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Recent Mergers and Acquisitions Activity in the Health Arena—Implications for the Future

Track: Health

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Summary: This session includes a discussion of recent mergers and acquisitions (M&A) transactions and implications for the future. The discussion is from the perspectives of different lines of health business and different types of organizations, including health provider organizations, group insurance products and individual and specialty health lines.

MR. BRIAN A. KANE: There are two things that can drive stock price performance. One is E, earnings, and the other is the multiple that is applied to those earnings. While earnings have gone up significantly—it's an impressive display across all the segments over the last three years—what you've seen is actually slight price/earnings (PE) multiple contraction. Since this presentation was put together, we've had the investigation by New York Attorney General Eliot Spitzer. That's taken these stocks down significantly, though there's been some rebound in most of them.

We've also had one M&A transaction. The Coventry First Health transactionadversely impacted Coventry's multiple, as the market didn't buy into the strategic fit of the transaction. But the larger message is that this has been an earnings-driven play and, in fact, the P/E multiples have come down because there's been concern among those in the investment community that, in fact, the underwriting cycle has turned for the worse (though there is conflicting data in this regard). The underwriting cycle's turned, and looking at forward earnings, they're

Note: The chart(s) referred to in the text are available through the link on the table of contents.

not as comfortable in capitalizing them at such a high rate, and so they bring down the valuations. But again, the earnings have been so strong that you've seen good stock price performance.

As an investment banker, this is one of our favorite pages (Kane page 3, slide 2). The X-axis is market cap, and the Y-axis is P/E multiple. These are two of the critical financial aspects that we look at in M&A transactions. Is the company large enough to digest the deal? Will it still remain in control if it's primarily a stock transaction, and how will it look from an earnings per share (EPS) standpoint? If they have a higher multiple, it's more likely that the deal will be accretive. When you think about companies that are particularly strong acquirers, you look toward the upper right-hand corner, the United Healths of the world, which trade at the highest multiples. They've completed multiple deals very recently. If you look at Anthem Health Plans—and that's pro forma for a transaction with Wellpoint that may or may not close; we'll see—you can see, it's been another very active acquirer for a whole host of reasons. But you can see that they're on the right-hand side of the page. The Aetnas and CIGNAs, from a market cap standpoint, are in the middle. From a P/E valuation standpoint, Aetna has done fairly well. CIGNA is a little lower, as it is completing its turnaround.

On the left-hand side, you have the regional players. Each of these has its own dynamics as to what causes its multiple to go up and down. But it's unlikely, given size, that they'll be acquiring Anthem or United any time soon. In fact, it could go the other way, or they could seek consolidation among themselves as they look to increase their geographic footprint, increase their local market share, etc. We'll talk about that. But this is an important page as we think about potential M&A transactions. Who might team up with whom from a financial standpoint?

In terms of a market overview, one of the key drivers of P/E multiples—and this goes back to what I was saying about the underwriting cycle—is the market's expectation for long-term growth. You can see that there's a good correlation—it's not perfect, but it's pretty good—to EPS growth, long-term growth, on the X access and P/E multiple on the Y axis. You can see, for example, United Health, over on the right, expected very high growth, and it trades at a premium multiple. It really goes down accordingly. When the sector historically has been in favor among investors, companies tend to be a lot closer to that 1.0 PEG line, or P/E to growth. There's nothing mathematical or logical for that. It just so happens that when a sector is in favor, it tends to trade on a P/E multiple basis in line with its long-term growth rate.

And so you see it's slightly below the line. It's actually come down a little bit since the Spitzer investigation. Again, that's driven by potential investor concern that the underwriting cycle may have turned. But some recent data would suggest that in fact, cost trends are in-line, and premium pricing is exceeding them, so it's unclear where that will end up.

Let me talk about one more page (Kane page 4, slide 2), which is the evolution

over time of these market caps. You can see on the right-hand side where we are today, that there are really three groups of companies. You have the Uniteds and the Wellpoint/Anthems, who are the big players in the space. The companies in the middle are the Aetnas and CIGNAs. And you have smaller regional players on the right-hand side, toward the bottom. There are several takeaways from the slide. First of all, there are a lot fewer names on the slide today then there were one, three or five years ago. We don't have all the names on there, but you can see there's been a lot of consolidation. Second, there's been a separation of the market caps. You really see the Anthem/Wellpoints and the Uniteds significantly increasing their size relative to the other players. That will have ramifications for the industry and M&A dynamics.

With that, let me go into what we call the drivers of M&A, past and present, and see what's been driving this. First has been the strategic need. If a deal doesn't make strategic sense, then it shouldn't happen, no matter how good the numbers look. As you've probably read, the number of mergers that have failed unnecessarily in health insurance—and there have been some well-known ones, as you're probably aware—are spread across the whole market. It is important that the strategic rationale makes sense. If you look at Coventry First Health and what investors are saying, maybe that deal doesn't make sense from a strategic standpoint. They've taken Coventry stock, which wasn't one of the highest multiples, down significantly. The stock's down 25 percent.

Second, the numbers need to make sense. As we talked about, you look at those disparities and market caps and P/E multiples. Is it an accretive deal? Can I announce believable synergies to the market? Will this help my long-term growth rate? As we discussed, that drives P/E multiples. How am I from a financial flexibility standpoint? Am I taking on too much leverage? All these aspects will be figured in to The Street's reaction to a potential transaction and will be in the back of minds of senior management of companies when they're thinking about doing deals. Finally, is the timing right? The deal can make all the sense in the world, but for a whole host of reasons, now is just not the right time.

First, let's discuss the strategic need. If you think about it and step back, what are the strategic alternatives for health insurance companies? For one thing, they can execute their business plans, and that's clearly the most important. They can get organic growth in their markets. You see some companies really going strong. Aetna is a great example. They are really driving the business. They've picked up members. The goal is to get a lot of growth organically.

Similarly, what's going on with pricing to get membership? Are you being forced to cut prices too much to get that additional membership? A lot of these insurers had trouble in the late '90s because, as they were going after business, they cut their prices and weren't profitable. So, when they think about executing their business plans, can they get their organic growth in membership without cutting prices too

much below medical costs? There's conflicting data that would suggest, on the one hand, that the underwriting cycle seems to have turned negative but, on the other, that things might not be so bad. Some people would argue that we're headed for what they would call a soft landing because players today are much more disciplined. There are many fewer players in the space today. A lot of the more irrational players have either left the market or been bought out or they've converted, frankly, to for-profit status. There's less pressure from a regulatory standpoint for these not-for-profit Blues to spend down their capital with price breaks. So some people would argue that the underwriting cycle has been muted. We'll see what happens.

