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Life Conference 2014

A case study of a reinsurance-supported management buyout

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Agenda

- RL360° perspective
- Munich Re perspective
- Summary and lessons learned

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RL360° perspective

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Introduction to the case study

The Royal London Group (‘RLG’) has entered into an agreement with funds advised by independent private equity firm Vitruvian Partners (‘Vitruvian’) to support a management-led buyout of Royal London 360° (‘RL360°’ or “the Company”) and its subsidiaries for an undisclosed sum.

RL360° timeline

- Jan – Mar: Initial enquiry and agreement in principle
- Mar – Jun: Financial due diligence
- May – Aug: Non-financial / strategic due diligence
- Jun – Oct: External finance
- Jul – Nov: Legal due diligence / prepare contracts
- 14 Nov 2013: Completion.

The main players

- Royal London Group
- Royal London 360° / RL360°
- Vitruvian Partners.

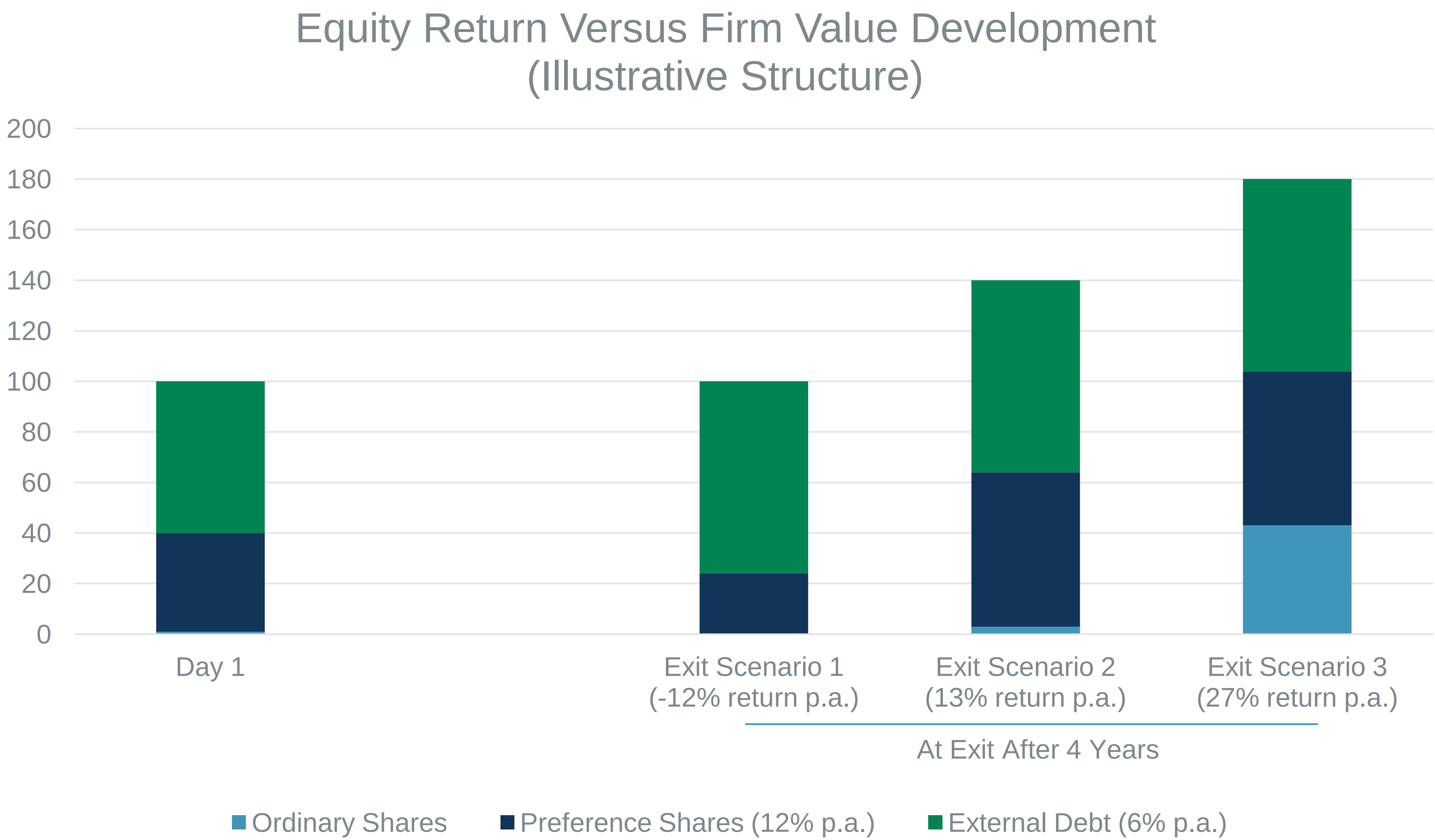
In the beginning

- RLG agrees to the concept of an MBO
- Identification of a suitable private equity company
- Deal struck with RLG.

Reasons for Vitruvian to invest

- Target investments of €30m - €150m
- Enterprise value of €50m - €500m
- Average investment is held for 4-5 years.

A geared equity investment



Obtaining external finance

- Identify potential sources of financing
- Involvement of specialist debt placement firm
- Lending considerations:
  - Capacity / timetable
  - New business financing
  - Financial / solvency benefit
  - Cost.

