SCHIFF'S
INSURANCE OBSERVER

Evening Telegraph Edition

December 2, 1999 *Volume 11e • Number 8*

Conseco's Disappearing Profits

Capital Infusion

WE'VE BEEN WARY OF CONSECO since we first wrote about it in February 1994, when the company's stock was trading around 13½. Since then we've followed the company's exploits, written a number of skeptical articles, and watched the stock levitate to 57⅞ before declining to about 20.

After Conseco acquired Green Tree Financial in 1998, it issued a press release stating that it "remain[ed] comfortable" with analysts' consensus estimates that it would earn $4.08 per share in 1999. Around the same time, *The Indianapolis Star* reported that "Conseco 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%+ growth in earnings per share *for the foreseeable future*." [Emphasis added.]

As it turned out, the "foreseeable future" was not even a year. On September 8, 1999, somewhere between 25% and 50% of Conseco's "earnings" vanished with the stroke of a pen. To hear Conseco tell it, the bookkeeping change that made its earnings vanish (doing away with "gain-on-sale" accounting for its finance business) was just a timing issue. (Conseco instituted its new accounting method in the third quarter—which also happened to be the first quarter in which one would have been able to compare 1998 and 1999 quarterly results on an apples-to-apples basis.)

The company explained that under the *portfolio* method of accounting, earnings would be lower now, but higher later. Said CFO Rollin Dick, "We expect that operating earnings per diluted share for the full year 1999 (including two quarters of results under our historical method and excluding revenues from securitizations already completed on a gain-on-sale basis this quarter), will be approximately $2.95." (If Conseco hadn't included the first two quarters of 1999 under its historical method, earnings might have been projected at about $2.10 per share.) Dick said that earnings per share should grow to about $3.00 per share in 2000, *and that annual earnings growth thereafter should exceed 15%*.

Perhaps nothing illustrates Conseco's adroitness better than the fact that despite predicting $4.08 in earnings per share and 20% growth—and then announcing a 25% to 50% *decline* in earnings instead—it immediately went back to its old ways and predicted 15% annual growth going forward. (Of course, the new "growth" would be starting from a lower level. At a 15% growth rate, Conseco wouldn't earn $4.08 per share until 2002.)

Conseco's contortions call to mind the disheveled comic, Professor Irwin Corey, whose métier was a fractured lingo of rambling double-talk. ("The independent indications indicate that the market may fluctuate. Sometimes it flucks up, and sometimes it flucks down."

To borrow from Professor Corey, Conseco flucked up—and flucked down.

A Desperate Deal?

On November 30, Conseco announced a deal with Thomas H. Lee Equity Fund IV that would result in an infusion of $478 million. Lee will purchase $500 million of Series F preferred shares convertible into common stock at 19¼. The preferred shares carry a 4% dividend, most of which will be paid by the issuance of more Series F preferred shares.

If one could buy Conseco's Series F preferred shares at 19¼, that implies that Conseco's common stock would be worth about 20% less than 19¼. Put another way, Conseco wouldn't have issued the Series F preferred if it could have issued common stock at a similar price.

The logic of this argument notwithstanding, Conseco's stock rose 1⅝ on the news of Lee's investment. The market (which is sometimes efficient) seemed to be saying that Conseco's apparent commitment to less leverage was a good thing.

Concomitant with the sale of stock, Conseco made two other announcements: 1) Conseco Finance will "manage" (read *slow down*) the growth of its finance receivables to levels consistent with the company's goal of seeking improved credit ratings, and 2) Conseco will cut its quarterly dividend from 15¢ per share to 5¢.

Predictably, Hilbert added a Corey-esque spin of obfuscatory bafflegab to these "strategic initiatives." The dividend cut, for example, was not a sign of financial strain or weakness. Instead, it was a decision "driven by our desire to strengthen the balance sheet and the importance of attaining higher ratings. As a *growth company* [emphasis added], we believe our shareholders will be better off if we reinvest earnings."

If Conseco is a "growth company," it is not one of those growth companies whose earnings will *grow* next year.

"After implementing these steps," Hilbert said, "we expect that our 2000 operating earnings per share will be approximately $2.80." That's 20¢ less than the figure Rollin Dick predicted three months ago.

Although Hilbert's predictive powers failed him in the last year or two, he hasn't lost his remarkable ability to foresee the future. "We expect," he said, "to generate earnings per share growth of 20% per year or more, beginning in 2001."

To recap: last year Conseco said it would earn about $4.50 per share in 2000. Three months ago it said it would earn $3.00. And two days ago it said it would earn $2.80. But don't tell this to Hilbert. Floyd Norris of *The New York Times* reported that during a conference call with analysts, Hilbert noted that Conseco *had never missed a quarterly earnings target*.

