S&P Capital IQ

CONTENTS

Kemper Corporation NYSE:KMPR

FQ4 2016 Earnings Call Transcripts

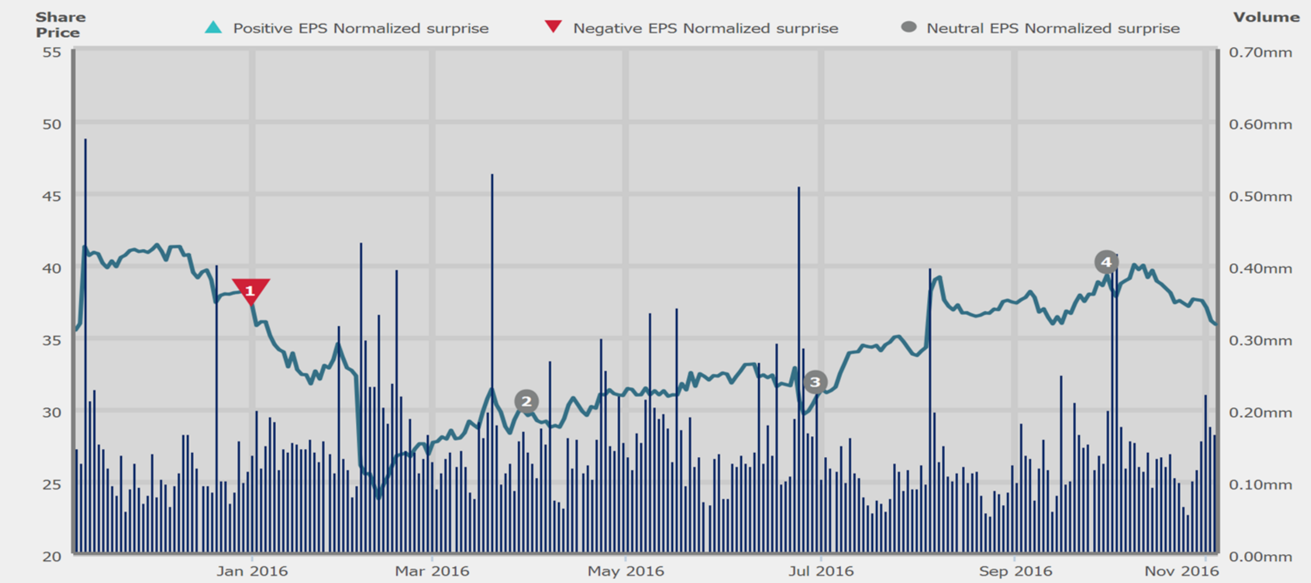
Friday, February 10, 2017 4:00 PM GMT

S&P Capital IQ Estimates

	-FQ4 2016-			-FQ1 2017-	-FY 2016-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.42	0.56	▲33.33	0.56	0.10	0.25
Revenue (mm)	631.71	642.30	▲1.68	638.91	2511.04	2521.50

Currency: USD
Consensus as of Feb-10-2017 12:05 PM GMT

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



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2015	0.59	0.09	▼1 (84.75 %)
FQ1 2016	0.03	(0.01)	NM
FQ2 2016	(0.15)	0.09	NM
FQ3 2016	(0.44)	(0.36)	NM

Call Participants

EXECUTIVES

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

James J. McKinney
Chief Financial Officer and Senior Vice President

Joseph P. Lacher
Chief Executive Officer, President and Director

ANALYSTS

Amit Kumar
Macquarie Research

Paul Newsome

Presentation

Operator

Good morning, ladies and gentlemen, and welcome to Kemper's Fourth Quarter 2016 Earnings Conference Call. My name is Austin, and I will be your coordinator today. [Operator Instructions] As a reminder, the conference is being recorded for replay purposes. I would now like to introduce your host for today's conference, Ms. Diana Hickert-Hill, Kemper's Vice President, Investor Relations and Corporate Identity. Ms. Hickert-Hill, You may begin.

