

*Fortune favours the brave – Early acquirers will shape the future Middle East insurance market*

## **PwC FS Point of View**



Market and industry commentators have long predicted a 'wave' of consolidation in the Middle East ('ME') insurance sector, but the volume and scale of deals has proven to be stubbornly subdued. The two fundamental drivers for consolidation remain unchanged:

1. The unsustainability of small to medium size insurers in highly fragmented markets; and
2. A hardening stance by insurance regulators on licensing, solvency and other regulatory compliance requirements.

The inevitability of consolidation is further reinforced by the increasing sophistication of the larger insurers in terms of underwriting models, securing external credit ratings and their stronger bargaining power with reinsurers, and by increasing expectations of customers in terms of services offered.

As insurers' results emerge for 2013, existing solvency positions and the capital required to underwrite future premium growth will come under scrutiny. Investors in the insurance sector will favour insurers with credible and scalable growth platforms. They are tiring of successive capital raising driven by the need to maintain solvency buffers on past underwriting losses. Demonstrating a track record of profitable growth, as well as for focused and well executed M&A will become the hallmark of leading insurance companies in the Middle East.

***Insurers that have the scale and the bravery to lead M&A activity in the region will benefit from 'first mover' advantage***

Regulators continue to be supportive of consolidation, but remain unlikely to intervene or to map out an insurance takeover framework. Prospective acquirers need to be prepared to pursue deals amid evolving regulatory frameworks and short term market inefficiencies, given the market fragmentation.

Sellers need to be realistic on pricing expectations - holding out has proven costly for some players in terms of capital value erosion. The bid/ask gap that has held back some deals to date, needs to narrow. Prospective acquirers may also need to revisit their bid valuations in light of the compelling market growth dynamics and the continued restrictions on new market entrants, while not ignoring the political risk factors in their calculations.

The coming years could prove to be pivotal for determining the 'new order' of insurers in the Middle East, with M&A activity being a critical determinant of the revised rankings.

## Recent M&A activity in the Middle East

M&A data for the Middle East insurance sector in 2012 and 2013 indicates some limited consolidation among regional insurers and continued interest and investment by foreign insurance players. According to Mergermarket, four inbound deals from non-ME acquirers and three intra-region deals were completed in the ME insurance sector between January 2012 to December 2013, totaling USD 356m and USD 71m in disclosed value, respectively.

### The inbound transactions were in Bahrain, Lebanon and Egypt:

In June 2012, International Finance Corporation, the financial investment arm of the World Bank, acquired a 15% stake in Mediterranean and Gulf Insurance and Reinsurance B.S.C., the Bahrain based insurance company, for a consideration of USD 124m.

In June 2012, Saham Finances, the Morocco based insurance company acquired a 81% stake in LIA Insurance sal, the Lebanon based insurance company from Bank Audi sal (part of Audi Saradar Group), for an undisclosed consideration.

In April 2013, Tokyo Marine Holdings Inc, the listed Japan based insurance holding company, acquired a 60% stake in Nile Family Takaful Company SAE and Nile General Takaful Company SAE, the Egypt based insurance companies, from Egypt Kuwait Holding Company SAE, the listed Egypt based investment company, for a consideration of USD 6.87m.

In June 2013, ORIX Corporation, the listed Japan based integrated financial services company, acquired a 25.75% stake in Mediterranean and Gulf Insurance & Reinsurance Company B.S.C., the Bahrain based insurance company, for a consideration of USD 225m.

### The intra-region transactions were in UAE, Oman and Kuwait:

In April 2012, HSBC Private Equity Middle East Limited, the UAE based private equity firm, acquired NAS United Healthcare Services LLC, the UAE based company that offers insurance claims management services, for an undisclosed consideration.

In February 2013, Oman's SWF, Oman Investment Fund, acquired a 41% stake in Oman National Investment Corporation Holding from Dubai Insurance Group, part of Dubai government-owned Dubai Group, for USD 58m.

In August 2013, Kuwait International Bank, acquired a 33.6% stake in Ritaj Takaful Insurance Company, the Kuwait based insurance company, from Warba Insurance Co. for a total consideration of USD 13m.

