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Merger and Acquisition (M&A) Issues Specific To Group Life and Health Products

Track: Health

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Summary: Panelists provide a "big picture" overview of the M&A process and the roles of the actuary, investment banker, outside counsel, accountants, acquirer and seller.

MR. THOMAS R. CORCORAN: The speakers today will be Jim Toole, Rajeev Dutt and me. I'm Tom Corcoran. I'd like to introduce our speakers first. Jim began his actuarial career with Integon Insurance Company in Winston-Salem, N.C., and moved to MetLife and then to Tillinghast in Mexico City, where he worked for two years before he moved to Milliman Global. Now he's with MBA Actuaries in Winston-Salem, as managing director of the firm's life and health division. He has more than 15 years of management and technical experience in the insurance industry. He has worked in various lines of business, including individual and group life, health and property and casualty (P&C). He's fluent in English and Spanish and has a working knowledge of Portuguese. Jim founded the SOA's Latin America Committee as a member of the Strategic Planning Committee, is a past chairman of the International Section and is a past member of the Computer Science Section Council. In 1996 he founded and edited the inaugural Actuarial Speculative Fiction Contest, and in 2001 he was head of the Global Update of the SOA Table Manager Database. He's co-editor of the SOA-sponsored textbook on M&As that is currently under development.

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Rajeev Dutt is a consulting actuary with Milliman in the Chicago office. His professional expertise includes actuarial appraisals—financial projections for M&A transactions, particularly in the group insurance industry. Prior to joining Milliman, Rajeev worked for more than 10 years in group operations of several large international insurance companies. Rajeev is also on the SOA's Health Risk Management Task Force, where he leads a section involved with developing a specialty guide for health risk management.

I'm Tom Corcoran. I'm a principal with Tillinghast in its Hartford office. I specialize in group disability, special risk, individual disability, accident, group life and other group nonmedical products. I work in the fields of M&A, risk management, product development, pricing, evaluations and actuarial opinions. My professional activities have included the Board of Governors of the SOA, chair of the Health Practice Advancement Committee, founder of the Disability Special Interest Group and chair of the Committee to Develop Morbidity Standards for Individual and Group Disability Coverages. I'm also chairman of the Joint SOA-AHIP Disability Chartbook Committee.

This session is based to some extent on the SOA M&A textbook that is currently being written. Jim will provide the context of the presentation, and we'll have breakouts for Rajeev to do a section on actuarial appraisals and for me to do a section on actuarial due diligence. Jim will wrap things up.

It is a new world for M&A. I would like to start off with a couple of quotes to position things. The first one is one from the *Harvard Business Review*: "The merger and acquisition wave of the '90s lost shareholders more money than the entire dot-com bust." The second is from a survey of 150 senior company executives regarding M&A deals through the '90s. They thought only 11 percent of those deals were successful and were worth repeating; they thought 59 percent of the deals were unsatisfying or even disastrous. A couple of the pitfalls, things they ran into that soured the deals, are shown in Chart 1. Incompatible cultures were a big issue. They did not anticipate foreseeable events.

The general perspective for M&As is a pretty high degree of skepticism, especially from rating analysts and investment firms. People who want to do M&As have to prove the worth of the deals or else their stock will take a hit. You can see the types of questions that management is being grilled with to justify the deal. It's moved, I think, from an environment in which M&As were generally looked at as good things and in which management was given the benefit of the doubt, to one of high skepticism. You have to do a lot more work to make sure it's the right deal.

MR. JIM TOOLE: I have worked on both the buy and sell sides of transactions. I've been on the consulting side and on the company side. I've been a protagonist and a victim, and I've worked in both the U.S. and Latin America. I've seen a lot of different directions. I'll talk about the rationale behind doing M&As, the investment banking process of premarketing the deal, the preparation of marketing materials

and the marketing of the seller. Then we'll move into the sell-side due diligence and valuation. Finally, there's the process of buy-side due diligence and getting the deal closed.

What are some of the justifications for M&A? Basically there are two: the financial and the strategic. On the financial side, you want short-term and long-term gains. On the strategic side, you're looking for revenue growth, economies of scale, horizontal and vertical integration or perhaps diversification of your revenue stream or your product portfolio. Another interesting aspect is that because the insurance industry is so regulated, it might be easier to buy access into specific regions or geographic areas than to try to develop it on your own. That's one of the big drivers for international companies buying their way into the United States. To get licensed in all 50 states would take years.

Also, research and development (R&D) is a big reason driving pharmaceutical mergers. In the insurance industry, there's less R&D impetus, but if you do not have variable annuities or variable life in your portfolio, you might want to purchase that competency rather than grow it organically. Finally, a big reason for M&A is hubris and fraud. It's a good way to cover up malfeasance, but we will assume that's not what we're talking about here.

Premarketing is the investment banking role. Basically you will review strategic alternatives with management. You don't go into your strategic objective saying, "I'm going to merge or buy." You ask, "What are our goals, and what are the ways of achieving those goals?" Sometimes it turns out that the best way to do it is to buy. There are many different types of sales processes: public auctions, private negotiated transactions and then what is called a modified public auction, which is in between those.

How to structure the deal—whether you're paying in cash or in securities or a combination—is also important, both for the buyer and the seller, because it has significant tax implications. You want to look at drafting a team to support your deal process. You have to get accountants, lawyers, actuaries and the different people in place to make the deal happen and get together a buyer list and marketing materials.

Your marketing materials include what is called a teaser. It's a three-page letter that will be sent to your buyer universe. Within that universe, it's like a direct-marketing campaign. A number of people will come back and say that they are interested. You'll make them sign a confidentiality agreement, and then they get the confidential information memorandum (CIM). This is the investment banker's package that's comparable to the actuarial valuation. It's thick. It has a lot of information—background on the marketplace, why this particular deal looks to be a good prospect and why you should buy it—and it's definitely slanted toward making the seller look good. It is biased.

Then you have the bid process letter and finally the actuarial appraisal. The actuarial appraisal is prepared independently by independent actuaries. It's an independent view, but it must go through management. If management doesn't want to send out the appraisal, it won't. In my opinion, it is part of the marketing material. Even though the Actuarial Standard of Practice (ASOP) No. 19 says differently, as a buyer you have to take the seller's appraisal with a grain of salt. From the marketing standpoint, you have initial contact with a buyer and follow-up preliminary bids and letters of intent, which are signed and have legally binding clauses to prevent the distribution of confidential information. Finally, you get to a purchase agreement and a review of the bid process.

Let's talk about sell-side due diligence. Tom will talk at some length about the buy-side process. Preparing the seller for the sale process is an important role that your sell-side team plays. Management may have a view of the company that may or may not coincide with the view of the market. It's members might think they are worth more than they are, or they might not know how much they're worth. You have to put all that into perspective. You also have to prepare what is called a data room. You want to put everything that you think the buyer will want to see in order to make an informed decision—and certainly everything that goes into the sell-side appraisal—in the data room.

