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## Session 61
## Where Did All the Mergers and Acquisitions Go?


**Track:** Financial Reporting

**Moderator:** John O. Nigh

**Panelists:** Stephen Fromm
Laird D. Zacheis



*Summary: This session discusses subjects related to mergers and acquisitions (M&A), including both the North American and international economic factors contributing to the lack of M&A activity, the factors that may influence the level of M&A activity in the near future, and what potential opportunities for M&A activity exist in the marketplace today. Other points covered include accretive/dilution analysis, the drivers that dictate the success or failure of a given deal and ideas for areas of study in order to find M&A opportunities.*


**MR. JOHN O. NIGH:** This is Panel Discussion 61, "Where Did All the Mergers and Acquisitions Go?" My name is John Nigh. I'm a Managing Principal with Tillinghast in the New York office, in charge of our mergers and acquisitions (M&A) practice for the Americas. Previously, I was in charge of the Latin America practice for Tillinghast and have been with the firm since 1987. On our panel is Steve Fromm, who is in the New York office of Citigroup Investment Banking. He's head of the insurance practice for Citigroup. Steve and I first did a transaction together in Latin America, and he has been involved in a number of transactions over the years. So has Laird Zacheis, our other panelist. Laird is a principal in the Chicago office of Milliman. He focuses his practice on M&A. Steve is going to speak first, followed by

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**Note:** The chart(s) referred to in the text can be downloaded at: http://handouts.soa.org/conted/cearchive/NewOrleans-May05/052_bk.pdf.

Laird, and then I will say a few words. At the end of the session, we'll talk about not where have the transactions gone, but where are they going. At that point, we'll also do a question and answer session. Feel free to ask a question whenever a thought comes to your mind, challenge the hypothesis that we might present or just disagree with any conclusions that we might also postulate. Let's begin with Steve.

**MR. STEPHEN FROMM:** I'm Steve Fromm with Citigroup Investment Banking. I'm going to spend a some time talking about overall trends over a period of time in North American M&A activity, as well as a little bit about valuation and drivers of transactions over time. Slide 2 on page 1 shows over the past decade the dollar volume of transactions within North America—the U.S. and Canada—showing North America acquirers in blue and foreign acquirers in green. The number of transactions is at the bottom, with sizable billion-dollar-plus transactions shown at the bottom as well. As you can see, there was a wave of activity through the 1990s into 2001, importantly driven very much by foreigners, particularly in the period of 1998 through 2001, including AXA, ING, Aegon and Swiss Re, and importantly driven by a couple of big AIG deals as well—the Sun America $18 billion transaction in 1998 and the American General $22 or $23 billion transaction in 2001.

In that same time period, if you look at the volume, there was a relative consistency of big strategic billion-dollar-plus transactions. In 2002, we saw a big slowdown in notable transactions consistent with the period of deteriorating credit and the deterioration of the stock market. Buyers were inward-focused. The deals that got done were much fewer, particularly the sizable ones where transactions to some extent had to get done. The only $1 billion transaction in 2002 was the Prudential U.S. acquisition of American Scandia, where Scandia, given its capital issues, had to sell that business to maintain its franchise value.

There was a bit of resurgence afterward as the market recovered. Year 2003 saw the Hancock transaction, which was the big deal in that year, but also the Canada Life and the MONY transactions. It was a period of more caution in the marketplace, but a return to more normal amounts of deal activity. In the past couple of years there has been activity, but not at the same level. The big transaction in this year to date was my parent company's sale of Travelers Life and Annuity to MetLife for $11.5 billion. It's important to note that in the past couple of years there were a few transactions that I would put in the category of strategic dispositions that were effected through the public markets, not the private markets, not your M&A, for example, GE's partial distribution to date of Genworth and Fortis's sale of Assurant into the public markets last year. This year I would put American Express's announced intention to spin off American Express Financial Advisors in that same category as continued evidence of renewed strategic disposition activity that doesn't show up in these bar charts because the path is the public market, not the private market.

Slide 3 on page 1 looks at the context of the same period with respect to looking at market performance, which is reasonably correlated to deal activity and deal valuations. What you see here in the blue is an index of the S&P 500 over the past decade, in green is a life insurance index, and in the red is a year-over-year stock price performance graph of the life insurance index, which are the same data but a starker demarcation of the different time periods and the movements in the market. What I labeled the bull market period in much of the 1990s, the markets themselves were evidence of confidence in the market and in companies and participants, which helped drive activity and helped drive valuations. Importantly, it helped drive flows in the business and account values, all of which was a bit of a positive virtuous circle driving more deal activity. The overall bull market continued in the period labeled demutualization, when the tech stocks were the darlings, boring insurance and financial services stocks fell in terms of valuation, and in particular, given the supply of new companies coming to market with the demutualizations, there was further pressure on values. But the underlying fundamentals of businesses generally in the life insurance sector remain fairly strong, driven partly by the continued performance of the S&P. M&A activity continued at a fairly strong pace, but valuations came down to some extent, in line with the green line on the chart that shows values.

Retrenchment was after the crash and all the credit issues in the marketplace and was consistent with the 2002 drawing up of some of these notably sizable transactions. Then as the markets recovered and credit issues faded a bit, there was what I call a revival in the past few years, which has been consistent with a bit of a renewal of a more steady state of M&A activity.

I called the last segment of the graph "search for growth?" in the context of the discussion today about where the M&A has gone. In the mature industry in which we work, M&A can be an important driver of both top- and bottom-line growth and a catalyst at least for public companies in driving their bottom line and increased improvement in shareholder value.

An important factor driving some of the deals and deal values in the late 1990s and through 2001 was the differences in the public market trading value of acquirers and targets, in particular the Europeans, as well as AIG's valuation at that point in time. Slide 1 on page 2 shows a composite of selected European insurers and price to earnings ratios (P/Es) versus a composite of U.S. life insurers. It's a pretty marked differential in value. If you look at measures such as price to embedded value and price to appraisal value, which is more relevant for a number of the Europeans, you'd see a similar kind of valuation arbitrage. Whether it was overinflated or not, buyers had paper to spend, consideration to spend, and it was priced more expensively than many of the targets in the U.S. That certainly helped drive transactions in the market, which was supportive of a number of those transactions at the time.

