Kemper Corporation NYSE:KMPR

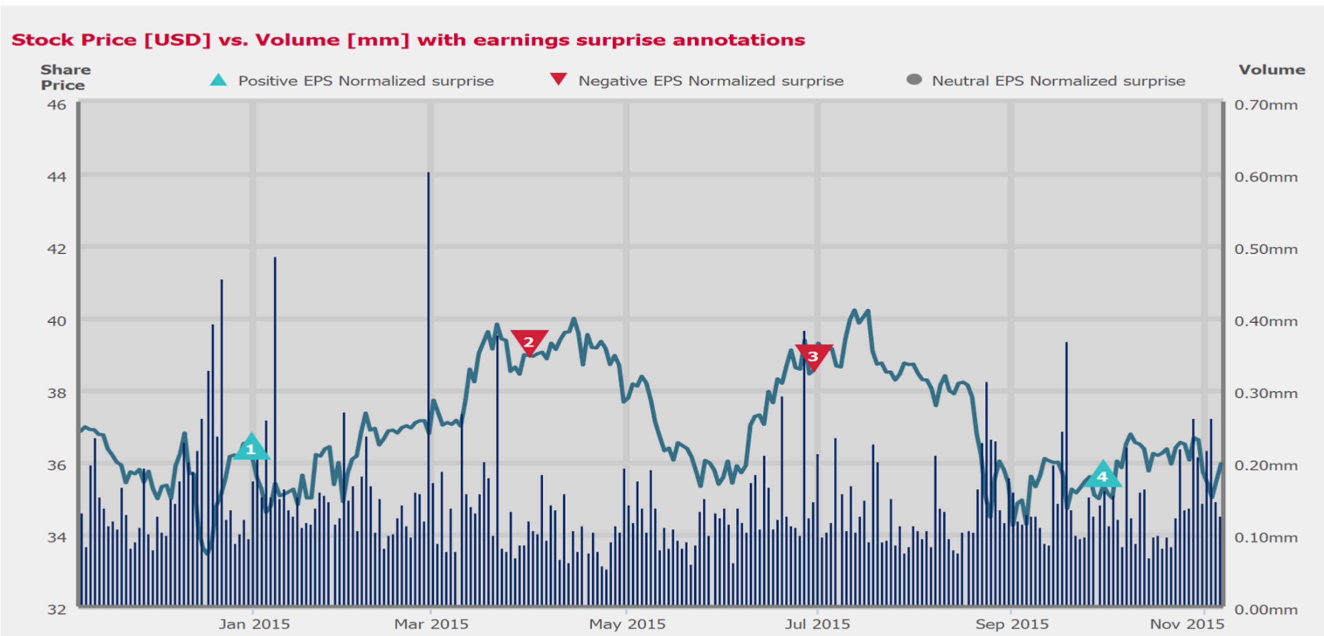
FQ4 2015 Earnings Call Transcripts

Friday, February 05, 2016 4:00 PM GMT

S&P Capital IQ Estimates

	-FQ4 2015-			-FQ1 2016-	-FY 2015-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.59	0.09	(84.75 %)	0.50	1.84	1.35
Revenue (mm)	583.06	622.30	6.73	589.05	2276.82	2315.90

Currency: USD
Consensus as of Jan-22-2016 10:30 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2014	0.73	1.02	1 39.73 %
FQ1 2015	0.52	0.42	2 (19.23 %)
FQ2 2015	0.49	0.13	3 (73.47 %)
FQ3 2015	0.56	0.71	4 26.79 %

Call Participants

EXECUTIVES

Denise Idell Lynch
Former Property & Casualty Group Executive

Diana J. Hickert-Hill
Vice President of Investor Relations & Corporate Identity

Frank Joseph Sodaro
Former Senior Advisor

John M. Boschelli
Chief Investment Officer and Senior Vice President

Joseph P. Lacher
Chief Executive Officer, President and Director

ANALYSTS

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

Brian Rohman
Boston Partners Global Investors, Inc.

Christine Amanda Worley
JMP Securities LLC, Research Division

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

Ronald David Bobman
Capital Returns Management, LLC

Presentation

Operator

Good morning, ladies and gentlemen, and welcome to Kemper's Fourth Quarter 2015 Earnings Conference Call. My name is Abbey, and I will be your coordinator for today. [Operator Instructions] As a reminder, this conference is being recorded for replay purposes.

I would now like to introduce your host for today's conference, Ms. Diana Hickert-Hill, Vice President, Investor Relations and Corporate Identity. Ms. Hickert-Hill, you may begin.

Diana J. Hickert-Hill
Vice President of Investor Relations & Corporate Identity

Thank you, operator. Good morning, everyone, and thank you for joining us. This morning, you will hear from 3 of our business executives, starting with Joe Lacher, Kemper's President and Chief Executive Officer; followed by Denise Lynch, Kemper's Property & Casualty Group Executive; and Frank Sodaro, Kemper's Senior Vice President and Chief Financial Officer.

We will make a few opening remarks to provide context around our fourth quarter results. We will then open up the call for a question-and-answer session. John Boschelli, Kemper's Senior Vice President and Chief Investment Officer, will join our presenters during the interactive portion of the call.

After the market's close yesterday, we issued our press release and financial supplement. You can find these documents on the Investors section of our website, kemper.com.

Please note that our discussion today may contain forward-looking statements. Our actual results may differ materially from these statements. For information on potential risks associated with relying on forward-looking statements, please refer to our Form 10-K and 10-Q reports filed with the SEC as well as our earnings release. We plan to file our 2015 Form 10-K on or about February 12.

