bottom line

In years past, share buybacks often were insurance companies' method of choice for satisfying investors' and rating agencies' expectations for managing excess capital. However, in light of today's corporate earnings increases, stunted organic growth, record cash reserve levels, and calls by activist investors to improve ROE, insurance company executives and boards are once again considering M&A as a tool to put their excess capital to work.

5. New entrants in the M&A arena

There is widespread evidence that historically less active players in all segments of the US insurance industry are becoming more interested and engaged in M&A. Boards of directors are having M&A-related conversations and management teams are looking externally for M&A strategy and capability-building support and information on how the market is evolving. Among key drivers for this intensifying activity: the supply of available targets has increased as a result of organizations divesting non-core assets; bid/ask spreads are narrowing; there has been a significant run-up in stock prices in 2013 and 2014; PE firms are divesting matured investments; and new regulations are prompting organizations to revisit their business portfolios.

Following MetLife, Inc.'s 2010 purchase of AIG's foreign life insurance business, Alico, for $15.5 billion[35] – the largest transaction in the last seven years – many US insurance companies decided to dial down large-scale M&A activity in favor of share buybacks. Recently, though, some traditionally inactive players have been entering the M&A arena in a big way. In April 2014, for example, TIAA-CREF agreed to buy Nuveen Investments for $6.25 billion – TIAA-CREF's biggest-ever transaction – helping the manager of teachers' retirement savings expand its mutual-fund assets and appeal to a broader set of individual investors.[36]

While a wave of large-scale deals like MetLife/Alico and TIAA-CREF/Nuveen are not anticipated during 2015, insurance companies looking to increase ROE and diversify balance sheet risk may engage in bolt-on transactions to acquire fee-based businesses and fill product, distribution, or geographic gaps.

In the near term, "new" players in insurance M&A are likely to come from within the industry or adjacent markets. However, a disruptive event – something that fundamentally alters the fabric of the industry (e.g., driverless cars) may attract non-traditional competitors. In addition, certain emergent-risk opportunities – cyber, nanotechnology, DNA sequencing, among them – may spur new types of insurance coverage and resultant M&A activity. In preparation, CEOs and their management teams should perform scenario planning analyses to understand how the industries in which they operate might dramatically change and how they could use M&A to capitalize on disruptive opportunities.

Another set of "new" M&A players – reinsurers – made their long-anticipated arrival in late 2014. Two transactions which were announced during the final six weeks of the year may have triggered a sea-change of consolidation in the reinsurance sub-sector. The first reinsurance deal was Bermuda-based RenaissanceRe Holdings Ltd.'s November agreement to buy Platinum Underwriters Holdings Ltd. (also Bermuda-based), which offers property, casualty and finite-risk reinsurance, in a stock-and-cash deal worth more than $1.9 billion.[37] RenaissanceRe bought a stake in Platinum during its 2002 initial public offering, and said the new deal will enhance scale and speed its growth in specialty and casualty reinsurance business in the US.[38] A few weeks later, XL Group Ltd announced it will acquire all of the capital stock of Catlin Group for an equity value of approximately $4.1 billion.[39] The combined company achieves significant scale within its core competencies of global specialty insurance and reinsurance, and provides the organization with a broader product offering and an expanded global network, particularly through Catlin's Lloyd's platform. Lastly, before year-end, the board of Bermuda-based catastrophe specialist Montpelier Re put that business up for sale, at a value of $1.5 billion.[40]

The consolidation trend has continued and, in fact, accelerated in early 2015, with the AXIS Capital Holdings $11.0 billion "merger-of-equals" with PartnerRe,[41] and Canada's Fairfax Financial Holdings Ltd.'s $1.88 billion acquisition of specialty insurer and reinsurer Brit PLC.[42]

Intense competition from traditional and alternative (e.g., insurance-linked securities, catastrophe bonds, etc.) sources of capital, marketplace overcapacity, and changing customer needs and buying preferences are the triggering mechanisms driving reinsurance firms to consolidate. We anticipate that transactions will focus both on increasing scale and product breadth (to enhance marketplace positioning) and on expanding into primary specialty insurance (to diversify revenue sources and insulate from competition), with a particular focus on obtaining a meaningful presence in the Lloyd's market. The development seems a double-edged sword for Lloyd's. While many of these transactions highlight the perceived value of being part of the Lloyd's market, the scale of these combined specialty organizations may provide them with greater flexibility to use their own brands for underwriting versus using the Lloyd's platform.

Bottom line

While it is not in insurance companies' DNA to be disruptive, some historical non-players are looking to M&A as a more innovative way to put their considerable excess capital to use. They are reinvigorating their business development departments, screening targets, and making sure they have plans and capabilities – internal or external – in place to jump on opportunities should they arise.

6. Heightened demand by foreign insurers to enter the US market

In recent years, large, international insurance companies with the capacity for cross-border ownership have pursued acquisitions in rapidly growing markets of Latin America and Asia. Entering those markets has proved very expensive, however, due to intense competition for available targets. Now, many of these potential buyers are expressing renewed interest in entering the US insurance market via acquisition.

