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Is M&A Really Worth the Trouble and Risk?

2004 Mergers and Acquisitions Roundtable Discussion

EXPERT ROUNDTABLE

IS M&A REALLY WORTH THE TROUBLE AND RISK?

Insurance M&A is on the rise again. A tier of stronger players has emerged who are looking to gain market share, raise capital or otherwise make more efficient use of capital to streamline their business.

However, the past has shown us that many mergers and acquisitions never fully achieve their potential benefits. Is M&A really worth the trouble and risk? What, then, are the keys to a successful outcome? The following is a discussion that took place when we posed these questions to a panel of experts.



Kevin Ahern is a Director with Standard and Poor's Financial Services.



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“Is it worth it? It depends on your dedication and your discipline. If you don’t have those things, don’t play the game.”

JOHN NIGH: There has been a great deal written about how many M&A transactions are not successful. In a survey done in 1996, across all industries, 59% of all transactions were viewed as either unsatisfactory or disastrous. Only 11% were viewed as successful and worth repeating. About 30% of respondents said the transaction was successful, but they added that they’re never going to do it again. The reasons ranged from incompatible cultures to incompatible marketing systems. In early 2003, Tillinghast conducted a survey of 30 life insurance company CFOs and got a somewhat more optimistic view of how these CFOs would measure the success of their M&A transactions. However, CFOs’ views were still, on balance, negative. Some of the reasons were that they did not anticipate foreseeable events, the acquirer paid too much money, synergies were overestimated or didn’t exist, and so on. Against this backdrop, I’ve asked each panelist to give a statement in response to the question: “Is M&A really worth the trouble and the risk?”

JOHN TILLER: I’ve done a lot of thinking about this question, and have come up with two words — it depends. I’ve been part of acquisitions that were very good. I’ve been part of acquisitions that were not so good. I don’t think I’ve been part of any that were totally disastrous, thankfully. What does it take to be successful? It’s really a dedication to making the deal work. Is it worth it? I’d say no, unless you are ruthlessly disciplined in such things as the due diligence process, integration, expenses, and platform changes while always remaining in control of the process. Without discipline, you can forget it. It will be more trouble than it’s worth. It’s like a quarterback in the NFL. Don’t try to force a pass where it doesn’t go.

The best process I was ever involved in was with my first deal. Tillinghast had been working with this company for about three days when I was brought in to spend two days looking at the reinsurance agreements to determine whether they made sense. I was only there about two hours when they called an end-of-day meeting. The person chairing the meeting went around the room and asked everybody to report. At the end of these reports he said,

“Okay, we need to walk this deal. Let’s start documenting why.” This was a shock to me on my first big deal, but it was one of the best processes I’ve ever seen. The decision to walk was made because, during the due diligence process, they found things that were going to make the deal not work.

So, my message is that it depends on your dedication and your discipline. If you don’t have those things, don’t play the game.

PHILLIP BARNETT: From my vantage point, investment bankers are often accused of trying to push deals on clients or to entice them into things that may or may not make sense. However, in the 15 years that I’ve been with Morgan Stanley, I’ve yet to see a client who didn’t have a strong view on a deal and did not look very hard at whether something made sense or not. Most of my clients have been highly disciplined about what they will and won’t do. I have seen people who are empire builders and have tried to build organizations that don’t make sense. For the most part, though, they

“Why do deals fail? It’s really execution, not the strategy.”

have had strategic vision and appropriate intentions.

In today’s world, because of scale requirements and the competitive environment, it is very difficult to build certain businesses from scratch. The only way to fashion a desired product set or distribution capability or to be in particular businesses that are complementary to what you’re doing — and to do so on an efficient timeline, while achieving an efficient size — is to do it through mergers and acquisitions. The realities of the marketplace dictate that companies move with speed and with size. There are a limited number of high-quality businesses out there that fit, and buyers want them.

I’ve seen many deals that were purely a financial play, purely for scale. That’s fine, as long as there’s a clear understanding of what goes into that situation and what needs to come out of it.

Why do deals fail? It’s really execution, not the strategy. In an A.T. Kearney survey of senior-level executives, they said that deals fail because of undercommunication to customers, employ-

ees, distributors and investors (58%); unrealistic financial expectations (47%); new organization structure has too many compromises built into it (47%); master plan missing (37%); lack of top management commitment (32%); and unclear strategic concept (26%).

