S&P Capital IQ

CONTENTS



# Kemper Corporation NYSE:KMPR

## *FQ3 2017 Earnings Call Transcripts*

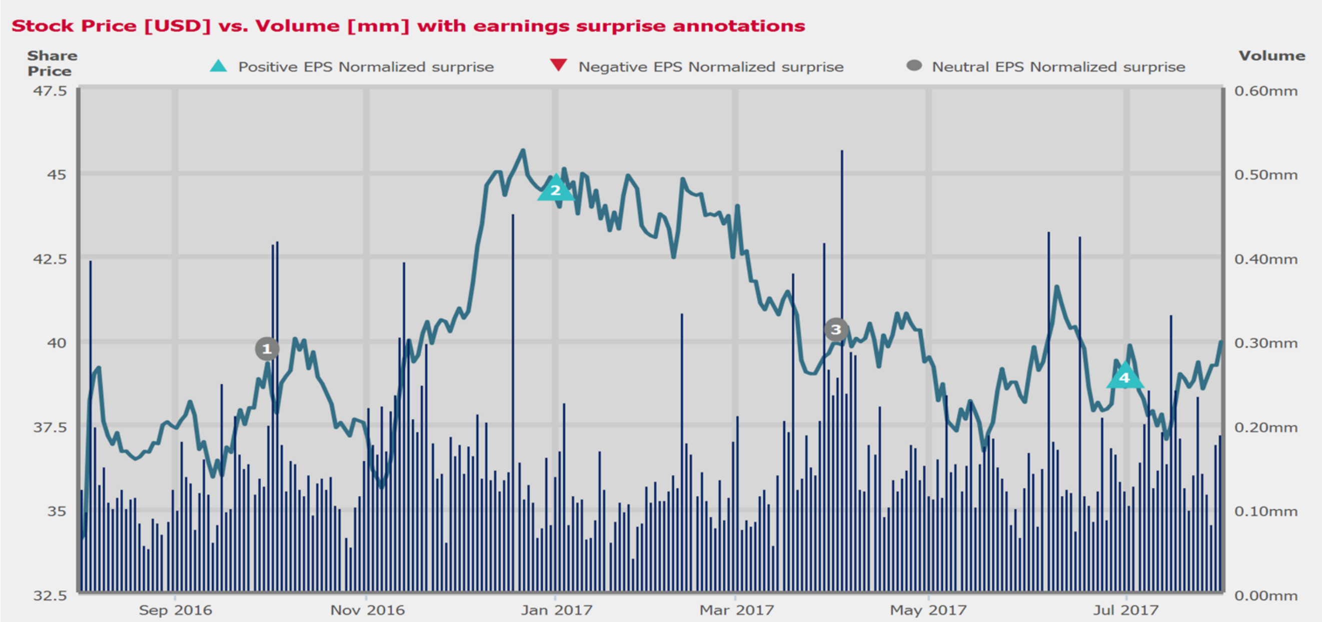
Monday, October 30, 2017 8:00 PM GMT

## S&P Capital IQ Estimates

| | -FQ3 2017- | | | -FQ4 2017- | -FY 2017- | -FY 2018- |
|---|---|---|---|---|---|---|
| | CONSENSUS | ACTUAL | SURPRISE | CONSENSUS | CONSENSUS | CONSENSUS |
| **EPS Normalized** | 0.32 | 0.85 | ▲165.62 | 0.72 | 1.67 | 2.72 |
| **Revenue (mm)** | 680.90 | 685.10 | ▲0.62 | 663.60 | 2642.55 | 2768.75 |

Currency: USD

Consensus as of Oct-17-2017 9:00 PM GMT




- EPS NORMALIZED -

| | CONSENSUS | ACTUAL | SURPRISE |
|---|---|---|---|
| **FQ3 2016** | (0.44) | (0.36) | NM |
| **FQ4 2016** | 0.42 | 0.56 | ▲1 33.33 % |
| **FQ1 2017** | (0.17) | (0.08) | NM |
| **FQ2 2017** | 0.23 | 0.41 | ▲2 78.26 % |