Transparency in the data room can increase the sale price. If all of your documents are inscrutable and it's difficult to see the financial progress of the company, or if you have numbers that aren't supportable, all of these will make your auditors nervous and will make your buyer just back off. You have to prepare management to talk to the potential buyers. You want management to be consistent with the view of the rest of the team. If your management is saying one thing, your sell-side valuation is saying something else, and your investment banker is saying something else, the confusion drives down price.

Then after the management presentations, you'll have breakout sessions with the different line managers. The line managers also have to be consistent with the view of the rest of the team. Throughout all this process you're concerned about the confidentiality of who in the company knows about the sale and whether it's public knowledge or not. I think we're now at the valuation process.

MR. RAJEEV MAXWELL DUTT: Thank you, Jim. My session is on the actuarial appraisal. The most common form of actuarial analysis for insurance company M&As is the actuarial appraisal. This is a discounted cash-flow analysis in which cash flows are defined as the earnings and capital available to be distributed out of an insurance company, recognizing the unique statutory accounting and capital requirements of the insurance industry. It can be used as a proxy for the market value of the company. It's a proxy because only the market can determine the value based on current market conditions. The actuarial appraisal can be used as a monitoring device for changes in value. There are certain best-estimate assumptions that are used for the actuarial appraisal. As time passes you can see

how those assumptions play out against reality. Actuarial appraisals also provide estimates of change in value because of economic conditions to illustrate the buyer's or the seller's position, for capital raising initiatives and to support regulators in distress situations.

Jim talked about confidentiality in the data room. The actual data request goes to a closed group of individuals. They know what's going on, and they are the ones who interact with the rest of the company. You may think that the data items that you need for the appraisal should exist in the insurance company, but they may be hard to get at without going beyond the select data contacts. The data requests usually consist of a number of items. Annual reports and annual statements are pretty important items, as you need to find out what you have in your historical financials and what you don't have. The historical financials are used to analyze past values versus planned assumptions. You need to make sure that you have all the relevant history for the lines of business that you want to include in the appraisal and that it ties back to the annual report.

The company business plan is the forecast that internal management has. From that you could develop go-forward values for the appraisal. The actuary's report, that is, the reserves and the assumptions, is needed in order to review the reserve basis and assumptions. Another important data item is any recent pricing study showing the sold rates versus the required rates. This gives an indication of how successful the sales team has been in getting the target rate. Other data request items include experience studies for LTD and waiver and any reinsurance coverage details, including the treaties for any lines of business that are heavily reinsured. Also requested should be any seriatim listings that are available for disability-type coverages.

The development of actuarial appraisal is described in ASOP No. 19. It is titled "Actuarial Appraisal," and Chart 2 contains definitions that are taken from there. Appraisal value is the adjusted statutory book value or statutory net worth plus the value of in-force and future business. Adjusted statutory book value is the excess of statutory assets over statutory liabilities. In addition, certain adjustments are typically reflected for the economic values of certain miscellaneous assets or liabilities that are in the nature of surplus and are not captured elsewhere in the valuation of the in-force business.

Let's move back to the value of business. This is the present value of distributable earnings (DEs), where DEs are excess earnings that could be passed on to shareholders, less the cost of capital. For in-force, this is defined as the business that is on the books as of the valuation date. Future business is what is projected to be written subsequent to the valuation date. Projected profits are calculated based on best-estimate assumptions, which I'll get to in a moment. Note as well that the total value of the company in the marketplace will reflect adjustments for other items that are outside of the actuarial appraisal.

The model approach could be seriatim or aggregate. The bulk of my comments are related to the aggregate model. Initially you combine the cases for the aggregate model by line of business, funding mechanism and/or size. You may be constrained as to the amount of flexibility being built into the model because of insufficient details in the historical data that you're receiving from the company, as well as the level of transparency of the internal management plan assumptions. For example, if you wanted to model by funding mechanism, but your data were not split that way, it may be difficult to do without giving up some precision.

When you are combining the cases by lines of business, you need to determine whether data are reported at the policy level versus the benefit coverage level. For example, you could have a large case that is predominately LTD — maybe 80 percent — and 20 percent life. The data reports may categorize this as an LTD case (policy level), as compared to splitting the premium between the two (coverage level). It's important to know whether the historical financials are categorized at the policy or the coverage level.

Another point in the model approach is to decide whether the projection is to be based on a contract year versus calendar year. Be sure to understand the type of historical data that you have when designing the projection model. The classification of the historical data sources is most important. Understanding this helps to make sure that all of the data sources tie and that they're on the same basis. Ultimately, you should balance the data back to the annual statement to make sure that you understand at least the current valuation year.

The model usually splits existing business and new business. Also, it is important to determine what business is to be included in the model. In other words, what should be excluded from the model because it's not part of the appraisal, is trivial in nature or is being modeled in a separate process?

In comparison to other valuations, the actuarial value is based on statutory principles, not GAAP. For public companies, the impact of the transaction on GAAP earnings and equity is an important alternative set of financial analysis. Nevertheless, the statutory earnings and capital — not GAAP earnings and equity — define the cash flow available to be distributed to owners of the company. Another valuation, the embedded value, is the appraisal value less the value of future business. The actuarial appraisal analysis is a key element in establishing the opening balance sheet for purposes of purchase accounting under U.S. GAAP. It can also form the basis for alternative accounting methodologies resulting from cross-border transactions — Canadian GAAP and U.K. Achieved Profits, for example.

The actuarial appraisal underlying assumptions are best-estimate, in that they are without margin for conservatism. These assumptions are based on some combination of the following. 1) The company historical experience; if these are credible data, then this is a good starting point for developing model assumptions going forward. 2) Industry experience for comparable blocks of business. This is

good not only for comparison to item No. 1, but also for when the company's experience is not credible. 3) Company management expectations, taken from the business plan or long-term forecast, are another source to base model assumptions on.

Assumptions are required for sales and extensions, morbidity and mortality, trend and other rate adjustments, lapses and expenses. Beyond the period of management's sales forecast, growth rates should reflect expectations for the overall growth in the specific market's line of business. Extensions mean new business on existing cases. Regarding mortality, the group life insurance industry has exhibited mortality improvements recently. Accordingly, an assumption of future improvements may be considered the best-estimate assumption. However, if you're doing that, you should include a sensitivity test that removes any assumed improvements.

I'll get into the projection of the line items now. Just because this is a long presentation, I will go through some of the line items faster than others.

