EMERSON, REID'S

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Eight Miles High and Falling Fast

Paths of Glory

On November 29, 1995, when Travelers won a bidding war to acquire Aetna's property/casualty operations for $4 billion, it was universally acknowledged that not only was this a great deal, but it was a harbinger of other great deals. On the New York Stock Exchange, Travelers' shares surged 6.8% to 58⅞ (an impressive showing for a stock that had already risen 75% in the previous 12 months), and *The Wall Street Journal* duly noted that the Aetna transaction, which had not been unexpected, was "applauded" by investors. So great was the feeling of well-being on the Street that the shares of Cigna Corp.—another messy multi-line insurer—jumped 3.9% on the speculation that it too might be able to unload its sickly property/casualty operations.

Although the insurance industry is generally considered stodgy and stagnant, insurance stocks, which have gained about 40% in the last year, have been anything but. In fact, the insurance industry appeals to many investors *because* it is not well run, because it is populated by fat, bureaucratic behemoths.

TABLE OF CONTENTS

Printers working overtime to manufacture new stock certificates for insurance companies to issue in public offerings.

In making the case for insurance stocks—as many are now doing—certain buzzwords invariably appear: consolidation, expense reduction, restructuring, and rationalization. Even the oft-skeptical *Forbes* jumped on the bandwagon recently and put a smiling bull on its cover, along with the headline: "Bank stocks had a tremendous rise. Are insurance stocks next?"

The mood was vastly different fifteen months ago, on December 8, 1994, when CNA struck a deal to purchase crippled Continental Insurance for $1.1 billion. *The Wall Street Journal*, for example, quoted one pundit as saying that the deal was "excellent news for Continental." Other analysts seemed genuinely puzzled by the deal. One, noting Continental's unrealized losses and weak reserves, speculated that the deal might be driven by some tax strategy whereby CNA's parent, Loews, could offset insurance losses with gains in its cigarette operations. Another, writing in *Business Insurance*, quipped that the combination of CNA and Continental was a case of "1+1=.8." At *Emerson, Reid's Insurance Observer*, where cranky contrarianism is always the norm, we bucked the trend and recommended Loews' stock, pointing out that Larry Tisch, who controls the company, "knows that the best time to buy something is when nobody else wants it." (As the adage goes, buy straw hats in the winter.)

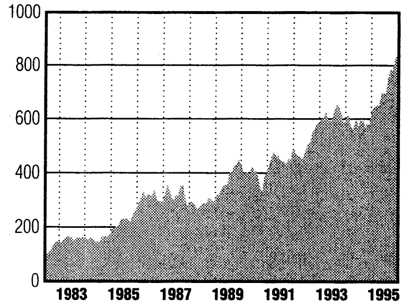
Perhaps the best measure of the malaise on December 8, 1994, however, was CNA's own stock, which closed within spitting distance of its four-year low, at $63\frac{1}{4}$. The market, in its collective wisdom, was valuing CNA at $3.9 billion—considerably less than its $4.5-billion book value. (CNA recently traded at $116, giving it a market value of $7.17 billion.) On that same day, Aetna's shares changed hands at $$44\frac{3}{4}$, giving it a market value of $5 billion—only $1 billion more than what Travelers is now paying for the troubled property/casualty business.

From today's perspective, it's easy to see that the pessimism that gripped insurance investors was too extreme. The question that begs to be asked, however, is whether the current optimism is equally unwarranted.

Certainly, there are a few positives to the industry. Private-passenger auto insurance, which represents 38.8% of the industry's premiums, has been good for several years, and will be this year as well. Workers comp, which is 10.2% of the industry's volume, also has been good, but is turning sour as insurers engage in brutal competition. That's not surprising. In the insurance-underwriting business, good news must be tempered by the realization that it is generally the result of cyclical factors, and will not be repeated every year. Underwriting profits, whether in auto, comp, or hole-in-one coverage, soon attract the attention of competitors, who drive down returns by cutting prices on business that was very

Dow Jones Property/Casualty Index

People in the business can gripe about catastrophes, the soft market, regulation, and environmental liabilities, but in fact, it's been a great 13 years for insurance stocks. Since June 30, 1982, the Dow Jones property/casualty insurance-stock index has grown at a 17.05% compounded annual rate, not including dividends.



profitable when rates were higher, thereby thwarting their own efforts to achieve superior returns. In that respect, underwriting is something like investing: good returns attract an influx of capital, which serves to depress future results.

Although underwriting is certainly important, it isn't the reason that money flows into the insurance industry. Few insurance companies make money underwriting; the profits come from investments. But one must bear in mind that stocks and bonds have been in a long-term bull market since 1982, when the Dow Jones bottomed out at 776. (It is now 5500.) Long-term bonds have performed almost as well as stocks, as interest rates have gone from 14% to 6%. Since insurance companies are, in essence, leveraged bond funds, the result has been stunning: the Dow Jones property/casualty index has grown from 100 on June 30, 1982, to 838 at the end of 1995. Although most wouldn't consider 1995 to have been a banner year for the property/casualty industry, it *was*, in fact: surplus grew 15.9%, from $190.6 million to $224 billion. Realized and unrealized capital gains accounted for 78% of this.

At a recent ISO get-together, six insurance-company CEOs discussed what they thought were the pressing challenges of the next five years: catastrophes, reducing expenses, harnessing technology, and so forth. Only Bill Berkley, the sagacious chairman of W. R. Berkley, touched on the flip side of the bond rally, namely, that low interest rates are going to depress earnings. That, of course, is part of the insurance-company conundrum: a bond-market rally fattens balance sheets, but it puts the income statement on a Slim-Fast diet.

What can insurance companies do to counteract this? They could increase underwriting profits—but how? They could cut costs faster than their competitors, but they're already trying to do that. (Only Bill Berkley spoke about *spending* money to improve underwriting results.) Or they could invest in riskier, higher yielding securities. Part of the problem, at least from our vantage point, is that bonds just don't look like attractive investments right now, and insurance companies, for better or worse, are fixed-income buyers. Whether interest rates will decline further is anyone's guess, but it's safe to say that there's a lot more downside than there used to be. And if interest rates move upwards, or the stock market—someday, somehow—actually *goes down*...

In the meantime, insurance companies, investment bankers, mutual funds, leveraged-buyout artists, and securities analysts are eagerly seeking insurance stocks to buy, insurance deals to invest in, and insurance companies to take over.

