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THE INSURANCE Insider

MONTE CARLO M&A ROUNDTABLE 2019

Capital versus capital-lite

The disconnection between MGA and carrier valuations continues

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The price is right… for some

The drivers of M&A have changed from the days of Bermudian carriers uniting and of overseas strategic investors seeking entry into Lloyd's.

Soul-searching among sub-scale Lloyd's players and their owners, mushrooming run-off opportunities, a hunt for fee income, and for new technology, are among the forces expected to propel consolidation in the months ahead.

Meanwhile a gulf between carrier valuations and those of capital-lite brokers remains a key feature of the deal-making universe.

Those were among the conclusions of panellists on *The Insurance Insider*'s Monte Carlo M&A roundtable, in association with Lloyds Bank.

M&A activity in the year to date has been sluggish at best for non-life carriers, with Tokio Marine's $3.1bn agreement to purchase Pure in early October a rare big-ticket transaction.

Broker deals have eclipsed non-life insurer deals, with Optis counting 490 M&A agreements in the sector in the first nine months in the US and Canada alone.

Acrisure led the acquirer pack in the period and as Acrisure CEO Greg Williams put it at the roundtable: "There are not many places you can get high recurring revenue, nice profit margins and low capex requirements."

The wide pool of potential suitors – particularly among private equity (PE) firms – and continued availability of cheap debt from multiple sources look set to support broker valuations for some time to come.

The outlook is more mixed for MGAs, though they too fall in the "fee-income" basket of businesses that have hitherto been attractive. In the wake of underwriting-remediation drives such as that at Lloyd's, some have seen their capacity abruptly curtailed.

That shortage of capacity could lead to distressed sales, Lloyds Banking Group's Seb Kafetz predicted.

Carriers themselves are keen to purchase fee businesses such as MGAs as a way to diversify from their capital-sapping mainstay.

However, goodwill from these types of deals can act as a deterrent by eroding buyers' tangible book value, particularly for those insurers trading at little or no premium in the first place.

Roundtable participants suggested minority-stake purchases as an accounting workaround that will allow the buyer to benefit from the fee income without the goodwill impact.

Meanwhile, the steady drip of transactions involving ILS fund managers, like Scor's purchase of Coriolis Capital, looks set to continue.

The Florida market, meanwhile, looks set to become a rare pocket of carrier-to-carrier M&A, while return hurdles are likely to deter PE firms from all but the most lowly valued (re)insurers.

From that point, to activism.

Despite high-profile interventions – such as CIAM's long-running campaign at Scor – healthy premiums to book value for the most part risk pulling the rug from under wannabe activists' feet.

In the past 10 years, noted TigerRisk partner Jarad Madea, carrier multiples have doubled.

"While an activist can agitate and can be successful in certain situations, many times there may not be a strategic acquirer who is going to pay a premium on top of where the stock already is," he told roundtable colleagues.

Aspiring Carl Icahns or Paul Singers, take note!

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Editor, *The Insurance Insider*

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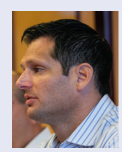
Head of M&A Advisory, GC Securities

Tatsuhiko Hoshina
Chief Commercial Officer, AkinovA

Sebastian Kafetz
Managing Director, Head of Global Transaction Banking North America, Lloyds Bank



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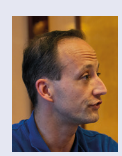

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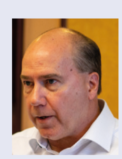

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Monte Carlo M&A
Roundtable 2019

Mark Geoghegan
It would be good to start off by talking about what is changing in the M&A space and whether the reasons behind deals are changing.

Andrew Beecroft
The last M&A wave was about expansion dominated by Bermudian consolidation on a grand scale and international trade investors entering the Lloyd's market, primarily US and Bermudian companies but also some Asian players. Both these trends are in decline and the next wave is likely to be different. Within Lloyd's, there's going to be a bit more rationalisation of the market. Historically, Lloyd's consolidation deals are difficult to do because of the geographical concentration of relevant personalities, resulting in management overlap. But we are now seeing some of these businesses, particularly those lacking scale, starting to consider options.

"In the old days private equity firms expected a 30 percent return but now the business model has changed. It's all about AuM"

Tatsuhiko Hoshina

Jarad Madea
We expect to see continued activity in the run-off sector in terms of whole company and portfolio acquisitions. Given the influx of capital into the run-off space over the past few years, we also expect to eventually see consolidation within the run-off players themselves.

