

The counterfactual

Structure

1. This appendix considers the operating environment, the parties, the transaction, and the financial position of both CBSPC and CBSIH before turning to the alternative options that would have been expected to prevail absent the merger (the counterfactual).

Operating environment

2. In January 2005, Argenta purchased Anton, reducing the number of members' agents from four to three. In the years prior to this there had been a steady decline in the number of members and their capacity, the number of members' agents and the number of syndicates open to unaligned capital.
3. While there is a range of views as to the future of unaligned capital in the Lloyd's market, CBS is more pessimistic than Hampden regarding the future of individual members and of members' agents: CBS told us that it saw no future for members' agents or for individual members in the market generally; Hampden told us that it did see a future for the business and even hoped to attract more members. The ALM told us it believed that the introduction of LLPs at Lloyd's in 2007 should lead to an eventual increase in the number of individual members of Lloyd's.

CBS group

4. The parent company of CBSPC is CBSIH. Following the sale of CBSPC's members' agency business, no CBS group companies are now engaged in the supply of members' agents services. Following the sale of the companies involved in the management of Insurance Capital Partners LP¹ in October 2006, CBS's activities now consist only of managing the run-off of certain underwriting vehicles.

Background to the sale of CBSPC

5. CBS told us that tentative merger discussions had been held with Hampden on an occasional basis at various times. The most recent negotiations with Hampden were initiated by CBS towards the end of November 2005. These negotiations began at around the same time as a series of discussions with CBSIH's banks culminated in a letter being received from the banks, requesting CBSIH to address as a matter of urgency the banks' desire to have their exposure to CBSIH reduced promptly from £20 million to nil.
6. The initial proposal was for CBSPC to be acquired for [REDACTED]. Following initial discussions with Hampden's principal shareholder, the structure of the transaction was changed and a potential 'Blue Book' offer (an offer under the Takeover Code) for the entire CBS group was mooted.

¹A fund which is designed to provide an alternative method of investing in Lloyd's.

7. After some time spent negotiating the terms of this proposed offer, the focus of attention switched to an acquisition by HAL of CBSPC's members' agency business only. [✂]
8. [✂]
9. CBS told us that Hampden's proposal that the transaction should be effected as a transfer of business rather than a corporate sale had the merit, in its view, of safeguarding employees' employment rights.
10. Further, the fact that Hampden's offer was not expressed to be conditional upon OFT or CC clearance was considered to be a full mitigation of the risk described in paragraph 8.
11. There was no bidding war and CBS did not see the possibility of creating one. Its investment bankers did not come up with any other potential buyers. CBS told us that it had had discussions with Argenta in the past about buying CBSPC but that Argenta had expressed only 'a modest interest' and perhaps more importantly was not prepared to make an unconditional offer. A management buyout was considered unlikely due to the high cost, management unwillingness, difficulty of sourcing third party funds and a declining business (see paragraph 49).

CBS's rationale for the transaction

12. The timing of the sale was driven by the financial position of the CBS group: CBS told us that CBSPC was a wasting asset and would be sold or closed soon, and CBSIH had just been approached by its banks when Hampden made the offer. CBSIH was under severe pressure from its banks to liquidate assets because of underwriting losses in 2001 to 2003 (see paragraph 40), of which CBSPC was the one most readily available for sale.
13. CBSPC's revenues, profits and thus value had been predicted to fall steadily from 2005. It had lost over 25 per cent of its external clients since 2003. CBS told us that costs taken out of CBSPC in 2004/05 had preserved its profitability but CBS did not believe that further cost savings could be achieved without compromising service levels to the extent that a spiral of declining service and client losses would be initiated.
14. HAL had renewed efforts to solicit CBSPC staff with significant personal followings among individual Lloyd's members. This was likely to continue to damage CBS's business and could ultimately have led to the collapse of CBSPC.
15. CBS told us that since the end of 2001 it has been in breach of its financial covenants under the letter of credit facility with its banks. As a result, the banks looked to CBS's assets as security for their commitment. [✂] The only readily saleable asset at that point was CBSPC. The group's syndicate capacity, held in CBSICP Capital Limited, can only be sold either through a sale of the company to Insurance Capital Partners LP or some third party, or through the sale of the capacity at auction in August/September 2006.
16. [✂]
17. CBS told us that if insufficient capital was raised for Insurance Capital Partners, this fund would be wound up and CBS would either be placed in administration or, more likely, solvent run-off.

18. CBS believed that the members would be better off at the enlarged HAL as the combined entity would be better placed to survive longer and provide services given that the business depends on scale. CBS believes that a bigger members' agent will better serve the members' interests.

