

Conseco and the Joys of Synergy

Perpetual Motion on the Street of Dreams

Alexander Woollcott once remarked, "All the things I like to do are either illegal, immoral, or fattening." For some reason we were reminded of that quip while pondering Conseco, the quintessential asset-shuffling life insurance company whose creative mastery of leverage and accounting have, in the past decade, propelled its stock on a trajectory reminiscent of Neil Armstrong's 1969 summer voyage.

In our May issue we suggested that Conseco's acquisition of Green Tree Financial might be an example of "reverse synergy." (That Conseco's stock has fallen from 50 to 29 neither proves nor disproves our point.)

At first glance, Green Tree's business—making subprime loans, particularly on "manufactured homes"—appears to have little in common with Conseco's business of hawking supplemental health insurance, annuities, and universal life. At second glance, the two companies still appear to have little in common.

In Green Tree, however, Conseco sees expanded distribution capabilities and "extensive cross-marketing opportunities under the umbrella" of Conseco's "emerging national brand." If these "opportunities" do in fact lead to increased earnings, it will be an example of *synergy*: the interaction of discrete entities that produces a total greater than the sum of the parts.

Synergy is said to be a $2 + 2 = 5$ concept, a financial fountain of youth—the secret sought by financial alchemists. Synergy is wonderful: it can be stretched to encompass almost anything. In the name of synergy a Japanese consumer-electronics giant might purchase a Hollywood movie studio, an international airline might build hotels in faraway places, or an American insurer might open a branch office in Jakarta.

This isn't the same sort of synergy that was exemplified 90 years ago by the Chicago Cubs' double-play combo, Tinker to Evers to Chance, three Hall-of-Famers whose lifetime offensive output included 71 home runs and a combined batting average of .274. That sort of synergy

is known as "teamwork."

In the late 1960's, the concept of synergy was exemplified by National Student Marketing, whose mission was to capture the youth market. (Students don't have a lot of money; nevertheless, National Student Marketing's accountants were so good that they were able to transform losses into profits and create white-hot *concept stock* that rose 2,380% in 18 months...before the company collapsed into bankruptcy a year later.)

Another high concept popularized during the "Go-Go Years" was the conglomerate. This offered a somewhat different take on synergy: by owning a diversified *portfolio* of businesses that had nothing to do with one another—and whose results were thus not correlated to one another or to economic cycles—a conglomerate could

achieve economies of scale and generate a predictable, ever-increasing stream of earnings. (Supposedly, this stream could flow faster with the addition of leverage). Steadily rising earnings were essential because investors, in anticipation of such, would bid up

the conglomerate's stock to an inflated multiple of earnings, thereby facilitating the conglomerate's use of its overvalued stock to acquire other companies, thus making earnings grow faster and the stock soar even higher. This process would be endlessly repeated, and earnings would compound at remarkable rates for eternity.

The concept of a *financial-services* conglomerate (insurance, annuities, stocks, bonds, mutual funds, deposits, loans, credit cards, and trading) is equally appealing—despite evidence that such an entity does not inevitably lead to ever-increasing profits and is prone to cyclical malfunction.

History is littered with examples of financial disasters, from USF&G's foray into mortgage guarantees in the 1920's to First Executive's overconcentration in junk bonds during the 1980's. As for the financial-services conglomerate, the best one can say is that the idea is not new. The Bank of United States "was the prototype of the modern financial-services company," writes James Grant in his definitive *Money of the Mind*. "Under its corporate

ownership were three safe-deposit companies, numerous real-estate subsidiaries, an insurance company, a securities subsidiary, and a bank with fifty-seven branches...serving 440,000 depositors."

Although the Bank of United States made great contributions to the Manhattan skyline by financing two Central Park West landmarks, the San Remo and the Beresford, it ultimately lacked one indispensable feature: solvency. That same deficiency would, in due time, plague other great financial institutions such as Barings, Drexel Burnham Lambert, Integrated Resources, and Donald Trump.

While it would seem that insurance and financial services would go together like love and marriage, such is not always the case. Some examples: CNA Financial, which, in 1968 bought Tsai Management and Research, the overseer of the disastrous Manhattan Fund; Sears, which owned Allstate and bought Dean Witter in 1981, then later unloaded both; Prudential, which, by mistake, bought Bache Halsey Stuart Shields (now Prudential Securities) in 1981; and American Express, which owned Fireman's Fund and, in a lapse of judgment, bought Shearson Lehman Brothers in 1981, only to discard the pair when it became apparent that they lacked what American Express was looking for: earnings.

These companies were recent forefathers of the financial-services convergence movement, and all contributed to the study of synergy by proving that if two plus two can equal five on a good day, it can equal three on a bad day.

