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Session 81TS
Valuing Long-Term-Care Insurance for Acquisition

Track: Long-Term Care

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Summary: This teaching session presents techniques and tools for valuing long-term-care insurance for mergers and acquisitions. Specific situations are discussed.

Mr. Michael S. Abroe: Let me introduce the panel. We're fortunate to have two actuaries who work on the investment banking side of mergers and acquisitions (M&A), which is something that we normally don't see. Mike Porcelli is an associate with Chase's Global Insurance Group and provides technical assistance within the structured and leveraged finance team. His primary responsibilities include financial models of M&A and debt issuance within the insurance industry. He joined Chase in 1999 following several years working at Metropolitan. He has an M.B.A. in Finance from Rutgers, and he's an ASA. Michelle Thomson has worked at Reliance and CNA as a casualty actuary. She got into M&A work while at CNA and later spent a while at Salomon Smith Barney. She is joining Donaldson Lufkin Jenrette in June.

Ms. Michelle A. Thomson: I'm going to go over the general M&A market starting with the global perspective and then moving down to the life/health insurance industry. Mike Porcelli will then go over more of the actuarial facets of the long-term care transaction. Finally we'll blend the two and discuss what happens during an M&A process—what gets done, who's involved, and what makes a successful transaction.

We'll start with the general financial services environment. In the past few years the financial services environment and, by and large the M&A area, have seen an enormous amount and volume of transactions. We've noticed in particular in financial services that a few things have been prevalent. Financial scale and overall size of organizations have become very important in order to get administrative savings and some access to larger marketplaces. Interregional consolidation, such as mergers within the U.S., have been overtaken by a lot of cross-border activity. A lot of the European organizations, such as Aegon and ING, have been very active participants in driving the volume and number of transactions. Obviously you've all

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Note: The charts referred to in the text can be found at the end of the manuscript.

heard about convergence. My former employer, Salomon, and Travelers and Citigroup is a prime example of that. Pooling of interests? transactions are being phased out by the end of 2000, so mergers in the future will have to be a little bit more focused on the true economics. People had been doing transactions because they had access to pooling. The accounting change will have more of an influence in areas other than insurance. On-line consumer finance is becoming much more commonplace and a bigger player in the market. We're seeing a bigger disparity in the valuations that people are putting forth in the top tier—what they're considering the top tier companies versus the standard companies. People are paying a premium for very well-run companies. As we can see in the long-term-care (LTC) arena in particular, within the past several months we've had three of the top ten players go through a sales process, one of which is still going on.

Charts 1 through 5 highlight the growth and volume and the number of financial institution M&A transactions. The number of transactions has gone from 373 to 573 over the past 5 years, but the dollar value has tripled over that period. Financial institutions are divided into asset management; depository-type companies, which are banks; diversified companies, which would be GE Capital or American Express Capital; and insurance companies. You can see the relative contribution to the overall volume of financial institutions that each of these sectors is giving. The relative number of transactions is reflective of the market sizes of the underlying players. All of the sectors have shown equally volatile activity.

Chart 4 shows the overall dollar volume in deals over $100 million that have been announced. We segregated out the transactions over $1 billion because, as we said earlier, financial scale is becoming an increasing factor for these acquisitions. We've even had some recent announcements with ING and ReliaStar. The year 2000 is following this trend and we expect to see even higher numbers this year.

These acquisitions have also shown some different bases. What we've done is segregate those past five years based on what we thought were the reasons for the transactions. Those reasons included diversification, i.e. different lines of business; cross-border activity, which we highlighted earlier; and consolidation, which is just company-on-company. Consolidation has been the biggest player in the most recent years, and cross-border has been ratcheting up since 1997.

If we move from the overall financial institutions M&A to the life/health industry, a lot of different influences are driving the companies to act accordingly. The market is evolving. People are trying to find new ways to distribute products. Consolidations are creating formidable competitors to some of the smaller companies. People are going more toward variable products in order to get higher ROEs and better profitability potential. In LTC in particular we see the demographics going heavily in the favor of this industry. We've seen a huge growth as the baby boomers age; it speaks for itself. One of the unknowns in the industry is the level to which the government is going to regulate LTC; it's more of a concern to the level at which they're going to put their fingers in the pot and try to influence rates. or the potential for the government instituting its own program. In the life sector we've seen a lot of demutualizations occur. That activity is fairly public and will continue.

One of the other more recent issues that the life/health industry is facing is a surplus of cash. It's cash-heavy. The equity-to-asset ratio is at a 30-year high. People are trying to figure out how to deploy these funds adequately. They're being required to keep them partially because of risk-based capital (RBC), NAIC regulatory requirements, A.M. Best, S&P, etc. So this is the challenge: What will enhance a company's profitability?

One of the things that we're trying to do in the industry is to know why acquisitions are taking place. What combinations make sense and will they be successful? Are they going to allow their acquirers and the sellers to achieve their goals? Competitive pressures are obviously driving down margins. New competitors are in the field because of that convergence of the sectors. The demographic trends have enlarged the market theoretically, but at least in LTC the penetration is still incredibly low. Part of the challenge is to figure out how to access the potential markets. The demographic trends are creating new markets and changing what people are expecting to do with their money. They need different assistance from the insurance companies than what they were getting in the past. Of course, deregulation, the government factor, is one of biggest drivers of company activity, as well as the government and rating agencies.

As stated earlier, there is a changing product mix which is responding to the consumer demand, so the insurance companies are trying to figure out the best way to meet their customers' needs. From both the customer and the company side it's a shift away from the more traditional products. The assets and reserves are changing as we move toward variable products.

The different distribution channels will be one of the major drivers to M&A. As we access new markets, at least in LTC, we have this underpenetration issue. Also we have to increase consumer demand because it's at low level right now e possibly due to mixed advice from experts. They're not comfortable in the need for it because they assume Medicare and Medicaid will step in. Consumers need to be educated. Distributors need to be educated to help sell the products. One of the easiest ways to get new markets is, of course, cross-selling opportunities. The company that has a customer base can sell a new product to that base; the customers already have some kind of trust in their current insurer.

As we said earlier, financial scale matters. Foreign insurers and strong players are emerging. As the margins are being depressed there's a competitive force that's being exerted. People are scrambling to make sure that they have multiple distribution channels and that they have the critical mass, the technology, and the administrative strength they need. Wall Street in particular has always thought life/health has some higher prospects than property & casualty just because they have a little bit more leeway—they have the more variable products and there's a huge demand for it coming up with the baby boomers.

