

## Hitting the right targets

How insurers are optimizing their capital strategies  
and what this means for the M&A market

Many insurers are on the ropes. Heavy blows from stricter regulation, low growth and increased competition have landed hard. Now is the time to come out fighting. A robust capital optimization plan and clear M&A strategy can increase efficiencies and build growth. That's a winning combination that can knock out your opponents.

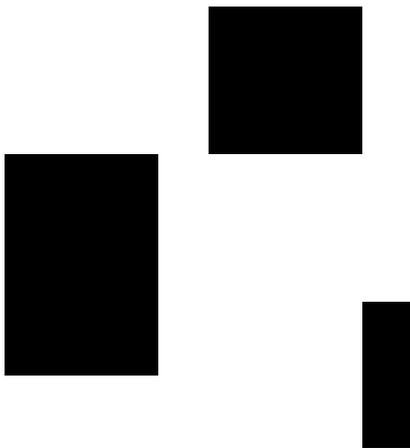


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# Foreword

We are delighted to introduce the latest Willis Towers Watson insurance industry survey, published in association with Mergermarket. In this edition, the focus is on not only M&A trends but also the capital optimization strategies that insurers are pursuing against a challenging economic and political backdrop.

The current low-yield environment means insurers will continue to prioritize higher-risk, higher-return assets. There will be an incentive to invest in alternative assets in the search for higher returns, until interest rates rise meaningfully.

Another important capital optimization strategy will be the divestment of capital-intensive businesses or divisions that are difficult to scale up due to competition. This is most pronounced in the annuities market, where huge closed books are likely to be sold as some of the industry's largest names seek to streamline their operations and refine their strategies.

After 2015 – a year in which insurance deals defied gravity – M&A activity came back down to earth last year. However, we anticipate robust activity for the remainder of 2017 after a solid first half year. In addition, the majority of respondents tell us that they intend to engage in M&A over the next three years. While there is a dip compared with those that acquired in the past three years, this is in the context of heightened political uncertainty and follows a record-breaking 12 months for deals in 2015.

Serial acquirers intend to continue to build through buying and, broadly speaking, they plan to sustain similar levels of activity as they have done in the recent past. This suggests that their past deals have created the value they set out to achieve.

Our survey shows that while revenue and financial synergies continue to be a strong motivator for acquisitions, as expected given persistent cost pressures and low growth, insurers

are prioritizing brand building when seeking new deals. This comes as they face greater competition from fleet-footed market entrants armed with proprietary technology and alternative capital providers, as well as the continued disintermediation and distance from consumers created by online aggregators.

These pressures will motivate insurers to seek out new deals and this should serve as a clarion call to those that have been sitting on the sidelines. Early M&A activity so far this year suggests that, while it is unlikely 2015's record will be bested, 2017 should be a marked improvement on 2016 – particularly in value terms.

# Executive summary

The insurance sector witnessed a marked drop in M&A deal value in 2016. However, looking ahead, we expect a healthy level of activity skewed towards the larger end of the market. Macroeconomic, demographic and regulatory pressures persist and this means that not only is a carefully planned M&A strategy more important than ever, so too are effective capital optimization strategies. With this in mind, we have identified the following themes from our survey results:

## Alternative optimization

Over the next three years, more than three-quarters of insurers expect to increase their exposure to alternative assets as a means of optimizing their capital. The liquidity premium that alternatives offer is an opportunity for insurers to achieve the high returns that are lacking in more traditional investment markets. However, the illiquidity of these assets means that firms will have to carefully manage their portfolios in order to match their liabilities with more liquid assets they can trade to meet claims.

## Competition concerns

Insurers say that their top concern is competition within the sector. While incumbents have been comparatively slow to adopt technology, insurtechs (fintechs that target the insurance sector), are shaking up the industry. Their low-cost, data-rich business models are effectively targeting niche product lines. Alternative capital vehicles that securitize policies are also common. This has created a soft market that benefits consumers, giving them more options at lower prices.

## Fewer, larger deals

Our survey shows a dip in the number of firms that anticipate doing a deal in future against those that have done a deal in the past three years. This suggests a focus on larger deals in 2017. Firms may not be as acquisitive as they were, but we expect to see a robust pipeline that is biased towards larger transactions and megadeals.

## Serial acquirers on the hunt

Despite this modest decline in M&A, serial acquirers are committed to dealmaking and aim to continue their pace of activity. With organic growth all but absent and technology disrupting the entire financial services sector, M&A will be the key to expansion. Developing internal

capabilities and external networks to sustain a successful M&A strategy have never been more important.

## The call of emerging markets

There is a modest increase in the number of insurers that expect to do deals in emerging markets in the next six years compared with the next three years. A growing emphasis on these markets is to be expected given the low growth and interest rates seen in the US and Europe. The under-invested emerging Asia region is seen as the most attractive region for future deals.

## Methodology

**In the summer of 2017, Mergermarket surveyed 200 senior-level executives in the insurance industry. Forty-two percent of those surveyed work predominantly in the Life sector, 42% work in the Property and Casualty (P&C) sector and 16% work in the Reinsurance sector. The companies involved were split equally across the Americas, Asia and EMEA regions.**

**The survey included a combination of qualitative and quantitative questions, and all interviews were conducted over the telephone by appointment. Results were analyzed and collated by Mergermarket and Willis Towers Watson, and all responses are anonymized and presented in aggregate.**

	EMEA	Americas	Asia-Pacific	Total
Life	28	29	28	85
P&C	29	28	28	85
Reinsurance	10	10	10	30
<b>Total</b>	<b>67</b>	<b>67</b>	<b>66</b>	<b>200</b>

# Chapter 1

## Capital gains

Low growth, strict regulations, greater competition and slowing demand have all backed insurers into a corner. Now more than ever, a robust capital optimization strategy is a must.

The global insurance industry faces considerable challenges. The decade since the financial crisis has been characterized by low-growth macroeconomic conditions in developed markets. Weaker demand and wage stagnation has meant that premium growth in the industry has been subdued as policies, particularly in property & casualty (P&C), typically grow in line with GDP. Demand for insurance products is also shifting in lockstep with demographics. Millennials are relatively underinsured, compared with previous generations, from P&C to travel and even health insurance. A recent Gallup poll estimates that 19% of millennial men in the US don't have health insurance – nearly double the 11.3% national average.

This is compounded by pricing pressures, due in part to a lack of major catastrophes, which drive rate rises in commercial insurance and reinsurance. Alternative capital has also entered the reinsurance space in recent years, creating competitive pricing tension.

Persistently low interest rates designed to stimulate inflation and growth have presented a particular burden for insurers. The low-yield environment means investment portfolios have underperformed, weighing down company profits.

The renewed focus of regulators on risk mitigation has also encumbered insurers. Solvency II rules have extended beyond the European Union (EU) to global systemically important insurers (G-SIIs) under the instruction of the International Association of Insurance Supervisors (IAIS). All of this comes at a financial cost.

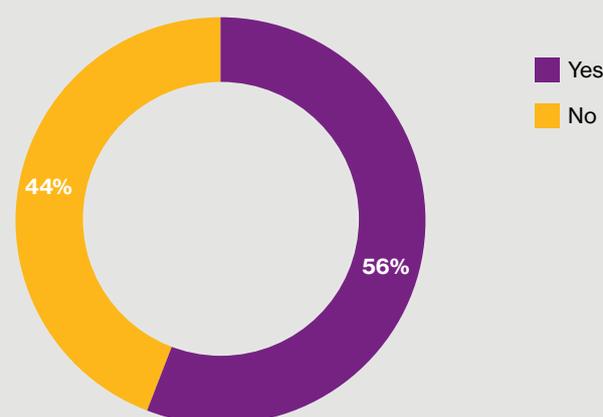
Less developed insurance markets, such as those in Asia-Pacific, are taking their own approaches to regulation and risk management. Regulators have made efforts to harmonize risk-based capital frameworks in the region. Insurers in major markets such as China have looked to developed markets to

learn from their experience, with the introduction in 2015 of the China Risk Oriented Solvency System (C-ROSS).

“In several markets, there is still a Solvency I-type regime and those are moving towards risk-based capital. Asia may be doing this slightly later than other regions but Thailand has already done it. Hong Kong is moving to a risk-based capital regime by 2021. South Korea is also doing that,” says Kevin Angelini, APAC strategy leader at Willis Towers Watson.

Despite this rather bleak backdrop, insurance companies have been able to weather the storm, in large part owing to carefully managed capital optimization

Figure 1: Over the last three years, has your firm had a capital optimization strategy in place?



strategies. For 56% of respondents in our survey, a capital strategy has been in place over the last three years, with the three primary motives being: to meet regulatory capital requirements, counterbalance increasing costs and prepare for global economic volatility.

“Companies increasingly recognize the critical importance of a capital management strategy,” says Fergal O’Shea, EMEA life insurance M&A leader at Willis Towers Watson. “Capital management interacts with so many fundamental aspects of an insurer’s business – risk management, product design and pricing, reinsurance, investments, actuarial, and investor relations.”

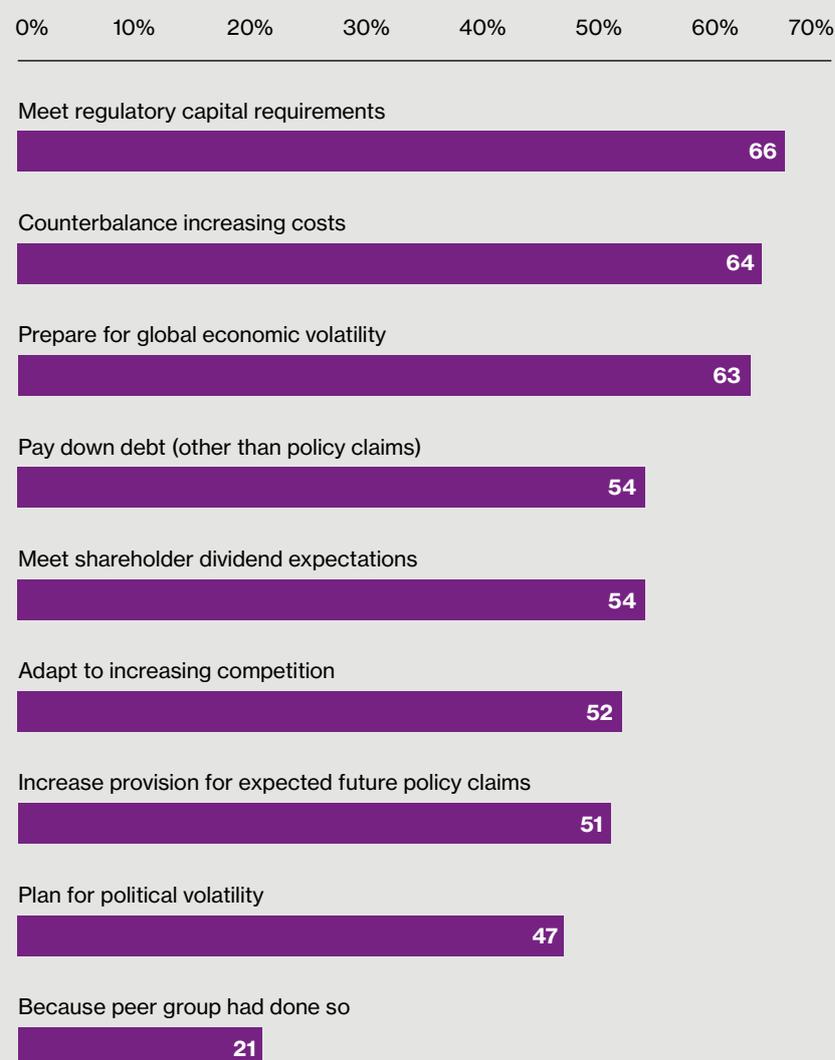
### New directions

In today’s low-yield environment, alternative assets such as private equity (PE) and real estate promise higher returns than mainstream equities and fixed income – the latter offering especially weak returns in recent years due to low interest rates. This is illustrated by data from New England Asset Management which shows that the US insurance industry has doubled its allocation to such alternative investment products from US\$141bn to US\$304bn in the past 10 years.

Similarly, the most popular capital optimization strategy has been to change strategic asset allocation to increase holdings of alternative assets. More than three-quarters of respondents intend to do the same over the next three years.

“Insurers face significant challenges in achieving the returns that they were once used to. Insurers from countries with particularly low growth are looking to do deals overseas to have better access to those investment markets because of the challenges in achieving competitive returns on their equity via local investments,” says Joseph Milicia, P&C M&A Practice Leader for the Americas, Willis Towers Watson.

Figure 2: **What were the drivers for initiating the use of a capital optimization strategy? (Select all that apply)**



*“Companies increasingly recognize the critical importance of a capital management strategy. Capital management interacts with so many fundamental aspects of an insurer’s business – risk management, product design and pricing, reinsurance, investments, actuarial, and investor relations.”*

**Fergal O’Shea, Willis Towers Watson**

Figure 3: Which of the following have you initiated in the last three years? And which do you intend to initiate over the next three years? (Select all that apply)



“When you consider the lower than historical GDP growth rates in the US and Europe, there is an incentive to seek out opportunities for growth such as in emerging Asian and Latin American markets. Meanwhile, the US remains attractive to Chinese buyers as equity markets are relatively more stable. Japanese buyers may also see the US as attractive, as the projected growth of the US economy in the long term is fairly high when compared to projected contraction of the Japanese economy,” he adds.

