Q2 2016 Earnings Call

Company Participants

- Alberto Minali, General Manager and CFO
- Philippe Donnet, CEO

Presentation

Philippe Donnet {BIO 4657671 <GO>}

Good morning, everyone. And a warm welcome to our first half results briefing. Our performance has been solid. While the financial markets and geopolitical uncertainty have been obvious headwinds, we have been able to deliver EUR2.5 billion of operating profit. And EUR1.2 billion of net income.

We are on track to deliver our promise to increase the remuneration for our shareholders. How? It is thanks to the fundamental strength of our insurance franchise.

In property-casualty, at 92.3% our combined ratio is extremely good, despite the natural catastrophes experienced in the Second Quarter. And in life, the careful management of our in-force portfolio and our innovative product offering are delivering benefits. Our new business margin of 25.5% is an indication of this.

Furthermore, our balance sheet is in a sound position. Our solvency ratio is at 188% based on our full internal model. And has proven resilient even with the recent market turmoil.

But while we have produced a solid result in the first half of this year, we know that the resilience of our performance should be further reinforced. This challenging environment is creating pressure on our results. We know that we cannot rely on the market to relieve this pressure, we need to act. We need to act decisively to continue to reshape Generali.

As you know, this is an organization that has radically changed for the better in the last few years. We improved governance and managerial effectiveness. We exited non-core operations to focus on insurance. We improved our profitability. We rebuilt a strong and resilient capital position.

Then, with the financial turnaround completed, we explained to you last May our plan to become a more agile, efficient. And innovative organization. But compared to May, some fundamentals in the financial markets have changed. Yields have fallen, volatility is amplified, geopolitical risk and uncertainty increased. This is why, in this month, we assessed the market and analyzed where Generali is today.

We wanted to determine if our strategy is still fit for the current environment. And our conclusion is that what we announced in May 2015 still stands. But we need to execute faster. And to go faster we have to be very focused on a few key elements which are going to make the difference to our results going forward.

The insurance industry cannot continue as it has done in the past. We are at a turning point. Generali is well placed. We have excellent technical capabilities, a high quality distribution platform and a highly motivated and experienced team who execute with passion. Generali can master these challenges.

In November's investor day we will show how we are executing our simpler and smarter strategy faster. But today, let me draw the outline of how we are accelerating our strategy, before handing over to Alberto for our results.

We have identified our two areas of attack and have already started working. On one side, we will further improve our operating performance. Delivery on this is urgent, the potential is great. And the results will be powerful. On the other, we will accelerate the way we shape Generali for long term value creation.

Let me focus on what these mean.

On operating performance, first of all, results have been good in recent years. And also in the first half. But we cannot be complacent, we will keep working with actions around three key elements.

First, the operating machine itself. We have made good progress. But we still have substantial opportunities. There is plenty of scope to further cut out redundant activities, to streamline processes. And to integrate platforms and entities, as has been achieved in Italy during the last three years.

This will have a decisive impact on our performance. But also on costs. The promise we made last May was that we would keep nominal costs flat to 2018, even with the significant investments we are making to transform and modernize the Group. These investments are crucial. But we will find ways to be more aggressive on savings elsewhere.

Second is about footprint. Our activities are spread far and wide across many countries. Our aim is to be of a relevant size, with good profitability in every market where we play. Where we don't see any possibility to achieve this aspiration in the medium term, we will release capital and resources from these activities. Those resources will be used to reinforce businesses where our strengths are already clear and the potential is greater.

Third, we will enhance our core insurance capabilities, our technical excellence. Compared to our peers, we are already performing well on average. But performances are not consistent across our portfolio. And the potential we have in both life and property and casualty is significant. In property and casualty, we can. And have, to improve pricing, risk selection and claims management.

In life, besides improving the quality and profitability of our new business, we will explore additional ways to maximize performance of our in-force books.

If we then turn to consider what we must do to secure longer term value creation, we again see three key elements that we will tackle.

First, is the structure of our business portfolio. Our heritage is traditional life insurance. We are managing with great skill and success the challenges this brings thanks to the investment and technical teams. But we need to accelerate the diversification of our sources of profit. For example, we need to exploit further the opportunities that exist to grow in property and casualty across all segments. And not blind, undisciplined growth. It will be carefully analyzed, profitable growth, in areas where we have the necessary expertise.

