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## Facts Versus Sentiment: Deals in the Insurance Sector

by Mark Wilson<sup>1</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.

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

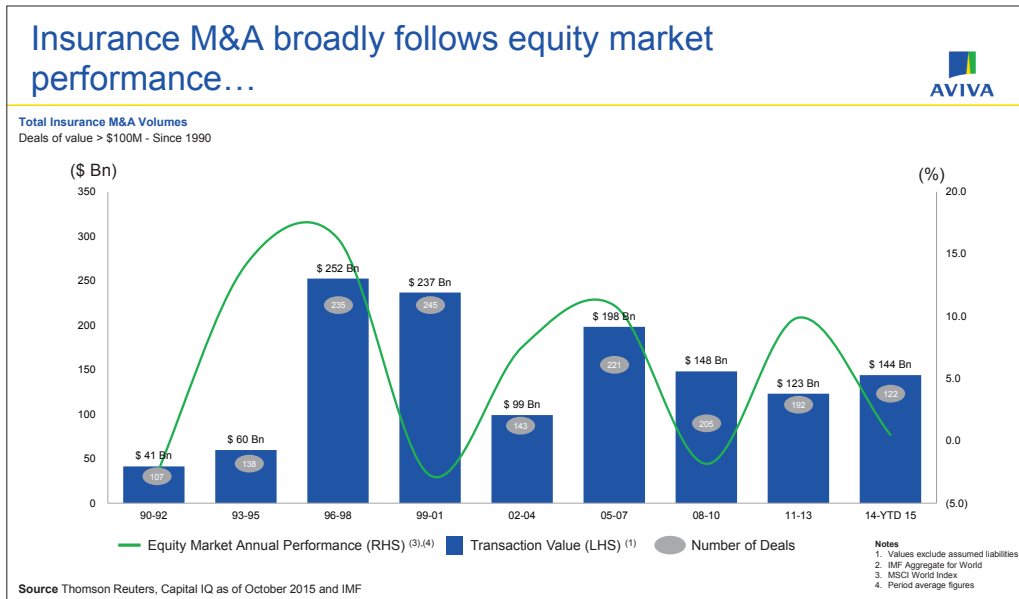
Figure 1 shows that insurance M&A follows equity markets. The volatility of equity market performance shows the impacts of both the dotcom crash in the early 2000s and the more recent financial crisis.

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.

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Figure 1



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

Figure 2

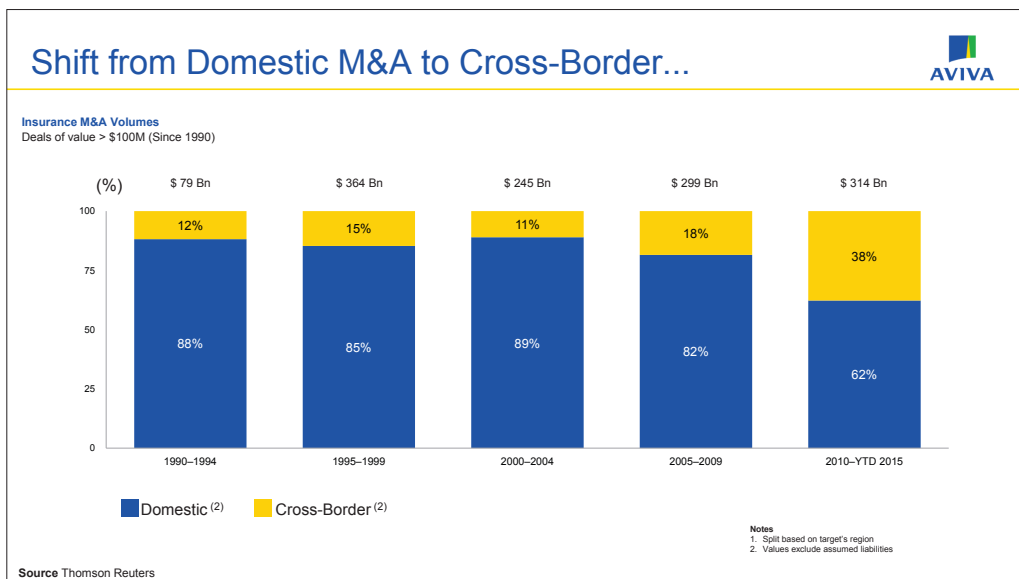


Figure 2 shows a distinctive trend towards cross-border rather than domestic M&A. From 1990 into the early 2000s, over 85 per cent of M&A activity was focused in domestic markets. Insurers searched for scale and synergies in local markets to derive a competitive advantage. In the past 10 years, the trend 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

