Insurers weigh benefits and risks of consolidation

The insurance industry needs to consolidate as regulatory pressures build and margins shrink. Yet last year M&A activity in the sector was at a record low. The beginning of 2010 looked promising, but if the Prudential/AIA deal does not succeed, will it signal to the market that it's still not time? Helen Avery reports

IF TIDJANE THIAM, UK insurer Prudential's chief executive, manages to buy the highly prized AIA, it will be something of a miracle. As part of AIG's plan to pay back the $180 billion of US taxpayer money that it had to borrow during the crisis, the firm has been considering the sale or IPO of its Asian life insurance unit, AIA, which has $60 billion in assets under management and is regarded as AIG's "jewel in the crown".

In February, Prudential stepped forward – the only competitor willing to pay the $35.5 billion that AIG was demanding for the Hong Kong business. However, UK regulator the Financial Services Authority (FSA) was unimpressed. After hacking it out with Prudential about whether the firm was putting itself at risk by making the purchase, the regulator finally relented. To meet the FSA's requirements, Prudential had to switch some $5.5 billion in cheaper senior debt into $5.4 billion of higher-cost hybrid bonds, and set up a £1 billion ($1.4 billion) contingency fund. Now the deal is back in Prudential's shareholders' hands. On June 7, they will vote, and at present analysts are split as to whether they will back Thiam.

If they do, it will be the largest insurance acquisition in the past 30 years, and the largest ever for Prudential. If they do not, at least Thiam's attempt shows that insurance M&A is back on the table after slumping to historical lows last year. It needs to be. There are too many insurers chasing too few profits. There are insurers that, under the proposals of new regulation in Solvency II, will have to divest to meet the new capital requirements. There are insurers, such as AIG, that urgently have to sell off businesses or undertake IPOs of them to pay back government loans. And there are banks that under Basle III will want to sell off insurance arms. Already M&A activity has picked up this year. But are the markets ready for the much-needed consolidation?

M&A's fallow period

"Consolidation has long been needed in the insurance industry," says Jeff Liebmann, partner at law firm Sidley Austin. "In the US, there are too many companies chasing too much low-margin business and acquisitions may make more sense than growing organically. Since the 1970s there have been waves of insurance consolidation. We are now, however, in a fallow period. And it's one of the most severe."

The financial crisis brought M&A activity in insurance to a standstill. In 2009, global M&A transactions were at historical lows in the industry. Despite what should have been a large number of distressed sellers, the credit crisis made it difficult for potential buyers to obtain capital to pay for acquisitions. In addition, says Jerry Theodorou, vice-president at Conning Research and Consulting, "the collapse of stock markets made potential targets less willing to be sold as their values were shrunken. Sellers wanted valuations that prevailed in earlier years but buyers wanted a discount predicated on the financial crisis. It put companies in a more defensive, hunkered-down mode."

This year, however, activity has begun to pick up. In the first quarter of 2010, $52 billion of deals were announced globally – the same amount as in the whole of 2009. "For most of this year, the markets have been open for insurance companies to raise capital. Credit spreads have tightened, and for a sensible deal there is an enormous amount of capital available," says David Schieldrop, managing director in the financial institutions group at Barclays Capital in New York. Prudential, for example, is confident it can raise £14.5 billion in a rights issue towards the AIA acquisition.

Schieldrop also says valuations have come back to a point where companies have started to consider sales but where prices are still attractive to potential buyers.

Prudential's Thiam might agree but analysts and shareholders remain unconvinced about that particular transaction. AIA's embedded value is estimated to be $20 billion. Barrie Cornes, analyst and director at Panmure Gordon, says: "The Pru/AIA deal values AIA at around embedded value plus 26 times new business profits. Given that we estimate that their own Asian operation is trading at about a five times multiple, it implies that either the AIA price tag is too high or alternatively Pru's existing Asian business is too low and maybe it should instead be divesting the Asian business if it is so undervalued."

One shareholder, Robin Geffen, founder of Neptune Asset Management, which holds about £50 million in Prudential shares, has

INSURANCE M&A GLOBALLY REACHES ALL-TIME LOW
2009 A DEAD YEAR

	No. of transactions	Value ($bln)
2007	750	138
2008	766	56
2009	601	52

Source: Public Announcements, Conning Research and Consulting Analysis

gone as far as to set up a website called prudentialactiongroup.com to lobby against the deal going through.

