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Session 18PD
Mergers and Acquisitions

Moderator: Mark A. Davis
Panelists: Kevin D. Mackay
Joseph M. Rafson

Summary: Panelists use recent transactions and examples to demonstrate various aspects of insurance company mergers and acquisition, including:

- *Business fit*
- *Consumer and market characteristics*
- *Value determination*
- *Earnings implications (GAAP and Statutory)*
- *Capital considerations*
- *Asset/liability analysis*
- *Market conduct exposure*
- *Administrative requirements*
- *Alternative deal structures*

MR. MARK A. DAVIS: I'm the manager of Tillinghast's Chicago office and one of Tillinghast's leading practitioners in the merger and acquisitions (M&A) area. Between 50% and 75% of my work in a given year is M&A related. As I look out in the audience, I recognize quite a few faces, and most of those acquaintances have been made in various M&A situations.

Chart(s) referred to in the text can be found at the end of the manuscript.

Our second speaker will be Kevin Mackay with GE. I came to know Kevin in the course of working on opposite sides of a few M&A transactions. Joe Rafson is with Allstate, and has been very active recently in some of the deals and transactions that Allstate has done.

It's no secret that M&A has been quite a big part of the insurance industry lately. There seems to be a never-ending consolidation. For many organizations, it has been a key component of their strategy. Some have been more successful than others (like American General, ING, Aegon and GE). That success list is not all-inclusive. The most recent failures that I could think of, in which the M&A strategy is what brought these organizations down, are PennCorp Financial, Conseco, and UNUM Provident. I might have missed one or two, but I would still put a question mark on UNUM Provident. They're down but not out. Conseco, in my personal opinion, is down and out. It might be a while before that comes about. I don't know anything. I'm not an insider there, but I think it's out. I spent two years trying to clean up Penn Corp Financial Group. That is an interesting situation.

Why do we have these failures? If there is an M&A strategy, and if we were successful in doing the deal, why do we have failures? What I've observed is that when you concentrate on the stock price in doing your M&A, and if you tend to let that be the overriding concern, you're heading for trouble. What we have seen is many companies' only concern is whether they can buy this other company, and will it be accretive to their earnings? That's the only consideration. If the answer to that was yes, they went ahead and did the deal. At Conseco, I think they were willing to pay any price, such that next year it was accretive to their earnings.

We know of some situations, through anecdotal evidence, where they paid two times what the company was really worth, but it still is accretive to their earnings. With some clever adjustments to purchase GAAP, we can get some positive earnings. Those situations are also brought about by the fact that your stock is a chief currency if your price/earnings (P/E) ratio is way more than the target. It can seem like a very cheap acquisition.

In the end, earnings are earnings, and if you sum them up using tax, GAAP, statutory or whatever, you get the same number. Don't paint a picture with your purchase GAAP that makes everything look really good at the beginning. It might not look very good at the end, and Conseco is starting to realize some of those things today.

Another characteristic of failures is a general lack of financial due diligence. You become eager to do a deal. It's going to make our earnings per share go up. There might be so many skeletons in those target companies that you don't know about. Overall, in those failures, there's just an overall lack of financial due diligence.

M&A is just a bigger part of the industry. Many of you have been affected by a merger or acquisition in some way or another. You might find yourself without a job, simply because your company has been bought out by a consolidator. Maybe you work for an acquirer that acquires a company. The company might want you to pick up and move somewhere to run new business. It could easily uproot you and your family; at the same time, it might provide you with some opportunities and even open some doors. Most actuaries either have been affected by M&A or will be affected in a very short time.

M&A is kind of like a high-stakes poker game. You only get one chance to do it right. You can't do it wrong at the beginning and then make it all work out right later on. One mistake at any point along the way can just ruin it for you. It will never turn out to be what you had hoped. You need to do it right at all points along the way for the overall deal to be viewed a success some years later. I'll now turn the discussion over to Kevin.

MR. KEVIN D. MACKAY: I want to discuss general trends in the insurance marketplace, specifically key market statistics on the M&A market and the strategic fit. There are many deals going on, but there are also some clear distinctions between the hunters and the hunted. U.S. asset managers are buying other kinds of institutions. We're seeing the foreign financial institutions buying up U.S. insurance companies, and, in general, we're seeing a lot of consolidation as well in the investment banking field.

I want to talk a little bit about industry trends as well. We have consolidation, convergence, and globalization going on, and that is leading to fewer, bigger, and stronger competitors. That puts us all in a rat race to achieve cost leadership. This is really one of the key things that is going to define future winners and losers of this whole game. One of the byproducts of that competition is there are more sales of blocks in subsidiaries, as consolidators really focus on their areas of strength. People are spinning out little blocks of business as the consolidation happens. We're seeing increased customer power. That's leading to margin compression, and insurers are responding by trying to develop deeper relationships with their customers. That's leading to the rise of brands being an important factor in a company's success. As a byproduct, compliance issues can turn out to be business killers. This is something that we all have to keep in mind as we're doing this.

On the e-business and technology front, we have new business models and new competitors coming at us. We're starting to see efficiencies, and we're starting to touch customers in all sorts of different ways. All these things are contributing to it "paying to be big." It is better to be big so you can defray the cost of this technology investment over all of your businesses. Of course, we've all seen market volatility as well. That's driving the need for great risk management. We're seeing swift punishment of management missteps.