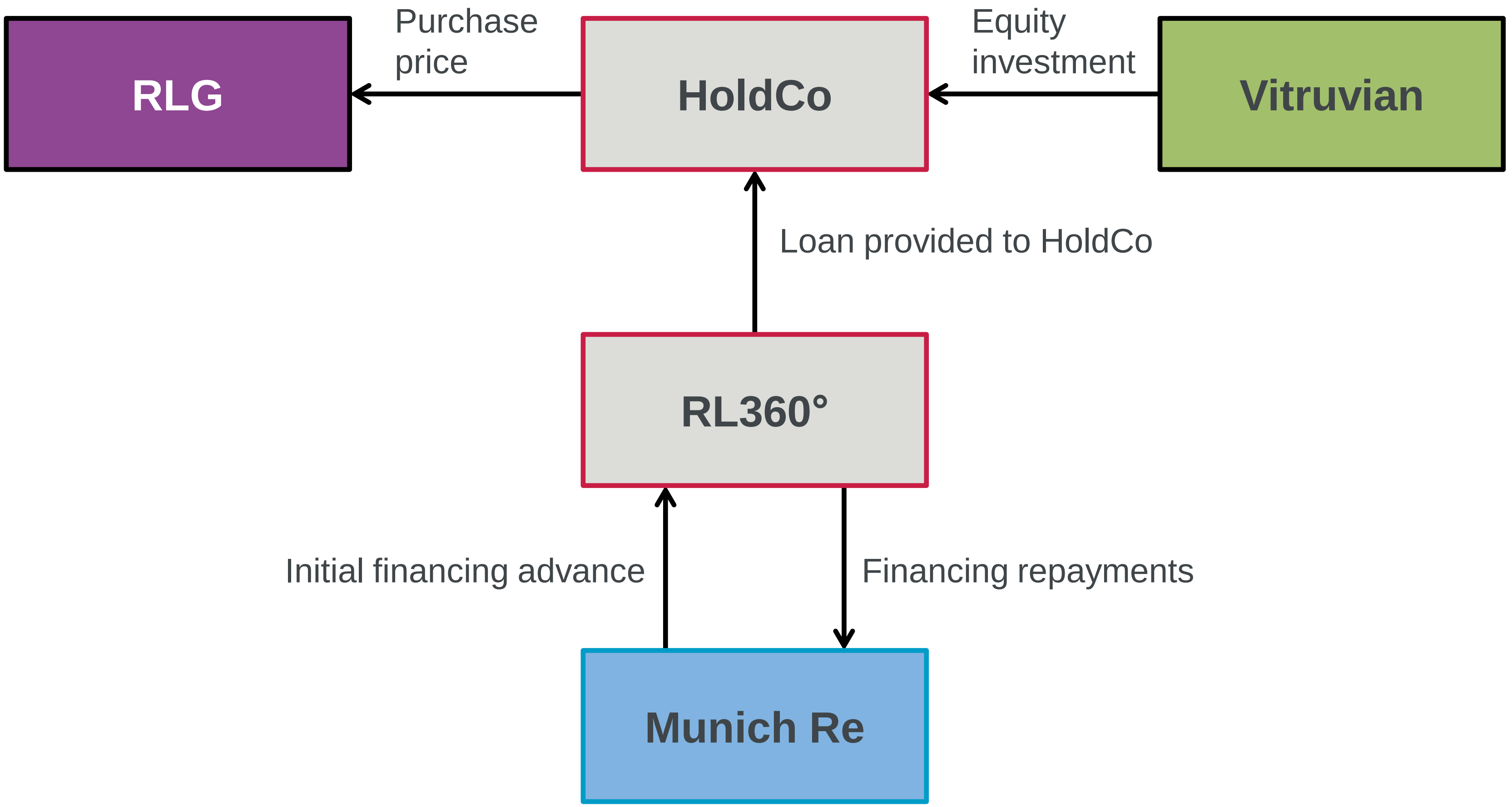
Indicative bank financing structure

- Provided to the holding company, not insurance company
- Initial advance to finance the acquisition, plus a revolving credit facility (‘RCF’)
- Pay for RCF even if don’t use it!
- Easy to add other services (LIBOR / FX hedging).

Reasons for choosing reinsurance

- Understood the business better
- Able to provide the capacity required
- Flexibility of the new business financing facility
- Repayment schedule.

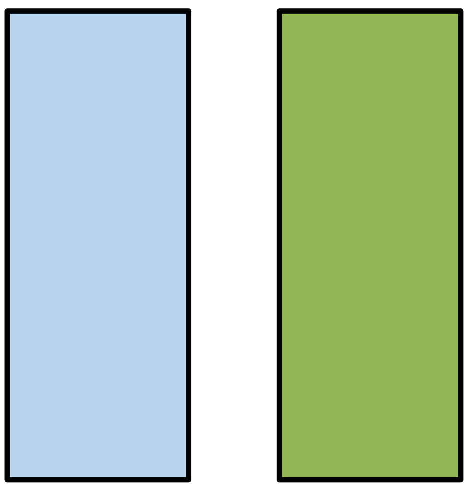
Financial structure of the deal



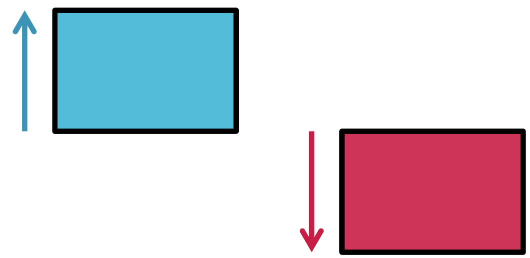
Rationale under Solvency I

Before entering into transaction **RL360° Balance sheet**	After entering into transaction **RL360° Balance sheet**

Assets Liabilities



Assets



- Increase by initial financing advance from Munich Re
- Reduce by the loan to HoldCo
- Net impact means assets unchanged
- Liabilities unchanged

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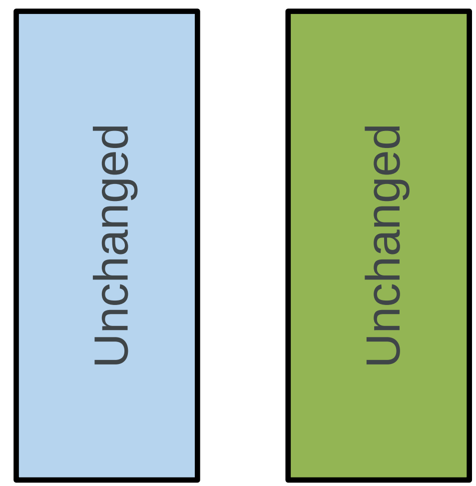
Liabilities



Regulatory approval

- Main regulator is in the IOM, but also have a branch in the Far East
- Early and regular communication
- Anticipate what they might need
- Be nice. You need their approval!