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

Thank you, operator. Good morning, everyone, and thank you for joining us. This morning, you will hear from 2 of our business executives, starting with Joe Lacher, Kemper's President and Chief Executive Officer; followed by Jim McKinney, Kemper's Senior Vice President and Chief Financial Officer. We will make a few opening remarks to provide context around our fourth quarter and full year results. We will then open up the call for a question-and-answer session. During the interactive portion of the call, our presenters will be joined by John Boschelli, Kemper's Senior Vice President and Chief Investment Officer; and Mark Green, Kemper's Life & Health Division President. After the markets closed yesterday, we issued our press release and financial supplement. You can find these documents on the Investors section of our website, kemper.com. Please note that our discussion today may contain forward-looking statements. Our actual results may differ materially from these statements. For information on potential risks associated with relying on forward-looking statements, please refer to our Form 10-K and 10-Q reports filed with the SEC as well as our earnings release. We plan to file our 2016 Form 10-K with the SEC on or about February 13. This morning's discussion includes non-GAAP financial measures that we believe may be meaningful to investors. In our earnings release and supplement, we defined and reconciled non-GAAP financial measures to GAAP where required in accordance with SEC rules. And finally, all comparative references will be to the fourth quarter of 2015 unless we state otherwise. Now I'll turn the call over to Joe.

