Property Casualty Intelligence Briefing

Inside P&C

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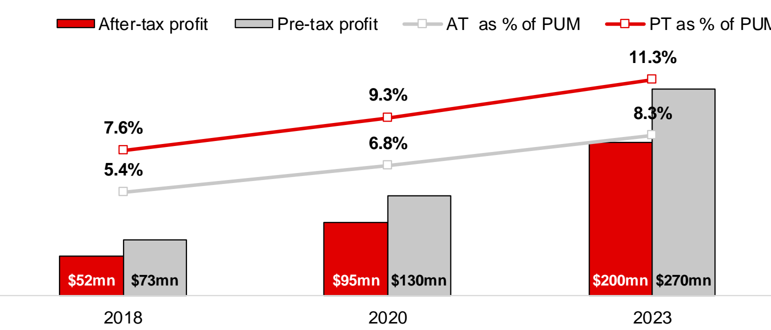
TOKIO MARINE MAKES A PURE BET ON HNW



Executive Summary: On Thursday, Japanese insurance conglomerate Tokio Marine announced it would be acquiring high net worth (HNW) insurer Pure for $3.1bn. At 33x forward earnings, the deal screens as expensive. However, the combination of a long-term strategic owner with a low cost of capital, potential growth, and a scarce and high quality business model contribute to the valuation. Even so, the deal represents four big bets.

(1) In some ways, in line with prior transactions by Tokio, this is a simple bet on business quality. Pure has scarcity value and a higher quality earnings stream from its fee-based business.
(2) Second, this partly a bet on HNW as a market niche. Pure is positioned in a market segment with a natural oligopoly-like structure that appears defensible from new entrants and is hard to commoditize. The segment's growth has also been strong and is predicted to continue (though faces political wildcards).
(3) Third, given the growth estimates outlined by the company, Tokio appears to be betting that Pure's market share gains can continue in a growing market (a "better mouse trap" bet). Given the context of its main competitor AIG pulling back, and the opportunity to turbo-charge growth with reinsurance support and a better credit rating, the timing appears excellent.
(4) Finally, though this is largely an additive and strategic transaction rather than a cost-driven consolidation, there does appear to be some available financial synergies, largely through reinsurance.

However, whatever the strategic rationale, ultimately this deal is premised on growth. Simply put, living up to the announced lofty growth goals is what will make or break the success of the transaction from a financial perspective, even with a long and patient owner.

Aside from the equity holders among the Pure management team, the clear winners of deal are early private equity backer **Stone Point Capital**, along with shareholders **KKR** and **Axa-XL**, with obvious losers being Pure's reinsurance partners and brokers. More details below.

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Index	QTD	YTD
Large Cap	(4.0)%	22.5%
Regional	(1.8)%	10.9%
Specialty	(2.8)%	24.9%
Personal	(3.5)%	17.5%
Bermuda	(2.5)%	34.9%
Florida	(2.6)%	(18.8)%
Brokers	(3.0)%	23.8%
IPC Select	(2.9)%	11.1%
S&P 500	(2.2)%	16.1%
S&P Fin.	(4.0)%	12.9%

Source: S&P Global, Inside P&C

TOKIO MARINE MAKES A PURE BET ON HNW GROWTH

- ***Tokio Marine agrees to buy Pure for $3.1bn, or 33x forward earnings***
- ***Deal represents a big bet on HNW market at interesting juncture, as some competitors pullback, but new entrants continue to attack the space with limited success***

On Thursday morning Japanese insurance conglomerate Tokio Marine announced it would be acquiring high net worth (HNW) insurer Pure for $3.1bn. At 33x forward earnings, the deal screens as expensive. However, the combination of a long-term strategic owner with a low cost of capital, potential growth opportunities, and a scarce and high quality business model contribute to the valuation. Fundamentally, the deal represents four big bets.

(1) In some ways, in line with prior transactions by Tokio, this is a simple bet on business quality. Pure has scarcity value and a higher quality earnings stream from its fee-based business.

