S&P Global
Market Intelligence

CNA Financial Corporation NYSE:CNA

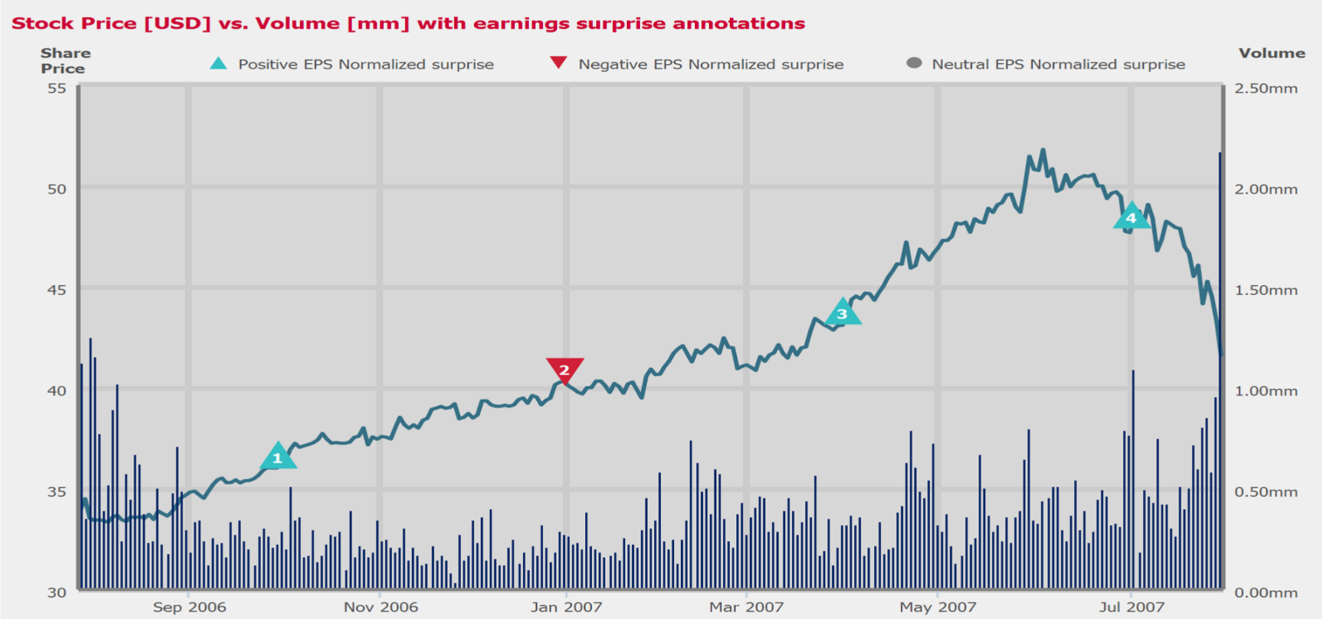
FQ3 2007 Earnings Call Transcripts

Monday, October 29, 2007 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2007-			-FQ4 2007-	-FY 2007-	-FY 2008-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.68	0.78	14.71	1.08	4.11	4.36
Revenue	-	-	(8.45 %)	-	-	-
Revenue (mm)	1790.25	1639.00	-	1700.00	6898.43	6793.30

Currency: USD
Consensus as of Oct-29-2007 12:17 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ3 2006	0.97	1.13	1 16.49 %
FQ4 2006	1.01	0.92	2 (8.91 %)
FQ1 2007	1.03	1.13	3 9.71 %
FQ2 2007	1.09	1.17	4 7.34 %

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EXECUTIVES

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John K. Welch
Former President & CEO

Tom Pottle

ANALYSTS

Randy Binner

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Operator

Good

day everyone and welcome to CNA Surety's Third Quarter Analyst Conference Call.

As a reminder, today's call is being recorded.

For

opening remarks and introductions, I would like to turn the call to Tom Pottle.

Tom Pottle

Thank

you. Good morning everyone and welcome to CNA Surety Corporation's third

quarter conference call. With me are John Welch, President and Chief Executive

Officer of CNA Surety, and John Corcoran, Chief Financial Officer.