Joseph P. Lacher
Chief Executive Officer, President and Director

Thanks, Diana. Good morning everyone, and thank you for joining today's call. First, a quick thought. Chip Dufala is usually with us for these calls. He unfortunately got a bit of a case of the stomach flu yesterday afternoon. So he is home and on the call with us. So we wish him well. And unfortunately, you're going to have to listen to me do Chip's part of the commentary, as we go through our introductory comments. Just a side note, the increased cost of pure L [ph] for the floor will not be an impact on our expenses. Before we walk through our results for the quarter and year, I want to step back and share a couple of quick thoughts. My sense is that you join these calls looking to evaluate our recent performance and to better project future performance. While some quarters, that's a relatively straightforward task, this quarter's results will require a little more work from you and from us to help you accomplish those goals. It's important to remember that we are on a multiyear journey to rebuild our franchise. I'm encouraged by the progress to date, but we've got more work to do. We delivered strong improvement this quarter, and we're pleased with our progress on our business transformation. That said, our underlying results are not quite as strong as the headline numbers may suggest, and it would produce an inaccurate conclusion to take the fourth quarter numbers and just add on projected improvements to model future earnings. So we're going to do a few things today. We're going to review this quarter's results, we're going to provide some insight into where these results are recurring and where, and why, you might make adjustments to estimate future performance. In addition, we're going to update you on our progress on key initiatives. With that, let's jump in. Net income for the quarter increased $27 million to $31 million, and net operating income increased $24 million to $29 million. For the year, full year net income was $17 million compared to $86 million last year, and net operating income was $12 million compared to $70 million last year. As I said before, we're pleased with the fourth quarter results. I want to make a few high-level observations that maybe helpful, as you think about future performance. Alliance United net income improved substantially. Last year, we identified this business' result as a major problem and committed to a multipronged overhaul. We're succeeding on these initiatives and remain on track with our expectations. That said, the fourth quarter benefited from a couple of nonrecurring items. First, we saw some favorable current year development related to reevaluation of the first through third quarter performance. This made the fourth quarter results look a little better than underlying. Second, as most of you are aware, our P&C business has some seasonal variance in loss frequencies. Historically, the fourth quarter experiences an increased level of losses. In this period, AU experienced an abnormally low seasonality impact. This suggests underlying results were somewhat better than we would expect going forward. I'll go into some greater detail on both of these items in a few minutes. Our preferred auto line is experiencing the same adverse loss trends you've heard discussed across the industry. We were a bit late to recognize these trends. And as a result, we had some unfavorable calendar year development this quarter. We see it now, and we're responding appropriately. That said, we do expect at least a couple more quarters where with this line's loss ratio will be pressured. I'll now update you on a few key items from our September strategy session. We're making good progress on our expense reductions. We're committed to the targeted reductions we outlined. While we achieved our 2016 run rate goal, we know we'll need to invest a bit in '17 to achieve our year-end run rate target. So we can expect some modest expense increases in the near-term before we achieve the anticipated reductions by the end of the year. On the loss and LAE front, we stated that we're going to take out at least $85 million of P&C loss cost on a run rate by the year-end 2018. We're on track to achieve this, but I want to be clear that these reductions will come in a lumpy fashion. They will not be recognized in a straight line. On investments, we had another good quarter, as we remained nimble in this challenging environment while adhering to our investment principles. We continue to make good progress strengthening our leadership team. We've added some key new members at the next level of our organization. The team is fully engaged, becoming a more cohesive unit and is committed to driving the execution of our strategy. This is a good time to shift to our Property & Casualty results. I mentioned how pleased we -- excuse me, I want to mention how pleased we are that Naimish Patel joined our team recently to head up the Kemper Preferred business. Naimish brings a wealth of insurance experience. We look forward to his leadership as we focus our efforts on delivering tailored solutions to the important preferred home and auto market. In terms of our strategic initiatives, Naimish's arrival has allowed acceleration of the separation of our preferred and nonstandard businesses, so that each can receive the focus it deserves. We continue working to build our capabilities for product and pricing sophistication, modernizing our platforms and improving our claims effectiveness. I'll now walk through each of our major P&C lines of business, starting with nonstandard auto. Since we purchased Alliance United in mid-2015, year-over-year comparisons blur the results and its performance in some cases was different from our legacy lines. So I'll walk through each individually. In Alliance United, we took aggressive rate and other underwriting actions in 2016. And as a result, our average earned premiums grew, our underwriting margin improved. In addition, we filed for and received approval for another 6.9% rate increase on our Gold product, which represents about half our book. We expect to implement this increase in the first quarter of 2017 and expect to see continued improvement in our underwriting margin. We're in the process of designing and filing a new consolidated class plan for Alliance United. This will slow the pace of new filed rate increases until this plan is approved, which will be late 2017 at the earliest. As we've discussed during previous calls, we made an intense focus on increasing our claims staffing and reducing pending claims inventories. We continue to make progress in this area and the inventory declined in the quarter. We expect it to take several more quarters to get to a normal level. For the quarter, Alliance United reported net income of $2 million compared to a loss of $16 million. The quarterly underlying loss ratio improved 13 points to 87.6%, but both periods included the impacts of current year development from the first 3 quarters of the year. Excluding this current year development, the underlying loss ratio improved 4 points in the quarter to 90.7%. The fourth quarter loss ratio was also down sequentially from the third quarter. This is unusual, as Alliance United traditionally experiences its highest loss ratio in the fourth quarter of the year. While we're pleased to see the underlying loss and LAE ratio is improving, some abnormal seasonality appears to have accrued to our benefit in the quarter. Factoring in all of these items, I would view the fourth quarter normalized run rate to be several points higher than the 90.7% we experienced. Our legacy nonstandard auto business has been underperforming in recent years. Over the course of 2016, we aggressively applied corrective measures to this line through significant rate increases, focused underwriting actions and agency management. We are now seeing positive results from these initiatives, with year-over-year improvement in our underlying profitability in each of the last 4 quarters. The underlying loss ratio improved 6 points for the quarter to 74.6% and 5 points for the year to 75.9%. In addition to these profit improvements, net written premiums grew 3% in the quarter and 2% for the year. We've achieved much of the needed profitability improvements. As we refocus and dedicate resources around our nonstandard auto business, we will continue our profit improvement initiatives, while expanding our long-term focus to policy growth. I'll now turn to address our preferred lines and will start with preferred auto. We finished the quarter with a $6 million net operating loss compared to $1 million of net operating income last year, primarily from the impact of both prior year and current year reserve development. Excluding current year development, our underlying loss ratio in the quarter was roughly flat. For the year, preferred auto reported a $4 million net operating loss, down $29 million, driven primarily by the impact of prior year development and a higher level of catastrophes. The underlying loss ratio increased about 1.5 points to 72.6% as loss cost inflation outpaced our rate and underwriting actions. On the top line, new business and policy retention both rose in the quarter and in the year. However, due to the smaller renewal base, net written premiums were flat in the quarter at $103 million and were down 2% to $426 million for the year. Finally, on homeowners, we earned $7 million in the quarter, down slightly from last year. Accident quarter, catastrophe losses were light, but results were impacted by adverse development on the 2 hailstorms in North Texas that occurred in the first half of the year. For the year, net income was $3 million, down $18 million, primarily due to those 2 hailstorms, partially offset by higher favorable prior year reserve development in 2016. From a top line standpoint, in 2016, similar to preferred auto, net written premiums on our homeowners book were down from a smaller renewal base, but both new business and policy retention were up for the year. We will continue to push forward on our initiatives to improve the business performance of all lines of business in Property & Casualty. Now I'll talk -- briefly talk about our Life & Health business. We earned $23 million in the quarter, up $5 million, benefiting from lower legal expenses. For the year, we earned $30 million, down from $72 million from a year ago, with the decline mainly driven by the $51 million after-tax charge we took in the third quarter of 2016, as we implemented new voluntary outreach efforts using databases, such as the Social Security Death Master File. The reduced legal expenses helped offset this charge. We're encouraged to see the earned premiums stabilize, and we'll continue our efforts on this front. Overall, we continue to focus on operational efficiency, getting the most out of our distribution channels across this division. Overall, again I'll say it, remember, we're on a multiyear journey to rebuild our franchise. I'm encouraged by the progress to date, but we have more work to do. With that, I'll turn the call over to Jim to wrap up our comments on the quarter.

