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FINANCIAL SERVICES

Perspective: Trends driving the insurance M&A landscape in 2015

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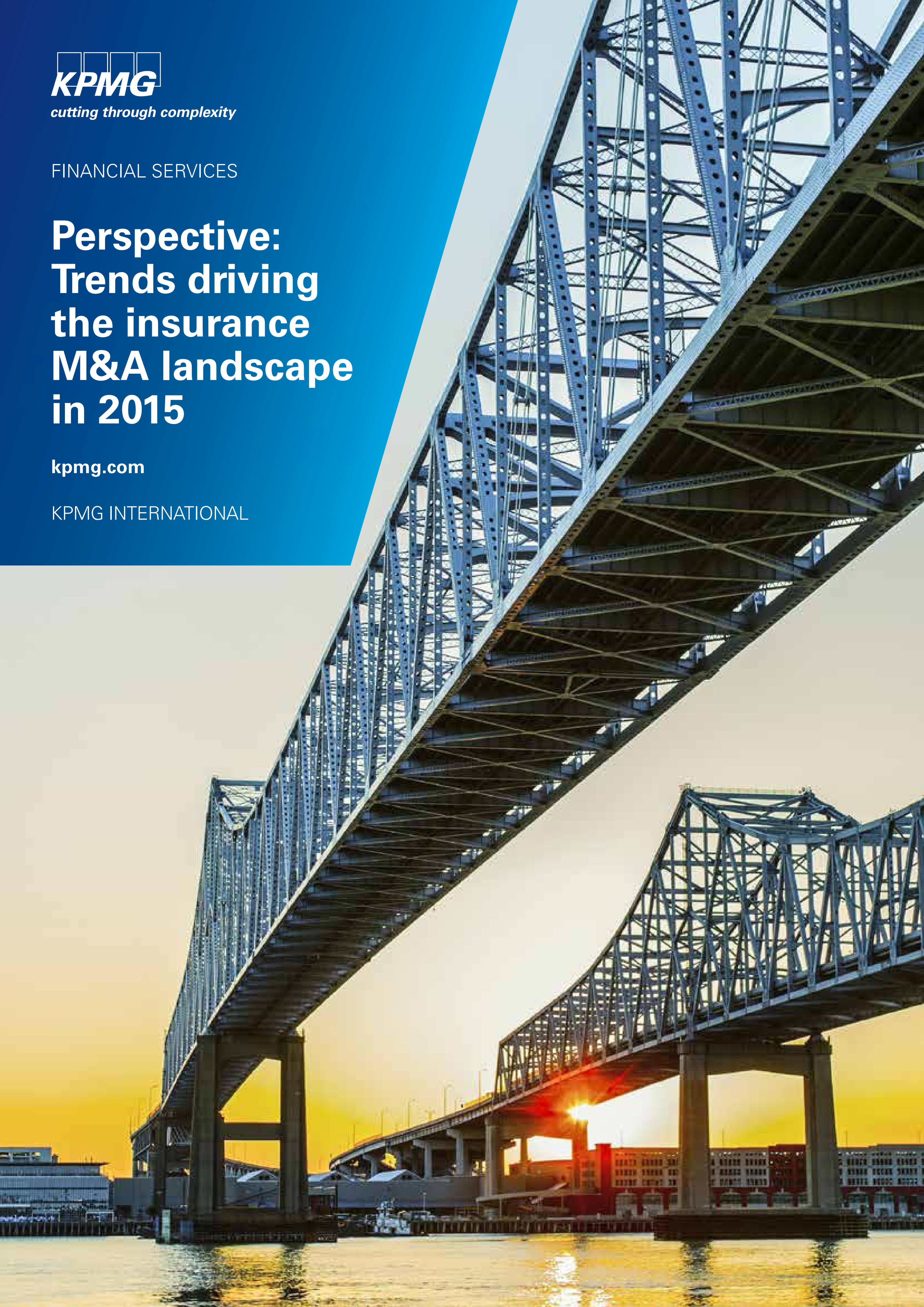