This morning's discussion includes non-GAAP financial measures that we believe are meaningful to investors. In our supplement and earnings release, we defined and reconciled non-GAAP financial measures to GAAP, where required, in accordance with SEC rules. And finally, all comparative references will be to the fourth quarter of 2014, unless we state otherwise.

Now I will turn the call over to Joe.

Joseph P. Lacher
Chief Executive Officer, President and Director

Thank you, Diana. Good morning, everyone, and thank you for joining us today. Before I comment on our performance on the quarter and the year, I want to let you know how honored I am to be here leading Kemper. I also want to acknowledge the hard work and many contributions of my predecessor, Don Southwell. He assembled a talented team and has been instrumental in helping me come up to speed quickly on the many aspects of our diverse business.

Since joining Kemper just 2 months ago, I've been doing a deep dive on many fronts and I'm learning a lot about our strengths, our opportunities and our challenges. Overall, I'd say we're not happy with our financial performance in the past couple of years and it's going to take a couple of years for us to get it fixed. While we do have areas that are going well, clearly, we have issues we need to address, including some that drove results this quarter. For the near term, I'm focused on a critical few points that need my immediate attention, while the team and I analyze our longer-term needs and plans. I commit to give you a strategic update this summer and so will withhold strategy comments for now while that assessment is still under way.

Given that context, I'll now shift to discussing our fourth quarter results and full-year performance. In short, it was a disappointing quarter overall, and we'll detail the drivers for you. Underneath those issues, we did have some positives as well and we'll explore those, too. Nonstandard auto was our main problem area this quarter, especially the Alliance United business. This acquisition will not be accretive in its first full year, however, we do expect it will be in its second year. We think the issues in nonstandard auto overall and Alliance United specifically are fixable. We still feel good about the acquisition. We're seeing positives from the changes we made to our preferred auto book, despite the headwinds and loss trends that the industry is experiencing, the fundamentals in our Life & Health segment were stable, and once again, our investments portfolio performed well.

In total, Kemper's net operating income in the quarter was $5 million. A significant driver was lower quarter from Alliance United. Other factors include increased catastrophe losses, a higher underlying loss ratio in our P&C legacy lines, lower levels of favorable reserve development and an increase in life insurance expenses. Additionally, in the prior year, we received a large special dividend from one of our alternative investments.

Similar to other companies in the nonstandard auto industry, Alliance United's loss trends were pressured in the quarter. It was not a good time to be growing the line so quickly, given the uptick in frequency and severity. As you may surmise, this is a key area for my immediate focus. Denise will cover Alliance United in more detail when she discusses the P&C segment's performance shortly.

In total, Kemper's revenues were up $57 million in the quarter and ended the year at more than $2.3 billion, up $144 million, as the Alliance United acquisition contributed to the top line, more than offsetting reductions in the legacy businesses.

Turning now to the Life & Health segment. The underlying results were stable. We earned $18 million in the quarter, down $16 million. You can see in our press release, we had 2 main drivers for the decline. The largest driver was related to the fourth quarter of 2014 when we benefited from a $14 million after-tax special dividend from the recovery of one investment in our alternative investments portfolio. The second driver was from an increase of $5 million after-tax for legal fees in our life insurance line.

On a full-year basis, we earned $72 million compared to $92 million last year. Excluding the impact of these 2 items, underlying earnings actually improved.

Life & Health revenues were $205 million in the quarter, down $18 million, with $16 million of the decline driven by lower net investment income. On a full-year basis, revenues were $811 million, down $21 million from 2014. These declines were driven by the 2014 special dividend I just mentioned.

In the Kemper Home Service Companies business, premium revenue was nearly flat at $116 million in the quarter and expenses benefited from the field consolidation. In Reserve National, premiums remain stable despite the transition away from hospitalization products and toward life, home health care, critical illness and accident expense insurance.

I'll turn now to investments. I'm pleased to report our investment portfolio performance remains an area of strength for us. Excluding last year's special dividend, our net investment income increased $8 million for the quarter and $15 million for the year. Our pretax equivalent yield is holding up well at 5.5% annualized for the quarter, slightly better than the full year. Our alternative investment portfolio, which primarily consist of LPs and LLCs, yielded 9% annualized for the quarter and 8% for the year. Total return was a positive 0.4% for the quarter and 2.2% for the year, primarily from net investment income, offset by rising yields.

We're very pleased with our alternative investments performance, both for the quarter and year-to-date in light of the equity and high-yield market volatility.

Now I'll turn the call over to Denise to discuss our Property & Casualty segment results.

Denise Idell Lynch
Former Property & Casualty Group Executive

Thank you, Joe. I'll start with the segment overview in total and then go through the performance of each of our lines of business. The Property & Casualty segment lost 5 premium deficiency, resulting in a partial write-off of deferred policy acquisition cost. For the full year, we earned $27 million, up from $25 million last year. Our Property & Casualty revenues were $414 million in the quarter, up $97 million, driven by Alliance United, which more than offset a decline in our legacy lines. On a full-year basis, revenues were $1.5 billion, up from $1.3 billion in 2014, primarily from having the 8 months of revenues this year from Alliance United.

Our policies in force increased sequentially, ending the year at $1.2 million, up from $823,000 last year, getting a lift from our acquisition. Net earned premiums were $392 million in the quarter, up $92 million. Excluding Alliance United, premium retention improved 2 percentage points, and new policies in force were up 15%, yet legacy earned premiums were $281 million, down $19 million.

For the full year, segment net earned premiums were $1.4 billion, up $166 million versus 2014. The impact of Alliance United makes the year-over-year comparisons difficult as Alliance United runs at a higher underlying loss and LAE ratio, but a lower expense ratio than our legacy business. I'll provide more detail on profitability by line of business.

