RECORD OF SOCIETY OF ACTUARIES
1977 VOL. 3 NO. 4

DETERMINATION OF THE VALUE OF A LIFE INSURANCE COMPANY

Moderator: SAMUEL H. TURNER. Panelists: RICHARD S. ANTES, BARRY L. BLAZER, JOHN C. HEAD III***

MR. SAMUEL H. TURNER: The stock company segment of the life insurance industry may have a problem--a return-on-capital problem related to (1) the first-year-loss-long-recapture-of investment phenomenon and (2) the burden of sterile capital funds. A stock life company has an equity only capital structure and must attract and hold equity capital within a competitive capital market in competition with other corporations; corporations which can on average generate an after-tax return on equity capital of approximately 12%.

> Assume that of the total capital committed in an acquisition of a stock company, 70% is allocable to the value of the business and 30% to the equity funds (i.e. sterile capital).
>
> Assume that sterile capital or stockholder equity funds are expected to generate a yield of 7-9% pre-tax; this would yield only about 5% after tax, since that investment income essentially bears tax at full corporate rates.

Therefore, if a stock life company is to generate a competitive overall after-tax rate of return of 12% on total capital committed, it must price its products and value its insurance business to yield approximately 15% after tax in order to compensate for the low after-tax yield generated on its sterile capital funds. While such a stock company is forced to price its products and value its business to provide a 15% return on capital, it must attempt to compete with mutual life companies who more likely view capital costs from the point of view of policyholders (i.e. 7-8%). The stock company also must attempt to compete to some degree with other savings institutions with a lower overall cost of capital, due to a significant gearing of debt in their capital structures (savings and loans, banks, and real estate are notable examples). There are some possible solutions to the problem.

First, a stock life company may achieve a tax position such that 818c(2) will finance the first-year surplus strains and thereby serve in lieu of otherwise committed capital funds. This position requires products to be priced to bear tax on the basis of 1/2(G+T); it requires avoidance of cash taxes; it requires G' in excess of T by the full amount of special deductions with a "bulls-eye" scored where G' equals $250,000 plus available other deductions. In this position, 818c(2) effectively provides surplus relief at $21 per $1000. This type of solution may be attainable by a few companies but is not likely to be a general solution to the problem.

*Mr. Richard S. Antes, not a member of the Society, is a national tax Partner of Ernst and Ernst.
**Mr. John C. Head III, not a member of the Society, is an associate at the investment banking firm of Morgan Stanley & Co. Incorporated.

Second, consider two life insurance companies stacked one over the other. Since the capital and surplus of the top company usually will reflect approximately 75% of the capital and surplus funds of the subsidiary, the same dollar of capital funds is used more than once. This leveraging of capital funds achieved by stacking companies can increase the utility of the capital and, therefore, reduce the overall cost of total capital funds committed and, particularly, reduce the effect of the low after-tax yields generated on statutory capital and surplus (sterile capital funds).

Third, consider a life company owned by a non-life holding company with a capital structure of 50% debt with a 5% after-tax service cost and 50% equity with a 12% after-tax service cost. The average cost of capital is now 8.5%, not 12%, after-tax return. However, the holding company must also have a non-life operation which generates cash and taxable income sufficient to service debt capital. This position is achieved, for example, if a stock life company is bought by a non-life company with fully taxed earnings and a mixed debt/equity capital structure.

If nature takes its course, a large portion of the stock life companies could be owned by non-life companies in the future; and from the viewpoint of the stock life company, that may not be all bad. The return-on-capital problem described, as well as some of the solutions, support a continued high level of acquisition activity within the life industry in the foreseeable future; and that supports the relevance of today's session--the determination of the value of a life insurance company.

As no doubt will be apparent by the end of this session, a title like "Determination of the Value of A Life Insurance Company" is enough to create trauma in the icy veins of investment bankers, actuaries, and accountants. We already can offer you a choice of market value, historic GAAP equity, statutory book value, purchase GAAP equity values (described as "fair values" in APB 16), and actuarial appraisal values.

