S&P Global
Market Intelligence

# Kemper Corporation NYSE:KMPR

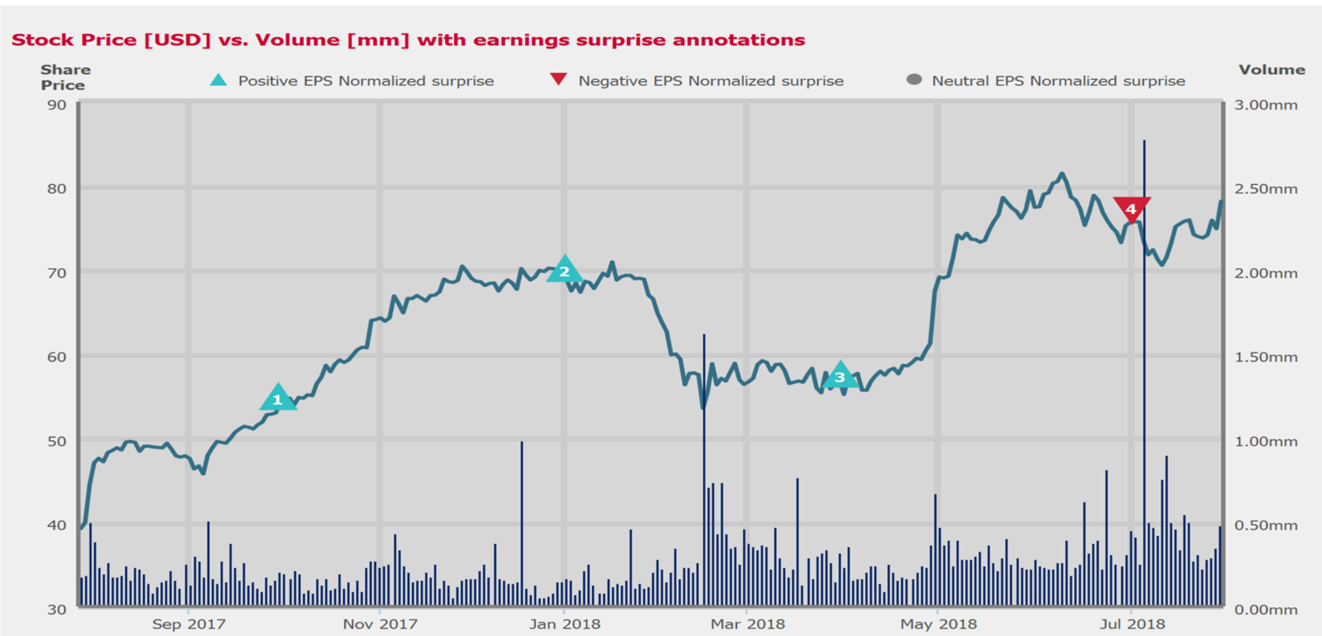
# FQ3 2018 Earnings Call Transcripts

## Monday, November 05, 2018 9:15 PM GMT

## S&P Global Market Intelligence Estimates

| | -FQ3 2018- | | | -FQ4 2018- | -FY 2018- | -FY 2019- |
|---|---|---|---|---|---|---|
| | CONSENSUS | ACTUAL | SURPRISE | CONSENSUS | CONSENSUS | CONSENSUS |
| **EPS Normalized** | 1.29 | 1.59 | ▲23.26 | 1.47 | 4.49 | 5.22 |
| **Revenue (mm)** | 1069.23 | 1182.70 | ▲10.61 | 1187.00 | 3749.60 | 4790.13 |

Currency: USD
Consensus as of Nov-05-2018 3:39 PM GMT




| - EPS NORMALIZED - | | | |
|---|---|---|---|
| | CONSENSUS | ACTUAL | SURPRISE |
| **FQ3 2017** | 0.28 | 0.85 | ▲203.57 % |
| **FQ4 2017** | 0.30 | 0.60 | ▲100.00 % |
| **FQ1 2018** | 0.74 | 1.10 | ▲48.65 % |
| **FQ2 2018** | 0.74 | 0.70 | ▼(5.41 %) |

# Table of Contents

# Call Participants

## EXECUTIVES

**Duane A. Sanders**
*Senior VP and President of Property & Casualty Division*

**James J. McKinney**
*Senior VP & CFO*

**John Michael Boschelli**
*Senior VP & Chief Investment Officer*

**Joseph Patrick Lacher**
*President, CEO & Director*

**Michael A. Marinaccio**
*Investor Relations*

## ANALYSTS

**Adam Klauber**
*William Blair & Company L.L.C., Research Division*

**Charles Gregory Peters**
*Raymond James & Associates, Inc., Research Division*

**Christopher Campbell**
*Keefe, Bruyette, & Woods, Inc., Research Division*

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

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

**Unknown Analyst**

# Presentation

**Operator**

Good afternoon, ladies and gentlemen, and welcome to Kemper's Third Quarter 2018 Earnings Conference Call. My name is Brandon, 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 call, Michael Marinaccio, Kemper's Vice President of Corporate Development and Investor Relations. Mr. Marinaccio, you may begin.

