

Transactions

The Buying and Selling Process





Introduction

The last couple of years have seen a steady increase in the number of run-off books changing hands – and a distinct increase in the amounts buyers are prepared to pay for them.

But does the whole transaction process of buying and selling these portfolios work to everyone's satisfaction? What types of companies are selling and why? And who is buying and with whose money? Does the auction process work well – or push up prices to unrealistic levels? What are the typical deal breakers and is execution risk a real concern? What is the attitude of the regulator? What changes could be made to the process overall?

This topical report tackles these issues and questions by presenting the diverse views of a wide range of companies and individuals involved in the process including accountants, lawyers and financial institutions.

As we go to press, the global financial markets are in a critical situation with unprecedented restraints on capital. Which means, paradoxically, that the run-off transactions market, could, as a result, haemorrhage further books for sale as companies move to restructure their business in the face of the increasing financial squeeze – while just at the same time the, up until now abundant, supply of eager financial backers and buyers may start to dry up.

Although nobody is able to predict exactly what will happen as a result of these factors it is clear that more run-off books will be put up for sale over the next couple of years, exacerbated in Europe, many believe, by the impending Solvency II legislation. However, who will buy them, for how much and with whose money remains to be seen.



Transactions - the buying and selling process

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The price is right



Right now it's a sellers' market with investors hungry for run-off books, in some cases leading to crowded auctions – but that equation could change quite rapidly

As the famous Publilius Syrus maxim goes: 'Everything is worth what its purchaser will pay for it,' and for those selling run-off books of business today, the world is a beautiful place. With buyers plentiful and increased interest from financial backers, vendors find themselves in the enviable position of calling the shots. Selling, though desirable, is not absolutely necessary, while buyers are anxious to buy into uncorrelated risk and have, for the moment at least, the financial backing to do so. As Dan Schwarzmann, partner at accountants PricewaterhouseCoopers recently described it in *Run-Off & Restructuring*, 'the stars have now aligned for run-off.'

Schwarzmann's optimism is certainly not without foundation. The increased number of buyers has dramatically raised the prices that sellers can expect to get for their books of business (see Figure 1. Transaction

multiples p.6). According to Charles Thresh, managing director of KPMG Advisory in Bermuda, 'where perhaps 50 per cent of book value was a typical benchmark for a run-off deal eight to ten years ago, rumours circulate that a larger UK deal (ongoing at the time of going to press) has seen final round players bidding around 110 per cent of book value.' He adds that 'some players are telling me that they cannot stay in the game at this pricing but there appear to be others prepared to carry on.'

Faced with such a potential market, sellers are now in a position to sell on books of business for the kind of prices they have always hoped for. Importantly, for some a sale is not even imperative but simply desirable. Nigel Montgomery, partner with law firm Sidley Austin, comments: 'For most, but by no means all, sellers there is a genuine possibility that they can carry on anyway. For some

at least, investigating a sale is partly a means for deciding whether their strategy is to sell at all.'

Mark Adams, partner with accountants Deloitte, says: 'Historically sellers may have wanted net asset value for a portfolio and because of the risks that exist in some legacy books the buyers were not willing to pay for it. But now buyers are prepared to pay the prices being asked – even though there is often a good deal of asbestos exposure, and subsequently volatility, in some legacy books.'

As such the market is saturated with buyers prepared to pay well over the odds for books that five, even two, years ago they wouldn't have given a second glance. Stephen Carter, head of law firm Charles Russell's Insurance/Re-insurance group, notes: 'At present there has been more capital chasing run-offs than there are desirable run-offs to chase.'

One of the main reasons for the rise in buyers' interest has been the increased motivation of financial backers to fund these acquisitions.

The explanation for this is two-fold. First, as Lloyds TSB's managing director of financial institutions Bill Cooper points out, 'one of the drivers is the lack of returns in other sectors.' In part the attraction of buying run-off books derives from the state of the larger market. Investment at the moment is risky and investors are looking for more guaranteed avenues of profit making. From their perspective, the 'uncorrelated risk' associated with the acquisition of run-off books is highly appealing. Says Montgomery: 'For investors considering buying into the sector, the case for buying into run-off is still perfectly viable, because you are asking – can this be affected by current shocks to the market? No, not really. Can war or terrorism make an impact? Not directly because it's all to do with liabilities that occurred in the past.'



'Now buyers are prepared to pay the prices being asked – even though there is often a good deal of asbestos exposure' Mark Adams

Faced with the prospect of a highly unpredictable future, investors are turning to the more predictable

past, even if that involves the kind of nasty surprises that asbestos throws up. In the end, although one cannot predict whether a court somewhere will decide that something gives rise to a liability for an insurer outside their calculations, the past still offers a safer bet since it's far easier to allocate a probability for that happening than it is for future occurrences.

Adds Montgomery: 'That's the thing about the law of large numbers and long periods, you can still get it wrong, absolutely – there is no reward without risk – the point is you've got something to go by.'

