Session 166 PD - Life Insurance M&A Update

Moderator:

Michael A. Hughes, FSA, MAAA

Presenters:

Sean L. Nossel, FSA, FIA
Esteban Ramiro Paez, FSA, MAAA
Jeremy Spier

Society of Actuaries Annual Meeting

Session #166: Life Insurance M&A Update

October 18, 2017

Moderator:
Michael A Hughes, FSA, MAAA, Ernst & Young LLP

Panelists:
Esteban Paez, FSA, MAAA, Oliver Wyman
Sean L Nossel, FSA, CFA, Resolution Life
Jeremy Spier, Ernst & Young LLP

SOCIETY OF ACTUARIES®

Life Insurance M&A Update

2017 Society of Actuaries Annual Meeting
Session #166 – Panel Discussion

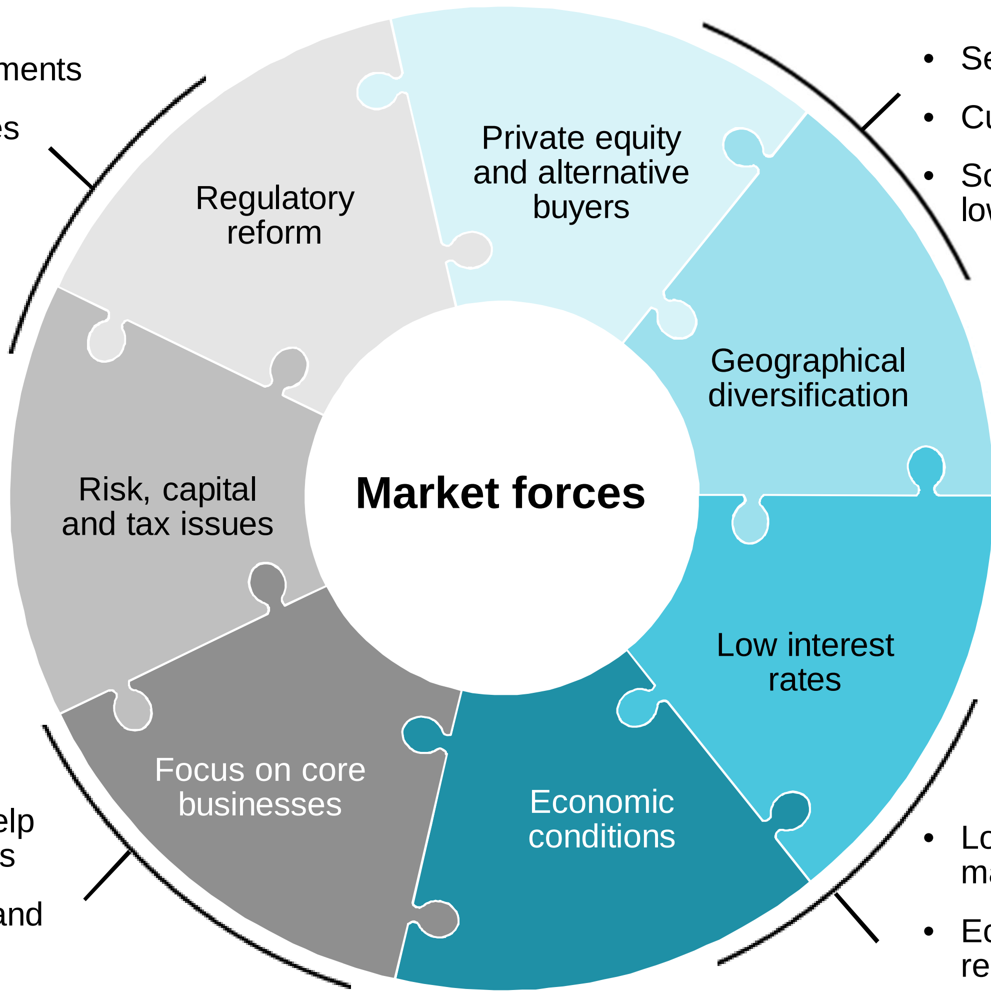
October 18, 2017

Forces driving insurance M&A activity

The insurance industry continues to be an attractive market for domestic and foreign investors, in spite of economic and regulatory pressures

- Enhanced solvency requirements
- Principles-based approaches for statutory accounting
- SIFI requirements
- Global capital standards

- Seeking non-domestic growth
- Currency discrepancies
- Scale and efficiencies to help offset low investment returns