While we aren't selling everything, we can't shake the feeling that as far as the industry is concerned, it's 12 o'clock high on a hot summer day. And...oh yes, everybody is buying straw hats. ■

Best's Moving Target

In 1995, A.M. Best quietly revised the definition for its B and B– designations, making it the second time in three years that the meaning of the rating has changed.

In 1993, B and B– companies were defined as having "good" overall performance and a "current ability" to meet their obligations to policyholders, but were considered "susceptible" to unfavorable changes in underwriting or economic conditions.

In 1994, B and B– companies were thrown into the newly created "vulnerable" category and were defined as having only an "adequate ability" to meet their obligations to policyholders. Had Best stopped there, this new definition would have clearly represented a significant downgrading. But in a move that may have been designed to lessen the sting of the downgrade, Best clouded the meaning by adding the caveat that B and B– companies "*may be* vulnerable" to unfavorable changes in underwriting or economic conditions.

Best corrected this ambiguity in 1995 by stating flat out that B and B– companies "*are* vulnerable" to unfavorable changes in underwriting or economic conditions.

Eighty-three property/casualty companies and 89 life/health companies have ratings of B or B–.

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Spinning Gold Into Straw

Annuities: Looking for a Reason to Believe

We have always been at odds with the annuity business, for a number of reasons. Annuities are investment products—often not particularly good ones—and their appeal hinges on their magical tax-deferral properties, which we believe are overrated. Much like banking, credit cards, and currency exchange, the annuity business is a spread business: to make money, an insurance company must take in funds at one rate and invest them at a higher rate. In doing so, it must make assumptions about the duration of its assets and liabilities and the duration and credit quality of its investments. History has shown that assumptions of these sort are easy to make, but difficult to make accurately. Finally, the annuity business tends to attract a gamier sort of player than does, say, the business of running a trust company.

That said, we admit that the annuity business appears highly desirable, perhaps too much so for its own good. It is the money business, after all, and it has been booming. Over the years, life-insurance companies have de-emphasized the mortality and morbidity business and focused instead on the "asset accumulation" business. The United States is undergoing a profound demographic shift: by 2030, when the last baby boomer hits retirement age, this country will be crawling with geezers and biddies. Twenty-two percent of the population, or 65 million people, will be over the age of 65. This is, of course, no secret, and folks have become increasingly concerned with the ramifications of living too long rather than of dying too soon. Insurance companies, naturally, have exploited this. (However, in an about-face, the life-insurance industry recently rolled out a $20-million advertising campaign that invokes the grim reaper and emphasizes the risks of dying without adequate life insurance.) Between 1980 and 1994, individual annuity reserves grew from $31.5 billion to $482 billion, group annuity reserves grew from $140 billion to $612 billion, and variable annuity reserves grew from $14.8 to $211 billion. To put these figures in perspective, at year-end 1994, total life-insurance reserves were only $468 billion, and the life-insurance industry's surplus was just $136 billion.

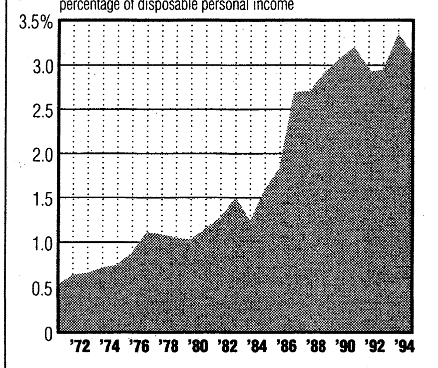
Whether the annuity business, despite its rapid growth, is a good business, however, is a question that one who is concerned with the insurance industry's profitability, solvency, and investment prospects, must ponder. According to a recent report, *Search out the Good Shepherds of Shareholder Funds*, by Lehman Brothers analyst Edward Spehar, as a result of the low barriers to entry, higher-growth markets such as annuities "often produce uneconomic returns." Spehar contends that there's "a fine line in the life-insurance industry between earnings growth that creates shareholder value and earnings growth that destroys it." He notes that the return on equity for fixed annuities is currently in the high single digits—a level that happens to be below the industry's cost of equity capital.

> **"There's a fine line in the life-insurance industry between earnings growth that creates shareholder value and earnings growth that destroys it."**

Spehar's negative sentiments are noteworthy for several reasons. First, sell-side analysts aren't usually given to negative pronouncements, mainly because negative pronouncements don't make money for their employers. ("Buy" recommendations can generate commissions from anyone, but "sell" recommendations can only generate commissions from someone who already owns that security.) Second, although Spehar is now down on the annuity business, he wasn't always that way. In 1994, when he was working at Merrill Lynch, he was in the bullish camp. His opinions created quite a stir, however, when he downgraded the shares of Conseco, a major writer of annuities, from "buy" to "hold" because of his concerns about its proposed acquisition of Kemper. (Conseco promptly dumped Merrill Lynch as its investment banker, and Spehar moved to Lehman Brothers the following year. Soon after Spehar left, Conseco rehired Merrill Lynch as its investment banker.)

Although the annuity business has grown rapidly, top-line growth doesn't necessarily translate into profits. Spehar calculates that the average annuity company needs to earn 170 basis points over its cost of funds to achieve an 11% return on equity, and a 200 basis-point spread to achieve 15%. Unfortunately, spreads currently average a measly 105 to 125 basis points. In the good old days of the 1980s, insurers could make a 170 basis-point spread and actually earn a 15% return on equity because of the higher interest rates they earned on their capital that supported the business, and because the rating agencies required less capital to support the business.

To increase its spread, the industry could invest in more speculative securities or reduce its crediting rates. The first choice would be a difficult one, since it was the toxic investments of the 1980s that brought many insurers to their knees in 1990 and 1991. The second choice isn't much better. If insurance companies were to lower crediting rates for annuity holders who are locked in by surrender fees, they might be accused of "bait and switch tactics" by their field forces. (They can't lower crediting rates too much for annuity holders who *aren't* locked in, because that business might move elsewhere.) As the annuity business matures, this "unlocked" segment becomes in-



Annuities Are In!
Annuity considerations as a percentage of disposable personal income

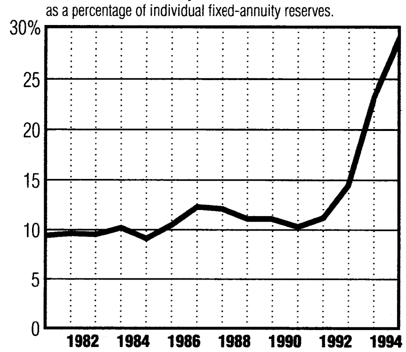
Sources: U.S. Dept. of Commerce, American Council of Life Insurance creasingly important. In the last five years, the percentage of annuity reserves that have minimal or no surrender charges has grown from 15% to nearly 35%. These reserves are to insurance companies what demand deposits are to banks.

