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Let's Make a Deal: Life and Health Mergers and Acquisitions

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Recorder: WILLIAM R. HORBATT

Summary: With all of the merger and acquisition activity in the life and health insurance business, every actuary needs to know how "deals are made." This session uses a case study to illustrate the process to buy or sell either an entire company or a block of business.

Mr. William R. Horbatt: In this session, we have Charles Carroll, a partner with Ernst & Young LLP; Herb Goodfriend, a managing director with KPMG Peat Marwick LLP; and me, a consulting actuary with KPMG Peat Marwick LLP.

Charles is partner in charge of Ernst & Young's insurance mergers and acquisitions (M&A) practice. He's a certified public accountant, attended Yale University, and began his career at New York Life.

With more than 30 years experience in the investment banking and securities field, Herb has been named many times as an *Institutional Investor* magazine All-American team member. He has been a past president, continuing charter member, and director of the Association of Insurance and Financial Analysts of New York. He currently is a member of the Society for Insurance Research and has done work for the *Journal of Risk and Insurance*. We always turn to Herb when we need the analytical as well as the subjective side of deals and valuations of companies.

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We're going to talk first about basic valuation theories (How do you set a value for a company? What price should you pay?), touch on some practical topics, and have a question and answer period. Then we'll present a case study on AmerUs' acquisition of AmVestors. We'll divide you into groups of buyers and sellers to work on the case, and our distinguished panelists will critique the results.

We're going to deal with valuation theories very quickly, i.e., the discounted dividend stream model, then we're going to go into the various models that the security analysts use. We'll touch on actuarial appraisals and then go into an area that's currently of keen interest, evaluating the effect of a deal on your GAAP earnings. Then, if time permits, we will split into groups to do a practical case study and team presentations.

I'm going to start with the discounted dividend model. The theory is that the value of a company is simply the present value of future stockholder dividends. It's a function of current adjusted earnings, future growth, and uncertainty. Some businesses are more uncertain than others. Take a utility company, for example. If we were valuing a utility company ten years ago, we'd use a relatively low discount rate to set its value because the dividend stream for utility companies was considered to be quite certain. That has changed dramatically, however, and the same company now would be valued at a much higher discount rate.

To give you a feel for today's stock market, let's look at a typical company. It has \$1,000 (or \$1 million or \$1 billion) of earnings, 50% of those earnings are paid out in dividends, and it's growing at a 4% rate. The leverage is twice the rate of inflation, about the rate of growth for the gross domestic product. Discounting it at 6.5%, you get a value of \$20,000. We were targeting the price/earnings (P/E) ratio and wanted something around 21.

The earnings yield, 4.9%, is not much different from Treasuries, and the dividend yield is much less, but still in line with bank money market accounts. We then tried some other growth and discount rates. A 0% growth rate would be equivalent to a 2.4% discount rate, and an 8% growth rate gives you a 10.7% discount rate. The market is anticipating a relatively high growth rate at these P/E ratios. I'll leave it up to you to decide whether that's really appropriate and turn it over to Herb Goodfriend.

Mr. Herbert E. Goodfriend: I think it was an Englishman who once said, "Things would have been simpler had they not been explained." That's the art of security analysis. I'm not here to defend Graham & Dodd—nor the way in which the practice of the art (not a science) is conducted today—but rather to show you parameters used by analysts in their everyday going concerns and in M&A activities

with varying degrees of accuracy and success. Nonetheless, they've stood the test of time and deserve to be included as one sector of parameters in an overall assessment of how to make a deal.

The amount of a dividend and its dependability are far more important than the dividend yield today. There's been distinctly less emphasis placed on the present value of future earnings manifested in recent years. The emphasis has been on plowing back money to get a higher yield over the course of time. With the tax rates the way they were, most institutional investors became less concerned (and remain so) with dividends than with the rate of progression in earnings over time. But dividend yield is still an important factor vis-à-vis the yield from a U.S. Treasury bond or other alternatives.

P/E ratios are a moving target. In the financial businesses as a broad genre, they continue to be markedly below those of most other industries. You can count the exceptions on your fingers.

Within the broad group of financial services, insurance stocks suffer even more. There's a whole roster of reasons, in the view of the pundits, that insurance stocks should not command higher multiples of earnings than they do: interest sensitivity, regulation, and a mystique about what product you're offering, whether it's a product that the consumer wants or is forced to take. In the case of life insurance, the old saw goes, "Insurance is sold and not purchased." In addition, we have the lagging demand characteristics of individual component parts of a life insurance business, the changing mix of what is being sold, and the tremendous heat up in competition. P/E ratios are less "dependable" than they are in other businesses and typically sell at a sharp discount. I use the word advisedly, from Standard & Poor's, Dow Jones, or other conventional indexes that are used as measuring rods and you will see that in due course, too.

Conversely, price to book value (P/BV) ratios have been much more preeminent in the calculation of reliability. The thesis is that if you plowed money back in—whether it be GAAP or statutory book—it would be manifested in accretion over time. The degree to which the pace of that accretion deserves to be accorded a premium in the imputed value of that company is manifested by book value—the imparted value being the amount someone is willing to pay, whether as an ongoing concern basis or an acquisition.

You can argue about what should be included in GAAP book value—nonetheless, it's here and we have to deal with the reality. It's far more important, relatively, in this business than it is in measuring a technology firm or an insurance broker, for

example, where goodwill and the future power of a marketplace position command much more respect.

By accretion to book value, I mean the compounded rate of gain in the book value per share, preferably GAAP book value over time. The time period can be three, five, or seven years. The measuring rod is a moving target, but suffice it to state that it ought to be more than one year.

The GAAP rate of return is another medium of measurement. It's the per share earnings divided by the GAAP book value as of a certain date or the average over a course of a year. One catch is that typically analysts and the rating agencies exclude from this calculation realized capital gains or any other construed-to-be nonrecurring or less dependable facet of earnings. There's an investment philosophy of which Mr. Warren Buffet is the champion that says, "Give me a dollar and I will return it to you in multiples over time, and the component parts of it are my discretion. Just judge the results at the bottom line, don't penalize me if 90% of my earnings gains come from the marketplace and only 10% from operations." Only a handful of institutions truly dedicate themselves to this philosophy to the degree that Mr. Buffet does, and they are notable exceptions in the insurance business, especially where a significant portion of the balance sheet is invested in fixed income and capital gains, which are not readily obtainable except after a marked plunge as we had about five years ago.