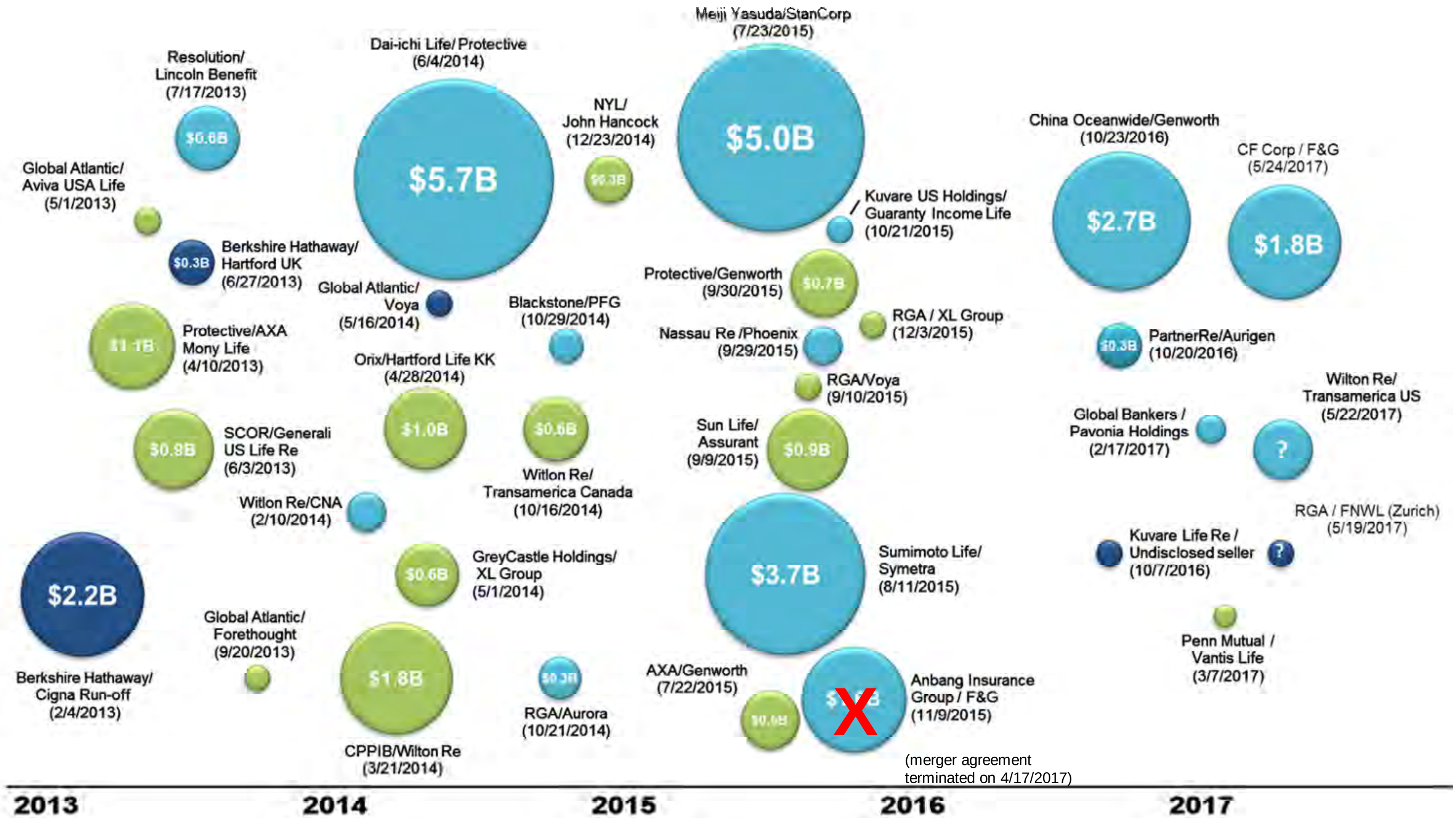


- Diversification benefits to help mitigate capital requirements
- Sellers shedding low ROE and non-core business
- Changes to captive reinsurance rules
- Tax motivations

- Low interest rates and rising equity markets fuel debt-based growth
- Economic fundamentals in certain regions remain very attractive
- Increased focus on alternative asset classes

Recent deals involving US targets

Several large transactions closed in 2014 & 2015, however 2016 and 2017 have shown deceleration in number and size of deals



Source: SNL Financial (announcement dates)

Type: Life Annuity/Retirement Multi-line

Traditional insurance companies ("TIC") vs private equity ("PE") buyers

	Category	TIC view	PE view
1	**Regulatory relationships**	• Typically have strong relationships with state regulators • Favorably viewed by rating agencies	• Require "buy-in" from regulators
2	**Deal motivation**	• Financial: viewed as inforce run-off block	• Strategic: potentially valued as inforce + new business platform
3	**Ability to close**	• Successful deal execution	• High execution risk if no prior track record of insurance acquisitions • May need to line-up 3rd party investors
4	**Off-shore leverage**	• Minimal to none	• Aggressively pursue tax and capital friendly jurisdictions (Bermuda, Cayman, Barbados)
5	**Desired return**	• 10% to 12%	• 12% to 18%
6	**Capital level & diversification**	• 300% to 400% of NAIC RBC • Increased capital diversification by offsetting with other risks/LOBs (i.e. mortality)	• Regulators may impose additional capital requirements • Limited use of covariance
7	**Value "lens"**	• Free cash flow / distributable earnings • Strong liability management	• Liability cost of funds • Strong asset management
8	**Investment approach**	• Conservative	• Aggressive

IPO/spin-off motivations
Several global insurers have publicly announced strategic decisions regarding their US life companies

