

# **1999 General Insurance Convention**

**Shareholder Value in Practice**

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# Shareholder Value in Practice

- What I won't be talking about
- Uses of shareholder value approach
- Practical issues of application
- What about the intangibles ?
- DISCUSSION

# What I won't be talking about

- Financial economic theory
- Finer points of different valuation approaches
- Previous actuarial texts

# Do you recognise these quotes?

..... is now ready to look outwards to the reaction of shareholder-value in the markets of the future.

....accounting measures do not perfectly reflect the creation of a shareholder value. As a result, the company is studying other indicators... that will better enable us to quantify the creation of a shareholder value.

....Each business unit must contribute to increasing the value of the Group as a whole and must, therefore, continuously assess which actions will make it possible to achieve a positive contribution above the cost of allocated capital. This is our key criteria for measuring the success of management.

...”We decided we would adopt a single objective: to double shareholder value every three years. Of course, we still had to improve customer satisfaction, motivate employees, and so on, but these things were means to an end, not an end in themselves.” Lloyd’s TSB

...”We have got to get out of areas we are not good at and build shareholder value in the ones we are.” GRE

# Capital and shareholder return

- **“The strongest driving force in the industry is the interplay between the cost of capital and the creation of shareholder value”**
  - Michael Butt, Director of XL Capital, rendez-vous 21 Financial Times business 1999
- **“The insurance industry is in trouble...it has too much capital. Shareholders should ask firms to give it back to them.”**
  - The Economist 16 January 1999

# Current topic

## Britannic / United Assurance

“From time to time Britannic reviews whether or not a combination with United Assurance would create additional shareholder value.”

“In terms of shareholder value, it’s an obvious area to investigate.....”

- Britannic spokesperson - 11 October 1999

# Analysts and investors are focused on value creation

**EVA...makes you invest in positive spread projects. Its gets management to think about how you manage the capital**

***Credit Suisse First Boston***

**Management of the composites are increasingly focused on Shareholder Value creation**

***Morgan Stanley***

**EVA can become an essential management tool ... the background of a powerful management approach**

***Morgan Stanley***

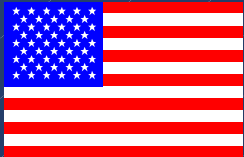


# Investment analysts' approach



**163 of the world's top 200 institutional investors use cash flow based software tools**

*Source : Investors Chronicle*



**68% of leading US analysts use free cash flow**

*Source : PwC Research, The Taylor Group USA*

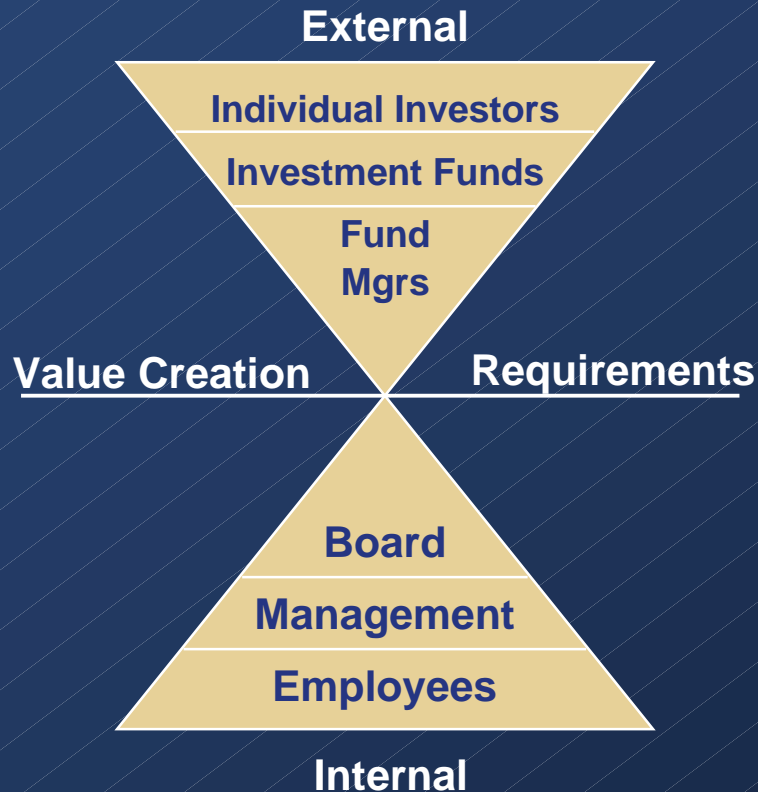


**65% of leading UK analysts regularly use free cash flow  
29% sometimes use free cash flow**

*Source : PwC Research, Harris Survey UK*

# Why focus on shareholder value

**Increasing pressure to manage for value...**



- Globalisation of markets - institutions invest where returns are greatest
- Consolidation of industry sectors - tougher competition and comparison with peers
- Deregulation, development of new equity markets and movement of investment
- Internal performance increasingly measured against value creation

