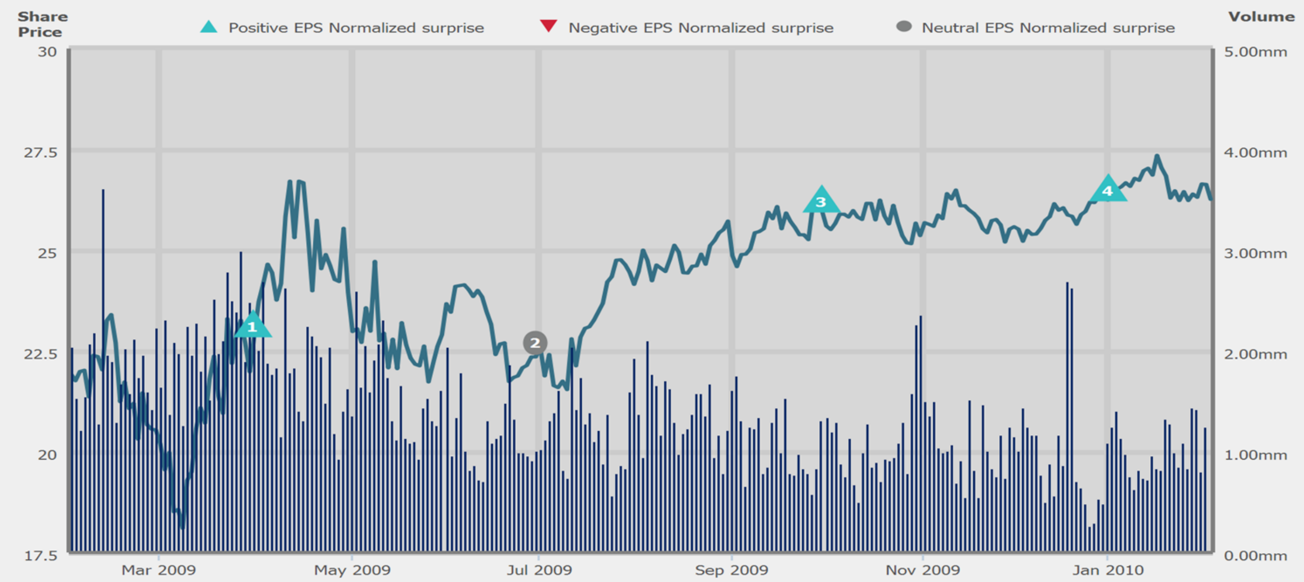
Cincinnati Financial Corporation NasdaqGS:CINF
FQ1 2010 Earnings Call Transcripts

Thursday, April 29, 2010 3:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ1 2010-			-FQ2 2010-	-FY 2010-	-FY 2011-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.44	0.39	▲(11.36 %)	0.36	1.61	1.99
Revenue	-	-	▲(0.78 %)	-	-	-
Revenue (mm)	893.95	887.00	-	885.65	3566.75	3612.75

Currency: USD
Consensus as of Apr-19-2010 3:27 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ1 2009	0.20	0.23	▲1 15.00 %
FQ2 2009	0.14	(0.03)	NM
FQ3 2009	0.42	0.59	▲2 40.48 %
FQ4 2009	0.52	0.53	▲3 1.92 %

Table of Contents

Call Participants

EXECUTIVES

Dennis E. McDaniel
VP & Investor Relations Officer

J.F. Scherer

Kenneth William Stecher
Non-Executive Chairman of the Board

Martin Hollenbeck

Steven Justus Johnston
President, CEO & Director

ANALYSTS

Dan Johnson
Citadel

Dan Schlemmer
Macquarie

Michael Phillips
Stifel Nicolaus

Scott Heleniak
RBC Capital Markets

Presentation

Operator

Welcome everyone to the Cincinnati Financial first quarter conference call. (Operator Instructions) Dennis McDaniel, Investor Relations Officer, you may begin your conference.

