MERGERS AND ACQUISITIONS IN INSURANCE INDUSTRY

By Jangaiah Paladi, Faculty Member, ICFAI

Akyam Srujan, Faculty Member, ICFAI

The global M&A scenario is witnessing new highs in terms of value and volume of completed activity. By the end of 2005, world over 24,806 M&A deals worth a combined value of US$2,059 billion were concluded. A significant rise in the number of deals has been recorded in recent times.

According to a KPMG media release[1], the Americas and EMEA (Europe, Middle East and Africa) still attracted the lion's share of deal-doing in 2005; the Asia Pacific is experiencing the largest growth in targeted M&A – up 39 percent by value and 50 percent by volume in the last one year. During 2005, the region recorded 6,921 deals valued at US$370 billion, which is said to be the highest activity levels ever logged for the Asia Pacific.

M&A deals in insurance sector have again gained momentum in 2005, and by September 2005, 191 deals valued at US$ 32,688 million have been recorded. Though the numbers of deals are lower compared to the previous year, the value of the deals is more than double.

Annual Deal Volume in Insurance Sector					
	2001	2002	2003	2004	2005
All Insurance					
Number of Deals	300	277	282	301	191
Aggregate Deal Value ($M)	65,212.0	9,271.2	59,669.1	14,182.2	32,688.0
Property & Casualty					
Number of Deals	55	42	50	22	34
Aggregate Deal Value ($M)	2,319.8	429.0	22,474.7	507.1	2,853.0
Life & Health					
Number of Deals	40	20	27	23	13
Aggregate Deal Value ($M)	58,554.1	2,718.0	14,124.3	3,455.5	14,084.5
Managed Care					
Number of Deals	13	13	10	17	9
Aggregate Deal Value ($M)	3,188.4	4,843.6	21,848.2	8,800.9	14,797.0
Broker & Agency					
Number of Deals	192	202	195	239	135
Aggregate Deal Value ($M)	1,149.7	1,280.6	1,221.9	1,418.7	953.5
Property & Casualty includes Multiline, Title, Financial Guaranty and Mortgage Guaranty. Whole deals only. Asset sales are not included. Data as of 9/30/2005					

Source: The SNL DataSource

---

[1] http://www.kpmg.ca/en/news/pr20051212.html

What are the forces that drive M&A activity in general and in insurance sector in particular?

According to J. Fred Weston, there are seven change forces[2] that are inducing more and more competition in the markets. It is becoming increasingly difficult for managers of to create value that would continue to delight the shareholders.

In a dynamic global market environment, growth opportunities and challenges come in various shapes and sizes, which need to be dealt innovative approaches. In order to meet the expectations of financial stakeholders and other market participants, managers have been reorienting their strategies. These strategies are considered opportunities for growth both internally and externally.

Traditionally, managers had concentrated on organic (internal) business growth. As a result, most of the corporate growth was achieved by internal expansion. As the organic growth model takes a narrow perspective of the opportunities, organizations could not grow to their full potential. But, the changing market forces have necessitated the organizations to identify their competitive advantage so that they can reposition themselves to exploit the opportunities globally.

Organizations that did not identify their competitive advantage were subjected to undervaluation and thus remained vulnerable to someone's (a competitor, supplier or customer) actions. "In the modern "winner takes all" economy, companies that fail to meet this challenge will face the certain loss of their independence, if not extinction"[3].

During the last century, managers have evolved some innovative strategic approaches to identify and leverage opportunities to create value. One such innovation in corporate world was *corporate restructuring*[4] (both operational and financial) or M&A[5]. While

---

[2] The Seven Change Forces

1. Technological change
2. Globalization and freer trade
3. Deregulation
4. Economies of scale, scope, complementarity, need to catch up technologically
5. Changes in industry organization
6. Individual entrepreneurship
7. Rising stock prices, low interest rates, strong economic growth

In a presentation by J. Fred Weston, Professor Emeritus Recalled, The Anderson School at UCLA, at The Martindale Center for the Study of Private Enterprise Lehigh University, April 27, 1999.

[3] Corporate Restructuring, Mergers, and Acquisitions: Creating Value in Turbulent Times at http://www.exed.hbs.edu/programs/crma/

[4] "Corporate restructuring is defined by Hoskisson and Turk (1990) as a major change in the composition of a firm's assets combined with a major change in its corporate strategy. It usually involves selling off (or liquidating) businesses in M-Form firms, either voluntarily through spin-offs or involuntarily through hostile takeovers. Restructuring also can occur once a leveraged buyout (LBO) of a firm has been completed. Thus, restructuring is viewed by Hoskisson and Turk (1990) as more than the simple divestiture of a single business unit." At http://oase.uci.kun.nl/~furrer/CS03/DefinitionsCS.htm .

operational restructuring refers to outright or partial purchase or sale of companies or product lines or downsizing by closing unprofitable and non-strategic facilities, financial restructuring refers to the actions taken by a firm to change its total debt and equity structure. In general, actions taken to expand or contract a firm's basic operations or fundamentally change its asset or financial structure are referred to as corporate restructuring activities.

Economic history has witnessed very high levels of merger activities since 1883. The period is marked by several cyclical movements in merger activities, which are known as merger waves. It would be relevant in this context to have an overview of each of these waves.

First Wave

The first merger wave occurred soon after the depression of 1883. The merger activity began in 1897, peaked between 1898 and 1902, and ended in 1904. The merger activity during this period had the greatest impact on eight industries viz. primary metals, bituminous coal, food products, chemicals, machinery, transportation equipment, petroleum and fabricated metal products. These industries accounted for almost two-thirds of the total mergers during this period.