There have been three major LTC transactions recently: the sale of Fortis's LTC operations to John Hancock, the sale of Travelers's LTC operations to GE Financial Assurance, and the impending sale of CNA's LTC operations. What we're talking about here mainly in these sell sides is individual LTC. It's not addressing the group LTC market, which is about 12% of the total market. These sales are just individual blocks. Part of the reason that this is going on is because of the general force impacting the life/health industry. But in particular to LTC, management is finding that LTC fits their risk profile. They're comfortable with a lot of the uncertainty that's intrinsic to this product because it is fairly new. A.M. Best issued a study last October and one of the articles from it was called "An Immature Product for a Maturing Clientele." I liked that title because I thought it encapsulated some of the issues that companies are facing. One of the statistics they quoted was, "Long-term care has been around about 30 years whereas life/health, the life insurers, have had about 200 years to formulate the morbidity and morality tables. Long-term care actuaries have not had the luxury of that time or the level of that experience." So, there is a lot of uncertainty there, and Mike Porcelli will go over that in some detail.

Chart 6 shows the volatility of the markets. Obviously, you've all been following the recent movements. This chart summarizes what's been going on. The insurance sector has seen a dearth of public interest. The market valuations are depressed. Large global institutions have a luxury of not being subject to the stock exchange's ups and downs. They can afford to pay premiums. They have the cash and they want to enter the country. The shareholders are also putting pressure on the company and taking increasing action to force management to do things to elevate their share price.

The implication is that strong companies prevail. Financial buyers are seeing more and more opportunities. People like Kohlberg Kravis Roberts are always looking at companies, especially some of the weaker ones. We're seeing heightened shareholder activism and a rise in hostile transactions in general. Insurance is not as subject to that just because of all the regulations involved. Hostiles are quicker transactions and usually require a quicker arena than exists with insurance.

I'm going to finish by introducing some valuation approaches. The first one is the standard discounted cash-flow analysis model; it can be done on a statutory or a GAAP basis. It should include not only income statements down to net income, but any balance sheet impacts—i.e., do they need additional capital to maintain RBC ratios? You would be very involved in the actuarial appraisal, if you haven't already been. The second aspect that would be used to drive valuation is precedent M&A transactions, especially now that we have two, almost three, LTC transactions on board, although not all the terms were publicly stated. People who have worked with them have a good idea obviously of what was paid and what is expected by any of the selling companies. A third approach is comparable company trading levels, or what the share prices are in the market of other similar companies. This would involve looking at the price-to-earnings multiple, or the price-to-book multiple, where here book value might be either GAAP or statutory. the fourth approach is something that's a subset of comparable company trading levels, which is ROE regression analysis. If you just take a regression of an ROE to a price-to-book, you're going to hopefully get an increasing line. If you do that on a comparable company, where does your company fall in that line in reality and where should it fall if it fits the line?

These approaches are all sort of sanity checks to one another. These all could give you separate data points, but you have to temper them. What are the resulting debt capacities assumed by each? What are the current debt-to-title capital trading levels? What are the rating agency implications? All these other things that you all deal with every day will temper what the values are that you come up with.

Mr. Michael Porcelli: The actuarial appraisal is a critical element when valuing a block of business. We've discussed a few different methodologies, but the appraisal is where the actuary can really come into play in this whole process. First of all, if you're a consulting actuary, you certainly want to be hired to do one. And if you're on the sell side, you want to make sure you make that phone call to your consulting actuary to get somebody from the outside to take a look at the business that you have there. It certainly lends a lot of credibility to the process. This is an essential tool and it's one of many, but I strongly recommend that you involve an actuary in the process. On the buy side, you should demand an actuarial appraisal—in other words, spend the money. I know they're not cheap, and I certainly know that Mike would be more than happy to field the phone call from anyone in this room.

If you are performing the actuarial appraisal, your work has to follow the standards of what an actuarial appraisal is. The main standard that applies is *Actuarial Standard of Practce (ASOP) 19*. In addition to that, there are a handful of other applicable ASOPs covering such topics as data quality. You want to make sure that you comply with all the standards that could possibly apply. By the nature of the profession we are bound by standards. That means that when your document is out there, you're putting your reputation on the line. There are people making some very important decisions based on your document. There are going to be a lot of questions and a lot of interpretations. Make yourself available as a resource for the prospective purchaser or seller, depending on which side of the transaction you're on.

Now as we all know, the appraisal is really based on three components. The first and easiest is the adjusted net worth. The other two are where you're really going to spend the most of your time and get the most questions. You're going to have to use a bit of judgment here, and you're going to have to defend your decisions. These two components are the value of the existing business (i.e., what's in-force currently) and the value of the future business (i.e., the capacity to write more business). The latter is a very important piece with LTC since we're talking about an industry where market penetration for individuals over 55 years old is about 3.3%. Certainly it's not where any of us would like it to be, but seven years ago, it was only 1.1%. So if there's anyone here with a crystal ball who could tell me what market penetration is going to be five or six years down the road, I'd be happy to see that. When you're doing an appraisal, that's part of what you're really doing. You're going to have to defend those assumptions. And investment bankers, heads of strategic planning, CEOs and CFOs are not shy about asking questions about these assumptions. Their careers really depend on how well they do their acquisitions and, frankly, financial markets aren't very forgiving. Boards of directors aren't very forgiving. So once again, I can't emphasize enough how important the ability to defend your appraisal is.

You also have to include a projection of the RBC ratio. The one single number that comes up over and over again when you're dealing with bankers is, "Where does this stand with RBC?" It's a nice convenient number. People want to see where it's going to be somewhere down the road to give them an indication of capacity and capital adequacy. Be very clear when you're talking about RBC. You can spend a lot of unnecessary time talking about whether you mean Company Action Level or Authorized Control Level. Now this is a very simple issue, but the clearer you are on this, the better. I'm going to emphasize how important communication is in this whole process. People are coming in from different disciplines. You have legal, accounting, strategic thinkers, actuaries, etc. Everybody has to understand what everybody's doing. Clarity is of the utmost importance.

Now for those of you who put together appraisals, you have one framework that is your methodology, and it's going to be translated into a different type of financial model. I want to review what you're looking at and how it's going to be used somewhere down the road. You have cells that represent individuals. When you add them up and populate a model, you're viewing it as say, "What's the 55-year-old looking like down the road in the fourth duration or the eighth duration?" This is a reasonable way to proceed. But in the end, you will roll all of this up, put it into an income statement, and create a balance sheet going forward. There's an old phrase, "The devil's in the details," but the details of what you're doing may be lost when it's finally brought up to the CEO/CFO level. Your cells may never get looked at on a cell-by-cell level. You're building your model based on those cells and those populations. You need to keep in mind what the deliverable is going to be and how it's going to be used. The morbidity assumptions are something that I think people are very comfortable asking questions about. And, frankly, even if they don't know what the correct answer should be, they want to ask you a bit more: "Where did you get your morbidity from? Where is this coming from? How much experience do you have here?" You're probably doing that at morbidity at the cell level. It's going to be viewed somewhere down the road on a more global level, so if there are anomalies within a cell, you want to make sure that you can explain and defend them.

