Practical considerations in a life company M&A

Mr Kenneth Wong of **Avicennia Capital** discusses the buyer's and seller's perspectives in an M&A exercise, examines the complexities of valuation, the tricky definition of projected future business, assumptions made as well as what both sides need to do.

The process of selling or buying a life insurance company can be quite complex. Given the long tail nature of typical life insurance liabilities, there are a myriad of factors one must consider from both the buyer's and seller's perspective. These factors can be seen to be often conflicting when price is the main consideration. It behoves the seller to seek the highest price it can obtain for its shareholders and conversely, the buyer will want to ensure that it is not overpaying beyond fair value for its acquisition.

The focus in this paper is on some of the key considerations both from the buyer's and the seller's perspective. At the end of the day, assuming an open market, both parties will want to ensure the deal to go through in an efficient and timely manner.

Given the uncertain nature of the future cash flows, the widely accepted approach would be to perform an actuarial appraisal valuation of the company. This approach combines the discounted cash flow (DCF) methodology with specific accounting and solvency requirements unique for a life insurance company.

Choice of actuarial consultant

The seller will need to give an indication of what it considers a fair value for its business. This is usually based on the actuarial appraisal value done by an independent actuarial consultant appointed by the seller.

In such cases, care needs to be taken in terms of the choice of the consultant. Depending on the reputation of the seller and the insurer involved in the market, as well as the budget available, use of a reputable consultant with ideally a good track record of having done other similar valuations in the local market is of paramount importance.

There could be situations whereby either due to the limitations of the budget placed on the consultant or the lack of resources within the consultant themselves, the appraisal done is not within the accepted international standards normally seen. This can lead to a poorly received report whereby the valuation figure does not fully reflect the fair value of the operation in the seller's eyes.

Valuation data

It is always best for the seller to ensure that the brief be communicated clearly to the consultant and to provide full access to data in order for the consultant to be able to project the cash flows accurately.

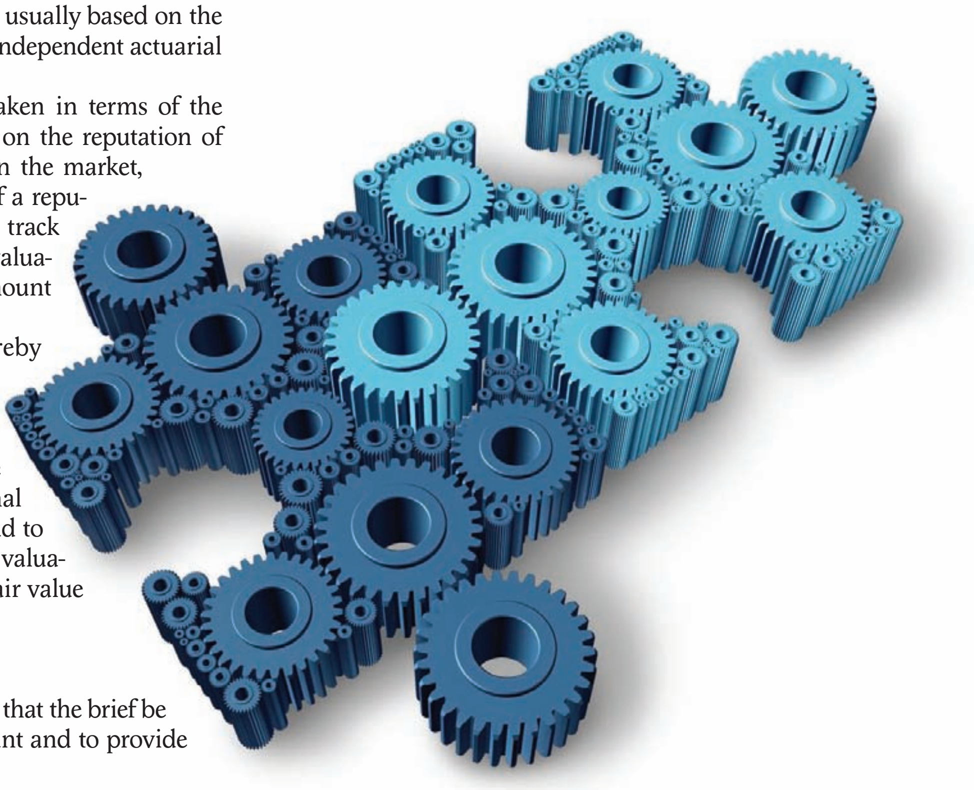
Similarly when the buyer does their own actuarial valuation, full access to data needs to be provided in the data room. The data should be on a seriatim (policy by policy) basis. Where seriatim data is not available either due to system constraints of the seller or due to time factors, grouped data should be provided based on key ages, sum assured, policy duration, sex etc.

