

The Insurer's Fatal Banking

This summer, the South Korean Asset Management Company was sold by the Korean Hana Bank to the German Allianz financial group. The company thus came under the complete control of Allianz Global Investors. This is another link in a whole chain of deals which have transformed Allianz from a large insurer into a universal financial holding.

Over the last three years Allianz has not been strikingly successful. While in 2000 its net income was EUR3.4 billion, combined with assets of EUR440 billion, in 2002 Allianz wrote EUR2.2 billion of net income and held assets of EUR994 billion. In 2002, the general stagnation in the world stock market became critical for Allianz, which reported a loss of EUR1.5 billion. During last two years the company has been climbing the slow road to recovering their operational and asset profitability. Even though in 2004 the conglomerate had not returned to 2000 profit levels, in a display of optimism it raised dividend payments from EUR1.5 per share to EUR1.75.

So what happened to Allianz Group in those five years to make its market rating change so wildly? The answer may be found by comparing the book value of the company's simple shares and their market value and

correlating that disparity to the crucial events in the history of the conglomerate. The market value of the shares was about three times as high as their book value at the end of 2000 and about twice as high at the end of 2001. At the end of the 2002 slump their price was 13% lower than the carrying value. Such was the market reaction to the decrease in the conglomerate's net income and profitability.

Allianz's share price reached an all-time high of EUR427.5 in March 2000 and its all-time low of EUR45.4 came about in March 2003. These extreme fluctuations over past five years show that the investors are especially conscious of the company's fundamental data since these peaks and troughs occur precisely when the company's annual report is released. In the light of general stock market stagnation and low interest rates in the company's areas of interest, Allianz was not able to withstand the blows

Table 1

Key Performance Indicators for Allianz Group, 2000 – 2004

	2004	2003	2002	2001	2000
Net Income, EUR Bn	2.199	1.890	-1.496	1.585	3.448
Operating Profitability, %	2.30	1.86	-1.39	1.66	4.12
Net Income per Share, EUR	5.98	5.57	-5.40	6.51	14.05
Dividend per Share, EUR	1.75	1.50	1.50	1.50	1.50
Dividend Payout Ratio, %	29.26	26.93	-	23.04	10.68
Insurance Reserves, EUR Bn	355.195	311.471	305.763	299.512	284.824
Shareholders' Equity, EUR Bn	33.380	30.825	22.836	31.655	35.102
Market Capitalization at Year-End, EUR Bn	35.936	36.637	22.111	64.156	97.813
Book Value per Share, EUR	91	91	83	114	125
Book Value per Share / Market Value per Share, %	93.53	101.90	113.48	53.12	36.79
Balance Sheet Total, EUR Bn	994.698	935.912	852.133	942.986	440.008
Insurance Reserves / Balance Sheet Total Assets, %	35.71	33.28	35.88	31.76	64.73
Shareholders' Equity/ Balance Sheet Total Assets, %	3.36	3.29	2.68	3.36	7.98
Third-Party Assets Under Management, EUR Bn	584.624	564.714	560.588	620.458	336.424
Group's Own Investments / Third-Party Assets Under Management, %	81.66	70.62	71.90	85	98.53
Third-Party Assets Under Management / Balance Sheet Total Assets, %	58.77	60.34	65.79	65.80	76.46

Source: Allianz Group annual report 2004

caused by a badly-timed merger with Dresdner Bank and the unexpected payouts for the 9/11 attacks.

The Stock Market Hostage

The shares of Allianz belong to the leading Germany's DAX Stock Index and are therefore typical and index dependent, thus their value dropped when a lull in the European market led to a fall in the DAX. On the other hand, according to Bloomberg, Allianz had a Beta coefficient of 1.227 on the DAX and so was more dynamic than the German stock index. An explanation for Allianz's slump may be the fact that the conglomerate had invested over half its assets in securities.