Health is another area where we see much potential to up our game. Finally, in life insurance, the shift towards unit linked and protection remains important. We will also increase the amount of fee-based revenues we are generating. These fees are less correlated and can help us navigate turbulent times.

Second, innovation and customer focus. We are experiencing a revolution in customer behavior and technological progress. We will continue to invest to stay on top of these trends. We must be simpler and smarter not only in our internal processes and operations. But also in the way we deal with customers and understand their needs.

And not only end customers -- Generali has a unique and truly exceptional proprietary distribution franchise. We can maximize the potential of it by increasing their capabilities by giving them better tools with which they can service our customers.

And lastly, our brand. We have a strong brand, built on a rich legacy. We can leverage this great asset much more. To increase its visibility. And to fully deploy its power is definitely a must do.

Now, all of that sounds common sense and simple. It is common sense and simple. So what will make Generali different? What will differentiate us is execution. We will do more. And we will do it simpler and smarter.

But for us this is not enough, we also need to be faster. To do it faster, we have made changes in the organizational structure. This new structure allows for a more obsessive attention on efficiency. And ever higher vigilance on performance.

For example, we have made changes in the Group Management Committee so that now all businesses and functions are represented. We have improved the effectiveness of reporting lines. And we are increasing the empowerment, alignment. And the accountability of local CEOs. All of this will accelerate the initiatives I have described and ensure we execute with excellence.

So let me summarize. Our strategy is the right one. And we are going to execute it faster. There are two fundamental lines of attack -- operational performance on the one hand. And shaping the Group for long term value creation on the other. I have outlined these for you today. We will have the opportunity to go into the details of these actions. And to give you proof points of delivery, at our investor day in November.

We know what we have to do. And we have the right team to do it. I am fully confident of our ability to execute with excellence. Despite the increasingly challenging environment, we remain committed to our financial ambitions and to our promise of delivering EUR5 billion of dividends in the four years to 2018.

Let's now turn back to the solid results we are reporting today and for that I pass the word to Alberto.

Alberto Minali {BIO 16909383 <GO>}

Good morning, this is Alberto Minali, General Manager and CFO of Generali. As Philippe has already explained, we operate in times which are undoubtedly challenging for the insurance sector. But I am pleased to report that our underlying technical performance is extremely solid. And our balance sheet remains robust. Even if the level of profitability is lower due to our prudency in realizing gains, our overall performance is ahead of market expectations.

Let's look at some numbers. The total operating result of the period reached almost EUR2.5 billion, down 10.5% year-on-year. Consistently with Q1, you see here the effect of our decision to realize a lower level of gains. Our annualized operating return on equity on a rolling four quarter basis declined by 1.3percentage points. This was broadly at our target level.

Lower realized gains and higher impairments are also evident in the non-operating result, leading the overall net result of the period down by 9.9% to EUR1.2 billion. Shareholders' equity is up 4.2% from year-end 2015, to EUR24.6 billion, driven by the increased stock of unrealized bond gains. The Solvency II ratio remains strong, at 188% according to our internal model view.

Looking at the operating result by segment, the life operating result posted a 3.5% decline to just under EUR1.7 billion. But showing an improving trend from the First Quarter of the year, which I will explain in a moment.

Property and casualty showed a 5.6% decline, due to lower investment income and to other components, which offset a very strong underwriting result. The segment holding and other businesses had a negative performance with EUR102 million losses, compared with EUR71 million profit of last year. This was mainly due to some specific items in the first half of last year, namely 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 half of this year.

If we now move from the operating result to the bottom line, non-operating investment income had a EUR45 million negative impact to net profits, as compared to the strongly positive contribution of last year, in line with our prudent approach. The first semester experienced EUR213 million lower realized gains. In addition, weak markets generated EUR178 million higher impairments.

Non-operating holding expenses increased by 11% to EUR405 million, mainly due to EUR24 million higher interest costs. This increase in interest expenses is temporary. And is linked to the EUR1.25 billion and EUR850 million subordinated bonds which we respectively issued last October. And at the end of this May.

These are to pre-finance one bond which was called in June and another one which has a call date in February 2017. Other non-operating expenses decreased by EUR297 million due to some exceptional provisions in the prior year number which will not recur.