The industry faces another dilemma. Notwithstanding the fact that spreads are inadequate, a key element to profitability is persistence. In putting on annuity business, insurance companies incur significant deferred acquisition costs that are written off over the period that the annuities are expected to remain in force. Insurance companies, therefore, must estimate how long an annuity will actually stay on its books. But human behavior is hard to predict, and past results are not necessarily indicative of the future. What will surrender ratios look like if interest rates rise 200 basis points? What if long-term rates rise faster than short-term rates, or the yield curve inverts? How will a financial crisis affect surrenders? How will people who bought annuities because of sky-high "teaser" rates feel a few years down the road? No one knows the precise answers.

"If the upward trend in out-of-surrender-charge fixed-annuity liabilities uncovers overly optimistic assumptions about liability duration," writes Spehar, "we could see accelerated amortization of acquisition costs and, therefore, a decline in margins." Nor are variable annuities a safe haven for insurance companies. If the stock market, by some mistake, were actually to decline, it might lead to higher-than-expected withdrawals, "which would lead to accelerated amortization of acquisition costs."

Bull Market: Rapid Growth in Variable Annuities

Individual variable-annuity reserves as a percentage of individual fixed-annuity reserves.



Sources: Lehman Brothers, American Council of Life Insurance

In sum, the past five years have been perfect for annuity companies. Insurance-company spreads widened because the crediting rate on policyholder liabilities fell faster than did the rates that insurance companies earned on their assets. Credit quality hasn't been a big problem, there haven't been any major disasters as a result of derivatives, and the investing public—which is currently under the influence of savants such as the Beardstown Ladies—"knows" that every investment works out well in the long term.

SunAmerica's founder and CEO, Eli Broad, whose 12,000-square-foot, Frank Gehry-designed postmodern abode was featured in the March *Architectural Digest*, recently told his shareholders that SunAmerica, which is one of the largest issuers of annuities, defines its niche as "retirement savings." Broad noted that SunAmerica—whose stock appreciated 1,890% during the last five years—has "developed a complementary, all-weather investment product line" that will "provide strong results across a broad range of financial- and interest-rate environments." Broad believes that to be successful in his business a company must have a "broad-based, low-cost distribution system," "advanced technological capabilities," and a "well-recognized brand identity." Whether these will offset the ravages of a bear market, intense competition, and margin shrinkage is questionable.

Although its seems obvious that a bear market will nip some profits off variable-annuity companies (because fees are based on account values), Spehar doesn't think "that investors fully appreciate the potential for margin compression, which could result from the accelerated amortization of deferred acquisition costs and from the negative impact of operating leverage." If Spehar is correct—and we have a feeling that he's on to something—that competition has reduced the marginal returns in the asset accumulation business to a level that's below the industry's cost of capital, then life-insurance companies' pursuit of "growth for its own sake," may, in actuality, be destroying value that has been built up over time.

It is human nature, especially in a bull market, to be optimistic, and the folks who run insurance companies are all too human. They tend to believe that they can eke out better returns by restructuring, revamping, and embracing the new—even when their companies have long and uninterrupted records of mediocrity. During bull markets, managements' enthusiasm tends to spread, and it is embraced by investors and annuity buyers.

But bull markets don't last forever. ■

Raging Bull

AT A RECENT CONFERENCE attended by institutional investors, Stephen Hilbert, who heads Conseco (see *Emerson, Reid's Insurance Observer*, March 1994 and April 1995), presented a lovely vision of his company's future. For starters, Hilbert, who has made scads of money with his leveraged forays into the buying and selling of life-insurance companies, showed that success clearly agrees with him. Looking trim and healthy, the whites of his eyes shining out from his deeply tanned face, he delivered his patented spiel with oleaginous confidence. Whipping off figures without referring to notes, he showed slides documenting the 55% compounded annual growth of his stock over the previous five years.

Speaking of the various products his companies peddle (annuities, life/health, etc.), he noted that these lines "hedge themselves perfectly in different economic cycles."

As for internal growth, it would be "25%" in the future. Although that's a mighty big number, he didn't flinch when he said it.

How terrific is his company's $624 million LBO fund? "Just about every commercial bank in the country is an investor." (Whether that's actually a ringing endorsement is a matter of opinion. Whether the statement is even true, is something else.)

Hilbert also told the crowd that he "couldn't be more bullish" on Conseco's Medicare supplement business, and noting that he owned a ton of stock, declared "I don't think anything speaks the way management ownership does." (He didn't bother to mention that he'd sold $125 million worth of the stock in 1994, but had been granted new options at the time of his sale.)

Hilbert projected that Conseco would earn $7.00 per share in 1996 and said that his "goal is to see our [stock] multiple at 12 to 14 times earnings per share." Since the stock was at $66 at that moment, for Hilbert's "goal" to be reached, Conseco's stock would have to trade between $84 and $98 this year and $105 and $122 next year.

It will have to go there without us.

'Superlative Business Opportunity'?

Catastrophe Reinsurers Just Say Yes

A recent issue of our favorite publication, *Grant's Interest Rate Observer*, provided a wonderful description of the cycles of lending and borrowing: "The classical [credit] cycle begins with the word 'no.' It proceeds to 'perhaps,' and 'the committee does not seem averse.' It ripens at last into 'yes,' and, finally, 'yes!' Then it begins all over again. At the start, the marginal transaction goes unfunded; by the end, it is funded to excess."

While it's hard to pinpoint our exact whereabouts in the catastrophe-reinsurance cycle, it seems safe to say that we're closer to "yes!" than to "no." A case in point: when the California Earthquake Authority (CEA) recently went into the market to obtain coverage for $2 billion aggregate coverage excess of $4 billion over two years, it hired E.W. Blanch to arrange the deal. (The fact that $2 billion of capacity is now available is telling; as recently as a couple of years ago capacity was one-tenth that level.) Blanch successfully rounded up a host of reinsurers—from ACE to Zurich—to participate in the deal and share in the $575-million premium. One signing on for $100 million of risk receives $14.38 million of premium per year.

Whether this reinsurance is cheap or dear depends on one's perspective. The offering document for the reinsurance contract discloses, according to *Property Insurance Report*, that "the CEA has agreed to the $575-million premium level in the interest of presenting the reinsurance market with a superlative business opportunity. The CEA understands it must do so to attract $2 billion of reinsurance capacity."

