Deloitte M&A Views podcast:
Navigating the deal market: The future of insurance M&A

Transcript

Greg: Welcome to Deloitte M&A Views, a Deloitte podcast series exploring the latest trends and topics in mergers and acquisitions. I'm Greg Jarrett. Today we discuss the current M&A climate in the insurance industry. We're joined by two members of the Deloitte Insurance M&A leadership team, Boris Lukan, principal with Deloitte Consulting LLP, and Matt Hutton, partner with Deloitte & Touche LLP.

Greg: Boris, why don't we get started with a quick overview of M&A activity in the insurance industry in the past year, 2016. Can you characterize what that was like?

Boris: Sure. When we issued our 2016 forecast, we had just wrapped up 2015, which was a record year for insurance M&A. About $70 billion in transactions were announced that year. There were more than a dozen deals valued at a billion dollars or more, and there was significant momentum in the marketplace. We didn't think 2016 would be a repeat of 2015 in terms of deal value, but we did think that deal volume would be on par. Our forecast for really an exuberant deal environment in 2016 did not play out as we had envisioned. I'd say '16 was a tale of two halves.

During the first half, announced deal activity was unexpectedly slow. But during the second half, deal making accelerated notably to the point where deal volume, at least for underwriters, for the year as a whole actually exceeded 2015 volume total.

As we reflected on the first half of 2016, we observed five factors that really drove the slow start. At a very high level, those factors were: number one, an increase in overall economic and market uncertainty. Second, valuations had expanded to the point where most buyers viewed them as pretty rich. Third, the most active players in 2015, the Japanese and the Chinese, were sidelined. Fourth, the strong US dollar effectively raised prices for non-US buyers. Then lastly, the serial acquirers in the industry were focused on integrating acquisitions that they had made the prior year. So our view at the time, though, was that the relatively low level of activity during the first half of '16 was a pause, not an inflection point, in what we felt would be an otherwise very active period for insurance M&A.

Greg: So the year was actually two completely different deal markets. That's interesting. Matt, do you have any thoughts around what drove activity in the second half of the year, and what that might mean for 2017?

Matt: Some of the reasons that might have led to that uptick in activity are the return of foreign buyers looking to establish a presence in the US. Second, acquisitions designed to enhance the scale and/or scope of acquiring organizations. Third, acquisitions that diversify the acquirer, also private equity-backed transactions. And lastly, noteworthy InsureTech acquisitions. Moving ahead to 2017, we anticipate that M&A activity in 2017 is likely to echo the active second half of 2016. However, there is a mix of tailwinds and headwinds that will influence the path forward.

Greg: Tailwinds and headwinds. It sounds like we're sailing and we're going to have to tack back and forth to get where we want to go. Can we talk more specifically, Matt, about what these look like? And can we start with the headwinds?

Matt: I think there are four major headwinds that may continue to blow counter to more exuberant levels of M&A in the insurance industry. First, even if potential buyers have cash in hand, not many company boards and executives are eager to sell. A lack of targets means fewer deals. Second, valuations, while not overdone, are considered by most potential buyers to be full. If an organization is going to pay notably over book value for an acquisition, the executives better have a strong, strategic rationale for how they are going to create incremental value. Third, uncertainty around the new administration's and Congress' policy/regulatory actions is unlikely to be clarified materially until the second half of the year, if not later, which may prompt some buyers to wait to pull the trigger on an M&A deal. And fourth, some question whether demand from Asian buyers will remain as strong as it has been over the last few years.

Greg: Boris, what might some of those tailwinds be? And a follow up to that is which will prevail this year? And what does that mean for the deal market in the insurance industry as a whole?

Boris: Well, I think there are many tailwinds that are supporting the market, but let me just mention a few. The most fundamental tailwind is that insurers are competing in an environment of slow economic growth that will likely drive only low, single-digit organic growth opportunities. To drive strong EPS growth, insurers also need to include inorganic growth into their plans. Another tailwind I'll mention is the fact that we're now operating in an environment of increasing interest rates. A key source of earnings for insurers are the returns they make from investments. Increasing rates will obviously increase those returns and make it easier for companies that are considering a transaction to model a favorable economic scenario in their deal pricing and make it easier for them to justify paying more, which can clearly help the environment.

