Q1 2016 Earnings Call - Pre-Recorded

Company Participants

- Alberto Minali

MANAGEMENT DISCUSSION SECTION

Alberto Minali {BIO 16909383 <GO>}

Good morning. This is Alberto Minali, General Manager and CFO of Generali. I'm pleased to report to you this morning our first quarter results. The Group has performed well, even if we did not match the unusually higher result of last year. This is due to our decision to realize lower levels of gains in volatile financial markets, while underlying technical profitability has been excellent. This demonstrates the benefits of our continuing focus on technical discipline in what is clearly a challenging environment for the insurance industry.

The total operating results of the period reached almost €1.2 billion, down 12.3% year-on-year, mainly due to a weaker investment result of the Life segment attributable to lower realized gains. Our decision has been to take a more cautious stands on capital gains in current marketing conditions, also in order to preserve future returns. I would highlight that the overall stock of unrealized gains has continued to grow. Despite this, the annualized operating return on equity was broadly stable at 13.3% and remains above our target level.

The decision to take lower realized gains is also evident in the non-operating result, leading to the overall net result of the period, down by 13.8% to €588 million, and earnings per share which are down by the same amount. Shareholders' equity is up 5.8% from yearend 2015 to €24.9 billion, mainly driven by the increased stock of unrealized bond gains attributable to shareholders, as I mentioned before.

The Solvency II ratio remains strong at 188%, even if decreasing 14 percentage points from yearend 2015, driven by adverse financial market conditions. This is in line with the indications we gave to the market in the middle of March and the sensitivities we published with the full-year results.

Looking at the operating result by segments, the Life operating result posted an 8.2% decline to €756 million. Property & Casualty showed a 1.4% decline due to lower investment income and to the other components, which offset a very strong underwriting result. The segment, Holding & Other businesses had a negative performance with a €38 million losses, compared to a €54 million profit of last year. This was mainly due to some specific items in the first quarter of last year, mainly the exceptionally strong performance of Banca Generali and some gains on private equity and real estate funds, none of which was repeated in the first quarter of this year.

Let's then see the journey from operating result to the bottom line. Non-operating investment income had a neutral contribution to net profits, as compared to the strongly positive contribution of last year. In line with volatile financial markets, the quarter experienced €180 million lower realized gains and €42 million higher impairments. Non-operating holding expenses increased by 5.3% to €197 million due to €11 million higher interest costs. This increase in interest expenses are temporary and is linked to the €1.25 billion subordinated bond issued last October to pre-finance the June 2016 call date.

Other non-operating expenses decreased by €101 million, mainly due to some provisions in the prior year number which did not recur. Tax rate was 30.9%, while minority interest were €41 million lower due to the lower contribution of Banca Generali as previously mentioned, and the presence of realized gains on equity investment in China during the first quarter of last year, which did not recur in this quarter.

Let's now turn to look at the balance sheet. Shareholders' equity increased by 5.8%, reaching €24.9 billion. The mark-to-market of available for sale assets resulting in €1.1 billion gain. The positive impact of reduced interest rates on unrealized bond gains was the main driver, slightly offset by the negative evolution of other asset classes. The net result of the period contributed for €588 million, as you've already seen.

Other items are €352 million negative and derived primarily from the negative effect on our German pension liabilities as a result of the reduced interest rates in the quarter, but also from the decrease of currency translation reserves due to the depreciation of the Swiss franc and Argentinean pesos.

Our solvency ratio remains strong even if financial markets pushed the number down from the levels seen at the yearend. In line with the indication we gave in the middle of March, the decline was 14 percentage points to 188% by the end of the quarter. I would say that the result is very much consistent with the sensitivities we provide you within our full year 2015 results presentation. The main drivers were the lower reference rates and equity markets and increased market volatilities, partially offset by organic capital generation. These effects have pushed the Eligible Own Funds down by €1.7 billion to €39.7 billion. The result in reduction in the loss-absorbing capacity of deferred taxes was the main contributor to a €600 million increase in the SCR.

Turning now to look at the Life segment in more detail. Overall Life premium decreased by 1.3% to €13.4 billion. Volatile financial markets witnessed in the first quarter caused a 15.4% drop of the unit-linked production year-on-year, in particular in Italy and CEE. Despite this, Life net inflows continued a positive trend, growing 6.4% to reach €4.5 billion. New business value increased by 12.7% to €361 million, notwithstanding a 6.9% APE drop; thanks to a 4.8 percentage points margin improvement.

Let me dive into the single drivers of the Life operating result, which overall fell 8%. The technical margin posted an €88 million increase, mainly thanks to higher technical profits on Group policies in Italy, but also higher margins on loadings in France and CEE. The investment result decreased by €125 million, despite growing current income. This is explained by almost €650 million lower net realized gains, gross (6:48) of policyholder shares compared to last year.

In 2015, market conditions combined with a tactical decision to take profits on some overvalued asset classes, led to the highest quarterly contribution of capital gains of the recent past. Expenses increased slightly due to increased acquisition costs and the royalties component which has been charged to subsidiaries from the Group head office starting from the fourth quarter of 2015.

