Importance of due diligence in insurance M&A

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Despite the economic challenges posed by the COVID-19 pandemic, the first half of 2021 saw an increase in insurance mergers and acquisitions (M&A) activity, with 215 announced transactions.[1] There were 407 completed M&A deals worldwide in the (re)insurance sector over 2020, down from 419 in the previous year, with the number of deals in the second half of 2020 (206) slightly up from the first six months (201).

The number of deals in the Middle East and Africa saw the biggest percentage gains, up 167% to 32 completed deals, followed by the Asia Pacific, up 9% to 75 completed deals, and the Americas, up 6% to 192 deals[2] in 2020. The activity in Europe saw a decline, down by 34% to 103 in 2019.

The pandemic has led to reduced consumer spending, operational cutbacks by businesses, disruption in supply chains, plummeting interest rates, and greater need for digital solutions, etc. These factors have compelled insurers to re-evaluate their business strategies and operations. Many pursue M&A as a way to manage financial stability over the coming years.

The key driver for insurance M&A tends to be the need to ensure adequate capital and manage the solvency position. Other reasons for M&A may include the desire for greater market share, expanding global outreach, achieving scale to deliver cost synergies, diversifying business, and introducing new distribution channels. As insurtech gains importance, improving sales, distribution, product development, customer services, underwriting, and claims management is becoming an increasingly important driver for M&A.

M&A activity in the Gulf Cooperation Council (GCC) insurance sector has picked up in the last couple of years following the strengthening of reserving and solvency requirements in some countries and as companies look for strategic expansion. In the GCC region, the United Arab Emirates (UAE) is the largest insurance market, in terms of both gross written premium and insurance penetration, followed by Saudi Arabia. The health insurance market in both the UAE and Saudi Arabia is undergoing rapid transformation. The UAE insurance market has more than 50 insurers. With intense competition and lower premiums, some companies are experiencing insurance losses that are unlikely to be sustainable in the long run. This trend is likely to result in consolidation in the insurance industry over the coming years. Some recent transactions in the UAE market include Dar Al Takaful's acquisition of the entire share capital of both Noor Takaful General and Noor Takaful Family in June 2020, Al Hilal Takaful's acquisition by Siraj Holding LLC in 2020, and Zurich Insurance Middle East's acquisition by Cigna in 2017. In November 2020, AXA sold its Gulf insurance business to the Gulf Insurance Group to shore up its capital buffers amid the pandemic.[3] We have also seen several potential deals in the GCC that have not come to fruition. This is mainly due to buyers not being prepared to pay the price demanded by the sellers.

Saudi Arabia's insurance market is set to witness consolidation, with M&A activity gaining pace during 2021. In January, the Saudi Central Bank (SAMA) reiterated the need for insurance companies to look at M&A deals because the sector is a key driver of the Kingdom's economy and a pillar of the Financial Sector Development Programme. The recent mergers—Walaa Cooperative Insurance Co. with Metlife AIG ANB Cooperative Insurance Co., Gulf Union National Cooperative Insurance Co. with Al-Ahlia Insurance Co. and Al Jazira Takaful with Solidarity Saudi Takaful Company—reflect efforts to organise and develop the sector and boost financial solvency by improving the insurers' capital positions. A highly fragmented market (with 28 out of 32 insurance companies competing for one-third of the marketshare measured in terms of gross written premium) and expected changes in the regulatory landscape, such as the potential introduction of a risk-based framework which may increase overall capital requirements, are likely to drive further consolidation.[4]

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[1] PwC. Insurance deals insights: 2021 midyear outlook. Retrieved 3 August 2021 from https://www.pwc.com/us/en/industries/insurance/library/deals-insights.html.

[2] Sheehan, M. (22 February 2021). Re/insurance M&A to surge in 2021: Clyde & Co. Reinsurance News. Retrieved 3 August 2021 from https://www.reinsurancene.ws/re-insurance-ma-to-surge-in-2021-clyde-co/.

[3] Parasie, N. (29 November 2020). Axa Sells Gulf Operations to Kuwaiti Group in $269 Million Deal. Bloomberg. Retrieved 3 August 2021 from https://www.bloomberg.com/news/articles/2020-11-30/axa-sells-gulf-operations-to-kuwaiti-group-in-269-million-deal.