The tax rate was 32.5%, while minority interests were EUR66 million lower, due to the lower contribution of Banca Generali as previously mentioned. And the presence of realized gains on equity investments in China during the first half of last year, which did not recur in this semester.

Let us now turn to look at the balance sheet. Shareholders' equity increased by 4%, reaching EUR24.6 billion. The mark-to-market of available for sale assets resulted in a EUR1.4 billion gain, driven by the positive impact of reduced interest rates on unrealized bond gains. The net result of the period contributed for EUR1.2 billion, as you have already seen.

On the other side, we have the EUR1.1 billion cost of the dividend payment in May, as well as other items that were EUR475 million negative. These derived mainly from the negative effect on our German pension liabilities as a result of the reduced interest rates in the quarter. And from a slightly negative impact of foreign exchange.

Let's turn now to Solvency. Our Solvency ratio remains strong, even if financial markets pushed the number down from the levels seen at year-end. This was mainly visible on our own funds, which decreased from EUR41.3 billion to EUR39.6 billion. Then, we also had a slight increase in Solvency capital requirement, from EUR20.5 billion at year-end, to EUR21.1 billion at the end of June. This mainly reflects the lower loss absorbing capacity of deferred tax, coming from the lower own funds.

We also show on this chart the view on the current scope of our approved internal model approval, that is, the regulatory view. Here, the ratio has also declined to 161% at the end of the first semester.

If we look at the roll forward of the Solvency ratio, we see that the contribution of normalized earnings has remained quite consistent at 8percentage points, i.e. at the same rate as the 16percentage points we booked for the full year 2015. As usual, we accrue dividends when they are declared, i.e. in the Fourth Quarter. And so there is no impact of dividends in these results.

This positive contribution of normalized earnings has helped to mitigate the sharp negative effect of financial markets year-to-date, that caused negative economic variances of 22 points, especially driven by the negative interest rate trend, falling equity markets. And increased volatilities.

Despite this negative effect, our Solvency ratio ends at a still strong level and far from any threshold where we would need to take action to defend it. Moreover, our ability to create Solvency capital organically will continue to be a strong line of defense, should we encounter further market weakness in the coming period.

Turning now to look at the business segment performance, starting with life. What I would like to stress on life is the evidence of the actions that we have taken to improve our product mix. And constrain or eliminate sales of products not meeting our requirements. Therefore, headline measures of volume are generally somewhat weaker. But the new business margin has been significantly positively affected by these actions, contributing to an overall 38% increase in new business value.

Let me dive into the single drivers of the life operating result first of all, which overall fell 3.5%. The technical margin posted a EUR111 million increase, mainly thanks to higher technical profits on group policies in Italy. But also higher margins on loadings in France.

The Investment result decreased by EUR226 million, despite a growing current income. This is again mainly explained by EUR931 million lower net realized gains, gross of policyholder share, as well as higher impairments, in contrast to the prior year where we had unusually high level of gains.

Expenses decreased by EUR54 million, in particular thanks to reduced acquisition costs in Italy and Germany.

Let me make one last comment on the life operating result, which is showing an improving trend if we look sequentially at the quarters. The main effect here is coming from the Netherlands, where we have taken actions on the asset portfolio, for example to lengthen duration. This has allowed us to reverse in the Second Quarter a provision of around EUR50 million for LAT which we had booked in the First Quarter, leaving an overall neutral impact on the first half result.

Turning to net inflows, in the first half we reached a very solid amount, EUR7.5 billion, despite the continued financial market volatility. And our decisions to actively cap or cease sales of some products given the interest rate environment.

These market conditions led to a contraction of the unit linked component compared to last year, representing 37% of total net inflows, although improving on first Q, where it was only 30%. I emphasize once more that even the traditional savings products we are selling right now are designed on a prudent and profitable basis. And we will not sell products which do not meet our requirements if the external environment deteriorates, as it has been doing.

Looking at the main country, in Italy we have stable net inflows at EUR3.9 billion, with reduced outflows which compensate declining premiums. Again, as in the First Quarter of the year. And after almost two years of very strong growth rates, hybrid products show a contraction year-on-year due to the volatile equity markets.

In France we see positive but decreasing net inflows, from EUR721 million to EUR332 million. This latter number is the result of encouragingly positive net inflows in unit linked and protection and health, counterbalanced by strongly negative net outflows in the savings and pension component.

