



“The European insurance industry is more cautious in its approach to M&A as the developing Eurozone crisis – combined with widespread regulatory reform, prolonged soft pricing and reserve inadequacy – means that boards and investors are scrutinising potential targets much more closely before transactions are authorised.”

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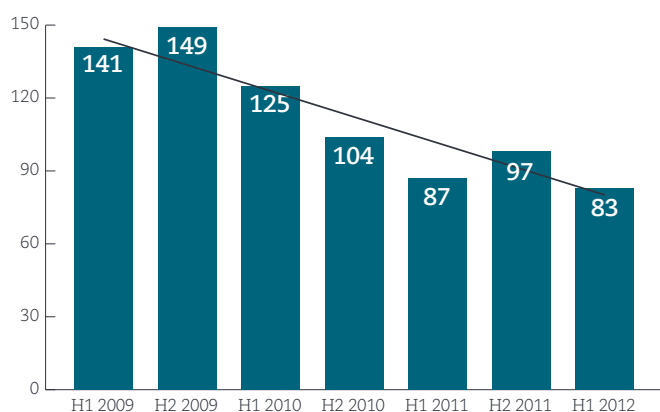
Europe

Overall, there has been a downward trend for M&A in Europe in the last three years. In general, activity was limited by the high levels of global economic uncertainty – especially around the Eurozone crisis – combined with widespread regulatory reform, notably around Solvency II and concerns around prolonged soft pricing and reserve inadequacy. When economies and markets are more buoyant, senior management is more willing to take greater risks in corporate deals. While, when times are tougher, there is greater uncertainty surrounding target businesses and future returns leading to increased scrutiny by boards and higher thresholds before transactions are authorised.

Although Europe was the region with the highest volume of insurance M&A in 2009 and 2010, 2011 saw a pronounced decrease in activity which has continued into the first half of 2012. There was a 21% fall in deals done between 2009 and 2010 – and a further 18% decline in 2011. This would suggest that the European insurance industry is growing more cautious in its approach to M&A despite a number of trends that might have suggested that activity would increase.

Despite the reduced number of deals, the region has retained its position as the second most active globally, after the US, at 38% of the total – still some way short of the 51% of global deals it attained in 2009. Europe's increased share has come as Asia Pacific and the Middle East have been relatively quiet.

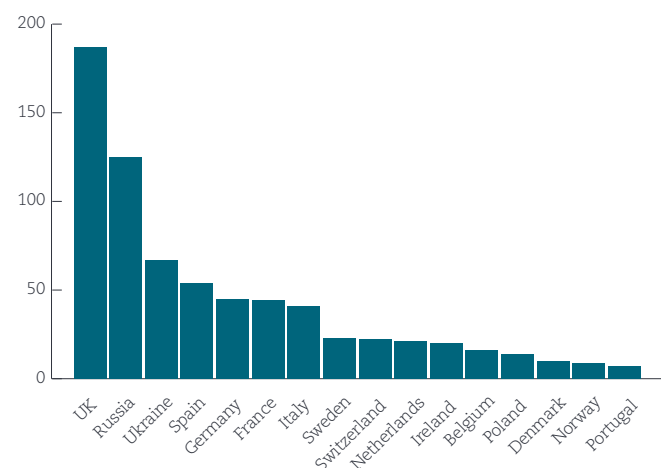
Volume of deals in Europe



The UK and Russia remain the two largest markets accounting for 40% of the deals taking place in the period. The Eurozone countries of Spain, France, Germany and Italy were also active, while the Ukraine (which had ranked third in last year's report) saw a sharp decline.

The Russian insurance industry saw premium growth in 2011 in excess of 10% and so continues to offer attractive long term growth opportunities. As such, it is not surprising that there is renewed interest from foreign players as well as an upward trend in domestic M&A activity as leading insurers continue to absorb market share. For example, in March 2012, Liberty Mutual announced the acquisition of 99.9% of KIT Finance Insurance as a platform to enter the growing non-life market, while, in August 2011, Res-Garantia agreed to purchase a 25% stake in VSK.

Deals in Europe by country 2009-2012



In many cases, the drivers for corporate activity that underpinned the M&A market in the previous report remain valid 12 months later. In terms of notable transactions, the fall-out from the financial crisis is still a key component. The largest deal was the sale by Old Mutual plc of the Skandia businesses in Sweden, Norway and Denmark to Skandia Liv in March 2012 – separately it also sold its Finnish business to OP-Pohjola osk.

