M&A in insurance

Presentation at the MABISZ conference

László Juhász

8th October 2013

SHAPING THE FUTURE. TOGETHER.
50 YEARS

Agenda

International view: M&A remains important in insurance

Hungarian reality today: The consolidation paradox

Many European Insurance player with a Price/Book multiple <1

Investors do not believe in insurers to having a convincing strategy

P/B-multiple <1

Financial Fundamentals
- Premium growth stagnant at peer average
- Profitability at peer average
- Subscale positions in foreign countries
- Home market in Europe limited

!

Corporate Strategy
- No clear positioning as value or growth stock
- Very scattered regional presence
- Many sub-critical positions
- Unclear competitive advantages

!

Investor Communication
- Issues in presentation of clear strategy and facts
- Unclear communication of strategy
- Value of the group being questioned
- No M&A transactions or movements to improve stuck-in-the middle position

!

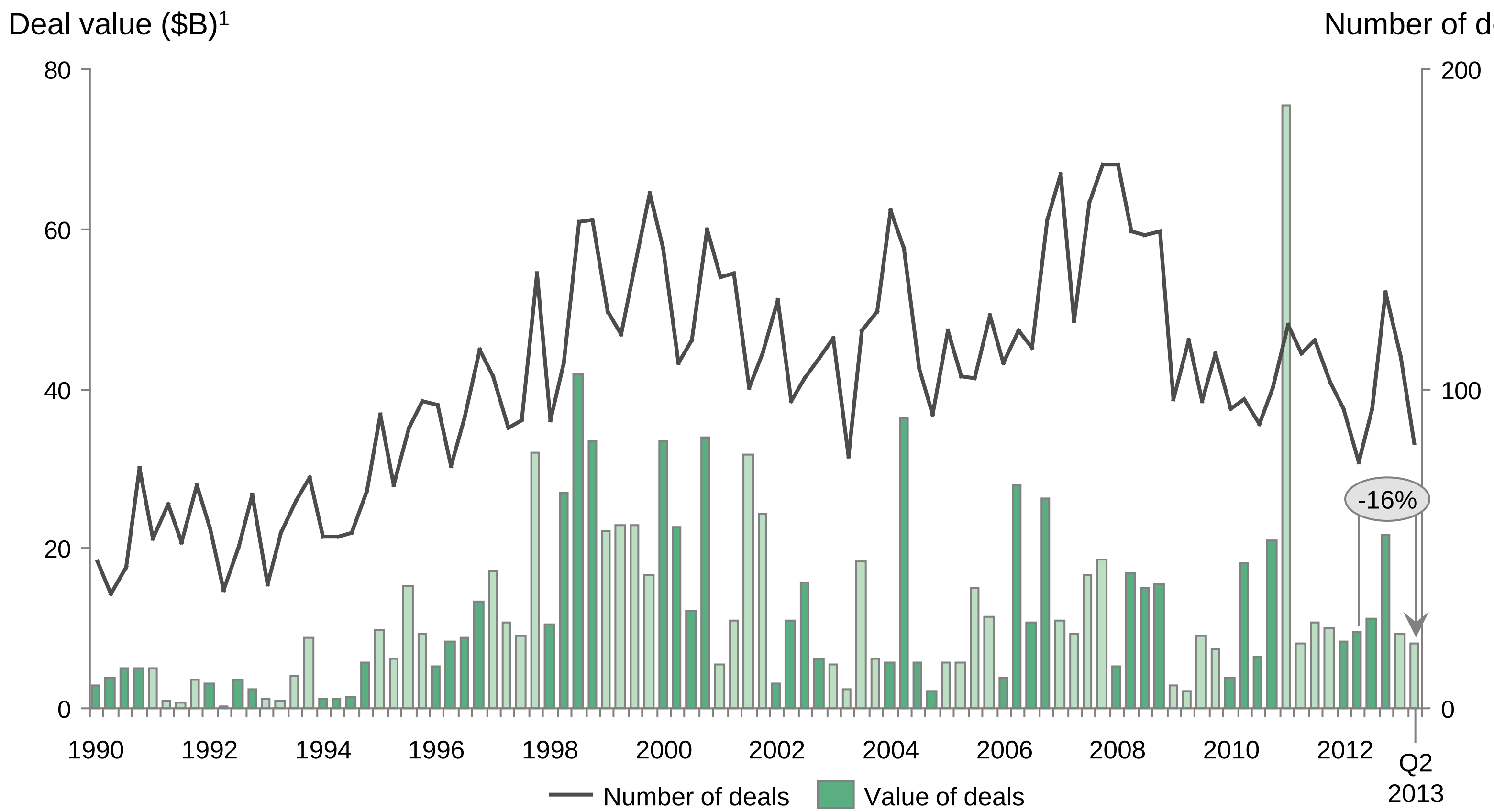
Clear strategy for capability build to create sustainable competitive advantage

Source: BCG analysis

Draft—for discussion only

M&A activity in the insurance sector reduced in 2012

Development of number and value of deals (1990-2012)



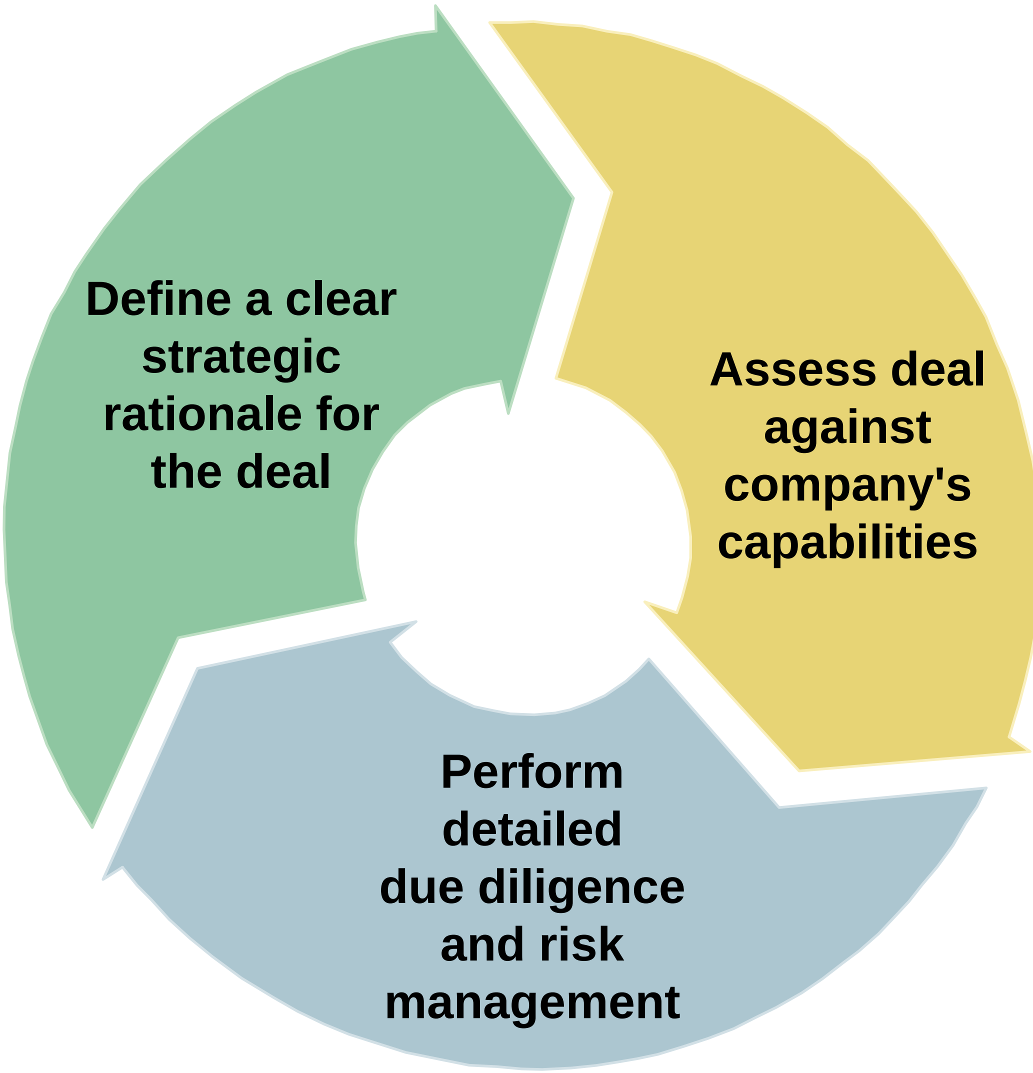
YoY (2011 vs. 2012)

