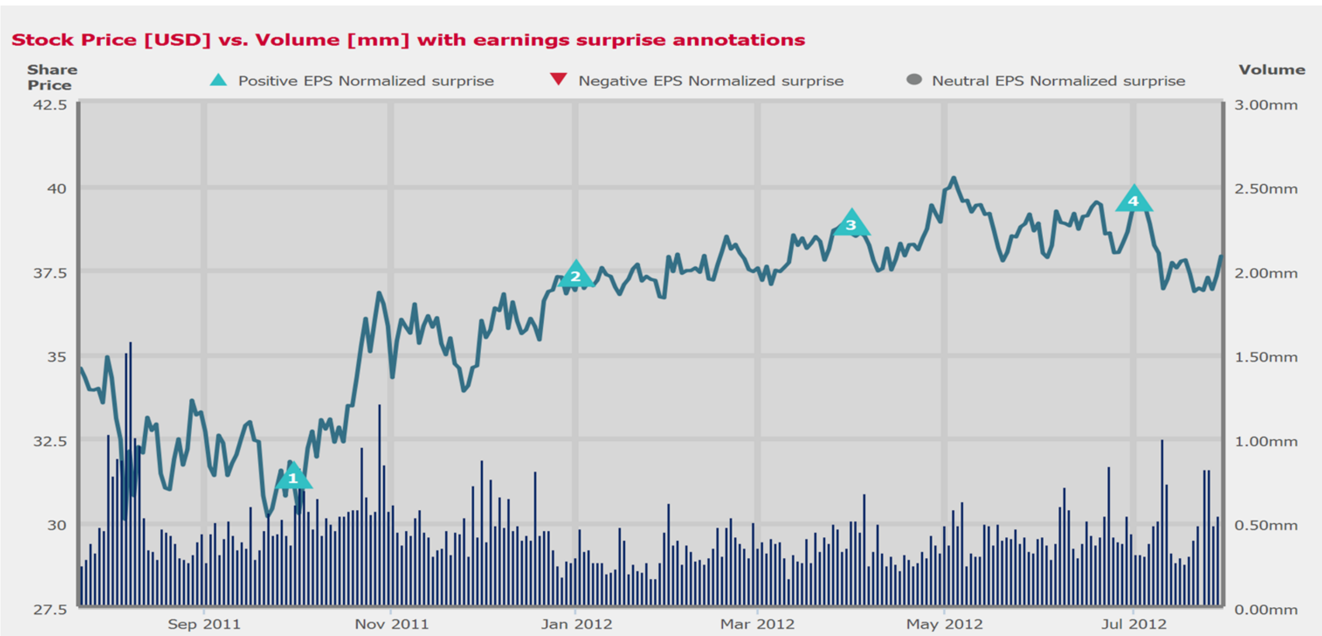
S&P Global
Market Intelligence

American Financial Group, Inc. NYSE:AFG
FQ3 2012 Earnings Call Transcripts
Tuesday, October 30, 2012 3:30 PM GMT
S&P Global Market Intelligence Estimates

	-FQ3 2012-			-FQ4 2012-	-FY 2012-	-FY 2013-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.60	0.82	▲36.67	0.86	3.23	3.74
Revenue (mm)	890.00	848.00	▲(4.72 %)	629.80	2803.50	2953.30

Currency: USD
Consensus as of Oct-30-2012 2:01 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2011	0.82	0.90	▲1 9.76 %
FQ4 2011	0.94	1.06	▲2 12.77 %
FQ1 2012	0.78	0.86	▲3 10.26 %
FQ2 2012	0.79	0.91	▲4 15.19 %

Table of Contents

Call Participants	....	3
Presentation	....	4
Question and Answer	....	10

Call Participants

EXECUTIVES

Carl Henry Lindner
Co-President, Co-CEO & Director

Keith Alan Jensen
Former Senior VP & CFO

Stephen Craig Lindner
Co-President, Co-CEO & Director

ANALYSTS

Amit Kumar
Macquarie Research

Matthew Jay Rohrmann
Keefe, Bruyette, & Woods, Inc., Research Division

Presentation

Operator

At this time, I would like to welcome everyone to the American Financial Group's 2012 Third Quarter Earnings Conference Call. [Operator Instructions] Senior Vice President, American Financial Group, Keith Jensen, you may begin your conference.