Hampden's rationale for the transaction

19. Hampden group invests in 'sunset' businesses, often insurance companies in run-off, and tries to turn them round. The attraction to Hampden of this transaction was that it:
- gives HAL more capacity and revenue at 'a relatively cheap price';
 - adds scale for marketing activities;
 - provides research scale for the combined group; and
 - gives the benefit of scale in providing capital to managing agents, who often want a minimum amount of capital before they are willing to add unaligned capital to their syndicate.

Hampden believes that the market still has growth potential.

20. HAL could have taken business away from CBSPC piecemeal by poaching the names' executives one at a time, but it believed that this may have resulted in greater leakage compared to a one-off transaction, ie that many of the members and their names' executives might well have left the market entirely or moved to Argenta.

Argenta's position

21. Argenta told us that it had been called late in the day and invited to make an offer for CBSPC, but believed that it had not been in real contention for the CBSPC business.
22. Argenta would have considered making an offer for CBSPC but was not willing to make an unconditional bid at that stage: it would most likely have made any offer conditional on OFT/CC approval.

The transaction

23. [✂]
24. In anticipation of the members novating to HAL, the research and back-office staff transferred to HAL under TUPE with the client records (the majority of the former CBSPC members agreeing to novate their business to HAL at the request of CBSPC). In addition, CBSPC signed a non-compete clause (regarding members' agents business) for five years after the sale.
25. It is relevant to consider closure costs for CBSPC. [✂]

'Failing firm' counterfactual

26. There is a particular type of counterfactual where the acquired company (in this case CBSPC) is stated to be failing. For a firm to be considered as failing, the CC would need to be satisfied that:²
- the firm is unable to meet its financial obligations in the near future; and
 - the firm is unable to restructure itself successfully.
27. In addition, if we believe that CBSPC is a failing firm and that its sales were likely to be dispersed across Argenta and HAL, then the merger, by transferring most or all sales of the failing firm to HAL, could potentially have had an impact on competition in the market. If the great majority of sales may be expected to switch to the acquiring firm anyway, the merger may have had little effect on competition.

CBSPC

28. As can be seen in Table 1, historically CBSPC has been profitable. We have been told by CBS that the trading position had deteriorated in 2006 and was expected to deteriorate further in 2007 and 2008 with a loss projected in the year ending 31 December 2008. The historical and forecast data is shown in Table 1.

Source of financial data

29. When analysing CBSPC financial performance, we have considered data from a number of sources. The results we have used are the 2006 budget created in June 2006 and the forecasts produced in May 2006. All figures were prepared by CBS. These projections were created for the purposes of this transaction (CBSPC did not produce forecast accounts more than one year in advance). They had been used internally for the sale decision and already existed, but CBS described them as a 'best guess'.
30. CBS told us that it did not set profit targets for CBSPC: as the income arises in part from percentages of the capacity written, setting profit targets might incentivize staff to recommend underwriting even when this was not in the best interests of their members.

²Paragraph 3.62 of the CC's *Merger References: CC Guidelines, CC2*.

TABLE 1 CBSPC

	2001	2002	2003	2004	2005	2006 6 mths (YTD) JuneB	2006 JuneB	2006 MayF	2007 MayF	2008 MayF
Number of members	1,030	946	883	833	706		597	597	N/A	N/A
										£'000
Turnover	7,769	7,221	7,771	9,324	7,053					
Turnover per member	7.5	7.6	8.8	11.2	10.0					
Costs										
Staff costs	3,535	3,418	3,669	3,809	2,944					
Other	1,680	1,728	1,676	1,756	1,752					
Total costs	5,215	5,146	5,345	5,565	4,696					
PBT	2,554	2,075	2,426	3,759	2,357					
PBT per member	2.5	2.2	2.7	4.5	3.3					
PAT	1,757	1,442	1,685	2,629	1,604					
Dividends	1,521	1,401	1,900	2,600	0					
Retained Profit	236	42	(215)	29	1,604					
Profit margin (%)	33	29	31	40	33					
Net assets	2,177	2,218	2,179	2,207	3,811					
Return on net assets (%)	81	65	77	119	42					

Sources: Statutory Accounts for historical data, CBS forecasts as at 22 May 2006 (MayF), and CBS budget as at June 2006 (JuneB).

Notes:

- Return on net assets is taken to be (PAT/net assets), profit margin to be (PBT/turnover).
- N/A = not available.

31. Key points to note are that:

- the number of members has been in decline throughout the period shown;
- revenues held steady from 2001 to 2003, peaked in 2004 and have been in decline thereafter;
- revenue per member has increased although the profit has not increased in proportion;
- CBSPC has been profitable throughout the period and has been paying out these profits as dividends, except for 2005 in which they were retained. The retention of the dividends almost doubled CBSPC's net assets;³
- [REDACTED].