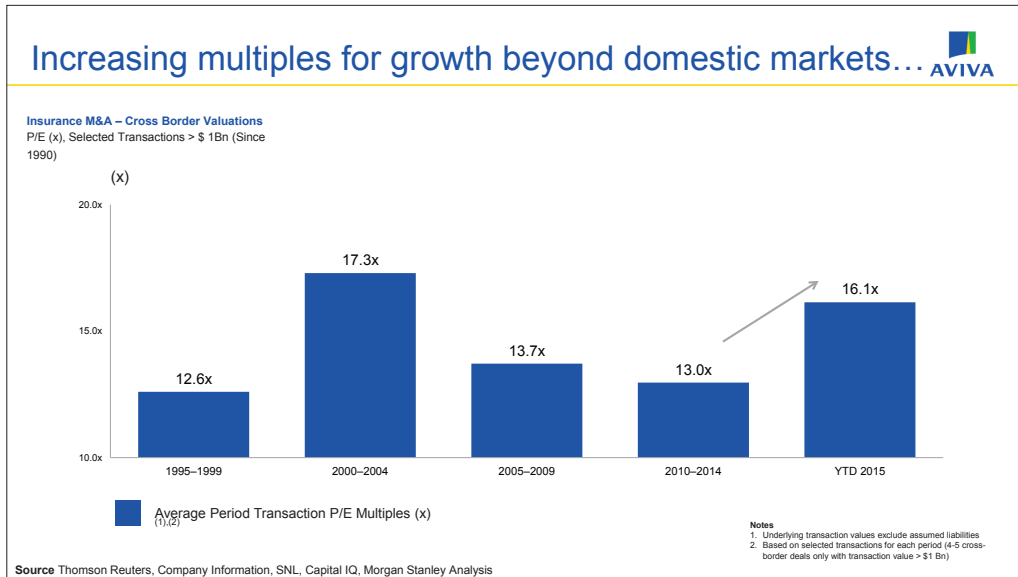


Figure 3 shows the average price-to-earnings multiples paid on a sample of large cross-border deals. As you might expect, multiples through this period reflect the economic cycle and correlate to equity market performance. Despite a reduction in multiples through the financial crisis, cross-border M&A 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

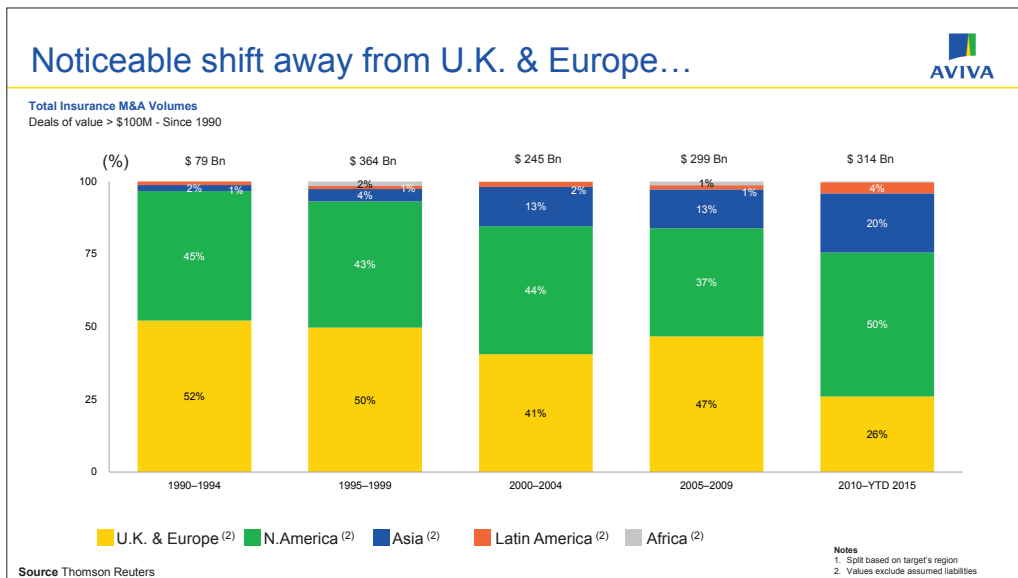


Figure 4 shows the noticeable shift away from the U.K. and Europe towards Asia, North America and Latin America. Through the 1990s, activity was dominated by the U.K. and Europe and North America. Since the 2000s, we can see a noticeable slowdown in activity in U.K. and Europe. In the past 5 years, we 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

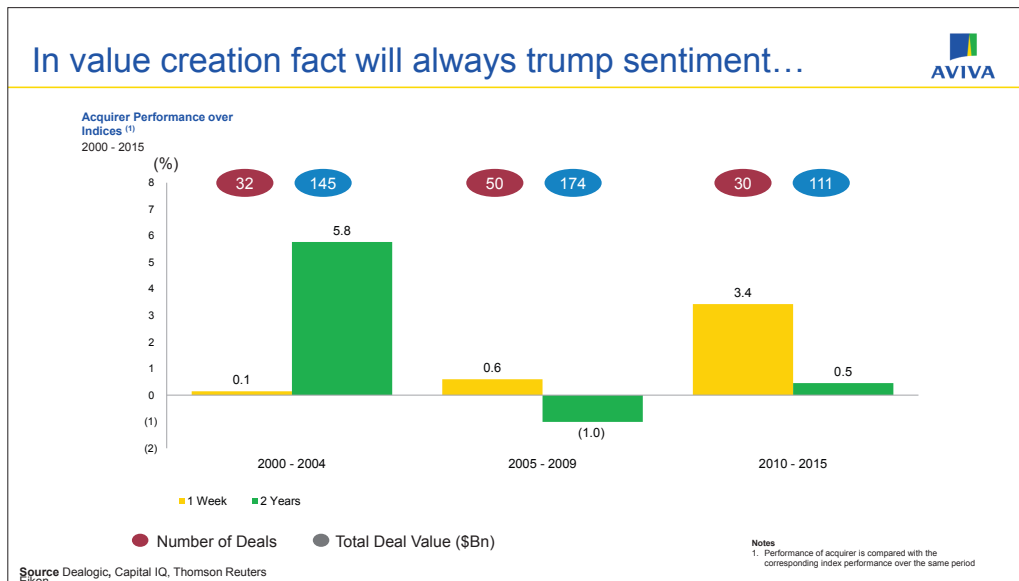


Figure 5 shows how the acquirer's stock price performs in the week it announces the deal, versus two years after announcement and once the deal has been completed.

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.