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How to Blow Money and Make Friends on Wall Street

Principal Financial Group

There was a time when insurance companies were not the exciting "financial services" players they are now; they were considered stodgy businesses run by boring, gray-flannelled organization men. Working in the employ of stock insurance companies was regarded as an exceedingly dull career choice by the best and the brightest. Mutual insurance companies were held in even lower esteem; they were run by *dimwitted*, boring, gray-flannelled organization men.

Whether these perceptions were accurate isn't important; there are worse things than being perceived as dull. Lack of intellect isn't necessarily an impediment in the insurance business—provided that one is conservative. Being *too* smart, on the other hand, can be dangerous: many clever fellows have driven decent insurance companies into the ground.

Over the years, a good number of dreary mutual insurance companies have done just fine without being ambitious. But slow growth, giving policyholders excellent value, and doing the same thing year after year is...well...*dull*. Perhaps it was inevitable that, as "consolidation" became a popular buzzword and CEOs were given bushels of stock options, the guys running many of the large mutual insurers would want to get in on the action. But action can be dangerous.

Mutual Benefit, for example, survived "panics," a Depression, and recessions during its 146-year history. It managed to achieve insolvency in 1991, however, due to its expansion into real estate and LBOs. The Equitable, which in the 1980s built a headquarters far too luxurious for an insurance company, brought itself to the brink of insolvency by 1992. General American, an early convert to the mutual-holding-company structure, become a ward of the state in 1999 after putting 500% of its equity in an interest-rate arbitrage (borrowing *very* short and lending long).

By 1997, most of the nation's giant mutual life-insurance companies had come to embrace the mutual-holding-company (MHC) concept—a financial neutron bomb that destroys policyholders' value but makes the mutuals' executives wealthy. The great war over the fate of the mutuals has been chronicled at length in these pages (see *Schiff's*, 1997 to 1999). The battle over Principal Mutual was a turning point. Principal was by far the largest company to convert to the MHC structure, and it was the first to meet vigorous opposition. Although Principal's "opponents"—which included Jason Adkins, Joseph Belth, Annamaria Lloyd, David Schiff, and David Winters—lost that battle, their viewpoint was subsequently vindicated and their objections now look prescient. The real losers, however, have been Principal's policyholders.

"How can we participate in the consolidation, much less globalization [of the insurance industry], if we're restricted to the capital in a mutual organization?" said David Drury, then Principal's chairman and CEO, in a 1998 interview with the Associated Press.

At the January 23, 1998 public hearing regarding Principal's MHC conversion, Drury wouldn't admit that Principal's policyholders owned the company—even though Principal had, for decades, told policyholders that they "owned' the company. Drury (and other mutual CEOs) conveniently adopted the mantra that *no one* owned a mutual. In their quest for power, size, and money, the CEOs lost sight of their fiduciary responsibilities, and of the value that belonged to their policyholders. To date, Drury's actions—and those of his successor—have cost Principal's owners more than $1.5 billion.

During his testimony at the public hearing, Drury repeatedly discussed issuing stock and making acquisitions for stock and cash. Yet, when asked by Schiff how much Principal was worth, he professed ignorance: "I don't have an opinion as to what...the market would assign as a current value to the company," he said.

When Schiff suggested that Principal was worth about $10 billion (a figure that the stock market agrees with), Principal's attorney objected, stating that "Mr. Drury has already said that he doesn't have the expertise to make such an assumption."

"If he doesn't have expertise," Schiff asked, "why would he want to acquire companies?"

"I have expertise on my staff," Drury responded, "and we hire expertise from investment bankers in these areas. I don't have personal expertise."

It is a fact that Principal has hired investment bankers and paid them well over $100 million in the last few years. It isn't clear that it got any "expertise" in the process.

In June 1999, a year after becoming an MHC, Principal bought Australia's second-largest asset manager, BT Financial Group, for $1.4 billion—about 27 times earnings. Drury called Australia a "crucial" market for Principal. Barry Griswell, then Principal's president (and now its chairman and CEO), said the acquisition "significantly propels our efforts to become a global retirement services and investment management leader."

