

# **REPORT ON THE USE OF ACTUARIES IN MERGERS AND ACQUISITIONS**

## **Valuation, Finance and Investments Committee**

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### **Background**

The Valuation, Finance and Investment Committee (VFIC) of the Casualty Actuarial Society undertook a project to explore the role that actuaries typically play in insurance mergers and acquisitions (M&A). The purpose of the study, as explained to those who agreed to take part in the project was:

*to provide feedback to the actuarial community as it strives to create tools and capabilities that will lend further insight into the financial operations of insurance companies.*

Further, the study had the goal of taking an assessment of the skill sets and knowledge base (both quantitative and qualitative skills) that actuaries bring to these increasingly frequent transactions in the insurance business. The vantage point that was sought during the course of the study was that of the chief financial officer of an insurance enterprise that had recently undergone a merger or acquisition. The preliminary results of this study were presented at the CAS Seminar on Valuation, held in April 2000 in St. Louis, Missouri.

### *Process*

During the year from the spring, 1999 to spring, 2000 a series of interviews were conducted with CFOs and other financial managers at ten major insurance companies. The interviewers (members of the VFIC Committee) sought to speak with individuals outside of the actuarial community (ideally the CFO or some other financial manager) so as to ensure that the feedback that was received would be objective.

In most instances, the interviewee received an introductory letter that explained the goals of the project as well as a list of areas that were to be covered during the interview. Samples of these documents are included with this report.

### *Goals*

As explained above, the goal of this project was to provide the actuarial profession with an independent assessment of the skills that we bring to the table in an M&A setting. At the end of this report, a series of recommendations are offered that draw on the feedback that we received during this exercise.

The interview forms that were used to guide our interviews are attached to this report. To summarize, the main topics that were touched upon are outlined below:

- I. Motivation for the Acquisition: Discussion of strategic and financial considerations for the deal(s) being discussed.
  - a. Qualitative Considerations
  - b. Quantitative Considerations discussion of valuation methodologies
- II. The Actuary's Role in the Valuation Process
  - a. Broad description of the role played
  - b. Commentary on the actuary's strengths/weaknesses
  - c. Commentary on other roles the actuary (did or did not) play

### ***Summary of Responses***

Below, we have summarized the recurring themes in each of the above areas.

- I. Motivation for the Acquisition: With few exceptions, those interviewed cited strategic reasons for the acquisition(s) that were discussed during the interviews. Specifically, most cited factors such as earnings diversification, the acquisition of complementary talent, or geographical diversification. Almost as frequently, the interviewees cited the as a close second the importance of financial considerations (i.e., the cost) of the acquisition. A notable quote was that strategic intent opens the door, financial considerations close the deal .
  - a. Qualitative Considerations: Not unlike the factors cited above, the qualitative considerations for the deal tended to be issues such as economies of scale, diversification (product and/or geography), enhancement of franchise value, and market access (via licenses and talent).
  - b. Quantitative Considerations: The resounding conclusion to be drawn from this portion of our discussion is that the valuation methods that were used by the participants in this study (which included many large, well-known companies) tended to be relatively straightforward, static valuation models. Stated otherwise, one could not conclude from this work that DFA has played a meaningful role in M&A work (one of ten interviewees cited DFA as factor in its quantitative work).

Typical models used to value companies were discounted cash flow analysis (DCF), method of comparable transactions, and method of market multiples.

## II. The Actuary's Role in the Valuation Process

- a. Broad description of the role-played: As might be expected, a universal response on the actuary's role in the M&A process was that actuaries are the experts in the analysis of loss reserves. Additional responses that surfaced with some frequency were the actuary's role in providing projected loss ratios (presumably used in the DCF analyses) and in evaluating outward reinsurance programs. Several interviewees cited the actuary's role in assessing loss payout variability, and a few noted that actuaries played a role in evaluating the target company's products (via rate and form filings in addition to profitability analyses).
- b. Commentary on the actuary's strengths/weaknesses: The actuaries were almost universally viewed as having strong modeling and quantitative skill sets especially as pertained to loss reserve and loss payout analyses. While most interviewees were complimentary of the skills that actuaries brought to the engagement, there were several recurring themes that should be noted:
  - i. Several interviewees cited the need for actuaries to better understand accounting principles. These individuals noted that the occasional inability of the accountants and actuaries to speak the same language was a source of frustration. The same comments apply (though they surfaced with less frequency) on the actuaries' knowledge of asset valuation principles.
  - ii. Several respondents cited that actuaries are too numbers driven and too theoretical. A common suggestion was that actuaries should get closer to the business and appreciate the drivers of market and intrinsic value.
  - iii. In at least a few interviews actuaries were chided for not providing the CFO or other financial analyst with the desired feedback on loss reserve and payout variability. A phrase that summed up the feelings of several was "I wanted a point estimate and got a range, or if I asked for a range I would get a point estimate."
  - iv. Following are several interesting (near) quotes which summarize the views of many of the interviewees:
    1. The actuarial role is to reconcile the target company's market value and intrinsic value.
    2. The actuarial role is to validate the income statement and the balance sheet.
    3. The better the actuary can relate to the business purpose of the transaction, the more value they represent.