On expenses, we had a $9 million charge to write down a portion of Alliance United's deferred policy acquisition costs. The legacy P&C expense ratio was up about 0.5 point in the quarter.

Now I'll provide a fourth quarter update on each of our lines of business. I'll start with the nonstandard personal auto line. In the quarter, net premiums were $186 million, an increase of $117 million. Net earned premium were $188 million, an increase of $113 million. While Alliance United drove the majority of the increase, the legacy nonstandard auto net premium written were up 5% and marked the fourth straight quarter of period-over-period increase. The total loss and LAE ratio was 95.6%, with the underlying loss and LAE ratio at 92.7%. I will address the underlying performance at Alliance United separately from the legacy nonstandard book.

The Alliance United loss and LAE ratio of 105% includes an underlying loss and LAE ratio of 100.9%, and 4.1 points from adverse pre-acquisition loss reserve development. Additionally, we saw significant current year adverse development that increased the fourth quarter underlying loss and LAE ratio by 6.7 percentage points. Obviously, this was a very disappointing performance. The drivers of the underlying performance include, 1, broadly, the industry saw loss trends nearly double in California over the last year to the mid-teens. Frequency and severity and bodily injury and property damage liability were the drivers as well as collision severity. Alliance United was subject to the same environmental factors that impacted the industry such as increased miles driven and more expensive repair costs; 2, Alliance United claims department was somewhat understaffed at acquisition. The staffing gap grew with the increased frequency trends, increased new business and some disruption to hiring during the integration; and 3, we filed the class plan change and rate increase for our product representing about half of the business midyear. This approval process is taking longer than typically expected.

In response to these developments, we have implemented a few very important operational actions. First, we continue to work with the Department of Insurance on this filing and are accelerating the filing to increase rates on the remaining business. Second, we hired and onboarded a significant number of new claim professionals in 2015 and expect to add more over this year to address the claim staffing issue. Third, we have taken actions to improve risk selection, price adequacy and agency management. Collectively, these are now slowing new sales to more desired levels.

While Alliance United is not meeting our expectations, a long-term strategic value of this business remains compelling. We do expect the acquisition to be accretive in its second year. However, it will take a few years before this business will meet our profit objectives. To our legacy nonstandard auto book. This business did not meet our target profitability last year. We, along with the industry, saw elevated loss trends over the course of 2015. Year-over-year profitability deteriorated every quarter and that trend continued in the fourth quarter. We are in the process of rolling out a new product and rating plan. It's currently being used on about 45% of our book. Over the course of 2015, we increased our filed rate levels to about 10 points. These efforts have yet to yield a significant impact on results.

In the quarter, we completed an overall review of our legacy nonstandard business and identified a number of initiatives to improve profitability. We are in the process of executing those initiatives and we are going to reopen and expand the scope and urgency of that review to include every function and operating lever to drive improved financial performance in this business.

We're planning to file rate increases of nearly 7 points, with the majority in the first half of the year of our entire legacy book. Unfortunately, given the current results and the current industry loss trends, it will take some time before we achieve acceptable returns.

In commercial auto, net premiums written were flat at $12 million in the quarter and down 3% at $54 million for the year. Earned premiums were stable in the quarter and for 2015 at $14 million and $55 million, respectively. For the quarter, the loss and LAE ratio deteriorated to 92%, driven by $1 million of adverse development and a 9.7% increase in the underlying loss and LAE ratio due to increased frequency and severity. We continue various agency management underwriting and rate actions.

Moving to preferred auto. Net premium written were $102 million in the quarter, down $8 million, and were $435 million for the year, down $52 million from 2014. Net earned premiums were $109 million in the quarter, down $14 million, and were $450 million for the year, down $76 million. New business written premiums grew by 8.5% as new policies in force increased for the sixth consecutive quarter to the highest levels since the third quarter of 2013. Premium retention at 84% improved both year-over-year and sequentially.

The loss and LAE ratio was 75.7%, up 6.6 points, primarily from lower levels of favorable prior year development. The underlying loss and LAE ratio increased to 76.2% for the quarter.

When you look at quarterly results, there are periodic changes that occurred from prior periods within the year. When we remove the current year development, we're seeing a modest improvement in the quarterly underlying loss and LAE ratio. Over the past several years, we've executed a number of profit improvement actions, which have been resulting in steady improvement in profitability. The underlying loss and LAE ratio was 70.9% for the year and improved about 1 point. We still have a ways to go, but continue to make progress.

Now turning to the homeowners line. Net premiums written in the quarter were $64 million, down $3 million, and totaled $276 million in the year, down 7%. Net earned premiums were $70 million in the quarter, a $6 million decrease. For the full year, net earned premiums totaled $286 million, an 8% decrease from last year. New business production grew 9% from last year. Premium retention improved 4 points to 84% and was up sequentially for the fourth straight quarter.

Catastrophes in the homeowners line finished at 18% of earned premiums in the quarter, up 13 points from last year and above our expectations. The quarter had been relatively mild until the last week of the year when tornadoes struck in North Texas. The loss and LAE ratio was 61.6% as the underlying loss and LAE ratio increased 4.9 points to 46.4%, primarily from increased severity from large fire losses.

Average earned premium decreased slightly as mix changes offset 4% filed rate increases.

