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CNA Financial Corporation NYSE:CNA

FQ4 2012 Earnings Call Transcripts

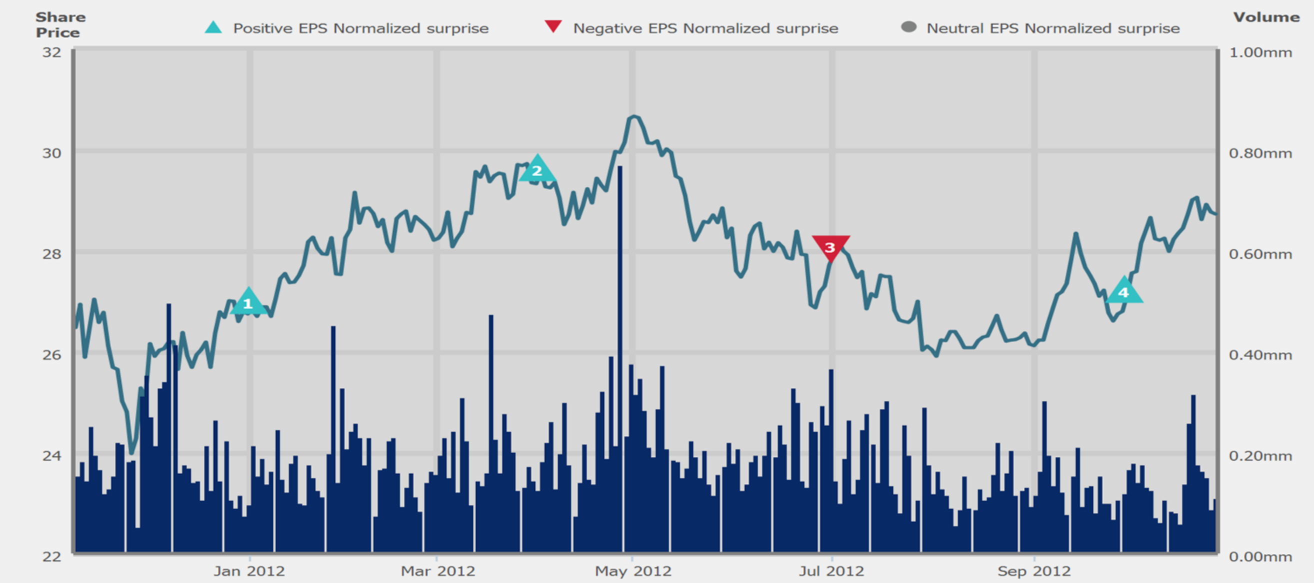
Monday, February 11, 2013 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ4 2012-			-FQ1 2013-	-FY 2012-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.22	(0.03)	NM	0.73	2.40	2.18
Revenue (mm)	2045.41	-	19.14	2073.59	8655.70	-

Currency: USD
Consensus as of Feb-11-2013 2:02 PM GMT

Stock Price [USD] vs. Volume [mm] with earnings surprise annotations



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ4 2011	0.69	0.71	1 2.90 %
FQ1 2012	0.69	0.84	2 21.74 %
FQ2 2012	0.59	0.56	3 (5.08 %)
FQ3 2012	0.65	0.80	4 23.08 %

Call Participants

EXECUTIVES

D. Craig Mense
Chief Financial Officer and Executive Vice President

James M. Anderson
Senior Vice President of Financial Planning & Analysis and Corporate Development

Thomas F. Motamed
Former Chairman and Chief Executive Officer

ANALYSTS

Amit Kumar
Macquarie Research

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Ryan Butkus

Presentation

Operator

Good day, and welcome to the CNA Financial Corporation's Fourth Quarter and Year End 2012 Earnings Conference Call. Today's conference is being recorded. At this time I would like to turn the conference over to Mr. James Anderson, Senior Vice President and Head of Investor Relations. Please go ahead, sir.

James M. Anderson
Senior Vice President of Financial Planning & Analysis and Corporate Development

Thank you, Shannon. Good morning, everyone, and welcome to CNA's discussion of our 2012 fourth quarter financial results. With us on this morning's call are: Tom Motamed, our Chairman and Chief Executive Officer; and Craig Mense, our Chief Financial Officer. Following Tom's and Craig's remarks about the quarter and annual results, we will open it up for your questions.

