

**1998 VALUATION ACTUARY  
SYMPOSIUM PROCEEDINGS**

**SESSION 19PD**

**MERGERS AND ACQUISITIONS/APPRAISALS**

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## MERGERS AND ACQUISITIONS/APPRAISALS

**MS. MEREDITH A. RATAJCZAK:** If you look in any trade publications today you'll see article after article about mergers and acquisitions (M&A) or financial restructurings that are going on both domestically and internationally at a feverish pace. Our two panelists are Brad Smith, a principal from Milliman and Robertson in the Dallas office, and Mike Hughes, a partner at Ernst & Young in the Chicago office. Each has many years of experience in dealing with helping their clients with financial restructurings.

Mike's going to start by talking about M&A activity and current activity. Brad's going to talk more about trends over time. I'll turn the presentation over to Mike.

**MR. MICHAEL A. HUGHES:** I'm going to talk a little bit about activity levels in the life insurance sector of M&A activity. We'll look at some of that activity being done to deal prices and the pricing dynamics that we're seeing. We'll look at some related activity and some of the motivations. We'll explore what it takes to succeed, what some of the implications might be going forward, and what we might expect.

It's no surprise that M&A activity has reached record levels by almost any measure. We're at very high levels of activity in the life insurance industry as well as in financial services industries and other industries. I think deal activity is very high across the board. We've seen deal volume go from a few billion prior to 1994 to in excess of \$10 billion in 1997, and it's even more in 1998. So I think there have been record levels as measured by deal volume. I would also hazard to guess that we all have been impacted to one extent or another by the activity that we're seeing.

Some of the top deals in 1997 tend to be dominated by larger U.S. stock life companies, but there was also some mutual company and foreign participation. Several of the deals were in excess of a billion dollars, but those are very large deals by historical norms. Think about the entire deal value being in the \$2 billion range prior to 1994; now we have single deals in excess of a billion.

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We're seeing both life and annuity transactions. Both sectors are fairly active. Each particular transaction or each seller has its own story, but I think that there are some common themes. Generally speaking, the smaller, weaker, less competitive players are getting gobbled up by the bigger, more competitive, stronger players. Companies are exiting noncore businesses to focus on some of their core activities.

Let's look at some of the more recent deals. It's not really fair to put Travelers/Citicorp in as a life insurance deal, but I just couldn't resist mentioning it. It does have a life insurance presence, but I think it's a relatively small part of the Traveler's operations. Nevertheless, that particular transaction really has sent shock waves throughout the whole financial service industry and throughout the board room and executive offices in the U.S. It's the type of watershed event that could lead to a whole new round of mega transactions within the industry. It could drive the much anticipated deregulation of the financial services industry.

I think that the deal value of Citicorp/Travelers has come down in more recent estimates to something more like \$50 billion, but it's still big dollars by any estimate. It's amazing to even comprehend companies of their size coming together. On the less grand scale, but still massive scale by historical norms (in terms of acquisitions) is the AIG/Sun America transaction. AIG is more of a financial powerhouse and Sun America is more of a marketing powerhouse. Those two companies coming together is a real significant development that has a lot of folks thinking about what it means for them in the accumulation business.

There continues to be investment by foreign firms like AIG and Swiss Re. We're also seeing that some of the biggest acquirers in recent years are not getting acquired themselves. Life Re, for example, has had a huge number of transactions over the last decade, mostly smaller to mid-sized life transactions, and now it has gotten acquired. Similarly, Sun America has been very active in acquiring, and now it has been acquired, so the hunters get hunted. Things can change quickly in this game. Some companies are looking to stay independent by using an acquisition strategy to reach a certain size to protect themselves from the possibility of being acquired. I think that's somewhat of a suspect strategy based on what we're seeing recently.

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There's no such thing as too big. I think we're seeing Lincoln emerge as a very significant force. I think we're seeing some of the demutualized companies, mutual holding companies and restructured companies emerge as very aggressive acquirers. Amerus has had a couple of significant deals in the last year or two. Guarantee Life had a significant deal, so we have some increased presence by some of the international firms. We're seeing the restructured mutuals play a significant role in the current environment.

What is happening to deal values? For more than 10 years, we had aggregate life insurance deal values at something like 1.0 to 1.3 times GAAP book value. We're seeing that shoot up to closer to two times GAAP book value or higher in more recent years. Obviously, the level of activity has had a significant impact on deal value. I think the stock market performance has contributed to that.

The price-to-book ratios and price-to-GAAP book ratios for recent transactions has not been uniform across different sectors or even within different sectors of the industry, such as life insurance or annuity. I think you'll note the variability between the sectors and within the sectors themselves. I think it illustrates the fact that you need to be particularly careful if you're trying to do deals using rough rules of thumb.

I think the numbers can vary greatly. We're seeing very high multiples relative to the industry norms. However, some of the life insurance transactions and some of the annuity transactions have been in the 1-1.5 range, which is more typical of what we've seen historically. Some of the other properties are going for much larger multiples.

Sun America is a very large price-to-book multiple. I think the actual deal value estimates are coming down from \$18 billion but it's still, by almost any indicator, a large price relative to GAAP book. I think that would mainly be attributable to the variable nature of Sun America's business. It is less capital intensive, and there is growth within the company.

I might make a slight observation that the annuity multiples could be higher. That might be due to the higher growth rates. I'm not sure if there are enough data points there to make that sort of

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observation though. We are seeing higher prices paid for companies with strong niche positions, strong distribution capability, and so on.

Deal pricing is dynamic and responsive to changing market conditions, and I think you need to recognize this and respond accordingly if you want to be able to participate and succeed in this kind of an environment. Old rules of thumb may not apply. I think there's still a lot of emphasis on actuarial appraisals, but it's probably a little bit less emphasis than what we've seen historically. Brad might get into some of that in his discussion, but I think we're seeing more emphasis on GAAP impacts, market multiples and that sort of thing influencing some of the deal values.

If you look at reconciling the deal values, I think we're seeing low discount rates, marginal expense assumptions, significant provision for new business, and less emphasis on interest rate and default risks. As such, I think the appraisal assumptions tend to be coming under pressure. One of the old rules of thumb was to take the appraisal value and knock off a third. I think the current rule of thumb might be to take the appraisal value and add on a third.