Nonetheless, per share earnings, excluding realized capital gains and other nonrecurring characteristics, are the mode to which we assert ourselves in this respect. If you want to call it underwriting operations, fine, but the important thing is that we also try to get rid of Mickey Mouse and Donald Duck ploys, such as releasing reserves for one year in anticipation of a deal to make your stock look good in earnings, taking some fast profit in real estate, or making your balance sheet and income statement look better in some other way than they are over time. Those are the things security analysts look at.

Mr. Horbatt: A typical actuarial appraisal will value a company through various components. These components generally include adjusted surplus, the present value of future profits (PVFP) on the existing business new business, and potential expense savings. To get an adjusted surplus figure, first restate (i.e., mark) the assets to their market values. We begin with our statutory balance sheet, move it over to something different, and include nonadmitted assets. Add back nonadmitted assets. The computer system that you wrote off has value, we hope.

Target surplus is a relatively new wrinkle. Basically, it's deducted from surplus and put over in your PVFP calculation because that business is driving the surplus you must maintain, and you'll release it in the PVFP calculation.

Generally, you eliminate surplus relief if the business is viable without it. If there were reinsurance treaties with a parent or an affiliated company that didn't have business purpose, take them out. However, if you're a fast-growing company and need financing for that growth, then you would project the surplus relief you were purchasing from the market to fund your growth.

You'd also do a tax adjustment since, as a result of all these other adjustments you're making, you may build up either a tax credit or a tax liability.

There are two ways to deal with interest-maintenance reserves and asset-valuation reserves. You can add them to surplus or, preferably, build them into your PVFP calculation.

PVFP is the closest that actuaries come to the dividend model because we're discounting cash flow to calculate the PVFP and projecting statutory profits available for distribution and the release of target surplus. Typically, actuarial appraisals are done at multiple discount rates such as 8%, 10%, and 12%, but there's another way to do it. If you were doing an actuarial appraisal for accounting or tax purposes where you have to pick a single discount rate, you would use an approach such as the cost of capital. You might ask, "What is the industry paying for capital, and what is the average cost of capital?" That includes both debt and equity. The assumptions used in a PVFP calculation are generally realistic. They're not GAAP assumptions. You generally take out margins for adverse deviation that may be in your GAAP assumptions.

One interesting area is the area of excess expenses. When a company is running at too high an expense level, actuaries will break those expenses out as a separate item and bring them down to make the company look more attractive. Frequently, expenses are brought down by merging the company and eliminating a lot of employees.

In an appraisal of new business, we're talking about the value of "existing structure." Herb mentioned, in brokerage firms and other distribution systems, there's a lot of goodwill and other value that isn't on the company's balance sheet. That type of value can be added in an actuarial appraisal. It's virtually always shown separately and frequently discounted. Buyers don't attach much credibility to this element of value.

The calculation of the value of “existing structure” is done just like the PVFP on your in-force business. You might, and probably should, use a higher discount rate to reflect the higher uncertainty of delivering the new sales. Sometimes a buyer will look at this much more favorably, for example, in a situation where the company has a unique distribution system. I’m thinking not of career agents, but rather of niche markets or a notably new product. Take the example of Hartford’s product in the annuity field. They’ve really fine-tuned it and made it very attractive to the brokerage community. In such cases, the existing structure really does have value.

An expense savings appraisal includes total company expenses, maintenance expenses, acquisition expenses, and overhead. Maintenance expenses are included in the PVFP calculations, either for the existing business or the new business, but have a much greater material effect on your existing business.

Acquisition expenses are included in your new business calculations, and overhead expenses are a balancing item. Historically they’ve been excessive, particularly for smaller companies that haven’t grown at relatively high rates. If their expenses are out of control, actuaries may write them off over several years.

Finally, ten years ago, virtually all actuarial appraisals were done on a deterministic basis, where they would have only a single-interest scenario. Today the ratio of multiple scenarios is much higher, so the appraisal involves a stochastic approach. But multiple scenarios are still very difficult to understand. A typical appraisal, if it includes year-by-year projections, will show a single scenario with illustrated data.

Mr. Goodfriend: Security analysts and investment bankers typically want to see three scenarios: best case, modal case, and worst case analysis. Depending on whether they’re bullish or bearish, and the degree to which they want to inflate or deflate a value, they choose one of those three. Interestingly enough, the rating agencies also use modal or worst case analyses. The best case analysis is given sharp discounts because it’s the future and nobody wants to reward too much in advance for it.

Mr. Horbatt: Actuaries normally think of a scenario from a cash-flow testing perspective, using, for example, multiple interest-rate scenarios. You’re taking it one step further where the analysts are looking for other types of factors, such as new business, production, and so forth.

Charles Carroll will now explain how GAAP can be a driving force in M&A. Being a CPA, he probably can actually do this.

Mr. Carroll: The valuation theories Bill has talked about so far focus more on what I would call intrinsic value. In other words, they are based on scientific theories. Even the analyst approaches, which are somewhat more artful and judgmental than the actuarial appraisals, attempt to measure the inherent worth of an entity. Analysts go through a comparability analysis largely; that is, if company A is worth X, and company B relates to company A in a certain way, then company B's value relates to company A's value in the same way.

The discounted cash-flow and actuarial appraisal methodologies are very similar, in that they take the very scientific approach of looking at cash flows and determining the investor's required rate of return. In almost every acquisition of an insurance company, particularly a life insurance company, you'll find all of those methodologies applied. But there's one other analysis that's particularly important to publicly traded companies: what an acquisition will do to the company's stock price. Many of the active acquirers are publicly traded companies. One of the reasons for this is that, by virtue of being publicly traded, they have access to capital markets to make acquisitions.

Compensation incentives for management are largely related to what happens to the stock price and their charge, as management, is to increase shareholder value. Therefore, an analysis of what's going to happen to shareholder value in the marketplace is a very important factor.

Determining how a particular acquisition is going to affect stock price is a dynamic analysis. I don't mean to imply that it's cut-and-dry, even though we're going to go through some analytics here. The fact of an acquisition, and how it plays with the analyst and general business community, is extremely important, and that's not predictable from a set of numbers. In the current environment, generally you'll find that making acquisitions per se is viewed favorably. Obviously, analysts and observers look critically at the strategic rationale for an acquisition, why it makes sense for this particular company, how likely it is to work, and whether the management has the will to do what's necessary. But all other things being equal, consolidation in the industry is viewed favorably and those companies that participate as consolidators are viewed favorably by the market. Right off the bat, before getting into the analytics, acquisitions can help the company's shareholder value.

