

TIME TO BUY AXA

Under CEO Henri de Castries, the giant French insurance company emerged from the financial crisis looking much stronger than its competitors.



Cover Story

AXA, the French insurance giant, is poised to lead the industry in a global recovery. Its stock could jump 50%.

Très Bien!

by Jonathan R. Laing Henri de Castries, chairman and chief executive of the global insurance giant **AXA Group**, has an unusual background even by the standards of Continental Europe. For one thing, he's a real, live count, with an aristocratic lineage going back to a courtier at Versailles who served as the ill-fated Louis XVI's naval minister, and to the incomparable finance minister of Louis XIV, Jean Claude Colbert, a century before. • Likewise, his career has taken some surprising turns. In 1989, at age 35, de Castries (pronounced de Cahst) spurned a promising future in government as a fast-rising star in the French Treasury and Department of Finance to join Paris-based AXA at the behest of its then chief, Claude Bebear. It was a stunning move for someone who'd finished first in his class in the prestigious incubator for French civil servants and politicians, École Nationale d'Administration, beating out such classmates as recent Socialist Presidential Candidate Ségolène Royal and former French Foreign Minister Dominique de Villepin. • "At the time I joined AXA, my mentor at Treasury, Jean-Claude Trichet [now head of the European Central Bank], told me I was making the mistake of a lifetime—a remark I still kid him about," de Castries chuckles during an interview with *Barron's* at the

Manhattan headquarters of his company's American unit, AXA Financial.

Of all his distinctions, de Castries' most remarkable one has been his stewardship of AXA (ticker: CS.France) over the past 10 years. It was a period of galvanic events, beginning with the heavy claims losses occasioned by 9/11 and the precipitous slide in stock prices during the 2001-2003 bear market and culminating in the global financial collapse of the past two years. During the decade, some of the biggest figures in the global insurance field—such as Rolf Hüppi of **Zurich Financial** (ZURN.Switzerland), Ramani Ayer of **Hartford Financial** (HIG) and Maurice “Hank” Greenberg—crashed and burned along with their companies.

De Castries and AXA, by contrast, have soldiered on, avoiding the highly dilutive equity raises, balance-sheet makeovers and government bailouts that so many of the company's rivals have been reduced to.

“We've made our share of mistakes, but fortunately they've been less than average,” the French executive notes with modesty. Others give him more credit. “On a relative basis, de Castries is a star, since he operates in an industry run by many nonentities or takers of foolish risks,” says one analyst at a major hedge-fund complex.

AXA, an also-ran until the late 1990s, now vies weekly with **Allianz** (ALV.Germany) as to which boasts the largest market capitalization in the international insurance industry—behind the state-coddled Chinese insurance giants **China Life** (2628.Hong Kong) and **Ping An** (2318.Hong Kong). Late last week, AXA had a market value of €35 billion, or \$51 billion, while Allianz was at €38 billion.

The company has emerged as a powerhouse in both property-and-casualty insurance and life insurance, with operations spanning from Europe to North America to Asia. In the U.S., it is perhaps best known for its majority-owned Alliance-Bernstein money-management unit.

With the financial crisis receding, de Castries & Co. are nicely poised to exploit a diversified earnings base and conservative balance sheet to make opportunistic mergers and grabs of market share from more wounded rivals. Indeed, AXA could be one of the very best plays on a recovery

in global financial services.

The Paris-traded stock has surged from a March low of €5.58 to a recent €15.60, but by some key measures, it remains unambiguously cheap. Bulls think it could climb another 50%.

For all this, de Castris, 55, comes off as down-to-earth and piquantly self-deprecatory. He jokes with colleagues and security guards at the end of the interview, telling them he's immediately flying back to Paris with his wife to avoid personal bankruptcy from her monumental Christmas-present buying in Manhattan. He's on an amiable, first-name basis with employees at all stations at the company.

But his style barely disguises his fixation on the company's profit growth. In the Manhattan interview, he said AXA will pull a billion pounds or so of capital out of its U.K. operation because of over-regulation of profit margins and capping fees there. "These socialist tricks have badly damaged the British life-insurance market," he says with palpable disgust.

Despite a close friendship with French President Nicolas Sarkozy, de Castris is clearly more a free-market guy than French statist. His fervent hope is that Sarkozy will be able to reverse 15 years of French economic stagnation.

