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Editorial

**Special Issue on Mergers  
and Acquisitions**

by Etti Baranoff<sup>1</sup>

Since the start of 2014 some 23 major (re)insurance transactions have been announced and the 2015 deals completed have amounted to more than USD 22bn. A series of macro-factors appear to be driving this phenomenon. The proliferation of alternative capital, global regulatory dynamics and market forces are just some of the issues weighing on margins and increasing the attractions of scale. In light of this multi-decadal high, The Geneva Association devoted its 2015 Symposium on Insurance Strategies to, 'Consolidation in Insurance: What is it about?'. The symposium was held at Aviva in London on 6 November 2015.

The first article is by Mark Wilson, CEO of the host company Aviva. He emphasises the importance of strategic and financial reasoning for any M&A activity. To ensure success, he said '...a deal must be aligned to strategy. But the acid test of a strategy is whether it creates financial benefits. That must be the bottom line. As I said before, strategy is only a way to a financial outcome and that is measured in years.'

The subsequent two articles are by executives responsible for the 'nuts and bolts' of M&A activities. Greg Taylor and Hugh Underwood of Manulife provide a 'practitioner's account' of acquisition integration from an inside vantage point at one of the world's largest life insurers. Greg and Hugh share the stories of two of Manulife's 'most transformative deals in the last decade, the acquisitions of John Hancock Financial in 2004 and of the Canadian operations of Standard Life plc in 2015.' One important aspect noted by Greg and Hugh is 'Solve the social issues for the top ten officers of the acquired company first. Who stays? Who goes? And, when? While it was agreed that this was one of the most challenging aspects of the integration effort, it was an absolutely critical step in order for us to begin to achieve the benefits we needed out of the deal.'

His article is followed by that of Adam Hodes of MetLife who discussed the importance of experience, leverage and correct cost estimates with built-in buffers. 'Having a template of a range of costs based on prior deals is often a useful tool to ensure all areas are addressed.'

The last three articles are 'Views from the Outside.' Beginning with that of Brian Shea, we learn about the past, current and future drivers to M&A in insurance. Going forward, value chain disruption could also produce new M&A drivers. Brian also analyses whether M&A activities create or

<sup>1</sup> Research Director, Insurance and Finance, The Geneva Association.

destroy value. His conclusion is that ‘the traditional view that M&A destroys value is not supported by longer-term share performance.’

Pia Tischhauser’s article comes next, providing, first, a confluence of forces that drives consolidation and second, key elements to creating value by M&A. ‘Fully 49 per cent of the time, acquisitions that appear to be financially attractive transactions do not deliver value because of poor post-merger integration.’ She provides examples and road maps for success in creating value.

Closing this special M&A issue is the article by Paul Klumpes, adding more of his views to his already abundant academic work in the M&A area. His article highlights ‘important trends in value creation emanating from M&A activity for insurance acquirers’. Paul suggests that ‘further research is needed to explore these issues using incremental innovations in both the measurement of efficiency, methodologies for valuing long-run stock returns and better controls for various corporate, environmental and technological influences on post-merger value creation.’

In conclusion, the series of articles provided here is built to find ways to create value through M&A activities in the insurance industry. Strategy, financial reasoning, correct cost estimates, experience and well-designed integration plans are key to success. This special issue is the first to provide actual case studies written by the ‘troopers’ leading the M&A process from the beginning to complete integration and post-mortem evaluation. Overall, the question of value creation is still open for further investigation.

## Facts Versus Sentiment: Deals in the Insurance Sector

by Mark Wilson<sup>2</sup>

Over my more than a quarter of a century in the insurance sector, I have bought dozens of companies and sold dozens of companies. One lesson I have learned is this: the deals that work are the deals that make strategic and financial sense. Strategy is only a method or way to a financial outcome. Deals must be underpinned by financials or they will and do fail. Take Aviva in 2011—weak on strategy, a weaker balance sheet than our peers and with a predilection for flag planting.

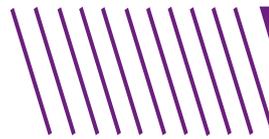
In the last three years we’ve sold businesses where it was right to do so. That might be because they didn’t fit with our strategy or because they were a drain on capital or because they just didn’t work under Solvency II. Back then, we were in 30 markets. Now we’re in 16. We have focused, simplified and strengthened. We think we’ve got it about right. The Group now makes a lot more sense, and certainly the acquisition of Friends Life made compelling financial and strategic sense. Financially, for us, it added cash flow, reduced leverage and created significant expense savings and was earnings accretive. Strategically, the acquisition is also the catalyst for the next stage of Aviva’s transformation strategy. We are using targeted M&As as a necessary tool to restructure and transform the business. We’re not looking at doing anything else big. But we might be interested in them—but only if they add strategic and financial value.

### What drives the deal?

In my experience, four factors drive deals in the insurance sector—or a combination of the four. These are:

- strategic
- financial
- necessity
- hubris.

<sup>2</sup> Group Chief Executive Officer, Aviva.



The first two are the right impulses. Unfortunately, the second two are more prevalent. I also believe that deals in insurance follow inevitable trends—and are driven by economic conditions and regulatory change.

**Macro trends: M&A through economic cycles**

Figure 1

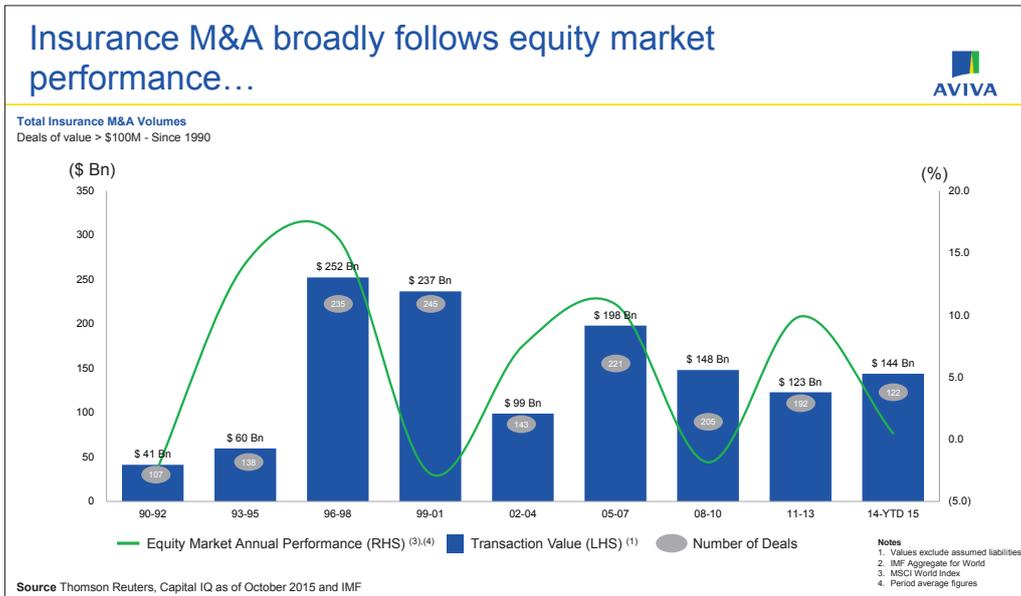


Figure 1 shows that insurance M&A follows equity markets. The volatility of equity market performance shows the impacts of both the dotcom crash in the early 2000s and the more recent financial crisis. M&A activity in insurance has been active, with over USD 1.2tn in deal-value changing hands—and has broadly followed the performance of equity markets through this period. And in 2015 we saw USD 85bn in activity—completed and pending—heating up to levels not seen since the late 90’s, with the most notable deal ACE/Chubb for USD 28bn.

**Macro trends: domestic versus cross border M&A trends**

Figure 2

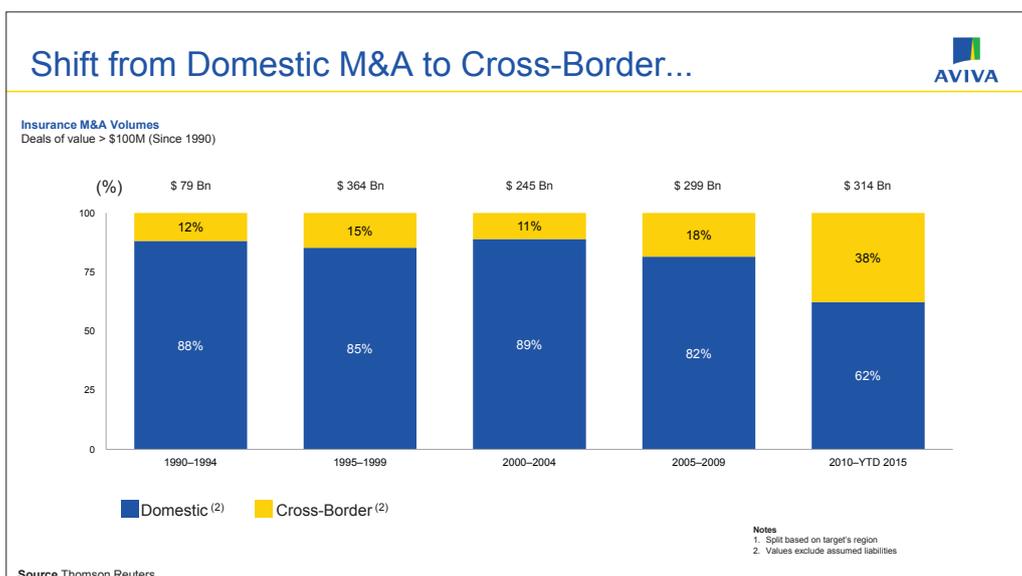


Figure 2 shows a distinctive trend towards cross-border rather than domestic M&A. From 1990 into the early 2000s, over 85 per cent of M&A activity was focused in domestic markets. Insurers searched for scale and synergies in local markets to derive a competitive advantage. In the past 10 years, the trend is towards cross-border acquisitions. Insurers are focusing on new growth markets. In 2015—not shown in Figure 2—79 per cent of activity is cross-border!

