

Insurance

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Trends in the acquisition of insurance companies in run-off

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Recent sales of insurance and reinsurance companies in run-off have seen twenty to thirty potential bidders and prices that are close to book value; yet transactions in the early 1990s saw few interested parties, each bidding just cents on the dollar. Mark Shepherd explains why prices have increased so much, why the asset class has become so popular, and the future of run-off post-credit crunch.

TRENDS IN THE ACQUISITION OF INSURANCE COMPANIES IN RUN-OFF

To understand trends in the run-off market, it is helpful to analyze how acquisitions have developed over the previous fifteen years.

The early 1990s saw a large number of insurers entering run-off. With few bidders, and apparently continual deterioration in liabilities arising from A&E and the 1987-1992 catastrophes, prices were necessarily low.

One of the earliest pure run-off transactions involved Ludgate Insurance Company. While there had been previous acquisitions of insurers with a significant run-off exposure, the focus of these earlier deals was primarily on restructuring a troubled company so that it could recommence underwriting. What was transformational about Ludgate was that profits were achieved out of managing the run-off rather than through reactivation as an ongoing underwriter.

With the establishment of specialist acquirers such as Dukes Place Holdings and Castlewood, other transactions followed in Bermuda, London and the US. However, prior to 2000 it was unusual for transactions to be competitive and prices paid by

acquirers were usually less than 50% – and often less than 25% – of book value.

Various factors changed the market. Insurers enhanced control of their liabilities through improved claims handling, through commutations (as facilitated by events such as the AIRROC/Cavell Rendezvous) and through solvent schemes (which at one level can be viewed as a policyholder-approved mass commutation overseen by a court). In addition, regulators increasingly accepted distributions of capital from insurers in run-off, which occurred first in Bermuda, then in the UK (particularly with the introduction of the FSA's ICA regime), and then in Northern Europe.

The strong returns achieved by the early entrants to the market attracted new competitors, the demand for insurance companies in run-off began to exceed supply, and valuations started to rise. At these increased prices, most acquirers were unable to obtain an acceptable rate of return using pure equity funding and therefore sought debt to leverage their investments. Banks became increasingly keen to lend,

their decisions supported by the emergence of predictable cash-flows from capital distributions and a record of successful transactions.

In theory, the use of debt benefits acquirers by increasing return on equity. In practice, with so many buyers in the market, the effect of leverage is to increase prices overall, to the benefit of the seller. Thus, the return to equity ultimately is not substantially enhanced by the use of debt, and the increased risk to equity investors of leveraging transactions is frequently neglected.

Discontinued insurance was not alone in seeing rising prices for acquisitions; prior to the credit crunch private equity groups in all sectors sought to outbid each other in ever more leveraged transactions.

So what of post-credit crunch transactions? The first stage of the credit crunch (July 2007-August 2008) certainly affected the largest, most leveraged, private equity transactions, which reduced in volume as liquidity declined. However acquisitions of insurance companies in run-off



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tend to be smaller and the track record of profitability is strong. The cash-flows arising from investing in an insurance company in run-off are, to some extent, not correlated with the wider economy. Thus the initial stages of the credit crunch appeared to have a limited effect on the acquisition of insurance companies.

However, the second stage of the credit crunch (late August 2008 onwards) may have a greater effect on the market. It is difficult to predict what will happen as 2009 unfolds, but we may get answers to the following questions:

- Will the credit crunch reduce the number of investors bidding on transactions?

- Will banks reduce either the amount that they lend to the sector or as a proportion of any one transaction?

- Will banks increase the interest rate at which they lend?

- Will banks continue to view the run-off acquisition sector as being insulated from the wider economy?

- Will a leveraged acquisition fail to repay its lenders?

The current strong market also reflects the current scarcity of supply. Investors in run-off seek to acquire a legal entity containing the run-off liabilities, and there is currently a finite supply of such companies. Therefore investors are increasingly looking in areas other than the UK, Bermuda, and the Nordic countries, as evidenced by the deals that took place in the US and Australia during late 2007 and 2008.

The acquisition of run-off liabilities in the US has been constrained previously by the limited willingness of regulators to countenance capital distributions from insurance companies in run-off. However, the sheer shortage of opportunities elsewhere has seen acquirers push up the prices of those US companies offered close to valuations seen in Europe. There has probably never been a better time to be a seller of a US company in run-off.

Outside of the Nordic region, there have been relatively few transactions in Continental Europe to date. This is driven

in part by structural factors – run-off liabilities are often contained within ongoing underwriting entities – and partly due to protection of employment legislation, which can make the closure of an insurance company a drawn out and expensive process. However, the establishment of insurance business transfer processes in all twenty-seven countries of the European Union means that mechanisms exist to separate ongoing business lines from run-off liabilities by portfolio transfer of gross liabilities and supporting assets, thereby creating stand-alone legal entities containing run-off liabilities that are available for acquisition. Another factor likely to influence this process is the restructuring of insurance groups in Europe in preparation for the introduction of Solvency II.

In the US, however, the long-term supply of companies for acquisition is constrained (except in Rhode Island), by the lack of an insurance business transfer mechanism. What we may see in the US, absent the introduction of widespread mechanisms for the mass novation of gross liabilities, are transactions whereby investors provide capital to

insurers in return for taking control of the management of, and profits arising from, run-off liabilities. While currently this can be partly achieved through a loss portfolio transfer reinsurance, retrospective reinsurance to third parties is treated unfavorably under the Risk Based Capital calculation. An investment of capital onto an insurer's balance sheet has potential advantages for both insurer and investor.

The market for the resolution of run-off liabilities has developed dramatically in the past 15 years and the market for acquisitions has been equally innovative and profitable for investors. Insurers will continue to withdraw from business areas thereby creating new run-off acquisition opportunities and, where there is a potential for a profitable return, institutions will invest. Supply and demand of opportunities and capital will affect the values at which transactions take place but with so much talent and capital deployed in the run-off sector, we can expect continued rapid development of ideas and concepts for the acquisition and resolution of insurers and reinsurers in run-off. □

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TRENDS IN THE ACQUISITION OF INSURANCE COMPANIES IN RUN-OFF continued



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