Germany also posted positive inflows by 28% below last year. Like in France, the decrease was driven by net outflows of traditional business, particularly as a consequence of the closing of the offer of pure savings products by Generali Leben. In contrast, we saw strong inflows in unit linked and protection.

We are experiencing a similar trend in EMEA, with positive but strongly declining net inflows. That is driven by the deliberate reduction of wealth protection related products in Ireland. And by net outflows in savings and pension in most markets, in particular in Austria, where we stopped the sale of traditional single premium businesses.

Lastly, in Asia we experienced a strong increase in net inflows, mainly coming from China and linked to the exceptional level of sales reached through our banking sales partners. As I stated in May, however, this production had been stopped due to interest rate development. And in the Second Quarter of the year we experienced a quantitatively more normal and technically sound production.

Overall, the strong net inflows of the Group contributed to a 2% increase of life technical reserves over the first six months, to EUR377 billion.

Turning specifically to look at the new business, we see similar trends. APE is down 4.5% to EUR2.6 billion, mainly explained by the drop of the unit linked component which is down 23.2%, due to the poor financial market conditions.

On the other hand, if we turn to look at new business profitability at the Group level, we see the margin improved strongly by 7.9percentage points to 25.5%. A number of offsetting factors have driven this. The higher level of swap rate and slightly lower swaption volatility, since we are using beginning of period assumptions, contributed a positive effect of 1.9percentage points.

The change in methodology that was introduced last quarter to align the calculation to Solvency II principles added further 60 basis points to this. But the biggest positive impact, equal to 4.5percentage points, derived from management actions.

Decisions like the closing of product lines which have become unprofitable in this interest rate environment, the launch of new more profitable products. And the further reductions in new business guarantees have all contributed. And demonstrate our strong proactivity to managing the business in the current challenging conditions.

The overall margin improvement more than offset the negative APE trend, allowing our new business value to grow strongly by 38.4%, up to EUR656 million.

Looking at the individual 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 22% last year, to a current 13%. We confirm nevertheless our strategy to focus on hybrid products and we are already taking actions to reduce the temporary increased exposure to traditional products.

We can already see first signs of improvement, with the share of unit linked going up from 11.9% in the First Quarter of the year, to 14.1% in the second. I would also add that even on the savings portion, guarantees have continued to fall sharply, down to only 26 basis points in the first half. This helped contribute to increased margins, up from 22.3% to 28.6% in the first half.

In France, we had a 10.7% drop in APEs driven primarily by savings business, down 18.2%. But also with unit linked posting a 12.6% decline. The weight of unit linked is quite stable at almost 20%, while there was an increase of the protection component from 30.5% to 35.1%.

In Germany, we saw a 18.1% APEs reduction, driven down by the strong reduction in savings component that fell by almost 39%. Unit linked and protection sales have correspondingly increased their weight to reach more than two-thirds of the total, which had a strongly positive impact on margins.

Finally, looking to the life investment portfolio, life general account investments reached EUR352 billion, up 6% from the year-end 2015, also driven by positive mark-to-market performance of available for sale bond investments. A higher balance of investments more than counteracted the decreased investment returns, which fell from 170 to 160 basis points on a non-annualized basis, driven by fixed income current returns. Net of these effects, current income consequently increased by EUR114 million.

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 half of last year, although with the overall allocation to equity, remain cautious.

In the first half of the year, we invested pre-existing cash, net inflows, bond redemptions and coupons at an average yield of 2.1% in the life segment, mainly in corporate and government bonds.

Now, turning to look at the P&C business. Gross written premiums increased by 1.3% on a like-for-like basis, to EUR11.1 billion. This confirms the recovery trend we have started to see. And in fact the standalone Second Quarter premiums are 3.9% higher than the corresponding period last year, again on a constant currency view.

The combined ratio improved by a further 0.3percentage points which was not quite enough to offset the lower investment income, leading to an overall operating result which decreased by 5.6%.

Looking at the components of the operating profit, we can see a particularly strong technical result at EUR681 million, up 5.6%. And a declining investment result driven by lower investment yields. The residual other items line worsened by EUR57 million versus the first half 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.