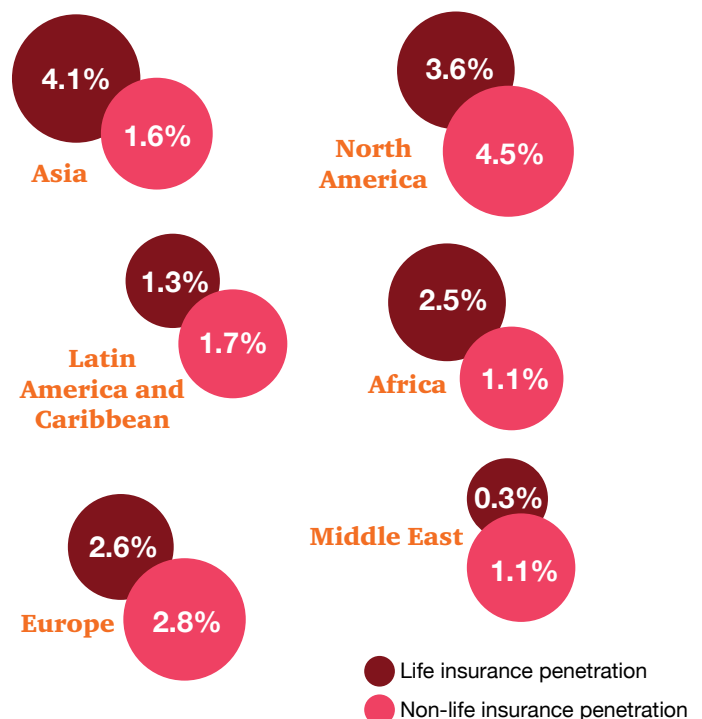
## The inevitability of further M&A in the insurance sector

The main forces that are compelling consolidation in the sector include some well-known factors and some new trends:

### 1. The competitive environment remains unrelenting

The Middle East insurance market has significant potential for growth, with an average insurance penetration of just 0.3% in life business and 1.1% in non-life business in 2012 (Figure 1). The ME gross written premium grew at a CAGR of 10% from 2010 to 2012, with 83% of the premium relating to non-life business and 17% relating to life business (Figure 2). In 2012, UAE, KSA and Egypt were the top 3 countries contributing to 36%, 27%, and 9% respectively of the total ME gross written premium (Figure 3). This represented an overall insurance penetration of less than 1%, with the exception of the UAE where non-life insurance penetration was 1.6% (Figure 4). Overall, life insurance remains largely underdeveloped and underpenetrated as evidenced in particular in the UAE and KSA markets (Figure 5).

Figure 1: Life and Non-life insurance penetration, 2012

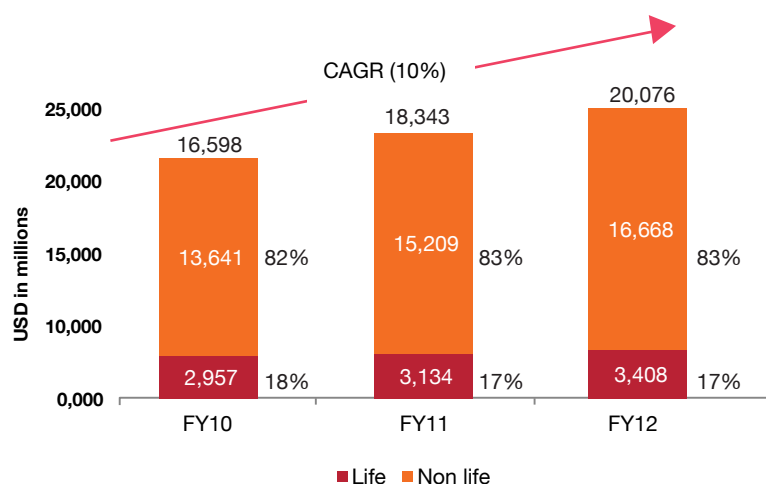


Source: Sigma 2013 and 2012 reports

Note: Middle East data was computed based on the average per country. Data for Yemen, Syria and Iraq are not available. Israel, Cyprus, Iran and Turkey are not included in this analysis.

