



**M&A due diligence:  
the role an actuarial  
advisor plays**

September 15, 2011

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**Merger and acquisition (M&A) defined**

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**Merger:**

- ▶ "Combination of equals"
- ▶ Friendly "deal" between two companies

*Examples: Max Capital Group and Harbor Point Limited, March 2010  
Allied World Assurance Holdings and Transatlantic Holdings, Inc.,  
June 2011*

**Acquisition:**

- ▶ One company takes over another (or another's book of business) and is new owner

*Examples: Hanover Insurance Group acquired Chaucer Holdings Plc, April 2011  
Virginia Farm Bureau Insurance Group acquired Countryway Insurance  
Company, May 2011*

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**Purpose of the M or A**

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**1 + 1 = 3**

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## What does due diligence (DD) mean?

According to Dictionary.com:

*"The care that a prudent person might be expected to exercise in the examination and evaluation of risks affecting a business transaction."*

Source: <http://dictionary.reference.com/browse/due+diligence>

According to Investopedia:

*"An investigation or audit of a potential investment. Due diligence serves to confirm all material facts in regards to a sale."*

Source: <http://www.investopedia.com/terms/d/duediligence.asp>

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## What are the key risks that an actuarial advisor evaluates in DD?

1. Balance sheet risk
2. Income statement risk

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## Balance sheet risks

Affect the value or solvency of the target at the specific evaluation date

1. Adequacy of recorded loss and LAE reserves
2. Variability in the reserves
3. Exposure to latent liabilities (any "skeletons in the closet")
4. Adequacy of recorded unearned premium reserves
5. Reinsurance collectability
6. Adequacy of profit commissions receivable (payable) under sliding scale contracts
7. Others

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## Income statement risks

Affect the quality of historical earnings and/or expected future earnings

1. Reserving process, methods and assumptions
2. Pricing
3. Underwriting
4. Claims handling
5. Exposure to CATs or large losses
6. Others

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## Actuarial roadmap to DD How do actuarial advisors perform DD?

1. Review publicly available information
2. Scope assignment
3. Request data/information
4. Attend management presentations/meetings
5. Catalogue and monitor data room
6. Perform procedures agreed to in scope
7. Document findings

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## Actuarial roadmap to DD Public information

First step is to read publicly available information about the target to obtain a general understanding of the target's business

- ▶ A.M. Best Reports
- ▶ Target website
- ▶ 10-K, if applicable
- ▶ Annual statements over historical period
- ▶ Statement of Actuarial Opinion (SAO) over historical period
- ▶ Search engines: target in the news
- ▶ Other

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## Actuarial roadmap to DD

### Scope

Next step is to scope out the work performed. This is heavily dependent on:

- ▶ The amount of time permitted
- ▶ Your client's key concerns
- ▶ The phase of diligence your client is in
- ▶ Availability of information
- ▶ Target's business and sufficiency of procedures performed by the target
- ▶ Access to target management and its actuarial advisors

The scope will generally include some level of due diligence on one or more of the following areas:

- ▶ Reserve adequacy and methodology
- ▶ Pricing and underwriting process, including CAT management
- ▶ Claims function and processes
- ▶ Assessment of reinsurance coverage

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## Actuarial roadmap to DD

### Request data or information

Provide a list of information or data needed. A broad list is as follows:

- ▶ Actuarial reports supporting the SAO over the historical period
- ▶ Actuarial opinion summaries over the historical period
- ▶ Any third-party actuarial reports on the loss and LAE reserves, in addition to the aforementioned
- ▶ Price monitoring or pricing adequacy reports over the historical period
- ▶ Pricing studies
- ▶ Qualitative and quantitative support for management's best estimate over the historical period
- ▶ Copies of third-party administrative agreements over the historical period, to the extent they exist
- ▶ Summary of the target's reinsurance coverage, including carriers, limits and layers by policy
- ▶ Etc.

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## Actuarial roadmap to DD

### Management presentations and meetings

- ▶ Management will generally hold a presentation for the buyer providing the history of the company and highlights
- ▶ Request to hold break-out meetings with management in the areas of actuarial, claims, underwriting and reinsurance
- ▶ Be prepared to ask questions based on a review of public information and information requested — you set the agenda

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## Actuarial roadmap to DD

### Catalogue and monitor data room

- ▶ Generally target will retain a third party to securely house financial information and other data about the company requested by buyers
- ▶ The third party data room will be the source for actuarial data
- ▶ The actuary should catalogue the information contained in the data room and check back often for updates

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## Actuarial roadmap to DD

### Perform procedures

- ▶ Each transaction is unique, and DD procedures should be tailored to the situation
- ▶ Varies from performing a review of company or third-party analyses to performing comprehensive, independent projections

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## Actuarial roadmap to DD

### Document findings

- ▶ Document findings with respect to the **risks** identified and your assessment of the relevant **facts** (e.g., recorded reserves)
- ▶ Clearly articulate findings so that a non-actuary can understand

*Don't just state the issue, quantify the impact.*

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## War stories

### Example #1

- ▶ Client looking to acquire another insurer to expand geographic footprint
- ▶ EY actuaries retained to perform actuarial diligence
- ▶ Client's concern focused on pricing due to high loss ratios (in the 70s)
- ▶ Client believed it could obtain synergies and reduce expense ratio (in the 40s)
- ▶ Deal went through

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## War stories

### Example #2

- ▶ PE firm looking to make an investment in an insurance company
- ▶ Retained to perform actuarial diligence
- ▶ Expanded to diligence of claims operations due to significant changes in claims handling uncovered during actuarial review
- ▶ Company growing in a line where the market was very uncertain and other carriers were pulling out
- ▶ Independent tests indicated reserve deficiency and implied that the target's plan loss ratios were low
- ▶ PE firm walked away from the deal
- ▶ Target eventually bought out by larger company

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## Conclusion

- ▶ You never know what the buyer's decision will be
- ▶ Provide unbiased facts, findings and observations about the risks
- ▶ Quantify the impact

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