Finally, as they think about their business—fully insured versus ASO—they ask, "Where do I want to be?" In fact, not too long ago the belief used to be—and this goes to trends, depending on where you are in the underwriting cycle—that ASO was the place to be. It was a fee business. You didn't have the volatility and the cash flows that you might have in the fully insured space. In fact, what we're seeing now is that the pricing is just as intense on the ASO side as it is on the fully insured side. And so these are the types of things, and many more, that companies think about in executing their current business plan.

In addition to their organic growth potential, they say, "Where else can I get it?" There are two categories. One is what we call in the banking world "bolt-on," or tactical deals, and the other is large and strategic M&A. On the bolt-on side, there are arguments that say, "Why don't we take small bites? Let's extend our presence in areas that we're in"—some specialty—which is a big theme among a lot of the health insurers today. By "specialty" I mean dental or vision or specialty pharmacy—Aetna just signed an agreement with Priority Healthcare on that front—Pharmacy Benefit Managers (PBMs), or disease management. Why don't you slowly expand your services in that respect and look for small, bite-sized acquisitions that you can easily digest, which have low integration risk at a potential high return?

The problem is availability. There just are not a lot of attractive targets out there. As these players think about their strategic options, in many respects they want to do tactical deals because they are low risk and potentially high return. The problem is that there are not a lot of deals out there, and the deals that are available are extremely expensive. Even though they're small, they are still expensive. So people still are being disciplined in that respect. When you think about executing your current business plan and looking at your tactical opportunities, sometimes people come to the conclusion that a large strategic M&A makes sense.

What's driving these large strategic deals? We see several factors, and it depends on the deal. Frankly, many of these different factors that are driving industry consolidation come to bear on any particular transaction. One of the most logical ones you'll hear is "expand geographic presence." Think about some of the Blue Cross/Blue Shield and other deals that have happened—the Anthem deals, the

Wellpoint deals and some of the United deals. They look for new markets to enter where they haven't been to get diversification. They also want to achieve dominant leadership in the local markets.

For example, United had a presence in the New York metropolitan area, but it wasn't very strong. When they looked at Oxford, they said, "This is a great opportunity for us. It's a really well run company. We can make the numbers make sense. Oxford has the best provider relationships in that area, and we don't really have scale in that market. Why don't we think about Oxford?" There were others as well, but that was one of the major reasons behind the United/Oxford transaction. They said, "We need leverage in those markets to drive provider cost down, as well as to have relationships with a lot of the employers." They could take Oxford's local presence and leverage United's national reach and really cater better to the larger Fortune 500 players that have such a strong presence in the New York City area.

What about leveraging existing infrastructure? What about scale? There's some debate as to whether scale really matters. Everyone agrees that scale matters on a local basis. But at some point, are you at a reasonable size at which the benefits of additional scale, just added members, may or may not make sense? Your argument might be that you can defer your fixed costs over a larger membership base. On the other hand, does it distract from your focus to just buy scale for scale's sake? If you don't have strong local presence in the different markets—because health care is very much a local business—then you're really not getting the benefit of that transaction.

What about further product penetration? By that I mean specialty, potential consumer-directed, which is another major trend whereby consumers have choice in some of their health care, at least more so than they might in the traditional plans. They may want to put more members through their dental plans, vision plans, and PBMs because these are scale businesses. It's important to be of sufficient scale that if you can buy a company that has that product depth and breadth, you can put that onto your platform and drive a lot of the costs out.

Another driver of these mergers has been to acquire new product customer segments. This is a situation in which you're not, for example, in consumer-directed, or you don't have a strong PBM. When Pacific Care was thinking about American Medical, an acquisition announced in the summer of 2004, one thing American Medical had, in addition to diversifying Pacific Care's business out of the Medicare or government arena, was a strong consumer-directed platform. So Pacific Care said, "How can we buy this company, leverage the benefits of their expertise in a new area and put that onto our platform?"

Finally, what are the synergy potentials of these deals? These make the deal more palatable from a financial standpoint. Typically, you see somewhere between 10 and 15 percent of the acquired company's sales, general and administration (SG&A)

being targeted for potential synergy reduction, so that really helps make the numbers work.

Given these strategic aspects, what's driving these deals? In the back of your mind, when you're thinking about doing a transaction, what are some of the things you need to consider? First on the list are social issues. I can't tell you the number of deals that have not happened because of social issues, whether it was who the CEO will be, where the headquarters will be or what the board composition will be. You need to work through all of those types of issues before you can really move forward with the transaction. You must think about that from a strategic standpoint. You also have to think about your ability to execute the business plan that you're laying out. As an acquirer, will you have the ability to make the changes you want to make? Will you have the people that you need in place?

Risk and impact of a leak is another determining factor. This is significant not only from a public equity market perspective, in that it causes havoc for everyone, but also in the broker community. You don't want whispering going on that one company is buying another, so they can negative sell you. It's essential that you feel confident when you go to these M&A discussions that you minimize the likelihood of a leak. So you try to keep the discussions relatively small until the very end, when you need to bring in a larger group for detailed due diligence so that you minimize the impact of any leak. This also relates to shock-loss and stability with customer base after a deal announcement. When a deal is announced, there could be a lot of turbulence in the customer base. You want to make sure that you have your customers locked down, and you want to quantify what the potential shock-loss could be as you bring the companies together.

From a systems platform perspective, from a people perspective and from a product offering perspective, some of the mergers in the mid- to late '90s ran into problems from a systems standpoint and from a due diligence standpoint. Acquirors really didn't understand what they were buying and weren't able to put the two companies together effectively. So, at least for a few years, it destroyed a lot of value. A lot of these companies have recovered since then as they finally integrated these deals, but that's an essential component. We're finding that in many of these transactions today, the level of due diligence is much greater than it was historically, which is important for a variety of reasons. One is to make sure that we can have a consistent and strong integration plan that we're comfortable with and that we can execute and convey it to the market.

Regulatory issues can create problems. These have become very prevalent recently. Obviously the Spitzer issues need to be dealt with, but so do the state departments of insurance (DOIs). Anthem-Wellpoint is currently held up by a California regulator. Consequently, when you're thinking about M&A, you need to think about a regulatory strategy. That's very important.