The trends in the life sector are not unique. Slide 2 on page 2 shows for the past 15 years the volume of M&A activity in the U.S. across all industries, as well as the number of over $1 billion transactions. You see a similar trend consistent with the overall market dynamics and a resurgence in the past few years. There's more of a steady uptick in the past few years than we've seen in the life insurance sector, but the pattern over a 15-year period is remarkably similar.

Everybody wants to be global. It's an oversimplification, but in the mature domestic markets that we're in, international expansion has been an important component to growth and an important part of the M&A activity, particularly for some of the larger players in the U.S., Canada and Europe.

Slide 1 on page 3 shows activity over the past 10 years in dollar volume and number of transactions by North American companies making acquisitions outside of North America. It's driven largely by a combination of Asia and Latin America. It's slowed down a little over the past couple of years, but our pipeline is as strong as it has been in a while. We're spending a lot of time in New York, for example, coordinating with our colleagues on the ground in Korea or China, Hong Kong, Mexico, Brazil, etc. in helping our domestic clients find opportunities to grow outside of our market in countries that either they're not in or that have less penetration and as an avenue for growth beyond the home market.

I'm going to shift to valuation. Slide 2 on page 3 shows, since 1997, transactions of size where publicly available metrics were available of GAAP price to earnings or GAAP price to book value. It shows the median for each of those years and then for the whole time period. For example, over this time period, the median forward price to earnings ratio for transactions where the data are available is about 14 times. In 1997—and though this is just one data point, it is indicative—it was 17 times. Then there are a couple of years where valuations were sky high, again consistent with and correlated to the stock market valuations of the buyers. Then there is a trending down, again consistent with the market values falling and key values falling in the marketplace. There is a low during the entrenchment period. There aren't enough data points necessarily to say what the trend is right now, but the one sizable transaction, MetLife's acquisition of Travelers, was priced at about a 14 times price to earnings multiple, which coincidentally or not is consistent with the median over this seven- or eight-year period.

The last column is price to forward earnings with expense saves. At the end of the day, from an acquirer's standpoint what matters more than the earnings of the acquirer on a stand-alone basis are the earnings of the acquirer reflective of the acquisition. Cost saves are the most tangible component of that and the component that for credible buyers and credible stories the stock market will give credit for as of day one. Our industry has shown a good track record in meeting expense targets, so when you look at that measure, as well, there were some fairly lofty multiples on that basis in the bubble period. They've settled down into the 10-ish range in the 2001 to 2003 period. They're back up a bit in the recent MetLife-Travelers transaction, and on a price-to-book basis, there's a similar trend.

I don't want to venture beyond my expertise too much into actuarial territory, but here is a little bit of actuarial perspective. Slide 3 on page 3 is an illustration of potential components of value for a typical transaction. They include capital and surplus, embedded value, capitalized synergies, new business value, plus goodwill that goes beyond just explicit new business value. These are strategic benefits in one form or another that in some instances people have been willing to pay for.

If you look back five years ago at the height of some of the exuberance in the market and at a period where people perceived there to be low implied market risk premiums in the market, you saw quite a few transactions being priced at the 10 percent to 11 percent discount rate and, in some cases, even 8 percent or 9 percent, where people viewed the transactions as particularly important or strategic. Again, all of this is an oversimplification, but you saw more transactions than you see today where buyers were willing to pay for new business value. There were also a number of transactions where buyers were willing to go a bit beyond because they felt a transaction was particularly important to them strategically, and paying a little extra for it, in the scheme of getting a deal done, was okay.

In the environment we're in right now and have been in for the past couple of years, buyers are more cautious. I think 12 percent to 14 percent is more typical. Rarely do you see people explicitly pricing much below 12 percent, maybe a shade below if something is low-risk, and moving on up from there depending on the risk profile of the target. It's less typical to see buyers willing to pay anything for new business, let alone extra for goodwill. Buyers seem willing in transactions that they're comfortable with from an integration standpoint to pay for embedded values, to pay fairly fully for the capitalized value of synergies, but then it's less typical where people are willing to pay beyond that. Again, this is an oversimplification, and in MetLife's acquisition of Traveler's it's certainly paid a lot for new business value, but more typically in the transactions that have come to market over the past couple of years that has not been the case.

Slide 1 on page 4 shows an illustration of drivers of M&A. It is intended to look at a typical mid- to large-cap U.S. life company over the past five years that might have had earnings per share growth on a staggered basis over the time period of about 12 percent. One of the typical sources of that might have been organic growth at 5 percent to 7 percent, which is probably consistent with market leaders. That's certainly more than some products have been growing in terms of the overall market. There might also be two or three percentage points of earnings per share growth from capital management, mostly share buyback; two or three points from M&A activity and the accretion that comes from that; a few points from expense saves; and then in the bull market, further inflation above the norm from above-average investment returns and flows. The latter is not something anyone is counting on or expecting. Expense saves are something that everyone is always striving to achieve, but for many companies the low-hanging fruit has been achieved, and it's harder to come by. That leaves share buybacks and M&A as continued important components of driving bottom-line growth and trying to find catalysts for public companies at least to drive value creation in their stock price.

Another important driver of M&A activity has been a long-term trend toward greater scale. People can debate the different components of this, but I would argue that there is a trend and that many drivers and factors are leading toward more scale. The market share in the mainstream life business in the U.S. remains not concentrated. However, Slide 2 on page 4 shows some of the specific lines of business. There are certain lines that are fairly concentrated, for example, the variable annuity (VA) business has become much more concentrated among the Top 5 and Top 10 players over the past five years or so. I've cited a number of the factors, including technology costs, back-office scale and distribution demands. They can be for technology-oriented easy interface between companies and distribution, or demands from producers and distributors for a range of best-of-breed products from their product providers.