There's a lot of other activity. My point is that there's a lot more happening besides transactions and purchase transactions. There's nonlife company purchase transactions, strategic alliances, and companies taking minority positions in some of their partners. You have mutual company mergers to some extent. Everyone knows about the significant restructuring that's going on in the mutual industry. There are deals on the asset side of the balance sheet. One interesting transaction is the CONSECO purchase of Greentree Financial. I think that was a \$6 billion transaction. It was sort of a new move for them, but it was a very significant deal. I think there is a lot of breadth and depth to the activity. There are all types of transactions, participants, and structures.

In terms of what's driving the activity, I think growth is a key issue. In certain sectors, like risk product sectors, the growth has been disappointing. One factor that has contributed to some extent is that the price/earnings ratio (P/E) multiples in the stocks have been expecting, if you will, fairly significant growth rates going forward. To justify those types of multiples, if you can't grow your revenues and earnings organically, I think transactions, to some extent, become the only solution.

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I think, in general, the two big Cs—consolidation and convergence—are what’s driving what we’re seeing in the industry, which is the perceived need for consolidation. I think most people would say it’s a real need, although there’s some question about how big is big enough and at what point does big become a liability. Consolidation trends are driven by the need to reduce unit costs, to achieve critical mass, to enhance market share, brand name, marketing clout, leverage, distribution, and increased distribution efficiencies. There is convergence within the financial services industries as companies look to enter new businesses, use new distribution channels, and cross-sell products.

The market has been dominated by a few big players, relatively well-heeled players that are experts in acquisitions. These are domestic companies. Internationally we’re seeing AIG, ING, Agon, AXA, Swiss Re, and Fortis. Those types of players also have a very significant and more recent presence, so it’s a crowded market.

Companies tend to have large market capitalizations with high P/E ratios. Acquisitions are part of a well-defined, well-articulated strategy, and not a “one off thing” that they do opportunistically. Historically, these companies have been consolidators and not conglomerates. As the financial services industry converges, I wonder whether we might see more reaching into what are noncore businesses a little bit outside of their current area of business.

What are some key success factors for these companies? They know how to get the deal done. They have well-defined goals and objectives. They’re organized internally for acquisitions. They know the market. They’ve gained the knowledge at the market firsthand through experience. Because of this knowledge and experience, they can do quick and accurate analyses, and they can be decisive in their decision-making. They know what’s out there, so when they see a deal they know if it’s priced appropriately or whether it would be best to wait for another property. They’re persistent, they don’t take failure badly, and they keep at it. They also know how to make the deal work once they get one done. I think there’s a lot of evidence out there that companies typically fail in the implementation stage once the acquisition has been completed. They don’t integrate it the way they need to, to reach the potential that they were hoping to in pricing the deal.

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In short, I would say that competition is large, and prices are fierce. Prices are at historic highs. I think the supply of targets is still limited relative to demand. Research would suggest that there's a need for caution in this kind of environment. And I think that you also need to be careful about who you work with because there are an awful lot of amateurs out there. There are companies that have just recently or within the last few years said that they're acquirers but they don't have much of a track record.

I think consolidation and convergence pressures will continue to intensify. Active acquirers will continue to be under pressure to grow their businesses. Others will be under pressure to sell their businesses if they're not meeting the expectations. It's unclear if and when this cycle would be broken. A major market correction, (one more significant than what we've seen recently), a major cratering of a deal, or a major implementation problem could take some of the momentum out of the market. In the longer term, I think we're likely to see the trend continue for the foreseeable future. There has been a 10-year trend in the banking industry. The deals have gotten larger and larger, and I think the life industry is probably just earlier in that phase, in my opinion.

The restructuring of the mutual life insurance industry will also, in my view, contribute to the level of activity that we're seeing as more companies have significantly greater access to capital to satisfy the pent-up demand for doing strategic transactions. The exposure of these companies to capital market forces will also add pressure on these companies to act quickly and to grow their business and divest of unprofitable, noncore operations.

Part of the reason that mutuals have restructured is because they needed access to capital. They don't need access to capital to support their organic internal growth because that has not been the problem. I think a lot of companies are overcapitalized, if you will, relative to their internal growth capabilities. However, I think they've wanted access to capital to do M&A activity and to do acquisitions. Now that they've completed their restructuring, I think there's going to be a lot of pressure on those companies to go out and do some of the things that they were talking about in the restructuring process. That's contributing to the competitive pressures we are seeing in the industry.

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There will be more targets available as the mutual companies reorganize. I'm also curious about the potential impact of the new life company shares on the market. As you all know, the mutual industry has had a very significant portion of the industry's assets and capital. As a significant part of that industry goes public, it will be interesting to see what sort of an appetite for those shares the market has for the mutual companies as well as the life companies.

**MR. BRADLEY M. SMITH:** To understand where we are today and how we got here, I think it's instructive to look at where we've been in the past. If you look at the capital structure of the acquirers in the 1980s, you'd see that they were dominated almost entirely by financial buyers as opposed to strategic buyers—barbarians at the gate. Incidentally, there's a great book describing that era of acquisition. *Barbarians at the Gate* is a book about the leveraged buyout of RJR Nabisco. I'd highly recommend it to anybody interested in learning more about that era. The financial buyers in the life insurance industry typically had a very skewed capital structure. A capital structure typically consisted of very little equity, a lot of senior debt, and mezzanine debt, meaning junk bonds or Drexel type stuff. And after Drexel went under, other banking firms, as well as some of the reinsurers stepped up.

What's interesting about this, and I think it's instructive if you look at the hurdle rates for the equity holders, is they were in the 35–40% range. The way they accomplished that was through extreme leverage. Interest rates were higher. The after-tax cost of senior debt was about 8%. Mezzanine debt—the coupons may have been 14–16% after-tax, but they typically had equity kickers. It represented somewhere in the neighborhood of 30% of their structure and the equity then represented approximately 10% of the structure. When you do that weighted-average calculation, you get a total return of 14.8% or 15%. This is interesting, because it's very consistent with how we price products or the hurdle rate we expected our products to meet back then.

We did two things during this period. We did the actuarial appraisal, which is a constant. Actuarial appraisal basically consists of the value of existing business, the value of new business, and the value of capital and surplus, and adjusted capital and surplus (either excess of target surplus or not, depending on whether we took into account the cost of target surplus).