Before

we begin, I would like to preface this call with the Safe Harbor statement under the Private Securities Litigation Reform Act of

1995, which is more fully described in the press release. Throughout the

discussion and subsequent question and answer session, forward-looking

statements that are not based on historical facts may be made. These statements

are based on today's market conditions and involve certain risks and

uncertainties. While every attempt is made to convey accurate information

regarding these forward-looking statements, no guarantees can be made that the

conditions will remain, and that the actual results will conform to the

statements being made today.

With

that understanding, I would now like to turn the call over to John Welch.

John K. Welch
Former President & CEO

Thanks

Tom. Thank you all for joining us again this quarter. As some of you may know,

this month we are celebrating our 10-year anniversary as a publicly traded

company, the only publicly traded surety company in the United States.

During

the past 10 years, the company has made some great strides. When CNA Surety was created 10 years ago, we wrote roughly $270 million in gross written premiums. As we move towards 2008, we are nearing $500 million in gross written premiums. The company's equity position has grown from $257 million in 1997 to $636 million today. Our book value per share has risen from $5.93 in 1997 to $14.44 today. All told, the company has been reporting record earnings, and is in the best financial condition in its history.

Turning

to this quarter's results, we are pleased to report record net income of $28 million. This brings nine months net income to nearly $71 million, which puts us in a good position to finish the year on a very strong note.

Overall,

gross written premiums increased 7% for the quarter, with contract surety leading the way with growth of 11%. Within the contract surety line, our small contractor book has grown substantially.

Our

small commercial surety book grew by nearly 3% while our corporate commercial segment was off by nearly 13%. Our corporate commercial book was off due to a more competitive environment and continued underwriting discipline.

Our

overall quarter production was strong, we tend to focus on the yearly growth rates as quarter-to-quarter comparisons can vary, given the timing of when construction contracts are awarded and when bonds are written. Our loss ratio remains fairly consistent with the prior year, with both years being affected by similar reserve releases.

We

completed our outside actuarial reserve review during the quarter, and as a result, we released $5 million of reserves dating back to 2003 and prior. Beyond the reserve release, we continue with the same level of current loss provisions.

On

the expense side, we continue to report nothing but good news as our expense ratio once again declined from 55% last year third quarter to 52.8% this quarter. Lower expense ratio was again driven by greater premium, lower reinsurance costs, and continued improvement in operating efficiencies.

Looking

forward, we continue to focus on growth prospects in the construction industry for contract surety and the overall economy for our commercial surety growth. Let me provide a little perspective on the construction economy. Through August year-to-date, according to numbers we got from the census bureau, overall construction spending was down 1.7% from 2006 levels.

The

decrease was driven by the residential sector, which was down 16.5%. Public construction spending was actually up 14.7%, while private nonresidential construction was up 15.2%. Our expectation is that the decline in the residential sector will moderate to some degree, while growth in the private nonresidential and public sectors will slow down some. The slowdown in the housing sector will ripple into various other sectors of the construction industry over the next few years.

Looking

forward, we hope to offset some of these downward pressures by selectively expanding into geographic regions where we do not have a large presence or any presence, and by putting additional emphasis on certain niches we have not focused on for the past few years. More importantly, however, is maintaining the credit quality of the book, and this along with exposure management will continue to be our top priorities.

During

the fourth quarter, we will be renewing our reinsurance contract given the strength of our capital. We are in a good position to consider numerous alternatives. We continue to believe it is important to maintain a very strong capital position in order to provide flexibility in the reinsurance buying, liquidity for any attractive acquisitions that might come along and to cushion against any downturn in the construction economy and/or its credit fundamentals.

Overall,

we are very pleased with our current results and expect to finish the year in a very solid financial position. We believe the company is well positioned for the next 10 years and we look forward to being part of that continued success.

With

that, I'll turn the call over to John Corcoran for some additional financial

details.

John Corcoran

Thanks,

John. Good morning, everyone. I will provide a few more details on our record earnings. A quick note, all the earnings per share amounts that I quote will be on a fully diluted basis.

We

reported net income for the third quarter of $28 million or $0.63 per share, compared to net income of $23.6 million or $0.54 per share for the third quarter of 2006. For the first nine months of 2007, we have reported net income of $70.6 million or $1.60 per share, compared to $61.1 million or $1.39 per share for the first nine months of 2006.

Realized

investment gains were minor in the current quarter, so net operating income was also $28 million and $0.63 per share, compared to net operating income of $24.3 million or $0.55 per share for the third quarter of 2006.

