

Why Interest Will Rise in Principal

By LESLIE P. NORTON

An infusion of TARP funds may dilute Principal Financial's earnings. But the insurer is being unduly punished for the sins of its peers.

Since Jan. 1, Principal Financial shares (ticker: PFG) are down 35% to a recent \$14.62, and are off 72% over the past 12 months. That compares with a 36% drop for the Standard & Poor's 500 in that span, and a 60% decline for the S&P Life & Health Insurance Index. The stock has rallied since April 8, when The Wall Street Journal reported that Washington was considering funneling money into life-insurers under the Troubled Asset Relief Program, boosting capital and liquidity. But, paradoxically, the prospect has put a cloud over Principal shares for investors who fear TARP aid would heavily dilute earnings for current shareholders.

Principal Fin'l Group (PFG - NYSE)

Weekly close on April 16



Add to that worries about Principal's investment portfolio, which includes a big chunk of commercial-real-estate loans and mortgage securities. In February, the shares plummeted after Principal revealed a 72% decline in its book value to \$7.45 a share, owing to asset write-downs, as unrealized losses soared. The company reported that earnings fell 47% in 2008. Moody's changed its outlook to negative, while Fitch downgraded the company. All this raises questions about refinancing the \$455 million of Principal bonds maturing in August.

Principal wouldn't comment, citing its quiet period before its first-quarter-earnings release on May 5. It isn't likely to be pretty -- analysts on average expect earnings of just 66 cents per share, or \$2.74 for the year.

Yet Principal's shares have been unduly punished, and they merit a fresh look by investors. It's unlikely that all the unrecognized losses in the company's portfolio will be realized. The stock is trading near a conservative estimate of its book value, operates an attractive money-management business, and, unlike other life insurers, it isn't exposed to the dangerous guarantees that accompany the popular variable annuities.

PRINCIPAL, WHICH HAS A BANKING operation, has for months hinted it would accept TARP, posing the threat of earnings dilution tied to the convertible preferred equity and additional warrants. Morgan Stanley has estimated a TARP infusion would dilute earnings by 7.8% this year, and by an additional 27% in 2010.

But the prospect doesn't frighten all investors. "If they take the TARP money, it could dilute long-term earnings by 25% to 40%, but I still have plenty of upside, especially if I have conviction there's enough capital to get them through the storm," says Mark Henneman, a portfolio manager at St. Paul, Minn.-based Mairs & Power.

Suneet Kamath, an analyst at Sanford C. Bernstein and one of Principal's few fans on Wall Street, thinks Principal has alternatives to TARP, including cutting its annual dividend of \$1.80 and paring operating expenses. As of February, it also had \$800 million in excess capital. But Kamath believes accepting TARP money is preferable to raising money at Principal's currently low valuations.

Principal is a leader in 401(k) retirement plans, and demographic trends bode well for that business. Moreover, because Principal has limited the size of its variable-annuities operation business, it's much less exposed to the equity markets than other insurers.

At the end of '08, some 70% of total U.S. invested assets -- \$38.8 billion -- was in fixed-income securities. Approximately 5.2% was below investment grade, including 0.65% classified as either "problem, potential problem, or restructured." About 17% of the portfolio was in mortgage-backed securities. International investment operations of fully consolidated subsidiaries held \$2.1 billion, or 64%, in fixed income, of which 18% is in government bonds. Of Principal's total invested assets, 19% was in commercial-mortgage loans, with 0.2% in the process of foreclosure. Some 83% of the loans had amortizing balloon-payment maturities. And 41% of the value of Principal's invested assets was in less liquid investments.

In a recent report, Bank of America/Merrill Lynch analyst Edward Spehar assumed "depression-level credit losses" for Principal's portfolio, with assumptions for impairments on commercial-mortgage-backed securities "equivalent to or in excess of the worst underwriting year ever for the commercial whole-loan market" -- 1986. He also assumed that Principal couldn't refinance maturing debt and that the S&P would decline an additional 25%, all of which would cause a decline in Principal's risk-based capital ratio, a measure of its solvency, to 220% by Dec. 31, 2010, from 440% at the end of '08. And 55% to 60% of the current unrealized loss would materialize as a realized loss. Still, Spehar added, intracompany borrowings and an unused credit facility mean the RBC ratio in such a stressed scenario would fall to just 300%. By Sanford C. Bernstein's reckoning, rating agencies gave double-A rankings to companies that ended '08 with RBC ratios of 350% or above.

The Bottom Line

Principal's shares have rallied smartly this month, but they still trade at just a conservative book-value estimate near 14. Within a year, they could reach 22.

"This suggests that economic book value under a stress-case scenario is \$13 to \$14 per share," Spehar says. "We think [Principal] is extremely compelling at 60% of economic book." He thinks its downside is "limited" because it's a desirable acquisition target, given its "extremely low valuation against a history of sector consolidation."

At its recent price near 15 last week, the stock is sharply higher now than the \$8.18 that it fetched when Spehar wrote his report at the start of the month. Still, to some believers there's plenty of upside. Kamath of Bernstein believes Principal shares will outperform the S&P 500 in the next six to 12 months by more than 15 percentage points. His target on the stock is 22 -- or 50% above last week's level.