Another big trend, of course, is demutualizations. That's leading to increased competition as those companies become more like stock companies. That's also enabling consolidation either by them or of them.

Let's discuss some data that we collected from SNL. I think we can draw a few lessons from this. The absolute number of deals is going down. It has dropped from 152 in 1997 to 113 in 1999 and to 52 in 2000. In the life insurance market, in 2000, it's probably going to remain flat or go up versus 1999 based on what has happened since June 2000. The Aetna deal wasn't done before the end of June. We're continuing to see prices close to historical levels. The life insurance business has a price/earnings (P/E) ratio of about 20 and around two times the price-to-book (P/B) value, which isn't all that different from 1998 and nowhere near where things were back in the early 1990s. However, for the nonlife business, there is a big drop in volume. You can also see a big drop in prices. You can see the price-to-book drop over the last couple of years as well. There's kind of a have/have not thing going on in the two markets now. We might see more big transactions like the Citicorp Associates deal happen between now and the end of 2000 as people get motivated to take advantage of the last time they can do that.

Let's discuss the strategic fit. You can define strategic fit by how our capabilities are enhanced by doing this deal. Typically, we'd measure that in terms of products. Do we enhance our offerings? If we use distribution as a measure, do we get more geographic areas? Do we get greater penetration? Do we get greater effectiveness of our field forces? Do we have the ability to cross-sell products from our target company into our distribution or our products into their distribution? These are all things that drive the appeal of companies in the eyes of acquirers. On the operational front, we're looking for more capabilities, more scale, and basically we are making things cheaper and better. We're looking for recognizable brand names. We're trying to increase the customer's affinity with us, and that's what brand is all about.

Let's look at a few deals in Table 1 and talk a little bit about the whys of these transactions, such as why these deals were done. I think the Citicorp/Travelers deal was largely about cross-sell, though not necessarily confined to consumer businesses. There was a tremendous amount of cross-selling that was possible in that deal on the corporate front. They could put their investment banking and corporate lending businesses together and really take advantage of the contacts that each side had. We can thereby do deals that each of them couldn't do separately.

TABLE 1
Selected Recent Deals

Enterprise Value	Target	Buyer	Target Production Lines	P/E
1998				
36.0	Citicorp	Travelers Group Inc.	National Commercial Bank	10.0
20.9	General Re Corp	Berkshire Hathaway Inc.	Casualty Insurance	21.0
18.2	SunAmerica	American International Group	Savings Products	35.0
2.5	USF&G Corp	St. Paul Cos. Inc	Focus on P&C Insurance	10.2
1.8	Life Re Corp	Swiss Reinsurance Co	Life Insurance	34.4
1999				
10.7	Transamerica Corp	Aogan NV	Life Insurance	14.3
3.5	CIGNA Corp	ACE Ltd	Property & Casualty Ins.	14.3
2.6	American Bankers Ins.	Fortis AG	Credit Related Ins.	NA
1.5	Guardian Royal Exchange	Liberty Mutual Group	Property & Casualty Ins.	NA
1.4	Orion Capital Corp	Royal &Sun Alliance Ins. Group	Property & Casualty Ins.	NA
1.2	General American MHC	MetLife	Life Insurance, Reinsurance	10.6
1.2	NAC RE Corp	XL Capital Ltd	Treaty & Facultative Reins	NA
1.1	American Heritage Life Investment	Allstate Corp	Worksite Insurance	24.0
2000				
7.7	Aetna	ING Group NV	Retirement, International	13.3
6.2	ReliaStar Financial Holdings	ING Group NV	Life Insurance	18.2
2.7	Financial Security Assurance	Dexia SA	Property & Casualty Ins.	19.5
0.6	Reliance Group Holdings	Citigroup Inc.	Surety Business	NM
0.6	Liberty Life/Liberty Insurance	Royal Bank of Canada	Life & Health	20.7
0.3	Reliance Group Holdings*	Leucadia National Corp.	Property & Casualty Ins.	NM
0.3	SW Life/Security Life & Trust*	Swiss Reinsurance Co	Life & Health	NM
0.2	Indianapolis Life Insurance	AmerUs MHC	Life & Health	11.5

* Subsequently Terminated

Sun America is also interesting because it added a big annuity capability to AIG, and they can now use that around the world to access markets and other product lines that they're already in. There is the TransAmerica acquisition by Aegon that gave Aegon a big U.S. brand. The Met purchase of General American I think is a great example of a distressed deal. We still see a fair number of distressed deals out there now, even in these times of plenty, because companies still go astray and still make risk management mistakes and drive themselves into the hands of acquirers. That's a good example of how certain deals or certain companies are kind of meant for certain acquirers. Met has the same mutual corporate structure as General American, which really enabled that deal to work well. They were both in the process of demutualization. It was just a lot easier for them to do that deal than it would have been for a stock company.

American Heritage and Allstate had the ability to drive property and casualty (P&C) through the worksite platform. We all know about the ING purchases this year. That's about getting size and mass in the U.S. for them. I guess the other interesting deal of this year is the AmeriUS Indianapolis Life deal again for structural reasons. It's one of the very few mergers of mutuals that has happened out there. I find that to be an interesting deal as well.

