S&P Global
Market Intelligence

# American Financial Group, Inc. NYSE:AFG

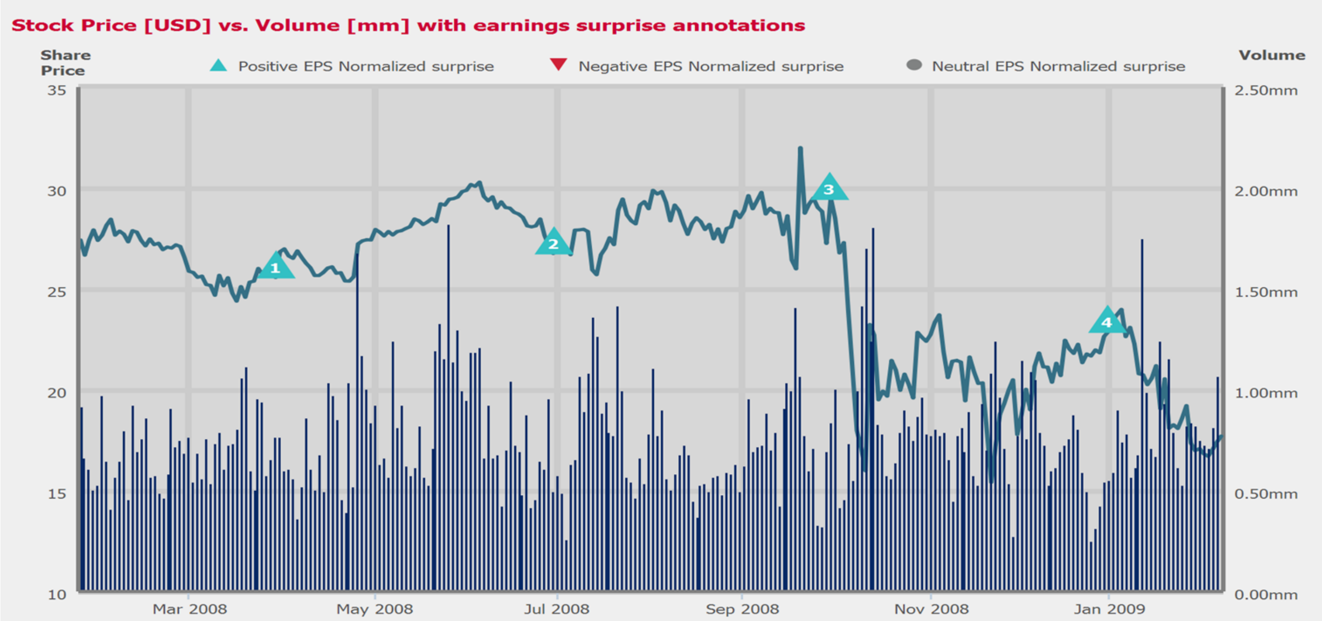
# FQ1 2009 Earnings Call Transcripts

## Tuesday, May 05, 2009 3:30 PM GMT

## S&P Global Market Intelligence Estimates

| | -FQ1 2009- | | | -FQ2 2009- | -FY 2009- | -FY 2010- |
|---|---|---|---|---|---|---|
| | CONSENSUS | ACTUAL | SURPRISE | CONSENSUS | CONSENSUS | CONSENSUS |
| **EPS Normalized** | 0.98 | 1.11 | ▲12.12 | 1.00 | 3.82 | 3.75 |

Currency: USD
Consensus as of May-05-2009 3:00 AM GMT




- EPS NORMALIZED -

| | CONSENSUS | ACTUAL | SURPRISE |
|---|---|---|---|
| **FQ1 2008** | 0.89 | 1.09 | ▲22.47 % |
| **FQ2 2008** | 0.90 | 0.96 | ▲6.67 % |
| **FQ3 2008** | 0.95 | 0.98 | ▲3.16 % |
| **FQ4 2008** | 0.94 | 1.04 | ▲10.64 % |

