CNA Financial Corporation NYSE:CNA

FQ3 2009 Earnings Call Transcripts

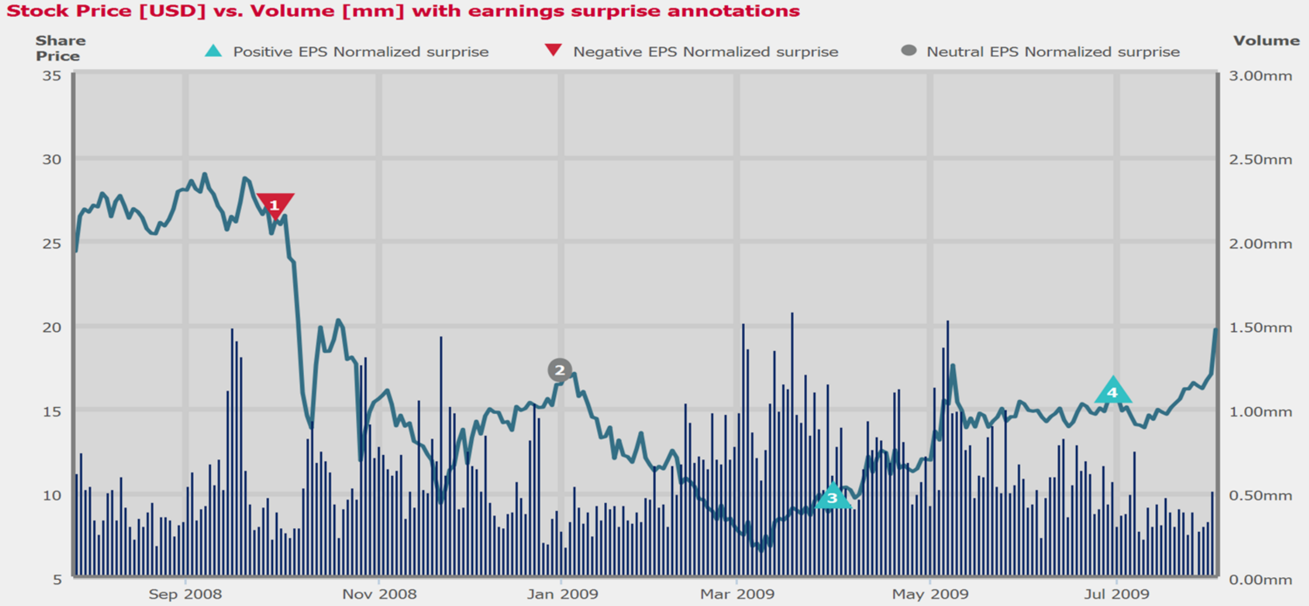
Monday, November 02, 2009 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2009-			-FQ4 2009-	-FY 2009-	-FY 2010-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.87	1.11	▲27.59	0.55	3.01	2.55
Revenue (mm)	2080.00	1477.00	▼(28.99 %)	1935.00	7844.00	7805.00

Currency: USD
Consensus as of Nov-02-2009 2:39 PM GMT

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



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2008	0.69	0.31	▼1 (55.07 %)
FQ4 2008	0.45	(0.15)	NM
FQ1 2009	0.30	0.44	▲2 46.67 %
FQ2 2009	0.68	1.02	▲3 47.83 %

Call Participants

EXECUTIVES

D. Craig Mense
Chief Financial Officer and Executive Vice President

Nancy M. Bufalino

Richard Scott

Thomas F. Motamed
Former Chairman and Chief Executive Officer

ANALYSTS

Dan Johnson
Citadel Investment Group

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Robert Glasspiegel
Langen McAlenney

Presentation

Operator

Good day and welcome to the CNA Financial Corporation's Third Quarter 2009 Earnings Conference Call. At this time, I would like to turn the conference over to Ms. Nancy Bufalino. Please go ahead, ma'am.

Nancy M. Bufalino

Thank you, Terry. Good morning, and welcome to CNA's discussion of third quarter 2009 financial results. Hopefully, everyone has had an opportunity to review the press release and financial supplement, which we released earlier this morning and can be found on the CNA website. With us this morning are Tom Motamed, our Chairman and CEO; and Craig Mense, our CFO. Tom and Craig will provide some prepared remarks about our third quarter results then we will open it up for questions.

