

WHITE PAPER

BCG Series on Permanent Capital – Part 2

Tapping into life and annuity (L&A) insurance carriers

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Tapping into life and annuity (L&A) insurance carriers

Alternative asset managers are increasingly focused on securing "permanent"[1] capital that they can deploy into various asset classes and strategies. This type of funding is an increasingly popular alternative to traditional closed-end finite life fund models for several reasons: the stable and predictable management fees can be highly accretive to a manager's valuation, less fundraising is necessary, and there's greater flexibility in capital deployment and long-term value creation. Key players such as Apollo, Blackstone, KKR, Carlyle, and Ares have invested significant resources in permanent capital approaches, a clear sign of its ascendency. The trend is not limited to scaled managers. Numerous middle market players have begun to access permanent capital in some form.

There are three primary sources of permanent capital. (See Exhibit 1.) Each source offers distinct advantages and presents unique considerations:

1. **Private wealth and retail products:** There is strong demand among private wealth and retail investors for access to private markets, but legacy closed-end fund products have not suited these channels well, curtailing their ability to invest. Recent product innovation, particularly the introduction of various semi-liquid Permanent Capital Vehicles (PCVs) that better address their needs, is expected to spur greater investment. For asset managers, these channels represent a large and potentially lucrative addressable market and an opportunity to diversify their investor bases. However, product packaging can be tricky and popular products of today lend themselves better to certain asset classes.

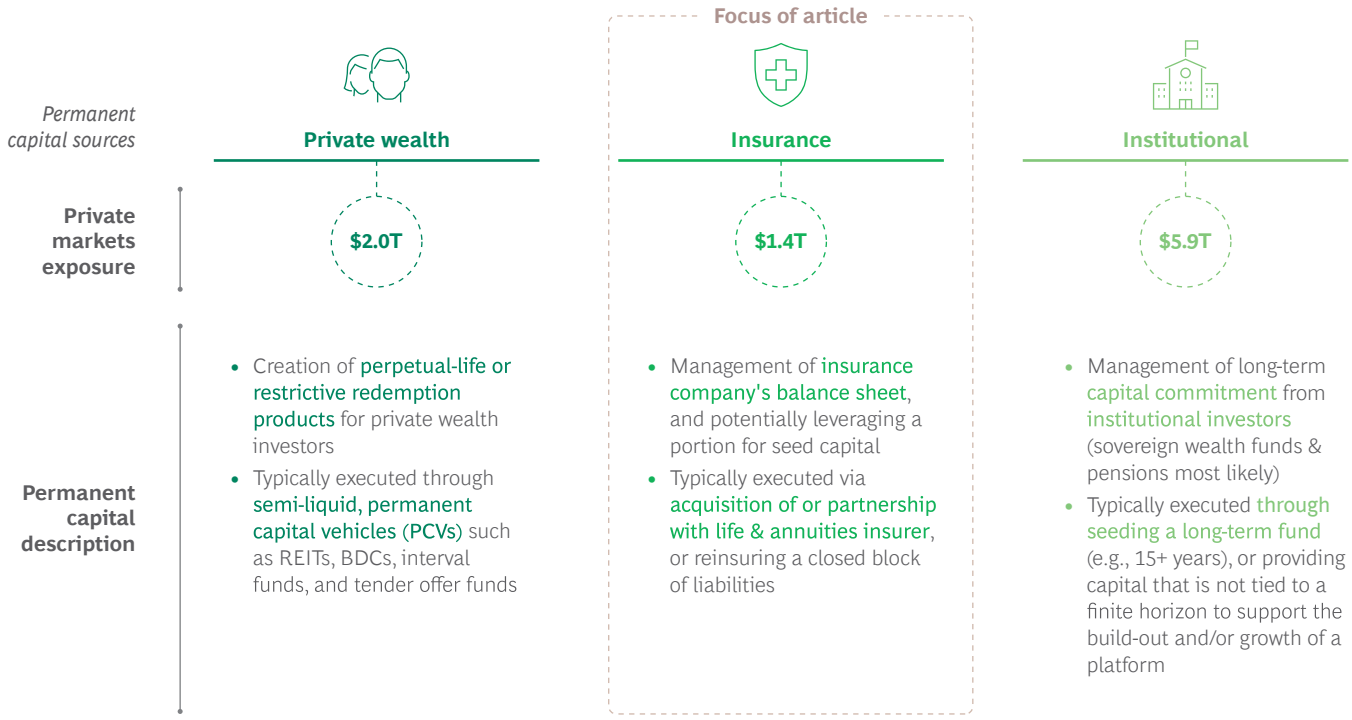
2. **Life and annuity (L&A) insurance carriers:** L&A carriers' large asset base and relatively predictable liabilities allow for more exposure to illiquid assets than other carriers. Asset managers that partner with L&A carriers benefit from the steady inflow of new capital from insurance policies and their ability to deploy such capital into longer-duration, higher yielding assets. That said, there are meaningful risks that asset managers must consider when tapping L&A for permanent capital. With proper execution, such partnerships can potentially generate powerful synergies.