Keith Alan Jensen
Former Senior VP & CFO

Good morning. Welcome to American Financial Group's third quarter 2012 earnings conference call. We appreciate you joining us this morning and we know many of you're in unusual circumstances as a result of the storms. I'm joined this morning by Carl Lindner III and Craig Lindner, co-CEOs of American Financial Group. If you are viewing the webcast from the website, you can follow on 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, projections, which management believes are reasonable, but by their nature subject to risks and uncertainty.

The factors which could cause actual results and/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, including 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 which could affect these statements.

Core net operating earnings is a non-GAAP financial measure, which sets aside significant items that are generally not considered to be part of ongoing operations, such as realized gains or losses on investments, the effect of certain accounting changes, discontinued operations, special asbestos and environmental, and annuity unlocking charges, lost recognition in our long-term care business and certain non-recurring items.

AFG believes this non-GAAP measure to be a useful tool for analysts and investors in analyzing ongoing operating trends and will be discussed for various periods during this call. A reconciliation of net earnings attributable to shareholders to core net operating earnings is included in our earnings release.

Now, it's my pleasure to turn the call over to Carl Lindner III, Co-CEO to discuss our results.

Carl Henry Lindner
Co-President, Co-CEO & Director

Good morning, and thank you for joining us overnight and this morning. We watched the devastation from Hurricane Sandy and the related storm systems affecting the northeastern part of the United States. We pray for the safety of those impacted the storms and the first responders, who are helping to help the victims and restore services in those communities.

As you know, last week, Craig and I shared news of some important organizational changes at AFG in the coming months. Keith has announced his intention of retire in March 2013, following the completion of AFG's 2012 annual financial reporting process. Keith, we're thankful for your leadership and vision in these past 15 years. We do look forward to recognizing your contributions when we report our fourth quarter results in February.

We are very pleased to welcome Jeff Consolino at AFG, who will assume the role of Chief Financial Officer on Keith's retirement. We've known Jeff for many years, first as a trusted financial advisor in several large financial transactions, and more recently as a board member of our 52% owned sub National Interstate. He's a respected industry veteran and we're delighted that he'll be joining our team.

We did release our 2012 third quarter results yesterday afternoon and are pleased with another quarter of strong operating results for AFG. I am assuming that the participants on today's call have reviewed our earnings release and some of the supplemental materials posted on the website.

I'll review a few highlights and focus today's discussion on key issues. I'll also briefly discuss our outlook for the remainder of 2012. Now let's start by looking at third quarter results, which are summarized on Slides 3 and 4 of the webcast.

Net earnings were $2.39 per share for the quarter, including $1.57 in after-tax non-core earnings, which include a gain on the sale of our Medicare supplement and critical illness businesses, our realized gains and the results of AFG's tax case resolution. These items were partially offset by a reserve strengthening related to the company's asbestos and other environmental exposures, and a write-off of unamortized debt issue expense related to the retirement of AFG's senior notes.

Net earnings attributable to shareholders for the 2012 9 month period were $438 million or $4.50 per share compared with $233 million or $2.23 per share in the comparable 2011 period. Core net operating earnings for the quarter were $78 million or $0.82 per share compared to the prior year's results of $92 million or $0.91 per share.

Record profits in our annuity and supplemental group were offset by lower underwriting earnings and lower investment income in our Specialty, Property and Casualty insurance operations. Our 9 month annualized core operating return on equity was about 9%. Our capital adequacy, financial condition and liquidity remain strong, and are key areas of focus for us.