While the US is not considered high-growth, it is the largest insurance market in the world. On a relative basis, then, establishing a material presence in the US and using an acquisition to build share organically or to make incremental acquisitions has emerged as a more viable and attractive strategy than looking for growth in markets where there may be a high-percentage growth rate but it is growing off of a relatively small base. On an absolute level, one percent growth of the US market provides far more opportunity than 20 percent growth in, say, Malaysia.

Several Asian buyers went shopping for US-based companies in 2014, as evidenced by Dai-ichi Life Insurance Co. Ltd.'s announced purchase in June of Protective Life Corp. for $5.58 billion.[43] The Japanese insurance market is mature and growing slowly; Dai-ichi Life is leveraging the Protective acquisition – its first foray into the US – as an additional source of growth. Large Chinese and Korean organizations are also looking to acquire both life and P&C insurance companies in the US and elsewhere. Fosun International's announced acquisition of Meadowbrook Insurance Group for $433 million[44] is another example of this trend. Some European insurance companies are also evaluating potential acquisitions, although not at the same level as their Asian counterparts.

Bottom line

As of December 2, 2014, overall global cross-border M&A was up 45 percent from 2013 and at its highest year-to-date volume since 2008.[45] The US, at 24 percent market share, was the year's top-targeted nation by both volume and activity for global cross-border M&A.[46] The US insurance industry benefitted from this heightened activity, as evidenced by the Dai-ichi Life/Protective Life and Fosun/Meadowbrook deals and other transactions. Inbound M&A – especially by Asian insurers – is expected to continue in 2015, as an improving US economy leads to more growth opportunities on both a relative and absolute basis compared to emerging economies, and foreign buyers seek to make a play before US interest rates rise.

Moving forward

We believe that 2015 will see continued acceleration of activity in the insurance M&A market, building upon the growth experienced from 2013 to 2014.

As high capital reserve levels, intense price competition, and stagnant organic growth continue to depress insurance company ROE, strategic buyers are expected to turn to M&A (inorganic growth) to build-out capabilities and markets; financial buyers may seek cash-flow businesses that aren't highly capital-intensive and aren't necessarily correlated to the stock market; foreign buyers should become more active in the US; and PE firms will seek to both buy and sell assets.

Yet, expect buyers to be prudent and selective in their acquisitions – today's is a more cautious M&A environment than it was seven or eight years ago, when there were always a few companies that had cash reserves and when the right opportunity at the right price came along, they would buy it. Few companies will transact a deal in 2015 unless they feel that it will be accretive from Day 1 and they can justify it to Wall Street and their investors. The key to long-term sustainability and fundamental success in a more risk-aware M&A environment is being able to walk away from a deal unless it ticks all the boxes.

The link between business strategy and M&A strategy will become increasingly important and visible in 2015. Whether they are serial acquirers or re-entering the game after a lengthy hiatus, strategic buyers looking for the right partner to provide new platforms, diversify books of business, or provide economies of scale should:

1. **Refresh corporate strategy** – Successful M&A programs are an outgrowth of and directly linked to corporate and business unit strategy. Without clarity on how the business will be positioned and what differentiated capabilities will enable it to win in the marketplace, M&A becomes a high-risk distraction that may destroy enterprise value rather than create it.

2. **Conduct an inorganic growth analysis** – Practiced acquirers know the types of targets they're looking for. They have done their homework and have identified the strategic needs that lend themselves to an M&A-driven solution. These needs could be as diverse as entering a new product line, expanding geographically, obtaining an efficient operating platform (technology and processes), or moving into a new customer segment. In general, the number of needs will far exceed the organization's capacity to transact. Senior leadership will need to evaluate the M&A needs that were identified and prioritize some subset as an initial focus of their program.

3. **Build or refine the ability to transact** – Clarity about the focus of an M&A program (e.g., likely number of deals; nature, size, and availability of targets; likely degree of integration) as well as an understanding of the acquiring organization's key attributes (e.g., approach to strategic decision-making, prior corporate and management M&A experience, cultural readiness) will strongly influence what a company needs to do to prepare. For most organizations, a well-functioning corporate development capability is essential to sourcing targets, evaluating them, and executing deals.

4. **Build or refine the ability to integrate** – Depending on the nature of the acquisitions an organization is considering, it may also be necessary to invest in building integration capability. Integration readiness is widely recognized as a vital consideration – especially by those executives with the most cumulative M&A experience. We observe near-universal agreement among experienced senior leaders that the most challenging part of the M&A process is successfully integrating the acquired company. Successful integration has its roots in effective due diligence and plays out in a series of important activities both before and after the close of a transaction. A serial acquirer's approach to integration readiness will differ from an organization that transacts infrequently but, in either case, readiness is vital to M&A success.

Endnotes

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