**Michael A. Marinaccio**
*Investor Relations*

Thank you, Brandon. Good afternoon, everyone. And welcome to Kemper's discussion of our third quarter 2018 results. This afternoon you'll hear from Joe Lacher, Kemper's President and Chief Executive Officer; Jim McKinney, Kemper's Senior Vice President and Chief Financial Officer; and Duane Sanders, Kemper's Property & Casualty Division President. We'll make a few opening remarks, provide context around our third quarter results and then we'll open up the call for a questions-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 earnings release and published our third quarter 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 at kemper.com. Our discussions 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 2017 Form 10-K as well as our third quarter 2018 Form 10-Q and earnings release. 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. You can find each of these documents on the Investors section of our website at kemper.com. Finally, all comparative references will be to the third quarter of 2017, unless otherwise stated.

I'll now turn the call over to Joe.

**Joseph Patrick Lacher**
*President, CEO & Director*

Thanks, Mike. And good afternoon, everyone, and thank you for joining us on the call. Before we get into the specific discussion of our results, I want to give you some overall color commentary. We had a great quarter and one as an organization that we're particularly pleased with. We had strong earnings and significant organic growth, particularly inside our specialty auto business, with double-digit increases in policies in force.

We also had a series of one-time items this quarter that impacted results. I mention them, because they're examples of our commitment to look at every aspect of our business in order to unlock value. These weren't merely fortuitous. They were a testament to our focus, specifically our relentless execution on looking for ways to create that value. We did all of that while closing a major transaction by acquiring Infinity and paying close attention to all phases of its integration.

The quarter had a lot of moving parts, and our team did a great job juggling all of those balls and producing great financial results. I want to pause for a moment and thank all of our employees for their dedication and hard work that enabled the success.

Now turning to the presentation, if you'll indulge me for minute I'm going to talk through a couple page we've reviewed before. I know we have a number of new or potential investors listening, and it's useful to remind everyone of our strategy and focus for value creation. In the rest of the presentation you'll see evidence of our successful execution on that strategy.

Beginning with Page 3, Kemper is a leading specialized multi-line insurer providing specialty auto, preferred home and auto, and basic life, accident and health products. We continue to maximize the benefits of our diversified platform to create more long-term value for our stakeholders. Our insurance subsidiaries are highly rated. We have a distribution network consisting of 2,200 career agents and approximately 30,000 independent agents.

Continuing to Page 4, our long-term perspective continues to focus on building Kemper's overall value by leveraging our competitive advantages while building core capabilities to earn consistent returns and increase book value per share. Our strategy remains focused on consumer-related businesses and growing in underserved niche markets with limited competition, but where our unique underwriting, claim, distribution and analytics expertise provides us with a sustainable competitive advantage.

Now turning to Page 5, I'm excited about another milestone in our transformation, the introduction of our new brand elements. Our new visual identity, brand positioning and architecture builds on the existing power of our businesses and helps to communicate the core of who we are, our strength and stability and our expertise in serving the unique needs of our customers.

Our previous brand architecture had over 20 consumer-facing trade names. Our teams were working hard, but with so many identities we couldn't leverage much of anything through this fragmented approach. Unifying around a common brand architecture makes it simpler and easier to focus our employees on our target customers, on building competitive advantages, on attracting and retaining talent and on helping us do what we need to do to win in the marketplace and ultimately on creating value for our shareholders. It's not just about a logo. It's an enabler.

We have a thoughtful implementation plan on this, appropriately transitioning legacy brands over the next 6 to 8 months. We don't anticipate any material disruption and the costs to make this change were anticipated and included in the transaction integration expenses.

As I stated earlier, we closed on our acquisition of Infinity on July 2. If you turn to Page 6, I want to remind you of the transaction rationale. It's squarely aligned with our overall strategy of building strength in niche and underserved markets. By combining the capabilities and strengths of our 2 companies, we've created a leading specialty auto franchise. We gain the benefits of a larger platform, including stronger claim capabilities, enhanced product management strength, improved distribution breadth, and the ability to attract and retain top talent and a higher revenue base to absorb fixed costs. This helps us serve our customers exceptionally well and win in the marketplace.

On Page 7 you'll find an update on our integration. We had integration teams formed within days of announcing the transaction to ensure we would deliver best-in-class capabilities for the combined organization. Upon closing, we immediately began executing on their plans. We've already seen meaningful benefits and expect more to come. I'll take this opportunity to highlight a few of these benefits.

First, the legacy Infinity leadership team remains highly engaged, adding considerable depth and breadth to our platform. Our claim departments are already integrating and leveraging our combined strengths, and we're in the process of using our data to enable us to better develop, price and manage our products. The transaction rationale is playing out as we expected.

The last point I'll mention is that our synergy realization remains on track and there is no change to the estimated projections we provided in February. That said, to date we've realized some initial synergies quicker than we expected. We've always anticipated that we need to temporarily increase some expenses to unlock certain longer-term synergy benefits. You can expect some lumpiness in the expense line to occur over the next several quarters, as we make some short-term investments to fully realize those synergies. But the end total isn't projected to change.