I’d like to touch on the point about organizational structure. This is a cultural issue. People often make suboptimal decisions when trying to meld organizations because they’re trying to make things work. Often, the best strategy is to “get to the right answer” even though you may have to break some glass along the way because, at the end of the day, you create something that’s right for the company. Sometimes, it’s simply taking one culture and obliterating the other. Other times, it’s melding the two cultures together. Companies who figure that out and do it with few compromises have been more successful than not.

How do winners succeed? The things I see relating to merger integration are vision, setting measurable financial and nonfinancial targets, leadership, confirming top roles and responsibilities early to reduce executive infighting and staff uncertainty, momentum and pro-

tecting current business and retaining existing customers during integration. Much can get lost during that integration phase. I’ve seen people remove the link between the company and the customer. When those important individuals that link the organizations are gone, you lose a lot of business. Other success factors include focusing on talent retention and creating the right incentives; identifying cultural differences and addressing them early and carefully; identifying and managing financial, operational and strategic risks; maintaining distribution; hedging portfolio risk as well as balance sheet issues; and communicating the vision and goals to the key stakeholders. That’s the list of things I think of to ensure or at least increase the probability of success.

KEVIN AHERN: The numbers basically say that M&A transactions are very difficult to bring to fruition. What do we look at the most? When a deal is announced, we always look at integration risks. If I had to play Tuesday morning quarterback, as opposed to Monday morning quarterback, I would still be very pessimistic about compa-

“Today’s cynicism and lack of tolerance is related to paying a strategic premium, not to doing a strategic acquisition.”

nies with two different origins coming together and overcoming cultural differences. You have a lot of people who are very protective of what they’ve built. There’s a lot of blood, sweat and tears invested in existing structures and the value that they’ve created in those organizations. I agree with Phil that hard decisions need to be made. However, the point in time at which you make that hard decision is very important to the long-term financial strength of the combined organizations.

When you lay out a deal, it makes strategic sense in terms of the financial combination of two entities. But when you start asking questions — “How is incentive comp going to be allocated?” “Who’s going to run this organization?” “Who’s going to be the decision maker at this point in time?” — if you don’t get the immediate responses you would expect, and you are instead told that these questions will be worked out as things come together, the decision making is probably not as good as it needs to be.

It’s almost like a marriage. You have to read body language as certain things develop and see how people are going

to react. In many cases, it’s just the power of individuals that gets things done.

My expectation is that deal structures are going to improve. I think the characteristics of deals, the modeling, the analytics and the quantitative approaches necessary are very clear. We have enough M&A history now so that we can look back and see what went wrong and how we can address those issues in the future. However, the big issue that I still struggle with and S&P struggles with is cultural integration.

TRICIA GUINN: I’ve heard a lot of cynicism expressed about strategic acquisitions — that they’re really being looked at today with a jaundiced eye. But, if you’re a buyer, there are many strategic reasons to enter into an M&A transaction. Today’s cynicism and lack of tolerance is related to paying a strategic premium, not to doing a strategic acquisition.

If you want to enter into a new market — like Mexico, Korea, Japan, China — you

don’t have a lot of alternatives. It’s a long, hard slog to do that on a de novo basis. If you want to get into a new product line, like long-term care or disability, or gain new distribution capabilities, the quickest way to get access to expertise is through M&A. In addition, there are many operational reasons for doing a transaction: increasing scale, getting to critical mass or affecting expense synergy. The bottom line is that there are many compelling reasons to do a transaction. So, the question is: “Is it worth the hassle and the risk?”

I believe it is worth the risk, provided three things are in place. Number one, you need to have a clear and well-thought-through strategy. Two, you need to be extremely disciplined, both in the due diligence and negotiation phases. You pay that acquisition price once, but you’ve got to implement forever. Finally, you need to have a well-defined implementation plan and the discipline, not only to execute the plan, but to hold people accountable. You need to give them room to execute, but hold them accountable for delivering the return that you need on the purchase price.

“To be successful, your strategy can’t be entirely dependent on M&A or, at the very least, it shouldn’t be dependent on any particular deal.”