We maintain sufficient capital in our insurance businesses to meet our commitments to the rating agencies in support of our current rating levels. Our excess capital was approximately $575 million at September 30, 2012 which included cash at the parent company of approximately $300 million.

In August, we did issue $125 million of 5.75 debentures, due 2042. The proceeds were reused to redeem all $115 million principal amount of our 7 and 8 senior notes due in 2034. We've continue to deploy our excess capital in ways that enhance shareholder value. We repurchased 4.3 million shares of our common stock during the third quarter, at an average price that was 88% of September 30, 2012, adjusted book value per share.

As of October 29, 2012, there are approximately 4.5 million shares remaining under our repurchase authorization. Share repurchases were $315 million through the first 9 months of the year, and are expected to reach approximately $450 million for the year. In addition to share repurchases and dividends, we've invested excess capital when we see potential for healthy profitable organic growth and we're always looking for opportunities to expand our specialty niche businesses through start-ups and acquisitions.

As you'll see on Slide 4, AFG's book value per share, excluding appropriated retained earnings and unrealized gains and losses on fixed maturities increased 11% from year-end to $42.72. Tangible book value on a comparable basis was $40.26 at September 30, 2012.

Now on Slide 5, you'll see summary results for our Specialty Property and Casualty operations. Property and Casualty Specialty Insurance operation turned in an another solid quarter, recording an underwriting profit of $16 million for the third quarter of 2012, and generating a combined operating ratio of 98%, a 5 point increase from the comparable period in 2011.

Losses of $12 million in our crop insurance business and approximately $25 million less favorable reserve development and several of our Specialty Casualty businesses contributed to the increase in the third quarter combined ratio.

Losses from catastrophes and overall favorable reserve development accounted for only one point each on the combined ratio. By comparison, catastrophe losses represented 2 points on the third quarter 2011 combined ratio, whereas favorable development had 4 points of impact in the 2011 period.

Underwriting profit for the first 9 months of 2012 were $116 million compared to $142 million in the comparable 2011 period. Gross and net-written premiums decreased by approximately 4% and 1%, respectively for the third quarter, when compared to the 2011 periods. The decrease in premiums was primarily attributed to lower crop commodity prices, which was offset by increases in most of our other businesses.

Gross and net-written premiums were up 2% and 4%, respectively for the 2012 9 month period, compared to the same periods a year earlier. Now, the growth was driven primarily by higher premiums in our Specialty Casualty Group. We continue to see price strengthening in most of our Property and Casualty businesses. And achieved a 3% overall renewal increase in the third quarter. This is the fourth consecutive quarter we've achieved an overall rate increase.

With low fixed income yields, we and the industry need strong underwriting results to achieve healthy returns on equity. This should create opportunities for additional price increases throughout 2013. Loss cost trends are stable and appear to be benign across our portfolio of businesses.

Frequency is generally flat. And severity tracks reasonably well with the modest increases in the core consumer price index. I'm encouraged to see these trends as they will help to drive meaningful growth and value creation in our business over time.

Now, I'd like to discuss a few highlights from each of our specialty business groups on Slides 6 and 7. Property and Transportation Group, our largest segment, reported a small underwriting profit in 2011 and 2012 third quarters. 2012 crop losses resulting from the effects of Midwest drought more than offset improved profitability and other businesses in the group.

The $12 million in crop losses recorded in the third quarter do represent the full extent of losses for the year as any additional losses are expected to be within the scope of our stop loss reinsurance agreement. Through the strategic use of reinsurance, our crop team had done an admirable job mitigating losses during one of the worst Midwest droughts, most of us have seen in our careers.

Underwriting profit in the first 9 months of 2012 in Property and Transportation decreased approximately $5 million from the comparable 2011 period. Most of our businesses in this segment had solid underwriting margins for the first 9 months for 2012. Gross and net written premiums in this group were lower in the third quarter and first 9 months of 2012, primarily and as a result of lower crop commodity prices in the year.