In summary, the trends we're seeing in general in the industry support continued consolidation. We see the pace continuing at a slightly slower level and the perceive strategic fit drives the deals getting done, or at least pricing, which really implies the deal is getting done.

MR. JOSEPH M. RAFSON: How many people in the audience have been affected or involved in a transaction, a merger, or an acquisition? Almost everybody. How many people have been involved in a deal from beginning to end? There are quite a few.

I thought it would be worthwhile to walk through a deal from the deal perspective so you can see more than just the due diligence or integration that you might be involved in. The aftermath of an acquisition obviously would affect everyone at both an acquirer and a target company. I will walk through what a deal looks like, but before you take any of these steps you must have a clear strategy.

Walking into an acquisition just because your CEO wants it or because everybody is doing it is almost a recipe for failure. There are so many ways to fail in this game. The consultants will tell you that between two-thirds and 85% of deals that are done (and this is not just in the insurance industry but in general) fail to return the acquirer's cost of capital and are therefore eliminating shareholder value. That's a pretty miserable track record, and yet everybody seems to want to be acquirers. It's a sobering situation, and it makes you think that you better be careful if you're going to play in this game.

Let's walk through and see what we do. Candidate identification obviously comes very early in the process. We have two different ways for candidates to come in. We have a proactive process by which we screen candidates. We self-assess, and we decide who might be a good fit for us, which companies will complement our strengths and file in our weaknesses. At the same time, we're also open to deals coming in from the outside world, which is reactive. Brokers might shop deals. Investment bankers constantly float ideas of what we should buy. We have to sort through those and go for the ones that we think make sense or could make sense.

Candidate identification ends with a confidentiality agreement and an assignment of a project code name. We're the type of people who typically walk around with code names, and don't talk about what we do. If you asked me what I think of a certain deal, I wouldn't be able to comment. The same would be true of Kevin. We're just covered by confidentiality agreements on so much of what we do in our lives.

Once we've identified a candidate, we try to learn everything we can about them. If it's a reactive deal that is being shopped, you have an offering memorandum that describes how great and wonderful the company is, how fantastic their distribution is, how much they're going to sell in the future, and how profitable it is. An actuarial appraisal will provide a numerical backup and, generally, those numbers get lifted right into the offering memo. They let the actuaries kind of do the valuation. Insurance opportunities are a little bit unique in that we pay less attention to multiples of book and multiples of P/E than in other industries. Actuarial appraisals really carry a lot of weight. Investment bankers say insurance is really different as is evident when you look at one block of business versus another block of business. You need actuaries.

At this stage, we also will be combing through all the public material we can. We'll be going onto Websites. We'll be trying to find out about their products. We'll be looking up financials, and checking the financial press. Everything you can find out about a company is fair game and probably useful. Typically, an auction situation will go into an initial bid, which simply winnows down the field. If you have ever been through due diligence from the sell side, you know trying to explain yourself to strangers is not the most enjoyable experience. They really have license to ask anything they want. Do you want to do that 20 times to anybody who has a copy of the offering material, or do you want to do it with the five serious bidders? That's really what initial bids are for. They come pretty early in the process to winnow things down.

Then you go into the due diligence phase, which is really the deep dive. You get to talk to management. It can be done on-site, but more typically it's done near site. You'll be at a hotel or at a lawyer's office. You'll be hidden in the basement, and people will come to see you. Occasionally you get the opportunity to walk the floor and see the company. Sometimes you get strange situations where people go in pretending to be an agent so that your operations person can walk around and see how things run. There's also a tremendous amount of information, and I'll go into what due diligence entails later on.

After due diligence, you go into a binding final bid situation. Sometimes there's more than one round in the final bidding stage, but we'll assume there's just one round. There's also sometimes a markup of a contract that comes at this stage. More and more sellers are realizing that price is not the only thing. It's price and coming to terms. The best way to get an idea of what a purchaser's terms are is by literally giving a preliminary contract and seeing how people mark it up. Sellers need to know they can come to terms and get to closure.

Selecting someone and not getting to close, and certainly signing a deal and not getting to close, can be extremely destructive to the value of a target company. If you announce a deal, you make your entire workforce uneasy, and many of them head for the doors not knowing what's going to happen to them. They listen harder to head hunters who might be calling and who might take this opportunity to call. Not closing a deal is much harder on a target company than on the acquirer. When you're evaluating companies that would be good acquirers, remember that their conditions and their ability to close are extremely important.

After the final bid, you enter a period of exclusive negotiations. The key to contract negotiations is to get them over quickly. Confidentiality is extremely important throughout the entire process. It is even more important once you've been selected. If you have met on price, and you are a public company like Allstate, arguably that is something you have to disclose. Shortening the period of time between when you come to that very narrow price range and when you get to contract and can make an announcement is extremely important. There may be press leaks at this point, and I suspect that some of those leaks are actually intentional, forcing an acquirer to complete the deal. There are a lot of things that happen at this stage, and it goes around the clock. Once you have signed contracts, you can go public, and all you want to do is go home and sleep, but that, of course, doesn't last for very long because of time.