A member of the VFIC team captured the spirit of these comments accurately by stating "The companies that were most satisfied with the

actuarial involvement in M&A were the ones with the most limited view of their role in the deal.

### ***VFIC Interpretation of Feedback***

Discussion of this project among the VFIC committee members has led to several interesting observations. First, there is recognition that the ideal actuarial role does not encompass every aspect of the due diligence process. However, the VFIC committee observed that in addition to specific quantitative roles for the actuary, there are broader management and analytical roles as well. The majority of the financial managers interviewed for this project view the actuarial roles as being limited to the former quantitative analysis.

We believe that this viewpoint is too limited. We believe the actuary can fulfill additional quantitative roles. For example, the actuary could play a prominent role in assessing the quality of the target company's claims database and reporting systems. Similarly, the actuary could be integrally involved in evaluating the target company's catastrophe exposure and reinsurance program. We note that these areas surfaced with surprising infrequency in the interviews that were conducted.

VFIC further suggests that a broader analytical role for the actuary could include a role in assessing the target company's business from a qualitative perspective (e.g., growth opportunities, diversification benefits, cross selling opportunities, etc.). We also note that actuary could play a role in making presentations to key constituents (e.g., board members and rating agencies). Comments of the actuaries' role in these areas were noticeably absent in the interviews that were conducted.

### ***Summary and Recommendations***

Overall, the actuary clearly plays an integral role in the typical company's M&A due diligence process. Equally clear, however, is the conclusion that the actuarial role could be expanded. In its discussions, VFIC felt that there were three areas to be addressed:

1. Expanding the role of the actuary in areas that could be considered core competencies of many actuaries. These areas could include evaluations of ceded reinsurance programs, catastrophe exposure, a role in deriving the projected loss ratios that lie at the heart of most valuation models, and a review of the target company's claims reporting systems.
2. Bridging the understanding gap between what actuaries have to offer, and the expectations and/or understanding on the part of the CFO or financial manager of the skill sets the actuary can bring to an engagement.
3. Expanding the actuaries' body of knowledge in the subjects identified by the interviewees as shortcomings.

The recommendations to address items (1) and (2) are similar. Both areas deal with expanding the role of the actuary using skill sets that are largely already acquired during the examination process

and the ordinary course of most actuaries work. The source of differentiation might rest on the fact that in item (1) above the onus rests primarily with the individual actuary to be proactive in marketing their skill sets during a due diligence engagement (i.e., not allow themselves to be typecast into doing only the loss reserve analysis). To facilitate that process, however, we believe that the CAS should reach out to CFOs, bankers, and other financial analysts to improve the understanding of our profession. Specifically, we recommend:

1. The CAS make efforts to increase the participation of CFOs and other financial professionals at relevant CAS seminars. If their attendance at CAS seminars increases, financial managers will come to better understand the skill sets that actuaries can bring to these engagements. A variation of this idea would involve inviting CFOs to speak at breakout sessions at relevant CAS seminars. For example, the CFOs could provide specific suggestions on how actuaries could enhance their value in the M&A process.
2. The CAS consider providing insurance financial professionals with regular email or newsletter updates on events in the actuarial profession. For example, the newsletter might include a list of upcoming seminar and recent call paper topics. The goal would be to heighten the awareness of the breadth of material that the actuarial profession encompasses.

To address the areas that were cited as subjects where actuaries need improvement, we recommend the following:

1. Revisiting the examination syllabus to ensure that it adequately addresses several of the comments noted in this report. Specifically, actuaries sometimes limited knowledge of accounting (GAAP and SAP), asset valuation principles, and finance arose in several interviews.
2. It may be possible to structure an on-line course that would enhance actuaries knowledge of the M&A process and the roles that they can play in it. The course could be designed through a joint effort between CAS members and financial managers (e.g., CFOs, consultation with investment bankers). The course could make use of case studies to illustrate the M&A due diligence process.
3. It may also be possible to increase the attention already being given at CAS meeting to issues of communication and presentation.