3. **Institutional capital/Sovereign wealth funds:** Large institutional investors, particularly sovereign wealth funds, can serve as an anchor for these long-term capital vehicles, or even provide the entire capital base. For such arrangements to work, however, asset managers must find a partner with the proper risk tolerance, long investment horizon, and aligned visions and objectives.

This article is the second in our series designed to introduce these permanent capital strategies, explaining the pros and cons of each, and providing a view of the critical issues that asset managers, insurers, wealth managers, and other key stakeholders in the ecosystem should carefully consider. In this piece we will focus on L&A insurance carriers, with a sidebar on institutional capital/sovereign wealth funds.

Exhibit 1 - Three potential sources of permanent capital

Each source with different partnership models



Sources: Partners Group; Jefferies Research; BCG Global Asset Management Report; Preqin; BCG analysis.

The Intersection of Alternative Asset Management and Insurance

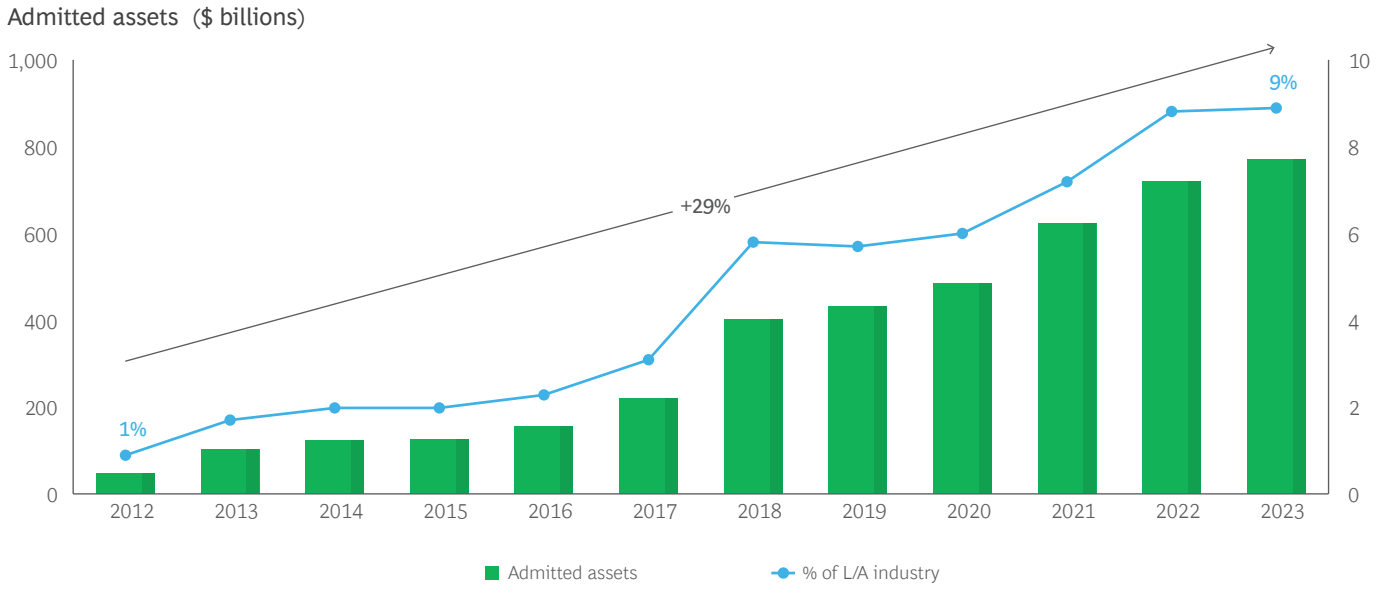
Over the last decade there has been a concerted push by alternative asset managers, particularly those with structured and illiquid credit capabilities, into the L&A insurance sector. This strategic shift is driving growth for both managers and carriers alike. A combination of two factors has enabled managers to pivot toward carriers and access this source of permanent capital.

- Formulaic regulatory capital requirements have opened the door to clever repackaging of investments that keep capital charges low on higher returning assets (i.e., enhancing yields at a given credit rating).

- Credit markets, particularly structured credit, have evolved and expanded. Managers have created innovative financial instruments to repackage credit, and the growing depth of credit markets has allowed managers to repackage efficiently at scale.

The rate of growth for manager-affiliated assets has been dramatic–more than 30%[2] annually over a 10-year period. Since 2012, when Apollo-owned Athene first began to scale, asset managers' market share of L&A admitted assets[3] has risen dramatically from less than 1% to about 9%, with growth derived from more than one hundred financial sponsor-backed firms. (See Exhibit 2.) Over this time, alternative asset managers have used several strategies to secure their access to this permanent capital—partnering with a carrier, engaging in a de novo build, or buying one outright.