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We assigned no new business value back in the mid-to-late 1980s and early 1990s. The reason was because the hurdle rate was 15% and we priced the products at 15%, so there was no value. You'll see as I progress that there's a difference from what we did back in the late 1980s and early 1990s to where we are currently. Let's say Mike went in and represented a company and Meredith went in and represented a company. Mike gave the company credit for 10 years of new business with phenomenal growth in the mid-1980s and Meredith gives credit for one year of business hesitantly. They both would come up with the same purchase price because they both assigned zero value to the new business. So the amount of new business that you assigned was not a critical factor and we'll see that that's different from where we are today.

Additionally, we gave no credit for expense savings back then. The logic was that if I'm acquiring your company and your company is not performing from an expense standpoint where it should be, (it didn't have enough business), or, it wasn't at a critical mass or capable of defraying its fixed expenses, then why should I pay you an additional price for a capability that I'm going to bring to the combined entity? That was the logic. It made sense, but things have changed.

In addition, the other thing that was suppressing the value of new business assigned is that financial buyers typically didn't want new business. New business represented a drain or a problem for them. In addition to the actuarial appraisal, as I said before, we did what was referred to as a cash-flow analysis. It's not cash-flow as valuation actuaries would think about it, but we were trying to determine the statutory earnings emerging from the entity that will help pay interest as well as repay debt. Obviously, I'm going to have a lot of interest on debt here and the senior debt is going to have to be repaid. In much of this mezzanine debt or subordinate debt, the payment was deferred, but I had to have cash-flow coming from the entity to pay current obligations. So we did that type of analysis along with the actuarial appraisal. The drain associated with new business brings my statutory earnings down. So if I wasn't meeting my hurdle rate on new business, I wasn't too excited about it giving any value for new business.

About a year ago, one of the Best weeklies said, "Insurance holding companies, in particular, their financial leverage can have a significant impact on the financial condition, and therefore, the ratings

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of insurance company operating subsidiaries. A strong, well-capitalized holding company can provide financial flexibility by providing access to capital. Alternatively, a highly leveraged holding company can burden an operating subsidiary by relying heavily on its earnings to service debt and other obligations.” All of this debt occurred at the holding company in these transactions. It’s instructive to see that Best saw the light of day about a year ago after many failures in the insurance and outside the insurance industry due to the leveraging up of the entity. It’s kind of closing the gate once the horse is gone.

The article continues—

that there have been no significant leveraged buyouts in the industry for more than two years. Activity by pure “financial” buyers in the insurance industry is diminished as most recent buyers have been “strategic” or industry buyers. Most of the recent transactions that have been completed have generally been structured with less financial leverage than those in the late 80s and early 90s. Strategic or industry buyers have relied less on debt and financial leverage to acquire companies and generate adequate returns. The capital requirements in the business, coupled with the negative impact of such transactions on ratings, have been significant factors in contributing to a reduced number of highly leveraged financially driven deals.

I certainly agree with that. There has been virtually no highly leveraged transactions, but you can make your own judgment after our presentations as to whether they’ve been financially driven deals. So what happened in 1991 and 1992, after the Executive Life and Mutual Benefit problems, was that the rating agencies said, leverage is bad. We’re going to start downgrading you if you have high leverage in your balance sheet. It diminished the capability of a lot of these companies to do transactions.

Best continues, “Deleveraging has also occurred in recent years as the industry has benefited from refinancing activity triggered by low interest rates. Most issues of high coupon debt have been refinanced.” I’m talking about the mezzanine debt that was incurred in the early 1990s and late 1980s. “Most issues of high coupon debt have been refinanced with low coupon issues or through equity offerings.” *Equity offerings*, in my mind, should be in quotes, and we’ll discuss that in a little bit. “In addition, the industry has participated in issuing various types of tax-advantaged trust preferred securities, such as monthly income preferred securities (MIPS), quarterly income preferred

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securities (QIPS), and trust originated preferred securities (TOPPERS). In many instances, proceeds have been used to repay bank loans or other debt obligations. Insurance companies have issued about 8.6 million of these quasi-equity tax deductible, preferred stock securities since 1994...”

We have these entities out there that were highly leveraged. Some failed. The rating agency said, “Wait, you can’t have this, we want you to recapitalize.” They’ve recapitalized with these financial instruments that Wall Street has generated. If we look at them just from a generic standpoint as opposed to the fact that they’re called equity by Wall Street, we’d realize that they have a stated due date for the principle, monthly or quarterly interest payments or coupon payments, and those payments are tax deductible. It sounds like debt to me, but, for whatever reason, the rating agencies are giving them credit in the equity equation.

So we move to today’s world and you’ll see that for Moody or Best to give an A type rating to their entity, it is required that debt as a percentage of total capitalization does not exceed 35%. You’ll see that if you look at CONSECO. It is always right around 35% as defined by the rating agency. Remember I’m trying to take us from where we were in the mid-1980s to where we are today. If you check the capital structure, you’d see we have 65% equity and we want a 15% return on our equity. Senior debt represents about 35% of our balance sheet. We have a 5% after-tax cost of debt actually decreasing as we speak, and our total hurdle rate is 11.5%.

In fact, if you agree with what I’ve said about pseudo equity being debt, you actually have more of a 50/50 type relationship. The cost of your senior debt is substantially less than the cost of your equity; therefore, your total hurdle rate has come down. A hurdle rate would be the minimum return on investment that you would accept to, essentially, break even given where the sources of your capital are. We’re suddenly at transactions that we moved from a 15% overall return on total capital to a 10% return on total capital. Anybody that has done an actuarial appraisal or any projections at all understands that a lower discount/hurdle rate results in a higher price. The cash-flows are discounted at a lower rate, which results in a higher price. That’s exactly what has happened.

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In addition, where are we when we're performing an actuarial appraisal? Remember that the components of actuarial appraisal are the value of existing business, the value of new business, and the value of capital and surplus. We're somewhere in the range of return on total capital of 8–12%. I'll talk about how we get from 10% to 8%.

We've talked about financial leverage. In fact, we are giving new business value and that, quite frankly, is one of the largest factors in the determination between winners and losers as far as who wins a bid, or ends up buying a company or merging a company.

