PurposeBuilt to FutureProof

ADOPTING THE RIGHT OPERATING MODEL FOR A SUCCESSFUL M&A

TABLE OF CONTENTS

M&A IN THE INSURANCE SPACE

Mergers and acquisitions (M&A) in the insurance space are not simply buy-and-sell arrangements. Instead, M&As are often very complex deals that come with a long list of challenges – and that present a wide array of opportunities for both buyers and sellers.

The right approach and the right operating model can make a world of difference in the success of any acquisition. **Acquisitions loosely fall into one of two categories.**

First, an insurance carrier, money manager or InsurTech can buy another carrier to enable and accelerate their growth strategy. This type of acquisition enables the buyer to potentially offer a broader array of products and mitigate risk. For instance, an annuity company might purchase a life insurer so it could sell life products, helping to mitigate its annuity risk with mortality life risk. Buyers acquire other insurers to gain additional capabilities and economies of scale. Purchasers also acquire other carriers to expand their distribution network. Those with a captive agency model might look to acquire a carrier with access to wire houses, for instance, and other distributors accustomed to selling the particular product.

The second type of acquisition is a carve-out arrangement, where a carrier wants to divest a portion of its business, selling off blocks and monetizing its existing portfolio. Over the years, the carrier might have accumulated a million in-force policies, for instance, and want to sell off a portion for the cash. The buyer benefits from the cash flow generated by the block of in-force policies.

M&A TRENDS

We're seeing quite a few M&A trends in insurance.

Private equity firms have been entering the market for the past 10 years or so.

While not insurance organizations, private equity firms buy insurance blocks for their investment value. These companies are also buying insurance blocks along with a small insurance carrier, or a shill, so even though the small carrier might not have in-force policies, the purchasing company can go through the regulatory process of being a carrier and then create and sell products. **When it comes to technology, private equity buyers have an advantage over carrier purchasers: they aren't encumbered by mainframe legacy systems so they can more easily create their own operating model.** This model typically taps the expertise of third party administrators (TPAs).

In addition, we've been seeing more foreign entities purchasing insurance companies. They have the benefit of generally lower interest rates, they can spread their risk geographically, and they find a market and willing sellers in the U.S.

For the past two years, we've also seen an increase in mega deals, acquisitions of blocks with more than a million in-force policies. Sellers tend to be very large insurance enterprises looking to outsource or sell large portions of their business. For example, The Hartford recently sold its life business to Prudential, and is now selling off its annuity business.