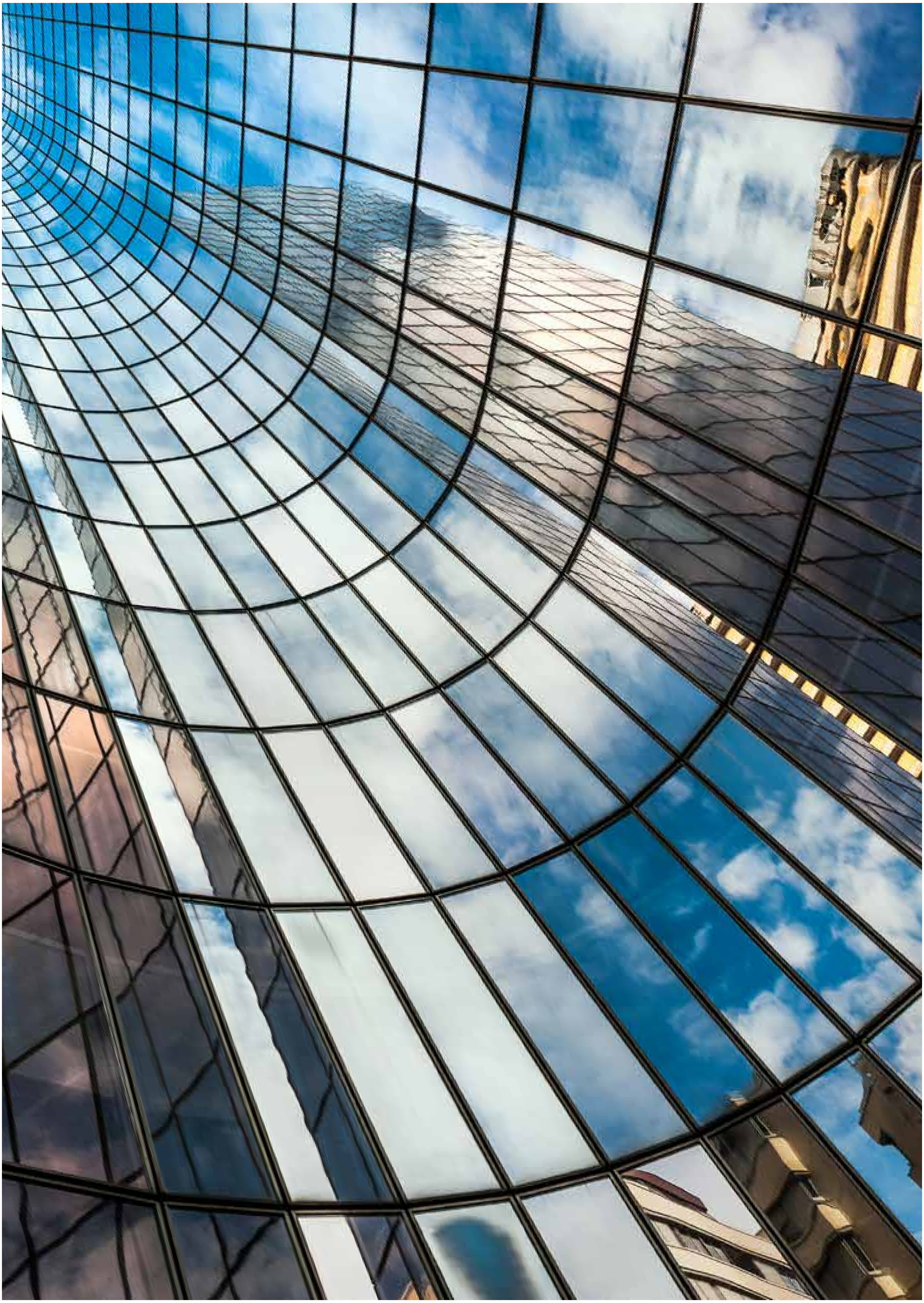

Foreword

The insurance sector's appetite for targeted mergers and acquisitions (M&A) grew throughout 2014, with continued confidence and strong balance sheets resulting in a steady flow of deal activity across many of the core global insurance markets. Ending the year on a high note, the sector witnessed a number of large transactions announced or being contemplated.[1]

At the beginning of 2014, KPMG Internationals Deal Advisory practice published a short report titled, *Ten Predictions for Growth: Trends shaping the future Insurance M&A landscape*. The predictions focused primarily on the importance of high growth markets and the impact of technology, alternative buyers and regulation. As KPMG professionals supported clients throughout the year, it became evident that many of the predictions were unfolding as expected, with some surprises along the way. *A Year in Review: Drivers and trends that shaped Insurance M&A in 2014*, published in December, provides a good overview of the deals and market conditions that influenced the landscape throughout the year.