You want contracts to go quickly. You also want closing to come quickly because you want to purchase a company, and you want to start doing things with this company for the very reasons that you wanted to purchase that company. Waiting three or four months is not what you want to do. Unfortunately, in today's regulatory environment, when you buy an insurance company, you almost always have to wait to get approval.

Other structures such as reinsurance can happen much quicker. The important thing is to narrow the time to close (a) to be more sure of closing, and (b) to get on with your integration because integration is so important to deals. One thing I'd ask you to take away is the importance of integration. Mark said that if you make a mistake, you're not going to be able to fix it later, but with good integration, you can mitigate a bad deal and make it better. More frequently, you can have a good deal and see it ruined without clear, quick, decisive integration. If people don't know what's going to happen, or if people are uncertain, or if there's unclear communication, you're going to see value dissolving. Deals are so competitive today that you really need to garner the value that you expect to get out of it, and you have to be realistic when pricing a deal and know that you are going to lose some value. Some agents aren't going to like the acquiring company, for whatever reason, and they might decide to go elsewhere. Your competitors are going to go after that field force. Your own operations are going to be distracted. There's no such thing as a seamless integration or a nondisruptive integration. The idea is to be clear and move quickly and get through integration successfully so that you can have a good deal. It is very possible, but it is also a challenge and one that certainly keeps our job interesting. Now I'm going to give it back to Mark who will talk about appraisals.

MR. DAVIS: I guess it wouldn't be an actuarial meeting if we didn't talk a little bit about an actuarial appraisal. We're not going to spend a long time on this. As Joe said, an actuarial appraisal is the centerpoint of the start of a deal. A bid package is sent out by the investment bankers for a company that's being shopped. Investment bankers prepare their offering memorandum, and the actuarial appraisal is usually attached to it or incorporated by reference somehow. The appraisal establishes the line in the sand, not that the value starts here and can only go up. It just gives two parties something to haggle over or discuss. They can disagree on assumptions or whatever. Buyers get frustrated when there's no appraisal, and sometimes there is no appraisal.

There was a situation in which I came in contact with Kevin and there was no appraisal. He was very mad and very frustrated. The appraisal can just give you something tangible to start from. It's an estimate of the economic value. Actuaries wouldn't say it's a discounted cash-flow analysis, but in the M&A business, we have a lot of communications with nonactuaries. When you say discounted cash-flow analysis, they know what you're talking about. The appraisal is a discounted cash-flow analysis with required reserves, and also with some kind of required capital or required surplus. Those can be viewed as constraints on your free cash flows. It's based on statutory accounting. In every presentation I've ever given to a board of directors that pertains to an acquisition, one of the questions that comes up is why isn't it based on GAAP? I want to say that its because GAAP is bad and cash is king, but I haven't quite said that in a boardroom yet. It is based on statutory because statutory determines what money could be actually given out to shareholders.

There are three parts of an actuarial appraisal. There's the adjusted net worth, which is generally capital and surplus plus adjustment. There's the value of your in-force business, the earnings expected, and the flow off of that as we go forward. There is the soft piece, which is the value of new business or goodwill or existing structure value or fudge factor or hoped expense reduction. All these kinds of things might be factors. I don't think I've ever seen an appraisal of a life insurance organization that wasn't done in this way.

Again, the adjusted net worth starts from plain and simple statutory capital and surplus right out of the Blue Book. There are adjustments. The asset valuation reserve (AVR) is considered an allocation of surplus. It goes into adjusted net worth. We add in the contingency reserve and the policyholder dividend liability, which is just the regulatory thing. You also take out certain items. It's always interesting to me that surplus notes for statutory are considered equity, but for GAAP they're considered debt. This is one of the rare instances where GAAP is more conservative than statutory. You treat surplus notes as debt, and you reduce your adjusted net worth.

Surplus relief reinsurance is usually unwound as part of a deal. You'll see the present value of a payment to unwind that surplus relief deal. Nonadmitted assets, to the extent they have value, probably spend more time on that than it's worth, but we typically like to look at whatever the carrying value is for GAAP for those types of things.

The biggest part of an appraisal and the most effort is probably spent on determining the value of in-force business that is a projection of earnings. We typically call them distributable earnings. These are earnings that could, in fact, be put in the hands of shareholders.

The earnings projections for your value of in-force business should be the best estimate. We'll talk about how wide a range that best estimate can actually be. It is earnings with best-estimate assumptions. We like to see appraisals with real assets and not assumptions for yield rates to get the cash-flow effects and even the interest rate risk impacts, but we don't always get that. There is a provision for cost of capital or required surplus, whatever you want to call it. Almost universally, for some reason unbeknownst to me, it's in the appraisal at 200% risk-based capital (RBC). It became a standard. I don't know who decided it should become a standard, but it has. It's an adjustment that's easy to adjust to whatever capital level you want. It's linear. The cost of capital is $10 million at 200%, and at 250% it'd be $12.5 million. That's why 200% just became a standard. You make your own judgment as a buyer as to what you require there or what you would want.