Before we look at Page 8, let me take a moment to briefly talk about what we mean by as adjusted. There are detailed reconciliations in the back of the presentation. The numbers as reported don't have Infinity's historical information and they do have purchase accounting entries particularly related to VOBA running through them. And as a result, it's very hard to see underlying business trends. So when we discuss as adjusted, we're adjusting for purchase accounting and adding historical Infinity information to make the trends more visible and understandable.

Now let's turn our attention to Page 8 and review the highlights of our third quarter. Overall we had a strong quarter, reporting net income of $92.2 million, or $1.40 per share as reported, or $131.7 million or $2.01 per share as adjusted. Adjusted consolidated net operating earnings per share increased from $0.85 per share to $1.59 per share as reported. Earned premiums increased 76% in the quarter to $1.053 billion or 12% on an as-adjusted basis, primarily driven by volume growth within our specialty auto business.

In the P&C segment, we had overall strong profitability and 15% increases in policies in force for the specialty auto business. We saw an improved underlying combined ratio on our preferred auto business. Please remember when you look at the third quarter results, there is a seasonality impact. The third quarter historically sees the lowest auto combined ratios.

In Life & Health, we had very stable earnings and predictable cash flows. It's important to note that a key part of our strategy is the diversification benefit these businesses provide. Our investments continue to be a strength and our balance sheet, capital and liquidity remain strong.

With that, I'll hand the call over to Jim to discuss our consolidated financial results in more detail.

**James J. McKinney**
*Senior VP & CFO*

Thank you, Joe, and good afternoon. I'll start on Page 9 and review our consolidated third quarter results and then briefly touch on our Life & Health results. Overall, we had a successful quarter. Net income was $92.2 million or $1.40 per share as reported, up from $47.7 million or $0.92 per share last year. On an adjusted basis, net income was $131.7 million or $2.01 per share, up from $62.7 million or $0.96 per share.

Adjusted consolidated net operating income was up 135% to $105 million, or $1.59 per share for the quarter, compared to $44 million or $0.85 per share. On an as-adjusted basis, adjusted consolidated net operating income was $144 million or $2.20 per share, up from $59.5 million or $0.91 per share. Please note that on a reported basis, our rolling 12-month return on average shareholders' equity was 9.7%, up from 5.7%. The significant improvement in this and the measures previously mentioned from last year's third quarter resulted from improved underwriting results, a lower level of weather-related losses, disciplined expense management and tax reform.

With the acquisition of Infinity, earned premiums increased 76% from last year, or $455 million in the quarter to $1.1 billion on an as-reported basis. On an adjusted basis, earned premiums increased 12% or $110 million. The increase in as-adjusted earned premiums is largely due to continued market share gains occurring within our specialty auto business, where underwriting margin exceeds target profitability ranges.

Book value per share excluding unrealized gains on fixed maturities ended the quarter at $45.22, up 26% from $35.87 last year. $7.67 or 82% of the increase was driven by the issuance of stock associated with the Infinity transaction. The remaining increase was due to net income earned over the previous 12 months. This represents roughly a 5% increase in book value. On the bottom of the slide, you'll note that continued to profitably grow our P&C policies in force while maintaining strong underlying loss and expense ratios.

We have received a number of questions which suggest purchase accounting's impact on the expense ratio. In particular, the value of business acquired or VOBA is a confusing topic that has the potential to misinterpreted. The numbers circled in red highlight the impact of purchase accounting adjustments. During the period, purchase accounting had a 5.3 percentage point impact on the expense ratio. Relative to VOBA, purchase accounting requires you to take the projected earnings from the premium acquired for the remaining life of the current policy period and place it on the balance sheet as an asset. This asset is then amortized over that period against the corresponding revenues. The net result is the creation of short-term non-cash expense noise with no change to book value. Therefore, we recommend focusing on the as-adjusted financials, as this impact is temporary. It will affect our fourth quarter financials as well and then have a minimal impact on future quarter results.

Moving on to the Page 10, here we isolate the key sources of volatility in our earnings. In the highlighted section at the bottom of the page, you can see that underlying operating performance improved 33% or $0.35 per share for the quarter. This improvement is largely driven by strong growth and underwriting margin expansion within specialty auto. We are pleased with these results and look forward to continuing to grow our operating income and book value per share.

Our Life & Health division's results are on Page 11 of the presentation. On the top half of the page, you can see the stable revenue trend. Earned premiums continue to show modest growth, increasing $3 million to $158 million, while net operating income improved to $27 million. The Life & Health division overall continues to provide stable and diversified earnings and cash flows.

I'll now turn the call over to Duane to discuss the results of our P&C division.

**Duane A. Sanders**
*Senior VP and President of Property & Casualty Division*

Thank you, Jim, and good afternoon, everyone. I'll begin with a discussion on specialty auto on Page 12 of our presentation. I will discuss this business on an as-adjusted basis, including Infinity's results in all prior periods. Earned premiums increased to $655 million for the quarter, up $101 million or 18% over the third quarter of 2017. The top line growth was primarily fueled by higher volume as policies in force increased 15%. More importantly, this growth was achieved profitably, as reflected by the strong underlying combined ratio. Specialty auto's underlying combined ratio remained in the low 90s. The business generated attractive returns due to modest loss trends, rate actions, and more scale than in the past. With the combination of Infinity, specialty auto is expected to further enhance the value we provide to all our stakeholders.

