Cohen Strategic Consulting
Michael A. Cohen, Principal

The State of Publicly Traded Life Insurance Companies
2009 Update

"Weathering This Tsunami"

Publicly-traded life insurers are facing the most difficult marketplace conditions in their histories. This is not to say that mutual life insurers have not had their own significant problems; they certainly have. Life insurers of both structural forms have faced a myriad of issues: substantial investment losses (both in terms of investment income and capital losses), in large part as a result of severely crippled equity and bond markets. These losses, combined with diminished operating profitability, have caused nearly all insurers to suffer substantial reductions in their capital. Sales have plummeted, as consumers have been loathe to spend in general, irrespective of the important financial needs that life insurers' products meet.

As difficult as these issues have been, public companies have faced additional hardships. Further, some of these companies have had their very existences challenged … to a much greater extent than their mutual company bretheren. Most visibly, their stock prices have taken severe beatings along with companies in all industries. The drastic downturn of the investment markets took a terrible toll on all companies, but more so on public companies and their stock prices.

GAAP accounting rules require that public insurance companies write down the value of investments that have fallen in value, on a much more accelerated basis than under Statutory accounting rules. Given the associated impact on their book values (which are typically benchmarks for stock prices), and because their fortunes are so closely aligned with the bond markets (which were also roiled in the financial crisis) given the substantial bond holdings virtually almost all life insurers have, the beatings that their stock prices took were severe. The largest 15 public life insurance companies saw an <u>average</u> drop of their stock prices of 88% from their peaks in late 2007 to their troughs early in 2009. The stock prices of these companies have 'recovered' to an average of 38% of their price peaks at the time of this writing (August, 2009). The companies in this group have experienced a wide range of results, but none were very encouraging. The best performing 5 saw their stock prices drop an average of **only** 75% and recover to an average of 60% of their peaks, while the poorest performing 5 saw their prices drop an average of **98%** and recover to only 17% of their peak prices. The middle group had price performance approximating the overall group as a whole. The Dow over this period sank to 46% of its peak, and the S&P 500 fell just slightly more, to 43% of its peak. The two broad indexes have recovered to a grater percentage of their peaks as well, 66% and 64% respectively.

As a result of all of these dynamics, their financial flexibility was greatly impaired. The deep freeze of the capital markets further exacerbated the problem. The federal government's TARP program (Troubled Assets Recovery Program) was literally a life saver for a couple of these companies.

A very popular product category, Variable Annuities, has suffered from a myriad of problems, hurting many of the companies who offer them. This is an industry segment that has seen considerable consolidation among the largest writers (with roughly 95% of sales coming from the largest 25), with the vast majority of sales coming from the largest public companies.

Public companies are confronted with a number of difficult questions:
- Have certain publicly-traded insurance organizations been damaged so severely that they cannot recover? For those that do recover, how long can their recoveries be expected to take and if they do so will they be able to approximate their overall strength of two years ago?
- Do they have businesses (or business elements) that will likely not be able to perform as well or as close to as well as they did prior to the financial meltdown (and be faced with the need to divest them at inevitably depressed prices)?
- Are there financial institutions from other sectors that can replace them in terms of satisfying consumer needs and wants for protection, asset accumulation, retirement income (rendering insurers at least partially irrelevant)?
- In the face of these significant business challenges, will they need to change their strategic focus?

There are a number of elements of their operations that public companies have to rebuild in order to regain their footing and return to their prior successes:
- Profitability
- Capital strength, quality of balance sheet, access to capital markets on favorable terms
- Product sales
- Soundness of asset portfolio

What strategies can or should they pursue to rebuild and strengthen themselves?
* Rebuilding profitability and capital
* Making acquisitions/divesting undesirable aspects of their operations
* De-risking their asset portfolios in particular, and their companies in general
* Reviewing their business and product portfolios to determine which have manageable profit and risk dynamics

A serious question these public companies need to ask themselves, on top of addressing the aforementioned strategic issues: Are there fundamental errors of management judgment or blind spots of thinking that need to be corrected going forward (that might have increased the severity of their problems and may well hinder their return to prosperity)?

The Origin of this Tsunami: What was the Role of Insurers in This Financial Disaster?