Why is an actuarial appraisal value important? First, such a value represents a realistic assessment of the economic value of the enterprise. It is unique in that it cannot be determined from, nor is it equal to, the market value or the shareholders equity reported in any financial statement.

Second, management and boards have an obligation to satisfy themselves that the sale or purchase price is fair and reasonable in a merger or acquisition transaction. This requires, among other considerations, that the management and the board make a judgment as to the economic value of the entity they are selling as well as the economic value of the assets that they are receiving which may be cash or securities (including the securities of another life company in a merger transaction) or a combination of cash and securities. It is difficult to envision a creditable judgment as to economic value which does not at least reflect consideration of an actuarial appraisal value.

The current traditional approach to determining an actuarial appraisal involves the implicit or explicit assignment of an actuarial appraisal value to each of three components:

1) The value of the business in force representing an appraisal value of the future earnings stream expected from the insurance business in force as of the date of valuation and reflecting a realistic estimate of the expected future revenues and costs associated with that business;

2) Adjusted net worth - an appraisal value assigned to capital and surplus funds, and certain other amounts judged to be in the nature of such funds, as of the valuation date; and

3) Existing structure value - an appraisal value related to the ability and capacity of the existing corporate and sales structure to produce profitable business in the future.

To the extent that traditional approaches have reflected these three components they can be described as classic; however, conformity and uniformity end there. Current approaches used to determine actuarial appraisal values can vary considerably with the result that the values produced by current approaches may not be understood by the users, particularly non-actuarial users, of those valuations.

Key issues in any actuarial appraisal valuation are the accounting basis of earnings, the treatment and recognition of Federal Income Tax, the nature and level of discount rates and the approach used to value adjusted net worth.

Accounting Basis of Earnings. With one exception, the accounting basis of earnings in actuarial appraisal valuations has been and is based on statutory projected earnings because it most accurately represents "available" earnings (amounts available either for investment in new business or withdrawal from the corporation). The exception to normal statutory accounting practices is that changes in certain liability items are not normally reflected in projected earnings (deficiency reserves, cost of collection, cash values and excess reserves, MSVR, etc.). The exception, however, cannot be justified conceptually where projected earnings are intended to represent available earnings, a representation which otherwise seems clearly implicit in the use of statutory earnings.

Federal Income Tax. At least two ways of reflecting Federal Income Tax have been observed. The first is as an adjustment to earnings discounting (i.e. the appraisal value is taken as the present value of after-tax earnings). The second is directly linked to the discount rates in that the appropriate discount rate is set and projected pre-tax earnings are discounted. The effect of Federal Income Tax then is reflected by determining and representing a lower equivalent discount rate associated with after-tax earnings.

For example, assume that an appraisal value equal to $20 million is generated by discount and projected pre-tax profits at 15%--the effect of tax then is expressed as a lower equivalent after-tax discount rate (approximately 11%) at which projected after-tax earnings could be discounted to produce the same $20 million number. The result of this approach is that the effect of tax is not reflected in the appraisal value but in the expected rate of return associated with that value.

The current approaches to actuarial appraisal valuations almost always describe the discount rate as a rate which is reflective of and commensurate with the degree of risk inherent in the realization of the earnings strain being discounted. In cases where the discount rate has been applied to after-tax earnings, it also has been described as reflective of the reasonableness of the overall composite rate of return, represented by the total appraisal value assigned to all components.

The second way of reflecting Federal Income Tax requires consideration in setting a discount rate--not only of risk but also the assumed impact of Federal Income Tax.

Discount Rates. The discount rates applied under current approaches represent a mixtuure of considerations--risks commensurate with the realization of projected earnings, Federal Income Tax effects, and the overall composite rate of return associated with the total appraisal value.