# Table of Contents

# Call Participants

## EXECUTIVES

**Carl Lindler**

**Carl Lindler III**

**John Birding**

**Keith Alan Jensen**
*Former Senior VP & CFO*

## ANALYSTS

**Abe**
*Maximum Group*

**Amit Kumar**
*Fox-Pitt Kelton*

**Peter Suess**
*Lincoln Square Capital*

# Presentation

**Operator**

I would like to welcome everyone to the American Financial Group 2009 first quarter earnings conference call. (Operator Instructions) Mr. Jensen, you may begin your conference.

**Keith Alan Jensen**
*Former Senior VP & CFO*

Welcome. I'm here this morning with Carl Lindler III and Craig Lindler, co-CEO's of American Financial Group as well as John Bruning, the Executive Vice President of our American Money Management Investment subsidiary.

We're pleased to welcome you to American Financial Group's 2009 first quarter earnings results conference call. If you're viewing the webcast from our website, you can follow along with the slide presentation if you'd like.

Certain statements made during this call are not historical facts and may be considered forward-looking statements and are based on estimates, assumptions and projections which management believes are reasonable but by their nature subject to risks and uncertainties. The factors which could cause the actual results or financial condition to differ materially from those suggested by such forward-looking statements include but are not limited to those discussed or identified from time to time in AFG's filings with the Securities and Exchange Commission and on its annual report on Form 10-K and quarterly reports on Form 10-Q. We do not promise to update such forward-looking statements to reflect actual results or changes in assumptions or other factors that could affect these statements.

Core net operating earnings is a net non-GAAP financial measure which sets aside items which are not considered to be part of ongoing operations such as net realized gains or losses on investments, effects of accounting changes, discontinued operations, significant asbestos and environmental charges and certain other non recurring items. AFG believes this non-GAAP measure to be a useful tool for analysts and investors in analyzing the ongoing operating trends and will be discussed for various periods during the course of this call. A reconciliation of net earnings to core net operating earnings in included in our earnings release.

Now I'm pleased to turn the call over to Carl Lindler III, Co-Chief Executive Officer of American Financial Group to discuss our results.

**Carl Lindler III**

Good morning and thank you for joining us. We released our 2009 first quarter results yesterday afternoon. We are pleased with American Financial Group's core operating earnings and financial strength especially during these challenging economic times. Craig and I thank God and our dedicated employees for a good quarter.

Now let's turn to Slide 3 of the webcast for some highlights. Our record first quarter core net operating earnings of $1.11 per share were up 2% from the first quarter of 2008. The improved results in our annuity and supplemental insurance operations and higher investment income and especially property and cash of the operations were partially offset by lower underwriting profits.

Our core operating return on equity was a strong 21%. Our net earnings for the 2009 first quarter were 37% higher than the 2008 period because of lower net realized losses on investments which include impairment charges. AFG generated an overall return on equity of about 16% including realized gains and losses.

Our capital adequacy, financial condition and liquidity remain strong and a key areas of focus for us particularly in this unstable economic environment. We have maintained capital in our insurance businesses at levels that support our operations and that are consistent with amounts required for our rating levels.

Our financial leverage is at the level committed to the rating agencies and to the capital markets. At the end of April, available liquidity at the parent company was in excess of $250 million and cash and cash equivalents in our operating companies was approximately $1.2 billion. We anticipate continuing to generate additional capital and cash through operations during 2009.

Book value per share including all unrealized gains and losses on investments increased to $22.15 from $21.54 per share at the end of 2008.

Now let's turn to Slide 4. I'd like to review the results of our specialty property and casualty operations. Overall underwriting profits in the 2009 first quarter were excellent, generating a combined ratio of 82%, a slight increase over the first quarter of 2008. The average renewal rates in the specialty operations in the first quarter of 2009 were flat when compared to rates from the same prior year period.