# Call Participants

## EXECUTIVES

**George D. Dufala**
*Senior Vice President and President of Property & Casualty Division*

**James J. McKinney**
*Chief Financial Officer and Senior Vice President*

**Joseph P. Lacher**
*Chief Executive Officer, President and Director*

**Todd Barton**

## ANALYSTS

**Jon Paul Newsome**
*Sandler O'Neill + Partners, L.P., Research Division*

**Matthew John Carletti**
*JMP Securities LLC, Research Division*

**Robert Ray Glasspiegel**
*Janney Montgomery Scott LLC, Research Division*

**Ronald David Bobman**
*Capital Returns Management, LLC*

# Presentation

**Operator**

Good afternoon, ladies and gentlemen, and welcome to Kemper's Third Quarter 2017 Earnings Conference Call. My name is Gary, and I will be your coordinator today. [Operator Instructions] As a reminder, the conference is being recorded for replay purposes.

I would now like to introduce your host for today's conference, Todd Barton, Kemper's Assistant Vice President of Investor Relations. Mr. Barton, you may begin.

**Todd Barton**

Thank you, Gary. Good afternoon, everyone, and thank you for joining us. This afternoon, you will hear from 3 of our business executives starting with Joe Lacher, Kemper's President and Chief Executive Officer; followed by Chip Dufala, Kemper's Property & Casualty division President; and Jim McKinney, Kemper's Senior Vice President and Chief Financial Officer.

We will make a few opening remarks to provide context around our third quarter results. We will then open up the call for a question-and-answer session. During the interactive portion of the call, our presenters will be joined by John Boschelli, Kemper's Senior Vice President and Chief Investment Officer and Mark Green, Kemper's Life & Health Division President.

Before the markets opened this morning, we issued our press release and published our earnings presentation and financial supplement. In addition, we filed our Form 10-Q with the SEC. You can find these documents on the Investors section of our website, kemper.com.

Our discussion today may contain forward-looking statements. Our actual results may differ materially from these statements. For information on potential risks associated with relying on forward-looking statements, please refer to our 2016 Form 10-K filed with the SEC as well as our third quarter 2017 earnings release and Form 10-Q.

This afternoon's discussion includes non-GAAP financial measures that we believe are meaningful to investors. In our financial supplement, presentation and earnings release, we have defined and reconciled non-GAAP financial measures to GAAP where required in accordance with SEC rules. And finally, all comparative references will be to the third quarter of 2016 unless we state otherwise.

Now I will turn the call over to Joe.

**Joseph P. Lacher**
*Chief Executive Officer, President and Director*

Thank you, Todd. Good afternoon, everyone, and thank you for joining us on the call today.

Before we walk through our quarterly results, I want to provide a few comments from a long-term perspective looking at Page 3 of the presentation. We remained focused on building Kemper's overall value and our strategy underscores this long-term view. We continue to leverage our competitive advantages while building core capabilities to ensure we maximize shareholder, agent and policyholder value. We continue to make meaningful progress on these fronts as you'll see throughout the presentation.

On Page 4, we provide our path forward to unlocking the embedded value of the company. We've made significant progress in our operations and on the profitability improvement targets we outlined in our strategic update. Not only have we restored profit at Alliance United as promised, but our total nonstandard auto business is outperforming our expectations. We are more than $5 million ahead of our $20 million run rate expense savings commitment for 2017 and have successfully rolled out the first wave of IT platforms for both P&C and Life & Health. Additionally, we continue to attract and retain exceptional talent, who want to be part of something great, where they have an opportunity to play a leadership role in reenergizing Kemper.

During the quarter, we added several key personnel who'll help us continue the positive operational and strategic enhancements we've made to date.