'Models are only as good as the assumptions they are based on, and time will tell if the transactions recently completed perform as expected' Chris Miles

Second, sellers have also benefited from the perception that run-off acquisition can generate much needed profit (and quickly) – a perception boosted by several high-profile sales (Equitas being the much quoted example). As Chris Miles, director with Barclays Commercial Bank, notes: 'The run-off market is generating significant interest from a variety of capital providers, as a result of the attractive returns generated by the acquisitions completed to date.'

From the perspective of an investor, these completed deals highlight

the viability of run-off acquisitions, even though the majority of deals have not yet been closed and little

long-term data exists to confirm the optimism of those buying into the



market. Miles continues: 'The run-off companies we have worked with employ sophisticated techniques to model the expected cash flows and ultimate profitability of any potential transaction ... However, models are only as good as the assumptions they are based on, and time will tell if the transactions recently completed perform as expected.' Moreover, the increased competition in the marketplace, 'will ultimately reduce the returns generated by investors' (see Betting the bank p.7).

The changing market

Up to a point, the interest in run-off acquisition has remained relatively impervious to the global financial crisis. 'The current conditions in the financial sector will undoubtedly have an impact on the availability of capital' says Miles. 'However, many banks, Barclays included, remain open for business and continue to support the right transactions'.

Paul Taylor of the UK's Finan-



Valuation: Transaction multiples

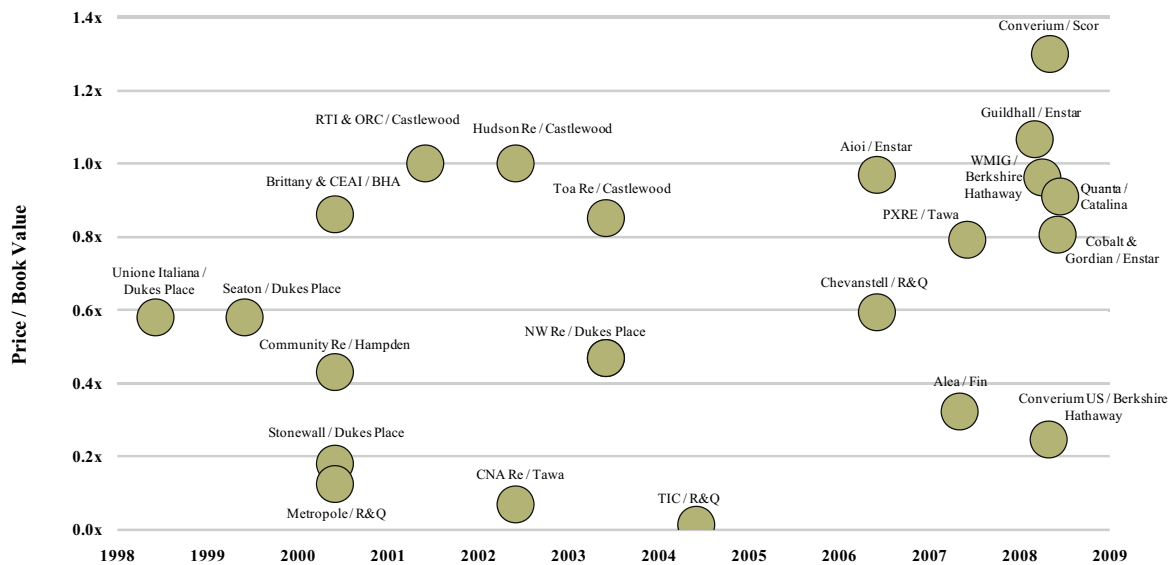


Figure 1 - Source, Hines Associates Ltd

cial Services Authority (FSA) notes: ‘Notwithstanding the credit crunch and financial turmoil, the FSA continues to see considerable activity in the buying and selling of UK regulated run-off insurers.’ Equally, Thresh observes that, ‘So far, the high levels of interest in run-off deals seem to have survived the credit crunch.’

Nevertheless, the increased pressure on the world’s banks has its repercussions and we are, perhaps, starting to see the beginnings of a slow down in their willingness to fund run-off purchases. From the perspective of the financial backer, Thresh notes, despite the attractiveness of run-off acquisition, the current global problems have raised the bar of what is acceptable risk associated with investment. As such financial backing for run-off acquisition now carries a higher level of qualification, he says: ‘Lenders

and investors have both discussed with me a generally higher hurdle in terms of the quality and experience of the management teams they will back, which bodes well for the established players and leaves those newer to the market with more to do to get necessary backing’. Those backing the finance then are just as concerned as the buyers themselves with the profitability of a particular book of business, conducting similar, if not identical, analyses of potential purchases.

For those like Barclays, according to Chris Miles, investment is only going to be offered to ‘experienced management teams with a good track-record.’ Equally, Bill Cooper says Lloyds TSB is ‘looking for people with a good track-record with whom we can build a relationship and who are likely to be repeat buyers of business.’ The current financial crisis

then may result in the considerable financial backing for run-off acquisition drying up as banks are forced to place high conditions for returns. As Cooper confirms; ‘There are quite a few companies around that have backing from various investors, but always conditional, as far as I know, on being deal by deal – there aren’t too many who have a fund they can just draw down on’. Accordingly, he continues: ‘We are a debt provider and we are looking for a reasonable return within a sensible timeframe. And it has to be reliable. So I think the kind of financing we provide won’t necessarily be suited to all types of run-off books.’