AXA has been reversing some problems of its own. The company did take a few lumps in the financial meltdown, with last year's earnings falling from a record 2007 level of €5.7 billion, or €2.73 a share, to just €923 million, or €0.44 a share. Revenues fell from €94 billion to €92 billion, as variable annuity sales declined and assets under management dropped as a result of the fall in nearly every asset class.

Profits were decimated by realized capital losses and impairment charges of €345 million and €2.8 billion in fair-value write-downs on various balance-sheet items and stock and fixed-income holdings.

But earnings at AXA seem to be turning from the second half of 2008, when the insurer finished in the red. Lower asset impairments and improvement in mark-to-market values on its balance sheet helped push first-half earnings to €1.3 billion. Consensus analyst forecasts for 2009 and 2010 are €1.55 per share and €1.97, respectively.

De Castris is actively pursuing new opportunities. To wit, AXA just raised €2.0

billion, largely for tactical expansion in emerging markets like Asia, South America and Central Europe and Russia. The company was also able to buy the Mexican property-and-casualty insurance operations of beleaguered ING (ING) last year for just €1 billion.

Likewise, AXA is attempting in a complicated three-way deal to hive off and own 100% the Asian business of its majority-owned Australian and New Zealand unit in return for selling its operations in those latter slower-growing markets to another insurer.

AXA's stock, at barely half its 2007 high of €34, may need some time to reclaim its growth status. Yet many analysts like what they're seeing.

The change in investor psychology was writ large in the generally upbeat analyst notes that followed AXA's recent investor conference in Paris. An example: "The message sent by AXA...was crisis over, lessons learned, fundamentals intact, moving." The writer was Keefe, Bruyette & Woods analyst Ralph Hebgem, who has a price target of 25 on the stock, based on the fact that AXA is trading at a discount to his large-cap insurance subsector of 15% to 20%.

Similarly, RBS analyst Jean-Francois Tremblay intoned in a note: "We returned from yesterday's investor seminar hosted by AXA with the impression that AXA is back to its normal self, focused on profitable growth and calculated risk-taking."

The stock, he points out, looks reasonably priced based on the insurance-industry metric of price to "embedded value"—net worth plus the present value of the ongoing premium streams that would follow a liquidation. That multiple now stands at 1.5, down from recent peaks of 1.8, and seems more than justified by the 25% return on embedded value that Tremblay sees for this year through 2011.

Much of AXA's attraction lies in its diversification. Over the past two decades it has used acquisitions to spread its wings around the globe. Last year France generated just 24% of its revenues, while Northern, Central and Eastern Europe contributed 26%, and North America accounted for 18%. Operations in Asia Pacific and the U.K. and Ireland chipped in revenues of 10% each and Southern Europe and Latin America, a combined 13%.

AXA's penetration of emerging markets is somewhat light compared with that of its international insurance rivals, reflecting a slow, systematic expansion of the brand beyond Europe. "We're a comparatively young company, put together in the last 20 years, so we've started our moves into the developing world a bit late," de Castries explains. "We plan on boosting the revenue contribution from the emerging markets to 25% by 2020 from the 10% level today."

He ticks off an array of areas from which he expects strong growth, including Indonesia, Philippines, Thailand, Vietnam, India, Turkey, Algeria, Latin America, Russia, and many of the republics rimming Russia. AXA is also enjoying strong growth in Poland and the Czech Republic.

Conspicuously absent from the list is China, a nation that has turned out to be a street of broken dreams for many global insurers. De Castries contends that China has stacked the deck against non-Chinese insurers by issuing licenses for foreigners to operate in a limited number of cities only and insisting that outside insurers dilute potential profits by partnering with domestic Chinese companies.

AXA also boasts a nicely diversified business mix. Its emphasis is on (and 64% of 2008 revenues were from) its life and savings operation. The savings business is made up largely of products like variable annuities and variable universal life-insurance products, in which customers end up owning stocks, mutual funds and the like in "separate accounts," often with death benefits and performance guarantees.

The prospects for the global life-insurance market depend on continuing population growth and rising levels of affluence, particularly in the developing world. But in variable annuities and other savings products, AXA is making a substantial bet in merely protecting policy holders and their family against premature death or accidents and health setbacks.

The thinking is that investors, after being decimated in their 401(k) stock portfolios, will increasingly flock to variable annuity products because of the protections they afford against market losses. People are likewise seeking better investment performance from their assets because of worry that they will outlive their retire-

ment savings and that dramatically underfunded government and private pension plans won't be there in current form in their time of need.