Whether one should take the CEA at its word is debatable; nonetheless, many reinsurers have indicated considerable interest in participating in this "superlative business opportunity." Phoenix Re and Partner Re, for example, are willing to risk 15% and 12.1%, respectively, of their GAAP capital. (Thank you, Dowling & Partners.)

The absence from this deal of Berkshire Hathaway's National Indemnity is noteworthy. When the price is right, the company is willing to step up to the plate with far bigger limits than anyone—say $1 billion. But when the price isn't right, the company is willing to sit out the season.

Perhaps the willingness of so many reinsurers to take a piece of the CEA's risk is indicative of the efficient market at its best: the prospect of "superlative" returns entices capacity to enter the market. On the other hand, perhaps the superlative returns that catastrophe reinsurers have earned in the past few years have served to sharpen competition and loosen underwriting standards to the point that underwriters are beginning to stretch for returns to justify their jobs.

We shall see. ■

A Surfeit of Surplus

When a host of offshore catastrophe reinsurers were formed a few years back, we were told that these companies were "different"—that unlike the fools who had mistakenly plunged into the insurance business in previous years, this new capital was not "naive," and that unlike the general public, which has a sorry habit of buying at the top and bailing out at the bottom, this new capital was "patient."

One worry bandied about was that these new companies would have *too much* capital for their own good—that they would soon venture into other businesses that might be less profitable than writing catastrophe reinsurance in a hard market. Given that catastrophe rates have been softening and that catastrophe reinsurers have been *very* successful the last few years, one may want to ponder a few recent transactions.

PartnerRe recently announced that it would repurchase 5,000,000 shares of its common stock. (Why didn't it think of this last year when the stock was 35% cheaper?) Mid Ocean will acquire Brockbank Group, a major Lloyd's managing agency, and Tempest Re, after failing to diversify into lines that weren't correlated to catastrophes (e.g., buying Methuen, a Lloyd's managing agency) is being sold to ACE, which *is* buying Methuen.

The catastrophe reinsurance business has been the best insurance business in the world for the last three years. The next few years are unlikely to be so good.

Have We Got a Deal for You

AIG's Unusual Relationship with Coral Reinsurance

You are sitting at your desk pondering various investment opportunities when Hank Greenberg calls. Greenberg, as we all know, is the tough-as-nails chief honcho at American International Group and a living legend in the insurance business. He has built AIG, of which he is only the second chairman in its 77-year history, into one of the world's great insurance organizations and one with an unrivaled international scope. The company earned $2.5 billion last year and its shares, since being sold to the public in 1969, have appreciated at a compounded annual rate of 17.7%, making Greenberg a billionaire. When Greenberg calls, you pick up the phone immediately.

"Hi Hank," you say with eagerness as well as trepidation. "It's nice to hear from you."

"Mr. Greenberg will be with you in one moment," the voice at the other end of the line responds.

When Greenberg comes on, he barks a quick hello and begins talking. "We're setting up a reinsurance company in Barbados that's going to write $500 million of business ceded by AIG. Under the reinsurance treaties, the reinsurer's loss is limited and a stop-loss arrangement will be in place so that the reinsurer is guaranteed to make money."

"Gee Hank," you say admiringly, "that's really interesting. If there's anything I can do—"

"The structure of this deal is clever. Investors won't have to put up any money. We've lined up a bank to provide financing at no risk."

"Hank, that's brilliant—"

"You can have $4-million worth of the deal," Greenberg continues. "You won't be risking a cent. Nothing but profit."

You are stunned. Hank Greenberg, the toughest man in the insurance business, is letting you in on this sweetheart deal. "God bless you, Hank," you blubber. "You're too kind. We must get together, perhaps over din—"

"Don't have time. Our people will fill you in on the details." Click.

While this conversation sounds like pure fantasy, it isn't. According to a 1987 Confidential Private Placement Memorandum, AIG *did* set up a company in Barbados and *did* allow certain "selected accredited investors" to participate in a no-risk sweetheart deal. Whether Hank Greenberg actually *talked* to the investors, who were a bunch of corporate bigwigs, is not known, and AIG has declined to comment on the matter. But it is safe to assume that Greenberg was well-versed in the details and approved the transaction.

The deal in question was the issuance of 1,000 shares of common stock, for a total of $60 million, to establish Coral Reinsurance Company Ltd., a Barbados-domiciled company that would reinsure certain risks from several of AIG's insurance companies. At year-end 1995, AIG had an estimated $800 million to $1 billion of reinsurance recoverable from Coral, making Coral a major reinsurer of AIG's business. (AIG's relationship with Coral was first reported in a 1995 *Business Insurance* article by Douglas McLeod.)

Why did AIG allow certain corporate bigwigs to make a risk-free investment in Coral Reinsurance?

AIG has claimed that it is not an owner of Coral and that it deals with the company on an arm's-length basis. Indeed, AIG's statutory filings list Coral as an *unaffiliated* reinsurer, and Coral does not appear on AIG's organization chart. There is no question, however, that AIG has a cozy relationship with Coral. Not only has its Barbados subsidiary, American International Management Company, managed Coral's operations, but AIG was responsible for Coral's genesis. The 1987 prospectus states that "AIG's interest in creating [Coral] is to create a reinsurance facility which will permit its U.S. companies to write more U.S. premiums. For a U.S.-domiciled company, a high level of statutory surplus is required to support insurance premiums in accordance with U.S. statutory requirements. The statutory requirements in Barbados are less restrictive." Implicit in this statement is the idea that by getting investors to stick $60 million into a start-up Barbados insurance company, AIG would be able to cede billions of dollars of its U.S. reserves, thereby improving its financial appearances by apparently removing this risk from its balance sheet.

It is unclear why AIG found it necessary to set up a Barbados company to do this, and why it decided to let certain investors into this deal on a risk-free basis. The investors include the Arkansas Development Finance Authority; Abeille Re; L. Donald Horne, chairman of Mennen Co.; Charles Locke, chairman of Morton Thiokol; Kenneth Pontikes, chairman of Comdisco; David Reynolds, chairman of Reynolds Metals; John Richman, chairman of Kraft; and Samuel Zell, chairman of Itel.

Under the terms of the deal, the investors were offered the opportunity to buy units of 67 shares of common stock for $4,020,000 a unit. The investors were not required to shell out one red cent, however, because Sanwa Bank would finance their investment with non-recourse loans secured solely by the investors' Coral shares. In other words, investors did not have to put up any funds or risk any money, but were nonetheless granted 100% ownership of Coral.