We were pleased to see rate increases in several of our businesses and the level of rate decreases moderate in others during the first quarter of the year which may be further indication of some firming in the market.

The overall decreases in gross and net written premiums for the 2009 first quarter were mainly driven by soft market conditions, decreases in commodity prices affecting our crop business and the economic downturn.

In addition, the higher premium sessions under our crop reinsurance agreement contributed to the lower net written premium. If you exclude our crop business, the overall decrease in net written premium was about 7.5%. Gross investment income related to our property and casualty operations was up approximately 7% for the quarter as we benefited from higher yields in this segments portfolio.

Now I'd like to review the results for each of our specialty business groups on Slide 5. Property and transportation group generated excellent underwriting results during the first quarter of 2009, reporting increased underwriting profit improvements in the combined ratio. Higher underwriting profits were driven primarily by impressive results in our National Interstate subsidiary and an increase in favorable reserve development in our crop operations.

Gross and net written premiums declined during the first quarter due in part to the crop pricing and reinsurance that I mentioned earlier. In addition, volume reductions in transportation and property and marine operations resulted from continued adherence to our underwriting discipline in a competitive marketplace.

This groups' average rates on renewal for the full year were about 1% below the same period a year earlier.

The Specialty Casualty Group continued to product strong underwriting profits in the first quarter of 2009. Gross and net written premiums decreased in the first quarter compared to the 2008 period largely due to the slowdown in the home builders market for general liability products and strong competition in the excess and surplus lines.

Average renewal rates for the first quarter were flat compared to 2008. The increase for some of the Casualty business and the level of decrease moderated in others.

The Specialty Financial Group reported solid underwriting profits for the first quarter of 2009. Improvements in our lease and loan and financial institution businesses were offset by lower underwriting results in our runoff automobile residual value insurance operations in our surety businesses.

Our run off RVI business posted a modest loss in the first quarter of 2009 compared to an underwriting profit in the same period last year. We've seen some moderation though in used car prices during the first quarter and are cautiously optimistic that our run off RVI business will improve during the course of this year.

Net written premiums for the first quarter of 2009 were up 7% largely due to higher premiums in our financial institutions business and higher premium retention in our surety operations. Gross and forced placed mortgage protection insurance resulted from a higher number of foreclosed properties owned by financial institutions.

These increases were partly offset by premium declines in our lease and loan operations. Gross written premiums were relatively flat and this groups' average renewal rates for the quarter were about 9% higher than the year earlier, really due primarily to increases in rates in our foreign trade credit operations. Rate levels were flat for the remainder of the businesses in this group.

Our California Workers Comp business reported lower underwriting profits for the first quarter 2009. The groups' combined ratio was 99.7 for the 2009 first quarter. The underwriting results were affected by lower prices due to the competitive environment and the potential adverse impact of a disability claim ruling and lower favorable development for the quarter.

The Workers Comp insurance rating bureau has recommended a rate increase effective in July that's nearly 24%. This increase is driven by expected increases in medical claim costs and influenced by recent rulings by the Workers Comp Appeals Board that may unfavorably impact prior accident years.

The Insurance Commissioner has not shown support for this recommended increase and has suggested that any increases be to waived pending the outcome of the judicial process related to these rulings.

We remain conservative in our reserving on more recent business until a higher number of claims have been paid and the ultimate impact of the California Reform Legislation and the recent Disability Claim rulings can be estimated with more precision.

Gross and net written premiums decreased for the quarter. We are happy that the average renewal rates in our California Workers Comp business decreased only 1% in the first quarter of 2009.

Now I'd like to review our Annuity and Supplemental Insurance Group on Slide 6. We continue to be pleased with the operating results in this group which has benefited from the impact of increased spreads on the profitability of the fixed annuity line. Our focus on fixed annuities is particularly advantageous in the current investment environment.