Persistency is probably one of the harder things to get your arms around. Persistency, when viewed in your financial model, is probably going to be viewed more as premium persistency. So it's going to get muddied in there. In the end, you need to defend it based on historical results for the particular company that is currently the target or any particular benchmarks that you may see, and explain the discrepancies between the two. People are going to ask, "Why is this business more persistent than the industry average?" They'll ask you to dig up that material. I want to keep everybody aware of that. What I'm describing is the product in some sense. What is the plan's design? Once again, this is a lower level of detail that is going to be brought up to a higher level. You know the design of an LTC product. But a lot of bankers might not be familiar with such things as commission levels and the proper deductibles. They are very familiar with looking at the whole thing such as, "What percentage of premium is going toward expenses? What percentage is going toward first-year commissions and renewal commissions?" They're familiar with it on a higher level and that's what they're going to see. Bankers are going to go to your statutory income statement, and they're going to say, "You know, what do we have here and how did you come up with this?" Explaining that is one of the major roles that an actuary can play in this whole process.

Then there are miscellaneous assumptions to set. Clearly there has to be a plan for rate increases going forward. None of us can really tell what the dynamics are going to be. We all have our impressions. You have to indicate that your plan is reasonable as to why there will be further rate increases and what those levels will be. Concerning tax rates, generally you can get away with assuming 35% of net income. Interest rates are important, but I think that that's an area that people don't ask as many questions about. Portfolio rates generally don't vary all that much. Riders are generally not considered important enough for people to spend too much time on. They can be modeled in the most convenient way possible. No transaction is going to be driven by riders, but be prepared to explain what you've done there.

Now that we've created this appraisal and we turn it over to someone and we have what essentially looks like a phone book, the first question that a banker is going to say is, "Well, what is this?" "What do I expect to get out of this?" or "Where's the answer?" The whole thing is the answer, but someone's going to want to know fairly quickly what are the cash flows and how can they be used to create a valuation and a balance sheet , both statutory and GAAP. The best way that I have seen to model a transaction is to take your statutory income statement and plug it right into a model that includes historical data so you can look backwards and see if all the ratios and relationships are consistent. If there's no consistency between your 1999 historicals and your year 2000 projection, that's a red flag; you can send the appraisal back because you cannot show an inconsistency from one year to the next. I know that when everybody's looking at a piece of business, they expect that there will be some improvements, that you can add value and that your company is creating scale or whatever it may be, or improving plan design. But the fact of the matter is that you're still going to have to explain that, and bridging is that process. Once we have the income statement, the next thing we want to do is see what the operating entities look like. What does the balance sheet look like and what are the cash flows? These are fairly simple exercises. You're given the reserves and your RBC numbers. You should have projections that are about five years out. I do want to mention that if you have projections that do go out further, you can at least look for things even though you're not planning on using them in the valuation. You can look for things that just become unbelievable. Use those other years for confirmation, if you will.

The last point is to keep in mind what you can dividend up to the holding company because, ultimately, debt's going to be serviced at the holding company level. It's going to be dividends that are flowing up to the holding company. If the transaction can't service the debt, if you're using debt financing, then the transaction doesn't make sense. I've indicated a desire to maintain target levels of surplus, and I believe I've stated it before as RBC. Once again, it's just an easy number that people feel comfortable with, even if no one really understands the underlying numbers and how you get to them. It's a pretty complicated formula actually, and you won't get too many questions of what factor you used there, but it's certainly something that people will gravitate toward and look for.

Now that you've created this model the way that I've suggested, and taken the appraisal and put it somewhere. You're going to go back to the appraisal, but for now you've created a model that is more along the lines of what I've called a 1 x t vector. In this case, t is five years. What you're looking at is a set of numbers that generally is driven off of premium. To begin with, where does premium come from? Premium is coming from a premium growth rate. How does it go up from one year to the next? Embedded in there are your actuarial appraisal assumptions of persistency and rate increases. You want to see how premium increased from 1996 to 1997, and then from 1997 to 1998 and 1998 to 1999. Then you get into your projection years. Are there consistencies? So what you're really doing in some sense is data checking your actuarial appraisal. Then when you have your top line, what you want to do is drill down a bit. What percentage of premium represents expenses? You want to keep it nice and simple and have all the underlying things that are going into expenses, be they fixed or variable expenses. They'll have to be there somewhere. Ultimately you're going to be looking at an income statement that's possibly five or six lines, and those lines will be loss ratios, expense ratios, and commission ratios. Income is going to be driven from them.

In addition, you're also going to be accounting for your investment income. Typically, I will include a separate calculation for investment income on your surplus, which you should also need to estimate. I tend to want to put it on a separate line, if possible. It's just important to keep in mind that you're holding a certain amount of surplus so you have a certain amount of investment income. You shouldn't lose sight of that because it's one of the things that's not driven off a premium.

Now that you've done this, everybody will ask, "Well, how did you come up with that? Why do I see loss ratios improving down the road? What are you doing here that isn't being done by the current management?" Generally, you'll be modeling with improvements in loss ratios. If this is going to make sense, I think that that's something that we're all looking for. But a reconciliation is critical and you're going to need to take all those components and determine percentage point by percentage point how you get from your 1999 loss ratio to your year 2000 loss ratio to your 2001 loss ratio. Part of it is going to be coming from rate increases. Part of it is going to be coming from antiselection. Some of it is going to be coming from selection wear-off, a change in the policy provisions, and a change in the mix of business. Quantify these things. Make sure that you can explain them. That means going back to your cells if you have to, and maybe sensitizing things. See if you change premium a little bit. What's the sensitivity here? Know it somewhere in the back of your head. Lastly, at some point or another you'll expect that there is a steady state, a point where the business is just going to resemble the prior year's results. Explain how you get to that steady state. Expect it to take a few years.

I want to speak a little bit more about other financial considerations. When you make a transaction, you should think about the ratings impact. You should think about the claims paying ability and your existing debt and any debt you will be issuing with the transaction. No acquisition is ever made in a vacuum. Consider the impact on ROE and accretion/dilution analysis. You can't expect every acquisition to be accretive from day one, but you should have a plan so that synergies will make this an accretive acquisition. Ultimately, if the synergies are there and you are correct, the market should recognize that. Markets like to claim they're efficient. They may not always be, but I can tell you this much—you don't want to get on their bad side. There will be some early judgment made in the markets, and certain companies are viewed as being very good bidders. If you're not viewed as a good bidder, your stock price will take the appropriate hit.