Coral would then take the investors' $60-million "investment" and place it in certificates of deposit issued by Sanwa bank. These CDs, which would be "held outside of Barbados," paid interest at the LIBOR rate for 90-day U.S. deposits. The investors were charged interest on their non-recourse loans at a rate that equaled a 37.5 basis-point spread over that which they received on their Sanwa CDs.

Once financed, Coral would receive "approximately $480 million" of reinsurance premiums from AIG. Under these reinsurance treaties, Coral's maximum loss in a given year would be $950 million, but that was then reduced to $480 million via a stop-loss agreement with Munich Reinsurance Company. "The 'stop-loss' is designed to insulate Coral from reinsurance risk in excess of the amount available from the $480 million of premiums paid annually and the investment income generated thereby," reads the prospectus. In other words, Coral would take in $480 million in reinsurance premiums and pay out $480 million in losses.

Coral's investors, however, would profit through the receipt of an annual "2% risk premium" on their "equity investment" (the $60 million that Sanwa lent them). From this 2%, the investors would pay Sanwa various fees and commissions that equaled 50% of the "risk premium" in the first year and 25% in each subsequent year.

The bottom line: an investor who purchased a $4,020,000 unit would receive an $80,400 annual "risk premium." Offsetting this would be the cost of the loan (37.5 basis points, or $15,075) and various fees and commissions ($40,200 the first year and $20,100 thereafter). The result: an investor's profit would be $25,125 in the first year and $45,225 in each subsequent year—with absolutely no risk.

Under the terms of the deal, the investors' stock could be redeemed for the price that they paid, and that is apparently what happened in early 1991. According to the *Business Insurance* article, at that same time stock was issued to several new investors, among them The Molson Companies, a Canadian brewing conglomerate. This is noteworthy because Marshall Cohen, Molson's CEO, has served on AIG's board of directors since 1992. Curiously, AIG's proxy statements have not disclosed what would appear to be a potential conflict of interest: Cohen's involvement with one of AIG's largest reinsurers, Coral Reinsurance.

It is not clear exactly what kind of business AIG was ceding to Coral, although various documents included in the prospectus give some indication. For example, a quota share replacement agreement between the National Union pool and Coral states that Coral will "accept all 'loss and premium liability' that had been previously ceded to various prior reinsurers whereby the company has or would incur a financial loss because of the inability of such prior reinsurers to pay amounts due or to become due by reason of 'financial impairment' or 'government regulation.'" Other agreements call for AIG to cede pre-1986 losses emanating from professional liability business written in Divisions 65 and 66, and 1987 accident-year losses on business written in Divisions 30, 35, 36, 65, and 66.

AIG's dealings with Coral are intriguing for numerous reasons. For starters, they have benefited AIG by allowing it to write more U.S. business without having more statutory surplus. Although AIG may have followed the letter of the law in these transactions, it appears to have sidestepped the spirit of the law (e.g., risk is not transferred unless it is ceded to a third party). On the other hand, since Coral appears to be little more than a shell over which AIG has de facto control, it seems that—absent tax or regulatory considerations—AIG was not accomplishing anything of economic substance that it couldn't have accomplished otherwise. Knowledgeable sources who preferred not to be quoted (in the words of one, "I like my job") suggested that the Coral transaction was driven by tax reasons.

Perhaps the most galling aspect of the Coral deal is that it was offered to "selected accredited investors" and not to, for example, *Emerson, Reid's Insurance Observer*. But one thing is certain: if Hank Greenberg offers to let us into his next no-risk deal, we'll gladly sign on. ■

To receive a copy of the Coral Reinsurance prospectus, send a check for $10 to "Emerson, Reid's Insurance Observer."

CONFIDENTIAL
PRIVATE PLACEMENT MEMORANDUM

MEMORANDUM NO._____
NAME ________________

1,000 Shares

CORAL REINSURANCE COMPANY LTD.

Common Stock

THIS PRIVATE PLACEMENT MEMORANDUM HAS BEEN PREPARED SOLELY FOR THE BENEFIT OF SELECTED ACCREDITED INVESTORS IN CONNECTION WITH THE PRIVATE PLACEMENT OF 1,000 SHARES OF COMMON STOCK (THE "COMMON STOCK") OF CORAL REINSURANCE COMPANY LTD. ("CORAL" OR THE "COMPANY"). THE RECIPIENT OF THIS MEMORANDUM ACKNOWLEDGES THAT IN CONNECTION WITH HIS OR ITS INVESTIGATION OF THE COMPANY HE OR IT WILL RECEIVE CONFIDENTIAL INFORMATION. SUCH RECIPIENT BY ACCEPTING A COPY OF THIS MEMORANDUM AGREES THAT NEITHER HE OR IT NOR ANY OF HIS OR ITS EMPLOYEES SHALL USE FOR ANY PURPOSE OR DIVULGE TO ANY PARTY ANY SUCH INFORMATION AND SHALL RETURN THIS MEMORANDUM AND ALL COPIES OF THIS MEMORANDUM AND SUCH INFORMATION TO GOLDMAN, SACHS & CO. (THE "SELLING AGENT") PROMPTLY UPON REQUEST. THIS MEMORANDUM IS NOT TO BE REPRODUCED OR REDISTRIBUTED.

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"AIG's interest in creating [Coral] is to create a reinsurance facility which will permit its U.S. companies to write more U.S. premiums..."

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GOLDMAN, SACHS & CO.

DECEMBER 1, 1987

AIG claims to deal with Coral at arm's length, but the prospectus indicates otherwise.

All in the Family

H.W. Kaufman Shafts Investors With Inside Deal

When buying stock in a publicly held insurance brokerage, one hopes that the company will achieve solid growth. One *expects*, however, that no matter how the company fares, its management will treat the shareholders fairly and safeguard their interests. That, as we know all too well, is not always the case.

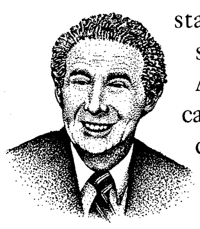
Although Herbert W. Kaufman, the CEO and controlling shareholder of H. W. Kaufman Financial Group, built one of the largest surplus-lines brokers in the country, he apparently had no qualms about putting his family's financial interests ahead of those of his shareholders. On January 4, 1996, H. W. Kaufman was sold in an unusual transaction that, according to a recent lawsuit, "grossly undervalued" the company. (As a former shareholder, we concur in that characterization.) Why would Herbert Kaufman allow such an occurrence to transpire? Perhaps it has something to do with the fact that the purchaser of the company was none other than his son, Alan Kaufman.