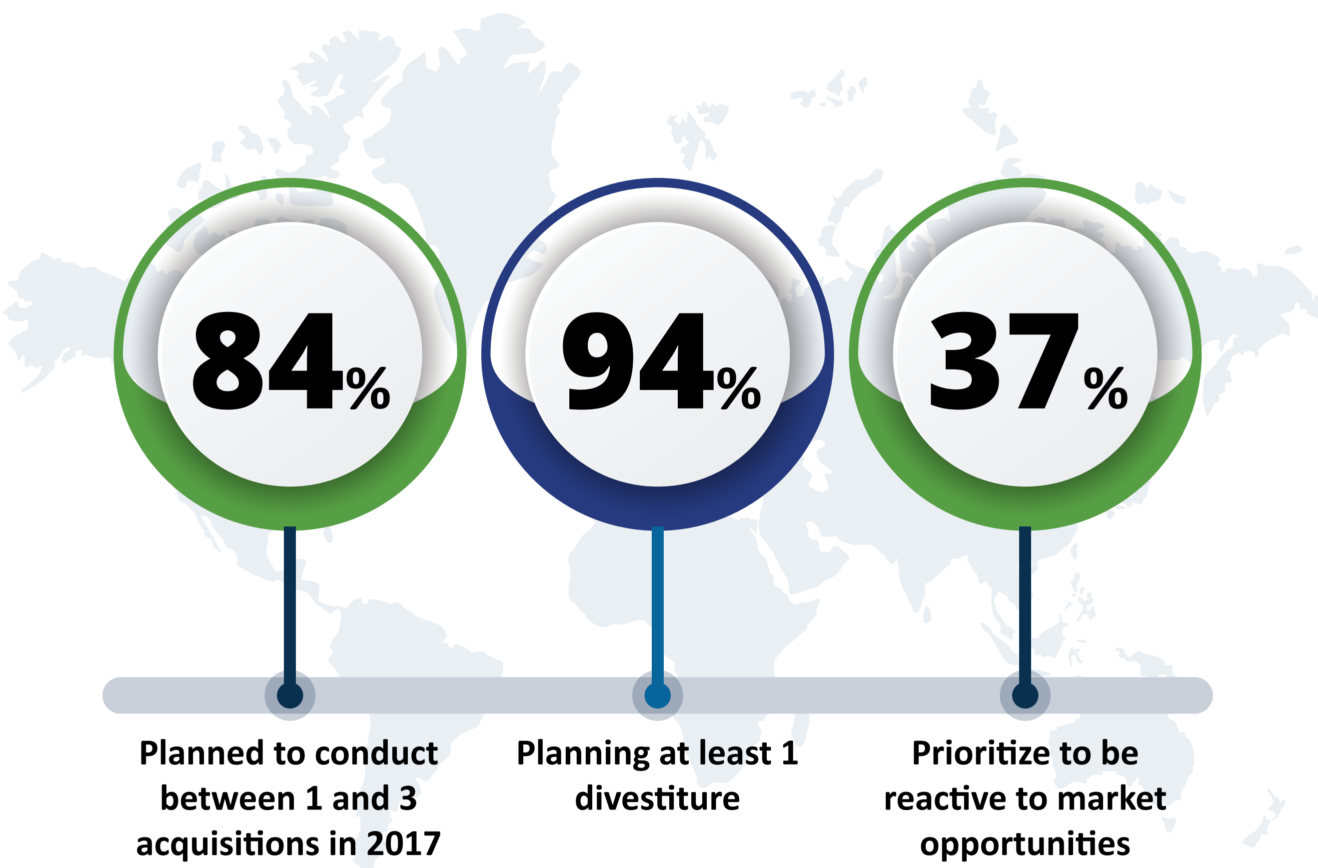
INSURANCE M&A ACTIVITY

IS ACCELERATING

In the past couple of years, insurance organizations have been ramping up acquisitions. Insurance M&A activity appears to be increasing dramatically.

In its 2018 Insurance M&A Outlook, Deloitte said that it correctly projected that 2017 insurance M&A activity would start slowly, but gain speed as the year progressed – and it did. **Deloitte data indicates the number of insurer transactions announced during the second half of 2017 increased 50 percent over the first half.**

KPMG's survey of 200 global insurance executives in Q4 2016 captures the perspectives and outlook for M&A corporate strategy and innovation. Here are the highlights.



There are several reasons for the acceleration of M&As in insurance. Three of the key drivers include:

Consistently low interest rate. We see more blocks of business change business now than ever before. Many annuities aren't profitable because they were priced assuming a higher interest rate, and carriers didn't anticipate the rate to be so low for so long. Carriers might want to get the business of their books, and buyers might benefit by investing the cash flow.

The need to get off legacy platforms. Carriers still operate on older technologies, with constraining and limiting multiple mainframe environments. It's become increasingly risky every year to operate on these legacy platforms, which are expensive to run and limit growth. In addition, carriers are finding it increasingly difficult to support legacy systems as COBOL programmers retire and new hires aren't COBOL-proficient. Buyers can remedy this situation with a more efficient operating model.

The lure of InsurTechs. Startup InsurTechs typically offer some advanced technologies that carriers might lack, and acquiring this type of firm can benefit from the additional capabilities while bringing a new level of innovation to the corporate culture.

THE REGULATORY

ENVIRONMENT

Because the insurance industry is so highly regulated, carriers must constantly deal with new mandates that increase both in number and intensity.

Meeting the challenges of new regulatory mandates is difficult in the old mainframe environment. It's fraught with risk and very expensive and total cost of ownership is high.

Companies must get over many regulatory hurdles when they make an acquisition. For instance, in order to operate in a new area, they must domicile in a state and get state and federal approvals. Some products need to be approved by the Securities and Exchange Commission (SEC). Each individual state might have its own requirements. Adding to the challenges, the seller sometimes specifies in the agreement that operations and jobs remain in the original pre-sale location following the acquisition.