Value: -51%

Number: -12%

[1] Enterprise value includes net debt of target. [2] Total of 9,672 completed M&A transactions in the insurance sector with no transaction-size threshold and excluding repurchases, exchange offers, recapitalizations, and spinoffs.
Source: BCG M&A Research Center; data provided by Thomson ONE Banker.

Three basic principles for value-creating M&A deals



Source: BCG analysis

Define a clear strategic rationale for the deal

Four main motivations for M&A identified

Motivation		Examples: Acquirer	Examples: Target
Complements	• Acquisitions of smaller players with complementary capabilities or skills • Could be either LOB, Product expertise, channels	MetLife	Travelers
Scale	• Primarily in home markets or those with substantial operations • Aim to achieve scale advantages	AXA	winterthur
Internationalization	• Acquisitions outside of the home country or base of operations • To expand operations globally	AEGON Local knowledge. Global power.	TRANSAMERICA The Power of the Pyramid®
Emergency deals	• Driven by solvency position • Or forced by regulator	Western & Southern Life A member of Western & Southern Financial Group	*Integrity Life Insurance*

Source: BCG analysis

Asses the deal against the company's own capabilities

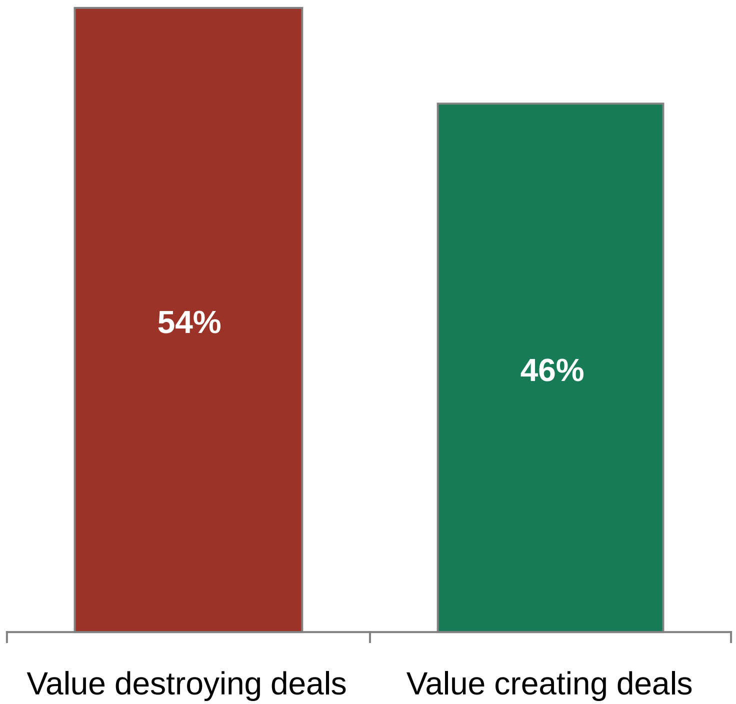
Three areas of relevance identified

1 Financial capabilities	• **Assess the availability of funding before embarking M&A** – Current economic situation makes adequate and persistent deal-funding a prerequisite – Strain of the transaction needs to be taken into account
2 Organizational capabilities	• **Spell out a clear logic and plan for integrating each function** – M&A deals affect all parts of the value chain – When sales functions are integrated, retention of sales force, branding, cross selling and the set up of sales support processes need to assessed – In life insurance, the integration of back-office and IT can take years
3 Cultural capabilities	• **Manage the cultural and change-related issues of the integration** – Maintaining morale and boosting confidence in the deal is crucial – Cultivation and communication of a shared understanding on how the PMI will work is important – Basic prerequisites such as language skills need to be clarified in advance

Overall, value creation in M&A is a challenge

Value creation of insurance M&A in total

Value creation of insurance M&A deals



Number of deals 188 159

Conclusion

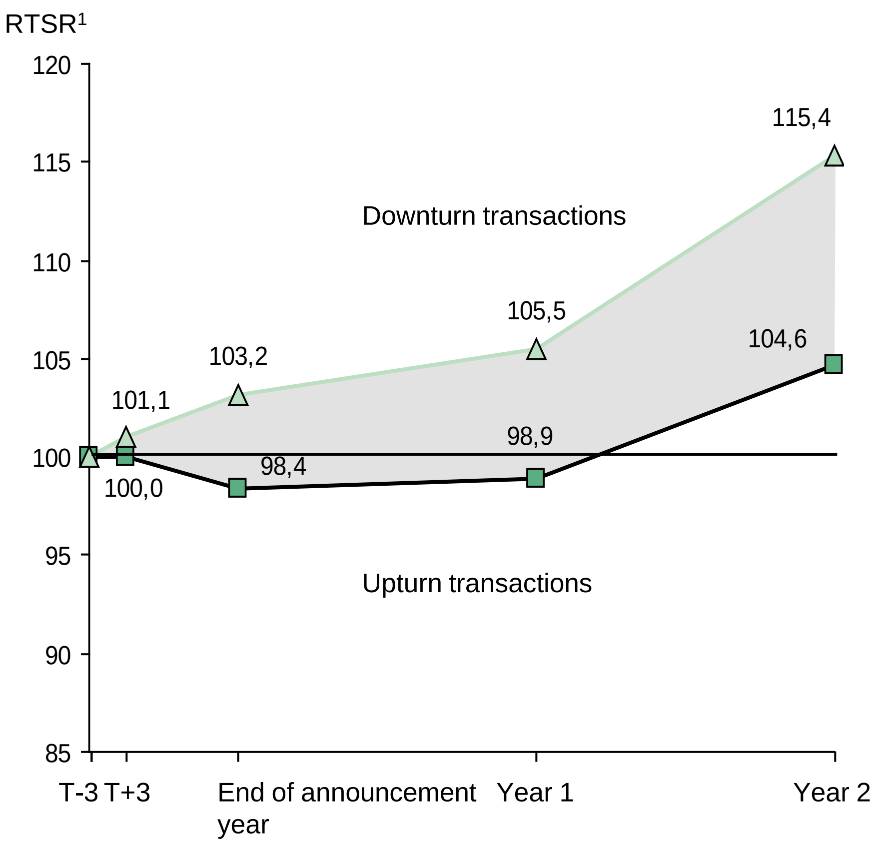
- Significant variability in value creation potential of deals
- M&A success is not a random chance event
  - Several success factors exist
  - Isolated in our study of insurance deals
- Value creation studied from the perspective of the shareholder of the acquirer

