Insurance in focus: Private capital's growing role

Tom Peacock	Hello. Welcome to the second of our current series of insurance podcasts. In this session we will be discussing the involvement of private equity and private capital more generally in the insurance sector. I'm Tom Peacock, a Partner in our insurance practice. I am joined by Harry Bacon, our Co-head of Private Equity. There has been a great deal of private capital interest in the insurance sector over the last five or ten years and this has really involved establishing or investment in life insurers or reinsurers and we'll highlight some of the key trends and challenges we've seen, including increased regulatory scrutiny over private capital ownership in recent years. We'll also talk about investment in general insurance, including consolidation of intermediaries and those that involve use of offshore structures. Harry as a refresher off the bat, why are we seeing this ongoing interest in insurance sector from private capital?
Harry Bacon	Well it's a really interesting time at the moment. I think more generally in the private equity sphere we are seeing record levels of dry powder, that is capital available for investment. It stands on an estimated basis around $2.5 trillion globally and if you look at private capital more generally, which would include other strategies such as private credit, an alternative and more hybrid forms of investment, that number rises to more like $4 trillion dollars. So the reserve of funding available to be deployed in all forms of investment is at a level we've not really seen before. The insurance sector's particularly attractive because it provides a number of different ways to deploy capital and some of the businesses are in an interesting proposition because of their self-funding nature through premia and the long-term nature of the liabilities in the business. We see this manifesting in a number of different ways. There is a kind of conventional private equity aspect of ownership which is acquisition, operational improvement, streamlining, cost reduction and looking at opportunities and also modernisation of an industry which has been relatively traditional in its views. We also see other more innovative structures where carrying capacity is deployed alongside capital and really just optimising the ways in which these businesses can run and grow.
Tom Peacock	And so when we think about the key aspects of the strategy for private capital investors, one of the key things that we could touch upon is of course scale, and scale in writing more policies through growth or through bolt on acquisitions or consolidation. The other is the interaction with asset management and the inclusion of that in the investment and the valuation cases being put forward. These are both obviously supported by access to capital. You could obviously have organic growth or you can accelerate that growth through third party investment or maybe through established insurers reinsuring to a third party, which we've seen through the growth in funded reinsurance over the last few years. Combine that with a differentiated asset management offering and you get

	something that becomes a bit of a self-reinforcing structure insofar as it drives more competitive pricing that enables the insurer to write more business to grow its market share and to enter new markets. Thinking about those types of strategies, what types of private capital players are involved?
Harry Bacon	So we see different types of players at different levels in the capital structure. I think most fundamentally traditional private equity, that is buy out investment has been at the forefront of investment through the insurance sector and we've seen that with the likes of Bain acquiring esure some years ago. We also see traditional investors like Apollo spearheading insurance platforms with its entities such as Athora and Athene which have really revolutionised the way that people think about investment in the insurance space. There are other growing asset classes within the industry through and you may look at people looking for more of a debt-like return, so private credit funds are now looking to support at different levels in the capital structure, through the deployment of leverage of similar interests. We also have hybrid equity which is increasingly interesting, providing fixed returns through a preference share or some form of downside protected capital which may provide a capital solution either to another sponsor as part of an acquisition or interestingly as some form of capital solution to a strategic player looking for a longer-term business partner to support new business origination or capital growth in a business. Then more generally across the industry we see consolidators that are backed by private equity, both in the form of traditional sponsors and some of the private credit players. Those really have changed things as people look to grow with scale. Again we mention Athora, Athene, there is a radical different model which has been tremendously successful and there are others in that role too.
Tom Peacock	And this investment has clearly been transformative in the industry over the last decade or so. With that has come significant regulatory scrutiny of private capital investors. We have seen this in Europe recently with IVASS in Italy and then BaFin in Germany as well historically with the PRA in the UK. It'd also initially be a focus from US regulators both at state level and the National Association of Insurance Commissions. With that early focus sometimes being around short-termism in maximising return and then making an exit. Is that something that's still a concern?
Harry Bacon	I think that weighs heavily on the mind because the model of private equity has pretty well tried and tested, which is to acquire, to improve and then to dispose, so there are pressures that are inherent in the structure of the private equity fund that mean time is always ticking and that's fund life and then expected hold period in the typical five to seven year period. I think though that things have moved on and I think there's a degree of sophistication now around the top players in the market where there's an understanding that you do have to take a long-term view. I suppose there should be a distinction drawn at this point between long-term insurance, so life businesses versus general or P&C businesses. The longer-term