Which brings us back to Conseco, the burgeoning financial-services agglomeration that predicts it can perform feats of accretion, synergy, and economies of scale right before our very eyes.

Let's start with some numbers. On June 30, 1998, Conseco completed its purchase of Green Tree (which "earned" \$300 million last year), in a pooling-of-interests stock transaction valued at approximately \$6 billion, a not-inconsiderable 20 times earnings.

Despite Conseco's spectacular growth and \$740 million of 1998 projected earnings, its shares were selling at only 15 times earnings. (Perhaps the market, in its collective wisdom—or lack thereof—was



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expressing skepticism about Consecos accounting practices.)

Although Consecos second-quarter "Investor Guide" informs us that the company's stock has appreciated 10,800% during its 12 years of public ownership, its price/earnings ratio of 15 raises questions. How can it be *accretive* to Consecos earnings per share for it to use its stock to pay 20 times earnings for Green Tree? Is the combination of Consecos and Green Tree that rare example of two plus two equaling five?

Some basic arithmetic: If Company C, which earns \$1 per share and sells at 15 times earnings, uses its stock to pay 20 times earnings for Company G—which is the same size as Company C and also earns \$1 per share—then the *combined* companies will earn 86¢ per share.

Here's how it works: assuming that each company had one share outstanding, Company C will have to issue 1.33 new shares to acquire Company G. Upon completion of the merger there will be 2.33 shares outstanding (Company C's existing share plus the 1.33 shares it issued to buy Company G). The combined companies will still earn \$2, which, when divided by the number of outstanding shares (2.33), equals earnings-per-share of 86¢.

In this hypothetical example, Company C's earnings are *diluted* by its acquisition of Company G. All things being equal, when a company uses its stock to acquire a company with a higher price/earnings ratio than its own, it will be *dilutive* to the acquirer's earnings per share. Conversely, it will be *accretive* to the acquirer's earnings per share if it uses its stock to buy a company with a lower price/earnings ratio than its own.

In acquiring Green Tree, Consecos issued about 124 million common shares, bringing the number of shares outstanding to about 338 million. (Green Tree's shareholders ended up with approximately 37% of the combined company.)

Given the mathematical parameters previously discussed, Consecos acquisition of Green Tree could be *accretive* to Consecos earnings under a number of scenarios: 1) If Green Tree's earnings grow more rapidly than Consecos's; 2) If Consecos's earnings shrink more rapidly than Green Tree's; 3) If there are cost savings or economies of scale; 4) If there is a spontaneous combustion of synergy, and

Green Tree's debtors start buying health-insurance policies from Consecos, and Consecos's annuity holders start borrowing money from Green Tree; or 5) If Consecos has very clever accountants.

It's difficult to say how likely the above scenarios are, but let the record note that Consecos has very clever accountants.

Although Green Tree has *recorded* rapid earnings growth, the quality of its earnings has left something to be desired.

From a borrowers' point of view, as *Consumer Reports* has noted, manufactured-home loans have the disadvantage of costing 200 to 300 basis points more than conventional mortgages (primarily because their 12% default ratio is about four times that of a conventional mortgage). Green Tree earns a higher rate of interest on the loans it makes because, at least in theory, it is taking a greater risk.

The process used to calculate Green Tree's earnings is, at best, an imprecise art involving numerous estimates, guesses, and assumptions. When a loan is made, a reserve for bad debt and prepayment is created; these reserves, however, may prove to be too high or too low.

In a process known as "securitization," Green Tree packages its loans into pools that are sold in the secondary markets. Green Tree still retains risk, however, because it usually provides some sort of guaranty and retains part of the original

loans in the form of interest-only securities and servicing rights.

Like virtually all lending institutions, Green Tree is inherently leveraged, which invariably entails risk, such as violating a loan covenant, not being able to borrow at attractive rates, or not being able to roll over debt as it matures. In addition, Green Tree's balance sheet is exposed to adverse changes in interest rates.

Green Tree uses "gain on sale" accounting, booking revenues when a loan is securitized, rather than as it is paid off. (The revenues booked are based on the present value of *expected* interest and principal payments—money that Green Tree *has not yet received*.) According to Standard & Poor's, Green Tree's "earnings and capital quality were low, as with all companies that employ gain-on-sale accounting."

In calculating the amount of revenues to be booked, Green Tree makes assumptions about default rates, interest rates, and prepayment rates. Even if these assumptions are reasonably accurate, a small miscalculation could have a disproportionately large effect, thanks to the company's inherent leverage.