The Annuity and Supplemental Insurance Group generated pre tax core operating earnings for the first quarter of 2009 that represented a 49% increase over the comparable period in 2009. These results reflect increased earnings in our fixed annuity operations primarily the result of wider spreads. Lower earnings in our supplemental insurance and other operations partially offset these increases.

We continue to work toward improving Annuity and Supplemental Insurance Group's return on investment and are encouraged by the improved results in this group.

Statutory premiums for the first quarter of 2009 were lower than those in the first quarter of 2008 primarily due to lower sales of indexed annuities in the single premium market. These decreases were offset somewhat by sales of fixed annuities through our bank distribution channel which was launched in the second quarter of 2008.

Now please turn to Slide 7 for a few highlight regarding our investment portfolio. As many of you are aware, in late April 2009 AFG issued new guidance related to a fair value measurement of investments when the trading volume and level of activity had significantly decreased compared with normal market activity. This guidance had little effect on the reported market value of our portfolio.

AFG also issued additional guidance regarding the process for determining and recording other than temporary impairments on debt securities held as investments. AFG adopted these provisions as of January 1, 2009 and recorded a reclassification of $17.5 million from retained earnings to accumulated other comprehensive income to reflect the cumulative effect of prior year investment impairments that were not credit related.

During the first quarter 2009 we recorded after tax realized losses on investments of $27 million including other than temporary impairments of $49 million or $0.42 per share. Over half the impairments were due to decline in corporate bonds.

By comparison, approximately two-thirds of our impairments in the first quarter of last year were related to declines in equities. As of March 31, 2009 AFG had after tax unrealized losses of $716 million compared with $683 million at year end 2008.

I'd now like to review the components of our investment portfolio which you'll see on Slides 8 and 9. You can see the vast majority of our portfolio is held in fixed maturities with over 93% being investment grade. Our holdings of cash and cash equivalents are higher than our historical levels. We're holding approximately $1.2 billion at our operating subs which provide us with additional liquidity in the current economic environment.

Over the past year, we've substantially reduced our holdings and equities to less than $15 million in publicly traded common equities. We continue to hold a small portion of the portfolio in real estate. We have a history of opportunistic investments in hotels, resorts, marinas and apartment complexes.

We continue to have minimal exposure to other investments that have received wide spread attention recently. We don't provide credit default protection. We have $20 million of asset backed CDO's. We hold less than $5 million in hybrid and preferred securities issued by European financial institutions. We have less than $57 million in what would be deemed alternative investments principally private investment funds. In the aggregate these holdings represent less than one-half of 1% of our investment portfolio.

In light of continuing investor interest in our investment portfolio, particularly our mortgage backed securities; we've invited John Birding, Executive Vice President of our Investment Management subsidiary to provide a more in depth discussion of those securities.

**John Birding**

On Slide 10, you will see an overview of the segments of our mortgage backed securities portfolio. We have also updated the ratings to reflect the most recent rating actions on this portfolio.

As of April 30, 92% of our mortgage backed securities were rated investment grade with 82% being rated AA or higher. We have provided additional detailed information on the various segments of our mortgaged backed portfolio in the investment supplement on our web site.

If you turn to Slide 11, I wanted to review with you this morning the components of risk in our non agency mortgage backed portfolio. From an economic risk of loss standpoint, there are two critical aspects of our mortgage backed portfolio that I would emphasize.

First, we invest almost exclusively in the senior traunches of securitizations. The result, there are subordinated traunches below us to absorb losses before our position is exposed to any risk of financial loss.

Second, the amortized cost on much of our non agency mortgage backed portfolio is substantially below par. This again serves to minimize our risk of economic loss relative to our book value. For example, on the Altay segment of our portfolio, our average cost is approximately 81% of par. On our non agency prime segments, the average cost is 89% of par.

We also thoroughly evaluate our portfolio for expected lifetime loss and have reflected such losses through impairments. We employ a rigorous loan level analysis which among other things assumes an additional 13% decline in housing prices.

