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What is the Logic Behind Consolidation? And Does it Create Value? A View from the Outside

by Brian Shea[1]

Looking at deal volume in the global insurance sector, 2015 was off the charts. In this article we address two issues:

- The drivers of this consolidation—past, present and future.
- Does this activity create value?

Drivers—past, present and future

Historic drivers

First, we briefly go over the generic reasons why M&A has historically happened in the insurance sector. Much of this is applicable to other sectors also. You have complementary expansion, e.g. in terms of product or geography. Scale has always been important too. There's also what we call value chain adjacency. For example, banks in the 1990s and 2000s bought insurance activities because they saw themselves as distributors, sitting next to the insurance product in the value chain. Outside money—private equity and run-off specialists—has also been active in the sector for years. Finally, apart from all the rational reasons for M&A, no doubt management hubris has been a driver of some deals.

Today's drivers

Moving on to look at what's driving today's M&As and why there is so much activity, some of the historic drivers are particularly relevant. There is greater impetus for scale today.

In Europe, Solvency II raises fixed costs and also gives explicit capital credit for diversification. The tiering of the reinsurance sector also means that reinsurers need to have a wide product and geography footprint and the ability to offer greater line sizes. Low interest rates also drive a greater need for cost efficiency, particularly in the life segment.

We all know that the boundary between traditional insurers and reinsurers on the one hand, and alternative capital providers on the other, is blurring. There has been a lot of activity—largely organic—of insurers setting up insurance-linked securities (ILS) vehicles and of ILS managers setting up rated balance sheets. It's not always organic though. Willis advised Catco, the ILS fund manager, on its sale to Markel. We would not be surprised to see more M&A activity between traditional and alternative capital players.

There are some specific cyclical drivers as well. Cyclically low prices tend to equate to more M&A. At the same time, the sector's profitability is actually quite good at present. So, excess capital is accumulating, and M&A is a way to invest that. Finally, new money is a particularly relevant driver today. The historical interest of private equity (PE) and run-off buyers is being augmented by the likes of EXOR and Asian money. This type of buyer is motivated by its perceived low cost of financing, a desire for diversification and the investment 'float' that insurers provide.

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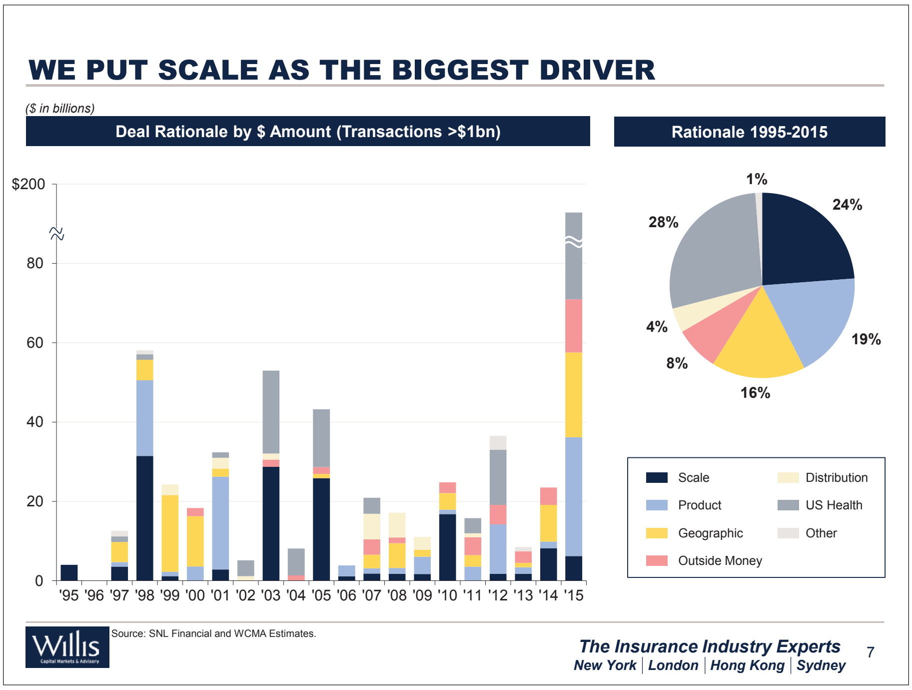
Categorising the deals to date

We have attempted to categorise the insurance sector's M&A into the various drivers. We looked at all the USD 1bn+ deals in the insurance sector since 1995. There are about 150 of these, and they account for about 70 per cent of the sector's total M&A activity. It's a rough science, of course. How do you categorise ACE/Chubb for instance? We call it product. It's a little bit of scale, distribution and geography too. But complementarity of products is pre-eminent in our view.

