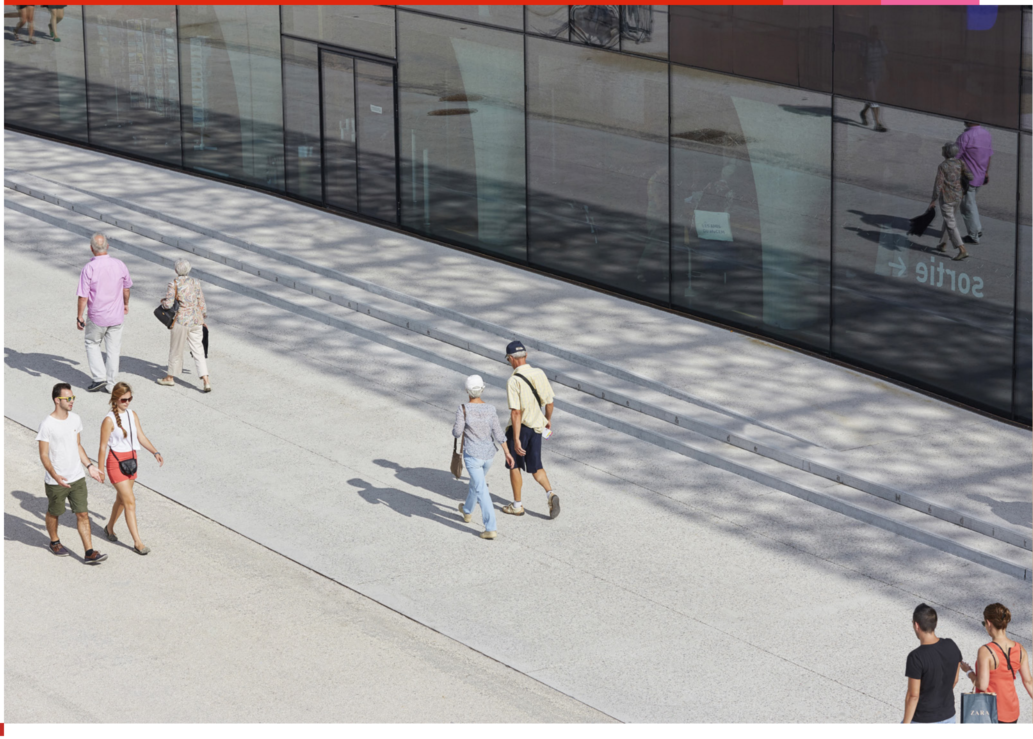
2017 outlook for M&A in insurance, reinsurance and global risk

PwC 'Snapshot'

September 2016



Hot topic

Last year, we characterised 2015 as the year of the 'mega deal'. Whilst we do not expect this level of volume to repeat in 2016/2017, there remain compelling 'push' and 'pull' factors for global mergers and acquisitions (M&A) to continue (for a number of years) in the insurance, reinsurance and global risk sectors.

Introduction

2015/2016 has been one of the most exciting periods in the insurance, reinsurance and global risk sectors' history for M&A.

This is not only due to the volume of transactions (depending on measure, a total value of c.$150bn+ of announced deals), but also because of:

1. the scale and high profile of the companies involved (e.g. Ace/Chubb, Tokio Marine/HCC, Exor/Partner Re, Mitsui/Amlin, XL/Catlin, Fairfax/Brit, together with Willis/Towers Watson); and
2. the underlying drivers and pricing of transactions (parallel increase in market and execution multiples, non-traditional capital 'behind the scenes', public company deals, prevalence of Japan, breadth of Chinese capital, hedge fund Re activity etc).

Whilst we naturally expect the scale of transactions to fall heading into 2017, we do still expect M&A activity in our sector to continue and, importantly, evolve in nature.

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Our views

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We remain excited and optimistic about the potential for M&A activity as we move into 2017. Overall, we expect to see a shift from 'mega deals' towards revenue enhancement, non-traditional capital and structuring opportunities:

- The longer term drivers for consolidation remain – from a macro perspective, our industry is still relatively fragmented. While scale, capital efficiency, growth in underwriting reach (geography, products) remain key, regulatory evolution will continue.
- On the 'pull side', interest remains high from non-sector capital – e.g. private equity, pension funds, overseas capital, an increasingly diverse Chinese investor base and start-up funding – with insurance/reinsurance being an under-represented, uncorrelated risk within portfolios.
- The extended soft rating environment continues with consequent ongoing pressures on growth and rates of return. In the absence of the '$100bn correctional event' referred to within the market, strategic acquisitions will remain of interest to boards, beyond which we also expect to see an increasing focus on the opportunities to use Insurance Linked Securities (as one example of structuring options in the sector) to drive reductions in core capital (thus driving up ROE, while also presenting an interesting alternative source of transaction funding).

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An interesting area within the recent global insurance/reinsurance trends has been Lloyd's of London, in particular since the Brexit announcement.

Following the announcement of Mitsui/Amlin in September 2015, valuations in the London market increased, on average, by c. 33% to over 2.0x P/TBV. Pricing multiples have since levelled back out to c.1.7x P/TBV, which still remains high compared to a 10-year average of c.1.3x. This uplift is in part reflective of a scarcity factor (listed groups), which is now embedded into Lloyd's pricing multiples.