More than half (52%) of respondents in our survey say they have reduced exposure to capital-intensive products/ increased exposure to less capital-intensive products, while 65% intend to do so over the next three years.

Many insurers have sold off the annuity component of their product offerings in recent years due to regulatory capital requirements making the business less profitable. Meanwhile, many are leveraging the in-house expertise required to effectively manage their own investment portfolios by expanding into the asset management industry – a strategy that offers low margins but at little cost.

The operational proximity of these two sectors is illustrated by two mega mergers in 2017: the tie-up of Prudential’s European insurance business with its UK asset management arm M&G to create MG Prudential; and the consolidation of Standard Life and Aberdeen Asset Management.

### Taking the lead

When it comes to designing and executing the firm’s capital management strategies, most respondents cite the investment department (80%) or the risk management department (79%) as most often involved, alongside other departments.



However, when asked which single department takes primary responsibility for this task, 44% of respondents claim that the capital management department takes the lead, followed by the investment department (22%).

Respondents are clear that effective capital management depends on the co-ordination and clear division of responsibilities between different departments. As the CFO of a Chinese Life insurer says: “This strategy is managed by the capital management team, but the strategy itself is developed by the management and the financial teams after thoroughly analyzing the needs of the company.”

### Trapped capital

Given the weight of risk mitigating regulation that has been introduced post-crisis, it is not entirely surprising that regulatory capital is reported most commonly (42%) as the most onerous capital standard.

Regulatory capital requirements complicate matters for many operators – as the chief investment officer at one Life insurance provider in Malaysia says: “The current economic capital standards put a lot of focus on setting aside capital.

Figure 4: **Who has responsibility for designing and executing the capital management strategy? (Select all that apply)**

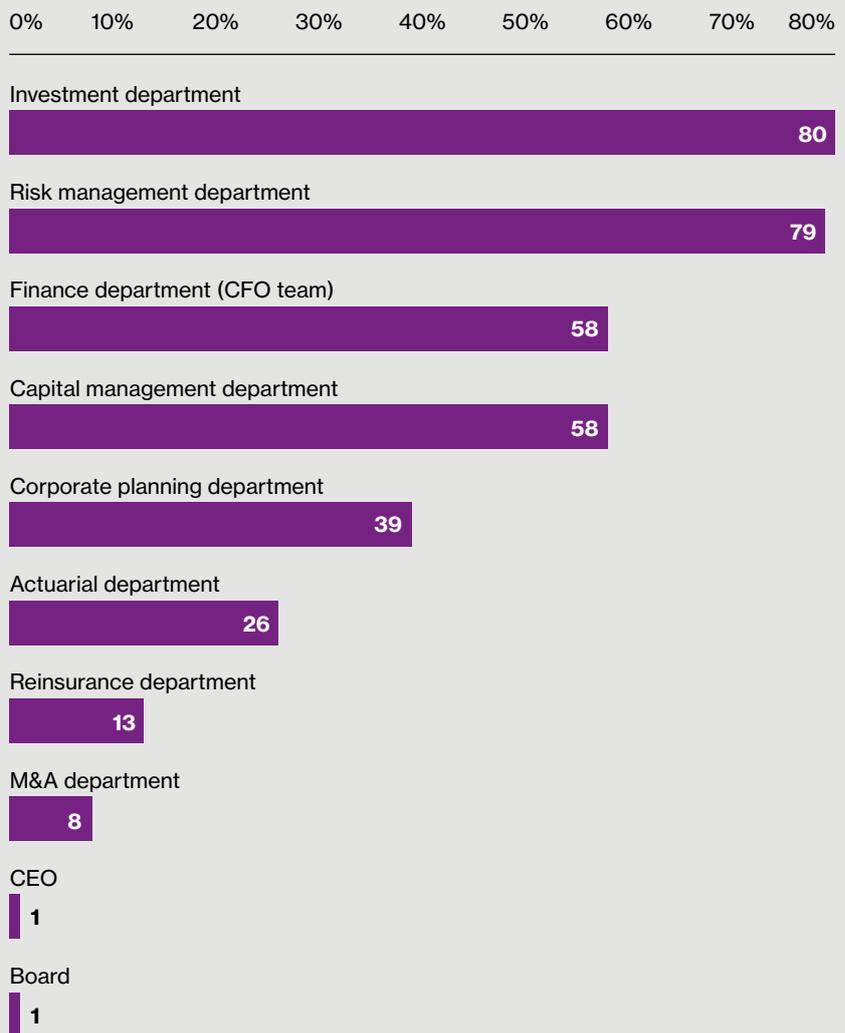


Figure 5: **Aside from capital standards, are there other restrictions or limitations on your firm's ability to distribute or re-deploy surplus capital? (Select all that apply)**

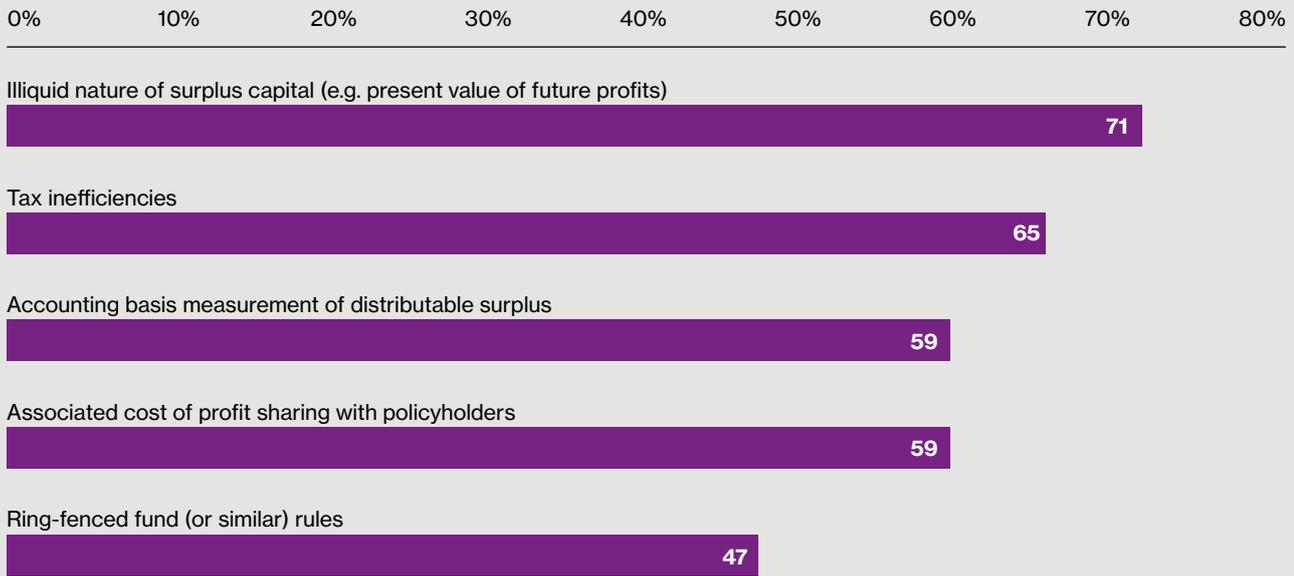


Figure 6: **What was your top use of capital three years ago? What is your top use of capital now? What will your top use of capital be three years from now?**

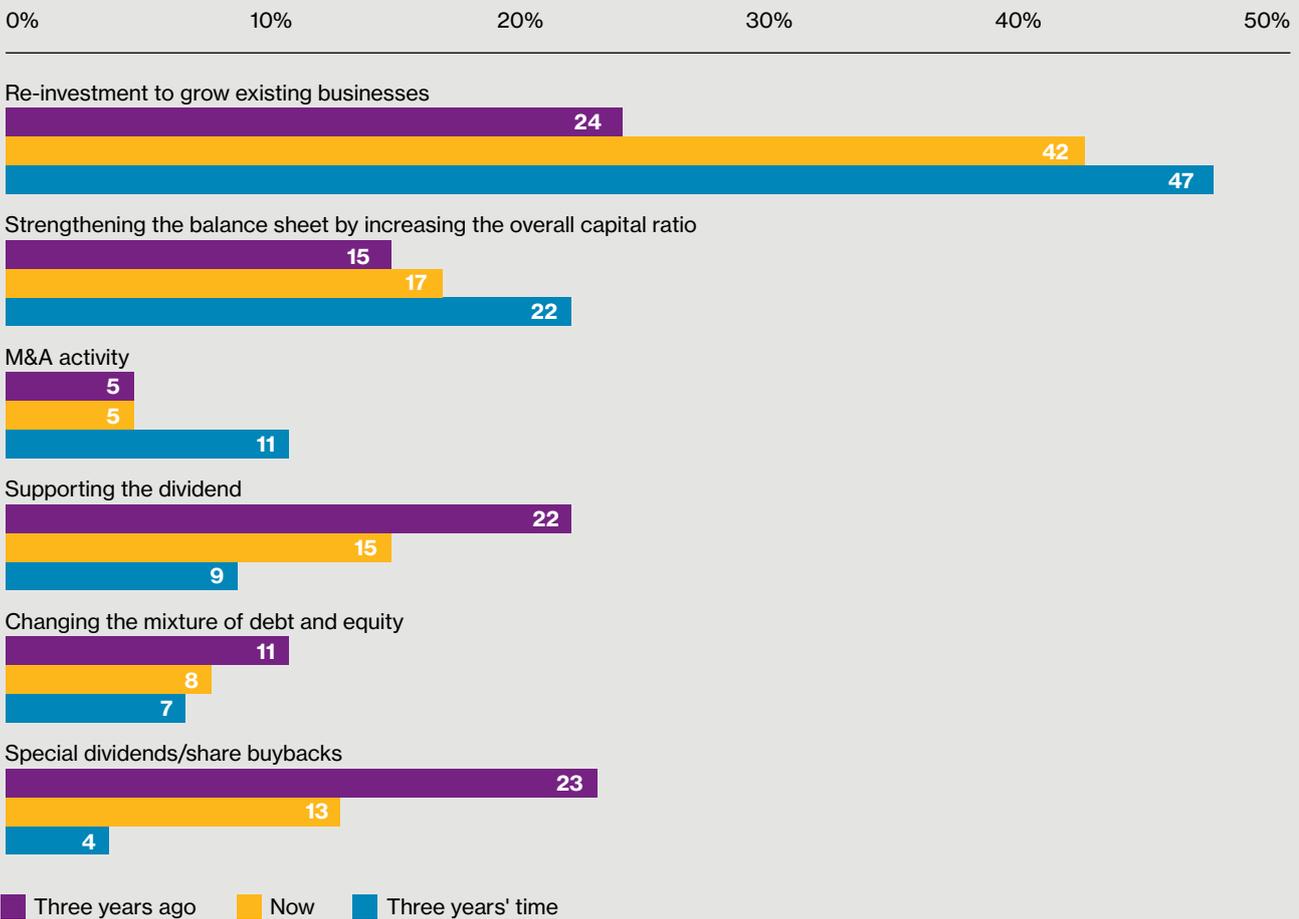
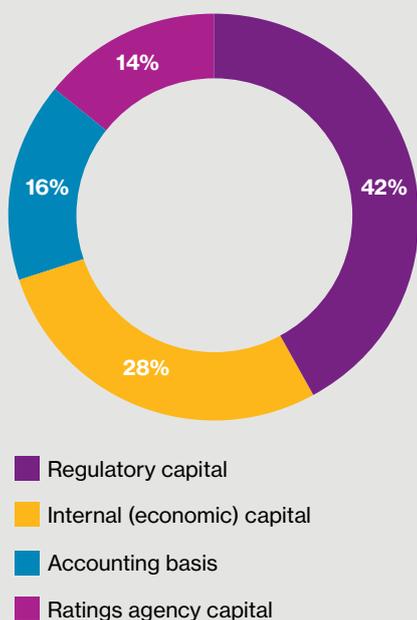


Figure 7: **Who has responsibility for designing and executing the capital management strategy? (Select most important)**



Figure 8: **Which capital standard is the most onerous for your firm? (Select one)**



Differences in market regulations further increase the need to put aside large capital amounts.”

Aside from the burden of various capital standards, 71% say the illiquid nature of surplus capital limits their ability to re-deploy or distribute surplus capital, while 65% say tax inefficiencies restrict the use of capital.

Sound portfolio management depends on judging and balancing risk-return profiles and the asset mix. In a high interest rate environment, firms are more likely to have a higher proportion of their surplus capital invested in fixed income instruments such as bonds, which are highly liquid.

In the persistent low-yield environment of recent years, however, insurers are incentivized to put their capital into assets such as private equity, which promises a higher return but at a cost of having capital locked up – the liquidity premium.

