

MERGERS & ACQUISITIONS

Willis

THE WILLIS INDEX

ALL CHANGE...!



There has been a raft of developments across both Willis and Willis M&A recently and there are more on the horizon as we continue to build the leading M&A practice in our sector.

All the changes, some of which are highlighted below, are positive and will help us better serve our growing client base on a truly global basis and in a consistent manner. Some of the key developments have included:

- 1) An increased focus on the globalisation of our model as our North American and International M&A practices become even more closely aligned, with a focus on client relationship management and service delivery consistency.
- 2) The recent recruitment of Alena Watchorn, formerly head of HSBC Insurance Brokers Corporate Finance team, to help drive our activity on the Transactions Solutions opportunities in the market.
- 3) The relocation of Josh Roach from Sydney to Hong Kong as M&A Practice Leader – Asia Pacific will enable us to better serve the increasing need of our clients across Asia. Josh, who launched our practice in Australia in late 2006, will work closely with Jason Wang in Hong Kong and others in the practice across the region.
- 4) The relocation of our London team into the new Willis Building in London. By bringing together all of the London resources of Willis under one roof we will be even better equipped to truly bring all of the resources of Willis to bear on clients' objectives during the transaction process. As part of the move the contact details of the London M&A Practice have changed and are provided opposite.

We are very proud of the progress we have made in recent years in the M&A sector but even we were surprised by the general consultant league tables on Mergermarket.com which showed us (based on the deal value of transactions worked on between 1/1/2005 and 31/1/2008) as the leading insurance adviser. We look forward to maintaining this position and using the experience we have gained to the benefit of our clients as the deal environment

changes further in coming months. There have also been a number of exciting developments in the Transaction Solutions insurance niche, with a rush of new entrants to the underwriting arena. We are pleased that these new entrants have taken a sensible approach to their entry by recruiting appropriate expertise to underwrite. For the most part this expertise is provided by ex-corporate M&A lawyers who have also spent some time in insurance and specifically the transaction insurance area. This increase in competition has driven further improvements in coverage as well as notable downward pressure on rates to a level not seen for a number of years. These moves coupled with our belief that the changing economic environment will drive increased recourse requirements in deals have prompted us to issue a one off update report on this area of our activities which will be published very shortly.

Alistair Lester

International Practice Leader
Willis M&A

RANK	COMPANY NAME	DEAL VALUE (GBP MILLION)
1	GEORGESON INC	263,255
2	HQB PARTNERS	40,087
3	SALISBURY ASSOCIATES	37,245
4	WILLIS	14,909
5	AON	14,089
6	AMERICAN APPRAISAL ASSOCIATES INC	12,838
7	BAIN & CO INC	11,062
8	SODALI	10,557
9	MARSH / MMC	9,290
10	PILKO & ASSOCIATES LP	7,107

Source: Mergermarket General Consultants League table 1/1/2005 - 31/1/2008

Note: For direct comparison purposes against our peers the Aon figures include all Aon entities on the whole league table (i.e. Aon M&A Group and Aon Consulting services), the Marsh figures include all MMC entities (i.e. Mercer Inc, Mercer Oliver Wyman, Marsh Inc, Mercer HR, Mercer LLC, Marsh PE, and MMC) and Willis includes all Willis entities (i.e. Willis GmbH & Gras Savoye).

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CAPTIVES:

Captives are commonly encountered during the Due Diligence process where a Group Company is divesting a subsidiary business that had benefited from its internal captive arrangements. These present their own issues in terms of historical claim recourse and stand-alone costs. So, are they to be seen as friend or foe?

Due to the increasing sophistication of mid sized business with lower capitalisation costs and increasingly flexible and inclusive captive structures, there is an increasing appetite for mid sized business captive ownership.

What are the issues to the acquirer (and in turn on exit), where an insurance captive is identified through the bid process? Is a captive Friend or Foe?

A captive insurance company is an authorised insurance company owned by a ('non insurance') company to insure the risks of its parent company stakeholders. As a subsidiary group company, it carries the agreed portion of the Group's insurable risks ceded by the business.

From an accountancy perspective, when reviewing the financials of the business, the presence of a captive may not be immediately apparent. There are however two main indicators – large provisions and funds in escrow.