So looking at the Property & Casualty segment in total, it was obviously a disappointing quarter. While the Alliance United acquisition failed to meet expectations, the long-term strategic value of the business remains compelling. However, it will take a few years before this business will meet our profit objectives. Our legacy nonstandard auto business continues to underperform against the backdrop of deteriorating industry loss trends. And so we are going to take a fresh look with an increased sense of urgency to significantly change the trajectory of this business. Efforts to stabilize preferred auto and home premiums show continued progress and we expect this progress to continue.

Now I will turn the call over to Frank.

Frank Joseph Sodaro
Former Senior Advisor

Thanks, Denise, and good morning, everyone. Today, I'll cover Kemper's consolidated performance, capital and parent company liquidity.

For the fourth quarter, net income and net operating income were both $5 million or $0.09 per share compared to net income last year of $65 million or $1.24 per share and net operating income last year of $54 million or $1.02. For the year, our net income was $86 million or $1.65 per share compared to $115 million or $2.12. Net operating income was $70 million or $1.35 compared to $97 million or $1.79 per share last year.

For the full-year results for 2015, both net income and net operating income included a software write-off of $7 million after-tax or $0.14 per share. Similarly, the prior year's results included a software write-off of $35 million after-tax or $0.66 per share. Total revenues were $617 million for the quarter, an increase of $57 million or 10%, as roughly $110 million of earned premiums from the Alliance United acquisition were partially offset by lower earned premiums from our legacy P&C.

On a full-year basis, our total revenues increased 7% to more than $2.3 billion, driven by lower -- driven by over $270 million of earned premiums from Alliance United, offset by lower earned premiums from our legacy P&C business. Earned premiums in the Life & Health segment decreased about $20 million, primarily from lower life insurance premiums which included an $8 million deferred premium adjustment in the first quarter of 2015.

Net investment income decreased $14 million for the quarter and $7 million for the year due to the $22 million special dividend we received in 2014. Excluding the special dividend, both the quarter and year increased from higher returns on our equity method investments, while the year was also driven by higher yield on fixed maturities. The investment portfolio in total generated a pretax equivalent annualized book yield of 5.5% for the fourth quarter of 2015 and 5.3% for the year compared to 6.5% and 5.5% for the quarter and year in 2014.

The Property & Casualty segment reported net operating loss of $5 million for the quarter compared to net income of $25 million last year. This decline was due to Alliance United's results, which included adverse development and the resulting DPAC write-off, as well as poor results from our legacy P&C book. For the year, the Property & Casualty segment reported net operating income of $27 million compared to $25 million in 2014.

Given Alliance United's fourth quarter, results did not meet our expectations and were a drag on the full year. Net operating income for the Life & Health segment was $18 million for the quarter compared to $34 million last year and $72 million for the year compared to $92 million last year. Last year, the Life & Health segment's net operating income benefited $14 million from the special dividend it received in the fourth quarter. Excluding that dividend, net operating income decreased for the current quarter and year by $2 million and $6 million, respectively, due to higher legal expense and a deferred premium adjustment booked in the first quarter of 2015, offset by higher investment income.

Net operating loss from Corporate & Other increased $3 million and $9 million for the quarter and year, respectively, primarily from higher pension costs driven by assumption changes at the end of 2014 and lower net investment income.

Looking ahead to 2016 pension expense. We increased our discount rate by about 40 basis points and adopted the most recently published mortality tables at the end of 2015. Additionally, we are reducing our expected long-term returns on pension investments and adopting the field -- the full yield curve approach for estimating interest and service cost. As a result of these assumption changes, we expect our pension expense to decrease about $11 million after-tax for 2016. To put that in perspective, pension expense increased by about that same amount in 2015 compared to 2014, largely due to the adverse effects of assumption changes.

I will now cover book value, capital and parent company liquidity. Book value per share was $38.82 at the end of the year, down 3% from last year, largely from the impact of higher market yields on our fixed maturity portfolio and dividends paid, partially offset by net operating income. Book value per share excluding unrealized gains on fixed maturities was $35.13, up 2% from the prior year, primarily from net operating income, partially offset by dividends.

Statutory surplus levels in our insurance companies remain strong and we estimate that we ended the year with risk-based capital ratios of approximately 390% for our Life & Health group and 325% for our legacy Property & Casualty group. We estimate that our insurance companies will have a maximum ordinary dividend capacity in excess of $170 million in 2016.

During 2015, we repurchased more than 1.2 million shares of common stock for a total cost of $44 million or $35.57 per share. In total, we returned $93 million of capital to shareholders. We estimate that we ended the year with more than $225 million of excess capital, and from a liquidity perspective, the parent company held cash and investments of about $340 million, while our $225 million revolver remained undrawn.

I'll now turn the call back over to Joe.

Joseph P. Lacher
Chief Executive Officer, President and Director

Thanks, Frank. Capital allocation is a key part of the overall business assessment process that I've been conducting. As I look at the sources and uses of capital, I'm mindful to address both our short-term needs and long-term return objectives. We work for our shareholders who expect and deserve production of attractive returns. The good news is that our current capital position is strong. Historically, we've described our strategic capital allocation priorities as funding growth for new business that delivers appropriate returns, acquisitions that are accretive to our business and returning capital to shareholders through dividends and share repurchases.

We'll share with you more about our capital allocation priorities during our strategic update in the summer. My commitment to you is that we will be prudent stewards of your capital.
Now I'll turn the call over to the operator to take questions. Operator?

Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Christine Worley with JMP Securities.

Christine Amanda Worley
JMP Securities LLC, Research Division

A couple of questions on United Alliance and the nonstandard book legacy, can you sort of give us an idea, over the past year, how much of the growth in those separate pieces has come from rate and then how much has been just growth expansion?