If you exclude our crop premiums, net-written premiums actually grew 3% and 7% for the quarter, and for the first 9 months of 2012, respectively. Increased premiums in our transportation, property, inland marine and ocean marine businesses contributed to the growth. Renewal pricing continued its upward trend and was approximately 4% for the quarter, and 3% for the year-to-date.

Now, the specialty casualty group reported net underwriting profit of $8 million in third quarter compared to an underwriting profit of $20 million in the third quarter of 2011. Improved profitability in our social services, and our E&S operations were more than offset by lower favorable development in our general liability, workers compensation and runoff casualty businesses during the quarter.

Year-to-date 2012 underwriting profits were $7 million higher than the comparable 2011 period primarily due to higher favorable reserve development in our general liability lines and improved profitability in our international businesses, which offset lower profitability in our E&S and executive liability operations. And most of our businesses in this group produced strong underwriting profit margins through the first 9 months of 2012.

Gross and net-written premiums increased by double-digits in both the third quarter and 9 month periods this year, when compared to the same prior year periods. Our workers compensation, excess and surplus, and target markets operations were the primarily sources of the growth in this group. Increased business opportunities arising from larger exposures and general market hardening have contributed to the increased premiums. Pricing in this group also continued its upward trend, and was approximately 5% for the third quarter and 4% for the first 9 months of 2012.

Moving on to the Specialty Financial Group, they reported a small underwriting profit in the third quarter, compared to an underwriting profit of $24 million in the third quarter of last year. Underwriting profit was $28 million and $52 million for the first 9 months of 2012 and 2011, respectively.

Losses from a runoff book of automotive-related business, as well as lower favorable development during the third quarter were the primary drivers of these results. Most of the businesses in this group achieved good underwriting margins during the first 9 months of 2012.

Gross and net-written premiums were up 6% and 2%, respectively, for the first 9 months of 2012 when compared to 2011. Higher gross written premiums resulted primarily from a service contract business initiated in the second quarter of 2011. All these premiums were ceded under a reinsurance agreement. Pricing in this group was up approximately 1% for the third quarter and first 9 months of 2012.

Now on Slide 8, let's move on to a review of our annuity and supplemental insurance group. Annuity and supplemental group reported record core operating earnings before income taxes of $81 million for the 2012 third quarter compared to $47 million in the 2011 period.

This 72% increase was largely attributable to our ability to maintain spreads on a larger base of invested assets in our fixed annuity operations. In the first 9 months of this year, the A&S Group reported record core operating earnings before income taxes of $224 million compared to $157 million in the 2011 period.

This 43% increase resulted from the same factors that contributed to the quarterly increase. The annualized 9 month operating return on equity in the annuity business is approximately 10%, largely the result of our continued focus on core business operations and ability to achieve excellent investment results.

Our Medicare supplement and critical illness businesses contributed pre-tax earnings of $28 million year-to-date, though these operations were sold in August of 2012. Statutory premiums of $801 million in the 2012 third quarter were approximately 19% lower than the third quarter of 2011, in line with our expectations.

The continued low interest rate environment was a key factor for actions taken early in the third quarter to lower crediting rates and agent commissions on several of our products, which resulted in a slowdown in sales. Statutory premiums of $2.7 billion for the first 9 months were 2% lower than the comparable 2011 period, as strong growth in the first 6 months of the year were tempered by lower third quarter sales.

Annuity sales have slowed somewhat as we maintain our pricing discipline. As previously announced, AFG sold its Medicare supplement and critical illness businesses to Cigna Corp. for approximately $305 million in cash, and we recorded an after-tax gain of approximately $101 million on the sale which is subject to post-closing adjustments.

We continue to analyze our projected long-term care claims and persistency experience with the assistance of an external actuarial consulting firm, including a comparison to their larger uniform data base of industry experience.

Furthermore, we expect to complete our analysis of the actuarial assumptions used to amortize deferred acquisition cost and establish reserves in our long-term care business prior to the end of 2012. Although AFG's long-term care of new claims and persistency experience through 2012 was reasonably consistent with current assumptions, 2012 experience may not be indicative of future trends.