(2) Second, this partly a bet on HNW as a market niche. Pure is positioned in a market segment with an oligopoly like structure that appears defensible from new entrants and is hard to commoditize or disintermediate with technology. Additionally, the HNW segment of the market has outpaced the growth of other segments, and is widely expected to grow faster than other areas of insurance.

(3) Third, given the growth estimates outlined by the company, Tokio appears to be betting that Pure's out-sized growth can continue. For context, the firm has grown premiums at a CAGR of 29% since 2014 but in recent years this has slowed to ~20%. With the company forecasting ~9% growth for the HNW industry but ~20% for Pure, this will require some combination of market share growth, deeper penetration of the HNW market into under-served mass-affluent customers (~$1-$3mn range policies), or pricing. Part of this bet is likely an explicit expectation that Tokio can turbo charge growth with financial support = a better financial rating, cheaper and more flexible reinsurance to allow more concentrations and aggregations that might have been harder in a tighter reinsurance market.

(4) Finally, though this is largely an additive and strategic transaction rather than a cost-driven consolidation, there does appear to be some available financial synergies, largely through reinsurance. At a high level, the company is projecting expanding dollars of after tax profit per dollar of premium under management from 7.6% to 11.3%. (Note, as we explore below = losers are the reinsurers). There could also be some available tax synergies available by offshoring earnings through reinsurance, and this does seem to be marginally implied in the firm's earnings projections (= implied marginal tax rate appears to be declining).

However, whatever the strategic rationale, ultimately this deal is premised on growth. Simply put, living up to the announced lofty growth goals is what will make or break the success of the transaction from a financial perspective, even with a long and patient owner. We go into more details below.

(1) The Bet on Business Quality

To understand the bet on quality, context is important. The move by Tokio is a continuation of a string of deals the company has made in the last decade, primarily focused on international expansion, adding scale and diversifying the company's earnings stream.

Tokio is among the large Japanese players seeking growth overseas in markets with more favorable demographics outside of the perpetually stagflating domestic Japanese market, where low interest rates and a shrinking population pose significant headwinds.

Founded in 1879, Tokio until the last two decades focused on domestic growth before looking outwards and expanding into emerging markets life and P&C insurance and reinsurance.

In 2008 the company made two major acquisitions internationally, picking up Philadelphia Insurance Companies for $4.7B along with Kiln Group and its accompanying Lloyds operations for $900M.

Tokio went back into the market in 2011 with its acquisition of Delphi Financial for $2.7B and returned once more with the $7.5B spend on US insurer HCC in 2015, citing growth diversification, and capital efficiency as the main reasons for the purchase.

EXHIBIT: TOKIO MARINE PRODUCT PORTFOLIO MIX

Source: Tokio Marine, Inside P&Cs

<table>
<tr><th colspan="2">Business Portoflio with limited overlap and high complementarity</th></tr>
<tr>
<td>

o Commercial Package
o Liability etc.</td>
<td>

o Homeowners
o Auto etc.</td>
</tr>
<tr>
<td>

o Excess workers' comp
o Group life, income indemnity etc.</td>
<td>

o Medical stop loss
o Crop
o Other specialty products</td>
</tr>
</table>

The acquisition of Pure is consistent with Tokio's historical M&A strategy of seeking out complementary businesses with limited overlap in product line, with high quality franchises and a respected management team in place.

Tokio's purchase of Pure also continues the trend of focusing on high growth targets—Pure grew at a 30% CAGR over the last five years—and higher margin businesses that require scale to succeed.

It also continues the repositioning of a company that this past spring closed on the sale of its reinsurance operations to Renaissance Re for $1.5B as the company focuses on product lines that allow it to get closer to the customer and take cost out of the business.

Where the purchase *departs* from Tokio's previous transactions is the fee-based nature of Pure's business.

Tokio's acquisition of Pure Group includes Pure Risk Management, the attorney-in-fact (AIF) for Privilege Underwriters Reciprocal Exchange, which receives premium and surplus contributions from policyholders.

