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2017 Insurance M&A outlook

Will tailwinds or headwinds prevail?



Overview

After a record-setting 2015, during which US- and Bermuda-based insurance underwriters and brokers announced approximately \$70 billion in transactions, industry observers were of one mind as 2016 began. Insurance mergers and acquisitions (M&A) activity would remain exuberant—perhaps even exceed the deal volume of 2015.

This forecast of an exuberant deal environment did not play out as envisioned. 2016 was a tale of two halves: 1) M&A activity during the first six months was unexpectedly slow, and 2) dealmaking accelerated notably during the second half. Seven deals valued at \$1 billion or greater were announced—on par with the pace of billion-dollar deals during the second half of 2015.² While 2016 aggregate underwriter deal volume was up modestly from 2015, aggregate deal value was down. This was a product of fewer large deals, with only one valued at greater than \$5 billion.³

Our view is that the relatively low activity level during the first half of 2016 was a pause, not an inflection point, in an otherwise very active period for insurance M&A. We anticipate that a mix of tailwinds and headwinds will influence M&A activity in 2017. Which will prevail? We seek to answer this question by looking back at 2016 and examining 2017 macro issues and key trends. By looking deeper, insurance executives can pinpoint M&A drivers and plan their strategy accordingly.

2016 in review

2016 insurance M&A had little appreciable activity through the summer months. In fact, no deals valued at \$1 billion or more were announced during the first half of 2016, driving aggregate deal value for insurance underwriter transactions down 90 percent from the first half of 2015. This decline in aggregate deal value was concentrated almost entirely within the property and casualty (P&C) sub-sector. The picture was much brighter during the second half of 2016; the industry collectively viewed the seven \$1 billion+ deals as a significant uptick. The three biggest deals of the year were Sompo Holding's purchase of Bermuda-based Endurance Specialty Holdings for \$6.3 billion, its largest-ever deal; Arch Capital Group's \$3.4 billion purchase of AlG's mortgage insurance arm, United Guaranty Corporation (UGC); and Liberty Mutual's acquisition of Ironshore for \$3 billion.

Total 2016 underwriter deal volume (in terms of number of deals) ended up roughly even with 2015—increasing five percent year over year (YoY)—and was in line with volume we've seen over the past two to three years. As of December 31, 2016, aggregate deal value was down by over 60 percent. However, if the ACE/Chubb deal (a significant outlier) is removed, the decline is still a sizable but less dramatic 45 percent (Figure 1).8

Figure 1. Insurance sector M&A activity, 2015–2016

	Num	ber of deals		Aggre	gate deal val	ue	Average deal value			
	2015	2016	YOY change	2015	2016	YOY change	2015	2016	YOY change	
Underwriters	79	83	5%	\$65.8b	\$20.5b	(69%)	\$1,317m	\$568m	(57%)	
L&H	28	23	(4%)	\$11.9b	\$3.3b	(72%)	\$699m	\$482m	(31%)	
P&C	51	60	18%	\$53.9b	\$17.2b	(68%)	\$1,636m	\$613m	(63%)	
Brokers	492	439	(10%)	\$4.2b	\$6.8b	62%	\$54m	\$151m	179%	
Total	571	522	(8%)	\$70b	\$27.3b	(61%)				

What caused the slowdown in the first half of 2016? We identified five factors, working in parallel to magnify their collective impact, which were responsible for the year's lackluster start:

- An increase in uncertainty dampened investor confidence.
 Abundant in 2015, investor confidence took a hit as US equity markets fell sharply at the beginning of 2016. Other contributors included global and domestic economic gyrations; difficulty predicting the timing and magnitude of interest rate increases; a slowdown in corporate earnings growth; uncertainty about the outcome of the US November elections and the implications on the future direction of regulatory policy and taxes; and the Brexit vote.
- Values were viewed as rich. Although not extreme by historical standards, insurance companies were more fully valued in 2016 than they were at the same time the previous year. While richer valuations are good news for sellers, they also may make it more difficult to demonstrate to an acquiring company's board of directors that an acceptable ROI is feasible.
- The most active players of 2015 remained sidelined. Japanese and Chinese investors were the most active acquirers of US-based insurers in 2015. While they remained active shoppers, they were less successful at announcing or closing deals during the first half of 2016. Deal scrutiny by US and Chinese regulators was a major factor.
- A strong US dollar effectively raised prices for non-US buyers. An increase in the value of the dollar relative to select foreign currencies effectively raised the acquisition costs of US assets by overseas buyers.
- Serial acquirers were focused on integrating acquisitions made in 2015. The *Deloitte M&A Trends Year-end report 2016*⁹ revealed a significant increase in respondents who said that recent transactions had not yet met expectations and that gaps in integration execution were one of the reasons. Some acquirers decided to focus on integrating previous acquisitions rather than engaging in M&A.

In the second half of 2016, the narrative changed. Improved confidence led to:

- The return of foreign buyers looking to establish a presence in the US. Although many of 2015's most active foreign players remained sidelined, October saw two major deal announcements by foreign buyers: Sompo Holding's (Japan) purchase of Bermudabased Endurance Specialty Holdings,¹⁰ and China Oceanwide Holdings' acquisition of Genworth Financial for \$2.7 billion.¹¹
- Acquisitions designed to enhance the scale/scope of acquiring organizations. As mentioned earlier, Arch Capital Group bought mortgage insurer UGC for \$3.4 billion. Boston-based Liberty Mutual agreed to buy 100 percent of global specialty lines company Ironshore from Chinese conglomerate Fosun International in an all-cash deal worth around \$3 billion.
- Acquisitions that diversified the acquirer. Nationwide Mutual Insurance Co. acquired Jefferson National, an annuities company that specializes in fee-based products,¹⁵ to expand its distribution network, partially in response to the Department of Labor's (DOL's) new fiduciary rule. Allstate purchased privately held SquareTrade, which sells warranties for electronics products, in a \$1.4 billion deal.¹⁶
- Private equity (PE) firm M&A activity. PE-backed brokers continued to drive numerous transactions in the brokerage space; among them, Genstar Capital's acquisition of Acrisure LLC for \$2.9 billion.¹⁷
- A noteworthy InsurTech acquisition. Hartford Steam Boiler (HSB), part of Munich Re, acquired Meshify, a start-up with technology that connects disconnected devices through the Industrial Internet of Things (IoT).¹⁸