I’d like to comment on these three points. First, public company deals, particularly auctions, where your access to information is limited and your due diligence is incomplete, are the riskiest deals. You’re at a knowledge disadvantage relative to the other side. You can mitigate this disadvantage by surrounding yourself with a seasoned set of advisors. I don’t mean that from a self-serving standpoint; I truly think that a good advisory team can add a lot of value by helping you to know what to look for and focus on the important items quickly. I think it’s important to make the most of the information that you can get, not only the information you get from the target, but also what you can get through networking. Sometimes your advisors can network on your behalf and do it better than you could. You should also get access to public information and general street knowledge about a target company. It is critical that you understand the risks that are there. You want to have a good idea of what could go wrong and just how bad it could get — in terms of asset liability management (ALM), distribution issues, systems issues, people issues and others.

Second, to be successful, your strategy can’t be entirely dependent on M&A or, at the very least, it shouldn’t be dependent on any particular deal. Unless you’re a venture capital fund or a company whose sole reason for being is to do deals, a good strategy needs to have organic options — whether it’s a growth option or a stay-the-course option — because you can’t control what deals are doable or the price at which they’re doable. You’re left with issues beyond your control — the willingness of the other side to do a deal, the competition for the deal, the reaction of the market, the reaction of the rating agencies. This isn’t to say that, on some occasions, you won’t be presented with the rare opportunity that will test you as to what your hurdle rate is and how much you will pay for revenue or expense synergies. But your negotiating position is undermined if you don’t have credible alternatives to doing any particular deal. Many of these comments would apply on the sell side as well. Many companies are divesting to get back to the core business. To realize a fair price for those other businesses, you must have alternatives to a fire sale.

Now, you may think I’m biased with my next comment, and I guess I am, but I believe you’d be crazy to do a transaction without an actuarial appraisal. I believe this is true even if a company is GAAP oriented.

Appraisals are often criticized because they’re complex and use a lot of assumptions. However, I believe the process of going through and building that very detailed financial model and tackling the choice of assumptions gives you incredible insight into the value drivers of the business and helps you understand where the risks are. It’s the best way to get a handle on economic value and to understand risk. You need those insights to develop a good integration and implementation plan. The appraisal will help you figure out what needs to go right and what you’re betting on, wrapped up in a price.

I favor an actuarial appraisal over a different type of model because of the way it’s constructed into components of value. It indicates how much value is coming from the in-force business and the assumptions on which that’s predicated. This will help you understand whether you have to restructure

“While the numbers are important, so are the people.”

the asset portfolio, take expenses out, revise the reinsurance program or take other such actions. The appraisal also indicates how much value is coming from new business. This will help you decide whether the profitability of the new business is acceptable and, if it's not, what you can do to improve it and the risks of those actions.

My final comment is that, while the numbers are important, so are the people. At the end of the day, it's people who execute. As a buyer, you need to have a very clear picture of what skill sets you will need to make the transaction a success. You should take a critical look at your organization, as well as the target, to see if those skills are present. To avoid pitfalls, you need the right people. You need to retain key talent after the merger. You may need strong project and change management skills. You may need people who can help you take the best of both approaches and build a new culture. You also need to make sure that people are incented to behave in a way that is going to ensure implementation success.

So, while I think there are many pitfalls, I think M&A is worth the hassle and the risk, provided you pay attention to strategy, due diligence and implementation.

AUDIENCE QUESTION: First, do people really do acquisitions without actuarial advice? Second, it's been said that the P&C runoff business is the fastest-growing segment of the industry. Can the panel comment on that?

PHILLIP BARNETT: I believe that, generally, the actuarial work done on the P&C side of the business is not as strong as on the life side because it's a much more difficult exercise. So, when we look at P&C M&A deals, the difficulties of estimating reserves on the long-tail side of that business are legion. The ability to understand what the ultimate asbestos liability is going to be when the courts change the rules of the game over time make an actuarial valuation more problematic. That's part of the reason why there have been many fewer P&C deals than life deals. Nevertheless, it is still very critical.

Whether the runoff business is going to be the next great growth industry is

hard to determine. A number of companies have been set up to do just that. There's a great deal of value to be extracted in the runoff process. I think you'll see companies that don't really want to be in particular lines of business put those businesses into runoff. They'll either do it themselves or, more likely, there will be people who will do it for them. So I do think that there will be groups that specialize in runoffs, and it's going to be viewed as valuable to the companies looking to discontinue certain operations as well as a profitable business to the runoff managers.

AUDIENCE QUESTION: We have certainly used appraisals. However, from a buyer's standpoint, the primary value of a seller's appraisal is to introduce an element of comedy into an otherwise serious process. Do you agree?