I talked about Mike and Meredith each representing companies in an acquisition scenario. Mike's company was giving 10 years of credit for new business and Meredith's was giving one year of credit. Meredith has become more realistic and is now giving three-to-five years of value. The reality is that the difference is critical. I've been on the losing side a lot and I've been on the winning side a lot. In virtually all the deals that I've been involved in, the difference has been the amount of new business my client was willing to assign to the actuarial appraisal and give the seller credit for. In our example, the business is still being priced at 12–15% hurdle rate. We're still pricing our existing business like that. Then we do an actuarial appraisal and if our hurdle rate in the actuarial appraisal is 8–10%, suddenly, one unit of new business has a substantial value. So the difference between three years of new business value and 10 years of new business value makes the difference between winning and losing. The advisers talk after each transaction has been consummated and you typically understand that the difference in your value versus the difference in the winner's value or the loser's value was the amount of new business that you credited to the purchase price.

There is so much competition for these deals. We'll talk about motivations for this. There is so much competition for these deals that we have now moved to giving credit for expense savings. So the best positioned company is the company that can't defray their expenses. As far as the dollar of value you're going to get for your company, we'll give you credit for 10 years of new business, possibly with growth.

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What you need is to develop one year of phenomenal growth and people will be just knocking down your door ready to give you 10 years of value at that compound growth rate. They also will give you credit for expense savings in the purchase price calculation. Remember that you may be issuing and maintaining your business at \$95 per policy on a universal life. We would come in and say, "\$50 to \$60 is where you should be and where the organization will be." Because we're the buyers and a large organization able to leverage your fixed expenses and bring that down, we will give you credit for the difference between the \$50 to \$60 that we have in our actuarial appraisal versus the \$95. The only reason we're doing that is because we need to get the price up. It's not like we sat around a table and said, "Let's give them credit for being inefficient." It was more like, "Holy cow, company A, B, C are competitors in this bidding process and they are offering \$10 million or a billion dollars more in this transaction. How do we get up there?"

If we give them credit for expense savings and 10 years of new business production, we can get to that purchase price. We do not perform the role at Milliman and Robertson and I would dare say that Mike does not at Ernst & Young ever tell a client what they should pay for a block of business or for a company. We just tell the implicit ramifications of the assumptions that you have to make in order to justify such a purchase price.

There are two large companies that have driven the M&A business in the life insurance entity the last two years. They are G.E. Capital and CONSECO. They both have some very common characteristics. G.E. Capital has an extremely low cost of capital because they, essentially, impute a huge amount of debt to their capital structures. They're still requiring a 15% return on their equity, which in this day is high. They're imputing, essentially, a seven or eight to one ratio between debt and equity in their capital structure. That, combined with the fact that their debt is extremely inexpensive, gets them to a hurdle rate of 6.2%.

I've lost some deals for G.E. Capital, and I've helped them on some deals. The reality is that I've never seen them go down to 6.2% in a transaction. But I've been on the other side of a transaction

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where we kind of knew that they were willing to go to 6.2% and we were at 11, 10, and 9. We just quit in the bidding process because it was pretty clear that G.E. Capital could acquire anything that it really wanted to acquire given its imputed capital structure.

In one of the transactions the client that I represented lost. One of the things that Meredith said is we should try to mix in a few war stories, so here comes war story number one. Back in 1994, we represented American Travelers. American Travelers is a long-term care company out of Philadelphia. If you remember back in 1994, everybody was selling their long-term care business. They came to the realization that it was underpriced due to lapse rates and lowering of interest rates, so everybody was divesting. American Travelers was a buyer and they bought two blocks of business for which we did sellers' appraisals. In that process, I got to know John Powell who was and I believe still is the CEO at American Travelers. John Powell simply wanted to buy Amex Life Assurance Company, which was dominated by long-term care. Basically, it came down to the last few days. It was us and G.E. Capital—it was pretty clear that G.E. Capital was going to win it. In fact, they did. I think they paid \$340 million or \$360 million for that company, and we were in the \$300 million range. After talking to the guy from G.E. Capital, I found out that they are very aware of not only their assets, but also the capital structure of their liabilities.

If you look at an analysis of the life insurance industry, you'd see that it is dominated by C-1 and C-3 type risk. G.E. Capital wanted to bring in some C-2 risk that they felt very out of balance. Given that they owned a large annuity company in the northwest, they felt very out of balance with their risk-based capital formula, and they were. They could bring on Amex Life Assurance Company, which is dominated by C-2 risk, primarily since it is a health insurance writer, and bring that balance, the co-variance, in effect, into place. Not only did they have a low cost of capital or a low hurdle rate; they had implicitly assigned substantially less target surplus to support that incremental block of business that we were doing. When you go back to your companies, you may want to look at this, because if your RBC is out of balance, C-1, C-3 versus C-2, you may have by definition a competitive advantage in the acquisition of a C-2 dominated business. G.E. Capital subsequently did the same thing when it bought First Colony, a very C-2 type company with a great deal of term insurance.

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The other company is CONSECO. They also have an extremely low cost of capital. It's not because it imputes a tremendous amount of debt; it's because its stock price is very high. Up until this Greentree Financial transaction, which the market has not viewed as very positive thus far, their stock always had a price/earnings ratio in the range of 19–22. This implicitly brings your cost of equity down. If your price earnings ratio is 20, your cost of equity is 5%. Then you can see how this would result in a very low hurdle rate.

Before we get more into CONSECO, let's examine the reasons for what's driving this merger mania. I've given you, hopefully, a good understanding as to how we got from 15% to 10%, but how did we get from 10% to 8%? Economies of scale is one reason. The professional consolidators typically cut the expenses for the acquired company 50%, and probably closer to 70%. That has to be your goal as far as cutting out expenses of the acquired company. You have to go into that company thinking that you can leverage what you currently have by eliminating 50–70% of that company's expenses. Increased market presence is another factor driving the merger mania.

If you represent a client that has lost a couple of mergers, you'll be able to recognize that the next time through it's almost like sticker shock. The first time you go in to look at a sport utility vehicle you think it is expensive. Then you go back the next time and you say, "It's kind of expensive." Then you drive out with the thing because you're used to the price. The sticker shock has worn off.

Those are good reasons and fundamental reasons. However, I think what's driving the market today is executive compensation through stock options. I think that is a huge driver of this market, and I think it's a huge driver of what CONSECO has done. They have been successful at what they've done. The way they've done it has to do with how you can account for the transaction.