As you can see on Page 13, our preferred auto business continued to show improvement. While our underwriting results remained below target profitability goals, we're seeing improved underwriting results with an over 1.5 point improvement in the underlying combined ratio. As we shared previously, we remain focused on improving this business and we're seeing early signs of our continued work efforts.

Turning your attention to homeowners, the underlying combined ratio was 91.7%, about 6 percentage points higher than last year, driven primarily by 2 items. We had a single large fire loss resulting from a lightning strike, which was approximately $3 million. That contributed about 5 points. And our ceded premium for our aggregate cat treaty contributed an additional 3 points to the loss ratio. We remain focused on all aspects of this business: product management, underwriting and claims; to bring it to an appropriate profitability level.

I will now turn the call back to Jim.

**James J. McKinney**
*Senior VP & CFO*

Thank you, Duane. Turning to investments on Page 14, during the quarter we largely completed the repositioning of the Infinity portfolio. The portfolio remains diversified and highly rated, as demonstrated on the bottom left of the page. Here we've broken out the portfolio by investment type and provided the fixed maturity ratings. The portfolio is conservative in nature with approximately 80% comprised of fixed maturities and short-term securities, and of those over 90% are investment grade.

Looking at the chart on the upper left, you can see the investment performance over the past 5 quarters. This quarter we delivered $92 million in net investment income. The core portfolio produced higher net investment income, primarily due to the addition of Infinity's investment portfolio. The alternative investment portfolio generated income of $13 million, which has slightly outperformed our expectations.

Overall in the third quarter, the portfolio delivered an attractive pretax equivalent annualized book yield of 5.2%. This is down from 5.8% last year, primarily due to mix shift resulting from the addition of Infinity's portfolio.

On Page 15 we highlight our strong capital and liquidity position. At the end of the third quarter, we had a debt-to-total-capitalization ratio of 26.8% and expect to revert to the low to mid-20s within the next 9 months. In the chart in the upper left-hand corner, you can see our parent company liquidity. At quarter end, we had $91 million in cash and investments and $300 million in borrowings available from our revolver.

Looking at the chart in the upper right on Page 15, you can see our insurance group remains well capitalized. If you look at the bottom left of the page, you can see that our businesses continue to generate substantial operating cash flows that are expected to grow over time.

With that, I'll turn the call back to Joe for some closing comments.

**Joseph Patrick Lacher**
*President, CEO & Director*

Thanks, Jim. So to wrap up, the strong results this quarter are further evidence of the significant progress we've made on our transformation. And the recent refresh of our brand is another milestone in that journey. We continue to focus on effective execution of our strategy. Closing the Infinity transaction solidifies our commitment to build strength in our core businesses and positions us as a leader in the specialty auto market. We've made tremendous progress on the integration and look forward to fully realizing the benefits of the powerful combined organization.
Now we'll turn the call back over to the operator to take your questions.

# Question and Answer

**Operator**

[Operator Instructions] Our first question comes from Greg Peters with Raymond James.

**Charles Gregory Peters**
*Raymond James & Associates, Inc., Research Division*

I wanted to circle back, the growth you're reporting in auto and the improvement in the underlying combined ratio are noteworthy. I was wondering if you could give more color around post-Infinity what states you're growing in and perhaps provide some perspective on the competitive environment in these states. And then I have a follow-up.

**Joseph Patrick Lacher**
*President, CEO & Director*

Sure, Greg. This is Joe and I'll take a crack at it to start and ask Duane to tag team with me. We're seeing growth across most of the states we're in. The bigger states obviously have bigger dollar growth, because they're bigger. So California, Texas, Florida present the biggest dollars of growth. But the majority of states either company were in are actually seeing growth and we've got fairly attractive combined ratios in virtually all of the jurisdictions where we're doing business.

**Duane A. Sanders**
*Senior VP and President of Property & Casualty Division*

And I was just going to -- Joe is exactly right. We're continuing to find opportunities across most of the states where we're writing business. Obviously in those states where we've got better penetration, we're continuing to get some acceleration behind it. But as Joe mentioned, we're writing more business in the states where we've got some good margin.

**Charles Gregory Peters**
*Raymond James & Associates, Inc., Research Division*

Great, and maybe as a follow-up just to the environment on the auto side, we can talk for a second about homeowners. It's been getting a lot of attention in the marketplace. A number of other companies have reported an uptick in underlying loss costs. And I'm just curious what your experience is, what your view on the market is, and how you think that line could improve over the next couple years.

**Duane A. Sanders**
*Senior VP and President of Property & Casualty Division*

Yes, as I stated in the early commentary, we continue to focus on that part of our business. We're certainly following the industry and looking at trends. That is a much smaller portion of business that we have. We're not necessarily spread out as many of the competitors are. So most of our stuff is a little more concentrated and it's reasonably firm yet. And we're in the middle of rolling out our new product offering and continuing to get rate. We're not where we need to be. But again, remain committed to it and continue to work that side of the business to get it to where it's profitable.

