MANULIFE FINANCIAL AND THE JOHN HANCOCK ACQUISITION

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CASE DESCRIPTION

This case mainly deals with the opportunity for Manulife Financial to acquire the legendary John Hancock Financial Services, Inc.. Students must consider both financial and non-financial aspects of the acquisition decision. Secondary subjects include a host of other financial and strategic issues facing Manulife Financial. The case would be relevant for either a senior undergraduate or graduate course in strategy or financial management as it requires analysis and support drawing from both disciplines. The case is designed to be taught in one to two class hours and is expected to require approximately five hours of outside preparation time. Students need to be familiar with financial management concepts and strategic analysis and formulation.

CASE SYNOPSIS

In June 2003, Dominic D'Alessandro is facing his most challenging time since becoming CEO of Manulife almost ten years prior. D'Alessandro must not only decide where to invest Manulife's large cash reserve now that a competitor, Great West Life, became the successful bidder for Canada Life Financial, he must also look at the strategic direction he is to set as consolidation in the financial services industry comes to a close. There are many investment alternatives, including the relatively safe bond market; but, more risky and rewarding options may be required if D'Alessandro wants to continue Manulife's legacy of exceptional financial performance. Aside from the investment and related strategic decisions, D'Alessandro must contend with an appreciating Canadian dollar, the increased re-insurance risk made evident by the events of September 11th, 2001 and the emergence of the Sudden Acute Respiratory Syndrome (SARS) in the Asian continent. In short, D'Alessandro must pursue an investment course that is strategic, and formulate and implement a plan that will ensure the future profitability of Manulife Financial in the short and long run.

INTRODUCTION

June 2003. It has been almost ten years since Dominic D'Alessandro was appointed President and CEO of Manulife Financial. There have been many changes at Manulife during his tenure and today Dominic D'Alessandro is currently facing a different future with room to maneuver. Manulife has a large cash reserve that was accumulated to bid for Canada Life Financial. D'Alessandro must decide where to invest the cash now that a competitor, Great West Life, won the bid. There are many options, including the relatively safe bond market; however, a more rewarding option is required if D'Alessandro wants to continue Manulife's exceptional financial performance. The three most viable alternatives are: 1) attempt to takeover another insurance company or 2) lobby the government to ease restrictions and merge with one of the big five Canadian banks or 3) formulate a new strategy since industry consolidation is ending.

Whatever course is chosen, D'Alessandro must devise a plan to face an apparently less certain world. The risk of terrorism is much larger than originally thought since the September 11th, 2001 attacks and the war in Iraq now has investors seeking greater security. The Sudden Acute Respiratory Syndrome (SARS) scare in Asia reminds health officials and insurers that pandemics are not beyond the realm of possibility even in this century. Finally, the rapid appreciation of the Canadian dollar is expected to hurt profitability since Canadian services will now be relatively more expensive internationally and overseas profits will be smaller when converted into the Canadian currency. These circumstances make it difficult for D'Alessandro to achieve Manulife's objectives of earning a return of 16 percent on equity and increasing earnings per share by 15 percent per annum. D'Alessandro must convince investors that Manulife will continue as a superior performer in the face of these new market realities.

HISTORY AND DEVELOPMENT OF MANULIFE FINANCIAL

The Manufacturers Life Insurance Company, or simply Manulife, has a rich history steeped with Canadian culture. The company was incorporated in 1887 with the former Prime Minister of Canada (Canada's first Prime Minister), Sir John A. Macdonald, elected as the first President. Ten years after inception, Manulife had expanded into Asia and entered the U.S. market a few years later. Its head office in Toronto, Ontario Canada is still presently the Company's global headquarters. Throughout its history, Manulife was known as a company that anticipated change and, for example, it was the first insurance company in Canada to offer low-policy rates to non-smokers, adopt mainframe computer technology, and open an online bank. Manulife's vision is expressed as:

> *"Our vision is to be the most professional life insurance company in the world: providing the very best financial protection and investment management services tailored to customers in every market where we do business."*