Perhaps, then, sellers should not feel overconfident that the circumstances so beneficial to high prices will continue. On the contrary the future may not be so bright. Not only does a financial crisis mean that

Betting the bank

The range and number of debt providers and investors looking to provide finance to run-off books buyers is as buoyant as it has ever been. Straightforward debt provision is taken care of by the commercial banks while capital is provided by a range of different sources from private investors and hedge funds to public listings. Expected returns vary depending on the risk profile but equity investors are likely to require returns in excess of 15 per cent with returns while debt providers on the other hand are typically looking for a reasonable return within a time-frame of between three and five years (see investment criteria).

As far as Bill Cooper at Lloyds TSB is concerned the sort of financing they are offering 'is most likely to be suited to those businesses being bought which are over-capitalised – it could be that the seller had to over-capitalise to keep a rating or through an agreement with the regulator – these are the sort of situations where it is easier to provide debt as it is easier to see how you are going to get it back. If you are much more dependent on longish term actuarial assumptions it is much more difficult.'

When backing a bidder for a run-off book, what sort of information will a debt provider need?

'In order to provide debt finance to support an acquisition we will obviously first need to complete a thorough analysis of the book', says Chris Miles of Barclays. 'Our analysis will focus on exactly the same factors as our client, namely classes of risk written, volatility, reserve certainty, anticipated future claims patterns, quality of the reinsurance book and the investment portfolio. Our analysis will also focus on the cash flow model created by the client to forecast expected capital releases and a review of the

management team's experience in the insurance/run-off sector.'

Not surprisingly, given the nature of the business books, almost all transactions are on a deal by deal basis as far as the backers are concerned with few, if any, prepared to offer a 'draw down' fund to clients. On the other hand, despite their expectations of making returns of up to 15 per cent returns, for investors the current banking crisis means total uncertainty over whether anything like that figure will turn out to be achievable.

Christopher Lee, director, financial institutions, insurance at Fortis Bank, points out that despite the potential high returns from discontinued insurance, 'the problem is that it doesn't fit into the typical investment returns of investment companies and hedge funds because the annual rate of return is very difficult to calculate until nearer the end of the investment.' Lee also feels the market is still relatively immature, and that while there were several deals in the late '90s/ early 2000s with private funding, the first deal that used bank medium-term debt in the non-life run-off sector was in 2005.

In any case the current crisis may well put the brakes on lending in the sector since cash for any investment is in short supply until greater stability returns. According to Richard Hines of corporate finance advisors Hines Associates, who gave a presentation on the financing of the run-off acquisition market earlier this year, balance sheets have not been replenished in 2008 and there is a severe shortage of debt capacity which will extend to hedge funds and private equity funds. He concludes that listed equity and own resources (or those of parent) will be primary sources of capital for non-life run-off for some time.

Investment criteria

Organisation	Return Expectations	Investment Horizon
Hedge Funds/ distressed debt funds	15% p.a. minimum	2 to 3 years
Family offices	10 - 12%	3 to 7 years
Investment banks	15% p.a. plus fee stream	2 to 3 years
Public equity markets	8 - 10% p.a. including dividend stream	Variable
Private equity	10 - 20% IRR	3 to 7 years

Source, Hines Associates Ltd



investment in purchases may wither but, coupled with Solvency II regulations, it may also throw many more



Furthermore, hasty purchases may undermine belief in the returns that run-off books can provide. Adds Cooper: 'Sooner or later someone will overpay for something and a couple of years later will realise that, so that could be another factor in correcting the market – when something goes wrong.'

Nick Pearson, partner with law firm Edwards Angell Palmer & Dodge, notes: 'We have seen a big change over the last few weeks in this market; when we were at the Monte Carlo RendezVous there were still a lot of people talking about investing money in run-offs. I think

return to bite sellers once the market forces are reversed.

Auctions

Selling books of run-off in today's buoyant market has sparked a small but energetic debate on the best process of sale. To put it bluntly: does one actively seek out the most likely purchasers and instigate a bidding war between just those pre-selected favourites, or do you go all out and invite as many potential bidders in a fully open, 'pure' auction?

In most cases, it should be added, the choice is more a matter of degree rather than a strict dichotomy. Notes Peter Taylor, partner, insurance & reinsurance group, at law firm Lovells: 'Most well run auctions already involve a degree of pre-selection of suitable bidders, just to keep expectations on both sides of the transaction within manageable proportions.'

With the abundance of buyers in the market, auctions are undoubtedly-

'Notwithstanding the credit crunch and financial turmoil, the FSA continues to see considerable activity in the buying and selling of UK regulated run-off insurers' Paul Taylor

run-off books up for purchase worldwide. As Tim Goodger, insurance partner at law firm Elborne Mitchell says: 'Solvency II will undermine profitability of some books but this is likely to have a greater impact on the Continent than in the UK. Still, even in the UK some insurers have calculated that there will be an unacceptable reduction in return on capital. Financial guarantee exposures are risky in the current climate and this line may be discontinued by some providers.'