Let's look now at gross written premium developments within our core countries. Italy is down 3.8%, at EUR2.8 billion. Primary motor decreased by 6.1%. But mainly due to the cancellation of some large fleet contracts, as I mentioned last quarter. Without this effect, the drop would have been 2.3%. And therefore on an underlying basis, is on an improving trend compared to that seen during 2015. Primary non-motor is down 2.3%, reflecting the overall weak economic environment.

France declined by 0.9% to almost EUR1.4 billion. Primary motor was slightly negative, at minus 0.8%, mainly due to continued pruning activities on the fleet business portfolio. But also as a consequence of decreasing average premiums. Primary non-motor decreased by 1.3%, due to the competitive market environment in commercial business and the continuation of strict underwriting guidelines and pruning activities.

In Germany, premiums fell by 0.5%. The reason for this lies in the non-motor segment, down 1.3%, where pruning activities in the broker channel and on non-performing agencies are still ongoing. Motor business inverted the negative trend of the First Quarter, posting a moderate 0.7% growth. CEE accelerated, showing a 2.3% growth, while EMEA confirmed a positive trend of 3.1% growth.

Moving to the analysis of underwriting performance, you can see the combined ratio improved by 0.3percentage points year-on-year to 92.3%. In contrast to the First Quarter of the year, the Second Quarter has been hit by several storms and floods across Europe that affected our P&L by approximately EUR125 million, after reinsurance.

Looking at the single drivers, the loss ratio improved by 0.4percentage points from the already outstanding result we achieved last year. This reduction has been driven by a 50 basis points lower current year loss ratio before nat-cat. Nat-cats weighted for

1.3percentage points, compared to 1.4percentage points last year, whereas the run-off reserve decreased slightly. The expense ratio remained stable.

Looking by country, Italy confirmed an excellent performance with an 88.6% combined ratio, driven by the lack of nat-cats. And making it again the best combined ratio of our major countries and regions. We continue to see pressure on the combined ratio in motor. But with the excellent development of non-motor counteracting it.

In France, the combined ratio worsened by 90 basis points to 100.1% due to a heavy nat-cat burden that affected the country for incremental 2.6percentage points, offsetting some underlying improvement.

Germany experienced an excellent 91.4% combined ratio, down 1.1percentage points, notwithstanding 80 basis points higher nat-cats. This is driven by an improving current year loss ratio, as well as by a reducing cost base.

In CEE, our combined ratio increased by 5.4percentage points, still negatively affected by regulatory changes that were introduced last year in the Polish motor market. And a higher level of claims in the Czech Republic. In Poland, we have already executed two tariff increases, launched cost cutting initiatives and plan further tariff increases in the course of the year.

In Americas, our combined ratio has improved by 3.2percentage points, mainly thanks to the strong actions we have taken to restore profitability in Brazil.

P&C investments decreased slightly to EUR39 billion, down 2.5% from the end of 2015.Total P&C current returns on a non-annualized basis decreased by 20 basis points year-on-year to 150 basis points, mainly driven by the fixed income trend.

The average reinvestment rate in P&C during the first half of the year has been 1.4%. 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.

Let me finally turn to our holding and other business segment, whose overall contribution to the Group operating result decreased from a profit of EUR71 million, to a EUR102 million loss. This decline has been mostly driven by the lower profitability of Banca Generali, which was particularly strong in the first half of last year. In addition to that, the other business line benefitted last year from gains on private equity and real estate investments that are not present this quarter.

Let me conclude, although we could not match the high level of operating and net profit we saw last year, this is mainly due to our conscious decision to realize lower gains. In fact, I am greatly encouraged at the underlying technical performance the Group is demonstrating.

In life, our discipline on product is showing clear benefits, for example the strong increase in new business profitability, despite lower headline volumes and weak markets. In P&C, we have an enviable combined ratio. And with a top line which is starting to show a recovery trend after the pruning actions we took in recent years.

As Philippe has already explained, we will take actions to further strengthen ourselves in the coming period, to combat the external environment which is putting ever more pressure on results. A particular focus for me will be to further streamline the operating machine. And the changes I have made in the General Manager area will facilitate that.

We will be exploring opportunities to grow in P&C and health, while never forgetting our strict discipline on profitability. And in life, we will continue an innovative but careful approach on new business, while also exploring all the ways in which we can optimize our in-force books.

Importantly, we will do all of this from a position of capital strength and resilience, which is of fundamental importance in a world of uncertainties. We are therefore well positioned to deliver on our promises. Thank you.