### P/E multiples—trends on cross-border M&A

Figure 3

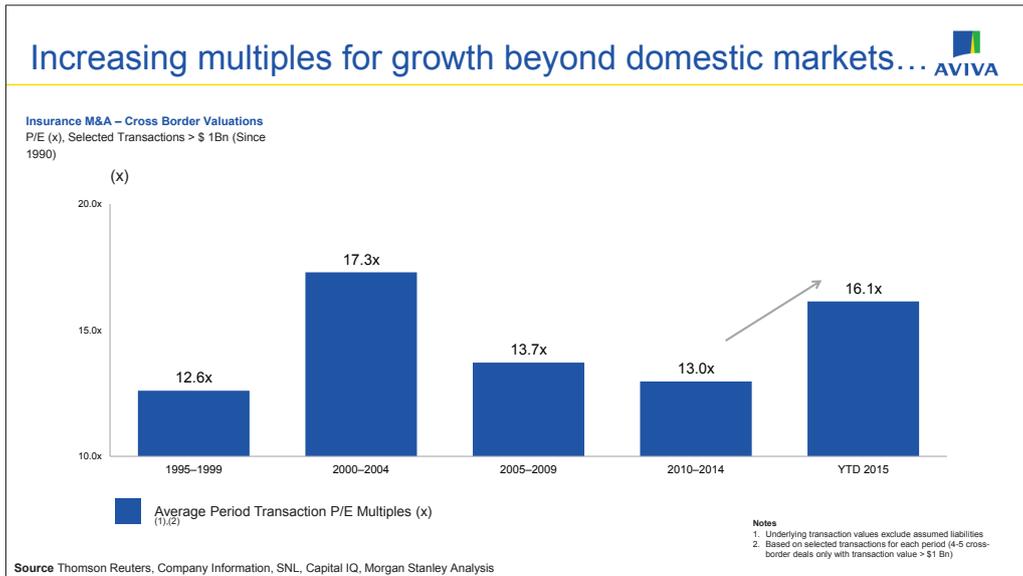


Figure 3 shows the average price-to-earnings multiples paid on a sample of large cross-border deals. As you might expect, multiples through this period reflect the economic cycle and correlate to equity market performance. Despite a reduction in multiples through the financial crisis, cross-border M&A activity is on the increase. We can see this in increasing multiples as insurers seek new growth markets. The big question is this: Is this level of multiples sustainable? Will these deals realise value at these multiples?

### Macro trends—geographic trends on M&A

Figure 4

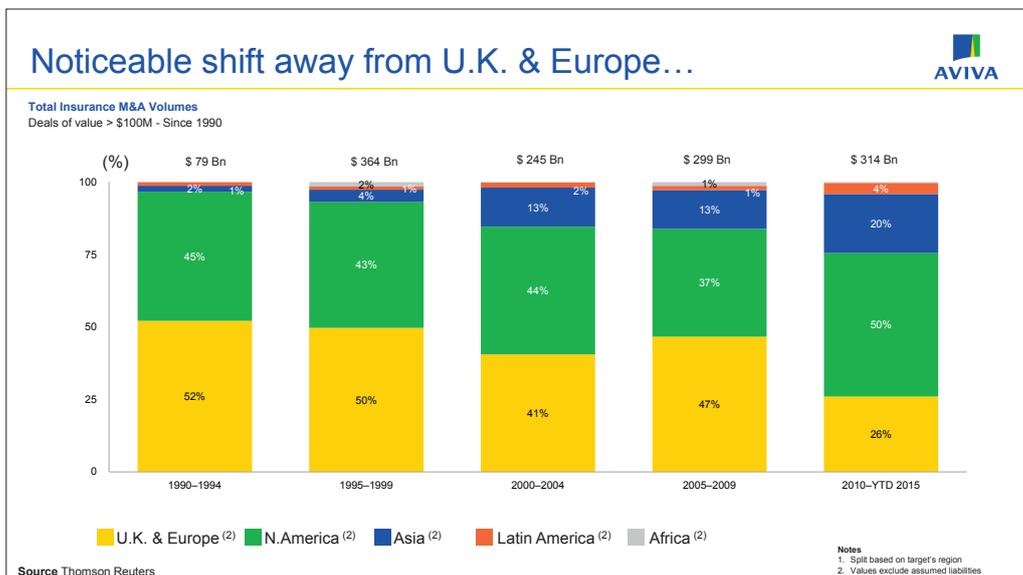




Figure 4 shows the noticeable shift away from the U.K. and Europe towards Asia, North America and Latin America. Through the 1990s, activity was dominated by the U.K. and Europe and North America. Since the 2000s, we can see a noticeable slowdown in activity in U.K. and Europe. In the past 5 years, we have seen a 50 per cent reduction in U.K. and Europe M&A activity since the 1990s—perhaps driven by the economic environment in the EU and uncertainties such as Solvency II.

The trend has been towards Asia, with continued activity in North America. In 2015, 72 per cent of closed or pending activity was focused on North America—perhaps reflecting the pickup in the U.S. economy. In addition, apart from the Ace/Chubb deal, over USD 15bn in pending deals involve Japanese insurers acquiring interests in the U.S.

### Value creation—facts versus sentiment

Figure 5

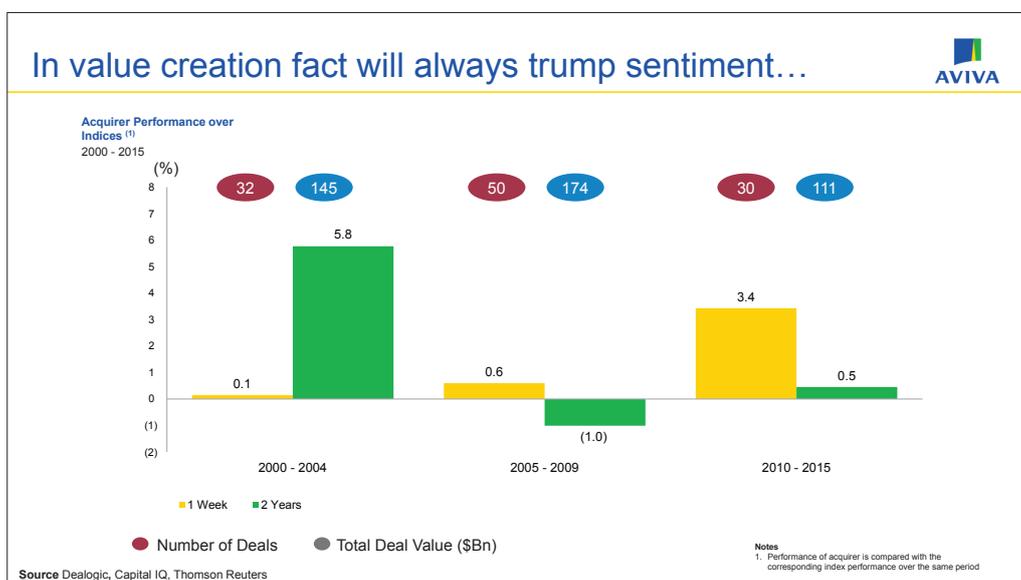


Figure 5 shows how the acquirer’s stock price performs in the week it announces the deal, versus two years after announcement and once the deal has been completed.

Interestingly, in the early 2000s there is not much sentiment on perceived value on Week 1, whereas after Year 2, there’s significant outperformance against the market. Contrast that with the past 5 years. Incredibly, Week 1 sentiment on the value of deals has driven significant outperformance against the market. Two years on, the facts prevailed, and perceived value did not materialise as expected. So when it comes to M&A, in the end, facts always trump sentiment. The question is: why is this? I suspect it has to do with the multiples paid.

### What makes for successful M&A?

To summarise these trends:

- M&A activity in the insurance industry broadly follows equity market performance.
- There is a definite shift in cross-border activity away from Europe to new growth markets.
- This seems to be driving an increase in acquisition P/E multiples—especially recently.
- Market sentiment is placing increasing expectation at Day 1 on value creation, but this is often not realised. In the end, facts will always trump sentiment.

But there are also some simple yardsticks for whether a deal works—or doesn’t. These are personal rules, but I think they are based on the facts.

**Customers.** If doing the deal means a business takes its eye off meeting the needs of customers, then that business is in trouble. We've seen that particularly in the telecoms sector.

**Shareholders.** They've got to agree to the deal. And sometimes it might be a wonderful surprise for them—like the Friends Life acquisition. But a successful shareholder vote is not in fact itself a test of a successful deal. That comes later.

**Strategy.** A deal must be aligned to strategy. But the acid test of a strategy is whether it creates financial benefits. That must be the bottom line. As I said before, strategy is only a way to a financial outcome—and that is measured in years.

**Success is in the execution.** To misquote Winston Churchill, only slightly, completing the transaction isn't the end, it's only the end of the beginning. And—to shamelessly mix my metaphors—Day 1 only takes you to the foothills of Mount Everest. The real climb is just about to start. Our industry is littered with broken deals and ill-fated attempts to execute. Hopefully with our recent deal we have learned the lessons—and so far we are executing ahead of schedule.

**Never get emotionally involved.** Always be prepared to walk away. That's a key lesson I learned from the legendary Claude Bébéar—a man blessed with quite extraordinary, legendary deal savvy. It's how he built Axa. I've taken that to heart and made it the cornerstone of my own deal philosophy. And in the Friends Life deal we were ready to walk away at any time if we didn't get the right terms.

## Conclusion

One of Aviva's oldest companies is the Amicable, which we bought in the 1850s. Its emblem was the serpent and the dove. Scholars think this is a reference to one of the gospels in the Bible, in which the disciples are told to be 'wise as serpents and innocent as doves'. For 'wise', I read 'shrewd' and for 'innocent', I read 'open', 'transparent' and 'honest'—in other words, doing what you said you would do.

Those are pretty good values for any business—and they are qualities you will need in abundance in any deal.

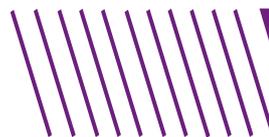
## Perspectives on Consolidation in Insurance: 'The Inside View'

by Greg Taylor with Hugh Underwood<sup>3</sup>

The insurance industry has recently been undergoing unprecedented consolidation. Capital availability, the pressures of mounting competition and the desire to attain greater scale, among other factors, resulted in more merger and acquisition activity in the global insurance industry in 2015 than in any previous year. Much has already been written and talked about the macro drivers of these trends and so, instead, this paper will offer perspectives with a different focus—we'd like to share a 'practitioner's account' of acquisition integration from a vantage point inside one of the world's largest life insurers.

Manulife and our wholly-owned subsidiary John Hancock together form the eighth largest life insurance group in the world. Today, our business is split almost evenly between Canada, the U.S. and 12 territories in Asia. We have built a presence in many of the world's largest economies, and we are rapidly expanding in most of the world's fastest growing markets, especially in Asia. While Manulife is often thought of as a life insurer, it is important to note that more than 40 per cent of our global business is in institutional asset management and the group

<sup>3</sup> Greg Taylor is Executive Vice President, Corporate Development & Strategy, Manulife Financial Corporation. Hugh Underwood is a Director in Manulife's Corporate Strategy Group.



and individual wealth management businesses of pensions, retirement savings and investment funds. In order to successfully achieve our global scale, we have deployed a strategy that includes focused, disciplined acquisitions. As a result, in the last 20 years we have made more than 40 successful acquisitions around the world.