The demands of product development and innovation include VAs and all the bells and whistles and options that come with that in today's market and the need to have sophisticated, dynamic hedging programs, whether it's term insurance or XXX. You need to have enough scale to deal with some of the structured solutions around reserve issues there. Brand matters more or less to the extent of the market that one is in, but in the markets where it matters, a number of market leaders are spending a lot of money building brand. If you're not doing that, you're at a relative disadvantage. Benefits come from scale related to cost to capital or the ability to manage volatility on the balance sheet. And, of course, ratings go part and parcel with the last point.

One measure of scale is market capitalization. Slide 3 on page 4 shows, as of five years ago and today, a snapshot of the Top 50 global financial services companies. It's hard sometimes to categorize some of these companies, particularly the Europeans, but the colors are indicative of what the predominant business is of the company. There are a fair number of red European insurers in the top half; the one at the top is AIG. There are some that aren't even on the chart any more, companies such as Munich Re and Swiss Re, because of lower valuations. The other important observation is that down toward the bottom, but in the pack, are a number of North American companies—Allstate, Manulife, Met, Pru—that were not on the list in 2000. In the case of Pru, it wasn't public at the time, but this is driven by relative improvement in stock market valuations. It's important to note that, because it is one measure of companies' scale overall, it's an oversimplified measure, but it's also true that size gives companies a degree of freedom to make investments and to pursue a range of strategic occurrences, M&A or otherwise, where they might be more constrained if they do not have the same market cap.

Slide 1 on page 5 contains a list, which is not all-inclusive, of companies and parent companies with significant U.S. life business. I'm not going to get specific in terms of predictions regarding any one particular company, but I would say that in the mature, consolidating market that all these companies are in, there are any number of potential combinations and matrices of combinations where there's good business industrial logic. Theoretically, every one of these companies could be a buyer and every one of these companies could be a seller. Time will tell. But depending upon relative size and position, some of these companies, over time, are positioned to more likely be acquired in a consolidating market, some are more likely to be sellers, and some more on the fence. It's also relevant to be thinking about forecasting relative to the past 10 years. There are probably fewer of the mid-sized companies that exist today in the public markets than existed 10 years ago because a lot of the "obvious transactions and targets" got bought. Not all of them, but there are fewer of the good $3, $4 or $5 billion franchises that are public companies, at least those that are potentially available, in the M&A marketplace than there would have been a decade ago.

There is one last driver to M&A activity, again for public companies, and that's investor reactions to acquirers. It does matter whether a CEO or board of management feels that the market is going to be accepting of a transaction, as well as what the tenor of the market is. Slide 2 on page 5 summarizes data across all industries going back a number of years in the U.S. For the different time periods, it shows the stock price performance one day prior to announcement through 90-day postannouncement for major acquirers, contrasted to the S&P. In the earlier periods, the M&A participants didn't fare as well as in recent periods, where they have done reasonably well.

If you look across the landscape of insurance companies over a similar time period, there aren't enough data points to draw any particular definitive conclusions. It's mixed across the board, but if you take, for example, the past couple of transactions of public companies buying other companies—Scottish Re buying ING's Life Re business and the MetLife-Traveler's transaction—the stock market has been rewarding those acquirers that are doing smart, strategic transactions. MetLife is an interesting example. I represent my parent company, so I won't comment on the price per se. It paid a 14 times multiple and bought a company that was one-third its size, which is a big transaction. If you looked over the past 10 years at the history of acquirers buying targets that were that much of their size, more often than not the stock would fall by 5 percent or 10 percent. MetLife stock fell a little bit the first day but has performed reasonably well thereafter. Again, that is consistent with the overall tenor of the market today across all industries, which has been generally accepting of acquirers entering into transactions that are viewed as strategically sound with decent financial footing.

**MR. NIGH:** If you can go back two slides, I'd like to postulate that the reaction correlates to Slide 3 on page 3, where pricing tended to be in the 8 percent to 11 percent range, which one could argue was fairly aggressive pricing. Yet the reaction was to drive down the stock price, which tells me the investor community realizes the aggressive or conservative approach to pricing the transaction.

**MR. FROMM:** Yes, I believe the market is semi-efficient, not always immediately efficient. But one of the simple things that people do, whether it's the market or the equity analysts, in looking at a transaction of one public company buying another is check the value of the expense saves that are articulated, believable and capitalized. If companies are paying more than that, the instinctive reaction is they're overpaying. That can be helped and has been in the past, particularly in the height of the bull market when people got away with it at least for a while, by acquirers whose stock prices are valued more than the target's, although that's not the case generally today. Those companies also benefited from the general tenor of the marketplace at that point in time. But, yes, I think they are generally correlated. If there are no other general questions, I'll turn it over to Laird.

**MR. LAIRD D. ZACHEIS:** I think both Steve and John were giving the market a lot of credit, but I would tend to agree that the market is looking at rationalizations for the deal and explanations for why it's a good deal. In this industry, at least, it seems that expense savings is something the investor community understands a lot better and has more confidence in than the benefits of growth for growth's sake. There's a lot of resistance to that as a rationale for paying a big price and may be a good strategy.

I'll use more of an actuarial focus than Steve did, although I want to start with a few comments that are consistent with Steve's presentation, though maybe with a different spin. Certainly there is a search for external growth. While the market may not reward transactions immediately for just that purpose, nevertheless, companies that are seeing their growth stagnate have a sense of how much the markets can penalize you for stagnating growth. There are cases in the slides Steve showed earlier of the mid-sized or somewhat larger U.S. companies that are feeling a lot of pressure for growth. M&A is one good solution that some companies have used to effectively manage their growth. Certainly, with both ManuLlife and MetLife, the two biggest deals in the past couple of years, this has been a key driver.

The search for scale and consolidation savings has driven the run-off business market as sort of the solution for divesting blocks of business. I'll discuss that a little more later.