James J. McKinney
Chief Financial Officer and Senior Vice President

Thanks, Joe. Starting with investments, we had another good quarter in terms of net investment income and the pre-tax equivalent annualized book yield achieved. Net investment income of $80 million was essentially flat for the quarter, as the larger investment base was mostly offset by lower rate. During the quarter, alternative investment income was $11 million for the quarter. This was slightly above our quarter-end run rate expectations. For the year, net investment income was down $4 million, as $9 million of lower investment income on alternative investments was partly offset by $5 million of higher investment income on the rest of the portfolio, as we benefited from a larger asset base. In total, the investment portfolio generated a pre-tax equivalent annualized book yield of 5.4% for the fourth quarter of 2016 and 5.1% for the year. It's important to note that despite the rise in interest rates, overall investment yields remain compressed. Maturing yields generally are above new money rates, creating a slight headwind in the upcoming quarters. Total return for the quarter was negative, as the impact of higher yields on our fixed maturities more than offset net investment income. For the year, total return was positive, driven by net investment income.

Moving to Corporate and Other. Results improved $7 million in the quarter and $14 million for the year. The quarter is driven by lower pension expense and higher net investment income, and the year is driven by lower pension expense. Turning to liquidity. The parent company continues to maintain ample liquidity. The company held cash and investments of approximately $300 million. In addition, the company's $225 million revolver remained undrawn and available at year-end. From a capital perspective, we ended the year with more than $200 million of excess capital. The statutory surplus levels in our insurance companies remained strong. We estimate that we ended the year with risk-based capital ratios of approximately 395% for our Life & Health group and 325% for our legacy Property & Casualty group. Looking to debt, our 6%, $360 million senior notes mature May 15. We're planning to refinance $250 million or more prior to maturity. The balance will be repaid using the company's cash reserves. To reduce our interest rate risk, in the fourth quarter, we entered into a $250 million 10-year treasury interest rate hedge. The year-end fair value of this financial instrument was $1.6 million. This fair value changes included an accumulated other comprehensive income. Last, book value per share, excluding unrealized gains on fixed maturities, was $35. This was an increase of $0.73 from the third quarter. On a year-over-year basis, book value per share, excluding unrealized gains on fixed maturities, was essentially flat. With that, we are pleased to turn the call over to the operator to take your questions. Operator?

Question and Answer

Operator

[Operator Instructions] And our first question comes from Paul Newsome with Sandler O'Neill.

Paul Newsome

I was wondering if you could talk a little bit about the form of the problem in the preferred business. Because while everyone seems to have a problem, it seems to be a little bit different between companies, whether it's primarily a frequency issue or also -- and/or also a severity issue?

Joseph P. Lacher
Chief Executive Officer, President and Director

Great question, Paul, and thank you. What we've got is a little bit of both. It's -- the primary issue here was, we were late in spotting the trend. I would tell you that the biggest chunk of it is probably for us in the frequency side of the house, which is part of the reason that we missed it. We had a reasonable significant -- reasonably significant shift in frequency inside of our book of business. We were consciously moving away from some parts of the higher frequency piece of the book that were underperforming. And that mix change, just as you'd logically expect, if you're selling some less high-frequency stuff and more low-frequency stuff. It causes the overall book to look like the frequency is tempering. That tempering masked some of the increased frequency that we were -- we are seeing overall. So that's the big driver of it. We saw some severity earlier in the year, and we're responding to that. Our issue now is because of the frequency miss. Does that make sense?

Paul Newsome

Yes, that makes perfect sense. So -- and I assume it's essentially a rate fix at the end.

Joseph P. Lacher
Chief Executive Officer, President and Director

Largely, it will be a rate fix. What I tell you is this is a case where, again, trying to figure out how to think about this on a marching-forward basis, there was some unfavorable intra-year development in this preferred line. So the current quarter, because it was intra-year or current year development, isn't quite as bad on a real run rate basis as it looks. But there is an issue there and that issue will percolate its way into the next 2 quarters and may actually go up a hair from that adjusted basis before it goes down. So this may be a reasonable number to think about when you project forward. Because we relayed, it'll take us a little while to get the rate moving and have it earn in. So it will be a quarter or 2.