TRICIA GUINN: I think the challenge is to take the information that you have (even if it's a seller's appraisal) and use that information as building blocks. Apply your own strategy against it, your own risk tolerance against it, as well as your own assumptions about defaults,

“I view an appraisal more like a high-level road map than a GPS system.”

credit spreads, cost of risk and so forth. I think it's better to go through that exercise than to cut the check and have to do it later.

PHILLIP BARNETT: Most buyers view the sellers' appraisals in the marketplace as overstated by anywhere from 25% to 50% in terms of the valuations they kick out. I believe buyers walk in believing that is the case. I agree with Tricia. You take the appraisal, which is basically a discounted cash flow, you change the assumptions and make it fit your beliefs. At least you have something as a starting base. Then, you reconstruct it and turn it into your own model.

JOHN TILLER: I view an appraisal more like a high-level road map than a GPS system.

JOHN NIGH: In fairness, there is an awful lot of intellectual analysis, analysis of risk (or at least presentation of risk), that would not otherwise be available without an appraisal.

KEVIN AHERN: There are many situations where S&P doesn't have a rat-

ing on the target company. So, to the extent that the acquirer comes in and is able to clearly explain assumption of risk and how they understand the business, I think valuations are beneficial. I think it's a step along the way. However, I believe the appraisal should provide a lot of new information that is necessary.

JOHN TILLER: It's the model that the buyer comes out with and the revisions it makes that's terribly important in terms of capital management. I haven't seen an acquisition yet that didn't benefit from knowing what capital is required to support the business as well as how much more you will have to put in or be able to take out. That drives a big component of the transaction, and I don't know how else you get that information. You can't get it from GAAP. You can't get it from P/E ratios. You have to get it from some type of model and a model is usually in an appraisal.

AUDIENCE MEMBER: I use the seller's appraisal in a number of ways. I've heard the comment of my learned colleague that the seller's appraisal often brings together different literary

genres — high comedy, low comedy, farce, hyperbole, mystery and suspense. However, I use the appraisal both as an initial road map through the company and as a starting-off point for a disciplined “all points across the front” attack by my team. In M&A, I tend to take the Attila the Hun approach. I'm going to come across the front and attack from the side at the same time. The seller's appraisal is of limited utility in terms of the final number it comes up with. As a rule of thumb, you generally divide the number by two and then subtract something else to get a real value. Maybe this is changing and not everyone does appraisals the same way. Some firms, while they beat the drum for their client on the sell side as judiciously as they reasonably and thoughtfully can, they don't go overboard as some others do. Other elements provide good information, though. The data room is a *Reader's Digest* guide to the company, if it's well constructed. The management interviews are a road map to the company. When you seek and get access to the external auditor, its working papers and its external audit team, that is also a road map to the company. The seller's

“The seller’s appraisal, the people who performed it, and the people who gave them information are all parts of the puzzle that you have to fit together in a very creative and disciplined way.”

appraisal, the people who performed it, and the people who gave them information are all parts of the puzzle that you have to fit together in a very creative and disciplined way. Every little bit helps, no matter how much you might suspect the parts, and I do believe that it is necessary.

PHILLIP BARNETT: In my experience, I have found that the actuarial appraisal is one methodology that is utilized and receives wide notice at board meetings. There are also other methodologies that come into play, ones that the investment bankers and others use in front of the board. Oftentimes, the actuarial appraisal is also modified based upon other viewpoints as to new business, methodologies and others.

TRICIA GUINN: I believe it’s as much the conversation with the board about what the numbers mean as the numbers themselves. It includes things like, “What would you have to believe to be true?” It’s largely the investment banker’s role to create the expectation in a place where they believe that an end transaction can be concluded and managed both profitably and successfully.

PHILLIP BARNETT: I agree. In the mid-to-late 90s, people were paying over the appraisal value. Today, that’s just not the case. Buyers start with capital and surplus and value of the in-force business. Depending on the expense structure embedded in the in-force, that will move around a lot. Then, clearly, value of new business is a factor. Buyers have been taking a very dim view of new business. So there are big haircuts to that. Finally, there is capitalization of the synergies. People understand what that could be worth, but it’s the buyer’s view on how much of that value they’re willing to transport to the seller. So there’s a whole spectrum when you break down that actuarial appraisal in terms of how buyers will look at it.

