Shining new light on European insurance M&A

Using SFCR data and the Solvency II appraisal value
technique to gain new insights into recent transactions
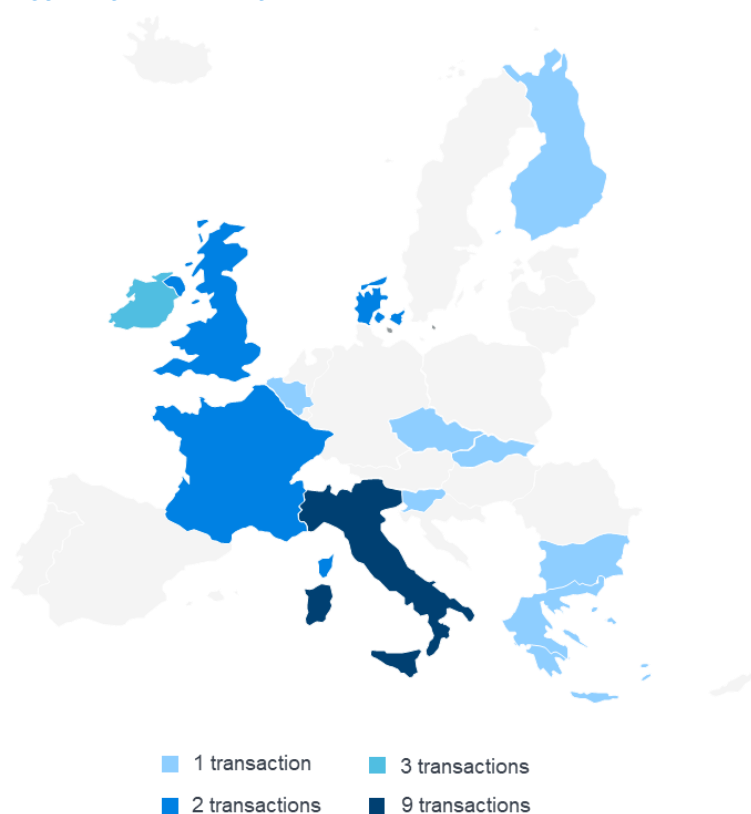
Jeremy Kent, FIA
Ed Morgan, FIA

Milliman

One of the consequences of Solvency II has been the requirement for all EU insurers to publish standardised annual information in the form of the Solvency and Financial Condition Report (SFCR). The public availability of SFCRs for EU insurers allows us to gain new insights into transactions. In this short article we illustrate the sorts of analyses which are possible by looking at a sample of 24 transactions in Europe over the last couple of years across a wide range of EU markets.

We believe that this analysis can be done most effectively using the Solvency II appraisal value (S2AV) technique. This is a technique we have developed to adjust Solvency II own funds for the cost of holding the expected level of capital at the shareholders' required rate of return, the impact of projected real-world expected investment returns and the expected value of future new business (franchise value) to give a value equivalent to the net present value of expected distributable profits.[1] This methodology gives a value equivalent to the net present value of expected distributable profits discounted at the shareholders' required rate of return, which is, in our experience, a measure which many buyers of insurance companies are interested in. This contrasts, in particular, with pure market-consistent methodologies like Market-Consistent Embedded Value (MCEV), which do not allow for the cost of capital associated with market risks and the impact of expected real-world returns on investments.

Methodology

We have analysed publicly disclosed transaction values and compared them with SFCR data in the public Quantitative Reporting Templates (QRTs) from the date closest to the transaction date. The sample analysed includes a wide geographic spread, as shown in Figure 1.

FIGURE 1: SAMPLE ANALYSED

- 1 transaction
- 2 transactions
- 3 transactions
- 9 transactions

We have used transaction information compiled by Mergermarket.

For clarity of analysis we have generally focused on companies that use the standard formula approach to calculate the Solvency Capital Requirement (SCR) under Solvency II.

The sample includes nine life companies, seven non-life companies, three health companies and five composites.[2]

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[1] For more information about this technique, see the Milliman research report 'S2AV: A Valuation Methodology for Insurance Companies Under Solvency II,' available at http://www.milliman.com/insight/2016/S2AV-A-valuation-methodology-for-insurance-companies-under-Solvency-II/.

[2] 'Life', 'non-life' and 'health' are defined based on the relative values of SCR for life, non-life and health underwriting, respectively.