“Companies are focusing more on lowering the “frictional costs” that reduce the ratio of distributable profits to earned profits, which also helps to deliver a clearer picture of the relationship between performance and returns to shareholders,” says O’Shea.

### Back in business

The positive news is that, after years spent retreating in the face of heightened regulatory scrutiny, firms are growing more confident and looking to expand their operations.

Forty-two percent say that re-investment to grow the business is their top use of capital, nearly double those that say reinvesting was a top use of capital three years ago (24%). This trend also looks set to continue, with 47% stating that it will be among their top three uses in the next three years.

“We’re investing our capital to fund our expansionary goals,” says the head of finance at an Australian Life insurer.

“Currently, we are seeking out ways to bring in capital to invest in crucial areas of the company and to boost returns. In the next three years, we hope to own a larger share of the market and will try to expand by merging with partners to increase the value of the business and to expand efficiently.”

Bolstering finances will continue to be an area of focus for the industry in future. For 17% of respondents, strengthening the balance sheet by increasing the overall capital ratio is their top use of capital, rising to 22% when looking three years ahead. This underlines the balance that firms are attempting to strike between growing their businesses and remaining financially robust.

“Our plans include strengthening our balance sheets to increase the overall capital ratio and to reduce debt. We want to increase the value of the company and become compliant under Solvency II regulations by altering our investment process, to make sure we do not lose our rating,” says the chief financial officer of a Finland-based Life insurer. “We will continue to focus on increasing the value of our balance sheets and will reinvest our capital in our business to enhance growth.”

Perhaps somewhat surprisingly, dividends appear to have been surpassed as a priority for insurers. The percentage of respondents who say supporting the dividend was a priority use of capital three years ago is 22%; this falls to 15% in terms of current top use of capital and drops further, to 9%, for those saying it will be the top use of capital three years from now.



While the focus on shareholder pay-outs appears to be decreasing somewhat, for some this strategy will remain a prime concern, particularly among those insurance companies hoping to draw investor interest where share prices have been depressed despite sustained growth and profitability.

The survey also demonstrates that there is a trend away from share buybacks. This is underscored by American International Group's (AIG) recent change of tack, slowing the pace at which it has been buying its own stock and instead spending on acquisitions under the stewardship of its new CEO, Brian Duperreault.

AIG was the target of activist shareholders led by billionaire Carl Icahn, prompting the firm to spend more than US\$18bn in buybacks as part of a turnaround plan.

"The likelihood we can continue the pace of share buybacks is low because there are other things I can use the money on. My job is to figure out the best use of the capital and I want a balance," Duperreault said earlier this year. "I'd love to find great additions to the company. I think the important thing is that we look at companies that can make us better."

"If you look over the past three years, firms have been focused internally on items such as improving their balance sheets and integrating previous deals," says Joseph Milicia. "Some are now turning their focus externally and looking for opportunities that will help them to grow."

One option to achieve that growth is through M&A. However, given the perfect storm of low premium growth, muted investment portfolio income

and regulatory capital pressures, insurers will have to be more selective than ever in seeking M&A targets.

This will require a clear rationale for any future deals – whether cost synergies, buying in technology and other intellectual property (IP), or moving into growth markets – and confidence in the anticipated return.

*"If you look over the past three years, firms have been focused internally on items such as improving their balance sheets and integrating previous deals. Some are now turning their focus externally and looking for opportunities that will help them to grow."*

**Joseph Milicia, Willis Towers Watson**

# The three Cs

## Costs, competition and capital requirements are the key challenges currently facing the insurance sector

Competition appears to be uppermost in insurance firms' minds – 40% of respondents say increased competition is one of the top three challenges facing the sector, including 18% who cite it as the top challenge.

This comes after a significant recent influx of alternative capital providers in the reinsurance space. Rather than taking policies with traditional reinsurance companies, primary insurers are turning to capital markets where dedicated funds securitize policies for the wider investor market. The majority of transactions related to alternative instruments are largely concentrated in the property catastrophe market in the US, which continues to grow.

This has put significant pressure on the traditional P&C reinsurers, according to Joseph Milicia.

“It's led to price competition to the point where, even if reinsurers are holding on to the accounts they're currently writing, if they were to renew 100%, they're likely to still see premium volume shrink,” he says. “We're also in a soft market: prices have dropped and there's more competition for the better risks. I do think we're seeing a more competitive environment.”

The threat of insurtechs (fintechs that specifically target the insurance

sector), while only just emerging, is very real. Insurers are relatively well insulated from competition posed by start-ups due to their deep capital reserves, years of underwriting experience and huge stores of proprietary data. However, innovative companies are now springing up in the sector, where incumbents have been slow to respond to digital disruption, relying instead on their scale and defensive market positions.

Clover Health became a “unicorn” (a start-up valued at more than US\$1bn) in May 2017 when Alphabet and others backed a US\$130m venture funding round that valued the data-led health profiling company at US\$1.2bn. Pay-per-mile auto insurer Metromile, meanwhile, raised US\$191.5m in September last year.

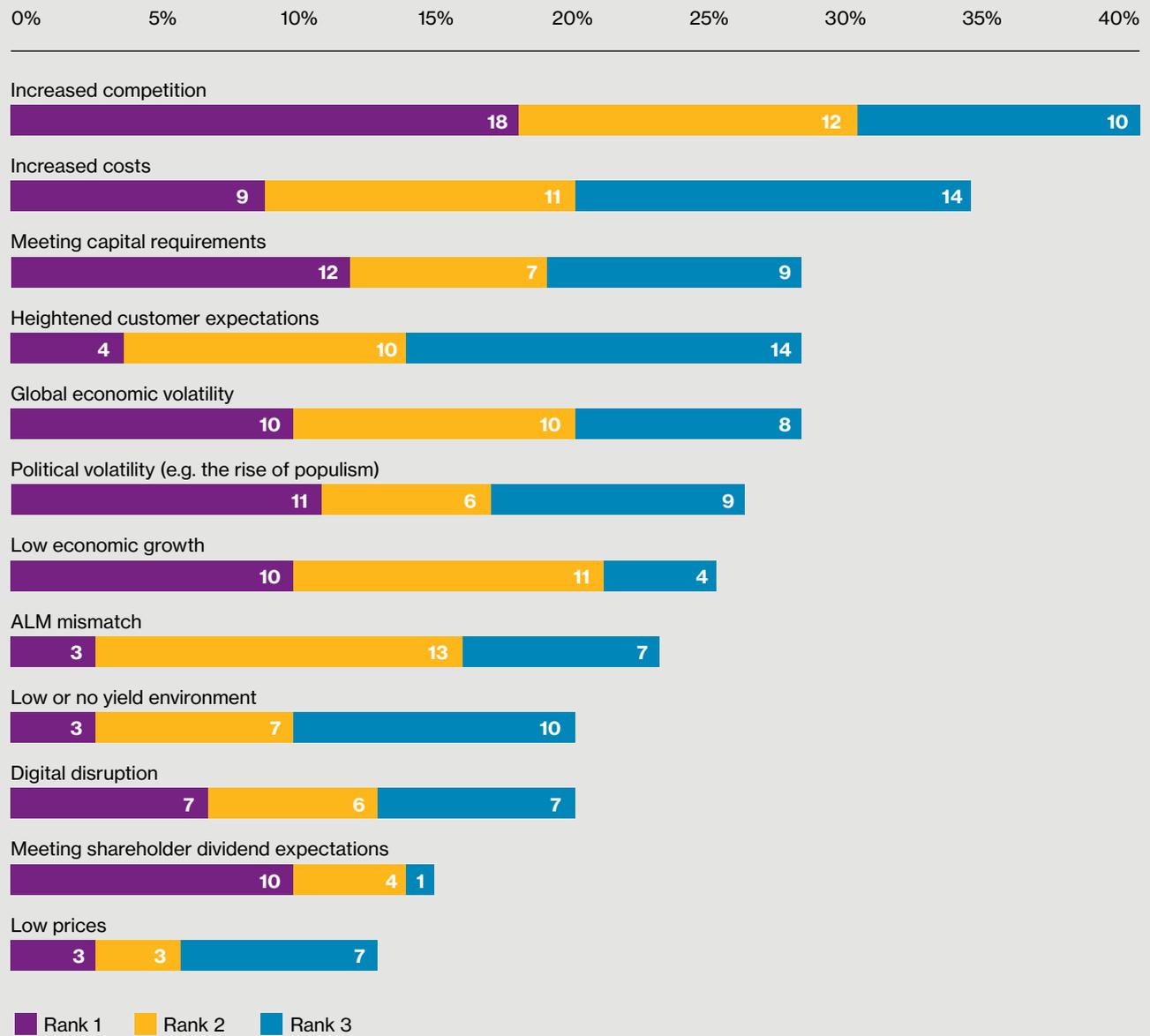
“Technology has led to potentially lower start-up costs. You can take on fewer staff and that lowers barriers to entry,” says Willis Towers Watson's Scott Spearman. “We're seeing specialist tech companies. They've got expertise in an area and then start offering insurance off the back of the data they're running analytics on.”

Aflac, the largest provider of supplemental insurance in the US, has also launched a venture arm, Aflac Corporate Ventures, in March 2017, looking to back insurtechs and other relevant start-ups.

Of course, no challenges exist in isolation. Increased costs is a top three challenge for 34% of respondents, and meeting capital requirements, heightened customer expectations and global economic volatility were each identified by 28% of respondents as top three challenges. Insurers have to balance the burden of increased regulatory capital requirements and competition at a time when many major economies are in a persistent phase of low growth.

“The major challenges are the high cost of doing business,” says the head of strategy at an Australian P&C insurer. “Regulatory issues have increased costs for our company. The state of the economy has slowed down growth rates and brought about uncertainty in markets where raising capital used to be relatively easy. It is not possible to generate revenues under these circumstances and trying to expand has become a major issue for our business.”

Figure 9: What are the key challenges currently facing the insurance sector?  
 (Rank the top three where 1= most important)



## Chapter 2: M&A

### Feel the quality

M&A in the insurance industry will be driven by the need to create synergies, build brands and tackle technological advances. However, as our survey shows, companies will be searching for quality over quantity.

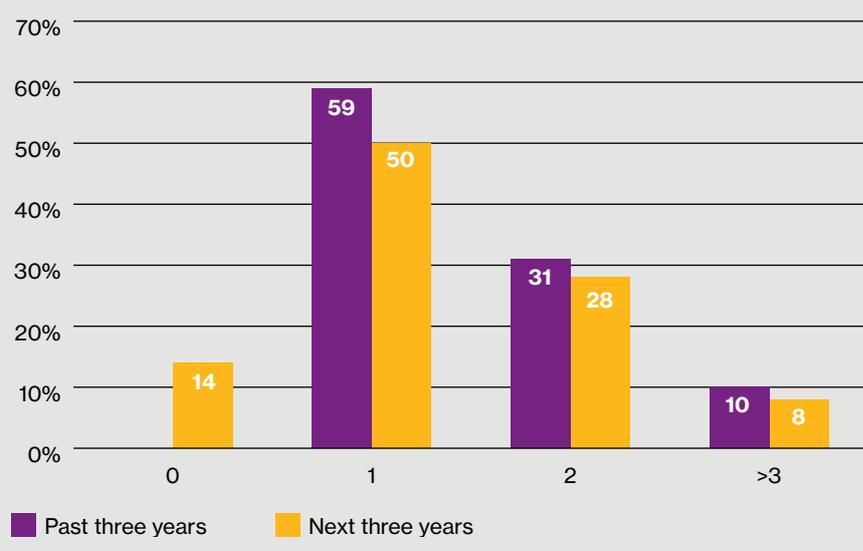
While M&A was seen as a key use of capital going forward (see Figure 6, page 8), the number of deals is likely to decrease in the next three years. The majority (78%) of respondents expect to undertake one to two purchases in the next three years, compared with 90% that have made one or two acquisitions in the past three years. However, it's important to put this into context.

At a time of heightened political uncertainty, fewer deals are being completed – but those that do complete are of a higher value. Mergermarket data shows that global deal value across all sectors increased by 8.4% in H1 2017 while volume sunk by 12.3%.

This trend is being replicated in the insurance sector. Year on year, deal volume has fallen by 17.7% from H1 2016, while value has increased by 170% over the same period.

This consolidation at the top of the market is prompting anti-competition authorities to block tabled deals. Earlier this year, US judges prevented both the US\$48bn merger between health insurers Anthem and Cigna, and the US\$34bn deal between Aetna and Humana on the basis that they would result in higher premiums for consumers.