When we did an actuarial appraisal in the mid-1980s, we would do an appraisal and a cash-flow analysis, essentially, making sure we can cover our debt. Today we do the actuarial appraisal, which is the base. But for every transaction we've done in the last two years, we also, for either a buyer or a seller, do the initial purchase GAAP balance sheet and a purchase GAAP income statement (a pro forma income statement). What has happened is that you can aggressively account for these

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transactions such that a deal that would be accretive, meaning would add to your earnings per share, would be associated with a purchase price that was substantially less than what we might view as a reasonable hurdle rate. Let's say actuaries, given the risk and given our backgrounds, say a reasonable hurdle rate for these transactions would be 10–12%. A hurdle rate is the discount rate with which we discount the projected distributable earnings. It is the minimum acceptable return. Among other things is cost of capital. We show our appraisal values at 10%, 12%, and 14% and the deal is accretive at an 8% purchase price or an 8% discount rate. This can be seen at companies like CONSECO.

CONSECO buys these acquisition targets up at what we would view as conceptually high prices. However, due to their accounting methodology, these transactions are immediately accretive to their earnings. Earnings times the price earnings ratio is the stock price. If I raise my earnings and my P/E stays the same, my stock price goes up. If I was issued stock options January 1, or, I may issue new stock options each January 1 at my current stock price—the way I'm going to get my stock price up is to raise my earnings. It's going to enhance the performance of my company, so I make the transaction and increased my earnings. In addition, there's a leveraging effect there. The analysts on Wall Street will say this is a growth company. If you do one deal, they aren't sure. If you do two deals they say, "They're here for sure." If you do three deals over a two-year or three-year period of time, they'll say, "Growth company." So your P/E goes from 11% to 12% to 20%. That's exactly what Life Re did. The Life Re stock price two years and three months ago was \$27. The company went out and aggressively did accretive transactions. Some of them were expensive, and some of them were not, but they were all pretty small when compared to the ones that Mike showed on the screen. But the bottom line is they added to earnings. Wall Street recognized it and raised Life Re's P/E. Their P/E today is 23. Their stock price went from \$27 to being bought out by Swiss Re at \$95 in a two-year, three-month period. And I'll guarantee you that's not through the life reinsurance market because everybody knows what the life reinsurance market is doing. It's done through the acquisition of blocks of business.

So CONSECO realized very early on that leveraging wasn't going to be the way to go, and they, consequently, went public. Prior to 1992, what they did was buy companies and, essentially, account

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for it using purchase GAAP. In this balance sheet, the purchase price, by definition, is the equity. The invested assets are the invested assets that mark-to-market. The benefit reserves are solid. The deferred federal income tax is a consequence of everything else. So the balance sheet has to balance and everything else is either the value of in-force business or the value of in-force present value of profit (PVP) or value of business acquired (VOBA) and goodwill. In order to balance the balance sheet, you have to put it all in either goodwill or value of in-force business.

Prior to 1992, CONSECO's hurdle rate was 15% or 17%. Prior to 1992, they basically amortized the value of in-force business using the 17% or 18% hurdle rate. If you have an amortizing asset and you're amortizing that asset using 17% or 18%, you don't get a lot of amortization in the first year. You get very little. You get very little in the first five years actually. That allowed them to be aggressive in their purchase price and still be accretive to earnings. They aggressively allocated the PVP and then amortized it using a very high hurdle rate.

FASB did not like this, so it formed the Emerging Issues Task Force 92-9. They came out with a pronouncement that said you can't do that. It says you can still capitalize the purchase price. It's consistent with interpretation 1B of our Standards of Practice. It says you still determine the value of in-force using this discount rate, but you can't amortize it using the high discount rate. You must amortize it using *Financial Accounting Standards (FAS) 60* principles or *FAS 97* principles depending on the type of business.

Now the game companies are playing involves aggressively allocating to goodwill. Goodwill is amortized linearly over 40 years. It's up to 40 years and it's not automatic. You have to prove to your auditor that it's reasonable. The bottom line is virtually all these transactions are being amortized over a 30–40-year period.

So you buy a block of business or a company. You put a lot of your purchase price in the goodwill, and you amortize that over 40 years, essentially at 2.5% amortization. That's a pretty slow amortization. That results in an earnings pattern that accelerates earnings in the early years. So it makes deals that look fundamentally expensive, that equate to a low discount rate, and become

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accretive earlier than you would expect. They're accretive for essentially three to five years. Depending upon the new business growth, they may not be accretive; they might be dilutive after that. If you're compensated using options, and earnings times the P/E is the stock price, and the deal is accretive, you don't want to lose that deal, so you make that deal.

**MR. HUGHES:** And the way to keep that story working is to keep doing bigger and bigger deals.

**MR. SMITH:** That's exactly right. Think about what CONSECO did in 1994. I think the company is composed of financial geniuses. In 1994, they did one deal. In 1995, they did two deals. In 1996, they did four deals. In 1997, they did seven deals. They couldn't do 14 deals in 1998, so they made one big deal—the Greentree Financial transaction. I mean once you get on that goodwill treadmill, if you still want to remain accretive, if you accept my premise that the deal that you did five years ago was going to be dilutive to your earnings, you've got to make more and bigger deals just as Mike said. Look at the history of CONSECO.

Best said of CONSECO, "Its chief executive officer and executive vice presidents" (I think there are four of them) "exercised outstanding vested stock options to purchase about 8.6 million shares of the company's common stock. The options exercised would, otherwise, have remained exercisable for seven years. As a result of the exercise, the company will realize a tax deduction of about \$225 million." That's making lemonade from lemons. You get a tax deduction for the \$225 million, which is equal to the aggregate amount of tax gained, recognized by the executive as a result of the exercise. If you're going to get \$225 million, you're going to figure out a way to be accretive and you're going to make deals that are accretive because they're going to raise your stock price. That's exactly what's happening.

Another war story. We talked about John Powell at American Travelers and how we lost the American Express transaction because we didn't recognize the value of incremental surplus and G.E. Capital did. After we helped John Powell with American Express, we looked into his company and found that he got the benefit of all of these transactions that he did buying long-term care. The analyst said, "It's a growth company and his earnings and his P/E went up." Back in 1996, the stock

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price went from \$12 to \$18. Frankly, when comparing that stock price to an actuarial appraisal, \$18 was pretty high.

