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Warts and All

Despite the company's troubles, the Prudential IPO looks like a solid deal for investors

By **ANDREW BARY**

Prudential, symbolized by its famous rock logo, is set to make its long-awaited initial public offering this week. But the insurer's financial performance has hardly been rock-solid in recent years.

Reflecting lackluster operating results and a low return on equity, Prudential is expected to go public at price between \$25 and \$30 a share, a discount to its book value of nearly \$35 a share.

In the deal, Prudential Insurance Co. of America will shift from mutual to public ownership by selling stock and distributing shares to millions of its policyholders. Assuming the deal is sold at \$27.50 a share, the midpoint of the pricing range, Prudential Financial, the new public company, will have a market value of \$15.5 billion, making it one of the largest life insurers in the country.

Prudential aims to sell 110 million shares in the IPO through an underwriting group led by Goldman Sachs; an additional 456 million shares will be distributed to policyholders. Smaller policyholders will get \$4.4 billion in cash or policy credits in lieu of shares. The Prudential IPO will raise about \$3 billion, making it the third-largest of year, trailing only **Kraft Foods** and **Agere Systems**.

While Prudential's financial performance in recent years hasn't been stellar, the deal could prove attractive if the company is successful in boosting its returns. By going public below book value, Prudential is admitting that it has work to do and is offering a concession to investors.



William Waitzman for Barron's

Investors may snap up Prudential shares, hoping for a repeat of the strong performance of several other demutualized life insurers.

John Hancock Financial has risen to 41 from its IPO price of 17 in 2000 and **MetLife** is up to 28 from its IPO level of 14.25 last year. More recently, **Principal Financial Group**, which went public in October at 18.50, has appreciated to 23. Prudential, however, isn't in as good shape as its rivals were when they went public.

Investors, naturally, would like to see the deal priced as cheaply as possible. Prudential has some incentive to set a higher IPO price, not least because it must pay policyholders getting cash a bonus of as much as \$440 million if the stock rises 20% in the initial 20 days of trading. A higher-priced deal would reduce the chances of such a payout.

The recent sharp stock market rally, which has lifted financial stocks, may tempt the underwriters to

price the deal at the high end of the range. Indeed, the talk last week was that the deal was well subscribed at the middle of the current range. Some investors think Prudential will trade in the low 30s after the pricing.

Prudential is aiming to boost its return on equity, which was around 5% in the first nine months of the year, to 12% by 2004 or 2005, according to several investors who attended meetings with management. That ROE goal, however, could be a stretch. Street analysts reportedly have said that Prudential can earn around \$2.20-\$2.25 a share in 2002 and \$2.60-\$2.70 a share in 2003. Profits of \$2.25 a share next year would translate into a ROE of around 6%.

Prudential bills itself as one of the largest financial-services companies in the country, but it has few top-flight divisions. Besides its marquee -- and mediocre -- domestic life insurance business, Prudential has an attractive asset management operation, but returns in that business are low.

Prudential Securities, a full-service brokerage operation, didn't earn a lot in good times and lost \$164 million domestically in the first nine months of this year. The broker is seeking to reposition itself by dumping much of its investment banking operations and focusing on individual investors. There's speculation that Prudential Securities could be sold, especially if its results don't improve.

Table: How Prudential Stacks Up ¹

Surprisingly, Prudential's best business is its successful and fast-growing life insurance operation in Asia. Prudential has done well in Japan by courting affluent customers with a college-educated sales force. Prudential has taken that model and exported it to Korea and Taiwan, and it has further expanded in Japan through the purchase of a financially troubled Japanese life insurer that catered to a middle-market segment.

Operating income in the overseas life operations rose to \$296 million in 2000 from \$144 million in 1998. Profits were up 20% in the first nine months of this year, excluding the effects of the acquisition of the Japanese life insurer, now named Gibraltar Life.

Prudential boasts one of the best-known brands in the country, but it has been tarnished by a well-publicized scandal involving sales practices in the insurer's life operations that ultimately cost the company over \$4 billion in settlements and other expenses in the late 1990s.

Prudential's chief executive, Arthur Ryan, a former Chase Manhattan executive, arrived at the Newark, New Jersey-based insurer seven years ago amid fanfare, but he has been unable to lift Prudential's returns to respectable levels. Ryan and his team may have greater financial incentive to do so at the helm of a public company.

Through the first nine months of this year, Prudential's adjusted operating income, which excludes the costs involved with the IPO and the impact of capital gains, was \$1.1 billion, down from \$1.7 billion in the same period of 2000.

Prudential's nine-month results were hurt by the loss at Prudential Securities and by lower earnings at the asset management arm. Profits also fell at its property/casualty division and its employee-benefits unit. The domestic life and international life divisions had higher profits in the first nine months of 2001.

One issue for investors is whether to bet on Prudential, which offers plenty of operating leverage if results improve, or play other demutualized life companies like MetLife, John Hancock Financial or Principal Financial that are better managed, carry less baggage from lagging operating divisions but

sport higher valuations. MetLife and Principal Financial already are earning roughly 10% returns on equity and have plans to boost their returns. John Hancock trades for two times book value, a premium to the group, because its ROE is best at 14%.

Prudential, by contrast, has been an ongoing restructuring story. The company has sold or divested its health-care, reinsurance and commercial mortgage business while overhauling its scandal-scarred life insurance operations to boost returns. Prudential has halved its number of agents and sought to stimulate sales through third-party channels, and has targeted a more affluent customer base.

Additionally, the firm is seeking to expand its presence in the "mass affluent" market of households with incomes or assets of \$100,000 to \$250,000, as opposed to its traditional mass-market approach. But the mass-affluent market is getting increasingly crowded. Prudential's domestic life operation has had flat to declining premiums in recent years.

Prudential's asset management operations, which managed \$177 billion for outside clients at the end of the third quarter, had fewer assets on September 30 than at yearend 1998 -- not an encouraging sign. One of Prudential Securities' initiatives has been to consolidate the management of the firm's equity funds under Jennison Associates, a growth-stock specialist. The Jennison shift, which occurred last year, wasn't well timed because Prudential's equity funds shifted their orientation to a growth bias from a value orientation just as the stock market was shifting the other way.

Warts and all, the Prudential IPO is apt to get a good reception, if only because investors figure that buying stock in a well-known financial company below book value is a low-risk proposition.

E-mail comments to editors@barrons.com²

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