Manulife experienced significant expansion during the 1980s. Growth in the U.S. was led by two acquisitions: the National Liberty Life Insurance Company and the Maine Fidelity Life Insurance. Manulife began a demutualization process in 1993 whereby shares were sold to the public and began trading on the TSE and the NYSE under the ticker 'MFC'. Manulife used proceeds from equity issues to acquire other insurance companies. The acquisitions have proven worthwhile as consolidation in industry has led to greater scale and scope efficiencies. Today, Manulife is a firm with operations spanning the globe, and divisions set up by geographic locations. The Company has experienced rapid change and growth, as reported in Canada's National Post Newspaper: *"When Dominic D'Alessandro came to Manulife, it was a staid, old-school insurer. Today, he presides over an innovative financial-services giant that rivals the banks in size, services and global ambition" (2002 and pp. 52 - 53).*

Dominic D'Alessandro has been President and Chief Executive Officer of Manulife since January 1994 and has guided the Company to nine consecutive years of exceptional financial performance, as revenues and net income have quintupled. During his tenure, D'Alessandro led the company's successful demutualization, and was named Canada's Outstanding CEO of the Year 2002. D'Alessandro has an extensive and varied background. He graduated with a Bachelor of Science degree in Physics and Mathematics from Loyola College, became a Chartered Accountant in 1971, and he was awarded an Honourary Doctorate from Concordia University in 1999. In 1975, D'Alessandro joined Genstar Ltd. where he worked as General Manager, and later as Vice President of Genstar's Materials and Construction Group. D'Alessandro next moved to the Royal Bank of Canada, in 1981 where he held a number of positions including Controller and Executive Vice President of Finance.

Manulife has generated a 25 per cent compound annual growth rate in earnings per share (EPS) over the past nine years and earned record profits in 2002. However, Manulife's financial performance has slipped in 2003. In the first quarter of 2003, the U.S. division contributed $107 million in profit, down $11 million from a year earlier, while the Canadian division profit was $94-million, up by only $1 million. The first quarter annualized return on shareholders' equity was 15.8 per cent compared to 16.3 per cent for the same period last year, while EPS, which includes a one-time charge of $15 million related to the abortive takeover bid for Canada Life Financial, increased four per cent to $0.73 from the $0.70. First quarter results did not meet financial objectives and D'Alessandro responded: "*I am pleased that we were able to perform so well this quarter given the extremely challenging conditions*" (Manulife 2003a).

THE LIFE INSURANCE INDUSTRY

Manulife's main source of revenue is premiums from Term, Universal, and Whole Life Insurance. In 2002, the Canadian division experienced an increase in premiums, while the U.S. division seen a decrease. However, the most concern surrounds the Asian division as it may suffer a decrease in revenues for various reasons. For example, the Sudden Acute Respiratory Syndrome (SARS) outbreak has become a major factor in Hong Kong and parts of mainland China. Sales activities have been hit hard in mainland China, where SARS is believed to have originated, as agents are worried about meeting clients face to face and vice-versa. Manulife is trying to bridge this gap by using the telephone and direct mail, but these do not have the same sales impact as face to face selling. SARS also has the potential to increase expenses, as claims due to sickness and mortality may increase. Thus far, its Hong Kong operation has received two or three death claims and one for hospital benefits. Although the disease seems to be under control right now, Manulife must be prepared for new waves of SARS contaminations. Manulife has made changes to their operations in the brink of SARS. Following an increase in public concern after the government took preventive measures to control the spread of the disease, Manulife is offering SARS-related insurance coverage and services, including:

1. Health insurance policyholders that contract SARS are eligible to claim for medical expenses.
2. The daily hospital income benefit related to SARS will be doubled for hospital confinement.
3. If quarantined at home, 50% of the daily hospital income be payable during the period.

INVESTMENT AND ACQUISITION OPTIONS

In the wake of all the uncertainties and emerging issues, Manulife still has to ensure that their premiums are invested in a vehicle that provides superior returns and meet financial objectives. On December 27, 2002, Manulife attempted to acquire all the outstanding common shares of Canada Life Financial to create Canada's largest insurance company. Manulife's plans were foiled when Great-West Lifeco made a takeover bid on February 17, 2003. There was an approximate $1-billion difference between the Great-West and Manulife offers. Even before Great West made an offer, Manulife failed to get Canada Life's board of directors and management on its side. To help persuade Great West to come in as a white knight, Canada Life agreed to give the company the right to match any competing offer and to pay it a break fee of $287-million or about $1.75 a share.