So I came in one morning, in mid-August of 1996 and looked at the *Wall Street Journal*. When you're in the M&A business that's the first thing you always look at to see which clients have been bought and sold. American Travelers had been sold and had been bought by CONSECO for \$36 a share. The stock price was \$18 and, \$36 a share was probably overstated. I called John Powell. I think his family, through a trust, owned over 20%. I figured he wouldn't be in, but, in fact, he was in and I said, "Well, congratulations, you're rich!" and we talked. I said, "Why didn't you hire us?" Even though he got a great stock price, we're egotistical enough to think that we would have increased that price. He said, "The way this all came down was that I was interested in Bankers Life and Casualty's long-term care business." Bankers Life is one of CONSECO's companies.

I called up Steve Hilbert, who's the CEO of CONSECO and said, "I'm interested in your long-term-care business." This is right after the failed AMEX (American Express) deal. G.E. Capital bought AMEX and Steve Hilbert kind of wants to be G.E. Capital. He said, "I'm not going to sell you my Bankers Life and Casualty business, but you've entered our radar scope, and we want to buy you." I said, "Well, that's why you should have hired us. We would have helped you out." He said on a Tuesday, "You know when that happened?" Last Thursday I (i.e., John Powell) initiated the call to buy a block of business. Three business days later it's in the *Wall Street Journal* that he's selling his company to CONSECO for two times its current stock price.

Let me ask you a question. What role do actuaries play in that? We're all consultants and we have a tremendous capability of billing. There's a finite amount of time between Thursday and Tuesday. Quite frankly, and all kidding aside, not very much analysis can be done.

**MR. HUGHES:** You have to have a good Rolodex.

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**MR. SMITH:** But if you're not concerned with actuarial appraisal values, and only concerned with accretion and dilution to earnings, you can do an analysis pretty quickly. It doesn't take an actuary; accountants can do it. It's arithmetic. And you can determine whether the deal is accretive or dilutive in a relatively short time. That's exactly what happened.

At that point in time, we were representing Transport, and Transport had just sold its long-term care business to American Travelers. American Travelers got this huge premium and someone called me up to say, "Can you believe this," because they had done due diligence on American Travelers and they knew it wasn't worth \$36 a share, at least from an economics standpoint. It clearly was from CONSECO's standpoint. They bought it for \$36 a share. It's easy for me as an actuary to sit here and argue that economically it's not worth \$36 a share, but the day that they made the announcement, their stock price went up, so who's to say who's wrong and who's right in this equation.

The CEO of Transport called me and said, "What are we going to do? We can't compete with this." We can't compete with these large stock prices. I said, "Maybe it's time to talk to CONSECO." Two weeks later I get a call about doing pro forma purchase GAAP for Transport, because CONSECO was coming in the next day. A week after CONSECO came in, it was announced in the paper, "CONSECO buys Transport."

There's not much of a role that actuaries can play if, in fact, you're not willing to get into GAAP and GAAP pro formas. You cannot just do the actuarial appraisal because the actuarial appraisal, in and of itself, is irrelevant to major participants in the acquisition marketplace. That's not to say other participants in the marketplace do not look at actuarial appraisals and use them. We always do them, but you have to add something additional if you want to consult in this marketplace.

So what does this all mean? You may be sitting out there saying, "This doesn't affect me. My company is not buying or selling. It doesn't matter." But it does affect you, because you never know if you're selling. That's the first point. Second, it affects you because the industry is being dominated by acquirers, and if acquirers are using an 8% hurdle rate for acquisitions, and if acquirers are affecting their capital structure, this will eventually affect your company's hurdle rate and capital

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structure. You can argue that it's going to affect their capital structure, and it's going to affect your capital structure, and therefore, affect your competition. So you cannot put your head in the sand and say you're not going to be affected. You may not play in this game, but you're going to be affected by this game, and you need to know what they're doing. Even Best recognizes this.

The nice thing about this as opposed to what occurred in the early and mid-1980s is that if it all comes tumbling down, the people that are going to be hurt are the equity holders. It's not a highly leveraged type entity where there's going to be debt all around. The equity holders may be hurt. Ask the equity holders at PennCorp Financial.

PennCorp Financial used the CONSECO model. They were acquirers of companies. Arguably, they made good transactions. They accounted aggressively for their transactions. What they weren't good at was consolidating it. They weren't good at cutting 50% to 70% of the expense out of the companies that they acquired. In fact, they didn't. They accounted for it in such a way that you couldn't tell that they weren't doing it for two or three years. After two or three years you can tell. The financials stink. Earnings keep going up and then, suddenly, they go down, and then the P/E goes up and the P/E goes down. That's how you go from a high stock price, less than a year ago, of \$33 per share to the current price of somewhere between \$1.00 and \$2.00. The people that got hurt there are the equity holders. Even Best asked what was going to happen? What's going to happen when these equity holders realize that they just bought \$5 billion worth of property for, essentially, an internal rate of return of 6–8%? What's going to happen is, they're going to leverage their capital structure.

A.M. Best believes consolidation in the industry will continue and accelerate, particularly, within product lines and market segments. Additionally, the low returns on equity generated by the industry will compel companies to increase their use of debt for financing and share repurchases to generate better returns and improve earnings per share.

While A.M. Best expects the use of debt and leverage to increase, a return to the highly leveraged transactions that were characteristic in the late 80s and early 90s isn't expected. A.M. Best does expect, however, or believe these issues will put an increasing strain on companies to balance the interest of policyholders, regulators, rating agencies with those of owners and investors.

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We have gotten more leverage. We don't call it debt, but we're more leveraged and I think it will be even clearer as we go along.

"Given the trade-off between capital requirements for our highest ratings and the return that capital investors require, A.M. Best wouldn't expect many new companies to achieve its highest rating, an A++." I think that that is understating the circumstance. We're talking about returns on total capital in the 8–10% range. If you have a return on total capital of 8–10%, you increase your return on equity by making a larger percentage of your capital debt and a lower percentage equity. I think that's what we're going to see.

If you're in the acquisition business and you go in to do due diligence, there are considerations other than financial ones. You need to be very aware of Internal Revenue Code (IRC) Section 7702 issues. We've seen a lot of companies that don't have their act together on IRC 7702. That's something that you want to check very carefully. Market conduct is, clearly, another thing. They could depress the value of the company if there's outstanding market conduct claims. The year 2000 is becoming a bigger issue.