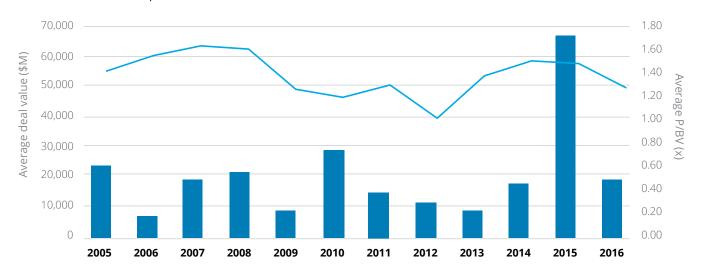
Insurance underwriters

In terms of the multiples observed in the insurance underwriters segment, Figure 2 indicates a decrease (approximately 16 percent) in the average price/book multiple (P/B) between 2015 and 2016, adjusting for certain outliers. In addition, as can be observed in the schedule below the graph, the average deal value in 2016 decreased significantly (56 percent) over the 2015 level, a result of the absence of several transformative transactions in 2015. If we exclude the ACE/Chubb transaction, average deal value still declined but by a much more modest 24 percent. In terms of aggregate deal value, 2016 exceeded the long-term average of \$248 million (since 2005, excluding 2015) by 129 percent.

Figure 2. M&A trends for insurance underwriters

Insurance underwriter transactions

Price-to-book value multiples



Year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Number of deals	74	84	99	95	83	107	99	98	88	82	79	83
Size of deals												
Low	0.7	0.4	0.4	1.3	0.0	0.30	0.5	0.1	0.1	1.3	0.3	1.0
High	11,500.0	1,120.9	2,744.0	6,225.0	1,900.0	15,545.1	3,534.6	3,100.2	1,125.0	5,579.6	28,240.3	6,303.8
Average	473.8	94.1	229.5	288.9	162.0	395.6	222.5	195.5	136.4	277.3	1,317.4	586.5
Observed P/BV dea	l multiples											
Low	0.87x	0.75x	0.79x	0.48x	0.77x	0.55x	0.54x	0.31x	0.68x	0.14x	0.10x	0.18x
High	2.12x	6.19x	2.34x	2.81x	2.98x	1.70x	5.81x	5.99x	4.11x	2.83x	2.53x	1.45x
Average	1.38x	1.54x	1.63x	1.60x	1.20x	1.12x	1.24x	0.91x	1.34x	1.48x	1.45x	1.22x
Median	1.24x	1.66x	1.65x	1.59x	0.89x	1.06x	1.01x	0.81x	1.55x	1.39x	1.26x	1.23x

Source: SNI Financial

Transactions represent US and Bermuda companies making acquisitions on a global basis and international buyers making acquisitions in US and Bermuda.

Insurance underwriters include P&C, L&H, multiline, title, mortgage guaranty, and financial guaranty sectors covered by SNL Financial. Transactions grouped by the year they were announced. Deal multiples represent closed multiples, unless the transaction is still pending close. Outliers have been removed from the average deal multiples. Outliers include all deals with a P/BV multiple smaller than 0.5x or greater than 3.0x. Analysis as of 01/04/2017. SNL has noted that some numbers may not reconcile to prior years as there may be a lag between deal public announcement and disclosure.

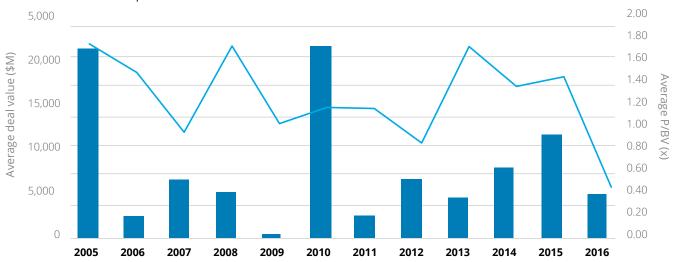
Life and health

It appears that the low interest rate environment continued to adversely impact 2016 M&A activity in the life and health (L&H) segment. In looking at the data in Figure 3, the aggregate deal value in this space reversed its upward trajectory and returned to a more normal level. Average deal value was nearly \$482 million, a 31 percent decrease from 2015. Note that the presentation of the multiples is somewhat misleading, as we were only able to obtain a multiple for a single 2016 deal from public sources. However, in looking at aggregate deal volume and value, one may conclude that this segment of the insurance market faced significant headwinds in 2016.

Figure 3. M&A trends for life and health

Life and health transactions

Price-to-book value multiples



Year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Number of deals	22	26	33	25	21	28	27	30	25	17	28	23
Size of deals												
Low	0.7	1.8	0.4	1.3	0.5	0.3	0.5	0.1	0.1	3.0	1.5	6.8
High	11,500.0	893.0	2,400.0	2,400.0	126.5	15,545.1	917.3	1,550.0	1,056.0	5,579.6	5,001.9	2,728.8
Average	1,338.9	92.2	227.1	188.8	28.7	1,026.2	122.3	299.6	204.6	544.5	698.8	482.5
Observed P/BV deal n	nultiples											
Low	1.33x	0.75x	0.79x	1.21x	0.88x	1.06x	0.54x	0.31x	1.73x	1.29x	0.10x	0.18x
High	2.12x	2.41x	0.79x	2.28x	0.88x	1.06x	5.81x	5.99x	1.73x	1.29x	2.17x	0.18x
Average	1.76x	1.44x	0.79x	1.73x	0.88x	1.06x	1.05x	0.67x	1.73x	1.29x	1.40x	0.18x
Median	1.84x	1.17x	0.79x	1.71x	0.88x	1.06x	0.94x	0.67x	1.73x	1.29x	1.13x	0.18x

Source: SNL Financial.

Transactions represent US and Bermuda companies making acquisitions on a global basis and international buyers making acquisitions in US and Bermuda.

Transactions grouped by the year they were announced. Deal multiples represent closed multiples, unless the transaction is still pending close. For years 2007, 2009, 2010, 2013 and 2014 there is only one deal with data, respectively. Outliers have been removed from the average deal multiples. Outliers include all deals with a P/BV multiple smaller than 0.5x or greater than 3.0x., except in 2016. Analysis as of 01/04/2017. SNL has noted that some numbers may not reconcile to prior years as there may be a lag between deal public announcement and disclosure.