However, this varies a great deal depending on geography. On a nationwide basis, we have assumed housing prices decline approximately 40% from the peak levels experienced a number of years ago. However, for example in much of California, we have modeled in home price declines of 50% to 60% from the peak.

In addition, our expectation of loss on the underlying collateral approximates recent rating agency models of loss as well as general market expectations.

The other principal risk associated with non agency mortgage backed securities if ratings risk and during the later part of '08 and thus far in 2009, the rating agencies have downgraded a large number of non agency mortgage backed securities that were previously rated AAA.

We have addressed much of the downgrade risk in our portfolio through a re-traunching and re-rating of approximately $560 million of non agency mortgage backed securities to more appropriately reflect the risk inherent in these securities. The new Standard and Poor's ratings on these securities are reflected in the capital now required for these securities.

In summary, while we have an unrealized loss in much of our non agency mortgage backed portfolio, we continue to believe that the substantial majority of the unrealized loss reflects unsettled market condition rather than ultimate principal loss.

We believe the ultimate risk of economic loss on our portfolio is not likely to significant in relation to the level of investment. Again, this is principally a function of owning almost exclusively senior traunches as well as having a low cost basis in many securities.

In addition, the re-traunching allows us to more accurately depict the economic layers of risk in our mortgage backed portfolio resulting in an enhanced rating and capital profile.

I will now turn the presentation back to Carl.

**Carl Lindler**

I'd now like to cover our expectations for 2009 on Slides 12 and 13. Because of our strong first quarter we've increased our core net operating earnings guidance to be in the range of $3.75 to $4.05 per share. This guidance takes into account our expectation of significantly improved earnings in the annuity and supplemental businesses and increased yields in our investment portfolio.

2009 expected results exclude the potential for significant catastrophe and crop losses, unforeseen major adjustments to asbestos environmental reserves and large gains or losses from asset sales or impairments.

We do plan to conduct a review of our asbestos and environmental reserves using an outside actuary and an independent expert during the second quarter.

We expect to maintain adequate rates in our Specialty Property and Casualty operations because of our strong underwriting culture and expect to achieve a combined ratio of about 87% to 90%. That said we're targeting flat to modest increases in overall average renewal rates in 2009.

We expect net written premiums in our Specialty Property and Casualty operations to be down 16% to 19% from 2008 levels primarily due to increased reinsurance sessions under our crop quota share agreement, lower spring commodity prices and the weakness in the economy. Excluding crop, that equates to a decline of 5% to 8%.

The Property and Transportation group is expected to maintain its excellent underwriting track record with a combined ratio in the 86% to 90% range. This guidance assumes accident year crop earnings that are in line with 2008 results.

We expect net written premiums to decrease by approximately one-fourth as a result of changes in our crop quota share and lower commodity prices. Excluding a decrease in crop, we expect net written premiums to decrease between 2% and 5%.

We expect the Specialty Casualty group to generate strong underwriting profit with a combined ratio in the 84% to 88% range. We anticipate decreases in net written premiums between 5% and 8% as continued pricing pressures in some of our operations will offset growth from our new initiatives.

We look for Specialty Financial Groups combined ratio to be between 88% and 92%. We expect these results to improve in 2009 as used car sales prices appear to be moderating and the vast majority of leases and loss position under our RBI contract expire by the 2009 third quarter.

We project net written premiums to be down 10 % to 13% as we expect to further reduce our exposure to auto related risks in 2009.

We project a combined ratio between 95% and 100% for our California Workers Comp business. Despite the expansion of our excess Workers Comp program and a 5% filed rate increase, we anticipated net written premiums will be down about 12% to 15% this year due to the economy.

Based on recent market conditions, we expect full year core operating earnings in our Annuity and Supplemental insurance group to be 15% to 20% higher than in 2008. This growth will be driven primarily by wider investment spreads in our fixed annuity business.