Adjusted Net Worth. The most common value assigned to an adjusted net worth is the statement of value of statutory capital and surplus funds and other items judged to be in the nature of funds, deficiency reserves, cost of collection etc. (value sometimes adjusted to market). This value can be viewed as the present value of projected investment income on such funds, discounted at a rate precisely equal to the earned yield rate on such funds, so one accumulates and discounts at the same rate. Current approaches, in effect, are going to assume that a buyer is willing to buy the adjusted net worth component on the basis of an expected after-tax return of something like 4-5%. Equivalently, current approaches assign a risk rate of return to the net worth component of approximately 4-5% after tax.

MR. BARRY L. BLAZER: The following is based on the assumption that the actuarial appraisal is being made for an entity that is considering the acquisition of all or practically all of the outstanding stock of a life insurance company. While the potential purchase of 100 shares of stock in a widely held company could benefit from an actuarial appraisal, the demand for such an appraisal has not reached the level where either the management of the company or the investment community is willing to pay for its preparation. Considering the current depressed market values of some companies, an appraisal might be a good idea.

Selection of a Valuation Approach. There is not a uniform approach in current usage. The three areas where the commonly used approaches differ are:

1) Whether to analyze future statutory or GAAP earnings.

2) Whether such earnings should be measured before or after taking into account Federal Income Tax considerations.

3) The level and nature of the discount rate or rates to be used in determining the present value of the future earnings.

The difference in appraisal value that can result from the choice between valuation approaches is likely to be surprisingly large to an experienced actuary. To a less technically oriented investor, these differences may be difficult or impossible to comprehend.

The most meaningful approach to me is one that analyzes future statutory earnings after a provision for Federal Income Taxes. The approach also should consider the various "risks" that such future earnings are dependent on in selecting appropriate discount rates. Since, as I will explain later, future earnings are subject to different risks, I prefer to use several discount rates in the appraisal.

My preference is for a statutory, after-tax analysis because:

1) The reasonableness of the valuation can be monitored after the acquisition if the analysis is prepared on a statutory basis. Reported GAAP earnings after acquisition are likely to follow a different pattern because of the application of purchase accounting principles.

2) Statutory data generally is made readily available and easier to work with.

3) An analysis based on statutory earnings will give the purchaser a clearer understanding of any statutory limitations on the payment of stock dividends.

4) The analysis should be prepared on an after-tax basis since only after-tax earnings are available for distribution.

Valuation Techniques. An appraisal normally will address separately the value of capital and surplus funds, the value of business in force, the value of future sales, and any additional "going concern" values.

The most common technique for valuing capital and surplus funds is to adjust the reported statutory capital and surplus by adding the value of certain non-admitted assets, the mandatory security valuation reserve (MSVR), and any deficiency reserves. If the valuation approach is designed to value future statutory profits, it is more accurate to project these accounts through the future statutory income statements and time value the changes using a discount rate. This refinement, however, often is overlooked or considered immaterial. In valuing capital and surplus funds, it also is appropriate to consider the need for any additional liabilities not otherwise reflected in the statutory balance sheet. For example, the funding of the company's pension plan should be reviewed to determine what provision, if any, should be made for unfunded pension costs.

A critical first step used in most techniques for valuing in-force business involves the creation of a model office for each significant line of individual business. The future earnings for the in-force business then can be projected and discounted using profit study or asset share techniques. In creating the models, reasonableness should be confirmed. One technique that is particularly helpful is to create sub-models by valuation basis for larger blocks of business; this will facilitate the testing of the model. It normally is not sufficient simply to confirm insurance in force and statutory reserves. The model's premium in force also should be compared to actual.

When valuing a company that writes both participating and nonparticipating business, it often is necessary to model each type separately in order to consider properly any restrictions on participating earnings. Group coverage generally uses a somewhat simpler approach.

The second step for valuing in-force business is gathering of the data needed to develop profit studies. For older companies, the gathering of basic policy data can be a frustrating job since this information often is not readily available. Keep in mind, however, that profit studies are based on currently appropriate assumptions rather than assumptions developed at the time of issue or those used in the preparation of GAAP financial statements.

Most computer-based profit study systems will produce present value of future profit factors that can be applied directly to the model in-force by year of issue to produce a value for the model. The value of the model business in-force should be adjusted based on the results of the confirmation tests.