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Munich Re perspective

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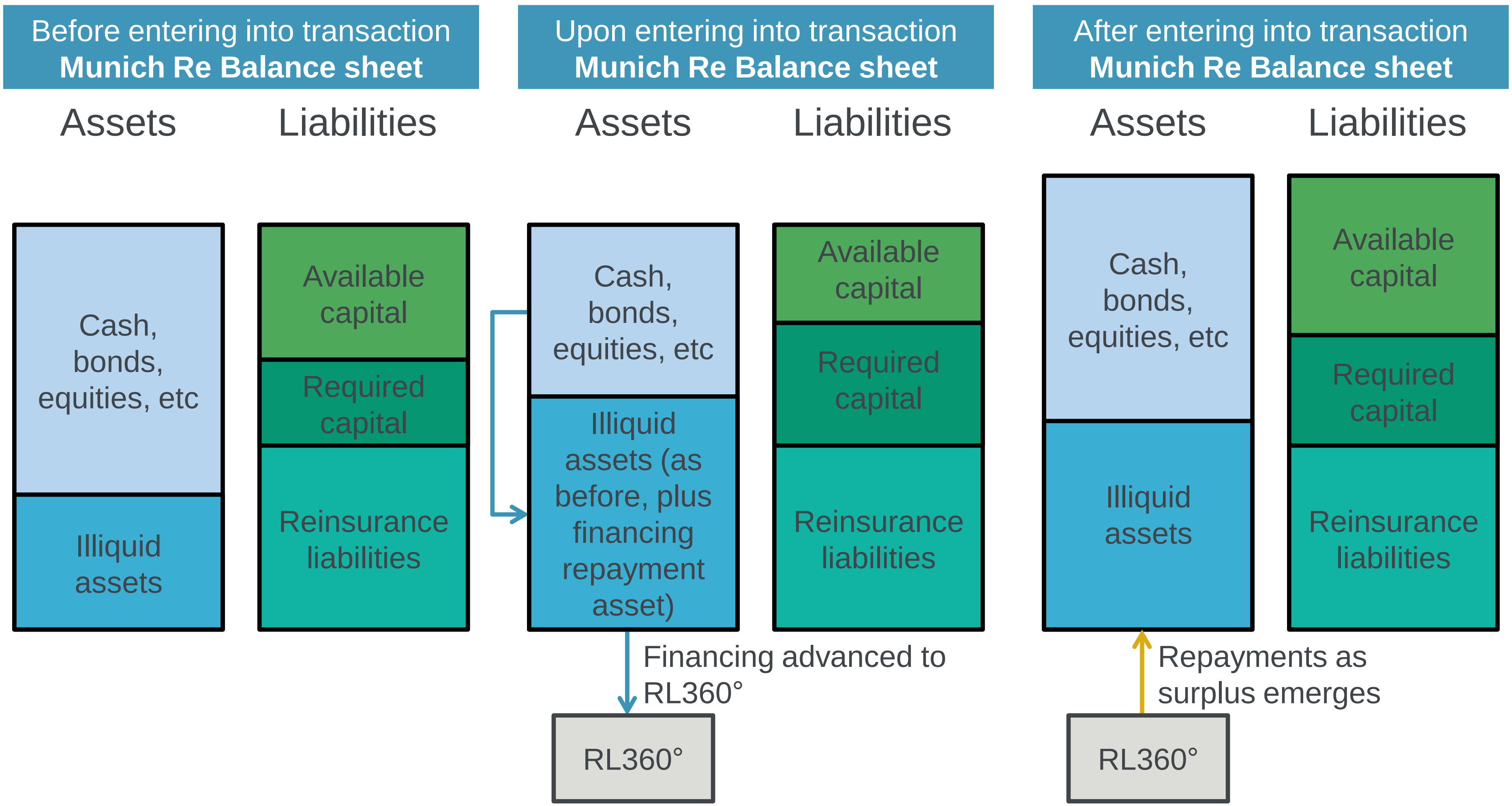
Rationale for providing financing