In effect the reverse situation of a vendor flooded marketplace with fewer buyers might easily, and quickly, materialise. Says Cooper: 'For those companies who have done the deals – there must come a point where they say "we can't take any more at the moment" and therefore as more books come on the market I think it will change and develop more, so it will really be interesting to follow.'

some of the money that was chasing run-off was naïve capital which was willing to take a chance but I think that naïve capital is out now.' Under such circumstances, swaggering sellers may have to beware that their arrogance does not come back to haunt them. Whilst at the moment vendors are simply choosing to sell given the high price, in future they may very well find themselves having to sell. Given the dissatisfaction many buyers feel towards, for exam-



'Financial guarantee exposures are risky in the current climate and this line may be discontinued by some providers' Tim Goodger

ple, auction processes which drive prices even higher, this may then

ly an effective way of getting a higher price and sellers are well-placed to

opt for this process.

Neil Golding, partner in the dispute resolution practice of law firm Freshfields Bruckhaus Deringer, says: 'If you are selling, then an auction which pushes the price up is great. You may not mind at all if it is annoying for the buyers. The auction process may cost the vendor more in terms of managing the process but even if it costs an extra £1 million or even £2 million, that's worthwhile if you end up getting an extra £20 million for the business'.

In any event, sellers can feel somewhat reassured that someone will cough up the cash. Adds Golding: 'Obviously from a buyer's point of view it is rather annoying to be one of a dozen or more bidders but if you are a serious buyer then you are prepared to go through the process to get what you want.'

Others however, such as Clive O'Connell, partner in the reinsurance and international risk team at law firm Barlow Lyde & Gilbert, make the case for other factors: 'Money is not everything, particularly in the sphere of solvent run-off. Reputation matters. Pure auctions run the risk

of leaving the buyer with little alternative to an over-aggressive strategy of liability reduction and asset realisation. This could harm the seller's reputation and standing in the live market.'

In other words one does not always sell books of business in a vacuum and so high prices can force purchasers towards strategies that may damage the brand in the eyes of existing policyholders in order to make a return. Will Bridger, partner



'Sooner or later someone will overpay for something and a couple of years later will realise that' Bill Cooper

at accountants Ernst & Young, notes 'Run-off is purely about financials and the vendor needs to be able to leave something on the table for the buyer.' The higher the price the less profit a purchaser can make with a subsequent greater risk to reputation. Furthermore, the auction process can also damage relations with other companies where bad air can

spill over into the live market, affecting other areas of a vendor's business. They can also foster a bad relationship with one's local regulator who may feel ill-disposed towards the prospect of policies being shipped off to the highest bidder regardless of who, or where, they are.

For Thresh at KPMG, despite the higher price that auctions

Changes to the transaction process

We asked some of our contributors what types of changes they would like, or expect to see, to the buying process. Tim Goodger of Elborne Mitchell advocates 'the greater use of warranties by the seller to truncate due diligence – particularly where warranty insurance is available – because the due diligence undertaken by the buyer can sometimes be too long and expensive.'

Equally there was interest in sellers providing some guaranteed financial backing for prospective bidders prior to an auction. Bill Cooper at Lloyds TSB believes 'it would be better from the vendor's side to look at doing this differently – by the vendor arranging the debt finance in advance, making the whole process less reliant on the support letters and subsequently making the process more efficient in the early stages. It might work that way – we have had discussions on this with a number of advisers, it might happen.'

According to Peter Taylor at Lovells this is something that is already happening to a limited extent: 'It is not unheard of for the seller to "arrange finance" either by way of an introduction through an adviser, or directly via a close relationship with one of the more expansionist banks or finance houses. Or, quite commonly, for example in the form of outward reinsurance coverage which is put in place in principle, "parent to parent". It is a question of trust – and knowledge of the corporate history – which influences to what extent a "pre-packaged" sale can be brought to market.'

However, as far as making any changes to the process are concerned, Nigel Montgomery of Sidley Austin stresses that the 'mechanism for change is, and should be, from within the market; the way to change things (like the increased use of speedier more selective auctions) is to let the market determine whether sellers do better by having a small-scale and more controlled bidding process. That's how you change a process, you don't try to force or induce change from outside.'



Furthermore, reputation for providing a reasonable process of sale will become more crucial should the market take a downward turn. Word is that buyers are becoming increasingly infuriated with the prospect of a long drawn out auction process that may involve up to 20 or 30 bidders. As Montgomery points out: 'Certain buyers might even consider withdrawing from the process if they saw too many people brought in, because they say they find it

'I think some of the money that was chasing run-off was naïve capital which was willing to take a chance but I think that naïve capital is out now' Nick Pearson

promise, this does not mean that the highest bid should always win. Rather that, 'sellers are well advised to look at the track record for completing deals, standing with regulators, plans for business post-acquisition, including employee retention, when assessing the overall execution risks attached to a given suitor.'