	Company	"NewCo" highlights	Motivations
1	Brighthouse FINANCIAL	• **$6.0BN revenue** • **$86.3BN general account** • **2.7MM contracts** • **A-rated by AM Best and Fitch**	• The new company represents approximately 20% of the operating earnings of MetLife and 50% of the operating earnings of MetLife's U.S. Retail segment – Approximately 60% of U.S. variable annuity account values – 85% of the U.S. universal life with secondary guarantee business *"The separation would bring significant benefits to MetLife as we continue to execute our strategy to focus on businesses that have lower capital requirements and greater cash generation potential"* – *Steven Kandarian, CEO*
2	AXA	• **$14.3BN revenue** • **$0.9BN net income** • **$75.6BN general account** • **2.5MM customers**	• List a minority stake of AXA's US operations in 1H18 (subject to market conditions), including AXA's interest in AllianceBernstein • *"The proceeds of the transaction will be reinvested in the Group's priority lines of business.. Our US operations would be better positioned as a listed company in the US, operating on a level-playing field under local regulatory rules"* – *Thomas Buberl, Group CEO*
3	Manulife	• **$15.5BN revenue** • **$0.9BN net income** • **$26.9BN embedded value** • **6,700 employees**	• The Wall Street Journal, reported on July 13, 2017 that Manulife is exploring an initial public offering or spinoff of the John Hancock business, according to anonymous sources *"Manulife has been under pressure from some of its shareholders to sell John Hancock after years of disappointing returns"* – *The Wall Street Journal*

Why deals blow up?

Misaligned price expectations

- Discount rates
- Complex and long-tail product lines
- Interest rate and risk premium expectations

Regulatory Uncertainty

- Reliance on financing, AG 48
- VA capital requirements
- DOL
- PBR

Execution Risk

- Consortium investor groups
- Rating agency and regulator feedback
- Risk must be analyzed across multiple geographies and accounting regimes

Bidding Strategy

- Not able to advance into Round 2?
- Is the base case actually a worst case?
- Sellers want to be compensated by buyer capabilities

Q&A

2017 SOA Annual Meeting & Exhibit

Life Insurance M&A - An Actuarial Perspective
Deal Process, Key Considerations and Best Practices

Presenter: Sean Nossel

Date: October 18, 2017

SOCIETY OF ACTUARIES®

Agenda

- Key stages of an M&A transaction
- M&A Transactions - Focus areas for actuaries
- Some key considerations
- Some best practices
- Conclusions

The key stages of an M&A transaction (buyers perspective)

Engagement		Signing	Closing
Ongoing	**3 months – 6 months+**	**3 months – 6 months+**	**Varies: 6 months - 2 years+**

Before the transaction
- Formulating goals e.g. risk/return, cash flow
- Type of business that best meets goals
- Investigating targets
- Exploratory discussions
- Exploratory analysis to frame a transaction
    - Transaction structure
    - Reinsurance vs stock purchase
- Decision to move forward or not
	The transaction process
	- Each process is different
	- Project plan and establishing deal teams
	- High level information
	- Potentially appraisal from 3rd party
	- Transaction model and pricing
	- Initial bid (first round)
	- Detailed information and due diligence
	- Reserves and capital requirements
	- Risk analysis
	- Refinement of bid (multiple iterations)
	- Adapting to overcome obstacles
	- Deal documentation
	- Financing – equity, debt, reinsurance
	- Regulator / rating agency discussions
	- Signing
		The closing process
		- Remaining confirmatory due diligence
		- Regulatory submissions and approvals
		- Closing transactions
		    - Reinsurance, financing, transferring assets, operational
		- Securing financing
			Post closing
			- Implementation and integration
			- Transitional arrangements
			    - Asset management, administration
			- Monitoring of performance

Highlighted:
Focus areas for actuaries

M&A Transactions - Focus areas for actuaries

Actuaries can be involved in all stages of a transaction though key areas which will likely be driven by actuaries are:

- Investigating targets
- Transaction structure
- Transaction model and pricing
- Due diligence
  - Experience studies, projection assumptions, reserves, tax information, asset analysis, balance sheet, capital requirements etc.
- Reserves and capital requirements
- Risk analysis
- Reinsurance structuring and execution
- Regulatory submissions
- Implementation and merging of actuarial processes
- Monitoring of performance after closing

Some key considerations

- **The initial balance sheet –** Projections must be consistent with starting balance sheet
- **Modeling approach -** Decision on using sell-side model vs in-house seriatim model
- **Cash flow testing reserves -** Consider all the impacts of the transaction; May not have access to the actual CFT models until late in the process
- **Legal entity analysis -** Appraisal typically adds up all lines of business irrespective of legal entity; Legal entity can be key for capital, dividends, DTAs
- **Reinsurance -** Typically innovative structuring is required to win a deal
- **Stress testing -** Appropriate testing to ensure adequate returns and solvency in downside cases
- **Experience studies -** Seller assumptions can be aggressive; Use of corporate actuaries at buyer
- **Investment portfolio –** can be a key upside
- **Synergies with existing company –** Look at target combined with the buyers existing business
- **Tax and DTAs -** Often the most complicated part of the transaction and can be very dependent on the scenario