Estimating and handling the effect of Federal Income Taxes is a tricky matter. Even without any significant planned changes in operations, a company's tax position may change; and future operating decisions could produce significant changes in the company's future tax position. Since the acquiring company can influence the future tax position of the company, it generally is appropriate to tax effect future earnings on the basis of the company's most likely tax position exclusive of changes that may occur as a result of the acquisition. This will produce a truer picture of what the company is worth as an independent going concern. In addition, a supplementary analysis that takes into account the tax implication of the acquisition can be extremely valuable to the acquired company.

The choice of a discount rate or rates to be used is perhaps the most important step in the valuation process. Simply stated, the discount rate is nothing more than a measure of the risk inherent in actually realizing the projected earnings. In this regard it should be compared with the risks associated with earnings available through alternative investments.

This last observation may be of critical importance when a surplus rich life insurance company is considering an acquisition. A company normally will realize a greater return on the surplus it "invests" in the sale of new business than it can in the securities marketplace. Often, however, companies find that their capacity to profitably invest in the business is limited. In such cases, if the company has built up substantial surplus, this surplus may be invested more profitably in an acquisition.

The risks inherent in realizing future earnings are very different when earnings are examined by source. Earnings can be thought of as arising from three sources: investment earnings on capital and surplus, earnings from insurance in force, and earnings from business yet to be issued. The risk of not realizing the anticipated investment earnings on capital and surplus is much less than the risk of not realizing the earnings on business in force, which in turn is a better risk than the earnings from new business.

My preference, therefore, is to use different discount rates for each basic source of earnings. An additional refinement could lead to still other discount rates, for example, on participating business where the company could adjust future dividend payments.

Actuarial appraisals often are prepared using a single discount rate which could be thought of as a composite of the source specific discount rates. Although at one time the single discount rate approach was influenced by processing limitations, processing capacity now is rarely a factor.

Some Comments on Specific Assumptions and Problems. A sound actuarial appraisal may sometimes seem to be just a large data processing job. While the job would be much less manageable without sufficient reliable data processing resources, one can expect to encounter many problems during a typical appraisal. Some problems will concern the choice of specific assumptions while others will be of a practical nature, including how to organize and present the results of the appraisal in the most meaningful way.

The preparation and presentation of the appraisal generally will be dependent on the nature and knowledge of the individual or the organization that authorized the appraisal to be made. Today, we find with astonishing regularity that an organization seeking to acquire a life insurance company is not another life insurance company and often is not even in a related financial field.

An appraisal prepared for a non-life company will differ in form from one prepared for another life insurance company. Occasionally, an independent actuarial appraisal is required by an insurance department (often when a closely held company proposes to buy out the minority shareholders). As a practical matter, different (probably less conservative) assumptions probably would be used in appraising a company who wanted to buy out minority shareholders than would be used if that same company was the target of an acquisition.

Treatment of Expected Changes after Acquisition. Another question that must be confronted, particularly when the acquiring company is another life insurance company, is, "What consideration should be given to reductions in expense levels, improvements in investment yields, and other similar benefits after acquisition?" Normally, the acquiring company will assess the value of such benefits as part of a separate calculation. This is particularly desirable if there is another potential investor interested in the company to be acquired. From the perspective of the company to be acquired, it may be important to identify and assess any special tax benefits or economies of scale that may be available only to a specific buyer. Such an effort could more than pay for itself if it resulted in the identification of the "ideal" buyer, one who would have the greatest potential interest in the selling company.

When multiple discount rates are used, it is important for the acquiring company to understand that the expected return on investment is a composite of the discount rates weighted by the values of each source of earnings.

Another important step in the valuation process that also serves as a test for reasonableness is the preparation of a projection of annual income. When combined with a projection of annual income on new business, the projection can be compared to recent results. While the projection period may vary depending on circumstances, a typical projection would run 10-20 years.

In valuing new business, the basic techniques described in the section on in-force business are followed. The appraisal would follow a similar valuation approach, i.e., the present value of after-tax statutory earnings discounted at a risk rate of return. Considerable judgment often is required to determine the new business capacity of the company. The actuary should examine closely the sales operations of the company including:

1) Production by agent and agency.