For

the first nine months of 2007, we reported net operating income of $71 million or $1.60 per share, compared to $61.7 million or $1.41 per share for the first nine months 2006. The increase in income was driven by higher earned premium, higher investment income and lower expense ratios.

Both

the current quarter and the third quarter of 2006 benefited from reserve releases of $5 million and $5.1 million respectively. John Welch covered the premium trends, so I will spend a minute on the loss and expense ratios.

While

the reserve releases were about the same dollar amount, the loss ratio impact in the current quarter was less, so we actually see a slightly higher loss ratio when compared to the third quarter of last year. However, our loss ratio selection for the current accident year remained at the same level as the previous quarters, at about 3/10 of a point better than our original selection for 2006.

As John mentioned, we did receive the results of the independent actuarial study using data as of June 30th. The study confirmed that our loss experience has been favorable. We released reserves from accident years of 2003 and prior, as we believe those years are sufficiently mature and unlikely to be impacted by current economic conditions.

While the reserve study did indicate modest improvements for the more recent accident years, we did not release any reserves for these years. There was nothing in the data that concerned us, we simply believe that the current economic conditions highlighted by the sub-prime mortgage issue and the housing slump call for a bit of caution as we assess the more recent accident years. During the fourth quarter, we will update the reserve analysis and will discuss those results during our year-end conference call.

We continue to be pleased with the improvements in the expense ratio, which improved to 52.8% for the third quarter, compared to 54% for the second quarter of 2007, and 55% for the third quarter of 2006. The biggest drivers of this improvement continue to be the growth in earned premium in part due to lower reinsurance costs and the fact that we have accomplished this growth with little additional expense.

Pre-tax net investment income for the quarter was $11.3 million compared to $9.8 million for the same quarter last year. The increase continues to be driven by the growth in invested assets due to strong operating cash flow and slightly higher yields.

Operating cash flow for the third quarter was $58 million compared to $43 million for the third quarter of last year. The third quarter is typically a high cash flow period for us, as we collect the premiums written in our heavy production months of June and July.

At

quarter end, our invested assets in cash totaled $980 million. The credit quality of our investment portfolio remained at AA+. Debt outstanding remained at $31 million at quarter end. Statutory surplus was $413 million at quarter end, resulting in a net written premium to surplus ratio of 1:1.

At

quarter end, our consolidated stockholders equity increased to $636 million or $14.44 per share, reflecting the net income for the quarter, and a swing back into an unrealized gain position in our investment portfolio.

That
concludes my remarks, so we will now open up the call for your questions.

Question and Answer

Operator

(Operator

Instructions) Our first question will come from Randy Binner with Friedman,

Billings, Ramsey & Co..

Randy Binner

On

the reserves: I think you mentioned that it was the whole $5 million was all

'03 and prior. Is it possible to break out more specifically what accident

years that applied to?

John K. Welch
Former President & CEO

Sure.

'03 itself was the biggest release - about $3.7 million. '01 had about $1.5

million. The rest of the years were a little movement back and forth; nothing

really material.

Randy Binner

'02

had an unfavorable development after a favorable development the year before,

so that related to, I think, some ongoing litigation. You had mentioned that

you think that those years are sufficiently mature, so can we infer from that

that the '02 and '03 accident years are pretty well locked at this point? I

mean, I know they are by definition, but just maybe more color on it.

John K. Welch
Former President & CEO

I

don't want to over-imply the level of precision that goes on in any individual

accident year. I think collectively as a group, now, we should see smaller

movements. We're always going to see small movements back and forth; one claim

develops worse than we expected, then another claim develops better than we

expected.

So

that could cause some blips across accident years, but in general, looking over that group of years, yes, I think we should see those settle down.

Randy Binner

Okay.

And so, now that would imply that '03 would be back to par. That's great.

One

other question, just maybe a little bit more color on what happened with the commercial line, the weakness there. And I know that that's trended down a bit sequentially and year-over-year. I mean is there a trend going on there? Is it competition? What exactly is making that happen?

John K. Welch
Former President & CEO

Sure.

Let me first distinguish between our small commercial book and our corporate commercial book.

The

corporate commercial book overall was relatively small, and that's the area that had decreased, I think, on a yearly basis; we might do $30 million give or take, and so that's the area that was impacted.

