S&P Capital IQ

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Cincinnati Financial Corporation NasdaqGS:CINF

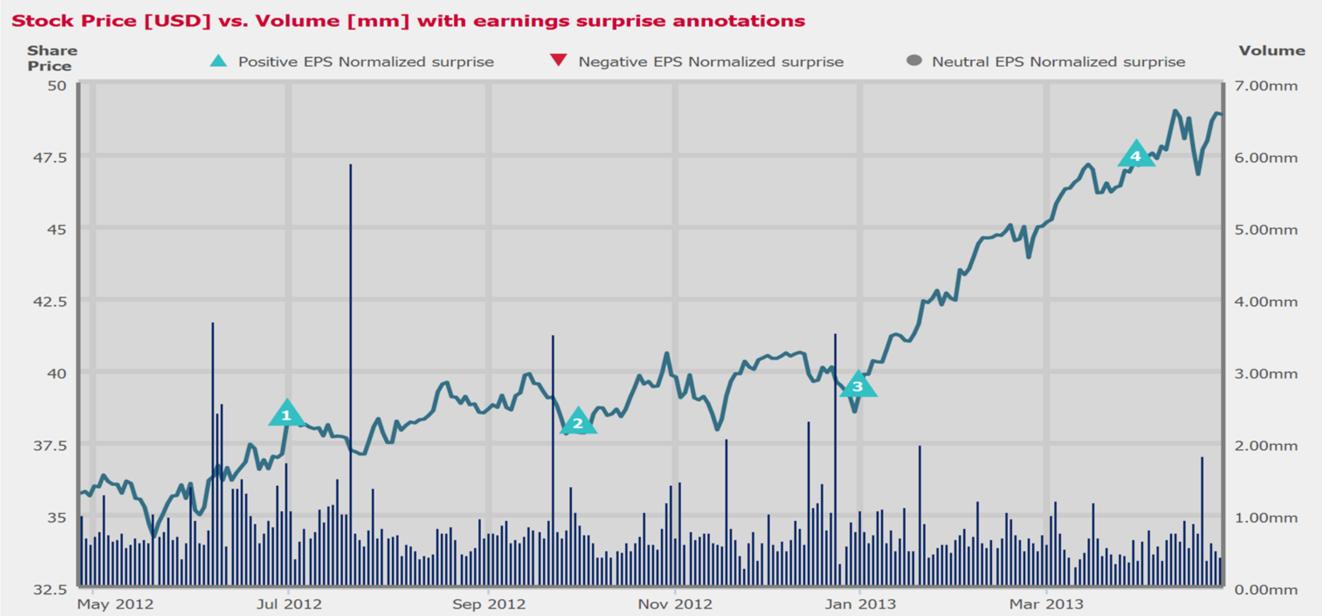
FQ2 2013 Earnings Call Transcripts

Friday, July 26, 2013 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2013-			-FQ3 2013-	-FY 2013-	-FY 2014-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.42	0.61	▲45.24	0.48	2.33	2.33
Revenue (mm)	1106.00	1104.00	▼(0.18 %)	1124.61	4461.40	4861.19

Currency: USD
Consensus as of Jul-25-2013 11:36 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2012	0.12	0.17	▲41.67 %
FQ3 2012	0.41	0.64	▲56.10 %
FQ4 2012	0.44	1.11	▲152.27 %
FQ1 2013	0.65	0.78	▲20.00 %

Call Participants

EXECUTIVES

Dennis E. McDaniel
Vice President and Investor Relations Officer

Jacob F. Scherer
Former Chief Insurance Officer

Martin Francis Hollenbeck
Chief Investment Officer, SVP, Asst. Secretary, Asst. Treasurer and President of CFC Investment Co.