# Uses of shareholder value approach

- “Corporate management”
- Strategic decision making
- Performance measurement
- Assessing mergers and acquisitions
- Executive compensation

# In reality few deals result in the increase in value originally anticipated

Study after study has shown that most acquisitions fail to create value for the acquirers' shareholders

**Banking Strategies**  
1998

Of 150 recent deals valued at \$500m+, about half destroyed shareholder wealth

**BusinessWeek** 1995

Merger costs are recovered within 10 years in only 23% of transactions



1997

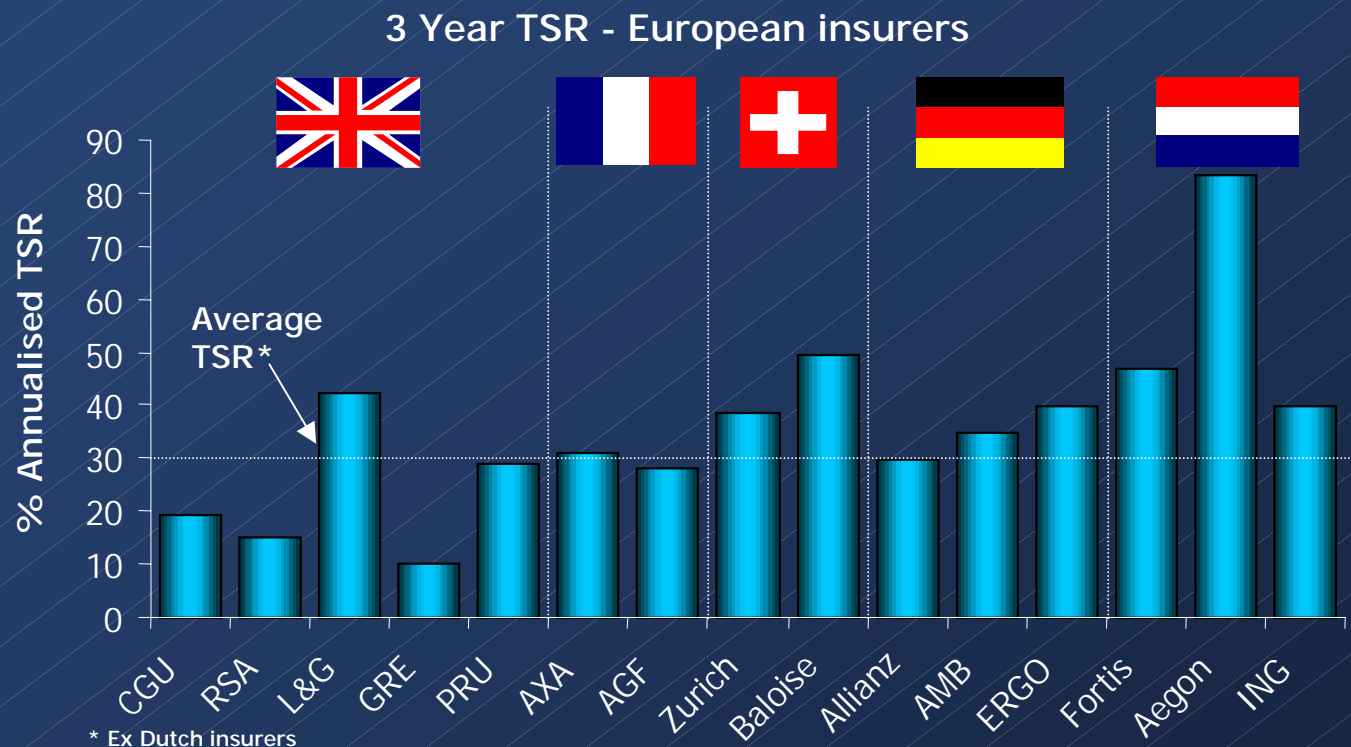
Barely 50% of mergers and acquisitions between financial organisations have created value for shareholders