2) Agent compensation agreements, with particular emphasis on vesting rights on renewal commissions.

3) Agent turnover, with particular attention given to the history with the largest producers.

4) Sales mix by agent and agency, with particular attention to those selling only "Special Market" products.

5) Sales management, focusing on the experience and performance of the current sales organization.

The results of this analysis will assist the actuary in deciding the level, mix, and number of years of future sales to be valued. In many situations, it may be appropriate to express the new business value of the company as a range. This can be handled most easily by using different levels of production and/or different numbers of years of production. As previously noted, the discount rate used to value the business should reflect the risks involved.

An amount often is added to the appraised value to reflect the value of the company's charter and licenses. A review of the company's operation also could produce additional positive or negative adjustments. For example, an assessment of the company's data processing systems and operating efficiency could lead to an adjustment, particularly if a major investment is required.

MR. RICHARD S. ANTES: In reviewing the tax aspects of valuing a life insurance company, I believe there are three basic procedures that should be performed:

1) Determine the tax attributes of the company (target company). The income tax law for life insurance companies is very complex. Several judges and tax litigations have ventured into the fantasy world of life insurance company taxation, and it sometimes is very difficult to find out what the tax attributes are (positive or negative).

2) Plan how to best use those tax attributes that exist, whether they are positive or negative.

3) Value the target company. On an operations loss carryover, for example, the seller thinks that he has something very valuable and he wants to be paid for it (perhaps at a full 48% rate). The buyer, on the other hand, may not think that it is of much use to him, particularly if in order to utilize it he has to put additional capital into the target company. The buyer may feel that he should get the benefit of the loss.

One tax aspect that must be considered is the current tax position of the company with respect to claims or refunds from the federal government for prior years. Typically, a life insurance company has many years open and many claims for refund. Concerning the tax attributes of the target company, will the current attributes remain after acquisition? Generally, the attributes will remain if the target company corporate structure remains intact or if the acquisition is in some form a tax-free reorganization. Generally, tax-free reorganization is one that involves the issuance of stock by the acquiring company. Basically, there are three forms of tax-free acquisition: (1) merger, (2) stock-for-stock type, and (3) stock-for assets type of transaction.

Generally, the tax attributes of the target company will disappear in a cash purchase of the assets of the target company or if there is a purchase of the stock of the target company followed by a liquidation of that corporate entity within two years of the time it is purchased.

Tax attributes vary depending on the tax posture of the buyer. In some cases, the buyer may be able to use these tax attributes to his advantage, in other cases he may not. A great deal of the value may depend on the quality of the tax planning that goes into the acquisition. Probably the most common tax attribute is carryovers, usually operations loss carryovers or capital loss carryovers; but investment credits, foreign taxes, and contributions may be included.

There are some very important statutory limitations on the use of carryovers in acquisitions. First, there is a general rule that if a principal purpose of an acquisition is to evade or avoid income tax by getting a benefit of credits or deductions which otherwise would not be received, the commissioner can disallow any loss carryovers. An existing rule concerning the purchase of stock (acquiring all the stock of another company by purchase) requires that, if there is a 50 percentage point change in ownership and a change in the character or trade of business of the acquired company, the loss carryovers disappear. Generally, this has not been a problem in the insurance industry because the trade or business usually is continued. Beginning June 30, 1978, however, the change in business no longer is required in order to have a reduction of loss carryovers. If there is a 60 percentage point change in stock ownership over any given three-year period, there will be a reduction in the loss carryovers available--a reduction of 3-1/2 for each percentage point in excess of 60, up to 80, and a reduction of 1-1/2 for over 80.

