S&P Global
Market Intelligence

# American Financial Group, Inc. NYSE:AFG

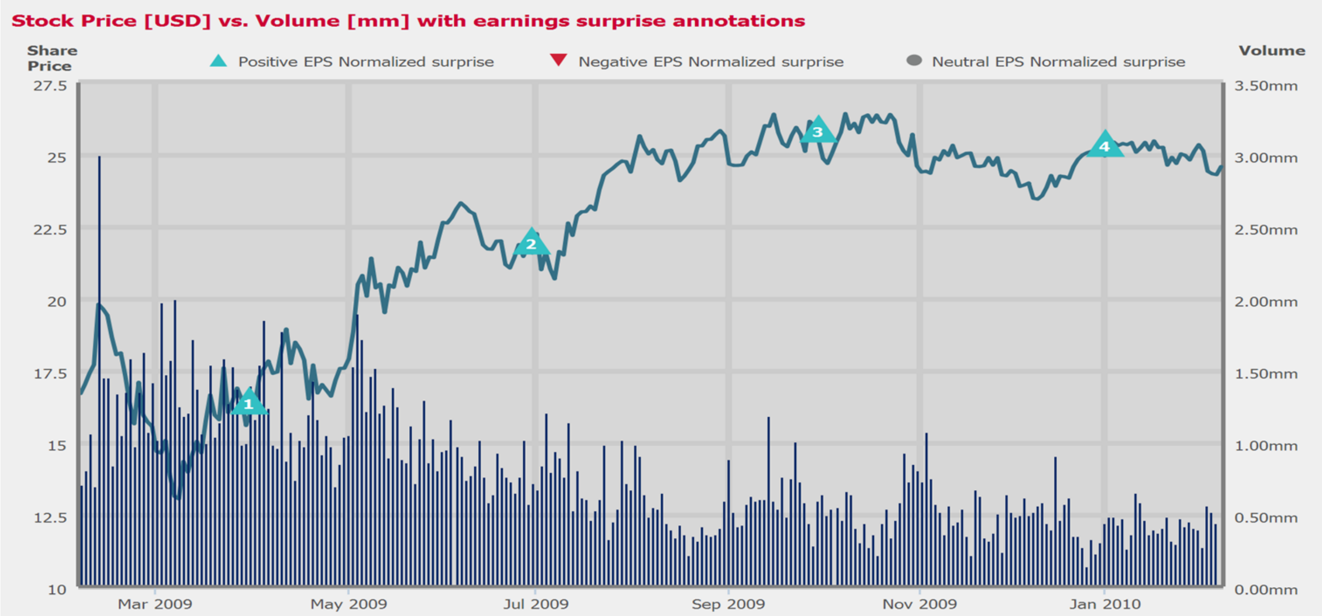
# FQ1 2010 Earnings Call Transcripts

## Thursday, May 06, 2010 3:30 PM GMT

## S&P Global Market Intelligence Estimates

| | -FQ1 2010- | | | -FQ2 2010- | -FY 2010- | -FY 2011- |
|---|---|---|---|---|---|---|
| | CONSENSUS | ACTUAL | SURPRISE | CONSENSUS | CONSENSUS | CONSENSUS |
| **EPS Normalized** | 0.83 | 0.91 | 9.64 | 0.95 | 3.82 | 3.73 |

Currency: USD
Consensus as of Apr-19-2010 3:27 AM GMT




| - EPS NORMALIZED - | CONSENSUS | ACTUAL | SURPRISE |
|---|---|---|---|
| **FQ1 2009** | 0.98 | 1.11 | 1 12.12 % |
| **FQ2 2009** | 0.92 | 1.01 | 2 9.78 % |
| **FQ3 2009** | 0.88 | 1.07 | 3 20.22 % |
| **FQ4 2009** | 0.94 | 1.04 | 4 10.64 % |

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# Call Participants

## EXECUTIVES

**Carl Lindner III**

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

## ANALYSTS

**Jay Cohen**
*Banc of America/Merrill Lynch*

**Keith Vincent**

# Presentation

**Operator**

Good morning. My name is [Plimpy] and I will be your conference operator today. At this time, I would like to welcome everyone to the American Financial Group 2010 First Quarter Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers remarks there will be a question and answer session. (Operator instructions).

