Talk About a Shake Out

By Kerry Pechter *Sun, Jun 7, 2009*

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But a shortage of acquisition financing means the anticipated shake out may not happen in 2009. And, despite the available bargains, divestitures of specific blocks of businesses are considered more likely than takeovers.

The companies mentioned as potential targets include **Genworth Financial**, **Lincoln Financial Group**, **Principal Financial**, and **Hartford Life**, which have all applied for TARP funds, along with **Phoenix** and **Protective**. **Prudential Financial** applied for TARP funds and suffered a ratings downgrade, but is believed to be strong enough to survive and even to be an acquiror.

“We probably will [see consolidation],” said **Terence Martin**, an analyst at Hartford, Conn.-based **Conning Research**. “I’m not going to predict who. I don’t know who. But obviously some companies are having some issues with the current situation economically.”

“No one’s untouched,” he added, “but certainly some are faring better than others. You may well see some companies in relatively stronger positions able to pick up either entire companies or blocks of business from those looking to sell off parts or all of themselves as a way out of their current situation.”

In a report last November, **Goldman, Sachs & Co.** insurance analyst **Chris Neczypor** noted the struggles of Hartford, Lincoln, Principal, MetLife and Prudential, and cited MetLife and Prudential as long-term winners in the contest for BabyBoomer savings. He also predict consolidation, with large property & casualty companies among the likely acquirors.

“The [life insurance] industry’s problems may ultimately force some of the smaller institutions to exit the business,” Neczypor wrote. “We would not be surprised to see well capitalized P&C insurers play some role in taking advantage of the current dislocation in equity valuations of the life insurance arena.

“Those insurers who survive the fallout, however, will be able to consolidate distribution, invest in appropriate capital markets infrastructure, and eventually lead the financial services industry in capturing the opportunities associated with the retirement of the baby-boomers,” he added.

And why are some companies more vulnerable than others? According to Martin, analysts look at an insurer’s current profits and capitalization, its risk-based capital ratio, the soundness of its pricing strategies, and its operating margin to see if its core underwriting businesses is profitable.

The amplitude of the merger talk about any single company appears inversely proportional to its stock price, which is driven by ratings, balance sheet strength, the magnitude of recognized losses, and investment and risk management policies. It’s unclear to what extent a company’s main problems exist at the holding company level, as with AIG, at the life insurance subsidiary level, or within an insurer’s variable annuity book of business.

Possible targets
With a closing price of only $1.21 as of March 1, down from a 52-week high of $24.88, shares of Genworth Financial, a former unit of General Electric, have lost more than 90% of their value in the past year. The Richmond-Va.-based carrier cut its workforce by 13% last December. It recently acquired Minnesota–based **InterBank** in order to apply for TARP funds.

“If [Genworth] doesn’t get those TARP funds, they’re in trouble, said **Scott DeMonte**, director of variable annuities at Boston-based **Financial Research Corporation**. I think the insurance end of [Genworth] is OK. The parent holding company is where all the problems are,” said DeMonte. “Everyone knows they are hurting.”

“I definitely see consolidation probably sooner rather than later,” DeMonte added. “Whether it’s a state-sponsored merger or whether it’s done on its own accord remains to be seen. I think firms out might have to merge in order to survive, unfortunately.”

Capital-hungry insurers should not expect the kind of taxpayer-funded rescue that AIG received, said DeMonte, because AIG was too big to fail. “But is Genworth too big to fail? I think the answer is no. But they have a good brand name and a good book of business, so someone will absorb them—if, heaven forbid, they do go out.”

Shares of **Lincoln National Corp.**, parent of Lincoln Financial Group, have fallen more than 80% in the past year, to $8.59 on March 1 from almost $60. A February 2009 Citi Investment Research report on Lincoln noted: “At this juncture we believe management’s best option appears to be an outright sale to a stronger competitor.”

“Lincoln’s annuity business all by itself might have been valued at approximately $3.72 billion about ten years ago,” a former Lincoln executive told RIR. “To have the entire corporation valued today at only $2.86 billion—including life insurance and Jefferson-Pilot—may seem cheap in comparison. Of course, current financial dynamics might warrant such a valuation.

“Clearly Genworth and Lincoln have a low market capitalization right now, making this an opportune time for any insurers looking to acquire specific blocks of business from these two companies or the companies in their entirety,” the executive added. “To the extent that Genworth and Lincoln are looking to increase capital, they might be amenable to selling selected blocks of business.”