We do not expect to see a fundamental change in the nature or volume of deal activity in 2015, assuming there are no significant macro-economic shocks. However, we do anticipate subtle changes in focus and geographic areas of interest.

Additionally, the world's largest corporates are expected to show an increased appetite for M&A deals and will likely have more capacity to fund prospective transactions in 2015, according to the latest analyst expectations in KPMG International's Global M&A Predictor. This bodes well for expected deal activity across financial services.

In this years 'Trends' report, we have grouped our predictions for M&A activity under four broad drivers:

1. importance of high growth markets
2. impact of regulation
3. efficiency and focus
4. consolidation.

If you would like to discuss M&A opportunities, please feel free to contact me or one of my Deal Advisory colleagues.

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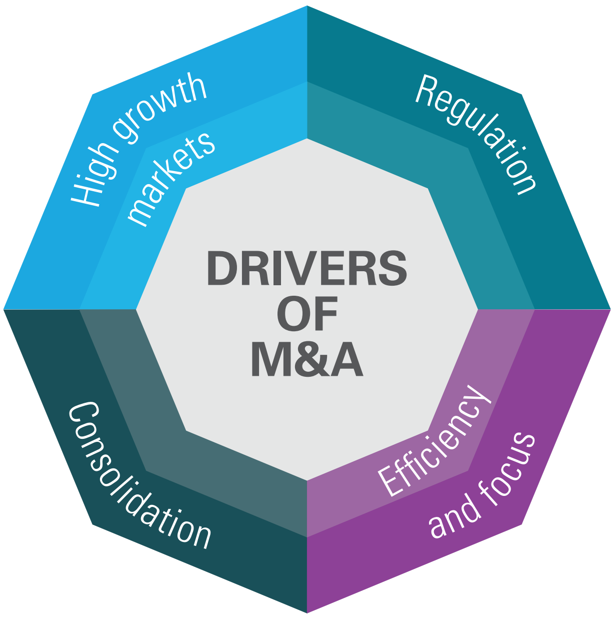

[1] Aviva acquisition of Friends Life in the UK and XL's proposed takeover of Catlin

High growth markets

The pace of change in developing economies brings diverse challenges and opportunities. As companies look to take advantage of opportunities in India, where the newly elected government has eased the restrictions for investors, or in Africa, where countries such as Nigeria and Kenya are resizing their GDPs to show the true value of their markets, the doors are open for a variety of businesses to enter.

For Insurance, there are a number of important ways that high growth markets are expected to influence the M&A environment this year.

Africa

The African region, and in particular Sub Saharan Africa, is becoming increasingly important to the insurance community. While the markets are still relatively immature and unable to move the dial of a large corporation in the short-term, the longer-term prospects are significant.

The potential for Africa is supported by positive demographic change. The population is expected to double in size by 2050[2], a developing middle class (forecast GDP per capita growth of 28.6 percent between 2013 and 2019) and the adoption of technology, particularly leveraging mobile technology to grow financial services, present many opportunities. Excluding South Africa, insurance penetration remains close to just 1 percent of GDP.[3]

We saw a number of global insurers, as well as insurance groups from South Africa, look to capitalize on this underlying opportunity and complete deals in 2014.[4] We expect this trend to continue, and indeed, increase in 2015.

[2] Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: The 2012 Revision, http://esa.un.org/unpd/wpp/index.htm

[3] Sector report: Insurance Africa, 2014, KPMG in Africa

[4] Prudential in Kenya & Ghana, Swiss Re in Kenya, Axa in Nigeria and [ ]

Reverse deal flow

Reverse deal flow refers to transactions involving acquirers from high growth markets investing into mature markets. This has been a developing trend over the last 12-24 months, with perhaps the Chinese conglomerate, Fosun, the most prominent example. Fosun announced a number of insurance related deals in 2014.[5]

We expect this trend to continue and increase in 2015 as large insurers, particularly from Asia, look for diversification, capability and access to international investment markets.