Aggressive Accounting

Before considering matters further, it's worth pondering Conseco's history of employing aggressive accounting to increase earnings per share.

In the past, the company has performed magical feats that have demonstrated that Conseco's hand is quicker than most people's eyes. Conseco has purchased insurance companies with almost no money down. It has made stock acquisitions. It has done poolings. It has used purchase accounting. It has sold off partial interests in subsidiaries to the public. It has bought back some of the subsidiaries' shares. It has repurchased its own stock. It has repurchased its shares through its insurance-company subsidiaries. It has sold companies. It has repurchased spun-off companies. It has managed an LBO fund that bought life-insurance companies. It has granted giant reload stock-option packages to its executives and then, when the options were deep in the money, repurchased the exercised shares from the executives at prices that were higher than the executives would have gotten in the open market. It has made loans to its executives. And it has guaranteed loans to its executives so that they could buy massive amounts of Conseco stock.

Conseco has also shifted its accounting methods enough times so that even the most learned accountants have trouble tracking one year's results versus another's.

For example, Conseco has carried insurance subsidiaries on its balance sheet on the equity basis (showing an entry for the value of the subsidiary); at other times it has used a consolidated basis (showing the assets and liabilities of the subsidiary combined with the company's other assets and liabilities). Conseco has recognized income when a partially-owned subsidiary, Bankers Life, issued stock—even though none of the proceeds went to Conseco. Yet it didn't reverse that bookkeeping "income" when, a short while later, it purchased Bankers' stock at prices higher than that which Bankers had issued shares. (See *Schiff's Insurance Observer*, April 1995, page 4-8.)

Conseco's past is relevant because the company's growth strategy has hinged on leverage and acquisitions. Indeed, Conseco Inc. is an amalgam of insurance companies, most of which were acquired in leveraged transactions. (Due to rating agency pressures, it is no longer feasible to make leveraged acquisitions the way Conseco once did.) Conseco's companies, many of which are being rebranded under the Conseco name, sell life insurance, annuities, and supplemental health insurance.

Conseco Finance Corp. (formerly Green Tree), which was acquired for stock in 1998, makes sub-prime loans (particularly on manufactured homes). In bad years, of which there have been a number, it has taken huge write-offs, negating previously reported profits.

If you don't like leverage, aggressive accounting, financial legerdemain, and ultra-bold projections, you will probably dislike Conseco's stock at almost any price. We bring this up because for many years Conseco has been a subject of controversy among bulls and bears. Where the bulls have seen a growth stock, the bears have claimed that the company's financial opacity masks a risky business.

The bearish case on Conseco is this: it is overleveraged, its acquisition of Green Tree Financial has been a disaster, and its reported and projected "earnings" are meaningless because its accounting methods—even if they conform to GAAP—are as smelly as a piece of Roquefort that's been sitting out all week. In addition, a cash shortage is looming at the parent company.

It has been our experience that bears—shortsellers, if you will—tend to be more meticulous about their work than bulls. That's probably because they have to be in order to survive. A "short" can lose an unlimited amount on an investment that goes against him whereas a "long" can only lose what he has invested. (That fact—and the prolonged bull market—are the reasons that there are so few dedicated shortsellers.)

Hilbert and Conseco espouse the view that shortsellers are manipulators who try to drive a stock down by spreading misinformation. (Shortsellers—and others—espouse a similar but different view: that Hilbert is a huckster attempting to drive Conseco's stock up.)

Some of the recent controversy about Conseco has focused on the parent company's ability to service its obligations, and on its insurance subsidiaries' ability to upstream enough dividends (or fees or interest) to the parent company. (Hilbert claims that Conseco does not have a liquidity problem.)

High leverage, rapid growth, and insurance are not a healthy mix. If Conseco were not concerned about cash, why would it issue $500 million of stock at an equivalent of $15 per share when, in 1997 and 1998, it spent $640 million to repurchase shares at an average price of $40.80?

It has been noted that Conseco's main insurance subsidiaries, Bankers National and Jefferson National, have negative unassigned surplus. Some have posited that these insurers' dividend-paying capabilities are almost tapped out, and the issue has been raised as to whether regulators will allow Conseco to upstream enough dividends from its insurance subsidiaries.

Regardless of whether these insurance companies have a current ability to upstream money to Conseco, it seems reasonable to say that their continued ability to upstream *enough* dividends is not assured. (That, of course, is one of the reasons why leverage and insurance don't make an ideal combination.)

So Conseco must delever, which entails raising capital, selling assets (probably), and slowing growth.

That's no way for a "growth company" to behave.

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