Those are the types of financial considerations that you should be thinking about. In addition, you look at all the measures of debt capacity. Simple interest coverage ratios and debt-to-cap ratios will work. These are very simple analyses that your banker should be able to provide for you. Perform sensitivity analysis. Stress your model. Stress it as much as you can. Take a look at worst-case scenarios. Management is going to want to see them. You put together a model based on what you expect to be realistic assumptions. Expect someone to doubt them. They'll come at you and say, "Well, what if loss ratios are wrong?" Know these sensitivities. See how the valuations change. See how your coverage ratios change. Find the point where you have to be where this doesn't make sense anymore and you want to back out of a bidding process. Actuaries, myself included, tend to be conservative. You want to make sure that your sensitivity analysis stresses the model to the appropriate level.

At this point Michelle, Mike and I are going to exchange thoughts and impressions.

Ms. Thomson: As Mike was saying, we're just going to take you through the logistics when you go through a buy or a sell process. One of the biggest points I wanted to make is the deal team. There are many different areas represented on the deal team from corporate development, internal company areas, and consultants, to senior management, and the board of directors. One of the biggest hurdles the actuary has to get over is being an effective communicator with all these different areas because in the LTC process the biggest impacts to value are going to be on things such as the loss ratio, the mortality ratios, and the morbidity ratios. Everyone's going to have their own opinions of them. The buy-side teams are going to have different opinions than the sell-side teams. In most cases, there are outside actuarial consultants on both sides. Getting these four sets of actuaries to come to consensus is not an easy thing and requires a lot of negotiation and diplomacy. You must be able to explain what you're doing and to communicate why you're differing from historical. Have you changed underwriting processes?

Do you have more underwriting classes? Do you have different types of goals on either side?

Timing is generally ruled by the sellers and what suits their needs; obviously, it's adjusted along the way. The actuarial appraisal, as Mike said, is probably going to be run many different times, and having the facility and a very dynamic model which can handle different inputs. If you're on the sell side, you "own" the model. The buyer's going to give you his or her assumptions and say, "Please run these through your model." Or they might have their own consultants take over that model somewhat and work with it. Also, if you're on the sell side, you're going to have due diligence conducted by your outside advisors. The actuarial consultants and the bankers are all going to come in and want to talk to you before they agree to represent you. If you're on the sell side, after you hire all these people, you're going to have to sort of prepare marketing materials. Marketing materials are the offering memorandum which tells the story of why you want to sell, describes the business and the management and the historical results, and puts forward future protections and justifies them. The sellers may have to come up with a list of prospective buyers. There may be people they want to own them, or people they don't want to own them. That has employee considerations on top of relationship considerations. There may be something else that the seller can get out of a potential buyer, such as cross-selling opportunities. So, there's a lot of thinking that you have to go through before you even get to the actual sell side. People have to really strategize what they expect to accomplish. How long is it going to take? Does it fit in with their board meetings? What kind of approvals do they need from a regulatory side? Are they going to assume rate increase or are they going to be neutral on them? Are they going to prepare the materials and let the buyers decide what to do? There's a lot of thinking that has to go on in that.

Mr. Porcelli: I'd like to add that it's really all in the preparation. When you go to a data room, you don't really have a lot of time. It's been my experience that the people who spend the most time and work the hardest are the actuaries. They have so many questions they have to answer, and they make every minute in the data room count. But no data room is ever complete. You should know that and expect that. You can't always take everything out of it that you'd like to take out of it. Some of it has to stay behind. The goal is to figure out what it is exactly you are getting out of it and how you are going to communicate those pieces of information. It has now gone from data to information. How are you going to communicate this to the other members of the team? What do you want to get across to them? Everybody has their own perspective based on their profession, and, in addition to that, maybe their own agenda. There might be reasons why the marketing person happens to like something that you, as the actuary, might not like it at all.

Deal teams that communicate work best, and communication is sometimes difficult, but it's important you don't want to hold anything back. It's really game time when you're there. Your initial impressions are going to stay with you for a long time. Once you determine a range when you're bidding on business, it's really tough to pull yourself out of that range. You're going to have to leave enough margin in the range. It's going to take some convincing from one of the parties to get the group away from the range that they initially came up with. That's one of the things I want to emphasize about this. The data room work is critical. Make sure you bring enough back and have everybody on board back at the home office, because there will be work for them. Get them excited about it. It's a fun and exciting process. It involves a lot of sleepless nights, but it's a fun and exciting process.

Ms. Thomson: The next step in the process is really the marketing. If you're the sell side, after you have the offering memorandum, your senior management needs to be in agreement with you on what the appropriate price would be. You must have that all in a row before you contact specific buyers because when the price hits a certain level; you're going to be in a different arena of buyer. Or, if you want to sell, distribution relationships or target cross-marketing relationships, you're also going to have a different sphere of buyers. If there's going to be a reinsurance agreement, where you're going to transfer the experience on the inforce block, and let them write the new block on their own paper after they get it set up, then you're going to have credit risk on the buyers, so you have to be comfortable with their ratings and their potentials. There's all kinds of thinking that goes into who the appropriate buyers would be.

On the buy side of this phase, once you get to the data room, you're going to have free access to what the sellers feel is an appropriate set of data. You may not be allowed to copy some of that data. Obviously the data provided is going to be in some ways incomplete. The sellers have to be comfortable that you're going to use the data appropriately. That's the whole point of confidentiality agreements. Once you go through all this, you're going to hopefully submit a bid that you feel is adequate and comfortable and has a shot of making it past the first round.

Mr. Porcelli: I know that people generally don't feel comfortable with the notion of physically opening up their homes to people. That's what's really going on. There's no way, of course, to get around this and certainly I've gotten plenty of phone calls where you've represented somebody who did not win the bid and you are asked to destroy all documents and then move on. But confidentiality probably can't be stressed enough, so that's one thing I want to leave with everybody. I know that everyone knows and understands this. You kind of have a position where you are expected to know things or sense things or have hunches. But there's a certain amount of confidentiality that, of course, is part of your profession. So that has to be kept in line. You have to be very careful, and I just want to emphasize that.

Mr. Abroe: I just wanted to make one comment about the deal team. I think it's extremely important in looking at your actuarial appraisals, especially from the perspective of a consulting actuary, that you have a consistent story, that the actuarial appraisal relates to the marketing of the particular product and is clear in terms of the assumptions that are developed. In many cases the seller will ask for our input in terms of determining what the appropriate assumptions are. In many cases they will be providing the sales and other assumptions to us. In many cases you'll have pricing assumptions that may or may not be consistent with the actuarial appraisal. The pricing assumptions will be in the data room, so you're going to have to be able to bridge the pricing assumptions to the appraisal assumptions. It's very important to make sure that you've got that audit trail and that ability to explain everything that's in the document. I can't stress that highly enough; it's just the most important thing that we've seen that we need to deal with questions such as, "How come you're using this assumption when it was priced this way?"