The

small commercial business continues to grow, and the core segments of that probably are rated more or less 3% The smaller corporate book, what's really been impacted there is a couple of things.

One,

we had emphasized it for a lot of years, and only got really more back into it, let's say, within the last year. And so we're in a position of trying to go out there and drum up production after having told everybody we didn't want to be in it for a long time. So it's been a little bit slow, and we've done it at a time when the market started to get a little more competitive, and we haven't really been willing to play at some of the terms.

And

then you combine that with the fact that some of the bonds in that sector had to deal with, like mortgage broker business for example, and there's less demand for that. So, some of that's gone. Some of the decrease was related to reclamation bond exposure where it's a “long-tail” exposure - that we're not crazy about, so, we manage that a little more carefully, and so, we've kind of moved some of that off the books. Then the contractor clients themselves who happen to need small commercial bonds at times have had less demand in the last quarter for whatever reason.

But

overall we're not really concerned about that because when we restructure this corporate commercial segment of our business, we essentially broaden it to more than just commercial surety bonds. We're having that group basically go after business that traditionally might have been considered contract bond. It's actually contract bond but for non-construction clients. They would be some of the larger companies like a General Electric, some people like that that you don't generally think need performance bonds but that actually do.

And

we haven't been a big player in that, and so we've had the people focusing on that, and so some of the production they're actually generating is showing up in contract, and you're not seeing it in commercial. So we're pleased with the unit, even though those numbers don't look so good at the moment, but we expect they will swing back.

Randy Binner

Okay.

The top line was very good in contract with 11%. Was there any lumpiness in there, or big contracts that came through in the quarter that made that seem a little outsized, relative to the go-forward trend?

John K. Welch
Former President & CEO

Yes,

maybe a little bit. We alluded to it a little bit. It's difficult to predict when construction contracts are going to get awarded and when we're going to bond them. And we saw actually a very good September compared to the prior year.

And

our October last year was very strong, and we're waiting to see how October turns out this year, but we are somewhat thinking maybe we flipped months. September was strong this year, and October was strong last year, and it might be the reverse this year.

But

so far October is turning pretty good, but, yes, I think it was a particularly

strong quarter, I would say that. It's hard to predict, but I would think it

would be hard to match that same number in the fourth quarter.

Randy Binner

Yes,

seasonally that would imply that, but also the rate was also high.

John K. Welch
Former President & CEO

I

would agree with that.

Randy Binner

Thanks.

I'll drop back and see if anyone else has questions. Thank you.

John K. Welch
Former President & CEO

Thanks

Randy.

Operator

(Operator

Instructions) We'll go next to Ron Pate with Banc of America Securities.

<TAG>Ron Pate - Banc of America

Securities</TAG>

Just

the first question is following the external actuarial reserves study, if you

can just tell us how the point estimate from the external actuaries compared

with your own.

John K. Welch
Former President & CEO

Sure.

As of 6-30, our booked reserves were $7.5 million higher than the actuarial

estimate. But I remember that's at June 30th, when the study is performed.

<TAG>Ron Pate - Banc of America

Securities</TAG>

Right.

Now, your overall aspect has remained the same. If you can just quickly tell us

whether each of the individual lines, the aspect stayed the same, and if you

can just remind us what they are.

John K. Welch
Former President & CEO

Sure.

They have stayed the same. Contracts, we've generally said, very slightly below

30; the large commercial the lower to mid-30s, and the small commercial in the

higher teens. That stayed pretty constant now for certainly through '07, just

slightly better than we had in '06. And that's really more driven by the

impact, again, of lower reinsurance costs than anything else.

<TAG>Ron Pate - Banc of America

Securities</TAG>

Okay.

Now, this is a separate question. Are you noticing any increased public

spending related to the infrastructure projects following the bridge collapse

in Minnesota? Has that affected the overall trend?

John K. Welch
Former President & CEO

I

would say, I think it will. We know of a particular big program in Missouri, where they're putting a whole program of bridges

out for bid all over the state. So, yeah, we think there will be continued

emphasis. That's probably a bright spot. We think despite the housing

situation, we think public spending has continued strong. Right now I haven't

seen anything that would suggest it wouldn't continue.