In-force premium is the starting point. You need in-force premium and ASO fees at the valuation date, making sure that any ASO premium equivalents are converted so that it's all on a consistent basis. These values should be compared to any historical financials, which should tie to the annual statement exhibits for the lines that are being modeled. Projected in force is the prior in force, plus new sales and extensions on existing business, plus any rate adjustments, less the lapses. You may have to grade to some ultimate rate of growth beyond the management-expected plan range. These factors should be applied either as additive or multiplicative increments/decrements — you have to see how it is in the internal business plan to be consistent with management's forecast.

Regarding premium and fees, earned premium is the weighted average of beginning-of-year and end-of-year in force, with the weights based on the current distribution of cases by renewal month. Due and unpaid and unearned premium are projected as a percentage of written premium. Fee income is projected in the same manner. Reinsurance is expressed as a percentage of direct and assumed premiums.

Now consider earned incurred loss ratios. Ordinarily, you should have two to four years of historical financials. You should make sure they tie to the annual statements going back in time. A review of the current reserve basis should also be done in order to understand how those incurred loss ratios were developed. The earned incurred loss ratios need to be adjusted for the impact of tabular interest and changes in the reserve margin. This adjusted earned incurred loss ratio is used for two reasons. In the absence of rate, underwriting or other management changes, adjusted earned incurred loss ratios can be assumed constant for the projection period, while the reported loss ratio changes annually because of the impact of tabular interest and reserve changes.

In addition, it's easier to validate this against pricing loss ratios. Projected earned incurred loss ratios are some weighted average of the past few years, keeping in mind any future rating initiatives that company management may have. These may be graded to some ultimate percentage of pricing targets. Also, you should examine any one-time adjustments and remove them from go-forward loss ratios.

Chart 3 provides a simple illustration. It shows three years' worth of historical incurred loss ratios with an equally weighted average grading linearly to the ultimate pricing targets by '06. If a company has stronger or weaker initiatives with respect to how it'll get to its ultimate, these should be reflected here.

FROM THE FLOOR: Why are the loss ratios decreasing over time?

MR. DUTT: In this illustration, the idea is that by '06 there would be sufficient rate increases that would be implemented either in the rating manual or with respect to the sold versus required ratio that the incurred loss ratio would improve. This is trying to illustrate a hypothetical situation of management's intended rating action going forward.

MR. TOOLE: It's an illustration of management action that a prospective buyer could take to achieve these long-term rates. You, as a buyer, would need to look at that and decide whether or not you wanted to buy into that.

FROM THE FLOOR: I guess I'll make the statement that the buyer should have a plan as to how that will happen.

MR. DUTT: That's right. Often the projections on the seller side are fairly optimistic, as Jim pointed out. You need to have an explanation as to what initiatives have been implemented to assure that any improvements happen.

Let's move on to incurred claims. Some equations on how to do the projection are shown in Chart 4 . Future incurred claims are calculated as projected earned premium times the projected loss ratio as we discussed. There should be separate handling for tabular versus nontabular claims, reserves and run-off factors.

Expenses are a complicated area. Fully absorbed unit expenses is a method often used for group lines of business where any expense improvements that are realized are expected to be passed back to policyholders. This is the case in yearly renewable-type policies. Under this approach, the expense budget of the appraised company is spread across the in force and new business units. A comparison of historical expenses versus plan expenses provides an understanding of any changes that management is expecting for the future. Expenses could be categorized as sales, renewal, overhead and claims-related. These should then be allocated by function using recent internal functional studies or some industry norms. Expenses projected in this way should be compared and trued up to match the company's expense budget.

Certain parameters need to be kept in mind. How does the projected expense growth compare to the projected in-force growth? This should not be an anomaly of the model but should be explainable. Keeping in mind the concept of fully absorbed unit expenses, will competition prevent expense reductions to flow to profits? How does the projected level compare to external benchmarks? Buyers often adjust appraisals for unit expenses that they believe to be more in line with their internal cost structures. Expense analysis is an important aspect of due diligence, and Tom will get into that in a little bit.

Commissions and premium taxes are fairly simple. They are projected as a percentage of written premiums. Be sure to compare these values to any recent financials and the business plan. You should also review the cede percentages in the reinsurance treaties.

The main point for dividends and refunds is to use the same methodology that was used in developing the future earned incurred loss ratios. For example, if you weighted historical loss ratios equally in developing projected loss ratios, then accordingly you should use the same equal weighting method for dividends going forward. Any fee-at-risk-type agreements in the reinsurance transactions or the sales arrangement should be reflected at this stage of the projection. One thing to check is whether any refunds are included in the historical reported incurred claims. Also, where are interest on deposits? Refund liability should be expressed as a percentage of written premiums.

Investment return assumptions are based on either an assumed rate of return or an explicit model of the existing asset portfolio, along with future investments. Lines of business in which returns are a significant portion of the overall profitability should be reflected in a complete model of the assets backing the liabilities. Explicit asset models should include maturities, prepayment characteristics, assumed defaults, and coupons. Here are some of the issues to review when coming up with your future investment income assumptions.

- Review existing asset pools regarding LOBs.
- Review actuary's report.
- Incorporate capital asset pricing model.
- Develop long-term investment income rates.
- Project as LOB rate applied to start reserves plus half of annual cash flow.

Actuarial appraisals are based on distributable cash flows, which are calculated after federal income tax. Federal income taxes are calculated as the tax rate times the taxable income. The tax characteristics of the company are often complicated, and as a result, tax experts should be included on the M&A team. Taxable income is defined as statutory pretax income adjusted for the following: difference between statutory and tax reserves, deferred acquisition cost (DAC) proxy tax — 2.05 percent for group life, interest maintenance reserves and any material asset basis differences. The tax strain from timing differences between statutory and tax

reserves and the DAC proxy tax often results in higher effective tax rates going forward than the current federal income tax rate.

The requirements for maintaining capital creates an opportunity cost because capital is trapped with the line of business. The opportunity cost is equal to the difference between the target return discount rate that could be earned if the capital could be used elsewhere and the rate the capital can earn backing the block. The exact calculation of the required capital may not be possible because of insufficient data available. An approximation method should be used in order that the ROE and income-on-surplus (IOS) calculations come out properly. The level of capital required is based on company directives. Most life insurers strive to maintain an A- or better rating. Recent actuarial appraisals reflect capital at greater than 200 percent of risk-based capital (RBC) company action level.

In addition to actuarial appraisal values, an appraisal report should include sensitivity analysis. The importance of the critical assumptions should be illustrated against appraisal results with reasonable deviations for these assumptions. An example might be the number of years of new business production. That's an issue that depends on the line of business being modeled. The sensitivity report could be show one, five and 10 years. Shock lapses and trend/growth assumptions are standard sensitivity items, as are different earned incurred loss ratio projections, expense allocations and treatment of overhead. It's common to illustrate a range of reasonable discount rates.