**Joseph Patrick Lacher**
*President, CEO & Director*

The fact that there's still a little bit of a hard market running on there, Greg, gives us the comfort that we're going to continue to see folks working towards improving profitability, which will make it easier to make that happen.

**Charles Gregory Peters**
*Raymond James & Associates, Inc., Research Division*

Right, I guess -- and thank you for Slide 9 and providing us the clarity on the expense ratio. Just to circle back, the final question I have just Jim, I think you said the fourth quarter we'll see another blip in the expense ratio. But then beginning in the first quarter next year, things should begin to revert back to normal. Is that the 20 to 21 range or could you see it drop below that?

**James J. McKinney**
*Senior VP & CFO*

Yes, I want to be careful in terms of very specific commentary on our expense ratio, other than to say I do anticipate it to revert back to kind of the normal ranges that you've seen our combined businesses achieve together, plus the synergy aspects that you would expect to kind of run through these numbers between now and over the next year and a half. That said, I would expect the impact to be specifically from a VOBA perspective about half of the impact that it was this quarter. From a net income basis, that was about $40 million. And so one way to kind of think about next quarter would be about half of what it is now. That would be equivalent to what you've seen kind of in our S-4 as well as the 8-K that we put out in terms of what was going to happen from a VOBA amortization perspective.

**Joseph Patrick Lacher**
*President, CEO & Director*

I have the benefit of not being the accountant in the room. The VOBA piece seems to be getting everybody tied up in their shorts. I'll give you the way I think about it. When we bought the business, all of the in force premium, the profitability associated with that, we had to put on the balance sheet. That will amortize itself in through the expense line as those policy periods mature. So some of them might have had a day left on their policy period. Some of them might have had 5 months and 29 days if they were a 6-month policy. Some of them might have had 364 days left if they were a 12-month policy. And as those policy periods expire, that VOBA goes away. So Infinity had a fair number of 12-month policies, but a lot of 6-month policies. So that works its way down. So Jim gave you that number that the first quarter was about 40, the second quarter will be about 20. So you can watch itself working down. It just works off as those policies mature and renew. So there's not rocket science around it. That's all it is. And then there's other stuff. We've got other intangibles that amortize in, but they're a much more modest dollar amount. And then you've got normal kicking around expense activity. That's really the eggs through the snake you've got to think about. And it's just those policy periods finishing their term.

**Charles Gregory Peters**
*Raymond James & Associates, Inc., Research Division*

And just to follow on to that Joe, is there going to be some of the restructuring or integration expense running through that expense ratio component or is that all carried below line?

**James J. McKinney**
*Senior VP & CFO*

Yes, no. Sorry, this is Jim. Big picture, that's all carried below line. That's essentially where we had forecasted it. And that is aligned with our policies. The key way that we think about that is what's above line are those items that are specifically related to what's the kind of ongoing run rate of the business. The unique kind of one-off things that would be in particular to how you bring the organization or other, it would not necessarily be included inside our pricing [indiscernible] inside how we price the Infinity transaction and whether we thought it was a fair deal, be included there. But it wouldn't be in the ongoing kind of segment results and whether or not that business is profitable or not from that perspective. And so we really try to segment where those expense line items fall by whether or not there's something that's kind of core to that business or if it's more a strategic activity that the organization has taken.

**Operator**

Our next question comes from Adam Klauber with William Blair.

**Adam Klauber**
*William Blair & Company L.L.C., Research Division*

A couple different questions, preferred auto showing good trend; is there room to go in that line of business?

**Duane A. Sanders**
*Senior VP and President of Property & Casualty Division*

In terms of room to go, I'm assuming you're talking about…

**Adam Klauber**
*William Blair & Company L.L.C., Research Division*

The margin, yes, margin.

**Duane A. Sanders**
*Senior VP and President of Property & Casualty Division*

Yes, we're -- right, I'd say we're on the front end of that. We continue to push the rate that we're able to get. And again, I mentioned we're rolling out new product in all of our states through our new program. So we continue to look for those opportunities and continue to try to push that.

**Adam Klauber**
*William Blair & Company L.L.C., Research Division*

Okay. Could you talk about loss trends, specifically in the non-standard? Are you seeing better frequency? Is that actually negative? And how is severity now compared to a year ago?

**Duane A. Sanders**
*Senior VP and President of Property & Casualty Division*

This is Duane. Frequency I'd say has continued to remain close to flat. There's certain covers. There might be slight upticks. But by and large, it's fairly flat. Severity again, I think depending on cover, has some movement in it. I would tell you that based on our mix of business and in terms of the covers that we write with the limits we write, we probably see a little less than that, what you might see in the industry at large. But so there's some movement, again manageable. And we continue watch it and respond accordingly.

**Joseph Patrick Lacher**
*President, CEO & Director*

Why don't you comment a little bit, Duane, on the BI increases? Because I want to make sure we have clarity on that one.

**Duane A. Sanders**
*Senior VP and President of Property & Casualty Division*

Yes, so as Joe pointed on the specific covers, there's a little bit on the BI side in terms of frequency movement. But again, we continue watch it and respond accordingly.