Largely this issue comes down to the *modus operandi* of the vendor involved. Those that favour a high price are naturally going to be drawn to an auction or those that have already assumed a particular run-off approach. Conversely, for those sellers for whom reputation is paramount, such as a major company continuing in the live-market, the criteria can be very different. As Julian Miller, partner with law firm Beachcroft, points out: 'Whether auctions are appropriate depends upon the book of business concerned, ie for a big player in the market, reputation may be key and therefore price is not the most important factor. In those cases the client would only be prepared to sell to certain people – not to one known to be difficult over paying claims for example.'

immensely tough and often unproductive if there are too many people involved. It's money-consuming, time-consuming and sometimes just a bit too chaotic.'

For some of the more 'experienced' buyers, the presence of less regular purchasers of run-off books can make the process slow and painful as they take time to get to grips with the more complicated books of business. As financial backing for acquisitions becomes more selective and buyers reduce in number, sellers may be well advised to begin catering for buyers' expectations since given the choice many will opt for pre-selected process of sale.

The chances that the number

'Money is not everything, particularly in the sphere of solvent run-off. Reputation matters' Clive O'Connell

of sellers will also dramatically increase following Solvency II and, not to mention, the (possible) break-up of major insurance companies (AIG seems an appropriate



‘Certain buyers might even consider withdrawing from the process if they saw too many people brought in’ Nigel Montgomery

example) will only add to an auction-room shun by exasperated bidders. For Aswari Kochar, partner at Edwards Angell Palmer & Dodge in London, such developments have already begun; ‘The auction approach is likely to get the best price return – but now fewer people are showing up at the auction.’

All out auction processes also may complicate matters for sellers regardless of reputation. If an auction is to include some 20 or 30 bidders, buyers are not going to conduct any expensive due diligence into the books up for sale with such a low chance of success. Inevitably, failure to get a good handle on complicated books increases the potential for deal-breaking price changes further down the line as previously unseen aspects of the purchase are suddenly exposed.

From the perspective of the seller then it is perhaps simpler in the long-run to only select those buyers who are known to have a good understanding of the book so as to reduce any surprises in the closing stages of a deal. For Sidley Austin’s Montgomery, ‘the skill to selling is not simply about how much money one

can get but to construct the process in such a way that by the time you are really into exclusivity you have removed as many legitimate reasons as possible for people to change their price.’

For the vendor a major problem with attracting too many bidders is that it becomes impossible to check the appropriateness of them all. In such cases it is not uncommon for potential purchasers to throw in substantial bids simply to get their foot

in the door, but without the requisite financial backing needed to see out a deal – in other words, execution risk. Having skimmed off the top bids then one faces the possibility that some, or all, may not be able to make the purchase in the end.

With pre-selection, however, sellers have the opportunity both to ensure that potential bidders both have an understanding of the book they intend to purchase and that they have enough financial backing to make the purchase when it comes to it.

Says Taylor at Lovells: ‘The more “pre-invitation” due diligence that

‘The auction approach is likely to get the best price return – but now fewer people are showing up at the auction’ Aswari Kochar

a seller can conduct on the aspirations, capabilities, and track record of the potential bidders, the more focused and more successful the sale process will be.’ Otherwise, vendors

may find themselves having to go back, on hands and knees, to previous offers from bidders who may feel a bit sore from having been put through such an exhaustive process. Consequently, these second choice offers may be considerably lower than the auction might have promised. Such an outcome would negate the advantages of taking the auction route in the first place.

On the other hand there is an important counter-argument. Being a bit sore about a seller’s business practice doesn’t make for good business acumen in a prospective purchaser. If the purchase still looks likely to make you a profit, who cares that you’re only second (or third or fourth or fifth.....) choice? As Montgomery notes: ‘Ultimately if something is desirable, if the problem is not something to do with the seller but with the buyer (i.e. a sale fails because the price drops or the buyer walks away), then there will be people who still want to come in without damaging the price.’

Take the recent acquisition of Quanta by Bermuda based group Catalina. Although having originally lost out to a higher bid by Enstar, when Enstar withdrew from the purchase at a late stage, Catalina happily returned to the process and bought Quanta. Hungry purchasers mean that sellers can essentially dictate the terms of the process of a sale without fear that the inconvenience to buyers of a drawn out auction, or the

‘bad’ purchasers it might attract, will ultimately affect the price they get.

In the end, auctions have both pros and cons, largely weighed out in price versus reputation. What the



When to contact the regulator

On the issue of at what point of a potential transaction the regulator should be contacted, Paul Taylor of the FSA says the following;

The FSA has well established procedures for interacting with and determining such transactions. Firstly in accordance with Principle 11, Relations with Regulators; selling firms are required to inform the FSA of their intentions at an early stage. In most cases the FSA will require the firm to produce an Individual Capital Assessment (ICA) predicated on the position at the point of sale. All companies including run-off companies are required to have an up-to-date ICA at all times. Therefore firms will need to consider if any amendments are required based upon the structure of the disposal, for example intra group transactions and guarantees. For London Market companies the FSA will want to know about the ongoing status of any market guarantees such as those provided to the Institute of London Underwriters. Generally (except in stressed circumstances) the FSA will only allow a sale transaction if the firm has sufficient capital to run-off its liabilities to extinction in most stressed scenarios. Therefore consideration of capital adequacy is generally the most important issue for the FSA in such proposed transactions and selling firms are advised to reach an understanding with the FSA at an early stage in the process.