After failing to acquire Canada Life Financial, D'Alessandro still has a few viable acquisition/merger targets, in a market that's rapidly winding down. A potential target for acquisition is John Hancock Financial. John Hancock's CEO made it clear that he fully expects more takeovers and mergers, including cross-border deals. The second candidate is the Canadian Imperial Bank of Commerce. Having been burned by the loss of Canada Life, Manulife wants to make sure its next major transaction is nailed down solidly before it becomes publicly known. If these potential acquisitions are overly risky, D'Alessandro still has the option of the much safer bond market. D'Alessandro and the Manulife management team are aware of the risks inherent in purchasing another company. Studies show that the acquirer should have a deep understanding of the target's business and industry before negotiations (Kaplan, S., et. al.1997). It is also evident that successful acquisitions are directly related to the post-acquisition integration strategy (Singh H. and Zollo M. 1998).

John Hancock Financial Services is one of the U.S.A's leading financial services companies, providing a broad array of insurance and investment products and services to retail and institutional customers, primarily in North America with revenues over $8 billion. The Company operates its business in five segments. Two segments serve retail customers, including the protection segment and the asset-gathering segment, and two segments serve institutional customers, including the guaranteed and structured financial products and investment management. The fifth segment is the corporate and other segment. The CEO of Hancock Financial has indirectly confirmed that he sees Manulife or Sun Life Financial Services of Canada as potentially suitable merger partners.

Canadian Imperial Bank of Commerce (CIBC) is one of the largest banks in Canada, with a presence in the United States. CIBC has consistently generated profits and a combination with Manulife would provide for a host of potential synergies, cost-savings and cross-sales. However, cross-pillar mergers are currently not allowed in Canada. Many CEOs of large banks believe these maybe likely in the future by arguing that the large number of financial institutions makes the affects of a merger on competition negligible. On January 14th, 2003, Manulife attempted to buy CIBC, but then-Finance Minister John Manley cancelled the deal. Mr. Manley declined to void the federal policy that prohibits the big banks from merging with either of the two biggest insurers, Manulife or Sun Life Financial. Analysts believe that the Manulife-CIBC deal would have gone through had the government not been confronted with another merger proposal (Scotiabank and Bank of Montreal). As such, it may be worthwhile for D'Alessandro to lobby the government to lift these restrictions and allowing for cross-pillar mergers.

CIBC is the natural target. Royal Bank and Toronto-Dominion bank are too big, and neither would want to become the lesser partner in a merger. Scotiabank and Bank of Montreal were engaged in their own merger talks and may also be waiting for restrictions to ease. That left CIBC, which had two key advantages. The first was that CIBC's share price, thanks to lending losses and the ailing Amicus bank system, had fallen from about $57 to the mid-$40s, making it a less expensive target. The second was that CIBC has an extensive retail and wealth management network. Together, Manulife and CIBC would be one of the most powerful financial institutions with more than 70,000 employees, 16.5-million policy holders and customers, and annual revenue of about $33-billion. By merging with CIBC, Manulife could offer banking, brokerage, insurance and wealth-management services and products.

Investing in the bond market is a lot less risky that the other two alternatives, but bonds do not provide high potential for growth in earnings. U.S. Treasury's have fallen hard over the past three years, pushing the yield on the 10-year note from 6.79 per cent in early 2000 to a recent 45-year low of 3.11 per cent. From 1970 to 1999, the average return on long term corporate bonds has been 7.64 per cent with a standard deviation of 10.57 per cent, while treasury bills have returned 6.04 per cent with a standard deviation of 4.04 per cent. Currently, Manulife's bond portfolio is diversified across many different industries, with the highest percentage invested in the government sector.