Thank you. Mr. Keith Jensen, you may begin your conference.

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

Thank you very much. Good morning and welcome to American Financial Group's 2010 first quarter earnings results conference call. I'm joined this morning with Carl Lindner III and Craig Lindner, Co-CEO's of American Financial Group. If you are 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 maybe considered forward-looking statements because they are based on estimates, assumptions and projections, which management believes are reasonable by their nature but are subject to risks and uncertainties.

The factors which could cause actual results and/or financial conditions 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 that could affect those statements. Core net operating earnings is a non-GAAP financial measure, which sets aside items that are generally not considered to be part of ongoing operations, such as net realized gains and losses on investments, the effects of accounting changes, discontinued operations, significant asbestos and environmental charges and other 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 this call. A reconciliation of net earnings attributable to shareholders to core net operating earnings is included in our earnings release.

Now, I'm pleased to turn the call over to Carl Lindner III to discuss our results.

**Carl Lindner III**

Good morning and thank you for joining us. We released our 2010 first quarter results yesterday afternoon even as we were faced with soft pricing, the decreased commercial demand resulting from a depressed economy and increased catastrophe activity. AFG reported strong core earnings, demonstrating that we're making solid progress towards our operational goals for 2010.

It's good to see AFG return to the Fortune 500 list after an absence the past few years, especially in light of the market considerations I just mentioned. I'm assuming that the participants on today's call have reviewed our earnings release and the supplemental materials posted on our website. I'll now review a few highlights and focus today's discussion on key issues and our outlook for the remainder of 2010.

Let's start by looking at our 2010 first quarter results summarized on slides three and four of the webcast. Our first quarter core net operating earnings were $103 million or $0.91 a share, about 21% below the prior year period. These results are consistent with our expectations and reflect improved results in our newly and supplemental insurance operations which were more than offset by lower property and casualty underwriting profit and lower investment income. Interest in other corporate expenses were higher during the first quarter, primarily due to increased borrowing costs associated with our $350 million debt issuance that was done in 2009.

Net earnings were $0.93 per share for the 2010 first quarter, an increase of 6%. Annualized operating return on equity for 2010 was approximately 11%. One of our important strategic objectives is to deploy our excess capital in a way that enhances shareholder value. To that end, we purchased nearly $3 million shares of our common stock at an average price of $25.76 per share during the 2010 first quarter.

We believe the purchase of shares below book values and appropriate means of increasing shareholder value. We also continue to seek opportunities to grow our specialty niche businesses, particularly when expected investment returns provide the potential to enhance long term shareholder value.

Our 53% owned subsidiary, National Interstate announced last week that it entered into a definitive agreement to acquire Vanliner Insurance Company. Vanliner is a market leader in providing insurance for the moving and storage industry, writing $104 million in gross moving and storage premiums in 2009. We believe this acquisition is a natural extension of National Interstate's business model.

As you will see on slide four, AFG's book value per share including all unrealized gains and losses on investments but excluding appropriated retained earnings increased to $35.46, as a result of AFG's earnings performance. Continued improvement in the market value of our investment portfolio and a share repurchase activity. This represents an increase of 6%, from the $33.35 per share reported at the end of 2009.

Tangible book value was $33.08 at March 31st 2010, up 7% from year end 2009. Our capital adequacy, financial condition and liquidity remains strong in our key areas of focus for us, especially in these times of economic uncertainty. We maintain capital on our insurance businesses at levels that support our operations and are consistent with amounts required for rating levels.

At the end of the quarter, available cash at the parent company was approximately $170 million with excess capital more than $450 million. We anticipate continuing to generate additional capital and cash through operations during this year. The recently enacted healthcare reform legislation is a topic that we're continuing to examine. Based on our preliminary review, we don't see a significant impact to our property and casualty insurance operations. However I do have concerns about potential further legislation to create additional costs of providing healthcare for employees.

A supplemental health business underwrites supplemental products which we believe are largely unaffected by the provisions of this legislation which primarily address major medical insurance sold to consumers under 65 years old. AFG's Medicare supplement, cancer, accident and other supplemental products are specifically excluded from the provisions of the legislation since our products are designed for the senior market over age 65.