Note: Analyses using announcement effect of deals measured using Cumulative Abnormal Return (CAR) over seven days, centered around announcement date. Results based on analysis of deals conducted between insurers over the period of 1999-2008. Only deals where the acquirer was from North America or from Western Europe were considered
Source: Thomson financial, Datastream, BCG Analsysis

Downturn deals outperformed upturn deals

Comparison of long-term RTSR

Downturn deals outperform upturn deals



Rationale

Chances for short and long-term value creation are better during downturns

- Lower competition results in better pricing
- Scarce capital leads to higher burden of proof on benefits
- Opportunity to acquire good parts of distressed companies (emergency deals)

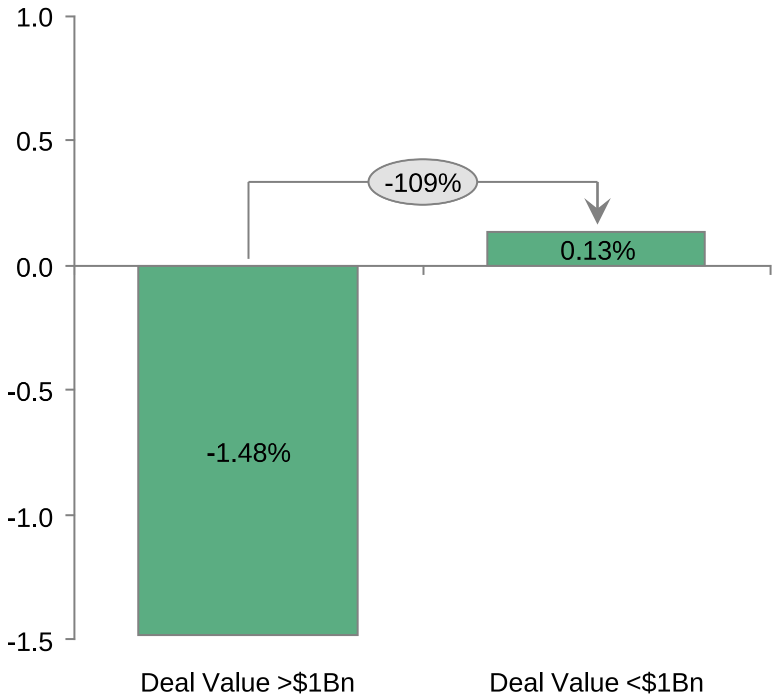
1 Cumulative relative TSR performance (3 days before deal = 100)
Note: Sample size = 347; values based on averages; Upturn and downturn periods defined using the movement of the MSCI world insurance Index –
Periods of upturn: 01 January 1999 to 31 December 2000, 12 March 2003 to June 3 2007. Periods of downturn: 01 January 2001 to 11 March 2003, 4 June 2007 to present
Source: Thomson Reuters Datastream, BCG analysis

Small deals are more likely to create value

Value creation of insurance M&A by size

Large vs. small deals

CAR %[1]



Number of deals	42	147

Rationale

- Difficult to integrate large targets and realize planned synergies
- Required capabilities not available in-house for most companies
- Extra caution and support required while indulging in large deals
- Smaller deals may be more prevalent in times of crisis with divestments

1. Results are statistically significant at conventional levels of confidence (at least 90 percent). Average CAR is calculated over a seven-day window centered around announcement day (-3/+3).
2. International deals are defined as those where the primary nation of operations of the target is not the same as the primary nation of operations of the acquirer

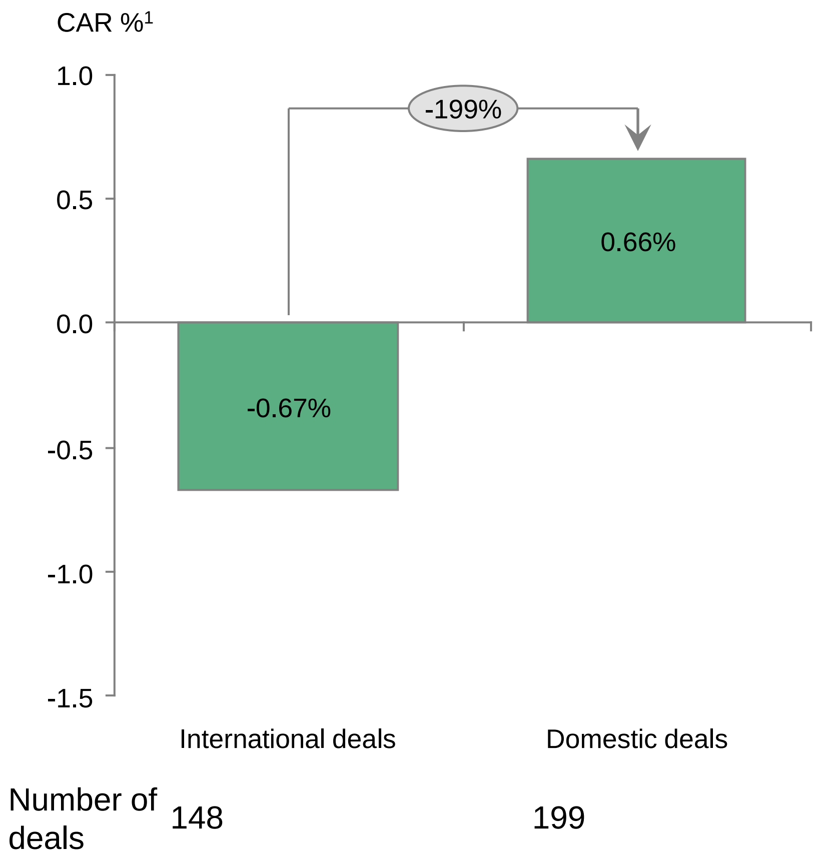
Note: Results based on analysis of deals conducted between insurers over the period of 1999-2008. Only deals where the acquirer was from North America or from Western Europe were considered

Source: BCG Analysis, Thomson Financial, DataStream

This is even more true for domestic transactions

Value creation of insurance M&A by region

International vs. domestic deals



Rationale

- International deals difficult to manage
  - Cultural, legal, regulatory hurdles
- Lack of understanding of international markets
  - May lead to overestimation of potential synergies
- Requires strong apparent logic to be successful

1. Results are statistically significant at conventional levels of confidence (at least 90 percent). Average CAR is calculated over a seven-day window centered around announcement day (-3/+3).
2. International deals are defined as those where the primary nation of operations of the target is not the same as the primary nation of operations of the acquirer
Note: Results based on analysis of deals conducted between insurers over the period of 1999-2008. Only deals where the acquirer was from North America or from Western Europe were considered
Source: BCG Analysis, Thomson Financial, DataStream

Solvency II adds new success factors to M&A

Each success factor implies desired features of potential targets

Desired features of potential targets	Rationale: additional value creation driven by SII
Active in severely hit markets where Solvency II will push all players to increase prices / adjust guarantees	**Markets:** Benefit from market-wide increase in prices / change in product features driven by SII
Currently low diversification, comple-mentary to buyer's	**Business mix:** Leverage diversification
Low current capital base limiting future yields – not enough elbowroom to pull all levers	**Capital:** Leverage own capital strength to increase room to maneuver
Low degree of sophistication, potential to consolidate in-force business and improve capital management	**Skills:** Utilize capability advantage in asset management/ALM, capital management and SII complexity handling to increase profitability

Solvency II provides only one perspective on M&A – "classical" strategic value drivers remain essential (brand, market position, etc.)