While our long-term care on amortized acquisition expenses were recoverable through September 30, 2012, the loss recognition margin as material declined in recent years for this closed book. Small adverse changes and assumptions and a further continuation of the low interest rate environment are likely to lead the loss recognition in this business. These charges would be excluded from core earnings if material.

We performed a review and are unlocking of our major actuarial assumptions of its life and annuity businesses throughout the year. Changes in assumed investment yields and other actuarial assumptions in these businesses could also affect earnings.

During the third quarter, AFG completed an internal review of its A&E exposures related to the runoff operations of its P&C group, and its exposures related to former railroad and manufacturing operations and sites. We conduct comprehensive studies with the assistance of outside actuarial and engineering firms and specialty outside counsel every 2 years.

As you'll see; if we turn to Slides 9 and 10, this year's internal review resulted in an after-tax charge of $21 million to increase A&E reserves. The charge relates primarily to an increase in environmental investigative costs and related loss adjustment expenses in certain environmental and asbestos files.

There were no newly identified issues that management believes would significantly impact the overall adequacy of AFG's A&E reserves. At September 30, 2012, AFG's 3 year survival ratio for the Property and Casualty exposures compared favorably with industry data.

Now please turn to Slide 11 for a few highlights regarding our investment portfolio. AFG recorded third quarter 2012 net realized gains on securities of $55 million after tax and after deferred acquisition cost compared to $5 million in the comparable prior year period. After-tax, after-DAC realized gains for the first 9 months of this year were $92 million, compared to $14 million in the same period last year. These strong favorable results are an important factor in our ability to maintain adequate spreads in our annuity business.

Unrealized gains on fixed maturities were $789 million after-tax, after-DAC at September 30, 2012. Our portfolio continues to be high quality, with 86% of our fixed maturity portfolio rated investment grade, and 95% with the National Association of Insurance Commissioner's designation of NAIC 1 or 2, it's the highest 2 categories..

During the first 9 months of 2012, property and casualty investment income was 6% lower than the comparable period, which was in line with our expectations. We have provided additional detailed information on the various segments of our investment portfolio in our investment supplement on our website.

I'd now like to cover our outlook for the remainder of 2012 on Slide 12. Based on results of operations through the first 9 months of the year and our assumption that there will be no additional crop losses in the fourth quarter, we've increased our 2012 core operating earnings guidance to $3.10 to $3.50 per share, up from our previous estimate of $3 to $3.40 per share. This guidance does exclude losses from Hurricane Sandy that would exceed our normal projected cap load in the fourth quarter.

In our property and casualty operations, we refined our full year 2012 net-written premium guidance to be in the range of 3% to 5% growth and continued to expect a combined ratio of 93% to 96%. Details surrounding guidance for our Property and Casualty segments is as follows.

In our property and transportation group, we now expect a slight improvement in our combined ratio to be between 96% and 99%. We've updated our guidance for net-written premiums for this group to be in the range of down 3%, flat primarily due to higher than planned crop premiums.

In our Specialty Casualty Group, we expect the combined operating ratio in the range of 92% to 95%. The low end of which is slightly higher than our previous estimate. Net-written premiums for 2012 are expected to increase by 13% to 16%, slightly higher than our previous estimate.

In our Specialty Financial Group, our 2012 combined operating ratio guidance has been revised slightly higher to 88% to 91%. 2012 net-written premiums for this group are expected to be in the range of flat to up 3%, when compared to last year's results, up slightly from the range previously estimated.

Then turning to our annuity and supplemental operations, we now expect that full year 2012 core operating earnings before income taxes will be 25% to 30% higher than our 2011 results, even with the absence of earnings from our Medicare supplement and critical illness operations for the last 4 months of 2012.

This increase is being driven primarily by our fixed annuity operating earnings. Based on current market conditions and trends, we expect annuity sales for the full year of 2012 to be slightly lower than the annuity sales in 2011.