In terms of cash flow, one of the significant advantages of a captive is that it allows the business to actively manage cash payments. It does this by replacing premium paid to the external insurance market with insurance premium paid internally. This internal premium is often tied up offshore and consequently may be visible on balance sheet as funds in escrow or similar. This may be the first obvious indication of the presence of a captive.

Because the risk hasn't been transferred from Group, the element of risk retained will have to be provided for. The subsidiary is therefore required to provide for its best estimate of the risk retained (this will be for future expected losses called Incurred But Not Reported Losses – IBNR, or for known losses.) This provision will be noted within consolidated accounts and may be recognised as the second indication of a captive.

Whilst these two balance sheet attributes – a large provision and funds in escrow – are the most obvious indicators of a captive, companies are typically required to publish a list of the significant companies that are consolidated in group accounts – from which the captive subsidiary may also be recognisable.

WHY IS THIS IMPORTANT FROM A VALUATION PERSPECTIVE?

As part of the purchase, buyers need to value the target company, which includes the identification and analysis of historic risks retained by the Company. For the following two fundamental reasons a captive should definitely be seen as a 'friend'.

1. A captive is a central location for the retention of insurance risk; therefore the understanding and analysis of a captive can greatly assist in the valuation of those historic risks.
2. A captive is a sophisticated risk finance tool and the use of a captive suggests that the management of a business has been committed to risk management and a structured approach to risk retention. The business will have undertaken analysis, possibly actuarial, of its losses and risk, and have a clear understanding of its risk retention threshold.

Captives can take many forms and can act as an insurer or a reinsurer; they can be a cell in a protected cell company or can be formed as a limited partnership (see opposite for more information). Liabilities assumed by captives can be short-tail in nature where it is expected claims will be settled within 12 months, or longer-tail exposures which may take many years, even decades to finalise.

Typically the captive will be used to retain a level of risk its parent company is comfortable with and is generally operated to finance risk and to cover the structured cost of anticipated claims. The captive will then look to transfer risks to the insurance markets in excess of that amount, which tend to be risks that are severe and infrequent in nature or the occurrence of which could impinge on the financial performance of the core business.

HOW IS A CAPTIVE FUNDED AND WHAT DETERMINES ITS SOLVENCY?

Following analysis of the risk and retention strategy between the company, its captive

Types of Captive

The term captive is associated with many entities where there is an affiliation between the owner(s) of the insurance company and the insured party. Relevant examples include:

Single Parent: A company that underwrites the risks of companies related to the parent company.

Rent-a-Captive: An insurance company providing access to corporations without the need to capitalise their own captive. The corporation usually has a participation or share agreement with the Rent-a-Captive that segments the latter's portfolio of insurance. The Rent-a-Captive is responsible for the assets and liabilities associated with its own segment.

Protected Cell or Segregated Portfolio Company: Similar to a Rent-a-Captive other than that the segmentation between participants is protected by statute in the domicile of the insurance company.

FRIEND OR FOE?

Most organisations see the captive as the focal point of the risk management effort...

Disadvantages of captives

The captive option is only one among many non-traditional ways to finance risk transfer. It is not the best approach for every organisation.

The capitalisation of the captive means long-term capital commitment to forming a captive.

There are certain overhead costs associated with the captive option collectively called management fees. The captive has fixed overheads in the payment of management fees, director and secretarial fees, accounting audits. These should be minimal and, hopefully, covered by investment earnings.

Within the cyclical insurance market, when the insurance market softens, conventional pricing can provide competitive premium levels.

The perception of retained liability risks may discourage buyers and prevent a company making a clean exit from the business.

manager and the regulator, a captive is capitalised in line with the agreed regulatory requirement of its domicile. This is its solvency requirement and is independent of the annual premium payments made from the Parent which will fund claims on a day to day basis.

Broadly speaking, capitalisation will consist of an inter group payment to its subsidiary for the amount of which it is to be capitalised in Year One. Payment may be cash, inter company guarantee or a letter of credit – depending on the requirement of the domicile regulators and the Parent company. In respect of accounting, whilst the cash is retained in the business, it is effectively tied up in the subsidiary and as such is noted on the balance sheet as a financial investment (asset).