We remain committed to achieving our 2018 goals and improving normalized net income by $90 million per year by 2019. This improvement nearly doubles the company's average normalized earnings over the past several years.

Now let's turn to Page 5 and look at our third quarter's results. Overall, we had a strong quarter. In total, we delivered net income of $48 million or $0.92 per share in the quarter, up from a loss of $16 million or $0.32 last year.

Net operating income was $44 million or $0.85 per share for the quarter compared to a net operating loss of $20 million or $0.40 last year.

Results for 2016 included a $51 million after-tax charge, which is $0.98 per share related to our voluntary Life & Health outreach efforts. Excluding that charge, net operating income increased $13 million or $0.26 per share.

Earned premiums increased 7% to $598 million and net investment income increased 11% to $86 million.

Life & Health continued to be a source of stability for the company. Earnings increased to $24 million, accompanied by modest premium growth.

In P&C, there were several key highlights. In nonstandard auto, we increased earned premiums by nearly 20%, while improving profitability. It's important to note that we are building one of the premier nonstandard auto franchises and it's becoming more evident with these results.

Our preferred auto business saw profitability improvement but remains pressured. Recall that in the fourth quarter last year, we acknowledged that we were late in responding to increasing loss trends with appropriate rate and it will take several quarters before meaningful improvement was seen. We are now several quarters down the road and the improvement is materializing as promised. Chip will have more on this later.

Turning to Page 6. We isolated the key sources of volatility in our earnings. And the highlighted section at the bottom of the page, you can see the underlying operating performance. This was the fifth sequential quarter of improvement. Most of the improvement over the third quarter of 2016 comes from our Property & Casualty division, where our nonstandard auto line drove a 6 percentage point improvement in the segment underlying combined ratio.

Our expense management initiatives contributed to the improvement as well. Sources of volatility stem from 3 main items: Catastrophe losses, prior year reserve development and alternative investment income. Cat losses, including Hurricanes Harvey and Irma were $22 million after-tax or $0.41 per share in the quarter. Adverse prior year development was less than $1 million after-tax or $0.01 per share.

Last, we benefited from strong alternative investment performance, which Jim will discuss. As indicated in last quarter's call, we continue to explore aggregate catastrophe reinsurance treaty options that have the potential during periods of elevated catastrophe losses to mitigate the impact of higher frequency, lower severity storms on Kemper's financial profile.

Assuming appropriate negotiation of economics, we expect to have the new treaty in place for January 1. Furthermore, in recent quarters, we've experienced an increased level of prior year reserve development. Claim practice changes make actuarial loss triangles inherently more difficult to read and often result in short-term noise.

As I have told you, we've made and continue to make significant changes to our claims processes to meaningfully strengthen our franchise, this noise is entirely expected. The important thing to watch is the significant improvement in underlying operating performance, which demonstrates our stronger ongoing franchise.

Overall, we are pleased that our underlying operating performance is heading in the right direction. I'll wrap up my comments with our Life & Health division's results, which are on Page 7 of the presentation. On the top

[Audio Gap]

Operating income improved to $24 million, primarily from lower expenses and higher net investment income. This division continues to be a stable source of earnings with strong and predictable cash flows.

Now I'll turn the call over to Chip to discuss the Property & Casualty results.

**George D. Dufala**
*Senior Vice President and President of Property & Casualty Division*

Thank you, Joe, and good afternoon, everyone.

I'll start with nonstandard personal auto on Page 8 of our presentation. We have seen significant improvement across our entire nonstandard auto business. Earned premiums increased to $247 million for the quarter, up $40 million or 19%. The top line growth was fueled by rate increases and increased new business. More importantly, the growth was executed profitably as reflected by the improved underlying combined ratio.

Nonstandard auto's underlying combined ratio improved nearly 12 percentage points over the third quarter of 2016 as the business benefited from rate increases as well as underwriting and claims actions. We currently have a leading nonstandard auto franchise with $1 billion of annualized net written premiums and we are focused on continuing to grow it profitably.