One of the problems facing Thiam, other than Geffen's webpage, is that there is still so much uncertainty about the global economy. Uncertainty is bad for M&A and economic slowdowns are bad for insurers, which need to sell more product to make the already small profit margins. "There may well be somewhat more financing available compared with a year ago and valuations may look reasonable but M&A activity will be slow to return to pre-crisis levels," says Liebmann. "The Greek debt crisis isn't helping and if that leads to more general problems in the eurozone, then we could be waiting another five years before we get back to that point." Liebmann says it is therefore unsurprising that large deals have been plagued with difficulties. "Look how long it took for AIG to get the Alico deal done. More than a year," he says. In fact, Metlife had begun eyeing the foreign life business just before the crisis in September 2008. It finally sealed the deal in March this year, paying $15.5 billion for Alico. Tony Ursano, chief executive at Willis Capital Markets and Advisory Services, an insurance M&A adviser, agrees that large deals are no small feat. "To pull these deals off and to pull them off successfully is very difficult," he says. "More than half of the insurance deals done over the last 20 years have probably destroyed shareholder value. It is a tricky game, and even trickier when valuations are where they are. It is hard to get people to agree on relative value. Probably in every 10 discussions we have, one deal gets done."

Regulatory uncertainty

It is not just an unclear view of where in the cycle the global economy is that is causing concerns. Regulatory reform is looming in the form of Solvency II. The guidelines so far for the EU-wide insurance company regulation propose that firms will have to increase the amount of capital that they hold to reduce the risk of being unable to meet claims. Consultants EMB estimate that UK non-life insurers will have to increase their capital requirements by anything between 10% and 120% – about €15 billion more in capital than at present.

While proposals are still being thrown back and forth across the EU and regulation will not be fully implemented until November 2012, insurers are already considering that they might have to sell off parts of their businesses to free up more capital. Richard Bonaventura, co-head of financial institutions M&A at Barclays Capital says European insurers are apprehensive of what might happen and are already considering how they may need to alter or restructure their businesses to comply with the new rules.

The head of Towers Watson's risk consulting and software business, Steve Taylor-Gooby, says that multinational insurance firms have already been testing their businesses against the capital requirements that might be enforced under Solvency II. The problem, says Taylor-Gooby, lies with firms that are headquartered in Europe but have US subsidiaries, because of the different accounting methods. "Under the regulation, the US subsidiaries of European insurers look likely to be affected," he says. "Accounting capital requirements in Europe will be based on a mark-to-market value while in the US it is largely on book value. The two do not mix well, particularly when markets are depressed and the book value of corporate bond portfolios and credit spreads of US life assurers hits the floor. How can European parent firms reconcile those two differences?" Taylor-Gooby

"Does the market have enough faith yet in insurers to trust them to do these deals?"

Steve Taylor-Gooby, Towers Watson

thinks the regulation might force European firms to consider divesting their US interests. "Many multinationals are lobbying Brussels to prevent US subsidiaries being affected, and there seems to have been some relief on forcing US subsidiaries' capital to be based on mark-to-market valuations," he says. "If that is not sufficient, and the insurance companies do not want to divest US interests, redomiciling could be another option. The holding company would be domiciled outside Europe with a European holding company beneath that. It would not be easy however." Taylor-Gooby points to Aegon as a European firm with such large interests in the US (70% of business is based there) that it will probably want to consider options outside of divesting but says redomiciling might be too difficult.

Until Solvency II rules are set in concrete, major divestitures and M&A are likely to stay on hold. Michael Diekmann, chief executive of insurer Allianz, announced in February that his firm would not be making any big acquisitions until regulators clarified the impact of the new solvency rules. Liebmann, however, says the perceived threat in the rules might spur insurers to rebalance their books of business, selling off parts of their businesses that they do not view as core in an effort to use existing capital more efficiently.

M&A in the insurance sector could also be boosted by proposed Basle III rules. If proposals issued by the Basle Committee on Banking Supervision come into force in 2013, the amount of embedded value that can be included in tier 1 capital will be reduced. In addition, insurance companies tend to hold equity risk on their balance sheets, which makes them less attractive for banks to own. Bonaventura says: "European and Canadian banks have a lot of insurance operations. If much of what is currently proposed in Basle III is

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Top-rank cover

Despite dropping in several of the regional rankings, AIU, now Chartis Insurance, ranked as the best insurer globally for the third year running in *Euromoney*'s insurance survey. The majority of last year's top 10 global insurers remained in the top 10; the exception was Mapfre, which was ousted by Australia-headquartered QBE.