The company's management, though, has to be concerned with the analytics; that is, how the acquisition will mathematically affect the factors that drive the value of the company's stock in the marketplace. And that is largely a function of what happens to the earnings per share (EPS) number—not entirely, but largely because

EPS multiples and P/E multiples are the primary benchmarks used in the stock market. Herb, would you agree with that?

Mr. Goodfriend: Yes, in the going concern. But not when it gets to the M&A side, where it is one measurement and not the only one.

Mr. Carroll: Yes. But once a company is bought and becomes part of an organization, its earnings are going to flow into the going concern value of that entity.

A company's P/E multiple includes a lot of information about how the market views the company and doesn't tend to change dramatically unless there's some cataclysm. If you assume that a company's P/E multiple will stay relatively constant as it makes acquisitions, then the EPS number from the acquisition will drive what happens to the company's stock price as a result of the acquisition. If the P/E multiple is enhanced, then things are even rosier and the management can anticipate a double benefit from making an acquisition. If you're viewed more favorably by the market, the market will push its P/E up and the EPS number, being larger one hopes, will drive an even larger stock price.

We're going to assume that the P/E multiple is a constant, depart from the subjective realm, and do some algebra. What determines whether an acquisition is accretive or dilutive? In almost every article you read about a public company making an acquisition, there is a statement by the CEO that this acquisition will be accretive, or at least nondilutive, to earnings in the first year after the acquisition. It's almost expected by the market. If the CEO doesn't say that, everyone will assume that it's going to be dilutive and the stock price will go down because the analysts will change their projections of EPS downward. This is an important statement for the CEO to make, and I think the fact that it is addressed so prominently gives credence to the analysis.

GAAP earnings of the acquired entity after the acquisition determine whether an acquisition will be accretive or dilutive to EPS. Another important factor is what currency was used for the acquisition: stock, cash, or a combination of the two? Did the company incur debt? If so, what kind? What was the cost of the debt? The answers to these questions mathematically will drive the effect on EPS.

In assessing GAAP earnings, the first thing you have to determine is whether the purchase is going to be accounted for as a "pooling" or a "purchase" under Accounting Principles Board *Opinions* 16 and 17. What constitutes a pooling versus a purchase is an area of tremendous study by accountants. Generally a pooling is a combination of two shareholder groups, as opposed to one shareholder

group buying out the other. The ultimate example of a pooling would be a merger of two mutual companies. The two policyholder groups come together. They're still policyholders of the combined entity and no cash gets distributed. The key thing about a pooling is that you don't disrupt the pattern of GAAP earnings, but rather carry everything forward on a historical basis. Ninety percent of transactions are accounted for as purchases, where I pay you \$20 a share for all your stock and cash and own your company.

The SEC has taken a generally skeptical view of pooling accounting, and, if the SEC has its way, there won't be any poolings in the future. In most cases, we'll be dealing with purchase accounting for the acquired entity, and that involves a very time-consuming and thorough-going reevaluation of the purchased entities: balance sheet, amortization methods, accounting methods, valuation of assets, and everything else. You'll have to throw out the historical GAAP financial statements and start over again at the purchase date. Everything's marked to market on the balance sheet. Historical deferred acquisition cost is written off and you record in its place an asset called "value of business acquired." And you may have to put up goodwill, depending on how much you paid for the entity.

Also very common these days is an announcement shortly after the acquisition that there will be restructuring charges taken. In the property & casualty setting, this is often done through loss reserves. Management is essentially saying, "We bought this company and paid a huge price for it, but decided that its loss reserves were understated by \$1 billion, so we have to write those up." A skeptic says those restructuring charges are designed to have a certain effect on future income, but restructuring charges are becoming common practice in large acquisitions because those charges will have an impact not just on the balance sheet but on the earnings going forward.

For example, company A is an acquiring company. It has GAAP equity of \$2,500, with 100 shares outstanding. Its GAAP net income is \$375 which translates to an ROE of 15% on beginning GAAP equity. Its EPS is \$3.75, or \$375 divided by 100. The P/E multiple is the share price (\$57.75) divided by the EPS, or 15.4. And the market cap, 5,775, is the share price times the number of shares. I picked 15.4 as a P/E multiple based on a formula I found in a Goldman Sachs publication dealing with valuation of insurance company stocks worldwide. Goldman Sachs studied a certain limited number of large life insurance companies over a fairly short time frame and did a regression analysis based on the ratio of stock P/BV per share. If you take the market price divided by the GAAP equity, that's price-to-book; it's a ratio over 100% generally. Goldman Sachs observed that this could be equated to ROE by making P/BV a function of ROE with this 17.612 factor minus a constant.

They found a fairly good correlation based on that formula for several large publicly traded life companies.

Algebra-wise, ROE is the relationship of earnings, E, over book value, B, and, if you do the substitutions, you can transform this formula into a formula for the P/E ratio. You can't have a P/E for a life company greater than 17.612, mathematically, because if ROE is infinite, this drops out to zero and you get 17.612.

Herb said that life companies shouldn't have very high P/Es in the market. This formula says the market is agreeing with that statement. Of course, some life companies do have P/Es greater than 17 but, in any event, it's an interesting relationship. If you apply this to the 15% ROE, mathematically you get a 15.4 P/E ratio and a 231% P/B ratio.

Mr. Goodfriend: It has been rare for most of the life insurance industry to earn a 15% rate of return. It is only in the last several years that most have come up to 11–13%. In normal times, whatever the word normal means, they were earning single digits, i.e., 7-9%; thus, 15% is a pretty noble goal.

Mr. Carroll: Yes. This company A is a powerhouse with its 15%, and, by definition, that's a 15% without any of the extraordinary items. In any case, company A is going to acquire company B, which is smaller, for \$500. Some actuaries have gone into the backroom, crunched all the numbers, talked to the accountants, redone the balance sheet, and come up with an estimate that the projected purchase GAAP ROE for the first year after the acquisition is made will be 8% after tax, or, in other words, earnings will be \$40. The ROE could be 8% even though the company was bought on the basis of an actuarial appraisal that used a 12% discount rate because GAAP doesn't mesh with actuarial appraisals. It's a different accounting basis, and there is a tendency when you do purchase GAAP for the early year returns to be lower than the implied discount rate in the actuarial appraisal. I won't go into why that is, but it definitely tends to be the case.

