

94/03-Company After My Own Heart

Unknown, unexciting, unheralded on Wall Street, and successful in Japan: What's not to like about AFLAC?

By Peter Lynch

AFLAC is my kind of company: a \$15 billion operation most people know nothing about. Its main source of revenue is selling cancer insurance, which is unlikely to top any list of exciting businesses. Its headquarters is in Columbus, Georgia, which is at least one change of planes from Wall Street. The original name, American Family, was forgettable enough that in 1992 the board of directors voted to drop it in favor of the acronym. The longer and drawn-out version is the American Family Life Assurance Co. "Life assurance" sounds completely old-fashioned. It makes you think of a roomful of clerks sitting at high desks, making notations in giant ledgers with their quill pens.

But AFLAC is exciting where it counts. Its earnings have increased for 12 out of the past 13 years and continue to grow at a 15 percent annual clip. The stock has outperformed the market for 15 of the last 19 years in spite of the fact that it's chronically unfashionable and therefore undervalued. If you put a piece of tape over the name of the company and looked only at the earnings and the growth rate, you'd figure this to be a \$37 to \$40 stock in today's market. Since it's AFLAC, it's a \$27 stock. A situation like this never bothers me. Stocks and singers may start out in the hinterlands, but if they keep making beautiful noises, they're bound to be discovered sooner or later.

In this case, the beautiful noises are in Japanese. AFLAC might just as well be named Japanese Family Life, or JAFLAC, in honor of its remarkable success in the country that has been the bugaboo of U.S. commerce. The Japanese won't buy U.S. products, you say? Twenty-eight million Japanese are insured by AFLAC. That's a quarter of the entire population. The only American-made product that has earned more money in Japan than AFLAC is Coca-Cola, also from Georgia.

To understand how this miracle happened, we have to go back to John Amos, a Colonel Sanders-ish character who got together with his two brothers to form the company on a shoestring budget in the 1950s. Their fledgling enterprise was nearly bankrupt when the Amos brothers revived it by dropping the general line of life insurance, which wasn't selling, in favor of cancer insurance.

Cancer insurance had its critics, who likened it to polio insurance and other "dread disease" coverage sold door-to-door to unsophisticated consumers at very high prices. What was a great deal for the insurers was often a lousy deal for the insured. Nevertheless, American Family earned a reputation for reliability and for paying its claims on time.

Through the 1950s and into the 1960s, American Family expanded its markets and prospered under the leadership of Amos. By the 1970s, when cancer insurance was no longer an easy sell in America, Amos took a pleasure trip to the Far East. I've always admired executives who don't let holidays interrupt their thinking. Some of the best ideas come from a relaxed brain. In this case, Amos was touring Japan with a

friend when he observed that the Japanese were obsessed with germs and preoccupied with cancer, which was both a leading cause of death and a taboo subject, just as it had been in the U.S. Meanwhile, they were madly puffing away on their cigarettes, so the surgeon general's warning hadn't quite caught up to them.

Investigating further, Amos discovered that Japanese salaries had increased to the point that millions of workers were wealthy enough to afford supplemental health insurance, and there were gaps in the national health system that might make such insurance desirable. In short, he realized he had stumbled onto the perfect market for the AFLAC cancer policy.

A family-run company such as this one can have its drawbacks, but one of the advantages is that there are no stodgy committees to pour cold water on a quirky yet fantastic idea. A committee might have pointed out that AFLAC had no contacts in Japan, no experience in doing business abroad, and no employees who spoke Japanese, and that larger U.S. companies with all three had failed to gain entry into that xenophobic country. Amos was not bothered by such trivial impediments. He came home and promptly filled out a formal application to the Japanese Ministry of Finance.

As it turns out, being small and unimportant worked in AFLAC's favor. It was hardly a threat to the Japanese insurance industry, since none of the Japanese insurers had any desire to sell cancer policies. That being the case, allowing AFLAC to operate in Japan was a painless way for the Japanese government to show its openness to U.S. business.

It still took four years of wrangling with the ministry before AFLAC was finally accepted into Japan. This was a lot like being accepted into an Ivy League college--difficult to do, but once you're there, the authorities will go to great lengths to prevent you from failing. Ergo, AFLAC was granted an eight-year monopoly on cancer insurance throughout the entire country. As if this weren't enough, it was allowed to sell its policies inside the major Japanese corporations, which agreed to encourage their workers to buy the insurance and to deduct the premiums automatically from the monthly paychecks. In this remarkable "sponsorship" system, retired executives from each corporation are often enlisted to do the actual selling. Imagine what it would mean to Aetna if General Electric offered to sponsor Aetna's policies in all its offices and factories, or to Travelers if Lee Iacocca returned to Chrysler to sell Travelers insurance to his former employees.