Additionally the subsidy being paid in Medicare advantage issuers is being phased out over time and this has already had a noticeable impact on the persistency our Medicare supplement products. Because provisions of the legislation will phase in over the next eight years, many details will be forthcoming and the full impact of these changes won't be fully understood until further analysis is completed. We continue to review the provisions of the legislation and watch developments that identify implications to AFG's employee benefit programs as well as to its property and casualty and annuity and supplemental insurance operations.

Let's now turn our discussion to our specialty property and casualty businesses. On slide five you'll see summary results for these operations. Overall underwriting profits in the 2010 first quarter were solid, generating a combined ration of 87%, five points higher than the prior year period. Lower levels of favorable reserve development were key factors driving the increase in the combined ratio.

Severe winter storms throughout several regions of the United States and early spring flooding and storms in the Northeast contributed to cap losses of approximately $9 million in the first quarter, compared to $2 million in the first quarter of the prior year. We continue to focus on pricing our business to achieve appropriate returns.

We simply won't write business that won't generate appropriate returns as evidenced by the reductions in top line growth in some of our lines. We know that we'll see the results of today's pricing decisions for years to come and believe our disciplined approach will allow us to provide quality products to insureds at competitive rates over the long run. The average renewal rates in the specialty operations during the first quarter of 2010 were flat when compared to the prior year.

A continuing soft market and competitive pressures, depressed economic conditions and our decision to exit certain automotive resulted businesses contributed to declines in gross and net written premiums during the first quarter of 2010. Sessions under our crop quota share agreement returned to historical levels resulting in higher levels of retained crop premium that partially offsets the other declines.

Excluding our crop operations, the overall decrease in net written premium for the first quarter was about 7%. Gross investment income related to our property and casualty operations was down approximately 14% for the first quarter of 2010 when compared to the same period last year, primarily as a result of decreased holdings and higher yielding investments and generally lower reinvestment rates.

Now I'd like to discuss a few highlights from each of our specialty business groups on slide six. Property and transportation group generated excellent underwriting results during the first quarter. Lower underwriting profit was driven primarily by lower favorable reserve development and higher catastrophe losses as I mentioned earlier. The risk management agency and the federal crop insurance corporation issued the second draft of the 2011 standard reinsurance agreement, commonly called the SRA in February of 2010. This draft includes several proposed changes to reduce revenue to participating insurers.

At the time the draft is released we estimated that the proposed changes to the SRA could reduce AFGs operating income by $15 million to $25 million annually. The first policy covered by the new SRA terms will be effective of July 1, 2010. So, we will have one more calendar year of business subject to the current SRA terms.

Our third and final draft is expected within the next several weeks and we expect this version to contain more favorable positions than the second draft. Regardless of the outcome, we ultimately need to adjust our business model to align delivery cost with underwriting margins.

Average renewal rates for this group for the first quarter for our Property and Transportation group were down about 1% compared to the prior year period. Our specialty casualty group reported lower underwriting profits for the first quarter of 2010 primarily due to a $13 million decrease in favorable reserve development and a continued challenging underwriting environment.

General economic conditions have dampened demand for coverage's in some markets particularly our general liability business that serves home builders and our California Workers Compensation business.

Underwriting results in our California Workers Comp continue to be affected by lower prices and a competitive environment. Our republic indemnity subsidiary filed for an 8% rate increase, effective January 1, 2010. In addition to the blended 8% rate increase filed last year, effective July 1, 2009.

We firmly believe that more rate is needed to achieve appropriate returns in this business especially as we are seeing some increases in severity trends primarily related to increases in medical costs. On a more encouraging note our average renewals rates in California were up 8% for the first quarter.

Although first quarter 2010 underwriting profits for most of the businesses in this group were at levels lower than the prior year. The vast majority of our business has produced excellent underwriting profit margins.

Average renewal rates for the first quarter were flat compared to the prior periods. Specialty financial groups posted a meaningful improvement in underwriting results for the first quarter of 2010. Attributed primarily to increased favorable reverse development in our run-off automobile residual value business and improved results in our financial institution operations.

Average renewal rates for this group were up about 1% in the first quarter. Now I would like to move on to review of our annuity and supplement insurance group on slide 7.

The annuity and supplemental insurance group generated pretax core net operating earnings for the first quarter of 2010 that were approximately 13% higher than the comparable period in 2009.

These results are principally the result of higher earnings in our supplemental insurance business. Statutory premiums of $497 million for the first quarter of 2010 were 33% higher than the first quarter of 2009 due to increased sales of single premium annuities and a higher sales in the bank market.