This ‘tsunami’, and the causes behind it, has been brewing for quite some time. Many powerful and disastrous forces converged to create the fragile economic/financial state we are now in. Insurers are asking themselves, “Did we have a role in helping create the situation we are in?”

A number of powerful factors contributed to this situation:

- **The real estate market plunged into its worst cycle in decades, and possibly ever.** This collapse was caused by a number of dynamics:
* Selling housing/making loans to individuals or companies whose financial positions were not strong enough to service their financial obligations. One of the great American ideals is homeownership, which in and of itself is a lofty goal, but another great American ideal is pulling oneself up by the bootstraps and making ones’ own way; these two ideals collided with tragic results for the real estate market and the American public. A substantial price bubble was created and inevitably burst, as many have before it, but this time the entire American society was hurt badly (as opposed to individual investors in past bubbles).
* An enormous price bubble in real estate was created by the outsized appetite of buyers (individually and collectively), and it burst with a vengeance. An enormous amount of delinquencies and foreclosures ensued, real estate values plummeted, lending institutions pulled back on credit, and a huge inventory of uninhabited properties resulted.

- **The banking system almost collapsed**, and may have had it not been for considerable government intervention, which has raised a host of other profound issues. An enormous amount of bad loans were made as the result of capricious underwriting, leading to huge amounts of bad assets on banks’ books and causing a paralyzing level of fear on lenders’ parts for making further loans.

- **The financial markets ‘froze’**. The flow of capital slowed to a trickle because lenders did not believe that borrowers were credit-worthy; ironically, the prevailing thought process evolved from lending money to anybody to lending money to no one. The markets are beginning to thaw, somewhat, over a year later.

- **Complicated financial instruments confused and overwhelmed the system**, creating enormous risk. Counterparties, partners in transactions, did not understand many of the vehicles they were buying and selling (and in many cases how their counterparts were managing their own enterprises) … and the risks they were taking on. A certain notorious business organization has long operated on the notion “Be close to your friends, and closer to your enemies”.

- **The equity markets were wracked by panic**. Institutional and individual investors completely lost confidence in equities and their values, and the ripple effects were crippling to the life insurance and every other industry:

* Stock prices fell dramatically (affecting companies' stocks and their equity holdings).
* Variable products had lost their appeal
* Prices for hedges rose dramatically

- **Asset managers made ambitious claims** about investment returns they said they couldn't possibly achieve, and others committed outright fraud

- **The rating agencies have been called to task** over their role in the current situation, and a number of vexing questions have been raised:
  * How are they analyzing companies and investment vehicles?
  * How are they to be paid for their rating services? Are there conflicts of interest imbedded in their client relationships?
  * How will they be operating going forward?
  * How will they be regulated?

- **Investment bankers and others facilitated transactions built on elements that had not been properly vetted**, and which have turned out to have crushing levels of risk and unforeseen financial liabilities

- **Consumer attitudes have been more negative than ever** since they began being monitored in the 1960's, although recently they have begun to improve as economic and financial stabilization begins to occur. The population at large is scared, more than just worried. The widespread view is that the current situation was beyond a cyclical downturn, and has been perceived as a failure of the system. Uncertainty about the financial system, widespread unemployment, restricted credit, and a depressed housing market have all contributed to depressed consumer sentiment.

The U. S. government has instituted a number of responses in the form of rescue programs of various types to address this unprecedented issue. These programs are just beginning to fix the problems within the financial system (banks and insurers) and key industries (automotive), and are gradually beginning to calm fears. Substantial efforts to revise the nation's financial services regulatory infrastructure are underway, conceived to both address current issues and create a more shock-free system in the future. A number of vexing problems have arisen, however, that will be very difficult to solve:
  * Well intentioned programs to interject capital to troubled sectors of the economy have been difficult to implement (in terms of getting the funds into the necessary hands)
  * Massive budget deficits are building, which will lead to substantial debt servicing obligations in the future (which will be further exacerbated by the inevitable rise in interest rates) and consequentially depressed economic growth
  * The government owns stakes in huge corporations (with the implication of socialistic-type government in the United States, something almost impossible to fathom), and is being perceived as making broad decisions on which corporations will survive or fail.
  * International relations (financial and otherwise) are particularly stressed, although many would argue that this is a normal state of affairs. Further:
    - Business/economic policies undertaken by countries are seen as counterproductive to their trading partners. The European Union is basically a great concept, but its

members (27 countries at the time of this writing) have different views as to how to solve their economic and financial problems
- Many countries are blaming the United States for the world's economic predicament, also arguably a normal state of affairs

