View from the
RIDGE

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State of the Property Casualty M&A Market – Implications of the OneBeacon Insurance Group Renewal Rights Transaction with The Hanover Insurance Group, Inc.

With the continuing soft market conditions in the property casualty industry and relative stability in the broader economy and financial markets, we expect that merger and acquisition activity ("M&A") for property casualty insurance companies will increase in 2010. As carriers continue to face a challenging rate environment with limited organic growth opportunities and excess capital, the appetite for growth through M&A will increase. We have seen a heightened interest in acquisitions from the buy-side with only modest interest in selling. Accordingly, as we move into 2010, we would also expect M&A valuations for property casualty carriers to increase.

Whole company acquisitions of insurance companies will likely drive a major portion of the M&A activity in 2010. However, the renewal rights transaction announced by OneBeacon Insurance Group ("One Beacon") on December 3, 2009 to sell its non-specialty book of small and middle market commercial business to The Hanover Insurance Group, Inc. ("Hanover") provides some contrasting and interesting insights into the state of the M&A market. StoneRidge has already received inquiries on the best strategic options to gain access and execute on any additional renewal rights transactions in the marketplace.

Transaction Summary – OneBeacon Insurance Group renewal rights transaction with The Hanover Insurance Group, Inc.

According to OneBeacon, the book of business that was acquired included approximately $490 million of premium. Hanover will pay $23.25 million (representing 4.7% of premiums) at closing and 10% for premiums renewed above $200 million. Historically, the book has renewed at a rate of approximately 80%. Since renewal rights buyers often use the transfer to re-underwrite the book and raise prices or non-renew unprofitable business, we would expect the renewal rate to be somewhat less than 80%. An 80% renewal rate would bring an additional $19.2 million payment to OneBeacon (likely not paid until 2011). The total payments of $42.45 million would represent an 8.7% rate on the $490 million of premium.

In addition to receiving consideration ranging from a minimum of $23.25 million to our estimated maximum payment of $42.45 million, OneBeacon will be able to release capital tied up in the business and reallocate it to support its specialty underwriting operations.

The company should also be able to generate cost savings from the expected transfer of certain employees associated with the business.

For Hanover, the transaction represents the opportunity to pick up an attractive book of business (which they can re-underwrite and re-price), expand their relationships with independent agents, utilize excess capital and avoid most liabilities associated with the business.

Overview of Renewal Rights Transactions

Renewal rights agreements represent the exclusive transfer of rights to renew business. Over the last decade, renewal rights have been used in several dozen transactions in the property casualty and reinsurance industry. See a sample of these transactions listed in the following table:

Examples of Renewal Rights Transactions in the Property Casualty Industry ($ in millions)

Year	Seller	Buyer	Business	Premium
2009	OneBeacon	The Hanover Insurance Group	Non-specialty small and middle market commercial business	$490
2009	AequiCap Program Administrators	Tower Group	Workers compensation	$40
2009	Employers Direct	GNW-Evergreen Insurance	Direct placed workers' compensation	N/A
2007	Unitrin Inc.	AmTrust Financial Services, Inc.	Business insurance segment	$165
2006	OneBeacon	QBE Americas	Agri business	$86
2005	Employers Reinsurance	ACE Group	Alternative risk hospital portfolio	N/A
2003	Argonaut Insurance	Coregis Insurance	Public entity business	$100
2003	White Mountains Insurance Group	CNA	Reinsurance	$600
2003	Travelers Property Casualty	Atlantic Mutual	Marine business	$110
2003	St. Paul Companies	Kemper	Middle market and small business	N/A
2002	Endurance Specialty Holdings	LaSalle Reinsurance	In-force CAT book	$133

Generally, renewal rights transactions have a few common components:

- Consideration is usually in the form of an up front, or guaranteed, payment plus additional, contingent payments in the future based on actual premium renewed above an agreed upon minimum. Typically, contingent consideration is based on renewal rates and paid out over a 1-3 year period. Occasionally, contingent payments have been tied to the loss ratios on the renewed business. Depending on lines of business and the renewal period, total consideration is typically 3% to 10% of the renewed premium. Niche specialty classes or lines of business tend to be valued higher than standard commercial or personal lines. The rate can also be scaled to pay a higher percentage based on the amount of premium renewed.