In terms of the capitalisation this will not equal the provision set by the subsidiary in its accounts as the capitalisation is the regulated required solvency margin, not the level of known and expected losses. Capitalisation will mean that there are now funds tied up. From a valuation perspective the cash still exists on balance sheet, however, cash is always more valuable than an asset that has the same face value. As such, cash capitalised in a captive may be discounted at valuation.

VALUATION

The key to valuing a captive is to understand the risks assumed by the captive and the potential impact, both positive (in terms of favourable taxation environments, potential investment income and underwriting profit) and negative to its bottom line.

The embedded value of a captive can only be

considered once the extent and limit of the exposures assumed are quantified and understood. This is a key area of cross reference for diligence.

Most captive programmes are structured so that the expected cost of claims is matched by a matching level of retained premium with an aggregate (maximum level) of claims agreed in excess of the expected amount. The captive managers will have reviewed and quantified this expected cost of claims and advised on the amount of premium required to meet this.

The aggregate maximum level of claims is the capped amount of risk to the captive. Over an above this limit, the reinsurance market responds to losses.

While the expected cost of claims can be assessed using actuarial models or by analysing historic claims performance, it is the risk gap in any captive programme that provides the uncertainty when assessing profitability and performance.

It is of particular importance in liability policies where there is a significant time gap between the original incident occurring and crystallisation of the final settlement amount of the claim (IBNR). Additionally, historical events can manifest themselves as latent claims (toxic mould, asbestosis, industrial diseases) which may not have been known when the original pricing and expected cost of claims were set.

Where there is a loss running captive, it is normal for an adjustment to be made to the premium paid from the Group to the subsidiary to meet losses – or for these losses to be met through further capital injection into the captive.

It is therefore key to understand the risk gap and potential exposure to the business, and the availability of funds within the captive to meet its maximum liabilities in the future.

Whilst there is an exposure due to the risk gap, there may be significant reserves and provisions tied up in a captive set aside for events which are most unlikely to be accepted as losses. This may be due to external factors (legal cases, EU directives) or company specific reasons (risk of pollution from particular source has been averted, division sold to competitor and all products liability sold on as part of the sale). There is therefore a possibility that a review may unlock sources of cash flow and liquidity not previously anticipated.

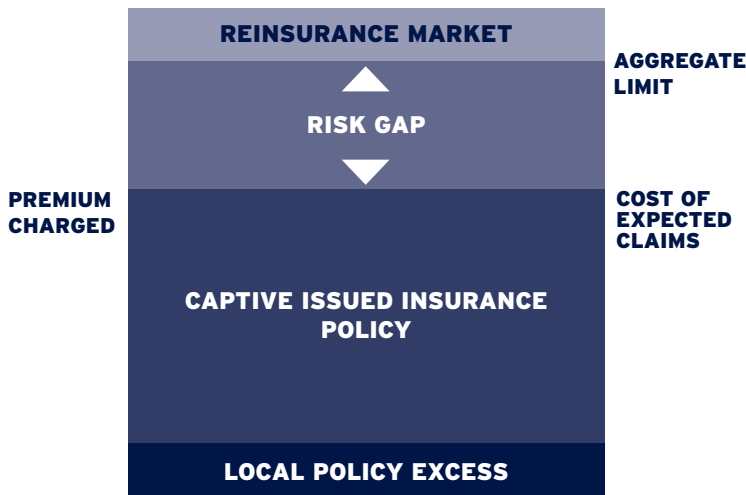
CLOSURE OF THE CAPTIVE

Where the Target company is purchased the common question is; “Can the capitalised cash be released?”

One of the key decisions for a prospective purchaser is whether the captive should be retained or disposed of post transaction. There are many points to consider in taking this decision, including differing views on risk financing. The purchaser may not wish to retain long-tail liability on its consolidated balance sheet or accept the presence of an existing captive within the new group.

There are two means of disposing of a captive insurance company – liquidation or sale. Regardless of which of these ultimate disposal options might be adopted, it is likely that some cleaning up of the balance sheet through the

The difference between the expected cost of claims and the aggregate limit is known as the risk gap. This is shown in the following diagram.



resolution of some or all of the insurance liabilities will be required. There are 4 ways in which this can be achieved:

- Commutation of reserves
- Portfolio transfer (novation) of liabilities
- Reinsurance to close
- Restructuring of liabilities

The preferred choice for the disposal of the company will dictate this selection to some extent; for instance, a reinsurance to close (RITC) will clean up the balance sheet but will not facilitate the liquidation of the company. Whatever other considerations need to be accommodated, all disposals of liabilities must be undertaken with the approval of both the appropriate regulatory authorities and the directors of the captive.