According to a statement from the London-based insurer “the transaction is part of Old Mutual’s commitment to streamlining its business,” and to paying down debt after it was hit hard by the financial crisis, particularly in its US and Bermudan units. In the UK, the forced sale of the insurance businesses within Royal Bank of Scotland continues. Over the last 12 months RBS has undergone considerable re-structuring to streamline its operations ahead of a planned flotation. However, there are a number of buy-out groups reportedly interested (either alone or in consortia) in RBS’ Direct Line, which owns leading insurance brands such as Churchill and Green Flag in the UK. The business – Britain’s biggest personal motor insurer by number of policies – is valued by analysts at about £4 billion. There is no guarantee that RBS will listen to the approaches given that advanced plans for an initial public offering of at least part of the business are underway.

Despite 2011 having seen two of the most expensive natural catastrophes in the history of the insured world – the Japanese earthquake and severe floods in Thailand – as well as a succession of less severe claims, the pricing cycle remains depressed with few signs of improvement, although the market perseveres in trying to talk rates higher! Pricing, therefore, remains an important catalyst for corporate transactions of all kinds as an on-going lack of profitability causes investors to take a hard look at their business model. In addition, the effects of further progress by insurers to meet the Solvency II requirements, as well as the deterioration of economic conditions within the Eurozone, have also meant that businesses are either very carefully scrutinising the component parts of their business or are being compelled to consider disposing of less efficient capital. While this means that there may be more assets up for disposal, it is also likely that these same conditions will make buyers much more cautious.

Consequences of Euro crisis

One key change since the last report has been the effect of the on-going European debt crisis, which has taken its toll across the affected countries in the region – both in terms of underlying businesses as well as investment portfolios. This has had a number of consequences with companies having to dispose of subsidiaries or books of business in order to improve their solvency ratios, and/or transfer their renewal rights because of ratings downgrades.

There are a number of examples of these transactions in the last 12 months. In July 2011, Mutua Madrileña and “la Caixa” completed the sale of Criteria’s 50% stake in VidaCaixa Adeslas Seguros Generales to the Madrid-based insurance company – a transaction driven by Criteria’s need to reduce its debt and increase cash reserves. Banco Popular, Spain’s third largest listed bank, and German insurer Allianz, finalised the creation of a joint insurance company to manage over 11 billion euros in assets. Banco Popular booked a capital gain of 490 million euros which was used to strengthen its balance sheet. In another example, Liberty Mutual Group and Anglo Irish Bank completed the acquisition of Quinn Insurance in November 2011; the Irish insurance company was placed in administration by the Irish financial regulator in April 2010 citing “serious and persistent breaches” of solvency rules as the reason.

Ratings agencies have been keeping a close eye on the effect of the Eurozone debt crisis, evaluating investment risk exposure and assessing financial strength and creditworthiness. In an example of the difficult rating environment, French mutual insurer Groupama went from an A- rating in May 2011 to BBB- in December of the same year based on weak capital adequacy and regulatory solvency levels. One result of this was that Groupama began a sale of assets in order to boost solvency, including its domestic marine business, UK business and a recently launched Polish direct insurance unit.

Other companies are looking at international alliances and acquisitions to overcome difficulties in Europe. For example, Zurich's international markets division contributed \$1.3 billion in gross written premium in the first quarter of 2012, an increase of \$240 million compared with the same period last year – the difference coming from a range of emerging market initiatives. For example, in April 2012, Zurich began to provide wealth insurance products to HSBC clients in Bahrain, Qatar and the United Arab Emirates after signing a ten year distribution agreement. It has also recently acquired Banco Santander's insurance business which is providing significant growth in Latin America – particularly Brazil.

Limited stock at Lloyd's

Over the last three years, eight London Stock Exchange-listed Lloyd's businesses have been bought and this process has accelerated and widened to encompass non-quoted businesses over the last 12 months. The principal stimulus to this trend has not changed; for a domestic insurer from outside Europe, a Lloyd's business means immediate access to a global network of licenses for a moderately sized capital investment. The demand created by this attractive investment proposition has been fuelled by the very stringent demands of the Franchise Board in terms of new entrants – if creating a syndicate is out of the question, then acquisition is the only route. The sale of Chaucer Insurance to the US group, Hanover Insurance, illustrates this ongoing appeal – with the deal being described by Chaucer as “a great complementary fit with Hanover”. Hanover had no UK presence and was looking for greater exposure to specialty insurance lines.

So, while interest in Lloyd's remains strong, supply is diminishing rapidly, with available targets becoming much harder to find. The majority of Lloyd's businesses are now part of multi-platform corporate insurers and the assumption is that they are not for sale. In terms of listed Lloyd's vehicles, among the small caps, the period from 2005 to 2009 saw the likes of Cox, Wellington, Kiln, Atrium, Heritage and Advent taken over. This left Chaucer, Hardy, Omega and Novae. Chaucer went in 2011 and Omega and Hardy have been acquired in 2012. Michael Watson,

executive chairman of Canopus is quoted as saying that “an increasing scarcity value” is a significant factor underlying Lloyd's deals.