In a related development we also expect to see more real estate and infrastructure investment coming from countries like China, reflecting the size of investment portfolios, need for diversification, relative immaturity of domestic investment markets and asset liability matching considerations. A recent example was the high profile acquisition of the Waldorf Astoria by Anbang.

The rest…

A continued interest in the traditional high growth markets in Asia and Latin America as well as countries like Turkey is expected.

With the exception of a small number of large deals, the Latin American region was relatively quiet in 2014 while activity may bounce back in 2015, some political and/or economic concerns remain for certain countries like Brazil.

China and India will also attract headlines in 2015 and are considered separately on the following pages.

[5] Fosun acquired insurance businesses in Portugal and US and invested into Ironshore in Bermuda

Impact of regulation

Regulation remains perhaps the most important driver, with a unique ability to quickly and fundamentally change the market landscape and, accordingly, potential for M&A. Relevant areas of regulation include changes in foreign ownership restrictions, capital reform and conduct regulation.

> In late December 2014 the Indian government announced an increase in Foreign Direct Investment to 49 percent.

At the time of publication the increase in the FDI limit has been promulgated through Ordinance and still requires ratification from parliament. However, as things stand the Insurance Bill is now law and insurers are able to act.

A view from India

We expect India to be at the forefront of many insurers' strategic agendas for 2015. Always an important market given its scale and potential, this increased focus will be driven by the change in the Foreign Direct Investment (FDI) limit from 26 percent to 49 percent[6]. Over the next 5 years, total life insurance premium is expected to be US$92 billion, and non-life (including health) at US$30 billion.[7]

The increase in FDI limit is expected to act as a catalyst, helping the industry re-discover growth after a challenging period, while encouraging an increased focus on innovation, international best practice and improving standards which in turn will drive better customer experience.

As a result, we expect to see a significant uptick in activity as existing Joint Venture (JV) partners consider whether to increase their stake, and new entrants are attracted to the market.

Furthermore, there is potential for consolidation within the market and the increase in capital created through increasing foreign participation will be a further enabler. Many foreign players operating in India are keen to increase their stake. The new capital infused as a result of increased shareholding is estimated between USD 3 to 4 billion.[8]

6 The Union Cabinet in India approved promulgation of an ordinance on the Insurance Laws (Amendment) Bill, 2008 on 24 December 2014.

7 KPMG market analysis, KPMG in India.

8 KPMG market analysis, KPMG in India

A view from China

China remains a core growth market and one that is experiencing significant regulatory change with a new risk based solvency standard being introduced in 2015/2016. The market has seen recent changes to bank distribution, imminent de-tarrification of motor insurance, initiatives to develop health insurance and pension markets.

> The Chinese government clearly appreciates the size of its demographic problem and the less than adequate condition of its existing aged care industry, so they've passed a number of new policies – including the recent opening-up to foreign direct investment.
>
> *Dr. Eamon McKinney, CEO, CBN Care Group*

Combined with relaxing foreign ownership restrictions and changes to local ownership requirements aimed to reduce government's ownership stake in the insurance sector, China is poised to see an increased level of attention, particularly in the health insurance and pension markets.

The current 5 year plan includes an objective to establish a social safety net of basic health services, including developing a comprehensive medical insurance system. We believe the government will increasingly look to the private sector to provide solutions.

A view from the UK

The UK is a good example of how mature markets are responding to the impact of new regulation. Recent changes to pension products, which created enhanced flexibility and greater freedom for pensions, and the continuing conduct focused regulation are at the fore.[9]

Further consolidation in the UK is expected, particularly in the life and mutual sectors in response to recent changes as the importance of scale, capital efficiency and distribution capability grows.

Solvency II

To some degree, Solvency II has acted as a break on deal activity due to uncertainty around future capital models. As the 'go live' date of 1 January 2016 gets closer and greater clarity is realized, it would be reasonable to expect to see this break released and increased confidence translate into more deal activity.

Areas of the market that are likely to see greatest impact are mono-line insurers, companies with long-term guarantees on legacy business and annuity writers.

Once capital requirements are clear, we expect to see an acceleration in M&A activity as some companies will require more capital, and others will look to use M&A to achieve greater diversification and reduce capital requirements.

