Case Study

An Indo-Japanese Life Insurance Joint Venture

Service(s) Offered: **Valuation Review for a Transaction**

Sector/Industry: **Insurance**

Valuation Review of an Indo-Japanese Joint Venture for a Leading Indian Bank

Our client (Client), a leading Indian bank, was **mandated to sell** a certain part of their stake in an Indo-Japanese Life Insurance Joint Venture (JV) to its Japanese partner. The Client and the foreign JV partner appointed reputed valuers respectively to ascertain the value of the JV.

The Client approached Nexdigm to **review the methodologies** and assumptions adopted by the Bank's valuer (Appointed Valuer) to arrive at the valuation and provide **inputs for negotiations** with the Japanese partner.

Approach

Our valuation review is bifurcated in phases :

Phase I - Reviewing the Valuation Methodology

Phase II - Identifying Negotiation Factors

Nexdigm started off by analyzing the life insurance sector in India and their operations, key drivers, competition, and recent transactions in the sector.

After analyzing the **draft appraisal value report** and other information provided, we conducted **preliminary discussions** with the Client, the JV and the Appointed Valuer to gain a **holistic perspective**.

Phase I - Review of Valuation Methodology

Our Client's primary concern was whether the Valuation Methodology applied by the appointed valuer was compliant with regulations from the Insurance Regulatory and Development Authority of India (IRDAI) and the Foreign Exchange Management Act (FEMA).

IRDAI

The Institute of Actuaries of India had prescribed **Actuarial Practice Standard 10** for determining the Embedded Value (EV) of life insurance companies for the purpose of an **Initial Public Offering** (IPO) under IRDAI regulations. The Standard prescribed the Indian Embedded Value (IEV) which is similar to the Market Consistent Embedded Value (MCEV) as the basis for determination of Embedded Value (EV).

For the calculation of the JV's EV, the Appointed Valuer had adopted the Traditional Embedded Value (TEV) methodology.

As Actuarial Practice Standard 10 pertains to an IPO, it did not have a direct impact on the Client's transaction. Therefore, Nexdigm determined that the methodology used was **not in violation of IRDAI standards**.

FEMA

The Reserve Bank of India has issued **pricing guidelines for Foreign Direct Investment** (FDI), which mandated that valuations be carried out as per internationally accepted pricing methodology.

As TEV-based valuation was a **prominent valuation methodology for life insurance companies**, Nexdigm concluded that the valuation was FEMA compliant.

Phase II - Identifying Negotiation Factors

Once the Client was confident with the valuation methodology, we proceeded with our **valuation review** and advised the Client on potential negotiation factors. Our recommendations are mentioned below:

Structural Value (SV)

While computing SV, the Appointed Valuer had considered the management's 10-year **business plan** but did not factor **continuity of business** into the SV.

As most businesses (especially newly established businesses) draw a significant portion of their value from the going-concern assumption, Nexdigm recommended that **business continuity** should be **incorporated into the valuation**.

Risk Discounting Rate (RDR)

The RDR arrived at by the Appointed Valuer was based on the Capital Asset Pricing Model and the use of beta of the CNX Finance index.

The CNX index pertains only to banks and NBFCs, and not insurance companies. The valuation evaluated the JV at a high RDR primarily on account of an **aggressive management business plan** but did not factor that a significant portion of a life insurance company's **cash flows** are derived from investing in **low-risk debt instruments**.

Nexdigm recommended that the RDR should be lowered based on the facts mentioned above.

Embedded Value (EV) multiple

The Value-in-Force (VIF) of the EV was also evaluated at the same RDR that was used for the SV. Apart from the Income Approach-based value, the Japanese JV partner wanted to benchmark the valuation negotiation around an EV multiple.

VIF is the **value of the policies in force** as on the **valuation date** and represents a value that is more certain than the SV, which is the value of future business. Evaluating both **VIF and SV at the same RDR will undervalue the VIF**, thus skewing the EV multiple based valuation.

Nexdigm recommended that if EV multiple must be considered for negotiations, a **new VIF** must be **computed** using an RDR commensurate to its risk

Solvency Ratio & Funds for Future Appropriation

The valuation was based on two scenarios, one considering Funds for Future Appropriation (FFA) as part of solvency ratio while the other did not.

If **FFA was not considered** for computing solvency ratio, the **profits attributable to equity shareholders would reduce** as fresh reserves would be needed to meet solvency requirements, thus reducing the valuation.

Nexdigm recommended that using FFA for calculating Solvency Ratio was permissible and there was no indication of any change to these rules (i.e. the higher FFA backed valuation).

Exclusivity

The aggressive management business plan was highly reliant on the **bank's assurance** (Client's bank branches) to **sell policies** although the JV did not have any exclusivity agreement with the Client. The IRDAI had recently permitted banks to tie-up with up to three life insurers to sell life insurance products.

Nexdigm determined that while both the JV and the Client were free to tie up with other banks/insurers, the question of whether the Client/JV demand for a premium (for exclusivity) **required a detailed cost-benefit analysis**.

Impact

Our explanations and recommendations assisted the client in better understanding the **valuation process for insurance companies** and thus helped **negotiate a better price**.

For more information on this case study, please write to us at:

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You can also visit our website to know how our services resulted in tangible business benefits:

www.nexdigm.com