Exhibit 2 - Admitted assets held by manager-owned L&A insurers



Source: AM Best data and research.

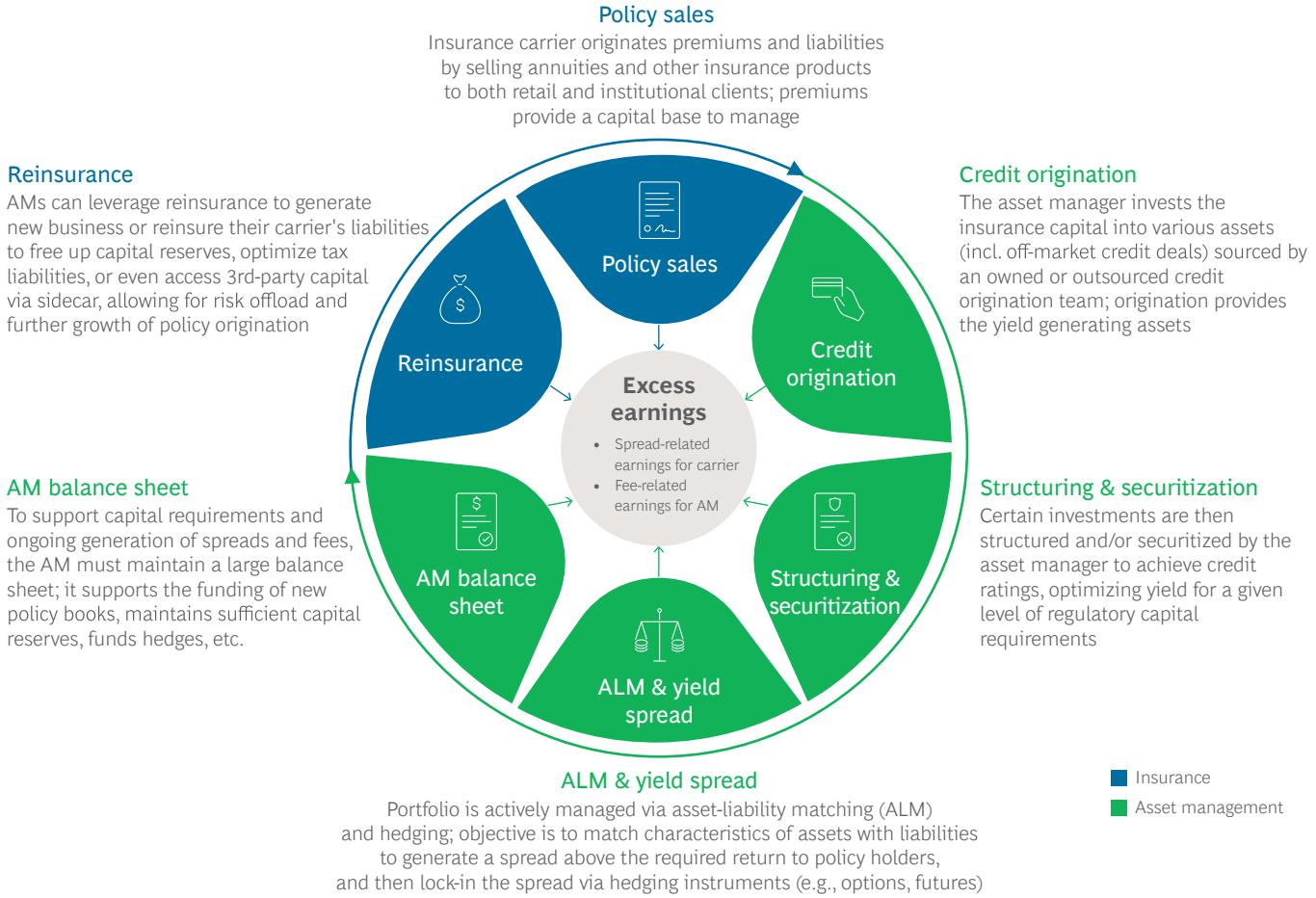
A Natural Symbiosis

At the center of this strategic push is a flywheel that generates synergies between the insurance carrier and alternative asset manager. (See Exhibit 3) . The carrier needs strong underwriting capabilities to generate annuity premiums, which the manager must then invest to generate returns sufficient to honor the long-dated liabilities. The manager provides the investment products and expertise in credit origination and structuring to manage the portfolio (or a significant portion of it), generating a healthy excess spread. The carrier can then invest these excess earnings to accelerate growth (e.g., higher sales commissions to scale, larger salesforce, new product sets, etc.), boost capital reserves to improve resiliency, or simply return proceeds to shareholders.