Before we get started, I'd like to advise everyone that during this call there may be forward-looking statements made and references to non-GAAP financial measures. Please see the sections of the earnings release headed Financial Measures and Forward-looking Statements for further detail.

In addition, the forward-looking statements speak only as of today, November 2, 2009. CNA expressly disclaims any obligation to update or revise any forward-looking statements made during this call. This call is being recorded and webcast. During the next week, the call may be accessed again on CNA's website at www.cna.com. And with that, I'll turn the call over to CNA's Chairman and CEO, Tom Motamed.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Good morning, and thank you for joining us. I will start by covering CNA's third quarter results and our Chief Financial Officer, Craig Mense, will discuss some of our financial highlights. I will then come back on the line before we open it up for questions.

Net operating income was $331 million, or $1.11 per common share compared with $83 million, or $0.31 per common share in the third quarter of 2008. Operating return on equity was 12.2% in the current quarter. We are pleased to have delivered another quarter of solid operating results. The big driver was the turnaround in our investment results.

On the business side, we had the benefit of a light quarter for catastrophes, although this was offset by the pressures of a very competitive environment and a weak underlying economy. Against this backdrop, Specialty Lines continue to perform well. Standard Lines results were disappointing, but our profit improvement strategies are beginning to surface in submission and new business metrics, more on the businesses in a moment.

Third quarter net income was $263 million as compared to a $331 million loss in last year's third quarter. This was due to improvement in the operating and realized investment results. The Property & Casualty Operations' third quarter combined ratio was 101% as compared to 107% last year. Catastrophe losses added 1.5 points in the current period compared with 15.7 points in the prior year. In addition, the combined ratio was reduced by 3.3 points of favorable development compared with 3.9 points in the third quarter a year ago.

Our investment portfolio continued the strong recovery that began earlier this year. Book value per share increased to $35.38, a 29% improvement from the end of the second quarter and a 69% improvement from year-end 2008.

Turning to our businesses, Specialty Lines produced a combined ratio of 91.9% compared with 87.8% in last year's third quarter. Favorable prior-year development improved the 2009 ratio by 5.5 points compared with 7.9 points in 2008. Catastrophes added 0.4 points to the ratio in 2009 as compared to 1.3 points in 2008. Before the impact of catastrophes and favorable development, the third quarter combined ratios for 2009 and 2008 were 97% and 94.4%, respectively.

With respect to the 2009 accident year, the Specialty loss and loss adjustment expense ratio is 67.3 compared with 68.2 for 2008, a slight improvement due to a lessening impact from credit crisis losses in 2009. On an overall basis, Specialty's net written premiums were down 3% driven primarily by a large program in Europe that we decided not to renew. More importantly, our Specialty business in the United States grew by 2%, driven by rate increases in financial institutions and corporate governance. In addition, our policy count in these businesses increased 13%. This reflects our strategy of shifting our mix in public D&O and related lines towards more mid and small-sized customers.

The third quarter ratio of new-to-loss business in the U.S. was 1.1:1. We retained 84% of the business up for renewal in line with last year's third quarter. Average renewal rates were essentially flat in the third quarter continuing the steady improvement over the past few quarters. In last year's third quarter, renewal rate decreases averaged 4%.

Despite some positive movement on rates, competition remains active and vigorous across almost all lines in Specialty. In our Healthcare business, rates were down 4%. In addition, we are seeing exposure decreases in our Architects & Engineers and Real Estate Agent businesses which relate to current economic conditions.

The good news is that individual markets do not appear to be increasing capacity to generate growth at this point in the cycle. At the same time, capacity seems to be migrating away from some of the large carriers to some of the more recent start-ups. Overall, we remain very positive about our Specialty businesses, we had another very solid performance in the third quarter and we believe we are well positioned going forward.

Turning now to Standard Lines, our third quarter combined ratio was 112.2% in 2009 compared with 129.3% in the third quarter of 2008. Catastrophes increased the 2009 ratio by 2.9 points compared with 32.4 points in 2008. Prior-year development was favorable in 2009, reducing the ratio by 0.4 points. It was unfavorable in the prior-year period by 0.9 points.