The majority of the risk is ceded to the reinsurance market. Like a mutual, policyholders own the reciprocal, but rather than having an in house management, the reciprocal outsources its management requirements to the attorney-in-fact for a management fee.

Other subsidiaries of Privilege Underwriters, Inc., or Pure Group, include an insurance broker, a claims service provider of fine arts, and an insurance company that assumes part of the reinsurance from the reciprocal (= skin in the game).

The level of the fee paid to the AIF is roughly 20% of the reciprocal's GWP.

In 2018 the reciprocal wrote roughly $1bn in DPW, and with a ~20% management fee, Pure collected roughly $230mn in fee income, and AT profits of $52mn.

Of course, the high quality earnings stream in the form of a fee-business is recognized in the valuation paid.

The price of $3.1bn, put the acquisition at a trailing earnings multiple of 60x. To get a forward multiple of 15x, Tokio will need 16 years of 9% earnings growth (its expected HNW population growth rate).

Another way to frame this is to consider that a 60x PE represents a zero-growth earnings yield of 1.7% - about in line with risk free rates in the US currently. Given the inherent business risks, and lack of cost synergies, clearly, this is a deal that needs a lot of growth to make financial sense – whatever the earnings quality.

Now, in general, the market tends to be suspicious of insurance M&A that is dependent on lofty growth ambitions. However, Pure's positioning in a growing market segment and track record of market share gains make this a more plausible narrative than many commoditized markets where growth simply means competing on price. We explore these themes below.

(2) The bet on high net worth

The HNW business has long been considered attractive. Unlike most forms of insurance which are largely mandatory purchases, HNW insurance often involves the rare situation where the purchaser has a significant affinity for the insured properties and is price insensitive.

They are therefore willing to pay for quality insurance coverage and service rather than simply buy on price = the product is less commoditized.

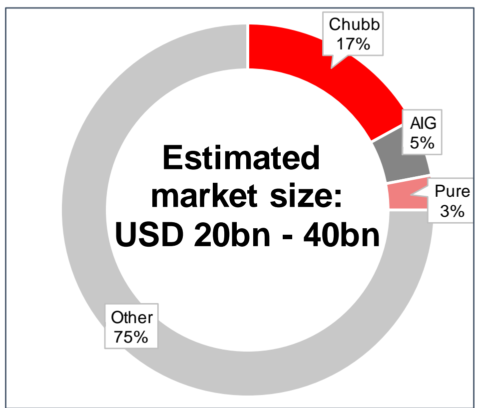
Similarly, the complexity of the buyers needs makes it hard to disintermediate with technology (The “Geico effect”), and the multiple coverages including umbrella and liability coverages lessen long-term redundancy risk inherent in some personal lines products (e.g. auto).

However, notably, the multiple coverages involved in these bundled products make it hard for external observers to track true profitability. Much of the business involves coverages for objects like fine art, yachts, private planes, and exotic cars, which are spread across multiple lines in the statutory accounts. Liability coverages can also include personal umbrella, liability coverages in the homeowners product, as well as workers compensation covers for domestic workers.

Even so, it has long been widely thought of as a highly profitable business for the leading participants.

EXHIBIT: HNW MARKET BROKEN DOWN BY MARKET SHARE

Source: Tokio Marine, Inside P&C



Conservative calculations put the industry at around $10bn for the ultra-HNW business dominated by specialty carriers like AIG, Chubb, and Pure. At the time of the ACE-Chubb merger, CEO Evan Greenberg put his firm’s share at about $5bn on its own.

However, the larger ‘mass-affluent business’ with homes valued at $1m or higher is more like a $40bn-$50bn business, and is more fragmented. This is partly due to the fact that standard lines carriers are more able to deal with aggregation issues and gross line sizes at these levels, meaning much of that business remains in the standard market.

Customers are also either more likely to “make-do” with more limited coverage options, or are unaware of their risk exposures as their wealth has expanded.

Market structure tested by new entrants post 2016 merger of Ace-Chubb

Following the merger of Ace and Chubb, many were optimistic that a spate of consolidation would provide opportunities for new writers to provide choice to agents and brokers, particularly in the lower end of the mass-affluent spectrum where less specialized products and services are required.

