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Sustaining profitable growth

AUTHORS: DAMIAN GULY, SIMON HOW, STEVE OSEI-MENSAH AND RUPERT TAYLOR-REA

European insurers are striving to sustain profitability in the face of an increasingly tough market climate. Realising opportunities for mergers and acquisitions (M&A) and organic growth could help companies to manage costs and strengthen revenues. Damian Guly, Simon How, Steve Osei-Mensah and Rupert Taylor-Rea examine the drivers and developments that are set to shape deal activity and revenue growth strategies in the year ahead.

'The uncertainty surrounding the outlook for economic activity remains high', said Jean-Claude Trichet, president of the European Central Bank, at a press conference in July.[1]

For European insurers, one of the most challenging aspects of this 'uncertainty' is the difficulty of predicting customer behaviour when the depth and duration of the economic slowdown is still largely unknown. As concerns over inflation and unemployment increase, discretionary spending is likely to be curtailed. The stalling in the property market could affect demand for term life, buildings cover and payment protection insurance, and further dislocation could follow. On the life side, the impact could include reduced demand for savings and investment plans. On the non-life side, people may buy less travel insurance or choose third-party motor insurance rather than more expensive comprehensive cover, for example. Whether the downturn is beginning to bottom out or worse is yet to come is a matter of conjecture; the challenge for insurers is planning for all economic eventualities amid the wider problems of softening non-life premium rates, falling investment returns and declining asset values.

In the deal market, the spectre of recession and how this may affect customer demand and corporate profitability are creating their own uncertainty. In particular, the uncertain prospects are making it more difficult to value businesses. Moreover, in the view of many commentators, sellers have not yet sufficiently lowered their price expectations to attract the committed interest needed to secure a sale.

However, in an insurance sector that remains fragmented, the case for continued consolidation is strong, especially as this could help realise opportunities for cost-saving synergies. As banking groups seek to release capital and sharpen their strategic focus in the wake of the credit crisis, some may choose to sell their insurance subsidiaries. An increased availability of acquisition targets could in turn help purchasers to secure deals at more realistic prices.

As competition intensifies, the need to manage costs and enhance efficiency will become more urgent. Companies may also need to focus more closely on client retention and cross-selling at a time when capital constraints and uncertainty over consumer spending could make customer acquisition and new product launches riskier and less cost-effective. As a recent PricewaterhouseCoopers survey highlighted,[2] the focus of investment in revenue growth is set to include multi-channel distribution and improved customer analytics. Customer 'ownership' will be especially important in enabling life insurers to win pension and investment business, as welfare reform and an ageing population rapidly increase demand.

In this article, we consider the challenges and opportunities for both acquisitive and organic growth within the current market environment. We will reflect on the level of M&A during 2007 and assess some selected deals and the underlying themes, before considering the prospects for, and possible drivers of, transaction activity in 2008 and beyond. We will also examine how leading companies are looking to enhance customer understanding, service and retention as part of their organic growth strategies.

Deal activity in 2007

Financial service deal activity accounted for almost one-fifth of all European M&A by value in 2007 (€207.7 billion[3]), a rise of more than 50% from 2006. European insurance deals made

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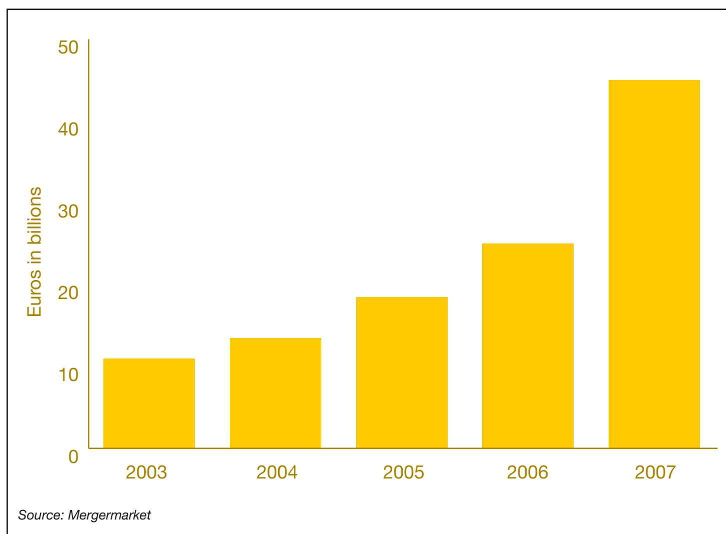
1 Transcript of ECB press conference, 03.07.08.
2. Survey conducted by PricewaterhouseCoopers and the findings presented at 'The Insurance Network Half Day Workshop', 15.05.08.
3. Mergermarket announced deals in 2007 excluding those that, in our view, are not 'true' financial services deals, e.g. real estate.