Agenda

International view: M&A remains important in insurance

Hungarian reality today: The consolidation paradox

Paradox: situation in Hungary bad but not so bad that it would catalyze immediate action

Situation deteriorated but still not as bad as to imply major structural changes

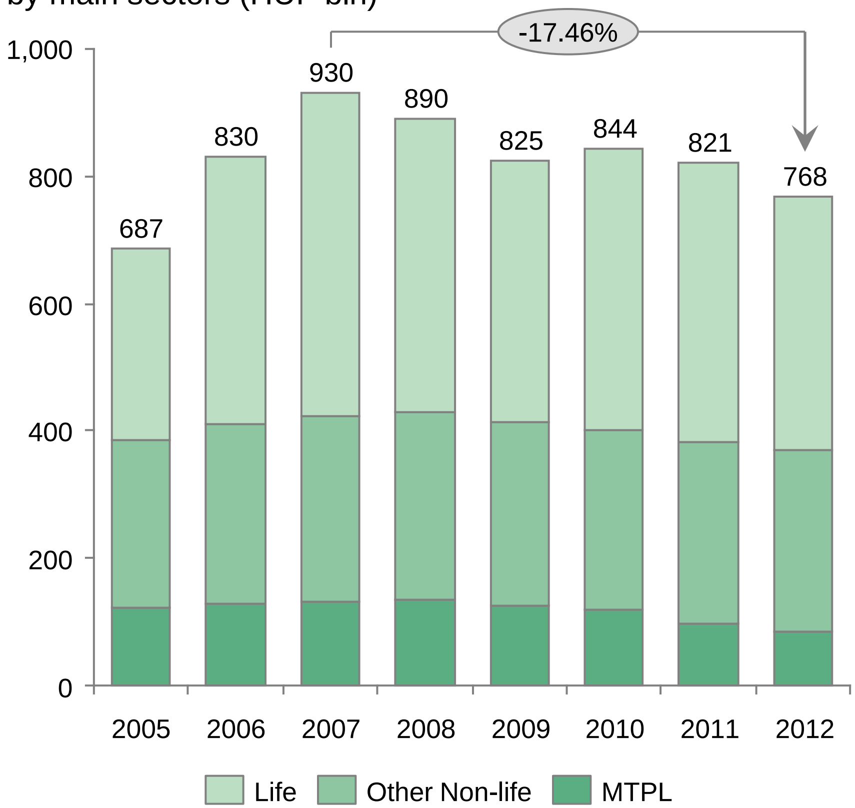
No easy way forward, no clear sweet spots or clear road to success

Market is still water, front lines frozen and everyone tries to sweat it out

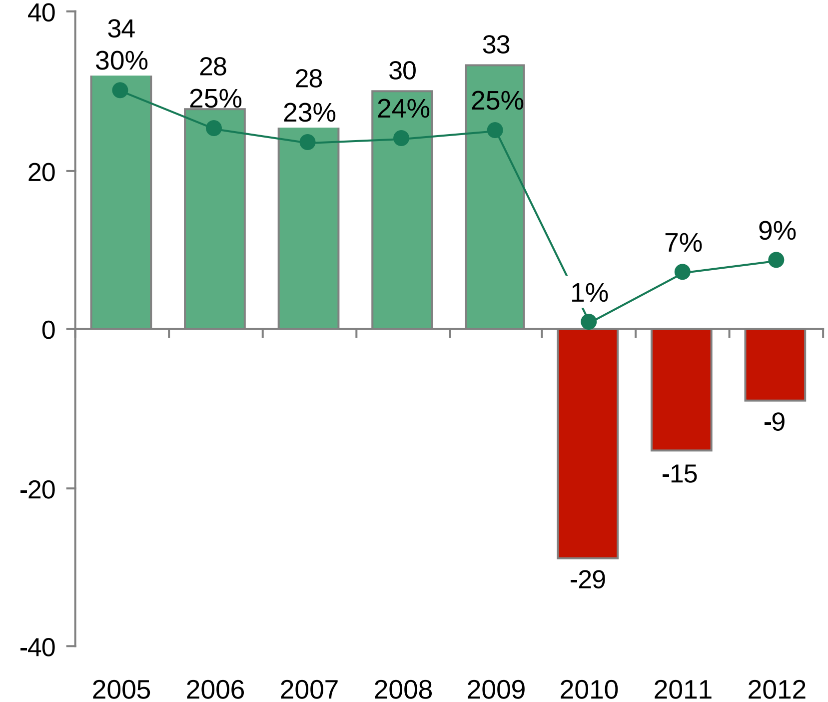
Clear need for consolidation in the market

Hungarian insurance today: a sluggish market with negative EVA, but overall profitable

Gross written premiums in the Hungarian Insurance Market by main sectors (HUF bln)



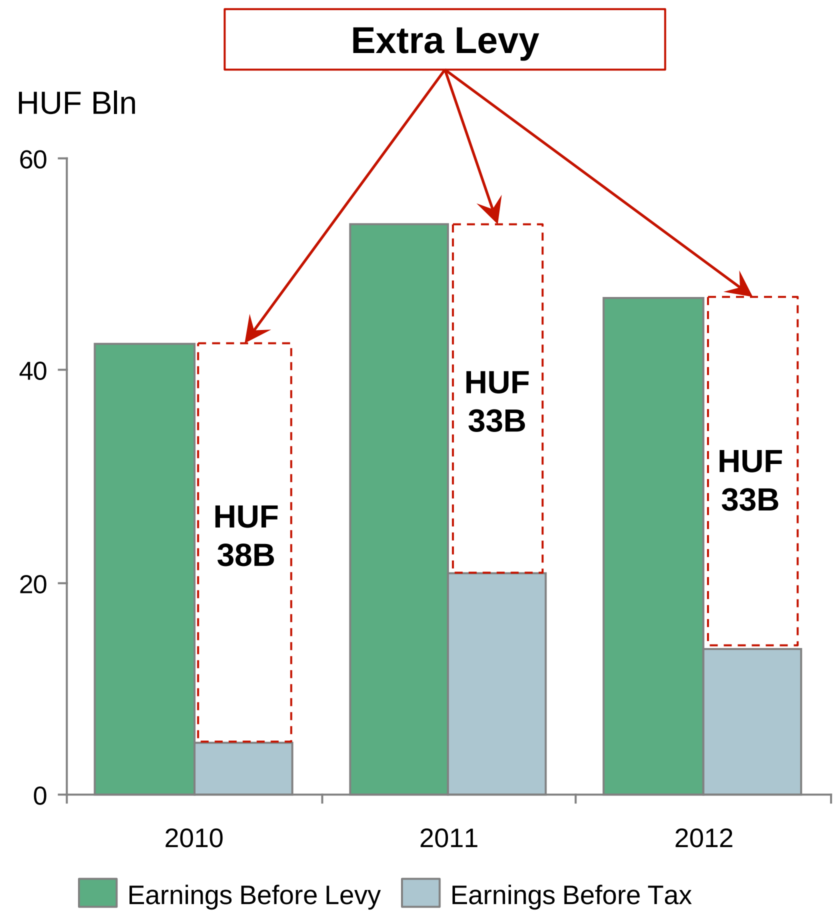
ROE and Economic Value Added (EVA) by the insurance industry HUF bln