Some best practices

- **Track changes from sell-side appraisal by type**
  - Keep an ongoing log to ensure the latest value is anchored and can be reconciled
- **Document all assumptions and key due diligence and keep these up to date**
  - Even if a transaction dies (they have a habit of reincarnating)
- **Look at different scenarios/sensitivities to test robustness of a deal**
- **Get experts involved**
  - Internal – e.g. Valuation actuary, capital experts, ALM actuaries, tax experts, lawyers
  - External - Actuarial, legal counsel, tax advisors, reinsurers, investment bankers, asset managers
- **Manage the process tightly**
  - Strong process management, regular group updates to ensure process stays on track
- **Use standardized models with flexibility and ability to show sensitivities**
- **Have peer review for all transaction model changes**
- **Be thorough but practical**
  - Can't look at everything in detail - can be tens of thousands of documents. Focus on key drivers

Conclusions

- Actuaries are key to life insurance M&A
  - Involvement in many aspects of transactions
- M&A Processes are long
  - Need to document the history and keep it up to date
  - Need to be resilient – it's not like flow business
  - Many deadlines
  - Long learning curve
- Interesting and rewarding
  - Work with a diverse range of people
  - See all aspects of an insurance company
  - Broad view of companies and the industry

Society of Actuaries meeting

Emerging M&A trends

18 October 2017

Building a better working world

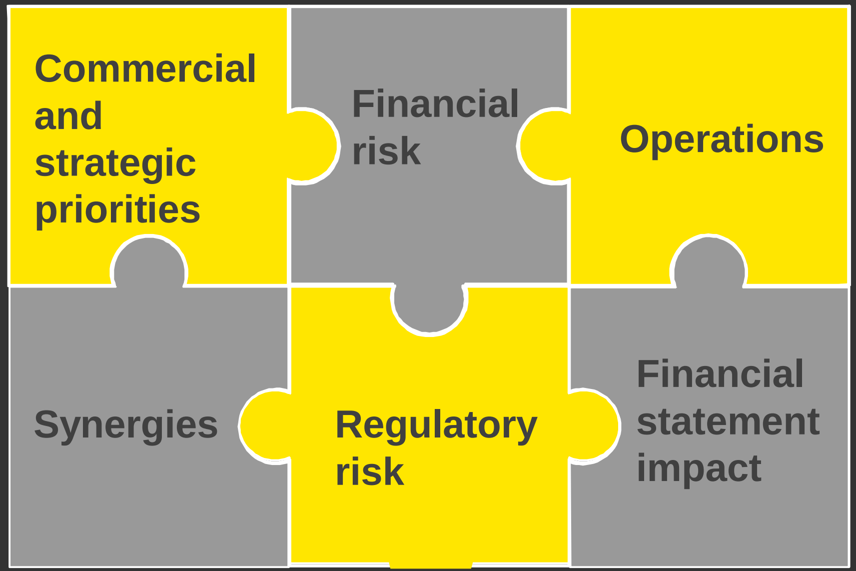
Disclaimer

- The views expressed by the presenters are not necessarily those of Ernst & Young LLP or other members of the global EY organization.
- These slides are for educational purposes only and are not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

M&A is evolving

Traditional diligence

Transaction diligence



As diligence focuses more on transaction value, newer work streams have evolved, including *cyber* due diligence, pre-transaction *integration* due diligence and data *analytics*.

Cybersecurity due diligence

Concerns about cybersecurity were the No. 1 reason deals failed according to a survey of 2,300 senior executives from 43 countries when asked to list reasons why deals either failed to materialize or were canceled.

EY Capital Confidence Barometer, May 2017

Sample cyber procedures

- Dark web searches
- Benchmarking against companies of similar size
- Compliance with payment card industry standards
- Collect external vulnerabilities and indicators of compromise
- Assess quality of personnel and policies
- Quantify exposure and potential cost of mitigation

Equifax 2017	▸ 145.5m records ▸ From mid-May through July, hacker group gained access to large swathe of names, street addresses, credit card numbers and Social Security numbers ▸ CEO, CIO and chief security officer all left the company and **company's share price fell more than 50% after news of the breach, wiping $6b from its market cap. Property Claim Services (PCS) published first estimate of the insurance industry loss due to recent Equifax cyber hacking breach, putting it at $125m**
eBay 2014	▸ 148m records ▸ Frequently cited costs for hardware and consulting were $50m to $75m ▸ Follow-up analysis after year-end indicated ***revenue growth slowed 5% after breach, gross margins declined 260 basis points and loss of customers actually estimated 3% to 5% for six to nine months ~ $300m in revenues***
Target 2014	▸ 40m personal information records, including credit card data, from online site ▸ Estimates of breach costs, including credit card liabilities of $39m settlement, were $50m to $100m ▸ Online traffic dipped significantly, ***but in-store traffic dropped 3% to 5% for roughly six months, indicating business value losses ranging from $300 to $500m***
Sony 2013	▸ Massive breach, hardware system shutdowns ▸ Personal information, email, salary data ▸ Hundreds of screenplays, full production plans (locations, casts, special-effect planning, marketing and release planning, merchandising plans and agreements) ▸ Most frequently cited range ("street value") of breach costs ***$8m to $30m, true value impact likely several hundred million dollars***

Integration preparation is moving up in the diligence process

Preparing to integrate

96%
say they start their integration planning before signing (64% in 2015).