Figure 10: **How many acquisitions has your firm undertaken in the past three years? And how many do you expect to undertake in the next three years?**



*“A number of companies have made large acquisitions in the past two years and have been in integration mode. Once that completes, they can turn from being internally focused back to M&A.”*

**Joseph Milicia, Willis Towers Watson**

Figure 11: Volume and value of global insurance M&A 2007–H1 2017

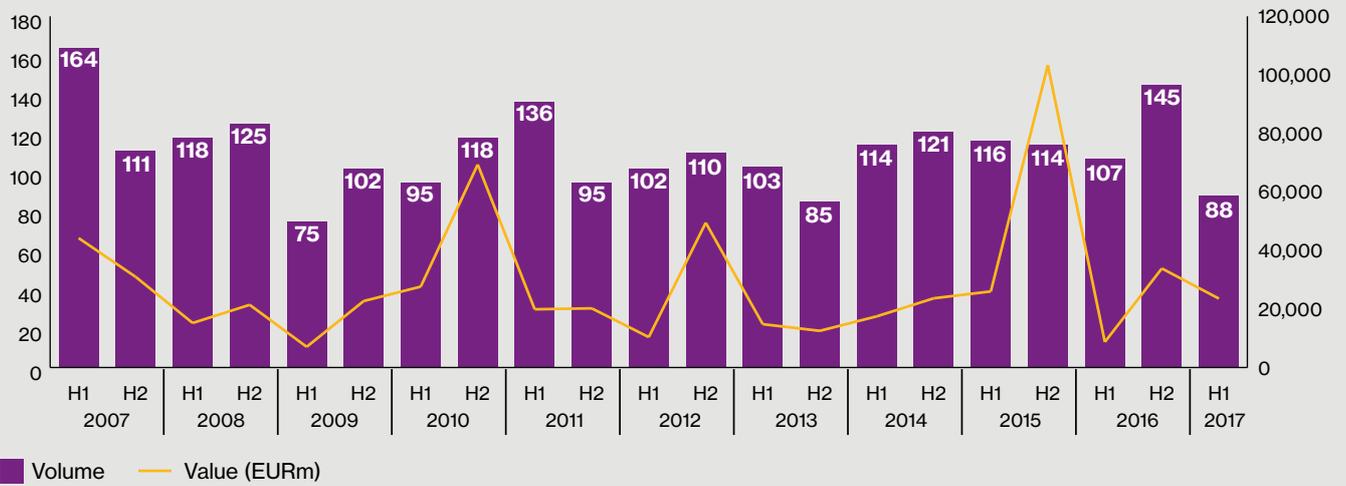


Figure 12: Global insurance M&A split by deal size 2007–H1 2017

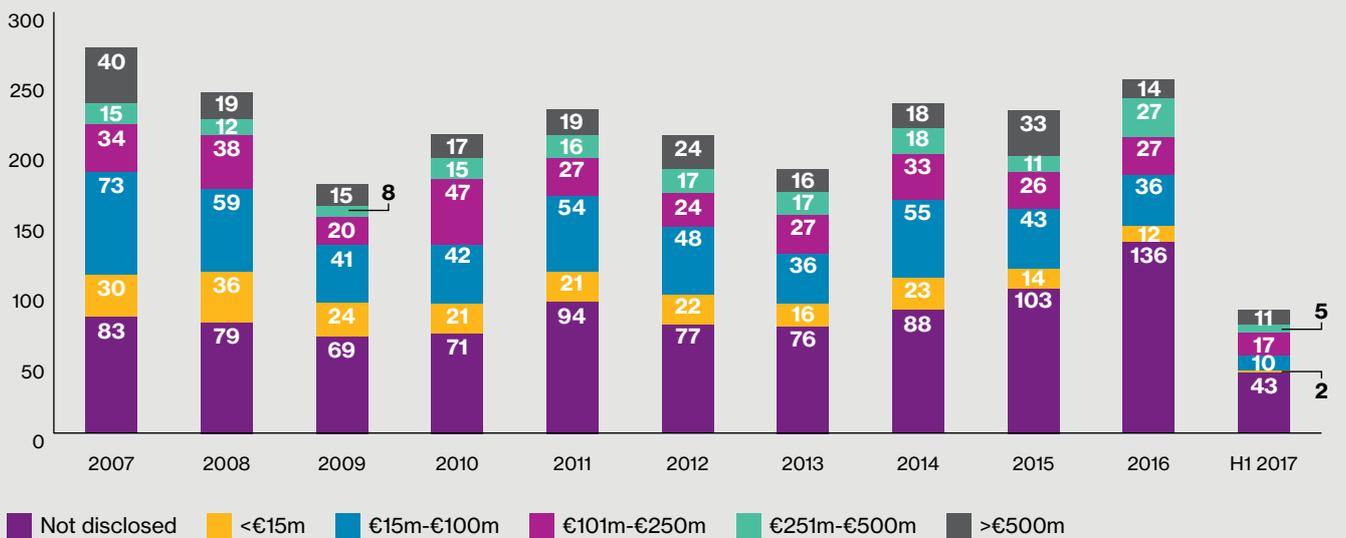


Figure 13: How many acquisitions in the past three years have been major deals (defined as an increase of at least 5% in overall revenues)? And how many are likely to be major deals over the next three years?

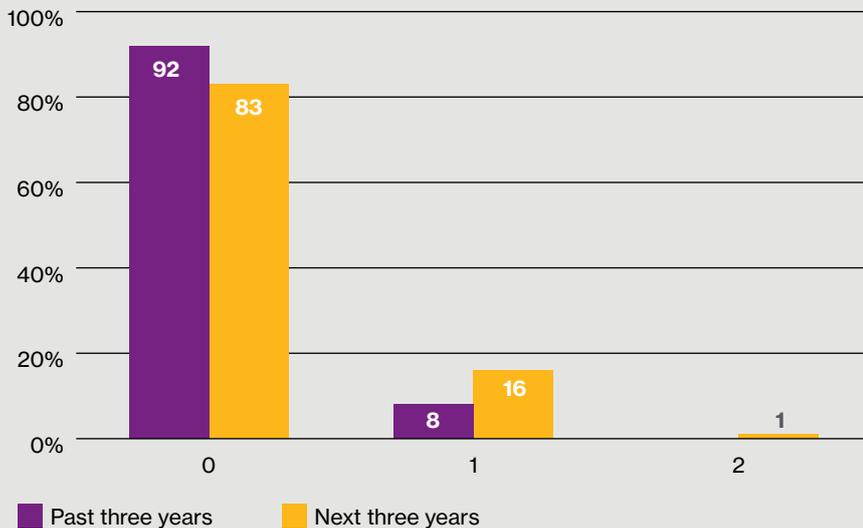
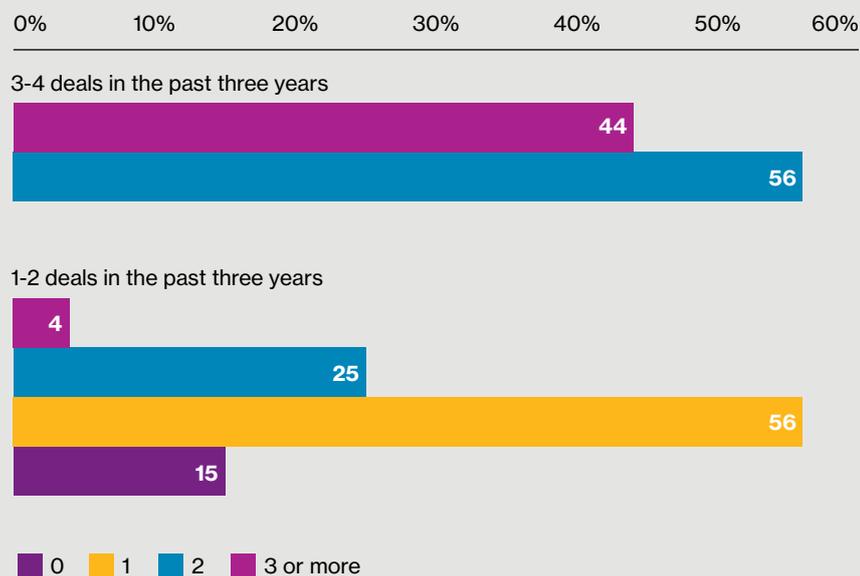


Figure 14: How many acquisitions do you expect to undertake in the next three years? (Split by number of acquisitions undertaken in past three years)



Had they been successful, these two megadeals would have topped the largest insurance deal to date – the US\$28bn tie-up between Ace and Chubb in 2015.

This move towards larger deals and megadeals can be seen in the split of deal sizes. In 2016, there were only 14 deals worth more than US\$500m. In the first half of 2017, there have already been 11.

This trend is commensurate with our survey findings, which show that 17% of firms expect at least one of their acquisitions over the next three years to be a major deal compared with 8% that have made one such acquisition over the previous three years.

### Serial acquirers on the hunt

Firms that have been most acquisitive in the past anticipate the most future buy-side activity. Of those firms that have made between one and two deals in the past three years, 81% expect to make the same number of purchases in the next three years. Of those that made between three and four deals in the past three years, 44% expect to make three or more deals in the next three.

“This seems to signal that activity will continue to be driven by serial acquirers and those that have been active in recent years, as opposed to new entrants that have sat out the past few years finally sticking their toe in the water,” says Joseph Milicia. “A number of companies have made large acquisitions in the past two years and have been in integration mode. Once that completes, they can turn from being internally focused back to M&A.”

Assuming successful integration and synergy realization, these firms stand the best chances of growth. Repeat deals are a sign that serial acquirers are



getting M&A right and looking beyond any one particular transaction to a more holistic M&A strategy.

This requires internal capabilities, strong corporate finance networks and persuasive abilities towards potential sellers that are ahead of the competition.

### Brand values

The most powerful motivation for undertaking an acquisition over the next three years will be to gain a strong brand. This reflects the impact that technology and the internet in particular have had on the industry, with the web being the primary distribution network for companies.

The transition to digital sales requires a strong, recognizable brand. This can be just as important as competitive pricing, reinventing the company through a major acquisition and rebranding to reintroduce the company to consumers.

Lower rates of insurance among millennials mean that insurers must

work harder than ever to win business and this increases the value of effective branding. According to a recent analysis of “brand equity” by Harris Poll, six Life insurers – Guardian, USAA, New York Life, MetLife, Allstate and AIG Direct Life – saw significant increases, notable because brand equity tends to resist movement.

This coincides with MetLife’s overhaul of its brand identity in 2016, including a revamped logo and tagline. It was the first big marketing shift for the brand in over 30 years.

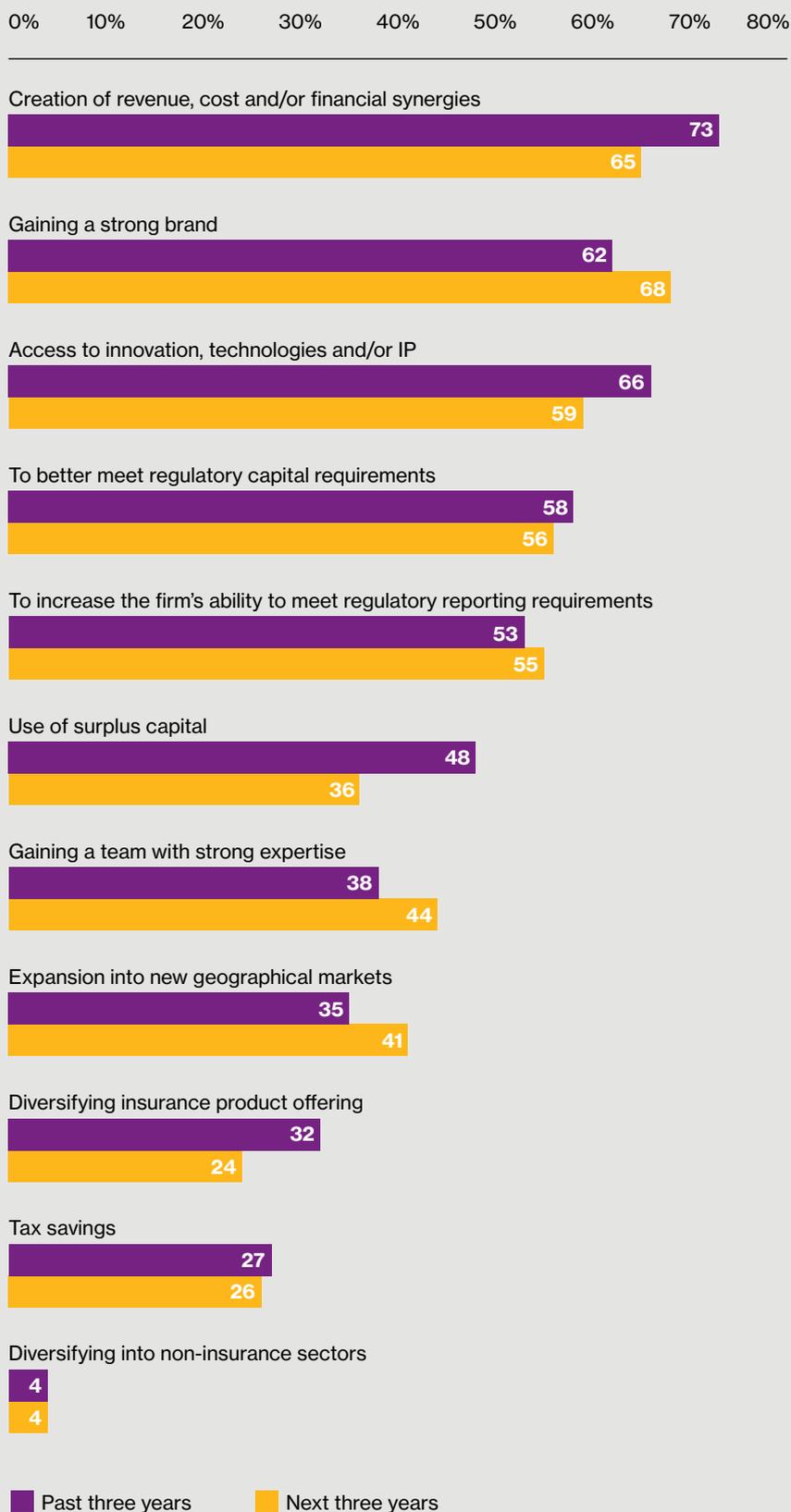
Unsurprisingly, given the cost pressures of a soft market for policies and regulatory capital burdens, 65% say “revenue, cost and/or financial synergies” is a major driver.