Before turning it over to Tom, I would like to advise everyone that during this call, there may be forward-looking statements made and references to non-GAAP financial measures. Any forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from the statements made during the call today.

Information concerning those risks is contained in the earnings release and in CNA's most recent 10-K and 10-Q on file with the SEC. In addition, the forward-looking statements speak only as of today, Monday, February 11, 2013. CNA expressly disclaims any obligation to update or revise any forward-looking statements made during this call.

Regarding non-GAAP measures, reconciliations to the most comparable GAAP measures have also been provided in our most recent 10-K and 10-Q, as well as in the financial supplement released today.

This call is being recorded and webcast. During the next week, the call may be accessed on CNA's website.

With that, I will turn the call over to CNA Chairman and CEO, Tom Motamed.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Thank you, James. Good morning, everyone, and thank you for joining us today. Today, CNA reported a fourth quarter net operating loss of $11 million and a net loss of $9 million, as compared with net operating income of $192 million and net income of $193 million in the fourth quarter of 2011.

Storm Sandy had a $190 million after-tax impact on CNA's fourth quarter results, including reinstatement premiums. This compares to $11 million impact from catastrophes in the prior year period. The Sandy loss, while a significant event for us, was not oversized given our market share in that region.

For the year, net operating income was $587 million and net income was $628 million, as compared with a net operating income of $610 million and net income of $612 million in 2011. The 2012 full year impact of catastrophes, including reinstatement premiums, was $270 million after tax, as compared with $144 million in 2011.

We've been hearing for years that the Northeast was due for a major event, and now we've had one. Loss estimates of as much as $25 billion put storm Sandy among the top 5 U.S. catastrophes on record. Numbers alone do not do justice to the devastation across the region, nor to the courage of first responders and the resilience of those who are putting their lives back together as we speak. I am extremely proud of the CNA claim team. Their tireless efforts on behalf of our policies and producers exemplify CNA at its best.

On a positive note, our core Property & Casualty operations produced net written premium growth of 7% in the fourth quarter and 3% for the year. We continue to achieve rate increases across our Property & Casualty portfolio, 6% in the fourth quarter and 6% for the year. This was our second consecutive year of rate improvement. Not only did the pace of improvement pickup in 2012, we sustained our rate momentum through the fourth quarter. We expect our sustained progress on rates should continue to drive improvement in our non-cat accident year loss ratio. Unfortunately, in the fourth quarter, rate-driven improvement was offset by several large losses. For the full year, the ratio improved 1.1 points to 67.7%.

With respect to the combined ratio, the fourth quarter and full year ratios were 116.1% and 105%, respectively. Excluding the impact of catastrophes and prior year development, our fourth quarter combined ratio increased 1 point to 103.2%. This increase was largely due to higher acquisition costs and some seasonality in our technology spend.

Our Specialty business delivered another solid underwriting result with a reported fourth quarter combined ratio of 93.9%. Specialty's net written premiums grew 3% in the fourth quarter and 2% for the year. As we've said before, we continue to increase pricing and tighten underwriting standards to address the unfavorable loss trends we have mentioned in earlier calls. In that regard, we are encouraged by the favorable rate trajectory in Specialty, reaching 6% in the fourth quarter with retention holding steady in the mid-80s.

Specialty's new to loss business ratio was approximately 1:1, consistent with recent quarters. Specialty's fourth quarter non-cat accident year loss ratio increased over the prior year period by 2.6 points to 68.4%. The increase reflects the continued unfavorable loss trend in Professional & Management Liability. For the 2012 full year, Specialty's non-cat accident year loss ratio was 67.7%, up modestly from the 67.2% we booked in 2011.

Commercial's fourth quarter apart the combined ratio was 132.7%. It was heavily affected by storm Sandy losses, which added over 28 points to the combined ratio. Commercial's fourth quarter non-cat accident year loss ratio improved over the prior year period by 1.2 points to 69.6%. For the 2012 full year, the ratio was 68.6%, a 1.6 point improvement over 2011.

Commercial's net written premiums grew 3% in the fourth quarter and 1% in 2012. These growth rates include the effect of the sale in November of 2011 of the First Insurance Company of Hawaii. Excluding this effect, Commercial grew 5% in the quarter and the year.