The Actuarial Appraisal Standard of Practice describes the risk-adjusted rate of return as to be reflecting risks inherent in the realization of the projected earnings and should be representative of the return desired by the buyer, seller or owner of the enterprise. The discount rate reflected in appraisals is a total asset discount rate. In other words, the discount rate is applied to distributable earnings before the impact of leverage and may include some or all of the capital asset pricing model techniques, internal company targets or hurdle rates, the cost of funds for the transaction and other M&A transactions market discount rates that have been completed recently in the industry. Chart 5 is a sample table of sensitivities. It gets much more complicated than this illustration indicates.

MR. CORCORAN: I'll cover the due diligence issues in six steps: when due diligence starts, what drives it, what the objectives are, who does it, how it gets done and the processes used. In general, actuaries are involved in all stages of due diligence. I will start off with the broad picture, which includes everybody's role in due diligence, and then focus on the actuary's specific involvement.

When does due diligence start? For the purpose of this discussion, the preliminary bid has been accepted by the seller. The potential buyer is now one of two, three or four companies that are going on to produce a final bid. Up until now, the buyer has relied on the seller's appraisal and offering memorandum. From the buyer's point of view, that represents potential value. Your job now is to pin down whether or not

the value is there. This has to be done in a brief time frame. Basically you have to collect all the data that could affect value, which goes well beyond financial information. The due diligence team must not only identify all the subjective criteria that could affect either the value of the deal (i.e., financial impact), but also the success of the deal (whether the operations will perform the way they need to generate that value).

You have to translate the information you develop into what I call a "buyer's appraisal." Seller's appraisals include, for instance, "reasonable" assumptions, i.e., if the seller's actuary does not have experience reports to support every assumption, he may fill in the gaps with reasonable assumptions. When you're the buyer, you cannot just accept those types of assumptions. You have to make the best evaluation you can and decide what the target is really worth.

Also, what needs to come out of the appraisal process is not just the price, but also specific terms and conditions. This is a lot to get done in a short period of time.

Why are we doing due diligence? You have to confirm the strategic, operational and financial values. What strategy are you trying to accomplish with the acquisition? Will the operations, in fact, support the strategy that you've outlined? The financial value — crunching the numbers and validating or modifying the seller's appraisal — is an obvious driver of value.

Confirming operational value is where the buyer's large due diligence team comes in. This team comes in to identify whether the operations really work the way they should. What are the target's strengths? What are the weaknesses? Can you leverage the strengths? How do you make up for the weaknesses? How much will that cost? How much time will be lost? Also within the due diligence time frame, you must consider the implementation issues. You will also need to construct the final bid, taking all of these things you've learned into account. Finally, you have to prepare for a successful integration. During the due diligence process, you're also saying, "If we do get the bid, what needs to happen for us to achieve the value that we've outlined?"

What do we mean by confirming strategic value? Due diligence is much more than getting the numbers right. Basically, your strategy should create leverage, which generates additional value; that can drive the winning bid. I think that's the key issue: acquisitions are generally bidding processes. If you cannot find something that makes the target worth more to you than to other bidders, it's likely you won't have the winning bid. Few deals get done for pure financial value alone. Examples of synergies include complementary markets, products or distribution (i.e., you can leverage somebody's sales force to sell your products). Another advantage may be merging similar business into superior technology. If you or the target has a good platform, that can increase the value of the other party's business in force. If you're buying a target with a good platform, it can make your in force worth more. If you have a good platform and put their in force on yours, again, that increases the

value of their in force.

Achieving critical mass may be another advantage. If you're new to a line of business, and you can't cover your unit cost because you don't have enough volume, acquisitions may be a good way to get there as quickly as possible. Increase in market share may also drive M&A activity. Many companies have strategies that depend on being one of the top three or four players in a product line. It's hard to get there organically, particularly in the group lines. Because group is so price-sensitive, the way people gain market share organically is often to cut their profitability.

What does confirming financial value include? You have to review the GAAP and statutory balance sheets and identify margins and inadequacies. Group claim reserves, such as disability and life waiver reserves, have margins. Those margins must be quantified. At the same time, you may have ignored or underreserved other liabilities. This has been common in disability insurance (DI) blocks historically. LTC blocks have recently had problems with underrecognition that original lapse assumptions may not be holding up. Another critical piece is reviewing expenses by function, especially parent company allocations and services. What will the expenses look like if the target is receiving little in the way of parent company allocations? Is that real, or is it just an internal mechanism? Will your allocations be more? Will you have to replace parent company functions? That may increase the expenses.

You have to review the target's financial systems and controls. Looking at audit reports and the Sarbanes-Oxley compliance practices is good for that. But clearly the numbers that you are relying on are only as good as the underlying data. You must perform due diligence to make sure that the target has appropriate controls and that you can rely on their data. You must review asset quality and liability matching, any potential asset impairments and any hedges the target is using (common in DI and LTC lines). You must review tax accounting status with the IRS. Has the target taken any aggressive tax interpretations, and what might those be worth? Is the target using tax reserving or other interpretations that are different from those your company uses? Even if you decide those practices might be reasonable, it doesn't mean that the two companies can have different tax policies going forward. Your auditors will usually have a problem with that.

How do you confirm operational value? First is to identify potential holes and what it would take to fix them. Does the target have adequate actuarial services? Is claim management not up to your standards?

One of the most important issues is company culture. Will the seller's operation fit within the buyer's? Are both cultures consistent? It's extremely difficult for a company to have two different cultures; one will almost always drive the other out over a period of time. This is important; it can significantly affect value.

What are the potential integration issues? Is the target dependent on staff members who are not part of the transaction? Will you have access to those staff members during the transaction? Those things have to be spelled out in advance. How will they be paid for? How will the distribution and sales functions be integrated? What is the target using for supporting systems? If the target is using a rented system, can you get a license? If they're using a proprietary system, can you get access? Do you plan to transition the target to your systems? What will happen immediately following the sale? Do you plan to use the seller's systems for a period of time? Are certain staff members critical to success? (In National Accounts or reinsurance operations, specific staff members often have relationships that drive a lot of the business volume.) Can you make sure to get those people? Will they be interested in coming?

How do you construct your final bid? Again, the price generally starts with the seller's actuarial appraisal. You generally adjust the seller's appraisal to create the buyer's appraisal. You add value in for your strategies, your synergies and any hidden values. You subtract value for everything you don't know or understand — potential volatility, potential costs of fixing problems and in particular unknown issues. Unknowns are often the biggest adjustment.

This is where we address due diligence from the seller's point of view — preparing the information so that the buyer can get the most value because generally, when the buyer doesn't know something, it places a low value. Finding out as much as you can during due diligence gets the range of the unknown as small as possible, which increases the amount you are willing to bid and, therefore, your chance of success.