So what is left? Amlin, Beazley, Catlin and Hiscox are now large businesses and are not regarded as acquisition targets. There is a view that in a tough market buyers are reluctant to invest more than ten per cent of their market capital in an acquisition. There are private-equity backed vehicles where the owners have perhaps not yet seen the return they envisaged (Ark, Cathedral, Antares and Barbican) or those owned by overseas insurers already (Ariel, Equity, Marketform and Sagicor) but these are also not without their challenges. There is also still a real striving for scale, with recently announced deals being explicit in welcoming new investors to go for growth. It is felt that certain scale is required to allow management costs and expenses to be better utilised. Others see the increased regulatory burden in terms of the demands of Solvency II, and staying competitive in terms of technical sophistication around subjects such as modelling, as meaning that smaller players are disadvantaged.

Significant legacy activity

Activity in the legacy market has undergone significant change in the last several years as the focus has shifted away from dealing solely with the historic issues of APH claims. The more traditional retrospective view of legacy has been replaced by a focus on active liability management, and this includes looking at more recent underwritten risks as well as those going back some years.

While Solvency II has long been cited as a potential driver of legacy deals, the ongoing uncertainty in capital markets and depressed investment conditions are putting even greater pressure on insurers to explore all possible options for releasing and managing capital. Management is scrutinising the returns generated by every ounce of capital they have deployed, and the result is that legacy activity is being driven as much by live business as run-off, and is now being more closely integrated into the overall management of an insurance business.

The level of corporate activity for either insurance companies in run-off, or run-off portfolios, appeared to slow in 2011 following a period of prolonged activity starting in 2008. However, this reduced activity should not be viewed as an indicator that the sector is currently inactive, or that it is not restructuring and responding to market and regulatory developments. As well as more formal M&A activity, there has also been a rising number of portfolio transfers and reinsurance deals to free up capital as debt markets remain broadly closed and equity raising difficult. According to a report in Insurance Insider, legacy M&A reached \$1 billion at the half year stage of 2012 – providing real evidence that there is life in the run-off market.

For example, having acquired very large run-off books from Zurich and Ageas last year, Swiss Re became a seller in May 2012, disposing of its US life and health legacy in Admin Re. It cited redeployment of capital to more profitable parts of the business, such as its live P&C lines, as the reason. Brit Insurance has also re-focused its business as a specialty carrier underwriting solely on its Lloyd's platform and sold its UK run-off arm to Riverstone – a subsidiary of Fairfax Financial. Brit group chief executive called the sale “a significant milestone” in the firm's restructure.

There has also been considerable consolidation in terms of the number of specialist buyers in the market. Those who remain are highly experienced in the legacy markets, and are committing considerable funds to acquisitions in this sector. Enstar recently described itself as the biggest standalone legacy company in the world, having completed 35 company acquisitions and 17 portfolio transfers since it was founded in 2001. It has articulated a keen appetite for further deals saying at its annual investor meeting in March 2012 that it had “significant financial resources”, including \$1.4 billion of shareholders' equity and over \$300 million of capital and financial resources, to deploy in future deals.

The last 18 months has also seen a spate of major group re-organisations across Europe ahead of Solvency II – often using Part VII transfers. Euler Hermes and Chartis – to name but two – consolidated their European operations to facilitate a more efficient use of their capital. This type of internal restructuring inevitably causes these groups to look more closely at the composition of their businesses – in particular their run-off business – as well as its on-going structure and management. It remains to be seen, however, whether books of business which are considered to be a restraint on the efficient use of a group's resources are being put into run-off or sold.

In one of the larger European transactions of the last 12 months in the life sector, Cinven bought Guardian life insurance in a \$453 million deal. The UK private equity group purchased the 190-year-old Lancashire-based company from AEGON, as a basis for further acquisitions in a sector where banks and insurance groups are looking to sell assets to unlock capital. Caspar Berendsen, a Cinven partner, said: “Guardian is an ideal entry point for us into the market and provides us with a strong platform from which to deploy further capital to create a leading closed life consolidator”.

The other developing trend is the blurring of the line between legacy and live business. This is being demonstrated in several ways; the first being the number of businesses more traditionally associated with run-off who have bid for live carriers with a view to putting live entities into run-off and disposing of renewal rights. Hand in hand with this trend is the creation of specialist central divisions within businesses to take a holistic view of legacy business – compared to previously rather fragmented structures with claims handlers in different profit centres – and using the transferable skills from legacy to live business in terms of chasing commutations.



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Despite the positive levels of recent activity, there are worries that the severity of catastrophic losses in 2011, concerns over the European debt crisis and ongoing delays with Solvency II are likely to slow down European run-off solutions and divestments. However, the European legacy market is estimated to be worth around \$200 billion and the pace of regulatory change is not slowing, so while there may be peaks and troughs in activity, it is unlikely that the long term trend will decline.