Diversified distribution and product portfolio seem to be motivating some companies and not others. It is interesting to look at Manulife's analyst presentation when it acquired Hancock. It was explicit about how Hancock covered the holes that were in its distribution and product range. It brought them the long-term care and some market distribution that it didn't have, so it had a nice, complete matrix. MetLife by contrast made it clear that all the businesses it was acquiring in Traveler's were something it had a tremendous amount of experience in and knew how to run. It wasn't a diversification of the business; it was an expansion of what it currently has.

Capital continues to be a concern. It goes up and down in the industry as to how much capital needs and capital considerations are driving M&A. There is renewed concern over capital on VA products, a lot of uncertainty over C3, Phase II and what that may do to some marginally capitalized VA carriers, but also XXX business. That has been leading and hardening the reinsurance market, which frankly has been a big source of capital for mid-sized companies over the past few years. All of that is going to cause some capital concerns in the industry.

There is a lot of focus on opportunities outside the U.S. Asia in particular has rewarded some of the U.S. companies such as Prudential, Aflac and AIG, and to a lesser extent MetLife. Asia seems to be a major source of growth and opportunity for U.S. companies, as is Latin America.

The return of private equity may be a key indicator where market pricing is and where the M&A market is. In the early 1990s, there was a lot of leveraged buyout (LBO) activity, a lot of private equity looking to invest in the insurance agency and seeing the kind of returns that the private equity market demands—more than 15 percent. Beginning two years ago or so, we started seeing private equity looking again at the life insurance industry. It had been absent for a number of years because returns just weren't there. I think that's an indicator of the opportunities in the M&A market. Certainly private equity has been looking at the life settlements emerging industry. Dozens of private equity groups are seeing whether they can make a go of that. More in the mainstream, there have been some reinsurance start-ups. Wilton Re is an example, White Mountain acquired Safeco, and there are other private equity sources out there now.

The reinsurers are continuing to be a major force in the M&A market on acquiring blocks of business. This was probably pioneered by Life Re a number of years ago, and continued with Swiss Re and other reinsurers. I see that as a real opportunity to leverage their strengths.

Fundamentally, we see two different markets in life insurance M&A. One is for the strong, growing viable companies, which leads to premium pricing such as the MetLife or Manulife deals. The other is run-off blocks. Companies that are somewhat stagnant and smaller companies may fall somewhere in the middle of that. As an example, the CNA business was split in two. The CNA group business was acquired by Hartford as an ongoing entity and acquired for growth, whereas the CNA life business was essentially acquired as a consolidation shutdown by Swiss Re.

The key differences between strong sellers and weak sellers in the industry continue to be product and distribution. The secondary guarantee universal life (UL) business has been a primary driver on the life insurance side, and long-term care has had its peaks and valleys, but the ability to differentiate your product and your distribution allows you to command a premium in the marketplace. Efficient administration is another key. Some of the mid-sized U.S. companies are good, efficient administrators and are able to leverage that. Jefferson Pilot is a good example. It has some of the lower costs in the industry and has been able to leverage that into some successful acquisitions. The ability to control those costs is a key differentiator.

A recognized brand is important. Many of you may have read D'Allesandro's book on brand management at Hancock, so you know that he thought brand was important in his sale. It ended up being a big asset on the purchase GAAP balance sheet. And, of course, a strong management team is key. By contrast, the opposites are markers of weak sellers, but I'd also include risky product design or risky investment strategies. In particular on the VA side, we've seen a number of companies that have had difficulties through their product design.

In terms of recent pricing, Steve had some good metrics from the perspective of public markets and public reporting. Appraisal values are not disclosed, and embedded values, at least in the U.S., aren't disclosed, so they are a little harder to track. It is clear, at least from our work, the discount rates have not trended down with interest rates. There is the capital markets theory that would say that discount rates should be based on risk-free rate plus the appropriate return for the risk. Maybe those two have offset as interest rates have come down, but in any case, discount rates have not trended down in the U.S. In fact, to some degree they've moved a little bit in the opposite direction. During the late 1990s, GAAP results were a major concern because of the high trading multiples of the target companies. That has become less of a concern as multiples returned to more of a normal range in the market. Finally, there is renewed importance for an appraisal focus or a discounted cash flow (DCF) analysis, as the focus has shifted to underlying value. This may be more specific to the small or mid-sized deals or the run-off blocks, but nevertheless there is a return to fundamentals that the DCF analysis needs to support the transaction pricing.

For those of you who are not dealing with this every day, an actuarial appraisal is simply a discounted cash-flow analysis going by a glorified name. That's the after-tax earnings adjusted for changes in required capital. It is an after-tax number, it does include required capital, and it is on a best-estimated basis. It's consciously intended to be a true best estimate as opposed to a conservative estimate or an aggressive estimate.

The components of value start with the statutory net worth or the adjusted book value, which includes some adjustment for items that may not be on balance sheets, such as realizable value from non-admitted assets. The value of the business in force is then added in to get what's called, at least in Europe, the embedded value. Embedded value sometimes has more specific meanings. In Europe, for example, it's what kind of discount rates you would use and what kind of adjustments for cost options and guarantees. Here, it is a more generic term, so we often try to avoid the term "embedded value" because it can mean specific things to different people.

The actuarial appraisal value includes a value of future business. All of this would reflect the anticipated tax situation of the transactions. For example, a closed block deal that's going to be a reinsurance transaction would reflect all the appropriate reinsurance taxes. The other items—the goodwill items, brand, for example, and other synergies that aren't captured elsewhere—are part of the total company value and can be a plus or minus. Frankly, any of these components can be a plus or minus, but these last items in particular may be plus or minus. The value of future business is something that is often described as the number of years of new business. The appraisals that are out there still tend to focus on 10 years of new business. During the heydays of some of the Europeans, they were pricing for much more than 10 years of new business. As transaction prices have come down, 10 years is probably at the high end.