[4] Deulgaonkar, P. (19 February 2021). Saudi insurance sector poised for increased M&A activity in 2021: Analysts. Argaam. Retrieved 3 August 2021 from https://www.argaam.com/en/article/articledetail/id/1444698.

Importance of buy-side due diligence and the need for experienced actuaries for such work

Thorough and independent due diligence provides the buyer with an unbiased strategic, operational, legal, and financial assessment of the seller (Target). This ensures it is a good fit for the buyer, while highlighting the key risks and opportunities that come with the transaction to help both parties make informed decisions.

Financial due diligence allows prospective buyers to validate the assumptions underlying a Target's valuations, providing an informed opinion on whether historical profitability is supportable and the value and sustainability of any market advantages, either in the product, delivery or service, as well as whether the cash flow projections are realistic.

The traditional measures like price to earnings (P/E) ratio or price to book value (P/B) ratio do not adequately capture the value of the insurance company. The nature of insurance requires a long-term perspective to realise value. Investors typically rely on the actuarial report developed by the actuaries to support the value of the deal or transaction.

Actuaries play a key role in any financial due diligence process, over and above the traditional assessment of loss reserves. Actuaries can perform the complicated task of assessing and providing insight into the relationship between value, performance, and risk. The role of actuary becomes even more important in international transactions, as buyers need experts to help them understand the local accounting practices, the preparedness of the Target to adopt International Financial Reporting Standard (IFRS) 17 standards, the different nature of products, and unfamiliar and technical terminology used in the new territory. In addition, regulatory approval for a transaction typically requires demonstration of the solvency projections of the consolidated entity over the next five years. This is also an area where actuaries can play a pivotal role by working closely with the entities to develop business plan projections and model the impact on solvency under various scenarios.

Key considerations for insurance company buy-side due diligence

This section sets out the qualitative and quantitative factors that investors need to consider at the time of performing due diligence:

- Reasons for sale: The buyer should have a clear understanding of the reason for sale as it may highlight some of the inherent risks underlying the deal. For example, if the company is being sold due to liquidity issues, it might be worth investigating whether the issues stem from inadequate premiums charged historically because claim experience has been worse than expected as a result of relaxed underwriting or aggressive business expansion policy, resulting in capital inadequacy.
- Target's profile: Given the tight window of opportunity for such transactions, the buyer needs to gather as much information, as quickly as possible, to understand the company profile and its financial and operational aspects. We have listed below some of the aspects of Target's profile that the buyer needs to consider at the time of the deal.
  - **Company overview and profile** includes a review of:
    - Information on the parent company and its subsidiaries
    - Size of the Target
    - Lines of businesses (health, life or general or multiline)
    - Types of products offered (protection and savings), any options or guarantees underlying the products, and other services offered by the company
  - **Financial review** includes a review of:
    - Independent actuarial valuation of liabilities to assess the adequacy of the reserves held and the solvency margin
    - Reserving methodology
    - Reinsurance treaties and their impact on the company's liabilities and profit
    - Business plan projections and future expected cash flows
    - Recent income statements and balance sheets to assess the financial condition of the company
    - Asset concentration/diversification
    - Shareholder equity
    - Regulatory reports to ensure compliance

    - Any other noninsurance liabilities held by the company like employee benefit obligations
    - Impact of IFRS 17 on profit pattern and equity
    - Solvency projections for the new entity (consolidated company)
    - Litigation: With increased policyholder awareness and greater emphasis of regulators on consumer fairness and protection, litigation has become increasingly common, especially in the health insurance business. This has resulted in companies setting up litigation reserves to make explicit allowance for disputed claims. It is important to analyse these reserves as a part of the due diligence process as it may highlight issues with policy wording, mis-selling practices, and marketing and sales strategy and policies to assess the impact on finances and company reputation.
  - **Operational review** includes a review of:
    - Claims and underwriting capabilities.
    - Recent changes in the underwriting policy likely to impact the company's risk profile and liabilities.
    - Existing and potential distribution strategies that determine the feasibility of business plan projections.
    - Internal and external risk management strategies and how well they align with the buyer's strategies.
    - Data: Data is a key asset for insurance companies. It is important to understand the level, quality, completeness, and accuracy of the data available not only to estimate the transaction cost but also to assess the possibility of advanced analytics and future business strategies. For example, meaningful healthcare data cannot only help make informed decisions for the policyholders but can also assist with providing quality and cost-effective care for those in need. Therefore, it becomes imperative to have a complete understanding of the Target's existing data and data strategy in place at the time of due diligence.