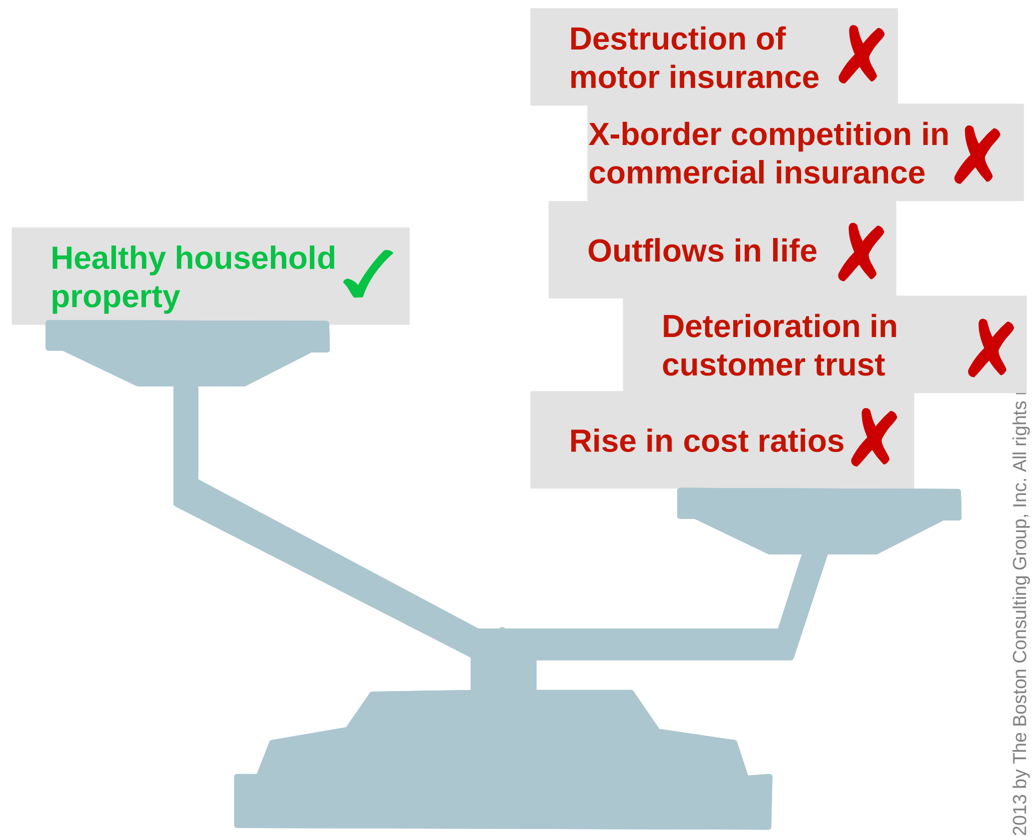
Note: Cost of capital calculated at 12,5%
Source: PSZÁF, BCG research

Several unfavorable developments beyond the financial services levy

Although the levy had the most prominent impact on industry performance...



... it concealed a number of mostly unfavorable developments of the last 5 years



Source: PSZAF, BCG Analysis

The situation is still far from the freefall of banking sector hit by a three wave 'Tsunami'

The banking 'Tsunami' and its impact 2008-12

Huge loan losses incurred from bad portfolios

HUF 2,500 bln loan losses in 2008-12 with 20.3% mortgage NPL, 24.9% in RE finance and 19.1% in corp.

Hefty regulatory burden from special taxes and other government schemes

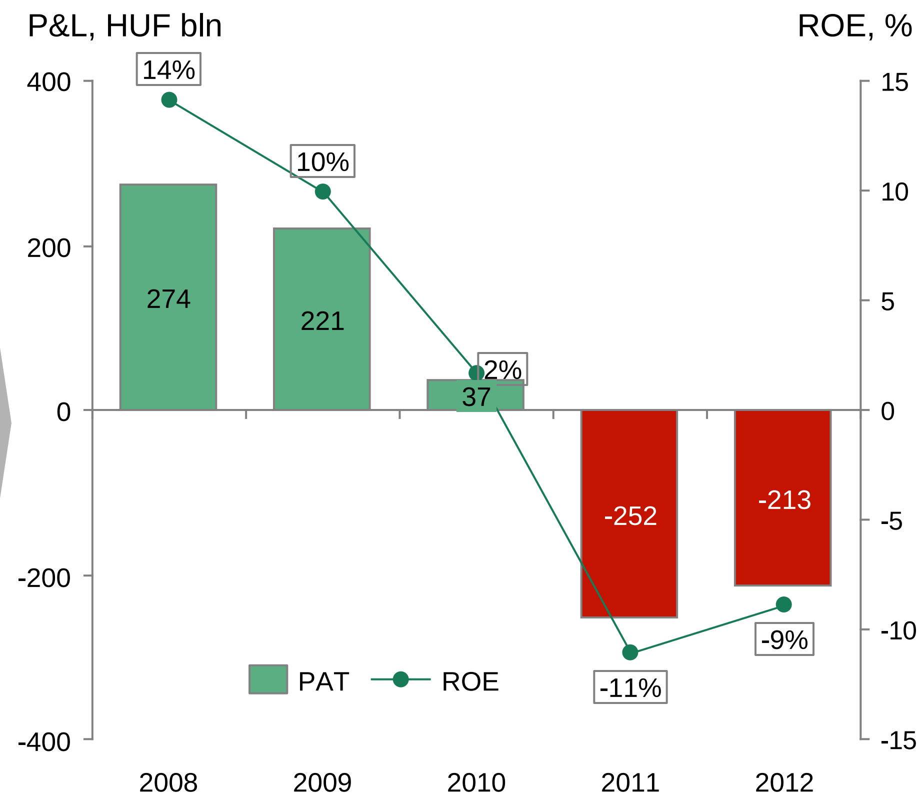
HUF 494 bln negative impact mainly due to banking tax and FX mortgage law in 2010-12

Decreasing top-line from reduced volumes and declining margins

HUF 300 bln decline in top-line in 2010-12 (-22%) with 4,000 bln net outflow in lending volumes and 70bps decrease in margins

Significant decline in the sector's profitability

Profitability of TOP 8 Hungarian banks



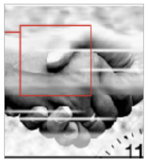
Source: Consolidated annual reports for Erste, Budapest Bank, Raiffeisen, K&H, UniCredit, CIB, unconsolidated annual reports for OTP and MKB, MNB Report of Financial Stability, PSZÁF Quick report on the Early Repayment Scheme, Press, BCG Analysis

Radical changes are necessary in the post-crisis reality?

Is there are way to move away from value destruction in current market structure?

?

Is there are way to move away from value destruction to value creation?



Is there a disruptive approach necessary in distribution?