Dennis E. McDaniel
VP & Investor Relations Officer

Hello. This is Dennis McDaniel, Investor Relations Officer for Cincinnati Financial. Thank you for joining us for our first quarter 2010 earnings conference call. Late yesterday we issued a news release on our results, along with our supplemental financial package and we filed our quarterly report on form 10Q. If you need copies of any of these documents, please visit our Investor website, www.cinfin.com/investors.</TAG>

The shortest route to the information is in the far right hand column via the Quarterly Results QuickLink. On the call, you will first hear from Ken Stecher, President and Chief Executive Officer; and Chief Financial Officer, Steve Johnston. After their prepared remarks, investors participating on the call may ask questions. At that time, some responses maybe made by others in the room with us that include Chairman, Jack Schiff Jr.; Executive Vice President, J.F. Scherer, Sales & Marketing; Principal Accounting Officer, Eric Matthews; Chief Investment Officer, Marty Hollenbeck; and Chief Claims Officer, Marty Mullen.</TAG>

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 data is prepared in accordance with statutory accounting rules, and therefore is not reconciled to GAAP.</TAG>

With that, I will turn the call over to Ken.</TAG>

Kenneth William Stecher
Non-Executive Chairman of the Board

Thank you, Dennis. Good morning to all of you. As highlighted in our news release we reported improving trends in several areas while our industry continues to experience significant challenges particularly in the commercial lines insurance market.

Improvement has occurred over the past year in securities markets and our book value per share reflects that with an increase of 25% while we also increased our shareholder dividend. The mix we have selected for our investment portfolio took advantage of favorable market movement. It is up 24% since this time last year. We also grew our first quarter investment income by 5%.

Growth in the portfolio and the income it produces reflect good choices made during 2009 as we invested more than $1 billion in cash that was held at the beginning of the year. We continue to add to our common stock portfolio including net purchases of over $60 million during the first quarter with the intention of balancing current income with long-term capital growth. We have a track record of holding attractive stocks with unrealized capital gains making up over 25% of the equities portfolio and we continue to monitor concentrations.

Our largest common stock position now is about 1% of the total investment portfolio. While our property casualty insurance underwriting results fell short of our goal of a combined ratio under 100% we saw favorable trends in parts of that operation as well. Our personal lines segments combined ratio improved by almost 20 percentage points. While most of that was due to more favorable first quarter weather there also was an improvement in the non-capacity loss ratio reflecting rate increases implemented during 2009 plus better pricing for risk that we attribute in part to our homeowner predictive modeling efforts.

Last year at this time our large volume of business in the Midwest made our property insurance results lag much of the industry due to weather related losses. Results so far this year demonstrate how weather effects tend to even out over time. Our excess and surplus lines operation made a positive contribution to premium revenue trends with earned premiums more than doubling to $11 million for the quarter. We continue to carefully manage excess and surplus lines exposure not only through policy terms and conditions but also by limiting our loss retention to $1 million per risk after reinsurance.

Competition for ENS business has been increasing and kept our new business written premium levels flat. Agents continue to give us opportunities to round out client accounts, keeping the non-standard part of the account in the Cincinnati insurance family. Our earned premiums for our life insurance operation grew at a double digit rate in the first quarter and it continues to be a steady contributor to corporate profit and book value.

Commercial lines is our largest segment and still is experiencing very strong competition making it difficult to achieve price increases. While we achieved price increases on some accounts during the first quarter, on average policies renewed at a price estimated at less than 1% lower than a year ago assuming no change in insured exposures or policy coverage terms. We are staying focused on identifying quality accounts and working to write insurance policies with an acceptable profit margin, walking away from business when necessary.

Our largest drop in new business premium volumes was from Worker's Compensation, currently an unprofitable line of business for our commercial lines segment. We aim to restore its profitability by carefully applying our underwriting guidelines along with other initiatives. Lower premium volume is a factor that has put upward pressure on our underwriting expense ratio. Investment in technology also contributes to a higher expense ratio in the short-term but it is justified over the long haul because we are confident there will be future benefits.

Our company has a long tradition of holding sales meetings the first few months of the year where we meet with agents face to face to renew relationships and discuss our plans for the coming year. This year was no exception as we have hosted 20 meetings across the country. Some of the important things agents told us this year reaffirm our efforts to build out our technology, to maintain our agency focus and to provide local support in the field.

Our agency centered business model has served us well for decades. We select agencies that are a good match philosophically and that have the potential to make us number one or number two carrier by premium volumes over time. We are able to replicate the benefits of our model for expansion into new states which also will benefit us in the long-term through less earnings volatility from weather related catastrophes.

Since 2007 we have entered five new states; New Mexico, Washington, Texas, Colorado and Wyoming. Those states generated over 10% of our first quarter 2010 commercial lines new business premiums. In the second half of this year we plan to enter Connecticut and Oregon. Our growth initiatives in new states and agencies are part of a positioning strategy for long-term growth. Agencies we have appointed during the past five years write over $7 billion in aggregate property casualty insurance premiums for all companies they represent. That represents significant growth potential as we generally are able to earn a 10% share of the new agency business within 10 years of its appointment.