A primary way alternative asset managers achieve these superior returns is by sourcing and managing illiquid assets, capturing an illiquidity premium for tying up capital longer term [4]. On average, asset manager-affiliated carriers allocate 46% of their general account to such assets, significantly higher than the industry average of 27%. (See Exhibit 4.) Despite the illiquidity of these assets, managers can still structure a strong duration match to the L&A insurer's longterm liabilities (i.e., the defined payouts occuring years down the line.)

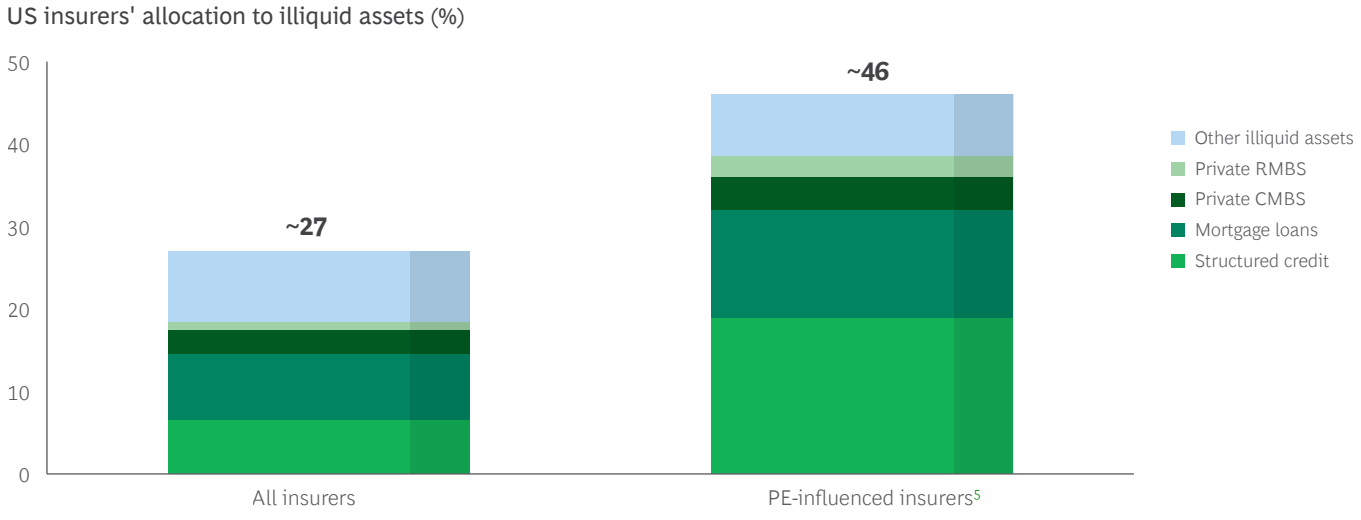
Alternative asset managers also benefit handsomely from this relationship. First, with access to insurance companies' stable asset base, managers alleviate some of the burden of labor-intensive fundraising cycles associated with closed-end finite life funds. Less fundraising also means that managers can keep their distribution headcounts relatively low compared to others with comparable AUM, or divert their focus to other strategies and products.

Exhibit 3 - The Operational Flywheel: Synergies between Alternative Asset Management and Insurance



Source: BCG analysis.

Exhibit 4 - Asset managers reshape the insurance portfolio to capture illiquidity premiums



Source: International Monetary Fund, BCG analysis.

Permanent Capital Vehicles Anchored by Institutional Investors

For sizeable and sophisticated alternative asset managers, large institutional investors are a third potential source of permanent capital. But for these partnerships to work, the institutions must have flexible investment mandates, strong appetites for private markets exposure, long investment horizons, and nimble governance models.

These requirements make sovereign wealth funds the most natural partner, although distinct regulatory environments of sovereign investors can complicate these relationships. Other institutional pools such as pension plans (Canada's Maple-8 are a prime example) can also fit the profile, giving alternative asset managers the freedom to pursue longer-term, buy-and-build strategies that benefit them both. In a typical arrangement, the institution serves as an anchor investor for a long-term capital vehicle. In some cases, the institution provides the entire capital base, and on occasion seeds a new platform for the manager.

It takes time to lay the groundwork for these arrangements, which requires building strong "top-of-the-house" relationships between the investor and the manager. Once an agreement has been reached, additional terms may also be negotiated, such as co-investment deal flow rights, an equity stake in the new platform, or even an equity stake in the manager itself.

The investment scale necessary for such arrangements to work limits the number of alternative asset managers capable of pursuing large institutions as a source of permanent capital, but for the largest and most well established managers it's another viable option.

In addition to fundraising relief, insurance capital provides asset managers with stable and predictable management fees. (See Exhibit 5.) Fee-related earnings (FRE) are the primary focus of capital markets, which place higher valuations on managers whose earnings tilt more heavily toward FRE[6]. Finally, an insurer's retail sales operation could offer cross-selling opportunity for alternative asset managers (although this opportunity appears quite nascent to date).