At the beginning of 2005, Allianz owned a 28.5% share in the Eurohypo AG bank, a 9.5% share in Banco Popular Espanol S.A., and a 4.9% share in UniCredito Italiano, which recently took over the HVB Group, a German competitor of Allianz. Allianz also owned a 9.8% stock in its parent company Munich Re. In addition, Allianz had a surprisingly strong presence in the German industry segment. As of the end of 2004, it possessed substantial shares in non-financial German companies, such as Schering, Linde, Bayer, RWE, HeidelbergCement, E.ON, BASF, and Siemens, as well as a share of France-based oil company Total. As of January 1, 2005, its managing investment portfolio alone totalled EUR14.5 billion.

The company's dependence on the world stock market was all the greater due to its asset management business. As of the beginning of 2002, Allianz managed to garner nearly EUR620 billion in managed assets, but by the beginning of 2003 the sum had fallen to EUR560 billion. What's more, at the beginning of 2002, 85%

Background

Throughout the Centuries

In summer of 1889, Karl Tiem, then the Director of Munich Re, and a well-known Munich banker Wilhelm Fink, decided to found an insurance company, which appeared in 1890 under the name of Allianz. In 1904 Paul van der Nahmer, the chief executive director of the company, began Allianz's international expansion, which led to one fifth of its premium being written outside Germany by 1913. In the 1920s the company saw several mergers owing to the unstable financial system in post-war Germany. It merged with Versicherungsbank, Stuttgarter Verein, and some other companies.

In 1933 Allianz entered the era of Hitlerite national socialism and its Jewish employees were subjected to repressions. Unlike German banks, Allianz did not become part of Hitler's war machine, but its activities altered according to the times, and its life, ship, and building insurance were especially popular. In 1945 most of the company's assets, as well as those of its general insurance policyholders, were destroyed. The devastation of the Second World War forced Allianz back to the starting block. Allianz resumed its international expansion only in the 50s by opening an office in Paris, followed by an office in Italy in the 60s.

In the 70s, Allianz successfully entered and settled in the markets of the US, Spain, Great Britain, Brazil, and the Netherlands. In the 90s it began expansion into developing markets, setting up a branch in Hungary and several joint enterprises in China and South Korea. At the same time, it took over the Paris-based Assurance General de France. On November 3, 2000, Allianz made an initial public offering in ADR form on the New York Stock Exchange. It soon became clear how the German insurer intended to spend the written premium: on April 1, 2001, Allianz announced the purchase of Dresdner Bank, which ranked fourth in asset volume in Germany, and had previously been negotiating a merger with Deutsche Bank.

Now Allianz operated under the model of a universal financial provider, which it considers the most profitable. In 2004, Allianz wrote one of the world's largest gross insurance premiums. According to Reuters, in July 2005 its gross premiums for that financial year were 15.8% higher than the figures of its nearest competitor AIG.

of these assets belonged to companies from the Allianz Group, but by the end of the year their share fell to 71%. The outflow of the group's own assets clearly demonstrated the devaluation potential of stock assets. The situation in 2004 was quite the opposite.

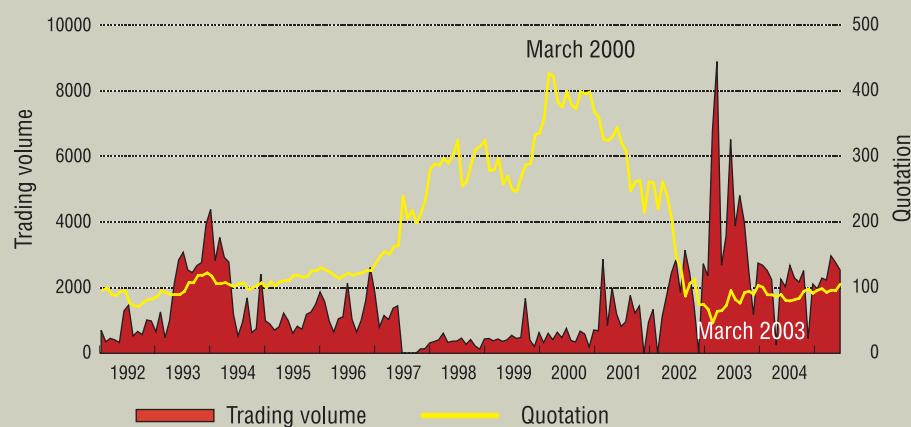
Along with the rise of the leading stock indexes and the slight growth of the company's management assets, the asset share of the other group members also grew. In other words, the company moved into richer pastures. The group began expanding its asset management sector only quite recently. In May 2000, Allianz purchased the PIMCO management company, followed by the Nicholas-Applegate management company in January 2001, and through its merger with Dresdner Bank obtained the investment branch Dresdner Kleinwort Wasserstein in August 2001. On the whole, the volume of its managed assets meet European standards, but without insurers and banks from the group, the sector could simply not exist.