- Questions abound:
* Were life insurers in the wrong place at the wrong time?
* Are they inexorably linked to other financial institutions (counterparties) that can falter and take other corporations down with them?
* What role did AIG play in dragging down the economy and its insurance company brethren? Were AIG's crippling issues insurance or non-insurance related? (or somewhere in between?)
* How has the ostensibly valuable business practice of risk management failed in its mission? More fundamentally, what is 'risk management'?
  - Understanding that things that can go wrong (either known or unknown), and making sure the adverse affects do not cause crippling and irreversible harm. If that is so, how did so many elements of this financial disaster occur that had aspects and implications of risk that no one either understood or quantified anywhere close to properly, or didn't bother to look at?"

Acquisitions: A Winning Strategy for Public Companies?

"Winning bids are made by winning bidders"

A*uthor Unknown*

"Is there such a dynamic as The Winners' Curse?"

Richard H. Thaler

Is an acquisition strategy a positive endeavor for a public company? Is it a strategy necessary for the survival of some public companies? What constitutes success? In these difficult times, even for companies that have a track record of success in this area, is an acquisition the answer? The following passage explores the various elements of the thought process companies go through when they consider an acquisition strategy, and handicaps what outcomes need to take place in order for an acquisition to be seen as successful.

Success: According to Whom?

A property isn't valued on the same terms by a buyer and a seller. Buyers and sellers are trying to accomplish different things relative to their particular situations:
- The buyer is trying to enhance his business (ideally strategically, not just only financially … although improving one's financial position at this time looks very

appealing!); on what criteria will the buyer's acquisition be viewed a success?
- The seller is trying to either raise capital or increase focus; on what terms will the seller's divestiture be viewed a success?

Acquisitions as an Element of Corporate Strategy: Various Perspectives

"We see the opportunity to make suitable acquisitions at the right price as just another way of meeting our corporate objectives"

"We see acquisitions as crucial to achieving our objectives"

"We are an acquisition specialist"

"Our strategy is to make acquisitions and then integrate them effectively"

Which is of these approaches is right for you, if any? … and, if so, under what circumstances?

Enhancing an Organization's Business Model: Can an Acquisition Be a Driver of Positive Change?
Existing business model → Clear business case → Enhanced business model

A well respected expert on business strategy and planning, Russell L. Ackoff, presented the concept of 'idealized design" … what is the best conceived business model a company can put into place? Does an acquisition help a company make its business model more effective?

What Does an Acquisition Accomplish to Enhance the Business? Does It Make a Company a More Successful Competitor?
- Expand distribution
- Expand geographic coverage
- Achieve business growth, scale
- Acquire functional capabilities
- Increase profits and capital

Enhancing the Business Model via Acquisition to Better Meet Corporate Goals and Objectives
- Mission, Vision
- Profitability: EPS, ROE, EVA; is the acquisition additive to earnings, and if not when will it be?
- Market share: Will additional share provide the ability to dictate competitive terms? Given how fragmented the life insurance industry is, can the largest companies (as large as they are) change competitive dynamics in their favor?
- Are economics of scale gained? Is less desirable (unfavorably priced) business being acquired? As said, since most insurance business segments are so fragmented, even after decades of consolidation activity, does market share even matter?

- Is a company's business profile materially enhanced?
- Is favorable diversification gained? Is focus lost?

Execution of an Acquisition Strategy Goes Through Several Stages (they must be performed well, and there are numerous junctures where things can go awry)
- Clarify corporate strategy and the enhanced business model
- Assess market opportunities
- Define the business case
- Develop selection criteria
- Identify potential targets
- Analyze and assess targets
- Integration

Q: Is an acquisition strategy a core competency of your company? Can you execute such a transaction successfully?