Such consolidation was caused by the acquisition of Chubb by Ace in 2016, combining two of the top four players in the space. Ace had already bought one of

the major competitors in that space in Fireman's Fund – for $365mn in 2014, adding to its own start-up operation that began in 2008 with the purchase of Atlantic Mutual, and was built out rapidly from there.

The combination led to a concentrated market, with three firms in Pure, AIG, and Chubb controlling well over half of the ultra-high-end market by most estimates.

Notable entrants in this space expanding with new teams, products, or geographies included Ironshore, WR Berkley, National General, and Cincinnati Financial, as well as many other standard line carriers simply expanding their risk tolerance.

However, the optimism about the opportunity for new entrants in HNW may be fading, with at least one carrier (Ironshore) abandoning its pursuit, while others have struggled to break out of the low single digit millions in growth.

This is an important data point for a big bet on HNW. There are three important reasons to think that a shakeout of new entrants was inevitable, and that ultimately an oligopoly like industry structure makes sense.

The first and most significant is aggregations of insured values. Not only does expensive real estate require huge gross lines, these exposures are often compounded by the expensive art collections/furniture contained within.

Additionally, these properties are very often agglomerated in highly concentrated geographic areas, typically in major urban areas or on the coast.

This is historically why it has been considered necessary to have a monster balance sheet like AIG to play in the high end of the market, as the strategy requires a tolerance for volatility and the ability to operate without reinsurance dependency.

(Significantly, this seems to have been the issue identified by Duperreault in AIG's recent losses in personal lines. Notably, 56 percent of the firm's homeowners premiums come from just three states: Florida, California, and New York).

A second issue is the high upfront expenses. The level of customer engagement requires a high level of service which can include appraisers, customer service agents on the front end, high-grade loss mitigation consulting and 'white-glove' claims handling post-event.

This type of service is not something that can be provided through third parties and therefore has to be built up-front. This means a lot of fixed rather than variable expenses. That makes it challenging to acquire sufficient scale to reach sustainable profits, allowing incumbents to compete by providing more expensive services.

Finally, there still remains the challenge of access to business. Though agents may value choice, their HNW individuals also often represent significant source of value for them. Quality products and a track record of service is still important, especially where clients are less price sensitive anyway.

This mentality leads to a certain amount of inertia, comparable to the old joke that "nobody gets fired for choosing IBM". Ditto for Chubb.

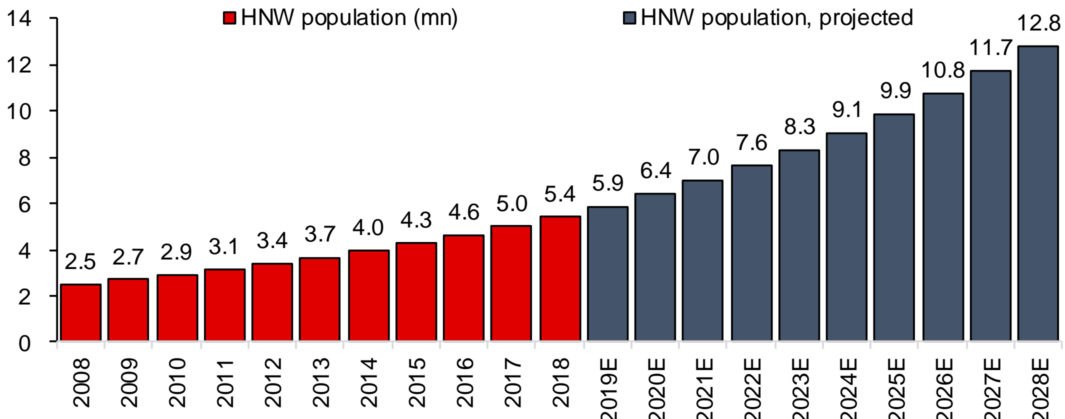
Ultimately, then, there are good reasons to think of Pure's position as one of a top 3 or so of players dominating the market is likely to continue despite increased market entrants, and as discussed above, the new entrants are unlikely to "poison the well" by price competition.

