Value Creation in Insurance

Laying a Foundation for Successful M&A

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The financial crisis has not diminished the game-changing power of mergers and acquisitions (M&A). The pace of transactions has slowed, but insurers continue to pursue deals in a bid to boost volume or profitability, complement existing businesses, or provide a stronger presence in foreign markets. If anything, the crisis has given companies more reason to explore these opportunities: historically, economic downturns have provided better conditions for creating value through M&A.

But the challenges of M&A remain as stark as ever. Slightly more than 50 percent of deals, not only in insurance but across all industries, do not create value for the acquirers. In this sense, M&A is like any other major initiative that redraws the boundaries of a business. The potential rewards are great, but so are the risks—particularly if a transaction veers away from the key factors that have traditionally underpinned value-creating deals.

To better understand these key factors, The Boston Consulting Group recently analyzed more than 1,100 M&A deals that involved insurance companies from North America and Western Europe, and were announced over the past ten years. Our analysis covered both domestic and cross-border deals but only included transactions in which a company acquired more than 75 percent of the target’s outstanding stock.

Not surprisingly, the study—along with recent conversations with insurance executives—reaffirmed the basic tenets of M&A: companies need to spell out a clear rationale for making a deal, ensure that they have the capabilities to integrate the target, and conduct thorough due diligence. The study also highlighted several factors—such as location, size, or acquisition premium of a deal—that make value creation easier or more difficult in specific circumstances.

For insurers contemplating inorganic growth—and we believe many can and will, given the state of the industry and the global economy—understanding these challenges and capabilities will be essential to success.

Reaffirming the Basic Principles of M&A

Many of the deals in our study were substantial. Some were landmark undertakings that involved significant direct costs; most put heavy demands on an insurer’s resources, particularly its managers. And yet 54 percent of the deals did not create value for shareholders of the acquiring companies. (For more on how we measured a deal’s impact on shareholder value, see the sidebar “Measuring the Value Created by M&A,” as well as the appendix on methodology.)

Measuring the Value Created by M&A

To assess the shareholder return generated by a deal, we analyzed the cumulative abnormal return (CAR) covering a total of seven trading days—a period spanning three days before the announcement and three days after. The CAR gauges the effect of a deal’s announcement on the acquirer’s share price return, relative to expectations. It is widely regarded as an accurate measure of the impact of an M&A deal on shareholder value. Where possible, we also looked at the relative total shareholder return (RTSR) of the acquiring company in relation to a relevant industry benchmark index one or two years after the announcement of the deal.
When deals falter, the costs extend well beyond lower shareholder returns. For months after a transaction is completed, postmerger integration (PMI) ties up internal resources and management focus—resources and focus that could be allocated to other strategic priorities that might lead to better profitability or stronger growth. The consequences of a flawed deal can linger for years.

Given the steep challenge of creating value through M&A, coupled with the long-lasting side effects of a suboptimal deal, insurers must ensure that their plans for inorganic growth are based on a realistic assessment of potential targets. Our study highlighted three steps insurers can take to identify opportunities that provide the best chance to create value: define a clear rationale for a deal; assess a deal against the company’s own capabilities; and perform detailed due diligence and risk assessment.

Define a Clear Rationale for a Deal

The outcome of a deal, to some extent, is determined by its premise. In our study, deals that lacked a clear objective or did not mesh with an insurer’s overarching strategy were less likely to create value than deals that were based on a well-defined rationale or aligned with an insurer’s mission.

The study highlighted four main rationales that insurers have used to justify their M&A deals:

- **Increasing Volume.** Some companies created substantial value by increasing volume while consolidating back-office operations for policy processing and issuance, and reducing overhead costs. Deals that were based on building economies of scale were done primarily in the home markets of the acquirers, usually among companies that were fairly similar.

- **Complementing the Existing Business.** Some insurers set out to acquire smaller insurers that had complementary lines of business, product expertise, or channels. Several traditional life insurers, for example, acquired variable annuity insurers when demand for these products was on the rise.

- **Expanding Internationally.** Insurers that pursued targets outside their home countries or main bases of operation were often looking for ways to compensate for constraints on organic growth. The vast majority of acquisitions by Swiss insurers, which have limited options for growth at home, were of foreign companies.

- **Taking Advantage of Distressed Markets.** With some companies facing economic or regulatory pressure to restructure owing to the financial crisis, stronger competitors have been making opportunistic deals. The same pattern was evident during previous downturns.