Price v. Appraisal Value: 2001-2004
Life Transactions in Excess of $250 million

| Transaction | Discount Rate | Price as a % of ABV+ Value of Inforce | Price as a % of Total Appraisal Value |
|---|---|---|---|
| 1 | 9%-13% | 107% | 82% |
| 2 | 9%-13% | 109 | 90 |
| 3 | 8%-12% | 124 | 92 |
| 4 | 10%-14% | 108 | 99 |
| 5 | 8%-12% | 147 | 108 |
| 6 | 9%-13% | 84 | 84 |
| 7 | 10%-14% | 104 | 86 |

Note: Ratio based on discount rate in midpoint of range.

The table above summarizes seven transactions over the past three years for deals in excess of $250 million. They aren't disclosed because the appraisal value information isn't public, but these are deals that were completed. We've looked at the central discount rates. The first transaction would be 11 percent. We've looked at the price paid as a percent of adjusted book value (ABV) plus the value of the in force and as the price of the percent of total appraisal value. Prices have been pretty consistently above the adjusted book value plus in force. The one exception is transaction number six. The reason that fell below had more to do with specific transition expenses that were reflected, but it was again a focused appraisal-type approach. Likewise, the deals have been pretty consistently below 100 percent of total appraisal value. The one exception there was a strategic deal where a fairly sizable goodwill premium was paid.

**FROM THE FLOOR:** In the cases where it was more than 100 percent of the ABV plus the value of in force, is that because of expense saves that the buyer brought to the table or because new business value is being paid, or both?

**MR. ZACHEIS:** It is a combination. Many of these are some premium paid for new business, though that maybe a somewhat limited premium. I'll be a little more explicit. The values here would have reflected reasonable target expense savings in most of these cases, but buyers in many of them would have been able to realize more than that.

**MR. NIGH:** In determining the value of in force, have you've seen more of an emphasis on pricing stochastic scenarios rather than looking at deterministic? I noticed you said best estimate, but maybe you could discuss that question.

**MR. ZACHEIS:** What we're seeing is that these costs of options and guarantees are being priced out in a stochastic way. For a VA block, it is appropriate to stochastically determine the cost of the guaranteed benefit, so maybe that turns into 20 basis points, which will then be reflected in the appraisal evaluation. There has been resistance to full stochastic appraisal, because it's been difficult to translate that into an expected cash flow or capital requirements for the next three years and validate that against recent experience. So what we're seeing more is a hybrid approach that these benefits will be priced stochastically.

**MR. NIGH:** In relation to interest-sensitive life and interest-sensitive annuity business, are you looking at more than a level interest-rate environment? Do you look at alternative scenarios, whether they're deterministic or something else?

**MR. ZACHEIS:** I think the jury is still somewhat out on that. What I would say is that for the more typical fixed-annuity and fixed-life guarantees, the 3 percent or 4 percent guaranteed floor, we haven't seen a lot of focus on pricing that on a stochastic basis. I think secondary-guarantee UL may be a different ball game, but there hasn't been much experience on that yet.

| | Market Value/ Reported Embedded Value | | | | Market Value/ Estimated Appraisal Value | | | |
|---|---|---|---|---|---|---|---|---|
| | Nov. 2001 | Oct. 2002 | Dec. 2003 | Feb. 2005 | Nov. 2001 | Oct. 2002 | Dec. 2003 | Feb 2005 |
| CGNU | 1.51 | 1.28 | 1.22 | 1.39 | 0.80 | 0.96 | 0.94 | 1.14 |
| L&G | 1.45 | 1.34 | 1.23 | 1.24 | 0.91 | 1.04 | 1.00 | 0.92 |
| Pru UK | 1.97 | 1.52 | 1.70 | 1.45 | 0.89 | 0.90 | 1.02 | 1.01 |
| Aegon | 1.96 | 1.19 | 1.17 | 0.91 | 0.72 | 0.82 | 1.05 | 0.87 |
| AXA | 1.73 | 1.57 | 1.58 | 1.30 | 0.86 | 0.88 | 1.15 | 0.88 |
| ING | 1.68 | 1.40 | 1.42 | 1.50 | 1.04 | 0.92 | 1.26 | 1.04 |

Source: Morgan Stanley analysts' reports.

The table above shows three U.K. companies and three continental European companies that have disclosed their embedded value in some form or another. It looks at the ratio of their current market value versus reported embedded value at the various points in time and then market value as a percent of estimated appraisal value. In this case, we looked at Morgan Stanley's analyst reports in Europe. It's developed an appraisal value based on an assumed multiple applied to the value of the most recent European sales. Those multiples change over time, and of course, the assumptions change over time for these different periods. But there's a general consistency in that the market values are somewhat above embedded value, and whether or not they're fully at this somewhat limited appraisal value may vary by company. Each of these companies is a large company where there would be a high strategic premium. It is therefore again consistent with the view that for the larger, well-run, highly branded company, there is more value being placed on the new business going forward.

Some issues have appeared in appraisals lately. Variable products have been a key area of concern, given the market turmoil. There have been some VA deals that came close to happening and then didn't. As the markets declined, the value of the blocks did, too, but even more so, given how highly leveraged VA can be. The death and income guarantees in the VA business have been and continue to be highly popular. They also increase volatility. There's a lot of attention being paid to what companies are doing with respect to hedging and how they're handling these benefits. The biggest area of potential concern will be policyholder behavior in terms of how antiselective they may be for various types of benefits.

At this point, the view is that, for the guaranteed death benefit, the policyholders are not being all that antiselective, and that both the older aged people and the in-the-money people are still lapsing. There was a lot of concern a year or two ago about the ability of policyholders to max out free partial withdrawals where the benefit was on a dollar-for-dollar basis, and there was limited experience of that happening. At the same time, there are general assumptions being made that for other elective-type benefits policyholders will be far more antiselective in their utilization of them. As those move into the money, the tendency is to assume that virtually all people will elect them. It will be interesting to see how that plays out over the next few years. A lot of insurance products are priced in more of an insurance paradigm, where policyholders are not acting efficiently, as opposed to Wall Street's paradigm, where it is assumed the policyholders will act efficiently. Consequently, there is still potential for a wide variety of experience in that area.