You must consider the provider community. Providers might get upset if all of a sudden the competition in the market goes from four to three. They feel that they'll be squeezed a little bit. It's important when you announce a deal to ask yourself, "Do I have my guys out there talking to the providers and explaining to them why this isn't bad for them?" Frankly, the same is true on the regulatory side. You want to make sure that maybe the night before you announce a deal, you have people out there communicating the story and explaining to them why this is good for everyone, particularly for customers. That's what the regulators are focused on. Obviously the providers are focused on that too, as well as on their own bottom lines.

A deal can make a lot of strategic sense, but you don't want to hamstring yourself going forward. Are you putting too much leverage on the deal? Will that cause you not to be able to do other things that you want to do, particularly in a volatile market? You've seen a lot of volatility in health insurance profits over the years. You don't want to have too much leverage. That can strain your financial flexibility.

Finally, equity market perception is important. It is absolutely essential in these large transactions that you communicate a clear story to The Street. This is why I'm doing this transaction. These are the synergies I think I can achieve. These are the benefits that will assume only to our stockholders, but also to our customer base. And be prepared for the questions that the investors ask. It is absolutely essential in these transactions that the senior management is prepared when it does the conference call.

What are the issues when we think about a merger transaction from a financial point of view? Clearly the price and premium are arguably the most important. From a target's perspective, particularly if it's a true outright acquisition, are you getting sufficient premium on your stock and a fair price? Look at your historical stock price and see where you've been relative to the offer you're getting. Look at the currency you're receiving. All that goes into whether transactions can be completed. Does it make sense from a financial point of view? If it's a merger of equals, maybe you want to accept a lower premium because you're willing to get other benefits, such as more board representation or senior management positions. Is it to be a cash deal? Is it to be a stock deal? Is it to be a mixture of cash and stock? That goes to financial flexibility. It goes to the taxability of the transaction. It goes to different shareholders' preferences for receiving cash and stock. There are all sorts of things that you want to consider.

What are the synergies you can communicate to The Street, both immediately out of the box and down the road? Is it just cost synergies, or can you drive revenue synergies as well? Will this deal be accretive? Will it be an accretion before synergies or after synergies? When will you achieve accretion? What will happen to the P/E multiple? At the beginning, we talked about the two things that drive stock price. One is the accretion, the EPS, and the other is the multiple. When you put

the two companies together, will people be concerned that there's integration risk or that your growth will be diluted and therefore the P/E multiple will contract? Or alternatively will they say, "This is a great transaction. Thank God they did this. I'm now excited about this deal." The P/E multiple expands.

When management teams are thinking about what they might want to do, these are the types of things they talk about. Then they consider other issues, such as return on capital and discounted cash flows. They want to make sure that this makes sense from a return-on-capital standpoint. The challenge in the health insurance world, frankly, is being able to develop a good set of projections. It's not exactly clear what will happen three or four years out. People worry about what will happen in a year to 18 months. That's sometimes a challenge, but it's nonetheless important to make sure that you're getting the returns you need.

Comparable transactions are another factor. This is really a banker's perspective, but you want to see from a multiple standpoint if you are paying too high a P/E multiple or too high a stock price premium. On the sell side, are you getting enough? What you can do is draw everyone's attention to comparable deals that have been done in the space and say, "Was this a fair price?"

And then finally, due diligence from a financial standpoint is important. It is essential in this day and age that you do good due diligence. You'll want to look at incurred but not reported claims (IBNR). Will they come after you and bite you at some point? Are there are any other potential liabilities that you don't know about? You want to make sure that you really go through the target's financials. If you're a target and you're taking stock from the acquirer, you'll do that same level of reverse due diligence. You want to make sure that the stock your shareholders are getting doesn't have risk with it or too much risk that they don't know about.

Typically, transactions have gotten done these days in a 20 to 25 percent stock price range premium. It really depends, but those are the kinds of the things we're seeing. There are some higher numbers and a few lower numbers.

Enterprise value per member has become a less important metric than it was in the old days, primarily because plans are much more profitable per member than they were several years ago. It's not surprising to see a higher enterprise value per member number, like, for example, in the United transaction. They paid $3,000 for Oxford, but only a 7.5 times earnings before interest, taxes, depreciation and amortization (EBITDA) multiple, which is relatively low. There are multiple things that you look at.

From synergies, you're typically in the 10 or 15 percent range of a target's SG&A. Most of these deals have been announced with accretion. That's what you want to do with the markets to sell them on the idea that this is a good deal. Most of the deals have been received very favorably. Typically, when the acquirer announces a

large transaction and he's issuing a lot of stock, that causes some downward pressure on the stock. It's natural for the first few days. Being a few percentage points down on the Standard & Poor's (S&P) is a tame stock price reaction, which generally suggests that the market was supportive of these transactions. Again, the recent Coventry deal is an exception.

Finally, what about timing? The strategic rational may make sense and the financials may make sense, but it may not be the right time. For example, the management or the board of a potential target or an acquirer, for that matter, may balk. They do that. "I have a lot of stand-alone organic growth potential. Why would I possibly want to sell out now? Why would I want to give up my stock when I think it's relatively cheap?" They'll think about that. "Why don't I wait six months to a year? Are there any key milestones or new initiatives that I'm putting into place that will help my valuation? What's the current state of my operations? Am I in a position right now to digest a large acquisition?" So much of this value, again, is created on the integration side. While the strategic rationale may make a lot of sense, if you're not in good shape in your own operations, you really can't do the deal these days.

There are proactive versus defensive considerations. Do you need to do a deal because you're threatened in your markets, or do you want to be proactive now and get these targets while they are available? For example, some companies might say, "I'm interested in target X. It's a great company, but I really don't need to deal with that now." But then they find out it might be in play, and that might change their perspective. It's a timing question because they don't want to lose it. Once it's gone, it's gone forever.

Relative stock prices are a consideration. This goes back to the financial aspect. Is now the right time to do a deal? Does the exchange ratio make this the right time to do a deal? Does your stock price versus the target stock price, the relative P/E multiples, make this the right time to do a deal? There's a lot of uncertainty in the regulatory environment. Do you want to announce a deal in the face of all this regulatory scrutiny today, or do you want to wait a few months and see how things unfold?