- Are major cuts necessary in the proprietary distribution network?
- Are there any shifts needed between the distribution channels as part of strategy?
- How will the role of alternative channels, mainly banks and MLMs/brokers evolve?
- What is the role of new entrants eg. telcos in the insurance market?

What are the successful product strategies going forward?

- How to move away from the value destructive status quo in Non-life? (eg. segmented approach vs standard / low cost - direct provide, pricing excellence)
- What is the winning strategy in Life when completely new approach is needed due to low customer trust, expected new capital requirements and low level of competetiveness of products vs other financial service providers?
- How to capture the Health and Pension opportunity? Will this materialize anytime soon?

How to build a customer-centric business model?

- Where to invest and how to develop to ensure consistent customer experience?

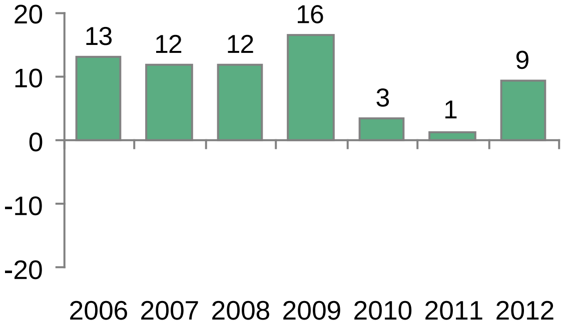
Are there new, non-trivial ways to improve cost-efficiency?

- What is the room for further improvement without increasing scale?

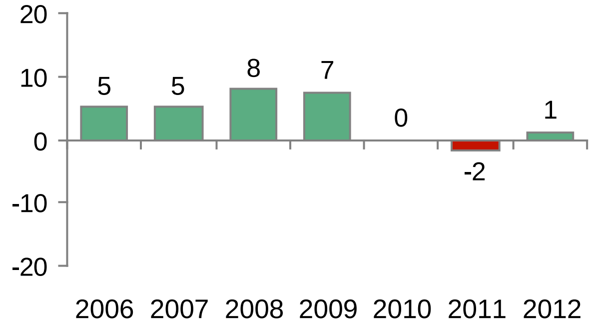
Standalone Hungary view: clear need for consolidation (I)

Top 5 players capture most of the industry EVA, rest of industry with negative return

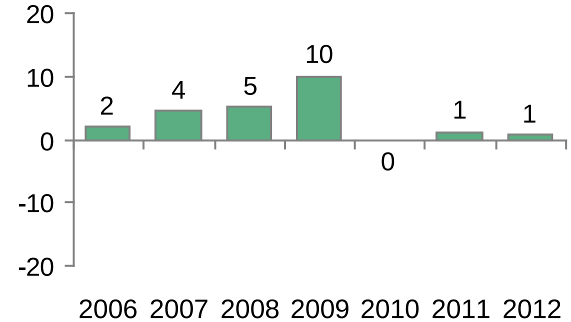
AEGON 67,5



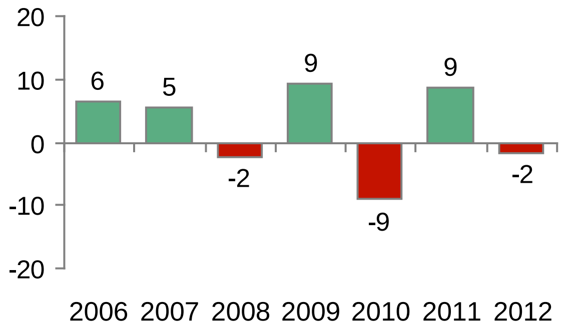
Groupama Garancia Biztosító 25



Generali 23

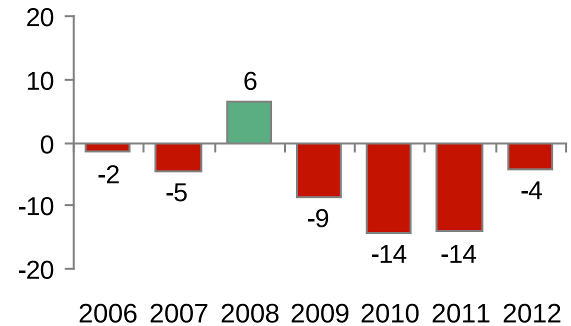


Allianz 17



ING -16

Rest of Industry -41



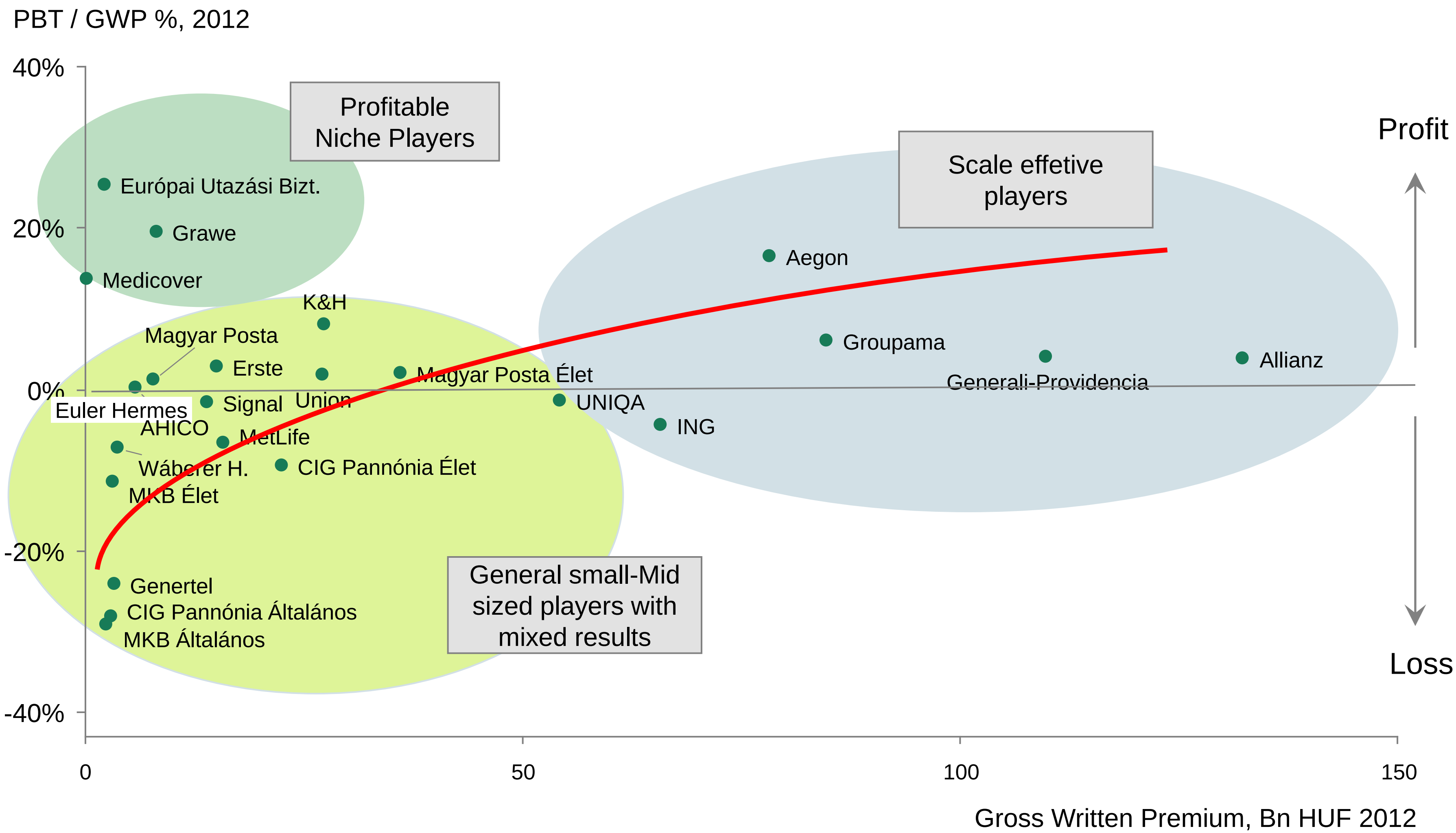
Half of the players are not making profits