The mergers in the first wave were predominantly horizontal combinations, which led to creation of large monopolies. For example, US Steel founded by J P Morgan merged with Carnegie Steel founded by Andrew Carnegie. The merged firm US Steel also acquired several other smaller steel producers and the resulting giant captured 75% of the US steel market.

The stock market crash of 1904 and the panic in banking industry in 1907 ended the era of easy availability of finance, a basic ingredient for takeovers, resulting in the halting of the first wave. Anti-trust legislation, which was hitherto lax, became more rigorous and large monopolies were targeted. For example, Standard Oil was broken into 30 companies. Some of the current corporate leaders like General Electric (GE), Du Pont, Eastman Kodak, Navistar International are products of the first wave.

Second Wave

The second wave of mergers took place between 1916 and 1929. Post World War I boom in the American economy and a buoyant capital market were the drivers for the second wave. The innovations in the forms of merger resulted in the emergence of oligopolistic industrial structures.

The stricter antitrust environment resulted in several vertical mergers, wherein firms involved did not produce the same product but had similar product lines. For example, Ford Motors became a vertically integrated company. It manufactured its own tyres for the cars from the rubber produced from its own plantations in Brazil. Further, the bodies for the car were made from the steel produced from its own steel plants. The steel plant in turn got iron ore from Ford's own mines and shipped on its own railroad. Several

---

[5] Mergers and Acquisitions (M&As) is a generic term used to represent different types of corporate restructuring exercises.

companies in unrelated businesses were also involved in mergers resulting in the formation of conglomerates. The industries which witnessed high merger activities were food products, chemicals, primary metals, petroleum and transportation equipment.

The second merger wave came to an end with the stock market crash of 29^{th} October, 1929, and the great depression. The crash resulted in a loss of business confidence, curtailed spending and investment, thereby worsening the depression. General Motors, International Business Machines (IBM), Union Carbide and John Deere emerged during this era.

Third Wave

The third merger wave, which occurred during 1965 to 1969, is marked by a high level of merger activity in the backdrop of a booming American economy. This period witnessed a new trend, wherein smaller companies acquired larger ones. In the earlier periods, the trend was opposite.

A large proportion of transactions that took place during this wave were conglomerate transactions. The conglomerates formed during this period were highly diversified and simultaneously operated in several unrelated industries. For example, during the sixties ITT acquired such diversified businesses like car rental firms, bakeries, consumer credit agencies luxury hotels, airport parking firms, construction firms, restaurant chains, etc.

Fourth Wave

The period between 1981 and 1989 witnessed the fourth wave of mergers. In this wave M&A activity spread across the globe, there was an active participation from the European and Japanese firms. This period was marked by hostile takeovers and the emergence of professional corporate raiders and arbitragers. This wave can be distinguished from the earlier ones in terms of size and prominence of the target firms. Some of the largest firms in the world (Fortune 500 firms) became the target of acquisitions; as such the average deal size was substantially higher.

The raider makes his profit by his takeover attempts, that is, without taking control of the management of the target firm. Hence, many takeover attempts were designed to sell the shares purchased by the raider at a higher price.

The use of debt to finance acquisitions reached unprecedented proportions during this wave. The ready availability of debt financing enabled even small firms to acquire large well established blue chip firms. This phenomenon is also known as leveraged buyouts (LBOs).

During this period, investment bankers played an aggressive role. M&A advisory services became a lucrative source of income for investment banks. Merger specialists in investment banks and law firms developed many techniques to facilitate or prevent takeovers. They pitched in for mandates from both potential targets and potential acquirers for hiring their services to prevent or bring about takeovers.

Fifth Wave

The fifth and current wave of merger begun in 1992 in the backdrop of deregulation and globalization of financial markets, and it is marked by mega-mergers and cross-border mergers.

Privatisation has thrown up opportunities for acquisition of erstwhile public sector firms and globalization has led to dissipation of geographical barriers. Countries across the world (including India) have facilitated the flow of foreign investment. Foreign firms often resort to a major acquisition in the local market as an entry strategy. Further with the reduction in the barriers to international trade, as a consequence of the setting up of the WTO, firms have to be globally competitive in order to survive in the new economy. The emergence of internet and the intelligent application of information technology have resulted in a paradigm shift in the operations of firms. The sectors where the impact of the fifth wave is most visible are telecommunications, entertainment and media, banking and financial services.

Due to deregulation, globalization and technology banking, financial services and insurance sectors have become the favorites of the M&A game. For example, the new Citigroup which is a result of the merger of Citibank and Travelers Group has emerged as a giant financial entity straddling the entire range of financial services including corporate banking, retail banking, investment banking, insurance, credit cards, etc.

Globalization led to geographical coverage across countries and internationalization of operations. This has resulted in a wave of cross border M&As, like the acquisitions of the English firm Rothschild by the Dutch ABN Amro Bank, the investment banking operations of the British firm Schroders by the American Salomon Smith Barney, the American brokerage firm Dillon Read by the erstwhile Swiss Bank SBC (now merged into UBS), the American bank Bankers Trust by the German Deutsche Bank, etc. Technology in general and the emergence of internet in particular is revolutionizing the delivery of financial services. Financial services are increasingly being delivered online and at competitive rates.