Ms. Thomson: Once you go through the marketing phase, you're going to have the due diligence phase. Basically the seller will have a room with all different topics, ranging from marketing, actuarial data, and underwriting to legal history, claims history, etc. It's up to the actuaries to pick the appropriate points of data and make sure that their initial bid has assumptions which match what they see. If it doesn't, they can revise their bids either up or down. For those of you who have been involved it's obvious that the sellers invite the buyers to come somewhere close to their operation for the due diligence. It could be on-site or it could be just off-site—a nearby hotel, for instance. This allows the buyers to interview the seller's management teams and get a thorough understanding of what the culture of the company is. Is it focused on quantity? How has the business been run? What has been the emphasis of the business?

With LTC in particular, these questions are important, because it is such a long-term policy with long-term exposure periods. The inforce block is very important. How was the business run in the past? What were the long-term profitability results? What was their underwriting philosophy? When did they start requiring attending physician's statements (APSs)? When did they start having face-to-face interviews? How many different underwriting classes do they have? How do they do follow-ups? What is their legal history? Do they have class-action potential because their distributors create their own marketing materials?

This is the buyer's opportunity to inspect the seller's company and see the seller's management and interview them. Make every opportunity to take advantage of those visits. Subsequent questions, of course, could be submitted after the visit, and should be, because the more questions that are answered here the better the negotiations will go. Also the simpler your final bid is, the more of a chance you'll have of getting it. People who throw in a lot of contingencies in a final bid are not playing in a safe field with people who throw out a clean bid and just say, "This is how much we feel the company's worth. We're satisfied with due diligence."

Mr. Porcelli: For those who haven't been involved in a due diligence process, I can tell you that if you can find a way for yourself professionally to be involved in the process, I think that's really a great thing. I think every single time that I do due diligence, I learn something. It may not be for a winning bid, but it's always worthwhile professionally. You learn a lot more by going out there and seeing other companies. So I want to kind of emphasize that. Get yourself involved in the process if you can.

Ms. Thomson: I would second that. It's very interesting to see how other companies function, effective other styles of management, and whether you can capture synergy. The way you can enhance your company's value is, of course, to learn from other companies through an acquisition. I want to word that carefully because you can just go out and say I want to participate on due diligence just to do it, but if a company is interested in pursuing that then you can be part of that team. It's a great way to learn for your personal education.

One of the things I just want to mention is the types of people who would be members of this due diligence team. You have your corporate development team, and they're the ones who probably go out and take a look around at what's available for an M&A transaction and the companies that are interested in pursuing one. They make some preliminary decisions as to whether it would be of interest to your corporation. What they then do is go up to senior management and clear it, eventually up to the board of directors, depending on the size and the process of the company. But they're the ones who go out there and say, "We should look at this company." They're the ones who probably have the contact among the senior management with the investment bankers who will be shopping companies to them.

Several other departments will become involved. The tax department has a big role in M&A transactions for obvious reasons. There are many different tax attributes that can influence the structure of their transactions or even determine whether it's a positive transaction for the company to engage in. On the administration side, systems people are critical to making these transactions successful because you have to get the inforce block of business data. Your systems are going to have to understand their systems, because these policies are set for many, many years, and if you're going to buy a LTC block, which is generally a division of a larger company, you can't transfer the systems sometimes. You have to be able to bridge them.

The marketing area has a key role, especially in LTC products because of who the customers are and the scrutiny that people place on how products are sold to, I won't use the word unsophisticated, but maybe vulnerable clientele. People don't want companies taking advantage of seniors. They want to make sure that the variable nature of products is exposed, that the fact that rate increases could take place is very explicitly expressed in the policy form. Underwriting areas get highly involved because they want to know, as I said earlier, when the APS started to become mandatory, or when face-to-face interviews were required. They want to know how many different classes the sellers put their risks into. Are there preferred cases or not? How has underwriting evolved during the time period that the selling side has been evolved as a business? Claims areas want to know what kind of claims are taking place and how many are denied. Why are they denied? Are there any lawsuits that could result from them. So lawyers are also involved. Lawyers actually have a huge role and they cover a lot of these other areas too, because ultimately they're going to be the ones who write the contracts or participate in the writing of the contracts. They really need to understand the issues. They're going to, in fact, probably need to have a really good understanding of the actuarial issues if there's any kind of mechanism that allows the buyers to get some money from the sellers if one of the assumptions doesn't quite work out.

Obviously, there are internal actuaries who are involved. Generally, external actuarial advisers are also hired and one of the key reasons, especially in this arena, is a dearth of experience within the individual company. The actuarial advisers can provide the depth of experience from having looked at a broader cross-section of the industry. We thought they were invaluable in the processes.
Investment bankers just generally help run the process, get people together and organized, and make sure it goes along. They get actively involved in the structuring side, providing some guidance as to what needs to be done. Because they have gone through this many, many times, their perspective can be of great assistance. I said it earlier and I'll say it again—in the LTC process, the actuarial is one of the areas with the most attention focused on them because of how sensitive the valuations are to the assumptions. You're going to get your CEO calling you, saying, "I thought this was worth a lot more," or "I don't think their business is worth this much." It's a very high-profile focal point in the entire process. I want to make sure that was clear.

Obviously, on due diligence, just going back to the logistics, the team has to get together and pregame the visit. You need to divide up who's responsible for what. You can have multiple areas looking at the same files, but there has to be some person whom everyone reports to, to make sure every item gets checked off, appropriate notes are assembled, and questions are compiled. You generally want to review as much as possible before going out to the visit, because you're only going to have a couple of days there—two or three days is typical—to go through mounds and mounds of data. So everything you can get in advance is great. Recently, at least, for a couple of the LTC transactions, they've been sending the data out prior, or they've been sending a complete set of the data back with the team when they return home, so there isn't the pressure to get through everything on-site. In this case, you can spend a lot more on-site time in management interviews and talking to the company. As I said, get that checklist completed and get the insight. There is material that can't be copied, such as outstanding legal cases or some other sensitive data, particularly if the seller is a division of a larger company. Tax returns will probably not be copied because they have information from other areas. Oftentimes, they'll blackline it but they still probably won't want it copied. Again, there should be a continuous thing from as soon as you're allowed to start, you get as much information as possible until that last day when you have to get the bid.