We have had 3 consecutive years of rate increases in Commercial, reaching 8% in the third and fourth quarters of this year with retention running at 78% in both quarters. New-to-loss business ratio was 0.9:1 in the fourth quarters of 2012 and 2011.

Now I would like to spend a moment on Hardy, the Lloyd's operation we acquired in July. Hardy reported a net operating loss of $26 million in the fourth quarter on net written premiums of $61 million. The loss was almost entirely attributable to the after-tax impact of $25 million from Sandy, including reinstatement premiums. Catastrophes increased Hardy's combined ratio by 45.2 points in the fourth quarter and 21.4 points since the July acquisition. Excluding catastrophes and development, Hardy's combined ratio was 105.8% in the fourth quarter and 100.1% since July. Hardy's non-cat accident year loss ratio of 51.4% in the fourth quarter and 47% since the closing, contributed modestly to the improvement in our Property & Casualty non-cat accident year loss ratio.

With that, I will now turn it over to Craig.

D. Craig Mense
Chief Financial Officer and Executive Vice President

Thanks, Tom. Good morning, everyone. In the fourth quarter, CNA's results were dominated by the after-tax loss of $190 million from Sandy. The losses produced by the storm, along with the reserve charges in our Life & Group segment, resulted in CNA reporting a net operating loss of $7 million. P&C operations produced fourth quarter net operating income of $60 million. Operating income, excluding the effect of storm Sandy, was $250 million consistent with prior quarters.

In the fourth quarter, our core P&C businesses continued to benefit from favorable prior year development, $67 million pretax or 4.1 points on the combined ratio, this compares to $244 million or 16.1 points in the fourth quarter of 2011.

In our Non-Core Life & Group segment, we completed our annual fourth quarter review of GAAP reserve adequacy for the runoff Life & Group business lines. The resulting reserve adjustments, while a negative, were significantly less than last year. In our payout annuity business line, which consists of single premium group and structured settlement annuities, we recorded a $24 million after-tax charge related to unlocking actuarial reserve assumptions.

The reserve charge and the assumption change were driven by the current low interest rate environment and our expectations about future investment yields. This charge compares to a $115 million reserve charge in the prior year period.

In our long-term care business line, we increased claim reserves by $20 million after tax as compared to a $33 million claim reserve increase in the prior year period. The claim reserve increase was driven by an increasing duration and severity claim trend. We, of course, reviewed and updated all of our assumptions to reflect our current views on interest rates, morbidity and persistency. We continue to believe our reserves are modestly redundant, although the amount of redundancy was meaningfully reduced. This margin contraction was reflected in additional shadow reserves associated with this segment. These details are further laid out on Page 19 of our financial supplement.

Excluding reserve adjustments in both years, fourth quarter Life & Group results were essentially flat to the prior year period and generally consistent with prior quarters this year.

Our corporate segments, which primarily includes corporate expenses, reported a $15 million fourth quarter after-tax operating loss, as compared to $4 million in net operating income in the prior year's fourth quarter. The prior period included a $22 million favorable tax benefit. Both periods benefited from a small amount of favorable reserve development associated with our runoff on CNA Re and other related reserves.

Our decision to increase our dividend this quarter reflects our confidence as we continue to improve our earnings power, and build on our balance sheet's financial strength and stability. All our capital adequacy metrics remain at or above our target levels and our liquidity profile remains very strong.

The value per common share at year end was $45.71 a share, a 3% decrease from the end of the third quarter, reflecting the lack of net income, as well as increases in shadow reserves and minimum pension liability. Year-over-year book value per common share increased 7%.

Our investment portfolio's pretax net unrealized gains stood at approximately $4.5 billion at year end 2012, a $100 million increase from the end of the third quarter. Our common shareholders’ equity, excluding other comprehensive income, was $11.5 billion or $42.62 per common share at year end, a year-over-year increase of 4%. Our statutory surplus at year end was $10 million, after the payment of a $150 million dividend to the holding company in the fourth quarter. We continued to maintain significant dividend capacity at the insurance operating company level.

Cash and short-term investments at the holding company level were approximately $450 million at year end 2012. We continue to target cash at the holding company equal to about 1 year of our annual net corporate obligations.