Martin Mullen

Michael J. Sewell
Chief Financial Officer, Senior Vice President and Treasurer

Steven J. Johnston
Chief Executive Officer, President, Director and President of Cincinnati Life Insurance Company

ANALYSTS

Joshua David Shanker
Deutsche Bank AG, Research Division

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Presentation

Operator

Good morning my name is Amy and I will be your conference operator today. At this time I would like to welcome everyone to the Cincinnati Financial Second Quarter Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks there will be a question-and-answer session. [Operator Instructions]

I will now turn the call over to Dennis McDaniel, Investor Relations Officer. You may now begin.

Dennis E. McDaniel
Vice President and Investor Relations Officer

Hello. This is Dennis McDaniel of Cincinnati Financial. Thank you for joining us for our second quarter 2013 earnings conference call.

Late yesterday we issued a news release on our results, along with our supplemental financial package, including our quarter-end investment portfolio. To find copies of any of these documents please visit our Investor website, cinfin.com/investors. The shortest route to the information is the quarterly results link in the navigation menu on the far left.

On this call you'll first hear from Steve Johnston, President and Chief Executive Officer; and then from Chief Financial Officer, Mike Sewell. After their prepared remarks, investors participating on the call may ask questions. At that time some responses may be made by others in the room with us, including Executive Committee Chairman, Jack Schiff, Jr.; Chairman of the Board, Ken Stecher; Chief Insurance Officer, J.F. Scherer; Principal Accounting Officer, Eric Matthews; Chief Investment Officer, Marty Hollenbeck; and Chief Claims Officer, Marty Mullen.

First please note that some of the matters to be discussed today are forward-looking. These forward-looking statements involve certain risks and uncertainties. With respect to these risks and uncertainties we direct your attention to our news release and to our various filings with the SEC.

Also a reconciliation of non-GAAP measures was provided with the news release. Statutory accounting data is prepared in accordance with statutory accounting rules, and therefore is not reconciled to GAAP.

With that I'll turn the call over to Steve.

Steven J. Johnston
Chief Executive Officer, President, Director and President of Cincinnati Life Insurance Company

Good morning and thank you for joining us today to hear more about our second quarter results. We are pleased to report our best second quarter operating results in several years and solid first half 2013 performance. The results reflect the benefits of ongoing initiatives that aim to improve insurance profitability, drive premium growth and create shareholder value over time.

With our second quarter combined ratio of 96.4%, our year-to-date combined ratio is 93.9%, in the range of the sub 95% we are aiming for. Our lower catastrophe losses helped our results. Our combined ratio before catastrophe losses also improved for the first half of 2013. We remain confident that our loss reserve position continues to be well into the upper half of the actuarial range of estimates.

We achieved the premium growth we expected for the first half of the year. Each of our property casualty segments grew as they benefited from greater pricing precision and higher pricing overall.

Commercial policies that renewed during the second quarter continued to average price increases in the mid single-digit range, keeping pace with the first quarter. Increases on our smaller commercial property policies again reached the low double-digit range. Personalized policies that renewed in the second quarter also averaged a price increase in the mid single-digit range with home owner policies continuing in the high single-digit range.

Our excess and surplus line segment experienced higher renewal prices for the 34th consecutive month, continuing at a low double-digit range. We continue to believe that our new business written premium growth reflects both the higher pricing we are able to get in the marketplace as well as the cumulative effect of growth initiatives.

Our pricing analytics and modeling tools continue to give us confidence in the level of our new business pricing. We are seeing good growth from newer agents in addition to ones that have represented us for decades. Likewise, we see growth in newer states in addition to our more established areas of operation.

Property casualty agency appointments are going well. We have appointed 63 new agencies as of June 30th and now estimate that we will exceed our initial 2013 goal of 65 agencies by about 15.

Our life insurance segments earned premium growth slowed during the second quarter. The primary driver was the effect of unlocking of interest rate assumptions for certain universal life insurance products. For all of our insurance segments we are careful to grow premiums only when we believe profitability is adequate. The quality of our recent growth has been as expected with overall pricing ahead of our loss cost trends.