We do expect M&A to continue. There are good strategic reasons to see both the national players looking at some of the regional players and some of the regional players getting together to expand their footprints. Over the next few years, I wouldn't be surprised to see a lot more consolidation, notwithstanding the fact that there are some regulatory issues that we need to get through, and some companies are dealing with their own internal turnarounds before they think about acquisitions. But I think over the medium term, we'll see a lot more deals.

MR. ERIC L. SMITHBACK: Brian gave a great overview of a lot of the recent transactions and the motivations for them. I want to focus on value and arriving at

value and expand on a point or two that he made.

During the past few years, I've had the opportunity to work on a couple of demutalizations. Demutualizations are interesting, at least to me, because you look back over the last 20 or 40 years, or at cases that were written in 1937, and see what happened to them over the years. Health actuaries often don't get a chance to think in anything other than three-year periods when we look at the past. When I first thought about this session, I wondered how I should think about this in a historical context. I then looked back at 1985 at the top 10 companies in group A&H premiums (Smithback page 2, Slide 1). That was 20 years ago. Obviously things have changed a lot. This excludes the Blues plans, because I was using life and health plan data that were readily available to me.

One thing that stands out is that the size of the companies has changed. United Health now expects about $30 billion in premiums for the year. Back then, Prudential was about one-tenth that size. The second thing is that the impact of M&A cannot be understated. If you look at this list of 10 companies, these were the largest group A&H writers 20 years ago. Almost half of them are out of group insurance entirely. Six of them are out of medical. Some of the reasons they're out of medical are the things that Brian listed, such as the fact that healthcare is local, so you need a large market presence. The other interesting thing about this list of companies is that almost every one on that list has been affected significantly by either acquisitions or sales.

In yesterday's *Wall Street Journal,* there was a section called "The Best Ways to Grow." It discussed companies and their growth strategies and whether organic growth was best or whether it was best to grow through M&A. One of the things the article said—actually a quote from McKinsey—was that 80 percent of successful growth companies use acquisition at some point. That seems to be true for health insurance. If you look at a list of the current top carriers, including United Health and Wellpoint, you can see that that list also shows that M&A is important. Clearly, for every large company, mergers and acquisitions are extremely important, and it's important to understand the issues that Brian talked about, not only in terms of how the market reacts, but also in terms of how to value blocks of business and companies.

Often we're looking at a block rather than a company, so stock price is not determinable. We often have to go away from the tools that Brian uses in the way he thinks about it to do a projection. Having said that, what tools does the actuary have to assess value? We usually use something called an actuarial appraisal. This is the definition from the proposed Actuarial Standard of Practice (ASOP) 19. (Smithback page 2, Slide 2) Basically it says something that I think you all know which is that an actuarial appraisal calculates present values of distributable earnings. I find it interesting that the first line is an assessment of the value of an insurance entity, including but not limited to an actuarial appraisal. So clearly the

new standard contemplates things other than actuarial appraisals, but the appraisal is the fundamental tool that we use to help in assessing value. Although we can never forecast exactly, I think the quote from Charles Babbage, “Errors using inadequate data are much less than those using no data at all,” is something to be considered when performing appraisals.

There are a lot of inputs that go into a typical actuarial appraisal. (Smithback page 3, Slide 1) All of them are important in some sense, and all of them have an impact. I want to focus on a few that are important in group appraisals. (Smithback page 3, Slide 2) Traditionally, in group appraisals, one of the most important assumptions is the product margin. Product margin is difficult to assess in a group appraisal partly because all business is rerated annually. There generally are no rate guarantees. If you’re losing money today, you can be making money two years from now. The impact of the acquirer on product margins is very large. If an acquirer takes over a business, they start running it in the manner in which they run all their other business. Therefore, expected margins may be very different from historical margins. Often in a sale of group business, the expected loss ratio is not equal to the historical loss ratio. It’s very important to think about how the current loss ratio may change and whether it will change because of the purchase of the business.

A couple of years ago, as part of some M&A work, I did a study to figure out how close people came to their pricing targets industry-wide. As nearly as I could tell, in the health business—and health being primarily medical—people generally achieved 60 percent of their pricing margins. In other words, if they priced for a 3 percent margin, over a period of years they only achieved about a 2 percent margin. When you look at an acquisition, it’s very important to think about what they can achieve, especially if they’re only achieving 2 percent today. Is it reasonable to assume that they’ll achieve 3 percent in the future? Conversely, if you look at the long-term historical averages for life and certain other products, you’ll find that, if anything, life products have yielded profits in excess of pricing margins. A lot of that is driven by interest rates and margins in reserves, which don’t really affect group medical. But it is an important consideration for all group lines.

Lapse rates are important, but typically, in group insurance appraisals, group carriers often don’t measure lapse and/or profitability the way we would like. Select and ultimate lapse rates are important. Lapse rates by size are important. To do a projection that includes those two things, though, you’d have to have some sense of how a company’s profit varies by size of group and how their lapse rates vary by size of group and/or how both of them vary by duration.

Typically, reserve margins are not that important in medical, but they can be extremely important in life and disability. We have done appraisals of blocks of business in the past that included group life in which more than 50 percent of the value was due to reserve margins. That emerges in two ways—by adjusting past

experience to reflect that the margins have effective loss ratios and also that the reserves have significant margins in some cases. The reserve margins can be extremely important in a group life appraisal, but in a medical appraisal they usually aren't. They can't be disregarded entirely, because you do want to evaluate recent experience in light of the actual past reserve margins. But generally speaking, it's not as important in medical.In assessing sales, it may make more sense to focus on overall growth rates for the group lines. This is the approach that was often used in the past. I think a reasonable approach is to assess the reasonableness of the overall growth rate that results from the combined new business and existing business projections. But I don't think the appraisal should be done on a combined basis. It has to separate new business and existing business to reflect the impact of sales expenses properly. Expense savings are extremely important. This is low-margin business. A savings of one percent of premium on the expense side is huge. Brian said that 10 to 15 percent of the value comes from synergies. If anything, that strikes me as a low number because expense savings often are really what drive value in appraisals.
Finally, discount rate is obviously a key input in the process. To some extent the considerations in setting a discount rate are similar to other business. However, for group business, especially medical business, people often wonder whether the discount rate should be higher. If we're doing an actuarial appraisal of medical business, should we be using higher discount rates than we're using for a closed block of individual life insurance? I think the answer is probably yes. There's a lot more risk in medical. We have cycles, we have the possibility of national health care, we have other governmental changes and we have high trends. I

If we focus just on healthcare, rather than on group insurance in general, there are a couple of assumptions that become even more important. (Smithback page 4, Slide 1) One is the medical trend. Yesterday a speaker in a reinsurance session was talking about how Financial Accounting Standard (FAS) 106 valuations 10 years ago used trend rates of 15 percent grading to essentially current GDP growth rates. Over 10 years they might grade from 14 percent down to 5 percent. He pointed out that 5 percent is completely inadequate today.