As of this writing, 92 percent of the corporations listed on the Tokyo Stock Exchange are involved in AFLAC sponsorships. Is it any wonder that in its first year in Japan, AFLAC had \$25 million in sales, roughly eight times more than its most optimistic projections? Every year thereafter, the sales and revenues have grown, proving again and again that Amos's trip to Japan is the best thing that ever happened to the shareholders.

AFLAC could have followed the lead of many of the giants in the insurance industry by investing its policyholders' premiums in risky real estate loans and junk bonds. This was the thing to do in the 1980s, which resulted in many better-known insurers losing their shirts, along with their pants, shoes, cars, boats, and houses. AFLAC took a less sophisticated approach and put the money into boring old Treasury bonds, so today its \$12 billion portfolio is one of the strongest and safest on earth. And since all its policies, Japanese or American, pay a lump-sum benefit, the company is not exposed to unlimited and unforeseen liability.

There are two bits of bad news in this story. AFLAC tried and failed to peddle its products in Australia, the United Kingdom, Italy and elsewhere. Apparently, nobody loves the cancer policy quite as much as the Japanese. And Americans don't love it as much as they used to, because by the mid-1980s, sales in the U.S. had begun to slow.

This was a transition period between the aging John Amos and his energetic nephew, Dan, who is now the CEO. Under Dan Amos, the company left the white-suit era and entered the gray-suit era. Among other things, the younger Amos installed modern management systems, improved and expanded the advertising, and launched a cost-cutting campaign that eliminated two of the four corporate jets.

Along with the internal makeover, the new leadership shut down operations in unprofitable foreign markets. They successfully introduced several new products into the U.S. market: accident, disability, nursing-home care, home health care, hospital indemnity and Medicare supplemental policies. In addition, AFLAC continues to own seven TV stations, which were acquired many years ago at almost no cost to the company, since the revenues covered the interest payments on the debt.

As the new products begin to pay off, cancer insurance is less important to the bottom line. In 1993, noncancer policies accounted for 68 percent of AFLAC's new domestic sales. Taking a lesson from its Japanese operations, AFLAC is selling these new policies through payroll deduction plans, to companies that range in size from 2 or 3 employees to 10,000.

Meanwhile, Japan is in a recession, and the sale of cancer policies has slowed even there. While there's still solid demand for the cancer coverage, AFLAC has begun to broaden the product line over there. It's introduced Super Cancer, an upgrade on the original, and Super Care, which helps defray nursing-home expenses for the elderly.

Nursing-home costs are a major concern in a country whose population is exceedingly long-lived, and Super Care has gotten a favorable reception to date. After one year of existence, it accounts for 25 percent of new sales in Japan.

AFLAC has been helped in recent years by the strength of the yen, since the bulk of its revenues come from people who pay their bills in yen. This could reverse itself at any time. A 10 percent drop in the value of the yen could take 15 cents off AFLAC's earnings per share and put a short-term drag on the growth rate.

But I'm convinced the long-term prospects are excellent. It costs a lot of money to bring new insurance products to market, and the big payoff comes several years down the road. Insurance companies are required to maintain sizable cash reserves for various contingencies. In Japan, AFLAC recently has reached the point where its reserves are fully funded, so it can now "repatriate" the surplus cash back to the parent company in the U.S. In 1993, it repatriated a record \$100 million, a number that is almost certain to increase in 1994 and beyond. This extra cash may be used to buy back stock or raise the dividend, either of which would add to shareholder prosperity.

Even on the basis of 1993 earnings, AFLAC at \$27 is a cheap U.S. stock with a price-to-earnings ratio of 12.9, as compared to the S&P 500's price-to-earnings ratio of 22. Viewed as a Japanese stock, AFLAC is the biggest bargain in all of Tokyo. Give it a relatively low Japanese price-to-earnings multiple of 30 to

40, and in the current bear market these \$27 shares suddenly become \$70 to \$90 shares. So if you've been searching in vain for a Japanese investment that isn't wildly overpriced, you haven't been looking in the right places. Try the New York Stock Exchange.

Peter Lynch writes the Investor's Edge column for each issue of Worth. From 1977 through 1990 he managed the Magellan Fund, the best performing of all mutual funds over a 15-year period, and he is a vice-chairman of Fidelity Management and Research. His latest book, *Beating the Street*, is published by Simon & Schuster.

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