The third highest motivation in the next three years will be accessing innovation and tech. This chimes with findings from a 2017 Willis Towers Watson/ Mergermarket survey, *New Horizons*. According to that report, 74% of global insurers believe their sector has failed to

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**Joseph Milicia, Willis Towers Watson**

Figure 15: What have been the drivers of your acquisition activity over the past three years? And what are the drivers of your anticipated acquisition activity over the next three years? (Select all that apply)



provide leadership in digital innovation and see acquisitions as a means to buy in that expertise and technology.

However, it appears that insurers still don't entirely accept their digital futures – the latest survey reveals that there has been a modest fall from 66% to 59% in the number of firms who expect tech to be a motivation for future deals.

There are many benefits to be realized from incorporating data into insurance business models, such as faster and more effective claims processing, self-executing parametric policies and predictive data analytics models.

“Insurers own a lot of data and it represents a great deal of value that has yet to be fully realized,” says Scott Spearman. “There’s a lot more value that insurers can extract from the data that they’ve built up over the years and from aggregating data from other firms.

“If a company wants to enter a new line, having access to the data of someone who has historically written that business presents a significant advantage. M&A will be really important because we are in a challenging environment for growing organically. M&A is the easiest way to access the technology that’s needed if insurers don’t want to be left behind.”

### Deal deterrents

When it comes to deal blockers, nearly half (45%) of respondents say that regulatory matters will be among the top three challenges they face in the next three years.

Ongoing changes to legislation and regulation can both encourage and inhibit M&A activity. For example, it has long been expected that Europe’s Solvency II regulation would prompt market consolidation, as smaller players would be unable to achieve the scale necessary to remain profitable under greater capital requirements, heavier compliance and reporting burdens.

This puts pressure on those insurers that cannot raise adequate regulatory capital to sell businesses if they believe that resulting capital charges could otherwise negatively impact returns. This could create deal opportunities for acquirers.

While the effect of the post-crisis rollout of regulations to ensure liquidity is that acquirers have better visibility of the risk and capital impacts of doing a deal, it also means there is greater potential for non-compliance post-deal in light of tighter capital standards and therefore incurring high regulatory costs. The introduction of regulations at the country level only complicates matters further.

“Insurers need to adapt to the new solvency standards,” says the senior vice president, corporate strategy, of a Life insurance provider in Canada. “The minimum continuing capital and surplus requirements are going to change from next year. In the current volatile climate, companies will need to cut back on dealmaking to preserve capital.”

Political instability is cited as a top three challenge by 36% of respondents. Following a year that included the UK’s historic vote to leave the EU and the election of President Trump in the US, this should not come as a surprise. While political volatility in itself is unlikely to hinder deals, it creates uncertainty over policy direction and can impact on financial markets, the macroeconomy and the regulatory outlook.

“Political instability, expectation of regulatory changes, difficulties in developing the right financial models and economic volatilities are all going to hinder dealmaking,” says the senior vice president, strategy and business development at a US reinsurance firm. “These challenges are going to stifle M&A because companies are going to be unsure of the changes and will avoid carrying out deals.”

Figure 16: What will the major challenges to dealmaking be over the next three years? (Select top three)



### Target acquired

When asked which metrics they use to assess potential targets, 83% say they consider return on capital or a similar risk-adjusted measure, with 21% saying this is the single most important metric.

Meanwhile, 67% prioritize revenue growth and 22% see this as the single most important metric for weighing up the attractiveness of investment targets.



This emphasis on the current and projected sales of a target may be expected given the difficulties in achieving organic growth. As firms continue to face economic headwinds, buying in revenue is the most effective and swiftest means to scale up.

However, the data shows that a more value-oriented approach to estimating return on capital is a priority for more respondents. This speaks to insurers' need to ensure that their capital is being invested efficiently in an era of heightened regulatory capital requirements, in which the cost of doing business remains high.

"There has been a focus on understanding the best deployment of capital. Companies are looking at how they can both stabilize their capital position and what's required of them but also how they can optimize their return on capital given their capital requirements," says Fergal O'Shea.

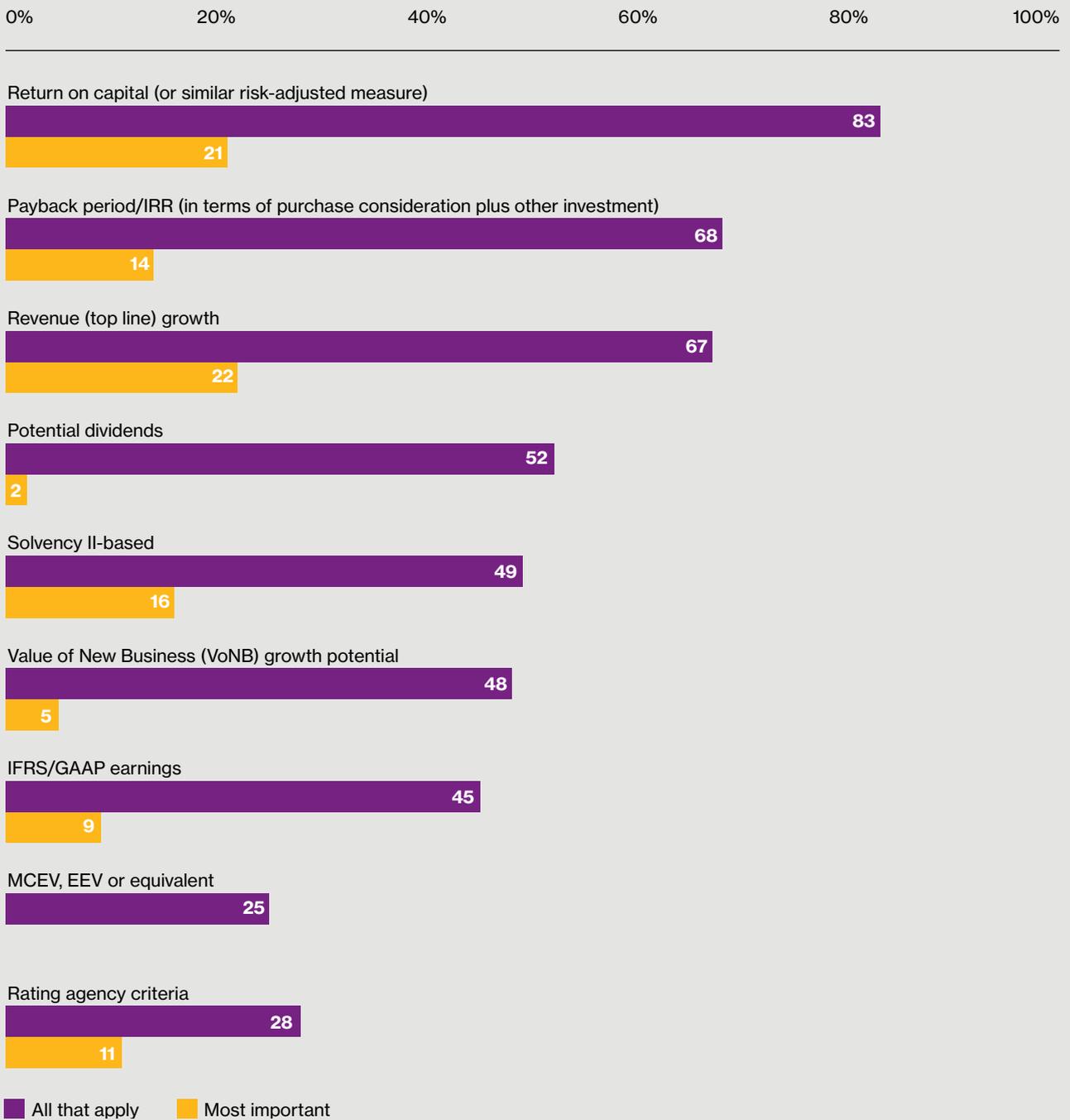
### Ways to pay

A clear majority (95%) of firms plan to finance their next deal with existing cash reserves and 38% say this will be the most important way of bankrolling their next transaction. This is followed by 46% that will use the proceeds from the disposal of a business, the top source of finance for 27% of the cohort.

This bias towards cash financing can be explained by the fact insurers have had to scrutinize their balance sheets – which are inherently large due to the assets-versus-liabilities nature of their business model – in recent years to ensure compliance with regulatory requirements. With cash on their balance sheets and with the potential for poor investment returns hanging over their heads, there is an incentive to direct any excess cash into deals.

While bond issuance is an option considered by 46% of firms, just 4% say this debt-focused approach will

Figure 17: **When assessing the attractiveness of a potential M&A target, which metrics do you use? (Select all that apply and the most important)**





be the most important deal financing method. This comes as the insurance industry in Europe is taking tentative steps to test new debt products that dovetail with Solvency II regulation. Firms are required to cover at least half of the solvency capital requirement with tier-one capital, most of which must be equity but one-fifth can be in RT1 (restricted tier-one) bonds.

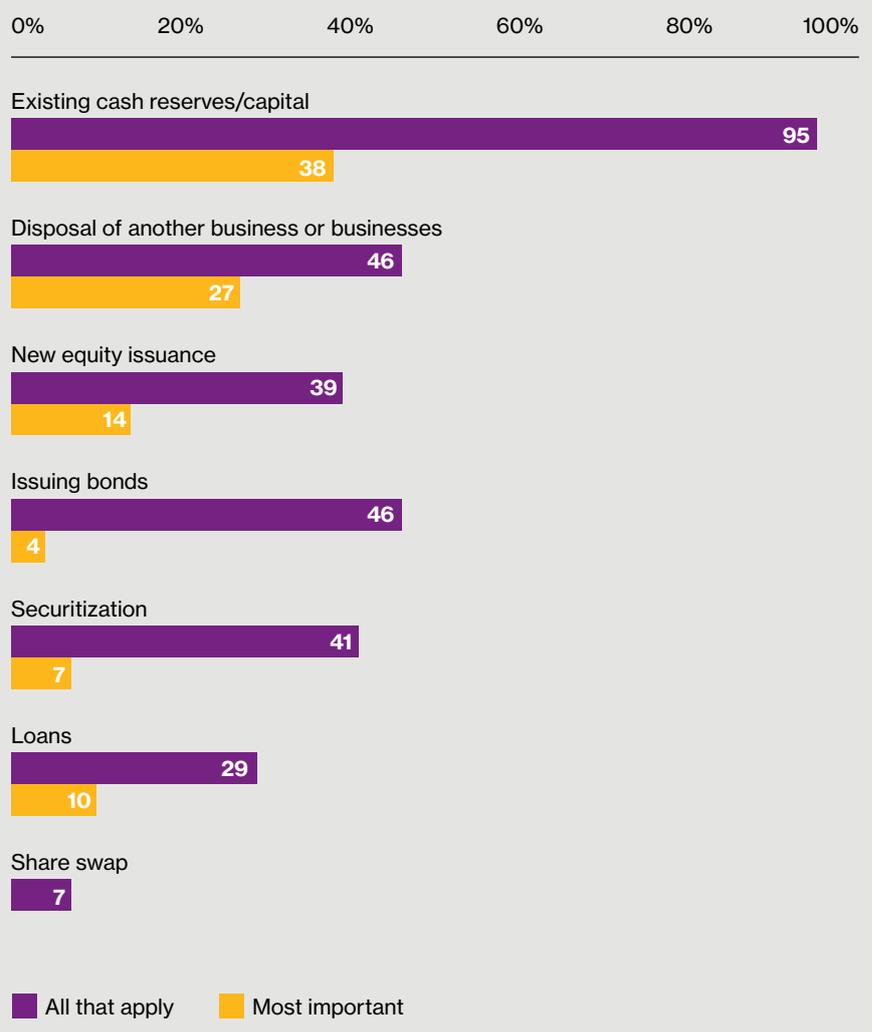
These instruments can count towards insurer's capital as they are structured so that they can be converted to equity or written down if the company's solvency ratio breaches a minimum threshold. However, issuance has yet to take off in meaningful volumes.