An Acquisition Involves Many and Varied Complex, Interrelated Business Issues
- Strategy
  * Fit vs. conflict
  * Synergies; <u>many</u> times potential synergies are overstated
  * Diversification
  * Competitive dynamics
- Operations
  * Technology
  * Administration
  * Core competencies
- Financial
  * Earnings
  * Capital
  * Economic value
- Investments
  * Asset classes
  * Loss positions
  * Liquidity
- Market/Competitive Position
  * Products
  * Distribution
  * Markets/segments
  * Brand/reputation
- Risk/Volatility/Confusion

Due Diligence is Performed on any Acquisition Target - A Critical Activity on the Strategic and Tactical Levels
- Valuation, impact on future financial results
- Management/staff
- Profitability of new (potential), existing business
- Competitive market position; product management, distribution capabilities

- Synergies: strategic, operational, financial, market/product/distribution
- Investments
- Expense structure (efficiency, opportunities for reduction)
- Technology
- Contractual obligations
- Areas of risk or uncertainty

Many acquisitions are viewed retrospectively as failures. A lack of accurate evaluation of prospective acquisition targets leads many (most) acquirers to have unrealizable goals for their transactions, and as a consequence the end results (strategic, financial or otherwise) do not meet expectations. Conversations with rating agencies often attempt to mask 'curious' expectations of acquisition activity:
"The deal is 'fully priced,' but we did not overpay"
"The deal will work because there is overlap"
"The deal will work because there is no overlap"
"Cultures are similar despite apparent differences"
"Although not accretive, it's non-dilutive"
"Growth & profit objectives will be met through synergies"
Due diligence has (unfortunately) often been performed using 'rose-colored' glasses. A cold, hard analytical view is critical to the accuracy of due diligence.

Evaluating the Capability of an Acquirer: Being a successful acquirer requires a number of skill sets:
- Knowing one's own corporate strategy and operating model, and where acquisitions fit in
- Disciplined approach: evaluating fit, paying an appropriate price
- Thorough and accurate due diligence
- Effective integration
- Proactive conflict resolution

Drivers of Successful Acquisitions
- The transactions support/complement acquirer's strategy, vision, mission
- Realistic prices are paid based on economic value, both current and future
- A clear strategic, operational model is created for the resulting entity going forward
- Careful, accurate and objective due diligence is performed on the target company and management counterparts … *caveat emptor*
- Timely, well planned and orchestrated integration activities focus on achieving a favorable operational model, attaining a satisfactory level of cost savings; a number of companies that acquired positive reputations as acquirers were in fact poor at integrating their acquisition(s), causing their organizations to implode
- Cultural and human resources issues are managed very carefully, and conflicts are resolved proactively; this is the broad area where acquisitions have encountered the most trouble (by far)
- Open and continuous communication
- *Discipline! Objectivity!*

The General Lack of Success From Acquisitions is Attributed to Several Pitfalls:

Strategy
- Incompatible cultures
- Incompatible business models
- Synergy non-existent or overestimated

Due Diligence
- Acquirer overpaid
- Foreseeable problems overlooked
- Acquired firm too unhealthy
- Excessive divestiture or liquidation required

Implementation
- Inability to manage target
- Inability to implement change
- Clash of management styles/egos

Studies of acquisition activity across all industries (not just insurance) consistently have found that approximately two-thirds of these transactions yielded unsatisfactory results

"So You want to be a Public Company": A Historical Perspective of Demutualizations … With the Benefit of Hindsight

The wave of mutual life insurance company conversions has long since subsided. This was inevitable, as any U. S. life insurer of an appreciable size considered conversion to public companies a decade or more ago, and either converted or made a conscious decision to remain mutual. Of the 20 largest mutuals in mid-1996, only six made the decision to remain mutual (with another seven converting to the mutual holding company form). Two of the seven companies that demutualized had previously converted to mutual holding companies.

How have these companies fared as public companies subsequent to their conversions? Have their structures enabled them to execute strategies that were unavailable to them as mutual companies and prosper as a result? Have they become more profitable? Have they better served their policyholders? Have they achieved other benefits that were not anticipated leading up to their conversions? Has the life insurance industry changed for the better as a result?