Within the top 10, Axa made the most progress this year, jumping from seventh in 2009 to second in 2010.

Regionally, Chartis topped western Europe's rankings, pushing Zurich back down to second place. Royal & Sun Alliance was ranked fifth in western Europe from ninth last year and ACE moved up to third place. Chubb and HGI Gerling were replaced in the top 10 rankings by QBE and Lloyds.

North American rankings changed a lot over the year. ACE, which was fifth last year, was ranked by poll participants as the best insurer in the region, pushing Chartis down to second place. Axa ranks sixth in the region this year; it did not make it into the top 20 last year.

Axa also improved its rankings in central and eastern Europe, being voted as best insurer in the region this year, with Chartis remaining second, and former winner Allianz ranking third. Axa also made it to the top 10 in Latin America this year, ranking third. Chartis kept the top spot in the region, although in Asia Pioneer pushed it down to second place.

By category of insurance, Chartis ranked top in every sector apart from catastrophe insurance, where Allianz was voted best globally.

The rankings for best insurance brokers globally remained unchanged this year, with Aon, Marsh, and Willis ranking first, second and third respectively for the third consecutive year. In western Europe, JLT moved up to third place below Marsh and Aon. Similarly in Asia and the Middle East JLT moved up from last years' rankings to third place.

passed, and it looks quite likely, then it will be much less efficient for banks to own insurance arms. That will probably lead to sales and IPOs down the line."

Sense of urgency

Although the lack of clarity on the regulatory front might be delaying much-needed consolidation from a fundamental perspective, there are insurance companies that cannot afford to wait. "While it is unlikely there will be many outright insolvencies, there is a sense of urgency among some sellers," says Liebmann.

For example, Security Benefit Life Insurance in Kansas, which is being acquired by private investor group Guggenheim Partners, has been very open about the fact that it had problems on the balance sheet, and that the acquisition would benefit the business. The deal, for example, will result in ratings improvements for the annuity provider.

For those insurers that required government help, however, there is also pressure to divest businesses. ING, for example, has to dispose of its insurance business before the end of 2013 as part of a government agreement that included €10 billion of state aid. Rather than sell the business to a competitor, however, the management has made clear it prefers an IPO.

Fortis's insurance units are also expected to be sold off over the next year. The Dutch government bought parts of the failing financial group in 2008, and has already sold one insurance unit, Fortis Corporate Insurance, to UK insurer Amlin for €350 million.

Aegon still owes the Dutch government €2 billion of the €3 billion it received as a bailout. And then there is of course AIG, which if it is successful in its sale of AIA in addition to the Alico deal will be able to pay back $31.5 billion in cash to the Federal Reserve Bank of New York. However, the US government will still be left holding around $47 billion in equity investments. If AIA's sale to Prudential does not go through, it's back to the IPO table, and AIG might have to scout around for other businesses to sell off to raise money.

Ultimately, says Liebmann, "there can only be sales if there are buyers. And right now not many potential acquirers are in the position from an internal perspective to make a significant acquisition." One market participant says he can think of only a handful of large firms that are in the position to be able to buy, and that have the inclination. Evan Greenberg, chief executive of ACE, said in the firm's first-quarter earnings call that there were opportunities to acquire because of the pressures on certain companies but admitted that even at his firm, which has produced good earnings, "the money is not burning a hole in [its] pocket". He added: "We're not imagining that 2010 could be a big acquisition year. Could be, may not be… It's opportunistic."

There is a sense that the large insurance companies that would be obvious buyers are hesitant. By offering to buy AIA, Prudential has put its head above the parapet in seizing so-called opportunities. Thiam has argued that the value of AIA will probably rise to $60 billion, 80% more than its sale price, within three years, in his attempts to win shareholders' backing. Whether Thiam can convince them remains to be seen.

Taylor-Gooby remarks that with the halt in M&A over the past two years, the question is: "Does the market have enough faith yet in insurers to trust them to do these deals?" EM

For full results of the *Euromoney* insurance survey, please go to www.euromoney.com