Over the next 12 to 18 months, we will also likely see a handful of transactions on the ILS manager side. Finally, consider the Florida carriers.

There is significant stress in the Florida market and I would be very surprised if, in the next 12 months or so, there is not meaningful consolidation within the 30 to 40 Florida carriers we have now.

Ken Randall
Lloyd's is certainly in our sphere of run-off business. It's M&A with a difference. We're not consolidating to grow but consolidating to shut them down and run them off, fundamentally. That's a harsh way of putting it but that's essentially what it is. For us at the moment, at least on the programme side, we're hell-bent on growing organically rather than through M&A.

Tatsuhiko Hoshina
In the old days private equity firms expected a 30 percent return but now the business model has changed. It's all about AuM. So you will probably see more and more private equities going after AuM rather than bottom-line results.

Zsolt Szalkai
Technology is changing the operating model of insurance companies, and this will be one of the M&A drivers in the next couple of years – buying capability instead of buying capacity.

Acquiring or developing technological expertise will be an increasingly important goal for M&A. This will ultimately drive demand for run-off solutions as a starting point towards creating new target operating models and focusing both capital and management effort on forward-looking business initiatives.

Mark Geoghegan
What is the view of your business on whether you're primed for organic growth or growth through M&A?

Barnaby Rugge-Price
We have strong organic growth but still believe that M&A is a significant play. But it's all around getting into markets we're not in and looking into specialty areas we want to be in. So it is strategic in that sense and, for us, it's the combination of the two that delivers real value.

Greg Williams
We still see valuable opportunities from a transactional perspective and don't anticipate taking our foot off the gas. Our numbers won't change dramatically because, on a blended basis, we're still getting accretive transactions done. Have prices gone up? No question, prices have gone up, if we look at the last year in particular.

In terms of the M&A strategy and our criteria, we look at businesses that have a record of profitability and organic growth. Given this, we're not taking the foot off the pedal from an M&A perspective, but the long-term strategy is to grow the business organically.

Mark Geoghegan
This is probably a good time to talk about valuations. I was at our Insider Honours awards event recently, giving a prize to Dane Douetil [group CEO of Minova Insurance] and during my eulogising of Dane before we handed over the award, I stumbled on the price at which the BMS deal had been done, which was 16x and 20x. Where is this going to stop?

Seb Kafetz
BMS is a broker. There seems to be a disconnect between distribution businesses and the carrier market, where valuations seem to have come in. Most Lloyd's businesses are now trading much closer to book.

We're seeing management teams exit. On the flipside, in the distribution space the valuations of MGAs and brokerage businesses are sky-high. It comes back to capital versus "capital-lite" business models and, right now, expertise wants to follow capital-lite. That's why we're seeing valuations going sky-high in that space. Increasingly, carriers are catching on to that and looking to increase the fee revenue side of their business, which the Lloyd's market has always done by attracting in third-party capital. But now they're trying to build MGA-type capacity to grow valuations. You're seeing that in Lloyd's and in the Bermuda space, by getting fees from sidecars and ILS funds.

That disconnect will continue between valuations on MGAs and valuations on carriers, but we see those two entities converging more than ever before.

Richard Askey
The interest rate outlook is completely different from 12 or 24 months ago. You've also got liquidity in the market and, staying with distribution businesses, if you look at the sort of leverage multiples negotiated in that market you could ask – is that liquidity partially driving the expanding valuations? We see certain debt funds who are happy to invest at 6x or 7x, coupled with investors in the US – in the more traditional market – who will look to continue that investment. That's great in a low interest rate environment but when you start increasing that rate, as we've seen in the past, things get a bit more interesting.

Mark Geoghegan
As a banker to that equation, are you near the point where you start getting unhappy?

Richard Askey
As a banker, we find ourselves being "outbid" now by debt funds in a number of those leveraged structures.

"It's all around getting into markets we're not in and looking into specialty areas we want to be in"

Barnaby Rugge-Price

That's just how it is and it's not only Lloyds Bank, it's the banking community. We will have a certain tolerance for leverage and it may top out at a level where you can maybe get another turn or turn and a half even from the debt funds/external investors.

So I don't think our tolerance has changed dramatically, it's the market that's leading this. That said, there are a plethora of financing opportunities for the banking community to continue to support.