Operating cash flow, excluding trading activity during the fourth quarter, was approximately $270 million, as compared to approximately $900 million in the prior year period. The fourth quarter of 2011 included cash inflows of $565 million from commutations.

Cash principal repayments through paydowns, bond calls and maturities were approximately $1 billion and $3.7 billion in the fourth quarter and full year, respectively. Net investment income was $563 million pretax in the fourth quarter, as compared to $523 million in the prior year period. The increase was primarily due to our limited partnership investments, which produced fourth quarter pretax income of $67 million in 2012, a return slightly under 3%.

For the year, pretax LP income was $251 million, a return of approximately 11%. Net investment income from fixed maturity securities was $494 million pretax, a $12 million decrease from the prior year period. The decrease reflects the effect of investing at lower yields.

We made relatively minor changes to our investment portfolio sector allocations this quarter. The investment-grade corporate bonds sector continues to represent the largest component of our invested assets. The average credit quality of our fixed maturity portfolio remained at A. The fixed income assets that support our long-duration lifelike liabilities had an effective duration of 11.3 years at year end, a slight decrease from 11.4 years at the end of this year's third quarter, and is in line with portfolio targets. The effective duration of the fixed income assets that support our traditional P&C liabilities was 3.9 years at year end, a slight increase from 3.8 years at the end of the third quarter.

Overall, our investment portfolio remains well diversified, liquid, high-quality and aligned with our business objectives.

With that, I will turn it back to Tom.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Thanks, Craig. Before we open it up for questions, I would like to summarize our 2012 accomplishments: positive growth in Commercial & Specialty for 2 years in a row; rate increases in Commercial of 7% and in Specialty of 5%; 3.3 points of favorable development in our core Property & Casualty business; a favorable impact from Hardy on growth and the non-cat accident year-loss ratio; improvement in our capital position reflected in a year-over-year increase in book value per share of 7%, and lastly, a 33% increase in our quarterly dividend to $0.20 per common share.
Now we would be happy to take your questions.

Question and Answer

Operator

[Operator Instructions] And we will take our first question from Mr. Jay Cohen with Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Yes, I just had one quick question. On the -- in the Commercial business, in the press release, you highlight a kind of a one-off large loss. And I'm wondering if you can give us a sense of how big that was.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Well, there were several large losses, Jay. We typically always account for a couple in that particular quarter. But we probably had twice as many as before, a total of 5 large ones. And we consider a large loss, $5 million or more. So the 3 in excess of what we normally look at were probably about $16 million.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

That's just in the Commercial segment?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Correct.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

And that's overall?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Commercial. In Specialty, we had a large dental malpractice loss as well.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Okay. So I guess the underlying question, of course, is when I look at this underlying loss ratio, you've taken Specialty, it looks like it ticked up in the fourth quarter relative to the first 3 quarters. Can we assume a lot of that has to do with some of this large loss activity? There was nothing underlying in there that we should be addressing, is there?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

No, think about the large loss impact.

D. Craig Mense
Chief Financial Officer and Executive Vice President

Jay, this is Craig. If I could just add on, take a look at the full year Specialty loss ratio, which was 67.7%, and you can see that's roughly equivalent to what it was at the end of last year's full year.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Right. I guess related to that, would you suggest that in that business -- and I would also think in the Commercial business, that the kind of earned price increases you should see in 2013, is it fair to say they are above what you would expect for normal claims inflation?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

We're certainly seeing that now in Commercial. It's favorable. When you look at written rate, earned rate, loss trend, yes, we have a positive margin in Commercial. We don't have that yet in Specialty, it's slightly negative. But as you know, we have been raising Specialty rates. The market is a little slower in that regard versus Commercial. But we expect Specialty rates to continue their upward swing.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

So at 6% rate increase, that you don't think materially exceeds your claims inflation?

D. Craig Mense
Chief Financial Officer and Executive Vice President

I think what Tom was referring to, Jay, is just the earned -- at the moment, the earned rate increase is more in the 3%, slightly over 3% range in Specialty.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes, the 6% that we said in the conversation was written rate, right? So of course, earned rate lags.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Right. I -- actually, the question was more in '13. So I guess, assuming this price increases continue even at this levels, in '13, your earnings increases, I would assume, certainly by the second half of the year, your earned rate would be exceeding your expected claims inflation?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes.