The CAS recently formed Committees on Nontraditional Practice Areas should go a long way toward meeting many of the critiques cited in this report. Specifically, the committees on Asset/Liability Management, Valuation, and General Business Skills seem particularly relevant.

The VFIC committee suggests that this report, or a summary of it, should be disseminated to the actuarial community. Although its conclusions, admittedly, rest on a small sample, the apparent under-utilization of actuaries at many of the companies we interviewed may entice the readers to become more proactive in carving out expanded roles should their company undertake an M&A analysis.

Lastly, the VFIC committee noted that the efforts of the CAS can supplement and enrich, but not supplant, individual experiences in this area of analysis. Many of the skills, both quantitative and analytical, that are necessary in a due diligence can only be acquired in on the job experience. For this reason, educational efforts that involve case studies may be particularly relevant.

## APPENDIX

### I. Letter to prospective interviewee introducing VFIC project.

CASUALTY ACTUARIAL SOCIETY: VALUATION, FINANCE, AND INVESTMENT  
COMMITTEE

Mr./Ms. CFO  
Company Name  
Company Address

Dear XXX:

The Valuation, Finance, and Investment Committee (VFIC) of the Casualty Actuarial Society is seeking interviews with key individuals in the insurance industry in order to better understand the role that actuaries have played in the mergers and acquisition arena. We are asking for your participation because of your company's recent involvement in the acquisition of another insurance entity. Our goal is to provide both feedback and guidance to the actuarial community on the role of actuaries in acquisitions.

The page that follows provides a more thorough statement of purpose as well as an overview of the type of feedback that we would hope to gather from managers like yourself. The time commitment we are seeking can be adapted to suit your availability. I would offer that initially we just speak briefly to set up a date and time to hold our discussion. I will contact you in the near future to gauge your interest and set up a time to speak.

Again, the page that follows will provide you with an overview of the type of information and feedback that we are seeking. Please know that all responses provided will remain strictly confidential. Consistent with the purpose of this survey, no names either of individuals or of companies will appear in any findings that are produced.

The actuarial community is continually striving to develop the knowledge and skills necessary to meet the demands of the rapidly evolving insurance and financial world. By taking part in this survey, you will be playing an important role in charting that course for the actuarial profession.

I will look forward to speaking with you soon.

Member Name  
Valuation, Finance, and Investment Committee

## **II. Additional information provided to interviewee regarding nature of interview.**

The Casualty Actuarial Society (or CAS -- a professional and educational organization dedicated to the advancement of the actuarial science) is interested in exploring the role that actuaries have played in the area of insurance company acquisitions. Your organization is being asked to participate in this survey because of its involvement in the acquisition of an insurance company.

The goal of this survey is to provide feedback to the actuarial community as it strives to create tools and capabilities that will lend further insights into the financial operations of insurance companies. A critical area to ensure that the demands for actuarial skills are being satisfied is in the area of mergers and acquisitions. To that end, the CAS would like to better understand both the types of quantitative and qualitative considerations that play prominent roles in the valuation of insurance companies, as well as the role that actuaries played in the valuation process. Moreover, this survey will provide you with the opportunity to offer guidance to the actuarial profession on the types of skills and knowledge that would add value to the acquisition process.

Please know that all responses provided will remain strictly confidential. Consistent with the purpose of this survey, no names either of individuals or companies will appear in any findings produced as a result of this survey.

### **Background of the Company's Approach to Valuation**

Recognizing that each acquisition is unique, we would like to first understand the background for the transaction under discussion. For example, what was your company's motivation for acquiring the target?

Next, we would like to explore the types of qualitative considerations that played a role in the acquisition. From management's point of view, what were the primary benefits of the acquisition?

Moving into the quantitative analyses, what methodologies were employed to value the acquired entity? Did financial projections (e.g., a discounted cash flow analysis) play a role in the valuation? How sophisticated was the modeling that was employed?

On balance, which considerations (quantitative or qualitative) weighed more heavily in the decision to acquire the company and in the final purchase price?

### **Background of the Role of the Actuary**

We would like to understand the role that the actuary played in the valuation process. What, in your view, was the actuary's key contribution(s) to the valuation exercise?

On a more specific note, we would like to understand the assistance that the actuary provided in both the quantitative analyses (e.g., loss reserve testing, discounted cash flow modeling) and in the qualitative analyses (e.g., assessment of the target's products, operations).

Finally, we would like your feedback on what the actuary could have done to be of greater assistance in the valuation. For example, did the actuary possess adequate general business skills to add value to the analysis? Were their technical skills adequate?