Let's look at three different scenarios to see what would happen to company A under certain circumstances. In scenario 1, company A is a cash rich company. It's going to take \$500 out of its general account and pay it in cash to company B shareholders. If that happened, company A would continue to have its \$375 of earnings, plus the after-tax \$40 from company B's purchase accounting exercise. They also would have \$500 less in their investment portfolio to earn investment income. I've assumed that the after-tax return they're giving up on that \$500 purchase price is 5%, which equates to about a 7.7% pre-tax rate of return, so their earnings now are \$390. Under this scenario, company A's equity pre- and postacquisition doesn't change. The basic theory of purchase GAAP is that if you

paid \$500 for an asset, that's what it's worth. GAAP net income is enhanced because the \$40 of after-tax earnings is more than the \$25 earnings on the cash that company A gave up. The EPS, (\$3.90 is \$390 divided by 100), and the share price (\$60.06) is determined by taking the 15.4 times EPS. For these 100 shareholders, their share price has gone from \$57.75 to \$60.06, so you take the difference between \$60.06 and \$57.75, or \$2.31 times 100, and get the value created (\$231). A theorist might say we've taken \$500 that was invested in Treasury bills and put it in a life insurance entity, so we should change the discount rate.

Mr. Goodfriend: Moreover, there's a somewhat new school of economics, the Dynamic Financial Analysis School, that believes you should deduct from these equations the amount of capital required to carry the risk quotient of the acquired entity—or for that matter, the acquiring entity—which is a variable amount. This so far has not been applied well to the insurance industry. It's been applied importantly to others, and there are devotees who believe in it and are using it. In the U.K., they have swallowed this whole and are using it in their M&A assessments. If it gains further stature, it probably will change some of the parameters here.

Mr. Carroll: Let's apply it to this particular situation. This theory would say that company A has made this acquisition, but company B is a company that requires capital of \$200, so I would subtract \$200 from the value of the acquired entity?

Mr. Goodfriend: Yes. That decreases it to \$100.

Mr. Carroll: Now my fair price should be adjusted for that and my P/E, etc.

Mr. Goodfriend: Precisely.

Mr. Carroll: That's an interesting theory and one that makes sense from an actuarial point of view.

Mr. Goodfriend: In fact, it was created by actuaries, I believe.

Mr. Horbatt: It goes back to PVFP calculations providing for the effects of target or risk-based capital (RBC).

Mr. Carroll: In scenario 2, company A decides to make the acquisition with stock. We're assuming here that even though they're making an acquisition with stock, it's still a purchase situation, not a pooling.

The earnings are \$415 (net income of \$375 plus purchase GAAP (P-GAAP) income of \$40 for company B) because you're not taking any cash out of your coffers or liquidating any investments. The purchase price is \$500 and our prepurchase market price was \$57.75, so \$500 divided by \$57.75 is 8.66, rounded. Therefore, we have to issue 8.66 new shares to make the acquisition.

In this scenario, the GAAP equity increases by \$500 after the acquisition, the theory being, again, that if you pay \$500, it's worth \$500. And, since we didn't get rid of any other asset, our net assets have now increased by \$500 and our shares have increased by 8.6. GAAP net income is \$415 and EPS is \$3.82. Share price has increased to \$58.82. You take that increase times 108.66 and the value created is \$116.

This is interesting because, in my mind, there are 2 pieces to this \$116. One is that on the original 100 shares, the per-share price increased from \$57.75 to \$58.82, which is \$1.07 per share or a total of \$107, which is less than \$116. The other shares were originally issued on the basis that they were worth \$500, but if you do this calculation, 8.66 times \$58.82 minus the \$500, you actually get \$509. Under this theory, you've created value even in the new shares that you offered because their P/E has gone up.

Mr. Goodfriend: The logic is irrefutable.

Mr. Carroll: Finally, scenario 3 is actually very similar to the first scenario, but company A borrows the money, paying a pre-tax rate of 8% on the loan. The \$40 in earnings is additive and that's after tax. You'll pay 8% on the \$500, or \$40 negative, but that's going to have a tax benefit of 35% of that, or \$14. The net income becomes \$389.

Mr. Goodfriend: Increasingly, you see hybrid securities offered by the acquiring company, and it is hard to discern whether they are debt or equity. It depends on conversion characteristics, whether they're convertibles or have a debt quotient to them, or whether they're amortizable or redeemable. There are disputes in and within each accounting firm. The SEC has its own idea of what is equity and what is debt, and last, but not least, the rating agencies have their own views (as do regulators). It's best to test the water with each of these constituencies before the fact or at least before you get too far down the road and can't turn back.

Mr. Carroll: Yes. Some of these securities can have very complicated terms, and their actual effect on things like GAAP earnings and EPS calculations can be complicated. For example, if they have convertibility features with them, they may affect fully diluted EPS calculations. This a very simple example, but when you're

doing an actual deal with a complex capital structure, the calculations can be much more complicated.

In scenario 3, you get a pickup in value of \$216. It's not quite as good as scenario 1, but it's still a significant pickup. The calculation is basically the same: 100 times the difference in the share prices.

Next we did some sensitivity testing on the three scenarios. Let's say P-GAAP ROE is 10% rather than 8%. We might be able to squeeze out more expenses, allocate the purchase price a little differently, or amortize goodwill over 40 years instead of 20. However we do it, the 2% increase has a very significant impact on the value creation opportunity (see Table 1).

TABLE 1
COMPANY A ACQUIRES COMPANY B
SENSITIVITY TESTS
EFFECT ON VALUE CREATED

	Scenario		
	1	2	3
Base case	231	116	216
P-GAAP ROE 10%	385	270	370
Pay 100 more	154	16	136
P/E of 8.0 vs. 15.4	120	(180)	112
P/E of 20.0 vs. 15.4	300	300	280

Let's say that, instead of paying \$500, we paid \$600 and got the same \$40 of earnings. In other words, your P-GAAP ROE actually goes down from 8% a little, but you get the same P-GAAP earnings, that is \$40 after tax. The interesting thing is you still get a fairly nice pickup in scenario 1 because your earnings potential from buying this company is better than investing in Treasury bills or other fixed-income investments. It's not as good as it was, but it's still a benefit for scenario 1. In scenario 2, we got virtually no pickup from issuing stock at \$600.