In today's economic environment another important objective for us is to maintain at least $250 million of available liquidity at the parent company through the year.
I thank you and now we'd like to open the lines for any questions.

# Question and Answer

**Operator**

(Operator Instructions) Your first call comes from [Abe - Maximum Group]

**Abe**
*Maximum Group*

I see you've raised your guidance and I see where it is in some of your insurance companies. Just in general, what is your outlook on the economy in general for this year?

**Carl Lindler**

I think the economy is going to remain tough. It seems like things have improved here mid year some but a little bit of a change in housing sales on existing homes which is a positive. I think the market seems to be reflecting a bit more optimism. That said, I still think that we're in for a pretty tough economy the rest of the year.

**Operator**

Your next question comes from [Peter Suess - Lincoln Square Capital]

**Peter Suess**
*Lincoln Square Capital*

Can you quantify your level three assets in the quarter?

**Keith Alan Jensen**
*Former Senior VP & CFO*

Level three assets represented about 5% of the portfolio.

**Peter Suess**
*Lincoln Square Capital*

I think you mentioned the foreign trade credit business. Can you size that business for us and discuss the recent top line and bottom line trends.

**Carl Lindler**

It's a pretty small part of our business. It's probably around $25 million in premiums and it's been a business where we've made money, made an underwriting profit every year for the last 18 years in that. It's a business right now because of problems in the credit markets where if properly done, particularly one off type of transactions, that we're seeing lots of price increase traction.

So carefully done, and our guys are very cautious underwriters. Carefully done in this environment I think there's some good opportunities right now at pretty sizable price increases.

**Peter Suess**
*Lincoln Square Capital*

On the investment portfolio, I think you mentioned you ran a sensitivity and you're currently implying with your valuation that housing prices go down 40% from peak to trough and I'm just wondering if you've run the sensitivity for beyond that level of housing decrease. For example, how big of an impact would it have if housing prices went down 45% or 50%?

**Carl Lindler**

An additional 10% decline in housing prices leads to something on the order of $30 million additional lifetime losses in our non agency mortgage backed portfolio. That's how we would model that outcome.

**Operator**

Your next question comes from Amit Kumar - Fox-Pitt Kelton.

**Amit Kumar**
*Fox-Pitt Kelton*

Going back to the crop numbers, first of all could you break out the crop premiums for Q1 '09?

**Keith Alan Jensen**
*Former Senior VP & CFO*

Actually in Q1 '09 because of the accounting associated with a change in our reinsurance the net written premium in crop would have shown a negative 16 and gross written premium in crop in Q1 is 42.

**Carl Lindler**

We record most of our premiums in the second and third quarters.

**Amit Kumar**
*Fox-Pitt Kelton*

This was a $1 billion book, right for '08, is that right?

**Keith Alan Jensen**
*Former Senior VP & CFO*

That's correct. You need to remember though that in '08 you had commodity prices that were really very high in the cyclical type arena that this operates in and the commodity prices currently are 25% or so off what they were at a similar time last year.

**Amit Kumar**
*Fox-Pitt Kelton*

I think you mentioned that premiums were up in financial institutions portion. Can you quantify, maybe give some more color on the book?

**Carl Lindler**

I think the premiums were driven primarily by our financial institutions business as I mentioned and there being more foreclosures. I think we're feeling the impact in that particular part of our business and a few of our other businesses had a little bit of growth there. But others reflect the reality of the economy.

**Amit Kumar**
*Fox-Pitt Kelton*

I think you mentioned that the asbestos environment review will be done in Q2 '09. Can you remind us as to what was the last finding of that review?

**Carl Lindler**

The last finding was two years ago although we have done an interim review last year and the amount was about $12 million in last year's study.

**Operator**

There are no further questions.

**Carl Lindler**
Thank you very much. We appreciate your taking the time to join us this morning. We're pleased to have been able to report to you and we look forward to reporting to you at the conclusion of the second quarter. Have a good day.