32. The 2005 profits include £851,000 charged to proprietary underwriting (which do not recur in the forecasts) and winding up fees of £418,000 (which would only recur in the event that further members left the market, rather than switched to a competitor). CBS told us that the adjusted profits for 2005 were therefore closer to £1 million. Similarly the 2006 June budget includes winding up fees of £[REDACTED] giving an adjusted profit of £[REDACTED].

33. We have been told that CBSPC's profitability is further overstated because of intercompany charges. The net group service charges in 2005 and the budgeted charges for 2006 are £319,000 and £[REDACTED] respectively. While the removal of these

³This is as a result of a change in accounting practice regarding the treatment of dividends.

(without removing any associated costs) would reduce the profits in both years, neither year would become loss-making.

34. The costs of the senior management (CEO, FD and Chairman) are already included in all of CBSPC's financial data (shown in Table 1). It would therefore have been possible to bring in new management without affecting the financial performance of CBSPC.
35. Members' agents have high fixed-costs, and rely on volumes to generate profits. The average age of CBSPC's members is 64 and CBS therefore expected the market to shrink as its members left. CBS believed that CBSPC's business volumes would decline and CBSPC would become unprofitable, and that it was a question of when, not if this happened. CBS believed that it would occur in 2006 or 2007. Moreover, CBS had expressed doubts as to the position of individuals underwriting at Lloyd's and the manner in which they should participate in the Lloyd's market.
36. CBS told us that it would have been difficult for CBSIH or CBSPC to restructure in such a way as to improve the group's profitability:
 - Any profit commission takes over three years to appear in cash form (even assuming the underwriting year is profitable, which is not known at the time) and would not therefore have helped CBS in the short term.
 - CBSPC had previously charged profit commission but it had stopped in the mid-1990s. It would have been difficult, and possibly fatal, for CBSPC to go back on this (it had gained some new business by changing the charging structure). CBS told us that CBSPC would have not been able to raise its flat fee sufficiently in the short term to cover its financial difficulties: it may have led to a loss of clients, potentially reducing revenues, and in any case the fees could not have been raised until 2007.
37. Hampden told us it believed that CBSPC did meet the CC's failing firm test as it would have soon been unable to pass its Lloyd's solvency test (required for each members' agency), due in particular to the contingent liability on CBSPC under guarantees for associated companies. However, Lloyd's told us that it had no concerns about CBSPC's ability to meet its solvency requirements at the time of the merger. CBS told us that the bank guarantees were qualified to restrict the banks' ability to enforce them beyond a point that would cause CBSPC to breach its regulatory capital requirements.
38. We do not believe that CBSPC was a failing firm. However, if a sufficiently large number of members or names' executives had left, the business could quickly have entered the spiral of decline mentioned in paragraph 13.

CBSIH

39. We have been told that CBSIH, CBSPC's parent, was in serious financial difficulties. Its chairman stated that it had 'insufficient capital to justify a continuing involvement in underwriting'⁴ and that CBSIH was planning a disposal process and a run-off of the Group's underwriting activities. Its results are set out in Table 2.

⁴CBSIH 2005 statutory accounts, p6.

TABLE 2 CBSIH plc

	£'000				
	2001	Restated 2002	2003	2004	2005
Net premiums written	259,015	115,249	139,610	110,302	79,311
Balance on technical account	-22,584	-2,925	-1,666	2,333	1,388
Non-insurance income	6,664	8,806	7,944	9,500	13,792
Other charges	-7,483	-9,275	-9,897	-13,263	-11,003
Operating profit/loss	-23,403	-3,394	-3,619	-1,430	4,177
Loss before tax	-29,233	-324	-3,565	-1,015	3,399
Net assets	12,338	9,904	7,452	2,283	2,051

Source: CBSIH consolidated statutory accounts.

Notes:

1. Balance on the technical account is the result from the company's insurance operations.
2. Other charges are expenses not attributable to underwriting or investment management business.
3. CBSPC results are included in 'non-insurance income'.

40. CBSIH made losses in each of the years 2001 to 2004, and a profit in 2005. Its losses were primarily driven by its insurance operations: it made insurance losses in 2001 to 2003, and profits in 2004 and 2005. These results reflect underwriting (syndicate) profits and losses in the periods three years earlier.
41. CBSIH told us that the impact of the hurricanes in the 2005 year of account is still uncertain but the year is expected to be loss-making. In addition to the uncertainty about the 2005 underwriting year, the Group is exposed to any improvement or deterioration in respect of 11 syndicate years of account in run-off relating to the 2000 and 2001 years of account. These have been kept open by their managing agents due to the uncertainty over the quantum of losses in respect of 11 September 2001 and US casualty business.