It isn't hard to see why one would want to buy H.W. Kaufman; it's a rapidly growing holding company that owns a number of specialty wholesale insurance brokers, including Burns & Wilcox, Casualty Underwriters, Floyd West & Company, Rathbone King & Seeley, and Howard-James. Some 15,000 agents placed more than $250 million in premiums with the company in 1995, netting it about $30 million in commissions. H. W. Kaufman has 485 employees in 37 offices, and maintains contracts with more than 400 insurance companies, several of which allow it to act as a general agent with in-house binding authority. Best of all, it is solidly profitable. Net earnings have grown from $431,000 in 1990 to $2,241,000 in 1995. Due to amortization of intangible assets, 1995's EBITA (earnings before interest, taxes and amortization) was even more impressive, hitting $5.2 million, or $1.51 per share.

Given that H. W. Kaufman was on a roll, it seemed particularly strange when, on May 5, 1995, the company disclosed that it had received an offer—it didn't say from whom—to be bought out for $8 per share, a modest 5.3 times EBITA. A press release said that its board had appointed a special committee to review the offer, "to assure that it is in the best interests of the shareholders."

Three weeks later, on May 26, H. W. Kaufman announced that it had signed an agreement to be acquired by AJK Enterprises for $8.20 per share, and fessed up that AJK Enterprises was owned by Alan J. Kaufman, Herbert Kaufman's 47-year-old son (and a long-time director of H. W. Kaufman). According to a press release, the deal would close in 90 days.

The actual terms of the deal remained a mystery until mid-November—by this time the deal was scheduled to close in 1996—when H. W. Kaufman finally issued a proxy statement. It seems that sometime in early 1995, Alan Kaufman had "indicated his desire to buy the company." On February 14, H. W. Kaufman entered into an agreement with him allowing his advisors to perform certain due diligence. H.W. Kaufman also agreed not to seek other buyers for 70 days.



Herbert Kaufman

On May 2, Alan Kaufman came back to H. W. Kaufman's board of directors with a proposal to acquire the company for $8 per share in cash. The board then appointed a "special committee" composed of two outside directors to evaluate the offer and negotiate on the company's behalf.

Three days later H. W. Kaufman finally got around to issuing a press release disclosing the takeover offer. That same day, the special committee hired Roney & Co., an investment banking firm, to provide an opinion as to whether the $8 offer was "fair" to the shareholders from a financial point of view. Roney, who was paid $40,000 for its opinion, then did what investment bankers in these situations almost always do—produced a pile of meaningless statistics that "prove" the deal is fair.

H. W. Kaufman is an attractive company. Since 1990, its earnings have grown from 14¢ per share to 65¢, and its return-on-equity has averaged 28.4%. Total revenues are close to $34 million. Nonetheless, Roney and Co. opined that it was fair for H. W. Kaufman's shareholders to receive only $28.3 million for their shares, or just 83% of revenues and 12.6 times earnings. (If one adjusts earnings for the $1.1 million charge for amortization of intangible assets, the p/e ratio drops to a less than ten times 1995 earnings, a bargain-basement price and a far lower multiple than that of other publicly traded brokers.) One of the main reasons the special committee hired Roney was that several members of Roney's corporate finance department worked for First of Michigan Corporation, which had underwritten H. W. Kaufman's 1989 public offering. This fact is especially interesting, because when Roney's employees acted as H. W. Kaufman's underwriter, they sold shares to the public at a valuation that equaled 150% of revenues and 6.74 times EBITA, about 100% and 30% more, respectively, than the valuation they were now according H. W. Kaufman.

Considering that H. W. Kaufman's earnings were projected to grow 26% in 1996 and 23% in 1997, it seems obvious that the company was worth far more than $8.20 per share to a strategic buyer and considerably more than $8.20 to a financial buyer—but not according to Roney. As part of its "fair market valuation," it concluded that H. W. Kaufman didn't have "sufficient assets...to leverage for a financial buyer to be enticed into a transaction [at a higher price]."

The company's financials suggest otherwise. In the first place, Alan Kaufman's deal *is* a leveraged buyout—and an unusually highly leveraged one, at that. AJK Enter-

Bargain Basement Brokerage: H. W. Kaufman Financial Group

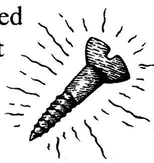
Although H. W. Kaufman was projecting excellent earnings, its board of directors approved a sale of the company to the boss's son for $8.20 per share, just 10 times 1996 earnings, and 4.6 times 1996 EBITA.

	1995	1996[2]	1997[2]	1998[2]	1999[2]
Premiums	$253,606	$291,647	$335,394	$385,703	$443,558
Commissions	$30,154	$34,677	$39,878	$45,860	$52,739
EBITA[1]	$5,200	$6,100	$7,060	$7,784	$8,641
Net Income	$2,241	$2,808	$3,467	$3,883	$4,360
EBITA/share	$1.51	$1.78	$2.06	$2.27	$2.52
Net Income/share	$0.65	$0.82	$1.01	$1.13	$1.27

1. Earnings before interest taxes and amortization. 2. Projection.
Source: H. W. Kaufman

prises put up just $1 million of its own money. The rest of the outside financing—$20 million of senior debt and $4 million of subordinated debt—came from NBD bank and Lillian Kaufman (Herbert's ex-wife), respectively. H. W. Kaufman's pre-tax cash flow, which is projected to be $6 million in 1996, provides debt-service coverage of about 3 to 1. Based on that alone, it seems likely that a higher price could have been obtained. In a typical LBO, a buyer might put up 20% equity and borrow the rest. Assuming such a deal, a financial buyer could have paid $38 million, or $11 per share for H. W. Kaufman, and still have had reasonable coverage. Here's how: a 20% equity contribution would provide $7.6 million, and H. W. Kaufman's excess cash would provide $3.3 million. That would leave $27.9 million to be financed. Even if the acquiring company paid an interest rate of 15% (AJK is paying 275 basis points over LIBOR, or about 8%), annual charges would still come to just $4.18 million, leaving the company with $1.8 million of pre-tax cash flow to fund growth or pay down debt.