***By improving their capture and use of data, the larger insurers are improving their risk based pricing models and underwriting quality. This increases smaller insurers' susceptibility to adverse selection. Thus the continued viability of small to medium sized insurance companies may depend on combining their businesses or joining with the insurance "majors"***

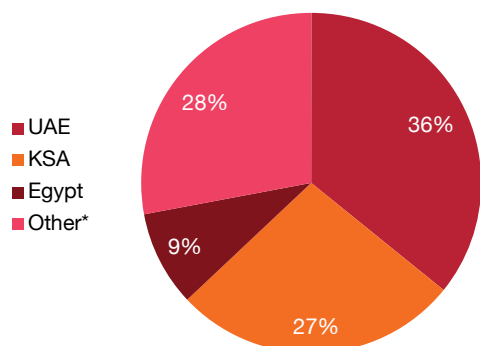
**Figure 2: GWP growth in the Middle East, FY10-FY12**



Source: Sigma 2013 and 2012 reports

Note: GWP data for Yemen, Syria and Iraq are not available. Israel, Cyprus, Iran, and Turkey are not included in this analysis.

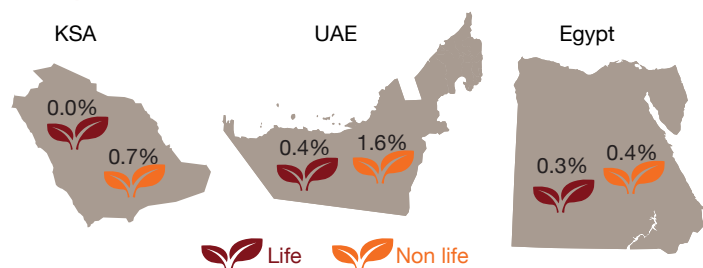
**Figure 3: Top 3 contributors in terms of GWP in the ME, 2012**



Source: Sigma 2013 and 2012 reports

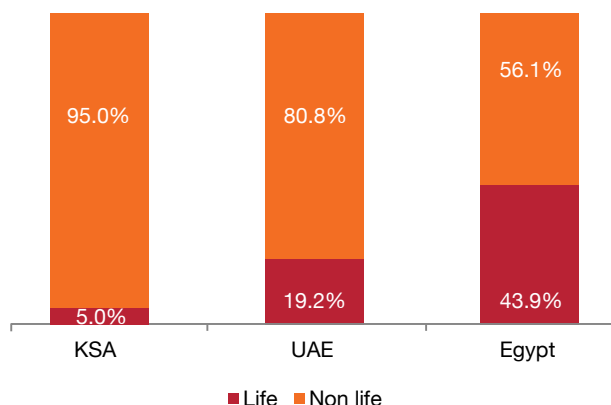
\* Other includes Oman, Jordan, Lebanon, Kuwait, Qatar and Bahrain. Israel, Cyprus, Iran, and Turkey are not included in this analysis.

**Figure 4: Life and Non-life insurance penetration (%) for KSA, UAE and Egypt, 2012**



Source: Sigma 2013 and 2012 reports

**Figure 5: GWP mix in KSA, UAE and Egypt, average FY10-FY12**



Source: Sigma 2013 and 2012 reports

The unrelenting competition and persistent fragmentation of the ME insurance market remain major forces for the sector to engage in more M&A activity. For example, in 2010 to 2012, SAMA's published statistics showed that the top 8 insurance companies in KSA contributed to c. 69% of the insurance market's Gross Written Premiums ("GWP"). The remaining 27 insurance companies contributed to c.31% of the market's GWP. Similarly, Business Monitor International's ("BMI") insurance report for Q4'13 showed that in the UAE, the top 5 insurance companies contributed to c. 60% of the market's GWP, and the remaining 54 insurance companies contributed to c.30% of the market's GWP. The Egyptian insurance market is already significantly consolidated with one national player capturing more than 50% of the total life and non-life market, while the remaining market share is split between 28 other players.

By improving their capture and use of data, the larger insurers are improving their risk based pricing models and underwriting quality. This increases smaller insurers' susceptibility to adverse selection. Thus the continued viability of small to medium sized insurance companies may depend on combining their businesses or joining with the insurance "majors".

## 2. The regulatory and solvency environment will increase in complexity

Stringent regulatory requirements in the region should promote M&A activity, notably KSA's strict admitted assets and solvency rules and limitation on granting new licenses. SAMA's annual report for 2012 showed that 10 out of the 35 insurance companies had accumulated losses in 2012 and shareholders of some KSA medium to small sized insurance companies had to have further funds injected in order to meet SAMA solvency requirements. Emerging evidence suggests that this experience was repeated in 2013. However there is a question mark over how long and how much shareholders will be willing to inject further funds into these companies. In addition, SAMA's continued restrictions on new market entrants should further stimulate consolidation of players in the market.