Of the approximately 1,100 deals we analyzed, we looked closely at the strategic rationale of deals that were larger than $100 million (about 200 in total). Roughly half of these deals were driven primarily by a desire to increase scale in domestic markets, while a third were focused on establishing or expanding an international presence.

The primary rationale for these deals varied over the ten-year period, often in line with economic cycles. (See Exhibit 1.) Opportunistic deals were more prevalent during severe economic downturns, when companies typically focus on boosting scale in domestic markets (thus reducing their operating costs). In periods of strong economic growth, the focus shifted to more strategic aims: expanding abroad and complementing the business.

We believe that all four rationales can and should remain relevant during the financial crisis. In particular, insurers should be careful not to focus solely on deals that will boost volume, given the potential for the crisis to continue forcing discounted sales of strategic assets. They should also search for deals that complement their organizations or underpin international growth.

Assess a Deal Against the Company’s Own Capabilities

Even if a potential deal is backed by a compelling business rationale, it might not be the right course for an insurer. The study highlighted three types of capabilities that are critical to ensuring that a transaction delivers value.
Financial Capabilities. Insurers must carefully assess the availability of funding well before embarking on an M&A deal—especially in these difficult times. Limited access to funding, together with the extra strain a transaction might put on an acquirer’s capital base, can be a deal breaker.

Organizational Capabilities. A successful PMI will be sweeping—it will cover all parts of the insurance value chain and the supporting information-technology infrastructure. Organizational capabilities will be critical to its success, as will careful planning. Before a deal is agreed upon, the acquirer should spell out a clear logic and plan for integrating each function.

For example, insurers often do deals in part to extend their sales footprints. To integrate the sales functions, acquirers must address issues such as brand fit and positioning, opportunities for cross-selling, compatibility of sales support processes, and, most of all, the retention of the sales force, which is often an insurer’s most important asset.

Life insurance deals present their own challenges, particularly around the integration of back-office infrastructure and functions such as IT. In some cases, these challenges have given rise to roadblocks that impede business development for as long as two years after a deal. Thus, for acquirers, organizational capabilities must span the entire value chain of insurance.

Cultural Capabilities. Companies tend to overlook the importance of managing the cultural issues associated with integration. Cultural issues include maintaining morale and boosting confidence in a deal; cultivating a shared understanding of how the postmerger organization will work; and communicating clearly, both before and during the PMI. An inadequate grasp of a foreign language is often the first of many cultural stumbling blocks in an international deal.

Perform Detailed Due Diligence and Risk Assessment
Companies are inclined to underestimate the risks associated with M&A. For a deal to have the best chance of creating value, the parties must identify and accept the risks before the transaction is conducted. Insurers should follow three steps to ensure that they understand the implications of a deal:
First, they must perform rigorous due diligence. Given the pervasive uncertainty in most financial-services markets, a company that rushes due diligence runs the risk of acquiring toxic assets or liabilities.

Second, insurers should ensure that their valuations account for unsettled conditions stemming from the economic crisis. Extreme scenarios might be used to set valuation parameters and test synergy assumptions. In some markets, acquirers may face constraints on their ability to restructure companies that have received government funds. In general, acquirers must understand the levers to use to create value, as well as the full range of outcomes possible under different market conditions and valuation assumptions.

Third, acquirers need to gauge the impact of a deal on the current business by conducting a side-by-side analysis of their company and the target. They should also run a simulation of the deal in order to understand the effects of the transaction on the acquirer’s financials and market position. In addition, they should look closely at the correlation between risks on the two balance sheets, as well as how markets and customers are likely to react. Finally, acquirers should compare the organizations and cultures of the two companies to identify obstructions to the PMI.

Companies often rely on third parties to assist with strategic due diligence and forecast the key performance indicators of a merged company under different scenarios. An outside perspective can prompt a company to change its M&A strategy, set a maximum price, and even refrain from planned deals if the value creation opportunity appears to be limited. (For more on the basic steps insurers can take to ensure the success of a deal, see the sidebar “An M&A Checklist.”)

Pursuing Deals in a Downturn

The financial crisis has forced companies, including insurers, to shift their attention away from M&A. But for companies that have the wherewithal—and confidence—to keep M&A deals on their agendas, an economic downturn can provide a window of opportunity.