[9] Enabling Business Opportunities for UK Companies in China's Elderly Care Markets, http://www.cbbc.org

Efficiency and focus

The key drivers underpinning efficiency and focus are rationalization of non-core operations, driving improved cost and capital efficiency though effective management of back books and a focus on enhancing the customer experience and distribution.

> As demographic, environmental and regulatory changes accelerate product innovation, there is an increasing pool of redundant products leaving behind a legacy which needs to be managed. Legacy business can be a drag on efficiency, agility, focus and customer-centricity.

Rationalization of non-core operations

In the current environment a 'flag planting' strategy is not viable, accordingly there is increasing pressure and focus on management teams to determine core markets for their respective businesses.

In certain instances, exits have been driven by stressed situations or fall out from the crisis which created short-term ownership structures. This particular element is diminishing, although a number of remaining assets will likely be sold in 2015.

KPMG professionals expect to see the large global players exit, close or look to restructure certain underperforming operations that are not considered strategically important.

Considerations for Insurers with legacy portfolios

1. Do you have a coherent strategy for your legacy business and if so, is it consistent with the group's wider business and customer strategy?
2. Do you have a clear understanding of the impact of your legacy business on P&L and capital?
3. Have you determined a target operating model for your legacy business and does the business operate in accordance with that model?
4. Does your legacy business show best practice in the management of claims, reinsurance collections and other operating functions?
5. And, do you have a strategy for the ultimate release of the capital that supports the legacy business so that it can be utilized elsewhere in the group?

Management of back books

The benefits of a successful program to enhance management of back books is self-evident with insurers seeing reduced costs, enhanced capital position and in certain instances improvements in cross sell and up sell revenues.

As insurers continue to explore possibilities, and with remaining appetite from closed book consolidators in certain markets, the chances of increased deal flow are high.

Enhancing the customer experience

An exciting and developing area of the market, insurers are looking to continually improve and enhance the customer experience through better use of technology, data and interaction with the client.

The rise in customer expectations and sophistication are encouraging innovation and increasing collaboration with organizations that may not have traditionally been part of the insurance value chain.

Telematics is one example of increasing focus among some insurers to deliver improved underwriting profitability but also enhanced customer service. Additionally, insurers are looking to transform their product design and claims management processes through innovations such as machine learning.

A number of insurers are investing heavily in these areas through in-house research and development centres. However, we also see advantages for insures looking to acquire capability or enter into partnerships with firms that bring specific capability, such as collecting and analysing vast amounts of data, or in the development of digital distribution capability.

Accordingly, we expect to see more activity, either outright acquisitions, Joint Venture's or partnerships involving insurers and FinTech companies.

FinTech continues to grow in importance

One example is the FinTech Innovation Lab operating in New York, London and Hong Kong. The Lab was established for entrepreneurs developing cutting-edge technologies for the financial services sector – particularly in the areas of big data and analytics, mobile and wireless, payments, risk management, security, and social media and collaboration technologies.

The Lab is gaining momentum as banks, capital markets firms and insurers continue to drive FinTech investment. Over the last 3 years, global investment in FinTech companies has grown four times faster than venture investing overall. "During the first three quarters of 2014, New York's FinTech sector received US$472.1 million of venture and private equity investment, which is more than was invested during the full year of 2013."

—FinTech Innovation Lab, 20 October 2014.

Spotlight on Joint Ventures… a viable option for insurers entering new markets

Insurance companies are experts at managing risks. They also wish to grow, but usually cautiously. Joint Ventures are a logical tool for a cautious market entry. But…only when guided to avoid the hidden dangers!

JVs are often considered to enter new markets, gain (local) expertise, increase production capabilities, and expand distribution, or share risks and investment requirements. Especially in markets where foreign ownership is restricted such as India or China. JVs are often the main or only market entry model.

Over the last few years JVs have become increasingly used, with the number transactions growing faster than the M&A volume, for example:

- over 35 percent of global corporate revenues are now generated from business alliances
- the 100 largest Joint Ventures generate > US$350 billion in combined revenues
- more than 5,000 new Joint Ventures have been established in the last 5 years
- equity-related Joint Venture transactions accounted for over 30 percent of M&A deals in 2013.