CBS options

42. The options facing CBS at the time of the transaction are set out below:
 - CBS sells CBSPC to HAL (the merger);
 - CBS sells CBSPC to another company;
 - CBS continues to run CBSPC as it is, perhaps after restructuring (eg its fee structure) to derive more income or refinancing the CBS group;
 - CBS closes CBSPC; and
 - CBS becomes insolvent and administrators take over CBSIH and CBSPC.

Sell

43. Other than HAL, potential acquirers of CBSPC may include:
 - Argenta;
 - a management buyout/management buy-in;

- Newton Follis; and
 - other.
44. Any acquirer would need to be authorized by the FSA and approved by Lloyd's before it could hire any names' executives or take on their members. Of the potential acquirers we are considering, only Argenta already has this status. The company post-management buyout/management buy-in may have been able to obtain regulatory approval if it had recruited suitably qualified senior management. Other than HAL and Argenta, the other potential acquirers were those with advisory functions but not the other skills necessary for a members' agency.
45. A sale to anyone other than Argenta would have been slower and more risky than the sale to HAL and each would involve delay which CBS's financial position could not tolerate. A sale to Argenta would have been slower as it would have been dependent on prior competition clearance.

Argenta

46. We believe that Argenta is the only realistic purchaser of CBSPC other than HAL. It had expressed an interest before and Lloyd's is unlikely to have raised any more concerns than for the sale to HAL. However, it was not approached until late in the day.
47. Similar competition concerns arise, although the combination of CBSPC and Argenta would have had fewer members than CBSPC/HAL.
48. However, CBS had had discussions with Argenta in the past about buying CBSPC and it had expressed only a modest interest. Argenta was at that stage unwilling to make an unconditional offer for CBSPC. It would not have taken on the risk of a referral to the CC and would have sought OFT or CC clearance prior to completion, as it had in December 2004 for its acquisition of Anton.

Management buyout/management buy-in

49. Both a management buyout or management buy-in appear to have been unlikely:
- The senior management of CBSPC would have remained in CBSIH and CBSPC would therefore have needed to acquire new senior management with the requisite skills which would have been time-consuming.
 - The senior employees in the business knew about the sale and expressed no interest in a management buyout.
 - It may have been difficult to find external finance for this business due to the expected decline in the size of the market. However, some individual members, eg Patrick Moore told us that they may have been willing to help finance the business.
 - The names' executives were, for various reasons, thought to be unlikely to extend themselves financially, for example by mortgaging their houses, to fund any management buyout. We have been told that they would probably rather retire or change career.

Newton Follis

50. Newton Follis is a small organization:
- it consists of four directors and one other employee; and
 - in the year ended 31 December 2005, it had a turnover of £448,000, profit after tax of £102,000, and net assets of £308,000.
51. Newton Follis would need approval from Lloyd's before it could become a members' agent. It would also need to have completely changed its business model in order to become a members' agency.
52. It told us that it had no intention of establishing a fully fledged members' agency and would only go into competition with Argenta and HAL if it were able to do so in the form of a Lloyd's adviser, not having to manage the administrative aspects which Newton Follis believes should be handled by LMAS.
53. In any case, because of its size, it may have had capital issues with the FSA/Lloyd's and is likely to have had to raise new capital to meet the Lloyd's solvency requirements.

Other buyers

54. There are no other identified buyers: neither Hawkpoint (CBS's advisers) nor CBS had identified a purchaser other than HAL and Argenta. Also, given the urgency of CBS's position, a key driver was the need for a quick sale.
55. One managing agent told us that in its opinion a large financial institution, such as a fund manager, would have been a possible buyer of CBSPC if it had been put up for sale more publicly.

Retention by CBS

56. As discussed earlier, we have been told that CBSIH was in a difficult financial position and that if CBSPC had not been sold CBSIH would have soon been in administration. CBS has told us that there was no 'plan B' to the sale.

Close

57. There appears to have been no reason pre-sale for CBS to have closed CBSPC: it was a profitable business and had some value.

Administration

58. If CBSIH had been forced by its bankers into administration, the administrators are likely to have been faced by the same options for CBSPC as CBS had been and a timetable that was as urgent.
59. It is likely that the principal requirements for the administrators would have been for a sale that was quick and unconditional. The administrators would not have wanted to take the risk that the value of the business would dissipate further as names' executives and members left.

60. It is likely that the buyer from the administrator would have been either HAL or Argenta.
61. However, if no buyers could be found for CBSPC in the short term then closure may have resulted. The likely result of closure would have been:
- some of the names' executives would have moved to HAL or Argenta taking with them their clients, and some would have retired; and
 - some of the members may have stopped underwriting. Hampden told us that in the Anton/Argenta merger, Lloyd's used its substitute agent powers to transfer 18 per cent of the members involved in the transaction and that a substantial number decided to leave the market rather than novate to a new agent.