- Financial reinsurance is a core line of business for Munich Re
- The nature of deals has changed over the years to keep up with changes in regulatory environment and market demand
- Financing deals in excess of £1bn over the past five years in the UK, Ireland and offshore UK
- Cash financing covers a variety of client needs:
  - New business financing
  - VIF financing
  - Combination of VIF and new business financing, e.g. M&A transactions
- Price on MCEV basis
  - Need to meet internal IRR, RoRAC and liquidity hurdles.

Model for providing financing

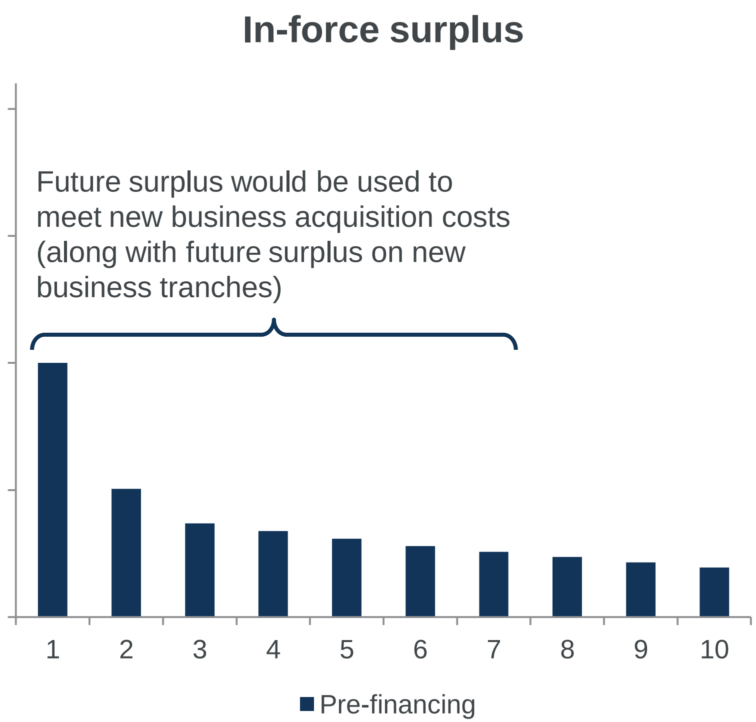


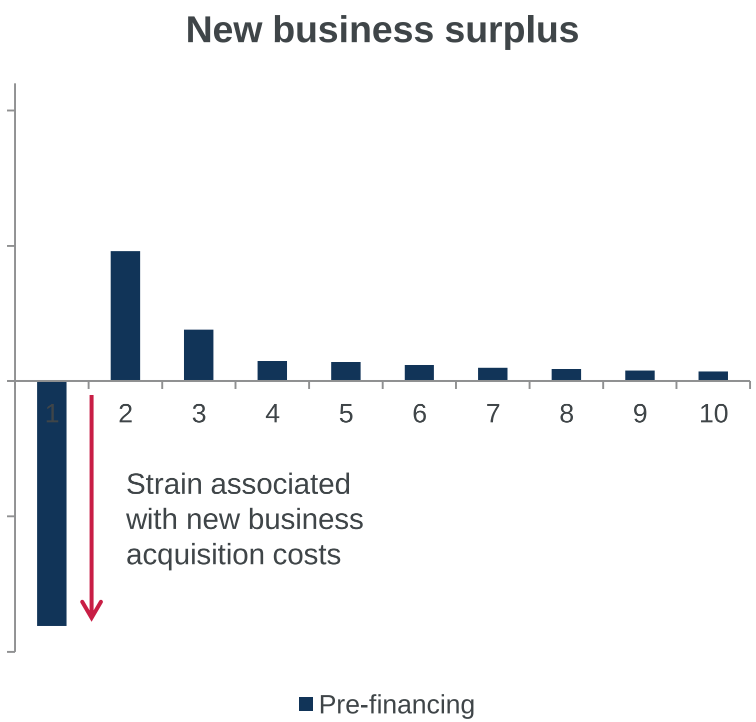
Munich Re timeline

- Jun 2013: Made aware of the planned MBO by RLG. Munich Re made itself known to Vitruvian