In respect of the sale negotiations process the FSA has little interest in this per se and has no view on how this is organised or conducted. The FSA does not consider it efficient nor does it have the resource to engage with all prospective buyers. Normally the FSA would only seek to engage when a preferred buyer was identified.

Prospective buyers (new controllers in FSA speak) will be required to be approved by the FSA in accordance with Part 12 of FSMA; specifically in section 186 the approval requirements are that—

1. The acquirer is a fit and proper person to have the control over the authorised person that he has or would have if he acquired the control in question; and
2. The interests of consumers would not be threatened by the acquirer's control or by his acquiring that control.

In addition and in order to exercise the FSA's judgement, potential new controllers are usually required to submit a Scheme of Operations (SoO) in accordance with the Supervision Manual Appendix 2. The SoO is a financial and operating plan usually to include an ICA. The SoO must demonstrate that the firm will meet Threshold Conditions particularly adequate resources. Adequate resources are both financial and operational.

current state of the market gives vendors is the option to choose either way without too much repercussion. However, in a marketplace where sellers outweigh buyers and selling becomes an imperative (due to either Solvency II or the break-up of companies brought on by the global financial situation) this simply isn't going to be the case. In this, very possibly emerging, scenario vendors' concerns over price or reputation will play second fiddle to the necessity of making a sale (see Changes to the transaction process p.9).

Deal or no deal

Opinion differs over what are the most common causes for ending a potential transaction in the final stages of a deal. Lovells' Taylor lists 'price; release or replacement of parental guarantees; lack of transparency of portfolio composition or performance; intricacy of relationships with affiliates and pool members; sale warranties; financiers' lack of focus until too late in the game; regulatory reaction to structure and/or purchaser solvency; jurisdictional uncertainties; and (with modern portfolios) change of control clauses.' Similarly, Adams at Deloitte says: 'Price, first of all, but also warranties, not getting a clean-break (for the seller) and regulatory approval.'

Not surprisingly price appears top of the list for most people involved in acquisitions. For Montgomery, 'price is a deal breaker, and has been on a number of occasions because a seller's expectation – their threshold "willingness to sell" price – is on occasion just greater than those in the market who are buying are willing to pay.'

Naturally, from this perspective price as a deal-breaker is tied into the supply and demand for books of business and, as it stands, the expectations of sellers are increasingly being met. For some, however, price shouldn't really damage the



‘The more ‘pre-invitation’ due diligence that a seller can conduct ...the more focused and more successful the sale process will be’ Peter Taylor

finalisation of a deal. According to Ernst & Young’s Bridger, ‘By the time you’ve got to the last round, you shouldn’t be wrangling over price.’ He continues: ‘Deal breakers have two principal drivers: the reinsurance asset – you have got to be comfortable that you can collect on that at par value rather than at a discounted rate, and the claims reserve – assuming that your claims reserve is adequate to pay the claims including the IBNR you should be able to run the business off and release the capital. If you get those two drivers right then the price drops out the bottom and is driven by the buyer’s funding structure and the required rate of return.’ Bridger also stresses that to avoid deal-breakers over cost, sellers ‘need to know at what point and what price the various bidders will make their return. How are they going to structure the deal? Then run the cash flow numbers both on a normal pattern of run-off and on an accelerated scheme run-off – ask what their likely return is going to need to be and therefore what their price is likely to be.’

Of course, most would agree that

if a sale is conducted properly a price should have always been agreed prior to the last stage. Nevertheless, the final stage due diligence can throw up some unhealthy revelations about the quality of the books being bought that can result in some purchasers withdrawing altogether. Says Freshfields’ Golding: ‘There are relatively few last-minute deal-breakers in this market because normally the buyers have done their homework early on and there shouldn’t be any major surprises. In situations where

the buyer takes the drains up and finds something unexpected, they could say that they are no longer interested.’ For some this highlights the tendency of auctions to increase the potential for deal-breakers. Since it is unrealistic for purchasers to conduct any expensive due diligence without first securing a good chance of success, such last minute discoveries can provide legitimate grounds to pull out or lower the price. On the other hand, the kind of money generated by a bidding war perhaps

‘Normally the buyers have done their homework early on and there shouldn’t be any major surprises’ Neil Golding

balances out the increased execution risks.

In any event deal-breakers are a natural risk of any potential sale regardless of the process by which it is operated. Furthermore, the discovery of a few bad apples in a book

does not necessitate a complete withdrawal. As Golding tentatively adds; ‘it is more likely to result in a discussion on price.’ In some cases, referring to unhealthy aspects of a book late in the game may be a tactical move by a buyer to reduce the price rather than a genuinely worrying and surprising discovery. The extent to which the discovery of something wrong with a book might turn into a deal-breaker depends on just what exactly is wrong. As Carter at Charles Russell points out: ‘When it comes to finding something wrong, whether that makes a buyer pull out of a deal depends on how wrong it is; does it require further negotiation or does it make any potential deal fundamentally unattractive?’