It seems like we are more often doing work for sellers. We start from their cash-flow testing models just to try to jump-start the process and speed it up a little bit. I'm not sure that it actually ends up that way, but it sounds good in the beginning. It's interesting to see various companies' cash-flow testing models in detail. What I mean by the 80% rule is that I think these companies are 80% of the way there from where they would be ideal for use in an appraisal. That's not a criticism; it's an observation. Generally speaking, you know you are going to pass cash-flow testing models. If you pick the low-hanging fruit, you'll be 80% of the way there. The other 20% probably doesn't justify the amount of time and effort it would take to really get it super accurate. So you'll make an assumption that you can prove or you know is conservative, and you go with that. You have a model good enough for the purpose of reserve adequacy testing, but in terms of an appraisal, it's not quite ideal. If we inherit cash-flow testing models, we spend a lot of time vouching for them, and then taking them so that they are appropriate for an appraisal process.

Like I said, cash-flow testing models are very typically conservative. If you're working for a seller, you certainly want to know whatever conservatism is built in there before you even get started. When I'm working on the buyer's side, one of the things I like to do is to get as much detail on the cash-flow testing that I can from the actuarial memorandum. Then I start to match that up versus the actuarial appraisal. When you see significant differences in assumptions or everything, you must ask, why? If there are deviations in the work you've done in the first place, you need to be ready to explain yourself.

The value of new business in the U.S. is different than in other parts of the world. We do a projection much like our in-force projection, except we start with no policies on the books, and we issue them as we go out. We compute the same earnings in the same way as the in-force. You have different, additional factors of first-year commissions and acquisition expenses, but it's kind of the same process. Typical practice in the U.S., for a normal company, if there is such a thing as a normal company, means we would assume that there are ten years of new business issued. We would make sure that each year of issue went out for 30 years. For the business issued most recently, it actually goes out 30 years. Business issued at the end of the 10th year goes out 40 years. We just take the present value of those earning streams at our discount rate. Value will emerge to the extent that this internal rate of return on a statutory basis is higher than the pricing or higher than the discount rates employed. When I first started doing this work back in the late 1980s, discount rates were much higher, and you might see 15% as your middle discount rate. There are typically three discount rates. You might have been using 12.5%, 15%, and 17.5% in an appraisal. You'd almost always see a zero value of new business, except at the lowest discount rate, which might have some small smidgen of a value. Nowadays, you see some rather large numbers, depending on what company it is and how successful it has been.

This is the fuzzy area. This is the area to be careful of. Most companies are quite proud of what they've done, and they're very optimistic about this value. Buyers tend not to be quite so optimistic. It can be very difficult to find a middle ground here sometimes.

Judgment is required. The second bullet on my slide says "Beware of hockey sticks in production assumptions." I can give credit for that to our professional standards officer in Tillinghast. He uses that term. It means that a company is going along like this on its production year after year after year. For the years out into the future after the appraisal, the production, if graphed, would look like a hockey stick.

You'll hear, "We just made a lot of changes in that ordinary life line. Last quarter, it really picked up. We're expecting that to go gangbusters next year." I typically won't believe that. As actuaries, we're in a bit of a pinch because if it's a seller's appraisal, the insurance company is our client, and they're paying us. They'll want us to use whatever they tell us to use. We have to find some middle ground with them. You could use that, but you might do more harm than good.

You might bring into question some of the credibility about what this whole thing is about. Sometimes we spend a fair bit of time, in discussions with our client so we can reach assumptions that we can support and that we think are best overall. We want to get this company sold at a fair price, which is also as high as can be supported. Again, if you have deviations in your new business projection from recent pricing assumptions, or even if the production differs materially from the internal production forecast or three-year plan or five-year plan, you need to be ready to justify those deviations.

I have a couple of closing points here. There is a wide range in reasonableness in the M&A arena. Two actuaries could be looking at an assumption of mortality. One will say it should be done one way, and the other will say, no, it should be done another way. However, both are reasonable. When you plug them in, you have millions of dollars of difference in the value when you're done. In most cases, you have a situation like this where, as you go to the right, that's the higher price or higher value. The seller's appraisal is usually to the right, and on the left are the knowledgeable buyers but losers in the bidding process. The winner is in the middle, and is usually pretty happy. You got the deal, you do the deal, but the thing you wonder about is whether you missed something. How did we win that?

Sometimes there are legitimate reasons. The target organization might integrate well into your organization, and even better than into the losing buyer's organization. You might be able to achieve more expense synergies than the other group, but you always have the question of what did you miss? This is typically where it ends up. Sellers' appraisals are optimistic, but I can't go as far as to say they're unreasonable. They're just at the optimistic end of reasonable.

There is an appraisal value that is strategically best. You don't know exactly what it is, but in theory, there is an appraisal value that will maximize the transaction price. It's not the highest possible appraisal value. Chart 1 shows that as we move to the right, the transaction price continues to go up. But after you cross a certain point on your appraisal value, the transaction price starts to go down. Why is that? If your appraisal value is too high, the whole appraisal starts to lose credibility, and the buyer starts to get really nervous and wary about it.

Then you start looking at other material produced by the target company, and you start to not believe that either. You just sort of find out what's wrong. We have to find the problem, where they're trying to pull the wool over our eyes. I've seen this happen recently with an organization. This organization put itself up for sale. There was an actuarial appraisal from the consulting firm. Buyers went through the whole process that Joe described. Then the organization decided it was not going to sell. It wasn't happy with the offers that came in.