The data points will then be used by the consultant to project the cash flows using a combination of actuarial modelling software which can be very sophisticated as well as spreadsheets. If enough data points are available, the cash flows would be available to drill down to the granular level by product on a monthly basis.

Product margins

Each product sold will have its own profit margins and these could vary considerably depending on the pricing formula used and the profit testing methodology adopted as well as the buyer and seller's own corporate requirements.

Using just the seller's derived product margins to project the future cash flows is not appropriate and is not granular enough especially when the margins are grouped by class



of product and some products like riders may not have been factored into consideration.

It is always best for the buyer's consultant to project the margins from first principles assuming seriatim data is available or if not, then employ accepted actuarial methods.

Projected future new business

The principles behind an actuarial appraisal valuation of the insurer are well documented in the actuarial literature and I will not discuss it here.

There are however, a few pertinent considerations that have a material impact on the appraisal. One such area is the projected value of future new business. This area is more subjective as it deals with projections of future business which have not been written as at the valuation date.

The period in question for the projected future new business is usually a fixed period and can range from 10 years to 30 years. This will depend on the perceived long tail nature of the products and expectations of future yet-to-be introduced products. For those policies where a bancassurance distribution agreement is involved, the period will extend to at least the end of the guaranteed distribution period.

A key component in the projected future value will be the expectations of future new sales. The seller will look at their own business plan as well as past history to get a reasonable gauge of future level of sales but more often than not, the past is never going to be exactly replicated far out into the future.

Therefore it is best to break down the sales in as much detail as possible via each distribution channel expected into the future. As in most cases, the value of future new business component turns out to be the one component that contributes the most to the final appraisal value and ironically also the one that carries the most subjective judgement. For the seller, this will be the one area where they will pay the most attention to so transparency here is paramount.

An alternative to using the projected future sales is to value the one-year new business separately and then apply what is known as the new business multiple (based on compounded annual growth rate and an increasing annuity factor). The factors will vary depending on whether it is a developed or under-developed market and the size of the company etc. Common factors seen will be in the range of 10-20 for developed markets and higher multiples in developing markets.

Economic assumptions

Economic assumptions include factors like the risk-free interest rate, government bond yields, inflation, equity risk premiums, growth of the GDP and industry market etc.

Such information would normally be available from the investment bank and would be as detailed as required for the projection. These assumptions would have an impact on expected investment returns in the future in the life and shareholders' fund and future sales projections.

Non-economic assumptions

The valuation should always be done on a best estimate basis by the seller's actuarial consultant and the choice of actuarial assumptions (mortality, morbidity, lapse, expenses etc) should reflect as much as possible the actual past experience of the company if it is reliable (or industry data if actual experience is not deemed to be sufficient) and over a reasonable period of time.

In any event, some judgement is usually called for in order for the actuary to derive the best estimate to use for the projections. As mentioned earlier, projections can be very long duration due to the nature of the product and the longer the duration, the more sensitive the choice of the assumptions. The golden rule of thumb for most actuaries is that the further out the cash flows from the valuation date, the more conservative should be the assumption.

Risk Discount Rate

In most valuations, the choice of the Risk Discount Rate (RDR) would play the biggest role in determining the final price of the Appraisal Value (AV), be it for the seller or the buyer.

The RDR would reflect each seller's and buyer's own internal corporate requirements and as a result, there is no right or wrong on the choice of the RDR. As a result, the AV report would usually show a range of values of the AV based on the RDR used as part of the sensitivity analysis.

Invariably, the seller's RDR would be on the lower end of the range as the perceived risk to the seller would be less than for the buyer given the seller's detailed knowledge of his own insurance business and the market for future business.

The buyer, on the other hand, has to face more uncertainty in the assumptions and future new business profits in order to breakeven. The buyer needs to reflect its own risk appetite and take into considerations factors like currency risk (if the bid offer is in a different currency from future profits) and different country sovereign risk ratings if applicable.

Price

The final price for the bid/offer may be quite different from the appraisal value and will vary from buyer to buyer. Factors to consider include potential synergies from existing operations in the market, value of the brand name of the entity for sale, the strength of the management, the duration of the sales distribution agreement, potential tax benefits, economies of scale and the desired rate of return versus the cost of capital.

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