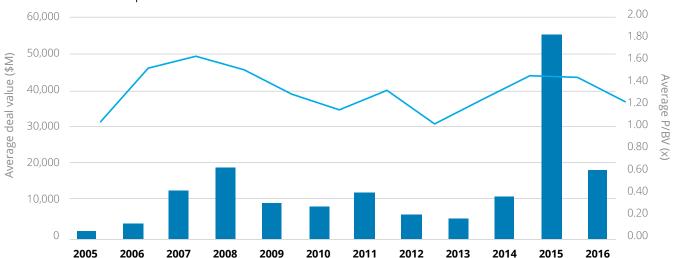
Property and casualty

The aggregate deal value of property and casualty (P&C) transactions in 2016 was significantly lower than 2015, a year in which deal volume reached a peak over the examined period, even with a slight uptick in the number of transactions (Figure 4). In looking at the data, the number of deals in excess of \$500 million decreased from the upward trend of the last two years, with four such deals announced in 2016, compared to seven in 2015 and five in 2014. The data also indicates that the average P/B multiple decreased by 18 percent from 2015, reversing its upward trend established in the last three years.

Figure 4. M&A trends for property and casualty

Property and casualty transactions

Price-to-book value multiples



Year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Number of deals	52	58	66	70	62	79	72	68	63	65	51	60
Size of deals												
Low	1.2	0.4	1.0	1.8	0.02	1.2	0.5	0.8	0.4	1.3	0.3	1.0
High	825.0	1,120.9	2,744.0	6,225.0	1,900.0	1,318.5	3,534.6	3,100.2	1,125.0	1,671.3	28,240.3	6,303.8
Average	78.3	95.1	230.6	323.5	196.9	145.7	266.8	148.5	110.3	199.4	1,636.1	612.5
Observed P/BV deal m	ultiples											
Low	0.87x	0.92x	1.23x	0.48x	0.77x	0.55x	0.73x	0.57x	0.68x	0.14x	0.99x	0.92x
High	1.15x	6.19x	2.34x	2.81x	2.98x	1.70x	2.69x	1.52x	4.11x	2.83x	2.53x	1.45x
Average	1.00x	1.58x	1.72x	1.56x	1.30x	1.13x	1.34x	0.97x	1.24x	1.50x	1.48x	1.22x
Median	0.97x	1.66x	1.73x	1.51x	0.99x	1.06x	1.16x	0.90x	1.38x	1.43x	1.29x	1.26x

Source: SNL Financial.

Transactions represent US and Bermuda companies making acquisitions on a global basis and international buyers making acquisitions in US and Bermuda.

Property & Casualty include P&C, multiline, title, mortgage guaranty and finance guaranty sectors covered by SNL Financial. Transactions grouped by the year they were announced. Deal multiples represent closed multiples, unless the transaction is still pending close. For 2004, there is only one deal with data. Outliers have been removed from the average deal multiples. Outliers include all deals with a P/BV multiple smaller than 0.5x or greater than 3.0x. Analysis as of 01/04/2017.

SNL has noted that some numbers may not reconcile to prior years as there may be a lag between deal public announcement and disclosure.

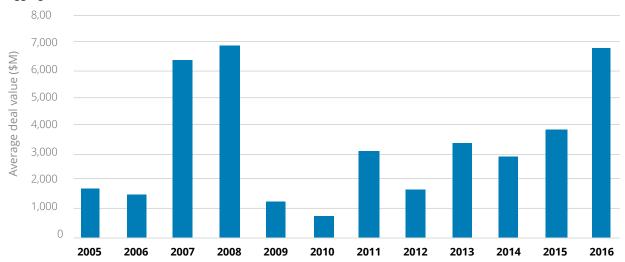
Broker/agent

The broker/agent segment continued to be the most active in terms of deal volume. Although lower than the preceding year, 2016 deal volume was still second-highest in the examined period, with 439 announced deals. Aggregate deal value, meanwhile, increased by 62 percent (Figure 5).¹⁹ The deal value was influenced by two large transactions: Genstar Capital's acquisition of Acrisure LLC for \$2.9 billion²⁰ and Allstate's acquisition of SquareTrade for \$1.4 billion²¹ (classified as a brokerage deal by SNL Financial). Approximately 55 percent of 2016's deals were purchases of small and/or regional brokers by serial acquirers, the five most active being Acrisure, LLC, Hub International, AssuredPartners, Inc., Arthur J. Gallagher & Co., and Confie Seguros California, Inc.

Figure 5. M&A trends for insurance brokers

Insurance broker transactions

Aggregate deal value



Year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Number of deals	201	220	267	293	183	240	304	344	239	351	492	439

Source: SNL Financial.

Transactions represent US and Bermuda companies making acquisitions on a global basis and international buyers making acquisitions in US and Bermuda.

Transactions grouped by the year they were announced. Analysis as of 01/04/2017. SNL has noted that some numbers may not reconcile to prior years as there may be a lag between deal public announcement and disclosure.

2017 Outlook

We anticipate that M&A activity in 2017 is likely to echo the active second half of 2016; however, a mix of tailwinds and headwinds will influence the path forward.

Tailwinds

Among likely macro-level tailwinds is an environment of continued slower economic growth that will likely drive only low-single-digit organic growth opportunities for insurers—although the post-election stock market climb appears to reflect investors' expectations for faster growth in the coming year. This enthusiasm may be bolstered by regulatory changes under a Trump presidency and Republican-controlled House and Senate. During the early part of the year, however, as the industry seeks clarity on which regulatory changes actually will be implemented, the prevailing impact of regulation on M&A will likely be to create headwinds. In terms of interest rates, the Federal Reserve's December 2016 quarter-point interest rate increase—and its signals for more frequent increases in 2017²²—can be viewed as a tailwind for 2017 M&A. Insurance companies' ROE is heavily dependent on interest rates, as reflected by the favorable movements in post-election stock prices. A trend of increasing interest rates may make it easier for companies considering a transaction to model a favorable economic scenario in their deal pricing and make it easier to justify paying more. Lastly, we see evidence to suggest a potential pickup in the activity of European insurers here in the US during the latter part of 2017 and in 2018. Seemingly favorable trajectories for economic growth, taxes, regulation, and interest rates are behind the renewed interest. We don't expect to see much activity, however, until the implications of the new administration in Washington become clearer.