To provide the 'inside view' on integration from Manulife's perspective, we will share the stories of two of our most transformative deals in the last decade, the acquisitions of John Hancock Financial in 2004 and of the Canadian operations of Standard Life plc in 2015. We'll also describe some of the key challenges we faced during the integration of these particular acquisitions as well as some of the general lessons that we have learned from executing many integrations over the years.

### **Case Study 1: acquisition of John Hancock Financial Services Inc.**

In 2004, Manulife acquired Boston-based John Hancock for almost USD 11bn. The deal was truly transformational for Manulife, adding millions of new customers, new products and distribution breadth, increased operating scale and a greatly improved competitive footing. In the U.S. market, the combined Manulife–John Hancock immediately became a top-five competitor in almost all of its lines of business. In Canada, the acquisition of John Hancock's Canadian operations, Maritime Life, made Manulife the number one or two player in almost all lines of our Canadian business.

Not surprisingly, the transaction also resulted in a very large-scale integration effort across the six newly expanded businesses in Canada and the U.S. We were faced with integrating millions of individual and group customers, a large corporate office in Boston, more than 7,000 new employees in facilities across North America (joining our almost 13,000 employees at that time) and 65,000 independent agents and advisors. Making matters more challenging, there was immediate and significant operational overlap, since John Hancock had operations in Canada and Manulife had existing businesses in the U.S. Significant benefits were expected from the deal, including projected pre-tax run-rate cost savings of CAD 350m targeted by the second year post-acquisition. A decade ago, this represented a very meaningful amount for Manulife, around 10 per cent of combined operating expenses at the time. The sources of these savings and efficiency benefits primarily resulted from eliminating duplication in operating management roles, IT platforms, distribution organisations and corporate management functions.

The John Hancock acquisition was an important moment in Manulife's history. It accelerated our growth strategy for high-priority global businesses, especially in North America; it diversified our business by strengthening existing capabilities and adding new ones; and it enabled us to acquire one of the most powerful brands in financial services in the U.S.

### **Case Study 2: acquisition of Standard Life in Canada**

In January 2015, Manulife acquired Standard Life plc's Canadian business for CAD 4bn. Though much smaller than the John Hancock transaction, this too was an important acquisition for Manulife. The acquisition enabled us to improve operating leverage through greater scale for several of our key Canadian businesses, particularly in pensions, wealth and asset management. We have also been able to build upon an already established and successful wealth and asset management partnership with Standard Life Investments. The acquisition provided us with nearly 1.5 million new customers for the very broad product shelf that Manulife Canada offers.

Similar to our experience with John Hancock in 2004 and 2005, Standard Life Canada's acquired lines of business had significant overlap with Manulife's, resulting in a complex integration, but one which enables us to target significant cost savings and efficiencies. We are currently into the 11<sup>th</sup> month of the integration and we are pleased with our progress.

### **Common challenges and keys to successful acquisition integration**

To get the real 'inside view', we sat down with those at Manulife who have been most instrumental in leading the John Hancock and Standard Life Canada integrations. Together, we discussed the key challenges and lessons

learned from these integrations and others that we have executed in years past.

Not surprisingly, everyone agreed that the top challenges that we faced during these integrations related to people and culture. John Hancock and Manulife had many cultural similarities prior to 2003 when acquisition discussions began. Both companies had long histories (Manulife was founded in 1887, John Hancock in 1862), had recently demutualised, then gone public in high-profile IPOs (Manulife in 1999, John Hancock in 2000 in the eighth largest IPO in U.S. history at the time) and had people and operations in similar geographies. Both companies even had CEOs named D'Alessandro at the time. In many ways, the transaction looked like more of a merger of equals than an acquisition by Manulife.

The cultural similarities undoubtedly made the integration process much smoother than it could otherwise have been, but they also left us with a challenging situation: a large portion of expected operating expense savings, an important aspect of the deal, was targeted to come from the elimination of duplication of roles in the corporate and operational management ranks. This is always a sensitive matter, but its importance to the success of the acquisition cannot be overemphasised. We had to be thoughtful about our approach and expedient in our execution. Predictably, where the overlap in roles was the largest, at the senior-most corporate officer level, the rationalisation was greatest and swiftest.

We spoke with our integration leaders to better understand the nuances of this, and they described it in the following way, offering some very to-the-point directives: 'Identify those new leaders, managers and employees who are critical to the success of the integration and the go-forward combined organisation, then welcome them and engage them.' 'However, don't fall in love with your public story and with the pictures of the CEOs shaking hands. Remember the primary objectives of the job you need to do to deliver the benefits.' 'Solve the social issues for the top 10 officers of the acquired company first. Who stays? Who goes? And, when?' While it was agreed that this was one of the most challenging aspects of the integration effort, it was an absolutely critical step in order for us to begin to achieve the benefits we needed out of the deal.

From a people and culture perspective, it's also important to consider the impact that undergoing a major integration has on your employees and operations. Many key employees will almost certainly end up taking on significantly more than their typical responsibilities as the organisation realigns in order to meet the acquisition objectives. Certain employees may become overburdened, which can have significant impact on their morale and productivity. Major integrations will always generate additional work, but the integration team leaders must plan and manage the inevitable time constraints and talent and resource strains appropriately. The success of the integration cannot be won at the expense of compromising the quality of current operations, employee engagement and commitment, and the customer experience.

Other significant challenges that we faced during these acquisition integrations typically fell into three areas. The first, information technology, is always a top challenge and source of risk, especially with acquisitions as large as John Hancock and Standard Life Canada. There was significant overlap between Manulife's systems and those of John Hancock and Standard Life Canada. They have been very costly and complex challenges and have required diligent engineering and management to resolve. Volumes have been written on this and so we will not dwell on the obvious. The second, premises and facilities, is slightly more straightforward. It is important to understand and plan for the integration's impacts on locations and non-IT infrastructure of the financial services organisation, including demands imposed by regulatory requirements, as well as by staffing needs and talent retention plans.

The last challenge area we will comment upon, size and scope, is somewhat broader than the others. We certainly encountered the relative size challenge in both the John Hancock and Standard Life Canada transactions, which caused the impact of the integration efforts to be pervasive throughout the organisation, as opposed to the localised impact of a smaller 'bolt-on' acquisition. One key dimension of scope is the breadth of product lines and businesses acquired. We had to integrate multiple business lines with significant operational overlap and duplication throughout. This required swift and decisive assessments of differing skill sets and talent bases, customer segments, breadth and productivity of distribution channels, differential usage of offshoring and outsourcing, and countless other operational considerations.



A second dimension of scope refers to managing geographic challenges, something that (luckily!) did not impact us as much for the John Hancock and Standard Life Canada integrations. We were dealing principally with Canada and the U.S. (plus some modest Asia business considerations) compared to, say, MetLife's 2010 acquisition of Alico, which had operations in more than 50 countries at the time of acquisition.

The following is always a good question to pose when you have a learned group held hostage: we asked the Manulife integration team leaders what they thought they could have done better with the benefit of hindsight. Interestingly, they all had a similarly themed answer: during the John Hancock acquisition and integration, we were perhaps too internally focused and, for future integrations, it was felt that we needed to do a better job of maintaining more of an external focus, in particular by paying closer attention to the factors influencing the retention of both advisors and customers. In other words, 'The Voice of the Customer' must be an even more important component of our early stage integration planning and its subsequent execution. The consensus among the group was that we have done a more thoughtful job with this aspect in the integration of the Standard Life Canada acquisition. The proof is before our eyes in terms of the customer retention numbers and the readily observable uptake by former Standard Life customers of our Manulife Canada products and solutions.

There is no single silver bullet to ensure integration success, but we did ask our integration leaders for their points of view on what has enabled us to integrate successfully at Manulife. Together, we were able to narrow it down to four common elements, regardless of the integration's size or complexity, that are most critical to success.

**Advance planning.** It is impossible to have too much forethought when planning for an acquisition and its integration. Before the acquisition is even made, the impacts of the integration should be thoroughly understood. The integration team should be formed early to ensure that the integration has as minimal an impact as possible on the organisation's current operations, employees, advisors and customers.

**Alignment with strategy and culture.** All decisions made by the integration team should align to the organisation's strategy. It is this dedication to following a clear strategy that will force action on the tough decisions that inevitably arise during all integrations. As discussed above, these tough decisions often relate to people and culture.

**Excellence in execution by people who are dedicated and experienced.** Successfully completing a major integration is no easy task. It requires dedication and hard work by individuals who understand from experience how best to act and not to act. For this reason, it is important that the integration team be selected from the company's best and brightest leaders and employees.

**Clear, consistent and frequent communication.** In these situations it is impossible to over-communicate, and the importance of good communication cannot be overly emphasised. All stakeholders, whether internal (e.g., employees of all levels and functions, agents and advisors) or external (e.g., shareholders and bondholders, governments and regulators, local communities, analysts and media), must be accounted for in a thorough, well thought-out communication strategy with clear and consistent (and necessarily repeated) messaging.

Ensuring that these four elements are part of the integration approach will not guarantee success, but based upon our experience at Manulife, we believe that they will significantly improve your odds.

## Perspectives on Consolidation in Insurance: 'More on the Inside View'

by Adam Hodes<sup>4</sup>

Global acquisitions have been a critical component for growth of multinational insurance companies. The structure of transactions can take many forms, but a key objective is to ultimately leverage capabilities and expertise to maximise the value of the acquired entity. The success of most transactions depends on some level of consolidation of operations. As a result, success depends on having a good view on the cost and timing of operational integration. From an M&A execution perspective, a solid estimate is critical for both a preliminary bid and a final bid. By the nature of the M&A process, the limitations on information and the circle of people involved create challenges to developing a good integration cost estimate. It is critical for the Corporate Development team to have the best information available, as the integration cost estimate could be the difference between advancing in the process or being excluded. While no two acquisition processes are alike, there are some things to be aware of. The mere recognition of information gaps can itself improve the valuation process.

### Developing integration cost estimates

From the perspective of transaction execution, it is critical to estimate the amount of integration expenses as well as the timing. Having a good estimate at 'Day 1' following the closing is not helpful, as the overall transaction valuation needs to be determined and agreed upon much earlier. The initial bid sets the stage for the flow of future negotiations. There are several unique issues which affect the ability to develop a solid estimate. In a perfect world with unlimited access to information and people and time, developing a fully scoped-out and costed integration plan would be straightforward. However, in a competitive sale process, none of these ideal conditions exist.