The savings products are particularly popular in the U.S. and U.K., but AXA plans to push variable annuities in other areas of its empire where folks are more risk-averse.

The bulk of AXA's other revenue (32% in 2008) comes from its property-and-casualty business, which is largely centered in Europe and heavily weighted toward plain-vanilla auto and homeowners insurance. The business is hardly glitzy, but it provided a nice ballast last year and early this year, when sinking stock-market prices around the world hurt sales and profit margins on savings products.

Moreover, personal lines is a business that AXA knows well and keeps getting better at in terms of efficiencies and cost control. At the recent investor seminar, the company said it plans to take €750 million in annual costs out of its European property-and-casualty operations through various claims-related initiatives. AXA has also been innovative in developing a direct, Web-based sales platform to supplement its large agent base.

When moving into new geographical markets, AXA uses its property-and-casualty business to establish a beachhead. Then it often moves up the value chain by rolling out higher-margin life and savings products.

De Castries recalls with some amusement how when he first took the helm at AXA in 2000, many analysts bashed him for refusing to sell the company's slow-growth property-and-casualty unit. Then the analysts' cavils turned into howls of protest later that year when he sold AXA's 70% interest in the U.S. investment bank Donaldson Lufkin & Jenrette for €8.4 billion to Credit Suisse. No matter that the sale allowed AXA to recoup in one fell swoop two-thirds of the €12.5 billion the company spent during the '90s to purchase DLJ's parent Equitable Insurance.

His disciplined approach, de Castries learned from his predecessor and mentor Claude Bebear, never wavered, and he was ultimately vindicated by events during the 2008 financial meltdown. ING and Fortis (FORB.Netherlands) were badly damaged by their banking connections, as was AIG

by its disastrous forays into derivatives insurance, securities lending speculation and residential mortgage origination. Even the formidable Allianz suffered acute indigestion from its 2001 purchase of Dresdner Bank—a company it has since sold.

“The lesson is that one must stick with what one knows,” de Castries says. “Banking and insurance are entirely distinct businesses with different balance sheets and risk profiles. And as for AIG, it became a gambling casino bolted on to an insurance operation.”

AXA management showed its mettle by acting quickly when the financial meltdown began in earnest in late '08 and the value of the mutual funds backing the variable annuities of AXA's U.S. operations began to sink far below the 6.5% minimum annual returns that had been guaranteed on most accounts. Fortunately, AXA had hedged its exposures well, but it couldn't completely protect itself. Many of the funds in its approved list performed far worse than the indexes AXA used to protect itself against market losses. A huge jump in market volatility also made AXA's hedging far more costly.

So AXA quickly reacted by lowering the guaranteed annual account-appreciation on new variable annuities and also raised its guarantee charges to customers. This has temporarily cost some market share in the all-important U.S. “We'll be fine once similar changes made by our competitors roll through the regulatory process,” says Christopher “Kip” Condron, CEO of AXA Financial, and as of late last week the executive with company-wide responsibility for AXA's life and savings business. “All business isn't good business, certainly,” Condron adds.

What's more, the quality of the €390 billion investment portfolio that backs AXA's policies and other obligations is far sounder than that of many of its competitors. At the end of the second quarter (the latest numbers available), 73% of the portfolio was deployed in various government securities or high-rated corporates.

AXA, an early skeptic about the housing and commercial real-estate market in the U.S., largely avoided the catnip of subprime and alt-A mortgage securities that laid low so many of its competitors. Such holdings amount to only €673 million, well under 1% of the portfolio. And AXA's real-estate investments, just 5% of the total, are mostly in

stable areas like Switzerland and Germany, with minimal exposure to shaky markets like the U.S. and Spain. Markdowns in both its residential and commercial properties have been light so far.

For de Castries, AXA's 64%-owned U.S. money manager Alliance-Bernstein has been a shop of horrors during much of his tenure. First, the growth-stock junkies on the Alliance side self-immolated during the bear market early this decade. Most infamous was one of the Alliance top guns who loaded up on 1.3 million shares of Enron for a state pension fund just two weeks before the company's bankruptcy in the fall of 2001.

Then a couple of years later, the Alliance mutual funds became ground zero for the mutual-fund timing scandal, in which hedge funds were permitted overnight profits at the expense of public investors by exploiting time lags in reflecting the values of foreign stocks in fund net asset values. That cost AXA \$600 million in fines and forgone fees.