As Figure 1 below shows, excluding U.S. health, scale has been the most important driver in aggregate over the past 20 years. (And much of the U.S. health consolidation has been scale motivated too.) In our view, 2016 will again be a year of heightened M&A, driven in particular by the desire for scale and by new money.

Figure 1

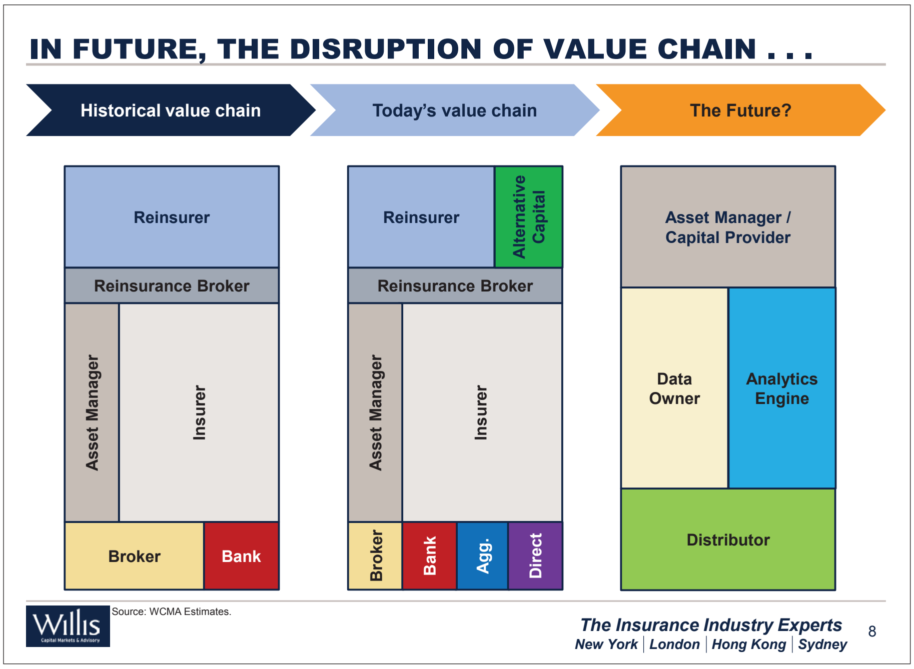


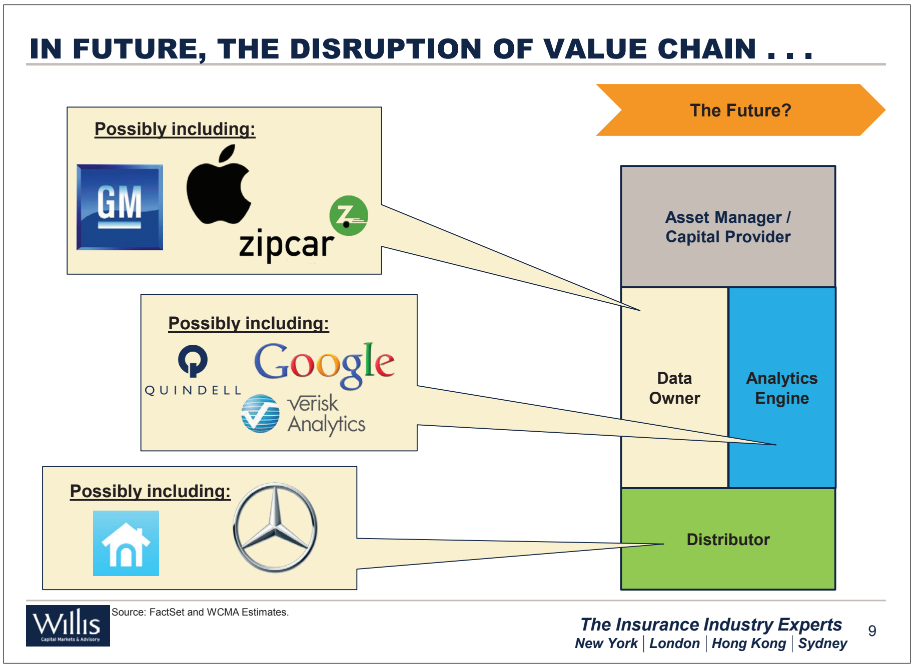
Drivers in future

Figures 2 and 3 below illustrate the insurance sector's value chain—past, present and what the future might look like. There has been some disruption to the value chain already. Aggregators and direct writers have taken share away from traditional distributors. And alternative capital has crowded out traditional reinsurance capital, particularly in the nat cat space. These disruptions have, as we argued above, already generated M&A activity. There have been some direct distribution-motivated transactions, such as Zurich buying 20th Century Insurance Company. And there's the Catco/Markel transaction.

But the disruption of the value chain to date is nothing compared to what disruptive technology could bring. Going forward, you could have an entirely new way of slicing the value chain, and firms outside the traditional insurance sector could occupy much of the prime real estate. Take personal auto, for example. The 'distributor' could be the car manufacturer that has installed the black box telematics device. The data owner could again be a car manufacturer. Or, if it's a smartphone collecting the data, it could be a firm like Apple. And the analytics engine could