The second quarter produced investment income that nearly matched the same quarter a year-ago despite a drop in interest income. Our primary measure of financial performance, the value creation ratio is on good pace for 2013. Our Chief Financial Officer, Mike Sewell will now discuss that further along with other financial items.

Michael J. Sewell
Chief Financial Officer, Senior Vice President and Treasurer

Thank you, Steve and thanks to all of you for joining us today. Our 6.4% year-to-date value creation ratio is on track to reach our annual target range and is well head of last year. That rate includes negative four-tenth of a percent for the second quarter due to the negative 3.2% effect of the bond portfolios' lower valuation as a result of rising interest rates.

Our company continues to benefit from our equity investing strategy during periods of rising interest rates or when investment income is pressured by low interest rate environment. The stock portfolio grew during the second quarter, with pretax net unrealized gains of $38 million to over $1.4 billion. Dividend income was up 11% for the quarter and 8% for the first half. Equity securities at quarter end fair value represented 30% of invested assets and there is some room for that percentage to increase.

The bond portfolios pretax unrealized gains declined $282 million during the quarter. Yields for our bond portfolio continue to move lower as the second quarter 2013 pretax yield of 4.92% fell 23 basis points from a year ago. That contributed to a 3% second quarter decline in interest income. Our bond portfolios effective duration measured 4.4 years at the end of the quarter, up 4.2 years at the end of 2002 (sic)

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Cash flow from operating activities continues to benefit investment income. At $251 million for the first half of 2013 net operating cash flow is within $14 million of last year’s first half, after paying an additional $139 million this year for income taxes.

Looking at our balance sheet, capital remains strong and reserve development on prior accident years during the quarter was at a typical level. The second quarter benefited from 10.1 percentage points of net favorable reserve development compared with 10.4 points a year ago.

Every major line of business contributed to the quarter’s favorable development. Our 6 month net favorable development was again spread over several accident years, including 53% for accident year 2012, 28% for accident year 2011 and 19% for all older accident years.

As always we prudently manage expenses. Our second quarterly property casualty underwriting expense ratio rose 0.4 percentage points primarily due to higher commissions to agents. We continued to maintain financial strength and liquidity. Cash and marketable securities at the parent company reached more than $1.3 billion at June 30, up 16% from the end of last year.

Our premiums to surplus ratio remain at 0.9 to 1 reflecting strong capital with capacity to support continued premium growth in our insurance segments. I will conclude my prepared comments by summarizing the contributions during the second quarter to book value per share. Property casualty underwriting increased book value by $0.14. Life insurance operations added $0.08. Investment income other than life insurance and reduced by non-insurance items contributed $0.53.

The change in unrealized gains at June 30th for the fixed income portfolio, net of realized gains and losses lowered book value per share by $1.12. The change in unrealized gains at June 30th for the equity portfolio net of realized gains and losses increased book value by $0.20 and we paid $0.4075 per share in dividends to shareholders. The net effect was a book value decreased $0.58 during the second quarter to $34.83 per share.

And with that I will turn the call over to Steve.

Steven J. Johnston
Chief Executive Officer, President, Director and President of Cincinnati Life Insurance Company

Thanks Mike. Our improved results in recent quarters are encouraging and the company's performance is being recognized. We were again recognized as one of Ward's 50 top performing P & C insurers based on safety, consistency and superior performance over a 5-year period ending 2012.

And during the second quarter our credit and financial strength ratings were affirmed by Fitch, Moody's and S&P. Moody's also upgraded its outlook on our ratings to stable. We will continue efforts to improve performance, fulfilling our insurance promises to policy holders and providing outstanding service to agents as we add value for shareholders.

I want to acknowledge the hard work and accomplishments of our independent agents and our associates. During the second quarter we wrapped up over 20 meetings with agents across the United States. Next month when all of our field associates meet in Cincinnati we will continue the discussion about how we can further improve service and performance.
We appreciate this opportunity to respond to your question and also look forward to meeting in person with many of you throughout this year. As a reminder with Mike and me today are Jack Schiff Jr., Ken Stecher, J.F. Scherer, Eric Matthews, Marty Mullen and Marty Hollenbeck. Amy we're ready for you to open the call for questions.