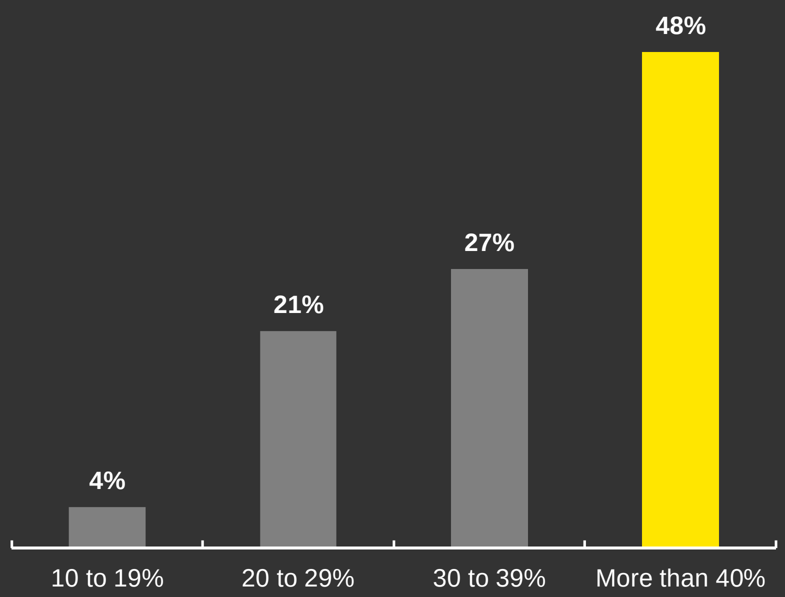
62%
implemented transitional service agreements (TSA) lasting one year or less.

Critical success factors	Leading practices
Align to a common **vision**	Define clearly aligned objectives and outcomes associated with the specific transaction intent
Achieve expected business **value**	Clearly define value expectations, accountability and performance expectations at completion
Establish program governance and **controls**	Conduct thorough impact assessment during due diligence Resource correctly and enable teams to act with speed Establish planning and execution consistency using standard decision-making and status-reporting Focus on the most immediate execution milestones and risk mitigation activities to drive positive momentum
Manage **change** across stakeholder groups	Focus on key external stakeholders and mitigate attrition or risks to brand perception Develop the resource deployment plan to achieve intent Establish credibility, minimize uncertainty, build performance expectations for new entity structure Identify and retain key talent, addressing possible risks

Proper integration can enhance deal value

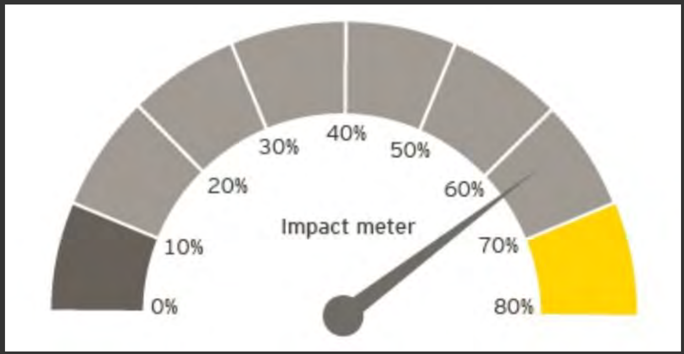
Insurance executives with governance and structure around an integration program realized significant cost synergies in their transactions.

We asked C-suite executives: as a proportion of the target's cost base in dollar terms, what were the annual cost synergies achieved in the end state, post integration?



Source: EY's Scaling new heights: M&A integration in insurance.

We asked C-suite executives: which of the following methods did you use for driving and monitoring synergy realization? (Select all that apply.)



Every synergy linked to an integration deliverable and milestone and tracked by the integration program management office (PMO)	72%
Targets built into executive management's individual performance plans	56%
Commissioned independent audits or reviews of benefits realization	54%
Merged into the business plan post-deal completion and not tracked distinctly thereafter	50%
Not specifically tracked or monitored	0%

Data analytics

46% of private equity PE executives believe availability of sufficient granular data most important factor keeping them in acquisition process

Changing landscape

- The amount of data being created by businesses has been growing exponentially, and the technology to analyze this data effectively has been evolving, too.

How does this impact M&A?