Aside from price, such discoveries may also force the issue of a ‘clean-break’ to the negotiating



table. Says Montgomery: ‘I’ve seen several where the solution that the seller wants is an outright disposal, and I’ve known purchasers propose solutions which would be things that could be done, or perhaps in their view should be done, in situ before a



Aside from the seller and the purchaser though, regulators have occasion to bring a transaction to a swift end. Once a buyer has agreed a cost at which they have forecast an acceptable risk against profit, demands from the regulator for a higher claims reserve can throw those calculations into disarray, ultimately forcing a buyer to renegotiate or withdraw.

Naturally this depends on the character of the host nation's regulators. Says Montgomery, 'the FSA is good at

of that market.'

On the other hand most problems can be overcome by the buyer approaching the regulator at an early stage, as O'Connell at Barlow Lyde & Gilbert stresses: 'The sooner the regulators are involved the sooner regulatory issues can be identified and resolved.' In short, any potential deal breakers involving the regulator should have been addressed beforehand by both vendor and buyer, the general premise being 'sooner rather than later' (see When to contact the regulator p.12).

'When it comes to finding something wrong, whether that makes a buyer pull out of a deal depends on how wrong it is' Stephen Carter

transfer – or hand in hand with the proposed buyer in a slightly different transaction than an outright sale purchase. The seller wants a clean break and the purchaser might say "well do you know there are a number of things which would be really quite helpful if you did before I took over – I'm happy to do them with you, but they are better done in your reorganisation or under your jurisdiction, before we do anything else".'

However, Golding comments: 'If for the vendor the sale is on a non-negotiable clean break basis then they will have made that clear from the outset. Alternatively, the vendor may offer to retain some element of residual risk in order to facilitate the deal.' From this perspective clean breaks should not be a major deal-breaker as the terms of

listening and very helpful in the run-off field, encouraging discussion, but there may be some countries where that isn't the same.' Thresh adds 'I remain fearful, for example that the environment in the US, particularly regulators that are not used to seeing run-off mergers and acquisitions,



'I remain fearful that the environment in the US may frustrate some deals and slow down progress in the development of that market' Charles Thresh

the sale should be explicit from the beginning.

may frustrate some deals and slow down progress in the development

Buyer beware?

The current buyers of run-off books vary considerably in their structure, their financial backing and, of course their business strategy when it comes to acquisitions. Of the large 'industrial' buyers for example, Berkshire Hathaway has no need for external capital and little interest in accelerated run-offs and along with Enstar, Randall & Quilter and Tawa, has access to public equity markets (see figures 2 and 3 on pages 16 and 18). Other buyers choose to turn to hedge funds, private equity markets or investment banks and some to private investors or parent companies for extra backing.

Equally some buyers opt to retain the full risk of the purchase post-acquisition and some choose to reinsure a large percentage out. Again, some companies are able to service the run-off themselves and build platforms for consolidation and others are purely capital providers who are keen to accelerate the run-off through a scheme as soon as they have bought it. But to what extent will the buyer landscape change with the current climate of credit crunch and market turbulence?

As we go to press there are very real concerns being expressed as to the viability of some of the purchase deals – in terms of value for money for the buyer; whether the backers will be there when it's time to sign

Broad range of sources of capital



Figure 2 - Source, Hines Associates Ltd

on the dotted line and if so whether the returns they are expecting will be there at the end. A couple of deals which were announced as being ‘done’ three months ago are still to actually close.

According to market sources, most deals normally close within 60 days, and any longer than that usually indicates issues. For example, that people who have put in very high bids might find in due diligence that their bid was a little high and are trying to renegotiate them or that when it came to the funding it’s a bit more of a struggle than thought or that the rate getting charged by the bankers has significantly increased – even over that short time.

Philip Holden, managing director of LCL Group, for one, is a buyer who is convinced that this current buying market won’t last and is moving against the vendor: ‘I think that all this money piled in on the basis of it being easy to make money out of run-off. It’s not easy to make money out of run-off because so many things can go wrong. I think the market is moving against the

vendor because of a) capital pressure and b) too much expectation by vendors. To be honest there are lots of bargains out there – you don’t actually need to overpay.’

Although LCL Group has entered recent auctions, Holden says: ‘We’ve bid sensible prices where we think we can make money. And if we’ve lost in an auction it’s either because we got our pricing wrong or because somebody is paying too much.’

He adds: ‘If you’ve priced the deal wrongly in the first place then you’re already starting from 20 yards behind the start line and trying to catch up. The question is when everyone’s caught the plague from this latest activity where is that capital going to go next?’

According to Gilles Erulin, CEO of Tawa, the current financial environment is definitely affecting the sales of run-off:

‘There is new money coming into the run-off acquisition market probably from investors with that idea at the back of their minds that they can somehow buy a very highly leveraged balance sheet with only a small

piece of equity investment.

