Restoring the Valuation of P/C Insurance Companies

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Although risk is the primary driver of value creation in P/C insurance businesses, risk can also destroy value. The recent financial crisis demonstrated that many companies did not manage these opposing effects of risk effectively. Shareholders have lost confidence and management has lost credibility. As a result, valuation multiples of P/C insurance companies declined dramatically. More significantly, they have failed to recover in 2010 in spite of improvements in earning reported by companies.

Although a company's valuation might be depressed at present by weakness in the economy and might improve as the economy strengthens and earnings improve, its valuation multiple is unlikely to recover significantly until the company restores its credibility with investors. To do so, a company needs to demonstrate that it has the strategies, capabilities and discipline required to:

- Increase its intrinsic value
- Mitigating risks of value loss
- Reduce valuation discounts imposed by investors
- Integrate risk management into business decisions

The "Risk Management and Business Strategy in P/C Insurance Companies" briefing paper, available at the Corner Store, outlines an approach that insurance companies can use to accomplish these objectives. It provides a road-map for an insurance company to:

- Align its business strategy with the risk tolerances of its stakeholders as well as the amount and cost of its risk capacity
- Develop the decision frameworks and analytical capabilities needed to integrate its risk and business strategy management processes

This briefing paper details how, by following this road-map, insurance companies can increase their valuation and their implied valuation multiple.

Increasing intrinsic value

In many of their businesses, insurance companies cannot convert competitive advantages into higher profitability. They cannot shelter themselves from price competition because their competitors can duplicate rapidly product, service or cost advantages they may have or are willing to accept lower profit margins. Businesses that operate under such strategic stalemate conditions cannot usually cover their cost of capital. They bring down a company's intrinsic value and valuation multiple.

Insurance companies, however, can create value in businesses where they can establish sustainable and defensible economic advantages on the basis of superior scale or superior insights about risk. Since risk insights are not easily observable, they cannot be duplicated by competitors. They enable a company to acquire a degree of pricing flexibility, break strategic stalemate conditions and convert their competitive advantage into higher profitability. Leading companies are investigating how they can leverage their risk exposures, losses and claim experience data to generate risk insights that they can use to build insurance portfolios with lower expected losses and lower loss volatility, i.e. achieve favorable risk selection. Advanced analytics can help insurance companies develop roadmaps for competing on risk insights, thereby increasing their intrinsic value and their valuation multiple.

Mitigating risks of value loss

Notwithstanding market risk, shareholders suffer losses when the value of their investment in an insurance company is reduced as a result of:

- Earnings declines caused by the inherent short term volatility of its business results or
- Developments that undermine its expected profitability or growth, and therefore its intrinsic value.

To mitigate effectively risks of value loss for shareholders, an insurance company needs to address separately

- Risks of the business that generate earnings volatility
- Risks to the business that reduce intrinsic value.

*Risks **of** the business*

Risks of the business reduce earnings when they manifest themselves. Risks of the business, especially the financial risks and certain operational risks, impact primarily the variance and the tail of the distribution of earnings of a company. An insurance company can reduce the variance of its earnings as well as the conditional tail expectation of their distribution by controlling risk assumption and accumulation activities. By reshaping the distribution of its earnings, a company can reduce its capital requirement and its cost of capital and enhance both its intrinsic value and its valuation multiple.

To control the risks **of** its business by reshaping the distribution of its expected earnings, a company needs to align its risk strategy with the respective risk tolerances of solvency and value focused stakeholders. Its challenge is to identify the combination of risk policy, risk appetite, risk limits and business strategies that optimizes its capital requirement, projected financial performance, risk, intrinsic value and valuation multiple. Although operational risks can increase financial risks, and therefore capital requirements, they are best managed separately through improvements of operating processes and strengthening of controls.

*Risks **to** the business*

Risks to the business originate externally and reduce a company's expected future profitability future, revenue growth or both. Although these risks may have little or no impact on current financial performance, they can cause shareholders to set higher return expectations (i.e. increase the cost of capital to the company) when assessing the value of a company, thereby reducing its value and valuation multiple.

To control risks **to** (the value of) its business, a company needs to anticipate the nature and effect of external risks on the inherent profitability of its business model and strategies. Having done so, a company can then determine whether and how it should build flexibility and options in its infrastructure and strategies to mitigate the impact of such risks on its future performance. Although such risks have no direct impact on a company's current capital requirement, a company may still decide to hold a larger capital safety buffer to increase its resilience.

Reducing valuation discounts

Weaknesses in a company's risk and strategy management frameworks create risks of value loss for shareholders by causing management to misperceive risks and make ill informed decisions. Since the opportunity cost of these decisions cannot be measured and can certainly not be passed on to customers, shareholders seek compensation for the resulting implied value loss by increasing the cost of the capital they provide. Such increases in the cost of capital necessarily take the form of additional valuation discounts that may include:

- Governance discounts reflecting imbalance in addressing the respective solvency and value risk concerns of creditors/policyholders and shareholders
- Credibility discounts resulting from deficiencies in the management of strategic and operational risks and from misalignment of risk, capital and business management processes and,
- Resilience discounts due to the opaqueness of financial statements and business strategies, which prevent investors to assess a company's risk of financial distress.

Correcting the weaknesses that cause these discounts will help companies restore investors' confidence, reduce their cost of capital and compound increases in their valuation multiple resulting from improvements in their intrinsic value.

Integrating risk management into business decisions

To demonstrate to investors that risk insights are integrated in business decisions before insurance policies are bound or investment decisions made, an insurance company needs to ensure that its business decision processes rest on a risk management framework that includes the following five components:

- A risk capacity management framework, to manage the amount and the cost of the capital deployed to execute the business strategy
- A risk policy, to generate a risk profile that meets the risk tolerance constraints and total return requirement of value-focused stakeholders (shareholders, financial analysts), thus containing the cost of the company's capital and supporting its valuation multiples
- A defined risk appetite and controlled risk capacity utilization framework, based on the capital required for strategy execution, in relation to available capital and the risk tolerance constraints of solvency-focused stakeholders (policyholders, rating agencies and regulators)
- Risk limits, to guide deployment of risk capacity and align business strategy and risk management decisions
- A risk return strategy evaluation framework, to evaluate business decisions in relation to the solvency and value risk concerns of external stakeholders.

Conclusion

Although the roadmap above does not address all the challenges that an insurance company needs to overcome to meet shareholders' return requirements and restore investors' confidence, it is intended to make risk management effective at last in creating value for shareholders.

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