Faster – data preparation

Software that enables faster data preparation improved data quality and more accurate analysis of large, complex unstructured data sets

Better – real-time data exploration

Real-time collaboration identifies data trends and value drivers that may enhance the future performance and on-demand technology enables dynamic insights through the analysis and visualisation of data

Deeper – dynamic insights and deeper analysis

Enriched third-party data sets enable deeper and faster insights, while predictive and prescriptive models used to unlock potential opportunities or identify risks critical to the deal

Benefits of analytics

44% of PE executives believe lack of confidence in information is most significant factor causing PE firm to reduce offer or walk away from a deal

Type of analytics	Why it's important
Descriptive analytics and visualization (e.g., historical, value-based analysis)	► Describes the base business and its historical performance, taking into account strategic, financial and operational dimension and levers ► Helps seller define assets to be included in the deal perimeter
Predictive analytics (e.g., future outcome and business impact analysis)	Helps identify: ► Issues early, allowing the seller time to remedy the issues or prepare in advance for a divestment before it becomes critical ► Opportunities to manage topline synergies through cross-selling and upselling, based on mix of mutual and new customers ► Cost synergy opportunities ► A forecast for future business performance under a new buyer's control, thereby helping define specific areas for synergies and supporting more rapid synergy realization
Prescriptive analytics (e.g., operationalization of predictive scenarios)	Helps: ► Optimize portfolio performance and enable decisions as to whether to fix an impaired or non-strategic business or sell it and when to sell ► Assess how to optimize financial and operational performance of a business, given the overall company strategy ► Define how to leverage the predicted future performance without compromising other priorities
Social media	► Helps identify and describe market sentiment about an asset or a transaction ► Helps identify customer, supplier, employee and other stakeholder sentiment about the company, brand, products and services ► Provides insights to rapidly recognize synergies ► Identifies trends not evident in internal data affecting transaction value
Other technologies (e.g., robotic process automation, machine learning, artificial intelligence)	► Automates data gathering, data processing and information generation processes ► Provides more rapid and on-demand analytics, enabling better and more confident decisions

Source: EY's Global Divestment Study 2017

Future M&A trends

1

Portfolio optimization

Sell-side due diligence

Large insurers will continue to divest non-core businesses, driven by reassessment of capital requirements, expense simplification, and rationalization and realization that management's time is better focused on future, core businesses.

2

Technology-driven investment

InsurTech due diligence

There will be continued acceleration by established providers investing and partnering with new start-ups, both to support development of and to leverage tech-based innovation. Going forward, there will be a sharper focus on and investment in advanced analytics, pricing tools, robotics and blockchain.

3

Ongoing consolidation

Sell-side and integration due diligence

Clear challenges in protecting and improving margins, achieving cost efficiencies, and investing in future technology and capabilities continue to make a compelling case for large-scale insurance consolidation. We anticipate mergers of insurance groups to achieve greater scale and position for ongoing transformation.

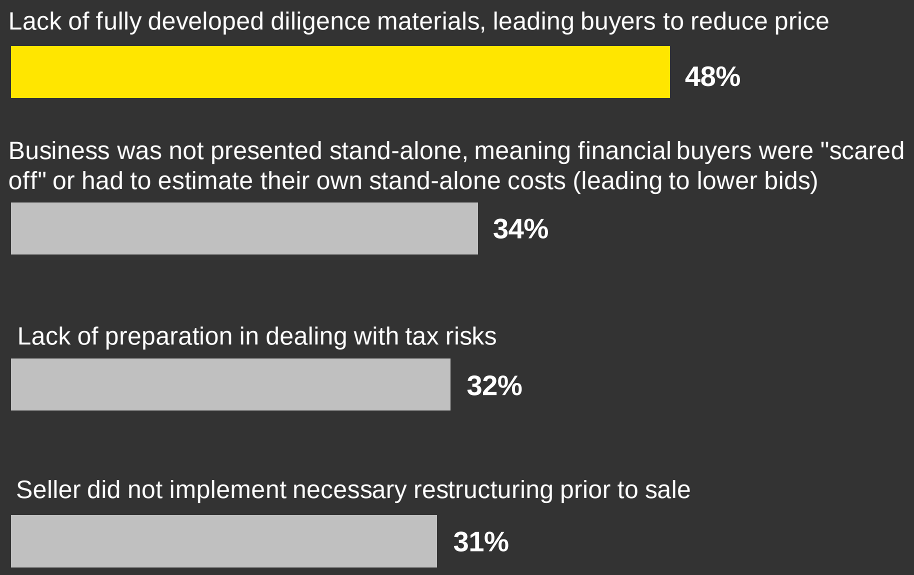
Divesting isn't like it used to be

Today's market is less structured and less certain

	Past	Present
M&A processes	▸ Large auctions ▸ Many corporate and PE buyers ▸ Fixed transaction process and diligence scope ▸ Short timetable ▸ Restricted access and data ▸ Integration planning buyer led	▸ Selected targeting of buyers ▸ More one-to-one situations ▸ Fluid transaction process and scope, influenced by buyer ▸ Buyer driven renegotiations ▸ Broken processes ▸ Mega PE evaluating smaller deals
Business performance	▸ Growth and expansion ▸ Earnings focused	▸ Volatile environment ▸ Balance sheet risk, focus on cash flow ▸ Increased skepticism around projections, buyer confidence easily diminished
Risk	▸ Large appetite for risk by buyers and their financiers	▸ Lower risk appetite with more scrutiny, more diligence by more parties
Financing	▸ Aggressive use of staple financing ▸ Competition among lenders	▸ Bank financing available for quality deals and known sponsors ▸ Seller financing and alternative structures
Legal considerations	▸ Seller led ▸ SPA terms dictated by seller	▸ Buyer led ▸ SPAs negotiated in detail

Causes of value erosion during the divestment process

We asked C-suite executives: what were the causes of value erosion in their most recent divestment? (Select all that apply.)