Let's return to net inflows and as I mentioned, we're starting with a positive trend, reaching €4.5 billion in the first quarter of the year. Volatile market conditions led to a contraction of the unit-linked component, representing 30% of total net inflows. Even with this deviation, we confirm our strategy focus on increasing the share on more capital-efficient products. And in addition, we will work on enhancing the flexibility of the unit-linked business, also to offer less volatile funds.

In any case, I emphasize once more that even the traditional savings products we are selling right now, are designed on a prudent and profitable basis. Looking on a country basis, in Italy, we have €2.4 billion positive net inflows, thanks to a moderately positive premium growth, up 2% and reduced outflows. However, after almost two (8:11) years of very strong growth rates, hybrid products showed a contraction year-on-year due to the volatile equity markets.

In France, we see positive but decreasing net inflows, which went down from €208 million to €151 million. The reduction is again related to current market volatility, which negatively affected the unit-linked component. This did not affect the profitability of our new business, which on the contrary has improved, as you will see later on.

Germany also posted positive inflows in absolute terms, but 30% below last year. In this case, the decrease was linked to the planned reduction of single-premium saving business. The decrease in EMEA is mainly explained by higher outflows in Austria and lower sales in Switzerland that should be mitigated by the launch of the new products in the following quarters.

Lastly, in Asia, we experienced a strong increasing net inflows, mainly coming from China and linked to the exceptional level of sales reach (9:13) through our banking sales partner. We expect these will slow through the remainder of the year, as I will explain in a moment. These strong net inflows contributed to another 0.8% increase of Life technical reserves over the first three months to €372 billion.

Life general account investments reached €347 billion, up 4.4% from the yearend 2015, also driven by positive mark-to-market performance of available for sale bond investments. Total Life current returns are stable at 80 basis points for the first quarter. As always, this is not an annualized figure. In absolute terms, current income increased by €91 million. This stability is driven by fixed income current returns, which remain broadly unchanged, also at 80 basis points. Current returns on equity instruments showed a substantial increase, thanks to dividends from private equity funds compared to an exceptionally low number in the first quarter of last year.

In terms of asset allocation, you can see that we had a tactical increase of cash instruments, representing 4.5% of invested assets at the end of the period and which we have already started to reinvest. In the first quarter of the year, we invested pre-existing cash, net inflows, bond redemption and coupon at an average yield of 2.5% in the Life segment, mainly in corporate and government bonds.

Turning to the new business, we see that APE is down 6.9% like-for-like to €1.3 billion, mainly explained by the drop of the unit-linked component which is down 22.8% due to the poor financial market condition. As I said before, we hope this to be temporary also because we are investigating ways in which we can also protect the unit-linked portion of our products to make them more able to withstand volatility.

Looking at our main countries. In Italy, APEs were overall flat, but as the result of a decreasing production of hybrid products compensated by traditional ones. The share of unit-linked on total APEs, therefore, dropped from 20.6% last year to a current 11.9%. We confirm nevertheless our strategy to focus on hybrid products and are already taking actions to reduce the temporary increased exposure to traditional products experienced during the quarter. I would also add that even on the saving portion, guarantees have continued to fall sharply in Italy, down to only 27 basis points in the first quarter.

In France, we added 21.6% drop in APEs, driven primarily by saving business, down 25%. Unit-linked had the more limited 6% decrease, increasing its weight from 18% to 21.6%. In Germany, we saw a similar trend to France, with APEs declining by 21% and driven down by the savings component that dropped by 37.3%. Unit-linked and protection sales have correspondingly increased their weight to reach almost two-thirds of the total, which had a strong positive impact on margins.

If we turn to look at new business profitability at a Group level, we see the margin improved by 4.8 percentage point to 27.3%. A number of factors have driven this. The higher level of swap rate and lower swaps in (12:48) volatility, since we are using beginning of period assumptions, contributed to a positive effect from financial markets. Unfortunately, we can already see that this will not be the case also in the second quarter, when the margins will be calculated using financial market inputs as at the 1st of April.

The further reduction in new business guarantees resulted in additional momentum. The average guarantee we sell has continued to decline to only 46 basis point in the Euro area, down from 60 basis point from full year 2015. In Germany and France, the shift to new business mix, as mentioned before, has also had a positive effect on the margins. The last point to note is around the 90 basis point of improvement, which is explained by a change in methodology.

Beginning from this quarter, we have aligned the reference rate and Required Capital Calculation with the Solvency II framework. The latter, in particular, was previously based on the maximum of Solvency I and Solvency II capital. And so, we see some uplift as we move on to a fully Solvency II basis.

So overall, the margin trend is a positive one, an exception is the Americas and Asia region. Here you see large increase in APEs, but with the new business value which is close to zero or even slightly below. This effect is mainly coming from our operation in China. While the margin is to a degree a peculiarity of the market consistent by the value methodology, it is fair to say that interest rates in China have been under substantial downward pressure, and this has challenged the economics of some lines of business.

Our response has been to put significant restrictions on the sales of certain contract types, and as a consequence, you should not expect to see the same high volumes, but also not the same poor margins later in the year. Apart from this anomaly, at the Group level, the overall margin improvement more than offset a negative APE trend, allowing our new business value to grow by 12.7% to €361 million.