The average premium charged to an employer for medical care increased by an average of 7.9 percent a year over the last 20 years. That includes periods of high trend and low trend. In that context, I'm not sure that 14 percent grading to 5 percent would be that bad of an assumption for an appraisal 20 years ago. In the long-term, if something is unsustainable it will stop. So the assumption that the trend rate will grade down to some low number, possibly near the GDP growth rate or possibly just above it, is a reasonable one. I think in the past, it was a reasonable assumption.

Another thing that is difficult to reflect is the underwriting cycle, which makes it hard to evaluate recent experience and to evaluate where you're going. I think the impact of the underwriting cycle may be much less important now than it was in the

past, but it's still something you need to be concerned with.

As I said, in medical insurance, reserve margins are not that important. Generally, if we look at historical GAAP adjustments, they're relatively small, so there are fewer issues there. Renewal underwriting, on the other hand, is much more important on group insurance and is especially important on group medical. We need to evaluate renewal underwriting, and we need to figure out whether the underwriting has changed. One of the key tools we use to do that is the billed-to-manual ratio. Unfortunately, there's no standard billed-to-manual ratio, so you have to spend a lot of time understanding what a company means when it says billed-to-manual ratio. Often, it's not so much the absolute level of that number as it is the change from one period to the next that is important. You need to look at the billed-to-manual ratio and try to understand what's going on in their renewal underwriting. This is something that should also come up in due diligence. Sometimes this data is not available at the time of the initial appraisal. But through the due diligence process, you really need to evaluate what's been happening to their underwriting.

Finally, rate increase selection, which is similar to the issue of renewal underwriting, is important. One thing about rate increases is the notion of distressed business and how they have put in rate increases in the past. Another issue, which can also be a due diligence issue, is rate guarantees. If anybody has done premium deficiency calculations, you are aware of the impact of rate guarantees on reserves.

In light of these important variables, I want to compare how the actuarial appraisal relates to the way Brian might think about this. Brian used a couple of metrics such as P/E ratios. The actuarial appraisal doesn't directly consider things like that. However, I think you'll see that if it's properly constructed, they frequently result in similar values.

To create some appraisal values, I looked at a plain vanilla appraisal: 8 percent trend, which is consistent with the 7.9 we looked at before; 10 years of sales—I essentially had sales offsetting lapses; 250 percent of NAIC risk-based capital (RBC); and 15 percent ROE on new business over the life of the projection (Smithback page 4, Slide 2). In this first column on the right—the baseline best estimate loss ratio projection—look just at the value derived by the actuarial appraisal relative to its earnings. It is four times earnings. That inherent value comes from expenses and a little bit from reserve margins. For medical, the impact of reserve margins is small. But on existing business, you have no sales expense. The combination of those two—and it's primarily driven by expense—is that, even on business priced at 15 percent ROE, there is still some value at a 15 percent discount rate, which is, in some sense, analogous to the deferred acquisition cost (DAC).

To get to the kinds of multiples that Brian sees in the market, we have to do one of a couple of things. We could decrease the loss ratio, put in some expense savings, or decrease the discount rate, which starts to get us up closer to the market. We could also put in both a loss ratio decrease and an expense savings. For group medical, these are both frequently measured in terms of percentage of premiums and are roughly equivalent. When we adjust our assumptions, our values now are perhaps 11 to 19 times our earnings. We can increase the trend, which would increase the values a little bit as well. You can also show existing business only, just to show how much of it is coming from the new business. This projection uses different expenses for new business and for existing, so the new business is running off at a slightly lower ROE than the existing.

When all is said and done, under certain assumptions the values that result from this appraisal are generally consistent with where the market is. A properly constructed appraisal that reflects expense savings will often be fairly close to the market. We also see that there is some element of expense savings inherent in most appraisals. Because I started with a block that was already earning a 15 percent ROE, there's no assumption of a change in loss ratios in the model. For a distressed block, we would probably model favorable changes in loss ratios.

For this model of a plain vanilla group operation, the actuarial appraisal turns out to be consistent with the kind of multiples that Brian is talking about when we assume some expense savings and use a slightly lower discount rate than 15 percent.

For some of the metrics that Brian talks about, he thinks in terms of earnings, revenues and members. (Smithback page 5, Slide 1) These types of metrics have some advantages and disadvantages when you compare them to an actuarial appraisal. The actuarial appraisal to me is a much more powerful tool for a number of reasons. You can model alternative scenarios or "what ifs." What does it take to move this business from Point A to Point B? You can do a lot of reasonableness tests. You can compare your business to the projection. If you only have two bottom-line numbers, it's very hard for people to understand what causes the difference between them, but if you start looking at a projection that includes all the components, you can see how that compares to your block of business. You can do scenario testing for expense and loss ratio scenarios. What would happen to the value of this business if we saved more in expense? There are ancillary purposes for which you can use an actuarial appraisal, such as doing purchase GAAP calculations. Since you will eventually need a projection, you may as well do it as part of the purchase process.

Obviously, thinking in terms of value from a P/E multiple or from a PEG standpoint has a lot of advantages because you can compare it to other companies. It's very simple to calculate. You can calculate one for almost every company out there, at least every traded company. You can calculate it for other blocks of business that have been sold. You can compare various companies to the market, which is very

difficult to do with an actuarial appraisal since you don't have an appraisal for a host of other companies. Having said that, I think there are major advantages to the actuarial appraisal. (Smithback page 5, Slide 2) It's probably a requirement for doing a merger in a fashion that will be successful.

MR. THOMAS CORCORAN: I want to talk about the other side of the health and life spectrum—disability blocks and group life blocks. I'll start by discussing recent M&A activity and consolidation in these areas. Then I'll discuss specific deals that have occurred and the strategic and financial considerations that drove those deals. Then I'll wrap up with implications for the future—where M&A activity will manifest itself in new deals.