Bees and Drones

The profitability of the various business lines of the group is rather unclear. In 2004 the group wrote 151% of net income from general insurance, this

Graph

Dynamics of Allianz AG's Shares Rate and Trading Volume, 1995 – June 2005



Source: www.allianz.com

100+ figure caused by the deduction of the group's internal turnover of EUR1.9 billion. Life insurance accounted for 37% of the net income, and banking for only 5%. In other words, general insurance was the company's working bee which fed its risk management, banking business, and partly even the life insurance segment, and which moreover served to cover the holding management expenses. In other words, general insurance is the lifeline of the Allianz group.

In 2003, the situation was similarly transparent. The net income from general insurance was two and a half times higher than the overall net profit, 68% of which went to cover banking losses and another 14% was used up by asset management. General insurance is also the leader in asset and operational profitability. In 2004, its operational profitability grew by 63% on 2003 levels due to a drop in payments. The segment had a loss ratio of 67.7% in 2004, down by 3.8% on the 2003 figures. Interestingly, in 2004 Germany accounted for only 28% of the general insurance premium, while other European countries accounted for 54% and North America for 14%.

Another observation to be made is that since the purchase of Dresdner Bank the company's banking business has accounted for 52-56% of all the group's assets. Even though banking assets are objectively less profitable than insurance assets, the case of Allianz, where the banking segment absorbs over half the assets, consuming the insurance income for three years straight, is obviously a special one and deserves extra attention.

Double Turn-Around

In 2001, Allianz began launching programs to restructure Dresdner Bank, aimed generally at reshuffling depart-

ments and reducing staff. By the beginning of 2005, Allianz had managed to reduce the bank staff to 36,000 by dismissing all in all about 13,700 employees. In September 2002, it developed a restructuring plan under the code name "turn-around 2003".

According to this plan, a few more thousand bank employees are to be dismissed in 2005. The planned changes generally concern the bank's corporate client branches. In August 2003, Allianz accepted another reduction plan with the code name "New Dresdner", which entailed the dismissal

of 4,700 back-office employees. Over the last few years, Allianz has spent EURO1.98 billion on restructuring Dresdner Bank, EUR290 million of which was spent in 2004. Obviously, for further development Allianz will need bring all units of the bank back into full operation.

In 2004 the bank reestablished its profitability. The operational losses of EUR369 million in the banking segment in 2003, had turned into an operational income of EURO603 million in 2004, mainly due to a EUR570 million reduction in administrative losses. The conducted reforms also raised net commission and net trading income by around EUR100 million apiece. The general picture was marred only by net profit, which fell from EUR2.7 billion to EUR2.3 billion with net margin falling from 0.94% to 0.58%. Apparently, the staff reduction was the only thing Allianz could do failing any growth in interest rates and consequently of net margin. It is not clear now how much lower the banking administrative losses will be after reducing the staff of Dresdner Bank to 30,000 to 32,000. But by doing so, Allianz is clearly losing a market share which may possibly still be profitable since the European Central Bank has still not made an unequivocal announcement to this effect. However, in the beginning of July 2005, Allianz demonstrated an original solution to the Dresdner Bank issue, selling a non-strategic credit portfolio of EUR1.4 billion to the consortium of Lone Star and Merrill Lynch. But concentrating its activity on the more profitable developing markets is still a more rational path for Allianz. This, at least, could raise its net margin by increasing the classical banking segment.