**Adam Klauber**
*William Blair & Company L.L.C., Research Division*

And then on the technology, have you made a decision on the policy management system yet?

**Joseph Patrick Lacher**
*President, CEO & Director*

We largely had internally, and I'm going to avoid commenting on it here, just because I'm not positive what we've communicated and where we are externally with vendors and the like. And I'm just not sure what the status is and whether we've buttoned up on all of those negotiations. If they're not at the point where we think they are economically, we'll change our mind.

**Adam Klauber**

*William Blair & Company L.L.C., Research Division*

Okay, and then from a capital standpoint, I mean you're growing a lot and that obviously requires capital. But you're also generating capital. Do you see as you get into '19-20, do you get to a point where you're generating excess capital or do you think you'll need your capital mainly to support your growth?

**James J. McKinney**
*Senior VP & CFO*

I think I would bifurcate that into a couple of components. I think the first component is when we look out over the next kind of quarter to 3 quarters, we've talked about a prioritization to return to a more normalized level of debt to capital. So I would suggest that our second priority other than making sure that we can have all the capital that we need to organically grow the business in a strategic footprint is there. That's probably the #1 thing. Assuming that we continue to grow at this pace or in margins that I think you would see us kind of taking a look at where we're at, kind of whether it be second, third, fourth; and we would have additional commentary on that. But my focus right now is really kind of over the next 6 to 9 months in getting and maintaining the state that we have. And then assuming that we do those things, then we get to have some of the exciting discussions that you're talking about in terms of additional capital management or other items for us to think through.

**Operator**

Our next question comes from Bob Glasspiegel with Janney Montgomery Scott.

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

Thanks for the VOBA English translation, Joe. That was helpful. October, a couple of hits from Michael in the financial markets. Any commentary on exposure there?

**Duane A. Sanders**
*Senior VP and President of Property & Casualty Division*

No, happy to comment. Michael, first and foremost, kind of our hearts go out to the people who've been impacted by that. We're doing everything that we can on our side where we have individuals impacted to make sure that we take all appropriate actions to do what we can there. From a financial perspective, right now it looks -- it's a reasonably small number for us. I would say consolidated in top of the house, it appears to be a number that's below $10 million, and kind of with inside the expectations for what normal cat activity might be for us for the fourth quarter.

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

And just financial markets and alternatives, any exposure to what happened in October?

**Joseph Patrick Lacher**
*President, CEO & Director*

Well, we're not seeing anything to speak of. There's noise on things, but nothing that we'd at this point describe as really noteworthy.

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

So you avoided 2 catastrophes. That's good to hear.

**Joseph Patrick Lacher**
*President, CEO & Director*

It had to happen eventually, Bob.

**Robert Ray Glasspiegel**

*Janney Montgomery Scott LLC, Research Division*

Yes, non-cat weather in homeowners hit a few people. You mentioned one lightning strike, which maybe you could qualify as that. But you're not seeing a broader trend that some others have seen?

**Duane A. Sanders**
*Senior VP and President of Property & Casualty Division*

No, we're not. The one lightning strike was a weird whacky item when we go through it from an underwriting perspective. We'd write the risk again every day. And sometimes as an insurance guy, claims happen. So that doesn't trigger anything with us. And as we found in other cases, we have a modest sized book and it's just -- at times we get popped a little more than the rest of the world, because of some concentration issues, and at times a little less. And right now we're getting a little less.

**Operator**

Our next 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 investment portfolio, particularly its impact on the life insurance business. Are we close to a place on the interest rate side where we could see I guess less interest rate spread compression given the higher interest rates, or are we still a ways off from a portfolio return perspective for the life insurance business?

**John Michael Boschelli**
*Senior VP & Chief Investment Officer*

This is John Boschelli. Thanks for the question. The interest rate environment, especially even in October, has moved very nicely for us. And with that in mind, basically we have our cash that we're reinvesting. And so that's going to be a slow slog of reinvestment concepts. But if this reinvestment rate continues, it should be a positive trend.

**James J. McKinney**
*Senior VP & CFO*

Not to be silly, but up is better than down.

**John Michael Boschelli**
*Senior VP & Chief Investment Officer*

Yes, exactly.

**James J. McKinney**
*Senior VP & CFO*

So it's moving back in the right direction.

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

Is new money above the portfolio rate from your perspective?

**James J. McKinney**
*Senior VP & CFO*

I mean it really depends, right Paul, in terms of where things are coming off. In general I would suggest that the portfolio is slightly higher than where new money rates are. But it's really dependent on which securities are maturing and which securities we're putting on. In general though, as John mentioned, I think we're kind of at a baseline. Potentially if the environment holds, it could be a slight favorable. But I would expect and kind of think about it largely in terms of the results that we've kind of had to date are a pretty good baseline for where we'll be at for a little while.

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

Great. And then could you just review where you are from a rate-taking perspective on the property casualty side? Are you still taking rates across the board and particularly in auto?

**Duane A. Sanders**
*Senior VP and President of Property & Casualty Division*

Yes, this is Duane. Yes, we are certainly working that on a state-by-state basis. And we continue to look at -- valuate loss costs and those drivers and then to general -- low levels of rate. But we're continuing to push it.