As a new instrument and one which has yet to be tested in a solvency stress situation, investors will be wary of putting their money into RT1s. Once a number of large issuances have been made, however, the market might be expected to gain confidence in this novel product.

### Slimming down

As firms continue to contend with regulatory capital pressures and a low-profit environment, and look to move out of capital-intensive business lines, our survey shows that more

Figure 18: **How do you plan to finance your next acquisition? (Select all that apply and the most important)**



businesses will be looking to divest in the coming three years.

While only a marginal lift, the number of respondents planning to offload one to two sections of the business over the next three years is set to increase to 57%, compared with 53% that made one or two divestments in the last three years.

Turning to sectors, P&C firms are least likely to participate in an asset sale in the next three years, with 46% expecting no sale at all (versus 42% for life and 30% for reinsurance).

The sector most likely to be involved in offloading just one business over the same time period is reinsurance, with 50% of firms in the segment saying they expect this to be the case, compared with 41% for P&C and 36% for life.

Both the reinsurance and life sectors face unique pressures to sell. The influx of alternative capital in reinsurance has made the market highly competitive, which may be creating a motivation for reinsurers to dispose of non-core assets in businesses with thinner margins.

In the life space, insurers are particularly hard hit by the low-yield environment. Annuities that pay out guaranteed returns to policyholders are weighing on portfolios as firms are unable to achieve the investment returns necessary to make annuities sufficiently profitable. For example, Italy's Generali is currently aiming to sell its US\$50bn German Life insurance portfolio which, if sold, will mark the largest closed book sale on record.

The primary motivation for offloading parts of the company over the next three years will be where those business units are not reaching their target value metric, cited by 75% of respondents.

Figure 19: How many divestments has your firm undertaken in the past three years? And how many do you expect to undertake in the next three years?

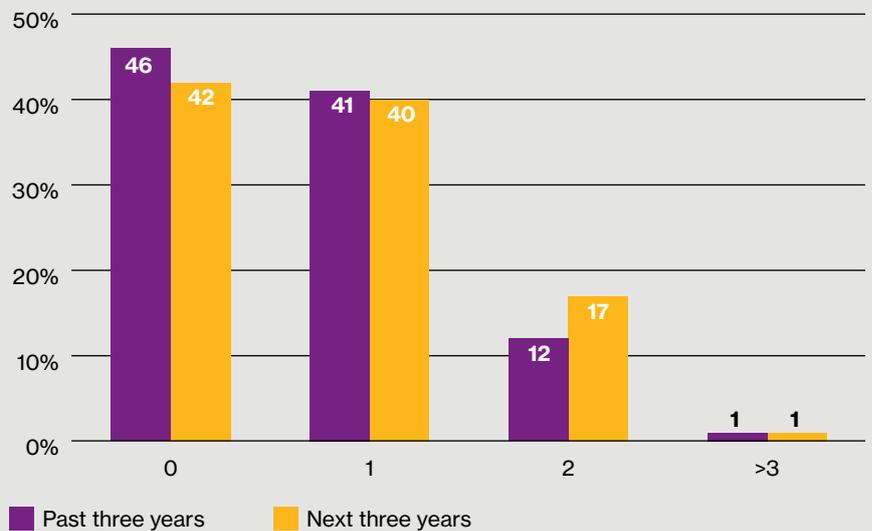
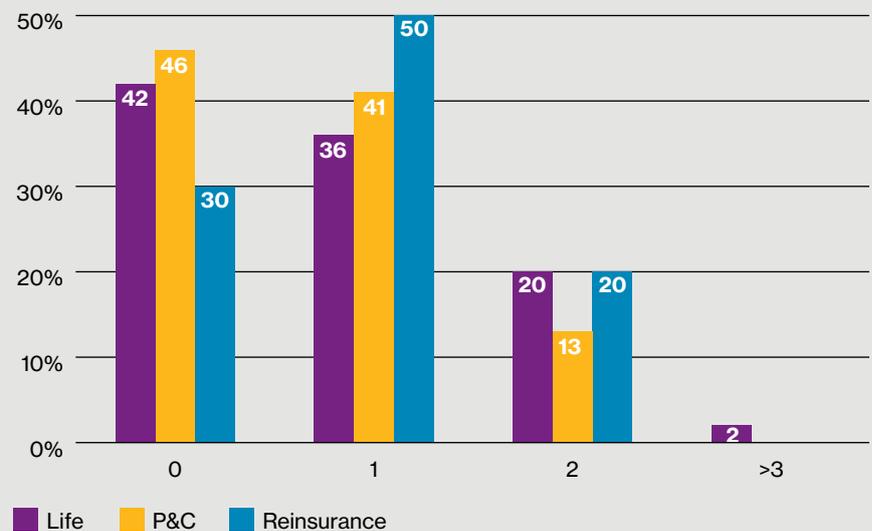


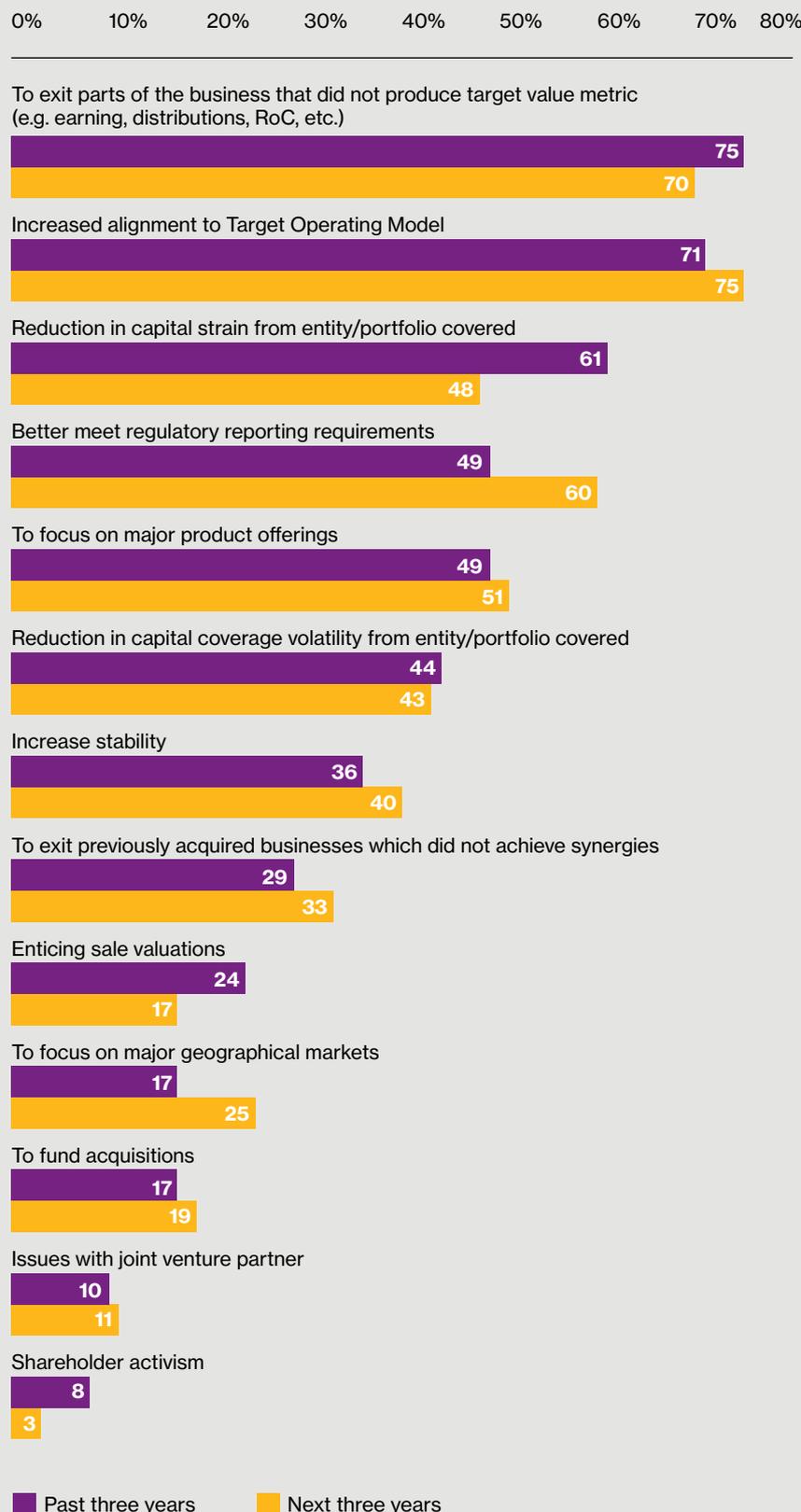
Figure 20: How many divestments do you expect to undertake in the next three years (by sector)?



*“Insurers are not just exiting capital-intensive businesses but also ones that are the hardest to scale up or have an insufficient scale. We’re seeing more consolidation in smaller markets and more specialism, particularly in the financial space.”*

**Fergal O’Shea, Willis Towers Watson**

Figure 21: **What have been the drivers of your divestments over the past three years? And what are the drivers of your anticipated divestments over the next three years? (Select all that apply)**



However, the biggest percentage jump when comparing drivers for past and future divestment activity is to achieve a reduction in capital strain from the business line or entity. This speaks to the pressure that insurers are under to move out of capital-intensive lines such as annuities in favor of capital-lite offerings such as asset management.

Insurers are concentrating more on the sustainability of margins and being more disciplined around their portfolio management, according to Fergal O'Shea.

“They are not just exiting capital-intensive business but also ones that are the hardest to scale up or have an insufficient scale. That could be directed at countries. It could be they’re exiting a line of business in the market in which they haven’t got the skills to be competitive. We’re seeing more consolidation in smaller markets and more specialism, particularly in the financial space.”

# Location, location, location

With low growth in developed economies, insurers are beginning to spread their wings in search of higher returns with emerging Asia seen a profitable location.

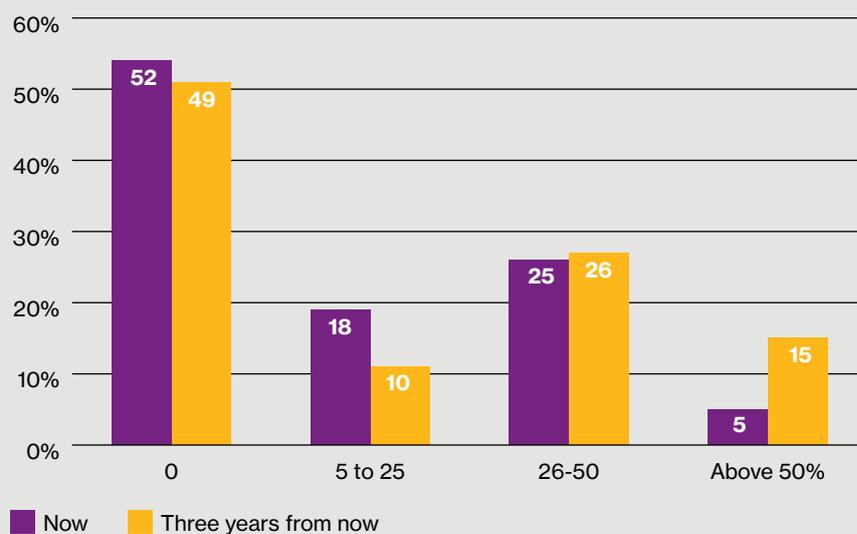
According to our survey, insurers are expected to become more outward-looking by generating more future profits from overseas. Only 5% of respondents currently generate more than half of their profits outside their home region, but 15% expect to do so three years from now.

A director of investment, P&C, in China whose firm has already pushed into non-domestic markets says the strategy has helped to spread earnings risk and balance its exposure to the vagaries of a single market.

“We have changed the way we invest our capital and have invested a larger portion into different markets abroad,” he says. “By focusing our capital on markets abroad, we have diversified our earnings and risks from unfavorable conditions back home – the changes in regulations and competition made us consider investing abroad. Depending on growth rates, we will continue to invest overseas.”

