

8. Actuarial Appraisal Value

One of the primary goals of the actuarial appraisal is to provide enough information for potential investors to make informed judgments as to the potential value of a property. The components of value typically presented in an actuarial appraisal include:

- the adjusted book value (ABV)
- the value of existing business
- the value of new business

While these elements are important indicators of value (and of the seller's expectations), they do not necessarily represent the value of a transaction in the open market. Each of these elements is considered in more detail below.

8.1 Adjusted Book Value

The ABV is calculated to determine the value of a company's net capital and surplus at current estimated-asset market values and includes the capital held in the opening model balance sheet. The adjustments are intended to eliminate possible accounting differences that over-or understate capital and surplus. In situations where capital infusions are required, this exercise is still performed to help determine the total amount of capital needed. The statutory book value is modified where appropriate for items such as:

- contingency reserves (reserves that are better characterized as allocations of surplus and NOT backing specific liabilities)
- case, IBNR and unearned premium reserve redundancies or shortfalls
- any accrued and unfunded employee benefit liabilities
- the realizable value of non-admitted assets
- the difference between the book versus market value of assets supporting the ABV.

It may or may not be appropriate to develop the ABV of the company in the appraisal report, depending on whether the company is part of a financial group and/or whether the appraisal is completed for the entire company or just for selected lines of business. Barring significant disagreements in technical reserving levels and current estimated asset market values, the ABV is generally valued at one-to-one.

The ratio of price/book is a number frequently used by the investment banking community to measure the relative richness of a transaction. There are no hard and fast rules for presenting price/book; typically, investment bankers rely on reported numbers. The extent to which the ABV adjustments flow through to price/book may depend on the home jurisdiction of the acquiring company and possibly impact the relative competitiveness of different bidders. Changes in international accounting standards are sure to further impact the presentation of ABV and price/book.

8.2 Value of Existing Business

The value of existing business is the present value of distributable earnings deriving from business in force as of the valuation date projected for a defined period beyond the valuation date. The value is usually calculated and presented using a range of risk discount rates in order to demonstrate sensitivity to the discount rate. This allows potential investors the opportunity to estimate the value of the block given their perception of the risk inherent in the block's emergence of profits. This also provides a relative indication of the weighting of profits towards the beginning or the end of the projection period.

The value of existing business is comparable to embedded value, although discount rates used in M&A transactions are typically much higher than those used in calculating embedded values for financial reporting purposes. The main discrepancies between buyer and seller in placing a value on existing business will come from differences in opinion over actuarial assumptions (often captured in the risk discount rate), perception of transaction risk (also captured in the choice of risk discount rate), tax differences and any possible expense savings that a buyer might anticipate.

8.3 Value of New Business

The value of new business is designed to measure and make a provision for the company's ability to produce new business, as well as take into account any franchise or "brand" value. The value is usually calculated and presented using a range of risk-discount rates in order to demonstrate sensitivity to the discount rate. For the purpose of this paper, a distinction is made between new business sold in currently operating lines of business produced by currently installed distribution capacity, and new business sold in new lines of business and/or new distribution channels ("alternative distribution channels").

It is the perceived value of new business production that typically causes the widest variation between bids and separates buyer and seller expectations. Assuming technical competency in the seller's appraisal and an efficient market, negotiations generally revolve around the perceived value of new business.

8.3.1 Value of Installed Distribution Capacity

The value of new business for installed distribution capacity equals the present value of distributable earnings from new sales in existing lines of business projected for a defined period beyond the valuation date, based on existing marketing and distribution capabilities. Alternatively, this may be presented as a multiple of one year of sales. This value is an indicator of the relative value of the distribution structure the company currently has in place.

8.3.2 Value of Alternative Distribution Channels

Valuing the currently installed capacity of a company may not make full provision for the franchise value of a company in their market. A company may not have taken advantage of leveraging its name to enter new markets with new lines of business and/or new distribution channels. Actuaries and transaction specialists alike are starting to recognize the importance of analyzing new business lines and alternative distribution channels in fully assessing value. Combined with the value of new business from currently installed marketing and distribution capabilities, this captures the franchise value of the company.

Determining the value of alternative distribution channels is a delicate balance. While a seller may provide significant opportunity in the form of an existing client base, installed distribution capacity or name recognition, buyers will not want to pay for value they feel they create with their technical and intellectual capital. Presented well, this sort of exercise can unlock significant value on behalf of the seller. Done poorly, with inflated premium projections and/or over-optimistic margins, it can detract from the credibility of the appraisal report or even derail the entire sale process by creating a chasm between seller's expectations and bidder's perception of opportunity, risk and relative contribution to value creation.

8.4 Actuarial Appraisal Value vs. Market Value

The range of values presented in an actuarial appraisal does not necessarily represent the absolute determination of value of an insurance

company or portfolio in the open market. The appraisal provides for a range of values based on discounted projected distributable earnings. These earnings are generated from a carefully crafted, internally consistent set of assumptions designed to produce best-estimate future cash flows from the seller's perspective. Different potential investors will typically come to their own conclusions as to what constitutes best estimate assumptions.

All things being equal, the relative value of a company or portfolio will be different for each bidder depending on their strategic goals, perceived synergies, expense savings, competitive position in the market, tax position, capital requirements, cost of capital, risk tolerance, etc. The values derived from an actuarial analysis serve as a reference from which potential investors can evaluate their position and arrive at a value based on their unique situation.