If our P/E ratio were 8 instead of 15.4, we'd still get some benefit in these 2 situations, even paying \$500. In this situation, we have actual value destruction of a significant amount because, basically, we're paying for the acquisition based on an implied P/E ratio of \$500 over \$40, which is bigger than 8. We're paying a higher price for these new earnings than the market is allowing us in our stock price. If we do that, we're going to start destroying value. This is the nightmare of the management making an acquisition. Finally, if we have a P/E of 20, we create more value than in the 15.4 case.

P/E ratios do change but, in general, a company with a high P/E multiple can create significant value through acquisitions. And the higher your P/E multiple, assuming you don't start making stupid acquisitions, the more value you can create. Also, small increases in P-GAAP earnings can have large effects on value, so companies are paying a lot of attention to this aspect of acquisitions. A lot of subjective choices are made in that process, and it's an area where the accountants have narrowed the range of practices, but there's still a wide range.

Table 2 shows P/E ratios and market capitalization for some life insurance company acquisitions. I added GE because it had been active in the acquisition marketplace for a while and made some relatively large acquisitions in a short period of time.

TABLE 2
ACTIVE ACQUIRERS

	Price/ Earnings	Market Cap. (\$ billions)
AG	16.4x	16.0
GE	32.5	275.0
Conseco	16.7	11.0
Jeff-Pilot	18.2	6.0
Lincoln	17.4	9.0

Two insurance companies, Jefferson-Pilot and Lincoln, had very similar ROEs, which would imply the same P/E ratio based on the formula. But Lincoln is viewed more favorably by the marketplace, so it's getting higher than its implied P/E, and Jefferson-Pilot is getting a little lower. This shows the power of that P/E in the acquisition marketplace. GE isn't going to do acquisitions purely for their intrinsic value, but in an auction situation, GE would be able to pay more than a company with a lower P/E. Although GE's P/E is nearly double the next highest company, the others are not too shabby. Again, the reason for that might be that the market views acquirers favorably, and these companies have had some notable successes.

That's the GAAP earnings view of the world. Any questions?

Mr. Goodfriend: Don't go by *The Wall Street Journal's* reported earnings. It typically will include realized gains and losses and extraordinary income gains and losses, and use the reported number as the trailing 12 months, which can be quite a disparity from the real world.

From the Floor: I just wanted to clarify that in the P-GAAP rate going from 8–10%, you're talking about a value. That was just the first year P-GAAP return. Was there no change on the long-term economics of the two yields? It's just the accounting by year.

Mr. Carroll: As I mentioned, there are a number of different reasons P-GAAP could go from 8–10%. It's short term, nonetheless, it could be an accounting effect. One of the things I have noticed is that, with respect to P-GAAP, the analyst community is picking up on the judgmental aspects. Some of the better analysts are viewing with skepticism some of these accretive-from-day-one statements that management is making and saying it should be an effect that's a real result of operations and not an accounting effect before they will give this value creation opportunity to the company. That's another caution.

Mr. Goodfriend: Thanks, Charles, for pointing that out. Another wrinkle, prospectively, for the more active American life company buyers is that a number of non-American life companies are acquiring American companies. Now you have to mix into the equation currency, foreign exchange characteristics, the quality of the paper delivered by a foreign company whose liquidity and accounting may be markedly different from our own, and the way in which its stock trades. If AXA, ING, Swiss Re, or Zurich buys an American life company, it may buy it on a completely different value judgment basis because maybe to the Swiss, for example, 30 times earnings and 5 times book value are much more compelling than the comparable numbers adjusted for U.S. capital and inflation here at home. If you see that somebody is paying much higher multiples than we have illustrated here, the logic is still the same; namely, in their currency terms and in their own way, they're probably paying comparable values, inflated as it might seem.

From the Floor: How does the valuation of a company that's being acquired differ when it's a hostile bid or a friendly bid? I'd expect a source of information on different assumptions.

Mr. Carroll: Yes. You'd be limited to public information, generally. If you were making a hostile bid, you wouldn't have a seller's actuarial appraisal.

From the Floor: There is a seminar on how to get information that's publicly available.

Mr. Carroll: Logic would indicate that a hostile bidder would have to bid higher than a friendly bidder just because he or she has to overcome the reluctance of management and the board to sell and make the case so overwhelming that they can't resist it anymore. That having been said, the values that you see today for friendly bids are so high, I'm not sure that you would actually observe much of a difference.

Mr. Goodfriend: We had a recent case of that, the Allied Corp.-Mutual case, which initially was hostile but subsequently was friendly, and the value judgments were quite comparable to others taking place in the market. Keep in mind that the lawyers are king here, not that they aren't elsewhere. A director must be cognizant of his or her fiduciary responsibility to be responsive to a reasonable bid, assuming it's not fraudulent money or Mickey Mouse and Donald Duck money. If it's good cash or equivalent, you can't reject it out of hand; therefore, it has credibility. It can still be lifted later on in subsequent negotiations between the two organizations, as in the case of Allied and Nationwide, but it's a compelling way to get started.

From the Floor: In this comparison of a P/E of 15.4 versus 20 how would you know during the process of making the judgment about what to pay for a company or what your postdeal P/E is going to be?

Mr. Carroll: You don't know, and you can't predict it. Having said that, I think you can make reasonable judgments about how the marketplace will view the strategic logic of your acquisition, for example. And, to the extent you're providing information to the market, you want to convince them not to lower your P/E. Nonetheless, the analysts are independent and they'll disagree with management in a number of cases.

Mr. Goodfriend: The major firms, whether it's Goldman, DLJ, First Boston, Smith Barney, or Salomon, have experts in their corporate finance departments, some of whom are former analysts. As insiders, they will discuss the popular perception. There's no guarantee this will happen in the real world, but they get fairly good educated guesses.

From the Floor: You say company A has an ROE of 15% and they're buying company B, which has an ROE of 8%. Obviously, the combination is going to lower the overall entity's ROE. Shouldn't company A be saving its capital to buy something that has a higher ROE?