Seb Kafetz
The UK is catching up with the US. In the US, all the leverage is provided by institutional and private debt funds. In the UK, banks have historically provided capital to distribution businesses and it is catching up as these debt funds gain assets and have more liquidity than we've seen before.

Richard Askey
The other underlying factor, and again it's for the distribution businesses, is lack of supply. If you look at the London market as an example, turn the clock back five or 10 years and there were a number of businesses in that £10mn to £30mn Ebitda range.

If you look today, there is not that much supply of these businesses any more. There's effectively an additional scarcity value now, isn't there?

"Sector transformation has driven M&A activity in the past 12 to 24 months in a number of ways"

Zsolt Szalkai

Andrew Beecroft
Yes, there's scarcity value. At the same time you've got consolidators in the space looking, insurers that are looking to secure distribution and private equity, flush with liquidity, also chasing these capital-lite assets. Limited supply and excess demand has driven prices up.

I don't think they're going to go much higher, but there's no reason they're going to come down any time soon.

Greg Williams
Whether capital is available or not there is a point where, as an investor, you don't want to buy at certain multiples. We find ourselves more frequently walking away from situations just due to the multiples getting to a point where it's no longer attractive.

When I started Acrisure a handful of private equity funds in the US were really active in the distribution space. Today, there are around 28 funds with real capital invested. So capital has beaten a path to this door because the fundamentals are so good.

As people in this room already know, there are not many places you can get high recurring revenue, nice profit margins and low CapEx requirements. And as long as these dynamics exist, which is going to be for a while, capital is going to be available to this industry. What does that mean? Until something changes one of those dynamics, purchase prices will remain high.

Zsolt Szalkai
We can agree that the level of valuation has changed in the past couple of years and [it always] comes down to the key question – what is the added value of the target company? So if the target has the right client base, the right model, technology, whatever you take as an important additional asset, you are more prepared to pay for it.

Greg Williams
The timing too. I think you're going to see some larger private equity-owned assets exit before 2022. And the closer you get to 2022, as a seller or holder of an asset, you are taking some risk given the tax law change in the US.

Mark Geoghegan
I want to pick up on something Seb mentioned – the difference in pricing between fee-earning businesses and balance sheet businesses. We've seen insurers and reinsurers buying ILS managers and lightening their capital load through that. Does everyone agree that is something we're going to see more of?

Jarad Madea
I agree with the premise that carriers want to acquire more fee businesses to increase their RoE, which will theoretically increase their price to book value multiples.

However, investors – including the public markets and private investors – are still going to be focused on price to tangible book value multiples for carriers.

And the big issue, if they are buying fee business, is the creation of goodwill which will be highly dilutive to this tangible book value. So, in reality, this dilution has kept the carriers away from being able to pay a competitive price versus other insurance services entities or private equity investors (for the most part).

Tatsuhiko Hoshina
The goodwill from purchasing MGAs is hindering the valuation of the carrier itself. When companies go out into the market to sell, everybody looks at the multiple against the tangible.

For a major incumbent buying a small MGA it may not be a big impact but for, say, a $1.5bn-$2bn capital company buying an MGA at valuation of $300mn, it will have an impact on future valuation when goodwill comprises 15-20 percent of their total book value.

Andrew Beecroft
It's the insurers that are valued closest to book that suffer the worst. If you have a decent multiple, an uplift in your earnings will lift your RoE and should increase that book multiple. When you have companies that are being valued with very little franchise value it's really tough, as you say, to pay goodwill and reduce your tangible book value.

Seb Kafetz
The other way people are doing it is with carriers making investments directly in businesses. Not buying them but investing in a tech fund, for instance, as a way of getting some of that intellect and having a stake, or just taking a stake in part of a carrier but not bringing it all on to their balance sheet.

Jarad Madea

I agree. If a carrier acquires less than 50 percent of a target, the accounting treatment will be different. They will use the equity method of accounting and not be faced with consolidation and the goodwill hit. In that case, you can benefit from the fee income without the goodwill impact.

Mark Geoghegan

I'd like to change the subject. We've mentioned fee-earning businesses and capital-lite businesses but we haven't really differentiated between MGAs and brokers.

With this market turn and, with capital looking for a better results environment, how has that changed the valuation of MGAs? We've had this amazing flowering of MGAs over the past 10 years – do you think the sector is ripe for consolidation?