Why did this happen? There was one issue, and it wasn't the only issue. The appraisal value, in my opinion, was too high. I also think it turned buyers off because it was so high. I also think the organization's management started to believe those inflated appraisal values, and when the bids came, they weren't at all what the company expected. They were very disappointed. So I have seen actual situations where an overly optimistic appraisal value contributed to no deal being done.

MR. RAFSON: You start with the appraisal, and go through due diligence and hopefully get to a deal structure. Kevin will be talking about deal structure as we talk about some of the more actuarial aspects of a deal.

Due diligence is one of the aspects of a deal that many people can be involved in. Due diligence can also be very small. What you're looking for as a buyer is everything you can know about a company in order to value it properly from a deal perspective.

There is an unbelievable amount of material. At some point, you have to winnow that down and ask yourself, what are the most important things I have to learn? What do I have to know before I can be comfortable pursuing an acquisition? The time is limited. Access to management is typically extremely limited. You have to maintain confidentiality throughout the process. It is a bit of a challenge.

It's also a fascinating process to go through as a buyer. You get to learn about the many different ways people do business. It can be an extremely uncomfortable process for the seller. You have people asking you all kinds of questions that maybe you wouldn't like them to ask. It's your job to answer everything, and make sure they know the pitfalls. The buyers might be your employers in a couple of months. Think about what would happen if you didn't tell them something important?

As a seller, you want a level playing field if it's an auction process. You don't want unequal dissemination of information. Investment bankers often insist that written information go through them to ensure that all bidders are treated equally. This sometimes leads to situations where an actuary will share information and want to just hand you a piece of information, but have to stop and go through channels.

You want to identify show-stoppers. Show-stoppers are things that will sink a deal. They can be environmental liabilities or serious product tax issues. It could be that we, as buyers, had a strategic design for this company, and now realize that it doesn't fit. That's a show-stopper in my book, but most things are not show stoppers. Show stoppers are rare. Everything else usually boils down to price. If something is wrong, you usually just adjust the price for it. If you find a reserve issue indicating that a company should have been holding a million dollars more, the price simply goes down a million dollars.

You're trying to value what the company means to you as a unique purchaser. Value can be different to different buyers. When you're talking about sales volumes, the company might have a plan for the next three years. Let's say that Allstate wants to introduce this product to the Allstate agency force. Then I can expect a higher level of sales. If Allstate has that advantage, it can beat a pure financial buyer because it might be able to drive higher new business projections. If I'm an acquirer who is very good at expense takeout, maybe I can beat the next bidder. It's not the same to everyone. You want to make sure you catch negative synergies as well because, ultimately, as a deal guy, you might be held accountable for your projections. Certainly those projections become the baseline for how you view the acquisition later. You want to make sure you don't forget your accounting for transaction costs and integration costs, which are almost universally excluded from appraisals.

There are other things you want to do from a deal perspective in the due diligence process. As I mentioned earlier, you want to position yourselves as buyers. You want to make sure that you begin to develop good relationships with the people that hopefully will become your co-workers down the line. You want to be able to work with these people and get the most out of them so they can be the most enthusiastic. You want to impart your ability to close because that's key to doing a deal.

You also want to begin to frame an integration plan. You don't want to wait until after you've closed a deal to begin to plan an integration.

You don't want to wait six months to first begin looking at which of the two operating systems you're going to have to use. You don't want to wait 18 months to begin a systems conversion. If you do, you will give away a whole lot of value. You've got to get moving. You've got to begin to get a framework. You don't need organizational charts for what the organization is going to look like afterwards, but you should have a general idea of whether you are going to be consolidating offices. If you both have field distribution, are you going to be consolidating regional management? You should have a pretty good idea because that will impact your cost projections. Will your expenses be higher or lower, and how much synergy can you get out of it?

Although Kevin and I are actuaries, and we're on the deal team, we certainly can't do it without actuaries. I'm not a good enough actuary to do all these things, and actuarial practice is so diverse and so difficult, we need help. We need help in a lot of traditional actuarial ways to review the financials and to make sure reserves, DAC amortization, and reinsurance agreements are correct and in place. What might your reinsurance program be like post-acquisition? You might be trying to recapture reinsurance because the target has lower retention limits. You might be trying to reinsure out pieces of business that don't necessarily fit into your strategic vision. You might be changing asset/liability management practices. When we purchased American Heritage Life, as a relatively smaller company, they held only public bonds. It's not surprising for a company that size. When you're part of a much larger organization you have the ability to invest in less liquid asset classes because you have a higher degree of liquidity as a much larger organization.

One of the most important things is to look at product pricing. This is one of the areas where you really have to integrate well with your distribution people who are going to be committing to sales levels. A company might be selling a whole lot of products, but if they're doing it below your cost of capital, that's not worth very much. If you're going to be buying the company, and you're going to be making them conform to your cost of capital and your pricing, the price of the product might go up, and sales should go down if you raise the price. It's a rational thing to do, but you have to make sure that the distribution people know where prices are versus competitors' prices and where the prices might be in the future so that they can commit to accurate sales level post-acquisition.

Obviously, actuaries will help with deal pricing. While price is frequently set on a statutory basis, a lot of management, and certainly our management, wants to know what's it going to do to us on a GAAP perspective? That's what's really important to us as a public company. That means doing an estimate of what purchase accounting will do to the acquisition. You kind of have to do statutory pricing and GAAP pricing to present the deal to management.