On a regional basis, it is the emerging Asian markets that come out on top, with 40% of respondents expecting the region to be a focus of M&A over the next three years. Countries such as Vietnam and Indonesia are attractive for a number of reasons: they have rapidly growing middle

Figure 22: **What proportion of your company’s profits are currently generated outside your home region? What proportion of your company’s profits do you expect to be generated outside your home region three years from now?**



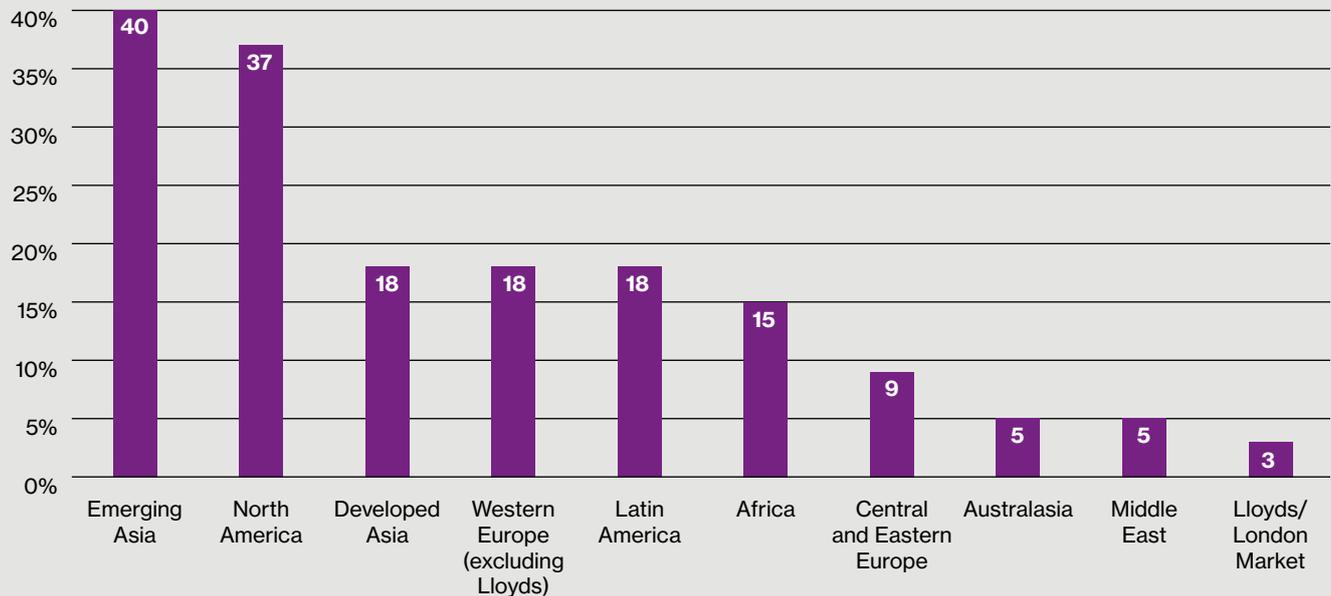
classes and the insurance markets are comparatively untapped, leaving plenty of room for growth.

That’s not to mention their favorable economic conditions compared to more established markets. For example, in 2016, Indonesia recorded growth of 5%, compared with a 1.8% average EU growth rate. Indonesia is also the fourth most populous country in the world and has an average age of 28.4 compared with 42.6 in the

EU, leaving plenty of opportunity to sell over the course of the lives of its inhabitants as premium rates converge with more developed markets.

Strong economic growth/prospects is the key feature for driving interest in any particular country for an overwhelming majority (54%), way ahead of an agreeable regulatory environment (14%) in second place.

Figure 23: In which regions/markets is your acquisition strategy likely to be focused on over the next three years? (Select all that apply)



*"[India and China are challenging markets]. It's been some time since those markets liberalized, but the former state monopolies created players who built scale when there were no competitors and they are giants. There is still room for foreign companies to play in those markets but it is going to be a fine line between success and failure."*

**Kevin Angelini, Willis Towers Watson**

Given the growth potential of the Chinese and Indian markets, it is somewhat surprising that only 18% of acquisition strategies are likely to be focused on developed Asia.

However, markets such as China and India are challenging compared to the rest of Asia, not from a demographic point of view, but more from an internal structural point of view, according to Kevin Angelini from Willis Towers Watson.

"Both countries have very strong incumbents, China Life and Life Insurance Corporation of India, because they both used to be state monopolies," he says. "It's been some time since those markets liberalized, but the monopolies created players who built scale when there were no competitors and they are giants. There is still a lot of room for foreign companies to play in those markets but it is going to be a fine line between success and failure."

Respondents expect dealmaking to tilt further towards emerging markets over time. This is likely because the secular low-growth environment found in Western markets in recent years, coupled with the relative lack of competition and burgeoning middle classes in emerging markets, makes these less tapped geographies more attractive.

Over the next three years, the average split of 51/49 in favor of emerging markets compares with 54/46 when extending the time horizon to six years ahead.

Figure 24: **What is it about this region that is attractive?**  
**(Please select the most important)**

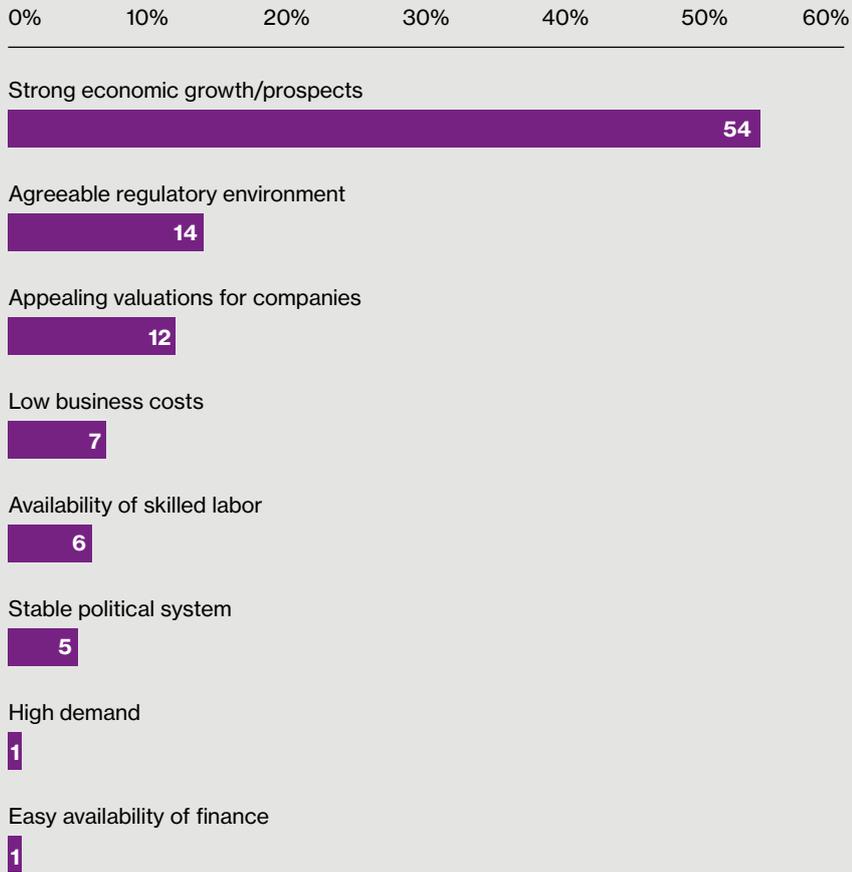
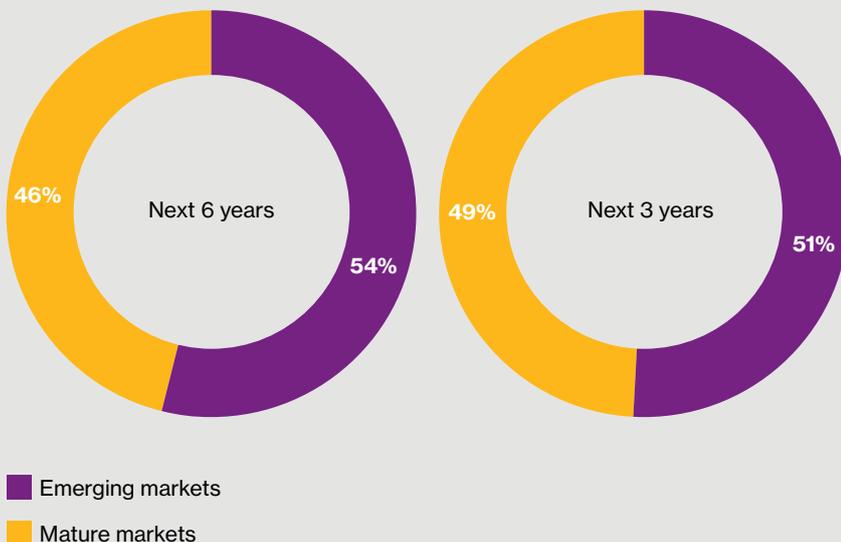


Figure 25: **What proportion of your company's M&A dealmaking is likely to target companies in emerging markets and what proportion is likely to target companies in mature markets over the next three years? And over the next six years? (Mean shown)**



# Chapter 3

## Powering growth

To understand the positive financial effect of dealmaking, we asked the cohort to what extent M&A has impacted and is expected to impact upon earnings. This chapter also explores the areas in which acquisitions have been successful and the obstacles to growth.

While our survey discovered that only 17% of respondents say M&A has produced 3% or more annual growth in earnings per share over the previous three years – dealmakers are more optimistic about the future. More than half (52%) of firms expect that M&A will help to drive this rate of growth over the next three years. Just under two-thirds (63%) say they anticipate M&A will result in earnings growth of between 2% and 3% in future.

In the main, however, firms are satisfied with the post-merger performance of their enlarged groups. Nearly four-fifths (79%) say they either exceeded or met target growth in their company resulting from M&A activity in the previous three years.

While insurers are more optimistic about the earnings potential of future deals, their satisfaction in reaching growth targets suggests they had lowered expectations when going into M&A situations in the last three years.

This is supported by a senior vice president of strategy at a P&C insurer in Thailand who felt that while growth rates were muted post-M&A, this was anticipated: “Slower growth

rates had more to do with external factors than with anything related to the M&A process itself,” he says. “There was a lot of volatility and changes in regulatory laws, both of which pushed down growth. We were successful in getting back the amounts we invested, by launching new products, reducing costs and altering existing strategies.

“We also integrated the company in a short span of time. These moves were planned and allowed us to bring about different types of synergies within the organisation that boosted revenues, creating a larger capital base for us to use to carry out M&A activities.”

### Success factors

Value creation largely hinges upon firms’ ability to realize synergies, be they related to revenues, balance sheets or the costs of doing business. These three synergy types are the areas that have been crucial to creating M&A value for 48% of those surveyed.

However, the most widely cited single factor for value creation deals is customer retention.

*“[Technology will be key to customer satisfaction]. On the P&C side, you’re starting to see the rise of mobile apps to report claims by submitting photos of damage. It increases customer satisfaction because the company is sent the information it requires instantaneously and the claim can be paid more quickly.”*

**Joseph Milicia, Willis Towers Watson**

This is to be expected given the emphasis that insurers are putting on sales, particularly revenue growth as a metric for deciding the attractiveness for acquisitions. Facing weak organic growth prospects, firms are seeking to buy in revenues and make synergistic gains, but if customers take their business elsewhere post-deal then any acquisition is fundamentally undermined and value will be lost. We therefore expect firms to place an increasing emphasis on the stickiness of customers and how they can successfully achieve higher retention through renewals and strategic upselling.

This represents a significant challenge. Given the popularity of price comparison sites, there is very little interaction between insurers and their policyholders. This is where data analytics to hyper-target existing customers with suitable products and delivering customer satisfaction will be all important. One of the keys to satisfaction will be harnessing technology to give customers the best experience possible and therefore encourage renewals.

“On the P&C side, you’re starting to see the rise of mobile apps to report claims by submitting photos of damage,” says Joseph Milicia. “That can reduce the expense component because the firm doesn’t need to send an adjuster out to assess the damage. It also increases customer satisfaction because the company is sent the information it requires instantaneously and the claim can be paid more quickly.”

In the 2017 Willis Towers Watson survey, *New Horizons*, 82% of insurers felt that customer retention/management would see substantial change as the result of digital technologies over the next five years. Further, claims processing and loss adjustment, and policy serving were cited by 85% and 53% of insurers respectively as areas that will see change, both of which will likely result in cost efficiencies.

Figure 26: How much do you estimate M&A has driven average annual growth in your company over the last three years as measured by underlying earnings per share? And how much do you estimate M&A will drive average annual growth in your company over the next three years?

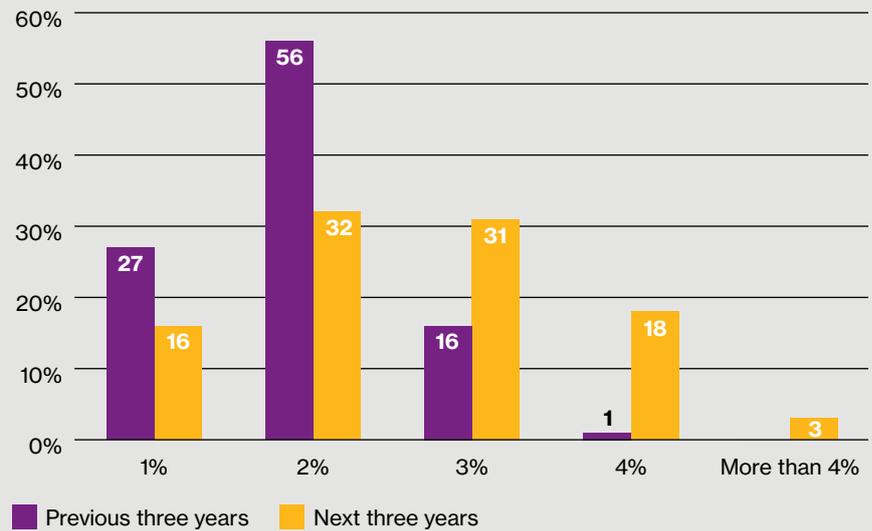
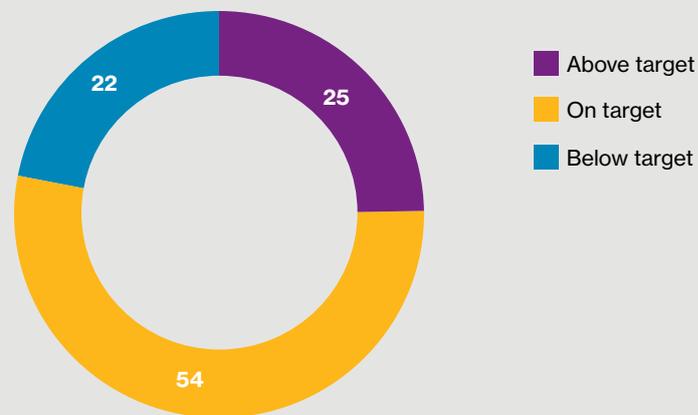


Figure 27: With regard to the last three years, was this...?