In the Indian context, the number of mergers is relatively smaller. Some of the prominent transactions are the merger of New Bank of India with Punjab National Bank in 1993, SCICI with ICICI in 1995 and Times Bank with HDFC Bank in 1999. The investment banking industry witnessed the merger of JM Finance with Morgan Stanley’s Indian Operations to form JM Morgan Stanley. The liberalization of insurance sector in India has paved the way for several foreign players to have stake in Indian insurance companies.

M&A: Different Forms

M&A can take place in different forms, depending upon the strategies of and agreement between the parties involved. Given below are some of the forms of M&A forms commonly employed by firms to expand their business.

- Consolidation/Amalgamation: It is a form of business combination caused by the fusion of two or more firms, resulting in the formation of a new firm. In this combination, all the firms involved loose their individual identity. This form is generally applied in combinations of firms of equal size.

- Merger/Absorption: The term `merger' is often abused, by being loosely applied to refer to any form of business combinations. It has however got a specific connotation. A merger refers to a business combination of two or more firms in which only one firm survives and the other firm(s) cease to exist. In a merger, the surviving firm acquires the assets and liabilities of the other firm(s). A merger takes place when the firms involved in the combination are of unequal size. The larger/stronger firm continues to exist because of its stronger bargaining power and the samller/weaker firms go out of existense.

- Takeover: Takeover refers to the process of acquiring control in the management of a firm by acquiring a substantial portion of its equity. After a takeover, the individual firms continue to exist but under a new management. A takeover may be a prelude to full fledged merger or consolidation.

- Asset Purchase: This is the simplest form of business combination from the legal point of view. In this case, the acquirer buys out a division or an asset of the firm. Both the firms continue to exist but there is a transfer of the business or the asset.

Given below are some of the M&A forms commonly employed by firms to reduce their size.

- Sell-offs: Sell-offs involve sale of assets or business entities. The assets may be tangible like manufacturing unit, product line etc. or intangible assets like brand, distribution network, etc. Sometimes the business entity as a whole may be sold to a third party. The reasons for Sell-offs are varied.

- Spin-off: Spin-off has emerged as a popular form of corporate downsizing in the nineties. A new legal entity is created to takeover the operations of a particular division or unit of the company. The shares of the new unit is distributed pro rata among the existing shareholders. In other words, the share-holding in the new company at the time of spin-off will miror the shareholding of the parent company. The shares of the new company are listed and traded seperately on the stock exchanges, thus providing an exit route for the investors. Spin-off does not result in cash inflow to the parent company.

- Split-off: In a split-off, a new company is created to takeover the operations of an existing division or unit. A portion of the shares of the parent company are exchanged for the shares of the new company. In other words, a section of the shareholders will be alloted shares in the new company by redeeming their existing shares. The logic of split-off is that the equity base of the parent company should be reduced reflecting the downsizing of the firm. Hence the share-holding of the new entity does not reflect the share-holding of the parent firm. Just as in spin-off, a split-off does not result in any cash inflow to the parent company.

- Split-up: A split-up results in the complete break up of a company into two or more new companies. All the division or units are converted into separate companies and the parent firm ceases to exist. The shares of the new companies are distributed among the existing shareholders of the firm.

- Equity Carveouts: An equity carveout involves conversion of an existing division or unit into a wholly owned subsidiary. A part of the stake in this subsidiary is sold to outsiders. The parent company may or may not retain controlling stake in the new entity. The shares of the subsidiary are listed and traded seperately on the stock exchange. Equity carveouts result in a positive cash flow to the parent company. An equity carveout is different from spin-off because of the induction of outsiders as new shareholders in the firm. Secondly equity carveouts require higher levels of disclosure and are more expensive to implement.
- Divestitures: Divestitures involve outright sale of a portion of the firm to outsiders. The portion sold may be a division, unit, business or assets of the firm. The firm receives purchase consideration in the form of cash, securities or a combination of the two. The divestiture is the simplest form of sell-off.

The Swiss Re and CNA deals indicate a combination of almost all facets of M&A, like spin-off, divestiture, merger, acquisition and run-off[6].

Reasons for M&As

Today the organizations do not depend on internal growth alone. Growth and diversification is achieved both internally and externally. Internal growth and external growth (through mergers and acquisitions) are not considered to be mutually exclusive; they support and reinforce each other. Sometimes internal growth is more advantageous, and at other times external growth is more suitable. Organizations that want to grow faster use various forms of M&As based on the opportunities available to them under the given constraints. The characteristics and competitive structure of an industry will influence the strategies employed.

The factors which support the external growth and diversification through mergers and acquisitions include the following:

- Growth: Firms that desire to expand have to choose between two generic growth strategies: organic growth or acquisitions driven (inorganic) growth. While organic growth is a slow, steady process and very often a function of time factor, acquisitions led growth is an aggressive strategy and is relatively riskier compared to an organic growth strategy. To meet stakeholders' growth expectations of shareholders Affinity Insurance Services Inc, Hatboro Pa, a unit of Aon Corp, Chicago, has acquired a division of JLT Services Corp, Latham, NY, that sells life insurance, health insurance and other products through a dozen large associations[7]. A similar experience can be expected from the Indian insurance sector also.

---

[6] K C Mishra, "Sooner or later, M&As will be the order in India, too", at http://www.dnaindia.com/report.asp?NewsID=1031525

[7] Ibid.