**Operator**

[Operator Instructions] Our next question comes from Chris Campbell with KBW.

**Christopher Campbell**
*Keefe, Bruyette, & Woods, Inc., Research Division*

First question is on the $43 million legal benefit. You guys left that in operating EPS, where normally I'd consider that non-operating. So I know that was kind of a partial settlement of a bigger legal issue. So I guess just how are you thinking about that going forward if there are subsequent settlements?

**James J. McKinney**
*Senior VP & CFO*

This is Jim McKinney. The way that I would think about it, the $36 million the pretax, we had about $28 million after tax, is really a recovery against some of the impairments that we took several years ago. Because of that and because those impairments went through the operating results of that segment, the best performance of the segment over time and individually is to include those. Now we would recognize those essentially as kind of one-time episodic issues. But when you think about the capital levels that are inside that business, when you think about the overall results and other items; the right place to put those in order to match both the expense -- both what it was previously and where it is today -- is to include it in that line item.

**Christopher Campbell**
*Keefe, Bruyette, & Woods, Inc., Research Division*

Okay, got it. And then if you're thinking about…

**James J. McKinney**
*Senior VP & CFO*

And then the follow-up Chris, the rest of that settlement, there was one big settlement and this was a partial. All the rest of it's going to follow the same path. That was the other side of your question.

**Christopher Campbell**
*Keefe, Bruyette, & Woods, Inc., Research Division*

Okay, got it. So it will still…

**James J. McKinney**
*Senior VP & CFO*

And that's not a -- this isn't a decision on how we'll deal with any settlement ever. This is all following the one arbitration award that we won.

**Christopher Campbell**

*Keefe, Bruyette, & Woods, Inc., Research Division*

Okay, got it. Because you ran it through operating -- or you ran it through operating earnings like with the impairment, so you're just running it back through. Because…

**James J. McKinney**
*Senior VP & CFO*

Correct. It was written off years ago through there. So we're undoing that with the arbitration award.

**Christopher Campbell**
*Keefe, Bruyette, & Woods, Inc., Research Division*

Got it makes sense. Okay, and then just kind of non-standard, so the net earned premium like on an as-adjusted basis and thanks for providing those -- it was very helpful to put the 2 businesses together. So that was up 18%. But if I look at the as adjusted expense ratio, that was actually up like 10 bps. So I guess I'm just trying to think as you're putting these 2 businesses together, does that mean there is no more expense synergies as we're thinking about this, at least on the non-standard side? I mean it's running at a 16, which is like an awesome expense ratio. But I'm just trying to think how low that could go.

**James J. McKinney**
*Senior VP & CFO*

Yes, Chris. So I want to be careful not to maybe touch on how low could it go or not. We are in line in achieving the synergies that we suggested and that we can pull out from an S-4 basis. Bigger picture-wise, I think it's important not to get too confused in terms of what the 10 basis point increases, when you look at these things quarter-over-quarter. Some of what's rolling through there is just a different policy that we have that just DAC-ed fewer expenses from that perspective. That was over a point. And so when you look at that line item, there's a timing difference that you would see. Now over time, that would be the same on us as theirs, as you get to a normalized state. But for the next few quarters for some period of time here, you might see that 10 basis points. But that isn't about more expenses being earned. That's just really a policy difference in terms of the Infinity versus kind of our own policy, both of which are appropriate.

**Christopher Campbell**
*Keefe, Bruyette, & Woods, Inc., Research Division*

Okay, got it. And then just the software proceeds, you guys have any plans for that? I mean are there a potential those could be used for buybacks?

**James J. McKinney**
*Senior VP & CFO*

Again, Chris, I'm going to point you to some of the comments that I made previously about capital. Our first priority is continuing to invest organically within the business and to look for options that would strategically enhance our operating profile and provide meaningful returns to shareholders. The second thing on that list is returning to a normalized debt level that we've indicated, which is going to be low-to-mid 20s. So we're looking at kind of the bank note. We look at the hybrid. We look at those instruments and what you can expect is that we're going to do what's in the optimal interest for shareholders from that perspective. Post that, we'll look at any kind of excess capital on that that we may have relative to growth and opportunities. And we'll be thoughtful about it in terms if there's excess and when we're unable to deploy that over some reasonable time, we would think about returning that. To the extent that there's opportunities that we can create significant shareholder value for our stakeholders, we would look to deploy it in ways that would allow us to do that.

**Christopher Campbell**
*Keefe, Bruyette, & Woods, Inc., Research Division*

Okay, and then just in commercial auto, another as adjusted kind of expense ratio question. So the 23.6, that seems higher than both even Kemper was operating. And I know like legacy Infinity was kind of the better, more efficient book, at least on an expense ratio basis. So I guess just should we think of now that the 2 commercial auto books are kind of merged together, it's going to look more like Kemper on the expense side or more like Infinity? And I mean are there any re-classes that are impacting the -- because there was also 600 bps of core loss ratio improvement year-over-year. So are there any reclassifications happening between expenses and loss ratios that could be throwing off?