One other thing I want to mention is earnings accretion or dilution. Purchase GAAP (PGAAP) pro forma projections of earnings have a significant impact on the attractiveness of the deal from the point of view of the investment community. Investment analysts want to make sure that the transaction will be accretive to earnings within a reasonable period of time. Historically, there have been several potential deals that, although the financial terms were okay, would not have been accretive. The buyer was afraid to expose its stock to the hit to stock price that would come based on the ratings analysts' opinions of the future earnings.

It's difficult to get representations and warranties that are effective. Generally, there is no recourse postsale. Sellers' rep and warranty insurance does exist; however, that must be finely crafted.

Finally, what conditions do you need to adjust the price between the time of your bid and the closing? What terms do you need from the seller? Will there be an opportunity for postclosing adjustments? There is also a special type of errors and omissions (E&O) coverage that is sold specifically for M&A transactions. As a matter of fact, most regular E&O coverage terminates upon announcement of a sale. It doesn't cover the sale transaction. If you want coverage for it, it needs to be

something specific to the sale.

Why do you need to prepare for successful integration? There's a huge gap between the potential value and actually capturing that value. A lot of companies have failed to realize that. Not only do you have a lot to do, but everybody will be looking over your shoulder to see how things go. Due diligence is the time to anticipate these implementation issues and to make plans to protect value. During the transition from the buyer to the seller, what should happen? When does it need to happen? How do you protect the employees that you want to keep?

Sarbanes-Oxley requires that the CEO and CFO sign off on the first quarter financials following the acquisition, so you have to be prepared. You have to have reviewed the financial controls and be prepared to rely on those quickly after the acquisition. How do they compare to your own controls?

Rating agencies will be demanding the rationale and financial justification for the deal. Once you announce the transaction, there will be an analysts' meeting, and the rating agencies will ask, "How did you price this deal? What's the internal rate of return? How did you do your due diligence? How did you value the reserves?" Your answers will have a significant impact on how they view the deal.

The seller's and buyer's employees and agents need to know what will happen to them. Acquisitions are a significant point of dislocation. People are uneasy and will be out checking their employment options. Communication is critical to keeping key people during the transition. Benefit programs will need to be integrated right away, and everybody will have a lot of questions. Results are best when you have answers prepared. Particularly in group insurance, any period of uncertainty will impact both sales and lapses. During any transition, your competition will be talking to the target's customers and saying, "Now is a good time for you to consider somebody else. You don't necessarily know how the buyer will treat you."

Who does due diligence? It's critical that the buyer's management oversee the overall process. There are both outside and inside experts who participate in due diligence. The due diligence team often consists of 30 or 40 people and sometimes as many as 80. Outside experts include people with specialized skills, expertise and experience who specialize in M&A transactions. Typical outside experts are the actuary, the accountant, the investment banker and legal advisor. Sometimes there are others, such as compensation specialists or systems specialists, especially if your board wants a third-party opinion. Outside experts bring expertise; they've done a lot of M&A deals. They can identify how specific approaches have worked for other buyers.

Generally, the operational experts are buyer's staff (inside experts). Due diligence generally works best when the future owners of the operations are involved directly. Operational experts are the people who will review the actuarial, accounting, underwriting, product management and administration functions. It

works best when the manager to whom each function will report is doing the due diligence. They are more critical of the things they'll have to deal with when they take it over.

What does due diligence look like? I put together Chart 6 . One of the most important things to pay attention to is the scale because it's nonlinear. I'll walk you through it. The top half is what the buyer is doing; the bottom half is what the seller is doing. You can see in the seller section that it selects the finalists, which starts the due diligence clock running. In week one, the buyer sends out data requests. The seller has already prepared its data room. Now the seller is setting up appointments for the various buyers to come through. At this stage, the buyer has also already started to develop its models for the buyer's appraisal and PGAAP pro formas.

Now the on-site visit takes place; this is usually one or two days. The seller does presentations. It brings you through the data room. Your team is usually 20 or 30 operational people. Your team asks the seller's operational people what they're doing. Your team goes through all of the seller's documentation and evaluate the seller's operation. What happens then? You have more questions, and the buyer has more answers. Questions and answers going back and forth is an almost continuous process. In the meantime, you are concurrently developing your buyer's appraisal and PGAAP pro formas. By the end of the third week, you're constructing your final bid.

Even though you're still doing your research, and you haven't necessarily locked up your buyer's appraisal, you've already started to construct your final bid and narrow down the price. At the end of roughly five weeks (these time frames can vary widely), you have to finalize the bid. This goes to the seller, who evaluates the bids and picks a winner. Finally, you have a closing period with adjustments.

What does the process look like? There are a couple of constraints. Time and data will never be sufficient to do everything properly; you have to concentrate on the high points. This is particularly disconcerting for actuaries, who don't like to leave stones unturned. You need to estimate a reasonable value range and be prepared to take action based on that. You may be able to flag some items. For instance, if there are a number of small liabilities that have not been specifically valued, you may be able to work out a deal with the seller that says, "Let's have a third party come in and value those." Neither side would be trying to create a gain on this issue. They want to make sure they didn't miss anything, but it wasn't big enough to devote a large amount of time during the limited due diligence window.

The buyer's ability to place effective reliance is limited. Any postsale negotiations are usually ugly; unfortunately, they are common. You may have relied on certain things, not done complete due diligence and then found out things are different. If you then go back and try to negotiate with the seller, those negotiations often don't work out well.

Effective representations or contractual provisions rely on thorough due diligences. They have to be specific to be effective. General reliances are not effective. As I said before, once the money changes hands in a stock transaction, it's done; you can't go back.

The question is whether it different in an asset purchase? I think the key is whether there is a surviving selling entity. If there's a survivor, there's somebody to go back to if you felt you were misled. It may not be satisfying, but at least it's somebody to go after. If there's not a surviving selling entity, there's no recourse. "They" are now "you."

I'll mention what this looks like specifically to the actuary. The actuary's role in confirming strategic value is to translate the buyer's strategies into values, which is not necessarily simple. How much is it worth to acquire key skills or technology? You have to translate that into a bid. Access key distribution of markets — how might you adjust your model assumptions to make that change your value? The same thing applies to superior technology. Reducing unit cost appears pretty straightforward; however, increase in market share — how much is that worth? What assumption do you change to translate that into a value? It's the actuary's job to take these and translate them into value.