I've been on both sides of transactions. Companies have said, "The investment bankers get paid to make the transactions." Companies typically don't want to put those type of indemnifications or warranties in the transaction. I'm here to tell you that you're much better off putting them in the transaction. The reality is the decision of who's going to get the company is based primarily on one thing, and that is price. If you have the highest price, even if you have more indemnifications, then you, typically, will be the winner. So you're much better off tactically, in my mind, offering a higher price with significant indemnification than you are discounting those indemnifications. You overstate the value of them, offering a lower price and removing the indemnifications. I'll get an argument from different people on that, but I think that, at least over the last couple of years, price has definitely ruled.

**MR. HUGHES:** I think that's a good point, Brad, although I have seen situations where companies have accepted lower prices in exchange for not having to take on market conduct risk going forward.

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**MR. SMITH:** Sure.

**MR. HUGHES:** I came up with some different questions. These are intended to be sort of thought provoking. I'm not going to lecture about how to do an appraisal, but if you've done an appraisal or looked at appraisals of other people, you've, undoubtedly, stumbled onto some of these questions and I think they're somewhat thought provoking, so I'll just rattle some of them off.

The first question is just about perspective. I think it's generally known that there are buy-side and sell-side appraisals. You need to understand who has done it and what their perspective is. This bothers some people who tend to think that the actuary should walk right down the middle and come up with the same sort of results irregardless of who he's working for. I'm curious about the whole issue of perspective. Is it appropriate for actuaries to take a particular slant in what they're doing?

**MR. SMITH:** The reality is that you're hired to, essentially, work for a buyer or work for a seller. If you are retained by a buyer, you need to know who did the appraisal. You need to get the output so that you can make adjustments to the assumptions. It's not that they're bad guys or they're being overly aggressive; it's just that there's a continuous spectrum of acceptable assumptions and you have to make sure that you're comfortable with the assumptions and that you can implement the assumptions that you've made in the appraisal. We get spreadsheet downloads of projections and make adjustments to expenses. We get one year of new business production so we can adjust the new business profitability and so forth.

There's a corollary to that. It's something that's particularly apropos for valuation actuaries. If your company goes into play either through management or otherwise, and you haven't done an appraisal or somebody hasn't done a seller's appraisal for you, the first thing I'm going to ask for as a potential buyer is your valuation actuary analysis. The valuation actuary analysis is a profit-retained-type analysis where you're accumulating surplus. We're all actuaries, and we can turn a profits-retained analysis into a profits-released analysis. If we have a profits-released analysis, we can do a GAAP pro forma and we can, basically, do everything we need here. The problem is, if you end up being ultraconservative, we would look at the level interest rate scenario in this circumstance. If you end

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up being too conservative in your valuation actuarial analysis, and it ends up in the hands of a potential buyer, it becomes the a priori base upon which negotiations are made. So it truly is amazing that so many management people will say, “We don’t have an appraisal performed, we’re going to save a couple of \$100,000 or a \$100,000.” Then they end up giving up millions in the price, because we end up using the valuation actuarial analysis, which, by definition, should be a conservative analysis, in our determination of purchase price.

**MR. HUGHES:** Good point. I think the reality is that users are expected to be relatively sophisticated and that there are slants given to actuarial appraisals. They’re intended to be used in the negotiation process. A seller’s appraisal would be put together with the perspective of the buyer in mind, so that the buyer can use it to establish a bid. It’s difficult for the seller to know who the buyer might be and what their viewpoint might be on a number of different things. So you set out a particular set of assumptions, and it’s really incumbent upon the buyer to scrutinize those from a fairly sophisticated standpoint.

Discount rates. A few years ago, we were seeing discount rates of 10–15%. I think those were, to a large extent, consistent with the capital structures at the time. We’re now seeing discount rates at 8%, 10%, or 12%. I would say that the majority of transactions are going off at less than 10%. Much of that is capital structure related. I think a lot of it is GAAP accounting related. All sorts of different things can factor into the determination of discount rate, and I think it’s a particularly intriguing question as to how you should come up with a discount rate.

**MR. SMITH:** It’s a very interesting question, because I wouldn’t be presumptuous enough to tell any senior member of management what their discount rate should be. But I was certainly embarrassed a couple times last year when we had done appraisals for sellers and, in fact, the purchase price ended up to be higher than the highest price that we showed in the appraisal. At that time, I had said that I was never going to go below 9%. We’re now at 8% and we show 8%, 10% and 12%. If the market is saying 8% or 9% is the right answer, who are we actuaries to say that they should not show 8% in our analysis? If we don’t, we risk becoming irrelevant to the process.

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**MR. HUGHES:** There's a relatively significant amount of inertia between the movement in interest rates and the movement in discount rates. Interest rates have come down significantly and discount rates stayed at their typical 10%, 12%, and 14% range. I think that it sort of catches up and there is a relationship among discount rates, the interest rate environment, and cost of capital, but I think it's not as correlated as you might suspect.

**MR. SMITH:** I would agree with that and I also would say that Mike made an excellent point earlier about how there's a tremendous number of mutual companies converting to mutual holding companies with the capacity to generate a lot of capital. Many of us believe that their ability to generate capital outstrips their ability to effectively use it. I think that that's going to have upward pressure on prices and downward pressure on discount rates. Because if I'm a mutual holding company and I have excess capital and surplus that is, at this point, earning 3.5% to 4.5% after-tax, and I can make a transaction that's going to make 9% after-tax, I'm going to have to do it or I'm going to be on the other side of that transaction. I think there's going to be some continued upward pressure on prices and downward pressure on discount rates. Thus, I think the incremental cost to the capital in the industry is going down.

**MR. HUGHES:** Interest rate risks. You know, there's a lot of debate out there related to the Standard of Practice and, generally, about how much interest rate risk should be reflected in a valuation. And I think the guidance says if it's deemed to be material, it should probably be considered and reflected.

My general view is that times have changed a little bit. In the early 1990s there was not as much recognition of the cost of capital. Oftentimes the cost of capital was sort of winked at or set at artificially low levels. Thus, interest rate risk seemed to be a main focus. You needed to take interest rate risk into account. As a profession, we have gotten more intuitively comfortable with interest rates. We've had cash-flow testing analyses for five or ten years and the whole issue of how to deal with interest rate risk is becoming a little bit more intuitive. I think there is more emphasis

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now with rating agency capital requirements going higher and higher and more emphasis on explicitly factoring in cost of capital. In my view, there is a little bit less emphasis on interest rate risk.