Mr. Carroll: In scenario one, it's almost a no-brainer. Even 8% is going to beat what they were doing with the money in cash, but if they could get a company that had 10%, it would be a better deal. Unfortunately, the competition for deals is so tight at this point, that if you have an opportunity to make an acquisition that makes strategic sense for your company, you should do whatever it takes, within reason, to make it happen because the opportunity to do something else is very limited. As a practical matter, every acquisition is going to be a competitive situation. You cannot assume that the next deal will be priced more realistically or more beneficially to your company. If the market crashes, we'll be looking at an entirely

different situation, but as long as the current market pertains, I don't think you'll see many alternatives.

Mr. Goodfriend: In the life insurance business, where it's difficult for companies to grow organically by any meaningful rate, it is essentially a zero-sum game. They're forced to look at this external mode of expansion. But stockholders and, for that matter theoreticians, will tell you there are at least two other alternatives: redistribute the capital—pay it out—or buy back the common stock. There are very real and sometimes hostile arguments on these counts. You've seen the number of buy-back programs; sometimes they work and sometimes they don't. That is also a function of the kind of market you're in. In bull markets, people ignore bearish news and in bear markets, they ignore bullish news.

For the case study you will be working on, first, let's take a brief look at what the life insurance business was at the time the AmerUs deal took place. This will give you a feel, from the vantage point of a director of either company, for what you're facing or you perceive to be facing.

The industry had been reporting strong results in 1997, even though total sales were not up very much. Sales of so-called retirement or accumulation products were pretty vigorous despite a sharp decline in interest rates and demonstrably lower yields. Not too many people were buying term or related products over the Internet, so neither company's participation in Web site marketing was important at that juncture, even though visionaries were taking a look at it. Year 2000 issues were nascent, but not nearly so pertinent as they are today because we're a year closer to it. However, companies that had the technology and the foresight to move forward two or three years earlier were at a distinct advantage.

Ten years ago, most of the retirement products, a.k.a., accumulation plans, not pension plans, were sold by Wall Street. Increasingly, the banks took a role and Wall Street's attention turned to what it perceived to be a hotter way to make a living, namely, the stock or bond of the day. There is a direct correlation between turnover in Wall Street, commissions generated, and the degree to which you need a sophisticated or unsophisticated spiel to generate a sale. If it's too complicated and doesn't generate enough commission, Wall Street's sales eyes glaze over.

More and more products were accused of being mismatched on the balance sheet, so greater sophistication and stress was placed on: (1) how you constructed your balance sheet, (2) how much capital you were applying to your business, and (3) what your ratings were and could be, especially if you were using institutional distribution. But this also applied to conventional distribution. If you were planning to be or already involved in selling products to a bank or a related

financial institution, many of the latter had started issuing dicta saying you needed an "A" or better rating for them to carry your products, and that was going to get increasingly tight. Companies in these businesses, irrespective of how much money they needed to run their business, had to be very cognizant of whether they could enter the new millennium with the right distribution organization, the right balance sheet, the right rating, and the right amount of capital.

Last week I heard somebody from a major banking firm say that, in his view, in due course there will be no mutual companies. Perhaps the earliest among the mutual companies in the Midwest to go public or at least to get out of the mutual genre was American Mutual, and they faced a lot of critical dispute within their own state. The regulators were all over them like a blanket, but American Mutual knew that it needed more capital to enter the new era, that it couldn't restrict itself to its old products, which were essentially vanilla, and that it had to look outside of its state and indeed perhaps outside of its conventional business for its livelihood.

It is no longer enough to be solvent. If you want to maintain a high rating and command the respect of the capital markets, you have to show that you're thriving as well. You have to show something else that most companies in a commodity-type business really can't say they enjoy, namely, a sustainable, competitive advantage. It's become an 11th Commandment that the rating agencies, analysts, and other company people use to distinguish themselves from their peer group.

However, when there is very little difference between products, it's very hard to discern what is a sustainable competitive advantage, particularly if you take the word sustainable literally. It should last, not three months, a year, or even two years, but rather three years, five years, and longer term.

In addition to the products, other factors prevent many life insurance companies from achieving a sustainable competitive advantage: the cost of opening and doing business each day, geographic niches, and the lack of incentive-driven management, namely, people who show up every morning and try to maximize how much money they make, rather than having a sinecure and just waiting for the doors to open and close each day, as was all too frequently the case. Obviously, nobody in this audience falls into that category, but Oscar Wilde once said, "The difference between idiocy and genius is that genius has its limits." There is all too much of the former in the insurance business, and that is something that cannot stand.

To its credit, American Mutual saw the light and said, "We cannot stay the way we are if we intend to remain solvent. We are going to go out and reconstruct ourselves into a mutual holding company, with or without the help of the

regulators, but we'll push for that. We're willing to take on the regulatory flack and buy companies." The first acquisition, Delta Life and Annuity, was a \$3.5 billion company that broadened American Mutual's product line, but it was only the first step. While this is going on, having "demutualized," the company began fighting with regulators about going public and having room to maneuver. Nonetheless, American Mutual had a tradable, or at least an issuable, stock. Managers paid cash for Delta, so now they could issue stock for another company.

While this is going on, American Investors Life Insurance had restructured itself into a holding company called AmVestors Financial. At one juncture, 99% of its products—essentially annuities and analogous products—were sold through financial institutions on Wall Street. The company prospered during a period when interest-rate gross spreads were liberal, for example, 400–800 basis points, and suffered when interest rates started to decline. AmVestors didn't have the size to compete against the aforementioned GE, which was buying a company every nanosecond, and it didn't have the clout to access the capital markets it really wanted because the company's stock was not liberally appraised, except early on. Some insiders wanted out, and managers now had the business of managing the balance sheet—making sure they were not so dependent upon one product or one class of products. They wanted to get broader distribution, not just from the banks, but distribution from independent general agents and personal producing agents while retaining the relationships with banks that were about one-third the size of American Mutual.

They hired Goldman Sachs and said, "Write a report for us, make some soundings, solicit Wall Street, and tell us what you think we can get for our business. If we don't sell it, we're going to have to take some alternative, namely, sell our stock at a discounted value, perhaps below book value." In one way or another, the company had to find a new power structure for itself that would accomplish the aforementioned aims I just listed.

