Mergers and acquisitions developments

Arrival of the expected M&A wave?
New capital inflows, excess capacity and benign catastrophe loss activity have contributed to falling (re)insurance prices and a challenging environment for specialty (re)insurers. These combined factors have been the rationale for predictions of a wave of market consolidation, which appear to have become a reality during 2015 as a series of rumours and announcements grabbed the headlines.

Cyclical drivers of M&A activity (the anti-correlation thesis)
Reducing profit margins and a history of pulsing rate cyclicity may create the impression that now should be the time to batten down the hatches and wait for the storm to pass. That conclusion fails to acknowledge the behaviours and economics that drive the insurance cycle. The accepted presumption is that there is a rational anti-correlation between the market pricing cycle and M&A activity, with soft market conditions leading to heightened activity and valuation multiples.

A study of the stages of the insurance cycle and the resulting drivers of M&A transactions reveals that in hard markets it is likely that the demand for M&A would be inhibited by the strong inherent profitability of market participants and continued potential to achieve attractive organic growth without the risks associated with an acquisition.

A symptom of soft markets is that the lower underwriting margin environment substantially challenges a business’s ability to maintain returns and deploy surplus capital through organic growth. While a number of strategies are available to optimise the capital base to reflect these challenges, many businesses are attracted to the alternative routes of deploying excess capital and achieving synergies through acquisition.

Current drivers of M&A activity
A review of M&A activity in the US specialty insurance market and the global (re)insurance market does support this anti-correlation thesis. However, while the strategic rationales for many of the recently announced transactions support this thesis, it is also noteworthy that the synergies of consolidation are not the only drivers of M&A activity.

A number of other strategic rationales have emerged during 2015, including the motivations for Fairfax and Brit, Fosun and Ironshore/Meadowbrook, Exor’s bid for PartnerRe and China Minsheng’s bid for Sirius. In each of these cases, the deal is not driven by consolidation synergies but rather by recognition of the inherent attractiveness of the target’s business model and ability to generate an acceptable investor return on capital within a diversified portfolio.

While most of the high-profile transactions announced to date are a response to the challenges in the (re)insurance market, more recent announcements such as Ace and Chubb, Tokio Marine and HCC, and Zurich’s approach for RSA demonstrate that the pick-up in M&A activity is now flowing over to the specialty and broader insurance markets.

Disruptive forces to M&A activity
The reality is that many external forces disrupt the insurance pricing cycle’s impact on M&A activity. In recent years the (re)insurance markets have been influenced by financial market conditions, new investors, globalisation and the benefits of healthy underwriting profits despite rate softening.

Capital markets conditions
Insurance company valuations have in recent years shown substantial appreciation. Given the soft premium rates and low investment yields, the heightened valuations can be attributed principally to broader market sentiment, but also to the anticipated M&A activity within insurance markets. The raised valuations and liquid capital markets have provided improved access to transaction financing.

Impact of ‘alternative capital’ in the reinsurance market
The flow of alternative capital into the reinsurance markets has been sustained and substantial. It is likely that the increased fluidity of capital in the sector simply accelerated the development of the challenging market and the onset of consolidation activity.

Capital with alternative strategic interests competing for M&A opportunities
Other investors that have entered the (re)insurance market via acquisition have blurred the anti-correlation theory’s parameter of the required level of underwriting margin to generate an adequate return on capital. Exor’s offer to acquire PartnerRe is an example of a knowledgeable investor identifying (re)insurance market returns as an attractive opportunity relative to the yields available elsewhere, despite current soft market conditions.

Similarly, the use of investment float has been a long-term feature of the market. However, the proliferation of the new hedge fund reinsurance model, as well as the strong interest from the Chinese funds with substantial capital resources and a desire to diversify and grow assets under management, has created a much greater focus on generating returns from the investment float than the market mean.

These acquirers exhibit a lower requirement for underwriting return than normally assumed. They can effectively compete in soft markets for M&A transactions with traditional market consolidators despite not accessing the benefit of underwriting synergies.

Solid financial results despite soft market rates
The combined impact of reserve releases, a benign loss environment, escalating solvency capital requirements and more robust balance sheets have helped to cushion the impact of the softening cycle and hence delay the onset of M&A pressures. However, these delaying influences cannot be expected to endure. It is reasonable to anticipate that the declining rate and low investment yield environments will eventually be realised more fully in financial results.

Future outlook for M&A activity
We are in a complex and changing environment, where macroeconomic developments, the pricing cycle, a wide array of sources of capital, globalisation and the benign catastrophe loss environment are all strong and interconnected influences.

With these dynamics in place, absent a major market catalyst or macro-environment event, we can reasonably expect a continued proliferation of M&A activity in the specialty (re)insurance markets.