Mr. Porcelli: You should start with all the public information you can get. Go through it as much as you can because that's going to get you up to speed so that when you get to the nonpublic information you know what you have in front of you. Make sure you get a data room index before you go in. In addition to that, you want to make sure that your investment banker can provide you with a generic data room index indicating what you should be expecting there so that you can fill in the holes. Quite often you're going to find that the things that you're looking for aren't there. It might not be that they don't want you to have certain items, but they certainly don't want to just give them up. The seller just doesn't want to voluntarily give some things up. But if you ask for it and you're a serious potential buyer, you will get those items. Make sure your investment banker has a generic list so you can look and say, "These things are important to me." You have to really pick and choose your battles there, too. Make sure that you don't have them running around for some rather insignificant piece of material when they could be running around getting you something that is significant. I can't emphasize enough the need to try to get management's perspectives. You can't take management back home with you, so spend as much time with them as you can. Get to know them and their outlook on things.

Ms. Thomson: What do you expect from the advisers? I'm talking about actuarial advisers, legal advisers, and bankers. Insight into the industry is a big item, and this is probably more of an actuary's or a banker's perspective. The perspective might be on typical things that have been evolving in contracts, especially with reinsurance. They can give you an overview of the trends in the industry: what's going on, precedent transactions, what are new issues they've seen emerge. Mike was emphasizing due diligence as a learning process. You always learn new things to look for and be sensitive to.

Bankers and actuarial advisers will give you advice on what's a fair-value range. Bankers will sort of couch that in terms of prior precedent transactions. Bankers should be able to give you an idea of other bidders or companies who potentially are on the project and what their bidding style has been in the past, if they can. They're supposed to provide you as much insight as possible to prepare you to be successful in this transaction if that's what you decided you wanted to do. They should be able to tell you what's coming up next in the whole process, what you should be focusing on, and what the timeline is, making sure the appropriate parties are giving their buy-in along the way so there's not a big surprise at the end. At the back-end, just make sure people are effectively using everybody's time, scheduling as many management meetings as possible, and doing due diligence because once you leave there are going to be other people in there for due diligence. You're not going to have the free access to management. These people have to still run the business, so it doesn't lose value during the process. Also if you need financing, bankers are there to help finance the transaction.

So after you go through all the due diligence and you've gotten all the advice and some level of comfort with the data and you come up with a value, you go into negotiations. This is when both parties get together and say, for instance, "We're comfortable with everything except for these five things," so you want to make sure they're incorporated into the contract. Give some level of comfort. You want to make sure that you know how strong your bid is or how strong a prospective bid is. They might say we will pay you three times what the next highest bidder offers, but there's such a contingency in there it reduces all the value. So generally the bankers will help evaluate the offers on the selling side and put them on an even keel or an even ground, show where the changes in value can potentially come from, and discuss what the probabilities of those were. Everyone gets involved with negotiations and signing. It's predominantly a legal exercise, but senior management is there all the way. In LTC, actuaries can be there all the way depending on what the sensitive spots are in the transaction. Finally there's signing, which doesn't mean the business has been transferred, it just means that everyone is finally in agreement and comes to some consensus.

Usually when people are submitting their final bids, draft contracts are sent out to companies. Potentially, actuaries would be involved with reading and making sure that their section of the contracts are in line with what went on in the actual appraisal, seeing that all the adjustments are in the indemnity reinsurance deal, that they are appropriately priced and that the value adjustments between when you signed and when you closed are based on changes and prospective changes in lapse rates and morbidity that are correctly accounted for. The actuaries can maintain a role all the way up until that end date.

Mr. Porcelli: I'm going to read something from my library about successful M&As for you verbatim, from A.M. Best, because it's so well-stated. This talks about what leads to disappointing results. "The prospective strategy and financial benefits of a transaction are overstated resulting in lower returns than otherwise would be achieved given a realistic and economically justifiable purchase valuation. The use of rich stock valuations as a currency to acquire targets at inflated prices produces disappointing results. The absence of a proactive and a substantive plan to integrate the two organizations drive desired outcomes. The cultural conflicts of diverse organizations are poorly managed, inhibiting the ability to realize meaningful synergies. The level and range of planning and execution is less than the amount required to overcome operational and cultural challenges. The impact of human resources is steeply discounted or overlooked but remains critical to the success of the integration process." We've talked so little about human resources, and frankly it's a very important issue. It's one that I don't exactly have my arms around and it's my experience that no one really seems to, but if you can get that, you're really a couple steps ahead of the game: "Changes to business models that should be considered concurrent with an acquisition are ignored. Consolidations of convenience do not contribute to operational enhancement or strategic advantages." And lastly, the winner's curse. It's based on empirical evidence, and it implies that winning bids in an auction process always exceed the underlying value of the acquisition target. There's one other point: "Poorly structured and planned transactions beget poor deals."

That's the negative side of it. Drivers to successful M&A transactions: "Transactions support and complement the acquirer's strategy, vision and mission." You can see these are the complements of what we were talking about before: "Realistic prices paid on economic value are a clear operational model for the resulting entity going forward. Careful due diligence of target company and management counterparts. Timely, well-planned and orchestrated integration activities focused on achieving operational model. Attaining satisfactory level of cost savings. Cultural and human resources issues managed very carefully. Proactive conflict resolution across corporate boundaries". And lastly, "effective and continuous communication."

Ms. Thomson: I would agree with that, and I would also highlight a couple of areas. Human resources and cultural fits were not mentioned except for that last point, and that's a key aspect, especially since the biggest drivers of LTC M&A activity are acquiring a company with experience because there aren't companies with a lot of experienced personnel management and access to distribution channels. Another key is making sure those distribution channels do not go away when you buy in, which may mean developing a good relationship with the career agents. Those are key things to make sure that will not go away just because you're the buyer. Energy is well spent on that up until the point of signing to develop those relationships.

There are tangible cost savings, and there is additional revenue or additional cost savings, which could potentially come in as part of the transaction. Make sure you know which one you're factoring in to the purchase price. Different companies are going to have different synergies with each acquisition. Different companies have different costs of financing, so those are going to drive different valuations and give some companies an advantage over others, but I would agree that making sure you get the agreements to maintain current management and access to distribution once again are the key parts.

Mr. Mark D. Newton: Mike, you mentioned that actuaries are usually somewhat conservative. I must confess that I haven't noticed that in too many sell-side appraisals that I've seen. So it's very important that the actuaries get as much information in advance so that you can literally go through and sit down with the actuaries and step by step determine how they got from the information they have to the assumptions they put in the bid. If you understand each of those steps then you can either agree or disagree depending on your point of view from the acquiring carrier.

Secondly, I'd say that not only is it important to determine what the factual data is and whether it's accurate or not, but imagination is required in these things. Not everything is set in stone, and since you're going to be probably going in from a particular viewpoint of a particular acquiring carrier, you need to try to figure out what that could be. Not just what is, but what eventually could be in any synergies or anything else that comes out of a successful bid.