The continuing selective expansion of our agency plan is one of several initiatives that move our business into a very favorable position for the future. By staying focused on quality coverage products, systems and service, we are confident we will bring value to all of the professional agencies that partner with us.

Now I will turn it over to Steve who will discuss the details of the quarter.

Steven Justus Johnston
President, CEO & Director

Thank you Ken. During the first quarter we continued to increase shareholder value. Our primary financial measure, the value creation ratio, was 3.4%. on an annualized basis that falls within our target range of 12-15%.

Breaking down the value creation ratio, book value per share increased by 2.1% and our dividend to shareholders contributed 1.3% with those two totaling to 3.4%. The first quarter combined ratio while an improvement over the first quarter of 2009 was an unprofitable 102.6. Catastrophes contributed 2.1 loss ratio points during the quarter and that number includes one point of favorable reserve development on prior year's catastrophe losses.

Total property and casualty reserves of prior accident years developed favorably benefiting the first quarter loss ratio by 5.6 points. Our reserving philosophy remains unchanged. We continue to target total reserves in the upper half of the actuarial range. The underwriting expense ratio for the quarter increased to 35.6 from 33.3% a year ago and calls for some discussion. The increase was due to a combination of both higher expenses and decreasing earned premiums. The main areas of higher expense include provisions for matters involving prior years related to Note [9] Commitments and Contingent Liabilities as described in our 10Q and also technology related costs.

We continue to invest in technology to increase the ease of doing business for our agency partners, improve our pricing precision and improve productivity. In terms of specific initiatives we deployed an upgrade to our Diamond Personalized Processing System to all states on February 1. We continue the rollout of our e-class commercial lines processing systems which started with 11 states in 2009 and was planned to go live in another 19 states during 2010.

We also continue to develop more accurate rating plans. We implemented predictive modeling for Homeowners and Worker's Compensation in the second half of 2008 and in 2009 and we have plans for personal auto in the third quarter of 2010 to be followed by the remaining commercial lines. In January we established a Worker's Compensation Claims Reporting Center to more efficiently handle Worker's Compensation claims and contain costs.

We are investing in additional loss control associates which we believe will result in better service for our agency partners and lower loss costs. With all of these investments we expect the expense ratio run rate for the remainder of 2010 to be in the 33-34% range.

Now for some details on investments. Pre-tax investment income increased by 5% to $130 million for the first quarter of this year. Pre-tax realized capital gains contributed $8 million. Also during the quarter we closed out a couple of items that we inherited in the third quarter of 2008 at the height of the financial crisis. We sold the remaining $36 million of collateralized mortgage obligations that we received when we terminated our securities lending program. While we realized a $12 million loss on the sale of the CMOs they had recovered to well above their lows and we feel the action reduces risk in our investment portfolio.

We also received the final payment of $5 million from the previously frozen primary reserve money market funds which generated a $1 million capital gain from the previously impaired level. Overall, the pre-tax unrealized gain in the investment portfolio increased by $149 million in the quarter to nearly $1.2 billion with the equity portfolio contributing approximately $64 million of the increase and the fixed income portfolio contributing approximately $85 million.

Liquidity, the balance sheet and our overall financial condition remain very strong putting us in a solid position to grow profitably. The P&C premium to surplus ration stands at a conservative 0.8 to 1 with property and casualty statutory surplus growing by $44 million during the quarter and that is net of a $50 million dividend to the holding company. At the holding company level we have approximately $1 billion in cash and marketable securities.

Summing everything up the contributions to book value per share for the quarter are as follows; Property and casualty underwriting loss subtracted $0.07. Life insurance operations contributed $0.05. Investment income other than life insurance and reduced by non-insurance expenses netted to $0.40. The change in unrealized plus realized capital gains on investments netted $0.63 and we paid to our shareholders $0.395 per share in dividends. The net effect for the first quarter was an increase in book value per share of $0.61 or 2.1%.

The value creation ratio which factors in both growth in book value and dividend contribution finished the quarter at 3.4% and builds on the full-year 2009 BCR of 19.7%.

That concludes my prepared comments. I will turn it back over to you, Ken.

Kenneth William Stecher
Non-Executive Chairman of the Board

Thanks Steve. Before we begin the question and answer session let me remind shareholders about our annual shareholder meeting on May at the Cincinnati Art Museum. The meeting is generally attended by most of our directors and senior officers and this year that will include a couple of new faces.