Unlocking Synergies

Success of the manager-carrier relationship relies on the carrier's ability to originate new premiums with associated liabilities that are predictable and below the yields generated by asset management operations to create a yield spread. This includes retail channels (e.g., selling new policies, especially fixed annuities (FAs) and fixed-index annuities (FIAs)) and institutional channels (e.g., closed block provide or flow reinsurance, group annuities, structured settlements, etc.). Institutional channels provide a faster path to scale, but origination can sometimes be erratic and more transactional in nature. Conversely, retail channels require significant distribution resources, but can offer a smoother more predictable sales trajectory. Both are critical for carriers to operate at scale.

With a steady stream of premiums secured, it is incumbent on the alternative asset manager to generate the excess earnings that will benefit both parties. We have identified six primary levers that managers can pull to unlock these synergies.

1. **Diverse and direct credit origination:** Alternative asset managers must source deals across a wide array of asset classes, including niche areas of credit, often via specialized subsidiaries. This broad sourcing capability not only diversifies the investment portfolio, but it also provides the ingredients for bespoke illiquid and structured credit instruments that enhance yield potential at a given level of risk.

2. **Advanced structuring and securitization:** Once proprietary origination capabilities have been established, sophisticated structuring and securitization practices take on heightened importance. In order to generate superior returns and minimize capital charges prescribed by insurance regulatory bodies, alternative asset managers need to structure high-yielding, illiquid assets in ways that achieve investment-grade ratings typically associated with U.S. treasuries and corporate bonds.

3. **Asset management including asset-liability-matching:** It is vital to carefully match insurance liabilities with corresponding assets to generate and preserve a spread. Prudent asset management includes hedging operations. These activities incur costs that will erode some of the returns, but they are necessary to mitigate downside risks and more securely lock in the spread.

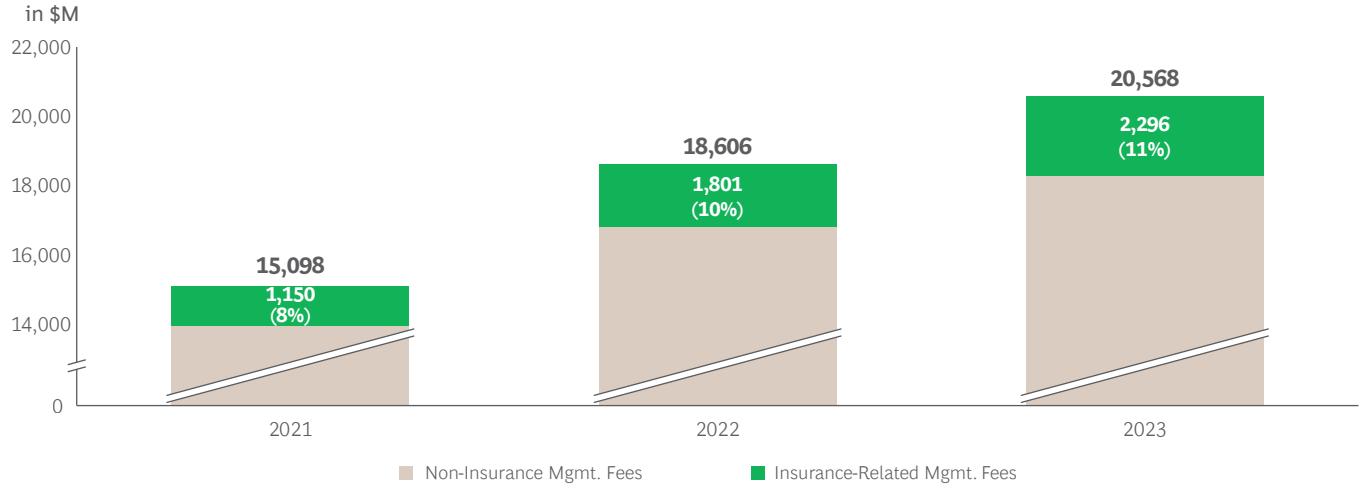
4. **Reinsurance (offshore):** Alternative asset managers can add scale and further optimize capital reserves by establishing an offshore reinsurer. By leveraging certain regulatory capital and tax advantages of the offshore entity, managers can reinsure other third-party liabilities (i.e., originate new business) or reinsure the affiliated carrier's liabilities. The combination of the three affiliated entities (asset manager, carrier and reinsurer) is known as the "Bermuda triangle" strategy. (See Exhibit 6.)

5. **Reinsurance sidecar:** A reinsurer can go a step further and raise third-party capital via sidecar vehicle. The sidecar adds further scale while simultaneously serving as a potential risk outlet, allowing the carrier to dial-down balance sheet risk by partially transferring liabilities to third-party investors. This frees up reserve capital if needed.