‘What I would say is that it seems that the liquidity crisis is starting to reach all areas of the industry and that today, some transactions that have been structured with borrowed money or even new money from shareholders may prove to be difficult to close.’

Erulin believes that what he sees as the necessary returns on deals are getting harder to structure: ‘Just as in all M&A markets there is a very real squeeze on cash at the moment – but even companies with cash are still trying to put some leverage on the deals because without it, the return being looked for – 20 per cent and above – is much more difficult to achieve. If you cannot get leverage from your bank, then you are looking at investing your own equity for a return probably as low as 15 per cent over five years, which is unsatisfactory in light of the risk profile of these transactions.’

However he stresses that ‘The quality of underlying insurance run-off business has not changed, so provided you can manage it profession-

ally, with proper management skills, which is probably the biggest challenge these days, you can probably still achieve the target 20 per cent return.'

'If we've lost in an auction it's either because we've got our pricing wrong – or because somebody is paying too much' Philip Holden

Holden feels the buying criteria is changing: 'All the deals we've done are with people we know and so have been driven by personal contact. Increasingly it has been about price when silly money was coming into the market. Now we are turning to a different criteria for doing the deal – will people do what they say they'll do and will they have the money and do the job properly not embarrass you or your policyholders?'

And Erulin admits his view of the market has shifted a little: 'Up until a few months ago I would have said that in our business the issue wasn't about money it was about having the right people. This has slightly changed and I would now say the issue is about finding the right deal, having the right people to manage it but also having the right financial backing.'

Not only is strong shareholder backing important, but also the attitude of those shareholders says Andrew Brannon, chairman of LCL Group. 'When Charles Taylor Consulting bought into us,' says Brannon, 'they made it clear that the upside of our deals was the icing on the cake; nothing beyond the fee stream is ever factored in and so we haven't gone out on a limb to buy things we can't afford. So we are looking at life business, motor, smaller deals that no-one else is interested in, everything round the edges. And we're not risking the bank every time we

LCL pulls together excellence, expertise and professionalism.



At LCL teamwork really matters.

We have produced and continue to deliver some of the most sophisticated new ideas and solutions in the run-off and professional services arenas. We also provide the highest quality service because we recognise that innovation means nothing without the teamwork that stems from a lasting relationship with our clients.

So, when you want to team up with a world class organisation delivering effective solutions call Philip Holden or Andrew Brannon.

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Quoted competitors

	Market Cap ⁽¹⁾	Book Value ⁽²⁾	Earnings ⁽³⁾	P / BV Ratio	P/BV Ratio at Float	P / E	P / E Ratio at Float
Enstar	\$1,361.0	\$476.6	\$60.4	2.9x	4.7x	22.5x	18.2x
Tawa	£91.5	£131.7	£9.4	0.7x	1.6x	9.8x	4.4x
Randall & Quilter	£75.5	£76.5	£7.4	1.0x	1.3x	10.2x	15.9x

(1) As at 29th September 2008.
 (2) As at 30th June 2008.
 (3) Last 12 Months.

Figure 3 - Source, Hines Associates Ltd

do a deal.'

LCL does however sometimes have to look for extra backing. Says Bran-non: 'We are looking at a large life book at the moment and are looking for extra capital from a range of providers. If a transaction works for us then it will work for them; the trouble is that for some of the deals that are being done they wouldn't be fundable on normal commercial banking terms. When you are paying an increase against asset value you have to go to hedge funds who want 15 per cent in three years. You can convince yourself, and do a good job of convincing them, of the 15 per cent returns – promises that in three years time are all remembered by them and forgotten by you. We just want to steer clear of all that.'

As far as new run-off books becoming available are concerned Erulin is looking across the Atlantic for business in the future: 'The London market is getting a bit dry and generally slowing down and we are finding

the US market more promising. We understand the NAIC has done a lot of work to become more familiar with the run-off professional management model and over the last two years we have seen a real evolution in the approach of US insurance regulators. We have dealt with five different State regulators recently and we find that their approach is very professional and there is much less of the bias which we may have seen before.'

Philip Grant, chairman of ARC and Ambant, feels a change is on its way: 'Vendor appetite will increase because the cost of external capital is so high that they will need to release it off the balance sheet; the conundrum of course is that because of tight capital it may force the buyer market to look at other ways of financing deals and avoid the prohibitive lender market rates. Maybe the best way to finance these transactions will be through reinsurance. Reinsurers are interested in the run-off market while their

traditional market is slow – and that is looking to be the case for the foreseeable future. Alternatively it also helps considerably if you have got a market listing and can raise finance that way.'

Grant is firmly convinced that many more run-off books of business are going to be up for sale – particularly from European insurers: 'I believe Solvency II is a key driver towards greater examination of balance sheets to find those areas where capital is under used - with discontinued business portfolios being obvious candidates,' he stresses.

Moreover, given the way Solvency II will treat risk factors such as premium risk, it is not inconceivable that portfolios of technically profitable live business will be either closed down or disposed of to run-off acquirers in order to free up solvency capital - for run-off to be the driver of strategy rather than its consequence would be a fascinating '*volte-face*,' Grant muses. ●