- Synergy: The concept of synergy is based on the principle that the whole is greater than the sum of its parts. Synergy is the ability of a business combination to be more profitable than the sum of the profits of the individual firms when combined. The synergy may be in the form of revenue enhancement or cost reduction.
- Managerial Efficiency: Some of the acquisitions are motivated by the belief that the acquirer's management can better manage the target's resources. This hypothesis is based on the assumption that the two firms have different levels of managerial competence. The acquirer's management competence is superior to the target's. Hence the value of the target firm will rise under the management control of the acquirer.
- Market Entry: Firms often use acquisition as a strategy to enter into new market or a new territory. This gives them a ready platform on which they can further build their operations. A case in point is Tokio Marine & Nichido Fire Insurance Co. which plans to buy the full stake in Singapore-based insurance holding company, Asia General Holdings, by March 2007, which would expand the operations of the former company in the South East Asian market.
- Diversification: Firms indulge in diversification to overcome concentration risk. Firms which are excessively dependent on a single product are exposed to the risk of the market for that product. Diversification, having products with revenues that are non-correlated or inversely correlated, reduces such risk. However, diversification into unrelated products in which the firm has no competitive advantage should be avoided.
- Tax Shields: Tax shields play an important role particularly in acquisition of distressed firms. Firms in distress accumulate past losses and unclaimed depreciation benefits on their books. A profit making tax paying firm can derive benefit from these tax shields. They can reduce or eliminate their tax liability by benefiting from a merger with these firms.
- Strategic: The reasons for acquisition can be strategic in nature. The strategic factors may change from deal to deal. The two firms may be in complementary business interests and a merger may result in consolidating their position in the market. Another strategic reason can be to preempt a competitor from acquiring a particular firm.

Table A: Forms of Restructuring

Expansion
Mergers and Acquisitions
Tender offers
Asset acquisition
Joint ventures
Contraction
Spin offs

Split offs
Divestitures
Equity carve outs
Assets sale
Corporate Control
Anti takeover defenses
Share repurchases
Exchange offers
Proxy contests
Changes in Ownership Structures
Leveraged buyouts
Junk bonds
Going private
ESOPs and MLPs

The last century has witnessed, a number of organizations restructuring their assets, operations, and contractual relationships with their stakeholders. Today, many organizations are able to rediscover their competitive advantage, exploit the emerging opportunities and respond to unexpected challenges. As a result, business world has experienced several waves of M&A activity.

Being part of the financial industry, the insurance industry has always been involved in mergers and acquisitions (M&As). M&As are carried-out with a view to expand market share, increase profits and to gain synergies. They enable accomplishment of better economies of scale and let superior investment to renovate the available resources. A rise in M&As in the insurance sector has also led to a rise in the reinsurance business too. Following the big M&A deals in the life and nonlife insurance sectors, companies are using reinsurance tools to essentially handle their business inforce.

The M&A Process

Any M&A transaction begins with the owner's decision to sell the business and other companies looking to buy additional business. In insurance industry the actuary plays a key role in the decision to sell or buy a company or a block of business. The decision to sell/buy is a result of various options brought to light through a strategic planning process. An actuary who understands the interplay of all the forces in insurance operation should seek to play a key role in this planning process.

1. Search: The first step is to determine the universe of potential target companies. Information is gathered about these companies based on their published data, industry specific journals, databases, past prospectuses, etc. If the acquisition involves buying only a part of the target company, segmental data may be difficult to obtain. Information about private companies may not be readily available. Once the universe is determined, targets may be shortlisted based on certain parameters.
2. Approaching the Target: This is one of the most delicate part of the deal. There are broadly two methods of approaching targets.

3. Passive Strategy: This approach is based on the premise that a overwhelming majority of firms are not for sale and are unreceptive to queries. The acquirer is unwilling to persue any acquisition on an aggressive basis. In such an approach, the acquirer passively waits till the time a potential target is available for sale.

4. Active Strategy: This is a more pro-active approach by the acquirer. The active approach may be either friendly or hostile. In the friendly way, a private and confidential line of communication may be opened with the CEO, Director or the Investment Banker of the target company. It is also made clear that if the target company is not interested, no further action will be taken. In the hostile approach, the acquirer assumes the role of a raider and actually starts accumulating the shares of the target. This approach assumes that while the management may be averse to the takeover, the shareholders would be receptive to the offer. When shares are accumulated by the acquirer, it is financially beneficial even if it is outbid in a counter-offer.

5. Valuation: Valuation of the target company is the most critical part of a deal. A conservative valuation can result in collapse of the deal while an aggressive valuation may create perpetual problems for the acquiring company. The commonly used valuation methods are:

    a. Discounted Cash Flow Method: In this method, valuation represents the present value of the expected stream of future cash flow discounted for time and risk. This is the most valid methodology from the theoretical standpoint. However, it is very subjective due to the need for several assumptions during the computations.

    b. Comparable Companies Method: This method is based on the premise that companies in the same industry provide benchmark for valuation. In this method, the target company is valued vis-a-vis its competitors on several parameters.

    c. Book Value Method: This method attempts to discover the worth of the target company based on its Net Asset Value.

    d. Market Value Method: This method is used to value listed companies. The stock market quotations provide the basis to estimate the market capitalization of the company.

    Acquirers rarely depend on a single method for valuation. Normally the target companies are valued on various methods. Different weightages are assigned to the valuations computed by various methods. The weighted average valuation helps in eliminating the errors that may creep in, if a single method is relied on. In the context of insurance sector, some special techniques have been developed for the M&A activities. Basically the valuation of an insurance company is done in three phaes viz. valuation of surplus, valuation of existing business inforce, and valuation of future business potential.