At an individual company level, lack of organic growth prospects may prompt organizations to look for ways to cut costs and grow inorganically—a potent combination to drive consolidation. Also, the need to scale and make continued technology investments remains acute. Fortunately, balance sheet cash reserves are very strong and there are abundant sources of alternative capital for M&A, so interested organizations may decide to purchase or partner to gain the capabilities they need.

Headwinds

Four major headwinds will continue to blow counter to more exuberant levels of M&A in the insurance industry. First, even if potential buyers have cash-in-hand, not many company boards and executives are eager to sell—a lack of targets means fewer deals. Second, valuations, while not overdone, are considered by most potential buyers to be full. If an organization is going to pay notably over book value for an acquisition, executives better have a strong strategic rationale for how they are going to create incremental value. Third, uncertainty around the new administration's and Congress' policy/regulatory actions is unlikely to be clarified materially until the second half of the year, if not later, which may prompt some buyers to wait to pull the trigger on an M&A deal. Fourth, some question whether demand from Asian buyers will remain as strong as it was in 2014 and 2015.

Based on the above macro-level and organization-specific conditions, we expect that tailwinds will prevail against headwinds in 2017. This will produce an overall favorable environment for insurance sector M&A. We are unlikely to see mega-deals of the scale we saw in 2015, but we anticipate eight to 10 highly strategic, \$1+ billion deals driven by both domestic and foreign acquirers. Our outlook, however, varies by sub-sector. The stagnant L&H sub-sector is likely to remain that way: Rising interest rates improve fundamentals for the business and Japanese players are looking to expand their existing platforms but available targets will remain scarce, as will deals valued in excess of \$1+ billion. Meanwhile, capital in the P&C and reinsurance sub-sectors is at an all-time high and organic growth is exceptionally difficult to come by, making them ripe for middle-market consolidation. PE-backed brokers are expected to continue focusing on brokerage deals, and seemingly everyone wants to get into InsurTech and direct distribution.

Insurance company executives contemplating M&A in 2017—as either a seller or a buyer—should consider planning for and addressing five marketplace drivers and trends that could help or hinder their ability to execute on their plans:

- Investor confidence
- Valuations and the pricing gap
- Regulatory policy and tax code developments
- Demand by foreign buyers to invest in the US market
- Exponential technologies: Buy, invest or partner?

Tailwinds and headwinds: 2017 Insurance M&A drivers and trends

1. Investor confidence

Investor confidence was abundant in 2015; one of the key factors driving record M&A. However, confidence took a hit in 2016 as US equity markets fell sharply upon the start of the year. Uncertainty increased about the timing and magnitude of interest rate hikes; the implications of the November elections on future regulatory policy and taxes; a slowdown in corporate earnings growth; and the Brexit vote. Some of these concerns have begun to resolve themselves so, relative to 2016, we expect to see increased confidence and certainty in 2017. What impacts could this shift have on insurance M&A?

Figure 6. SNL US insurance and S&P 500 index YTD total return (%)

Source: "For life insurers, a reversal of fortunes in 2016," SNL Financial, December 29, 2016.

Data compiled Dec. 29, 2016. Market data as of Dec. 28, 2016. The SNL U.S. Insurance index includes all insurance underwriters and insurance brokers in SNL's coverage universe that trade on US exchanges (NYSE, NYSE MKT, NASDAQ, OTC). The SNL U.S. Insurance L&H index includes all insurance underwriters in SNL's coverage universe in the Life & Health sector whose primary shares trade on a U.S. exchange (NYSE, NYSE MKT, NASDAQ, OTC). The SNL U.S. Insurance P&C index includes all insurance underwriters in SNL's coverage universe in the Property & Casualty sector whose primary shares trade on a U.S. exchange (NYSE, NYSE MKT, NASDAQ, OTC). Total return calculated from Dec. 31, 2015, through Dec. 28, 2016. Source: SNL Financial, an offering of S&P Global Market Intelligence.

If the post-election stock market's record highs are an indicator, there appears to be a general assumption among investors that President Trump and a Republican-controlled Congress will promote and adopt pro-business policies that are intended to accelerate economic growth. Although their gains haven't been as substantial as their banking counterparts, insurance companies have benefitted from the recent stock run-up (Figure 6), which could spur movement of assets in the sector and increase M&A deal value. L&H stocks have enjoyed the most significant increase since the election, but this increase cuts both ways in terms of its impact on stimulating M&A.

A robust stock market creates an environment of higher confidence, which is favorable to M&A. Also, higher stock prices generally reduce stock buybacks. Executives ask: What are we going to do to enable our company's excess capital to earn a higher rate of return? One option is to turn it into acquisition currency. For example, an insurance company could buy a firm with lower PE ratios in an all-stock deal that wouldn't be dilutive to its existing shareholders. Such transactions make it easier for higher-performing firms to buy under-performers whose PE ratios would not be bid-up as much in the market.

The Federal Reserve's December 14, 2016, interest rate hike of a quarter point was widely regarded as a virtual certainty by financial markets in the wake of a string of generally strong economic reports. Its current signals that the pace of rate increases will accelerate in 2017²³ also should lift investor confidence, especially as the Trump administration takes office with the goal of boosting growth through tax cuts, increased spending on infrastructure, ²⁴ and deregulation. Importantly, the Fed describes the pace of rate increases as "gradual" and supporting some further improvement in the job market. It anticipates unemployment falling to 4.5 percent in 2017 and remaining at that level, which is considered to be close to full employment.²⁵

Bottom line

Call it an environment of cautious optimism. Entering 2017, the postelection stock run-up and quarter-point interest rate rise are signs of a strengthening economy that have boosted investor confidence. Yet this confidence may not translate into an immediate uptick in insurance M&A. Most sector M&A takes place for strategic reasons, and insurance company strategy is not really driven by federal policy. We expect that companies may plan for but delay M&A for up to the first six months of 2017 as executives watch for market corrections within insurance sub-sectors and evaluate the impact of new regulations and Congressional activity on the economy.



