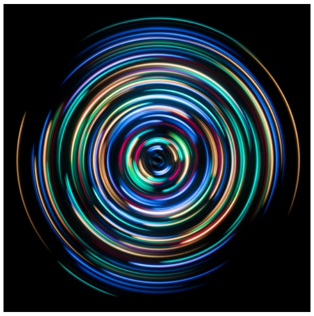
William Blair



How COVID-19 is Impacting the Insurance Industry

Based on conversations with management teams and investors, we examine how the pandemic is shaping near- and longer-term market conditions for insurance brokers, P&C carriers, claims service providers, and warranty and F&I administrators.

Industry Commentary

Mike Gebo
+1 212 237 2718
mgebo@williamblair.com

Aaron Van Osdol
+1 312 801 7804
avanosdol@williamblair.com

Kale Klekota
+1 312 364 8427
kklekota@williamblair.com

Since the COVID-19 pandemic began, William Blair's insurance investment banking team has been conducting regular conversations with management teams and investors throughout the insurance industry to see how the shutdown has been affecting their companies. These discussions have covered topics such as working from home, technology adaptation, and potential positive or negative effects on volumes and margins, both in the near and longer term.

As a whole, the insurance industry is relatively attractive in periods of economic disruption because demand for insurance is largely nondiscretionary and claims activity has a low correlation to overall economic activity. This is a point that we highlighted in our November 2019 report, "Insurance Services Draws Heightened Late-Cycle M&A Interest." It is important to note, however, that there are several unprecedented aspects of the current situation that have implications for the insurance industry that differ from a typical slowdown. Also, the pandemic's impact varies significantly among the various segments of the insurance industry.

Based on our ongoing conversations with management teams and investors, we provide a preliminary look at how the pandemic is affecting four components of the insurance value chain: (i) insurance brokerage/distribution, (ii) P&C carriers, (iii) claims services, and (iv) warranty and finance-and-insurance (F&I) administration. We also share our perspectives on the current M&A environment.

Insurance Brokerage/Distribution

In our November 2019 report, we examined the reasons why property and casualty (P&C) insurance, broadly speaking, is a nondiscretionary purchase. As a result, the industry's volumes tend to be largely resilient to macroeconomic events. At a high level, this has proved true so far amid the COVID-19 pandemic. Brokers generally are experiencing normal to increased renewal closing rates over the past month because clients are less inclined to shop for new coverage and want to get renewals done quickly.

Certain industries, however, will be pressured as nationwide shelter-at-home and social-distancing orders have forced nonessential businesses to temporarily close their doors. We have heard that some clients have been slow to renew; we expect that this is due to clients evaluating where they can potentially save money. Brokers we spoke with that are currently seeing a negative impact from the pandemic expect to be able to withstand the current environment better than most industries and recover more quickly.

Most of the negative business impact of the pandemic for brokers has been concentrated in nonessential industries or customer segments that are experiencing widespread furloughs and/or business closures, including hospitality, leisure, retail, and energy. Brokers focusing on providing employee benefits and other coverages for small and midsize enterprises (SMEs) are also seeing a significant negative impact.

The financial impact of the pandemic likely will not materialize until June or July for brokers. The nature of brokers' sales pipelines means that there often is a lag of several months before the impact of an economic slowdown is fully visible on financial statements.

The magnitude of the impact is nearly impossible to quantify at this point; obviously, it depends on how long the government-ordered shutdowns last, how quickly economic activity resumes, and the degree to which it approaches pre-pandemic levels. We expect that brokers focused on sectors deemed to be essential, such as healthcare, food supply, and manufacturing, will fare well and experience fewer impacts.

Before the pandemic, rates had been trending upward in several insurance lines, including directors and officers (D&O), umbrella, commercial auto, and certain property lines. Brokers we spoke with expect these trends to continue despite the pandemic, driving increased profitability for intermediaries focused on these lines. We have also heard that lines focused on seniors, including Medicare Supplement, Medicare Advantage, and other retirement-focused markets, are faring well. These markets are expected to face little disruption from the pandemic because of the seasonality of open enrollment, which is not scheduled to occur until the fall.

Most of the brokers we spoke with have experienced very little disruption to their day-to-day operations. Many noted that more than 90% of their workforce is now working remotely and that the transition was fairly seamless with no impact to service delivery for their customers. We have heard that brokers with strong call center operations and technology platforms have been doing well, especially compared with brokers that rely on feet-on-the-street models.

In a post-pandemic environment, we expect brokers with robust digital distribution capabilities to be extremely well-positioned to gain share in the eventual recovery. Shelter-at-home orders have forced many consumers to begin shopping for all types of products online, insurance included. So brokers that are adept at reaching existing customers and prospects online will most likely see a positive step-change.

P&C Carriers

We highlight key themes we heard from our recent conversations with P&C carriers:

Capital position: By and large, P&C carriers were in a strong capital position heading into 2020. In assessing how balance sheets will be affected by volatility in equity and fixed-income markets, it is important to look at the composition of each carrier's investment portfolio. Insurance carriers typically maintain low-risk portfolios, providing a ballast against market volatility. Exposure to residential-mortgage-backed securities and commercial-mortgage-backed securities, however, could pose a significant threat as mortgage forbearance and defaults increase.

Automotive insurance: In the near term, auto carriers will benefit from lower claims frequency as individuals stay home and commercial drivers reduce their mileage. Many auto carriers have begun announcing premium rebates and renewal discounts to customers to drive retention and new business during the slowdown. Over the long term, carriers expect that an extended recession's negative impact on auto rates would be minimal.