- Jun: Initial pricing work and indicative terms
- Jul: Munich Re selected as financing partner
- Jul – Aug: Detailed pricing and due diligence
- Aug – Sep: Internal approval process completed. Sent commitment letter to RL360°
- Sep – Oct: Agreeing reinsurance treaty
- 14 Nov 2013: Completion.

Typical U/L insurer cashflow profile

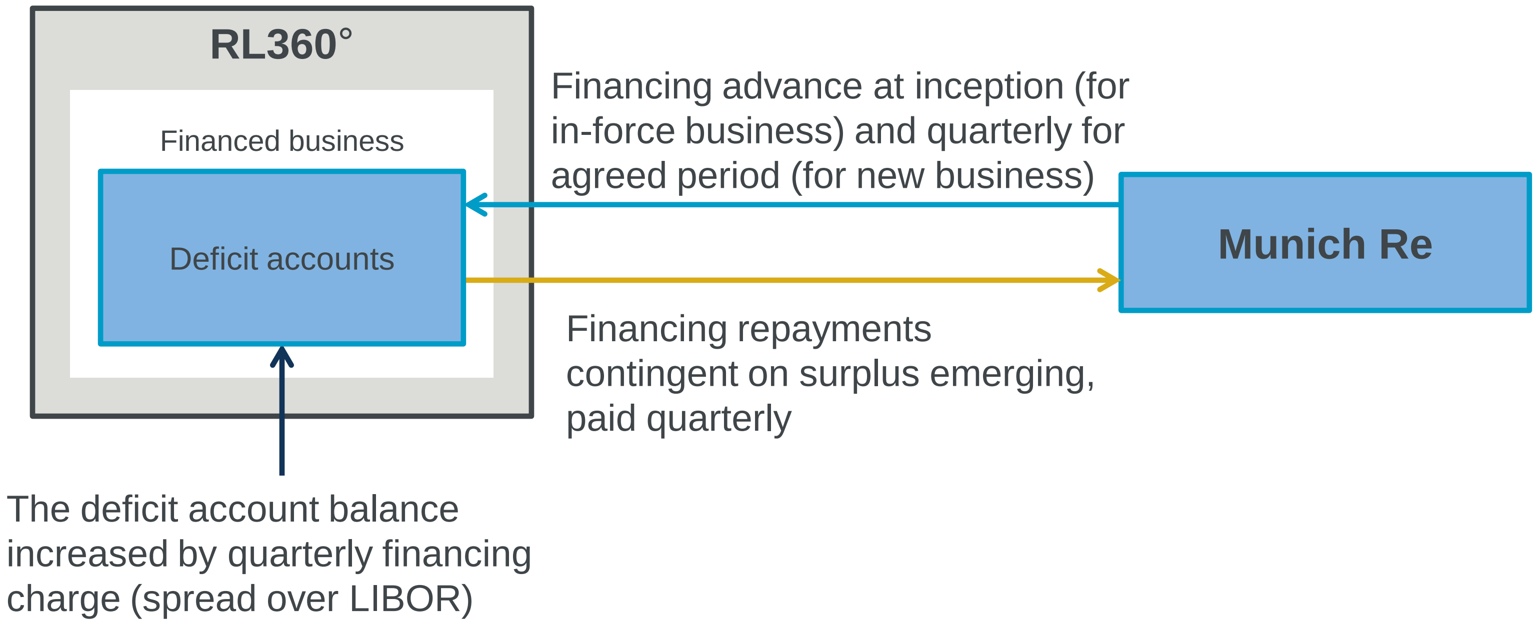
- In the absence of financing, the future surplus emerging on in-force business would be used to meet the new business strain (although there is still a risk of rapidly growing new business volumes)
- The following cashflow profiles for in-force and new business are broadly representative of the RL360° business (in relative terms):