An example of confirming strategic value is acquiring a block of complementary business to significantly reduce marginal expenses. That sounds great; however, there are implicit assumptions that your products are similar and you can put them on your system. Of course, you would need to validate that. Other assumptions may include that the seller has high expense levels and high staff levels. Obviously you're saying you'll improve efficiency. For that to happen, those high staff levels would need to be due to less efficient systems rather than to issues specific to the business. In fact, the seller's operations may be more labor-intensive. Its systems may not be as good as yours. These are the types of assumptions that may be implicit in your idea that you'll drive down the cost.

What actions have to occur? One may be that the transition will occur in a certain time frame and within certain technological parameters, in particular, that you'll be able to transfer the target's policies to your system using an electronic transfer. To the extent that you have to use manual intervention, all of a sudden that's a huge difference in cost. You need a transition plan that identifies whether you need access to the target's staff and systems while the transition is taking place. If the target is renting its systems and if it's planning to keep its staff, those things need to be negotiated now as part of the bid. You can't start looking at those things postsale and trying to negotiate the terms then. How much would that cost?

What other roles does the actuary have in confirming financial value? Clearly you review the statutory and GAAP balance sheets for accuracy and completeness. Compliance is also a big issue. You have to review that the assumptions the target is using are consistent with its experience studies and its reserve adequacy tests.

You need to quantify any margins or inadequacies. The same thing applies to the income statements.

You have to review the target's financial control environment. It's particularly important that the target has controls that allow you to have confidence in its numbers. One of the things you'll be looking for is how it is reserving compared to your own practices. If the target sets up a large DAC and front-ends its profits, and you don't, that business will look different when you have it because you'll almost certainly follow your own policies. You have to review product level profitability for consistency with the findings of the due diligence team. If the underwriting due diligence team says, "These guys don't know what they're doing; they're selling by discounting," you have to take that into account. Look at the financials and say, "Do I see evidence of discounting? Is there rapid growth due to the fact that they have been underpricing?" That could obviously have a huge impact on profitability.

As an example, you could have a company that has not been profitable, and it then decides to concentrate on profitability. Its sales fall way off, but its profitability has turned around. It says, "Now that we've fixed our profitability problem, we'll concentrate on sales." It's showing sales in the future increasing dramatically, but keeping the high recent profitability. It looks at it as two independent things when, in general, they are quite related. Those are the types of input that you need to get from the rest of the team. The actuary has to work closely with the other operational subteams because the weaknesses and strengths in the operations will be translated into the actuarial values.

In group insurance, comparing against industry benchmarks is critical. A company can have good profitability, but, in the group lines, you cannot get profitability that's significantly in excess of the industry unless you have a well-defined niche. Looking at the target's recent experience alone may not be sufficient. You have to make sure that the assumptions are consistent with external benchmarks as well.

Besides putting a financial value on everyone else's work, the actuary also has to confirm the value of the actuarial operations. If the buyer will be taking over the target's actuarial operations, you have to look at the seller's actuarial operations (its valuation, pricing and profitability, product development and risk management). You also have to support the other operational team's assessments. Assess underwriting effectiveness — how does the underwriting translate into pricing? If you will be using its administration systems, are they going to work efficiently? How much more or less might it cost you than what they have assumed?

Asset liability management is also a critical aspect of value. Are the sales projections reasonable? You need to work with the sales due diligence team to try to determine if the projections are reasonable and what the impact on pricing and value may be. Is the company using exotic tax strategies? Are they strategies that you'd be comfortable using? You may have to work with your tax department not only to evaluate those issues, but also to translate those back into values.

What is the actuary's role in bid development? You develop a buyer's actuarial appraisal, which requires reviewing the seller's actuarial appraisal and documentation. Often, for the group lines, the actuary develops the buyer's actuarial appraisal from scratch; as a matter of fact, often it's easier to do so. External actuaries usually develop the seller's appraisal because they have the existing models, assumptions and external benchmarks and can jump right in.

For individual health lines (or group LTC), you need detailed model office projections. You need to rely on the seller's models and make adjustments to the seller's appraisal. This requires reviewing the seller's experience reports. You have to strip out its unit costs and build in your own. You have to quantify the value of your strategies. You need to identify synergies and translate those into values. You need to develop pro forma projections; we've talked about how insufficient accretion can be a show-stopper from the analysts' perspective. You have to support the final bid development and negotiations. You need to identify areas that may require closing conditions. If you couldn't pin down a value for something significant, you need to address that. Are there any representations and warranties that you should have in the final bid?

How will you make preclosing adjustments? Are there things that you'll want the seller to pin down before the actual closing transaction? You may also have to define ranges of values for various negotiation scenarios. Often, the negotiations that follow the final bid are not a clean process. It isn't like the seller gets the bids and picks one. Almost always the seller gets the bids and starts negotiating; the actuary may have to do valuation adjustments on the fly and negotiate some conditions. You may be needed to determine, "What is that worth?"

The final actuarial due diligence step is preparing for successful implementation. You have to prepare for the closing. The CFO will generally answer the analysts' questions. "How did you value the business? How did you value the reserve margin?" One of the key questions asked in each of the analyst calls I've heard is, "What's the internal rate of return that you priced to, and how comfortable are you with that calculation?" They're asking specific questions about the transaction and how you arrived at your value.

Because of Sarbanes-Oxley, your CEO will have to sign off on financials quickly. How do you integrate the target's control environment into yours? That has to happen quickly. You don't have six to nine months to build your own process. You have to understand the target's process and have an idea of what you'll do to shore that up as soon as the transaction takes place. You must consider critical systems capabilities and key staff. Now's the time to make specific plans on how things will play out between the closing to when you take over the business.

So far, we've identified each of the roles of the actuarial team. We have talked about strategic, financial and operational due diligence; the buyer's appraisal; constructing the GAAP pro formas; and constructing the bid. The strength of the

internal actuaries is that they understand the buyer's environment. They quantify the findings of other members of the operational due diligence team. They own the actuarial processes. They collaborate with the other operational teams to translate the findings into specific changes in the assumptions that go into the buyer's actuarial appraisal. They analyze the target's experience.

The external actuaries bring special due diligence expertise and experience. They provide external benchmarks and can fill product-specific gaps (i.e., if you're taking over a product that is new to your company). They have M&A-specific knowledge. What has worked for other companies? What pitfalls or reserve shortfalls have they seen? Are there holes in values that they've seen in other transactions? They have existing models and techniques, and they have had experience identifying and developing closing conditions (for example, what contractual language has worked and what has not).

Back to Jim.

MR. TOOLE: That was incredibly valuable. I don't think the due diligence process has ever been so well-defined. Tom has also been coordinating the due diligence chapters that are going to be in the book, which include life, health, P&C and also the perspective of the accounting, investment banking and legal aspects. That was a rich presentation. There's another little component in the book from which I'll briefly read. We're getting contributions from members of the community to talk about their experiences in due diligence. We're loosely calling them crypts because they are kind of "Tales from the Crypt," which could be horror stories or fun. This one I think is illustrative of some of what Tom has been talking about.