<table>
<thead>
<tr>
<th>An M&amp;A Checklist</th>
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<tbody>
<tr>
<td><strong>To a large extent, the success of a deal depends on</strong></td>
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<tr>
<td><strong>the acquirer’s ability to manage the PMI. This is a</strong></td>
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<tr>
<td><strong>complex undertaking that requires specialized skills</strong></td>
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<tr>
<td><strong>(not to mention a separate report). But the seeds of</strong></td>
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<tr>
<td><strong>success are sown long before the PMI, when a</strong></td>
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<tr>
<td><strong>company is exploring its M&amp;A options. There are</strong></td>
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<tr>
<td><strong>several steps companies should take to ensure that</strong></td>
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<tr>
<td><strong>an M&amp;A transaction is their best option for fueling</strong></td>
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<tr>
<td><strong>growth, boosting profitability, and generating value</strong></td>
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<tr>
<td><strong>for shareholders:</strong></td>
</tr>
<tr>
<td>◦ Analyze all other options to ensure that M&amp;A is the**</td>
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<tr>
<td><strong>most suitable strategy for achieving your</strong></td>
</tr>
<tr>
<td><strong>goals</strong></td>
</tr>
<tr>
<td>◦ Assess your assets to identify opportunities for**</td>
</tr>
<tr>
<td><strong>divestments or swaps</strong></td>
</tr>
<tr>
<td>◦ Create an up-to-date, prioritized list of potential**</td>
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We compared insurance deals done during downturns (as measured by the MSCI World Insurance Index) with those done during better economic times. We analyzed the relative total shareholder return (RTSR) of acquirers—a measure of a stock’s performance relative to the regional industry index—for a period of up to two years after the announcement of a deal and found that downturn deals led to significantly higher RTSRs than upturn deals. (See Exhibit 2.)

The benefits of a downturn deal are more substantial than simply riding the coattails of an economic recovery, particularly when the downturn is severe. In an economic crisis, capital becomes scarce. As a result, investors and stakeholders require more proof that a deal will create value. Fewer deals get through the screening process; those that do stand a better chance of creating value.

A financial crisis can also give rise to an unusual and favorable combination of low asset prices—some companies will be forced to sell all or parts of their businesses—and muted competition for assets that are up for sale. Many companies will lack either the resources or a convincing argument for pursuing a transaction.

A recent BCG study examined the Great Depression to understand what drives performance in a downturn and the following upswing. It found several examples of companies that took advantage of opportunities to make acquisitions that were more affordable and more likely to create value.1 The findings were echoed in a subsequent study of the impact of past economic and financial crises on the insurance industry.2


Exhibit 2. Downturn Deals Outperformed Upturn Deals

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Sources: Thomson Reuters Datastream; BCG analysis.
Note: This analysis was based on a subset of 347 deals conducted by publicly listed acquirers or subsidiaries of publicly listed companies; values are based on the average cumulative RTSR of downturn or upturn transactions. T–3 and T+3 refer to three days before and three days after the announcement, respectively.

*Cumulative RTSR performance; three days before the deal equals 100.
Apart from the benefits of pursuing a deal during a downturn, there are several other reasons why we expect M&A activity to persist:

**Insurance M&A has been resilient.** The economic downturn has weakened M&A activity, but its impact on insurance deals is not as great as is commonly thought. The number of insurance deals declined in North America and Western Europe in 2008. The number in North America, however, was not much lower than the 2006 total, and the number in Western Europe was higher than the 2006 total. (See Exhibit 3.) Given the severity of this crisis, the number of deals may continue to decline, particularly in the most affected markets, but we expect M&A activity to remain substantial.

**Most companies have not radically reduced their M&A plans.** A recent cross-industry survey of CEOs and senior managers of European companies by BCG and UBS found that most companies have not changed their M&A plans in the wake of the economic crisis. In the survey, about 30 percent of insurance companies had decreased their planned M&A investments, but 71 percent expected to see deals that would significantly alter the industry landscape. At the same time, however, only about 14 percent of insurers considered themselves likely to engage in large-scale transactions. This suggests that some insurers expect transformational deals to be initiated by the sellers, perhaps as a result of financial distress.

**The market will continue to present favorable opportunities.** Low valuations will provide the impetus for some insurers to pursue deals, often as a way to improve their cost structure and profitability but also to lay the foundation for future growth. In addition, some deals may be forced on insurers that need to maintain a strong capital base. We expect to see further divestments of noncore assets.

As much as the economic crisis has given insurers more reason to pursue M&A deals, it has also raised the cost of miscalculating these transactions. Many companies are operating with little margin for error. They

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cannot afford to spend time and effort on transactions that destroy more value than they create. Nor can they afford to let their competitors step into deals that would have been a good match for their own aspirations and capabilities.

It is a delicate balancing act. Insurers must not move with incautious haste, but they need to be prepared to move quickly once the right opportunities arise.