Denise Idell Lynch
Former Property & Casualty Group Executive

Sure, Christine. I'll take that question. The majority of the growth at Alliance United this year has come from new policy growth. Although there is some additional rate flowing into the book from primarily mix shift changes that we are experiencing in that book, but the majority of that growth is in fact coming from policy in force growth.

Christine Amanda Worley
JMP Securities LLC, Research Division

And can you quantify what the rate increases you have achieved on that book have been?

Denise Idell Lynch
Former Property & Casualty Group Executive

The average written premium is up mid-single digits on an exposure basis.

Christine Amanda Worley
JMP Securities LLC, Research Division

Okay. And then, same question for the legacy book. I mean, are you getting any growth there outside of rate?

Denise Idell Lynch
Former Property & Casualty Group Executive

In legacy business, our legacy nonstandard business, our policies in force are actually down. So we are not adding policies to our portfolio at this time. And what we're seeing is rate coming through from our actions in the book.

Christine Amanda Worley
JMP Securities LLC, Research Division

Okay. And I mean, from an actuarial perspective, how -- I mean, I know you filed the 7%, how much additional rate do you think you need to sort of get in line with what you're seeing from a loss cost perspective?

Denise Idell Lynch
Former Property & Casualty Group Executive

There's a ways to go on this book of business. As I said, this is going to take a few years to get this book. You're talking about Alliance United turned around. And we will take the rate that we need on our portfolio as we work with the Department of Insurance on the product that we've got filed right now. We'll continue to take the additional rate on the rest of the book and then we'll continue to take other underwriting agency management risk selection issues to be able to improve our price adequacy and our overall risk selection in the book. But it will take a period of time to get it to our target returns.

Joseph P. Lacher
Chief Executive Officer, President and Director

And Christine, this is Joe. I'll just add on top of that. I mean, obviously, we're dealing with California, which is a more challenging environment to get rate. So we'll have to -- we won't rely solely on the rate lever to respond, and as Denise was saying, we will be more aggressive with all of the tools at our disposal.

Christine Amanda Worley
JMP Securities LLC, Research Division

Okay. And what's your average policy length on the United Alliance book?

Denise Idell Lynch
Former Property & Casualty Group Executive

The vast, vast majority is well under 12 months.

Christine Amanda Worley
JMP Securities LLC, Research Division

Okay. Well under, so more in the 3 to 6 month range then, is that fair to say?

Denise Idell Lynch
Former Property & Casualty Group Executive

Yes, under 6 months.

Christine Amanda Worley
JMP Securities LLC, Research Division

Okay. Under 6 months. Great. And then, just sort of one last question. I mean, how should we think about sort of the moving pieces from a combined ratio standpoint? I mean, if we look at the addition of people on the claims side, how quickly do you expect the losses to come down due to that sort of offsetting what additional expense spend you may have there?

Denise Idell Lynch
Former Property & Casualty Group Executive

So let me see if I can answer the question around Alliance United and the combined ratio there. What we are seeing is a significant deterioration in industry loss trends. And those same deterioration in industry loss trends affected Alliance United. We saw that come through in our prior year development and in our current year development. We're addressing that with rate and underwriting and other actions, but it is going to take a period of time to restore that book of business to our profit objectives. The key issue on this book of business, really, is the loss trend, recognizing the loss trend and then acting upon it. With respect to the claims, we are already working on the claims to address that staffing issue. We've added several claims professional throughout the year and we'll continue to do so to address the staffing need that we have.

Joseph P. Lacher
Chief Executive Officer, President and Director

If your question, Christine, was narrow -- Denise is trying to answer the full impact on the combined ratio. If it's really a narrow question on, are we going to drive up LAE by adding claims adjusters before they have an ability to impact loss costs, on that one in particular trade, we're very confident that adding the adjusters will more than pay for itself in loss cost management.

Operator

Our next question comes from the line of Paul Newsome with Sandler O'Neill.

Jon Paul Newsome

Sandler O'Neill + Partners, L.P., Research Division

I have a broad question and then a couple of narrow ones. Broadly, we're referencing a lot of trying to get profitability up to our targets, but we have a bit of a change in management. What are those targets now?

Joseph P. Lacher
Chief Executive Officer, President and Director

Paul, I'm going to defer giving you a real specific answer on that one. What I want to do is spend a little more time digging into all of our businesses and really get a sense of where we want to take all of them broadly. It's a fairly easy statement when you look at our nonstandard businesses, our legacy and Alliance United to say that they're not close to a reasonable target. We need to provide very reasonable returns for our shareholders on a consistent going forward basis and do it by delivering consistent and replicable competitive advantages in the marketplace. And particularly, these 2 businesses were not delivering that right now. So at a minimum, we've got to be in the double-digit ROE range. But we'll give you a more specific answer by the summer as we dig more into these businesses.

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

That's fair. Specific question. The $5 million in after-tax legal fees on the life side, is that related to the lawsuit with the Illinois Treasury and should we expect that those be, at least in the near term, a recurring type cost?

Joseph P. Lacher
Chief Executive Officer, President and Director

The $5 million is related to our unclaimed property litigation and issues on a number of front. We will continue to pursue our legal options in that arena, hopefully until we have an appropriate conclusion. I don't anticipate you will see charges of that size on a regular basis, but it would be somewhat surprising to me if this ends quickly. Our hope is that this is an adequate view of what should be -- which should cover the issues we know that are out there over a reasonable period of time, but things may change on that. So the crisp answer is you shouldn't expect this kind of number every quarter.

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

Okay. Back to the Property & Casualty business. When you filed the rate plan, could you talk about the timing of when you filed the class plan for United Alliance and then sort of what's the -- how long it took? And then, if there's any way to think about how quickly it can go through. I realize it's California and that's a hard question to ask. But any more details about when it was originally filed and kind of how long it lasted would be great.