"This was an actuary who was on the due diligence team for his buyer. He had dug into the financials. As is typical with casualty firms, there wasn't an actuarial appraisal. The company inserted several inconsistent items, such as improving loss ratios and conservative reserves. His guard was up. He looked into the development of reserves during the last two years. He ascertained that the company made two significant changes in reserve assumptions: one, tail factors were reduced, and two, expected loss ratios were lowered (that lowers reserves). The current estimates were based on an average of historical results with improvement to reflect enhancements in the underwriting model. The actuary then uncovered that the company had lowered its explicit margin for conservatism from 8 percent to 1 percent, and he further determined that the improvement in loss development factors was driven by backlogs in the claim department. With the slower processing, there were fewer dollars played. He concluded that these facts alone overstated reported earnings by \$6 million each year, hugely overstating the value of the company!"

I think what Tom accurately described was that in doing due diligence, you have to do two things. You have to look out for the holes, but you also have to look out for value. That's important. I think Tom already incorporated a lot of this, but how do

you get to yes in the final assumption? There are many pieces of this process, and the actuarial appraisal is only a part of it. It's just one tool that management and the bankers and the rest of the people use to get to value. It's like selling your house. You just don't look at the appraisal and say, "That's the value." You try to take other considerations into account, such as your price-to-earnings ratios, similar transactions and the peer group in the industry at large. Also, you must look at control premiums. What is the value for controlling this entity? The stock value today is \$10, but when you own it, the value might go up to \$12 because of the control premium. That's because people perceive that you might be able to add value to the company.

What are some reasons that appraisals have different values? We talked about three different aspects to the appraisal value. One is the adjusted book value, one is the value of in-force business, and one is the value of the new business. One of the reasons your adjusted book value might differ is because of the disagreements on the level of reserves. Your view on how those reserves will work out may differ. I'll read a quick crypt on that one just so you know it's not all about the numbers.

"The selling company had a block of disability income business whose claim reserves were acknowledged to be short. Of course, the question is, how much? The seller's actuaries had provided an analysis that indicated a deficiency based on a one-year test as performed in Schedule H. That's a back-of-the-envelope analysis, and the buyer received that information very late in the game. A lot of times, important information will come on your desk the day of, and you have to make a decision. The actuary on the buy side went through a calculation based on the value of future benefits, revealing a much larger discrepancy in reserve. The issue had to be resolved with only a few hours to go. With the discussion starting with technical discussions the side interpreted as stonewalling, the two opposing attorneys started yelling, and one of them ran out of the room and said, 'We can't have this at this point when we're getting ready to close.' It seemed straight out of a TV movie. Finally, after considerable huffing and puffing, the issue was resolved. The final numbers were not based on actuarial calculations, but 'why don't we split the difference?'"

Sometimes, that's what it boils down to. Actuarial calculations help influence negotiations, but the final numbers are based on other factors. As an actuary, I thought everybody had to believe every number that I created, but it doesn't work that way. Most of the time, management and the investment bankers don't even understand what you're doing. You have to work on communicating that and becoming part of the process and part of the solution, or your voice may be lost.

We were talking about whether you show zero years, one year, five years or 10 years of new business. The amount of value that you ascribe to new business production is based, in part, on how much you value the distribution channel. If you think your distribution channel is important and you need to have that distribution, then you'll pay more for it. Part of the rationale for bringing in actuaries is to try to

quantify that value. But at the end of the day, once management agrees on a value, then you have to do the confirmatory due diligence, which we've talked about. You come to a definitive agreement, and usually a willing buyer and seller and creative lawyers can work out any details. Typically actuaries don't see that part of the process. We don't get to see every item that was brought out in due diligence in every closing detail, but rest assured that the lawyers wrestle long and hard over that one.

I think Tom brought this out — there's no substitute for due diligence. You could have the best lawyers in the world, but if you haven't done your due diligence, your definitive agreement won't save you.

Finally, you get to closing and regulatory approval. One of the most interesting definitive agreement clauses that was brought to my attention was another potential crypt. "When I bought the company back, one of the provisions that I agreed to was to never discuss any of the experiences regarding the transaction. Accordingly, I can't share these experiences." That's the agreement.

After you've done the deal, you have to present it, and many different constituencies, stakeholders and publics have to buy into the deal, or your stock value will dive. First, you have to present it to the board of directors, and the members have to buy into it. Then you have to present it to the rating agencies. You have to present it to the regulators. You have to present it to the analysts. I don't know how many of you followed the AXA/MONY debacle, but whatever you saw in *The Wall Street Journal* was kids' stuff compared to what went on in some of those stockholder meetings. There's a lot of name-calling and fingerpointing. They believe that the value of the stock was \$48 a share for a year. It had been going up, and then management decided to sell out for \$31 dollars a share. Everybody rightly felt that he had been deceived. There were a lot of angry investors.

Of course, finally, you have to communicate it to your shareholders, and the type of information that these people are looking for include the accretion/dilution ratios, the strategic rationale, the financial implications, the ratings impact and returns going forward. What is your GAAP ROE? That's an important number. What's your hurdle rate?

The fun part is that you have to do it. You have to implement it. You have the operational integration and the cultural issues that were discussed previously and dealing with employees, the distributions and the policyholders. At the start we said, "M&A is a difficult process, and nine times out of 10, people don't think it went well." It begs the question as to why people would do it. But there are successful acquirers, and AIG is first up there among them.

What does it take to be a successful acquirer? You have to do it regularly. Your first time will not be as easy and probably not as good unless you have some luck on your side. You have to identify value and bid appropriately. Don't get caught up in a

bidding war. Many of the situations are bidding situations, but if you can't identify value and find a way to achieve that, get out. You have to protect your investments through due diligence. If you don't do good due diligence, there's no way to make the deal a success. You must get the lawyers to protect your deal. Finally, you have to become proficient at integration. That is a learned skill. You can get consultants to help you with that process, but you don't want to delegate it to the consultant so that management is not responsible and does not understand. It's another great way to make it fail. Just like in the due diligence process, you have to have management involved in the integration process.

Whatever the drivers of the deal were during the integration process, you have to make sure that you capture those drivers of value. If you don't set your targets on the expense savings, on the revenue synergy and on the strategic aspects that you rationalize the deal to your publics, your analysts will come back to you in a year or two years and say, "Why didn't you do that?" You will be penalized for it. You have to address the cultural issues in a timely and forthright manner with your internal stakeholders, employees, distributors and other people. I think that's it.

MR. CORCORAN: We have a few minutes for questions.