Operator

[Operator Instructions] Our next question is from Amit Kumar with Macquarie.

Amit Kumar
Macquarie Research

Just a few questions. First of all, just going back to the discussion on the loss cost trends. Was that on the BI side or on the PD side?

Joseph P. Lacher
Chief Executive Officer, President and Director

Great question. Thank you. It was pressure and collision in BI. The mix changes are really what muted it in the BI side of the house. So both were running through there. The part where we missed, that's probably driving the biggest issue on this, is BI.

Amit Kumar
Macquarie Research

Got it. That's helpful. And, I guess, related to that is, and I know we've previously discussed this regarding the pricing. How should we think about, I guess, the level of price increases you need from here versus the loss cost? And what sort of impact it will have on your book, going forward in terms of top line?

Joseph P. Lacher
Chief Executive Officer, President and Director

Yes, this one is going to be a complicated one, Amit, for us to be able to talk about and for us to help you model going forward, because a couple of things are happening. We clearly are at least several points away from target profitability in a number of the P&C lines. We've identified a series of improvements for you that we are driving on expenses and P&C loss cost and LAE. We expect the economic equivalent of that $50 million to $65 million of pre-tax expense and the $85 million of pre-tax loss, together a $90 million after-tax benefit. We expect that to accrue to the bottom line. And anything else we're doing, we'll adjust around making ourselves appropriately competitive in the marketplace. So from a practical perspective, we're going to increase rates to get us to where we think we're to be in the right -- at the right time. At the same time, we're doing those things. So we're going to be operating all the levers. While we're not trying to give you earnings guidance, we're trying to tell you that the net effect of what we're doing on rate and underwriting and the loss and LAE and the expense, should put us in the zone of being near that target profitability. And that's the net of all those items, you should expect to see. That's not exactly what you asked, but I think it's what you're looking for.

Amit Kumar
Macquarie Research

Yes, directionally, it helps. I guess, related to that would be, can you remind us how much of your book is 6 months versus 12 months?

Joseph P. Lacher
Chief Executive Officer, President and Director

That varies by line. Our AU book has a variety of policy terms, that 3/4 of it -- 2/3 to 3/4 of it -- we're going to have to get back to you on this precisely, but I think 2/3 to 3/4 of it is 6 months or less in AU. Our split in our legacy nonstandard is -- our legacy nonstandard ex California is 90% 6 months. We've got a little longer duration in our California nonstandard. The bulk of our preferred is 12 months. And then the homeowners is, obviously, all 12 months. I'd love to have a crisper answer for you. What we've got is a quilt of series of businesses here that operated differently, and each one of them was working a little differently in the market.

Amit Kumar
Macquarie Research

That's -- again, maybe a suggestion might be to add some commentary in the 10-K. That would be very helpful, if that makes it easier for you. Then, the final question I have is on the capital situation. I know that previously you've talked about pulling back on repurchase since you want to fix this issue first, and you mentioned a $200 million number. I'm curious, has any thought process changed on capital management? Or is that on the back burner?

James J. McKinney
Chief Financial Officer and Senior Vice President

Yes. No, thanks. Great question. Right now, my focus in terms of our capital management strategies are aligned with kind of resetting the debt story associated with our upcoming maturity. And I'm focused centrally on ensuring that people understand the story, understand the risk aligned with the business. Once we get to that event, we'll continue to look for opportunistic ways to deploy capital in the most efficient way for our shareholders. And when we get to that point and we understand what the opportunities are, then we'll have further thoughts on it.

Operator

This concludes our question-and-answer session. I'd like to turn the conference back over to Joe Lacher for any closing remarks.

Joseph P. Lacher
Chief Executive Officer, President and Director

Thank you, operator. I'm pleased that we're starting to get some traction on several fronts in our quest to deliver profitability improvements. Our Life & Health segment delivered solid performance. We're encouraged to see some positive trends from our ongoing actions in Alliance United. We're seeing tangible progress in our legacy nonstandard auto line, and we're taking some clearly needed actions within the preferred lines. We're focused on taking the right steps we need to deliver the improvement we outlined in our strategic update last fall. We appreciate your time today and your interest in Kemper, and we look forward to future updates. Thanks a lot.

Operator
The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.