First, information during the diligence stage, while broad, does not generally include the level of detail sufficient to fully develop an integration plan. Second, given the desire for confidentiality by both buyer and seller, the number of people involved is limited and so the individual that will be responsible for integration may not be fully involved. Finally, a project management leader, who is often not a subject matter expert, may be reluctant to commit without the input of his or her larger team. However, certain best practices can be developed to limit the gap and improve the quality of even early stage estimates.

The first element is the imperative need to understand the integration strategy and objectives. By understanding the integration strategy, it is easier to evaluate the scope of the initial integration plan—i.e. full operational integration or only selected functions. It is then important to work with the functional partners to develop the discrete buckets and an estimated cost.

The second key element to ensure more effective integration is ownership and accountability. It is important to have the right people involved—not just the titular leaders of an affected area. This leads to much better engagement with business partners. It is then important to work with the owners so they understand the need for increasing specificity over time, but that initial high-level estimates are necessary.

The third element is to draw upon prior experiences. The estimated cost can be rooted in specific information provided, prior integration experiences or industry benchmarks. Having a template of a range of costs based on prior deals is often a useful tool to ensure all areas are addressed. By having a template of integration items and an associated cost, a more productive conversation can result. If a representative from a certain functional area is not involved, a preliminary cost can still be incorporated versus omitting the item or deferring it to a later stage.

<sup>4</sup> Executive Vice President and Global Head of Mergers & Acquisitions, MetLife, Inc.



## Multi-jurisdictional transactions

A conventional wisdom for M&A transactions is that scale is better. However, in certain situations mere scale may not create synergies in the same proportion. This is often the case for regulated entities.

The requirements for distinct regulatory approvals and limitations on intercompany services need to be considered. Relating to the approval process, there is a high likelihood that not all regulators will approve their parts of the deal on the same timetable. Structuring for this potential can be quite complicated, as the buyer and seller's objectives are in obvious conflict. Further, it is not always assured that the new company can operate to fully leverage enterprise capabilities.

It is important to work with both local business teams as well as advisors to develop a full view of the viability of a fully integrated model and the time frame to achieve.

## Thinking about unanticipated changes

Insurance or other transactions that require regulatory approvals, not just for the initial change of control, but also for intercompany agreements, new products or employee changes, tend to take longer to get to the desired integration state.

Often the focus is how the current state of the target can be integrated with the current state of the acquirer. The issue is that such states change over time. For example, if the acquirer is considering a future change in a basic technology such as email, then factoring in the cost for the target to get to the current state would be insufficient. Further, with the passage of time, external parties may require changes that affect the entire enterprise.

Therefore, it is important to have a good view of the overall approval and integration process under consideration if an additional buffer for currently unknown changes should be added.

## Transitional services agreements

A cousin of the integration plan is transitional services arrangements (TSAs). The timing for integration will determine if certain services need to be provided by the seller. This tends to be an area of complicated discussions, as the scope of services, cost and timing all need to be negotiated, generally on a service-by-service basis. By having a clearer picture of the ability to internalise or transition to the acquirer's functions, the TSA negotiations can be more or less critical.

TSAs by their nature have embedded optionality whereby the buyer is seeking access for lower cost and for more time, and the seller is seeking to avoid being a low-cost outsourcer. As with the integration plan generally, TSA discussions can benefit from an historical review of experiences. If the acquirer's integration plans tend to be well estimated, the time frame for a TSA can be narrowed. If not, then the time frame will need to be more open-ended.

## Post-mortem review

Given that integration costs and plans initially are formulated with limited information, it is not uncommon that the initial estimates for both time and costs may be proving incorrect. Active acquirers can improve the process of consolidation and integration by incorporating a systematic post-transaction review process. Actual costs should be tracked and compared to the initial estimates. Misestimates can result from several factors: incomplete information, deficiencies in the diligence process, unanticipated events.

It can be difficult to get to the root of the problem and the sponsoring business may be reticent about being evaluated. However, it can be very beneficial to identify the source so the process or approach can be corrected or an additional element can be evaluated the next time around. In many cases, the mere identification of an issue will result in a different level of focus by the team during the next diligence process. It is easier to conduct a post-mortem assessment if it is clear to the business partners that such a process is done in all cases and a particular deal is not being singled out.

## Summary

Integration expenses are often under-analysed in the context of a significant acquisition but can be the difference between meeting and not meeting a targeted return. Successful companies address these issues early on in an acquisition process and focus on identifying key areas of risk and timing. To be successful, all deal team members need to understand the importance of getting integration costs right with limited information. Finally, the M&A leaders and deal sponsors will often need to incorporate a buffer to ensure there are no major surprises as more information is made available.

## What is the Logic Behind Consolidation? And Does it Create Value? A View from the Outside

by Brian Shea<sup>5</sup>

Looking at deal volume in the global insurance sector, 2015 was off the charts. In this article we address two issues:

- The drivers of this consolidation—past, present and future.
- Does this activity create value?

### Drivers—past, present and future

#### *Historic drivers*

First, we briefly go over the generic reasons why M&A has historically happened in the insurance sector. Much of this is applicable to other sectors also. You have complementary expansion, e.g. in terms of product or geography. Scale has always been important too. There's also what we call value chain adjacency. For example, banks in the 1990s and 2000s bought insurance activities because they saw themselves as distributors, sitting next to the insurance product in the value chain. Outside money—private equity and run-off specialists—has also been active in the sector for years. Finally, apart from all the rational reasons for M&A, no doubt management hubris has been a driver of some deals.

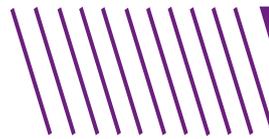
#### *Today's drivers*

Moving on to look at what's driving today's M&As and why there is so much activity, some of the historic drivers are particularly relevant. There is greater impetus for scale today.

In Europe, Solvency II raises fixed costs and also gives explicit capital credit for diversification. The tiering of the reinsurance sector also means that reinsurers need to have a wide product and geography footprint and the ability to offer greater line sizes. Low interest rates also drive a greater need for cost efficiency, particularly in the life segment.

We all know that the boundary between traditional insurers and reinsurers on the one hand, and alternative capital providers on the other, is blurring. There has been a lot of activity—largely organic—of insurers setting up insurance-linked securities (ILS) vehicles and of ILS managers setting up rated balance sheets. It's not always organic though. Willis advised Catco, the ILS fund manager, on its sale to Markel. We would not be surprised to see more M&A activity between traditional and alternative capital players.

<sup>5</sup> Head, Willis Capital Markets & Advisory Europe.



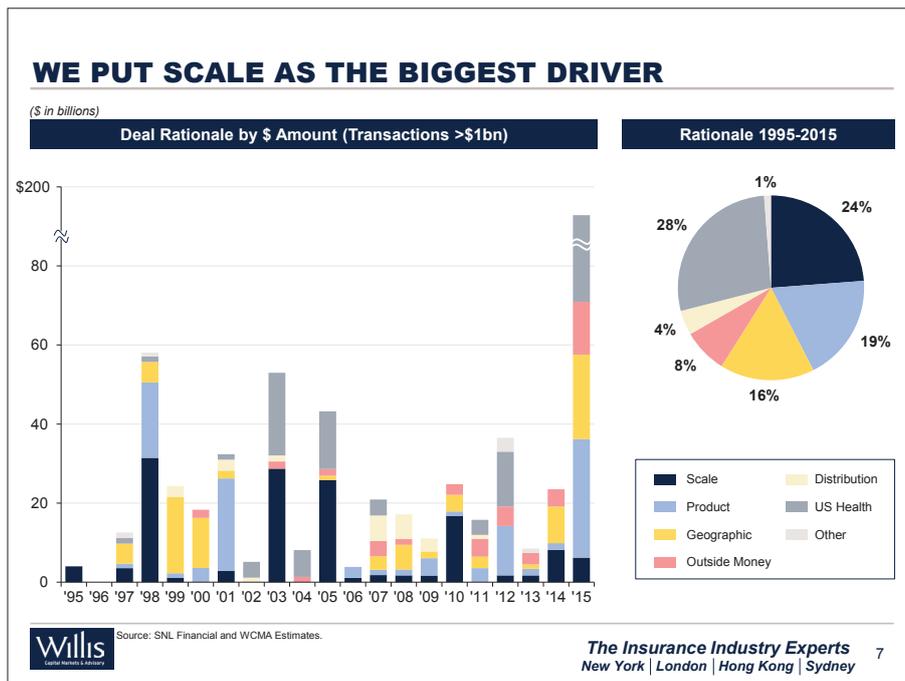
There are some specific cyclical drivers as well. Cyclically low prices tend to equate to more M&A. At the same time, the sector’s profitability is actually quite good at present. So, excess capital is accumulating, and M&A is a way to invest that. Finally, new money is a particularly relevant driver today. The historical interest of private equity (PE) and run-off buyers is being augmented by the likes of EXOR and Asian money. This type of buyer is motivated by its perceived low cost of financing, a desire for diversification and the investment ‘float’ that insurers provide.

### Categorising the deals to date

We have attempted to categorise the insurance sector’s M&A into the various drivers. We looked at all the USD 1bn+ deals in the insurance sector since 1995. There are about 150 of these, and they account for about 70 per cent of the sector’s total M&A activity. It’s a rough science, of course. How do you categorise ACE/Chubb for instance? We call it product. It’s a little bit of scale, distribution and geography too. But complementarity of products is pre-eminent in our view.

As Figure 1 below shows, excluding U.S. health, scale has been the most important driver in aggregate over the past 20 years. (And much of the U.S. health consolidation has been scale motivated too.) In our view, 2016 will again be a year of heightened M&A, driven in particular by the desire for scale and by new money.