Linda Clement-Holmes was just appointed as a Director in January. She brings a great deal of executive experience in the technology area. John Kellington, our new Senior Vice President and Chief Information Officer also has a great track record and broad knowledge of insurance technologies. We are pleased to have them both on board and multiplying our efforts to make it easier for agencies to do business with us. We are fortunate to have many talented board members and company leaders devoted to the success of Cincinnati Financial Corporation and the Cincinnati Insurance companies.
We thank investors and shareholders for supporting the good work they do. To address investor questions, Jack Schiff Jr., J.F. Scherer, Eric Matthews, Marty Mullen and Martin Hollenbeck are here with Steve and me and we are all available to respond. Operator, we are ready for questions.

Question and Answer

Operator

(Operator Instructions) The first question comes from the line of Michael Phillips - Stifel Nicolaus.

Michael Phillips
Stifel Nicolaus

On reserves, you mentioned in the Q the commercial casualty development was from 2008 and 2009 accident years. Give us comfort on how that can be done so quickly on that long-tail line.

Steven Justus Johnston
President, CEO & Director

That is a good question. I think it boils down to what we have been seeing in the casualty line and Worker's Comp for that matter but in the casualty line in terms of audit premium. With audit premium going down it is kind of an indication that exposure was less in those more recent accident years than one would have anticipated at the time. So I think I can see on the one side where there could be some concern reserves might be being released too early but I think it is really a reflection of just lower than anticipated exposure during the period. Again, an emphasis of our comment we are very consistent in our reserving practices and haven't done anything different in terms of our practice over that period of time.

Operator

The next question comes from the line of Dan Johnson - Citadel.

Dan Johnson
Citadel

I guess the right way to think about it is we are not releasing casualty reserves from more recent accident years based on some differing view of the performance of the year were basically releasing reserves sort of in line with reversing out some revenue we had previously booked under assumptions that didn't turn out to be true. So this is really losses that really weren't attached to real business?

Steven Justus Johnston
President, CEO & Director

I think that is right. I guess I am trying to emphasize we didn't pull reserves out for any other reasons than different pick from our actuaries based on their view of the exposure and with that exposure has turned out to be less at audit than it was going into policy period.

Dan Johnson
Citadel

On the expense front the 33-34% that you talked about was that for the full-year 2010 or was that for the remaining three quarters of 2010?

Steven Justus Johnston
President, CEO & Director

That would be for the full year.

Dan Johnson
Citadel

When you think about the plusses and the minuses let's work with the assumption we are not headed into any sort of fabulous hard market any time in the next year or year and a half, what do we have that is going to help us the most to or what is going to influence the most the expense ratio as you look out over the next year to two?

Steven Justus Johnston
President, CEO & Director

I think it is a combination of where is our earned premium going to go and you appropriately referenced the market. So there is some uncertainty there. Also I think we have some technology roll outs and investment. We are seeing the pay back on that on the personal lines already I think in terms of growth and lowering of the loss ratio. Maybe I will just get to the point here. I think the expense discussion this quarter is a tougher one. We had an increase in our contingent liability reserve this quarter from a matter several years ago. It is a legal matter affecting personal lines. We think it is nonrecurring so I think you will appreciate the sensitivity of the issue and I can’t give you any more detail on that one event.

So we have this one-time expense in there. I didn’t want anybody walking away thinking that explained everything. We do have the technology investments that we are seeing payback on. Our premiums are down. So I thought the best way to communicate that is to give the run rate we think for the full-year and that is the 33-34% range. I didn’t want anybody coming away from the call thinking we had a one-time event and our 32.8% last year would hold up because as you mentioned we have had some pressure on the premium side and I think we are making some very appropriate investments in our technology.

Operator

The next question comes from the line of Michael Phillips - Stifel Nicolaus.

Michael Phillips
Stifel Nicolaus

Sticking with comp and commercial casualty the premium drop wasn’t as bad this quarter. It doesn’t sound like it is because of rate so is there some type of one time quarterly anomaly because of the [inaudible] or something else going on? Or do you think it will go back now the way it has in the past couple of quarters? Is it more of an audit thing I guess is the question. An exposure issue?