HNW market growth

There are also two good reasons Tokio cites as reasons to be optimistic about the growth of the market niche in general. The company cited market studies that showed 8% CAGR market growth over the past 10 years, and projected 9% growth in the following years, in terms of population.

EXHIBIT: PROJECTED US HIGH NET WORTH POPULATION (MN)

Source: Tokio Marine, Inside P&C



Secondly, there is the under-penetration aspect. As noted above, the leading HNW players only really account for a market of ~$10bn. If market estimates are right, there is plenty of opportunity to grow from under-penetration in the mass affluent space – the $10-40bn or so of market space not dominated by the specialists.

Additionally, recent wildfires in several HNW areas in California have undoubtedly raised the awareness of the risks facing very wealthy and affluent homeowners from under-insurance.

However, there is one wildcard worth noting. Many economists and financial commentators have observed the wealth gap in America has reached cyclical highs not seen in generations, and a resurgent populism emerging on both sides of the aisle (e.g. See Bridgewater's Ray Dalio just this week).

As such, there does appear to be policy risk from proposals such as wealth taxes or more aggressive income taxes that could reduce the growth rate of the HNW population, reduce the demand for scarce and luxury property assets (and therefore lower pricing and potential exposure), and generally make the future less like the recent past.

Call this the potential "Warren/Bernie headwind" for the HNW market, that represents a binary risk on the long run growth potential of the market that could impair the most optimistic growth forecasts.

(3) The Market Share Bet

However, even without the wind fully at its back on market growth, there would be reasons to be optimistic about the firm's near term growth opportunity.

First and foremost, the acquisition just appears fundamentally well-timed. Recall, just a few months back in February, AIG announced a major re-underwriting and risk-trimming of its HNW personal lines book due to concerns over its aggregations and earnings volatility.

This is likely to cause significantly more "at-bats" as more business comes to the market to be quoted. Recall, Pure's own retention rate is in the high 90s, which is a reasonable estimate for its two major competitors in the ultra-high end market absent a re-underwriting "push".

Second, there are the added benefits that come from being owned by Tokio Marine. The firm will likely see a boost to its financial strength rating – currently an A with AM Best to an A++ in line with its ultimate parent and putting it in line with Chubb.

Additionally, there is the prospect of Tokio providing more generous and flexible reinsurance terms that could allow the company to be more creative with concentrations and aggregations given Tokio's enormous balance sheet.

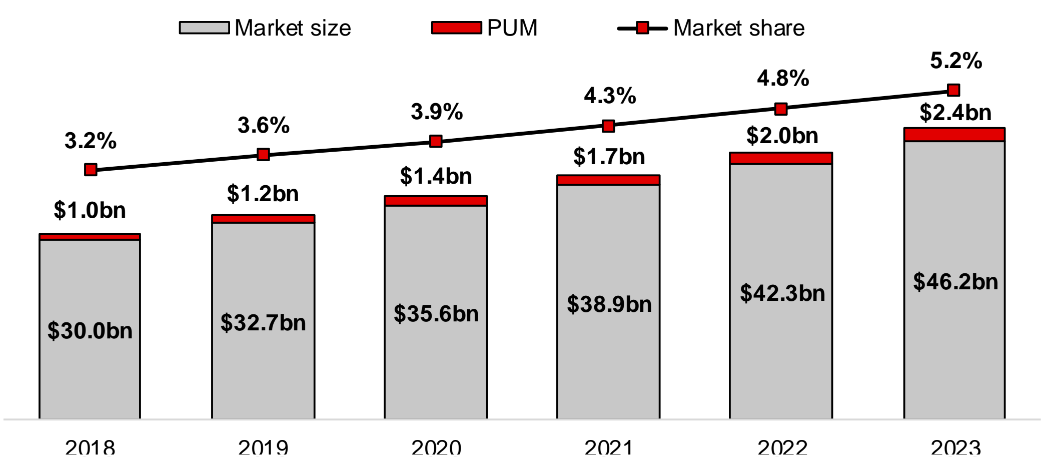
This is especially beneficial in a market where ~25% of its business is concentrated in California and Florida where reinsurers are tightening capacity and attempting to re-evaluate risk exposures.