Figure 1



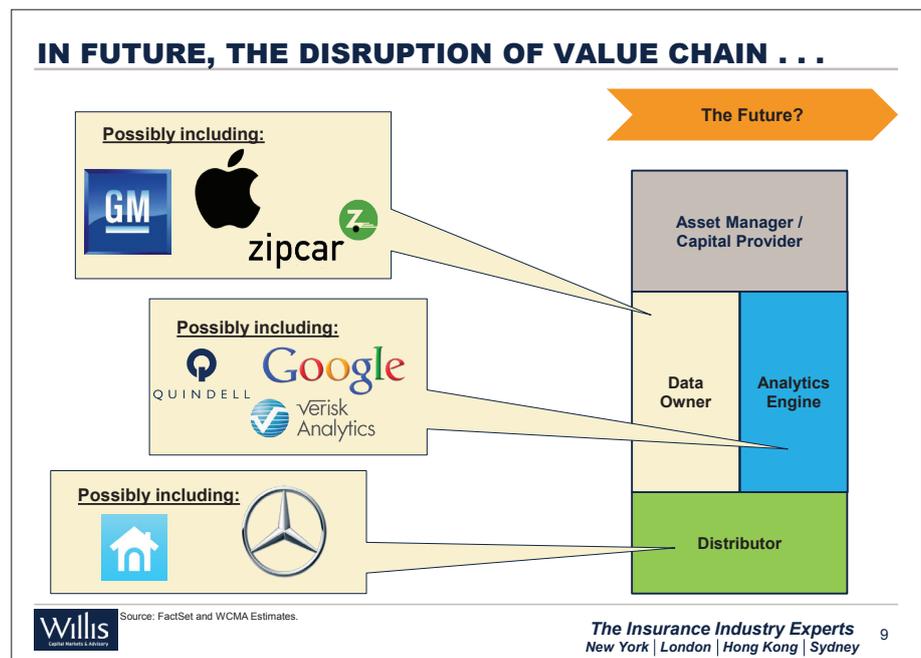
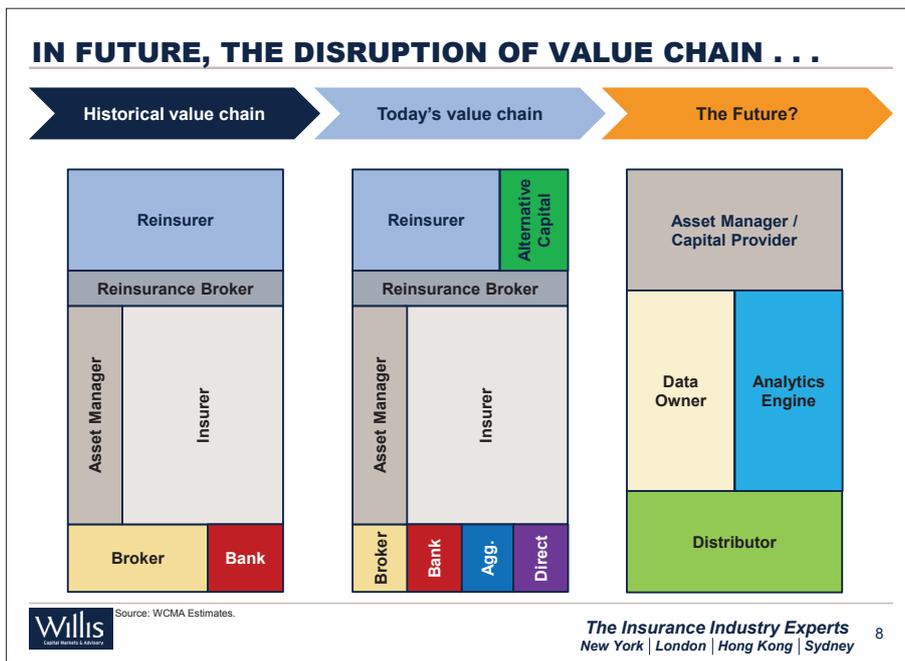
### Drivers in future

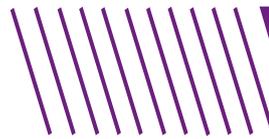
Figures 2 and 3 below illustrate the insurance sector’s value chain—past, present and what the future might look like. There has been some disruption to the value chain already. Aggregators and direct writers have taken share away from traditional distributors. And alternative capital has crowded out traditional reinsurance capital, particularly in the nat cat space. These disruptions have, as we argued above, already generated M&A activity. There have been some direct distribution-motivated transactions, such as Zurich buying 20<sup>th</sup> Century Insurance Company. And there’s the Catco/Markel transaction.

But the disruption of the value chain to date is nothing compared to what disruptive technology could bring. Going forward, you could have an entirely new way of slicing the value chain, and firms outside the traditional insurance sector could occupy much of the prime real estate. Take personal auto, for example. The ‘distributor’

could be the car manufacturer that has installed the black box telematics device. The data owner could again be a car manufacturer. Or, if it's a smartphone collecting the data, it could be a firm like Apple. And the analytics engine could be provided by Google, or you have specialists like Verisk. Also, much of the value chain going forward, rather than being about loss compensation, could be about risk mitigation. If you can install sensors in the home that detect and mitigate the loss from burst water pipes, that should reduce loss costs, but maybe some of that benefit will be shared and the consumer will be willing to pay for risk mitigation. Who knows, perhaps insurance agents in the future will make some of their money selling Nest thermostats. The point is, maybe today's insurers can occupy this prime real estate, but it will require some morphing.

Figures 2 and 3





To address this, insurers have already made a few technology-driven acquisitions, for example Generali’s acquisition of MyDrive. But the key word here is few. Over the past four years we count just under 40 transactions that had something to do with technology that could be applied in the insurance sector. Insurance buyers numbered less than five. Private equity has been a much more active buyer, as have other value-chain adjacent buyers such as TomTom and Verizon. Surely, we ask, with so much to play for and with the leverage that such an acquisition could provide to a large global insurer, shouldn’t insurers be more active buyers?

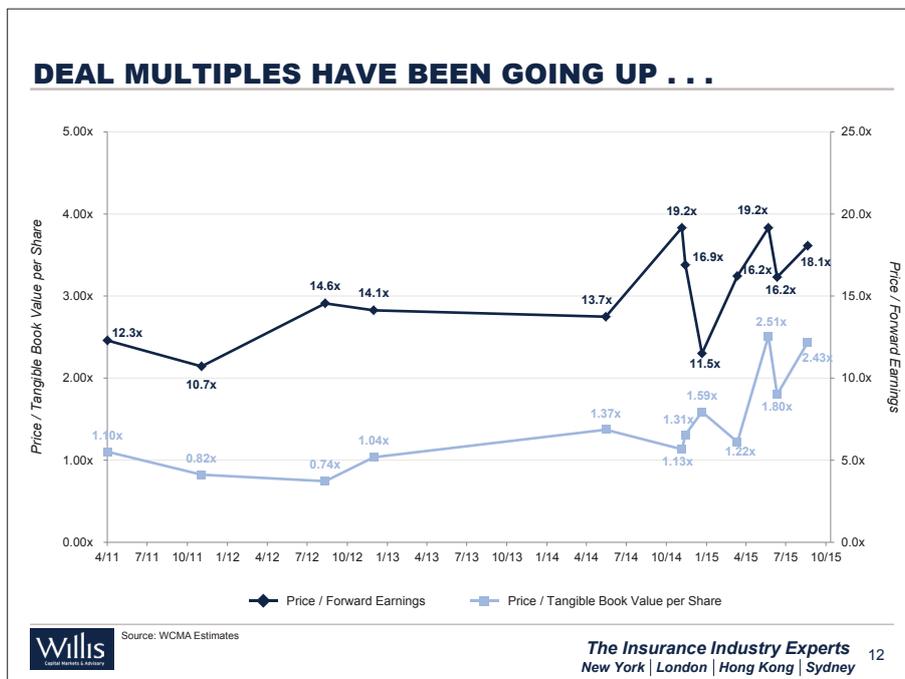
A final point on value chain disruption and future M&A: if disruptive technology works and claim costs fall, this could drive more traditional M&A. Shrinking premium income could encourage acquisitive growth. And shrinking capital requirements could produce ample funding ability.

**Does M&A create value?**

We’ll take a step back in a moment and try to answer this with a long-term perspective. But first, let’s look at recent deals. We’ve analysed 12 deals from the past four years where a public company has bought another public company—i.e. you have a good view of the financials. You’ve got all the big 2015 deals, for example, from XL/Catlin at the start of the year to MSI/Amlin which was announced in September. You can see from Figure 4 below that deal multiples have been going up, whether you look at price/tangible book value or forward earnings. Over 2011–2012, deals were being transacted at about 1x TBV (tangible book value). Now, with few exceptions we’re looking at 2x or higher. MSI/Amlin has caught a lot of attention with its 2.4x multiple.

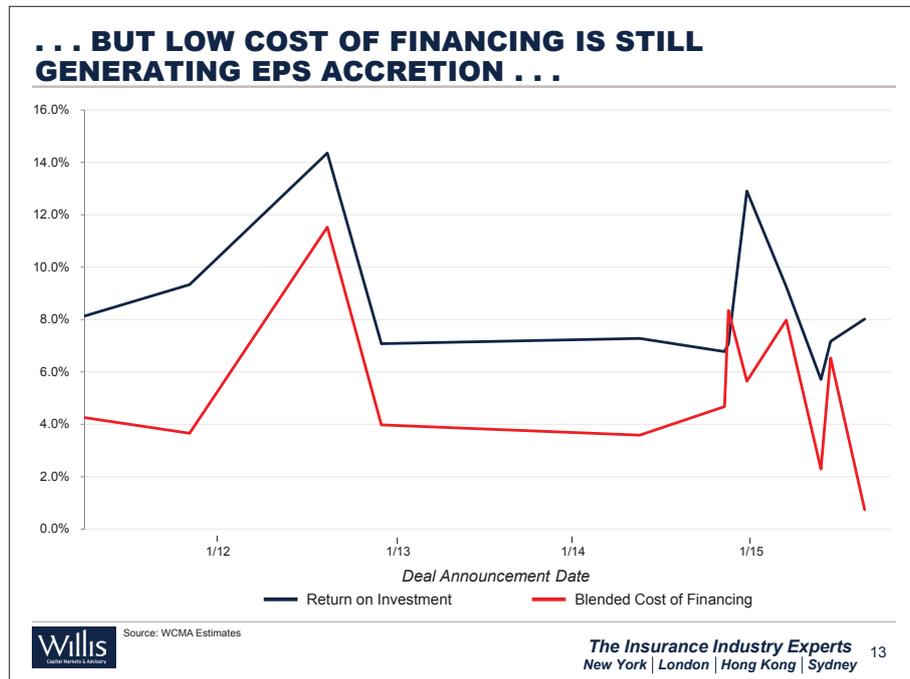
On its own, Figure 4 doesn’t precisely answer the question about value creation. Maybe a lot of value was being created with the 2011–2012 deals, and you’re still getting some value creation today. Or maybe better companies are being bought today. But certainly a priori it makes you think that value creation must be a lot harder today. And if you think about what’s going on in the current difficult operating environment, it’s a bit counter-intuitive to think that returns on equity (ROEs) and earnings quality are better today than in 2011–2012.

**Figure 4**



Now, in our opinion, the most important metric you should look at in considering whether an acquisition makes financial sense is the return on investment (or internal rate of return). You then need to independently consider your cost of financing. It’s the two together, though, that determine whether a deal is accretive to earnings per share (EPS). And a low return on investment (ROI) deal can still appear accretive to EPS if it’s financed inexpensively.