Total EVA

Source: Annual reports, BCG analysis; Note: Cost of capital calculated at 12,5%

Standalone Hungary view: clear need for consolidation (II)

Lack of scale hurts small insurers under current economic conditions



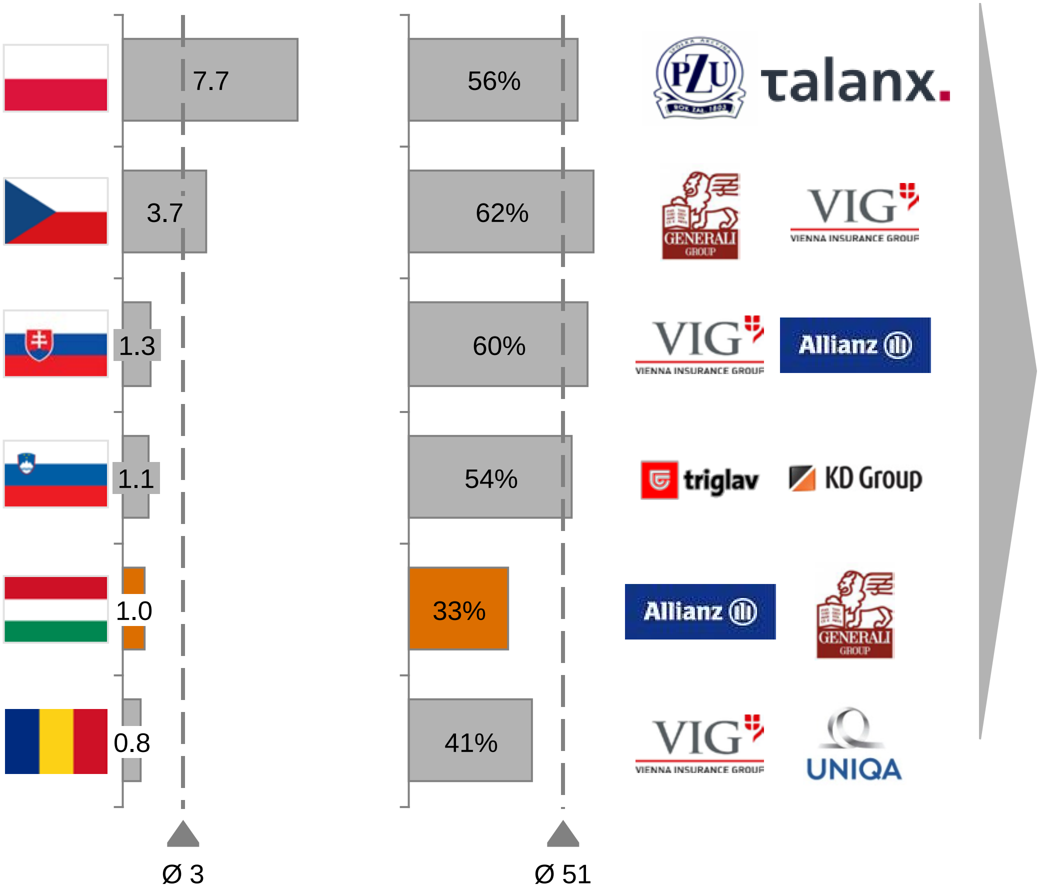
Standalone Hungary view: clear need for consolidation (III)

Even top players lack scale and dominance in CEE comparison resulting in costly operation

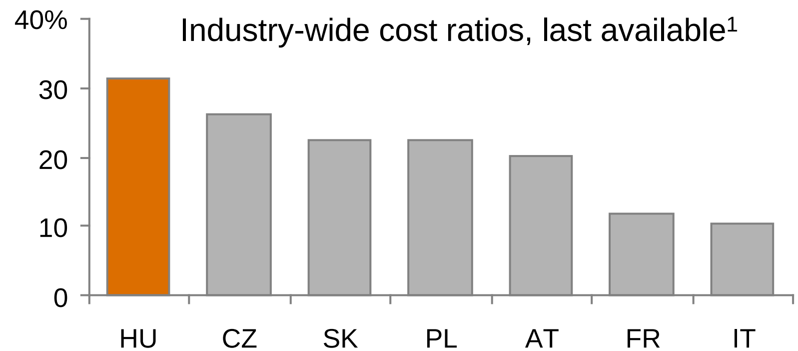
Even top players lack scale and dominance in CEE comparison

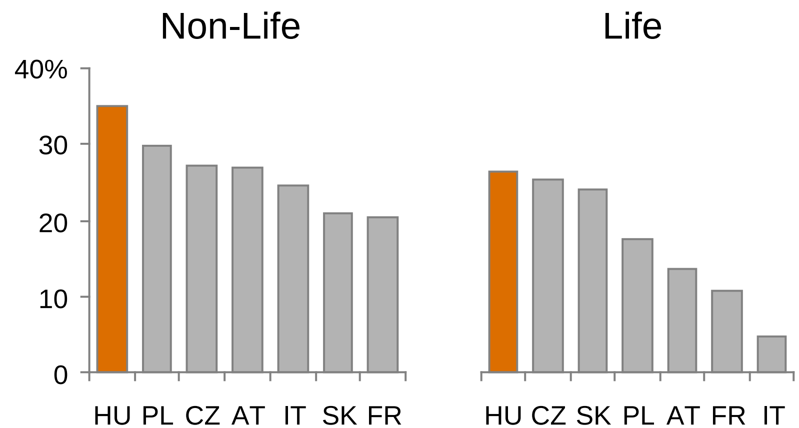
GWP of top-2 players
EUR bln

Market share of top 2 players
%



Hungary with one of the highest cost ratios in Europe





1. Axco statistics, updated between July and October 2012 for the displayed countries

Source: Supervisory Authorities and Industry Associations, AXCO Country Reports, BCG analysis