Steven Justus Johnston
President, CEO & Director

I think we are seeing a little bit of both. I think we are seeing the audit pressure but I also think prudently as we manage the results on that line and start to deploy our predictive modeling we are I think seeing some premium decrease there in Worker’s Comp is a positive. We are just now rolling out the predictive modeling. I saw some of the first reports on retention by [inaudible] and it looks like our [inaudible] management is effective in that we saw the retention on the poorer modeled risks lower than the retention on the better modeled risks but with a recent deployment in a long-tail line like that I think it is probably too premature to get into exactly the impact on the loss ratio yet. I do think the premium going down is a combination of the audits and more prudent underwriting.

Michael Phillips
Stifel Nicolaus

Can you talk about the predictive modeling you are doing now for comp is that something you have built in-house or is that something you paid for outside?

Steven Justus Johnston
President, CEO & Director

We partnered with consultants on most all of our predictive modeling. We have been also staffing up on our actuarial department internally and see it as a partnership. We see the value though in the consultants that are doing this 100% of their time.

Michael Phillips
Stifel Nicolaus

On the comp development, this is where I think I got caught off last time, can you say what accident year that was? Is that more of the older years? You have been kind of flipping back around and that was a long-tail but kind of more recent or more older action years?

Steven Justus Johnston
President, CEO & Director

It was across the board. In terms of dollar sit was down around $9 million or favorable development of $9 million. We saw minus 5 from accident years 2007 through 2008 and minus five from accident years prior to 2007.

Operator

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

Scott Heleniak
RBC Capital Markets

I wonder if you could talk about what kind of price declines you are seeing for new commercial business? I know you talked about flat for renewal but obviously the bigger deal for you as you are rolling out everything to new states. I am wondering what you are seeing on that front relative to renewal pricing.

J.F. Scherer

It is especially competitive on the new business side. We have to pick and choose. What we continue to see is particularly on larger accounts very, very aggressive pricing across the board really. In terms of quantifying it last year versus this year it is a little tough because exposures continue to be down a bit. We are seeing much difference between the renewal pricing stability we are starting to see and what it takes to write a new piece of business.

As we go to new states what we find compared to existing states is a larger percentage of the new business we write are in accounts that are controlled by agencies. When we make an agency appointment there is a more deliberate effort on the part of the agency to do business with Cincinnati. We tend to get a look at their current book of business where there is more control and you don't have to go out into the marketplace and compete against everyone for the new business.

We are, as we have reported doing well in Texas, New Mexico and Colorado and the newer states. Not quite as price sensitive as the priced new business as it would be in some of our more established states where the new business tends to be new to the agency as well.

Scott Heleniak
RBC Capital Markets

Along those lines I was wondering if you could talk about some of the loss trends. I know it is early but quantifying some of the loss trends in some of the newer states you have expanded into since 2007 and how that is comparing to your expectations in some of the other states?

J.F. Scherer

I think as far as loss trends I couldn't give you a specific on that but as far as Texas and a variety of the newer states are concerned as far as the loss activity we have seen we are pleased with what we are seeing. We are seeing very good accounts, seasoned accounts for the agencies. Accounts they know the history. So we are not seeing anything surprising at all in that area. Actually in Texas, I might add, our excess and surplus lines company has been well received there as well. So we are pleased with the activity levels.

Scott Heleniak
RBC Capital Markets

On the investment front, dividend income still a little bit down. I think you mentioned putting new money into equities. I am just wondering how you are thinking about that over the balance of the year? The cash balance is at about $1 billion now. What is your expectation or outlook for the investment portfolio and what kind of investment income growth assumptions you are looking at for this year?

Martin Hollenbeck

Dividend income was down slightly from fourth quarter. That was almost exclusively due to some anomalies in the fourth quarter that inflated that number a little bit. For example, MetLife is a company that pays a single yearly dividend that occurred in the fourth quarter. Additionally we have two other stocks that pay quarterly but for accounting reasons that dividend occurred twice in the fourth quarter.

Going forward we will probably stick to our historical pattern of about a quarter of new money going into the equity portfolio. Right now we are at 25% roughly of the overall portfolio in equities. That is a number we are comfortable with. So we are I think for the first time in a number of years back to a reinvestment pattern that more matches what we have historically done.

Interest income was up actually 1.5% sequentially from the fourth quarter. That is about a 6% annualized rate so that is a number that we are pretty pleased with in this rate environment.

Operator

The next question comes from the line of Dan Schlemmer - Macquarie.