Figure 5



In Figure 5 we see that financing costs have come down: debt costs have come down; if using cash in hand, the yield on that foregone cash has come down; and the 'cost of equity' has come down as price-earnings ratios ( PEs) have gone up. This low cost of financing means that most deals have indeed been EPS-accretive.

But our point is that you shouldn't necessarily infer that value is being created. ROIs themselves are running at about 7–8 per cent. We suggest that this is roughly break-even based on hurdle rate costs of capital.

Immediate stock market reactions are not really a good indicator of whether M&A actually creates value in the long term. The typical stock market reaction with respect to the acquirer is often to shoot first and ask questions later. And immediate stock price moves may also reflect technical factors. If the deal is equity financed that means an increase in the supply of stock.

The problem is: how do you measure long-term success? To address this, we've looked at the longer-term share price performance of acquirers—going out three years from the announcement date of the acquisition. It's not particularly scientific—but is hopefully thought-provoking nonetheless. We looked at 25 deals done over the past 20 years in the global insurance sector where the deal size was at least USD 1bn and it represented at least 20 per cent of the acquirer's market cap. We then looked at how the acquiring company's shares performed relative to its local index—for example ACE relative to the S&P 500. We looked at this over the 30 days, 90 days and so on up to 3 years (or 1080 days) after a deal's announcement.

The results shown in Figure 6 indicate that, on average, insurers have performed in-line following large acquisitions. They don't support the consensus view that about two thirds of all M&A destroys value.<sup>6</sup> The bottom line is that maybe, over the long run, a higher proportion of deals actually do create value. It's all down to execution, of course.

<sup>6</sup> There are a lot of caveats to this work—chiefly that other factors may be driving the share price other than the acquisition. The deal could be as small as 20 per cent of the company. Or maybe it's the case that good companies are acquisitive—so they outperform for other reasons too.

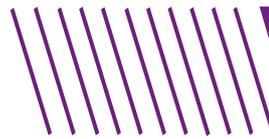
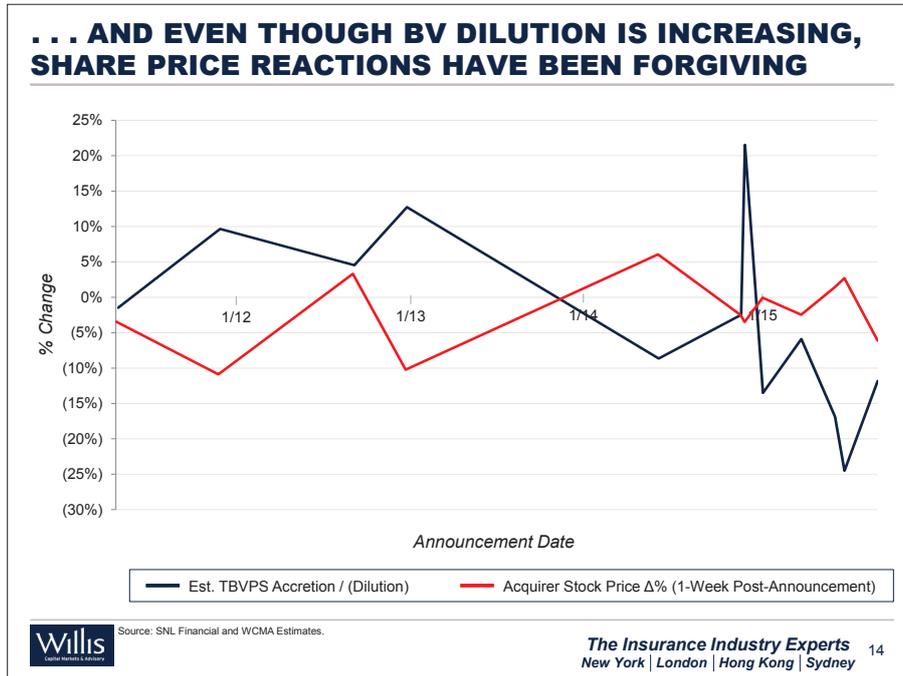


Figure 6



## Conclusions

We draw the following conclusions. Regarding the what and why questions:

- The current hump of M&A activity has not yet run its course. We will see more scale and new money deals, in particular.
- Disruption of the value chain will be a driver of future M&A—and as to whether or not M&A creates value.
- Deal multiples have been increasing, which raises the bar for value creation.
- The EPS impact of current M&A is being softened by cheap financing, but higher multiples are driving up book value dilution.
- Still, the short-term perception of value creation (i.e. immediate share price reactions) has become more forgiving.
- And the traditional view that M&A destroys value is not supported by longer-term share performance.

Finally:

- Investment bankers need to be industry experts. Now, more than ever, the ability to be a trusted advisor is essential.

# Influencing Outcomes in a Consolidating Insurance Industry: Three Keys to Value Creation

by Pia Tischhauser<sup>7</sup>

It's easy to see why the colourful term 'merger mania' has been applied to the global insurance industry. Axis-PartnerRe, Willis-Towers Watson-Gras Savoye, ACE-Chubb and Anthem-Cigna are just a few of the high-profile acquisitions announced around the world in 2015.

But behind the triumphant headlines, a stark reality lies. Within the global insurance sector, only 51 per cent of acquisitions created value; 49 per cent actually destroyed it.<sup>8</sup> How can insurance executives influence the probability of success in mega-mergers that are, statistically speaking, simply a coin toss? This article presents a strategic framework of best practices to address the full life cycle of insurance acquisitions—proactive target search, disciplined deal execution and effective post-merger integration (PMI)—to accelerate transactions and help maximise value creation.

First, a little background.

## A confluence of forces drives consolidation

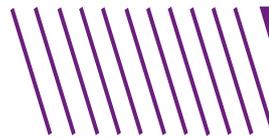
A multitude of macro-level forces impact the insurance industry and will continue to propel consolidation over the next five years. These forces include:

- *Regulatory requirements:* Capital requirements, such as those contained in the Solvency II Directive in the EU, continue to intensify, putting pressure on both independent insurers and conglomerates. Other requirements, such as IMD2, PRIIP and MiFID2<sup>9</sup> will likely decrease some consumers' willingness to pay current levels for financial advice.
- *Low interest rate environment:* Interest rates are likely to stay for some time—at least in mature markets—making profits in traditional life insurance difficult if not impossible.
- *New competitors:* Players as varied as supermarket chains (e.g. Tesco) and technology companies (telcos) are in a position to disrupt the insurance value chain using collected customer data and owning the 'last mile' to the customer.
- *New operating models:* Incumbents find it more difficult to play across the entire value chain, creating vulnerability to specialists disrupting existing models such as price-transparent aggregators. Midsized insurers that still handle all aspects of their business internally will face rapidly declining efficiencies.
- *Big data and predictive analytics:* Insurance companies are prime candidates to exploit analytic insights into customer behaviour and needs, but building the technology, culture and teams to do so is easily cost-prohibitive.
- *Limited organic growth opportunities:* Mature markets are consolidating and while risks increase, the insurance industry has not been successful to convince customers to buy insurance to cover risks beyond the most basic. Emerging markets present market share growth options, but profitability lies only in the future. Scale can be achieved most realistically through acquisition.

<sup>7</sup> Senior Partner and Managing Director, Global Leader - Insurance Practice, Boston Consulting Group.

<sup>8</sup> One-year relative total shareholder return (RTSR) of completed acquisitions (%). The Boston Consulting Group's analysis of insurance sector is based on 778 transactions involving insurance companies between 1990 and 2014 (Standard Industrial Classification Codes 6311, 6321, 6331, 6351, 6361, 6399, 6411). Analysis includes only transactions with deal value >USD 25m and share transfer >75%.

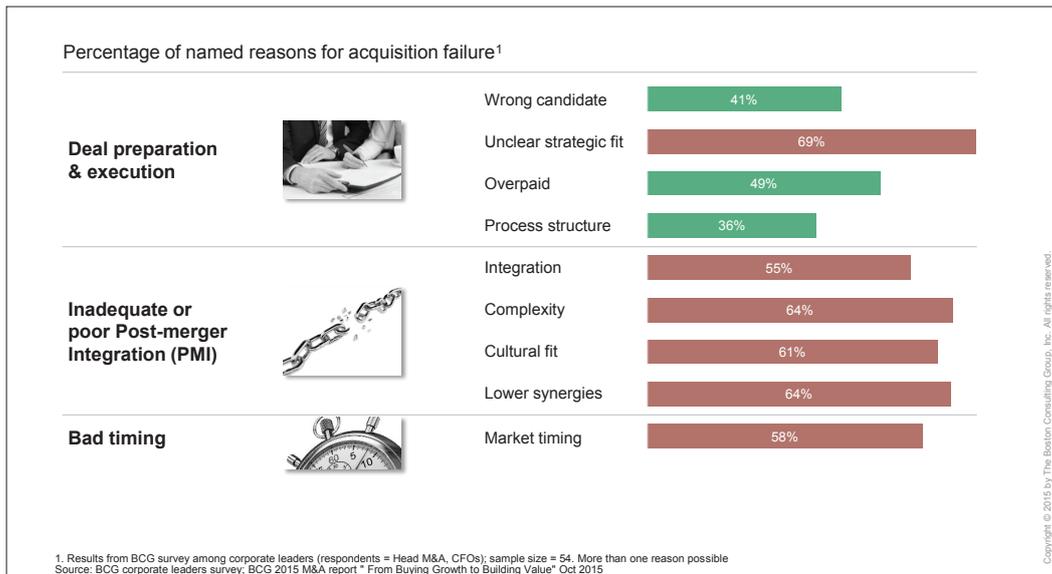
<sup>9</sup> IMD2 = Insurance Mediation Directive (new IDD—Insurance Distribution Directive), PRIIP = Packaged Retail Investment and Insurance-based Products; MiFID2 = Markets in Financial Instruments Directive.



### More than a mathematical transaction

Against this backdrop, failed recent merger attempts illustrate the fact that successful insurance mergers require more than mathematical transactions calculated in a vacuum. Furthermore, the 49 per cent of insurance mergers that are completed and still fail to deliver value fall prey to a wide range of culprits.<sup>10</sup>

**Figure 1: Key reasons why acquisitions fail to create value**



Source: Boston Consulting Group (2015).

### Three keys to creating M&A value

Insurance executives can significantly enhance their ability to drive value-creating mergers by adhering to the three-pronged strategy outlined below.

#### Key #1: Proactive target search

Many insurance acquisitions are made opportunistically, in a time-pressurised window, with an investment bank providing the target. Here, candidates are analysed largely on their financials, which are ultimately only one component of a successful acquisition.