Similar rules have applied to reorganizations. Under the existing law, there is a reduction in carryovers if the stockholders of the loss corporation receive less than 20% of the stock of the acquiring entity (also a 5 percentage point reduction in carryovers for each 1 percentage point less than 20%). New rules for acquisitions after December 31, 1977 will increase the cutoff point for starting reduction in loss carryovers from 20% to 40% (3-1/2 percentage points reduction for each point less than 40% down to 20% and 1-1/2 percentage points for each point less than 20%). The new law applies to more types of reorganizations than before: stock-for-stock transactions and reorganizations into subsidiaries of the acquiring corporation.

Tax Basis of Assets. If property has appreciated in a life company and these tax attributes are going to remain at the time of sale of that property, the acquiring company is going to have a tax. Theoretically at least, if assets have gone down from their cost to the target company, they are worth more than appreciated assets, because losses can be developed on those assets.

Reserving Methods. If the target company has been using a modified preliminary term method and has not made the 818c election to revalue those reserves for tax purposes, the acquiring company has the possibility of getting a tax benefit by reserve strengthening which may require putting additional capital into the acquired company and/or making the 818c election.

Policyholders and Shareholders Surplus Account. In the case of a merger or asset exchange, these amounts carry over; additional policyholders surplus in the target company may be a detriment for the acquiring company in an acquisition, whereas additional shareholders surplus may be a real benefit.

Premiums. Another item that usually is not thought of as being a tax attribute is the amount of premium income that is generated from the business. However, it is a tax attribute because 50% of premiums represents one of the limitations on the policyholders surplus account.

Compatability. A very important consideration is the fit of companies from a tax standpoint. Companies may fit together so that they produce a lesser combined tax than if they operated as separate entities. For example, a merger of a company whose tax posture is taxable investment income of less than $250,000, with a company which has gain from operations in excess of its taxable investment income should result in lesser combined tax, everything else being equal. On the other hand, they may not fit so well together. A company which has a taxable investment income of less than $250,000 merging with a company whose gain from operations is more that $250,000 less than its taxable investment income generally will produce a greater tax. There also would be a problem in the case of a merger of a company which has a Section 818c election in effect with one that does not. Under some general tax rules, when there is an acquisition merger of companies, they are required to convert to the same accounting method. There is some uncertainty as to what happens when one has an 818c election and the other does not. The situation requires planning. There are a number of disputes in this area with the Internal Revenue Service at the present time.

Deductibility of Purchase Price. In a cash acquisition, is it possible to obtain a deduction for part of the purchase price? The cost of insurance in force is deductible over the life of the policies, but in order to get this advantage, one must do more than purchase the stock of a company and leave that company in existence. The acquiring company must acquire the target company's assets, which may have other business considerations. Obviously, if the acquiring company can get a deduction for part of the purchase price, it is paying less for the company.

Consolidated Returns. At the present time, it is possible for a consolidated return to be filed only between a non-life company and another non-life company or life companies with life companies. In order to make consolidated returns, there must be a tier structure, so that the life company owns the stock of another life company. Two life subsidiaries owned by a holding company are prohibited from filing consolidated reports. Under the tax formula, there also is a tax disadvantage when a life company owns another life company. The stock of the subsidiary is part of the assets of the parent which means that in practically every case the paying of dividends from a subsidiary life company to a parent life company is taxable. The parent incurs tax on those intercompany dividends at the same effective rate as is incurred on tax-exempt income.

There are new rules which are effective after 1981 allowing the elective inclusion of life insurance or mutual casualty companies in groups with non-life companies. One provision of the new rules requires the life company to be a member of the group for at least five years. Even then, there are substantial restrictions in this legislation on the use of non-life losses against the income of life insurance companies. Generally, after the rule becomes fully effective, 35% of the losses of the non-life company can be offset or 35% of the income of the life company diminished, whichever is less.

MR. JOHN C. HEAD III: In a sale or acquisition of a life insurance company between a willing buyer and a willing seller, there are a number of methods that may be used to determine what value really means. There are hundreds of acquisitions in this industry every year with the vast majority being acquisitions of smaller insurance companies by larger insurance companies or by other financially related companies.