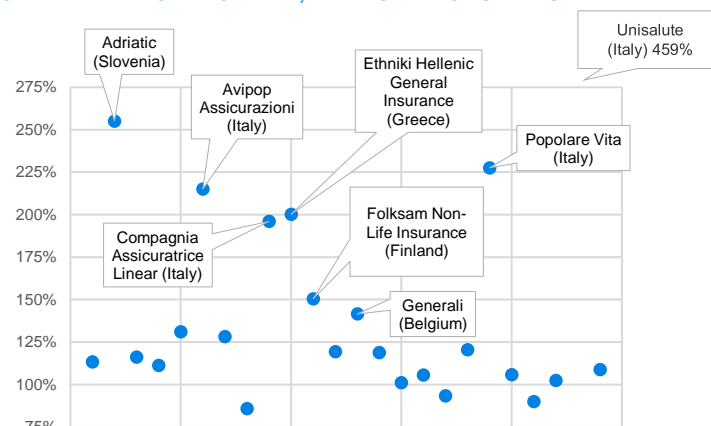It has been necessary to make a number of simplifying assumptions and calculations, including the following:

- A 150% solvency ratio is maintained and all capital in excess of this is distributed.
- The duration of the liabilities is estimated from the risk margin and corresponding capital for non-hedgeable risks, and the cost of capital is then a function of this duration, allowing for the shareholders' required rate of return.
- Real-world uplifts from investing in risky investments such as equities and corporate bonds have been assumed to be proportional to the amount of market risk as measured by SCR for market risks and calibrated to roughly equate to a 5% per annum (p.a.) equity risk premium.
- Considering the target entities on a standalone basis, without any post-acquisition actions (e.g., de-risking, synergies with acquirer's existing business).
- Deducting subordinated debt included in own funds and adding back foreseeable dividends that had been deducted from own funds.

These assumptions were made to allow us to cover a large sample of transactions in a consistent and relatively simple way. If it was of interest to look at a specific transaction it would generally be possible to find additional information (e.g., from the annual report and accounts, the SFCR narrative etc.) and to make judgemental assumptions which are more tailor-made to the circumstances of the particular cases. We have not attempted to do so in this article because we wanted to carry out a simple and objective exercise to show the great potential we see in the methodology, rather than to make definite conclusions about particular transactions.

Results

We have initially assumed a required return on capital of 10% p.a. above the risk-free rate and compared the estimated S2AV value of the company (multiplied by the proportion acquired), assuming zero franchise value, with the actual transaction price. Particular outliers are marked on the graph in Figure 2, and we comment on some of those below.

FIGURE 2: TRANSACTION PRICE / S2AV @ 10% REQUIRED RETURN ON CAPITAL P.A. ABOVE RISK-FREE, WITH NO FRANCHISE VALUE

In several of the cases the transaction prices are ending up fairly close to 100% of the S2AV estimates on this basis, with 15 of the 24 transactions having a ratio below 130%. A transaction price above 100% means that, on these assumptions, the buyer is seeing value in excess of the in-force value. This might be due to expectations of profitable future new business, or potential post-acquisition actions, for instance:

- Changing the level of market risk taken.
- Synergies with the acquirer's existing insurance business, e.g., diversification benefit in respect of capital requirements, eligibility of capital, expense synergies, tax synergies.

A value of less than 100% could mean that the shareholder is looking for a higher rate of return than 10% p.a. above risk-free, or that there are some value-destroying aspects of the company which are not being captured in the Solvency II numbers in the QRTs. In some cases there may also have been capital or other material movements between the SFCR date and the transaction date leading to inconsistencies between the two valuations.

Particular cases which might lead to higher or lower prices compared to the S2AV (excluding franchise value) could be cases where the transaction price is influenced by factors other than a pure economic valuation. For example, this may include:

- Shareholder agreements, such as those linked to bancassurance arrangements, which specify particular criteria for the value to be used in a transaction (e.g., Popolare Vita, which has a ratio of price to S2AV, without franchise value, of 228%) or intra-group transactions.
- Health insurance business having short contract boundaries, meaning that there may be a high probability of future renewals which are not captured in the S2AV valuation (e.g., Unisalute with a ratio of 459%. We note that, in this case, the underwriting profit in 2017 was €61 million, meaning that the implied franchise value at a shareholders' required rate of
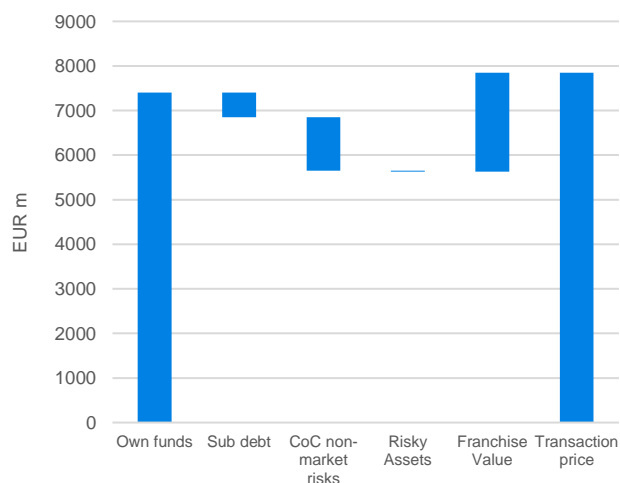
return of 10% p.a. above risk-free of €559 million is not unreasonable.)

We should point out that these explanations are speculative and there may be other factors which we are not aware of or which are not showing up in the disclosed Solvency II numbers in the QRTs.

BUILD-UP OF VALUE

One of the particular advantages of the S2AV methodology is that it breaks down the value of an insurer into components, starting from own funds (with foreseeable dividends added back) adjusted for subordinated debt, together with the cost of capital for non-market (which we are taking as the same as non-hedgeable) risks at the shareholders' required rate of return and level of capitalisation, the impact of investing in 'risky' assets (both the impact of the expected additional real-world returns and the cost of the capital associated with the corresponding market risks) and the franchise value. In Figure 3 we show, for the 24 companies in total, the bridge between own funds and the transaction price if we assume that the difference between the estimated S2AV and the transaction price can be attributed to franchise value. Once again S2AV is calculated assuming a required return on capital of 10% p.a. above risk-free (i.e. a cost of capital of 10%) and a 150% solvency ratio.

FIGURE 3: BRIDGE BETWEEN OWN FUNDS AND TRANSACTION PRICE, ASSUMING 10% COST OF CAPITAL AND 150% SOLVENCY RATIO
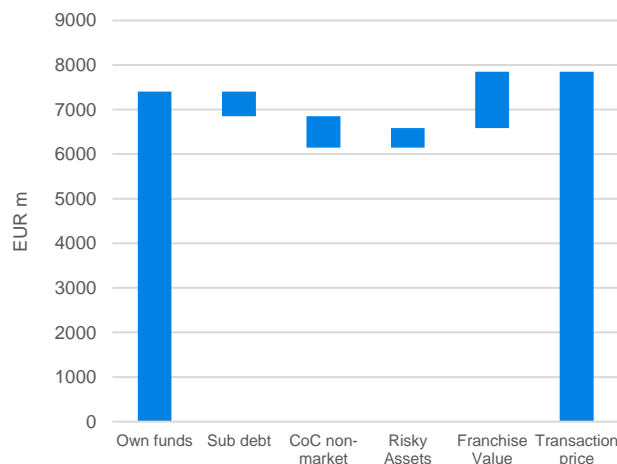

It can be seen that, if we assume a cost of capital of 10% and a 150% solvency ratio, then the cost of capital for non-market risks (including the cost of capital associated with the risk margin) is much higher than that assumed in the own funds, which includes a risk margin based on a 6% cost of capital and a 100% solvency ratio. The value added by investing in risky assets overall is close to zero and the implied franchise value is around 28% of the total of the transaction prices.

If, alternatively, the shareholders' required rate of return is reduced from 10% p.a. above risk-free to 8% p.a. above risk-

free, and a 125% solvency ratio, rather than a 150% ratio, is maintained, then the graph looks like the one shown in Figure 4, with the implied franchise value now being only around 16% of the total of the transaction prices.

FIGURE 4: BRIDGE BETWEEN OWN FUNDS AND TRANSACTION PRICE, ASSUMING 8% COST OF CAPITAL AND 125% SOLVENCY RATIO
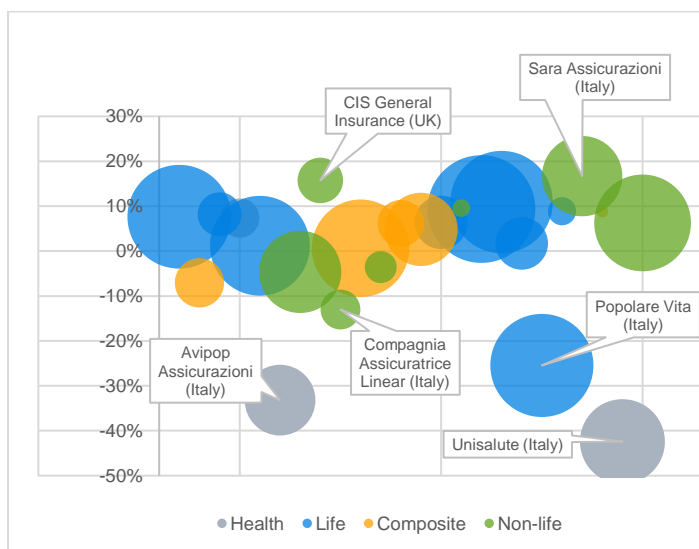
RETURN ON CAPITAL