Instead, acquirers should actively seek proprietary deals, employing a proven, systematic approach and analytic framework. All aspects of the merger must be thought through prior to the transaction—including potential bids by competitors and interlopers and not aim at completing the transaction, at any or all costs.

#### Key #2: Disciplined deal execution

Deal teams are driven to complete deals. However, due diligence can reveal that acquisitions that initially looked attractive truly aren't. Acquirers should focus on assessing key value drivers during the due diligence period and walk away from a deal if meaningful future value cannot be extracted. 'We have already invested so much time,' is not a sufficient reason to complete a poorly conceived transaction.

#### Key #3: Effective, thorough post-merger integration (PMI)

Inexperienced deal teams often do outside-in estimates of synergies and integration costs, failing to include business operations people in the discussion. Effective PMI requires bearing integration—of businesses, people, processes and technology—in mind from the start of the due diligence period. Realistic synergy expectations can

<sup>10</sup> Results from the Boston Consulting Group survey among corporate leaders (respondents were heads of M&A and CFOs). See Boston Consulting Group (2015).

be formed only when there is operational experience on the deal team. Adding deep insurance industry knowledge to the process and planning and successfully executing PMI accelerates downstream value creation.

### PMI complexity is driven by hard and soft factors

Fully 49 per cent of the time, acquisitions that appear to be financially attractive transactions do not deliver value because of poor post-merger integration. A best practice approach to assessing integration examines five key factors:

- *Geographic footprint and number of countries:* Sometimes mergers do not deliver economies of scale due to profound differences across the countries insurance companies operate in. The success of the merged company depends on managing the integration process to derive synergy.
- *Legal entity structure and regulatory context:* Ideally, the merged entity should operate as one legal entity structure. There can be numerous legal and regulatory hurdles. For example, in the U.K., Part VII of the Financial Services and Markets Act 2000 enables a book of insurance policies to be moved from one legal entity to another. For some purposes reinsurance will suffice, but if the acquirer wants to separate the policies permanently from the transferor, reinsurance is insufficient.<sup>11</sup> This is just one example of a PMI issue that is best assessed prior to the acquirer making an offer to the target.
- *Brand, product and channel landscape:* Pure financial analysis rarely examines the target's brand, products and distribution channels, with an eye on operating a converged entity. Insurance companies have some of the most recognisable branding in the world, presenting significant equity, and these decisions cannot be made lightly. For example, when Axa bought Winterthur, there was almost an identity crisis, albeit short-lived on whether the Swiss town of Winterthur should now rebrand itself into Axa. After a four-year journey, the transition to Axa has been made in most countries. Trygg-Hansa logo incorporates a life preserver, and life preservers emblazoned with the company's name are ubiquitous in Scandinavia. The situation captures a classic quandary as to whether acquired brands should be kept or rebranded, based on customer equity and overall strategy.

Distribution channels present a similar issue—some companies have brokers, others their own agents and still others sell direct to consumers. These important tactical issues must be thought through to drive value in the merged entity; they can also be deal-breakers.

- *IT/operational landscape:* Most insurers' IT shops are heavily weighted towards legacy systems. On paper, these costs may appear low and thus attractive, but acquirers will inevitably need to invest significantly to upgrade core business systems. This impacts ultimate value and can substantially alter deal terms.
- *Organisational/cultural fit:* A high number of adjacencies—in M&A, similarities between two organisations—allow the acquirer to most effectively evaluate a target. For example, an insurer that sells auto insurance (short-tail products, high turnover, automated sales process) will have difficulty in assessing the potential value of a low-adjacency target that sells B2B (business-to-business) commercial insurance, using qualified underwriters and a high-touch sales process.

The impact of organisational and cultural fit cannot be underestimated. Figure 2 illustrates where three recent major insurance mergers fell on a complexity continuum. All three announced mergers were mathematically attractive, yet one failed.

<sup>11</sup> 'Part VII Transfers,' *The Actuary*, <http://www.theactuary.com/archive/old-articles/part-5/part-vii-transfers/>

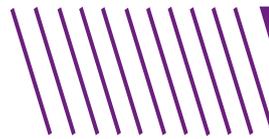
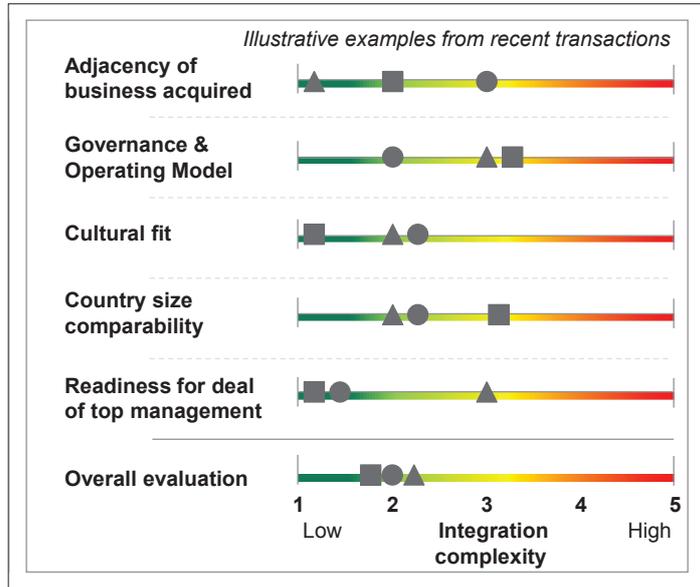
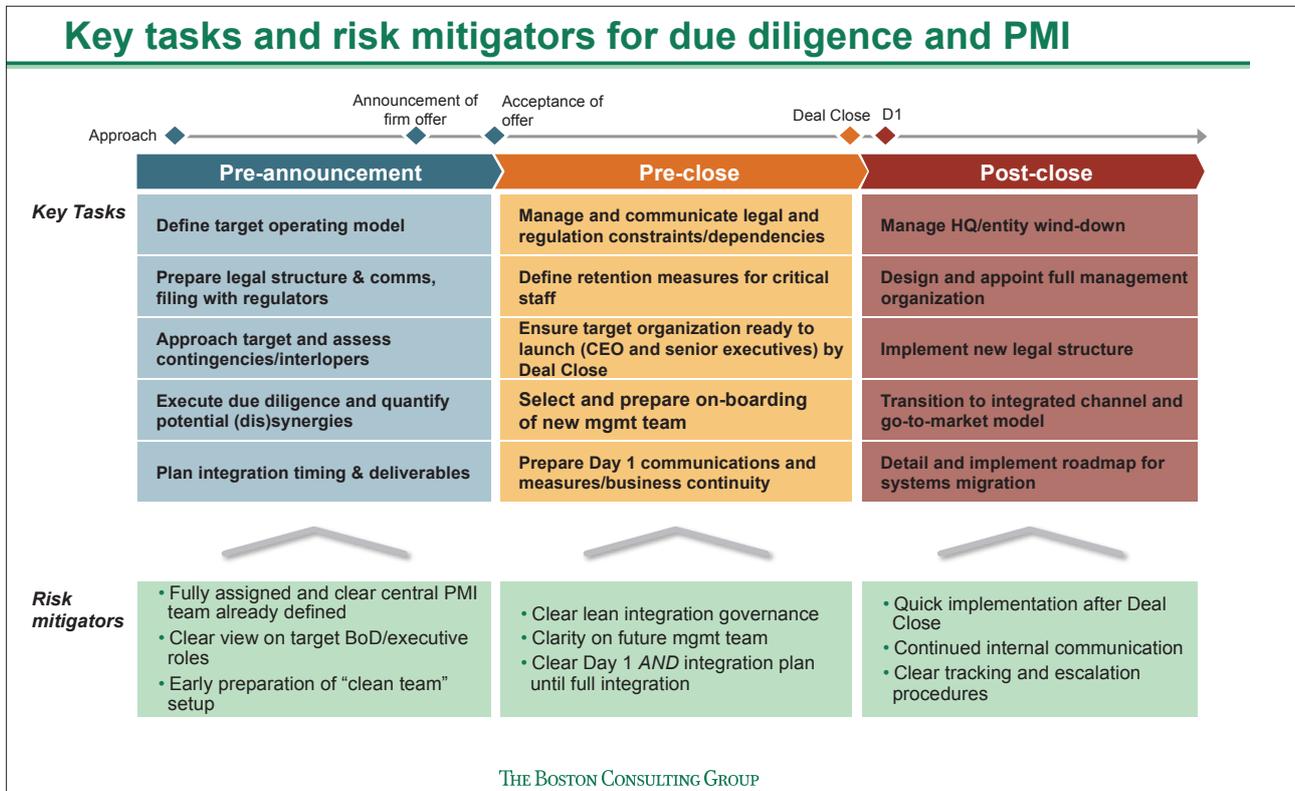


Figure 2: Five key drivers of organisational integration complexity



Source: Boston Consulting Group (2015).

Figure 3: BCG methodology to help acquirers to significantly accelerate value creation before, during and after target acquisition



## The road to value

While the ‘three keys to value’—proactive target search, disciplined deal execution and effective post-merger integration (PMI) are essential in their own right, their application within a coordinated timeline unlocks the true potential for M&A value. Figure 3 provides an orchestration framework for effective insurance mergers. The role of the clean team: trusted intermediary

In M&A scenarios, the clean team is responsible for collecting relevant data, safeguarding and analysing it, and presenting all manner of recommendations to the acquirer. It ensures that sensitive competitive information and data on the target company’s business (prohibited from disclosure before deal close) are fully captured. After clearance, the clean team facilitates fast information exchange between both parties.

A clean team is therefore particularly relevant in insurance M&A, where antitrust concerns may delay an acquisition.

## Beyond the deal

In sum, it’s clear that creating value in today’s consolidating global insurance environment goes far beyond financial compatibility between two companies. By applying the ‘three keys to value creation,’ merger partners can mitigate the industry’s 49 per cent risk of value destruction and dramatically boost the odds of long-term success of the merged entity.

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Boston Consulting Group (2015) *From Buying Growth to Building Value, Increasing Returns with M&A*, by J. Kengelbach, G. Keienburg, K. Gjerstad, J. Nielsen, D. Walker, S. Walker, Boston, MA: Boston Consulting Group, from [https://www.bcgperspectives.com/Images/BCG-From-Buying-Growth-to-Building-Value-Oct-2015\\_tcm80-198704.pdf](https://www.bcgperspectives.com/Images/BCG-From-Buying-Growth-to-Building-Value-Oct-2015_tcm80-198704.pdf).