A Look Back

As recently as 1986, the mutual life insurance company segment in the United States comprised approximately 50% of assets, capital and sales of the total life insurance industry. Most mutual life insurers gave serious consideration to the merits of becoming a public company. The prospective advantages of being a public company (vis a vis a mutual) were identified:

- The ability to raise capital through public stock offerings
- Additional flexibility to restructure the company
- Determination of a market value of the company
- Creation of a 'currency' (the company's stock) that can be used in transactions
- The ability to more quickly take advantage of market opportunities
- Enhanced public scrutiny of company operations and results, increasing the focus on growth and profitability
- The ability to incent management and employees with stock and align individuals' performance with company goals, which has been shown to be a significant enhancer of company performance, and to use these incentives to attract management talent
- Accounting comparability with the vast majority of companies across all industries

Following the conversions of Metropolitan Life and Prudential in 2000 and 2001 respectively, the 'share' of the total U. S. life insurance industry in terms of assets, capital and sales held by mutual companies shrank to approximately 15%. Clearly, the vast majority of mutual life insurance company executives felt that converting to a public company was the way to go. Executives of many of the remaining mutuals, however, were staunchly committed to that structure. They had strong beliefs that managing their enterprises for the benefit of their (participating) policyholders was of paramount importance, and many believed that operating as a public company would significantly compromise that focus; they also believed that they could manage proactively, and didn't need to have the pressure and expectations of a public company to manage well. Others were too small to be desirable demutualization candidates, in that being below a certain size would significantly limit the amount of float their stock would have and/or the cost to convert would not justify the limited advantages gained.

Benchmarks for Success

How successful have the demutualized companies been following their conversions? What are the appropriate indicators of success?

There are a number of relevant benchmarks to consider in evaluating the success of a demutualization:

- Enhanced financial strength
- Stock price appreciation
- Stronger businesses
- The effectiveness of actions taken because a company has converted, which wouldn't have been possible as a mutual company

<u>Enhanced financial strength</u>

Demutualized companies have not materially increased capital, and therefore their financial strength, at the point of their conversions; it has been common that they *replaced* capital that had been dispersed to their participating policyholders as compensation for ownership of the mutual company.

However, reflecting on the potentially advantageous action plans available to a public company, stated previously, many were thought to lead to greater financial strength (and flexibility) going forward as they were executed. As relatively little time has elapsed since the vast majority of demutualizations have taken place, few companies have yet enhanced their financial strength as they can be expected to. The financial crisis of the last couple of years has rendered this argument moot.

<u>Stock price</u>

The discussion earlier in this article has answered this question, as the financial crisis of has also rendered this argument moot.

<u>Stronger businesses</u>
(or the strategically advantageous businesses for the public company structure)

- Effecting actions that could not have been taken as a mutual company

One of the most anticipated benefits of demutualization by those companies contemplating it was the ability to use their stock as currency. MONY was able to acquire the broker dealer/money manager Advest by using its own stock to cover the acquisition price, outbidding a mutual company that did not have such currency. MONY, of course, was subsequently acquired by AXA Financial.

Another more general 'action' that demutualized companies have taken, more in terms of psychology than business execution, is that they have increased their overall sense of urgency. For years, any number of mutual company executives have commented that their companies needed to "act like stock companies". This observation clearly implied that they didn't want their companies to plod along, doing things at their own pace, but instead be fast-paced innovators and bring new products and services to the marketplace to more promptly meet consumer demand. It also meant that bloated budgets that depressed earnings were unacceptable, because equity analysts would be openly critical of mediocre financial performance. This is not to say, however, that all mutual companies have lacked this intensity and market focus. There are well documented examples of mutual companies that are extremely well managed, and well focused on their business fundamentals; they have decided that their corporate mission is (and should continue to be) to manage their enterprise exclusively for the benefit of their policyholders, and in a number of cases quarterly earnings pressures contradict this mission. It is not clear that conversions to the public company structure in and of itself has proven to be a differentiator of management effectiveness. Some observers opine that converted companies have exchanges one set of issues for another.

Was Conversion to the Public Company Structure (via Demutualization) for Everybody?

Clearly, the answer was and remains ‘no’. As previously stated, a number of companies have been resolute in their belief that their mission is solely to manage their businesses for the benefit of their (participating) policyholders, not compromising in any way their focus to please stockholders, and therefore remained mutual. Were one to survey managements of companies that demutualized, it would not be hard to imagine that their enthusiasm for managing a public company would be at least muted given all that has occurred over the last two years. It is not to say, however, that mutual companies have not had a number of the same problems as their public company brethren.