As it turned out, Green Tree's assumptions missed their mark. In November 1997 the company wrote down the value of its interest-only securities, taking a \$150-million charge and restating prior results. In January 1998 Green Tree upped its pre-



Consecos Chairman and CEO, Stephen Hilbert, several years ago

vious charge by \$40 million and took an *additional* \$200-million charge.

If these charges did not raise sufficient doubts about the quality, reliability, and predictability of Green Tree's earnings, then surely the July 1998 \$484-million pretax writedown—which wiped out one-third of Green Tree's equity—did. This massive charge, announced by Conseco shortly after it had closed its stock acquisition of Green Tree, was the result of the implementation of something that Con-

seco is not known for: more conservative accounting assumptions.

"The writedown is in line with Standard & Poor's expectations, based on discussions with Conseco's management in April 1998," noted Standard & Poor's, with typical nonchalance. "[It] is a manifestation of [Conseco's] desire to begin its ownership of Green Tree on a solid accounting footing, [and] to minimize the chance of negative earnings surprises in the future."

Some speculated that Conseco's charge was a version of the "big bath" write-off in which management builds a reserve that will be used to bolster future earnings. Conseco, however, denied that to be the case.

Regardless of whether Conseco is starting its ownership of Green Tree on solid *accounting* footing, one has to wonder why the acquisition makes sense on a *valuation* footing. The \$484-million write-off, for example, was greater than Green Tree's projected earnings for 1998, and greater than the company had earned in any previous year.

On the other hand, Conseco paid for Green Tree with *stock*, not cash. Conseco wasn't blindsided by the \$484-million charge; for whatever reason, it made the decision that Green Tree's "earnings" were worth a higher multiple than its own earnings were.

Conseco is a marvelously complex entity that requires a whopping 120-page description in the 1998 hardcover edition of *Best's Insurance Reports*. (By comparison, *Best's* devotes 60 pages to American General, 21 pages to Prudential, 17 pages to SunAmerica, and 7 pages to Northwestern Mutual.)

Conseco's complexity is the result of a magnificent whirlwind of financial activity, which, according to Conseco's financial statements, has been quite profitable (so far). A considerable amount of Conseco's value, however, was accomplished by acquiring numerous life insurance groups with borrowed money, a technique that can no longer be employed. (The rating agencies now frown upon highly leveraged holding companies.)

Conseco, that hyperbolic earnings-growth machine, must make acquisitions if it is to keep up the heady rate of growth for which it is known and loved. Yet growth is not without risk; acquisition prices are sky high and business is intensely competitive.

As for Conseco's "extensive cross-marketing opportunities," we're not the only skeptic: "Conseco will be challenged to realize the cross-marketing potential of selling insurance to Green Tree's finance customers while also trying to manufacture loans and other finance products to be sold to Conseco's existing customer base," notes A. M. Best. "Conseco has yet to demonstrate its ability to sell multiple policies to its customers through cross



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C. Burton Kellogg, Best's senior vice president, describes the behind-the-scenes rating process in a fascinating and revealing 207-page deposition. (An excerpt appeared in the November 1994 issue of *Schiff's Insurance Observer*.)

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As for cost savings, who knows? Consecos will maintain its headquarters in Carmel, Indiana and Green Tree will stay in St. Paul, Minnesota. Consecos's chairman, Stephen Hilbert, announced that with the combined companies' financial strength, Consecos should be able to achieve five basis points more from securitization spreads by taking advantage of timing opportunities. Shareholders had better hope that Consecos's timing is good, because it will take a lot of basis points to amortize the \$204 million of investment-banking fees, accounting fees, legal fees, regulatory fees, severance payments, and other merger-related costs that were incurred in acquiring Green Tree.

In a recent press release, Consecos stated that it “remains comfortable” with analysts' consensus estimate that Consecos will earn \$4.08 per share in 1999. That bullish affirmation of Wall Street's hopes—made in the wake of Consecos's tumbling stock price—was no surprise. *The Indianapolis Star* had previously reported the following: “Consecos chairman Stephen Hilbert said he is *more certain than ever* that the purchase of...Green Tree will help the company deliver high-level performance. He said to expect 20-plus percent growth in earnings per share *for the foreseeable future* [emphasis added].”

The Indianapolis Star did not mention the number of years into which Hilbert can foresee the future. ■

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If you've been getting *Schiff's Insurance Observer* for a while, you've probably noticed that it hasn't adhered to a regular schedule. Well, that's changing. The publisher, the editor, and the writer recently had a lengthy meeting with the bulldog who types this rag, and they all decided



to get more organized. From now on an issue will come out every two months—give or take a little. At least that's the plan.

As for the content of this newsletter, it will continue to be the unpredictable, insightful, delightful, iconoclastic mix that it's always been—only better.

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