Although Brexit led initially to uncertainty, there has been no significant discount to valuations, with groups trading at similar multiples to Tangible Book Value as one month prior to the referendum. On the contrary, certain sterling denominated Lloyd's of London groups have benefitted from a weak pound as currency gains have driven higher short-term ROEs.

Our views

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Data and analytics are at the heart of how insurers drive value (underwriting, pricing, reserving, claims). However, the operational and time constraints of typical M&A processes mean the handling of large transactional data has always been challenging during pre-deal evaluation. We believe that:

- This is set to change with the emergence of analytics techniques that are having a transformative impact on how deals are done in the sector (deal-specific analytical tools are being increasingly used to support sellers' equity stories, while also allowing investors to interrogate granular data on their own terms), allowing greater trust and transparency (and thus better pricing/execution).
- In the ongoing soft market conditions, the ability to leverage strong analytics capabilities acquired through a merger or acquisition into the rest of the enlarged business can bring real competitive advantage. The deployment of superior risk segmentation and technical pricing, and ability to identify and target more profitable niches, are just some of the additional benefits enabled by recent deal activity.

The enlarged scale and diversification benefits achieved by M&A activity have also encouraged some players to introduce or ramp up their capacity around standalone cyber coverages, one of the bright spots in the market in terms of rates, and an area of growing demand in light of recent high profile cyber breaches.

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We have seen two key influencers in non-life run-off in continental Europe over the last 12 months:

- The continuation of a very low interest rate environment has meant insurers are having to focus even more on achieving underwriting profit, leading to an increasing number of lines of business being put in to run-off.
- The proactive management of legacy business is becoming more commonplace with Solvency II continuing to throw the spotlight for (re)insurers on the most efficient and optimal use of capital.

Consequently the non-life run-off sector has seen a significant amount of disposal activity and the expectation of respondents to our latest Survey of Discontinued Insurance Business in Europe expects the high level of exit and restructuring activity for legacy business to continue. This illustrates increased confidence within the seller community and the continuing strong appetite of an established group of run-off acquirers.

Our views

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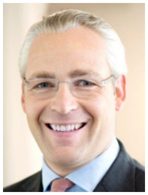

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Boards continue to look to: a) streamline governance and controls; and b) optimise capital. For companies that have recently come together through M&A, this translates into a focus on realising the synergies expected from the transaction by rationalising legal entities and integrating operations.

Being adept at navigating the regulatory landscape remains important to the completion and timing of transactions, as these naturally attract scrutiny, while regulatory expectations remain a hurdle to entry for start-ups where the 'burden of proof' sought by regulators is high.

We are therefore seeing certain capital looking to access the insurance market being guided towards less regulated structures (reinsurance side-cars, insurance-linked securities) or towards the acquisition of existing businesses.

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The potential for rising tax costs is a concern for insurance CEOs in the context of realising growth ambitions. The implementation of the OECD's Base Erosion and Profit Shifting project (BEPS) and the drive of international governments for increased tax revenues from multinationals fuels this.

The implementation of BEPS creates new uncertainty for M&A deals and deal valuations, including:

- Certain changes (e.g. in respect of debt financing) impact deal structuring and deal teams will need to re-evaluate their approach to financing transactions in the light of these developing changes.
- Others include reform in transfer pricing and the definition of permanent establishment for tax purposes, which may have significant ramifications for the tax profile of (re)insurance businesses.

The modelling required for deal assessment and valuation has consequently become more challenging with the need to take account of the increased tax risks faced by international (re)insurance businesses in the light of these developments, which still have several years to run. Sophisticated tax modelling may, however, provide significant capital savings in jurisdictions where the loss absorbing capacity of tax can be factored into regulatory models.

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Our views

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Integration naturally brings a number of issues and challenges for those involved, including the ability to achieve the revenue, cost and capital synergies per the original deal rationale, and being able to demonstrate these to the market. It is key that both policyholders' and intermediaries' confidence are maintained by seamlessly continuing to deliver products and service without disruption.

A key goal in the post deal environment is to use the integration to enhance capability by combining the "best of breed," driving out inefficiencies through consolidation and the removal of duplicated operational activities and support functions.

Within the insurance/reinsurance sector, a focus on people should remain central to the process, with retention and engagement of key talent high on the agenda of buyers, before establishing a high performance culture applied consistently across the combined organisation.

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Cost synergies are a key driver of deals in our sector. It is therefore of no surprise that insurers are seeking new and more enterprising ways to reduce cost, especially in the claims environment.

Outsourcing is one potential source of synergies but strict governance, controls and oversight need to be firmly embedded to ensure the regulatory box is ticked and any delegated activity must be managed in the same manner as if the insurer were carrying it out themselves.

Multi distributed ledger technology (i.e. Blockchain) is now actively being considered, and we believe this could have a huge and beneficial impact on deal efficiencies in the future.

For further insights, data and blogs into the M&A insurance sphere, please visit Deal Talk:

www.pwc.co.uk/deals/deal-talk

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