Denise Idell Lynch
Former Property & Casualty Group Executive

Okay, Paul. For Alliance United, we filed a new class plan with a rate increase in the summer of this year and we have been working back and forth with the department to get that filing approved and we are still working with the department to get that filing approved. We expect to very soon after file another rate increase on the remaining product in the Alliance United portfolio.

Operator

Our next question comes from the line of Ron Bobman with Capital Returns.

Ronald David Bobman
Capital Returns Management, LLC

I had a couple of questions, I guess, largely focused on Alliance United. What -- could you describe the -- and I assume, sort of following, Joe, your arrival, what sort of claims reviews been done on both case and

IB&R levels, whether you engaged any outside providers or whether you relied upon solely in-house staff. For starters, could you describe that?

Joseph P. Lacher
Chief Executive Officer, President and Director

Sure. What we've done in -- I'll comment again, as you requested, largely during my tenure. We've dug into case reserves, how those were put up, how the process is managed. We've done that ourselves. We've had our outside auditors doing it and we had at least 1, maybe 2 third-party groups, depending on how you think of the review going through and take detailed reviews for us on those case reserves and claim practices, their claim -- AU's claim practices compared to ours, compared to the industry. So we've taken a broad and deep review of all of those elements. And all of those are informing both the numbers that we booked this quarter and the actions that we are currently executing.

Ronald David Bobman
Capital Returns Management, LLC

Do you consider -- and I understand you can get more information through the continued passage of time, but do you consider sort of the headquarters review, this work that you've done, complete or is there still broader, additional case files to be looked at, broader production areas to look at? In essence, sort of is your claims audit, your reserve audit on this acquired enterprise and the book they're producing for you today and that you inherited, is it complete or is it fair to say that there's really some more work to be done?

Joseph P. Lacher
Chief Executive Officer, President and Director

Ron, while there's always the potential for something else to be found, I would say this is a largely complete review. We've been very deep and thorough. This is a book that turns over. It's a relatively short tenure. We've been looking at the data since we've been owners for more than 8 months. We've been deep inside of those items. There were a number of issues that made it somewhat challenging to read when we first acquired it. Alliance United, as companies do from time to time, had undergone a claim process where they were closing some claim files near the back end of last year and the early part of this year in a different way than they had in the past. That causes data to be a little more challenging to read, I think it was challenging for the folks that were booking their numbers. It was certainly a challenge for us reviewing that information in the first 90 days that we had the book. We have cleared all of the clutter out of that and understand how that impacts the numbers and have a clear view on it. Again, our outside auditors and the outside expert we had look at it have all been through it, understand it. And when you get a dozen actuaries, you'll get 15 opinions. But even with them as a group, they are largely honed down a consistent view of this and believe we've got a thorough view and a thorough understanding and have taken the appropriate action based on that.

Ronald David Bobman
Capital Returns Management, LLC

And I assume that all claims are handled in-house, they don't and Kemper doesn't rely upon third-parties?

Joseph P. Lacher
Chief Executive Officer, President and Director

We do periodically use independent adjusters or appraisers and TPAs for parts of the item. We don't have the scale that we want in all spots. So it's largely in a case where we don't have the geographic presence or the geographic spread. It's not a case where we're wholesale, taking a state or taking a whole section of a state, it's more covering the edges. And we typically drive that only on the simplest claims. Anything that's got what you might describe as hair on it, regardless of where it is, we pull those in. And the group has a much tighter, narrower authority. You can almost think of it as a minor use of supplemental staffing rather than a broad outsourcing.

Ronald David Bobman

Capital Returns Management, LLC

Okay. In the same area. And I know nonstandard retention levels are much, much lower than standard lines, but I'm curious about sort of -- what I would like to understand is, rate isn't where you want it to be, where it needs to be. And it sounds like it's materially lower and it's going to take a couple of renewals, and firstly, an approval by the state to get rate on this book where it needs to be. What -- so are retention levels higher than they might otherwise be desirable? I mean, you sort of -- are we continuing to write business that effectively is underpriced, it's got a deficient margin, or is that not the case?

Denise Idell Lynch
Former Property & Casualty Group Executive

Ron, are you asking about Alliance United or...

Ronald David Bobman
Capital Returns Management, LLC

Yes, Alliance United. Sorry.

Denise Idell Lynch
Former Property & Casualty Group Executive

Alliance United's retention persistency is actually pretty consistent over time. And so with, really, with the policies being 6 months and under policies, we have the opportunity to get the rate into the book for new business as we write it, and then, the renewals as we renew them. So we have that opportunity. And yes, as soon as we get that rate filing approved.

Ronald David Bobman
Capital Returns Management, LLC

And then my last question, thanks for your patience because I know it's been a few. You said that you expect Alliance United to be accretive calendar '16. I assume that's sort of on a total income basis, the investment income off of the cash flow and underwriting, add it to underwriting income. But can you give us a statement on what you think the combined is actually going to be for calendar '16, or you hope it to be?

Joseph P. Lacher
Chief Executive Officer, President and Director

Well, let me adjust first a little bit on your question. What we said, and I'm not trying to parse words, but make sure we understand it, what we said is it was not going to be accretive in its first full year of ownership, which is not a calendar year of ownership, it's a year from acquisition, and that we believe it would be accretive in the second year. So that's a little bit of a time spread there. We don't typically do forward-looking views of combined ratios, so I'm going to defer for giving you that much detail. We do recognize for this book that they are largely 6-month policies, that we do have a number of levers that we can pull, that we have not been pulling as hard as they can be pulled and we'll actively engage in those. And the analysis to the other part of your question on how we're defining accretive, we're looking at it on an independent basis to say what did it add to the organization by being here. So that takes into account all of the different components of that, investment income, the fact that we -- as we do that analysis, if we hadn't bought the business, we wouldn't have made the $70-ish million payment, we would have had those dollars in-house. So it's a view of with and without.