Although offering a number of possible benefits, the sale process itself can be complex and expensive and buyers are not always easy to find. The key potential advantages include:

- The realisation of a capital gain rather than the realisation of taxable profits
- The provision of complete and unambiguous finality

Disadvantages include a number of factors that impact costs, including difficulty and timescales to complete a sale. However, there are additional potential disadvantages arising out of the inevitable divergence of the interests of the new captive owners and the policyholders. Disadvantages include:

- Loss of control over claims process
- Loss of security following reduction of capitalisation to minimum levels
- Possibility of the compromising of commercial interests by the new owners of the captive who are acting to bring about the early resolution of the insurance business
- Need to persuade counter-parties and other interests to agree to the change in ownership i.e. fronting insurers, reinsurers, regulators, policyholders etc.
- Significant management time commitment
- Given the need to offer potential buyers the prospect of profits, it is unlikely that full value will be obtained by the captive owner

Given all of the above, captive sales are rare and generally feature in circumstances of parental distress or where the captive is a substantial business in its own right.

CAPTIVE, FRIEND OF FOE?

Generally, the evolution of a captive within an organisation comes from developments in risk management and appreciation of the true cost of risk. They are developed where the organisation has identified the potential financial and efficiency upside.

Most organisations operating captives will have a deeply entrenched risk management philosophy throughout the group and will see

the captive as the focal point of the risk management effort. As the cost of risk is being borne, at least partially, by a subsidiary rather than an external insurer, a greater appreciation of the benefits of loss prevention and increased risk management focus can be generated and the tangible benefits of reduced premiums and wider coverage can be recognised. Without a captive at the centre, it is more difficult to harness and quantify the separate achievements in reducing losses and improving safety.

Only active diligence, including a review of the captive management and assumptions on the risk analysis underpinning a captive, can provide comment as to the exposure a captive brings to a transaction. This can determine whether it is Friend or Foe, but the presence of a captive itself should point towards a level of sophistication of risk analysis and management within the business. It need not signal increased exposure and liability. The captive communicates the group's insurance activities in the form of an income statement and balance sheet rather than insurance jargon. This may support the company's risk management philosophy that insurance and risk management is an integral aspect of the day to day business, taxation, potential cash generation and profit – rather than a remote but necessary external operating cost.

For further information regarding any aspect of this article, please contact your local M&A team.

A two-hour working seminar and lunch; **Captives - Cash Cow / Hungry Wolf** is planned for May in Willis' new London offices in Lime Street. Please contact Amy Dawson at dawsonaca@willis.com to express your interest in reserving a limited place.

Advantages of Captives

A captive income statement and balance sheet replaces insurance jargon.

Cost reductions: A corporation paying an insurance premium to a conventional insurance company contributes to the expenses of an insurer (including potentially inefficient administration and other insureds' losses) and profits of the insurer. By establishing its own insurance vehicle, such costs and profits ultimately are controlled within the same economic family.

Risk Management and Underwriting Profitability: Conventional insurance is typically guaranteed cost and there may be little incentive to improve risk management as there may be little opportunity to participate in the profitability of the insurance program. However, with a captive insurance company the parent does benefit from good claims experience and any surplus in the company may be available to the parent by way of dividend. A captive can therefore provide a great incentive to improve risk management throughout an organisation.

Reinsurance: Reinsurance is insurance that is available to insurance and reinsurance companies only. Typically, cost ratios associated with such reinsurance are far less than conventional primary insurers. Reinsurance is not accessible directly by the general public. This can allow for greater variety in the development and design of insurance coverage than would otherwise be available from the conventional insurance market.

Availability of cover: Certain types of cover are unavailable or difficult to obtain because of events such as historic loss experience for a sector of an industry. An example of this would be medical malpractice. By setting up a captive, a corporation can insure such risks as well as allowing access to the reinsurance market that may have greater appetite for a risk than primary insurers.

Underwriting Stability: A captive insurance company is less vulnerable to the cyclical nature of the hard and soft markets that blight the conventional insurance market. A captive can aid a corporation that requires accurate financial projections for their business.