2. Valuations and the pricing gap

Insurance equity valuations are not extreme by historical standards but are viewed as more fully valued than they were in 2015. In P&C, the price/book value (P/BV) ratio of announced deals actually decreased from 2015 to 2016 and was slightly below the long-run deal average of 1.35 (Figure 4). In addition, P&C deals in 2016 were completed at prices that drove a very narrow range (relative to prior years) of P/BVs (low of 0.92 to a high of 1.45) (Figure 4). Due to the lack of data availability, a similar analysis for L&H companies (Figure 3) is not possible. And while richer valuations may make it a better time to be a seller, they can also make it more difficult for buyers to demonstrate that an acceptable return on investment is attainable.

As depicted in Figure 6, life insurance stock prices increased 20 percent post-election and are trending slightly upward. ²⁶ A continued upward march in 2017 may widen existing pricing gaps, make properties less attractive to potential buyers, and create headwinds for sector M&A.

Bottom line

Agreeing on price can make or break an M&A deal, and in the current era of high valuations it may be difficult for buyers and sellers to bridge the price/value gap. Over the last 12-18 months, higher insurance company valuations have kept a lot of potential buyers on the sidelines. While some fairly good assets are on the selling block, only strategic and Asian buyers have been active. Asian acquirers, which typically use a longer-term time horizon in their deal models (as far out as 10-15 years, in some cases), have shown that they are willing to pay a premium for certain assets, and their approach appears to be working, as evidenced by the Sompo/Endurance and China Oceanwide/Genworth transactions.

3. Regulatory policy and tax code developments

It is possible that the Trump administration and Republicancontrolled Congress will make some very significant changes to financial services industry regulations and the US tax code in 2017. While lack of clarity about specific proposals and their timing may be a short-term inhibitor of M&A, once implemented, some of the changes may drive increased dealmaking as the year progresses. For the insurance industry, one potential reform to follow is the establishment of a SIFI "exit ramp"—a mechanism by which insurers designated as a systemically important financial institution (SIFI) will be able to escape designation in the wake of significant restructuring that lessens systemic risk. A related issue is MetLife's pending litigation around its designation by the Financial Stability Oversight Council (FSOC) as a nonbank SIFI. How the Department of Justice (DOJ) proceeds and the litigation's final outcome will impact if, how, and when Congress responds.²⁷

Another potential regulatory change that may have considerable impact on insurance M&A is a delay or elimination of the April 2017 compliance date for the Department of Labor (DOL) and the Consumer Financial Protection Bureau's (CFPB) "Definition of the Term 'Fiduciary'; Conflict of Interest Rule—Retirement Investment Advice." Released in April 2016, the Final Fiduciary Duty rule stimulated the acquisition and divestiture of certain distribution channels or other forms of restructuring and business model changes in wealth advisory networks. Such acquisitions and divestitures are likely to slow if the rule is delayed or amended. Interestingly, many insurance companies are quite far down the road in preparing to comply with the DOL rule and may be unlikely to go back to their prior state. They view acquiring or divesting the designated assets/capabilities as an opportunity to differentiate in the market by demonstrating that they are a good fiduciary.

Figure 7 provides a snapshot of evolving legislation, potential changes to existing rules or guidance at the agency level, and the implications for insurance M&A.

Figure 7. Potential changes to financial services regulatory policies and implications for 2017 insurance M&A

Avenues for changes Implications for insurance M&A

Evolving legislation

- The insurance sector may be exempted from the statutory asset threshold, codified in Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111–203), which triggers SIFI designation and the imposition of enhanced supervision and prudential standards.
- The Volcker Rule could be repealed or amended to permit a greater deal of flexibility.
- FSOC activities could be subject to greater transparency and could be subject to Congressional appropriations.
- There are expectations that a Republican administration and Congress will be more deferential to state-based insurance industry regulators.

- Lessening the overall regulatory burden particularly if SIFI designations are changed should make it easier for insurance companies to engage in M&A.
- Some large-company divestiture efforts could be tabled if SIFI avoidance becomes a non-issue.
- Any changes to the Volcker Rule may impact how financial services organizations invest in alternative investment management vehicles (for example, hedge funds, PE).

Changes to existing rules or guidance at the agency level

- The DOL could delay the initial April 2017 compliance date for its fiduciary standard "Conflict of Interest" rule.
- The Treasury Secretary, as Chair of the FSOC, could seek to rescind the existing nonbank financial company designations and decline to pursue additional designations.
- The compliance date for the DOL's fiduciary standard and its related exemptions has already jump-started strategic reconfigurations and divestitures in the insurance industry. However, in 2017 organizations may wait for clarity about any delay in the compliance date before choosing among the paths that have been created by the rule. These could influence portfolio shifts, M&A activity, operating models, and compliance intensity, and change the nature of risks that constitute the costs of doing business. Regulatory policy and the industry's choices could, in turn, influence the future structure of revenue pools within the market itself. Also, a current key challenge in deal-making is modeling pro forma Comprehensive Capital Analysis and Review (CCAR) in diligence, so softening in this area would reduce a key deal-making impediment.

Source: Deloitte Development LLC.

Potential US tax code changes

Substantive tax reform may generate both tailwinds and headwinds for insurance companies contemplating M&A in 2017. Enacting corporate tax code changes that President Trump is likely to propose in 2017 should be made easier by the fact that Republicans control the House of Representatives and the Senate; however, the president's stated positions, the House GOP's tax reform "blueprint" introduced in June 2016, and the draft tax legislation previously released by former House Ways and Means Committee Chairman Dave Camp, do not align on all issues related to tax reform.²⁸

All three reform proposals have certain insurance industry provisions. Among those with the potential to have a significant operational impact are the following:

- The Trump proposal has a provision for the phase-out of the income deferral on life insurance contracts for high earners as well as the repeal of the Affordable Care Act and related taxes. The first provision may have a potential adverse impact on L&H insurers' future "whole-life" premiums, which should be modelled for M&A diligence purposes.
- The House GOP proposal contains various changes to net operating losses (NOL) utilization, which may have an industry impact given the number of insurers currently with NOLs. These potential provisions include prohibiting NOL carry-backs while potentially increasing NOL carry-forwards by an interest factor that compensates for inflation. This proposal would limit yearly NOL utilization to 90 percent of taxable income. The House proposal also includes a "border adjustable, cash flow tax" which, due to its loss of deduction for the "import" of insurance, would essentially provide a similar result to the Camp proposal's (see below) prohibition of a tax deduction for reinsurance outside of the US.
- The Camp proposal contains a number of potential insurance company provisions. One that may have a decidedly adverse impact, given most insurance companies' desire to reinsure substantial segments of their book, is a prohibition for a tax deduction related to untaxed reinsurance premiums. Another is a restriction on the insurance business exception to passive foreign investment company (PFIC) rules. Both of these provisions, if enacted, have the potential to increase tax liability for certain insurers, adversely impacting M&A valuations. Nevertheless, these potential adverse consequences may be more than mitigated by the potentially favorable proposals discussed below.