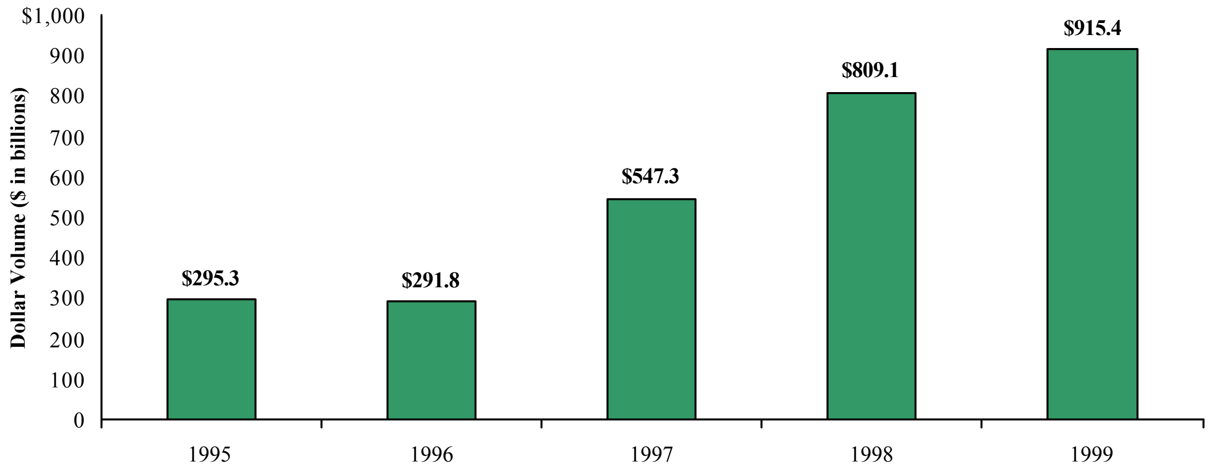
Mr. Porcelli: I would actually agree with that. The actuary's role in this is meant to be more than just taking what management says is going to happen and then finding a way to analytically justify it. It's not just taking management's opinion of revenue growth of X percent. You should have a ??dialog with the individuals who are trying to present these scenarios to you. What are the risks here? I think that's one of my favorite questions. When all is said and done, you have a model. You say, well, I'm ready to stress it but, what could go wrong with this? What are the scenarios where things could go wrong? Get opinions from different people. List them out. See what that does, going forward. Draw up those scenarios and ask for everyone's input in it. Then provide the analytical solution and come up with your own, also.

Mr. Stephen A. Beker: Could you comment on purchasing a block of business as opposed to acquiring a whole company, in particular with regards to arriving at a purchase price and the aspects of due diligence?

Ms. Thomson: Sure. They're obviously different transactions. First and foremost, there's a whole bunch of legal issues that have to be explored when you're buying a whole company, because of the stay with the stack. Tax attributes generally "stay with the stack" company. When you purchase the whole company, there are different levels of due diligence you have to undergo when you buy a whole company versus just the division. However, when you buy the whole company you generally, assuming it's a stand-alone company, get all the infrastructure that you need to run the business. When you divide a division, you're leaving behind some of the legal exposures and tax exposures, but you're also leaving behind some of the systems capabilities. You're going to have to create your new ones and build some new infrastructure to maintain that block of business. Generally, when you buy the whole company you get all the personnel you need to run the company. Conversely, when you buy divisions, oftentimes you'll get the product people but you might not get all the claims system, administrative, and senior management that you need to run that block of business. So there are different costs that people have to factor into valuations when they're comparing those two structures.

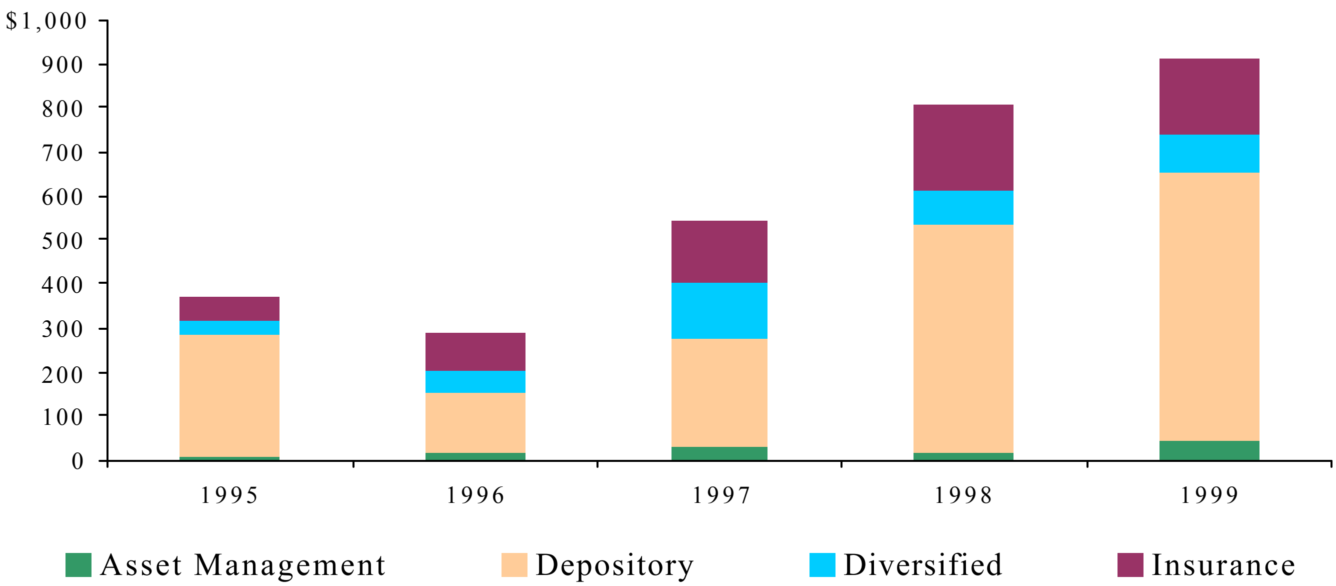
Mr. Porcelli: The one thing I would like to add and I haven't mentioned it yet is that one of the plays that I happen to like is combining an LTC transaction with a Medicare Supplement business. That might be part of the company's strategy to put the two together. That might be a case where you're looking at the entire company instead of just an LTC block. Sometimes there's a very good rationale for this. Of course, you're not just acquiring lives when you do this. There are the issues of people, systems, and distribution. Let's face it—people will pay for distribution. It's one of the things that the insurance industry right now is struggling with. If you have a group of loyal agents, people will pay for that. That's where you have a transaction that's mostly going to have a premium attached to it.