# Does M&A Add Value in the Long Run?—Evidence from the International Insurance Industry

by Paul J. M. Klumpes<sup>12</sup>

## Motivation and problem statement

A controversial issue in the M&A literature concerns the long-term benefits of M&A activity—does it create value? The financial press and professional literature is equivocal concerning the merits of M&A to the acquirer. For example, Deloitte argued that the synergies do not offset the costs of the announced deals.<sup>13</sup> This paper takes a longer-term perspective—does it add value in the long run (i.e. two to three years post-acquisition?).

This question is important for a number of reasons. First, overall there has been a significant increase in M&A activity in recent years, with 2015 recording an all-time high number of deals since 2007, much of which is cross-border. However, prior literature has provided conflicting evidence on this issue of value creation. Second, there are special characteristics of the industry that warrant further investigation. These range from the uniqueness of insurance contracts as risk-sharing and risk-pooling devices, the extent of industry regulatory oversight and the sheer magnitude of financial investment and financing activity that dominate the sector vis-à-vis standard R&D.

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<sup>13</sup> Deloitte (2016).



Further, there are a number of information asymmetries that further complicate the analysis of long-term benefits from insurance M&As. These include the importance of enterprise risk management, the role of 'embedded value' and regulatory arbitrage from IFRS vs Solvency II implementation. There is also the influence of emerging risks such as the environmental, social and economic trends. Finally, there are also important organisation strategic risks associated with reputation.

There are three alternative perspectives on rationales for M&A activity (although in theory, with perfectly efficient markets, it should not make any difference!).<sup>14</sup> The good view is that M&A value increases over time as the merged firm extracts cost and profit efficiencies from consolidation. A bad view is that any value from M&A is dissipated by managerial consumption incentives, loss of business strategy focus. An ugly view is that M&A is undertaken for 'instrumental reasons' such as regulatory interference, pure frictional costs (such as tax-related incentives as recently occurred with the pharmaceutical industry) and/or pure managerial hubris. Each of these perspectives are potentially relevant to explain the recent uptake in M&A in the global insurance industry.

This paper briefly overviews each of these alternative rationales for M&A and then draws some conclusions for fruitful areas of further research in this area. We specifically focus on research findings that seek to examine the post-acquisition efficiency gains or losses for acquiring firms up to three years after the takeover. We further restrict our analysis of prior research that focuses on the relation between abnormal stock returns and post-takeover cost and profit efficiency in the U.S. and European insurance industry, where a combination of deregulation and consolidation was particularly evident in the last two decades.

### Prior literature—the good story?

Cummins *et al.* (2015) discriminate among these perspectives to examine whether global insurance mergers and acquisitions (M&As) create value for shareholders, by conducting an event study of M&A transactions for the period 1990–2006.<sup>15</sup> In the overall sample, insurance acquirers realised small positive cumulative average abnormal returns (CAARs). Market value gains for acquirers are centred in the U.S. and Europe. They find that acquirers from the insurance industry realise small market value gains from within-industry transactions, but cross-industry M&As are value-neutral. The results suggest that insurers should concentrate on focusing rather than diversifying transactions.

An important issue arising from the above results is whether specialised acquirers that have lower costs and higher profits than others where M&A activity involves diversifications across subsectors, is consistent with the strategic focus hypothesis in Cummins *et al.* (2015). However, the evidence on this issue is mixed. For example, in the European domestic context, Bikker and Gorter (2011) examine trends in consolidation of the Dutch life insurance industry during the post-deregulation period 1995–2001; they find that more specialised insurers have lower costs.<sup>16</sup> Further, at least in the European setting, there is no evidence that achieving scale economies (e.g. through M&A) necessarily results in more cost efficiency.

By contrast, the results are more equivocal in the U.S. market. Cummins and Xie (2008) examine the productivity and efficiency effects of mergers and acquisitions (M&As) in the U.S. property-liability insurance industry during the period 1994–2003 using data envelopment analysis (DEA) and Malmquist productivity indices.<sup>17</sup> Their results provide evidence that M&As in property-liability insurance were value-enhancing. Acquiring firms achieved more revenue efficiency gains than non-acquiring firms, However, they also find evidence that M&As are motivated to achieve diversification.

Moreover, there are reasons for doubting that the presumed positive relationship that underlies this 'good story' that M&As in the insurance industry are primarily motivated by the desire to achieve higher 'X-efficiency'. Fenn *et al.* (2008) find that most European insurers were operating (at least during this period) under conditions of

<sup>14</sup> Ahern and Weston (2007).

<sup>15</sup> Cummins *et al.* (2015).

<sup>16</sup> Bikker and Gorter (2011).

<sup>17</sup> Cummins and Xie (2008).

decreasing costs (increasing returns to scale) and that company size and domestic market share are significant factors determining X-inefficiency.<sup>18</sup> In particular, they find that larger firms and those with high market shares tend to have higher levels of cost inefficiency. Further, in the international context, Gaganis *et al.* (2013) examine the relation between cost and profit efficiency and stock returns for a sample of 400 listed insurance firms in 52 countries during 2002–2008.<sup>19</sup> While they find that there is a positive and statistically significant relationship between market-adjusted returns and current and past profit efficiency changes, but not for cost efficiency changes.

### Poor corporate governance and investor protection—the bad story?

A major problem with all of these studies is that they evaluate the merits of M&A by only analysing the short-term market reaction to announcements of M&A in the insurance industry. Boubakri *et al.* (2008), in contrast, examine the long-run stock performance and consider the impact of firm-level and country-level corporate governance mechanisms on the performance of U.S. property liabilities insurers involved in intra-industry acquisitions. They find that positive returns are significantly higher for frequent acquirers and in countries where investor protection is weaker. They also find that internal corporate governance mechanisms (such as board independence and CEO share ownership), are also significant determinants of the long-run positive performance of bidders.

These results support the ‘bad news’ story that the longer-run performance benefits of M&A activity, at least in the insurance sector, is more likely to be associated with a combination of ‘bad stories’ related to poor governance and ‘ugly stories’ related to the level of regulatory corruption and/or frictional costs. Moreover, Boubakri *et al.*’s (2008) finding of a long-run over-performance for M&A in the insurance industry is inconsistent with those of other studies that excluded financial institutions and insurance companies.

### Information asymmetries and regulatory corruption—an ugly story?

A consistent finding of the above research is that, in general, M&As are value-creating for the insurance sector. However, the high level of cross-border activities raises deeper issues, not explored in prior research, about the impact of information complexity and regulatory corruption as potential ugly stories that could explain the long-term benefits of M&A documented in these studies. Further, there are issues about whether the alleged cost and profit efficiency enhancements garnered from M&A are ‘real’ or just ‘illusory’. Finally, insurance firms are particularly susceptible to emerging economic, environmental and social trends that may impact the incidence and value created garnered by M&As.

Information asymmetries pervade insurance contracts, but also can create opaqueness in the transparency of insurance companies. This is particularly pertinent in the European context with the forthcoming Solvency II implementation. But whereas banks have provided Pillar 3 disclosures of their compliance with the equivalent Basel requirements, insurance firms face the double whammy that the Pillar 3 requirements are yet to be finalised, while the accounting rules to which they must be reconciled (IFRS 4 Phase II) have been delayed. Further, there are more subtle issues concerning the quality of accounting rules themselves and the quality of their application by individual firms. Concerning the former, an important issue is the continuing ambiguity as to the definition and scope of the risk margin and residual margin component of IFRS 4 versus Pillar 3 balance sheets and the risk adjustment measurement basis for discounting liabilities.<sup>20</sup> Further, there is considerable scope for insurance firms to manipulate key parameters underlying the reported figures. The resulting opacity and inherent complexity is often credited as a reason why fewer equity analysts follow the industry and may even be a source of a structural valuation discount for the sector.<sup>21</sup>

A further set of factors influencing the quality of reporting concerns the influence of environmental, economic and social risks on the volatility of reported figures used by analysts to value insurance firms. This is primarily evidenced

<sup>18</sup> Fenn *et al.* (2008).

<sup>19</sup> Gaganis *et al.* (2013).

<sup>20</sup> Ernst & Young (2014).

<sup>21</sup> Serrafin (2011).



by the reliance on market based or fair value measurement principles that underlie the majority of assets and liabilities reported on insurers' balance sheets. These influences are quite subtle. For example, Chodorow-Reich (2014) finds that the introduction of near-zero interest rates and quantitative easing in 2008–2009 had a clear and beneficial impact on the U.S. life insurance sector.<sup>22</sup> He cites the MetLife 2010 report which acknowledged that the announcement of this policy resulted in 'a significant improvement in net investment income and favourable changes in net investment and net derivative gains', the latter of which was attributable to a 'decrease in impairment and a decrease in the provision for credit losses on mortgage loans'.

### An alternative explanation—defensive takeovers?

The above good, bad and ugly explanations for value creation by M&As for insurers assume that their business model remains unaffected by such activities. However a significant recent new source of business risk for insurers is the impact of technological innovations in service delivery by new IT providers.<sup>23</sup> The increasing presence of 'FinTech' firms in the banking industry has recently attracted increased attention in the financial press.<sup>24</sup> Moreover, the increasing incidence and gravity of cyberattacks on the integrity and security of insurance firms' networks and information systems has only recently been documented.<sup>25</sup>

These issues are important because of the real and illusory value-creation incentives facing insurers to manage both the recursive and adaptation elements of their business.<sup>26</sup> They also raise an alternative defensive rationale for M&A for insurers. However the potential importance of risk culture and the need for greater transparency about the future viability has only recently been recognised as an important element of management narrative reporting in the U.K.<sup>27</sup> Insurers are likely to be particularly sensitive to these issues given the role of chief risk officers and their maturity in adoption of enterprise-wide risk management systems by ratings agencies.

### Conclusion

This paper has highlighted important trends in value creation emanating from M&A activity for insurance acquirers. Moreover, it appears that the rationale for and justification of such activities is subject to a range of alternative possible explanations. Further research is needed to explore these issues using incremental innovations in both the measurement of efficiency, methodologies for valuing long-run stock returns and better controls for various corporate, environmental and technological influences on post-merger value creation.

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<sup>22</sup> Chodorow-Reich (2014).

<sup>23</sup> Swiss Re (2015).

<sup>24</sup> For example see Kaminska (2015).

<sup>25</sup> Insurers are likely to be subject to the provisions of the new Network and Security Directive of the European Union, approved for implementation in December 2015 but yet to be implemented in most EU states.

<sup>26</sup> Babbel and Merrill (2005).

<sup>27</sup> For instance the newly revised U.K. Corporate Governance Code, effective for reporting periods ending on or after 30 September 2015, now includes specific requirements for reporting managerial performance incentives, risk management policies and a viability statement.

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