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Enterprise Risk Management

Its Role in Mergers and Acquisitions

Faced with tight time constraints, transactions involving mergers and acquisitions often use rules of thumb and back of the envelope methodologies. ERM has long been practiced as part of these due diligence efforts. Many firms have developed a standard procedure to look for potential issues. How else can ERM lead firms to accept only risks where they are compensated and avoid the rest? There are several ways ERM can help M&A analysis, even if time is short. Much of this is good old fashioned common sense, but all of us can remember past projects that would have benefited from a more consistent analytical framework. While the examples in this paper will focus on insurance, the general concepts are useful in all firms.

A company with an ERM process will already have in place a list of risks it faces in its business. This also proactively provides information for a risk audit. An acquisition team can use this list to identify risks that might interact to provide diversification or increase contagion risk, create stress scenarios that highlight potential issues, and identify the risk owner with the greatest knowledge of each stated risk.

Culture

Having a strong risk culture in place is beneficial, particularly when those assigned to the deal team are excited and have expended a lot of energy. In this situation, the deal team members have invested emotional capital and may find it difficult to recommend backing away from a potential deal even if it is not expected to add value. The team should receive more than lip service from the board chair and CEO that it is okay to say no to the deal if it does not make financial sense. A risk culture embedded throughout the organization encourages all employees to speak up about concerns without repercussions. Many companies that earlier discouraged such independence wish they had such a person several years later when a deal's expected synergies turn out to disappoint.

Pricing Discipline

Whether the strategy involves an acquisition, internal growth, or the exit of a line of business, having a pricing discipline developed in advance that is used, followed, and not overridden is very important. This common structure, agreed to in advance, will allow for consistent decisions. This should include hurdle rates, capital charges, level of conservatism in assumptions, and predetermined sensitivity analysis (for both positive and negative events). The calculated price should consider the marginal impact on capital (potential diversification benefits) and tax implications. Equally important is to gauge whether any projected cost savings are realistic across a variety of potential scenarios.

Skepticism

I can remember a potential acquisition about 15 years ago where our team realized the initial work to value the universal life block had been modeled in the same actuarial

software we were using. My recollection is that the single scenario provided had marginal expenses, and no taxes or capital charge. It looked great! Why wouldn't anyone buy this block of business? While we expanded the model to include these features as they were likely to be used at my company, we spoke to others on the team about the block. Each of the team members had their own perspective and experience, so we asked if there was anything about the block that worried them. We used this information to build deterministic financial stress scenarios where interest rates dropped or rose quickly and stayed at that level. Adding overhead and taxes to make the price consistent with our internal pricing discipline made the deal begin to look questionable. Running a scenario where interest rates dropped shut the deal down due to the high interest rate guarantees inherent in the block. For this team, a coordinated effort and critical analysis allowed us to make the right decision for our company.

A team considering a potential acquisition might designate one member to act as chief skeptic, available as a resource to all team members. This could be the team leader or someone with a contrarian view who is skilled at seeing and understanding the implications of multiple interpretations of the same issue.

Scenario Planning

The simplest and easiest method to use when making decisions is to play the what-if game. This analysis can be qualitative, where you try to determine a range of positive and negative events. The objective is to determine if some scenarios that could plausibly occur make the project too risky to accept. Or the analysis could be quantitative, where deterministic scenarios are evaluated at the enterprise level to see if there are unintended consequences (both positive synergies and negative consequences) that were previously hidden. A company with an ERM process will already have in place a list of risks it faces in its business. An acquisition team can quickly go through the list and choose stress scenarios, working with the risk owner who has greatest knowledge of a specific risk as well as the overall risk officer. This analysis should include the actual form of financing to be used in the deal, reviewing various balance sheet ratios and anticipating rating agency and regulatory reactions.

Stochastic Analysis

As Principle-Based Approaches (PBA) becomes more prevalent, companies will increase their ability to perform stochastic analysis in a short time frame. Flexible models will allow quick turnaround of results without having to start from scratch.

An acquisition team must have modeling resources available, including someone proficient in asset modeling and analysis. While relying entirely on quantitative analysis would not be appropriate and could lead to poor decision making (see When Genius Failed: The Rise and Fall of Long-Term Capital Management), modeling can provide a useful filter that provides a foundation for the overall analysis.

Emerging Risks

An important component of a strong risk culture is thinking into the future about what risks might impact a specific product line. Current discussions of life insurance might focus on obesity, antibiotic effectiveness, Middle Eastern tensions, and growth of economies such as China and India. Each industry will have its own hot topics.

The team should brainstorm about emerging risks as well as why the seller would choose this particular time to put the firm or block of business on the market.

Summary

An existing ERM process during an acquisition or divestiture can help a firm make better decisions. While walking away from a deal where you have invested much time and capital on research is challenging, it often is the right thing to do. If the numbers don't make sense during the shopping phase, it is unlikely that they will improve during the implementation phase. A healthy balance is needed between quantitative models and qualitative common sense practice. Neither of these groups should dominate, and it is important to have team members who can integrate the two groups together.

Investing Counterpart

I am currently reading Poor Charlie's Almanack, a book detailing Charlie Munger's investment philosophy. Charlie is a billionaire investor who serves as Vice-Chairman of Berkshire Hathaway, the firm run by Warren Buffett. I will paraphrase an investment checklist shown on pages 61-64 of the first edition. These attributes work together to provide excellent results, but few investors are able to get past the psychological forces fighting against them.

- Risk
    - reputations are hard to rebuild
    - margin of safety
    - character counts
    - get paid for the risks you accept
    - inflation and interest rates cycle
    - potential big mistakes should be avoided
- Independence
    - Be skeptical – the sellers know more than you do, and they are selling!
    - Be rational and objective
    - When others agree with you treat it as a red flag
    - The herd has average returns by definition
- Preparation
    - Hard work leads eventually to insights
    - Self learners do not become complacent in their skills
    - Just like Little League, good things happen to those who prepare and anticipate
    - There is more than one way to skin a cat – learn a variety of models from various disciplines
    - Ask why

- Intellectual humility
  - The older you get, the more you should recognize what you don't know
  - Circle of competence
  - Look for facts that don't line up and ask questions until you understand why
  - False precision leads to bad decisions
  - Be skeptical
- Analytic rigor
  - Develop a process that is your own, and follow it
  - Recognize that price is not the same as value
  - Don't miss the forest for the trees
  - Look at the fundamentals of the asset you are valuing
  - Consider combinations that lead to second order (and higher) effects
  - Invert – look at the question as well as its opposite
- Allocation
  - Opportunity cost is measured by the next best opportunity, not the risk-free rate
  - Bet big when you have found an undervalued asset (I personally do not follow this one as strongly as the gurus at Berkshire – there are plenty of undervalued assets in the sea)
  - Be prepared to sell your favorite investment if conditions change
- Patience
  - Use compound interest to your advantage
  - Avoid frictional costs and taxes when possible
  - Luck is a good thing – accept it if it comes your way
  - A repeatable process is more important than what you made on your last deal
- Decisiveness
  - Act with conviction once you have reviewed the facts
  - Be fearful when others are greedy
  - Be greedy when others are fearful (be a contrarian)
  - Seize the day
  - Prepare in advance for opportunities so your process is in place
- Change
  - Some things are just too complex to understand – avoid them
  - Adapt as the world changes
  - Challenge your own ideas
  - Reality stinks sometimes
- Focus
  - Keep it simple stupid
  - Reputation and integrity are necessary for long term success
  - Success does not breed success – continued hard work and lifetime learning do
  - Stick to the information that matters
  - Don't ignore the big issues

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