There was rife anticipation of this on Wall Street, and the stock moved sequentially from about \$16 to \$25 or even higher. This was a result of the market anticipating that as a function of either earnings or book value. This piece of paper was going to sell at a pretty husky rate because it had a discrete value, a niche with institutions, and a proven and profitable book of business. Even though all of this wasn't reflected in the marketplace in high values, to somebody else it could be, so speculation was rampant about at what levels this would take place—not if, but when and with whom. Along came Goldman proposing the auction. They put it into play and the winner was AmerUs. AmerUs was American Mutual's new name.

Before AmerUs bought AmVestors, Goldman and the management had been looking at several different classes of buyers. They were looking at strategic buyers, people who liked the business, wanted to be in it, and weren't interested in financial sleight of hand or the quick buck. They were looking for companies that wanted to stay in the business for the long term so they could build the proverbial one plus one equals three, or a multiple thereof. There were tactical buyers who needed to fill a specific weakness in themselves. Those would be less desirable but, nonetheless, they might pay up because they were in a hurry, so you couldn't rule them out. There were financial buyers who saw one plus one equaling a multiple of that in quick money, either through a consolidation or through financial balance sheet maneuvering.

There were a number of other selling companies on the block, so they had to be cognizant of that. Some companies represented disengaged subsidiaries of diversified companies who didn't want to put up more capital, who were afraid of staying in the business, and who were being penalized because of RBC, etc. Some were closely held family companies that wanted out, those that wanted liquidity for state or tax reasons, and independents who just saw a brighter light as valuations for insurance companies were rising.

Although it was quite clear that AmVestors wanted out and at the highest price, what price, in what form, with whom, and how quickly it could be done became key variables. The company's managers also had to show Goldman and others that they'd be flexible in the way in which a deal would be constructed. It didn't have to be only cash or only stock; it could be a hybrid of the two. With the latter, however, different tax allocations and tax consequences spring up that could be inimical to the companies' interests, so they had to be cognizant of what happens after the deal. When a company is reborn the next day, what does that do to the buyer and seller?

In any case, AmerUs did decide to buy AmVestors, and the deal was consummated in September 1997. For the case study, we're providing data from about a week and a half or two before the impending deal was to be announced on the logic that it was circulating at that time and the information was no longer privy to only a handful of people. AmerUs' stock was selling at 28 and 5/8 and had a GAAP book value as of the most recent fiscal period (June 30) of \$23.10. Its EPS for the last 12 months preceding this date was about \$1.50, and it was growing at about 10% a year. If you want to factor in a compounded rate of gain in earnings, that's its pace of gain both in earnings terms and in book value terms. The stock price represented about 125%, a premium of 25% over book value.

On a P/E basis, again operating earnings only, excluding nonrecurrings, the company was selling at multiples about 20 times above the industry at that juncture. There was a cachet about AmerUs that lent itself to selling at a multiple higher than the peer group. It was the first of its class, it was known that it was looking to acquiring picking its spots, and it had ample capital. A very good question was raised earlier about whether acquisitions are the optimum use of capital. The answer is, I don't know, but AmerUs felt it was.

In contrast, AmVestors' stock was selling at around \$25 but was highly volatile, unlike for AmerUs, whose stock was staying in a relatively narrow range. On given days, AmVestors' stock could vary by as much as 20%, again a function of the all too rampant speculation about tomorrow for AmVestors. Its book was about \$16 a share in the last 12 months and earnings were about \$1.65 and not growing very much, relatively unchanged from the prior year, a function of those aforementioned competitive conditions, narrowing spreads, changing distribution modes, and the like. Clearly, earnings were not rising nearly at AmerUs' rate, let alone other companies.

The stock price was about a 60 point P/BV. A lot of the vigorish was already in the price of the stock. Therefore, you as a buyer would have to say, "If I'm going to enter the fray at this juncture, I have to make sure that it's going to pay for me to get more than \$25 a share," and you'll have to compare that with other transactions taking place. Keep in mind that it was already selling at a pretty husky P/BV. The P/E ratio was lower than AmerUs' but, justifiably, higher than most of the peers at that juncture. Those are your parameters and that's the scenario.

Mr. Horbatt: Now we'll divide you into three groups of buyers and three groups of sellers. Each group should select a leader or spokesperson to present your case at the end of this session. Remember that the arguments and rationale behind your case are probably more important than the final number.

Mr. Goodfriend: The world is your oyster. You can name any terms and in any form that you want, but they must be accepted by the other side.

[BROKE INTO GROUPS FOR APPROXIMATELY ONE HOUR]

Mr. Horbatt: OK, two groups have made a deal. I'm impressed. Would you please bring your spokesperson up here?

Mr. Carroll: What price did you get and on what terms?

From the Floor: We bought both companies for stock and paid \$27.50 for the first group and \$27 for the other.

Mr. Horbatt: Impressive.

Mr. Carroll: Were there any other terms discussed, such as management stability?

From the Floor: Management stayed in place for a relatively reasonable interval. We didn't divide it very well. At least a month, I'd say.

Mr. Carroll: Which deal did you do first, the \$27.50 or the \$27?

From the Floor: The \$27.50. The second one was done under the wire.

Mr. Horbatt: OK, now let's go to our next group of buyers. The last group was "Buyers Are Us." Do you have a name for yourselves?

From the Floor: "Price Club." We're the discount firm here. We paid cash, \$23, for our deal. We did not set any specific terms, other than it was a cash deal—no time, no additional constraints on management. We have a lot of ideas about what we're going to do with the company after we get it. Since there was no stock, we adopted the Consec philosophy and implied we were going to leave it there, but we're actually going to move it, sell the shell, and do everything we can to lower the credit rating. We thought we came away quite well.

Mr. Horbatt: OK, what about the group that didn't make a deal?

Mr. Goodfriend: You want to approach the bench as they say?

Mr. Carroll: Your stock has just gone down \$5 a share because you're not doing anything.

From the Floor: The companies that we approached and that approached us didn't identify themselves as companies willing to sell at \$27.50 or \$27. They were looking, at the time we spoke to them anyway, for \$29 and upwards. One company said it would not settle for less than \$30. We felt that was a little too rich for us, considering what we would be gaining in terms of earnings, enhanced distribution, savings, and such so it wasn't worth the price at that point. We initially were going to offer around \$21, hoping to bid up, but the company's floor was significantly higher than our ceiling, so we never bought it.