6. Negotiation: This is the process of formulating the structure of the deal. The merchant banker plays a vital role in closing the financial side of the negotiations. From a financial standpoint, the key elements of negotiations are the price and the form of

consideration. Both the elements are interrelated and affect the attractiveness of the deal. The acquirer must ensure that the final price paid should not exceed the perceived value of the target to the acquirer.

7. Due Diligence: The basic function of due diligence is to assess the benefits and the costs of a proposed acqusition by inquiring into all relevant aspects of the past, present and the predictable future of a business to be purchased. Due Diligence is of vital importance to prevent “unpleasant surprises” after completing the acquisition. The due diligence should be thorough and extensive. The Due Diligence exercise is carried out by a team of executives from the acquirer, their Investment Bankers, Solicitors and Chartered Accountants. The team should have members with experience in all dimensions of the business like finance, marketing, human resources, operations, legal, etc. The exercise should cover all material factors which are likely to affect the future of the business. Due Diligence exercise covers careful study of information in public domain like financial statements, corporate records like minutes of meetings, past prospectuses, share price movements, etc. All contracts entered into by the firm with lenders, suppliers, customers, franchisees, lease agreements, asset purchases agreements, etc. need to be carefully studied. Special attention should be given to litigations, contingent liabilities, environmental disputes, liens & encumberances, product warranties, inter-company transactions, tax disputes, etc.

8. Acquisition Finance: Acquisitions may be paid for in several ways: all cash, all securities or a combination of cash and securities. The securities offered may be equity, preference shares or debentures. Further the debentures and preference shares may be convertible. The cash may be raised from internal accruals, sale of assets, etc. It may also be financed by bank borrowings, public issue or private placement of debt and equity shares. As timing is a critical factor in such deals, the investment banker involved often gives/arranges for a bridge loan against subsequent refinancing.

Seller/Buyer Fit[8]

Various sales situations dictate the type of fit that a seller and buyer must have to close the transaction. Some of the circumstances that lead to a proper fit are the following:

- The business is profitable, but it is a non-core business to the seller and a core business for the buyer.
- The segment is good intrinsically (e.g. profitable loss ratios), but the seller’s administrative and marketing costs are too high which the buyer can control those costs or his profit objective is lower than the seller.
- The segment is posting operating results primarily due to poor management of the business by the seller, which the buyer will be able to improve.
- The reputation of the seller is such that corrective actions cannot be taken, such as rate increases or selective termination action.

---

[8] James T. O’Connor, “The Actuary and Health Insurance Mergers and Acquisitions” The Society of Actuaries.

- For some types of business, a win-win transaction can occur due to a reserve lock-in situation in which the seller has conservative active life reserves.

M&A in Insurance

Usually the existing mature insurance players/markets haunt to enhance their growth potential by way of expansion in the developing and under developed markets. M&As are seen as trouble free way of expansion and growth. Slow down in the growth of their core business operations, and cheaper availability of both equity and debt capital, motivate the companies in the developed countries to look for expansion in developing markets.

Largest Insurance Deals 2005 (Ranked by Deal Value)					
	Buyer	Target	Sector	Announce Date	Deal Value ($M)
1	MetLife Inc.	Travelers Life & Annuity Co./CitiInsurance International Hldgs.	Life & Health	01/31/05	11,500.0
2	UnitedHealth Group Inc.	PacifiCare Health Systems Inc.	Managed Care	07/06/05	7,996.5
3	Lincoln National Corp.	Jefferson-Pilot Corp.	Life & Health	10/09/05	7,556.3
4	Swiss Reinsurance Co.	P&C business of GE Insurance Solutions Corp.	Property & Casualty	11/18/05	6,800.0
5	WellPoint Inc.	WellChoice Inc.	Managed Care	09/27/05	6,618.4
Data as of 01/03/06					

Source: The SNL DataSource

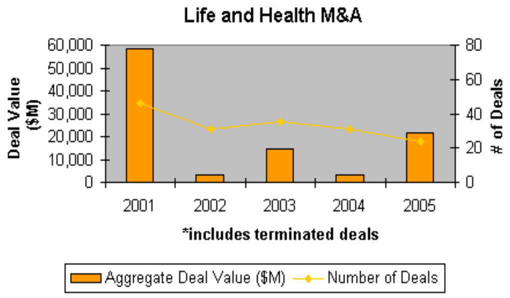
On M&A, the newly formed company often has an improved investment management capability and can offer a strong line-up of products. It may have extended research activities and dynamic investment management abilities.

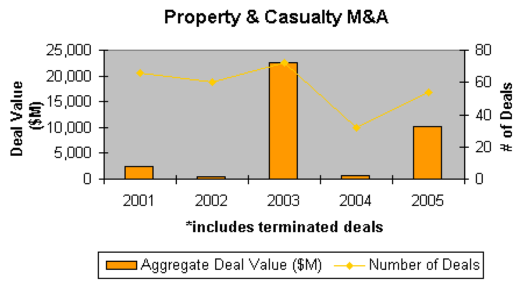
M&A is also undertaken to leverage current operating and asset management capacities. Another reason would be cost saving benefits, as M&A brings down the per-policy expense rates through enhancing critical mass and getting rid of uncalled-for operations. M&As also augment the competencies of the company as well as its products portfolio.