Turning to our preferred lines on Page 9. Earned premiums in total were $184 million, down slightly from last year and the underlying combined ratio improved to -- improved 0.5 point to 93%. The preferred auto underlying combined ratio continue to be elevated at 99%.

In the fourth quarter of last year, we stated that we were a bit late to recognize the adverse loss trends that the industry experienced, but we're responding appropriately. We also mentioned that the preferred auto business will be pressured for at least a couple of more quarters.

In the first quarter, we described claims challenges that added pressure and would take a few more quarters to resolve. We are seeing profitability improvement working its way through the book as rate increases and improvements in claims practices, underwriting and other nonrate actions materialize.

From a top line standpoint, net written premiums decreased $2 million, primarily from lower new business as we implement the necessary rate and underwriting actions.

Looking at homeowners, the underlying combined ratio was 86%, about 0.5 point higher than last year. Premiums were down slightly. As we all know, the big story for the P&C industry was extraordinary hurricane season, which included 2 of the largest hurricanes that made landfall in the United States in recent years. While we are not immune to these storms, our geographic exposure limited the impact.

In total, the company incurred $33 million of pretax catastrophe losses, $30 million of which came from P&C. This includes $18 million related to Harvey and Irma with the balance coming from smaller third quarter catastrophes and some modest development on first and second quarter events.

In total, P&C had a great quarter, even with the historic hurricane season. We continue to make progress on building the strength of our nonstandard auto business and improving the underlying performance in preferred. [Audio Gap] execute on our transformation. Together, these are critical to positioning the company for long-term profitable growth.

With that, I'll turn the call over to Jim.

**James J. McKinney**
*Chief Financial Officer and Senior Vice President*

Thanks, Chip, and good afternoon, everyone.

Starting with investments on Page 10. This function continues [Audio Gap] strength for Kemper. We manage a diversified and highly-rated portfolio that has performed well over time. Looking at the chart on the upper left, you can see our performance over the past 5 quarters. We delivered $86 million in net investment income in the third quarter, an $8 million increase from last year. The increased returns were driven by our diversified alternative investment portfolio, which outperformed our expectations for the quarter. The core portfolio produced slightly higher net investment income this quarter as the higher investment base was partially offset by a slightly lower rate.

Overall, in the third quarter, the portfolio delivered a pretax equivalent annualized book yield of 5.8%, 50 basis point higher than the same period last year.

On the bottom of the page, we've broken out the portfolio by investment type and provided the fixed maturity ratings. The portfolio remains conservative in nature with more than 75% of the portfolio comprised of fixed maturities and of those, 90% are investment grade.

On Page 11, we highlight our strong capital and liquidity [Audio Gap] financial flexibility. In the chart in the upper left-hand corner, you can see our parent company liquidity. At quarter-end, we had ample liquidity with $188 million in cash and investments as well as $384 million in borrowings available from our revolver and the insurance subs.

Transitioning to capital, the chart in the upper right shows our insurance groups continue to be well capitalized at levels that exceed our rating requirements.

Finally, our book value per share, excluding unrealized gains on fixed maturities, was $35.87, up 2% from $35 at year-end.

On Page 12, we have outlined our capital deployment priorities. Our first priority is to invest in the business, which we accomplish by either funding profitable organic growth at appropriate risk-adjusted returns or making strategic investments in acquisitions that enhance the business and meet or exceed our ROE targets over time.

Our second priority is to return capital to shareholders. If there is capital that we don't think we will deploy in an appropriate time period, we will look to repurchase shares opportunistically and to maintain competitive dividends.

Last, I want to touch on 2 subsequent events. The details are on Page 13. The first item is the California Wildfires. The company expects that catastrophe losses and loss adjustment expenses that it has incurred from these wildfires in the fourth quarter will be significant and have the potential to trigger recoveries under the company's catastrophe reinsurance program. It is still early. We're still receiving loss reports and are in the early stages of the adjustment process. As such, it is too early to assign and provide an initial estimate.