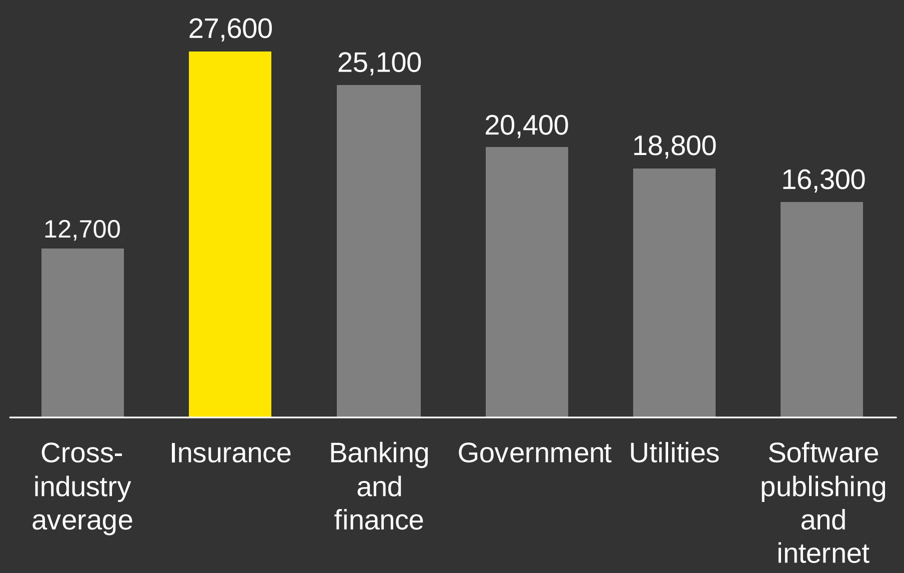
Divestiture leading practices

- **Evaluate:**
  - Start early and empower a cross-functional team of key stakeholders
  - Evaluate structuring alternatives and tax planning
  - Understand constraints affecting your timetable
- **Examine:**
  - Analyze your business from the buyer's perspective
  - Anticipate buyer questions to prevent delays
  - Add value through operational improvements
- **Execute:**
  - Develop a well-supported value story
  - Bridge historical results to projections and validate forecast assumptions
  - Prepare for potential negotiation hurdles

Source: EY's Global Divestment Study 2017

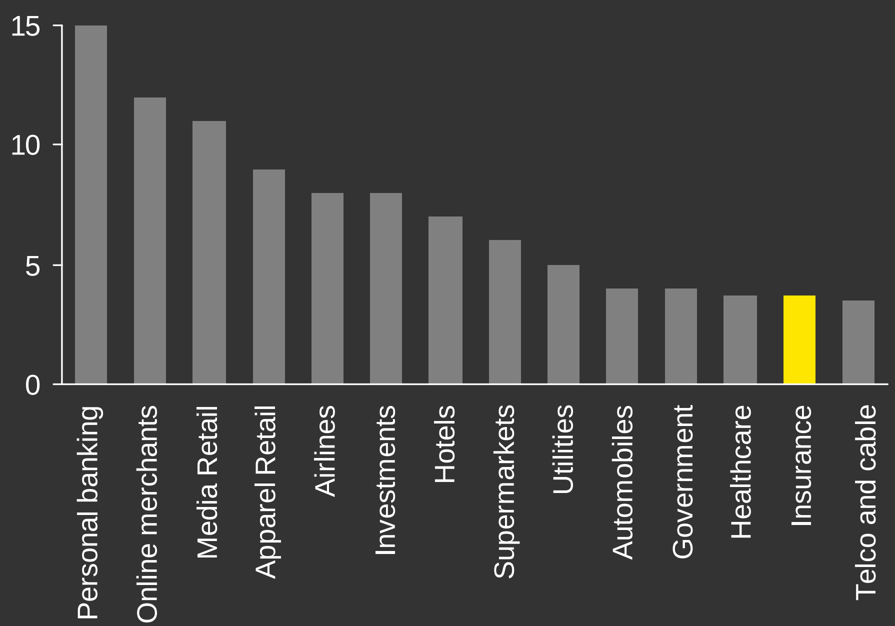
Digital technologies are disrupting the traditional insurance marketplace

IT spending per employee (USD)