In the UAE, the Insurance Authority "IA" has restricted the entry of foreign players into the insurance market most tangibly by not issuing any further new licenses. Consequently, overseas players would need to partner with a local insurer up to the maximum permissible 'onshore' ownership limit of 25% in order to enter the UAE market. Some foreign based insurers have been able to achieve economic exposure greater than this limit via a branch arrangement in conjunction with a national trading partner. As a result, they are better positioned together with the domestic insurers to lead the market consolidation.

In Egypt, the regulatory reforms and the restructuring of state owned insurers in recent years has confirmed the relatively stable and well evolved regulatory environment. The less restrictive foreign ownership regulations, as well as the country's compelling demographics and growth potential, will continue to attract foreign participants, subject to restoration of political stability.

Insurance regulators in the Middle East are closely following developments in international markets, where advanced risk based capital frameworks, such as Solvency II in the EU, continue to evolve.

*As the region's insurance markets grow in size and sophistication, regulators are likely to consider adoption of enhanced capital frameworks at some point in the future*

### 3. Size matters when negotiating reinsurance programmes

As the insurance market is growing both in premium and underwriting risks, the more sophisticated insurance companies have been focusing on improving the cost vs. retained risk profile of their reinsurance treaties and facultative placements. The insurance companies' bargaining power increases with the size and quality of their portfolio. In addition, top rated reinsurers have reinforced their requirements in terms of volume and rates when dealing with small to medium sized insurance companies. These factors should further stimulate consolidation of smaller players in the market as managing risk on a price effective basis becomes harder for smaller or less well managed businesses.

### 4. Getting an external rating widens the competitive advantage of scale players

Over the past 2 years, an increasing number of insurance companies have chosen to "get rated" by the major external credit rating agencies in order to increase their bargaining power with reinsurers, banks, and even potential acquirers. The rating process and the requirements set by rating agencies are complex and onerous. Insurance companies subject to rating need a well-articulated business plan, investment strategy, enterprise risk management strategy, catastrophic strategy and coverage, and information systems that are sufficiently evolved to satisfy the complex data requirements. All these requirements necessitate adequate resources (both money and talent), which may be a barrier to some small and medium sized insurance companies, and hence further promote M&A in the market.

### 5. Customers expect increasing sophistication of products and services

As the market continues to mature, customers' needs for more products and services have increased. In order to offer such products, insurance companies need to have skilled resources, competitive rates, and advanced underwriting systems. Innovative and flexible distribution channels are also becoming a differentiating factor for satisfying the growing sophistication of clients. This will increasingly penalize some small to medium sized companies. Moving forward, consolidation may become a more attractive option for those smaller scale players in order to retain an active role in the market.

### 6. Foreign insurers remain eager to expand in the market

Existing foreign insurers in the ME and aspiring entrants remain poised to take advantage of the right investment opportunities that would give them access to the key growth markets of KSA, UAE, and Egypt, as well as to the largely un-penetrated "frontier" markets of Iraq and Libya. While some have made successful acquisitions and investments in the past 12 months, some foreign insurers seem to be holding back due to a mix of expectations gap around valuations with sellers, restrictive upper limits on foreign ownership and uncertainty around regulatory processes. If these barriers can be overcome, their role in driving future M&A in the sector will be important.

***With the right level of discipline and flexibility by each of the ME insurance industry participants and regulators, the market and consumers stand poised to benefit from a series of value enhancing deals***

### Conclusion

Whilst the data from 2012 and 2013 includes some sizeable insurance deals in the region, some deals are not materialising because of a gap in expectations between buyers and sellers in terms of pricing, culture, and M&A process. Most of the insurance businesses in the ME are either government or family owned and often culturally less receptive to M&A, or the businesses may not have matured enough to go through an M&A process. Some shareholders may be holding out for an unreasonable price, or are being poorly advised.

To promote M&A in the region, regulators can play a catalyzing role. A number of ME insurance regulators have made encouraging comments about the need for consolidation in their markets. Prospective acquirers would welcome more affirmative initiatives, such as tax incentives and transitional flexibility on solvency, a loosening of the rules on foreign ownership of insurers, and a comprehensive takeover code that addresses minority shareholder positions amongst others.

With the right level of discipline and flexibility by each of the ME insurance industry participants and regulators, the market and consumers stand poised to benefit from a series of value enhancing deals.

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