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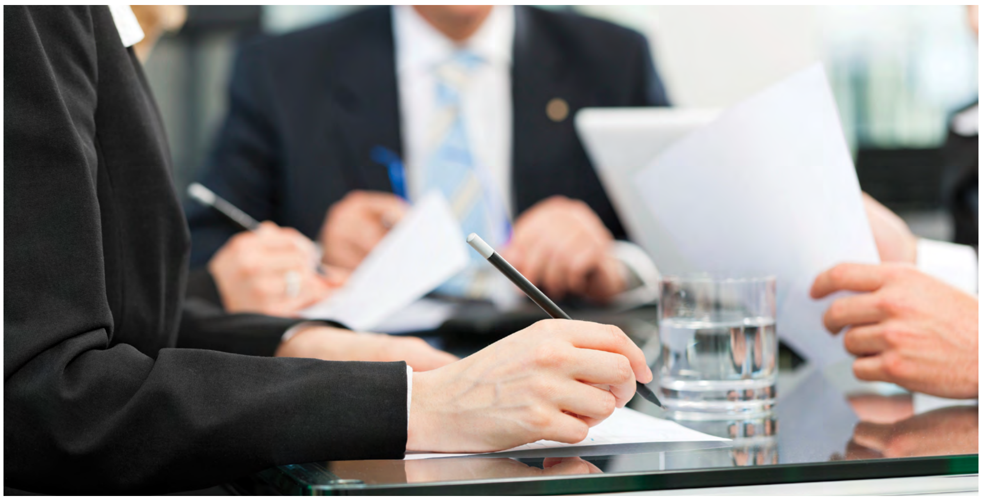
INSURANCE ADVISOR



BUY-SIDE DUE DILIGENCE WHEN ACQUIRING AN INSURANCE COMPANY

By Rich Bertuglia & Imran Makda

Successful acquisitions require efficient coordination of skilled internal and external resources focused on maximizing value and minimizing risk in tight time frames. The focus should be on the strategic objectives, negotiation opportunities, accounting and cash-flow pitfalls, tax exposures and savings, and operational efficiencies in defining the value of each transaction. Many large insurance companies are pursuing accretive acquisitions of insurance companies to accelerate their growth potential while leveraging off their robust IT capabilities (i.e., data analytics as well as claim and risk control capabilities). Due diligence is a critical step in the process of acquiring a business. While all buyers should conduct a thorough assessment of the financial, operational, technological, and human resources health of a potential target company, there are also key diligence considerations unique to the acquisition of an insurance company that should be carefully analyzed.

DISTRIBUTION NETWORK

The inherent value of any acquisition depends on successful transition of the producer and distribution networks. Any missteps along the way can have a serious impact on the overall profitability and success of any deal. An acquisition could disrupt the relationships between the insurer and its agents and brokers, resulting in a significant decline in renewals. Maintaining producer relationships

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DID YOU KNOW...

BDO's annual Retail RiskFactor Report, which analyzes the 10-K filings of the 100 largest retailers, found that 37 percent more companies cited the cost and reliability of insurance to cover potential losses as a risk to their business this year.

According to a market briefing from broker ***Marsh***, 33 percent more of their clients purchased cyber insurance in 2012 compared to 2011.

According to a ***Strategy Meets Action*** survey, 83 percent of P&C insurers indicate that they will increase their data spending over the next three years.

Property, casualty and professional liability insurance rates were up 5 percent in April, according to ***MarketScout***.

The ***Property Casualty Insurers Association of America*** reports that natural disasters across the U.S. generated $35 billion in privately insured property losses, $11 billion more than the average over the last decade.

A ***LIMRA and CANNEX*** study found that nine of the top 10 companies offering income annuities have employed some measure to mitigate against the risk of a liquidity crisis for the consumer.

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BUY-SIDE DUE DILIGENCE

is especially important in the property and casualty industry as polices are generally renewed annually. Generally, employees with key distributor and producer relationships are retained using employment agreements and, conversely, noncompete agreements are executed with key departing employees in order to limit their access to such key relationships. It may also be necessary for the terms of the transaction to require the seller to assist in the transition of the distribution relationships to the acquirer.