Dan Schlemmer
Macquarie

Staying on the investment portfolio if I heard the prepared remarks correctly I think what you said is your largest single holding is now 1% of the portfolio. Correct me if I am wrong. I want to know is that something you intend to stick to as a limit going forward or is that most that is where you are currently at? What would you see as a limit on an individual holding? Maybe if you could comment on what you see as a concentration risk within an industry too?

Martin Hollenbeck

Right now Procter and Gamble is our largest holding. As Steve mentioned it is 1% of the overall portfolio and 5.7% of the equity portfolio. We had a hard limit of 10% of the equity portfolio for a single name. As far as sectors go we kind of monitor it on an overall basis and I think we are maybe at about a 30% limit there as well as a multiple [VS&P] weighting for some of the smaller sectors. We are currently in line with all of those limits.

Dan Schlemmer
Macquarie

On the premium growth, what you are seeing is sort of a down in commercial and some increase in premium on the personal line side which somewhat mirrors what we are seeing industry wide. I wonder if you can comment on how much of the increase is coming from the changes, if you have a sense, how much is coming from changes you are making on the pricing and technology on the personal line side and how much is driven just by overall market conditions that divergence between the growth in commercial versus growth in personal lines?

J.F. Scherer

In personal lines certainly it is a combination of improved technology we rolled out and perfecting the pricing modeling together with that. We are where we want to be. In the ballpark. Not the lowest on the street but in the ballpark on pricing. We weren’t for several years and our current agencies along with agencies in newer areas out west, North Carolina and several other new states where they have been very pleased with their relationship with us like our claims service have really given us a lot of opportunity in the personal lines area.

On the commercial lines side as I mentioned earlier it is much tougher on the larger accounts. Maybe to add a little color, the new business for us in property was up 22.5% in the quarter. Policies were up 9.1% and casualty we were up 3.5% in policies but down 2.1% in new business premiums. The big issue for us in terms of affecting our new business growth was Worker's Comp. We were down 41% in new business in Worker's Comp but down 20.7% in new policies in comp.

So we are seeing in the market place we are more comfortable operating in the sub-$100,000 size of accounts. We continue to have some success in that area. It is a bit reckless if you will in terms of pricing of new business at the upper end. We are just having an increasing number of situations where we won't go there because it doesn't make sense. In terms of victories and in terms of effectiveness with our agencies, in terms of the numbers of new business policies we are writing for our agencies in that middle area, especially $10,000 to $100,000 range we find ourselves being effective.

I think our agencies appreciate that. We are defending our position and our agencies in terms of our preferred position and doing what we can to pick off appropriately priced larger accounts. Maybe that is more than you asked for but maybe it is a bit of a picture of what we are facing.

Dan Schlemmer
Macquarie

You mentioned the number of states you have added and you have a few more going. I am not sure what it is exactly but I think you are basically in every state except for the largest single state and you have faced these growth pressures. I wonder if that is something you will revisit or if there is any thoughts on would you have an interest in being in California and expanding into that territory? Is that something that is on the horizon?

J.F. Scherer

California is from a population standpoint the only meaningful state we are not in. We are in 37 states now. Oregon and Connecticut will raise that to 39. California is a bit down on the list currently in terms of a place to activate. We are examining in every single state market share. We think we have a lot of opportunities in all states. Certainly in the Midwest because of economic pressures in the Midwest; Ohio, Michigan, Pennsylvania and Illinois, not so much in terms of near-term opportunities but we have tremendous opportunities we think in a variety of states including Texas.

We do have teams of people that examine every single state and California is not being ignored. We think with what we have on the drawing boards right now competing for a larger share of our agencies books of business, the improvements we have made in personal lines. Our excess and surplus lines company is doing well. Our target markets division is getting up and running. We are satisfied right now we have enough on our plate with states we are in and are going to enter into next year and this year to keep us busy.

Kenneth William Stecher
Non-Executive Chairman of the Board

If I can just add a little more to what J.F. said, we think we have quite a few states we have been in for quite a few years that our market share in that state is less than 1%. As we deliver the technology we are going to try and focus on increasing that market share. We are not going get anywhere near like we have in Ohio with approximately 5% but if we bring those states up to 1% or possible between 1-2% I think it gives us a lot of opportunity for growth. As J.F. said we will continue to look at the new states but we don't believe we have to make that move at this time. We have other opportunities.

Operator

There are no further questions at this time. I would like to now turn the call back over to Ken Stecher.

Kenneth William Stecher
Non-Executive Chairman of the Board

Thank you all for joining us today. We look forward to speaking with you again on our second quarter call.

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