**Joseph Patrick Lacher**
*President, CEO & Director*

So there's a couple of things going on and I'll give you an overall comment, then Jim is going to follow with a little detail. On the expense stuff, Chris, we had the same VOBA issue running through commercial vehicle. The Infinity book was significantly larger than Kemper's. So that's going to be the overwhelming driver of the performance of the results, if you just start with a simple weighted average. That's going to be a driver. I would love to tell you on each and every one of these numbers there wasn't purchase accounting noise or other items in them. And I wish they weren't there. But they just wind up needing to be in this quarter. We were trying with the S-4 and the 8-K to put some detail out there in advance to sort of preview where those were coming. The fact that the Infinity business was performing better than we had expected at the time of the transaction actually increases the VOBA and increases this. That's a great first real problem to have. Because it means the business is performing extraordinarily well and better than we all expected. But it creates a quirky little piece of noise in the expense ratio. It's going to be hard for you to pick this quarter's expense numbers on a line-by-line basis, and use those in and of themselves as a basis for building models going forward. You're just going to get the wrong answer doing it that way. I think you've got to step back and look at some of the S-4 from a projection set of items to give you some guidance, and can use some reasonable view of some premium weighting of each of the 2 organizations' historical size. If Infinity was 75% of the business and Kemper was 25% that's a reasonable weight. And then use the overall synergy number to adjust. If when you add up your model you're getting something different than the overall synergy number, you made a mistake. Like that's got to be the bias where that's the best map overall we can give you. And I'll let Jim clean up whatever the non-accountant just said.

**James J. McKinney**
*Senior VP & CFO*

No, Chris, I'd just point to what I said earlier about having a little bit of a difference in terms of the DAC fee. You've got kind of a point or 2 that's essentially kind of -- that you just wouldn't normally have in there. It will take a little bit of time for that to normalize. Long term I would expect that really the Infinity book of business and the historical expense ratio is where I would expect it to trend. And there's not going to be a significant time period really before we probably -- where you can kind of see that play out in greater degree. So maybe remainder of this kind of quarter, first half of next year I would expect you to get to more of a normalized number.

**Operator**

Our next question comes from [ Marc Cohen ] with Guggenheim Partners.

**Unknown Analyst**

Joe, just a follow-up on that capital indication in respect to returning to debt-to-capital over the next 6 to 9 months. Would that be the liability management initiatives or through the retention of earnings and growth of equity capital?

**Joseph Patrick Lacher**
*President, CEO & Director*

I think it's largely the latter. We're expecting to grow the business and throw off earnings inside the place. The business right now is growing at a particularly high rate, which is again a very first real problem to have, which is terrific. We're organically growing the business. And that's a plus. So we expect to deal with that. And then we've committed to rating agencies that we'll reduce that debt-to-capital load going forward.

**Unknown Analyst**

And just a follow-up…

**James J. McKinney**
*Senior VP & CFO*

One item that I would just add to that, and you've seen this as a part of our S-4 and some of the other items; we had projected when we were bringing both Infinity and ourselves together that we would be using some of the excess capital that was inside Infinity to bring debt levels back to a normalized state. That we expect to happen kind of in the fourth quarter or first quarter, kind of the timing of an extraordinary dividend. And then from there forward, it would be as Joe mentioned, the additional retained earnings and other items that would bring us back to our normalized state. It's really those 2 activities that lead us there.

**Unknown Analyst**

Great. I guess that's a great preamble to my next question. As of September 30, I think the holding company had about $90 million of cash or unrestricted capital at the holding company level. Is there a specific target of unrestricted capital at the holding company level you plan on maintaining to cover fixed charges and corporate expenses? And then a follow-up to that, based on your 3 or 4 operating insurance companies, can you discuss what the dividend capacity is following the transaction that would be ordinary dividends that would be upstream from those entities to the holding company?

**James J. McKinney**
*Senior VP & CFO*

Great, a lot of questions there. Let me try to pick them off one at a time. And if I miss something it's not intentional. Please just let me know that I missed it and we'll answer it. Big picture-wise-- hold on 1 second. In terms of the target, generally speaking and what we've talked about with the market is that we intend to hold 1 year of operating cash flows, different things at the HoldCo in terms of our overall liquidity. That is obviously there to handle periods of stress or unplanned growth that we would then quickly follow up and bring ourselves back to kind of normalized levels. That said, we don't specifically put a target out there absent that. We do have those internally. They do include other economic considerations and whatnot that we manage appropriately. In terms of the capacity that would be ordinary, we've got about $16 million more in terms of the Infinity component. We've got about $20 million more in Trinity. And then we have the extraordinary dividend coming out that we've chatted about as it relates to Infinity that would go to the bank loan repayment of $150 million.

**Unknown Analyst**

And would that be a 2018 event or a 2019 event on that extraordinary dividend from Infinity?

**James J. McKinney**
*Senior VP & CFO*

Generally speaking, I would expect it to be a 2018 event. But again, these things are dynamic to some extent in that we're always ensuring that we're doing the right things for the business.

**Operator**

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

**Joseph Patrick Lacher**
*President, CEO & Director*

Thanks, operator. And thanks for everybody on the call today for your time and your interest in Kemper. We look forward to updating you again next quarter. Have a great night.

**Operator**

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