- Employees associated with the business are often transferred through a commitment of the buyer to hire a certain number of the seller's employees. Sellers most often agree to non-solicitation of employees in addition to a non-compete on the book of business.

- Loss and loss adjustment expense reserves and other liabilities are generally not transferred, although in some reinsurance renewal rights transactions, unearned premiums have been transferred through quota share reinsurance agreements. The seller generally retains existing reserves and manages the run-off, thereby benefiting or suffering from development in that run-off.

- Fixed assets associated with the business (software, furniture, etc.) are often transferred at fair market value. Insurance licenses are generally not transferred, although sometimes shell companies with licenses are sold as part of the transaction. Alternatively, sellers may "front" for the buyer until the buyer obtains the proper licenses.

- Capital and surplus associated with the business is usually not transferred as it would be equivalent to "swapping dollars" between the buyer and seller. The seller can reallocate exiting capital supporting the business to new lines or extract the capital through dividends or a sale of the remaining shell company.

Implications for the Property Casualty Insurance M&A Market

We think the OneBeacon/Hanover transaction highlights some interesting themes on the state of the insurance M&A market. Most often, renewal rights transactions are seen in distressed situations where acquirers do not want to purchase the stock and liabilities of a particular insurance company or during hard markets when buyers are scarce. In the OneBeacon transaction, neither the buyer nor the book of business was distressed. For several reasons, however, a renewal rights transaction probably was the "best execution" for the line of business exited by OneBeacon.

First, renewal rights transactions can be a much more efficient way to transfer a business rather than the sale of a whole company. Unless buyers are interested in some of the contractual assets or licenses, infrastructure, agency plant, etc., buyers will tend to favor renewal rights transactions for the relatively modest premium paid and for the "you get what you pay for" aspect of the transactions. Buyers do not have to value existing reserves or an investment portfolio because they are not acquiring those items. We presume that OneBeacon did not have a company to sell, and Hanover did not need the licenses or the infrastructure associated with the business. Due diligence efforts and costs are also reduced compared to a whole company acquisition.

From a valuation perspective, a one-time payment of 4.7%-10.0% of premiums seems modest, especially compared to the 57% premium to book value paid by buyers for acquisitions of whole property casualty insurance companies over the last three years according to data from Capital IQ. However, depending on the amount of capital released in the transaction and the size of the contingent payments, the transaction is roughly the equivalent of OneBeacon being paid between 1.05 times and 1.20 times book value while retaining any profits in the unearned premium reserve and investment income during the run-off of the loss reserves. Additionally, when you consider that the average, publicly traded commercial lines insurance company is trading around 90% of GAAP book value, the "premium" to implied book value appears somewhat higher. M&A control premiums for the industry have generally ranged between 25% and 30% above trading values, putting an expected M&A valuation today closer to 1.20 times book value than the historical 1.57 times. As demand for insurance company acquisitions increases in 2010, however, we would expect the median valuation to increase as well.

One of the major challenges for the property casualty industry today is the increase in excess capital. Until excess capital is reduced through losses (e.g. catastrophes, inadequate pricing, and investment losses) or returned to investors through dividends, buybacks or M&A proceeds, the excess capital will continue to be a factor in prolonging the soft market environment.

During a soft market, it is increasingly common that companies have divisions or lines of business that are not earning an adequate rate of return to cover their cost of capital. In today's M&A environment, it is unlikely that such a business would command any meaningful premium to book value. However, a renewal rights transaction can free up capital while generating some consideration for the seller as well as provide premium growth in a capital efficient manner for a buyer. As M&A activity increases in 2010 and valuations for insurance companies increase above book value, we do expect to see a shift towards whole company acquisitions.

About StoneRidge Advisors

StoneRidge Advisors is an investment banking firm that specializes in the insurance industry. Our clients include property, casualty, life and health insurance companies, reinsurance companies, as well as insurance brokerage, managing general agency, claims management and other related service companies. Our firm combines extensive experience and best practices to help our clients achieve their strategic goals and financial objectives.

Services

StoneRidge Advisors provides services related to all aspects of an M&A transaction, including identification, valuation, negotiation, structuring and financing. In addition, we assist companies in developing and executing upon capital raising initiatives.

Mergers & Acquisitions

- Buy-Side Advisory
- Sell-Side Advisory

Capital Raising

Consulting Services

Financial Advisory

- Business Valuations
- Fairness Opinions
- Consulting Services

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