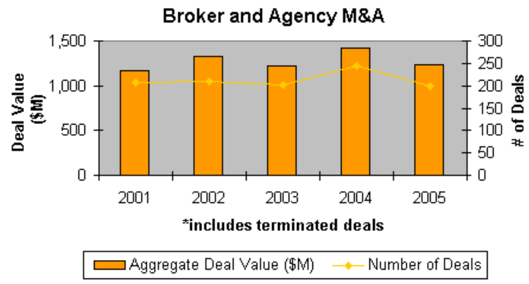
A significant reason for M&As in the insurance sector is cross-selling of complementary products to the customers of one another by identifying companies with matching insurance products. In the era of growing consumer demands, the insurance company with more variety of products and services, definitely has an upper edge over others.

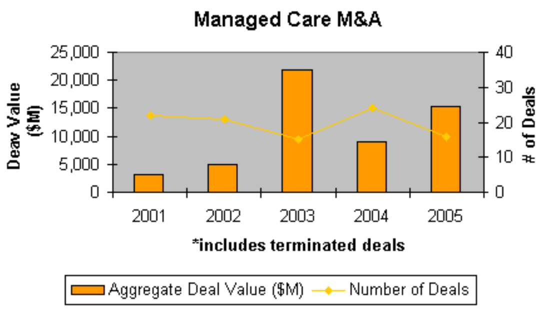
M&A in insurance industry has emerged as an important activity of late, and this fact is no secret. The insurance industry is on boundless consolidation phase. To name some of the most successful companies in M&A activities are American General, GE, ING and Aegon. However not every merger or acquisition is successful, some failures are also seen in this arena. UNUM Provident, PennCorp Financial, and Conseco are some of the companies that have failed.

During the nineties, the M&A activity in insurance sector was on a roller coaster. The period observed a wave of cross-border mergers and acquisitions in the global insurance markets, especially in the United States and European insurance markets. Though took off in the early nineties, it was only after 1996 that record number in volume and size was witnessed in M&As. The year 1998 is described by renowned financial magazines like Fortune and Economist, as the 'year of mega mergers' in the history of the insurance industry.









Source: The SNL DataSource

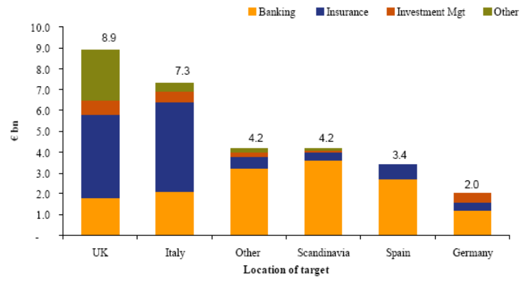
M&A in United States Insurance Market

In the year 2001, there was a down fall in the M&A activity, according to a report published by the Conning & Co[9]. As per the report, the total number of transactions declined by about 37 percent - from 468 in 1999 to 293 in 2000, and the number of transactions declined significantly in all sectors in 2000, from a 16% decrease in property-casualty to a 68% decrease in the services sector.

---

[9] Conning & Co titled "Mergers and Acquisitions and Public Equity Offerings" 2001

In the year 2004, there has been an enormous rise in the M&A activity in the insurance sector, but the total value of transactions has declined. As per Conning's Study[10] most of the deals took place in the health insurance and the insurance distribution sector. The study also found absence of mega mergers deals of $10 billion or more, and in any of the sector the value of transactions was under $15 billion, which is the lowest in past ten years.



Source: 2003: M&A deals by sub sector, at 31stAnnual GIRO Convention, Ireland

M&A in European Insurance Market

The European insurance sector noticed significant M&A activity in the early nineties, due to European Union's deregulation standards adopted to create a single market for financial services. Their research also found that on the whole, there were around 2,595 deals from the year 1990 to 2002. M&As in year 1996 set a new record in terms of volume and size, with total reported deals rising to 380 from 349 in the year 1995, correspondingly the volume jumped to $41 billion from $27 billion in the year 1995.

In the year 2004, the M&As touched a four-year high in the European insurance sector as per the data compiled by Bloomberg . It added that the total value of announced takeovers relating to European insurance sector has almost doubled to $25.4 billion and is highest since 2001.

Insurance and Bank M&As

The financial services industry is witnessing a major transformation, with the banks and the insurance companies getting merged to obtain the synergies. Both banks and insurance companies have traditionally been catering to the same customer for long periods. A merger of a bank with an insurance company would although not eliminate competition drastically, the advantages due to cut down on costs, economies of scale, and growth potential cannot be ignored.

There are mixed experiences on the bank and insurance mergers. The European experience on bank and insurance M&As has always been positive. However the same is not the case with the US. A report published by the Conning & Co[11], states that the union of the banks and insurance companies also did not give encouraging results as expected.

.

[10] Conning Research Study "Mergers & Acquisitions and Public Equity Offerings-2005 Edition"

[11] Conning & Co titled "Mergers and Acquisitions and Public Equity Offerings" 2001

Leading European Bank-insurance Mergers and Acquisitions

Dominant banks	Insurance partners	Country	Size*	Subsequent sales
KBC (Kredietbank & CERA)	ABB	Belgium	233	
Dexia	DVV Insurance	Belgium	368	
Rabobank	Interpolis	Netherlands	393	
SNS	Reaal	Netherlands	37	
SEB	Trygg-Hansa	Sweden	141	Trygg-Hansa non-life (sold to Codan)
Handelsbanken	SPP	Sweden	144	
Danske Bank	Danica	Denmark	247	Danica non-life (to TopDanmark)
Nordea (Unidanmark) Nordea (CBK)	Tryg Baltica Vesta	Denmark Norway	67 26	Tryg Baltica & Vesta non-life (to Tryg Baltica foundation)
Sparebanken NOR	Gjensidige	Norway	36	Gjensidige non-life not included
DnB	Vital	Norway	55	
DnB	Storebrand	Norway	55	Failed acquisition attempt
Credit Suisse	Winterthur	Switzerland	689	
Deutsche Bank	Deutscher Herold	Germany	795	Deutscher Herold (to Zurich)
Lloyds Bank Lloyds TSB	Abbey Life Scottish Widows	UK UK	334‡	Abbey Life salesforce (to Allied Dunbar)
Abbey National	Scottish Mutual Scottish Provident	UK UK	284	
Halifax	Clerical Medical	UK	512‡	
NatWest	Legal & General	UK	649‡	Failed acquisition attempt

