Trends And Opportunities In Canada's Insurance M&A Market

By **Laurie LaPalme and Derek Levinsky** (November 1, 2022)

In recent years, the Canadian insurance industry has witnessed an insatiable mergers and acquisitions appetite from domestic and international deal makers.

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Despite the enduring pressures of the COVID-19 pandemic, Canada's insurance M&A market proved resilient last year — in part thanks to M&A transactions that served as a vital tool for organizations to pursue innovation, gain scale and achieve healthy top-line growth.

Over the next year, the stage is set for continued activity in Canada's insurance M&A market as the effect of the pandemic continues to wane, with buyers from both home and abroad leaping into the insurance M&A arena even in the face of rising interest rates globally and other market uncertainties.

However, there appears to be a shift in the nature of assets that deal makers are interested in. It is expected that there will be an increased focus in the accident and sickness insurance space and technology-focused assets.

The above-referenced expectations are based on a survey of 30 Canada- and U.S.-based deal makers active in Canada's insurance market. The survey was conducted by Dentons Canada with its research provider, MergerMarket, and focused on key M&A drivers, the challenges deal makers are facing and such deal makers' outlook for the future.

Perceived Opportunities in Canada and Increased Interest from U.S. Private Equity Firms

When looking at the most appealing insurance M&A opportunities in Canada, survey respondents believe individual accident and sickness insurance presents the most attractive M&A opportunities. Four in 10 say it is the single most appealing, the highest share across all subsectors, and a further 17% feel it is the second most attractive.

In contrast, survey respondents believe that property and casualty insurance — both personal and commercial — lag in terms of acquisition appeal.

We have witnessed a material increase in client interest with respect to acquiring assets in the individual accident and sickness insurance space — this interest is expected to continue to increase going forward.

More and more property and casualty insurance brokerages are starting new verticals in the life and benefit space, diversifying their business opportunities and taking advantage of all aspects of the insurance sector.

Notwithstanding the survey results, we continue to see many acquirers interested in expanding the breadth of their property and casualty asset portfolio. Based on discussions with insurance industry participants, we expect continued interest in the property and casualty space as well.

The survey also showed that there is interest from U.S. private equity firms in scaling operations through acquisitions in the Canadian market. Among the bulk of U.S. private equity firms surveyed, 70% expect their cohort to become more involved in Canada's insurance sector.

These results are consistent with what we have witnessed: For some time now, we have seen an aggressive expansion into Canada by U.S. private equity firms. The Canadian market appears to be receptive to the deal structures offered by U.S. firms, often providing sellers with flexibility and unique post-acquisition opportunities, including continued managerial control.

However, we have also witnessed some targets, when searching for a suitable acquirer, expressing a desire to seek out so-called made-in-Canada partners. We suspect that such a desire is no secret to U.S. firms, so it will be interesting to see what solutions they implement to address this desire.

Innovation, Digitalization and ESG

Insurance industry participants have been hearing about "insurtech," the tech innovations implemented to improve the efficiency of the insurance industry, for years now. The survey results showed that, given the importance being placed on digital assets and solutions across all sectors and industries, insurtech specialists are, and will continue to be, popular targets among Canadian and U.S. private equity firms.

Indeed, with the increased value of innovation, 60% of Canadian private equity firms, and 30% of U.S. private equity firms are interested in targeting more insurtech specialists, saying they will prioritize M&A involving this type of company over the next 12 months.

As they look to a post-pandemic future, there is plenty for deal makers operating in Canada's insurance sector to be optimistic about. Yet, they must learn to grasp the opportunities presented by the changes happening in society — such as digitalization and the implications of environmental, social and governance, or ESG, issues — if they are to preserve the value of deals and drive growth.

When it comes to digitalization, survey results revealed that both insurers and private equity firms are increasingly adopting disruptive technologies in this race for innovation, and M&A continues to be an important tool to gain an edge. Interestingly, recent data published by certain insurance industry publications suggests that the number of insurtech M&A transactions have materially decreased.

At this time, there is uncertainty as to the cause of this decrease. Such results do not necessarily mean that there is not an interest in insurtech assets. Rather, there very well could be, at this time, an absence of willing insurtech sellers or compatible or scalable insurtech assets available to interested acquirers.

Investors, nongovernmental organizations, regulators and other stakeholders are increasingly expecting corporations to commit to ESG principles such as net-zero, ethical supply chains, and diverse and inclusive senior management.

Private equity firms, pension funds and financial institutions have made it clear they are using ESG frameworks and standards to make so-called impact investment decisions.

Companies considering M&A deals will need to add ESG reviews to their due diligence, as they will be taking on the target's track record on these increasingly important issues. From the target's perspective, a good ESG rating will add to the company's value.

Joint Ventures Atop the Agenda

In terms of the types of transactions that respondents are looking to carry out, deal makers favor joint ventures or strategic alliances, with 57% of respondents saying they are prioritizing this type of deal. Half of respondents say the same of transformative acquisitions as well as bolt-on deals.

Carveouts or spinoffs and the sale of noncore assets are less popular choices among respondents, which seem to be adopting more of a growth mindset rather than looking to streamline operations. Only a third, 33%, and just over a quarter, 27%, respectively, say they will prioritize these types of deals.

Deal makers are similarly indifferent to minority investments, with only 23% considering this type of transaction, making it the least popular option among the survey's respondent group.

That said, insurance companies and institutional investors, including certain pension funds, continue to take minority equity or debt positions in brokerages, as brokerages tend to be safe investments and give insurers the ability to control the distribution chain. However, when pursuing a minority investment structure, determining the appropriate distribution of control over the operations of the brokerage can be tricky and should be considered.

Earnouts and other contingent considerations can be a useful tool to safeguard value in the deal process. The survey results reflect this trend, with 77% of respondents saying they employed earnout provisions in their most recent deal.

Earnout popularity is on the rise, with almost all respondents, 90%, expecting the use of earnouts or other contingent considerations to increase in deals relating to Canada's insurance sector over the next 12 months. Three in 10 expect their use to increase significantly, while only 10% predict no meaningful change.

Earnouts and other forms of consideration bridge any valuation gap between the buyer and the seller, but they also ensure that sellers remain committed to the growth and progress of the target.

These survey results are not surprising, considering that the material assets comprising these target businesses are principally composed of revenue streams and goodwill. The use of a well-drafted earnout mechanism is an effective means by which to better ascertain the value of a target business. However, utilizing an earnout mechanism does complicate a transaction, often requiring, among other things, difficult negotiations regarding what the acquirer is prohibited from doing during the post-closing earnout period.

Takeaways

Rampant digitalization shows no sign of slowing in our modern society. The expectation is that deal makers will continue to show significant interest in technology-based assets, but the important question will be whether there are sufficient scalable technology assets available for acquisition in the marketplace. Moreover, deal makers who are serious about innovating through acquiring technology-based assets will need to actively follow technology and innovation trends in the insurance industry, due to the rapid creation and evolution of such assets, if they want to be first to acquire them.

Canadian and U.S. deal makers continue to employ M&A as a tool by which they can rapidly enter new lines. As evidence does seem to suggest that the individual accident and sickness insurance space is of great interest to deal makers, those interested in expanding their lines may want to consider focusing on this area, as it appears to be a great value proposition. However, this line of business does differ from property and casualty insurance in certain material ways, so any deal maker looking to enter the space should ensure that they have the proper resources and experience in place prior to acquiring such assets.

Finally, ESG, though not the most pressing concern today, will become a prominent feature of deal making over the longer term and should be an area of increased focus by deal makers.

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