Question and Answer

Operator

[Operator Instructions] Your first question comes from the line of Josh Shanker from Deutsche Bank. Your line is open.

Joshua David Shanker
Deutsche Bank AG, Research Division

I wanted to ask for questions about home owners. Growth was quite strong, and I wanted to know first-off if we could parse that into unit volume in traditional territories unit volume and new territories and rate. And two, talk about whether or not there is lack of viable options for home owners and that's becoming a big opportunity for Cincinnati.

Jacob F. Scherer
Former Chief Insurance Officer

Josh, this is JF. I guess to put into perspective, unit volume for us, since January of '09, just to give you an idea, we're up 24% in home owner policy count, we are up 35% in private passenger auto policy count and we've gone and this is something to consider as well. We've gone from 73% of our book of business being packages, both the home and the auto, up to 81%.

We have been pretty strong with our agents that if we can't write the auto with the home owners we're not interested. So on new business, it would be a rare situation, that situation might be that we write the commercial, the private passenger autos under the commercial lines, where we are requiring the private passenger auto. So that can have a way of muting a little bit of the home owner growth, overall maybe another item, in terms of rates, and we have been increasing rates. Over the past 15 quarters we've increased home owner rates by 43.4%.

Now we have increased them more than that in some of the mid-western states, for example Ohio was 51.4%. So and that includes rate increases that would go into effect a little later this year. So and one other item in terms of growth, just for purposes of personal lines, we have appointed 558 -- over that same period of time, 558 new locations to represent us in personal lines, 214 of which were commercial lines agencies because they have a greater appreciation for our technology and how we can help them issue the policies have started writing business with us.

So we have a -- I think we have a lot of good things going, the increases certainly on a percentage basis from newer states for us has been strong. But we're continuing to write business in the Ohios, Indianas and the Illinois, but we are a lot more pleased with the growth, with the rate levels that we're at.

Couple of things have happened this year. I think as mentioned before April the first we strengthened our underwriting requirements. We've required higher deductibles on home owners on all new business. We've also added actual cash value endorsement to the home owner policy if the [roofs] are 15 years or older. We're not writing shake shingles for example. So we are managing rooftops a little stronger and I think that has had the tendency as we would have expected it to, to mute the new business in the second quarter.

So between rate increases, tougher underwriting and, a third thing, a lot more inspections we're going to be inspecting over this year and the next 2 years 300,000 structures in personal lines for us to verify the condition of the property. Add it all together I think we're comfortable we're going to have a more profitable book of business. And secondly it is going to have an effect of slowing growth down just a little. I hope that wasn't more than you we're asking for, but that gives you a little bit of an overview of how we're doing in home owner.

Joshua David Shanker
Deutsche Bank AG, Research Division

More is always is better. And on these inspections are they, obviously there is going to be lot of things. But is roof a particularly important part of this inspection process or what are you really trying to get at?

Jacob F. Scherer
Former Chief Insurance Officer

Roof is a significant part of it. We had some of our employees that do those inspections, but vendors that we've hired to do them with a specific focus on roofs. They are actually taking with them cameras that can zoom in on it, pictures of the shingles and the best they can verifying how old the shingles are. But we're also looking for overall condition of property, whether it's casualty, cracked sidewalks, things of that nature, dogs that we didn't know about, wood burning stoves, verifying the protection class the property is in. Sometimes we have it as a better protection class than it's actually in. So it's across the board, pictures front and back, pictures of every deficiency, very thorough, but we were pleased with how our agencies approach doing business with us, but we are verifying everything right now.

Joshua David Shanker
Deutsche Bank AG, Research Division

And on the investment portfolio, I was actually surprised a little bit at the book value shrinkage. I look at your investment portfolios more resilient than peers, but it was kind of at a peer level. Is there any reallocation that's going on in your mind with the 2Q surge of interest rates and thinking about the next 18 months out.