TECHNOLOGY

CONSIDERATIONS

Any acquisition is difficult or challenging, whether a carrier or company buys a small block or a large insurance carrier. To a great degree, the ability of the acquiring company to integrate systems from both companies is key to the endeavor's success. Integrating systems, external and internal applications and processes is complicated. Those that get it right can potentially reap tremendous benefits, but those that don't will be in for an expensive and frustrating ride.

Integration is the key risk that needs to be dealt with to make the project successful

The first key step in the integration process is coming up with an operating model. Buyers can consider a high growth model in which they sell additional product, or a low-cost model, in which they close the block. **Then, the company works with the seller to understand the source of the data, which most typically resides on multiple mainframes.** The acquiring company typically then takes the data from the mainframes and integrate the information into its own systems. This process is inherently risky, even with the most detailed planning.

TECHNOLOGY CONSIDERATIONS

Insurance is a complex and arcane industry. Products are very complex and they require specialized skills. Keeping up with new technologies has been very difficult and the industry hasn't kept up. Many carriers are trying to leapfrog now, trying to get into the digital age.

An integration effort involved in an acquisition can reveal the deficiencies in a carrier's technological capabilities. An operating model that doesn't require complete technological transformation can increase the likelihood of integration success.

Using a Third-Party Administrator (TPA) to access the latest technologies and expand distribution with a Business Process as a Service (BPaaS) approach enables carriers to begin a new, with a greenfield approach.

A SUSTAINABLE, SUCCESSFUL

OPERATING MODEL

What keeps CEOs up at night is the persistently low return on investment (ROI). Since the recession, ROIs have been extremely low, with some much less than book value.

CEOs are always looking for ways to improve. Complete transformations are very expensive and risky and fraught with risk. They always wind up costing more than planned, and it's common that carriers don't realize all the benefits they were seeking. Training staff on the new systems is difficult. But in order to grow, carriers must transform to take advantage of the latest technologies that can keep them competitive and deliver value to their policyholders.

At the same time, operations and technology costs continue to rise and it's become very expensive to provide stellar service to customers. Even if a carrier wants to close an unprofitable block of business, fixed costs remain as policies lapse, increasing unit costs. A COBOL mainframe might cost $5 million to maintain, whether a carrier must service 500,000 policies or 300,000 policies. The situation puts insurers in a tough situation.

A BPaaS approach offers carriers a variable cost model, enabling organizations to access the most current technologies, break their dependence on their constraining mainframes and eliminating the fixed-costs headaches.

BEST PRACTICES FOR A SUCCESSFUL

ACQUISITION

Following these steps can increase acquisition success:

Set goals and objectives. These goals and objectives will drive the operating model.

Consider legal requirements. Comply with the transfer services agreement (TSA). There will be severe financial penalties to buyers that miss the deadlines.
In addition, carriers risk disrupting the sellers' business.