Slide 3 shows a list of companies by LTD premium volume as of 1997, and where those companies and blocks of business are in 2004. On the left-hand side is the 1997 data. The companies are ranked by premium in force. There are letters along the right-hand side of the list that indicate companies that were involved in merger or acquisition deals; these are the blocks that were acquired. On the right-hand side, you can see where those blocks ended up. The data is from John Hewitts' market surveys, with some adjustments that I have made to fill in blanks for companies that didn't participate.

In general, if we say there were about 45 or 50 good-sized LTD writers in 1997, that block has consolidated to about 30 to 33. I also collected similar information for group life M&A activity for the same time period. The data is from A.M. Best, again with some adjustments that I had to make for companies that were missing. Group life encompasses a larger universe of companies. I included 50 companies before I cut the list off. There were about 15 or 16 deals. The right-hand side shows how those companies stack up now. Even though this is 2003 data, I have combined companies to show the consolidations that occurred in 2004. This includes The Hartford's acquisition of CNA's group life and health block and Jefferson Pilot's acquisition of the Canada Life block.

There's a substantial overlap between these two sets of data because many of the deals that included group life also included LTD. However, there have been a few stand-alone group life deals. Guaranteed Life merged with Jefferson Pilot. On a parallel track, Ohio National was acquired by Canada Life, which was then acquired by Great West, who then spun off the group life and disability operation to Jefferson Pilot. CNA's group division was acquired by the Hartford at the end of last year. The Professional Insurance Company and Union Fidelity merged and formed GE's original group insurance block. Later GE acquired Phoenix Home's group block. In a recent transaction, Standard acquired TIAA-CREF's group life and disability division. Another deal that's several years old now is U.S. Life, which was the group sub of American General and was merged into AIG.
Paul Revere was acquired by Provident, and later that company merged with Unum to form UnumProvident. There were also some complicated deals. General

American sold its group block. A piece of that block went to Great West and another piece went to Metropolitan. Great West, at a similar time, acquired Allmerica's group block. Metropolitan acquired John Hancock's group life operation recently, and earlier had acquired the Businessmen's Association group block. We've talked about Aetna acquiring New York Life's block of group insurance a while ago. That's an old deal. So is AEGON's acquisition of J.C. Penney Life. .

I've analyzed four of these deals and identified why I think they occurred, i.e., what types of issues drive the deals and why it made sense for these buyers and sellers to consummate these specific deals as opposed to something else. I've divided my discussion into both strategic and financial considerations. I think both Brian and Eric indicated that deals need to be made for strategic reasons, in addition to financial reasons. Very few deals are done for financial reasons alone, and there are good reasons for that. In particular, for a deal to make sense, the resulting entity has to be worth more than the sum of the parts. That allows the acquirer to pay a premium to the seller, which gives a reason for the deal to take place. In a bidding situation, it allows the winning bidder to provide a higher price than the other bidders and still have the deal make financial sense for it.

So, let's talk about The Hartford's acquisition of the CNA group business. Some of the strategic reasons why this transaction made sense for The Hartford are that it allowed The Hartford to increase its scale. The company has been trying to grow its group business, and the acquisition provided it with additional distribution capacity, namely sales force. The scale also provided an opportunity to improve expenses.

An interesting perspective is that The Hartford is looking at this as a way to diversify. As many of you are probably aware, The Hartford is one of the largest annuity writers in the United States, and that's its dominant line. It sees the group business as a way to provide some spread of earnings across other product lines. Diversification is something that is not generally popular in the insurance industry today. Rather than diversifying, most companies, in fact, are focusing on their core businesses and shedding non-core businesses. This is where the sellers' block for M&A transactions primarily comes from.

Another interesting dynamic is that before this deal The Hartford was the number two writer of group disability, but numbers three and four were quite close. It's pretty clear that UnumProvident is the number one writer, and they're off in a range by themselves. But The Hartford has been making a great effort to increase its visibility and market recognition in the group life and disability arena. The CNA acquisition gave The Hartford the opportunity to leapfrog its competition and establish its reputation as the number two writer. This was both offensive and defensive strategically. The Hartford is now clearly number two in LTD. If it had not made this deal, somebody else would have, and might have leapfrogged to number two.

Another important aspect of the acquisition is that this is a "clean" block. CNA was selling lines of business that The Hartford wanted and the block did not include lines of business that The Hartford did not want. That's a critical issue in valuing deals, because if you're acquiring a product line that you don't want as part of an acquisition, obviously you can't afford to pay very much for that piece. That can create a disconnect between the buyer and the seller because, of course, the seller wants to be paid the full value or a premium on all of its pieces. If the buyer can't pay something for one piece, that makes it harder to provide an attractive bid. Later we'll talk a little bit about some of the cases where that type of situation has lead to alternatives to traditional M&As.

Finally, we need to look at the financial end. To do any deal, the numbers need to work. In this case, The Hartford was able to make the numbers work, in particular through expense synergies and the power of the additional distribution force. The Hartford was able to provide a return on the purchase price that satisfied the investment analysts and therefore maintained its stock value. The investment analysts looked positively on this deal because the explanations that The Hartford was able to give were convincing to the investment analyst community.

One of the things that can be noted about The Hartford–CNA deal is that The Hartford was able to move unusually fast. I think they started the negotiations in earnest in October and were able to close the deal by the end of the year. Speed is important to transactions to save value. For the group blocks, in particular, the business can move very quickly if the word gets out that it's being shopped. Consequently, not only do you lose the value of the in-force business, but also your distribution force tends to look for more secure positions. Many of your better sales reps won't want to wait until the transaction is complete and then see how they stand. They'll look for offers from other companies, and group insurance companies are always on the lookout for good sales reps. Buyers and sellers are potentially exposed to substantial diminution of the value of both the in-force and new business if a transaction drags out or it becomes known that the business is being shopped.

In another transaction, Jefferson Pilot acquired the group business of Canada Life at the end of last year. Again, the strategy was one of gaining scale. Jefferson Pilot, in particular, was looking to leverage its superior technology platform. JP has built an administrative system that it thinks is an industry leader and has publicized that fact. This represents an opportunity to move business onto that platform and reduce expenses in the process, so JP is looking for blocks of business to leverage that capability. It's a lot more efficient for JP to do that by buying blocks of business than by trying to build it one case at a time.