▶UNDERWRITING PRACTICES

A careful analysis of the underwriting practices is required to ensure the target's risk appetite closely aligns with that of the acquirer. The purchase price for an acquisition should be adjusted accordingly if the results of this review indicate the acquirer may not renew a significant book of business since it does not meet the underwriting guidelines of the acquirer. This review should be conducted by experienced underwriters of the acquirer.

▶INSURANCE LOSS RESERVES

Loss reserves represent the largest liability of an insurance company, and an in-depth review of past reserving practices is extremely important. The loss reserves recognized by an insurance company are based on highly subjective estimates. A close analysis of reserving practices, claim payment patterns, claim closure rates, claim lags and other pertinent actuarial assumptions used by the target should be reviewed by the acquirer's actuaries. The acquirer's actuary should also independently estimate the loss reserves, as this information will be required during the fair value accounting exercise. It is also critical to verify the reliability, accuracy and completeness of the historical loss data used in the development of the reserve estimates.

▶CLAIMS PAYMENT PRACTICES

Acquiring companies need to scrutinize the claims paying practices of the target insurance company. Is the target insurance company overly aggressive in denying insurance claims? Companies that are motivated to sell because of insufficient capital requirements may be denying claims to defer settlement of liabilities and lower established case reserves. Companies may also be downsizing claims departments in an effort to enhance profitability, which could lead to a risk of significant backlog in unprocessed claims. Does the company or its third-party claims administrator have adequate controls for tracking claims received, yet to be processed? The ratio of historical loss adjustment expenses to settlement amounts is a good indicator of the cost of settling future claims.

▶MARKET CONDUCT ISSUES

Sales practices of insurers are subject to triennial regulatory examinations. Deceptive sales practices and other noncompliance with state laws could result in significant risk of fines, suspension of sales, litigation and future claims costs. A potential acquirer should review the results of the target company's recent regulatory exams and monitor the status of any ongoing examinations to assess a company's compliance with applicable laws and regulations.

▶ADMINISTRATIVE AND TRANSITION SERVICES

A thorough review should be made of a target company's operating costs, contracts and vendor relationships. Certain costs with related parties may be more or less than can be obtained in an arms-length arrangement. These related party agreements should be analyzed closely and, more importantly, fair market values of such services going forward should be independently determined. Does the potential acquirer have the ability to retain key employees, brokers, agents, reinsurance contracts and intellectual property? The acquirer should ensure that any transition services agreement includes all services for a time frame necessary for it to fully integrate the operations of the business.

▶OTHER CONSIDERATIONS

Here is a list of other areas and specific considerations that should be assessed during the due diligence process:

Financial Due Diligence

- Quality of earnings/EBITDA adjustments
- Analyze cash flow
- Carve-out consideration
- Sales, product and consumer analysis
- Non-operating items
- Analyze overhead expense
- Working capital trends
- Quality of assets
- Accrual and reserve exposures
- Capital expenditure needs
- Accounts receivable, collections and bad debt
- Review business plan feasibility

Tax Due Diligence

- Federal/state/local income taxes
- Gross receipts and other "business activity" taxes

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- Inbound/outbound and foreign tax expertise
- Sales and use taxes
- Employment taxes
- Property taxes
- Tax incentives and credits
- Quantification and risk assessment of identified exposure/opportunity
- Modeling/quantifying tax implications of structuring alternatives - assessment and computation of potential cost/benefits
- International structuring – inbound, outbound, intellectual property migration, etc.
- Transaction cost analysis
- Post-transaction tax integration and planning

Human Resources

- 409(a) plans
- Personnel administration
- Employment policies and agreements
- Benefit plans
- Compensation strategies

Information Technology

- Risk and security
- Process flow redesign
- Technology integration
- IT infrastructure/strategy
- Software applications
- Security and administration

▶LOOKING AHEAD

Buy-side due diligence, at its core, is meant to protect a buyer from potential risks and enable it to successfully execute an acquisition. But no two deals are the same and, therefore, the diligence process from deal to deal shouldn't be the same either. It's important that a buyer take into consideration the specific due diligence considerations that are pertinent to the industry in which a target company operates. Tailoring a process will get a buyer one step closer to completing the deal and, ultimately, earning a profitable return on its investment.