***AUDIENCE QUESTION:** Would you advise American companies to do acquisitions in Asia? If not, why not? If you would, why would that be?*

JOHN TILLER: At ERC, we looked at acquisitions in Asia. The reason we did not do them came down primarily to the life reinsurance business. The market is so small and the growth so slow that waiting five to 10 years

wouldn’t harm us. In fact, we just shut down over there because of that. In five or 10 years, it’s not going to be a lot bigger, and we can jump back in.

PHILLIP BARNETT: I think you have to take a very long view if you’re going to be an investor in Asia. AIG is probably the most prolific and best acquirer in Asia and has been at it the longest. So what’s their strategy? Namely to plant seeds all over Asia, and the timeline is 10, 20, even 30 years. At any given point, they have mature operations that are throwing off a lot of profit, ones that are building and making sub-par returns, and others that are seedlings that are losing a lot of money. They’ve done this over a number of years and they’re building and growing. They understand the local climate. They’ve put local resources against it. They have senior people traveling to the area to really understand the local terrain, to get to know government officials, to really gain that almost domestic status. Then they exploit opportunities as the market emerges, and they make a tremendous amount of money in Asia on both the life and P&C side. There

The consensus is that M&A is worth the trouble and risk. To be successful, you have to be focused and disciplined. You have to work to get the answer right.

are places where they don't do well also, but they have picked their markets and I think they've done it in an intelligent way. There are places where they're not going to make it and they'll get out. As a long-term strategy, it's worked quite well.

I don't think it's good for small companies to play. I think that you have to be a very big company to play in that type of environment, because your investment could very easily get wiped out and you'd end up with nothing in two or three or four different countries.

Pru U.S. has done a tremendous job in Japan. That's worked out extremely well for them. Most of the money that they're making in Asia is in Japan, and secondly in Korea, where they've devoted resources to both life and asset management. There are a few other countries where they're break-even.

So it's finding the spots where you believe you can build something that's unique and where there's opportunity and then being willing to take the risks, which are tremendous. It is a very difficult proposition. I would only suggest going there if you're going to be in it for the long term.

AUDIENCE QUESTION: We haven't talked much about the long-term nature of the investment. In some respects, it's like a marriage. It's like good, bad or ugly, for better or for worse. If it's not essential to the mission of the buyer, then it's not worth getting into.

JOHN TILLER: I think Tricia made a comment about whether it fits the strategy, long term in particular. That's also where my capital comments came into play. It's how fast you can get the capital back, because it is long term.

AUDIENCE QUESTION: A long time ago, I was under the impression that you would have trouble expatriating earnings from a country like Japan. If there are restrictions on bringing cash back to the U.S., is that an impediment to investing in foreign countries?

JOHN TILLER: I think it varies somewhat by company and by what your structure is. If you're buying a legal entity over there, it can be an impediment. I've been involved in several reinsurance agreements between a domestic parent and a foreign subsidiary and a fair amount of the risk and premium was transferred through that.

PHILLIP BARNETT: I do think repatriation is an impediment in the sense that there is additional tax when the profit comes back to the U.S. The ability to redistribute the earnings in a pan-Asian way (or just not back to the U.S.) can mitigate that. Those are some of the strategies that we see our clients employing.

KEVIN AHERN: From a rating agency perspective, repatriation is very important to understanding the strategic value. It's better to have the capital local, because there are a lot of tax strategies around that. But, at the end of the day, if the capital's going to be viewed as fungible, maybe that long-term commitment is not there.

JOHN NIGH: We need to wrap up. It seems to me that the consensus is that M&A is worth the trouble and risk. However, to be successful and believed, you have to be focused and disciplined with a plan that captures vision, assigns roles and responsibilities while retaining customers and talent. In other words, you have to work to get the answer right. Thank you.

About Towers Perrin

Towers Perrin is a global professional services firm that helps organizations around the world optimize performance through effective people, risk and financial management. The firm provides innovative solutions to client issues in the areas of human resource consulting and administration services; management and actuarial consulting to the financial services industry; and reinsurance intermediary services.

The Tillinghast business of Towers Perrin provides global actuarial and management consulting to insurance and financial services companies and advises other organizations on risk financing and self-insurance. We help our clients with issues related to mergers, acquisitions and restructuring; financial and regulatory reporting; risk, capital and value management; and products, markets and distribution.

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