Figure 1 **European insurance deals total announced value**



Source: Mergermarket

up €44.8 billion[4] of the total, an increase of 76% from 2006. This rise was significant, given the growth rates of around 30% already recorded in 2005 and 2006 (see Figure 1).

Figure 2 lists the 10 largest European insurance transactions in 2007. A key driver was the desire for cross-border growth and diversification, as exemplified by Allianz's acquisition of the remaining 42% of Assurance Générales de France (AGF), the year's most valuable deal. Allianz believes that its 'home' market is Europe as a whole rather than just Germany. 'The transaction will strengthen Allianz's position in its core home markets and business lines', said Michael Diekmann, CEO of Allianz SE.[5] Similarly, the acquisition of Converium by SCOR, the French reinsurer, demonstrated a desire to achieve critical scale and leveraging of complementary markets and business lines. 'The consolidation in the insurance and reinsurance industries shows that size, diversification and expertise are critical success factors', said Denis Kessler, chairman of SCOR.[6]

Another key motivator was the opportunity to realise synergies in cost and efficiency, as was evident in the acquisition of Resolution by Pearl and the merger of Saga and the AA. Completed in May 2008, the takeover of Resolution illustrated the continued willingness and ability of major insurers to undertake transformational deals. At above embedded value, the price also indicated that Pearl sees significant opportunities to develop and extract value from the merged businesses. Hugh Osmond, Director of Pearl Group Ltd, said: 'We wish to combine the proven strength and expertise of both teams to create one organisation capable of delivering far more than either of its constituent parts.'[7] The merger between Saga and the AA also highlighted the increasing influence of private equity in the European financial services sector. The link-up of the two private equity-owned businesses is designed to achieve greater scale and synergies. 'Both organisations can grow and benefit from sharing expertise and systems', said Andrew Goodsell, CEO of Saga.[8]

Developments ahead

The search for competitive scale and cost-saving synergies will be even more important in the challenging market conditions of 2008 and beyond. The strategic reviews and realignment within the financial services sector as a whole could also open up new opportunities for acquisition and revenue growth.

Divestment

Events so far in 2008 indicate a possible shift away from the bancassurance model in some markets as banks look to release capital and refocus on their core activities. In an interview with La Repubblica earlier in the year, Henri de Castries, chairman of AXA, said that he expects banks with a stretched capital base to reduce their presence in the insurance sector, mainly in the second half of 2008.[9]

The Royal Bank of Scotland (RBS) has announced plans to sell its insurance division. The assets on offer include the well-known UK brands Direct Line and Churchill. 'RBS Insurance… remains an excellent business, but is not central to the very strong banking franchises we have now built', said Sir Tom McKillop, chairman of RBS.[10] Grupo Santander is also reported to be considering a sale of its insurance business.[11] A number of insurers are themselves carrying out reviews that may result in the sale of non-core operations. Examples include Friends Provident, which is seeking to release Lombard as part of its renewed focus on life and pensions.[12]

4. Mergermarket announced deals in 2007.
5. Allianz media release, 18.01.07.
6. SCOR media release, 26.02.07.
7. Pearl media release, 16.11.07.
8. Saga media release, 25.06.07.
9. La Repubblica, 21.04.08.
10. RBS General Meeting statement, 14.05.08.
11. Reuters, 19.07.08.
12. Friends Provident media release, 31.01.08.