Recently, however, greater attention has been focused on the insurance industry, particularly the life insurance segment, by the acquisition or intended acquisition of a number of very large life insurance companies. The acquirers have included not only insurance companies but industrial concerns. My remarks will emphasize these larger transactions, particularly those involving industrial companies.

A smaller insurance company is purchased by another insurance company not only for its tangible financial results but for certain other factors which are individually difficult to analyze or to value in terms of dollars and cents. The acquisition may be to gain entry into a geographical region not presently served, to acquire product lines which are complementary to existing businesses, or simply to gain management expertise. These intangible aspects of an acquisition obviously affect value. Larger size transactions, those in excess of $100 million, must be viewed slightly differently. Companies with market values in excess of this amount generally are not as regionally concentrated and tend to offer a number of varying products and services and are not as dependent upon a few key executives. Also, the number of potential acquirers of insurance companies with market value of this size is extremely limited. Pure life companies with a market value in excess of $500 million probably number less than a dozen.

Industrial concerns recently have become very interested in acquiring life insurance companies. As with most securities these days, stock prices are depressed, making acquisitions for cash or a combination of cash, fixed income securities, or equity, feasible and affordable. The following considerations, specifically related to an acquisition by an industrial company, make the industry attractive:

1) Capital intensity. Relatively mature life insurance companies do not need large infusions of external capital requiring recurrent trips to the debt and equity markets. Most industrial businesses do require periodic trips to the markets to finance extensive capital expenditure programs. The petroleum companies and the metals and mining companies are two examples of industries which finance on a recurring basis. An industrial company can purchase a life company, knowing that future capital requirements from external sources will not be significant.

2) Stability of earnings. The life insurance industry is known for consistent year-to-year earnings gains without the large swings prevalent in certain cyclical industries. As earnings will not increase dramatically from year to year, the earnings swing from a peak to valley, as with a cyclical company, will not be present. Lower absolute growth rates in earnings are traded for consistency of earnings growth.

3) U.S. earnings. As we all read about the problems of doing business in lesser developed countries and as the economies of Western Europe fail to match the growth in the U.S. economy, increased emphasis is placed on the source of earnings as well as the absolute level. U.S. earnings are preferred. The accounting profession has introduced F.A.S.B. 8 or Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements. This release has increased the volatility of the earnings of corporations with significant non-U.S. subsidiaries. F.A.S.B. 8 requires corporations to recognize immediately the effects of certain foreign currency appreciation or depreciation versus the U.S. dollar. The vast majority of life

insurance companies, unlike many industrial concerns, do not have significant foreign earnings exposure. A premium is paid in today's market for domestic earnings, not subject to the vagaries of foreign politics or floating currency rates.

4) Accounting treatment. Most life companies can be consolidated with an industrial concern on the equity method. That is, only the acquirer's net investment in the insurance company need be reported on the industrial company's balance sheet and only the life insurance company's net income is reported as a one-line entry on the industrial company's income statement. The assets and liabilities of the insurance company are not shown on the consolidated financial statements of the industrial concern, and any indebtedness or fixed charges of the insurance company are not readily recognizable. This treatment is very appreciated by industrial executives.

The acquisition of a life insurance company by an industrial company may be accounted for as a purchase transaction. The assets and liabilities of the insurance company are adjusted to their fair value in accordance with A.P.B.16--the accounting guideline for acquisitions. Not only must investments be valued at market, but current actuarial estimates of mortality, withdrawals, and interest must be made to fairly value the reserves. Small changes in interest rate assumptions can produce large swings in future profitability as reported on the financial statements of the industrial concern. Since these actuarial estimates are judgment factors, the ability to produce significant purchase accounting adjustments is present.

The executives of an industrial concern, however, do see certain things which they view negatively. As the earnings growth is stable year to year, the growth rate itself is not spectacular. The insurance business is highly regulated, something many businessmen seek to avoid. More importantly, the business is atypical to that of most industrials, management skills are different, the product is intangible, and the financial results difficult to analyze because the accounting is complex and unique to the industry.