The second item is the arbitration ruling announced earlier this month, where we were awarded damages of $84 million. As permitted under the award, we subsequently petitioned for prejudgment interest at an annual rate of 9% and the reimbursement of legal fees and costs. We expect the arbiter to enter a final award before the end of the year. We are accounting for the award as a gain contingency.
With that, I am pleased to turn the call back to the operator to take your questions. Operator?

# Question and Answer

**Operator**

[Operator Instructions] The first question comes from Paul Newsome with Sandler O'Neill.

**Jon Paul Newsome**
*Sandler O'Neill + Partners, L.P., Research Division*

I want to ask about the top line growth and maybe just a little bit more about why it should be profitable growth and maybe a little bit more about specifically where it comes from, particularly, geographic region, et cetera, in the nonstandard business?

**Joseph P. Lacher**
*Chief Executive Officer, President and Director*

Sure, Paul. Chip and I will tag team this one. Thank you for your comments. I would've felt better if you hadn't said it was amazingly good, but the growth is -- unit growth that we're seeing, the big chunk of it is coming from California and we're highly confident that it's profitable because the book right now is highly profitable and it's very consistent profile to what we've been seeing coming in. There is not much we've meaningful changed in that underlying new business. There's a couple of other geographies that are generating it. But overall, very confident.

**George D. Dufala**
*Senior Vice President and President of Property & Casualty Division*

Paul, this is Chip. I agree with Joe. We continue to take rate as appropriate. We've done a lot of work with our underwriting guidelines and in our claims organization as we've continued to fine-tune it has enabled us to continue to grow profitably [Audio Gap] in terms of rate growth, probably 2/3 of that's coming from rate and then probably another 1/3 is coming from unit growth.

**Jon Paul Newsome**
*Sandler O'Neill + Partners, L.P., Research Division*

Fantastic. I'm afraid you're cutting out, I don't know if it's cutting out for other people as well. But I did have a second question. I wanted to ask about the expense ratio in the quarter for the Property & Casualty side of the house. It was also a little bit lower than I expected and wanted to know if there was anything in there that was of onetime nature or if that was a reasonable run rate as we think about perspectively?

**Joseph P. Lacher**
*Chief Executive Officer, President and Director*

Yes. Paul, I'll apologize. We've got a set of mics in here that keep losing their Bluetooth connection. So it's a comedy to watch as we're jumping up and down trying to figure out which mic is actually working at the moment. So my apologies to everybody on the call. From an expense perspective, I mentioned earlier that we're $5 million ahead of our $20 million commitment for 2017 expense reduction. And we're largely pushing those expenses off the board. There's nothing particularly unusual in there. It's just the result of us continuing to work, sort of looking at every nickel and squeezing out fat.

**Operator**

The next question comes from Bob Glasspiegel with Janney.

**Robert Ray Glasspiegel**
*Janney Montgomery Scott LLC, Research Division*

The 85% I heard was fantastic. Hopefully, the transcriber got it. But maybe, you might want to submit the rest to the services or to put it on the website.

**Joseph P. Lacher**
*Chief Executive Officer, President and Director*

Yes, we'll get the written version of the transcript guys for what we missed. Again, our apologies.

**Robert Ray Glasspiegel**
*Janney Montgomery Scott LLC, Research Division*

No, the gist I think we could follow it pretty carefully. So you did a good job on that. You said you want to continue the profit restoration at Alliance United, suggesting you're not quite ready to declare victory. I mean, those are pretty solid results in that line. What more needs to be done before you can declare victory?

**Joseph P. Lacher**
*Chief Executive Officer, President and Director*

Yes, if I described it that way, Bob, then I picked the wrong word or I stepped over myself. I think we've definitely concluded that we've successfully restored the profitability in Alliance United and we're focused on profitably growing that business.