6. **Capital markets (including fundraising):** The creation of structured products for the affiliated carrier inevitably leads to the creation of certain debt instruments as a by product that are not suitable for the carrier. Strong capital markets capabilities enable the manager to sell debt into the open market or distribute the debt internally to other, more suitable funds allowing for further monetization.

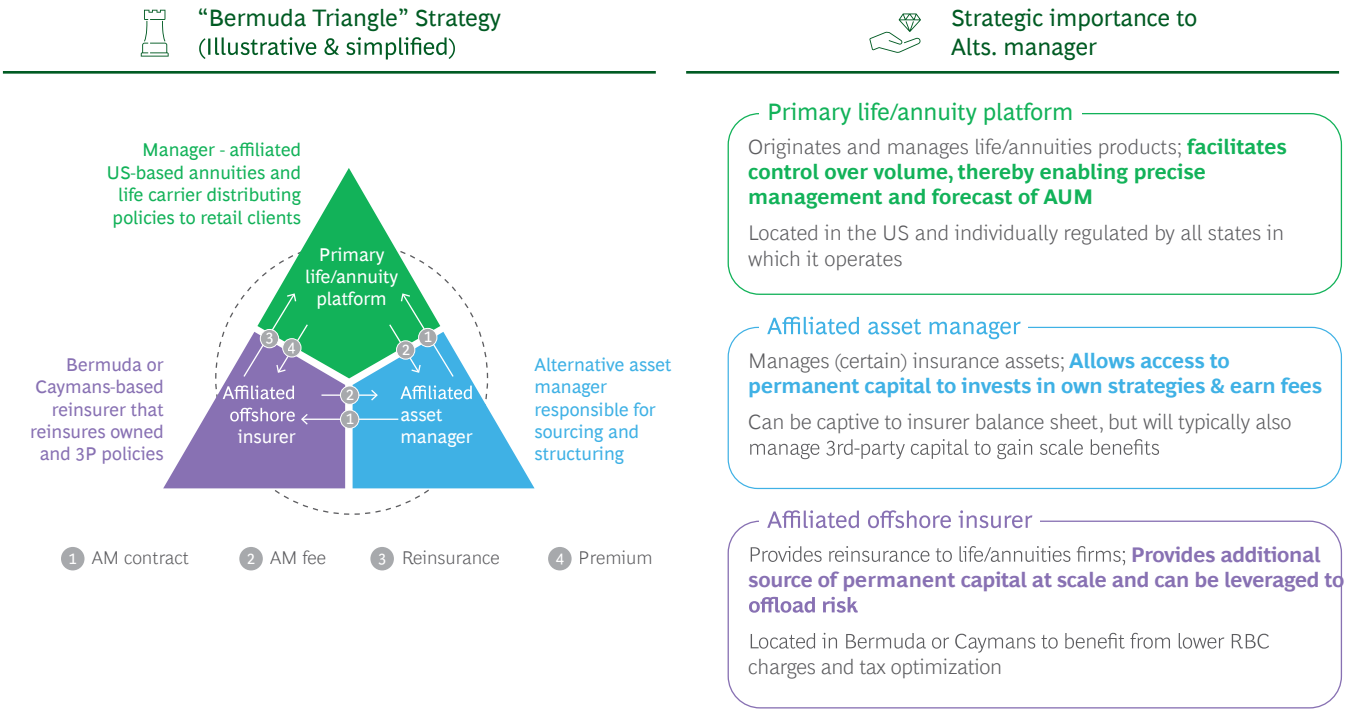
Exhibit 5 - Insurance-related management fees continue to grow

Insurance-related mgmt. fees as % of total mgmt. fees.[7]



Sources: Goldman Sachs Equity Research.

Exhibit 6 - Asset managers are leveraging combined distribution model



Sources: Company Investor Relations; Press Research; Market participant interviews; BCG analysis.

Accessing Insurance Capital

For managers that are seeking to avoid owning a carrier or assuming a certain level of balance sheet risk, a partnership model is a viable option. This typically comes in the form of a minority equity investment in the carrier, coupled with a long-term asset management agreement for a portion of the General Account.

While this arrangement allows managers to tap a source of permanent capital, they typically do not have exclusive access and so cannot fully leverage they synergies between the two entities. As such the relationship, and thus the permanency, can be less stable. For managers willing to assume a higher level of risk to build the insurance permanentt capital engine, there are three typical entry points. (See Exhibit 7.) Each presents unique opportunities and considerations. And all require a sponsor with a robust balance sheet to facilitate strategic acquisition at the carrier-level, comply with regulatory capital requirements, and implement proper risk management strategies to safeguard against the risks associated with higher allocations to illiquid assets.

1. **Building an insurance carrier de novo:** A de novo build involves significant up-front operating and capital expenditures–driven by personnel, technology, day-to-day operations, and SEC registration/licensing fees. The risk and size of the business, as well as the entity's registered location, can also increase capital requirements. Moreover, regulatory capital and/or capital requirements to achieve an "A-" rating–and thus break into bank, broker-dealer, and IMO channels–will be substantial.

