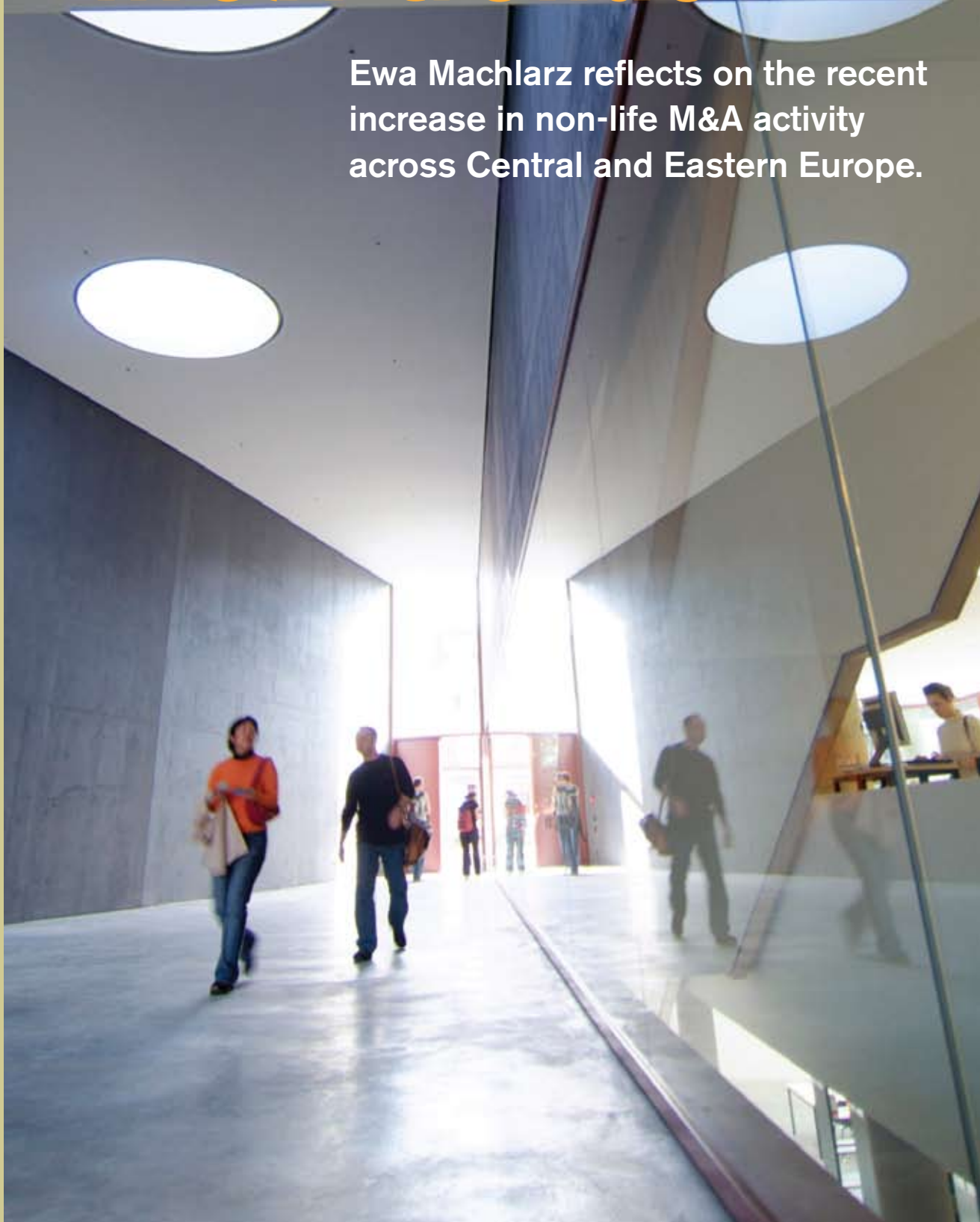


M&A trends

Ewa Machlarz reflects on the recent increase in non-life M&A activity across Central and Eastern Europe.



M&A activity in the non-life insurance sector across Central and Eastern Europe (CEE) has increased substantially in the last financial year. Much of this has been driven by insurers' market-entry strategies with the potential for high premium and profitability growth. The prices being paid, however, appear to already include a strategic premium – raising the question of whether shareholders will actually benefit from paying the current high prices.

Geographical patterns

Multinational insurers are beginning to gain a firm foothold in the insurance sector across CEE countries and into Asia. For example, over the last 36 months, multinationals have taken over the majority of the non-life insurance companies in Turkey. Those owning operations in the country now include AEGON, AIG, Allianz, Aviva, AXA, Ergo, Eureka, Generali, Groupama, Liberty, Mapfre, TBIH and Zurich (See **Figure 1** overleaf). With only a few local companies left in Turkey, multinationals have turned their sights to other CEE countries with high growth potential such as Romania, Bulgaria and Slovakia. Russia is the next obvious target with the potential for high volumes of business, whilst the Ukraine is also starting to attract interest.