**Robert Ray Glasspiegel**
*Janney Montgomery Scott LLC, Research Division*

How fast could you grow it in the current environment, assuming that it is fixed?

**Joseph P. Lacher**
*Chief Executive Officer, President and Director*

My sense -- a little bit, and we got -- actually almost had a challenge in the other direction. I think we applied 3 doses of antibiotics and maybe we only needed 2. So we've got to tweak that a little bit, some of the profitability improvement actions may still be rippling through. And we've got to work on shifting ourselves towards growth. The -- believe we had high single-digit unit growth in the quarter there and anticipate that we could do better than that. And we're upon the appropriate levers to sort of shift directions. We definitely think it will be above marketplace growth.

**Robert Ray Glasspiegel**
*Janney Montgomery Scott LLC, Research Division*

By first quarter next year, you think, or soon?

**Joseph P. Lacher**
*Chief Executive Officer, President and Director*

I think it's above market now. And I think we can improve on where we are.

**Robert Ray Glasspiegel**
*Janney Montgomery Scott LLC, Research Division*

Great. On the California fire, I assume it's homeowners mainly or there are some other lines that seeps in? What was your exact wording, could hit your -- top of your retention or is likely to? What was the wildfire?

**Joseph P. Lacher**
*Chief Executive Officer, President and Director*

Bob, the comments that I made is that it has the potential to, which I think if we're [Audio Gap]

**Operator**

[Operator Instructions] The next question comes from Matthew Carletti with JMP Securities.

**Joseph P. Lacher**
*Chief Executive Officer, President and Director*

Matt, why don't you hold on a second. Let us finish answering Bob's. We were -- again, these -- we're getting new mics. We had a big quarter. We are buying new microphones. Jim and I were tag teaming. The comment was, we said potentially hit the retention. So not trying to be parse words or be too cute on it. But it could hit the retention. It's early, it's early in the process. We are still getting claims. It is principally a homeowners' event. They'll, I'm sure, will be some modest number of autos in there, but it is a principally a homeowners issue. And Bob, jump back in if I missed a part of that. Go ahead Matt.

**Matthew John Carletti**
*JMP Securities LLC, Research Division*

First, I have a couple of questions. The first is on preferred auto. Chip, I think you made the comment that you're still kind of working through a few more quarters of improvement there. What would you view as kind of a target combined ratio level, kind of how when you look at nonstandard and say we're kind of there back to growth mode? Kind of where you do you think we get to in preferred before you kind of feel comfortable, kind of feel in the same way?

**George D. Dufala**
*Senior Vice President and President of Property & Casualty Division*

Matt, we're really targeting where I'd like to be is in the mid-90s, mid- to high 90s combined. You work within a 10% to 12% ROE [Audio Gap] Matt, I'm sorry. It looks like we lost you there. To make sure that you heard my answer...

**Matthew John Carletti**
*JMP Securities LLC, Research Division*

Yes, I got you. Right after 12% ROE, it cutout.

**George D. Dufala**
*Senior Vice President and President of Property & Casualty Division*

Okay. And so we generally like to target a 96% to 97% combined ratio for that business. And if we can hit that, we will be very pleased.

**Matthew John Carletti**
*JMP Securities LLC, Research Division*

Okay, great. Then on commercial auto, the kind of the underlying was -- you took an uptick in the quarter, ran a little hot. Just -- what was going on there, anything in particular? I know it's a smaller segment.

**George D. Dufala**
*Senior Vice President and President of Property & Casualty Division*

We continue to see noise with [Audio Gap] Matt, I lost you there again. Our apologies. Essentially, what you're seeing in commercial auto is as we've looked at that book and we've spent a lot of time with the claims team of adjusting the losses, looking at some of the claims that we already have on the books. We've seen a little noise in those numbers. That, again, as Joe had mentioned, regarding our other lines of business, that's not unexpected. And there was just a little prior year development there.