**Focusing on Specific Kinds of M&A Deals**

In normal times, M&A provides exceptional opportunities for growth, but it almost invariably poses significant challenges. The stakes are even higher now. As a result, insurers need to do more than follow the general guidelines for M&A. They must focus on specific kinds of deals that are more likely to create value.

Our study highlighted several factors—such as location, size, or acquisition premium of a deal—that make value creation easier or more difficult in specific circumstances. For this analysis, we looked at a subset of 347 deals involving publicly listed acquirers or large deals conducted by subsidiaries of publicly listed companies.

It is important to note that the value creation factors relevant to public deals are also relevant to nonpublic deals. In nonpublic companies, however, value creation for the owner—whether it be the policyholders (in the case of mutual insurance companies), the government, or private entities—may not be the primary objective of an M&A deal.

**Focus on Domestic Opportunities**

Investors tend to favor deals that are done in acquirers’ home markets. About 52 percent of such deals created value for acquirers’ shareholders, compared with only 38 percent of international deals. The average cumulative abnormal return (CAR) of domestic deals was 0.66 percent, compared with –0.67 percent for international deals. (See Exhibit 4.)

**Exhibit 4. Smaller Deals and Domestic Opportunities Created Value for Insurers**

<table>
<thead>
<tr>
<th>CAR (%)</th>
<th>Domestic deals</th>
<th>International deals</th>
<th>Sample size</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.66</td>
<td>Domestic deals</td>
<td>–0.67</td>
<td>199</td>
</tr>
<tr>
<td>0.13</td>
<td>Deal value &lt; $1 billion</td>
<td>–1.48</td>
<td>147</td>
</tr>
</tbody>
</table>

Sources: Thomson Reuters; BCG analysis.

1Results are statistically significant at conventional levels of confidence (at least 90 percent). Average CAR is calculated over a seven-day window centered around the announcement day (–3/+3).

2International deals are defined as those in which the target’s primary nation of operations is not the same as the acquirer’s primary nation of operations.
A 0.66 percent CAR means that in the periods around the announcement dates, the share prices of the acquirers delivered returns that were, on average, 66 basis points higher than what they were expected to have been, had the acquisitions not taken place. A –0.67 percent CAR means that the returns were, on average, 67 basis points below what they were expected to have been in the absence of the deals. CAR is thus a very real measure of how investors and markets rate the value creation potential of deals.

The bias toward domestic deals was stronger in North America than it was in Western Europe, where companies are given more leeway to expand internationally, mainly because their markets tend to be small and highly concentrated, but also because many companies already have a foreign presence.

Even among cross-border deals, investors still prefer proximity. Deals done within an acquirer’s home region—North America or Western Europe—were vastly favored when compared with deals done further afield, based on their average CARs.

However, not all international deals are punished by shareholders. A foreign acquisition that aligns with an acquirer’s strategy, is carefully planned and prepared, and is supported by proven execution capabilities is viewed by investors as having the potential to create value.

**Prioritize Smaller, More Strategic Deals**

The larger the deal, the more difficult it is to manage the integration and deliver the expected value. In our study, 52 percent of deals that were less than $1 billion in transaction size created value for the acquirers, compared with only 38 percent of megadeals, which were at least $1 billion. The difference in CARs was just as sharp. Deals that were less than $1 billion generated an average CAR of 0.13 percent, whereas megadeals generated an average CAR of –1.48 percent. (See Exhibit 4.)

The difficulty of integrating large targets was made plain by an analysis of the size of a deal relative to the acquirer’s market capitalization. Insurers that attempted to integrate targets with market capitalizations that exceeded two-thirds of their own size had a significantly lower chance of creating value.

The challenges associated with large deals, coupled with investors’ tepid reaction to international deals, suggest that insurers should focus their M&A ambitions on small local companies or divestitures from larger competitors. Divestitures, in particular, can provide a good opportunity to pick up complementary assets without having to integrate an entire company (which might include parts that do not suit the acquirer’s strategy). Our research indicated that such deals are looked upon favorably by investors.

**Avoid Hostile Acquisitions**

The vast majority of deals in our study were friendly. This is quite unlike many other industries—where a significant proportion of deals are hostile—but not surprising, given the nature of the insurance industry.

In most insurance M&A transactions, an acquirer sets out to buy a book of in-force business and a set of capabilities that can help win new business. A book of in-force business is difficult to value on the basis of conventional financial parameters; to make an accurate assessment, the buyer needs access to privileged information, which can be gained only in a friendly deal. In addition, the ability of a target to fuel the acquirer’s growth—for example, by providing certain product-development skills—usually depends on a handful of key individuals. A hostile takeover might compel these people to leave.