Supply and demand

M&A activity has been driven by factors affecting both the supply and demand sides of transactions. On the supply side, the credit crunch has been significant, with bancassurers in many CEE countries deciding to offload their non-life assets to repair their balance sheets. For most bancassurers, non-life insurance is considered to be a non-core activity as it is not as closely aligned to banking as it is to life assurance (where the amount of funds available for investment is attractive to banks). So for those affected by the credit crunch and looking for additional financing, the sale of non-life insurance assets is an attractive option. In addition, the likely significant increase in required capital under Solvency II has caused bancassurers to further question the benefits of retaining their non-life insurance businesses.

On the demand side, competition for the available insurance assets in CEE was already strong as companies in mature markets such as the UK have been finding it increasingly difficult to grow organically, and so have been looking for growth potential elsewhere. This has forced organisations to think strategically about where they should best deploy their capital in the near future. The credit crunch has not had the same impact on insurance companies as it has had on bancassurers, and as such, insurers are in a relatively favourable position with an opportunity to increase their portfolios as the non-life insurance

assets come back onto the market. In addition, the implementation of Solvency II could make geographical diversification more attractive to non-life insurer groups by reducing overall group capital requirements. That said, the precise treatment of groups and the extent to which the transferability of capital within a group will be allowed under Solvency II is still uncertain.

Pricing and profitability

Demand for CEE non-life insurance assets has also been driven by the historically high profitability of companies in these markets. The annual rates of return on equity achieved in this region have often been above 30 per cent: such returns are difficult to find in more developed insurance markets.

In addition, in most of the transactions we have seen in Turkey and in CEE countries, the target companies usually have a relatively high proportion of reinsurance. In less developed insurance markets, such reinsurance has allowed use of the reinsurers' expertise in pricing some products and lines of business, as well as reducing the volatility of bottom-line financial results. It has also meant, however, that a large amount of profit is passed on to these reinsurers.

As multinationals acquire the companies, the pricing expertise of the reinsurer becomes less important. In addition, reducing the volatility of results through reinsurance is not as important, as the volatility of a subsidiary's results can be absorbed



Figure 1 | Multinationals in the Turkish Insurance Market

Multinational	Company	Year
AEGON	Ankara	2007
AIG	Greenfield	Founded in 1989
Allianz	Şark Sigorta	Partner in Şark Sigorta in 1988; JV with Koç Group; 2008 buys out Koç shares in 2008
Aviva	Greenfield	Founded in 1988
Axa	Oyak Group	JV with Oyak Group in 1999; 2008 buys out Oyak shares in 2008
Ergo	İsviçre	1996
Eureko	Garanti	2007
Generali	Greenfield	Founded in 1989
Groupama	Başak	2006
Liberty	Şeker	2007
Mapfre	Genel	2007
TBIH	Ray	2007
Zurich	TEB	2007
Groupama	Güven	2008
HDI/Talanx	ihlas	2007

within group worldwide results with relative ease. Furthermore, to the extent that some reinsurance remains necessary, the multinationals will have greater negotiating power with reinsurers because of the amount of business they transact worldwide. All of this implies higher retained profits for the insurance company, justifying a higher purchase price.

In less developed insurance markets, pricing techniques for non-life insurance products are usually less sophisticated than those in the UK and some other western European countries. This provides an opportunity for companies to employ these techniques to extract further value from the purchase. As more and more multinationals purchase businesses in CEE, however, competition in these areas is likely to increase leading to correspondingly lower profitability: there may be only a small window of opportunity to achieve high profits in CEE.

Although the possible future growth in volumes, the reduced dependency on reinsurers and the potential to apply more sophisticated pricing techniques make local CEE insurers very attractive to multinationals, from our experience the prices being paid are significantly greater than would be indicated by financial projections of the local companies as they stand – in other words, a strategic premium is being paid which appears to take into account much, or all, of the value that can be generated.

Expected developments

We expect M&A activity to increase over the next couple of years in the CEE region. There will be further consolidation of the markets with companies trying to get a foothold in each. The multinationals will end up with operations in most countries across Europe and there will be few large local companies left.

Indeed, it is possible that demand for acquisitions will outstrip supply. Such is the strategic imperative of multinationals to spread their risks and their global brand that there is the possibility that those multinational insurers which have been unable to acquire a non-life insurance operation in a particular territory will enter into a bidding war, forcing prices up beyond realistic valuations. It appears that this may already have occurred in a few cases.

There are, however, a number of factors which could slow down M&A activity, the most obvious being the depth of multinationals' pockets. Large unexpected events such as catastrophes could sharply reduce multinationals' net asset values and their ability to fund acquisitions. Another potential influence could be one of the key drivers of demand: Solvency II. At the moment it remains unclear how group companies will be treated with regard to the transferability of capital between companies within the same group.

There is also the risk that some deals will turn sour. This is a particular risk where a multinational buys the insurance operations of a bancassurer and the seller becomes a distribution agent of the purchaser. In this case, the interests of the bank's shareholders may not be fully aligned with the interests of the insurance company's shareholders, the insurer seeks high profitability, the bank seeks high commissions (and hence volumes). In such cases, distribution and service level agreements are key to the overall success of a transaction.