<TAG>Ron Pate - Banc of America

Securities</TAG>

And

then, I think you had eluded, John, in your initial comments about linkage from

the private construction, the residential construction probably going into the

commercial construction on the growth prospect side.

What

loss experience are you seeing on the residential? Maybe not on your own book, because I think you have a very small book, but industry wide, has there been in a need deterioration and the credit trend on the housing side and are you worried about it spreading into the commercial side?

John K. Welch
Former President & CEO

I

thick there's two different points here, essentially. I think as far as the trouble in the housing market spilling into the rest of the construction industry, yes, in my opinion, I think it will to some degree, because as there's less developments in housing developments, you just need less schools, less shopping centers - less retail. I mean it just kind of follows.

The

secondary aspect that could cause you a problem down the road is that a lot of the guys that did that type of work, particularly in the infrastructure, the sewers, roads, that type of thing, it's fairly easy for them to transition over back into some of the public work and give them more competition, which then eventually leads to lower margins on their income statements.

So,

but that's just beginning, and, you know, that takes a while for it to work its way through the system. The private market has been so strong, and they have made a lot of money, so they have pretty healthy balance sheets, so even more competition is going to take a while for that to work through and result in actual bankruptcies at the end of the day.

As

regards the housing sector, you know, you read the papers. I mean, it's been pretty dramatic decrease in that market, and you know, all the surety companies have bonding in that sector, and really to date, no, there hasn't been any significant losses that I've heard of.

There

was a recent bankruptcy of a Chicago firm in the last week or so, and the thing about the bonding in the housing sector that makes it difficult to determine what will result is a lot of the bonds are basically just to guarantee the improvements of the development. They don't guarantee the building of the houses or anything like that. It's just that they put through infrastructure in, and most of the time it's put in kind of upfront. So you're not really certain that even if some of them fail, what kind of losses you'll have.

Yes,

it's an industry that's got a lot of troubles. We fortunately are focused on the top end of that, the biggest national builders, and we've managed our exposures at least internally here to be in line with our reinsurance parameters, and also our capital.

So

it's something to keep an eye on, and, you know, -it’s going to be a little rough road for them. It's been a rough '07, and '08 I done think is going to be any better, so we're keeping our eye on them, but we do feel good about how we've managed our exposure so far.

<TAG>Ron Pate - Banc of America

Securities</TAG>

Great.

And I guess the last question if I may for John Corcoran. The premium to surplus is at 1.1 times. What level of premium to surplus are you willing to tolerate before you think you need to increase capital management?

John Corcoran

I

don't think that ratio in and of itself is going to be the driver for us. I think we're taking a much more broader view of the economic conditions; certainly take some comfort in the fact that we're providing good returns on the capital currently, so I think we have to look at all of those issues, you know, especially the economic conditions that we see and then we'll address capital as we go.

<TAG>Ron Pate - Banc of America

Securities</TAG>

Okay.

Thanks for the answers. And good quarter.

John K. Welch
Former President & CEO

Thanks.

Good to have you back.

Operator

We'll

take follow-up question from Randy Binner.

Randy Binner

Hi

again. John Corcoran, just real quick on the investment yield. I notice that this quarter we saw just sequentially a little dip down. I got about 4.62% as the investment yield for the quarter in my model. Are you seeing anything in the portfolio as far as lower yields and a lower environment, or is there any story behind that sequential decrease in yield?

John

Corcoran

Probably

a little bit more of a concentration in short-term during the quarter. As I'm sure you follow the broader market, you know the treasury yields obviously are down. There's a big flight to quality issue, and some of the credit spreads have widened, but I think, we say generally the new money rates are a little lower than they have been in the past.

Randy Binner

That's

interesting. You're 67% maybe so I guess that whatever spread widening opportunity you got is somewhat hampered by the lower absolute return?

John Corcoran

Right.

I think that's fair.

Randy Binner

Okay.

Thanks for the color. Good quarter. Thank you.

John K. Welch
Former President & CEO

Thanks,

Randy.

Operator

We

have no other questions at this time. I would like to turn it back to our

presenters for any additional or closing remarks.

John K. Welch
Former President & CEO

Okay.

If you have any questions, please do not hesitate to contact John Corcoran or

myself. Thank you.

Operator

That

does conclude our call. We would like to thank everyone for your participation.
Have a great day.