Today’s issues aside, there is an important issue that speaks to the relevance of different structures. A critical question needs to be asked with regard to any company’s corporate structure: “Is its structure optimal for supporting its vision, mission and the business lines in which it is operating and ultimately its performance, and if not, which form is?” The answer to this question is invariably different for different companies, and centers around the particular attributes made available by the various corporate structures. As previously stated, many companies’ managements cited the need for access to capital as the reason for wanting to restructure their companies. In some insurance businesses, there is an overabundance of capital (or there used to be!) and competitive ROEs are difficult to attain; there aren’t enough expansionary opportunities for additional capital to be deployed (let alone existing capital), and the returns in a number of insurance businesses do not cover the cost of capital invested in them.

A different scenario relates to the mutual segment of the industry and its long term practice of career agents selling permanent life insurance. The relatively high cost of distribution in this channel is well documented (in its defense it is a high value-added strategy), and as a result its returns on equity in this segment have trailed those of most other insurance (as well as non-financial services) lines, in part due to dividends paid to policyholders. It may just be, however, the best way to penetrate upscale markets and provide these demanding consumers with the personalized and sophisticated advice they seek; one might therefore conclude that a mutual company, without the need to satisfy shareholders with competitive returns, could be the most appropriate entity to provide recognized value added for this particular business thrust. On the other hand, capital intensive businesses such as disability income, long term care and annuities may well fit better within a stock company, where additional capital to support growth and build scale could be more easily raised and returns might be more attractive.

Sponsored Demutualizations

A variation of the demutualization theme is known as a sponsored demutualization. In this form of conversion, the converting company will not be operating on its own, but has a partner who in effect will be acquiring the converting company immediately upon its conversion. Sponsored demutualizations are very much like acquisitions, with the sponsoring (acquiring) company injecting capital or equity into the target (acquired, demutualizing company) to compensate its participating policyholders for their ownership stakes. Three examples of this particular variation of demutualization are: AXA and Equitable Life Assurance of New York (1992), AmerUs and Indianapolis Life (2001), and Nationwide and Provident Mutual (2002). These transactions ostensibly had favorable attributes for each of the partners, which varied depending on the particular situation, providing compatible business lines for the acquirer, while integrating the acquirees into larger, more diverse insurance operations. In the case of Equitqable, it had significant liquidity and asset quality problems it could not resolve on its own, and the infusion of capital from AXA enabled it to resolve these problems. It subsequently was able to perform at a much more successful level.

Conclusion: Rating Implications As Barometers of Future Performance

Performance is the Issue – What Drives the Relative Claims Paying Ability of Public and Mutual Life Insurance Companies?

Comparing the profitability and capital strength of mutual and stock companies is an unwieldy exercise, one that has frustrated insurance industry analysts over time. That mutual companies operate in part to offer their policyholders insurance "at cost" (by returning excess premiums as part of the dividends) has a dampening effect on income. Accordingly, it is difficult to make meaningful comparisons of profitability/ operating performance generated by public and mutual companies and hence make relevant observations about which are more successful and which should be more highly rated.

Cohen believes that either of these forms of organization could well have a positive impact on a companies' future prospects <u>if</u> it fits the business characteristics of a given company. He strongly contends that no particular form of organization is a panacea to overcome poorly conceived and executed strategies, and underperforming operations. It also remains to be seen how companies with the two structures fare coming out of the current economic and financial crisis.

Capable, disciplined management is critical to the future success of all companies, rergardless of the form of organizational structure. Cohen believes that companies that have in place strong management, sound business franchises and efficient operations, and can understand and manage their corporate fundamentals effectively and <u>then</u> subsequently decide to reorganize to leverage off their strengths are the likeliest candidates to be successful; companies who simply try something new to overcome previously insoluble problems could well find themselves treading water ... or worse, <u>and</u> have their problems exposed more clearly to the public.

In conclusion, there are a number of both mutual and public companies in the rating agencies' highest rating categories (but certainly fewer of each at the time of this writing in August, 2009), reflecting the view that in and of itself corporate structure is not a differentiator with regard to claims paying ability. It comes back to performance: how well does a company manage its business fundamentals to enhance its overall strength in terms of management and corporate strategy, operating performance, capitalization, investments, liquidity, financial flexibility, competitive position, risk tolerance?

Public and mutual companies have some different circumstances that they address in conducting their respective businesses, and these varying scenarios are taken into account in the ratings process.

August 31, 2009