Jarad Madea

TigerRisk has advised on and sold seven MGAs over the past two years. First, I think valuations have plateaued a bit recently.

Some high-quality MGAs have traded in the past two years but I've seen discipline from buyers. What buyers are looking at – private equity and others including insurance services buyers – is the importance of the capacity on the back end, including diversification of carriers. And can the capacity be replaced if one carrier exits?

For the first time in a while, there is a shortage of capacity for some MGAs, particularly on the property side. Given current market conditions, if carriers can grow organically – and they're seeing rate increases and opportunities without MGAs – they may choose to grow that way without giving their pen away to MGA relationships.

Over the next 12 months we may see some MGAs struggling on the capacity side which could lead to stressed situations and shifts in valuations.

Mark Geoghegan

Ken, do you feel there's a squeeze in the programme business?

Ken Randall

Lloyd's is in pretty sharp focus in this regard. You've got ILS that invests, effectively, as Names on syndicates. But there are so many mouths being fed before it gets through a Lloyd's syndicate, I don't see the sense in that. There's going to be some re-engineering in that area. Lloyd's is on to it but they've come to it pretty late.

Barnaby Rugge-Price

There's always a squeeze on poor performers and quality MGAs will always stand out. If you look outside the US, there aren't many MGAs of scale which is why they've attracted frankly amazing numbers in the past couple of years. So if there's potentially a return to normality, that does make it easier.

Mark Geoghegan

It seems that, culturally, everyone is now more ready for legacy as part of a solution than they have been for a long time. We've been talking about this for a long time and it seems we've got a huge amount of capital waiting on the sidelines.

Ken Randall

I've been doing this for rather a long time. Thirty years ago it was about problem-solving, if you could get people to admit there was a problem. Now it's moved to the other end of the spectrum, it's just life cycle.

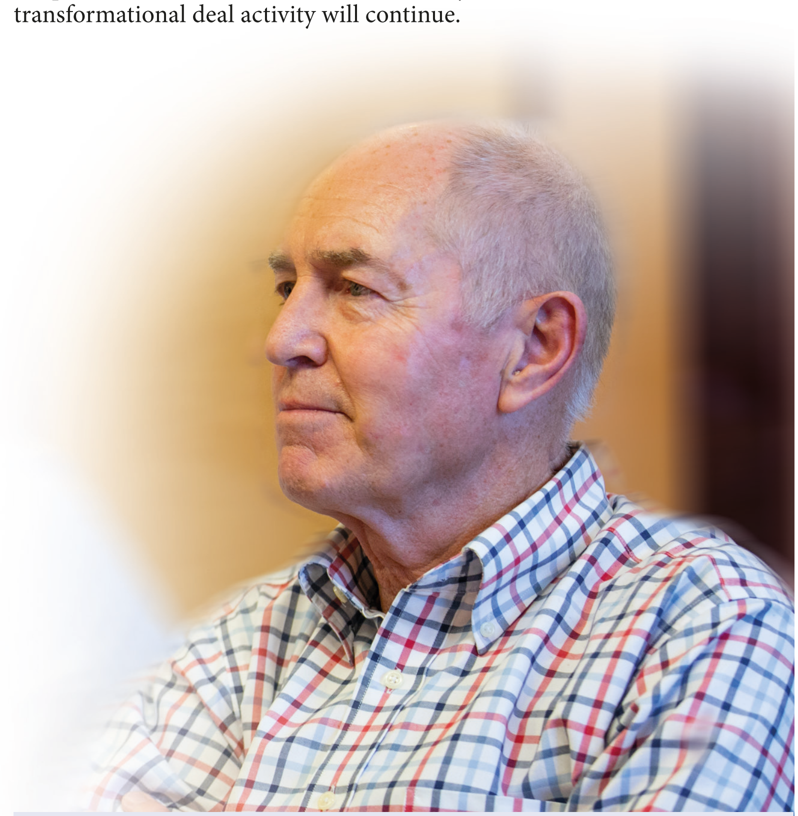
It's a logical transition. Why would you keep on the balance sheet and pay a 40 percent capital charge in Solvency II for something you don't even want? Then there are management costs on top of that. So it's down to life cycle. I see the deals getting bigger but it is much more about capital than problem-solving.

Zsolt Szalkai

Buyers are getting more sophisticated about the benefits of using run-off solutions and legacy transactions. There are different drivers for this. We have seen challenges for the industry – rate declines, the investment yield environment and changing regulatory demands putting more pressure not only on the capital side but also on the cost side.

