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in Global Insurance Industry

Private power

Private equity – ever on the lookout for new opportunities to turn a profit – has turned to the global insurance industry. Retail insurance brokers have been pinpointed as offering the best prospects of good returns.

By Andrew Barile

THE WAY IS OPEN for private equity to play a leading role in the global insurance industry, a complex part of the financial sector that has reached the limit of its ability to grow organically. Whether it be in backing a new syndicate at Lloyd's of London or a Thailand reinsurance company after the floods; investing in a new brokerage firm; starting a new insurance company in China; or starting a new insurance and reinsurance broker and risk-management provider, the prospects are favourable.

To enter the market, the first essential is identifying a broker with a good track record and the potential to expand, structured in such a way that it can compete with established companies such as Marsh, AON and Willis. Changes in the economic model on which the business is based have made the sector more attractive. Today, there is an emphasis on the generation of new revenues from consultancy, as the role of the broker changes to that of an advisor. Brokers are thus less dependent on contingency fees from the insurance carrier — and consultancy, of course, is guaranteed income. AON's recruitment of executives from the consultants McKinsey is clear evidence of this shift in policy.

Private-equity firms, with huge amounts of available investment capital, are also poised to change the historical structure of Lloyd's brokers, another element of the non-risk-taking market. These brokers are set to expand their influence beyond just Lloyd's syndicates in Britain and place business with the large global insurance companies.

This process has already started. In the last 25 years, Lloyd's brokers have joined forces with holding companies with outlets strategically located in the United States, South-East Asia, and South America. The combination of technology and expertise in local markets will make it possible to create a global Lloyd's broker, generating good returns for private-equity investors. The efficiency of private-capital investments will enable them to compete with the mega-brokers which enjoy access to public capital.

A wealth of opportunities also exists in the global reinsurance market. The challenge is to understand the scale of risk, which has in the past deterred the banking industry from investing. However, private-equity firms have executives with the appropriate business skills to operate effectively in this sector, and the capital to cover worldwide catastrophe risk. This applies particularly to the newly-capitalised Bermuda global reinsurance companies, established in the wake of catastrophic major hurricanes and earthquakes in the last couple of years. There is a perceived over-capacity in the market, but that need not necessarily hold back new operators that have the commercial courage to exploit new markets in the developing countries.

The staffing of global reinsurance companies will be an issue. Due to a shortage of successful executives in the reinsurance sector, private-equity firms will need to have their own people at the heart of any venture they are funding. With ready access to senior executives with the necessary business training and experience, it should not be beyond them to take operational control where necessary as well as manage the ventures.

They also have the scope to create new global reinsurance firms, whose activities can then be extended to catastrophe-prone countries such as Japan, Thailand, New Zealand, and even the US. Moreover, a global reinsurance company is a capital-intensive business, and the involvement of private equity will help finance the technological improvements needed to judge catastrophe exposures — at present these are in their infancy. For those looking to invest in this sector, a useful model is that of Berkshire Hathaway — the conglomerate built up into a $195-million business by Warren Buffett. — which provides investment opportunities through insurance and reinsurance premiums.

Moreover, after several years, many companies investing in Bermuda-based global reinsurance companies used the initial public offering (IPO) as their exit strategy. With earthquakes and hurricanes increasing catastrophe reinsurance pricing, the private-equity firms earned significant returns on their initial investment. Munich Re and Swiss Re provide the most significant operating model, as they have been able to dominate the global reinsurance market. The Korean Reinsurance Corporation (KRC) has become the world's twelfth-largest reinsurer by adopting a global perspective. After opening offices in New York City, it is investing widely and working hard to develop reinsurance relationships across the world.

Acting as third-party administrators or claims management firms are other avenues for private-equity firms to exploit. This may be a less glamorous sector, yet, when properly managed, it provides a significant return. Several firms are already involved in backing claims management companies. This field is in its infancy, as geographical differences still restrict the ability of a global venture to handle claims in India, Japan, the US and Brazil. But a single company administering both property and healthcare claims can profit from economies of scale.

Many global insurance companies need a third-party administrator to expand internationally. Acquisitions in different countries can provide the necessary global platform and, making use of state-of-the-art technology, claims management companies can provide services to insurance and other companies to facilitate the administration of claims, as well as data-management. There are also lucrative opportunities available for those who invest in companies providing insurance technology services, a comparatively unexploited sector. The duplication of work in filling out insurance applications, whether in China, the US or Korea, needs to be significantly improved to increase efficiency and reduce costs.

Private equity can also become involved in IT firms to provide them with resources to focus on the insurance industry and develop the global services that the sector requires. Many outsourcing companies have failed to focus on the insurance industry, and therefore have not been successful in creating the necessary technological environment. To create an automobile policy operating system in China, US, Brazil, and the United Kingdom, for example, needs detailed knowledge of each host country, which enables the services-provider to overcome significant cultural differences.

When a private-equity firm buys a managing general insurance agency for $300 million and three years later sells the same agency for $400 million, it delivers a significant return to investors. The way is open for private equity to explore the many new opportunities that are developing in the global insurance industry, and consequently to play an important role in its growth.

SUCCESS STORY

One example of a private-equity firm successful in investing in the global insurance industry is the US venture Spectrum Equity Investments. SEI sold a managing general insurance agency, Arrowhead General, to a large publicly-held insurance broker, Brown & Brown (BRO) for $395 million, plus $5 million potential earn-out. Brown & Brown paid $200 million in cash and $200 million in term notes.

Arrowhead General has net revenues of $105 million, which includes $27 million from a claims management company. Spectrum Equity Investors, JMI Equity and a management equity-holder group was able to obtain a purchase Price at 3.8 times revenues and nearly ten times EBITDA, substantially above the insurance industry norms for a sale of a managing general agency.

By insurance industry standards, Arrowhead General is a large programme insurance manager, providing some 19 insurance products and representing some 25 property and casualty insurance carriers. Significant insurance premiums being written are in workers' compensation and earthquake insurance with insurance company markets of QBE, Munich, AXIS, C V Starr, and Bank of America (Balboa Insurance Group). Spectrum Equity saw that the value in the company came from its position as a virtual insurance company without the underwriting risk. It was possible to sell the company at a substantial profit by focusing on developing all aspects of the business.