be provided by Google, or you have specialists like Verisk. Also, much of the value chain going forward, rather than being about loss compensation, could be about risk mitigation. If you can install sensors in the home that detect and mitigate the loss from burst water pipes, that should reduce loss costs, but maybe some of that benefit will be shared and the consumer will be willing to pay for risk mitigation. Who knows, perhaps insurance agents in the future will make some of their money selling Nest thermostats. The point is, maybe today's insurers can occupy this prime real estate, but it will require some morphing.

Figures 2 and 3





To address this, insurers have already made a few technology-driven acquisitions, for example Generali's acquisition of MyDrive. But the key word here is few. Over the past four years we count just under 40 transactions that had something to do with technology that could be applied in the insurance sector. Insurance buyers numbered less than five. Private equity has been a much more active buyer, as have other value-chain adjacent buyers such as TomTom and Verizon. Surely, we ask, with so much to play for and with the leverage that such an acquisition could provide to a large global insurer, shouldn't insurers be more active buyers?

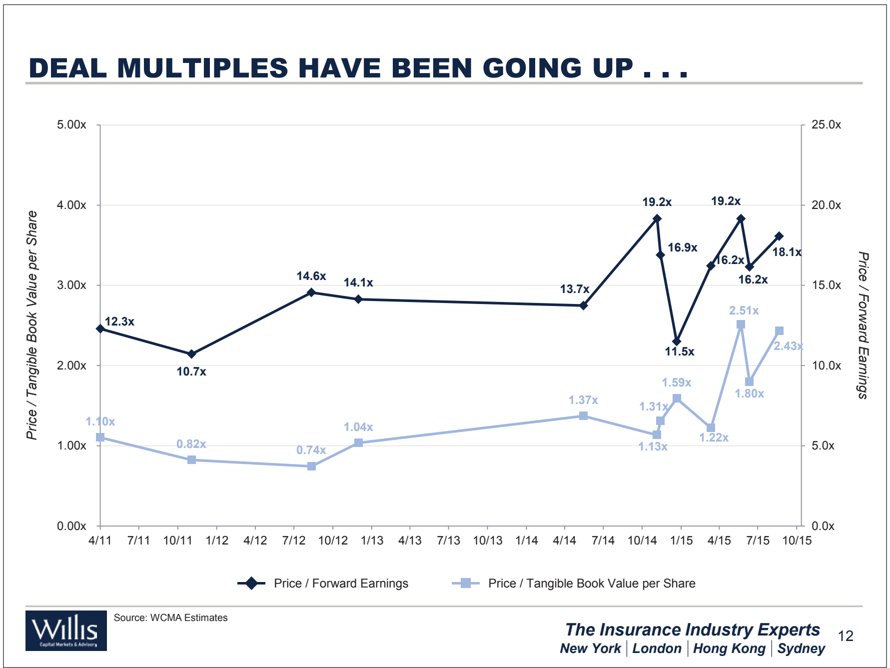
A final point on value chain disruption and future M&A: if disruptive technology works and claim costs fall, this could drive more traditional M&A. Shrinking premium income could encourage acquisitive growth. And shrinking capital requirements could produce ample funding ability.