Before the impact of catastrophes and development, the third quarter combined ratios for 2009 and 2008 were 109.7% and 96%, respectively. The 2009 third quarter combined ratio reflects strengthening of the current accident year, driven by higher severity and workers' compensation and automobile in recent accident years. This increased the accident year loss ratio by three points in the quarter and one point for the full year. In addition, insurance-related assessments increased the third quarter combined ratio by three points.

The Standard Lines 2009 accident year loss and loss adjustment expense ratio is 74.5, an improvement over 2008 at 78.1. The improvement is due to the light amount of catastrophe losses this year. Excluding the impact of catastrophes, the 2009 loss ratio and loss adjustment expense ratio is 71.2 as compared to 68.5 for 2008. Margin compression is the primary driver of the increase.

Standard Lines' net written premiums decreased 13% in the third quarter as we continue to focus on achieving needed weight in certain segments and walking away from unprofitable business. At the same time, Standard Line premiums are being pressured by declining exposures due to depressed payrolls and revenues as well as premium audits that are generating return premiums. Standard Lines' policy count was essentially flat during the quarter.

Although, we are not satisfied with our top line in Standard Lines, we are pleased with our new business production. Our ratio of new-to-loss business was 1.1:1 this quarter, a slight improvement over last year's third quarter. In Standard Lines, 81% of new business is coming from the industry segments that we outlined to you earlier this year. We continue to drive more of our business from segments that we believe have greater profit potential.

Renewal rates were essentially flat in the third quarter. In the third quarter of 2008, the average rate decrease was 5%. Third quarter retention came in at 80% compared with 81% in third quarter of 2008. We are prepared to see a decline in our retention as we push for more rate to improve profitability.

Market conditions in Standard Lines remain very competitive for new business. We continue to see aggressive pricing on accounts of all types and sizes, including catastrophe-exposed locations, high-value property, large casualty accounts and small business.

Our Property & Casualty Operations expense ratio for the quarter was 33.3% compared with 31.5% in last year's third quarter. The increase came from lower net earned premiums as a result of negative premium growth and return premiums as well as higher underwriting expenses and the previously mentioned assessments. Craig?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Thanks, Tom. Good morning, everyone. I would like to spend the next few minutes discussing our performance against the financial priorities that we laid out at the beginning of the year. The quarter's highlights include net operating income of $331 million, an operating return on equity of 12.2%, which approaches our target range and a very substantial improvement in CNA's balance sheet and capital position.

The recovery in the market value of our investment portfolio together with the third quarter net income of $263 million increased book value to $35.38 per share, a 29% improvement from the end of the second quarter and a 69% improvement from year-end 2008. At the end of the quarter, all of our capital metrics were at or better than 2007 year-end levels.

We also continued to make significant progress in our efforts to reposition our investment portfolio, to reduce risk and volatility and drive more consistent performance in the future. The operating income results were fueled by strong net investment income, primarily from limited partnerships, as well as a $61 million after-tax gain from the previously disclosed settlement with Willis.

Third quarter net investment income totaled $660 million, a 50% increase over the prior-year period. Our fixed income results continue to reflect historically low short-term rates, as well as a high-level of our holdings in cash and short-term investments. We benefited from another quarter of very strong performance from our limited partnership investments. Income from these investments was $145 million in the third quarter, a rate of return of approximately 8%. Year-to-date, these investments have returned 14%.

You will recall from previous discussions on these calls that we invest in LPs as an alternative to equities. We expected that over time our portfolio of limited partnership investments will bring us higher cumulative returns than equities with less volatility. While they represent only 5% of our total invested assets, they remain an important part of our ongoing investment strategy.

I would like to remind you of two important characteristics of our LP investments. First, the overwhelmingly represent investments in marketable securities. With the valuations driven by the fair value of the LPs underlying securities holdings, only 6% of our LP holdings by value are in private equity and less than 2% in real estate.

Second, approximately 90% of our LP holdings, as measured by reported values, report results on a one-month lag or less. Consequently, our quarterly earnings reflect current market valuations.

Net income for the quarter was $263 million and included after-tax other than temporary impairments, recognized in earnings of $96 million as compared to an after-tax OTTI losses of $380 million in the prior-year period. The OTTI credit losses in the quarter were centered primarily in residential mortgage-backed securities.