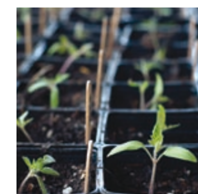


FIGURE 2 **Top ten insurance deals by value in 2007**

Rank	Announced date	Target company	Target country	Bidder company	Bidder country	Deal value EUR (m)
1	Jan-07	Assurance Generales de France	France	Allianz	Germany	9,800
2	Oct-07	Resolution Plc	UK	Pearl Group Limited	UK	6,582
3	Jun-07	Saga Group Ltd	UK	Automobile Association Limited	UK	4,156
4	Apr-07	Generali PPF Holding	Czech Republic	Assicurazioni Generali SpA; PPF Group NV	Italy; Netherlands	2,600
5	Feb-07	Converium Holding AG	Switzerland	Scor SA	France	1,951
6	Jun-07	SPP Livforsakring AB	Sweden	Storebrand ASA	Norway	1,914
7	Apr-07	AXA Nederland BV; DBV Verzekeringen; Winterthur Verzekeringen Holding BV	France, Netherlands	SNS Reaal NV	Netherlands	1,797
8	Jul-07	Abbey Life Assurance Company Ltd	UK	Deutsche Bank AG	Germany	1,451
9	Feb-07	Nuova Tirrena S.p.A.	Italy	Groupama SA	France	1,250
10	Mar-07	Banca Monte del Paschi Siena SpA (50.0% stake); Montepaschi Assicurazioni Danni S.p.A (50.0% stake); Montepaschi Vita SPA (50.0% stake)	Italy	AXA SA	France	1,150
				Total top 10		**32,651**
				Other		12,156
				Total Europe		**44,807**

Source: Mergermarket

Increasing private equity focus

Although private equity has been less of an active buyer in financial services than some other sectors, its presence has been growing. Much of the investment has focused on non-risk carrying businesses such as intermediaries, brokers and outsourced activities, which typically have lower capital requirements and are subject to a comparatively lighter regulatory touch. However, many private equity firms are now seeking to develop greater expertise in financial services as they come to recognise that the sector is too significant an element of the European economy to be ignored.

Although the rising cost of debt is making it more difficult for private equity buyers to secure the necessary finance for large transactions, many still have considerable funds to invest. The appearance of distressed sellers (troubled UK bank Bradford & Bingley has been one of a number to attract private equity interest), and a belief that the more difficult economic climate may increase the prospects for securing deals at attractive prices, is likely to draw further interest from private equity in financial services going forward. Targets could include insurance divestments.

Softening market

As the non-life insurance market continues to soften, the need to maintain underwriting discipline could mean that there is less scope for volume-led growth. Insurers may now need to look to those classes of business that are less affected by the insurance cycle, and bolt on acquisitions in order to deliver earnings growth. In particular, it can be difficult to value the earnings stream of an insurance business in a softening market, and if it becomes harder to control the top line then focus will inevitably shift to the control of expenses. A particular focus might be deals capable of delivering expense efficiencies and synergies along the lines of the Pearl/Resolution and AA/Saga mergers in 2007.

Opportunities in life insurance and pensions

In August 2008, Barclays agreed to sell its life assurance division ('Barclays Life') to Swiss Re.[13] The business was closed to new customers in 2001. The planned sale is the latest in a growing wave of life insurance buyouts. Although the sale of discontinued business has so far been predominantly confined to the UK, the move to Solvency II could heighten the spotlight on capital-intensive run-off business and prompt more Continental companies to divest.

13. Barclays media release, 05.08.08.

2008 and 2009 are also likely to see a continued increase in pension scheme buyouts. Sales in 2007 included Paternoster's €1 billion acquisition of the pension scheme of P&O. PricewaterhouseCoopers latest pension survey in the UK[14] found that many companies are interested in selling some or all of their pension liabilities, with most citing the volatility of their funding position as the chief reason for their continued interest.

Owning the customer

In the face of funding constraints and an uncertain economic outlook, many insurers may focus more closely on safeguarding existing business and cementing long-term client relationships, rather than new customer acquisition. This is already evident in the purchase of a number of brokers by AXA and other leading groups, as they seek to gain closer control over the customer relationship. It is also likely to frame client retention and customer management strategies as part of the wider pursuit of organic growth.

Organic growth

A recent PricewaterhouseCoopers survey explored the revenue growth strategies of a number of leading European insurance executives.[15] Four key imperatives emerged from the findings:

Greater focus on technology, especially the internet. Customers are demanding faster response and more choice of access points from their insurers. This ranges from electronic data exchange between brokers and underwriters to the ability to follow up the status of car repairs being carried out in insurers' garage networks.

Joined-up channel strategies, with pricing reflecting the channel cost. The leading European insurers now offer multi-channel services and are developing their understanding of the relationship between individual customer's channel preferences and profitability.

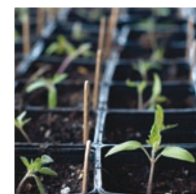
Enhanced data management, feeding more sophisticated rating engines. The fires and flood losses in Europe in 2007 highlighted the need for underwriters to develop a better understanding of their aggregated risks. The insurers that are improving their data management as a result will be able to enhance risk selection and improve their loss ratios accordingly.

Well-defined market segmentation, identifying the most profitable customers and focusing on the business that will reap the best returns on investment in customer acquisition and retention. In the current market, this may include focusing more closely on the quality of core business and how this compares to peers rather than new markets as they seek to secure greater customer 'ownership'.

