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SCHIFF'S

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Demutualizations for Fun and Profit

Principal and Prudential

The upcoming demutualizations and concomitant IPOs of Principal Financial Group and Prudential Financial Inc. are major events that might offer respectable investment opportunities for value-oriented insurance investors.

Both companies are solvent, and well-known in their markets. Prudential is one of the largest financial-services companies in the United States. It's a giant in the life-insurance, property-casualty, and investment businesses. With its famous "Rock" logo, it's one of the world's most widely known financial-services conglomerates.

Principal isn't a household name, and it isn't a financial-services *supermarket*. It's a life-insurance company that has evolved into a leading provider of retirement-savings and asset-accumulation products and services, most notably those for pension and profit-sharing plans.

Both companies are, in many ways, testaments to the strength of mutuality: they were able to grow into major enterprises without any outside capital, and with a structure whose goal was to deliver value to policyholders rather than profits to shareholders. Now, both companies have decided that the mutual structure that brought them to the party is not the corporate structure they want to go home with.

Although we can't help but lament the loss of mutual insurance companies dedicated to the well-being of their customers, this article is concerned with the investment ramifications of such transactions.

The question at hand is, "Are these companies good investments?" The answer is "Yes…at a price." Because mutuals are run—at least in theory—for the benefit of their policyholders, they haven't concerned themselves with maximizing profits for shareholders or achieving the highest possible return on equity. Converting from a mutual to a stock company involves a significant cultural change—a change whose results are uncertain.

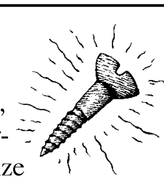
For that reason and others, mutuals' IPOs tend to be priced well below the companies' private market value. That makes these deals of interest to value investors who are willing to forgo earnings momentum, rapid growth, and high ROEs, and settle for buying something cheaply.

If both IPOs go as projected, Principal will come out at a small premium to book value and Prudential will come out at a bit of a discount to book. Under those circumstances, we'll probably buy Principal and pass on Prudential.

We're not convinced that the financial-services supermarket—of which Prudential was an early proponent—is the path to riches. Fidelity and Vanguard are better mutual-fund operations, Merrill Lynch and A. G. Edwards are better brokerage operations, and Northwestern and New York Life are better life-insurance companies. It's difficult to excel in all these fields, and no one has yet reaped the benefits of "synergy" that supposedly exist when diverse financial operations are melded into one. Prudential, in fact, has achieved some "reverse synergies": it has paid dearly for its involvement in life-insurance sales scandals, has struggled to find profits in Prudential Securities (called Bache before Prudential bought it in 1981), and had its Prudential Property and Casualty Insurance Company rendered insolvent by Hurricane Andrew in 1993. Since Prudential hasn't demonstrated excellence in the past couple of decades, there isn't much reason to expect it to do so in the future. Turnarounds are rare in the insurance business; changing stripes from mutual to stock won't transform an average company into an above average one. Nonetheless, if Prudential comes out at a sizable discount to book value—say 30%—it will be worth considering simply because it's impossible to buy a *whole* company of Prudential's caliber at that price.

Principal, on the other hand, is a pretty good company. It provides services to more 401(k) plans in the United States than does any other bank, mutual fund or insurance company, and stands a good chance of earning a good (but not necessarily exceptional) ROE. More importantly, even though Principal is sheltered from hostile takeovers

Liberty Mutual Public Hearing



At 10:00 on the morning of October 11, Linda Ruthardt, Massachusetts' commissioner of insurance, will commence a public hearing regarding Liberty Mutual Insurance Company's plan to reorganize itself as a mutual holding company. Unlike the demutualizations being conducted by Principal and Prudential, in which policyholders will receive 100% of the value of each company, Liberty Mutual's proposed plan will give policyholders absolutely nothing.

Although Liberty's plan is misleading, deceptive, and in opposition to the best interests of the company's policyholders, the odds are 999-to1 that Ruthardt will opt for expedience and approve it, declaring it to be "fair and equitable."

David Schiff will be on hand to testify in opposition to the plan, take notes, and watch the wheels of insurance governance turn in their underhanded, predictable fashion.

and is likely to remain independent for at least five years, it would make a nice acquisition for many larger companies.

Nationwide Mutual, for example, recently announced that it would acquire Provident Mutual for $1.6 billion, or 148% of its GAAP equity. If we assume that Principal is worth a similar multiple, an investor who buys in near book value is getting a good deal—provided he has the patience to wait for something to happen. In the meantime, Principal is likely to grow about 5% to 7% per year, and maybe more. In any event, the company's inherent value should surface at some point.

That's the kind of equation we like: limited downside and a fairly nice upside.

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