Actuaries also get involved in reinforcing strategic scope. You've looked at a company. You thought you had a reason for purchasing it. You have to make sure that reason is valid. You might think its distribution would fit nicely with yours. Does it, in fact, fit nicely? You thought the products were complementary. Are they? Do they fit? Will your sales force sell their products?

There is an actuarial aspect to integration. You should begin to think about how new reporting relationships might look in the future? Will you, in fact, be able to do with less actuaries? Where's your piece of the pie post-acquisition?

The actuaries will support many other aspects of the due diligence, such as systems. You've got to make sure your systems people know about the products and the quirks you've discovered from an actuarial perspective. You want them to be aware of what a conversion might cost. It's challenging. Due diligence is challenging because of the kind of detail that you can get into. There's almost an endless amount of detail you'd like to know, and, at some point, you have to stop and say I have a good picture of what this company is today, and I have a good picture of what the company will look like tomorrow. This has to happen in a couple of days.

There's one trend in due diligence that's worthy to note. Some people in the investment banking community, in an effort to share information more fully, have begun copying entire data rooms and sending them to prospective bidders in advance. You actually have a week or two to spend time with these file cabinets full of information to become better informed. So when you go in and talk to management, you have better questions. It is an improvement in the process. We see better informed buyers and a better ultimate meeting of the minds in any kind of a deal.

MR. MACKAY: I'm going to talk about structures now. The main things I want to talk about are really what broad categories of structures there are and what considerations might be involved in each of them. The three I'm going to talk about are entity acquisitions, reinsurance agreements, and equity investments.

An entity acquisition is an outright purchase of an entity. You're buying the stock of this company, and that's going to give you all its assets and liabilities, all its operations, all its problems, and all its hopes and dreams. The contract will be in the form of a purchase agreement between the buyer and the shareholders of the company.

Let's talk a little bit about the terms of that agreement. The key thing is purchase price. How much is it per share? What adjustment process might you have to use to take care of things like interest rate changes between signing and closing, or different amounts of business that have been written in that time period, or lapses, or whatever? What worries do you have about how the value of the business can change if you don't buy it immediately?

The next main term of the purchase agreement is representatives and warranties of the buyer and seller. Here we're talking about what people are saying about what the seller is saying about the company aspects, like, compliance with laws. What kind of reserve methodology are they using? There are covenants of the buyer and seller. We're talking about controlling the operations and making sure they don't drive off a cliff between signing and closing. We also have closing conditions. This is kind of your to-do list, things that have to be settled before you actually sign the deal. Another key term is indemnification. This deals with what happens when those representatives and warranties or covenants are breached? If things are not as advertised, what happens? That section will contain things like how long those representatives and warranties survive. In terms of financial remedies, what are the caps on those remedies or floors on the minimum value that someone will get paid for?

The indemnification section will likely have some specific issue statements on tax or existing litigation so that those things that are clearly known before the transaction will be carved out. The seller will say we'll take care of litigation with John Doe and his family.

Let's talk a little bit about accounting. The statutory might be a little bit elementary for you. You would change your historical accounting basis on the statutory side. Things stay as they were before. You're not going to come up with new reserves, and you're not going to mark your assets to market or anything like that. On the GAAP front, though, you will do both those things. You're going to come up with new reserves, and you're going to have to set up intangibles. One of the hardest parts about this whole thing, particularly if you're an earnings-focused company, like most companies are, is going to be this allocation of value between the present value of future profits (PVP) and goodwill. The more PVP you have, the lousier your earnings are to start, and vice versa. You're going to want to, think that through, get it right, and get a reasonable earnings pattern that you're comfortable with. You don't think it is going to get knocked off because of changes in what really happened.

Tax accounting basically follows statutory, but you can end up with certain intangibles. You can actually make your goodwill deductible or your intangibles deductible and total through the Section 338(h)(10) elections, which we're going to talk about next.

Section 338 is an artifact of the tax code that allows you, under certain conditions, to deduct any goodwill that you have over a 15-year period. It allows you to treat the acquisition of the stock of this company like a reinsurance agreement and like an asset purchase. In an asset purchase, you would typically have to pay taxes on the difference between the value of your assets and liabilities. Section 338 enables that.

The key requirements are that the buyer and seller must be corporations. It doesn't work for a public company or the typical public company because the owners of a public company are typically individual shareholders. They don't meet that requirement. Section 338 works nicely for subsidiaries and other things like that, but it doesn't work for the big-bang acquisition. Another requirement is that the seller must own at least 80% of the target or the target must be a subchapter S corporation. That's not something you run into too often.

On the disadvantage side, there can be some technical issues about the basis that the seller has in the stock versus the basis that the company has in its assets and liabilities. That can make the

Section 338 election more expensive and can actually kill the whole idea of doing it if the deviation is big enough. Another historical artifact is the Phase III tax. Phase III tax must be paid for life insurance targets.