   Given these challenges, the risk and return profile of a de novo build is VC-like in nature, with heavy capital outflows over the first four to seven years until the NewCo can reach meaningful returns on annuity sales (but with no guarantee of success). Alternatively, some sponsors have spent significant sums to acquire "shell carriers" with licenses in some states (typically <25) but with few if any premiums written. These in-place licenses can shorten the timeframe to scale by 12-24 months.

2. **Acquiring and building a sub-scale platform:** Another option is acquiring a sub-scale carrier ($2–10 billion in the General Account) that is fully operational in many states and writing premiums, with General Account capital to invest. Such acquisitions can be more costly than a de novo build but give the parent immediate asset management scale and significant product and distribution capabilities. The risk profile looks more like a small or mid-market private equity investment, but the new owner will have significant growth levers to build a more robust suite of products and expand distribution capabilities.

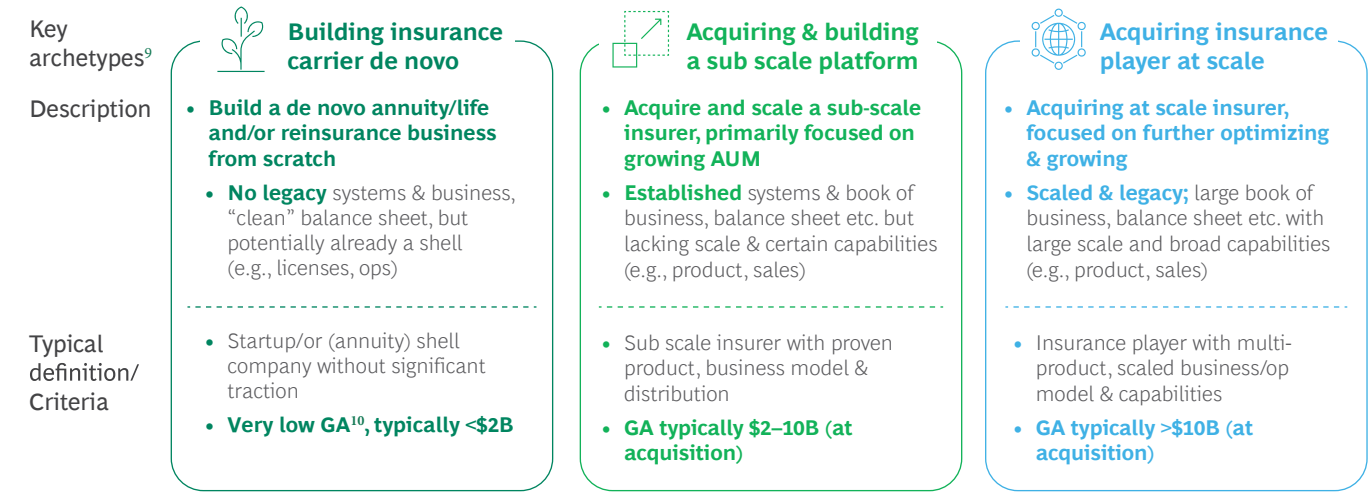
3. **Acquiring an insurance player at scale:** Acquiring an 'at-scale' carrier ($10 billion+ in the General Account) is only possible for the largest and most well-capitalized sponsors. The company comes with a very large General Account of investable assets and a scaled operation that will continue to bring in capital from premiums. The risk profile of this approach looks like a mature large-market private equity investment, with the most likely short-term value creation lever being the parent's ability to massively expand the FRE generated from the new carrier subsidiary.

Future Directions and Considerations

As alternative asset managers deepen their engagement with the L&A insurance sector, they must manage increasingly complex operating models. On the asset management front, there is heightened market volatility and hedging costs, elevated interest rates, the threat of persistent inflation, and geopolitical tensions that have triggered protectionist policies. These factors all impact investment risk and yeilds. On the carrier front, there are proposed regulatory changes, and the potential impact of macroeconomic conditions on product demand.

We anticipate multiple business models will be able to win in this space and alternative asset managers will need to make a few strategic decisions upfront in order to execute and quickly scale their carrier partners. But the reward for making the right decisions and managing these myriad complexities is potentially immense. FAs and FIAs represent large and growing[8] addressable markets where demographics trends (i.e., aging population) portend stable and sustained growth. Thus, carrier partnerships are not only accretive to the manager, but they are also scalable. For sophisticated managers willing to manage the capital intensity, risk management requirements, and regulatory oversight, L&A carriers provide a compelling path to acquiring and growing a substantial permanent capital base.