It is worth noting that Tokio Marine expects Pure's premiums under management to grow at ~20% annually during the next 4 years.

This is down from the ~30% CAGR since 2014, but significantly ahead of its own estimate of market size growth. This implies some combination of market share gains, and/or further penetration into the mass affluent market, and/or price increases. For simplicity, we illustrate the implied market share gain, isolating the other two factors, below.

EXHIBIT: IMPLIED MARKET SHARE GROWTH

Source: Tokio Marine, Inside P&C

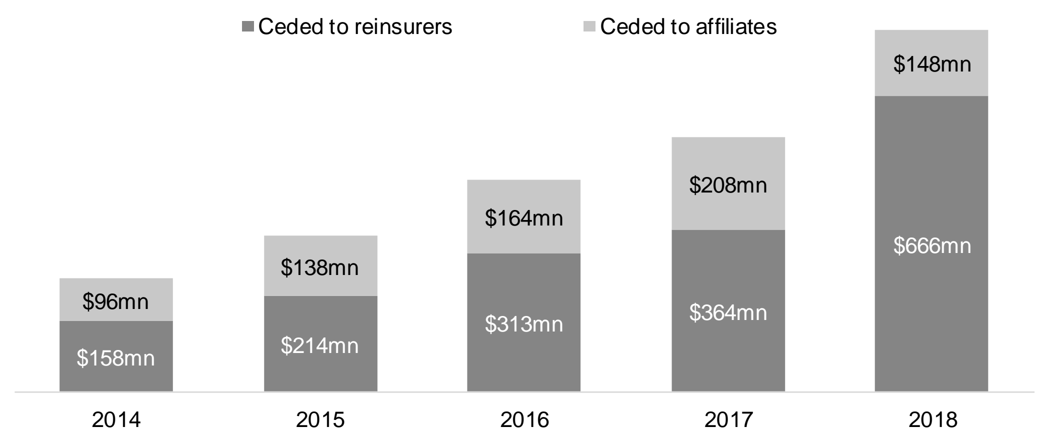


(4)The Bet on Financial Synergies

Though the transaction is largely a strategic business combination, there does appear to be some available financial synergies, largely through reinsurance. The reciprocal ceded mere 15% of 2018 premiums to Pure affiliate and 69% to non-affiliate reinsurers (more details below) that can be ceded to Tokio Marine affiliates.