**Sir Brian Pitman, Chairman**



1998

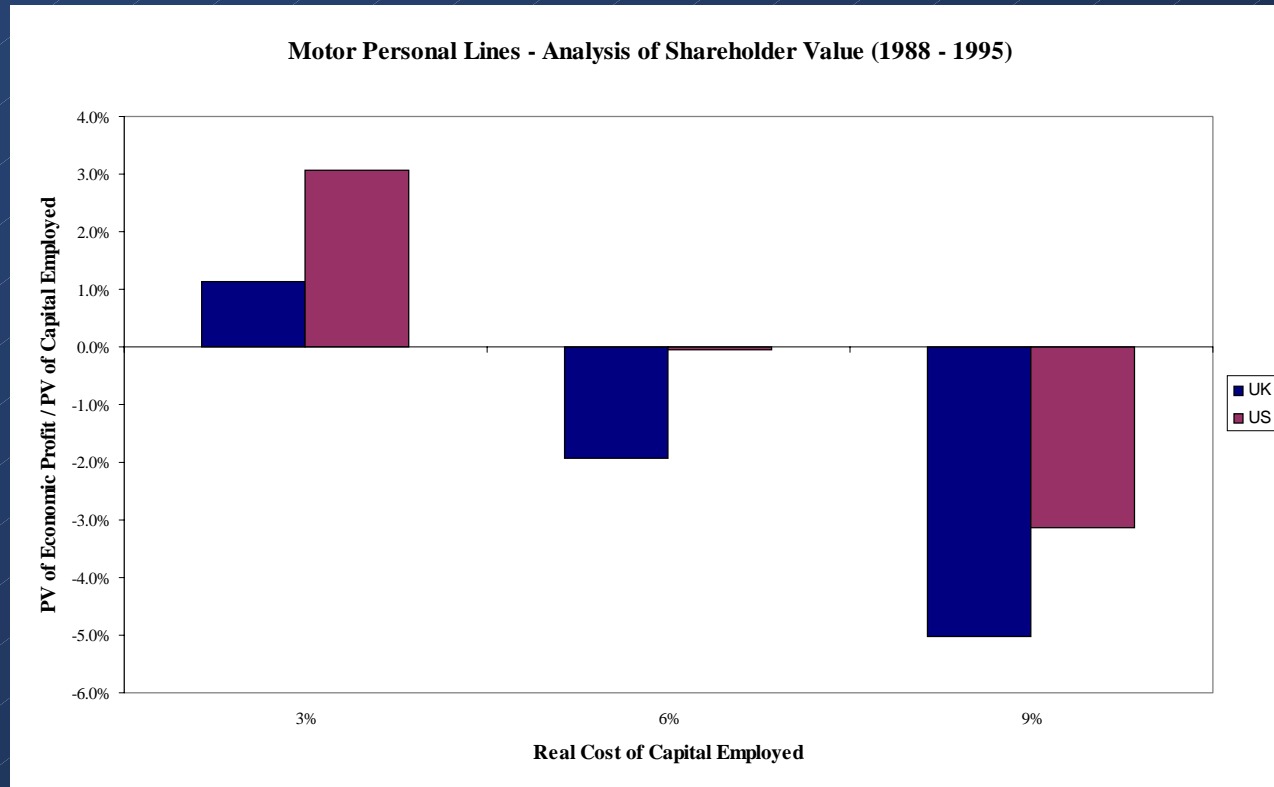
# Shareholder Value for Insurance Companies



The Total Shareholder Return (TSR) over the 3 year period from December 1995 to December 1998 for Europe's largest quoted insurance companies averages 27%.

However, some companies, most notably UK composite insurers have significantly under-performed the European average.

# Shareholder Value - Example



# Shareholder Value - Theory

*“Value is created if the spread on policyholder funds is greater than the (negative) spread on investor’s capital”*

*This will be close to the risk-free rate*

$$(\text{Funds}) \times (\text{Inv. Return}_f - \text{Cost}_f) > (\text{Equity}) \times (\text{Cost}_e - \text{Inv. Return}_e)$$

*This is where the insurer traditionally makes money: getting this rate well below the risk-free rate*

*This will be determined by investors’ demands*

# The usual approach

- Discounted cash flows
- What risk - adjusted discount rate ?
- Contentious actuarial issues !



# Other practical issues

- Time - horizon for projections
  - competitive advantage
- The insurance cycle
- “Realistic” projections
- Value - drivers
- The information gap
- Degree of complexity

# Measuring the intangible !

- Brand value
- Customer satisfaction
- Market sentiment
- Scarcity value

# Introducing shareholder value concepts in corporate management

- Straightforward and understandable vs. realistic
- Need for a “balanced scorecard” approach
  - non-financial measures
  - operational effectiveness
  - technological capability
  - innovation and development
  - HR issues
    - personal career development
    - training
    - retention / recruitment
- The really difficult issues !

# A few suggested points for discussion

- Does shareholder value concept make sense ?
- Complexity of modelling framework
- Where can actuaries add value ?