So life is getting more challenging and, at the same time, we see new entrants coming in and challenging existing business models. The insurance sector is going through a period of rapid transformation. The overall propositions need to change radically, while operations and costs need to be streamlined.

Sector transformation has driven M&A activity in the past 12 to 24 months in a number of ways and this transformational deal activity will continue.



"I see the deals getting bigger but it is much more about capital than problem-solving"

Ken Randall

"Diligencing reserves can blow up an M&A transaction. But the biggest problem is uncertainty over reserves"

Andrew Beecroft

Which means that, coming back to the first point, companies have to start thinking about change – how they want to use technology and how they want to get more efficient. And I see legacy transactions as a catalyst and enabler in becoming agile.

Richard Askey

Do you see a pause in the heightened regulatory scrutiny in the market? Are we seeing extra scrutiny overall? For us as a financier, you can imagine that there may well be additional questions asked in the due diligence process, for example.

Zsolt Szalkai

From a legacy perspective, we see developments in the US, the UK (including Lloyd's) and in Continental Europe as having different dynamics. In the US, retrospective reinsurance always existed but it is now used more often as a management tool to optimise the use of resources, get capital release and limit risk from previous underwriting years. There is still no legal framework for legal transfers but there are developments heading in the right direction.

The UK is quite an established market with the Part VII framework. Nevertheless, it's a framework that takes time to get completed. On the Continent, we have the regulatory approval process which takes three to four months, so it seems to be efficient. But the European market is different because the companies are less capital market-driven than those in the Anglo-Saxon area. You have to take time and explain to the market how and why legacy solutions are useful.

But the regulatory requirements under Solvency II have been useful in making benefits more obvious. There is a change in the regulatory framework in general, with more scrutiny having implications for both sellers and buyers of businesses. The additional scrutiny increased not only capital requirements but also costs in general to fulfil the reporting requirements. Regulators are getting also focused on due diligence to understand who the players are in the run-off area. More and more, capital is interested in providing capacity for legacy transactions.

However, the run-off area is not just about capacity in the form of capital, but also about operational capability and minimising execution risk which comes with the record of an experienced management.

Richard Askey

Yes, and reputation.

Mark Geoghegan

Something we've been talking about for as long as I've been an insurance journalist is the reserving cycle and how reserves would probably run out at some point. They managed to keep going but there's now some consensus that reserve releases have dried up. Is that having any effect on carrier M&A. Are reserves more of a diligence factor than they have been for a while?

Andrew Beecroft

I haven't seen much of it actually stopping M&A. Diligencing reserves is always the major issue that can blow up an M&A transaction. But the biggest problem is uncertainty over reserves.

Currently, balance sheets aren't quite as strong, with the management margin on reserves being smaller than a few years ago. But that can easily be taken into account in valuation. We've now seen a number of transactions specifically structured to exclude the back years, removing any potential issue.

Ken Randall

The big change is in interest rates. Historically, you had a huge margin for error in the investment income but it's not there anymore. If people don't focus on that, we'll have run-off of run-off.

Zsolt Szalkai

I agree. With this low investment yield environment, underwriting discipline is more important. I also agree that we see the comfortable level of reserves has changed in the past couple of years, also because the surplus has been used to smooth results which have suffered under low interest yield and higher operating costs.

Run-off transactions for prior year business are a facilitator for M&A transactions. It can be used prior to sale by the seller to clean up the balance sheet and get a better purchase price or after acquisition by a buyer to limit potential adverse development and release financial and operational resources for the implementation of the strategy.

Tatsuhiko Hoshina
With the RenRe-TMR deal there was a $500m ADC cover that was part of the package. You may see something like that going forward to make sure buyers don't have that adverse development impacting them.

Mark Geoghegan
Shareholder activism has been on the rise in our space. Do you think activists might come in and force us to do more deals or get rid of the underperforming parts of our business?

Jarad Madea
If we are talking about the carrier side of the business, if you go back 10 years and look at valuations in the public market the index was trading at 80-85 percent of book value for carriers. Today, they are at around 1.5x book value.

Multiples have almost doubled so while an activist can agitate and can be successful in certain situations, many times there may not be a strategic acquirer who is going to pay a premium on top of where the stock already is.

Mark Geoghegan
Are we likely to see more private equity coming back in now valuations are not challenging?