Taxation: Certain tax benefits may be available by utilising a captive insurance company. Any tax benefits, however, should not form the reasoning or basis behind the establishment of a captive insurance company.

Without a captive, it is more difficult to quantify reducing losses and improving safety...

...costs and profits are controlled within the same economic family

M&A PORTFOLIO UPDATE

Over the past 18 months the interest in portfolio insurance initiatives, both from private equity houses (PE) and insurers has increased. This is as a result of the PE fraternity becoming more aware of the significant cost reductions, immediate and medium / long term, that are possible and also to the appointment of Portfolio Directors within PE's which allows more time for them to consider the numerous alternatives for cost reductions / increased margins.

Although many insurers actively invest as Limited Partners (LPs) or, in other forms, in PE's, insurers from a traditional insurance perspective, are beginning to acknowledge the significance of PE's contribution and influence over their ultimate client base. They are realising the opportunities a portfolio approach provides for their own organisations, i.e. reduced distribution costs and the potential for greater stability. There has been a differing approach taken amongst insurers in demonstrating their commitment to PE, resulting in some organising actual teams and some virtual M&A teams. These teams are working directly with the M&A focused brokers to deliver a professional and bespoke product or service to the PE and investment community.

The majority of insurers have taken a virtual

approach to M&A. In these instances the insurer will have a designated contact within their organisation, to whom all inquiries and propositions will be directed. These individuals will then co-ordinate their response, using their existing internal resources. One global insurer has created a specific M&A team, which includes underwriters for all major classes and transactional products.

The majority of insurers have taken a virtual approach to M&A

Insurers who are demonstrating a proactive approach include Ace, AIG, QBE, RSA and Zurich.

To date the majority of portfolio initiatives have focused on general insurance. However, a similar approach can be taken to employee benefits and several PE's are exploring the opportunities in this area.

Although there are not many at present, those PE's who can be considered advanced in their implementation of portfolio initiatives, are also considering captives as the next phase in their development.

MEET THE TEAM



Ben Cooper has been with the Willis M&A Practice as Portfolio Director since August 2006. His main focus is the development of portfolio insurance programmes for the benefit of our UK private equity fund clients and their portfolio companies. He is also seeking single portfolio company insurance opportunities emanating from our original due diligence engagements for the wider Willis Group.



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Willis Mergers & Acquisitions Practice performed the insurance due diligence for the

£12,400,000,000

Acquisition of

Alliance Boots plc



by



August 2007
This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice performed insurance due diligence on the

Acquisition of



by



August 2007
This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice performed insurance due diligence on the

Acquisition of

Farmabios Spa



by

Ergon Capital Partners II SA




September 2007
This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice supported the

Acquisition of

POHLAND
Bleiben Sie anspruchsvoll

by




September 2007
This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice performed insurance due diligence on the


Acquisition of

Symingtons



by

fund managed by Hermes Private Equity



September 2007
This announcement appears as a matter of record only


Willis Mergers & Acquisitions Practice performed insurance due diligence on the

AS440,000,000

Acquisition of

THE HOYTS GROUP

by



September 2007
This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice performed insurance due diligence on the

£81,000,000


Acquisition of

Clinisys



by

funds managed by ECI Partners LLP



September 2007
This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice performed insurance due diligence on the

£170,000,000

Acquisition of

RACING POST

by



October 2007
This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice performed insurance due diligence on the

Investment in




by




November 2007
This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice performed insurance due diligence on the

Acquisition of



by



December 2007
This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice performed vendor insurance due diligence and supported

Advent International
GLOBAL PRIVATE EQUITY

in the sale of



to




December 2007
This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice performed insurance due diligence on the

Acquisition of

Latitude Group Ltd



by

Vitruvian Partners LLP

December 2007
This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice supported the

acquisition of



by



January 2008
This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice performed insurance due diligence for the

£600,000,000

acquisition of

Alliance Medical

by




January 2008
This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice performed insurance due diligence for the


investment in

Gaucha Grill Ltd



by

Intermediate Capital Group PLC




January 2008
This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice performed insurance due diligence on the

£62,000,000

Acquisition of


Geo Networks



from Hutchinson Whampoa

by

A newco backed by the Alchemy Investment Plan



January 2008
This announcement appears as a matter of record only

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