Does M&A create value?

We'll take a step back in a moment and try to answer this with a long-term perspective. But first, let's look at recent deals. We've analysed 12 deals from the past four years where a public company has bought another public company—i.e. you have a good view of the financials. You've got all the big 2015 deals, for example, from XL/Catlin at the start of the year to MSI/Amlin which was announced in September. You can see from Figure 4 below that deal multiples have been going up, whether you look at price/tangible book value or forward earnings. Over 2011–2012, deals were being transacted at about 1x TBV (tangible book value). Now, with few exceptions we're looking at 2x or higher. MSI/Amlin has caught a lot of attention with its 2.4x multiple.

On its own, Figure 4 doesn't precisely answer the question about value creation. Maybe a lot of value was being created with the 2011–2012 deals, and you're still getting some value creation today. Or maybe better companies are being bought today. But certainly a priori it makes you think that value creation must be a lot harder today. And if you think about what's going on in the current difficult operating environment, it's a bit counter-intuitive to think that returns on equity (ROEs) and earnings quality are better today than in 2011–2012.

Figure 4

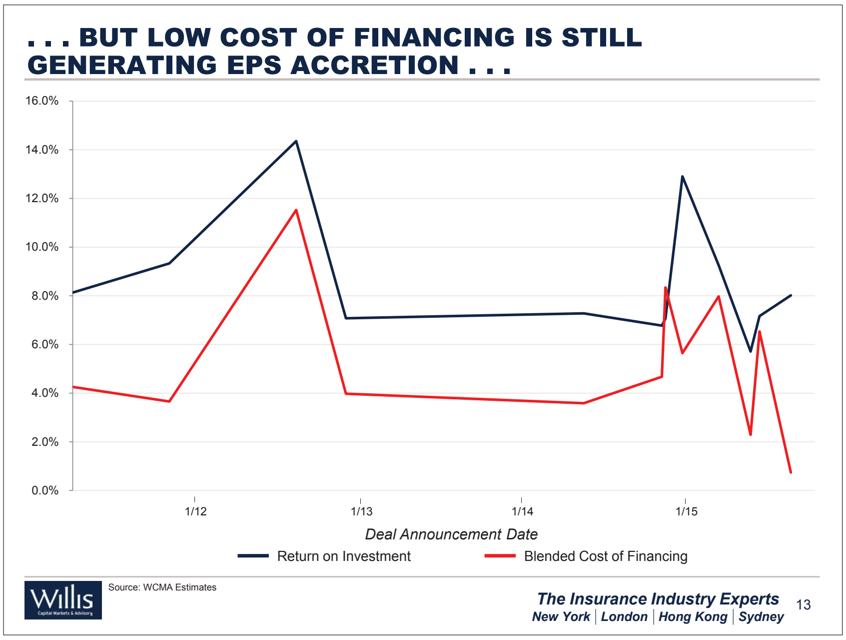


Now, in our opinion, the most important metric you should look at in considering whether an acquisition makes financial sense is the return on investment (or internal rate of return). You then need to independently consider your cost of financing. It's the two together, though, that determine whether a deal is accretive to earnings per share (EPS). And a low return on investment (ROI) deal can still appear accretive to EPS if it's financed inexpensively.

In Figure 5 we see that financing costs have come down: debt costs have come down; if using cash in hand, the yield on that foregone cash has come down; and the 'cost of equity' has come down as price–earnings ratios (PEs) have gone up. This low cost of financing means that most deals have indeed been EPS-accretive.