Financing structure

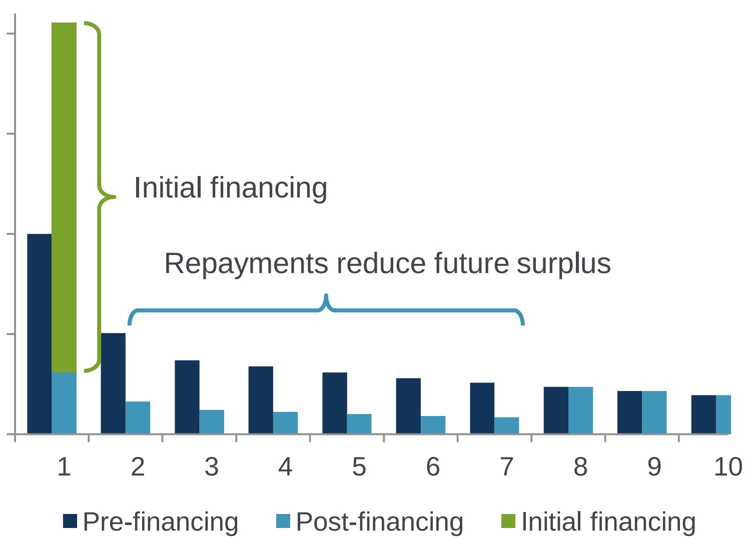
- Operates on the asset side of the RL360° balance sheet by providing cash
- No impact on the liability side as financing repayments are contingent on surplus emerging
- Similar to a contingent loan, but written in legal form of a reinsurance treaty
- Deficit accounts are used to track the outstanding balance between RL360° and Munich Re.



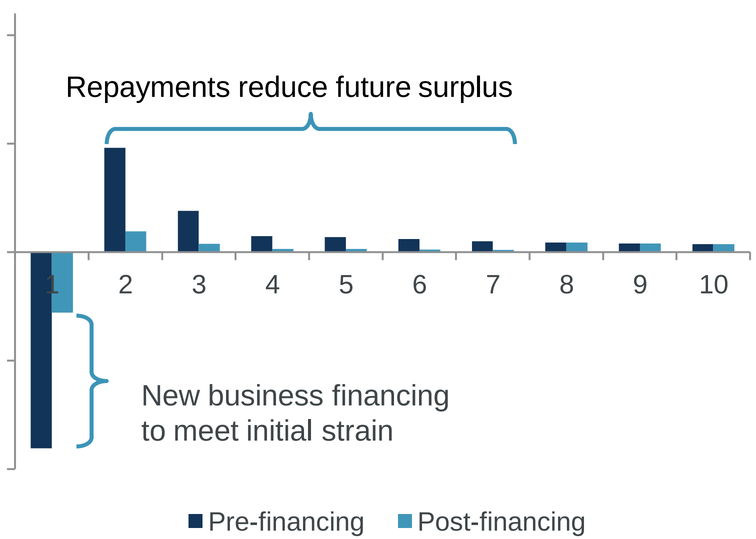
Initial and new business financing

- Initial financing up-streamed as a loan to part-meet the purchase price to RLG
- Initial financing means that the VIF is encumbered and so the future surplus can no longer be used to meet the new business strain
- New business financing is provided to meet the new business strain (and ensure solvency requirements are met)
- Future surplus is reduced to meet financing repayments.