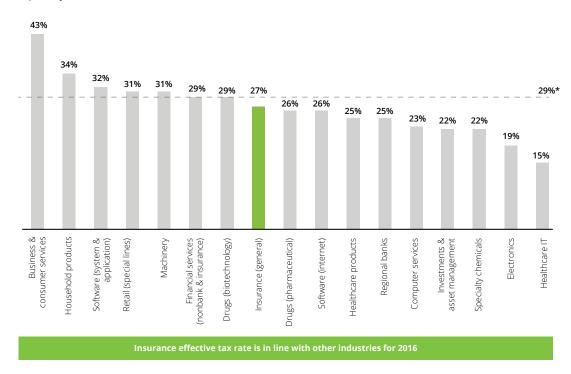
From an M&A perspective, two proposed tax code changes with the potential for substantive impact—reducing corporate income tax rates and reducing taxation on repatriating certain foreign earnings of insurance companies—should be on executives' radar in 2017:

Corporate tax rate: President Trump has called for reducing the top corporate tax rate from its current level of 35 percent to as low as 15 percent, while the House Republican tax reform blueprint has proposed a top corporate rate of 20 percent.²⁹ Camp's proposed top corporate tax rate sits above the two, at 25 percent.³⁰ While there may be key differences between these three proposals, lowering corporate tax rates seems likely. Enacted legislation may have a two-fold impact on insurance M&A. First, and most obvious, since the reduction in corporate income tax rates will effectively reduce a major corporate expense and theoretically increase net free cash flow and net income, it is likely to increase valuations of insurance targets (given that most operative valuations are performed on a "dividend discount methodology"). The second, less obvious, implication is the impact for the many insurers that have "net deferred tax assets" on their balance sheets. The reduction in statutory income tax rates for such companies seemingly would have the potential detriment of reducing the value of such net deferred tax assets (with the opposite impact, of course, if they are in a net deferred tax liability situation). Nevertheless, there is a potential tax planning opportunity for insurance companies with net deferred tax assets. To the extent that they may accelerate tax deductions into pre-tax-reform years (for example, carryback NOLs, etc.), or defer income into post-tax-reform years, they may be able to produce a permanent tax benefit. It is important to note that any rate decrease would most likely be coupled with offsetting revenue-raisers impacting insurance companies (for example, changes to computation of DAC, tax reserves and certain credits) in order to make any rate drop more economically feasible and, hence, likely mitigating the net effective tax rate reduction.

The insurance industry's 2016 corporate effective tax rate is in line with other sectors (Figure 8). Morgan Stanley estimates that for a P&C insurer, the average EPS impact of a 20 percent corporate tax rate reduction would be 7.6 percent.³¹

Figure 8. US corporate effective tax rate by industry

As of January 2016



*Average among all industries.

Source: Aswath Damodaran, "Tax Rates by Sector," http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/taxrate.htm, accessed January 23, 2017.

International tax-repatriation of off-shore accumulated

earnings: Trump's discussion of international tax issues during the campaign focused largely on his call for a one-time deemed repatriation of accumulated deferred foreign income at a 10 percent tax rate. By contrast, the House GOP blueprint, advocates a one-time deemed repatriation with differential rates for cash (8.75 percent) and noncash assets (3.5 percent), which could be paid ratably over eight years at the taxpayer's election. Unlike a general corporate tax rate reduction, enactment of this provision is likely to disproportionately impact certain insurers. Large, multinational companies with significant un-repatriated earnings in foreign jurisdictions will derive a distinct increased permanent cash tax benefit through such repatriation of untaxed foreign earnings (although for financial accounting purposes, some companies may see an effective tax rate spike as a result of such repatriated earnings, heretofore deemed "permanently reinvested" under APB 23). Note that Trump's tax proposals currently do not address the broader issue of how to tax active foreign-source income of US multinationals nor, as of December 2016, has he offered specific proposals to strengthen current-law rules to prevent inversions or guard against base erosion.32

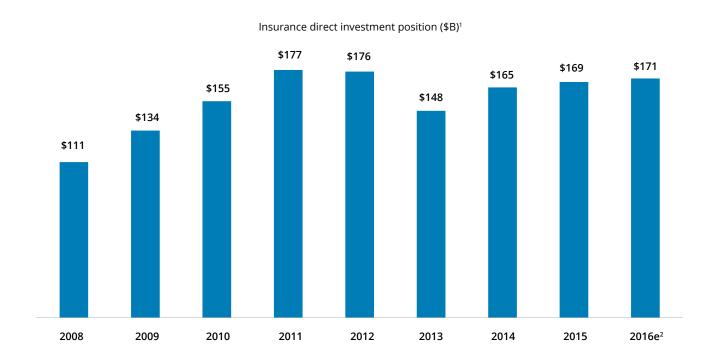
Bottom line

One likely result of the 2016 election is that state-based regulation of the US insurance industry will be returned to its uncontested, pre-eminent place, as the federal players created by the Dodd-Frank Act (FSOC, FIO) may be eliminated, restructured and/or subject to increased transparency and Congressional oversight. In addition, certain proposed major overhauls are likely to promote an active environment for insurance M&A by encouraging the biggest players with the largest balance sheets back into acquisition mode. But there are cross-currents: Faster economic growth and increasing interest rates create organic growth drivers for insurers so they may not be as dependent upon acquisitions. Companies should closely monitor legislative developments in 2017 and engage in scenario planning around what may be a large-scale regulatory reset. Fortunately, insurance companies and the financial services industry in general are getting better at taking waves of regulation-induced change in stride. Many insurance firms already have invested considerable money and effort in key regulatory-related activities, such as enhancements to risk management and compliance frameworks. These investments may be expected to deliver long-term business benefits regardless of the specific regulations that are enacted. Still, complying with a yet-undefined number of potential regulatory and tax changes in 2017 and succeeding years will require careful assessment and navigation if insurance companies hope to reap the resulting benefits. 13

4. Demand by foreign buyers to invest in the US market

Foreign investors, especially Chinese and Japanese companies, have been on a shopping spree for US- and Bermuda-based insurance companies over the last several years as they seek to diversify outside their home country into financial services at a time when capital is plentiful and debt is cheap.³³ These investors have driven a 16 percent increase in the foreign direct investment position in the insurance industry since 2013 (Figure 9).