Dominant insurers	Bank partners	Country	Size*	Subsequent sales
Fortis (Groupe AG) Fortis (Amev)	ASLK-CGER Generale Bank VSB	Belgium Belgium Netherlands	404 404‡	
ING (Nationale-Nederlanden)	NMB Postbank	Netherlands	500	
Sampo	Leonia	Finland	19†	Non-life business (sold to If)
Swiss Life	Banca del Gottardo	Switzerland	9†	currently attempting to sell Gottardo
Allianz	Dresdner Bank	Germany	434	
AMB	BfG	Germany	29†	BfG (to Crédit Lyonnais)
GAN	CIC	France	–	CIC (to Crédit Mutuel)
Axa (UAP)	Banque Worms	France	5†	Banque Worms (to Deutsche Bank)
Axa	Banque Directe	France	–	
Irish Life	Irish Permanent	Ireland	36	

Note: former names are shown in brackets

‡ now part of larger group whose assets are shown

* total assets, US$ billion at end 2002 (source: *The Banker*)   † bank assets only

Regulation of Takeovers in India

In theory, the acquirer needs to get hold of 51% stake to obtain control over the management. In practice, takeovers have been carried out by acquiring a smaller stake between 15% to 50%. A takeover can be either friendly or hostile. A friendly takeover is one which is carried out with the consent and support of the existing management. In a friendly takeover, very often, the Board of the target company recommends to the shareholders to accept the offer and tender their shares. For example, the takeover of Indian Aluminium Company (Indal) by the Kumarmangalam Birla group. Alcan of Canada which held 53% stake in Indal decided to exit for strategic reasons. They voluntarily sold their stake to the Birla group. The Birla group has acquired Indal in a friendly takeover. On the other hand, a hostile takeover is one where the acquirer attempts to get control over the company in spite of the opposition from the existing management. One of the earliest cases of hostile acquisition in India was the hostile takeover of Shaw Wallace by Manu Chabria in 1987. The then existing management led by S P Acharya had strongly but unsuccessfully opposed the takeover of the company.

It is a common misconception that regulation of takeover means prevention of hostile takeovers. Such regulations, if formulated, would be a travesty of the principles of law and justice. It would also militate against the basis of a free market economy. The purpose of takeover regulations is, therefore, not discouraging takeovers but in ensuring fairness, transparency and protection of minority interests. Some of the salient features of the Takeover Code of India are:

- The acquirer should intimate the target company and the stock exchanges where the shares are listed as soon as its holding cross 5% of the voting capital of the target company;
- As soon as the holding of the acquirer cross 15% of the voting capital, it should intimate the same to the stock exchanges. The acquirer is also required to make a public offer to the shareholders to acquire a minimum of another 20% of the voting capital.
- The public offer should be priced at higher of the following:
    - the highest price paid by the acquirer to acquire shares in the target company;
    - the higher of the average price (average of the daily high and low) prevailing in the market for the last six months or the last two weeks.
- The public offer is required to be managed by a SEBI registered Merchant Banker, who exercises due diligence over the process and ensures full disclosure of all material facts;

Thus, it can be observed that the takeover code brings about transparency by ensuring disclosures. It also ensures protection of minority interests by giving the small shareholders an opportunity to exit from their investments. It achieves fairness by ensuring that the minority shareholders get at least the same value as those who transferred the controlling stake.

The Takeover Code has attracted a fair amount of criticism as well. Firstly, it has been criticized that the threshold limit of 15% is too low. It has been suggested that the limit should be raised to a “more reasonable” level of say 25% to 30%. Secondly, the criticism of the requirement to make a tender offer for 20%, appears to be more valid. The law in most other countries requires that the acquirer make a tender offer for the entire balance of the voting capital. This would provide an opportunity to all the shareholders to exit from their investment, if they so desire. However, the requirement to make a tender offer for only 20% of the voting capital may entail that shareholders are not given adequate opportunities to exit.

While M&A attempts in insurance sector are few in India, it may begin sooner than later. As Mishra[12] says “Not only will insurers try to acquire other insurers, part of their spin-off business, or part of their ownership capital by acquiring the JV partner, but there will also be consolidation and spin-off of activities in intermediary and support service segments. Run-off of some business of improperly managed companies will be a natural outcome of the de-tariff regime. The insurance order in India cannot be kept as a secluded island from the global business space”.

---

[12] K C Mishra, “Sooner or later, M&As will be the order in India, too”, at http://www.dnaindia.com/report.asp?NewsID=1031525

He feels that life assurance may re-emerge as the most powerful industry in financial services as life expectancy has increased, requiring those approaching retirement to put money into equities for long-term growth. However, the industry needs to be re-branded in order to realize its full potential. Life insurers have not done enough to promote the “fantastic benefits” of their products.