	nature of the insurance products in the life business I think promotes a longer-term investment horizon and that is more of a patient capital play perhaps better suited to vehicles either permanent or semi-permanent in nature and that's an area of the market we can see evolving quite significantly. On the P&C side it is a slightly different investment opportunity. I think you're looking at more short-term liabilities, in general terms, or at least the duration between premium and payout tends to be shorter. There the focus on investment is more around classical operational improvement and leveraging growth either through that through introduction of technological advances and through consolidation in the market and so perhaps a short-term approach there is more warranted. But what I would say is that any structure has to be resilient and the regulator is going to be looking very carefully at the sustainability of capital structure, the intentions of any investor to support the business in times of need, particularly if you are looking at P&C with a more short-term sort of demand in the event of wide-scale claims to top up capital and support the business even when its in periods of stress. So it's not just a fire and forget type of attitude. These really are committed investments and they will be front of mind, I mean we've seen that in some of the situations in Europe that we can talk a little bit about.
Tom Peacock	So it seems like there has been innovation amongst investors to make some of these concerns around short-termism less acute. There are obviously still other areas of focus and perceived risk for regulators that are worth mentioning. For example, high exposure to private, sometimes unrated, asset classes, valuation and recapture risk in downturn scenarios with some examples of failures and PRA scrutiny recently of insurers' exposure to liquid assets in other contexts such as funded reinsurance and another example being links between affiliates. Do these remain as issues? Are they still being worked through?
Harry Bacon	I think there are issues there. I mean, I don't think they're problems per se but I do think they are high up on the list for consideration and assessment whenever an investment is made that requires regulatory approval and indeed from a supervisory point of view on an ongoing basis. I mentioned earlier that we are seeing evolutions in the types of fund that invest and one of the major developments has been an increasing focus on permanent or semi-permanent vehicles that enable funds to be deployed almost indefinitely, so that's particularly well suited to the long-term insurance business. I think there have been instances where difficult situations have arisen. We see Euro Vita as the major example in recent times where there has been an insurance failure and lessons have been learned from that I'm sure on the regulatory side which will prompt new questions.

	I mean you mention high exposure to private asset classes. I do think that is a feature particularly on the long-term side where part of the value creation play is all about portfolio optimisation and driving yield and a stretch to yield, that said there is a broader interest in private asset classes more generally. We look at this large insurance companies that have been investing in private assets for a very long time and that's part of their own portfolio optimisation strategy. The same for pension funds and other institutional investors. So the degree of sophistication and the track record in those asset classes I think provides a high degree of comfort. One of the other things you mention there is the links between affiliates, and it is definitely the case that there is an ever increasing degree of connectiveness between the various different entities involved and we see that through some of the different strategies and we focus quite a lot here so far on the investment in insurance companies but as I mentioned at the start there's quite a lot of interest in ancillary business that goes around the industry and so you can end up with a single private equity fund, or private equity house controlling a number of different investments all in an ecosystem so there is this growing sense of connectiveness and intra-relationships between parties and I do think that will become increasingly important for regulators to look at and really understand the ecosystem in which businesses are operating, and the extent to which there are systemic risks arising from that, if at all.
Tom Peacock	Given some of these themes we've been discussing, what we are seeing in M&A deal terms is a degree of apprehension on the sell-side when it comes to intense focus on deal certainty. This could manifest around conditionality, also around seller involvement in the regulatory approval process to obtain greater visibility and ownership of that process. Can we just unpack the purchaser perspective on this little bit. Is this right that it should be a purchaser issue, or is it something that needs to be more of a shared problem?
Harry Bacon	If you think about a typical sales scenario Tom, you would envisage a seller potentially with a great asset arranging an auction process. It's competitive, buyers will be vying for pole position and there will come a moment in the deal where the seller has to decide who to transact with. At that point in time they're running ahead with someone, ultimately signing a contract and they want to be confident if not certain that the deal will go through once its been signed. So from a seller's point of view they really are looking for a buyer to assume as much risk as possible around the regulatory conditionality and as a recap in almost all of these transactions you will require an approval from a regulator to allow a transaction to complete where somebody's taking control of that asset. The buy side it's a far more complicated picture and it arises whenever you have an asset that has a regulatory capital requirement and has a business plan that's subject to regulatory approval in some way or another, and that is that these businesses typically are not going to be investments that are very high yielding