Mr. Horbatt: Would the sellers like to tell us why they did sell for \$27.50, and why you did so much better than the group who sold for \$23?

From the Floor: We knew we really had to sell the company, particularly since the stock price had been bid up. We were nervous about what would happen to the stock price and employee morale if we didn't close a deal, as well as all the uncertainties, so we knew we had to get a deal closed. We were interested in working with this group, but they only offered us \$20, which was at a significant discount from the current stock price, so we closed the deal with this group at the last minute for \$27.50 and thought it was a good deal.

Mr. Carroll: Did you notice the other group that accepted the \$23?

From the Floor: We had an offer for \$25 outstanding when we heard about the \$23 group, so we thought we were doing well.

Mr. Horbatt: How about the group that went for \$23? How are you going to explain that?

From the Floor: The volatility of the stock was too much for us to absorb. We're family-owned and wanted a vacation in Maui. We didn't want any part of the insurance business anymore and we felt the \$23 in cash was a reasonable price.

Mr. Carroll: Before the \$27 and the \$27.50 groups congratulate themselves too much, you should recognize that the stock that you accepted in this deal is from a company that's 3 times what it was before. You have a currency, but the buyer is using paper that is amazing. It's gone from a market cap of X to three times X in one day. It's incredible.

From the Floor: Then they tried to sell it.

Mr. Horbatt: Yes, let's hear the other side of that from our last seller group.

From the Floor: We were comfortable with \$25, but we wanted to hit somewhere around \$27 so we started out a little high, apparently a lot higher than some people who wanted an average cost, but we didn't have a problem with that. Even though this group had already purchased one company, we figured the exact same company, except for the distribution systems, would be able to manage both companies. It could roll both in at the same time and still get the value to the stock. And we thought that \$27 was still a good price.

Mr. Carroll: Well, Herb, will you tell them what really happened?

Mr. Goodfriend: Effectively, AmerUs offered two-thirds of its own share for every share of AmVestor's, and that worked out to \$20 a share, or roughly a \$360 million deal. The value of the paper was discounted sharply; in somebody else's mind, it might have been worth \$25. It was a 25% P/BV and related to earnings of \$1.65 of roughly 13 times over, again a discount—not only what we were selling it for, but about the same as what other pieces of paper were selling it for.

Even though it was put into play and Goldman drummed up interest, when push came to shove, in reality, this was not considered a first-class opportunity. It had been shopped and had problems that probably couldn't be readily solved, except by a particular kind of buyer. That buyer knew it and had the wherewithal to get the deal done quickly. Had time permitted and it went over a year or so and the company resumed its earnings growth, maybe you'd have a different price, but \$20 in the context of the paper that Charles just alluded to is probably a fair price. Could you have rationalized \$23? Probably, but they took the money and ran.

From the Floor: Has the price of AmerUs stock gone up or down since then? Did they have any transaction problems?

Mr. Goodfriend: Their stock is about 5% higher than it was before. It's held up in the market nicely, not a world beater, but against other things, it's done fairly well. I think it's too soon to say whether AmerUs bought a good piece of paper or not because it's been less than a year since the deal. I think the people who didn't make a decision made the best choice. They had the most rational logic.

Mr. Carroll: My vote is for the middle group, the ones who bought the two companies. They paid for it in their own stock. They've fashioned themselves into an entirely different company; they've remade themselves.

Mr. Goodfriend: They're certainly much bigger.

Mr. Horbatt: I'm going to vote for the seller who took the \$23 in cash and ran. Cash is good. Obviously, this is somewhat of an artificial situation, but there were a lot of dynamics from my observations of what actually happens in deal making, particularly the emotion and the feeling of pressure. Any observations?

From the Floor: Before buying the two companies, this group was growing at a relatively good pace and experiencing good business situations. Now that it has bought two stagnant companies that require a lot of surplus capital, I'm not sure it's in a better situation.

From the Floor: They will have to raise capital to make progress. They will have to go out and sell stock in the market to get cash.

Mr. Goodfriend: Perhaps they might have done so anyway.

From the Floor: I disagree. I think the company that bought two companies is in a much better market position than it was at one-third the size the day before. It has much more flexibility to try to put things in order.

Mr. Goodfriend: Certainly it's true that in this business, size means clout. That's the way GE got to be where it is. Interestingly enough, though, GE has stopped buying like this.

From the Floor: But it didn't go through distribution channels; it only bought one distribution channel.

Mr. Goodfriend: Yes, but it's a generic business. You can vary the attack on the annuity business, but essentially the principles involved are the same. There are no big commissions and you manage money with spread. Whoever does that best carries the day.

From the Floor: They also bought a block of fixed annuities that they could have persistency problems with down the road.

Mr. Goodfriend: If you got a marked change in interest rates, yes. This is not a riskless business.

From the Floor: In your analysis of paying stock or cash, if you were outside investors looking at the AmerUs stock after this acquisition deal, what would be your assessment of all three groups who bought these companies? What's going to happen to AmerUs' stock under all three scenarios?

Mr. Goodfriend: If we assume that the rate of return on AmerUs before the deal was 7% (\$1.46 on 23) and pro forma the deal, even in line with the savings we gave up (\$6 million dollars unrealized pre-tax), they pick up some savings. But they have to pay termination costs to assure the state regulators that they're not going to kill everybody. Basically, it's a wash in terms of return. There are no great incremental results. Does it enhance AmerUs' status with the investors? Probably.

From the Floor: I'm talking about the three deals we made here.

Mr. Goodfriend: I think the \$23 in cash, the take-the-money-and-run scenario, was the best of the three.

From the Floor: I'm talking from AmerUs' standpoint.

Mr. Goodfriend: They're just dealing in paper and couldn't care less about its value to the seller. They know what it is to themselves so they're giving away very little.

Mr. Carroll: I would say that the Buyer Group that bought two companies has a significant operational challenge. With two companies, however, they have opportunity along with that challenge. The Buyer Group that didn't buy anybody has no opportunity.

Mr. Goodfriend: They can buy somebody else. They're not all in the insurance business, Charles.

Mr. Carroll: That's true. But, assuming that the Buyer Group's charter was to be a life insurance company, the Buyer Group that bought two companies has some opportunities. It has to take advantage of them and there's risk involved, but there's also opportunity. The Buyer Group that didn't buy can buy somebody else, but do you think the sellers are going to be any different from the ones that you dealt with here? I don't think so.