Companies will not only need to develop effective customer profiling, but also ensure that staff understand and make best use of the opportunities to provide more responsive products. This can present cultural and change management challenges. 'Established practice is difficult to change', said a survey respondent. 'We have a lack of proper intelligence to accurately segment our chosen market space.'

Another central challenge is how to deliver a more favourable customer experience, while still being able to compete on price. 'Our current tailored approach, which is built around face-to-face relationships, is expensive', said a survey respondent. 'We need to utilise the expediency and reach of web distribution, while still appearing to give a personal service and offer our unique expertise.'

14. 'PricewaterhouseCoopers pensions survey: Tracking the views of key decision-makers', June 2008.
15. Survey conducted by PricewaterhouseCoopers and published at 'The Insurance Network Half Day Workshop', 15.05.08.



The focus on controlling costs is clearly essential. However, as we outlined in an article in the previous edition of Digest,[16] companies should avoid setting arbitrary cost reduction targets that may prove unsustainable or even commercially disruptive. In particular, it is essential to identify the people and operations needed to compete, grow and deliver strategic objectives. A clear case in point in the current market is the need for people with customer relationship and entrepreneurial skills to spot and realise opportunities in a downturn.

The importance of integrated cost, channel and retention strategies has been brought into sharp focus by the rise of price comparison websites ('aggregators'), a distribution phenomenon that has grown rapidly in the last three years in the UK and may become a major new channel in other European countries. The aggregators offer price quotation comparisons for retail products such as private motor, personal loans and home insurance. The quotes are binding and in many cases the contract can be executed on the internet there and then. Insurers featured on comparison sites are seeing rapid increases in the use of the internet channel (in the case of one major player a rise from 20% of motor policy sales via the internet in 2005, to 40% in 2007). This suggests that a multi-channel strategy is going to be increasingly critical for personal lines insurers as the aggregators provide instant choice and greater convenience in the buying process, although policy inception and service (including claims) are still largely executed via conventional channels, such as voice and post.

Survival and success

The soft cycle, falling investment returns and uncertain economic outlook are making it harder to sustain profitability and assure capital providers that anticipated returns can be achieved. Success depends on being able to manage the uncertainty ahead.

This challenging environment is likely to accelerate consolidation as insurers pursue scale, synergies, diversification and complementary earnings streams. The difficult climate is also likely to spur further developments in distribution and customer relationship management (CRM) as insurers look to enhance their understanding of their clients and offer more integrated and responsive multi-channel services. From cost control to customer ownership, effective growth strategies cut across acquisition and organic development. The key to success is determining what business fits best with the strengths of the company and developing this through targeted acquisition and customer service investment.

The prospects for growth will be strengthened still further by new opportunities, including the divestment of insurance subsidiaries by banks. As sellers begin to adjust their price expectations, purchasers may be able to secure these deals at more realistic prices. They might also be able to enhance the value of the transaction by extending investment in more effective distribution and CRM to newly acquired businesses.

While funding is likely to be challenging for some time to come, continuing investment and growth will be critical, both in equipping companies to manage the downturn and in preparing them for the eventual upturn in the economy and insurance cycle. Sustaining profitable growth will clearly be difficult in the tough market conditions ahead. Pressure on margins and investment returns will leave insurers with less room for manoeuvre and turn the spotlight on insurers that may struggle to deliver competitive returns. The key to sustaining profitable growth is decisive strategic evaluation and execution capable of realising the opportunities that are now emerging within these tough market conditions. □

AUTHORS

Damian Guly
Partner, Leader of Transaction Services, Financial Services Deal Team
PricewaterhouseCoopers (UK)
Tel: 44 20 7804 3494
damian.guly@uk.pwc.com

Simon How
Director, Financial Services, Performance Improvement Consulting
PricewaterhouseCoopers (UK)
Tel: 44 20 7804 9717
simon.x.how@uk.pwc.com

Steve Osei-Mensah
Partner, Financial Services, Performance Improvement Consulting
PricewaterhouseCoopers (UK)
Tel: 44 20 7213 1892
steve.s.osei-mensah@uk.pwc.com

Rupert Taylor-Rea
Manager, Transaction Services, Financial Services Deal Team
PricewaterhouseCoopers (UK)
Tel: 44 20 7804 8737
rupert.taylorrea@uk.pwc.com

16. 'Smart cost management: Making every cent count', European Insurance Digest April 2008 (www.pwc.com/insurance).

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