**MR. SMITH:** The cost of capital is reflected because if you're going to translate your actuarial appraisal results into GAAP financials, your GAAP financials have target surplus in them and you need to take that into account. As far as interest rate risk, people like the level interest rate scenario. We generally perform the level interest rate scenario. If it's a deferred annuity type company that is potentially exposed to a lot of interest rate risk, we'll do stochastic testing to see whether the target company is reasonably matched. As long as the difference between the average of the stochastically generated results and the level interest rate scenario result is a change of somewhere between 2% and 3% in your discount rate, we will come to the conclusion that you're reasonably well matched. We present a big range of discount rates using the level interest rate scenario with the thinking that one of the reasons you're getting a higher rate of return, like 8%, 10%, and 12%, is that wherever you fall, it is a result of you accepting that interest rate risk.

**MR. HUGHES:** That's a good point. As a profession, we become more comfortable with the issue of how to value interest-sensitive liabilities and what the fair value of liabilities is. There's an increasing recognition of the fact that there's a very close relationship between the discount rate that you're using and the methodology that you're using. If you're doing option-adjusted valuation of interest-sensitive cash-flows, you'd use a discount rate that's consistent with that.

To the extent that you reflect less and less risk in the actual projection of cash-flows, it's sort of appropriate to make a provision for that in your discount rate. I think that's what Brad is mentioning. So I think there has been a shift in emphasis. That's not to say that there isn't interest rate risk out there. There's plenty of that. I think companies are more intuitively comfortable with it and handling it in perhaps different ways. Who is the seller to say what the buyer's perspective might be on interest rate risk? I think there's a tendency not to overplay that in the analyses.

As actuaries, we don't do much with mortality anymore, so we can skip this.

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**MR. SMITH:** Whenever you're looking at an actuarial appraisal, you'll be shocked at the number of times that this is not true. The first thing we do, if it has any mortality risk at all, is look at the death claims per 1,000 projected in the first year as compared to the historical death claims per thousand. You'd be shocked at the number of appraisals that have a severe disconnect. We're using pricing mortality or industry mortality. The companies are not realizing that. There's not a mortality study to support the assumption. Either it wasn't statistically credible or it just wasn't done inside the company. If there's a disconnect between your projected mortality per 1,000 and your historic mortality, that's a question in due diligence that you want to investigate. You might take your Lotus spreadsheet of results and move the mortality assumption up to reflect a more realistic assumption.

**MR. HUGHES:** I would say that's true. That's a very good approach. I like the idea of taking cash-flow testing memos and looking at them and comparing them to the appraisal assumptions. We do the same thing. We do the same sort of valuation type of analyses. What's troubling though is when you know you're in a difficult competitive situation and there is a huge disconnect between actual historical results and the appraisal results. There's no attempt to reconcile the appraisal projections to the historical results.

I was in a situation a while back where we were helping a buyer look at an annuity company. There was no information on spreads for a fairly significant annuity company. We asked, "What are your historical spreads on aggregate?" They said, "We can't tell you. We can give you 28 pages of crediting rates, but we don't know what our spread has been." There was a huge disconnect between the projected results and the historical results. It was sort of left to the buyer to figure it out. I think that speaks to the level of sophistication that's sort of expected of buyers in this kind of market. It's sort of a buyer beware environment.

**MS. RATAJCZAK:** One more comment regarding mortality. I was involved in a due diligence process, and we actually took in an underwriter with us. The company that was being targeted and the company that was wishing to buy it didn't have a lot of experience in a segment of business. They had heard through the grapevine that their underwriting practices were a lot more aggressive than how the products were priced. In that situation, we actually took an underwriter in to look at

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underwriting case files to see if there was a disconnect between the underwriting pricing assumptions and how the underwriter was actually pricing for that. And we did come to the conclusion that there was probably a lot of aggressive action being taken that was not reflected in the appraisal value going forward. That's another instance where mortality was an important consideration in a particular situation we were looking at.

**MR. HUGHES:** Maybe I should have stayed on the mortality slide. YRT can be particularly troublesome to try to factor into models as well.

Brad mentioned what's happening in the expense arena and I would agree with that. I think most deals are going off now with pretty much marginal type expenses going forward at levels that were unheard of previously. That's one area where there's some upside potential relative to what's in the appraisal. You know, an appraisal might have a \$30, \$40, or \$50 unit cost for policy maintenance or what have you. I know a number of companies have said they would expect something more akin to maybe 10% or 15% in terms of the real marginal costs. They might be willing to stretch in some other areas of some of the other assumptions because they could make upbeat more than what's reflected in the appraisal with respect to expenses.

Brad mentioned new business. I think it is a critical factor and I think it's a particularly difficult factor to value because I think there are so many issues with it. You need to be cognizant of how much production you're willing to pay for, how much of that is attributable to the structure that's there as opposed to what you could bring to the table. What's the rate of return on the product in the appraisal relative to what they've been able to achieve historically? How does that compare with the discount rate? Expenses are usually a critical factor. The major offset to the new business value would be some sort of allowance for expense overruns. I think new business, in particular, accounts for a great deal of variance between the prices that people are willing to pay.

**MR. SMITH:** There's a real dichotomy and it's very difficult. Say you pay a relatively high price in a transaction for the existing business, and a reasonable level of new business keeps you accretive for the three-to-five-year period. Eventually, the amortization of goodwill makes a deal dilutive.

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There is one way you can offset that. The reason you paid a higher price is because the value of new business is growing and the two entities combined grow at a higher rate. The problem with that is when you're pricing for these transactions at 8% and cutting 70% of the entity's expenses and producing new business for 10 years, essentially, you're pricing for the best case scenario. Many things can go wrong and not much more can go right. It's a real dichotomy because you have two opposing forces.

If I go into a company, and want to cut 70% of its expenses, I'm going to cut some field expenses, and I'm going to cut some distribution expenses. That's a big part of the expense equation for most companies.

On the other hand, I'm projecting 10 years of new business at a certain growth rate, so the good news is the bad news. I determine the price. I tell management what they have to do. They have to cut 70% of the expenses and they must grow new business at a certain level. They say they are comfortable with that. The next day they get the deal and they say, "We have to cut 70% of expenses while we're still growing new business." That's really the dichotomy and there is a really fine line. The people that are successful in doing it are going to be ultra successful because these deals are going to be profitable deals that raise stock prices and lower their cost of capital. They'll be able to build on each other. The companies that aren't able to do that are going to get killed. We've seen some recent examples of that.