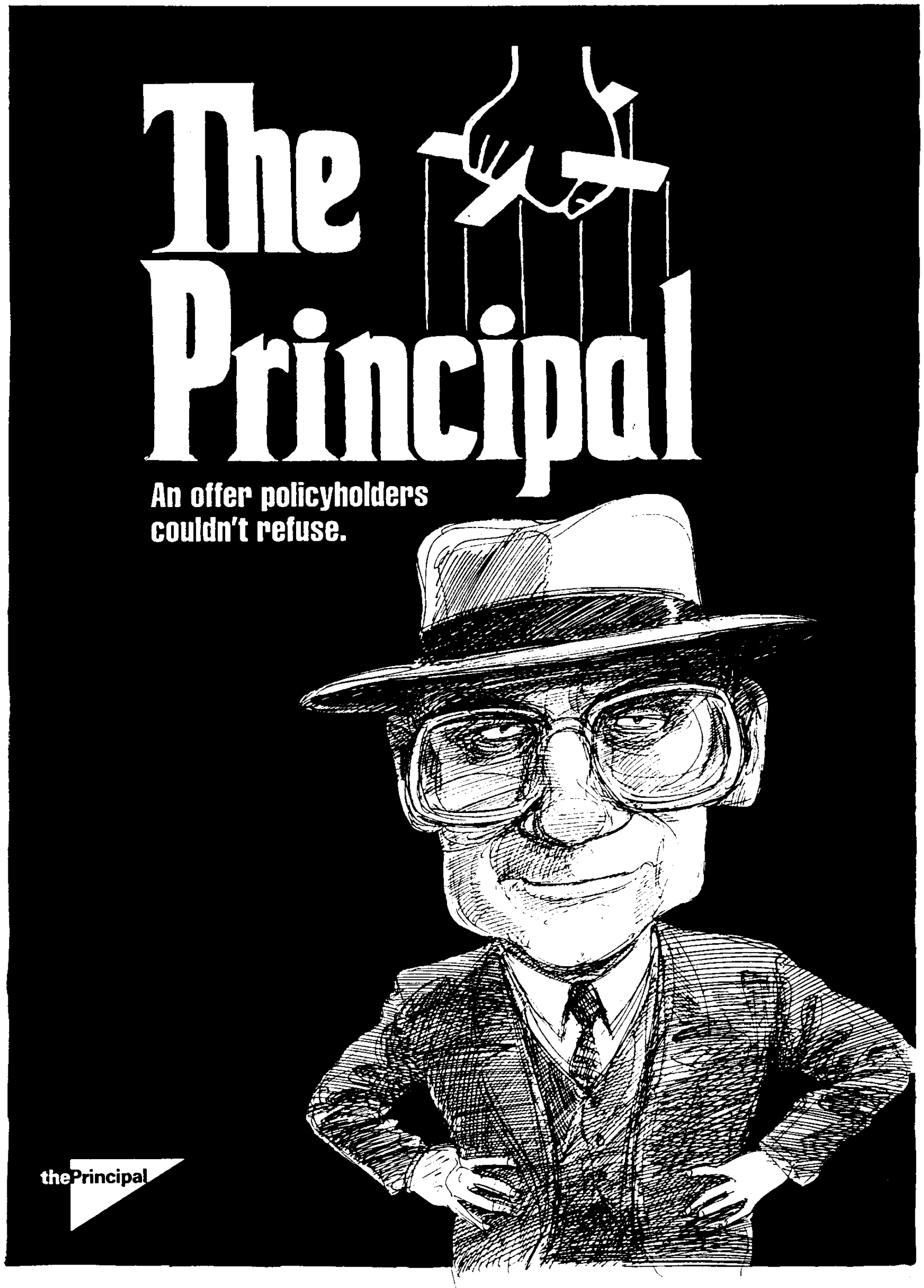
According to Drury, Principal's MHC conversion had been a brilliant move: "Without a doubt," he said, "[the MHC] has been a tremendous success and enabled us to do many things, one of which was to acquire BT Financial Group, the largest acquisition in the company's history and extremely important to our global strategy."

Whatever Principal's global strategy was then, it is something different now. On August 25, Principal announced that it was selling BT Financial. It will receive about $600 million less than it paid for the company. In a press release, Principal described the transaction in linguistic corporate gabble intended to make failure look like a smart move: "The [sale] was made with a view toward focusing the company's resources, executing on core strategic priorities, and meeting shareholder expectations."

Chairman and CEO Griswell, who had played an important role in developing Principal's strategy, provided additional clarification: "This move reflects The Principal's sharp focus on accelerating growth in our retirement services businesses and enables us to redeploy assets to produce greater value for shareholders than would continued ownership," he said. "Changing market dynamics since our acquisition of BT, including industry consolidation, have led us to conclude that clients and staff will be best served under Westpac's [the buyer's] ownership."

Griswell's words may dismay anyone who expects a CEO to give shareholders a straight account of both good news and bad, but they're typical of Principal, which misled its policyholders when converting to an MHC.

Although Principal blew a good chunk of its money on BT Financial, it destroyed even more value in other transactions.



David Drury, Principal's former Chairman and CEO

According to the big mutuals, one major advantage of an MHC (compared to a full demutualization) was that it allowed a company to "time" its IPO. Instead of undergoing a lengthy demutualization process, the MHC structure, supposedly, would enable a company to be nimble and issue stock quickly when the market was favorable. That the big mutuals repeated this so often makes one wonder whether the folks in charge were little more than financial rubes waiting to be fleeced by Wall Street sharpies. AmerUs, for example, the only large MHC to conduct an IPO, "timed" its offering so well that it issued shares at 80% of book value—about half what the company was actually worth.

After converting to an MHC (and spending a good amount of money in the process), Principal made its "extremely important" BT Financial acquisition. It then decided that the MHC no longer served its needs and opted for a full demutualization, which generated another round of fees for investment bankers, lawyers, accountants, and actuaries.