	and they will be an attractive return and often a way to deploy a significant amount of capital into a very good quality stable investment with a good, strong return but they're lower IRR and the margins typically are finer. What that means is that if there's a fundamental change in the business plan or the capital requirement of the underlying business, the margins and the profitability of the business and its attractiveness as an investment can be rapidly eroded. So there are a number of different points which need to be validated with the regulator as part of any change of control process and part of any regulatory approval. And any well-informed seller will understand I think that a buyer is facing those challenges and the buyer simply cannot underwrite a deal unconditionally and particularly a private equity investment investor with duties to its own LPs, so yes its right and understandable to some degree that a seller wants a very robust process but I view this as a bit of a joint problem and I think the best deals are deals where there's a bit of a partnership spirit around the regulatory process. The buyer will need to show its putting its best foot forward. It will have had to look at some of these issues ahead of time and feel confident that it's been sustainable in its approach. Equally it should expect any good seller to be looking at the process quite carefully and wanting a good degree of oversight and transparency to make sure that the buyer is doing everything they ought to, to get the approvals that they need. I think where it ends up being more complicated is agreeing between buyer and seller the extent of any change that would be acceptable. You know, effectively the degree of variants and the tolerance that can be accepted in the transaction before everybody agrees it's uneconomic for a buyer to go ahead with the deal and therefore be fair for the seller to allow them out of the deal. So that tends to be where a good negotiation centres and the rest of it then falls in behind.
Tom Peacock	So it sounds like there's a need to recognise that for the purchaser of the investment proposition means evaluation that rides on both the capital generating a stable IRR and the ability to extract that return but also the impact on incremental cashflows from asset management play alongside them.
Harry Bacon	Yes exactly Tom. I think the seller really ought to understand what it is that underpins the buyer's decision and then through that they can understand where the pressure points are likely to be on any regulatory approval and what could lead to a walk away.
Tom Peacock	Harry – we focused a lot today on life. Obviously General Insurance has a different business model that's more capital light rather than long-term liabilities matching long-term assets which means there can be less of an asset management play. There are those still similarities such as scaling for policies and larger platforms meaning efficiencies in operational costs. We have seen a lot of private capital coming to the sector leading to consolation of intermediaries, brokers and managing general agents, both in the UK but also in other jurisdictions with fragmented markets such as Spain.

	What's been the impact on the recent economic volatility on the deals in this sector?
Harry Bacon	So I think volatility has chilled the sector as whole and by that I really mean the private equity industry. If you look at deployment of capital, its slowed down quite a lot. We mentioned earlier on the business around GI I think is more of a play into operation improvement, operation efficiency and value creation that way. The deals have historically been funded with a good amount of leverage which creates a need for free cash flow for debt service. I think whilst rates have been lower though the cashflow demands have been lighter on businesses as we move into a higher rates environment. I think people have been looking and seeing that stabilise, that does present new challenges. It's more about understanding the business model rather than anything revolutionary but I think people haven't waited to see whether or not things would stabilise to get a good sense of what's yet to come before going back out into the market. You mentioned as well interest in some of the businesses are ancillary to the core insurance operations, things like brokers and MGAs, we have seen a huge amount of focus in those sectors. Ardonagh has had a huge amount of success with its brokerage consolidation play globally and there have been other examples as well as you mentioned across Spain and more broadly. There's also been quite a lot of disruption and people looking for ways to deploy capital in innovative structures. If you look at what Blackstone and Fairfax have done with key financial they've taken the Lloyds of London market which is traditionally a very conservative, well-established player. They have deployed technology into that through the form of algorithmic underwriting to drive huge efficiencies and improve the customer journey. That gives you a flavour I think of what's coming, I mean tech is going to form a huge part of what people do on value creation and that will include deployment of AI in particular. If you look at the nature of these businesses, huge amounts of data, huge amounts of trend analysis, very well suited to computing power. But also you think about the customer journey and the reliance on individuals and people through that. Yes, there's a degree of opportunity for cost saving of replacing large headcount with tech but I actually I think I see the excitement more about improvement from scale in the sense of using the same people to deliver a far better and larger service and that really is what's going to be coming as well as radically improving response times and journey times through from quote to underwriting.
Tom Peacock	We'll leave it there. Thank you again Harry again for joining. If you would like to discuss any of the points raised in more detail, please get in touch with either of us or your usual Slaughter and May contact. You can subscribe to the Slaughter and May Horizon Scanning Podcast wherever you get your podcasts.