Having discussed the reasons behind the increased flurry in these large transactions in the merger field, let us take a look at four of the biggest deals which either have been announced or consummated and the financial terms involved. First, the Richmond Corporation which, as you probably know, is the holding company for the Life Insurance Company of Virginia and a number of financial companies. In June of 1977, Richmond Corporation was acquired by The Continental Group, Inc. (the old Continental Can Company). The aggregate value of the transaction was approximately $370 million. The consideration to the shareholders of Richmond Corporation was approximately $28 in cash for 25% of the shares with a package of Continental Common and Continental Convertible Preferred for the other 75%. This aggregated to a multiple of approximately 1.1 times GAAP book, 11-12 times 1976 GAAP earnings, 1.8-1.9 times statutory book of the insurance companies, and 15-16 times statutory earnings. The stock price was at 13-1/4 on the day before the first announcement, which puts a premium of over 100% on the consideration given to the previous stock market value. The earnings of the company, however, significantly increased from the time of the original announcement of the offer and the time the deal was consummated in the middle of the year.

Second, Franklin Life Insurance Company has received approval for the sale of 27-1/2% of its outstanding shares (owned by Continental Corporation) to the American Brands Company (the old American Tobacco Company) for $30.50 a share cash. American Brands has announced its intention to acquire the remainder at a similar price. The aggregate value of the company at approximately $30.50 per share is in excess of $640 million, a multiple of 1.9-2.0 times GAAP book, 13 times GAAP earnings, 15 times statutory earnings, 2.3 times statutory book, and a 35% premium to Franklin's market price approximately one month before the deal was announced.

Third, Philadelphia Life--Tenneco has announced its intention to offer 1/4 of one share of $100 par--$7.40 straight preferred--for each share of Philadelphia Life. Tenneco already owns 23% of Philadelphia Life and is seeking to acquire the remainder. The value for the 75% not owned by Tenneco is approximately $185 million, putting a value on Philadelphia Life of approximately $250 million. This is a multiple of 10-11 times GAAP earnings and is in excess of a 100% premium to Philadelphia Life's stock value one month prior to the announcement.

Fourth, Farmers New World and Farmers Group--Farmers Group presently owns slightly in excess of 50% of Farmers New World and has offered $51.75 for the remainder. The value of the consideration is $160 million, putting a value on Farmers New World of $340 million. This is a 30% premium to market, 2 times GAAP book, and 12 times the previous year's GAAP income.

As is obvious from recent life company acquisition transactions, there have been significant premiums to market values, sometimes in excess of 100%. The multiples to GAAP net income have been within a range of approximately 12 times the previous year's earnings and multiples to GAAP book have been about 1.5. These considerations are not the only things an investment banker looks at in helping a company determine value. Dividend effect to public shareholders and the value of the securities to be received by the acquired company must be considered. Cash is easy, securities are not. If debt is offered, the ratings by the rating agencies must be ascertained; coverage of fixed charges and percentage of debt and capitalization must be determined. A determination of the ability of the acquiring company to ride through financially difficult periods must be made as well as a determination of whether the acquired company's securities will sell in the free market. If equity securities are offered, the dividend policy of the acquired company must be determined as well as gross earnings prospects, the liquidity of the securities, how many shares will be in public hands, whether there is a listing on the New York Stock Exchange, and another important intangible, the quality of the management.

Every deal is unique and must be analyzed differently; there is no rigid valuation process, and you really cannot use any rule of thumb. Values do change as alternative investments change. The value of debt securities and the value of where one can spend other money must be determined. An analysis of the value being offered for an insurance company by another company must be compared with the alternative investments.

So far, I have said nothing about an actuarial appraisal and its value and relevancy to the very large stock transactions. Only in the Richmond Corporation transaction was there an actuarial appraisal that was made public to shareholders and the investment public. From an investment banker's point of view, an actuarial appraisal helps a layman to understand reserves

and, very basically, to determine whether reserves are adequate. An actuarial appraisal puts boundaries on certain types of assets in the same way that a geologist's appraisal might help to determine the value of oil and gas reserves, or a real estate consultant to determine the value of bricks and mortar.