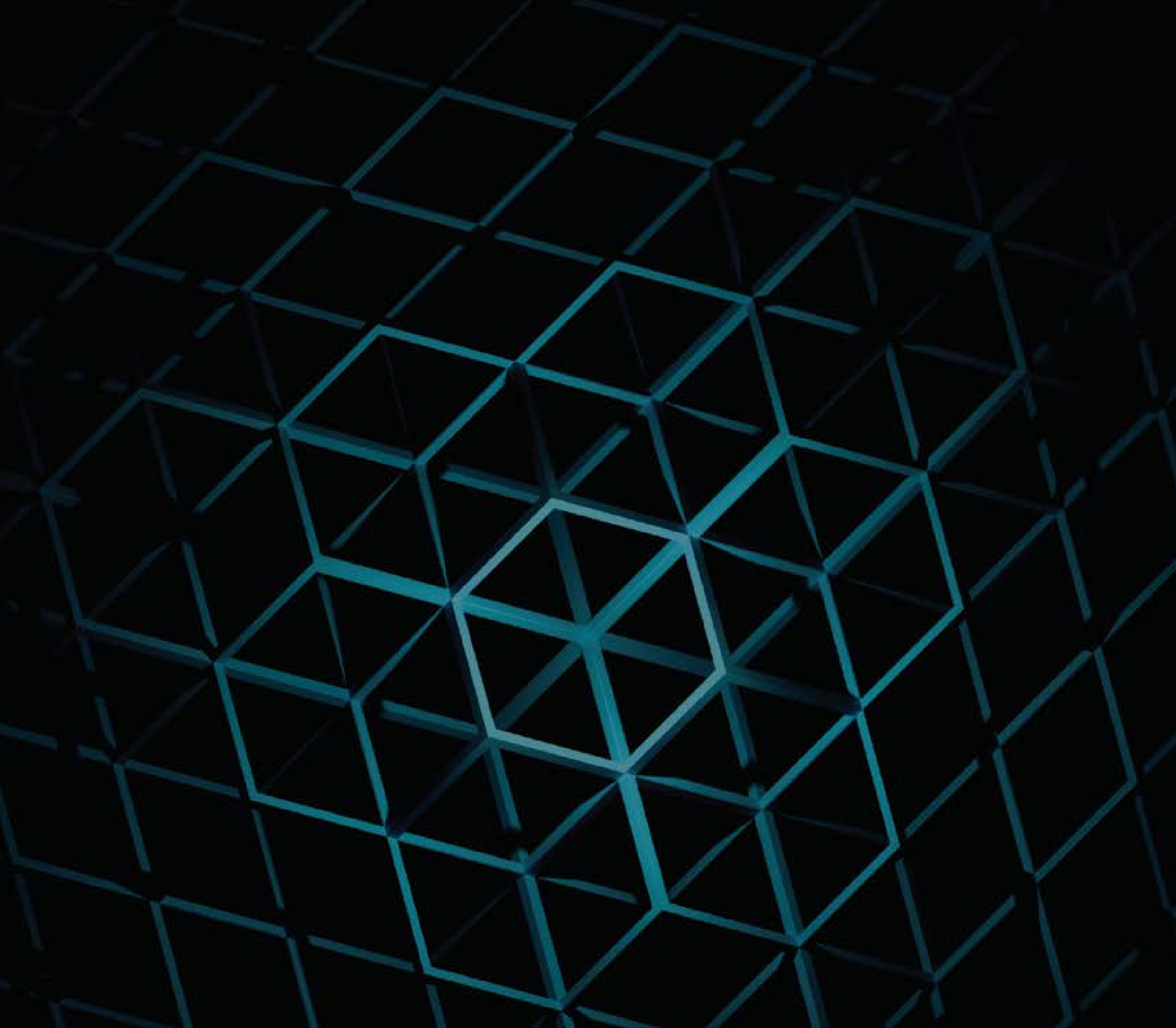
Encourage collaboration across the enterprise. Involve every department in the acquisition process. Carriers will need – and benefit from – input from operations, IT, legal, compliance, audit and valuation.

Coordinate closely with the seller. Integrating buyer-seller teams is essential. Work with the seller to determine its constraints, understand the resources it might have to ease the transition and coordinate with the seller's actuarial and compliance teams.

Consider a TPA. Third-party administrators can bring carriers deep industry knowledge, the latest technologies and a variable cost model. Instead of carriers spending millions of dollars to build their own systems or try to adapt their legacy, they can go with a TPA that can lower the cost of onboarding, provide expertise and lower unit costs. As a technology provider with an advanced platform, we see private equity firms and insurance carriers coming to us for our digital technologies, capabilities they don't have. An insurance carrier that buys a block of business or another carrier can benefit from a TPA not just because it can operate at lower cost, but has access to critical digital technologies that can enable them to reach policyholders across channels, increasing growth and boosting customer experience.

SE2

PurposeBuilt to FutureProof



SE2 can take life insurers light years beyond the competition

SE2, an Eldridge Industries portfolio company, is a leading technology and third party administration company focused on the North American life and annuity insurance industry. SE2 has an unmatched track record in optimizing back-office operations to future-proof insurance companies. SE2 combines peerless industry domain knowledge with a leading-edge administration technology platform to help clients launch products rapidly, improve efficiencies, shift to a variable cost model and maximize profits while dramatically improving the customers' experience. SE2 supports more than 20 direct clients, represents more than 35 carriers in North America and services more than 1,000 life and annuity products. SE2 has approximately $100 billion in assets under administration and has been recognized as an industry-leading innovator. In May 2017, SE2 was recognized as one of the "20 Most Promising Insurance Technology Solution Providers" by CIOReview.
Visit SE2 at www.SE2.com, LinkedIn or info@SE2.com to learn more.