Although the interest in JVs has grown, the success rate is unfortunately is still rather low, driven by common mistakes made during set-up of the Joint Venture, such as:

- disagreement over levels of investment and differing views about what is needed for JV success
- unclear roles and responsibilities, undefined accountabilities or escalation procedures (i.e. Delegation of Authority)
- disagreement over standards and processes or, both partners expecting/wanting to impose their own
- insufficient detail in the JV agreement—'Legalistic' drafting with no practical, commercial solutions
- differing motives and drivers between JV partners, leading to a lack of transparency and trust
- difficulty adapting to a collaborative 'partnership' as a result of working as individual entities in a competitive environment.

At the same time, KPMG member firm research and experience show that these risks can be mitigated and the probability of success be improved.

Consider the following actions:

- **develop and articulate the logic for the JV 'win-win'**
- **ensure clarity on contributions**
- **build-in mechanisms that allow for flexibility**
- **establish a clear, practical governance plan supported by a sound business case**
- **include the ability to detect and deal with issues early, including areas of potential contention**
- **test the JV design early using a range of scenarios**
- **build in practical flexibility and protection**
- **invite operational teams to contribute insight pre-deal**
- **get to know your partner well, formally and informally**
- **proactively invest in managing the relationship.**

It is important to note that the success of a JV is built on working together, not competing against each other. Those leading the deal need to have a structured, comprehensive approach to generate options, prioritize and enable well informed and clear decisions, in order to enter new partnerships with confidence.

Based upon our experience, the 'softer' aspects tend to drive the success of the JV. While these too can be addressed and managed in a structured manner, they need a significantly different approach than conventional M&A deals.

Bancassurance

Bancassurance remains a key distribution channel in many markets and will be an important channel in high growth markets like Africa where leveraging a mobile banking platform represents an excellent opportunity to increase insurance penetration.

In countries where banking and insurance capital reform is putting pressure on the common ownership model we expect to see an increase in deal activity throughout 2015. An interesting example being in Australia, where the life market is dominated by integrated bancassurers. We expect to see certain banks looking to divest their insurance operations and enter into distribution agreements.

It is interesting as to what makes a successful bancassurance model and why a particular approach tends to dominate in certain countries (common ownership, joint venture or exclusive/open distribution agreement). We plan to issue further research on this topic later this year.

Expanding broking sector

The broking sector has been one of the most dynamic from an M&A perspective in 2014 as the large global brokers look to enhance capability and geographic reach. This trends is expected to continue, with a focus on both mature and high growth markets.

Consolidation

Our final key theme captures those additional drivers that are supporting consolidation or changes in ownership.

> One of the key trends for 2015 will be linking alternative capital with underwriting capability.

Reaction of reinsurers to continuing rate pressure

Excess capital in the reinsurance markets, both traditional and alternative, combined with relatively benign catastrophe experience is resulting in an increased focus on strategic M&A to build scale and drive efficiency.

We expect to see more consolidation within the reinsurance sector as well as activity from the Bermuda based carriers. A recent example is the PartnerRe and Axis announcement of a proposed US $11 billion merger. A strong indication of the appetite for consolidation within the reinsurance sector.

One of the key trends for 2015 will be linking alternative capital with underwriting capability.

A view from Russia

Continuing economic upheaval in Russia is placing strain on the financial sector. This follows a number of exits by foreign players towards the end of 2014.

Alternative capital providers

We expect to see continued appetite from private equity and other sources of capital to make acquisitions in the insurance sector, increasing competition for the incumbent players (e.g. CPPIB's acquisition of Wilton Re in the US in 2014).

We are also seeing private equity investors using their existing asset to drive a roll up/consolidation strategy. Given private equity involvement in the insurance sector has existed for a number of years, it is reasonable to start to see more private equity divestments in 2015, further encouraging deal activity.

Achieving your growth objectives: Opportunities and challenges

Recognizing both the underlying opportunities and the associated challenges, we want to highlight three aspects that will be critical to future success as you consider M&A.

1. Maximizing the potential of innovation

The importance of joint ventures, partnerships and collaboration will increase in the current environment. We already see this in many high growth markets where regulation requires a local partner. While evolving market dynamics in more mature countries require new solutions that insurers will not be able to provide on their own. This is particularly true for technology as insurance groups look to keep pace with new innovations that support a positive customer experience and to gain competitive advantage.