REINSURANCE DIVISION

Reinsurance refers to insurance purchased by an insurance company to cover all or part of certain risks on insurance policies issued by that company; retrocession is a form of reinsurance involving the assumption of risk from other reinsures. A dramatic change occurred to the

Reinsurance operations on September 11th 2001, when terrorism risk appeared to be more serious than previously thought. The Reinsurance Division incurred a $145 million expense for anticipated claims in 2001. The risk of terrorism involves prospective losses of potentially high severity and unknown frequency, which makes risk quantification difficult because it reaches beyond first-party property coverage to involve other coverage's (workers compensation, business interruption) that are difficult to quantify. Since the attacks, reinsurance premiums for property and casualty have nearly doubled. Manulife recorded claims resulting from the September 11th attacks as a non-recurring expense; however, the recent war in Iraq may have increased the probability of future attacks, thus increasing the likelihood of similar losses in the future. Warren Buffett, of Berkshire Hathaway, said that insurers and reinsurers were foolish for not pricing man-made mega catastrophes before the attacks. "In effect, we and the rest of the industry, included coverage for terrorist acts in policies covering other risks - and received no additional premium for doing so. That was a huge mistake, and one that I, myself, allowed. Had the attack on New York been nuclear, it is likely that most of the U.S. insurance industry would have been destroyed" (Berkshire Hathaway 2001).

RISING CANADIAN DOLLAR

On May 20th, 2003, the Canadian dollar climbed above 74 cents US, the highest it has been since the autumn of 1997. In general, economists claim that once the exchange rate starts to move, it's virtually impossible to predict where it will find its next equilibrium. The belief at Export Development Canada (EDC) is that as the world economy gradually returns to normal during 2003 and into 2004, the Canadian dollar will slowly make its way back to the US 70 cent level, possibly a little higher. Manulife's profits are going to be negatively affected from the recent resurgence of the Canadian dollar value against the U.S. dollar. Analysts predict that Manulife's profits could fall by as much as 9 per cent in 2004 ($129 million) if the dollar remains at its current level of 73.28 cents relative to the U.S. dollar. Estimates are based on projected profits from Manulife's foreign operations that have to be converted into Canadian dollars for accounting purposes. Manulife doesn't hide the fact that "*the Company may be exposed to losses resulting from adverse movements in foreign exchange rates due to the fact that it manages operations in many currencies and reports financial results in Canadian dollars*" (Manulife 2002). Manulife has a policy of reinvesting its U.S. profit in the U.S., so it technically does not lose money on the currency conversion; however, it could affect the company on an accounting basis, since Manulife is required to report its results in Canadian dollars. The effects of the appreciating Canadian dollar are already visible. In the first quarter of 2003, premiums and deposits were up four per cent, but excluding the impact of the dollar, the growth rate would have been eight per cent. Acquisitions could also help to mitigate any loses as a rising Canadian dollar makes it more affordable to purchase a U.S. insurer.

STRATEGIES FOR THE FUTURE

As Dominic D'Alessandro sits in his office in late June 2003, he knows that is was time to make decisive decisions regarding the future of Manulife Financial. The current market conditions and uncertainties require a thorough analysis of all relevant external and internal factors, assessment of feasible options, and formulation of a renewed strategy that is accompanied by an equally compelling implementation plan. The formulation and implementation of a plan must address the issues facing Manulife as well as to set a new direction for the company now that industry consolidation is coming to an end. Many questions need to be answered including these three major groups of questions:

1) Where should the large cash reserves be invested? What is the feasibility of Manulife acquiring John Hancock Financial, or merging with the Canadian Imperial Bank of Commerce? Would the safer bond market be the best place to invest the money?
2) If further acquisitions prove the best option, how would Manulife Financial handle the post-acquisition strategy to ensure that Manulife adds value in its offerings in different markets over the long term?
3) What, if anything, should be done with respect to the environmental factors such as appreciation Canadian dollar, the increased risk of SARS and other potential pandemics?

All of these circumstances will make it difficult to achieve Manulife's current objectives of earning a return of 16 percent on equity and increasing earnings per share by 15 percent per annum. D'Alessandro must determine how he can convince shareholders that Manulife will continue as a superior performer in the face of these difficulties. Finally, there is the nagging suspicion that much of Manulife's success is owed to the aggressive acquisition spree engineered over the decade past. What must be done to ensure a bright future for Manulife in the next decade, assuming it will not include many more acquisitions?

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