There are other concerns regarding variable products. Stochastic analysis is being used for some asymmetric benefits and then embedded in a static scenario or a range of scenarios. Additionally, a level best-estimate type of appraisal scenario may be coupled with results under a stochastic framework, or at least under a variety of different assumptions. Variable life performs much better in a variety of equity return scenarios because of the natural balancing effect of insurance charges, which move in the opposite direction of a fixed base amount, while a variable account value moves in the opposite direction from the fund-based charges. Finally, the proposed NAIC requirements can be severe for unhedged benefits. The requirements are still subject to a lot of debate. We'll see exactly where that comes out, but potentially that will have severe valuation implications.

From an M&A point of view, the current interest-rate environment has left companies in position where their reported earnings have performed well on spread-based business. They've been able to manage spreads at optimal levels as credited rates have been able to be dropped more quickly than portfolio rates. If rates were to go up, that could reverse quickly, but even if rates are going to be at a level where they are now, I think we'll see spread compression relative to what's been reported in the past few years. That is a major concern in M&A work for two reasons. One is that it has had the potential to inflate historical earnings and therefore inflate prices. But also looking at going forward, under Purchase GAAP, the portfolio is marked to market, and you'll get a new money yield. That may lead to spread compression and therefore a challenge on near term earnings.

In long-term care, this has been a major concern. The long-term-care business in the industry has generally performed pretty well from a morbidity point of view but has gotten heavily beat up from both lapses, persistency being far better than expected and interest rates falling. There is the ability to reprice long-term-care products. Many of the majors have repriced their blocks, and maybe we're getting to a point where most of them will have.

With fixed annuities, there's the classic disintermediation risk concern. If rates should rise sharply, there could be substantial outflows at this point with capital losses as a result of funding those. For secondary-guarantee UL, if interest rates were to go up, it would alleviate a lot of the pressure on profitability in those products. However, if they stay where they are, that will continue to be a concern.

For any of you who have done work in Asia, you are aware that the interest-rate environment is a perennial issue. Having spent some time living and working in

Japan, I've seen that it is a primary focus, given all the pressure that industry has undergone.

On expense savings, the areas we see with the greatest potential for cost savings are back-office systems; corporate support, which can often be eliminated or at least heavily reduced in an acquisition; and the distribution front. The cost savings are substantial in this industry. On some of the larger deals, there may be 20 percent or more in expense savings. It brings expenses to below what a target pricing level would be because of the ability to pull out corporate support. Whether these are fully paid for by the buyer is a separate issue, but it's become commomplace for companies to highlight what kind of cost savings can be expected. Excessive cost savings can damage the intrinsic value of the organization. At some point, if you shut down the organization but have paid a goodwill premium, you wonder why you paid the goodwill premium. That can clearly go too far. Several of the effective consolidators such as some of the reinsurance companies have utilized outsourcing effectively. They will take a block of business and often keep the people, but just shift it over to someone else's responsibility at a fixed unit cost.

There are a few more valuation issues. Defaults have been an issue over the past couple of years, though it has since stabilized. I thought we were rid of that issue from the early 1990s, but this does go in cycles. Mortality is an issue once again. For a number of years, the direct companies had passed off all their mortality risk to reinsurance companies. Mortality just wasn't seen as exciting or important. As the reinsurance market has hardened, reinsurers have come back with some significant price increases. Suddenly direct companies are starting to worry about it again. Coupled with the introduction of 2001 Valuation Basic Table (VBT), that's causing a lot of product repricing. I'm hearing a lot of debate as to what the appropriate mortality slope is for the long term, because the VBT is different from the 1975/1980 table. Consequently, we're talking about mortality again. Future mortality improvement is a perennial issue.

The XXX and AXXX reserves that are out there are considered valuation issues. Securitization is increasingly being seen as a solution to that problem, or various other alternative financing solutions are becoming prevalent. Depending on where the regulators end up on some of these issues, we would expect that trend to continue. Tax consequences are a part of any of these transaction analyses. For reinsurance blocks, for 338 H (10) acquisitions, the tax benefits of the potential transaction can be significant to the deal price.

In closing, I'll highlight a couple of GAAP accounting issues. Financial Accounting Standards (FAS) 141 and 142 came out a couple of years ago, and goodwill was no longer allowed to be amortized. At the time, one of the issues was that FASB was focused on was allocating value to other intangibles such as agents under contract. In practice, it has ended up being a relatively modest issue. Generally, the amortization of these other intangibles has been fairly slow and the items fairly modest, so we haven't seen that as having much of a dampening effect, although there was a lot of concern early on. The low-interest-rate environment has some potential impact and challenges on Purchase GAAP earnings. Standard of Practice (SOP) 03-1 and the earnings of variable products, in particular, though potentially some of the UL products, as well, have great potential for earnings volatility. That is much better appreciated now than a couple of years ago, which is something that the buyers are concerned about. The SOP 03-1 reserves under a Purchase GAAP environment continue to be somewhat of an open item. We've seen a number of different approaches taken on that, and there are some advantages, perhaps, to some purchase structure over another.

With that, I'll turn it over to John, unless there are any questions.

**MR. BARRY POLE:** In a session on stochastic embedded value, one of the speakers commented that a traditional actuarial value produced a $2 billion appraisal, and the stochastic embedded value was a negative 100, if I recall it correctly. Can you comment on whether that type of disparity is feasible, and if so, wouldn't that argue for embedded value approaches or stochastic approaches being the norm?

**MR. ZACHEIS:** It's an excellent question. To a certain extent, I view reported embedded value as being something that actuaries are going to continue to argue about and regulators will continue to argue about, as opposed to market values in market or appraisal deals where two well-educated, well-informed parties are negotiating a price. Deals are often done with a number of buyers, so the price paid in a transaction is the best indicator of economic value. Public reported market value is also a good indication of economic value. That was part of the point of the two slides on how those compare both to some of the appraisal values in recent transactions and to reported embedded values.