In some regards, a traditional insurer can be a difficult partner, with a conservative mind set, legacy and inflexible systems, complex structures and restrictive regulatory requirements. This contrasts (potentially painfully) with a new tech start up, so how can success be achieved?

Clearly finding the right partner with aligned objectives is a critical first step and while we do not underestimate the importance of an appropriate legal structure and protections, we advise a greater focus on the softer aspects. For example, cultural flexibility, operating model and communication. Freeing the innovators from the constraints of a day to day P&L and creating a safe environment to 'fail and learn' can help deliver long term success.

2. Entering new 'second horizon' markets with the right strategy and partner

As the more traditional high growth markets reach a mature state, often with significant foreign presence, attention is shifting to 'second horizon' markets, with Sub Saharan Africa a prime example. The challenges associated with completing a successful deal in an unfamiliar geography, particular in a very immature market, increase exponentially.

Abandoned deals or inability to work with your local partner can result from a buyer's lack of understanding or ability to navigate the foreign culture and issues associated with the realities of the local market-regulation, channel dynamics, customer behaviors and employee engagement. As a result, successful buyers must gather detailed market intelligence and tap into knowledgeable local players to better appreciate on-the-ground conditions, culture and operating considerations.

The prospective buyer should also carefully map out their M&A strategy and approach, precisely identifying underlying goals for the acquired asset and how they will achieve growth. Without such in-depth, upfront strategic reflection, buyers can find themselves invested in the wrong market, with the wrong partner, or lacking clearly defined post-deal direction. Flexibility in an uncertain and evolving market environment is key.

3. Dealing with underperformance

Tightening regulation, increased competition and the continued challenging economic conditions have all led to insurers looking more closely at their operations, the risks affecting those operations and the regulatory capital required commensurate with those risk assessments.

Tolerance for underperforming businesses is at an all time low and the time of insurers 'planting flags' in new geographies has passed. Accordingly a rapid, dynamic and robust process around the decision to fix, sell, close or invest in a business is required. Management need to be able to challenge existing businesses in a thorough, dispassionate and iterative way to ensure the right decisions are made.

There are a number of potential strategies ranging from targeted investment to drive a turnaround through to putting a business into run off or seeking a sale. Regardless of the preferred approach, management need to act quickly and decisively and ensure that a detailed implementation plan is developed and followed.

In conclusion

We expect 2015 to develop in a similar way to last year, with high growth markets at the forefront given continuing demand to secure access to the underlying growth opportunity together with regulatory change driving interest in markets like India and China. Potential buyers could come from many different sources with the traditional global players facing increasing competition from high growth market giants, private equity and alternative capital providers.

All of the above suggest we can expect another active and exciting M&A environment in 2015 for the insurance sector. If you would like to discuss M&A as part of your firm's growth strategy, please contact your local KPMG Insurance M&A contact.

KPMG's global insurance M&A platform is positioned to help you achieve your objectives

To help ensure the highest level of support to satisfy KPMG member firms clients' M&A planning and execution requirements, we have established an integrated global network of multidisciplinary M&A professionals focused on the insurance sector.

Our dedicated insurance teams provide strategy, market entry, due diligence, joint venture advice, restructuring, valuation, separation and integration and M&A advice across mature and high growth markets.

KPMG's insurance deal advisory practice approach helps to ensure in-depth local market experience is complemented with global deal experience, customized to individual assignment requirements.

The result is an impressive track-record of M&A deal support and a roster of leading global insurers who have turned to us to help ensure their transaction ambitions and activities achieve their strategic business objectives.

Our network of member firms across the world can help you meet your growth objectives:

- achieve corporate growth, realize synergy potential and profit objectives
- create and execute on a well-developed growth strategy
- release capital and enhance liquidity from sale of core or non-core businesses
- restructure or wind down of non-core businesses
- implement an optimal separation plan
- tailor M&A advice to ensure a successful outcome when assessing opportunities
- identify a wide pool of potential opportunities in your core markets
- understand value drivers, opportunities and risks related to a potential acquisition target
- design and execute an effective post deal integration plan
- establish or enhance your joint venture, including structuring, maximizing protection and improving operating effectiveness.

KPMG's Deal Advisory practice, comprises M&A, debt advisory, valuations, transaction services, strategy and restructuring services.

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