Again, the products and markets were a good fit. The block included products that Jefferson Pilot wanted to expand in, and there were no blocks of business that it didn't want. In addition, this block of business was the right size for JP to absorb

within its current organization without overwhelming it. That's a critical piece. You can't have an organization that's too big to integrate effectively, because if you screw up the integration, you lose a tremendous amount of the value.

Also, from a financial perspective, the numbers worked. It was primarily an expense-driven strategy. It was easy to present to the investment analysts because that's a pretty simple concept. It's one that investment analysts can buy into and give JP credit for. It also generated a good return on the price JP paid, because JP's system platform increased the value of the block. Essentially, rolling the Canada Life block onto JP's systems platform would generate lower unit costs. JP was able to take that expense deduction as additional profit. Therefore, the same block of business could generate more profit for Jefferson Pilot than it did for Canada Life. This is before figuring that JP now had more units, so marginal unit cost would also go down. The fact that its systems platform allowed JP to increase the bigger profit margin on the Canada Life block meant that the block was worth more to Jefferson Pilot than it was to Canada Life. As a result, Jefferson Pilot could pay a premium to Canada Life to acquire it, and still have it be a good deal for JP.

Another interesting company, of course, is GE. When it acquired the group business of Phoenix, GE was using one of its standard business strategies. Again, it wanted to grow. Its corporate objective is to have lines of business that are big enough to make a difference. Given GE's overall size, that's a pretty respectable amount of business. Going into this deal, GE had a small group block; clearly it was doing this to grow. One of its strategies is to leverage its internal business models. Many of you are familiar with the "Six Sigma" process that GE uses. That is a set of systematic processes that not only drives down expenses, but also improves operational effectiveness. They use Six Sigma for all their businesses, including all their acquisitions. This is a strategy that they have down to a science.

Again, from the financial perspective, the numbers worked. GE's business model would increase the value of the existing block. In many ways it's similar to the Jefferson Pilot model. In taking over a block and applying its business processes, GE expected to increase both the value of the in-force block and the value of the business.

In addition, with a company like GE, just bringing its name and reputation to a group business can increase the value of the distribution system tremendously. The distribution will be selling for a company with unquestioned financial strength that is also a household name. Adding those attributes to a group distribution force can make it much more effective, even with the same people. So those are some reasons GE was able to pay a premium and win the bidding situation on the Phoenix block of group business.

The merger of Provident and Unum is a different story. Those companies come at the business from a different perspective. This actually involved two transactions.

Provident first acquired Paul Revere, and then merged with Unum to form UnumProvident. The strategies here were interesting because it was a different situation. All three companies were market leaders in disability products. Not only that, they were major nondiversified players—they were essentially in disability, individual and group disability, and that was pretty much all they had. The disability business, especially individual disability, was not popular with analysts at the time. So this put them in a defensive position. Clearly they were in an unpopular product line, and that was all they did.

However, they were able to leverage that with the analysts. They turned the argument around by pointing out that disability is not bad when you're the expert. Clearly, these companies were the experts, and they were able to sell that to the analysts. It's a simple and direct message; if you're doing disability, you'd better make sure you're the expert. Being the expert can create a big advantage over everybody else.

When Paul Revere was put up for sale, Provident looked at the situation. At that point, there were three companies that were big IDI players. If Provident took over Paul Revere, there was no question who was number one. If anybody else took it over, Provident would not be number one and may be well behind in the number two position. Market dominance and reputation are important things to have. Clearly, after the first transaction Provident was the leader in the individual disability marketplace.

The same strategic issues really applied to the Unum transaction. If The Hartford or somebody else had taken over the Unum block, it would have been the number one group disability player and a serious player in IDI. Provident then would have been a second-tier player in the group disability marketplace. So with the second transaction, UnumProvident clearly became the dominant force in disability, not only from a market leadership position, but also from a product expertise position. It was pretty much conceded that the three companies represented a lot of the disability intellectual leadership in the industry. They had a lot of people who were experts in disability, and there weren't that many experts in disability in the industry . By consolidating these companies, they were able to consolidate a lot of that expertise, as opposed to having it be acquired by their competitors. These capabilities, skill sets and expertise normally take many years to be built up in companies. The merger of Unum and Provident allowed them to concentrate expertise and maintain an advantage over their competitors.

Looking at the financial side, obviously these are big companies. Not only do you have the expertise and the market share strategies, but there were also significant opportunities to improve expenses by driving down unit costs. Because each of these three companies had a lot of units, that created a substantial opportunity to reduce unit costs.

A final strategy addresses intellectual capital in terms of large databases. Among them, these companies had as much data as everybody else put together. The information that they were able to get out of those databases were competitive tools; merging allowed them to leverage that competitive advantage further, rather than seeing it go to a competitor.

Finally, for the stock analysts, the companies had a simple, effective message: "When you're doing disability, do it all the way." There's no question that they planned to be the disability experts. The stock analysts may or may not have always bought into that argument, but it's an easy one to understand.

FROM THE FLOOR: Given the size of that transaction was there any regulatory oversight or regulatory response?

MR. CORCORAN: There was. I know there were antitrust issues they had to work through. In any merger, the local insurance departments do have oversight. There's almost always a requirement that you maintain operations in the location. But that seems to be the biggest issue. Stabilizing the workforce and that type of thing seems to be their biggest concern. The antitrust issues are something totally different. But once you work through the antitrust issues, that's sort of a yes or no.

So what are the implications for the future? The data refers back to the original slide that we looked at for long-term disability. I've summarized that data in this slide (slide 11). The top 30 companies have consolidated to about the top 19. The top five then had the same market share as the top three do now. The next 10 have consolidated into the same market share as the next seven, and the next 15 have consolidated into nine. The remainder is still at about 5 percent. There have been 12 transactions over seven years. The rate of consolidation implies about one company per year going forward. Even though there have been, on average, 1.5 per year over the last seven years, that's equivalent to one per year going forward on the smaller underlying base. If the same rate of consolidation occurred, you would see only one transaction per year on the LTD side. That's material, but not an enormous rate of consolidation.

For group life, there's a similar pattern. The top four have had the same market share from 1997 to 2004. The next 20 have been consolidated into 13 companies. Then, the next 25 consolidated to another 15 companies. There were about 15 transactions across the top 50, which is similar in proportion to the LTD. As I said, there was more activity across the second and third tiers than the top tier. The historical rate of consolidation was about 2 per year; a similar trend going forward would be about 1.5 per year due to the somewhat smaller base. There have been a few transactions that have been group life only, but not many.