And then lastly, we see evidence that suggests that we'll see pick up in the M&A activity of European insurers here in the US during the latter part of 2017 and in 2018. We see the Europeans reacting favorably to the positive trajectories that exist in the US for economic growth, taxes, regulations, and interest rates. A key thing, though, is that we don't expect to see much activity from them until the implications of the new administration in Washington become clearer. At an individual company level, we think the need to grow faster and obtain the scale needed to make continued technology investments will help drive the M&A market. Also really important is that balance-sheet cash reserves are very strong and there are abundant sources of alternative capital for M&A.

To answer your second question, based on the macro level and organization-specific conditions that I just mentioned, we expect that tailwinds will prevail against headwinds in 2017. This should produce an overall favorable environment for insurance sector M&A. We don't expect to see the kind of mega deals we saw in 2015, but we would anticipate—say eight to 10—highly strategic, billion-dollar-plus deals, driven by both domestic and foreign acquirers.

Greg: Let’s pivot a bit. We always bring up disruption, no matter what the industry. The obvious shifts in the auto industry with autonomous driving and alternate power sources. Health care and life sciences with robotics and wide database diagnostics. So how about the insurance industry? Both of the previous examples, auto and health care, which seem to affect the insurance world, not to mention the complete disruption of actuarial science. Do you see M&A between insurers and IT to better facilitate such disruption? Well let’s start with you, Matt.

Matt: I think you are going to see more folks invest in the InsureTech space to figure out if there’s a way to build a better mouse trap when it comes to underwriting and claims processing. I think it's still in its infant stages, but eventually somebody will build that better mouse trap and turn the industry on its ears.

Greg: Do you think it's going to be one of the big firms? Do you think it's going to be something new? What do you think, Matt?

Matt: My guess is one of the big tech firms that has not played in the insurance industry traditionally could be the winner here.

Greg: What about you, Boris? Is this something that is really going to disrupt the insurance industry, or are they going to be able to make it work?

Boris: There isn't a client in our portfolio that isn't actively thinking about InsureTech and how to leverage those capabilities to enhance its business performance. There's widespread concern that these kinds of organizations are going to create major disruptive impacts in the industry, and our clients are trying to get ahead of that. In some cases, by partnering with InsureTech organizations to enhance or extend their core businesses. Or, in other cases, executing outright acquisitions to bring a particular capability or business model into their portfolios.

Greg: One thing I think that might be helpful to understand from both of you at this point is what should leading insurance organizations consider doing to help identify and capitalize on M&A opportunities as they do move well into 2017? Can we start with you, Boris?

Boris: I'd say number one, make sure your M&A activities are guided by an overall M&A strategy. To formulate that M&A strategy, you'll need to start with an overall enterprise growth strategy, and determine the role that M&A will play in realizing it. Your proactive target screening efforts would certainly need to be in alignment with that strategy, and if necessary, consider modifying a corporate structure to make it easier to execute deals.

Number two, ensure your existing business portfolio continues to make sense. Examine each business, consider divesting assets that you may no longer consider core. Also consider acquisitions, or investments in businesses or capabilities that will improve your positioning in core markets. Certainly, leading organizations already routinely review their portfolios and make these kinds of additions and subtractions.

Greg: We've got the answer from Boris. Matt, do you agree with that? And is there anything you'd like to add?

Matt: Sure. In addition to what Boris mentioned, I'd say to sellers, be better prepared to market the assets identified for sale. Nothing degrades value quicker than a buyer losing confidence due to inconsistent or incomplete financial data provided by sellers. And to buyers, be disciplined in setting a payment ceiling for a business or capability, especially since a shortage of high-quality targets and foreign buyers' willingness to pay a premium may drive sales prices to levels that cannot be justified. Be willing to walk away if the price becomes too rich. And finally, stay informed and stay the course. Remain engaged and informed as policy, tax, and other uncertainties are clarified over time. There will be a lot of quickly moving legislative activities in 2017. You will need to evaluate how marketplace drivers and trends impact your ability to execute your enterprise growth strategy and then adjust your M&A strategies accordingly.

Greg: I'm Greg Jarrett. Thanks for listening to Deloitte M&A Views, sponsored by Deloitte's M&A Institute. For more information around insurance M&A, download the latest report at www.deloitte.com/us/insurance-ma-outlook. We also release new podcasts regularly, and if you subscribe, you won't miss a single one. To stay connected and receive more information on Deloitte's M&A service offerings, visit www.deloitte.com/us/MAsubscribe, and follow us on Twitter @DeloitteMnA. Until next time.