Source: Gartner

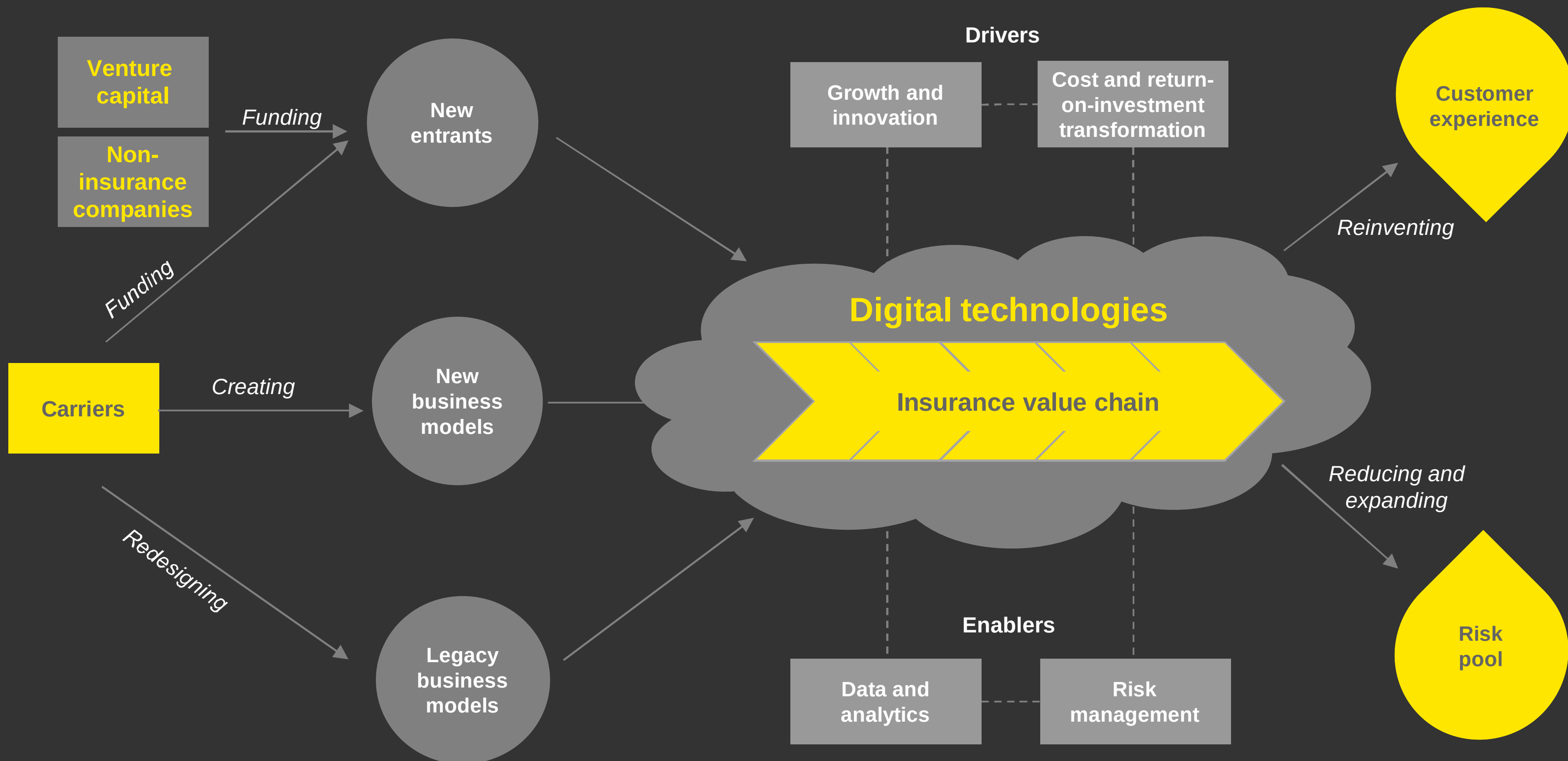
Customer satisfaction with online experience (relative satisfaction utility score)



Source: Morgan Stanley/BCG Insurance customer survey 2014

Online customer satisfaction in insurance lags other industries, despite being among the highest IT spenders.

Digital technologies are disrupting the traditional insurance marketplace



Standard M&A diligence vs. start-up diligence

Core due diligence work streams

Diligence area	Traditional diligence	Start-up diligence
Financial due diligence	► Detailed analysis of historical quality of earnings ► Analysis of net working capital for SPA ► Identification of debt-like items ► Quality of accounting department, systems and reporting process	► Commercial due diligence of competitors and market expectations more important ► Earnings analysis focused on cash burn and revenue recognition practices ► Linking projected cash flow and earnings with historical experience ► Identification of debt-like items ► Understand difficulty of reporting under a more robust accounting organization
Tax due diligence	► Assessment of historical tax compliance and exposures ► Focus on indirect (e.g., state and local, employment) tax in addition to federal tax exposure ► Tax structuring advice	► Start-up likely has minimal earnings and, therefore, limited income tax exposure (considerations should be given to tax treatment of start-up costs and intellectual property) ► Focus is on creating an efficient structure after transaction
Operations and IT	► Assessment of front-office and back-office IT environment	► Understand scalability and security of product key to validating valuation and investment thesis ► Stress test business and operating models for sustainability in a variety of scenarios

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

1710-2437041

ED None

ey.com