Alliance with Allianz

Allianz is quite cautious in its dealings with developing markets, especially Asia. It often begins operations as the co-founder of a joint enterprise, then takes full hold of it if conditions prove favourable. Such was the case with the South Korean Asset Management Company (SKAMC) which was sold to Allianz by Korea-based Hana Bank in July 2005. The Korean managers are now under the control of Allianz Global Investors. A substantial part of Allianz's Russian business, is run through Dresdner Bank's subsidiaries.

Interestingly enough, according to Spiegel magazine, the head of the Russian branch of Dresdner Bank is Matthias Warnig, who previously worked for the Stasi (The East German Intelligence and Security Service) and knew the Russian President Vladimir Putin.

But apparently they were not on close terms. As of January 1, 2005, the assets of Dresdner Bank Russia CJSC came to no more than EUR249.2 million, accounting for only 0.04% of the banking assets of Allianz. Yet it did have a 2.6% asset profitability in 2004, which leaves behind even the general insurance segment with a corresponding figure of 1.8%. In the vast expanses of Russia and Ukraine, Dresdner Kleinwort Wasserstein (DKW) was especially active. Its previous work included valuation of Yuganskneftegaz under the Yukos case and the placement of Ukrainian state eurobonds. Now it is taking over Tinkoff brewing company, a part of the Belgium-based InBev, and is involved in valuing the assets of Gazprom and Rosneft. The Russian press has already hinted at a close relationship between DKW and the Kremlin, but this is no

more than guess-work. Few people know that DKW was set up by Dresdner Bank after the takeover of the British bank Kleinwort Benson Group in 1995 and of the American investment bank Wasserstein Perella&Co in 2001. DKW is quite strong in London, New York, and Frankfurt, which makes it a good underwriter. Its present popularity in Moscow automatically extends to Ukraine, Kazakhstan, and other former USSR members.

The central company of Allianz Group is the reinsurer Allianz AG, which has a definite bearing on the way the holding's financial dealings are managed and interpreted. Allianz AG's main sources of income are the reinsurance business and subsidiary dividends.

The Russian insurance segment contains a namesake subsidiary of Allianz and a joint enterprise with Sistema Corp., ROSNO insurance company, which is Allianz's representative for expansion in the CIS markets. Allianz says that the conglomerate's expansion in the CIS insurance market will depend on the standard of living in these republics. The most profitable banking and investment

segments of the Russian market are probably of greater interest to Allianz than the slowly developing insurance sector.

Thus, despite the fairly good results of 2004, the Allianz has not reached 2000 figures, which marked the maximum share price of the conglomerate. A sore point for Allianz remains the profitability of its banking segment. Since top managers are not attempting to restructure it through a merger with some other German bank, the conglomerate presumably has another solution in mind. This solution most likely consists of expansion of the company's banking and investment segments in the developing markets. Let us hope that the developing markets, including the CIS, are ready for this expansion.

Vitaly Shapran

Table 2

Allianz Group's Business Structure, 2001 – 2004 (%)

Business Segment	Segment Net Income / Total Net Income, Not Including Inside-Group Turnover				Segment Assets / Total Assets, Not Including Inside-Group Turnover				Operating Profitability				Return On Assets			
	2004	2003	2002	2001	2004	2003	2002	2001	2004	2003	2002	2001	2004	2003	2002	2001
Non-Life Insurance	151	248	-468	149	19	21	22	21	6.80	9.20	12.60	4.80	1.77	2.43	3.69	1.22
Life-Insurance	37	2	2	14	34	33	35	30	2.30	0.10	-0.10	0.70	0.24	0.01	-0.01	0.08
Banking	5	-68	91	-14	54	54	52	56	0.90	-9.20	-6.40	-1.70	0.02	-0.25	-0.31	-0.04
Asset Management	-7	-14	31	-22	1	1	2	2	-4.60	-8.80	-14.70	-12.70	-1.34	-2.33	-3.10	-2.44

Source: The Insurer, based on Allianz Group annual report 2004