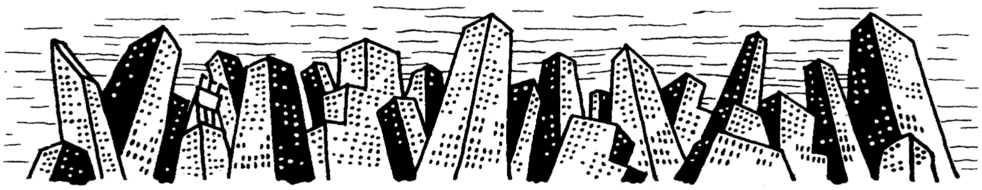
Although H. W. Kaufman might have been attractive to many potential suitors, the board of directors took steps that minimized the chance of a higher bid emerging. For starters, the proposed takeover wasn't well publicized. Although the story was reported by the wire services, *Business Insurance* and *National Underwriter* didn't pick it up. Furthermore, since Herbert Kaufman owned the controlling block of shares, those familiar with the company knew that no deal could be completed without his approval. A potential bidder would have thought that if Herbert Kaufman was really interested in receiving a higher price, he would have sought a buyer. Finally, the board made a halfhearted effort to elicit a higher bid: Roney & Co. was instructed to contact only the two companies that had expressed interest in H. W. Kaufman in the previous 18 months. (Neither was interested in bidding higher.) If the board had really wanted to obtain the best price, it could have hired investment bankers to approach the numerous insurance companies, brokers, and financial buyers that might have been interested.



On May 26, three weeks after AJK's $8 bid had been made public, H. W. Kaufman's board of directors met and were told the following: 1) that AJK's bid had been raised to $8.20, 2) that Roney & Co. had performed various analyses and concluded that the takeover price was "fair," and 3) that there was an "apparent lack of interest by other possible bidders." The special committee even said that, because no bidders had emerged, it "did not believe that it would be worthwhile to further seek a third-party acquirer for the company."

The special committee then recommended the acceptance of the takeover proposal. Although the directors had many good reasons to vote down this transfer of wealth from father to son, they unanimously approved the deal. That's not surprising. Herbert Kaufman controlled 75% of the company's stock and had hand-picked the board, which included his sons Steven and Alan (Alan abstained from voting); Gerald Horton, the company's executive vice president; Neal Zalenko, a CPA; special-committee member Alan Barry, president of Brass-Craft Manufacturing; and special-committee member Jeffrey Barry, the retired president of Walsh College, of which Herbert Kaufman is a trustee.

The result of all that is that Alan Kaufman now owns H. W. Kaufman at a bargain price. In all likelihood, the company will continue to generate profits, which will be used to pay down debt. And who knows, at some point in the not-too-distant future, Alan Kaufman may decide to cash in by selling the company or—who knows?—taking it public. If, however, Alan Kaufman turns out to be a chip off the old block, potential investors may want to think twice before getting involved with him. And, at the very least, they may want to ask if he's got any sons that have "indicated" a "desire to buy the company." ■



THE INSURANCE BEAT

Honest Abe's Annuities

LINCOLN NATIONAL, the Fort Wayne, Indiana based insurance holding company that's the largest writer of individual annuities in the country, was founded by Arthur Hall four score and 11 years ago, 40 years after Abraham Lincoln's death. Despite the company's feel-good association with our 16th president, Lincoln National has no more to do with Honest Abe than does Lincoln Continental, Lincoln Center, or Lincoln Fried Chicken on West 125th Street. Nonetheless, Lincoln National recently shelled out $6 million to build a new and improved 30,000-square-foot Lincoln Museum in its headquarters. The museum will house Lincoln National's collection of Lincoln memorabilia, which happens to be the largest privately-held collection of its kind in the world.

At the risk of sounding like philistines, we can't help but wonder whether Lincoln National's shareholders are really better off because the company spent $6 million for a museum. Says Ian Rolland, Lincoln National's chairman and CEO, "We believe that people will have a positive feeling about Lincoln National because we have this sensitivity to the heritage of Abraham Lincoln."

As Lincoln himself once said, "Public opinion in this country is everything."

Hoosier Horse Racing

IT SEEMS UNLIKELY THAT CONSECO, the high-flying buyer, seller, and all-round wheeler-dealer of life-insurance companies, would plunk down $6 million to honor the memory of *anyone*, when it could, instead, give that money to its senior executives, especially its chairman, CEO, and president Stephen Hilbert.

On December 20, Conseco, which now bills itself as a "diversified financial services holding company" (perhaps on the theory that such companies get a higher p/e multiple than mere life-insurance companies), announced that it had spent $2.8 million for a 10% interest in Hoosier Park, Indiana's only pari-mutuel racetrack. Conseco also received a three-year option to increase its stake to 57%.

"This investment is consistent with our interest in the gaming industry and in other industries which demonstrate the potential for superior returns," said Hilbert.

Rock Wise, Market Solid

ON OCTOBER 2, 1995, the Prudential Insurance Company of America was finally able to unload its property/casualty reinsurance holdings, which go by the name of Prudential Reinsurance Holdings. Although previously, Prudential Insurance had failed to find a buyer for the operation, and had been unable to foist this laggard off on the public, this time the market for insurance stocks and initial public offerings was such that Prudential Insurance was able to dump its entire position, not just a percentage, as was originally planned. In fact, the offering turned out to be a hot deal: it was priced at $16\frac{3}{4}$ and quickly traded up to $20. (It is now $24\frac{1}{2}$.)

One would assume that Prudential Insurance, which is approaching $200 billion in assets and which is—at least in theory—a sophisticated investor, had good reasons for selling Prudential Reinsurance. In fact, one would assume that Prudential Insurance wouldn't have sold Prudential Reinsurance if it hadn't got a good price. Furthermore, Prudential Insurance must have thought that it was better to be a seller of Prudential Reinsurance than to be a buyer.

Prudential Securities, Prudential Insurance's troubled securities brokerage, apparently thought otherwise. A month and a half after the offering, it rated Prudential Reinsurance a "buy."

Pissed-off Actuaries

IT HAS BEEN SAID that an actuary is someone who doesn't have enough charisma to become an accountant. Whether that's a fair description is subject to debate. What isn't debatable, however, is that these number-crunchers are in short supply. There are approximately 6,000 life/health actuaries and 2,000 property/casualty actuaries in the United States. In 1992 and 1994, *Jobs Rated Almanac* identified the actuarial profession as the number one to go into.

Despite the high demand, being an actuary isn't what it used to be, at least not at Travelers. According to a well-placed source, "Every actuary there is pissed off because the company stopped giving them 100 hours of compensatory time, stopped paying for them to go to actuarial meetings, and stopped paying their dues to the American Academy of Actuaries."