AXA at this point decided to put the untainted Bernstein management in charge, which worked well for a time. At least until the market convulsions of last year, when the Bernstein value-stock mavens loaded up Alliance-Bernstein portfolios with financial names like Fannie Mae, Freddie Mac, Lehman, AIG and Citigroup, which all turned out to be death stars.

“In just four months of 2008, the company managed to ruin a fairly good three-year performance record,” says Peter Kraus, a longtime U.S. financial executive and friend of de Castries who was brought in late last year to head up Alliance-Bernstein and clean up the mess.

So far he has succeeded in improving investment performance, cutting costs and expanding the company's activities. But redemptions, particularly by institutional investors, continue. It could be a long road back. Mostly because of poor performance, the company's assets under management are down from nearly \$840 billion in the fall of 2007 to \$462 billion at the end of last year.

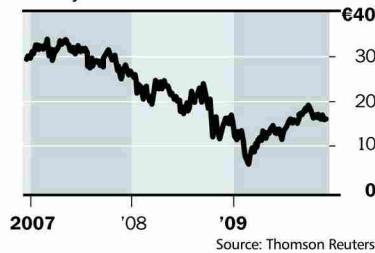
De Castries is stoical about such reversals. “Money managers are thoroughbreds, but when they break down one has to intervene,” he muses.

Perhaps his sang-froid comes from the military lineage of his immediate family. His maternal grandfather and his father

were both much-decorated military heroes, the latter seeing action in World War II, Korea, Indochina and Algeria.

Henri De Castries, for his part, prefers war of the financial variety. "Insurance is a less bloody activity, at least in principle," he says. His competitors, considering the mayhem of the last few years, may not be so sure. ■

AXA (CS.France)
 Weekly close on Dec. 11



"We're a comparatively young company, put together in the last 20 years, so we've started our moves into the developing world a bit late," de Castries says. "We plan on boosting the revenue contribution from the emerging markets to 25% by 2020 from the 10% level today."

Spreading Its Wings

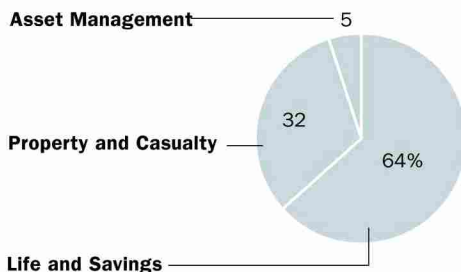
AXA and German's Allianz are neck-in-neck to be the largest global insurer in market value after China's two state-supported giants. AXA, well diversified by products, has been expanding further geographically. Next stop: emerging markets.

Company / Ticker	Market Value (bil)	Recent Price	YTD Change	Earnings Per Share		P/E 2010E
				2009E	2010E	
China Life/LFC	\$135.4	\$77.61	67%	\$0.16	\$0.18	27.8
Ping An Insurance/2318.Hong Kong	63.1	9.03	87	0.24	0.29	31.1
Allianz/ALV.Germany	56.4	124.21	17	14.19	15.80	7.9
AXA/CS.France	51.7	23.33	4	2.28	2.90	8.0
Assicurazioni Generali/G.Italy	40.3	25.88	-6	1.53	2.20	11.8
Zurich Financial/ZURN.Switzerland	31.3	212.89	-1	22.88	28.59	7.4
Munich Re/MUV2.Germany	30.4	105.93	-5	17.85	19.52	5.4
ING/ING	35.1	9.17	8	0.15	1.47	6.2
Manulife Financial/MFC	30.1	17.21	1	0.79	1.89	9.3
Metlife/MET	29.5	36.05	3	2.88	4.16	8.7

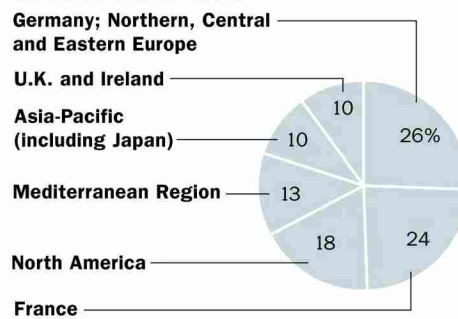
E=Estimate. Source: Bloomberg

2008 Revenues Mix

BUSINESS



GEOGRAPHIC REGION



Source: Company Reports



AXA CEO
Henri de Castries

Brad Trent for Barron's