So how do I wrap up my predictions? I would expect the consolidations to continue, but again, it doesn't appear that it's at a rapid rate. It's pretty clear that what's

driving the pace of consolidation is the industry narrowing its definition of core business. Periodically, companies look at what businesses they have been in and decide that for one reason or another they will get out of the group business. That's where the supply of companies for acquisitions comes from. It's pretty clear that there are a lot more buyers than sellers for blocks of group business. You can't predict who or when companies will make a decision to consolidate, however, it's been a pretty steady trend, and there seems to be little indication of new trends.

One other thing that we notice is that acquiring small companies or blocks of business is generally not worth the effort. We have not seen a lot of acquisitions of small companies in particular, because small acquisitions do little to further strategic goals. Even when it's a good financial deal, an acquisition is always a complicated process. If a good deal can't help you with your strategy because it's too small compared to your in-force, then it's not worth the effort. It's not much different than growing organically. As a result, we've seen many of the smallest companies discontinue lines rather than try to sell them. When they de-emphasize a business, they may let it just run off, because the market for small blocks is very weak.

Another aspect of the group, life and disability business is that there are very few new entrants. The only one I can think of in the past 10 years is Northwestern getting into the group LTD business. Other than that, I don't know anybody who's gotten into the group business in a meaningful way as a new entrant. We do not see a supply of companies coming from new entrants.

The most interesting new trend, one that is consistent with the concepts I have brought up, is that we've recently seen a couple of initial public offerings (IPOs), in particular, GE spinning off its life division into Genworth, and Fortis spinning off its health operation into Assurant. Again, I can't say why they're doing it; I can only say what my observations are on it. In my opinion, they're seeing that as an alternative to a traditional M&A. Both of those blocks included businesses that weren't particularly popular with potential buyers. If you look at the GE block, for instance, its group block included medical and dental insurance. There aren't many buyers of group life and disability that want to take over medical and dental as well. Most of the big players in group life and disability don't have any medical anymore.

Also, GE's individual business includes a big block of long-term care, which is not for everybody, to put it mildly. It doesn't mean there aren't purchasers out there, but most of the big long-term care players aren't big group players as well. Potential buyers were not ready to pay full value for that block. The way that GE hoped to realize full value was to spin it off through an IPO.

Similarly, the Fortis block included a large block of individual medical insurance, which almost nobody else has. Thus it would be difficult for them to be paid a good value for all their businesses. It would be a hard block to sell. With the IPO, they

were able to go to the stock market to try to recognize what they think is the value for all the businesses they had.

MR. JIM TOOLE: I have a question for Mr. Kane. I love your numbers. I was looking it over on your acquire price reaction versus S&P 500 performance. On all of these except for one, even though these deals were accretive, their stock price took a hit. Perhaps it's because they were issuing stock. Maybe there's a separate reason for each one of them, but if you could explain some of that, I'd appreciate it.

MR.KANE: That's a good question. It's very common, whenever there's an acquisition with a large stock component, for the acquiror's stock to drop. The question that we always ask ourselves—because our clients ask us all the time—is, how much will it drop? It's very rare that you'll have a stock deal in which the price will go up. In a cash deal you'll see it, but in a stock deal it's very rare to see the stock price go up on acquisition. There's technical pressure, because what you have is an offer based on an exchange ratio. I'm going to get X number of the acquired shares exchanging for the target. So, the natural thing for arbitragers to do is to sell the acquirers' stock and to buy the target stock to drive the numbers to parity. What you'll see is typically an adverse reaction from technical pressure.

What we worry about is, if the market doesn't like the strategic aspect of the deal, they'll really pan it and take it down double digits. In most of these transactions, you've seen that hasn't happened. There have been very few deals in the last few years, but for the one I referenced that was just announced, people haven't seen the strategic benefits. That's a pretty positive chart in spite of what it may appear.

MR. MARK TROUTMAN: I have a question for Brian. Are there any interesting trends in the smaller plays, such as the provider-owned HMOs? Are they more focused now on their hospital reimbursement and maximizing that across all payers versus taking underwriting risk themselves?

MR. KANE: I have to confess that I don't know the answer fully. What I do know is that a lot of these provider HMOs tend to be focused on the government space and the Medicaid space. They have a lot of that business. We're seeing a lot of them saying, "This really isn't core to my business operations. Why don't I think about selling it to the Medicaid players?" In fact, one of the areas I didn't address in my presentation was Medicaid companies. They actually trade at higher multiples than the commercial companies precisely because there are so many small plans out there that they can buy and basically roll up the space. Though I don't know the complete answer to your question, I do see a lot of these smaller plans coming to market. They tend to be Medicaid blocks. But I don't know about the commercial side.

MS. CYNTHIA S. MILLER: Eric, you talked about the fact that when you do appraisals for blocks of business that you would typically include new sales. Would

you also give credit for new sales if that was an in-market transaction, where you were acquiring a block of business in a place where you already had a business presence?

MR. SMITHBACK: I think so, generally. When you go through something like that, you try to figure out the overlap between your sales forces. If you're already in an area, and your sales forces overlap, you might take much less credit for new business than you would otherwise. If you're going into a new area where you're gaining new field people who do not overlap your business at all, you might take much more credit. It's not an on/off switch, but clearly what you just mentioned is a key factor in determining how much value you'll attribute to new business.

MR. KANE: Can I answer that from a banker's perspective? When we look at these types of transactions, we call that a revenue synergy, which is, can we generate additional revenue? We typically don't focus on that because we want to be able to sell to The Street the merits of putting the two companies together, without having to get new business. Sometimes we'll announce that synergies out in the future, a few years down the road, will be a lot greater than what we're announcing today. We'll say that these are the types of things we can do—for example, generate new sales in these markets—but we won't hang our hat on that for valuation purposes.

MR. SMITHBACK: Often in the past, valuations for new business were discounted heavily when purchase prices were actually set. In other words, 10 or 20 years ago, you might look at valuation and see a value of existing business of $100 million and a value of new business of $400 million. When you saw those numbers, the purchase price was probably closer to $100 million than it was to $400 million, so there was a lot of discounting. In my mind, that was partly because the values for new business were inflated. If you're pricing it at 15 percent ROE and you're hitting your targets, the value for new business really shouldn't be that high.