On October 23, 2001, David Drury may have proved that he wasn't lying when he said that he didn't have the "expertise" to know how much Principal was worth. On that day, Principal completed its IPO and concomitant demutualization, selling 100 million shares at a net price of $17.54 per share. Although Barry Griswell (now chairman and CEO), would subsequently tell shareholders that Principal "experienced the euphoria of a successful IPO," selling stock below book value (and for far less than intrinsic value), isn't something to get euphoric about.

Two days after the IPO, Griswell told *Best's Insurance News* that Principal had "excess capital right now," which raises the question: If the company had excess capital, and since issuing shares at $17.54 was a terrible deal for policyholders, why didn't Principal do a much smaller IPO, or wait until it could do an IPO at a decent price? (Principal's executives and investment bankers benefitted from an underpriced IPO.) *continued*

One month after the IPO, Principal announced that its board had authorized a share repurchase. As of June 30, 2002, the company had bought back 25 million shares for $642 million—an average price of $25.68 per share. That's $203 million more than it received when it sold those shares in the IPO.

On August 29, with its stock up to $28.92, Principal issued a press release announcing that its board had authorized the repurchase of up to $300 million of stock. Unlike his predecessor, Griswell says he has an opinion about what Principal is worth. "We believe share repurchase continues to represent an outstanding investment opportunity at current prices," he said.

He didn't bother to explain how Principal's owners benefit when the company issues shares at $17.54, then buys them back at $28.92.

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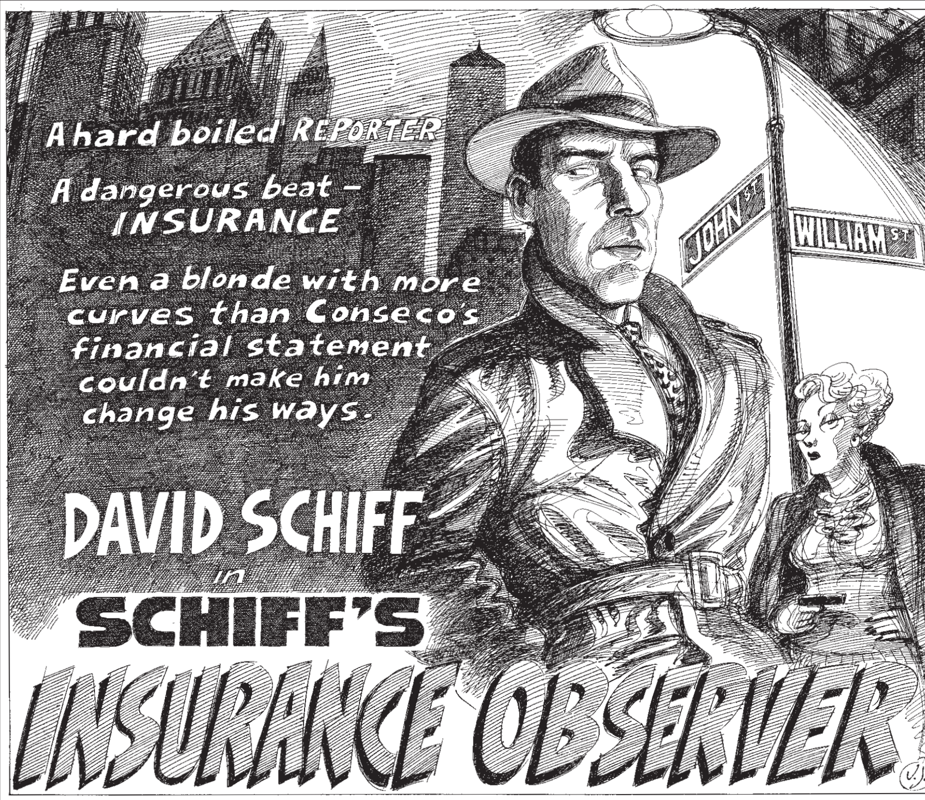

Far from the Art Deco spire of the Chrysler Building and the glamour of Rockefeller Center is another New York—a lost New York where cheap hotels line the streets, and gin mills provide solace to doomed souls. This is a chiaroscuro world of streetlamps reflected on wet pavement, populated by crooked insurance adjusters, unlicensed insurance brokers, and corrupt underwriters.

This is where I work and I live. Life is cheap here in the insurance district, but so are the rents. My office is in the old Fidelity Inland Marine & Flywheel Inspection Building, home to a dying breed of tradesmen who provide services to the insurance industry: hot-lead typesetters, second-hand support-hose dealers, tabulating-machine salesmen, orthopedic-molded-arch wholesalers, and bail bondsmen.

I go out after dark—the only time it's safe—to meet my sources, comprising bartenders, boiler & machinery underwriters, burlesque queens, shoeshine boys, dyspeptic insurance executives, B-girls, milliners, gun molls, firemark collectors, vaudevillians, disgruntled actuaries, and coeds at The College of Insurance. They all have stories to tell and no one to tell them to—except me.

There are many who'd prefer that these stories not fall into the hands of a hard-boiled muckraker who will craft them into searing exposés, detailed financial analyses, and elegant manifestos. There are many who'd pay to have an honest insurance observer silenced, and many who'd pay to buy the silence of an honest insurance observer. But my silence is not for sale.

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