Figure 9. US insurance foreign direct investment position



¹ Foreign direct investment position on historical-cost basis.

Will foreign buyers seek to further expand their US insurance company footprint in 2017? While the coming year should see a continuation of inbound M&A, overall activity may be somewhat muted—especially compared to 2015-2016's blockbuster levels. There are a few potential inhibitors: An increase in the value of the US dollar relative to select foreign currencies effectively increases the acquisition cost of US targets for overseas buyers. Continued interest rate increases in 2017 would likely further strengthen the dollar, making deals more difficult for foreign buyers to execute. These buyers are also likely to want additional clarity about the changes that the new Trump administration will bring about. In addition, the complex US regulatory environment and the significant capital requirements to support a domestic business may be viewed as discouraging factors for inbound M&A.

From a regional perspective, the latter part of 2017 and 2018 may see greater interest in US properties from European buyers than in the past few years. The perception of favorable trajectories in economic growth, taxes, regulation, and interest rates are triggering the renewed interest, as well as efforts to reevaluate the role the US market will play in buyers' business portfolios. Valuations, however, could be a challenge. In the past, European firms have been more reluctant than, for example, Asian buyers in paying materially over book value for insurance targets.

² 2016 estimate based on US GDP growth. Source: Bureau of Economic Analysis (2016). OECD.

Potential acquirers from Japan, on the other hand, may decide to pause and take a breath after the trio of multibillion dollar acquisitions in 2015 by Tokio Marine, Meiji Yasuda Life, and Sumitomo Life;34 and Sompo Holding's October 2016 announcement that it will buy Bermuda-based Endurance Specialty Holdings.³⁵ Meanwhile, non-insurance companies from China that are seeking to purchase US insurance assets are fighting headwinds from both Chinese and US government regulators. The Chinese government announced in November 2016 that it is preparing new restrictions on outbound foreign investment to prevent capital flight.36 The Chinese State Council will ban outbound investment deals worth more than \$10 billion or M&A transactions above \$1 billion if they are not within the Chinese investors' core business.³⁷ In addition, the China Insurance Regulatory Committee (CIRC) has been examining Anbang Insurance Group, Shenzhen-based Funde Sino Life Insurance, and at least one other group about the sector's aggressive investment policies and funding of overseas acquisitions.38 Regulators are concerned that illiquid assets overseas might make companies unable to pay off policyholders. The issue moved front-and-center when Liberty Mutual announced in December that it will acquire 100 percent of specialty lines insurer Ironshore Inc. from Fosun for \$3 billion.³⁹ Fosun has accumulated significant debt in a 20-year acquisition spree, mostly in Europe and the United States, 40 and regulators have been expressing concerns about the company being overleveraged.

The US Treasury Department's Committee on Foreign Investment in the United States (CFIUS) and state-level regulators have been closely examining M&A plays for US insurance assets by Chinese companies that have opaque financing and ownership structures, which can extend the timeline from announcement to deal close—or derail a deal entirely. Ironshore's previous acquisition by Fosun had attracted scrutiny by a US national security panel.41 Anbang's 2015's proposed acquisition of Fidelity & Guaranty Life ran into delays when New York State's financial services regulator requested additional information on its funding and shareholder structure. 42 That transaction has been delayed until first quarter 2017. Similarly, China Oceanwide's proposed acquisition of Genworth is not yet approved. It is likely that Chinese-originated M&A activity, especially early in the year, will be muted as players observe how these two deals play out.

Bottom line

A short hiatus in 2017 inbound insurance M&A would not mean that foreign buyers have shuttered their plans to create and/or expand their US platforms. In fact, we see evidence suggesting heightened interest by European buyers during the latter half of 2017 and beyond. In addition, there is abundant available capital in some Asian countries, especially China and Japan, and companies there are looking for safe homes to park their money. We expect that there are more deals to do. Japanese buyers, employing their long-term view of deal ROI, likely will take their time vetting desirable assets before taking action. China is expected to make additional US acquisitions, although each proposed deal will be highly scrutinized. What will Chinese acquirers have to do to earn US regulatory approval? How do they crack the regulatory code?

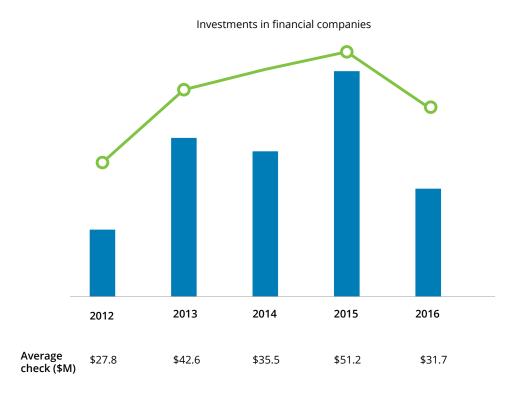
5. Exponential technologies: Buy, invest or partner?

More than a year ago, we asserted that insurance companies would be increasing their involvement in the financial technology (Fintech)/insurance technology (InsurTech) space. That is becoming a reality although, despite all the marketplace excitement, insurance companies' 2016 YoY aggregate InsurTech investments declined (Figure 10) as insurers digested their investments from 2015 and continued to build capabilities around innovation and corporate venturing. Dealmaking is taking several forms. Some prominent examples include:

- 1. Making outright acquisitions of InsurTech assets;
- 2. Standing-up venture funds to make off-balance-sheet investments in InsurTech innovations and exponential technologies (investment vehicle only);
- Making an equity investment that's on the balance sheet with the intention of testing/incubating a business opportunity or capability that will impact the investor's core business;
- 4. Making indirect investments in which carriers work with InsurTech startups on projects and proof-of-concept initiatives. These tests may evolve into outright equity investments.

