The Role Actuaries Play in Mergers & Acquisitions

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Due Diligence Issues

- Balance Sheet
- Operational Profitability
- Risk to Franchise

The Actuary should play a role in all of these areas!!

Balance Sheet Issues

- Capital adequacy
- Adequacy of loss and LAE reserves
- Quality of reinsurance
- Loss receivables
- Financial management/controls

Operational Profitability Issues

- Strategic and business plans
- Business development
- Underwriting (including risk selection, product, pricing, application of coverage)
- Claims management and reserving
- Rate adequacy
- Expense management
- Performance monitoring

Franchise Issues

- Latent or emerging exposures
- Exposure concentration/catastrophe management
- Technology to support operations and financial requirements
- Regulatory compliance
- Retention of key personnel

Nature of Due Diligence

- Buyer-driven or seller-driven
- Projections based on historical premium, loss, expense experience
- Going beyond the numbers to assess operational issues
- Because each transaction is unique, due diligence must be tailored to the situation

Spectrum of Due Diligence

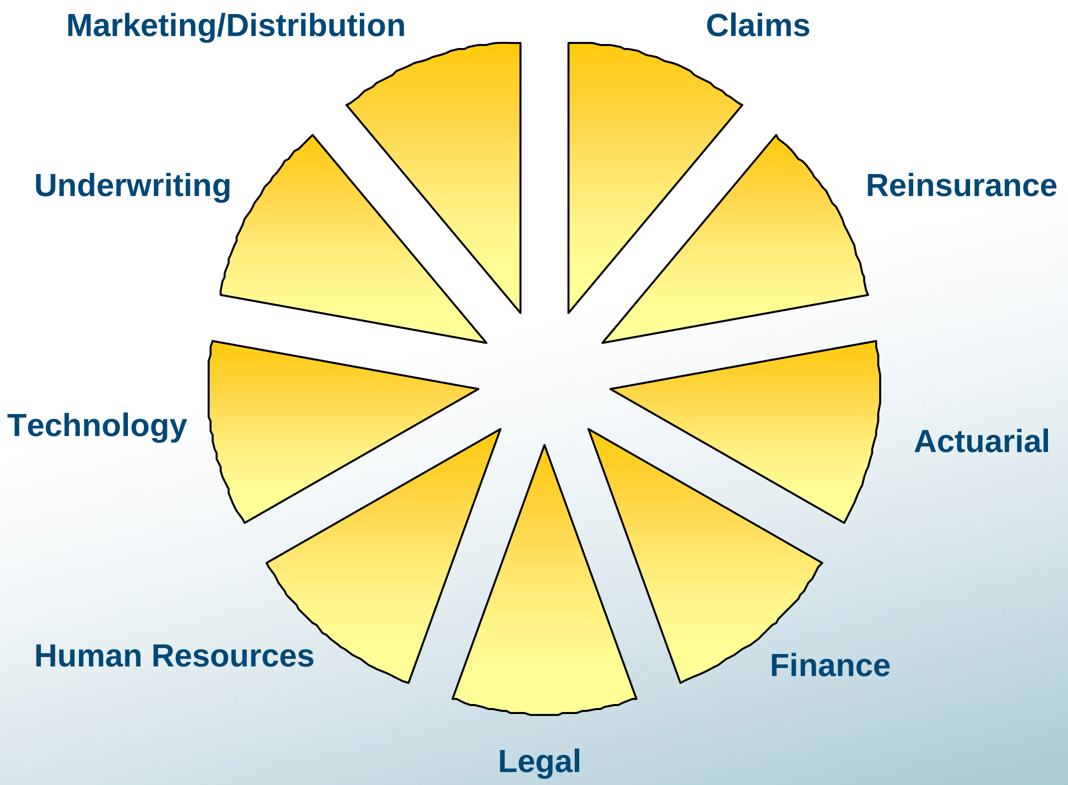
- Financial
- Single state/terr
- Single line
- Few classes (homogeneous)

- Strategy
- Countrywide
- All lines
- Many classes (heterogeneous)

Optimal Approach

- Multi-disciplinary
- Team of technical experts with executive/managerial experience
- Coordination among disciplines
- Continuous feedback to client

Multidisciplinary Approach



Case Study #1

BUYER - financial group with multiple insurance company investments

SELLER - privately held national carrier writing EQ and wind cover

Seller approached Buyer seeking an investment partner to finance a management buy-out of the company with ultimate goal of taking the company public.

Buyer conducted due diligence before proceeding.

Case Study #1 - Key Issues

- Buyer focused on strategic business plan to understand potential for growth and profitability
- Underwriting (including risk selection, product, CAT modeling and pricing)
- Claims management (recently brought in-house)
- Actuarial review found loss and LAE reserves adequate
- Appropriate CAT reinsurance structure supported by cost/benefit analysis
- Regulatory support for transaction

OUTCOME: Transaction proceeded

Case Study #2

BUYER - large publicly held national multi-line writer

TARGET - medium-sized publicly held regional multi-line writer

Target wrote primarily middle-market personal and commercial lines business produced by independent agents. Target was having difficulty differentiating itself, had been losing market share and results had been deteriorating.

Buyer saw a growth opportunity in acquiring Target.

Transaction was directed by an investment banker working on behalf of Buyer.

Case Study #2 - Key Issues

- Company indicated that contractor business no longer written. Underwriting review discovered otherwise.
- Asbestos exposures surfaced from an old assumed reinsurance program
- Multiple IT systems (from a prior merger) that had not been integrated
- Loss and LAE reserves carried at the low end of the actuarial range.

OUTCOME: Buyer walked

Case Study #3

SELLER - small privately held single state, mono-line carrier

BUYER - regional multi-line carrier

Buyer approached Seller stating their interest in acquiring them. Initial offer of 1.0 x book value.

Seller was very interested but felt they needed help prior to proceeding.

Case Study #3 - Key Issues

- Review found weaknesses in claim investigation that were easily addressed
- Lacked price monitoring system; subsequently implemented to better price risks
- Independent actuarial review supported level of reserves projected by in-house actuary
- Implemented actions to retain key personnel

OUTCOME: Transaction proceeded at 1.2 x book

Case Study #4

BUYER – private equity fund with insurance specialty

TARGET - countrywide multi-line carrier

The target (X) was a company that was formed from a prior merger of A and B. A & B had different case reserving philosophies prior to merger (A = Probable Ultimate; B = Stairstep). Merged X took on the philosophy of A.

Buyer requested full scope due diligence review.

Case Study #4 - Key Issues

- X actuaries assumed that the conversion to the “probable ultimate” case reserving philosophy had been implemented throughout the organization; therefore, old A development patterns were applied to consolidated losses to project ultimates
- Claim review revealed that many of the old B claims offices were still “stair stepping”; thus, use of old A development patterns understated ultimates

OUTCOME: Transaction proceeded with a large adjustment to surplus of X

“Skeletons in the Closet”

- Underwriting of problematic exposures
- Inadequately prices business
- Mass torts or emerging claim trends
- Changes in claims handling/reserving
- Lack of compliance with filed rates and underwriting programs
- Improper loss ratio and loss reserve assumptions
- Lack of franchise product (vs. commodity)
- Uncollectible reinsurance
- Over reliance on key personnel

Due Diligence Keys to Success

- Acknowledge that all deals have skeletons
- Find and address critical ones
- Place emphasis on post-deal integration
- Beware of shortcuts
- Use caution - at times the right decision is “no deal”
- Actuaries need to be involved in all aspects of due diligence so that their quantitative reviews reflect appropriate qualitative factors.