*“Successful M&A is about finding the right balance between rapid and effective integration whilst protecting and nurturing the core value within the acquired business.”*

**Jana Mercereau, Head of Corporate Mergers and Acquisitions for Great Britain, Willis Towers Watson**

A head of strategy at a UK Life insurer cites the value accretion benefits of acquiring both technology assets and access to an enlarged product portfolio through M&A: “Our earnings are up because post-deal we got access to some important, in-demand technologies and products that helped reduce costs, improve all our strategies and develop a better business.”

## Obstacles to growth

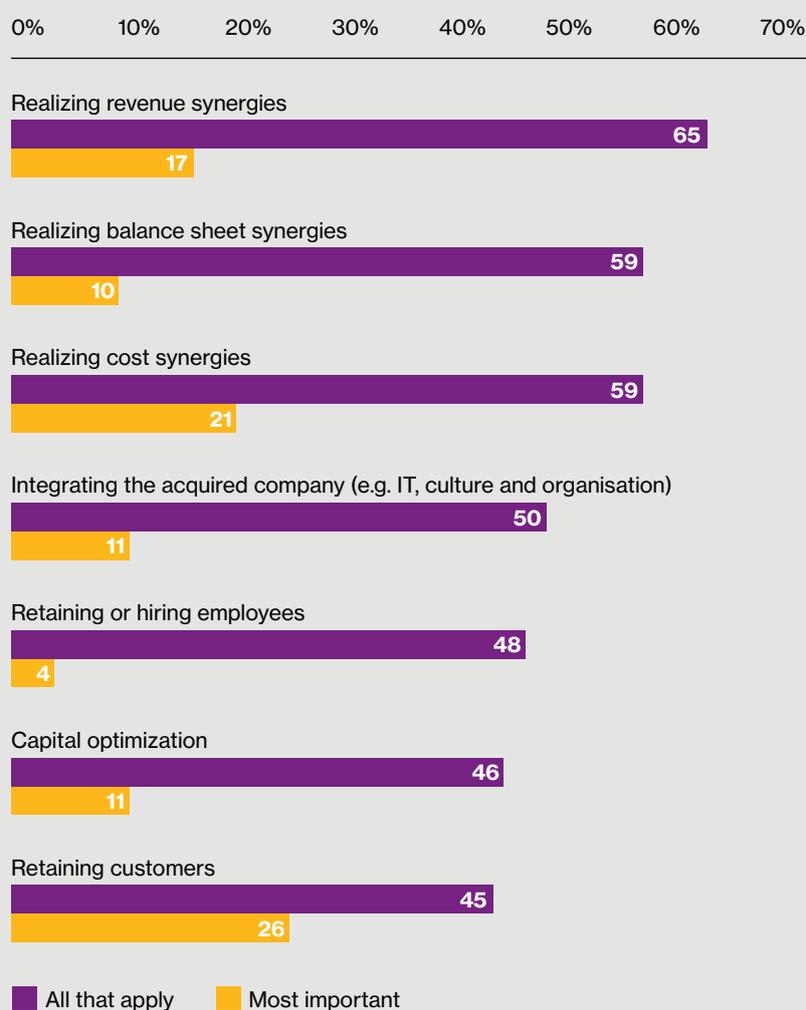
Given that synergies are seen as fundamental to creating M&A value, it should come as little surprise that over-calculating these benefits will result in disappointment. The most widely cited (21%) factor that undermined post-deal target growth is the limited realization of cost synergies, while 49% say it played at least some role in undershooting growth targets. Additionally, 60% point to both limited realisation of balance sheet synergies and revenue synergies as playing a role.

Just as customer retention is seen as the single most important driver of value creation in successful deals, similarly it is one of the top three most cited single hindrances to growth post-acquisition. Once again, focusing strategies on keeping customers renewing with the enlarged firm will be critical in both preserving and creating value going forward.

Given the importance of effective integration in any M&A situation, regardless of sector, difficulty in merging the two companies is cited as an issue in failing to realize growth. The head of strategy at a UK Life insurer highlighted that not only is post-merger growth dependent on the pace of integration, but that value creation benefits are not always the same for the acquirer and the acquired.

“One of the biggest lessons we have learnt has been that the value created through a merger for the targets can be

Figure 28: In which areas have your acquisitions been successful in creating value for the business over the last three years? (Select all that apply and the most important)

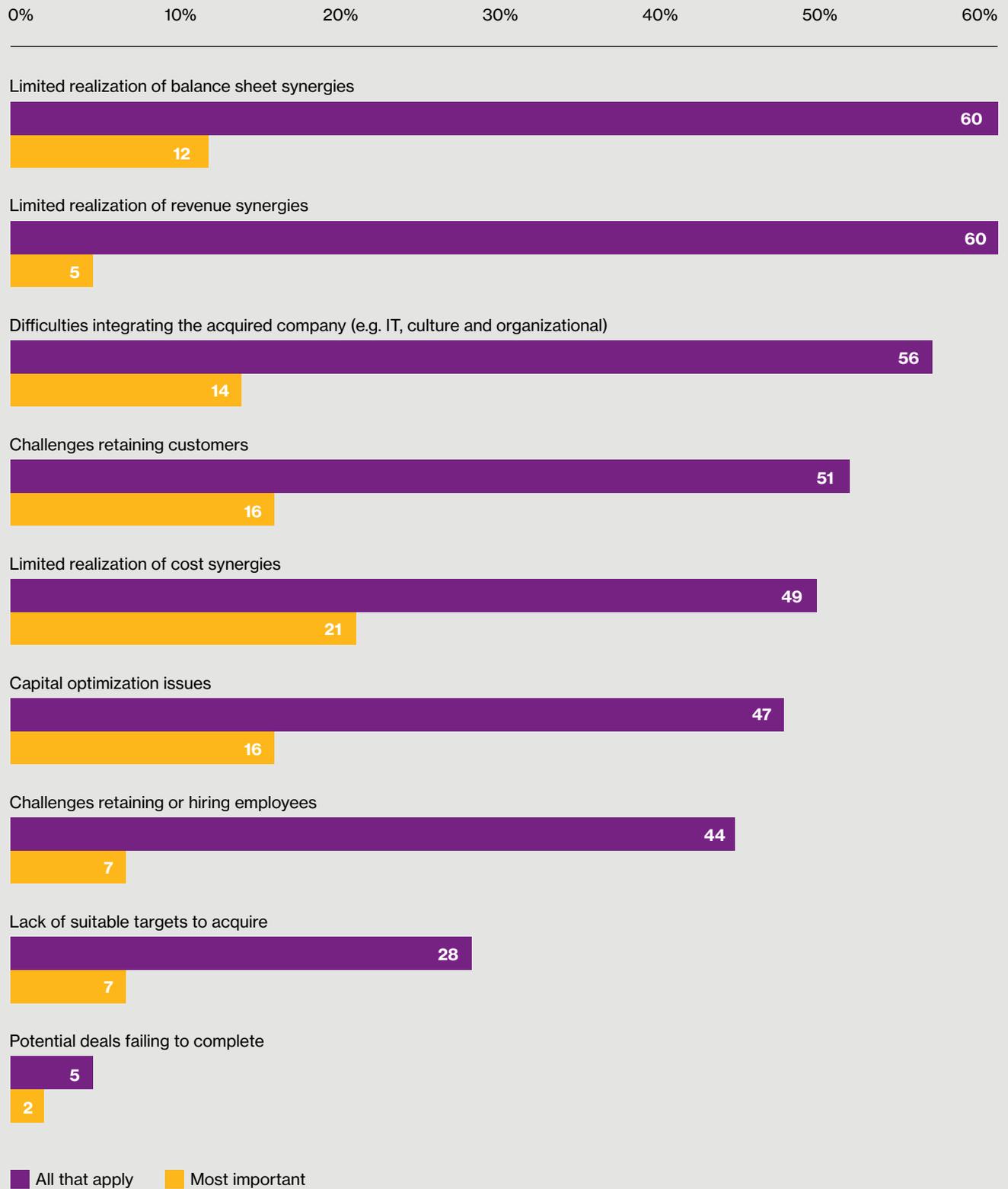


different than that for an acquirer,” he says. “This is important because there needs to be a focus on the strategies that are developed around the new company. Also, the value created through M&A does not always lead to higher growth. Achieving this requires quick and effective integration.”

As well as conducting thorough due diligence to identify cost, revenue and balance sheet synergies, insurers must think carefully about the post-merger integration process before initiating a deal to maximize value creation. A clear roadmap will be necessary to navigate the process.

According to the head of global finance at a reinsurance firm in the UK: “Value creation in M&A is directly related to how effective the post-merger integration is. It is a complex process and if not executed properly can melt away all the synergies and values.”

Figure 29: What are the reasons why M&A activity did not translate to expected growth in underlying earnings per share over the last three years? (Select all that apply and the most important)



# Conclusion

## Capitalizing on opportunity

Caught between the ongoing pressures of tepid growth in premiums, low interest rates and the burden of regulatory requirements, insurers must ensure they are making the most efficient possible use of their capital. Those who pay the closest attention to their strategic aims, and how managing their capital and pursuing M&A can underpin those goals, will have the best chance of success.

The following five takeaways from this research will help insurers to prepare for the challenging road ahead:

### 1. Refocus attention from the regulatory to the strategic

Those who have already gained assurance that they are and will remain compliant with regulations will have a head start on honing their strategy. “For the last few years, companies have been trying to understand the new regulatory regime,” says Fergal O’Shea. “Now there seems to be a focus on understanding the best deployment of capital to optimize their returns in light of those requirements. Firms need to move into that new phase, beyond the regulatory or measurement phase to a more strategic focus.”

### 2. Put a capital optimization strategy in place

A little over half of firms have a capital optimization strategy in place. That leaves more than two out of five with no such strategy to determine where their capital would be best deployed. As focus increasingly turns to strategic considerations and growth, insurers will benefit from dedicating resources to capital optimization and understanding the most efficient use of capital to both protect and create value.

### 3. Beware of the competition

Insurers see competition as a key challenge. As the market for securitized insurance investment products grows and as technology enables new market entrants, traditional insurers will come under increasing pressure. Insurtechs are growing in number as niche start-ups identify gaps in the market and

address them by exploiting data and harnessing proprietary technology. This will be compounded by the fact that the competition is pivoting towards re-investment to grow their businesses. Having a capital optimization strategy in place to understand how best to reinvest and grow the company will help insurers compete in a tough market. And, for many, M&A will be an effective solution to achieving this growth.

### 4. Have a clear portfolio strategy

“We have seen some companies become more focused on their portfolio management strategy – the businesses they want to dispose of and those they want to keep. More companies will follow those strategies and become much more clearheaded on the markets they want to play in and the markets they want to exit,” says Joseph Millicia.

*“For the last few years, companies have been trying to understand the new regulatory regime. Now there seems to be a focus on understanding the best deployment of capital to optimize their returns in light of those requirements.”*

**Fergal O’Shea, Willis Towers Watson**

This will require an in-depth understanding of suitable geographies, disruptive technology and IP, and an ability to recognize existing business lines that are either unscalable or overly capital intensive.

## 5. Effective integration

A carefully considered M&A strategy is nothing without effective execution. This is true in any sector, but it's important to stress that any future acquisitions must be well integrated into the buying group as value creation in M&A is directly related to the effectiveness of the post-merger integration. This requires a clearly communicated purpose for the deal and a well-articulated vision for the enlarged group. It is also important to consider the cultural compatibility of the two organizations and how the acquired group can smoothly adopt the cultural values of the acquirer.

*“Typically deals are built upon the premise that acquiring new capabilities will help boost growth and profitability. This means new colleagues coming together for the new business. This requires leaders who can manage change and bring the new workforce with them while maintaining a focus on deal synergy goals and ensuring that the underlying business does not get distracted.”*

**Jana Mercereau, Willis Towers Watson**



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