These impairment decisions were driven by our assessment of the likely future performance of these securities, as well as intent to sell decisions consistent with our ongoing management risk and volatility in the portfolio. Our realized investment result for the quarter do not include the effect of the sale of 100% of our common stock holdings of various analytics, formerly known as ISO [Insurance Service Office]. We sold these holdings in the various IPO in the first week of October. As a result, we increased the fair value of our position to $370 million at third quarter end, which is reflected as an unrealized gain in our balance sheet.

During the fourth quarter, the after-tax sales proceeds of $240 million will be recorded as a realized gain. As of September 30, our investment portfolio had a pretax net unrealized gain of $176 million. This compares to a $2.7 billion pretax net unrealized loss at the end of the second quarter and a $5.4 billion pretax net unrealized loss at year-end 2008.

The substantial improvement reflects not only the recovery of the broader financial markets, but also the work we have done to reposition our portfolio. The recovery and the value of our investment portfolio was reflected across virtually all asset classes that was led by corporate and municipal bonds.

During the quarter, we made net purchases of $2.6 billion of investment grade corporate bonds. This asset class now represents 39% of invested assets, up from 24% at the beginning of the year. We also purchased a little more than $400 million in agency collateralized pass-throughs and CMOs. We took advantage of continued favorable conditions to further reduce our holdings of high yield corporate bonds by over 350 million in the quarter and over $1 billion year-to-date.

In non-agency mortgage-backed securities, principal payments and sales reduced our holdings by another $400 million in the quarter and $1.3 billion year-to-date. We started the year with $6.4 billion of book value in this class, it now stands at $4.9 billion of book value at 22% reduction.

Overall, our investment decisions are consistent with the framework that we outlined to you at the beginning of the year. We continue to manage our portfolio to align with the needs of our Insurance business. The effective duration of the overall portfolio was 6.2 years at quarter end, up from 5.6 years at the end of the second quarter. Most of the duration increase can be attributed to simple duration drift caused by an overall lower interest rate environment.

The effective duration of the assets backing our P&C liabilities was 4.3 years well within our target range. The effective duration of assets matching our long-duration lifelike liabilities was 11.4 years, which is also in line with portfolio targets.

Our overall investment portfolio liquidity and substantial positive cash flow continue to be major advantages. As a reminder, we still had $4.1 billion, roughly 10% of invested assets in short-term holdings at quarter end, including approximately $400 million at the holding company.

Positive cash flows from operations and the investment portfolio were approximately $1 billion in the third quarter. Included in these amounts are principal cash flows from the structured securities portfolio of approximately $500 million during the quarter, which are in line with the past few quarters and consistent with our expectations.

Turning to our capital position, GAAP equity increased from $8.7 million to $10.8 billion during the quarter and our regulatory capital improved as well, approximately 10% to $9 billion. We regularly evaluate our capital adequacy against regulatory, internal and rating agency metrics. Against all of these measures, we believe that our capital is more than sufficient to support our current ratings. All of our key capital metrics: Total capital, statutory surplus, RBC ratios, debt to capital, coverage ratios and all rating agency capital models or at or better than year-end 2007 levels.

Before I turn the call back over to Tom, I would like to report briefly on our non-core business. Our life and group non-core segment produced $51 million in net operating income, driven by improved investment income and the previously mentioned settlement with Willis. The Corporate segment produced third quarter net income of $9 million, reflecting steady underlying performance and increased net investment income.

In summary, CNA ended the quarter on a very solid financial foundation. With that, I will turn it back to Tom.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Thanks, Greg. Before opening it up for questions, I would like to take a moment to summarize our progress on our priorities to grow the top and bottom line.

First, we continued to be encouraged by submission activity in our expanded set of industry segments. During the third quarter, submission activity in the U.S. increased 32% in U.S. Specialty and 11% in the Standard Lines. These positive trends tell us that our producers support us and that we are positioned for profitable growth over time.

With respect to improving profitability in Standard Lines, we told you we would be focusing on driving growth in our target industry segments. In that regard, our production metrics are encouraging. During the third quarter, 69% of our small and middle-market submissions were in our target segments.

In addition, our hit ratio on submissions in these segments was 19% in the third quarter as compared to 12% outside of these segments and reflecting our emphasis on only writing great adequate business. Renewal metrics on our small and middle-market business show the same focus. We are retaining 81% of the renewals in our target segments as compared to 72% among less profitable risks.