But our point is that you shouldn't necessarily infer that value is being created. ROIs themselves are running at about 7–8 per cent. We suggest that this is roughly break-even based on hurdle rate costs of capital.

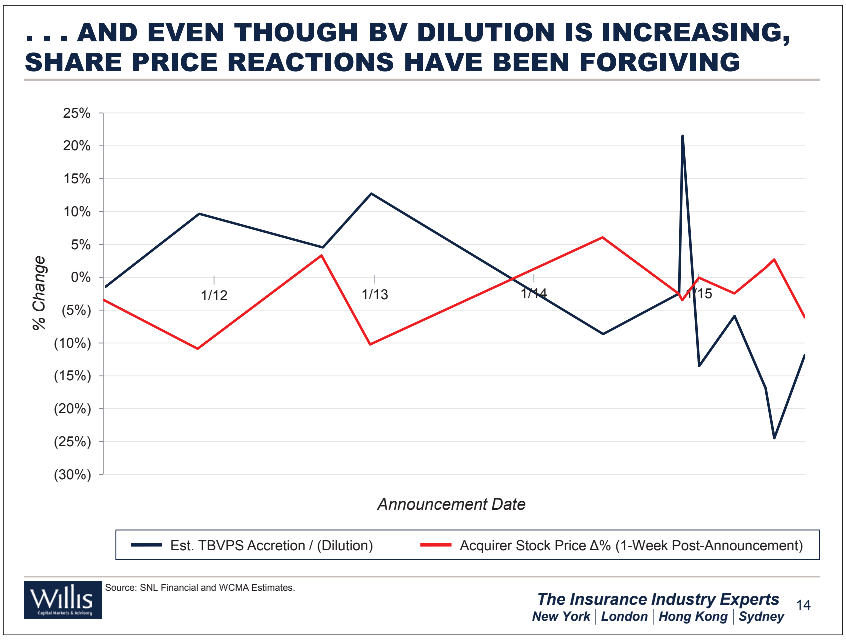
Figure 5



Immediate stock market reactions are not really a good indicator of whether M&A actually creates value in the long term. The typical stock market reaction with respect to the acquirer is often to shoot first and ask questions later. And immediate stock price moves may also reflect technical factors. If the deal is equity financed that means an increase in the supply of stock.

The problem is: how do you measure long-term success? To address this, we've looked at the longer-term share price performance of acquirers—going out three years from the announcement date of the acquisition. It's not particularly scientific—but is hopefully thought-provoking nonetheless. We looked at 25 deals done over the past 20 years in the global insurance sector where the deal size was at least USD 1bn and it represented at least 20 per cent of the acquirer's market cap. We then looked at how the acquiring company's shares performed relative to its local index—for example ACE relative to the S&P 500. We looked at this over the 30 days, 90 days and so on up to 3 years (or 1080 days) after a deal's announcement.

Figure 6



The results shown in Figure 6 indicate that, on average, insurers have performed in-line following large acquisitions. They don't support the consensus view that about two thirds of all M&A destroys value.[2] The bottom line is that maybe, over the long run, a higher proportion of deals actually do create value. It's all down to execution, of course.

Conclusions

We draw the following conclusions. Regarding the what and why questions:

- The current hump of M&A activity has not yet run its course. We will see more scale and new money deals, in particular.
- Disruption of the value chain will be a driver of future M&A—and as to whether or not M&A creates value.
- Deal multiples have been increasing, which raises the bar for value creation.
- The EPS impact of current M&A is being softened by cheap financing, but higher multiples are driving up book value dilution.
- Still, the short-term perception of value creation (i.e. immediate share price reactions) has become more forgiving.
- And the traditional view that M&A destroys value is not supported by longer-term share performance.

Finally:

- Investment bankers need to be industry experts. Now, more than ever, the ability to be a trusted advisor is essential.

2 There are a lot of caveats to this work—chiefly that other factors may be driving the share price other than the acquisition. The deal could be as small as 20 per cent of the company. Or maybe it's the case that good companies are acquisitive—so they outperform for other reasons too.