Now, let's turn to look at the P&C business. Gross written premiums decreased by 0.6% on a like-for-like basis to €6.3 billion, Primary motor posted a 0.9% decline, mainly driven by Italy, as I will explain later. Primary non-motor decreased by 0.3%. The combined ratio improved by 1.3 percentage points, thanks to the absence of nat cat burden. The operating result decreased by 1.4% due to lower investment income and to other components.

Looking at the components of the operating profit, we can see a particularly strong technical result at €369 million, up 27.9%, and a decline in investment result driven by lower investment yields. The residual other items line worsened by €55 million versus the first quarter of last year, partially reflecting the payment of brand fees to the parent company and some higher indirect tax items. The prior year was also affected by some minor positive one-offs. Overall, the level of the first quarter of 2016 is quite consistent with the average of previous quarter once brand fees are taken into account.

Let's look now at gross written premium developments within our core countries. Italy is down 6.2% at €1.3 billion. Primary motor decreased by 11%, but mainly due to the cancellation of some large fleet contracts. Without this effect, the drop would have been 3.8%, and therefore, on an underlying basis, is on an improving trend compared to that seen during 2015. Primary non-motor is down 3.4%, reflecting the overall weak economic environment.

France declined overall by 1.7% to €819 million. Primary motor was flat, notwithstanding continuing pruning activities on the fleet business portfolio. Primary non-motor decreased moderately due to the competitive market environment and the continuation of strict underwriting guidelines and pruning activities.

In Germany, premiums fell by 1.7%. The reason for this is that the motor business, down 1.7%, is similar to last year, also affected by the ongoing shift to the main renewal date from January to other months in the year. So, we expect that this effect will be leveled during the remaining nine months, also benefiting from relatively good market conditions.

Non-motor declined by 1.5% due to ongoing pruning activities in the broker channel and on non-performing agencies.

EMEA showed a good increase of 3.2%, mainly due to the solid performance we achieved in Spain.

Moving to the analysis of underwriting performance, you can see the combined ratio improved by 1.3 percentage point year-on-year to 92%. The main driver behind the improvement from an already excellent combined ratio was the absence of nat cats. Looking at the single drivers, the loss ratio improved by 1.3 percentage point, thanks to the above-mentioned benign nat cat environment.

The current-year loss ratio excluding nat cat, deteriorated slightly by 50 basis point, although I would underlie the unusually low number we experienced in the first quarter of last year. Prior years' releases are overall stable. The expense ratio remained flat. Reducing administration costs were compensated by higher acquisition costs, mainly linked to the effort to develop more profitable non-motor business lines also through new partnership in France.

Looking at the combined ratio by country. In Italy, the performance improved further to an excellent 88.7%, down 0.6 percentage points, driven by the lack of nat cats and making the best combined ratio of our major countries and regions. In France, the combined ratio improved by 50 basis points to 99.7% as a result of our turnaround exercise, although the number, like last year, benefits from the absence of nat cat. In Germany, we experienced an excellent 90.4% combined ratio, again helped by the absence of nat cat, which was relatively severe during the first quarter of 2015.

In CEE, our combined ratio was once again very good at 89.7%, although still negatively affected by regulatory changes that were introduced last year in the Polish market. We started to increase our motor tariffs in Poland already during the second half of 2015, and have just recently executed further actions to adapt to this new environment, hoping that the rest of the market will behave in a similarly rationale way. Our priority, as always, remains the preservation of (19:53) underwriting discipline. In Americas, our combined ratio has improved by 7.8% percentage point, mainly thanks to the strong action we have taken to restore profitability in Brazil.

Overall P&C investments reached €41 billion, up 3% from the end of 2015. Total P&C current returns on a non-annualized basis, decreased by 10 basis point year-on-year to 70 basis point, mainly driven by the fixed income trend. The average reinvestment rate in P&C during the first quarter of the year has been 1.3%, as well as reflecting the overall interest rate environment. The figure is also explained by the asset classes we invested in during the first quarter, which were mainly government bonds. I would also highlight that the amount of money invested in this quarter has been relatively low in absolute terms.

Let me finally turn to our Holding & Other business segment, with overall contribution to the Group operating result decreased from a profit of €54 million to a €38 million loss. This decline has been mostly driven by the lower profitability of Banca Generali, which was particularly strong in the first quarter of last year. In addition to that, the other business lines benefited last year from gains on private equity and real-estate investments that are not present this quarter.

That concludes my analysis of the figure. Let me sum up by saying that, even if we were not able to repeat the unusually higher result of last year, I think the Group has performed well in what are clearly very challenging financial and insurance markets. A sharp focus on technical profitability remains of critical importance in these conditions. I think you can see the evidence and benefits of that in our numbers, and it will continue to be our top priority in the coming period.

I'm happy to say that our solvency position remains a very comfortable one and well above the thresholds we have defined. This is despite the clear headwinds from the financial markets which impacted not only us, but the whole insurance industry in the first quarter.

I, therefore, also reiterate our commitment of delivering on the promise of attractive returns to our shareholders. Thank you very much for your attention.