Andrew Beecroft
We've already seen a bit of it. There have been at least three or four transactions in the Lloyd's market in recent times where private equity has been in the hunt. There have been a couple where the assets have gone for 1.3x and above, and private equity hasn't quite been able to get to the price versus trade. And then there have been a couple of recent processes where private equity are favourites to do the deal but there's a question about whether they'll transact.

We've seen one transaction fall apart and we're waiting to see the result of another. Either way, with the lower valuations, private equity is looking at a lot of asset sales at the moment.

Jarad Madea
There are more than 100 private equity investors that would be interested in fee-based insurance services businesses, whether that is retail brokers, wholesale brokers or MGAs. On the carrier side, where there is balance sheet risk, maybe only 10 to 20 private equity firms are interested.

Once a carrier valuation approaches 1.1x or 1.2x book value, private equity is not going to do that deal given the return hurdles. If you assume a carrier RoE of 10-12 percent, and add in the fact that you can't lever a carrier balance sheet significantly, you will not hit private equity's required returns in the 20 percent range unless you assume meaningful multiple expansion.

There could be some one-off situations where carriers are hovering at or below book value in which a private equity player acquires, but I don't see a big wave of carrier-driven private equity activity.

Mark Geoghegan
We've got some newly formed technologists sitting here. There's been some interesting M&A activity in InsurTech and I want to ask you about that. We've had a lot of investments but there have also been some exits. Where do we feel InsurTech is at the moment?

Barnaby Rugge-Price
InsurTech isn't building necessarily to make money, it's building to sell. If you try to do that in an existing business that is looking to make a profit, it's a very different proposition. Looking at valuations of existing businesses and InsurTechs, they're different worlds.

You also see a lot of people talking about greater collaboration between InsurTechs and incumbents – that's been the flavour of the past 12 months. And I'm assuming from within there, you're seeing investments from incumbent players in InsurTechs who presumably take a view that if it works, great, if it doesn't work it helps me solve a problem I've got so I can bring it in-house and use it within what we do.

Greg Williams
We've been watching InsurTech investing closely for five years. We've been tracking who is investing in what to better understand the motivations of our trading partners. We're delivering significant premium to many of these firms so their strategic direction is of great interest.

"In terms of the businesses we acquire, quality of leadership is our number one issue and culture is number two"

Greg Williams

A number have invited us to invest or co-invest and we've passed on all of them. That said, we recently formed a joint venture with a tech company, which is more of a sales strategy than a disintermediation initiative.

Seb Kafetz

We've just done a deal with a tech company on the US West Coast that has a good middle system and a client end system we will white-label. And so we'll keep our distribution base but use their infrastructure. We're not buying the company, but they recognise they don't have the brand and distribution in the UK but they have a great piece of kit. They'll get a fee income and our proposition to our end-client should look a lot better.

We're a big incumbent organisation, traditionally relatively slow-moving, but that's a great example of where we're partnering to better serve our clients.

Mark Geoghegan

The final question is a bit of an old chestnut but it's interesting because we've had some big deals recently. We're a people industry and we're in the middle of a cultural change in how we talk about our people. Have we got any better at the people side of these deals?

Greg Williams

In terms of the businesses we acquire, quality of leadership is our number one issue and culture is number two. We've built our business with an "investors'" mentality. So what does that mean? If you look at the companies we've acquired since 2013, the average Ebitda margin is 38 percent. So these are healthy companies that perform well.

Given that these companies are financially solid, the appropriate concern is how we best partner with the principals without damaging their business and the investment we just made. For us, it means not fundamentally changing how they operate their business. Instead, let's make sure that when the deal closes the principals' relationship with their employees is strong and remains intact. We don't want disruption around that relationship and part of that is not changing the culture.

Further, we seek no change to the three Cs: compensation, covenants and culture. If you're an entrepreneur who has built a business, blood, sweat and tears have been poured into the endeavour. As an entrepreneur, you care deeply about your people, the business, your legacy and your clients. We care about the same things and really don't want any of that to change. Our interests are aligned and, as an entrepreneur, that's what you want to hear.

Barnaby Rugge-Price

On the question of culture, as far as M&A in concerned some do it well and others do it badly. I work for an organisation that puts culture at the heart of everything it does. As a business that was acquired four years ago by Hyperion, we live and breathe it. That's the reason the merger was such a success – the cultural alignment is there.

Mark Geoghegan

Great. Thank you everyone.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