Figure 10. US insurance company InsurTech investments 2012–2016

Aggregate investment (\$M) and number of deals





- Aggregate investments decreased from a high in 2015 along with number of deals
- Aggregate investments in insurance companies decreased by 52 percent year-on-year while overall deal activity increased by 23 percent
- Average check size decreased by 38 percent year-over-year to \$31.7M per deal

Investment size (\$M) — No. of deals

Source: Deloitte analysis utilizing CB Insights data.

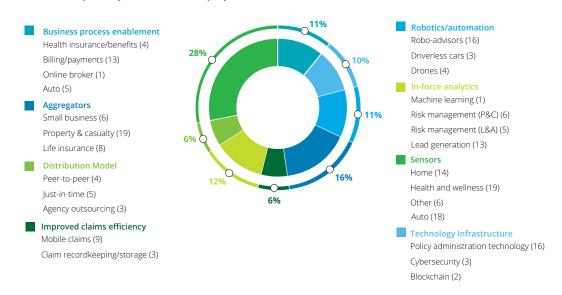
Several broad trends are driving a significant increase in the pace of technology innovation in insurance. Prominent examples include:

- Marketplace disruption. Insurers are rethinking products, coverages, risks, pricing, and services in response to dramatic marketplace changes that are impacting the businesses that commercial lines carriers have been covering for decades.
- **Broader generational divide**. Traditional and aging customers are being replaced by millennials, and these millennials interact with product and service providers in a nontraditional manner.
- **Elevated customer expectations**. Insurance customers' expectations are being shaped by (consumer) technology; they expect an omni-channel buying experience.
- Ineffective distribution models. Carrier and producer partnerships are no longer unique selling points as traditional models fail to resonate with modern consumers' expectations.
- **Need for operational improvements**. Insurance companies are making significant investments to support increased ease of doing business (for example, robotics, service clouds, analytics).
- **Outdated sales and marketing strategies**. Current strategies focus on small segments (that is, affluent consumers) and current methods are too costly to tap into underserved markets.

What types of exponential technologies are large insurers seeking to bridge current capabilities and emerging consumer expectations? Sensors, aggregators, and business process enablement have emerged as early standouts for insurer interest and innovator start-ups (Figure 11). Claims and underwriting solutions, potentially high-impact areas, have received less focus. And since insurers typically do not possess the in-house expertise to develop InsurTech solutions, they are either buying the technologies outright or investing in the innovative companies developing them. Hartford Steam Boiler (HSB), part of Munich Re, acquired Meshify, a startup company with technology that connects disconnected devices through the Industrial IoT (IoT). The acquisition "supports HSB's IoT strategy of providing services and technology to help businesses and insurers improve operations and prevent or reduce loss." Most large (re)insurers have set up InsurTech venture funds to make equity but non-controlling investments in company incubation and acceleration. Ventures (passive-to-active) investing is evolving into an M&A+ model that could alter an insurer's core business from a product- to services-based model.

Figure 11. InsurTech capabilities focus

Over 200 US-based InsurTech innovators have emerged over the past 24–36 months. Sensors and aggregators have seen the most startup activity and insurance company interest.



Source: Deloitte Bridge Database.

Bottom line

InsurTech M&A and venture funding transactions are likely to increase in both number and strategic significance over the next 24 to 36 months. Rather than adapting only current strategies to address short-term issues, organizations should also embrace and integrate exponential InsurTech capabilities. Both insurers and innovators have taken notice and begun to explore the use of exponential technologies that have the potential to transform their businesses. We can envision a day when these equity investments made through venture funding or other vehicles become significant enough that they influence the amount of capital available for outright acquisitions of insurance businesses.

Moving forward: How to identify and capitalize on 2017 insurance M&A opportunities

Our earlier-stated view that the second half of 2016 (versus the first half) will likely set the pace for 2017 activities is driven by a belief that industry fundamentals create an environment highly conducive to transactions, particularly in the P&C, brokerage, and InsurTech segments. Specifically, entering 2017:

- Organic growth remains exceptionally difficult to generate.
- A perceived pro-business administration and Congress, a regulatory softening, and a robust stock market should lead to continued investor confidence.
- The industry is awash in excess capital that is not earning a sufficient return.
- Interest rates, although up a quarter point from 2016, remain at historically low levels.
- Increasing scale is essential to enable the technology and capability investments needed to remain competitive.
- InsurTech innovators will have a disruptive impact, compounding the significant forces of change already reshaping the industry.
- There is intensifying interest in divesting non-core assets for both regulatory and competitive reasons.
- The insurance industry continues to become more global.

What should leading insurance organizations be doing to help identify and capitalize on M&A opportunities as they move forward in 2017?

Formulate an M&A strategy. After formulating an enterprise growth strategy, determine the role M&A will play in realizing that strategy and conduct target screening on companies in alignment with that strategy. If necessary, modify corporate structure to make it easier to raise capital to fund acquisitions.

Focus business portfolios. Divest assets no longer considered core and acquire or invest in InsurTech capabilities to improve back-office operations and meet evolving consumer expectations. Build a playbook around attractive properties and assign a valuation of what those properties will be worth.

Sellers: Be better prepared to market the assets identified for sale. Buyers' diligence process is more efficient and, thus, more likely to find any potential weaknesses in selling targets.

Buyers: Be disciplined in setting a payment ceiling

for a business or capability, especially since a shortage of high-quality targets and foreign buyers' willingness to pay a premium may drive sale prices to levels that cannot be justified. Be willing to walk away if the price becomes too rich.

Stay informed and stay the course. Remain engaged and informed as policy, tax, and other uncertainties are clarified over time. There will be a lot of quickly moving legislative activity in 2017, with the reforms discussed in this paper likely to remain the subject of debate for many months. Company executives will need to evaluate how all five marketplace drivers and trends impact their ability to execute their enterprise growth strategy and then adjust their M&A strategies accordingly.

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