

The Embedded Value of Insurance Companies - A global approach to estimating Shareholders Worth



A global Business Concept

“THE EMBEDDED VALUE (EV) RECOGNIZES THAT, SHAREHOLDERS HAVE A ‘HIDDEN WORTH’ – THE LIKELY FUTURE PROFITS THAT CAN BE GENERATED FROM THE BUSINESS ALREADY ON THE BOOKS”

In recent years, there have been global efforts aimed at ascertaining the true “economic” worth of insurance enterprises. This has arisen for a range of reasons, particularly:

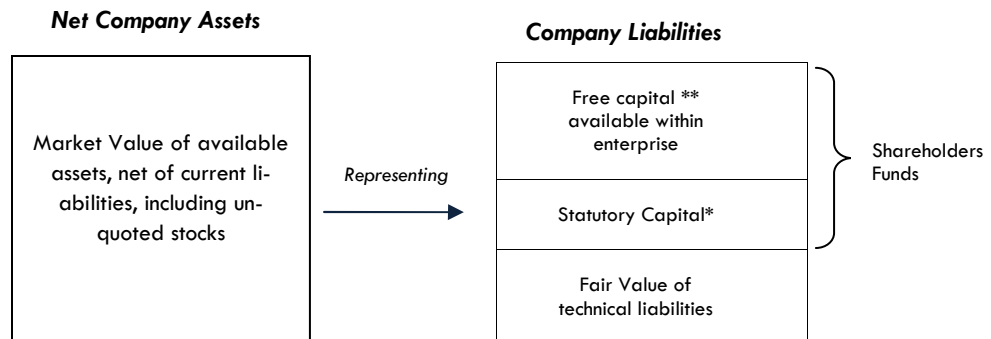
- Increased **Merger and Acquisition activities** and the need to fairly value the worth of affected shareholders,
- The emerging trend of linking **management rewards** to their performance to enhancing shareholder value over a period (say 1 year)
- **Investment analysts** aiming to better

understand the make-up and trend of cashflow, profits and the relative financial performance within insurance entities.

An economic measure that has been generally accepted as meeting the requirements above is the EMBEDDED VALUE (EV). This article discusses EV from a top level perspective.

The market value of the Shareholders Worth in insurance companies, can traditionally be glimpsed from their balance sheets, as illustrated below:

Figure 1



* In Anglophone West Africa, Insurance companies are required to hold *undistributable shareholder capital*

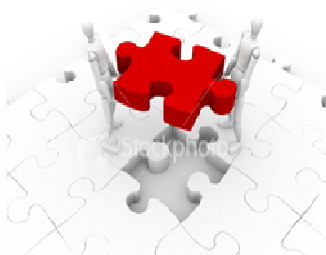
** The free capital are shareholders funds within the insurance enterprise that are in excess of the statutory requirements and in practice *can be distributed*

The Embedded Value (EV) recognizes that, in addition to the capital illustrated above, Shareholders have a ‘hidden worth’ – the likely **future** profits that can be generated by the business already on the books - technically referred to as the Present Value of Inforce Business (PVIF). PVIF will be calculated by projecting future monthly cashflows from the current business portfolio

through to run-off anticipating investment earnings, lapses, surrenders, deaths etc .

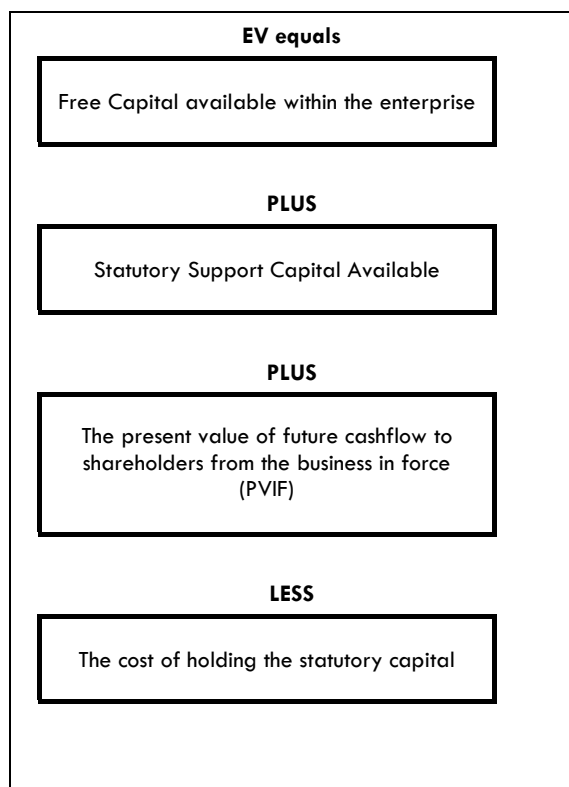
An illustrative definition of EV is given in figure 2 overleaf.

EV clearly gives a better insight into shareholders’ worth than the traditional Net Asset Value (NAV) approach. However, because it is derived from the value appropriated to



An important part of business

Figure 2



the technical liabilities (see figure 1 above), it is essential for the basis of its calculation be disclosed so that, interested third parties can readily ascertain its reasonableness.

It is worth mentioning that, the EV will typically be different from an enterprises' Market Value (MV). This is because EV excludes some aspects of **good-will** which will be in the MV - the market's perception of the entity's ability to generate profits from future new business—brand value.

It is usual for EV reports to diagnose how the EV (Shareholders worth) has changed over the reporting period. EV reports will attribute the contribution to the "EV change" to the various sources that brought about the change. Such sources will typically be:

- new business written over the period
- investment activities
- expenses incurred, and
- insurance experiences (lapses, surrenders, deaths etc)

West African insurance companies are becoming more economically active. This has in part, been brought about, by:

- the sector's increased capitalization and consequent higher relative financial influence
- the stock exchange listing of more insurance companies and consequent increased sectorial visibility
- increased Merger & Acquisition activities – sector consolidation
- gradual employment of higher quality staff especially in the areas of finance and investment

Increased capitalization has led to wider webs of shareholders and the need for management to demonstrate accountability. The EV method of reporting is a useful tool in demonstrating the needed accountability and we encourage all insurance companies to voluntarily embrace this method. Embedded Values are routinely calculated throughout Europe and South Africa – in many cases – half yearly! A case for joining the bandwagon?

H R Nigeria Ltd is an independent consulting actuarial firm with over 25 years of experience advising leading Insurance companies, Pension Funds and Health Institution in the West Africa Region.

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