Keith Anderson, a spokesman for Travelers, confirmed that the company doesn't pay its employees' professional dues, but pointed out that its employees are paid quite well (at least those that haven't been laid off).

Said Anderson, "This company's been very successful over the last couple of years."

Who are we to argue with success?

Bad Timing?

IN A MOVE INTENDED TO "increase the efficiency of its capital" and "improve future operating returns," UNUM blew out its entire $700-million common-stock portfolio in the second quarter of 1995. Considering that the market has soared about 25% since then, the decision to sell seems, with the benefit of hindsight, premature. On the other hand, the portfolio was chock full of technology stocks, which took a beating in the second half of 1995.

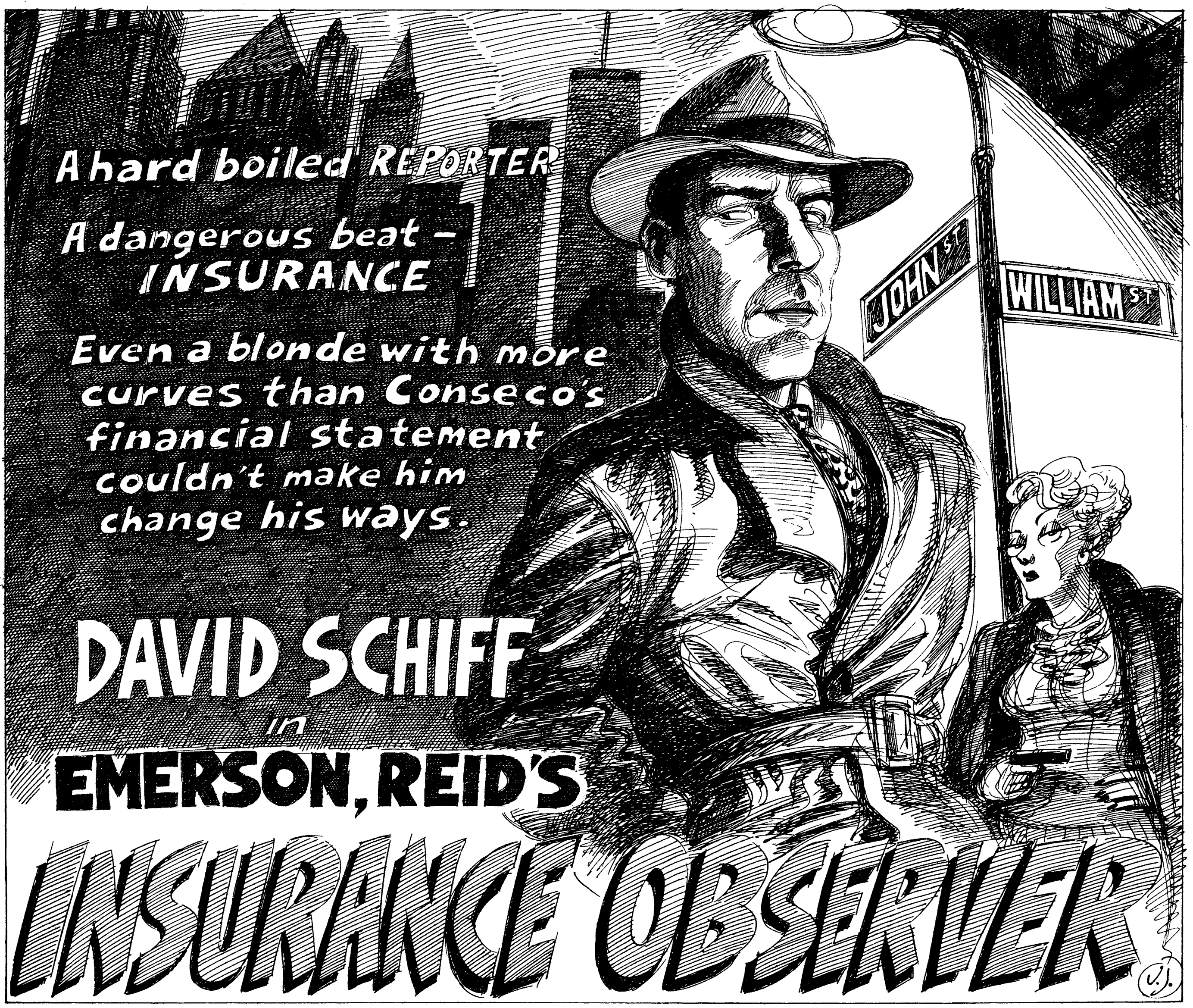
Robert Crispin, the company's executive vice president, insists that the move had "nothing to do with timing. Nothing to do with our view of the equity markets. We were able to enhance our risk-based capital position by 30 points."

Why would a company with a strong business and an A++ rating from Best and an AA from Standard & Poor's worry so much about its balance sheet?

"We want to be prepared for the next negative industry move," says Crispin. "I don't want to be in a position that our ratings might go down."

By selling stocks and buying bonds, UNUM will, in effect, free up $140 million of capital in its insurance companies. This capital could be used for dividends or stock repurchases. (Wall Street is especially enamored of the latter right now.) Either of these courses, however, would weaken UNUM's statutory capital position somewhat.

As the stock market makes new highs almost daily, it is painful to be left behind, sitting in bonds. But sometimes that's the price one pays for prudence.



The narrow cobblestone streets in New York's insurance district assume a menacing look on a rainy midnight. The nine-to-five boys are long gone and the night watchmen have drifted off to sleep. Except for the sound of steam hissing from a manhole cover, the streets are silent. This is when David Schiff, the editor and writer of *Emerson, Reid's Insurance Observer,* takes to the shadows and the back streets, connecting with his confidential sources in the dead-end alleys off Maiden Lane and in the deserted subway stations beneath John Street.

Insurance is a dangerous beat, but an insurance reporter who wants to make it in this town can't be afraid of plowing through a pile of convention statements after hours or eyeballing some incurred-but-not-reported claims up close. It's dirty work, but Schiff revels in it: it's his calling to crank out the iconoclastic musings, hard-hitting analyses, and fearless commentaries that have made *Emerson, Reid's Insurance Observer* so successful that someday it may even turn a profit.

But Schiff doesn't want your sympathy...or your money. You see, *Emerson, Reid's Insurance Observer* isn't for everyone. It's written for a select audience of tough guys, intellectuals, hepcats, existentialists, trumpet players, and pastry chefs who just happen to have a keen interest in insurance.

All others should think twice before subscribing.

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