Operator

[Operator Instructions] Our next question comes from the line of Brian Rohman with Boston Markets.

Brian Rohman
Boston Partners Global Investors, Inc.

A bunch of questions. You talked about doing comprehensive claims review for Alliance United, are you doing that for the other property casualty lines?

Joseph P. Lacher
Chief Executive Officer, President and Director

We have expanded that review for all of our nonstandard where it's the principal issue. It does run across and use similar claim resources. So we are looking and exploring that. We haven't made a call on whether we'd do it in our preferred area. What I'd tell you is a lot of what we're learning out of those 2 nonstandard reviews, we'll lift and update where appropriate and use it across.

Brian Rohman
Boston Partners Global Investors, Inc.

I'm sorry, 2 nonstandard reviews, Alliance United and then?

Joseph P. Lacher
Chief Executive Officer, President and Director

Alliance United and then our legacy nonstandard business.

Brian Rohman
Boston Partners Global Investors, Inc.

Got it. Okay. So...

Joseph P. Lacher
Chief Executive Officer, President and Director

There's some element, Brian, that those needed to be fully insightful to look at them differently because we'd start with what was Alliance United doing before the acquisition, what were we doing as we integrated it and then what was our legacy nonstandard business doing. So you could think of it as 1 with 3 parts, you could think of it as a couple, I'm trying to be fulsome in the answer.

Brian Rohman
Boston Partners Global Investors, Inc.

And I'm interested in Alliance United as well as the other nonstandard businesses. I mean, you bought Alliance United, you closed on April 30th of last year. So between April 30 and basically the beginning of the first quarter -- pardon, fourth quarter of fiscal '15, October 1, you saw a need for rate increase, you saw a need for a comprehensive review. Is there something that changed precipitously during that, what's that about, 6-month period or is it just things that have been mounting for a while?

Joseph P. Lacher
Chief Executive Officer, President and Director

There were a handful of issues, Brian, that sort of hit simultaneously. The loss trend in the nonstandard business in general had been relatively benign across the industry for a number of years. It has spiked during that time period you described, and California has spiked more significantly. That spike probably started just before the business was acquired. So you get that as an environmental factor. Alliance United has had a long history of significant growth and it would've been our expectation that, that would have generally continued. So it did going into the wrong time to be growing with that loss trend. Given their growth, they have been, for some period of time, somewhat behind on claims staffing, and where, at acquisition, that was known to us earlier and they were sort of constantly running to hire folks to staff as they could to keep up with their growth. We probably got a little delayed in that claims staffing on integration. And so we're behind on that staffing level, so we've been aggressively to catch that up, which is not ideal from a timing perspective as well. They had made those claim actions where they were -- altered their behavior on some claim closing items near the end of last year and the early part of this year, which made the data that we look at to determine loss trends and determine where we are harder to read. It was hard for us to read. It was hard for our outside expert to read. It was hard for our outside -- our auditor to read. Everybody had the same challenge. It wasn't a brain cramp on our side of having a problem reading it. All of those things were simultaneous. And then, the normal ordinary course rate process that they would have gone through, they probably were a little delayed from what they normally would have been. My guess is, with a relatively small set of staffing, their side was distracted and was a little behind on that because they were dealing with an acquisition. So we diligently moved on that after closing, got it filed and it's gotten hung up in the department longer than any of us would've expected. So there's a lot of things that happened simultaneously. We wouldn't describe those as excuses, but it's an explanation. All of them happening at the same time with that industry rising loss trend made it hard to see the pace that this was deteriorating, and that's what's, I think, driving the issues and where we are now.

Brian Rohman
Boston Partners Global Investors, Inc.

Whoever you bought Alliance United from, is there any sort of earn-out?

Joseph P. Lacher
Chief Executive Officer, President and Director

There is. There is a couple of indemnification provisions. And, Frank, do you want to help describe what the numbers are on that because I'll get them off.

Frank Joseph Sodaro
Former Senior Advisor

Yes. From a holdback perspective, there was a $12.5 million holdback that was a general indemnification bucket and then a $5 million holdback that was related to some legal matters.

Brian Rohman
Boston Partners Global Investors, Inc.

And have those been paid or are they still being held back?

Frank Joseph Sodaro
Former Senior Advisor

They're still being held back at this point.

Brian Rohman
Boston Partners Global Investors, Inc.

And what's the trigger that says that -- I guess...

Frank Joseph Sodaro
Former Senior Advisor

The first part of it, Brian -- I think, I know where you're going with the question. The first part of it, the $12.5 million, will not be paid out based on where the results have been. And I'm fairly certain that the $5 million for legal expense accrual, there will be some piece of that or all of that which will not be paid out as well.

Brian Rohman
Boston Partners Global Investors, Inc.

And what will that do, lower your cost basis? How does that work? Or is that just a cost that you will not incur in the future?

Frank Joseph Sodaro
Former Senior Advisor

Well, the amount that we paid or we published that we paid for this was the $71 million, in that range. That included this holdback. So effectively, that amount would be reduced by whatever ultimately comes back to us.

Brian Rohman

Boston Partners Global Investors, Inc.

And as stockholders, how do we get that back? That will be through what, some sort of reversal or -- of the purchase price?