**Matthew John Carletti**
*JMP Securities LLC, Research Division*

Got you. And then last question, sticking on that business. Longer term, do you view commercial auto as kind of a core business to Kemper? Should we expect you to grow it? Is it not a core business and stay tuned?

**George D. Dufala**
*Senior Vice President and President of Property & Casualty Division*

At this time, it's really kind of to be determined. It's something that we feel makes sense. We continue to watch it. It presents an opportunity. We don't want to close any doors as we've transformed as an organization. We feel there's a good connection there potentially to nonstandard auto and we want to just have those options available to us.

**Operator**

The next question comes from Ron Bobman with Capital Returns Management.

**Ronald David Bobman**
*Capital Returns Management, LLC*

I had a question about the wildfires. And I understand its early days and it's still developing as far as information is concerned. But as it relates to your reinsurance program, is it crystal clear that the fires are considered one event, multiple events? Is there some degree of uncertainty in that regard or not?

**Joseph P. Lacher**
*Chief Executive Officer, President and Director*

Ron, this is Joe. Our reinsurance programs [Audio Gap] Sorry, blipping in and out. Our reinsurance programs have a clear definition in them around the timing and geographic distance. I believe we have a 250-mile radius and 168 hours and the contract allows us to pick the center of that event and it picks the start time. So we'll go through the process of looking where our losses are and determining the optimal start and stop of that.

**Ronald David Bobman**
*Capital Returns Management, LLC*

And just so I cut to the chase, it sounds like, I'm sure you've done some preliminary review that you're, whatever, highly confident or very confident that it is going to be largely considered one event as far as -- in effect where retentions are concerned?

**Joseph P. Lacher**
*Chief Executive Officer, President and Director*

We do not see anything that would suggest that we could possibly have a number big enough to pierce 2 retentions.

[Audio Gap]

I'm back. We do not have anything to suggest we could pierce 2 retentions. So it's possible there could be some losses from the fire that if I'm making up numbers now illustratively. But if we had a number that went through the retention and had numbers that went against the reinsurance treaty, it's possible there could be some losses that were outside of that treaty. They maybe outside of the 250 mile radius or outside of the 168 hours. The bulk of what we would expect would be inside of that range.

**Ronald David Bobman**
*Capital Returns Management, LLC*

Okay. So it can only be marginally adverse, not all that material? I think it's what you said [indiscernible]

**Joseph P. Lacher**
*Chief Executive Officer, President and Director*

I would not think it would be materially outside of that. There could be marginal items. That's the right way to think about it.

**Operator**

This concludes our question-and-answer session. I would like to turn the conference back over to Joe Lacher for any closing remarks.

**Joseph P. Lacher**
*Chief Executive Officer, President and Director*

Thank you, operator. And before I sign off, I just want to provide you a couple of quick closing comments. First, you should expect that next quarter's earnings will be $500 down because we're buying new microphones. Beyond that, overall Kemper had a strong quarter. It was our fifth consecutive quarter of improved underlying operating performance. While we recognize we still have work to do before achieving target profitably and optimize growth across each of our businesses, we're pleased with the significant progress we've made on our turnaround. We continue to attract and retain exceptional talent, who want to play a leadership role in reenergizing Kemper and building something great. We're focused on building a premier nonstandard auto franchise and our strong results demonstrate our progress in this initiative. In preferred auto, we're pleased with the impact of the profitability improvement actions we initiated in the fourth quarter of last year and they're materializing as promised. Our Life & Health business continues to perform well with higher net income and earned premiums in the quarter and our investments function remains a source...

[Audio Gap]

Our investment income function remains a source of strength and -- as indicated through this quarter's results. Thanks for your time today, and thanks for your interest. I apologize again for the telecommunications problems and we appreciate your patience. We look forward to updating you again next quarter.

**Operator**
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.