  A comprehensive review of the Target's profile helps the buyer identify the areas of opportunities and risks that come with the transaction and how well they align with the buyer's strategy and vision.

- **Material adverse change (MAC):** Emergence of the COVID-19 pandemic has resulted in organisations revisiting the MAC provision under the existing agreements. Typically, the nonexistence of MAC is a condition to closing under a merger agreement. Even when a MAC (or other) provision does not clearly provide a right to terminate or not meet the terms of the deal, the potential that a MAC has occurred may create leverage for a renegotiation of terms.
- **Other factors:** In addition to those listed above, some other factors that require consideration at the time of due diligence include:
  - Other companies bidding for the Target.
  - Timing of the transaction to attain the maximum value from the transaction.
  - The competitive position of the Target and the buyer to help define transaction terms.
  - Brand recognition: A loyal customer base, key people, and/or valuable technology that could improve the overall service and performance of the buyer.
  - Regulations: Regulations governing M&A activities, including but not limited to foreign shareholding, regulatory approvals, capital requirements, etc., need to be considered early in the process to assess the feasibility of mergers and acquisitions.
  - Existing service level agreements with external vendors.
  - Service and staffing levels.
  - IT organisation, structure, and governance practices to achieve potential synergies.
  - Tax implications: It is important to consider the tax implications of M&As and the structure of the deal to improve tax benefits from the deal.

Case study

OBJECTIVE:

Perform due diligence for insurance companies for a potential merger in the GCC.

ACTIVITIES INCLUDE:

- Reserving and solvency review
  - Conduct an independent review of the actuarial reports and provide comments on the data, assumptions, methodologies, and conclusions.
  - Conduct an independent analysis of the unpaid claim liabilities for all lines of business and provide opinion on the adequacy (redundancy or deficiency) of current reserves and solvency margins.
  - Review the actual solvency position of each of the entities and comment on the assets' admissibility and other areas of concern.
- Valuation of the entities
  - Review the business plans and underlying assumptions for each entity.
  - Conduct an independent calculation of appraisal value including looking at selected scenarios and performing sensitivity tests on key assumptions.

    The appraisal value reflects the value that each entity brings to the merged entity in terms of generating future earnings. It comprises several components, including:

    1. Future premium volumes generated from the respective distribution channels and the profitability of the business allowing for acquisition costs, management expenses, and investment income.
    2. Expected profits from in-force business allowing for expenses and investment income.
    3. Adjustments for over- or under-provision in claim reserves transferred to the merged entity.
    4. Market value of net assets (excluding shareholders' funds) that both parties agree will be transferred to the merged entity.
    5. Cost of capital, which is the difference between the risk discount rate used to discount future earnings (i.e., shareholders' required return on equity) and the investment return they are able to earn on the assets in which the capital is invested. This reduces the appraisal value. The capital required is the statutory capital required if each party were to continue operating as separate entities.
  - Derive assumptions from the financial statements, actuarial reports, management interviews, and our market experience.
- IFRS 17 financial impact assessment
  - Perform a high-level financial impact assessment based on main lines of business.
  - Compare the profit pattern and equity impact due to IFRS 17 on business.
- Business plan and solvency projection for regulatory approval
  - Prepare a five-year business plan for the combined entity which will include all the lines of business written by both companies.
  - According to the business plan, project the solvency position for the merged entity as per the financial regulations.
  - Conduct a sensitivity analysis on the major assumptions such as premiums, loss ratios, expenses, etc.

Milliman's experience

We have subject matter experts that have worked on many facets of several major mergers and acquisitions in insurance in the Middle East. We can assist either party in estimating a likely range of prices for a proposed transaction and perform in-depth financial and operational review of the Target as part of the due diligence process.

Milliman routinely develops actuarial appraisals of Target companies both large and small. The breadth of our experience in completed transactions gives us a unique knowledge base of current market pricing and market views on potential transactions.

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