For more information, please contact Richard Bertuglia, Assurance Partner, at rbertuglia@bdo.com or Imran Makda, Assurance Partner, at imakda@bdo.com.

BDO SPOTLIGHT:

Q&A with Tom Hiller

What led you to focus your accounting work in the insurance industry?

I started at BDO in 1974 and my very first audit client was an insurance company. While I've worked across many industries throughout my career, I have always found the insurance industry both interesting and challenging. The industry is complex and constantly evolving, which makes my job more interesting. Seven years ago I became the national leader of the Insurance practice and now focus on the industry full-time.

What do you see as some of the biggest challenges facing the industry today?

I see a few critical challenges for the insurance industry that we are currently working with our clients to address. First, the low interest rate environment puts pressure on an insurer's ability to generate income from their investment portfolio, meaning that insurance companies must look at other revenue sources – such as rate increases – to support their operations and bolster top-line growth. This marks a significant shift in the business model.

And, particularly for P&C carriers, our sluggish economy has meant that for the past several years, there have been fewer assets to be insured, making organic growth difficult. As the economy improves and the insured base purchases more homes, boats, cars and other assets, the challenge will be capturing that market share, which could be made difficult by the pressure to increase rates.

Further, the shifts that we've seen in weather patterns cannot go unnoticed. We are experiencing vastly more extreme weather than in the past, which causes major implications for insurers. Insurance companies now have additional challenges related to underwriting – it's now critical to consider the amount of insurable risk they want to hold in various regions of the country, and how to appropriately price risks in higher-risk geographies.

Last, the industry will continue to face changes in a complex regulatory environment. Regulations, which are constantly evolving and costly to address, are simply a fact of life for insurers. This next year will be no different.

What are some of the biggest growth opportunities in the insurance industry?

As the economy continues to improve, the opportunities in the insurance sector come down to gaining market share, which I believe will come from developing and maintaining new client relationships. But what's different now is the use of technology – many of these new relationships will be developed and tracked online. This alters the traditional process which has been dominated by agent relationships. The opportunity exists for carriers, and their agents, to cement these relationships through brand building efforts and the right mix of in-person and online interaction.

What's ahead for BDO's Insurance practice?

I believe that our future is bright. The success of our practice thus far has been grounded in our deep sector knowledge and strong client service culture. Today, we know that our clients need more than auditors and tax providers; insurers need true advisors that can help to assess the viability and appropriateness of various decisions as they work through challenges. In light of that need, we are currently growing the depth of our team across the country. Our focus is to continue to build our service model in technology, capital transactions, due diligence, regulatory consulting and other areas critical to industry's growth.

Tom Hiller is the national leader of the Insurance practice. He can be reached at THiller@bdo.com.

▶ Read more

MARK YOUR CALENDAR...

The following is a list of upcoming conferences and seminars of interest for insurance industry executives:

JULY

July 16-18
ACLI's Compliance & Legal Sections Annual Meeting
Hyatt Regency Grand Cypress
Orlando, Fla.

AUGUST

August 4-7
American Risk and Insurance Association Annual Meeting
Washington Court Hotel on Capitol Hill
Washington, D.C.

August 24-27
NAIC 2013 Summer Meeting
JW Marriott Indianapolis and Indianapolis Marriott Downtown
Indianapolis, Ind.

SEPTEMBER

September 8-11
PCI Investment Seminar
The Meritage Resort and Spa
Napa, Calif.

September 15-18
Society of Insurance Financial Management Annual Conference
Revel Hotel
Atlantic City, N.J.

September 29-30
IASA Executive Edge
Hartford Marriott Downtown
Hartford, Conn.

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BDO INSURANCE PRACTICE

BDO's Insurance practice understands the complexities of the industry and the implications for your business. Whether you're looking to tap our extensive SEC experience in order to enter the public market, discuss the latest insurance accounting and reporting requirements from the NAIC, or comply with state regulatory agencies, BDO's Insurance practice provides proactive guidance to our clients. We know that no two insurers are alike, and we tailor our services accordingly. We're proud of our industry focus and experience, and our commitment to delivering the right team with relevant industry experience, both as we begin our relationship and for the long term.

ABOUT BDO

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, financial advisory and consulting services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through more than 40 offices and over 400 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multinational clients through a global network of 1,204 offices in 138 countries.

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