Failures in M&A

An M&A deal carried out only for the sake of making a deal, does not always give anticipated fruits on post merger. Cases where the initial investigations and financial analyses were not carried out properly, the possibility of unsatisfactory results of M&A is noticed in the past in the financial sector and insurance in particular. Hence issues like strategic rationale, growth potential, economies of scale, market niches of each company, profitability, strengths in terms of skills and capabilities, financial projections of the impact and value of the merger or acquisition, etc., need to be methodically thought-out and planned.

It is observed that in an M&A strategy, where much concentration is paid only on the stock price, and if the price is let to override, it could lead to failures. In companies like Conseco, much of attention was paid on the earnings for the forthcoming years, and a price which was much higher than the actual worth was paid, which lead to troubles later.

Clever adjustments in accounting principles can project positive earnings, whereby the acquisition would appear to be a cheaper one, but turns out to be loss making venture for the acquirer later on. Another factor which usually account for M&A failures is lack of financial due diligence, where the prices shoot up due to anxiety created about the impending M&A in the general public.

Hence the people (usually actuaries) who are involved in the M&A of insurance companies need to have expert knowledge, in addition to the fundamental skills. While advising a client to buy or sell an insurance company, they must carefully evaluate the reliability of reserves and pricing margins of the insurance company.

Unlike the other sectors, the M&A transactions in health insurance sector were primarily strategically driven rather than financially driven, with rational pricing and comparatively balanced supply of buyers and sellers. This sector is hitherto opined as not a best place to park the funds. The past results were bitter for many M&As with mediocre gains or substantial losses. Though there was a trend reversal in the early nineties, but with the rise in competition in the health sector, and sudden halt in the medical inflation has led to unbridled M&A activities. Whereas the opening of risk-based capital norms and rating activity has undeniably paved way for divestitures.

Conclusion

In the current scenario, where the world is becoming a global village, there is a need for larger insurance companies which can play a significant role in the global markets, especially in the emerging markets. Though, M&As are favored in the insurance sector, they are also criticized for the hampering the competition within the sector. However insurance companies should undertake M&As provided the financial sector is restructured to allow them to offer existing or enhanced services to the consumer sector with adequate level of competition within the sector.

Reference:

1. http://www.kpmg.ca/en/news/pr20051212.html
2. Corporate Restructuring, Mergers, and Acquisitions: Creating Value in Turbulent Times at http://www.exed.hbs.edu/programs/crma/
3. "Corporate restructuring is defined by Hoskisson and Turk (1990) as a major change in the composition of a firm's assets combined with a major change in its corporate strategy. It usually involves selling off (or liquidating) businesses in M-Form firms, either voluntarily through spin-offs or involuntarily through hostile takeovers. Restructuring also can occur once a leveraged buyout (LBO) of a firm has been completed. Thus, restructuring is viewed by Hoskisson and Turk (1990) as more than the simple divestiture of a single business unit." At http://oase.uci.kun.nl/~furrer/CS03/DefinitionsCS.htm .
4. K C Mishra, "Sooner or later, M&As will be the order in India, too", at http://www.dnaindia.com/report.asp?NewsID=1031525
5. James T. O'Connor, "The Actuary and Health Insurance Mergers and Acquisitions" The Society of Actuaries.
6. Conning & Co titled "Mergers and Acquisitions and Public Equity Offerings" 2001
7. Conning Research Study "Mergers & Acquisitions and Public Equity Offerings-2005 Edition"
8. Conning & Co titled "Mergers and Acquisitions and Public Equity Offerings" 2001
9. Kerem Cakirer, "Growth Strategy of a Firm via Mergers in Complementary Markets", The Icfai Journal of Mergers & Acquisitions, September, 2006
10. Jayshree Bose, "Bank Mergers in the US : The Road Ahead ", Professional Banker, August, 2006
11. Jayshree Bose, Cross-border Mergers in Europe : Poised for Growth?, Professional Banker, July, 2006
12. Avishek Sengupta, Sumit Kumar Chaudhuri, M&A Favorites: Cross-border Deals or Domestic Deals?, Effective Executive, June, 2006.

About the authors:

Prof. Jangaiah Paladi holds a Masters degree in Business Management (M B A) and a Masters degree in Commerce (M.Com) both from Osmania University. He majored in Finance and Cost Accounting. He completed his bachelor's degree in Commerce (B. Com) from Sri Venkateswara University. His Ph. D on derivative markets in India is in progress with Osmania University. He also holds a Post-graduate Diploma in Computer Applications (PGDCA) and is well versed in the use of information technology. He has a varied and rich experience in industry and academics spanning over 15 years. He began his career as a manager in a finance company. Currently he is with The ICFAI University as a Professor of Finance. He is also Consulting Editor of 'ICFAI Reader' (a monthly magazine focusing corporate finance), and has several articles, research papers, and case studies at his credit. Earlier he worked as General Manager (Projects) with Pragnya Software Systems Ltd, and as a Consultant and Associate Professor with Apollo Hospitals, Hyderabad. He was Assistant Professor of Finance with Vasavi Academy of Education prior to joining Apollo Hospitals. (Email-Id:jpaladi@icfai.org)

Prof. Akyam Srujan is an MBA-Finance, and Fellow Insurance Institute of India (FIII), working at Institute of Chartered Financial Analysts of India (ICFAI), Hyderabad, as Faculty Member for insurance programs, for over three years. He is also consulting editor for ICFAI Journal of Risk & Insurance, a quarterly refereed journal. Prior to ICFAI he served in LIC of India for six years. He is also pursuing actuarial studies. (Email-Id: srujan78@gmail.com)