As been our practice, our earnings guidance excludes realized gains and losses, including the gain on the sale of the Med supp and critical illness business, as well as the results of loss recognition testing in our runoff long-term care business or significant A&E charges and annuity unlocking's as well as other significant items, including the result of the tax case that may not be indicative of ongoing operations. Thank you. And now, we'd like to open the lines for any questions.

Question and Answer

Operator

[Operator Instructions] Your first question comes from Amit Kumar, Macquarie Capital.

Amit Kumar
Macquarie Research

With Jeff coming in, does this signal a shift in strategy and capital management going forward?

Carl Henry Lindner
Co-President, Co-CEO & Director

I think AFG has got a long history of target acquisitions, of start-ups, pursuing organic growth, and appropriately and aggressively trying to allocate capital. I don't think there is going to be any dramatic change in philosophy or appetite for acquisitions or necessarily capital allocation. One thing is for sure, we'll definitely benefit from Jeff's network relationships in the industry, though. So as with the addition of Vince Mclenaghan, we're hoping that we see an increased number of opportunities throughout the world.

Amit Kumar
Macquarie Research

So you're saying that it's not a binary option. The capital management which we have seen, those trends will likely continue and above and beyond that you'll also look at other things. Did I infer that correctly?

Carl Henry Lindner
Co-President, Co-CEO & Director

Yes. And I think as long as our stock is very attractive, selling under book value and around intangible book value, that certainly is a wise use of capital. That said, as if we have opportunities for acquisitions or to startup businesses or if this market provides opportunities to internally grow our business at a more rapid rate, certainly that could take the place or supplement share repurchases also. Those are all great things. And we want to grow our business, the scope of our business in more specialty niches and grow the business we have and increase our market position in the specialty lines that we have, also. So as we have other opportunities on the acquisition or above average organic growth opportunities, we can always go that direction versus a larger share repurchase.

Amit Kumar
Macquarie Research

Then the other question I had is, I know it's too early to talk about Hurricane Sandy. And I'm curious, first of all, if you have a view on the markets as it relates to Hurricane Sandy? And secondly, if you could also remind us what your Hurricane Irene loss was?

Carl Henry Lindner
Co-President, Co-CEO & Director

We'd have to go back on Irene. It wasn't any significant number. We have a lower relative catastrophe volatility the most. That said, this storm is a large storm, and with low interest rates driving price increase, I think this just adds to the momentum. It's hard to tell, it's too early to know how significant of an event it is. Clearly, it was a very broad-base and wide geographical event that could add continued heat on pricing. I would only see that it would turn the price increase notch up a little bit in that.

Amit Kumar
Macquarie Research

And when you talk about pricing you are probably referring to this more as a primary event than a reinsurance event, is that fair?

Carl Henry Lindner
Co-President, Co-CEO & Director

Yes, we think that would be more of a primary event than a reinsurance event.

Keith Alan Jensen
Former Senior VP & CFO

Amit, the one thing I'd remind as a group is that this area is an area that we've been very cautious in for a number of years. And in fact, if you look at our return period, if you had a return period of 500 years that would be about 3% of equity. So while that past this no indicator of what happened this last few days, has been modeled into the actuarial models, historically. It would say that it's going to be a relatively low percentage of equity.

Operator

[Operator Instructions] Your next question comes from Matt Rohrmann, KBW.

Matthew Jay Rohrmann
Keefe, Bruyette, & Woods, Inc., Research Division

Just one quick question. Most of mine were hit already, but Carl, you had talked about growth in the workers comp line. So I just wonder if you could maybe talk about the rate and sort of state whether California or others, where you're seeing that growth currently, since obviously that business has been one you've been cautious and for a number of years now?