Operator

Our next question comes from Amit Kumar with Macquarie Capital.

Amit Kumar
Macquarie Research

Just a few quick questions. First of all, you mentioned the uptick in non-cat AYLR for Specialty and you referenced some trends in Professional & Management Liability. You had talked about this trends even in the third quarter. Is this the same trends we're talking about? Or was there something new this quarter?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

No. If you look at the Specialty business, what we would call large lawyers, program lawyers and employment practices are 3 hotspots for us, and we continue to push on the pricing. And there's a falloff in retention as we push for pricing. But we like that tradeoff. So we'll continue to push on that. But the claims don't go away after 1 quarter, so we're on top of it. But we'll continue to push rate and we are getting good rate in that business.

Amit Kumar
Macquarie Research

Okay. The second question relates to Hardy. We've talked about how CNA will be providing 100% capital support for 2013. We talked about the expense ratio even last quarter, and my question is, does that sort of normalize immediately for Q1 2013? Or is there a lag where the expense ratio will fall over the next few quarters?

D. Craig Mense
Chief Financial Officer and Executive Vice President

The answer, Amit, is it will fall over the course of the year. So we're still -- remember, we said earlier that we expected marginal to any positive negative out of Hardy this year. We'd expect a small positive in '13. We still have some purchase accounting adjustments, unusual ones running through operating expenses. You'll see that in the K when you get it, but it's about $5 million of unusual. We still -- most of the money we'll spend on the financial systems integration, which will be spent this year, so that should start -- that expense there should trend down by more than 10 points over the course of 2013.

Amit Kumar
Macquarie Research

That's helpful. And similar to that, how should we think about the retentions for 2013 for Hardy?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Well, Hardy is -- I'm not sure exactly how to answer. Remember Hardy is a little bit lumpier business, because it's specialization and one-off coming, as well as the -- just how the business really is conducted there. So I think it's a little less -- a little less meaningful in terms of looking at retention, honestly.

Amit Kumar
Macquarie Research

Okay. The other question I had -- this is the final question, it's sort of a big-picture question, and this goes back to the prior discussion. Just based on, I guess, the margins on rate you're getting, what do you think -- and again, I'm not looking for a specific guidance, what do you think is now an achievable ROE goal for 2013?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Well, I think you're going to -- maybe the right way to answer -- right now, we're probably running at about somewhere around 6% on a run rate basis. If you kind of look back at P&C ops improvements over the course of '12, that might be a reasonable thing to think about as you think of '13. So -- and it's also important when you think of '12 that you kind of look back -- and it's in the financial supplement, by the way, the way we look at '11 today. So the way we look at '11 today in terms of non-cat accident-loss ratio is probably 1 point higher, recall that we increased comp medical severity and auto frequency was up. So if you looked at that, you'd see that P&C probably got close to 2 points better in combined over the course of the year. Maybe that's a reasonable way to look at it. We do have some headwinds, naturally, out of investment income because of lower yield rates, which will slow -- to a certain extent, slow the progress.

Operator

[Operator Instructions] And there are no further questions in the queue at this time. Oh, I’m sorry. We have a question. It comes from Ryan Butkus with Citi.

Ryan Butkus

Could you talk a little bit about your upcoming debt maturities? I know it's 2014. But just curious to see how you're thinking about that as we head into 2013.

D. Craig Mense
Chief Financial Officer and Executive Vice President

Right. We don't have any debt maturities as you've suggested, Ryan, until fourth quarter of '14. It's like $550 million. And we'll take a look at that over the course of '13, likely, in terms of where interest rates are. And we looked at refinancing, but it's really on -- and has been uneconomic as we've looked at it. It would help the future income, but it's not really helping the overall book value of the place. And remember, we've got a $46 billion investment portfolio that also benefits from any rise of interest rates. So we'll be paying attention to the direction of rates over the course of '13, but no real anxiety here about when we might act.

Operator

[Operator Instructions] And there are no further questions in the queue at this time.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Okay. Thank you very much.

Operator
And that does conclude today's conference. We do thank you for your participation.