Finally, I want to say a few words about expenses. We are in the process of conducting a cost benchmarking initiative that will help us identify potential cost-saving opportunities and process improvements across the entire organization.
Looking ahead, we expect the fourth quarter to be a continuation of the prior three quarters, lingering problems include lack of consumer spending, a depressed housing market and increasing unemployment. While rates may improve, exposure growth will be under pressure and will not improve until the underlying economic environment improves. Against this backdrop, we continue to believe that focusing our appetite on specific industry segments, shifting our mix of business and expanding our geographic reach will help us manage through this cycle until there is improvement in the underlying economy. With that, we will take your questions.

Question and Answer

Operator

[Operator Instructions] The first question comes from Jay Cohen with Bank of America, Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Three questions. The first one, can you just quantify and describe those assessments? Where did those come from and how much were they?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Jay, it's Craig. Some of it's from the Department of Labor and some from New York Second Injury Fund. In total there, about a little less than $20 million.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Is this initially one-time in nature, or could it continue?

D. Craig Mense
Chief Financial Officer and Executive Vice President

It should be one-time in nature.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Next question maybe for you, Craig, on the capital side. Obviously, you had a great recovery in the equity position. Your capital looks to be at or better than it was in the end of 2007. And I guess it was about that time, I forget the exact timing, where the company acknowledged it had excess capital, it began to pay a dividend. Can you talk about your flexibility now versus then having just to live through the credit crisis, whether it's on your own metrics, whether it's from the rating agencies, that would be helpful.

D. Craig Mense
Chief Financial Officer and Executive Vice President

I think, Jay, you obviously recognized it. We'd be certainly more cautious this time having lived through what we did. It's nice to be in a position to begin to think about the financial flexibility we have. As I said, last call, we think one of the most important things that we can do for this company is position it to get an increase from the rating agencies. Obviously, the first step would be to get up the outlook change. So as we think about things, those are kind of the -- that's really what's front and center in mind of what we would do or might do, if that answers your question.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

What were the terms of the preferred from Loews, as far as what will the maturity of that if there was any?

D. Craig Mense
Chief Financial Officer and Executive Vice President

There was not a maturity. There is -- it's 10% preferred dividend, there is an automatic reset in 2013, which at that time it goes to 700 over whatever the 10 year treasury is.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Maybe a bigger picture one, on the new business, which is encouraging to see but I guess we continue to hear a constant drumbeat from everyone in the industry that new business is very competitive and when you see a company that is increasing its new business, it is a bit of a red flag in this environment. How do we get comfortable with your new business generation given that backdrop?

D. Craig Mense
Chief Financial Officer and Executive Vice President

I think the answer, Jay, you have to start with when you look at these 10 industry segments that we're focused on, how they are performing as a part of the total book. We believe, based on our analysis, that they are running somewhere between 12 to 14 points better than the rest of the Standard Lines portfolio. And we believe that the pricing is coming in at that area on new business. So we are being select. I mean, you only write 19% of what comes in your Core, you're writing 12% outside of the Core, and we know the Core business outperforms the Non-Core, so we continue to watch those metrics closely, but we believe it's shifting the book to become more profitable over time without dropping prices to get it and holding -- getting rates up to flat is a considerable improvement from earlier this year so we're hopefully not giving away a lot on the renewal book and we're going to be pushing rates into the positive domain going forward.

Operator

We'll move now to Robert Glasspiegel with Langen McAlenney.

Robert Glasspiegel
Langen McAlenney

I guess the rating agencies had question regarding your portfolio dropping below cost. Now that you're at or above cost, what sort of dialogue do you have with them? Does this sort of take care of their concerns there, or what more do they want to see to take the negative outlooks off?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Bob, I'd say that's -- I mean, the reason they put the negative outlooks on were concerns about asset values. So I'd hope that this recovery would address it. I think, just like we said, we are being cautious and whether we like it or not, I'm sure they are being cautious in the actions in thing they take. And the key thing for us, future is really improving, the things that Tom said, so we're just improving our competitive position and the overall underwriting results to the place.

Robert Glasspiegel
Langen McAlenney

How much further do you have to go on repositioning the portfolio? I mean, at what point do you think it's where you want it?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Richard Scott is here with us, let me say a couple of things and then I'll him if he wants to elaborate. If you look at the investment grade portion, both Corporates and munis, I think it's now something less than 60%, like 57%, so we're probably -- we have some room to continue to add there. And we'll keep working the structured side of the portfolio. Do you want to elaborate on that, Richard?