MR. JAMES E. OATMAN: I guess most of the context here was probably for a stock deal in which the transaction is done, and it's over. But about 80 percent of the M&A deals that we've been involved with have been a block of business in which somebody is divesting a segment. It seems to me the art of the deal is often in crafting deal structure and working to understand the other party's needs and then trying to figure out what kind of a structure would work best for the deal and what kind of contingencies might be involved. I wonder if you might speak to some of your experiences on that aspect, when it comes more to somebody divesting a business segment and acquiring blocks?

MR. CORCORAN: We did try to narrow the scope to focus on certain aspects or certain types of deals. Block deals give you some more flexibility. You do have a surviving seller. You can have earn-out clauses and other things that allow you a little more flexibility in how you structure the deal. I think that most of the other aspects that we talked about are just as critical there. Again, if you do not do thorough due diligence, the best earn-out clauses or "we'll work it out later" type agreements prove to be generally unsatisfying.

MR. DUTT: In terms of the complexity, the three components of the process or the value that we look at actuarially in terms of ASOP No. 19 are the book value, the in force and the new business. If you're just buying a block of business, you're basically looking at the in force, so you don't have to worry about the other two elements. If you're buying a line of business, including the distribution, then you still have to deal with the new business. But obviously for the asset transfer, which we didn't get much into in this, you do have to look at your backing assets.

MR. JAMES T. O'CONNOR: Could you comment on the appropriate length of the projection period and how that might vary by the type of block of business we're talking about, particularly on the group life and health side?

MR. DUTT: This should show up in the sensitivity part of the appraisal report. There is no particular "correct" period for any one block of business. For disability-type business, the cash flows should be projected for a longer period of time. Ten to 20 years is an appropriate period of time. It also may be a function of the time that the seller believes that any internal management action would become apparent. For example, there may be a certain period in which new system expenses are expected to be paid such that greater value, because of the systems initiatives, starts showing up in year X. Thus it would be important for this line of business to include beyond Year X in the projection.

MR. CORCORAN: In the group lines, I'd say 10 years is a common period from the point of view that the premium flow is not guaranteed — renewal premiums are not guaranteed — and the lapse rates tend to be fairly high. We don't see that many buyers who are willing to pay for much more than 10 years of renewals.

MR. TOOLE: One rule of thumb that you can look at is that on the cash-flow testing, you have to do it until reserves are no longer material. I think you can apply that.

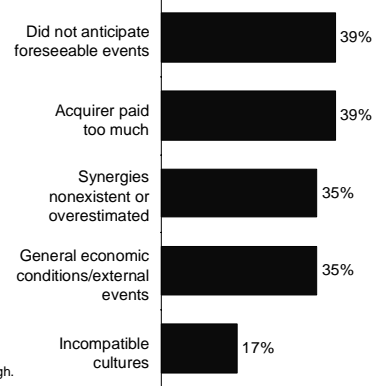
Chart 1

Potential pitfalls are generated by various factors

Problems Encountered in M&A Transactions That Did Not Fully Meet Expectations

Rank	Top Ten Pitfalls	Negative Impact
1	■ Incompatible cultures	5.60
2	■ Inability to manage target	5.39
3	■ Unable to implement change	5.34
4	■ Synergy nonexistent or overestimated	5.22
5	■ Did not anticipate foreseeable events	5.14
6	■ Clash of management styles/egos	5.11
7	■ Acquirer paid too much	5.00
8	■ Acquired firm too unhealthy	4.58
9	■ Need to spin off or liquidate too much	4.05
10	■ Incompatible marketing systems	4.01

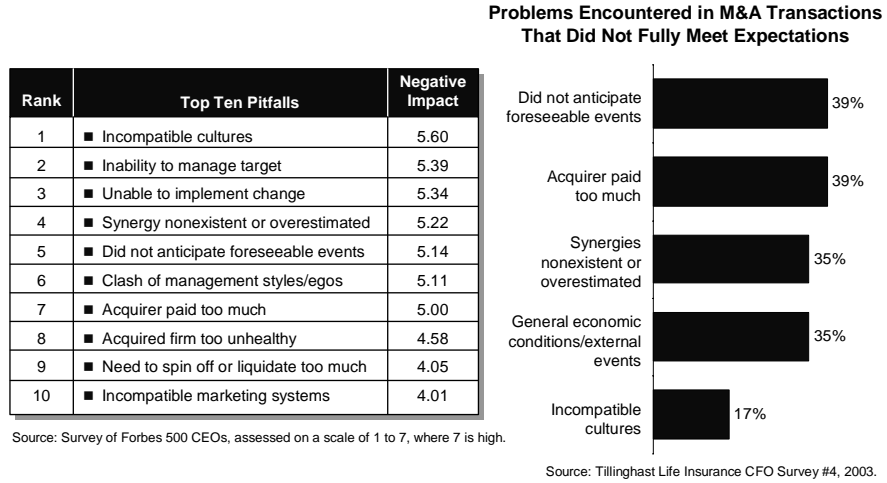
Source: Survey of Forbes 500 CEOs, assessed on a scale of 1 to 7, where 7 is high.



Source: Tillinghast Life Insurance CFO Survey #4, 2003.

Chart 2

Potential pitfalls are generated by various factors



3

Chart 3

EILR Illustration: Grading to Pricing Targets Over Three Years

LOB	Adjusted Loss Ratios						
	2001	2002	2003	Weighted Avg	Projected 2004	Projected 2005	Projected 2006+
Life	76.5%	57.6%	76.4%	70.2%	69.9%	69.7%	69.4%
LTD	64.6%	83.6%	72.5%	73.6%	69.9%	66.3%	62.7%
Dental	92.8%	87.3%	81.2%	87.1%	78.8%	70.6%	62.3%

Chart 4

Incurred Claims

- Projected earned premium x projected EILR
- Tabular lines
 - Seriatim projection
 - Projected paid claims = current reserve x runoff factor + adjusted incurred claims x runoff factor
 - Projected reserves = PV of future paid claims x reported-to-adjusted for PAD ratio
 - Runoff factors based on company data
- Non-tabular lines
 - Incurred claims projected using projected EILR
 - Reserves projected as ratio of reserves to incurred

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Chart 5

Sensitivity Illustration

PV of Pre-Tax Profits at Valuation Date		
Assumption	Discount Rate	
	8%	10%
Base Projection	\$233	\$195
5 Fewer Yrs Projected	\$205	\$178
3% Higher Lapse	\$226	\$190
5% Lower Rate Sold	\$214	\$180

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Chart 6

(How) So What Does This Look Like?

BUYER									
	data request		more questions						
		on-site visit	additional due diligence						
	develop buyer's appraisal & PGAAP pro formas								
				construct final bid				closing	
week #	1	1.2	2	3	4	5	x	x	
selection of finalists		seller's presentations & host data room					accept bid		
	prepare data room		more answers						closing
SELLER									