CHART 1
GLOBAL FINANCIAL INSTITUTIONS
M&A VOLUME 1995–1999



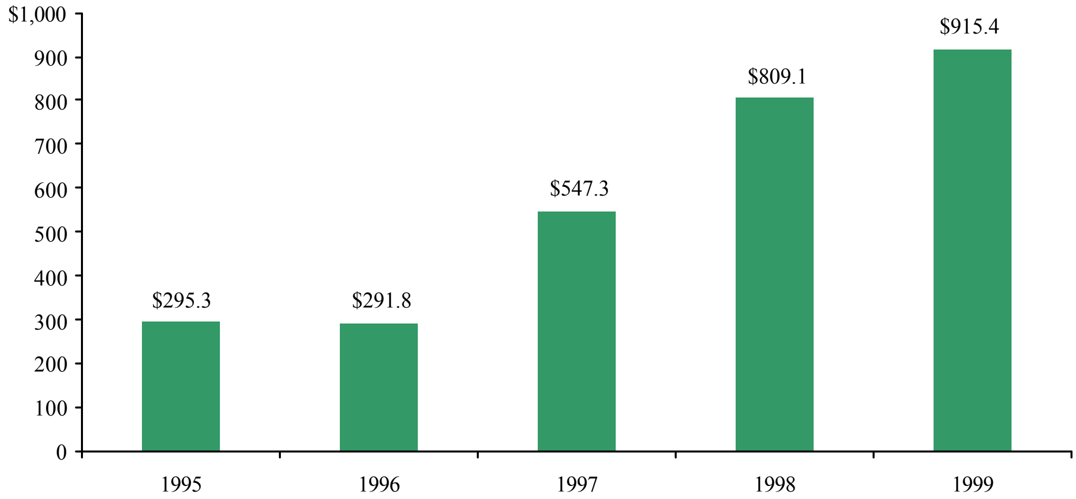
Note: Includes all announced financial services transactions over $100 million.
Number of deals over $100 million noted at base of each column.

CHART 2
TRANSACTION VOLUME BY INDUSTRY: 1995–1999



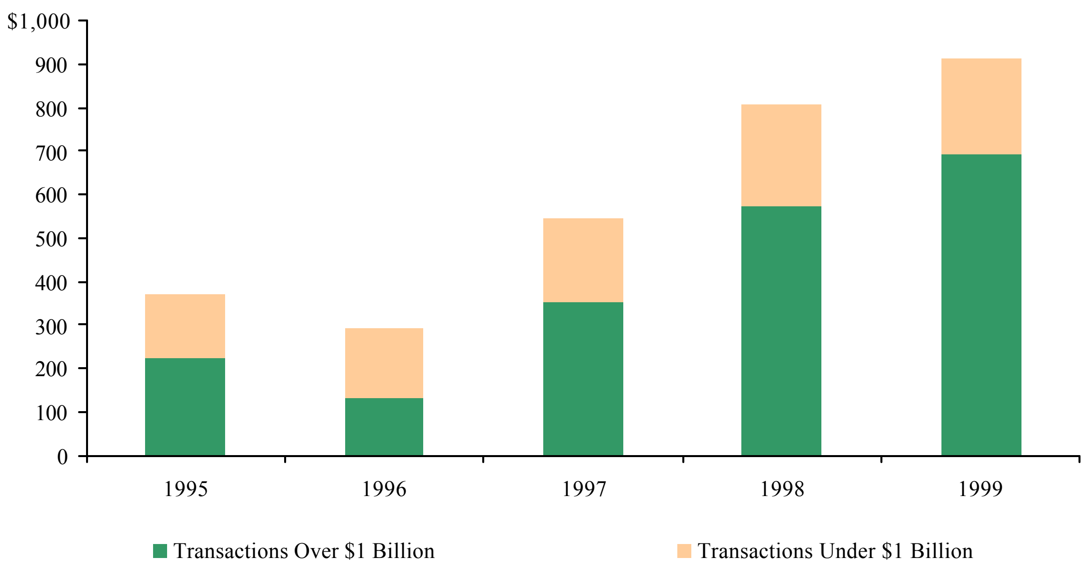
Note: Includes all announced financial services transactions over $100 million.
Industry and geography based on target company.

CHART 3
GLOBAL FINANCIAL INSTITUTION M&A VOLUME: 1995–1999



Note: Includes all announced financial services transactions over $100 million.
Number of deals over $100 million noted at base of each column.

CHART 4
TRANSACTION OVER $1 BILLION: 1995–1999



Note: Includes all announced financial services transactions over $100 million.
Number of deals over $1 billion noted at base of each column
Percentage represents the number of deals over $1 billion.

CHART 5
GLOBALIZATION TRENDS

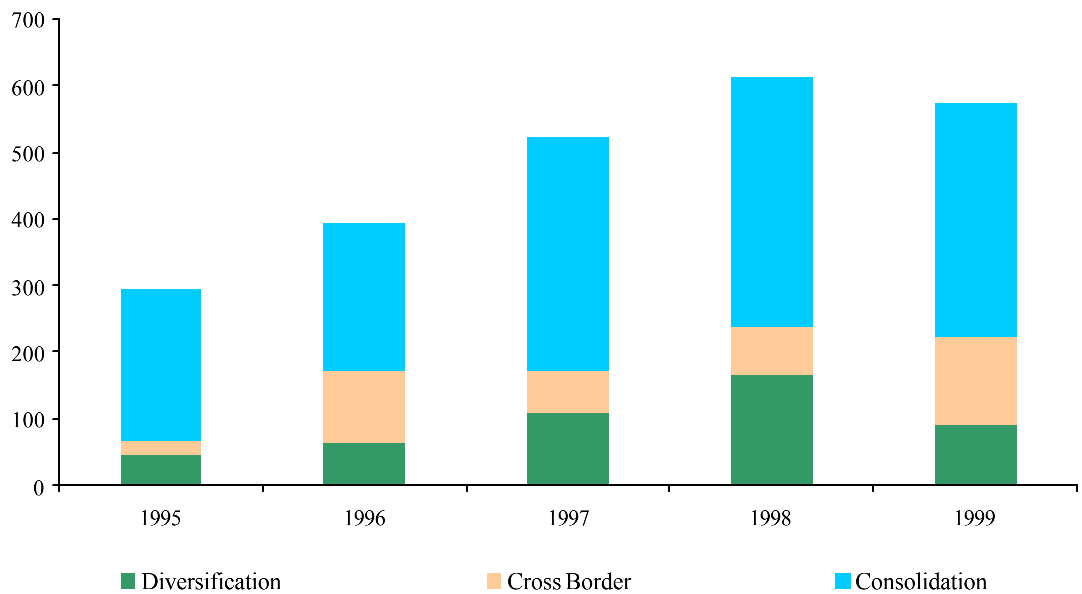


CHART 6
RELATIVE PRICE PERFORMANCE