Hartford Financial Services Group, whose stock fell to $6.10 from a 52-week high of almost $80 a share as of March 1, appears to be in similar straits. Hartford received $2.5 billion in capital from Allianz last fall and was granted a $1 billion reduction in its reserve requirements by the Connecticut state insurance commissioner in February.

Any takers?

For an industry that has seen few big mergers and acquisitions in recent years due to the lack of interested sellers, a new conundrum exists for struggling outfits: the absence of capital for interested buyers. "Lots of people may be looking to sell," said Martin. "But no one can buy."

That may not be entirely true. MetLife, for instance, could be among the potential buyers, DeMonte said. While MetLife's fourth-quarter income fell 12%, it exceeded Wall Street's estimates. Though downgraded by **Goldman Sachs**, MetLife raised $2.3 billion in October through a stock offering.

"The ability to raise that kind of money in this market was impressive," said DeMonte. "And they're just enormous. They are so diversified have so much cash on hand. They could actually do a big merger." According to **A.M. Best**, Metlife has about $28 billion in unrealized losses but about $30 billion in cash and short-term investments.

SunLife Financial, the Boston firm whose parent is based in Canada, has also been mentioned as a possible buyer. Last October, SunLife sold its 37.6% stake in CI Financial Income Fund, Canada's third-biggest mutual fund, for C$2.3 billion and, according to one insider, has had less exposure to VA losses than some larger competitors.

"Sun Life for one recently announced its interest in finding a suitable life and annuity target in the U.S.," said a February 6 bulletin from Tamiko Toland of *Annuity Insight*, a publication of New York-based **Strategic Insight**, which quoted a Sun Life source saying that "We have people on both sides of the border beginning to think about [acquisitions] and starting to take action."

"The list of potential buyers includes **Ameriprise**, **MetLife**, [and Canada-based] **ManuLife**," Toland reported. "Prudential, which itself applied for TARP funds, mentioned its history of acquisition during 'choppy markets' in its fourth quarter earnings call."

"Prudential has proven itself adept at capitalizing on distribution and manufacturing synergies, making the possibility of a merger real despite financial circumstances that would deter many other companies. MetLife, which has been interested primarily in international targets, would consider a domestic acquisition in the right circumstances," Toladn wrote.

In October 2007, Toronto's *Financial Post* cited ManuLife as a possible suitor for Lincoln National Corp. or Principal Financial Group, based in Cedar Rapids, Iowa, whose stock price was down 85% as of March 1. But the Canadian dollar was much stronger against the U.S. dollar at that time.

Analysts cautioned that in a buyers' market, prospective sellers might fail to get a good price. That applies to companies with long-term weaknesses that already wanted to sell as well as to companies that are forced to sell because they're short of capital. "The pricing is just not going to be attractive," said **John Nigh**, a managing principal at **TowersPerrin**.

Consumer impact

A shrinking life insurance industry might not hurt the consumer, one analyst said. Even in 2004, Nigh believed there were too many insurance companies. "I expected to see consolidation whether we had economic travails or not," he said. "I think the current economic environment will merely force or accelerate some of the consolidation we needed."

He doesn't think pricing will be any less competitive from a consumer perspective. "I don't see any impact on the consumer," he added. "We have about 500 life insurance companies. There's no way we need that many. Even if we went from 500 to 100, that's still a lot of competition."

Baby boomers were already driving the simplification and consolidation of the retirement business anyway, says Larry Cohen, vice president and director of New Jersey-based **Consumer Financial Decisions**, a research firm.

As they evolve from full-nesters and empty-nesters to pre-retiree and retirees, they will naturally reduce the number of financial relationships they have and the number of financial products they use. Boomers might even benefit from having fewer insurers to choose among.

"I think the choices now have actually been paralyzing," Cohen said. "Free choice is a wonderful thing but sometimes you can't make a decision because there are too many choices."

But less competition could lead to higher prices. "I believe that reduced competition would take away the pricing issue," said DeMonte. "Somebody could come out charging 2% for a living benefit. And if there are fewer companies out there, they could all do it."

Uncertainty about TARP

As of February 27, the Treasury Department had not given any indication that it would provide TARP money to any of the insurance companies that had applied for it, including those that purchased banks in an effort to qualify for the bailout money.

A February 27 report in the *New York Times* noted that while AIG "still seems to enjoy bottomless support from the government . . . the rest of the insurance industry has growing needs and little indication that any support will be coming its way."

Frank Keating, president of the **American Council of Life Insurers**, which lobbied the government last fall for TARP assets on behalf of its members, said the government hasn't been sympathetic. He told the *Times*: "As we say in the monastic life, it's the magnum silencium—the great silence. We have not had our phone calls answered."