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How and Why Private Capital Continues To Invest in the Insurance Sector

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Key Points

- As private equity firms and other sources of private capital expand into new asset classes and seek to bring more assets under management, the insurance industry has become an increasingly important target for investments.
- Buying or launching primary insurers gives financial sponsors direct access to long-term capital that they can deploy through their lending arms.
- Insurance intermediary businesses such as brokerages have also drawn private capital investment, often because of the potential for consolidation.
- But sponsors are having to address concerns expressed by elected officials and regulators about private capital ownership of insurers.

Financial sponsors have become progressively more involved in the insurance sector over recent decades. Their involvement broadly falls into three categories:

1. Sponsors establishing or acquiring their own life and annuity insurers or reinsurers on an own-account basis, either wholly owned or with co-investors.
2. Sponsors acquiring an insurance intermediary business as a portfolio company, such as a brokerage group, and then using it as a platform for a roll-up. There has also been significant and accelerated activity in one-off acquisitions of intermediaries, business development and subsequent sales.
3. Sponsors establishing or acquiring reinsurers to write new reinsurance or legacy business. These vehicles have often been formed in Bermuda.

The diversification of private capital into the insurance sector reflects several factors: the ever more competitive environment for private equity type deals, well-established play-books for success in the sector and a desire to acquire new long-term money to manage.

There have been recent headwinds, such as the rising cost of debt finance, secondary effects of the recent banking crisis, and regulatory and legislative concern around private equity involvement in the sector. The general view, however, is that financial sponsors will continue

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to expand their share of the sector as they steadily recast themselves as diversified financial businesses.

Life and Annuity Business

The top five financial sponsors all now own or partially own a life and annuity business insurer or reinsurer. Many other sponsors do as well, or are seeking to find their way into the sector.

Why?

Financial sponsors are becoming diversified alternative asset managers. They are looking to maximize their assets under management (AUM). They are particularly interested in opportunities that provide long-term capital to manage; such capital is hard to move and can be invested in private credit strategies where they have strong origination capabilities.

Life and annuity insurers and reinsurers offer these characteristics. They can also provide the opportunity to spread income in various lines of business based on the difference between what is earned on investments and the return required to be paid on the underlying policies. Typically, on acquisition, the AUM will be transitioned from lower-yielding assets into private credit strategies that offer higher yields. This is subject to the constraints of insurance regulation.

The transition of asset portfolios has not been without controversy. For example:

- The U.S. Senate Committee on Banking, Housing and Urban Affairs has discussed asset transitioning of this nature and whether state regulatory regimes are capable of assessing and managing the associated risks.
- The National Association of Insurance Commissioners (NAIC) has identified 13 regulatory considerations relating to state regulators' ability to regulate the risks presented by sponsor-owned insurers or traditional insurers with similar characteristics. For example, there are concerns around structural transparency and whether nonapproved control or economic ownership is being facilitated indirectly through contractual arrangements like investment management agreements.

Sponsors have worked hard to establish their regulatory credibility in light of these concerns. In turn, regulators worldwide have become increasingly comfortable with the regulation of sponsor-owned insurers and the techniques required to regulate them. This is demonstrated by the now widespread ownership of both life and nonlife insurers by private capital businesses.

Brokerage Consolidation Platforms

Life and annuity insurers and reinsurers are balance sheet businesses that require considerable amounts of capital. They are typically valued by reference in some way to book value. In contrast, insurance brokerages are "capital light" and usually valued on a multiple of earnings before interest, tax, depreciation and amortization (EBITDA).

The ability to leverage investments in life and annuity businesses is meaningfully constrained by insurance regulation. In contrast, brokerage investments can be made with a considerable amount of debt, which historically could be at a six or seven times EBITDA level.

In many jurisdictions, brokerage business was and continues to be highly fragmented, offering a substantial opportunity for roll-ups, with all the cost and revenue synergies that can come from combining businesses.

Executing a roll-up to create a larger platform, with the support of leverage, is a well-established private equity playbook across sectors, but the insurance brokerage arguably has been the area where the approach has been most successful.

In many ways, the success of the roll-up strategy is demonstrated by a number of the larger consolidators, where the platforms have become so considerable and successful that they have become backed by multiple sponsors.

While the consolidators easily catch attention, we should not disregard single company strategies. These have typically been at their most successful where a sponsor has taken equity in an insurance intermediary that handles specialty lines. The sponsor has then helped the company improve its business and often exited after EBITDA has grown materially and at an expanded multiple.

Bermuda Reinsurance Vehicles

No survey of the sector would be complete without reference to sponsor investment in Bermudian reinsurers. Reinsurers are the support of the insurance industry, allowing primary insurers that face the public to lay off risk and, as a result, write more business.

While the large life and brokerage consolidation platforms draw significant press, investment in Bermuda reinsurance vehicles continues, particularly given the recent hardening of pricing in reinsurance markets.

What's Next for Sponsor Involvement in Insurance?

Financial sponsors have evolved dramatically over the past 20 years, expanding into new asset classes and, in the case of some of the biggest firms, going public. They continue to search for ways to develop into the financial supermarkets of the world, alongside and competing with the large banks. As such, it is only reasonable to expect that their desire to become ever more involved in the insurance sector will continue.

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