It is critical for appraisal values to reflect the full cost of benefits. To say that under a 9 percent equity growth scenario VA benefits have no cost is clearly fictitious, so including some stochastic cost for it is appropriate. But to go all the way to a full stochastic appraisal value has a number of downsides. It has some benefits and may be worth looking at, as well, but it is difficult to interpret that, to validate it, and to interpret it relative to capital commitment. I'd also say that in a case like you referenced there, what would be critical is to understand what the company is doing to hedge. If it's not hedging, that's a different ball game. If it is hedging, how has that been reflected? It can get complex.

**MR. NIGH:** That is an interesting question. If you talk in terms of market-consistent valuations, one could argue that the risk discount rate for term insurance should be the risk-free rate. I'm not sure there would be too many buyers in this crowd pricing a block of mortality business at the risk-free rate of today, which is about 4.5 percent. It's an interesting debate. I wanted to add onto Laird's answer to the question on stochastic testing. Embedding stochastic modeling fully into a seller's appraisal is a daunting task. But it's fair to say that a buyer looking at an interest-sensitive book of business, a variable life or VA block of business will stress-test it and will look at stochastic modeling as part of its appraisal process. That's another way of saying that a seller's appraisal is a tool and needs to present the requisite information to allow a buyer to do the sort of testing that would be required for whatever the block of business is. It is a mainstay today that you're going to see stochastic modeling. You may not see ruin modeling for mortality books. I've never seen anybody put in a 1919 Spain influenza into its appraisal of a mortality book, but it is coming.

I'd like to set up where we're going so we can end with our panel discussion and our crystal balling. Looking at an overview of the insurance markets of life or property and casualty (P&C), they're not concentrated. I don't think anybody would disagree with that. Revenue growth is pale; it's certainly not positive. There is a little bit of a bright spot in penetration. But back on the negative side, the industry does not reflect spectacular ROEs when compared to other industries, including other financial services sector companies.

Slide 1 on page 11 shows the concentration of the U.S. insurance markets. Roughly 86 percent of the market is represented by the Top 50 groups, with roughly 80 percent for P&C. Slide 2 on page 11 shows the trend. It's interesting that a year or so ago the same graph would have indicated that the Top 10 banks had over a 60 percent market share. They've gone through a reverse consolidation phase in the past couple of years, so that they're on a par with the life and health and the P&C industries.

Slide 3 on page 11 shows an example of a concentrated market. I could have picked the railroad industry, but this one shows it clearly. What does a concentrated market look like? This shows the domestic cigarette producers' market share: the Top Four versus the rest. This is a consolidated, mature market, and clearly we do not see that yet in the insurance industries. In some respects, I could show a mature insurance market by picking the U.K. insurance market or some of the European markets, which would show similar pictures of concentration.

How has this changed over time? For both the life and P&C companies, you can see on Slide 1 on page 12 that the groups beyond the Top 50 have lost significant market share, particularly in the life/health arena. Where that market share has gone differs whether it's life or P&C. The life market has had most of the decrease in market share from the beyond-50 companies move to the 11 to 50 group, but the opposite is true for P&C, where a lot of that concentration has gone to the Top 10.

Slide 3 on page 12 shows the premium growth from 1973 through 2002. The average annual growth for the life/health industry is slightly under 3.5 percent, and the average annual growth for the P&C industry is under 3 percent. This does not paint a picture in terms of organic growth that is a positive picture.

Penetration is one area where we can say that the industry in the U.S. has performed relatively well, where penetration is defined as insurance purchasers as a percent of gross domestic product. In the U.S. we are at 9.61 percent. Some of the other countries that have higher percentages than the U.S. have unique characteristics. In particular, the privatization of social security schemes has moved insurance premiums into the private sector, so a number of other countries do reflect that. Of course, we don't have it yet, but President Bush is pushing his way toward privatization. The growth of penetration over time has gone from slightly under 7 percent to, as we just indicated, 9.61 percent. As a percentage growth that's pretty good, and the GDP is growing, as well, so this is one area where it's not a bad picture. The ROEs for both industries are slightly under 9.1 percent. P&C is right at 9 percent, and life is at 9.3 percent.

To summarize the market overview, we've got relatively good market penetration, relatively low growth in industry premiums, and 9 percent ROE, so I feel that M&A is coming. Slide 2 on page 14 shows what has happened in the mutual arena, and Steve's second slide showed the period of demutualization. That certainly is reflected in the market share of the U.S. mutual insurance company industry.

I'm sure we're not here to talk about P&C, but P&C has its own set of challenges. Everything is about legacy—legacy systems, legacy personnel, legacy thinking and legacy liabilities. The last of these is probably the biggest impediment to doing a pure stock transaction, but they are all impediments.

The drivers of M&A haven't changed over time. The emphasis may have changed a little bit: changing demographics, the need to get access to capital, globalization and the continual need for critical mass. In the U.S., deregulation has not been a big deal. But in other areas of the world, it's been a significant challenge to the insurance industry to compete against banks as banks have truly gone into insurance. Economies of scale are also drivers of M&A, including expense saves and the benefits of consolidation. In many respects, rating agencies and the stock analysts do hold veto power over acquisitions, and so they are a key consideration in any transaction.

Other trends will also point to increased M&A activity. Remember, I'm setting this up as what I see to be an obvious outcome. We've done a number of CFO surveys, and insurance executives continue to say that organic growth won't get it done. The slide earlier showed the increase in premium revenues over time, which supports that. Cataclysmic events will cause mergers, whether it's a cataclysmic event to a particular company or to the industry. We will see further spin-off activity as noncore operations are deemed to be either unmanageable or too volatile. That's also one reason why companies of the mode of the old Life Re, now Swiss Re, and others have as a key aspect of their strategic business plan to make acquisitions of companies doing spin-offs. European companies continue to show interest in acquiring U.S. companies. In addition, larger companies are well-equipped to handle the cost and complexity of the Sarbanes-Oxley compliance, but for smaller companies, introducing that infrastructure for compliance is in some cases a challenge that is difficult to continue to meet.