In-force surplus



New business surplus



Reinsurance treaty – Key provisions

- **Financing advances**
  - Initial financing at treaty inception, based on an optimal quota share of the VIF
  - For new business, the maximum financing advance in each quarter is calculated at the end of the quarter as the present value of future surplus emerging on new business, discounted at a high interest rate. RL360° able to choose a reduced amount
  - Consequently, financing advance is dependent on the volume of new business written
  - There is an overall new business financing limit, with respect to the financing advance and the number of tranches of new business
- **Financing repayments**
  - Financing repayments are taken as surplus emerges on the covered business
  - Repayment of the initial financing is capped at the expected surplus as projected at treaty inception, provided the VIF coverage for that business remains at agreed level
  - Financing repayments allow for an expense allowance specified in the treaty.

Reinsurance treaty – Key provisions

- **Deficit account interest**
  - Specified as a spread over LIBOR
  - Spread is primarily driven by the credit risk inherent in the agreement
  - Flexibility allows the spread on new business financing to be increased in a formulaic way if there is a significant increase in the perception of future credit risk
- **Recapture**
  - Additional flexibility built into the treaty allows for recapture possibility
  - A private equity firm would look to exit the venture at a future point. Recapture options allow for maximum flexibility in the exit process
- **Currency**
  - The treaty recognises the international nature of the business
  - Allows for the inclusion of multiple currencies.

Due diligence

- Meetings and discussions with RL360° to understand the business and ask key questions
- Analysis of RL360° cashflows of both the in-force book and projected new business
- Built a model of the RL360° balance sheet to examine projected solvency and risks of insolvency
- Lots of scenario testing
- Credit risk analysis of RL360° performed.

Risk assessment

- **Credit risk**
  - Munich Re acquired credit risk exposure to RL360° – this is often the dominant risk for reinsurers in typical cash financing deals
  - Reinsurer will carry out a full credit risk assessment of the insurer to form a view on the extent of the credit risk
  - Local insolvency rules applicable to the insurer are a key element of the assessment
- **Market risk**
  - Indirect exposure, as one component of surplus is the fund based management charges, which are influenced by movements in underlying fund values
  - Lower market returns will result in lower repayments, thereby extending the repayment period and potentially increasing the risk of non-repayment
- **Currency risk**
  - Greater part of the currency risk is matched, with a small portion of the risk remaining with RL360°.

Risk assessment

- **Surrender risk**
  - Surrender protection at early duration because of commission claw-back and surrender penalty on surrender
  - Some surrender risk on longer duration fund based charges
  - Need to examine past experience to understand the main drivers behind surrenders, including the impact of changes in economic conditions and market and regulatory reforms
- **Biometric risk**
  - Low, as the contracts covered by the treaty do not contain any material sum at risk
  - But there is a loss of future surplus when a policyholder dies
- **Operational risk**
  - Low, due to the characteristics of RL360° and the type of business it sells
- **Expense risk**
  - Remains with RL360° as the surplus emerging is calculated using an expense allowance.

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Summary and lessons learned

What each party got out of the deal

- **RL360°**
  - Initial financing which was used to part-meet the purchase price
  - Flexible new business financing facility to allow RL360° to continue operations in the face of much reduced surplus from in-force business
- **Munich Re**
  - Existing long term assets replaced by financing repayment asset
  - Obtained a relatively predictable, secure, low risk asset
- **Vitruvian**
  - A geared equity investment, consistent with the typical private equity model, but without risking the insurance company
  - Return is dependent on sale price at exit (as shown in example).

Lessons learned from the process

- Problems do crop up
- Look to work with people who want to solve problems
- It takes longer than initially expected
- Look to involve the regulator at an early stage and take on board any concerns that are raised.

Effect of the deal on RL360°

- Little day-to-day change
- No longer part of an insurance group
- But ... things have been going relatively well so far.

Questions

Any questions?