Let's move on to reinsurance. The key thing here is obviously you're going to be choosing selected lines and selected assets and liabilities that you want to take on. Your contract is going to look very much the same except that you have to design in this selection. On the other hand, entity acquisition is very simple. We're buying the stock. In this case, you're going to have to define a little bit more. One key structural issue about reinsurance is going to be whether you use coinsurance or assumption reinsurance. That's going to drive your regulatory process and taxes, and, in general, buyers would rather be doing coinsurance, and sellers would rather be doing assumptions.

With regard to the accounting side for reinsurance, the key difference on statutory is that you're going to mark your assets to market. That's because any assets that you get are going to be delivered to you in very much the same way as they would if you actually went out into the open market and bought them. You're going to have to mark them at the time. GAAP is very much the same, and tax follows statutory. The key tax point is, do you get to deduct your ceding commission up front, which you get to do under indemnity, or do you have to capitalize it and amortize it over 15 years. Of course, with reinsurance, you have to pay DAC tax on the reinsurance premiums as well. There are a few differences on the tax side.

Let's compare the whole thing. You're obviously more likely to be doing an entity acquisition if the thing that you want to buy happens to come in an entity. If there's a lot of other stuff in there, like environmental liabilities or something like that, you're going to be going towards reinsurance. If you have serious liabilities, you're going to have to deal with it as purchase price, and you're going to have to get protected. That is not going to be easy. If the 338 works on the entity side, or you happen to be in the happy situation that you're buying the company for book value, you don't need the 338 to work in that case. On the reinsurance side, in cases where the 338 doesn't work, and you obviously need deductible goodwill to make your economics better, you're going to want to go down the reinsurance road.

I want to talk about equity. I'm referring to the purchase of a stake in a company without acquiring the entire entity. The simple question might be, why would you do that? I think there are three key reasons. One is that a company's business model doesn't work if you're the sole owner. That might be true for an infrastructure company like a software company or maybe an insurance aggregator or other distribution company where they have to sell through or sell to, not just you, but many other folks as well.

A second reason is you might want to preserve the unique nature of the business. Many companies are successful because they're small and nimble. If we bring them into a much larger organization, like an insurance company, they will often break that.

There is a third reason to not acquire the entire entity. With start-up companies and in other situations, you might not want to consolidate earnings. In the start-up case, you're typically going to be looking at early-year losses, and you might not want to have those on your books. It is much better to just own the stock and not have to mark that through.

In terms of the form of the contract, it is much the same, but it might be called a subscription agreement instead of a purchase agreement.

Let's talk a little bit about terms. This is something that most of us don't run into too often. You might be dealing with a smaller organization, and you might have less history, thus ending up with a smaller agreement. There's a lot less to do. Instead of having a 50- to 200-page document, you might have something that's 10 or 20 pages long. You're going to be looking for control over your investment so that you're not as inclined to lose money. You're really trying to get yourself into a position of total control over this organization. Obviously, this is a give-and-take situation in which your partner is going to be trying to control the situation as well.

You're going to do a little give and take in order to come to some sort of agreement. I think the area where that's most important is really in governance. You want to keep this and get some control over management, even if you're down at maybe 10% or 15% of a company or even less. You want to make sure that this company has an independent board of directors. Maybe you want to get a board seat yourself if you have enough interest in it. You might also want to get veto power over them doing things like selling off an operation or get veto power over their budget. You're going to want things like performance triggers to allow you to throw out management or otherwise influence the operations of this company so that they don't run off with your money and spend it all.

Typically, you're going to take on venture agreements, particularly with small companies. You're going to be taking preferred interest so that you can allow yourself to have much more control over the organization than you would if you were doing a common investment. The conversion rights will define what portion of the company that you actually own.

Another key term affected by lack of complete control is liquidity preference. That's all about getting your money back first if the company blows up. What you might want to define into your agreement is that you, as a preferred holder, get your money back with some interest return, or something like that, if the company goes broke, just so that you reduce your downside. That makes the deal more appealing to you. You might have tag-along or drag-along rights. These are all about trying to treat various shareholders equitably. It might be that you own 5% of a company, and there are other much larger shareholders. What the tag-along rate does is if somebody else forms an agreement to sell a stock at a price that you like, you can tag along with them and share pro rata in the amount at which it is being sold. A drag-along is similar. In the opposite case, where they want to sell, and they want to keep you from holding out for more money, you get dragged along so that they can actually form an agreement with a prospective purchaser.

There might also be financial covenants in equity deals, like minimum net worth or revenue growth. Antidilution refers to your right to purchase more stock in later venture rounds of a company.

On the accounting front, you're going to mark for statutory. You're going to mark everything to market or use the equity method if it's not traded, just like you would with other stocks. On the GAAP front, it gets really complicated, particularly as the amount of ownership that you have changes. You'll be trying to use cost or book value when you're down below 20, and you don't have influence. You'll have to move to equity when you cross 20, and you'll have to move to consolidation if you go above 50 or if you get significant control over the organization.

There are some main points that I want you to take away with you. There are many different ways to structure a deal. The choice of your structure is going to be driven by business accounting, the tax issues, and your complicated problems will lead to complicated structures. I think you can see that there are lots of different ways that you might go about getting the thing that you want. When you're thinking about a deal, and you're confronted with a problem, you really have to think about what contractual methods or tools you might have that can be used to remedy the situation to get what you want in a way that still works for the other side.

CHART 1
Strategically "Best" Appraisal Value