EXHIBIT: PREMIUMS CEDED

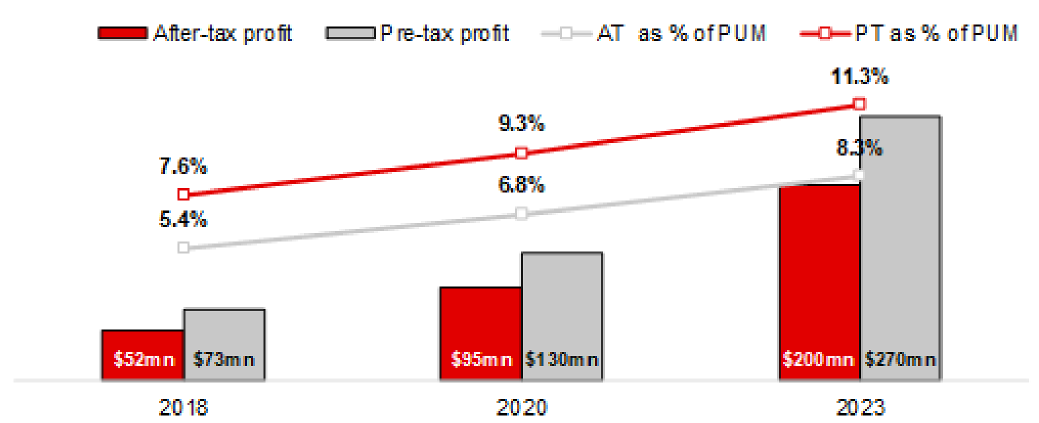
Source: S&P Global, Inside P&C



Tokio Marine's projections appear to include some explicit synergies. The company seemingly modeled in some synergies from margin expansion, evident from gradually increasing earnings (both pre-tax and after-tax) as a percent of premiums under management (see chart below). Though the company made some mention of cross-sell synergies from its other business, we're skeptical these will be a meaningful contributor. Our back of the envelope on the implied margin improvement and size of ceded reinsurance puts this at $30-40mn of pre-tax earnings synergies year 1 (= a net economic loss to reinsurance market – see below). Note, the implied marginal tax rate appears to suggest some modest tax synergies available too.

EXHIBIT: IMPLIED MARGINS

Source: Tokio Marine, Inside P&C



Deal Winners and Losers: Stone Point, XL Come out Ahead; Reinsurance Market Drops Premium

Winners: Aside from the equity holders among the Pure management team, the clear winners of deal are early private equity backer **Stone Point Capital**. Stone Point was among the seed investors to Pure, first investing in 2006 and leading a secondary offering in 2015. Stone Point played a key role in the company's early days and development, facilitating introductions with rating agencies, regulators and capital providers instrumental to Pure's launch.

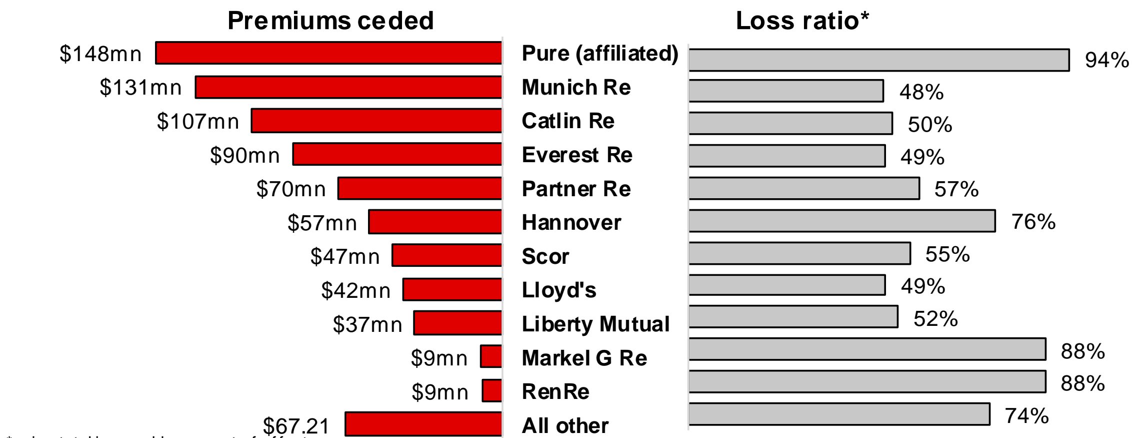
In addition to being closely intertwined with the launch of the business, Stone Point led several debt recapitalizations and surplus note capital raises for the reciprocal exchange. Stone Point introduced the Company to **XL Catlin**, as a minority investor and partner, another one of the deals' winners.

The selling shareholders are Stone Point, which holds 51 percent of the stock, **KKR,** which owns 34 percent, Axa XL, which holds 10 percent, and management and others, which hold the remaining 5 percent.

Losers: Among the losers of the transaction include Pure's reinsurance partners and reinsurance brokers. With a $200B balance sheet, Tokio is likely to retain a significant portion of PURE's $666M of 2018 ceded premium net. PURE's biggest reinsurance backers include **Munich Re**, **Everest Re**, **Partner Re**, and **AxaXL**, among others.

EXHIBIT: CEDED PREMIUMS AND LOSS RATIO ON CEDED PREMIUMS

Source: Tokio Marine, Inside P&C



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