Workers' compensation: The workers' comp carriers we spoke with expect to benefit in the near term from lower claims frequency. Fewer man-hours are being worked, and remote work, which presumably leads to fewer on-the-job accidents, has increased. An extended recession that leads to reduced payrolls, however, would hurt coverage volumes, especially in high-risk industries, such as hospitality, leisure, energy, and retail.

Business interruption insurance: One of the most contentious and politically fraught aspects of the pandemic for the insurance industry is whether the closures caused by COVID-19 are covered under business interruption policies. Many policies in the United States have language that specifically excludes coverage for pandemic-related events. But legislators in several states have introduced bills that would require insurers to cover COVID-19–related disruptions, and proposals to create a federal backstop for pandemic disruptions—similar to the federal backstops for terrorism added after 9/11—have been discussed in Washington. These measures, if enacted, could pose a major risk to carriers. In addition to assessing the likelihood of such governmental intervention, carriers are weighing the potential long-term implications of declining COVID-19–related payments versus the goodwill benefits of making exceptions.

Excess and surplus (E&S) insurance: E&S activity has remained relatively strong during the pandemic, particularly in core markets such as construction and general business liability. Carriers that had previously been pulling back from E&S have not reentered the market, resulting in continued business flow and increasing rates for the remaining carriers. The SME segment of the market will likely be more negatively affected by the economic downturn, but this impact should be mitigated by the fact that E&S has limited exposure to workers' comp. During the 2007 to 2009 downturn, the E&S market lost share to standard carriers, but there is a good chance that things will be different in this downturn. During the last recession, the P&C market was relatively soft and standard markets aggressively sought to retain risks. The opposite is true today because the standard market is still firming.

InsurTech: In the InsurTech segment of the market, we expect carriers with digital platforms and strong technology backbones to continue to outperform given their cost structure advantages. Insurers continue to see the need to accelerate their digital transformations and collaborate with leading technology partners. The pandemic has heightened the importance of a robust online presence. Online leads for new customers have spiked as individuals become more cost-conscious about their personal insurance heading into a recession and have more time on their hands to shop for coverage online. An extended recession would likely cause new business opportunities to slow on the commercial side of InsurTech.

Claims Services

Commercial P&C claims have generally remained steady thus far during the pandemic. The backlog of claims work, however, is mounting because adjusters have had difficulty accessing work sites during the shutdown, causing processing delays. In personal lines, homeowner claims have been flat, but auto claims have declined significantly and are expected to continue declining given the reduction in miles driven.

Activity for larger, more complex claims, which are often caused by severe weather events, is generally not correlated with economic activity. But activity for smaller claims may be affected by an extended recession; volume is particularly at risk in the energy, hospitality, foodservice, and retail sectors, all of which have seen widespread shutdowns. Conversely, several of the more specialized claims consulting sectors are seeing higher volumes. These areas include legal and expert witness testimony services and forensic accounting, which is seeing surging demand because federal and state governments need assistance verifying applicants' qualification for various loan and stimulus programs.

Warranty and F&I Administration

With most automotive dealerships closed because of shelter-in-place restrictions, many of the businesses that provide automotive warranties have seen volumes fall significantly in the past month. Auto finance and insurance (F&I) coverage sales, broadly speaking, will continue to lag until the broader economy reopens. It is possible that pent-up demand for these coverages will be unleashed once dealerships reopen. An extended recession will cause declines in sales of several ancillary coverages, but more functional coverages, such as vehicle service contracts (VSCs), should perform well in a recessionary environment. VSCs provide peace-of-mind for cash-strapped consumers by protecting consumers against large, unplanned expenses.

For the warranty market, the length of the recession and how it affects original equipment manufacturer (OEM) sales tactics and consumer behavior are key variables. We expect OEMs to begin offering significant rebates and favorable financing to reinvigorate sales once the economy comes back online. This should boost warranty sales. We also expect consumers to shift toward used cars during a recession, and it is important to note that buyers of used cars typically see a greater value proposition for VSCs during a recession. Administrators with significant exposure to used car sales or those with a strong independent dealer distribution channel should benefit from the anticipated growth in used car sales.

M&A Outlook

The pandemic's impact on dealmaking activity in the insurance industry varies depending on where companies are in their processes. Most of the strategic buyers we have spoken with are honoring the deal terms of transactions that are under letter of intent. These strategic acquirers, however, are re-evaluating valuations for new opportunities and sometimes pulling back on M&A entirely to focus on their own core operations. Those pushing forward with acquisition strategies are excited about the favorable valuation and pricing dynamics, especially for smaller acquisition targets.

The current extreme level of uncertainty, in both economic activity and public policy, is making it very difficult for buyers and sellers in the insurance industry to develop constructive valuation viewpoints. This is especially true when the buyer's stock is a significant part of the purchase consideration; sellers are challenged to value stock offers and gauge the amount of potential earnouts when the long-term economic impact on the buyer's business is still unclear.

We expect M&A activity to slow significantly during this market dislocation. Given the general industry view that insurance businesses will remain resilient during the pandemic and ensuing recession, sellers will likely want to stay on the sidelines until conditions normalize. Once that economic normalization begins to happen, we expect dealmaking activity to increase significantly.

Once M&A activity resumes, we expect that valuations for smaller, subscale businesses will see the largest declines from pre-pandemic levels. This reflects our expectation that smaller insurance companies will face the largest disruption from the pandemic. Today's highly volatile market conditions highlight the importance of insurance companies being part of a larger platform to create maximum value, and we expect buyers to continue taking advantage of this dynamic to drive their acquisition efforts.