Exhibit 7 - Three strategies to enter the L&A insurance business



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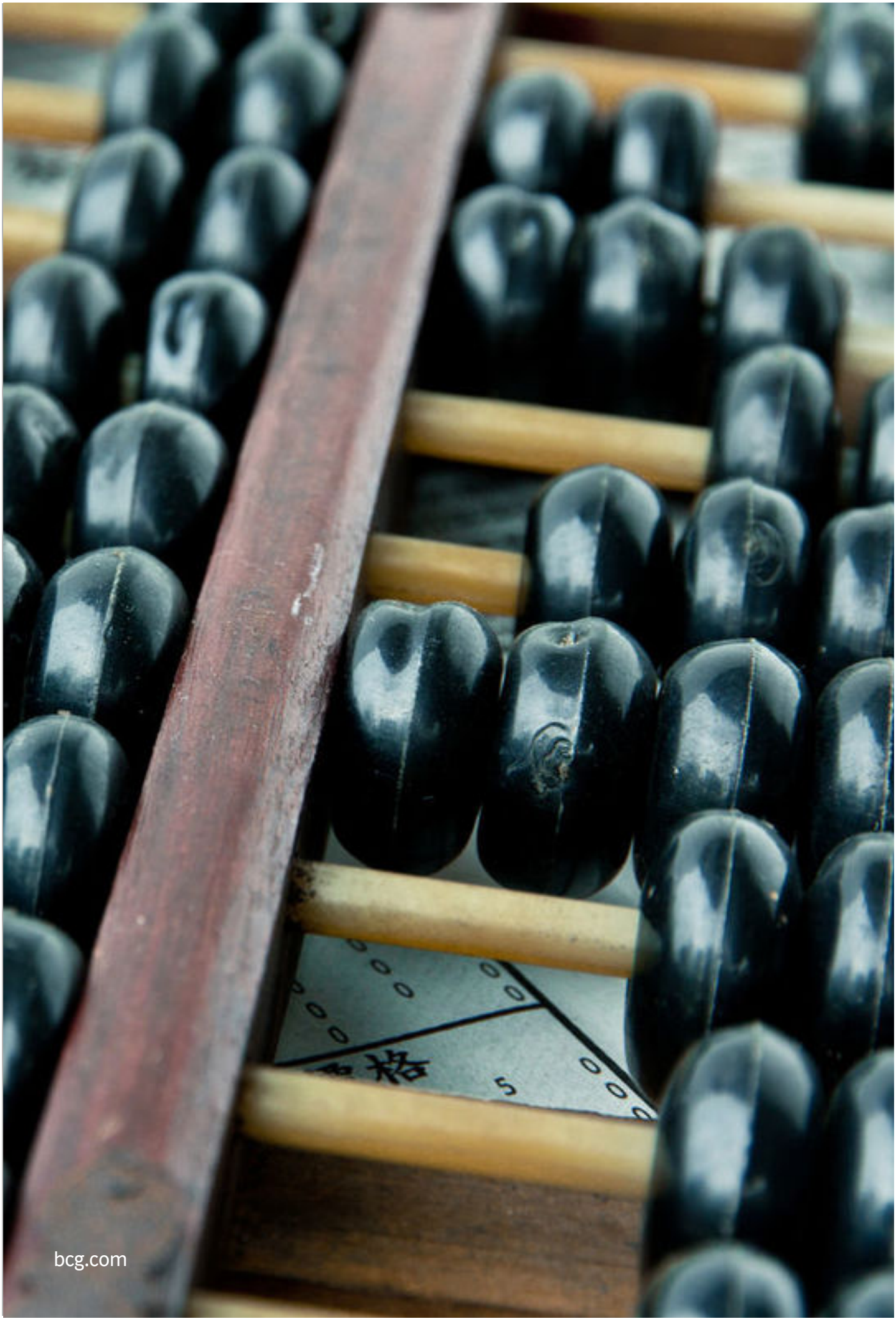
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Appendix

1. Here we define permanent capital as capital available for an unlimited time horizon or for a long-term horizon extending well beyond the standard 10–12 year private capital fund life cycle. Note that despite the “permanent” descriptor, partial liquidity may be offered in some form. p.1

2. 10-Year CAGR from 2012–2022. p.2

3. Admitted assets (AA) refer to those assets that an insurance company is allowed recognize for regulatory purposes on its balance sheet, ensuring they have the means to meet their obligations to policyholders. p.2

4. While credit is the main focus, a small share of the carrier's general account may be invested in other asset classes such as private equity, p.3

5. The term “PE-influenced insurers” refers to insurers that are either a portfolio company of a PE firm or in which a PE firm holds an ownership stake. p.4

6. Alternative asset manager valuations are largely comprised of two main components: fee related earnings and earnings from carried interest p.5

7. Total mgmt. fees only shown for the following managers with affiliated insurance mandates: APO, ARES, BAM, BX, CG, and KKR. p.6

8. Fixed annuities and Fixed index annuities, grew at 21% and 7% CAGR respectively from 2017–2022. p.8

9. Archetypes not fully mutually exclusive; some examples may have elements of different archetypes. p.8

10. GA = General Account