Hostile takeovers have become less relevant owing to the financial crisis. Many insurers are eager to reshape their businesses through divestments or asset swaps.

**Take Advantage of Low Acquisition Premiums Without Excluding Other Deals**

The economic crisis will continue forcing companies to offload parts of their businesses. The pressure to sell could lead to low acquisition premiums. It makes sense, of course, for buyers to minimize acquisition premiums—it effectively lowers the value creation hurdle—but this should not deter astute buyers from paying high acquisition premiums.

In a previous study, BCG found that value-creating deals tend to involve higher acquisition premiums. Between 1992 and 2006, value-creating deals had a 21.7 percent premium, on average, compared with an
18.7 percent premium for non-value-creating transactions.⁴

More important than the premium are the target’s valuation multiples. The opportunity to improve the target’s fundamentals, as reflected in low valuation multiples, is a decisive factor in the success of the deal.

**Moving Forward**

The fact that most deals in our study failed to create value should be enough to make companies cautious about pursuing M&A. But a sizable proportion of the deals in our study—46 percent—*did* produce value. Although M&A is a challenging way to grow (as are all transformative undertakings), it does not have to be a gamble, particularly for companies that are well prepared.

Insurers should do two things to take advantage of M&A opportunities arising from the financial crisis. First, they must recognize that the current climate, despite all of its turmoil and uncertainty, lends itself to deals that create value. But the justification needs to be clear: insurers must show a precise alignment between their strategies and prospective deals.

Second, insurers must start adhering to the fundamentals of sound M&A. They can begin by pairing potential deals with specific strategies that suit their business objectives. This will allow them to act quickly (even proactively) when the time is right. They should also catalog their M&A-related capabilities so that they understand the kinds of deals they can pursue.

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Appendix: Methodology

We analyzed all reported M&A transactions in which both the acquirer and the target were insurance companies, and all the acquirers were from North America or Western Europe. A total of 1,144 such deals were announced from 1999 through 2008. This total excludes deals that were described as recapitalizations, exchange offers, or repurchases.

To analyze shareholder returns generated by M&A transactions, we focused on a subset of 347 deals conducted by publicly listed acquirers or subsidiaries of publicly listed companies. To analyze the drivers of value creation, we used subsets of this group, depending on the information that was available.

Although different samples were used to assess the drivers of value creation, all analyses employed similar econometric methodologies. For any given day and company, the abnormal (that is, unexpected) returns were calculated as the deviation of the observed from the expected returns. (See Equation 1.)

Equation 1
\[ AR_{i,t} = R_{i,t} - E(R_{i,t}) \]
Where:
- \( AR_{i,t} \) = Abnormal return for given security \( i \) and day \( t \)
- \( R_{i,t} \) = Observed return for given security \( i \) and day \( t \)
- \( E(R_{i,t}) \) = Expected return for given security \( i \) and day \( t \)

We used a market model estimation—the most common approach—to calculate expected returns. This approach runs a one-factor Ordinary Least Squares (OLS) regression of an individual stock’s daily returns against the contemporaneous returns of a benchmark index over an estimation period preceding the actual event. (See Equation 2.)

Equation 2
\[ E(R_{i,t}) = \alpha_i + \beta_i R_{m,t} + \epsilon_{i,t} \]
Where:
- \( \alpha_i \) = Regression intercept
- \( \beta_i \) = Beta factor

The derived alpha and beta factors were then combined with observed market returns for the given event day to calculate the expected return for each day of the event window. (See Equation 3.) The market model thus accounts for overall market return on the event day as well as sensitivity for a particular company’s returns relative to market movements.

Equation 3
\[ AR_{i,t} = R_{i,t} - (\alpha_i + \beta_i R_{m,t}) \]

Using a 180-day period, running from 200 days before the announcement (day –200) to 21 days before the announcement (day –21), we estimated a market model that related the returns on individual stocks to a relevant benchmark index. We did not consider the time period from day –20 to day –4, to ensure that the market model parameters were not contaminated by leakage effects prior to the announcement. Finally, we aggregated the abnormal returns (that is, the difference between actual stock returns and returns predicted by the market model) over different time windows around the announcement date to derive CARs. The figures cited throughout this paper uniformly relate to the event period of plus to minus three days.

We assessed the statistical significance of the abnormal returns using a test. The standard \( t \)-test establishes whether average abnormal returns are different from zero (one-sample test) and the statistical significance of the differences between the mean abnormal returns of different subsamples in the cross-section (two-sample test).
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