Carl Henry Lindner
Co-President, Co-CEO & Director

Yes. Speaking to the California workers comp market, it's competitive, but the market is definitely turning. We've been getting some price increase over the last 2 to 3 years. We got 8% of the third quarter which is about 5% year-to-date 2012. That was on top of 8% in 2011. I think the ability there will be with the industry results in California comp estimated last year to be 136. I think there is going to be continued momentum by the market need to take rate. And although our results are projected much better, probably our '11 was probably 115 to 117 accident year. This year we're projecting our results at 108 to 110. We still need 12% plus to get to a 12.5% return or get to around 100 combined ratio, figuring 3.5% investment return. So I know what our plans are. We're going to continue to focus on getting more adequate price for our business, and with the industry combined ratio at last year at 20 points worse than us; I can't believe that they don't have to do the same thing.

Matthew Jay Rohrmann
Keefe, Bruyette, & Woods, Inc., Research Division

I guess, Carl, obviously pushing for that rate, do you think that 12% is achievable next year in California in a given calendar year? Is it going to be multiple years?

Carl Henry Lindner
Co-President, Co-CEO & Director

Hard to say, I can just see what we're doing right now. We got 8% this past quarter. We're going to continue to push to get to right amount of rates. So I think over a couple of years, that's reasonable, but we can get there assuming that we also need to stay above loss cost trends in that. To me, when you look at the industry results, there ought to be a continued major push to get rate in that market. And as far as our other, we are growing double-digit at Republic, in our California worker's comp business for really a growing period for the first time in a number of years. And we're growing double-digit, primarily supported or driven by price increase and payroll increase. So to us that's a positive. On our non-California based business, written and strategic comp, we're continuing to see good opportunities in some 12 states or so that we write that high deductible, heavily loss prevented business. And we're finding opportunities to continue to grow that business at a good rate.

Keith Alan Jensen

Former Senior VP & CFO

Matt, your last question with respect to Irene, I've been given a note that Irene was $8.5 million net of reinsurance.

Operator

And we do have a follow-up question from Amit Kumar, Macquarie Capital.

Amit Kumar
Macquarie Research

Just two questions on the non-P&C operations. First is on the discussion on the interest rate and life and annuity book. I think in the K, it mentions that the average crediting rate is 3.1% and average GMIR was 2.5%. Do you have those numbers as of Q3 2012?

Stephen Craig Lindner
Co-President, Co-CEO & Director

Amit, this is Craig. I don't have those numbers. I do believe that the spread has stayed about the same as at the end of the second quarter.

Amit Kumar
Macquarie Research

And I guess the other question is on the long-term care book, how should we think about the possible range of outcomes?

Carl Henry Lindner
Co-President, Co-CEO & Director

It's just premature to really address that. What I will tell you is the study by the outside actuarial firm is expected to be completed in the fourth quarter. We would expect that in some time in December. We will have detailed information to pass on to you. The one piece that I can give you guidance on is related to reinvestment rates and our disclosure in our SEC filings says that a 10 basis point change in reinvestment rates results in an impact of around $10 million. And I can tell you that as of today, the difference between the actual and what we had previously assumed in terms of reinvestment rates is between 70 and 80 basis points. So that's the one guidance that I can give you. The rest of it related to future claims, related to future mortality rates, related to lapse rates, related to increases in premium rates. Those are the things that the outside actuarial firm is studying for us, and we will have an answer sometime in December. And as soon as we have it, we will pass that on to you.

Amit Kumar
Macquarie Research

And it seems like if you could take that number and throw in some other stuff in that bucket, it's probably around, I don't know, $100 million-ish number, right?

Carl Henry Lindner
Co-President, Co-CEO & Director

You probably need to take a pass on that one.

Operator

And there are no further questions at this time. Are there any closing remarks?

Keith Alan Jensen
Former Senior VP & CFO

We would express our continuing appreciation to you for your interest in the company, for you joining us today, and for those of you that have had damage, either friends family or yourselves in these last few days, we wish you all the best. And we want you to know our prayers are with you. We look forward to reporting at the end of the year to you. Bye.

Operator
This concludes today's American Financial Group 2012 third quarter earnings conference call. You may now disconnect.