Richard Scott

No, I think that's a fair summary. I mean, as a practical matter, we view the non-agency residential portfolio as being a portfolio that will continue to shrink over time, and the alternative asset classes are primarily going to be investment grade asset classes, munis, Corporates and potentially some agencies structure, depending on market opportunities.

Robert Glasspiegel

Langen McAlenney

Just one clarification, it's three points of current accident year development was total company -- I mean total Property Casualty?

D. Craig Mense
Chief Financial Officer and Executive Vice President

No, that was Standard Lines.

Robert Glasspiegel
Langen McAlenney

And did Specialty have any?

D. Craig Mense
Chief Financial Officer and Executive Vice President

A small amount, a little bit. We did strengthen the current accident year in Specialty, but marginally.

Robert Glasspiegel
Langen McAlenney

And you said there was auto in comp? Just to make sure I got that right.

D. Craig Mense
Chief Financial Officer and Executive Vice President

Yes.

Robert Glasspiegel
Langen McAlenney

And any in particular you saw there that drove it, or is just the economy...

D. Craig Mense
Chief Financial Officer and Executive Vice President

From the word severity. Severity in the '08 and '07 accident years.

Operator

[Operator Instructions] And we'll move now to Dan Johnson with Citadel.

Dan Johnson
Citadel Investment Group

I was really going to ask about the expenses but that's sounds like it's maybe more of a discussion for next quarter, maybe I missed the timing on that. Do you think we'll have something to talk about by next earnings call?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes, we will report to you in the future as to our cost benchmarking initiative.

Dan Johnson
Citadel Investment Group

Sorry to be picky, but when you say future, is next quarter a reasonable timeframe?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes.

Dan Johnson
Citadel Investment Group

Certainly over the last couple of months, we've seen press releases on people hired. Would you mind just taking a walk through some of the more senior folks who have been hired and what they're going to be doing?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes. As we announced early in the year, we are going to increase, I'll say the quality of talent here at CNA. We have hired Bob Lindemenn to run all of Standard Lines. That would include small business middle market, large accounts. Bob's been in the business probably about 35 years and a real professional. So as our Standard Lines, as we pointed out, it's not performing to our satisfaction, we've made a change there. Also on the small business, we have moved internally our fellow Mike Coyne from the finance area to run our small business portfolio, so that would be the changes in Standard Lines. We have also hired an executive by the name of Tim Szerlong to run all of our branch operations, that's a new position at CNA. He probably has 35 years in the business as well, and he'll be responsible for driving execution at the point-of-sale. So I think that would be the key people.

Dan Johnson
Citadel Investment Group

And Tim and Bob came from where?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Bob came from Zürich North America, Tim came from Chubb.

Operator

[Operator Instructions] And we'll take our next question from Jay Cohen with Bank of America, Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

[Audio Gap] increase in severity we're seeing in those two lines of business, can you talk about the frequency side of the coin?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Frequency is down in, I believe, every line of business, with the exception of Property, it is up mid-single digits.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

I guess not enough to offset that increase in severity, you're saying?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Repeat that, Jay.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Since you did sort of take a more cautious view on the accident year loss ratio, at least in those several lines of business, it sounds as if the frequency to improve frequency is not enough to offset the increased severity that you are seeing for the more recent accident years.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Well, overall, we continue to see favorable frequency trends. In other words, new arising activity is going down. So that's all figured in there with the severity. We don't look at one item exclusively and adjust. We look at all aspects. So that's built in. What we do like is the decline in frequency. Typically, when frequency goes up, severity ultimately goes up as well. So we're hopeful that there will be less severity in the book over time. And in the meantime, we have adjusted our 2009 accident year based on what we saw in '07 and '08. So we think we're ahead of the curve, we're not going to deal with discount on the road, hopefully.

Operator

[Operator Instructions] And we have no further questions. I'd like to turn the call back over to Ms. Bufalino.

Nancy M. Bufalino

Thank you, Terry, and thank you, all for joining us today. Once again, I call your attention to the disclosure concerning forward-looking statements and non-GAAP measures. A taped replay of today's call will be available until November 9. Please see the earnings release for a replay detail. Thanks, everyone and have a good day.

Operator
Ladies and gentlemen, that does conclude today's conference. We thank you for your participation.