Joseph P. Lacher
Chief Executive Officer, President and Director

Are you asking how it runs through the financial statements or the economics?

Brian Rohman
Boston Partners Global Investors, Inc.

A little of both, but also the financial statements because this doesn't happen very often.

Frank Joseph Sodaro
Former Senior Advisor

So the holdback is effectively already booked as a receivable. I mean, that's what's happened as the development and these other things that have led to filling up that bucket. So from a financial statement perspective, it's essentially booked.

Joseph P. Lacher
Chief Executive Officer, President and Director

As we book some of the incremental charges, we booked and offset from the income statement for a receivable. So it was -- as it was being used, it was a buffer to the results.

Brian Rohman
Boston Partners Global Investors, Inc.

Okay. Is Alliance United a standalone company from an A.M. Best standpoint?

Joseph P. Lacher
Chief Executive Officer, President and Director

It is. It's a standalone company, we did not bring it into our pool. It's a nonstandard company and writes on a more leveraged basis than the rest of our pool, so we have it separate.

Brian Rohman
Boston Partners Global Investors, Inc.

And do you think it will need a capital injection at this point? Or is that -- obviously, that is to be determined, but is it something you could see them needing at some point?

Frank Joseph Sodaro
Former Senior Advisor

Yes, Brian. We do anticipate with the fourth quarter results that it will need a capital contribution, we're waiting and finalizing stat because that's really what will drive it.

Brian Rohman
Boston Partners Global Investors, Inc.

Okay. Joe, just I wanted to get back to something you said earlier, you don't project returns -- do projections, but you talked about expecting double-digit returns on equity. When you review or go over your strategic plan with investors, as you said this summer, are you going to try and provide some sort of pathway to some higher level of return on equity?

Joseph P. Lacher
Chief Executive Officer, President and Director

I'm trying to see if I'm understanding your question and making sure I'm answering it correctly. We'll -- we have to, from a reasonable perspective, to deal with investors, tell you what we think what our strategy is and what kind of reasonable returns that we're going to get. And it will not be a pie-in-the-sky hope strategy. We'll have a point of view about how we're going to operate and how we're going to get there.

Brian Rohman
Boston Partners Global Investors, Inc.

Okay. And right now, you've got plenty of capital, right?

Joseph P. Lacher
Chief Executive Officer, President and Director

Correct. That is one of the things we feel particularly good about.

Operator

Our next question comes from the line of Adam Klauber with William Blair.

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

A lot of discussion on Alliance and nonstandard. But I also noticed that the loss ratio on the preferred book also jumped a lot during the quarter. I guess, a couple of questions there. One, is that a bit of an accident, your catch-up, because it moved from 68 to 76, so a big jump? And 2, could you talk about the trends that necessitated a higher loss ratio on the preferred side?

Denise Idell Lynch
Former Property & Casualty Group Executive

Sure, Adam. So with the preferred auto, there really are a couple of things going on here in the preferred auto in the fourth quarter. First of all, we have seasonality in our loss cost in the preferred book of business and we have that in the fourth quarter. It's always our hottest, and in fact, continues to be our hottest in 2015. So that is really just seasonality in our book of business. I think, the second thing going on here, it has to do with prior development. So if we strip away the prior development from current year and prior year, what we actually find is that the underlying performance of this book of business continued to improve in the fourth quarter. So we actually are continuing to make progress in the underlying when you strip away those pieces of information.

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

Okay. So as we think about that book of business, are you still, I guess, pushing for more rate next year? And at what point do you think that will start showing unit or PIF growth?

Denise Idell Lynch
Former Property & Casualty Group Executive

Yes. So while we like the progress we've been making now for -- for many quarters, it's still not sufficient to get us to where we need to be. So we have more work to do to improve this portfolio. And it does mean increasing rates in the next year. We're looking at mid-single digit rate increases next year across our portfolio and continued efforts around improved segmentation and underwriting actions to drive continued progress on that line.

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

Okay. And then, one question on the equity method investments. With market stress, can we expect lower income out of that portfolio?

Joseph P. Lacher

Chief Executive Officer, President and Director

We had a background noise on our end, can you just repeat that one more time, Adam, I'm sorry.

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

Sure. Yes. On the equity method investments, with having some stress in overall financial markets, does that suggest a tougher outlook for that portfolio?

John M. Boschelli
Chief Investment Officer and Senior Vice President

This is John speaking. From the equity method, most of those assets or most of those investments are debt-related. So the underlying investments are in debt-related instruments. So I kind of always go back to general economic trends. So if we have a recession, those would probably be hurt, but if it can just move along, like we are right now, we hope it continues to perform like it has.

Operator

And I'm showing no further questions. I'd like to turn the call back to management for closing remarks.

Joseph P. Lacher
Chief Executive Officer, President and Director

Thank you, operator. And thank you for all of you for joining the call today and your interesting questions. I'd like to leave you with just a couple of final thoughts.

We do know this was a disappointing quarter and we had some tough financial results for the last couple of years, but I don't believe that these results define our franchise or our potential. We have a strong brand, we've got a strong balance sheet with a strong capital position and a talented and committed team. We are fully engaged and I'm committed to you to let you know that we're going to work tirelessly to address our near-term issues and to deliver a focused strategy, one that delivers attractive financial returns to our shareholders, serves our customers and agents well. I appreciate your patience as we evaluate every aspect of our business to refine our plans. Our team is energized as we move to keep -- to help Kemper realize our full potential. And I look forward to updating you in future calls. Thank you for your time this morning and for your interest.

Operator
Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program. You may all disconnect. Everyone, have a great day.