We can also calculate the return on capital implied by the transaction prices assuming zero franchise value.

The various cases are shown in Figure 5, with the sizes of the bubbles representing the value of the companies implied by the transaction prices.

FIGURE 5: IMPLIED RETURN ON CAPITAL P.A. ABOVE RISK-FREE, ASSUMING ZERO FRANCHISE VALUE

The return on capital p.a. varies significantly, with a cluster of values around 10%. The very negative values represent cases which probably have significant franchise value. On these assumptions, the median return on capital of these transactions was around 6% p.a., but we would note that if some franchise value is assumed (which would clearly be the case on some transactions) this value would increase.

We have not attempted to estimate what a reasonable franchise value for particular cases in this sample could be, but it should be possible to do that based on information about new business premiums, and some measure of profitability together with capital consumption. This could be particularly feasible for companies like non-life and some health insurers, where accounting profitability is a reasonable proxy for new business added value before cost of capital.

Conclusions

We do not claim that it is possible to make many generalised conclusions about the pricing of these particular transactions from the analysis in this paper. As we have explained, to do that would require more in-depth analysis of particular cases using additional publicly available information.

What we hope we have shown is that the availability of publicly disclosed Solvency II data and the S2AV methodology do allow us to get insights into the possible valuations of companies and the factors influencing those values.

This can be particularly useful for those such as investors, investment analysts and those wanting to benchmark potential transactions, who wish to understand the economic value of insurance companies from publicly available data.

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CONTACT

Jeremy Kent

jeremy.kent@milliman.com

Ed Morgan

ed.morgan@milliman.com

Appendix: Transactions included

The following table lists the transactions included in this analysis:

ENTITY	YEAR	COUNTRY	TYPE	TRANSACTION PRICE (EUR M)
Abbey Life Assurance Company Ltd	2016	UK	Life	1,085
Adriatic Slovenica d.d.	2018	Slovenia	Composite	245
Aegon Ireland plc	2018	Ireland	Life	194
Aegon Pojistovna, a.s.; Aegon Slovensko	2018	Slovakia and Czech	Health	155
Antarius SA (50% Stake)	2017	France	Life	502
Avipop Assicurazioni SpA (50% Stake)	2018	Italy	Health	252
BPCE Assurances SA (40% Stake)	2017	France	Non-life	272
CIS General Insurance Limited	2019	UK	Non-life	209
Compagnia Assicuratrice Linear S.p.A.	2017	Italy	Non-life	160
Ethniki Hellenic General Insurance S.A. (75% Stake)	2017	Greece	Composite	718
Folksam Non-Life Insurance Limited	2018	Finland	Non-life	103
Friends First Life Assurance Company Limited	2018	Ireland	Composite	220
Generali Belgium SA	2018	Belgium	Composite	540
Generali PanEurope	2018	Ireland	Life	286
Net Insurance SpA (30% Stake)	2018	Italy	Non-life	9
Nordea Liv & Pension, livsforsikringsselskab A/S (25% Stake)	2017	Denmark	Life	292
Nordea Liv & Pension, livsforsikringsselskab A/S (45% Stake)	2018	Denmark	Life	475
Old Mutual Wealth Italy S.p.A	2017	Italy	Life	278
Popolare Vita SpA (50% Stake)	2017	Italy	Life	536
Pramerica Life SpA	2018	Italy	Life	80
Sara Assicurazioni S.p.A. (20.78% Stake)	2018	Italy	Non-life	135
UBB Life Insurance EAD (40% Stake)	2018	Bulgaria	Composite	6
Unisalute S.p.A. (98.53% Stake)	2017	Italy	Health	715
Vittoria Assicurazioni SpA (40.76% Stake)	2018	Italy	Non-life	384