On the other side of the coin, M&A hasn't been so successful. While we might talk about why M&A should happen, we can also talk about why companies have been burned in doing transactions. The left-hand side of Slide 3 on page 15 is a survey that was conducted in 1996 across all industries trying to assess the level of success of transactions. Roughly 59 percent of the transactions were deemed to be disastrous or unsatisfactory. Thirty percent were viewed as successful, but they wouldn't ever do it again. At the bottom are the Top 10 pitfalls listed in the same survey, defining the reasons for failure which include incompatible cultures; inability to manage the target, though unwillingness to manage the target is probably a better characterization; and inability to implement the changes that were announced when they did the acquisition.

A couple of years ago, we did a CFO survey, and we attempted to get the same information. In many respects, it does mirror the first one, but it was directed at insurance company CFOs. Instead of 59 percent, 57 percent effectively said it was not successful. The reasons that were given are again listed and include lack of anticipation of otherwise foreseeable events, overpriced transactions, synergies that they thought were there that weren't there or that were overestimated and external events that they thought were out of their control. Incompatible cultures was cited at 17 percent versus 39 percent for not anticipating foreseeable events, which is surprising, given the No. 1 ranking of the culture issue for the earlier survey.

There is a solution to meeting those problems and pitfalls, and it's doing the right M&A process. All 10 of the pitfalls identified in the earlier survey are aligned under certain aspects of the M&A process: the strategic aspect, the due diligence process and the implementation. If companies can learn to do these things right, they can avoid the pitfalls.

What are the keys to implementation? Keep good talent, insure good understanding, communicate objectives, manage and implement the change, deal with the cultural issues and align incentives with the successful implementation.

At this point, I'm going to ask Steve to do his prognostication, and then we'll ask Laird.

**MR. FROMM:** John has asked us to look in our crystal balls at what we see for the next few years and compare notes. I see the drivers to activity that we've talked about continuing arguably on the margin. It is even more so in terms of the search for top- and bottom-line growth, scale issues and technology issues. There is also the desire of participants that don't necessarily feel they are situated to be a long-term survivor and leader to put themselves in position to do so either as an acquirer or seller.

There are lots of constraints and impediments, not the least of which are short-term issues such as the fact that people's capital positions are pretty good right now. There are also social issues, which at the end of the day often have been an impediment to deals and discussions that have occurred. Where there's strong business logic, the social issues just don't come together. It is hard to predict exact levels of activity, but we'll continue to see a decent amount of activity. Acquirers will remain cautious, but they are more experienced than they were 10 years ago. Many of the large-cap companies have done a lot of transactions and learned lessons—sometimes costly lessons—so I don't predict any rationality over the next two or three plus years in transactions and transaction pricing, but a continued desire of companies to use M&A to achieve their strategic objectives.

In terms of the strong sellers, to use Laird's phrase, particularly some of the larger companies, the extent of those transactions and timing is hard to predict. From the pipeline of dialogue that I at least know about, I would be surprised if we don't see one or two sizable transactions a year. These will be from larger companies that are reasonably well-positioned but aren't in the Top 50 today on a global basis but that want to be survivors. Again, whether they're buyers or sellers remains to be seen in some cases.

I don't think there is necessarily a catalyst for a huge wave of five massive $10 billion transactions. What could drive a wave eventually could just be irrational exuberance and a return of crazy pricing, but I don't expect that. At some point, people might perceive there to be an endgame approaching in the marketplace. Other markets and other industries have seen that when a market becomes more concentrated and people can see a vision out two or three years to a smaller group of leading players. That's when you often see more rapid movement as people feel their partners are going away. I don't think most CEOs feel that if they miss out on one specific deal today, they're stuck. People see multiple paths to being long-term winners.

On the mutual landscape, many of these same pressures exist. The social issues are even tougher to overcome. We're seeing some of the mid-sized mutuals realizing that they have scale issues and hoping that they can find the solution within the mutual community. We've seen some mutual-to-mutual mergers, and I think we'll see some more. We've seen fewer sponsored demutualizations in sales to stock companies. There are plenty of stock companies that would like to buy some nice quality mid-sized mutual franchises, but they just haven't been for sale. I don't see an immediate or a short-term catalyst for that changing, but to some extent I think it will depend on the success of some of those mutuals being able to solve their issues within the mutual world.

There will continue to be small- and mid-sized deals that come out of companies wanting to rationalize what business they're in and/or deciding they're just not going to be winners in certain lines of businesses. We will continue to see some block transactions or companies like CNA Life that effectively were priced as blocks every year.

Laird talked a bit about private equity. In the life sector, I do not predict a lot of private equity acquisitions of companies. In that sector, private equity is more conducive to start-up companies like the Wilton Re or some of the new business life settlement type of opportunities. The Safeco Life situation was a more extreme example of a dynamic that allowed for a purchase price that gave the private equity sponsors an adequate return. For most companies like that, there are enough sizable existing players that have more cost saves that are sitting on capital that are willing to do financially oriented acquisitions to drive the bottom line. It's tough for the private equity players to compete and get adequate returns.

I'd like to make a final side comment about the question earlier on disparity in one case between appraisal value or embedded value and true stochastic value. Sometimes there is a difference in how the public market values a certain situation and a true private market valuation taking into account all the risks that a rational and cautious buyer would take into account. There have been a handful of transactions in the past few years where it did not happen because of just that dynamic. Sellers were getting a value either for the company as a whole or for the business that they were interested in selling that was not necessarily fully reflective of the optionality in that business or that book that a buyer doing a full risk analysis of the tail risk would take into account.

**MR. NIGH:** It's your turn, Laird.

**MR. ZACHEIS:** As my leading indicator, I'll point to the fact that the SOA just published its textbook on M&A. I'll also point out the Dow 36,000 was published in 1999, so it could mean this market falls apart tomorrow. Again, all the drivers and fundamentals are there. I think that the industry will continue to see a lot of benefits from consolidation and that will continue at a more modest pace than at some points in the past. I will echo the comments that a number of the buyers out there have developed a lot of confidence that they know how to do transactions, both domestically and internationally. They're seeing a lot of success from that, and I think that will create some more momentum.