Martin Francis Hollenbeck
Chief Investment Officer, SVP, Asst. Secretary, Asst. Treasurer and President of CFC Investment Co.

Josh, it's Marty Hollenbeck. Not really we actually welcome a gradual rise in interest rates. I mean it spiked a bit in the second quarter, but we still like to see it work its way up further. Obviously the balance sheet takes a quick hit, takes along for the income statement to get the benefits of that, but nonetheless we would welcome it.

Our bond portfolio I don't think, to be honest with you, took as big a hit as you might think into book value. I mean we have a pretty generous dividend, which comes out of that as well. We have a slightly higher duration but we have less allocated to fixed income and certainly as a percentage of our shareholders equity that is the case. So we are not doing anything dramatically different going forward, corporate bonds, municipal bonds and dividend-growing stocks are still our favorite asset classes.d

Operator

Your next question comes from the line of Scott Heleniak of RBC Capital Markets.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

I was just wondering if you could touch on the new business growth. It was good in the quarter I guess it was down a little bit, the pace, but I was just wondering if you could touch on that? Was there certain areas, more so than others, where you decided to dial back on and if you could just talk about that a little bit?

Steven J. Johnston
Chief Executive Officer, President, Director and President of Cincinnati Life Insurance Company

Yes, Scott, as already mentioned on home owners we expected the new business to moderate a little bit on that, and consequently, since we are only accepting packages, private passenger auto. Otherwise no, actually there are timing differences and booking differences. And so I think the best way to look at all of this is over the first 6 months of the year. But frankly it's going along as planned. We projected out to the end of 2015 to be a $5 billion company and that does just keep in mind does include life insurance, but the kind of new business that we expected to write, we are actually little bit ahead of plan on it.

The only thing I would say that was somewhat remarkable in the second quarter was the level of competition on larger accounts. They always draw a crowd that's not surprising, but we saw a bit of a, I guess a bit of a tick up in terms of the aggressiveness of the marketplace in that area. After we really dug into it turned out not to be as remarkable as we thought, but I guess that's just, I suppose, worth mentioning. So across the lines of business we write packages. So we are not writing or targeting commercial auto or workers comp or something of that nature, but all-in-all I have to say we finished the quarter and pleased with what we saw.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

And what is the pricing differential, you mentioned large account business what's the pricing differential between your sort of core small to mid-account customer than a large account customer? What kind of -- where is pricing for the large account business that you were talking about? Is that kind of just low single digits?

Steven J. Johnston
Chief Executive Officer, President, Director and President of Cincinnati Life Insurance Company

No it's little bit better than that I would say overall a little below 5%, I suppose, with the smaller accounts up towards 10%.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Okay. And then just wondering if you could talk about the E&S business obviously everyone is talking about how more business is coming into E&S and just wondering if you guys could touch on just the opportunities now that Cincinnati has versus a couple of years ago and maybe there is an opportunity to grow that at a faster rate than maybe you thought?

Steven J. Johnston
Chief Executive Officer, President, Director and President of Cincinnati Life Insurance Company

Well what we are seeing in our book and keep in mind we are pretty conservative in our underwriting appetite. I think there is fair amount of business that's on the fringe that kind of floats back and forth between the standard market and the E&S market. What we have seen in that area, larger accounts we have seen a lot of competition from standard carriers. And so we've lost a few accounts in that regard. We are not seeing it from other ENS carriers in terms of the competition. So that was a noticeable really through the first 6 months of this year.

We still think we have a great opportunity. I can't say that we've seen anything in the way the market has changed, that has caused us to think this is really going to -- the doors are really going to fly open and some business is going to come in. Still deliberate, we are still trying to be pretty conservative about what we do. And so as a general statement we're seeing some standard market players take some business out. But other than that it's been pretty steady for us.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Okay. So just kind of tracking along as planned then I guess. Okay and then the only other question I had was you guys mentioned equity as being 30% of invested assets, and I'm just wondering, you said there is a little bit of room to move that higher, and what did you have in mind as far as how much higher? Is there new policy on that as far as how high they can go?