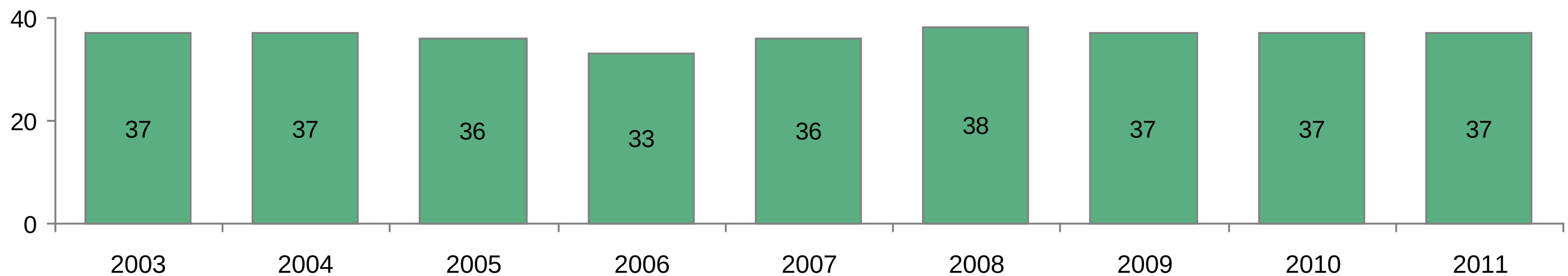
Reality: Front lines frozen, no structural change for a decade

M&As driven by regional portfolio decisions, not resulting a decrease in number of players

M&A timeline in Hungary 1999-2013

	1999-2000	1999-2000	2002	2002	2007	2008	2008	2010	2013
Acquirer	VIG Vienna Insurance Group	agrupaciómútua	CGNU	UNIQA	AXA	Groupama	VIG Vienna Insurance Group	MetLife	MetLife
Target	Gloria-Swiss Life	Fun-europa	MEBIT ABN·AMRO	AXA	winterthur	otp Garancia	ERSTE	Alico	AVIVA
Scope (local / regional)	**Local**	**Local**	**Local**	**Regional** (Hungarian subsi together with AUT operations)	**Regional** (aquiring Winterthur operations from Credit Suisse)	**Local-Regional** (regional banc-assurance partnership with OTP)	**Regional** (additionally banc-assurance partnership and x-ownership)	**Regional** (Acquiring ALICO from AIG)	**Regional** (extending to 3 countries - CZ, ROM, HUN)

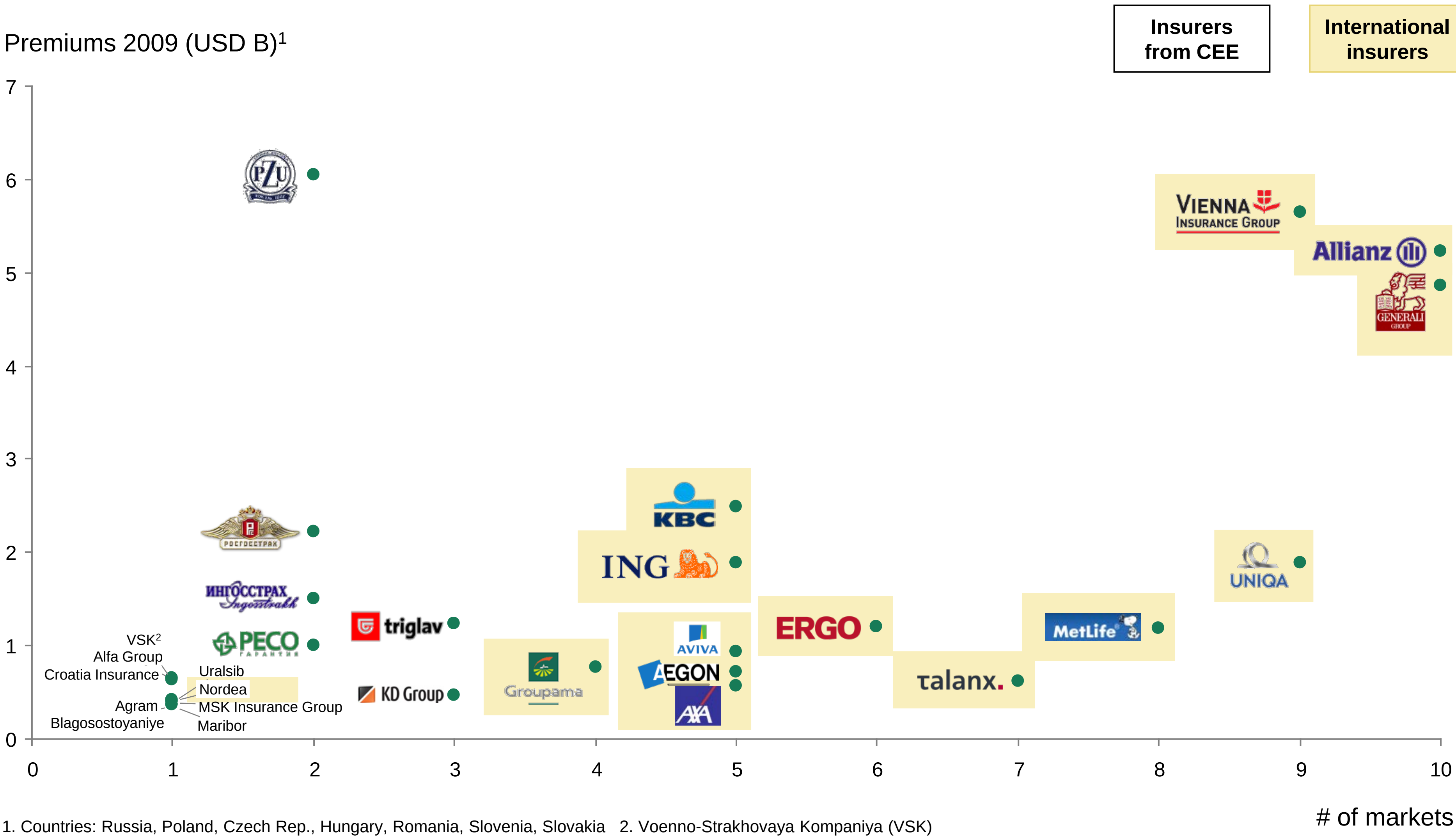
Number of insurance companies



Note: M&A timeline excludes capital increases, increase in ownership and forming of JVs
Source: Zephyr, Press, PSZAF, BCG analysis

There is a clear need for consolidation on regional level

Only a few players with comprehensive and strong coverage



1. Countries: Russia, Poland, Czech Rep., Hungary, Romania, Slovenia, Slovakia 2. Voenno-Strakhovaya Kompaniya (VSK)
Note: Top 30 insurers by total premiums in the ten largest markets
Source: BCG analysis

Hungary does not seem to be a separate decision factor

Only major markets attract special attention (PL, UA, RUS) or where local company is mkt leader

Player	GROUP: 2011 GWP (€ B)	GROUP: # of CEE countries	GROUP: Profitability PAT/ GWP[1], %	% of group GWP	Profitability PAT/ GWP[1], %
VIG (Vienna Insurance Group)	4.5	19	4,0%	3,1	1,9%
Generali PPF Holding	3.9	14	13,2%	11,2	5,6%
Allianz	3.7	10	5,6%	14,0	3,9%
PZU	3.5	3	19,9%		-
ING	1.6	8	4,5%	16,4	0,4%

1. Based on 2007/2009-2011 average figures; VIG is based on profit before tax applying 20% tax rate, Allianz based on operative profit after tax, Other companies are represented with Net results / GWP; Number for ING also includes Spain and Greece as these countries form part of CEE and Other Europe besides HU, PL, CZ, SK, RO, Bulgaria and Turkey
2. Net Cor is based on 2009-11 figures, NBM is based on 2010-11 figures
Source: Annual reports, BCG Analysis