Martin Francis Hollenbeck
Chief Investment Officer, SVP, Asst. Secretary, Asst. Treasurer and President of CFC Investment Co.

Scott, it's Marty Hollenbeck. There is a lot that goes into that decision. We look at, really from the bottom up by entity, by company in regards to regulatory issues, tax issues, et cetera. We don't have a hard target. Obviously the last few years equities of the type we buy have been very attractive just on a pure income basis. And they're still relatively still by historical standards. We're not looking for a large scale bump up. I think we were just trying to convey the fact that we had not reached a maximum there. We do have some room.

Operator

[Operator Instructions] Your next question comes from the line of Vincent DeAugustino of KBW.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Just to start off, a question for Marty Hollenbeck and Marty Mullen. Curious if you guys have had any good debates lately on interest rates versus loss cost trends and the relationship there and just how you are feeling about those looking out?

Martin Francis Hollenbeck
Chief Investment Officer, SVP, Asst. Secretary, Asst. Treasurer and President of CFC Investment Co.

It's Marty Hollenbeck, I will go first. Again with the influence that the fed has, we just don't see interest rates dramatically galloping from here. I mean we had a nice spike. Frankly the equity markets are up, since this whole thing started. But we don't see rates taking off any time soon. Inflation appears to be under control, looking out past 3 years is probably not worth the time to spend on it at this juncture.

So we see a slow drift up, but not a considerable move in interest rates and this is on the investment side. Marty can comment on the claim side.

Martin Mullen

Sure. Thank you, Marty. Marty Mullen, Vince. Mainly focusing on certain initiatives within different avenues of our operation, in particular for instance work comp, we're focusing on medical spend and the consolidation of vendors and we're really focusing on work comp specialization, which I think is really proving beneficial.

In addition to that, on the property side, we've identified large property specialists that are now responding to large commercial and home owner fires in an effort to first of all bring that Cincinnati service firsthand up to a large policy holder, but also cut down on the expenses incurred with adjusting those types of fees. So those are just couple of examples of special initiatives we have in place.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Okay, perfect. And then just on our side, about a month ago we hosted a call on predictive claims initiatives with the way [ph] consulting. And the key takeaway for us is that underwriting margins you can potentially get up worth of 5 points or better with the implementation of predictive claims tools. And from what I recall I think that was something that had interested you guys as a future upgrade on top of what you've done from the predictive pricing tool side. So I am curious if that might still be on the horizon and if it's something that we might expect to see within the next 2 or 3 years?

Steven J. Johnston
Chief Executive Officer, President, Director and President of Cincinnati Life Insurance Company

Yes this is Steve. And that is we agree with you 100% on the importance of that, the potential benefits. And we are definitely into that. It's fallen within Marty Mullen's area and our actuarial group. And we agree that we see that as a very important initiative that we can put in place and one that's got a lot of room yet to help with the lost cost trends. And I don't if Marty wanted to add anything in addition to that.

Martin Mullen

Sure thanks, Steve. Vince, our first foray into that is going to be in work comp and our predicted analytics approach at forecasting outcomes based on the type of information received initially at the outset of the call -- of the claim and we hope to have our first implementation of that by the end of third quarter or fourth quarter this year. So we're pretty excited about that opportunity.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Great. So that's actually a lot closer than I was expecting, perfect.

Operator

There are no further questions at this time. I turn the call back over to the presenters.

Steven J. Johnston
Chief Executive Officer, President, Director and President of Cincinnati Life Insurance Company

Well Amy, thank you. Thank you for moderating the call. Thanks to all of you for joining us today. We look forward to speaking with you again on our third quarter call if not the fourth. Have a great day.

Operator
And this concludes today's conference call. You may now disconnect.