Primarily as a result of our distribution through PNC Bank. The single premium annuities and bank market sales were offset somewhat by lower sales in the 403(b) annuity market. We continue to experience strong persistency in our annuity business. We continue to move toward product design that reward policyholders and agents for long term persistency.

Please turn to slide 8 for a few highlights regarding our investment portfolio. During the first quarter of 2010 we reported after tax realized gains on investments of $3 million compared to realized losses of $27 million in the comparable prior year period.

After tax unrealized gains were $290 million at March 31, 2010. This number reflects the pretax unrealized gain on fixed maturities of $437 million. The vast majority of our portfolio is held in fixed maturities for approximately 92% being rated investment grade and 95% with a designation of NAIC 1 or 2.

We provided additional detailed information on the various segments of our portfolio and the investment supplemental on our website. Now I would like to cover our outlook for 2010 on slides 9 and 10. Our 2010, core net operating earnings remain in the range of $3.30 to $3.70 per share. 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 88% to 91%.

That said we are targeting modest increases and overall average renewal rates this year due to competitive conditions in certain markets. We expect net written premiums in our specialty, property and casualty operations to be up 7% to 10%. As we have returned to historical levels of reinsurance session under our crop quota share agreement.

Property and Transportation group is expected to maintain its excellent underwriting track record with a combined ratio in the 84% to 88% range. Guidance assumes accident year crop earnings at a more normal rent rate, therefore lower than the record 2009 results.

We expect this groups net written premiums to increase by approximately 25% to 30% primarily as a result of higher retention in our crop operation and National Interstate's acquisition of Vanliner. We expect the specialty casualty group which includes our California Workers Comp business to generate strong underwriting profit with a combined ratio in the 91% to 95% range.

We anticipate net written premiums will be down 4% to flat. We look for the specialty financial groups combined ratio to be between 85% and 88%. We project net written premiums to be down 5% to 9% primarily due to our exit from additional auto related businesses.

Based on a recent market conditions and trends, we expect 2010 full year core pretax operating earnings in our annuity and supplemental insurance group to be 15% to 20% higher than in 2009. These 2010 expected results exclude the potential for significant catastrophe and crop losses, significant adjustments to asbestos and environmental reserves, large gains or losses from asset sales or impairments and earnings or losses realized in connection from our mocking adjustments to annuity deferred acquisition costs.
Thank you and now we are open to any line -- our lines for questions Thank you.

# Question and Answer

**Operator**

Thank you. (Operator Instructions). Your first question comes from line of Jay Cohen with Banc of America.

**Jay Cohen**
*Banc of America/Merrill Lynch*

Yes. I missed the beginning of the call and I apologize for that. And if you already talked about this, we can do it offline, but the book value growth in the quarter obviously had to do with the accounting issue that you brought up. And you acknowledge that it would come down -- that benefit would come down over the next, it didn't say how long. That's really the question is, what is the pattern one would expect for the first quarter benefit to disappear, basically?

**Keith Vincent**

This Keith, let me just highlight a couple of things. If you look at book value per share all in, that did go up to 37% - 48% but what we have done in highlighting in the press release is we have highlighted the book value for share that leaves out the appropriated retained earnings that's what the 36. 46 is, because essentially the appropriated retained earnings is the amount that's required to be recorded into retained earnings on adoption of the new standard. But it is not for the benefit or it doesn't inure to the benefit of the shareholders of American Financial Group, it inures to the benefit of debt holders and so that $225 million we have excluded from the book value per share that we have reported in the press release.

**Jay Cohen**
*Banc of America/Merrill Lynch*

That is helpful. Thank you. And I guess a second question -- maybe on the specialty casualty business ex the comp, are you seeing a notable degradation in the terms and conditions on the policies? Are those starting to widen out relative to last year?

**Carl Lindner III**

This Carl, I wouldn't necessarily say that. We really didn't achieve any increase there, and there wasn't any significant decrease in rates. I think the -- seems like competition has definitely picked up and is stronger towards the end of the fourth quarter and the first quarter. But as far as any major degradation of terms and conditions I don't think we are seeing that right now.

**Jay Cohen**
*Banc of America/Merrill Lynch*

Okay. And the last question, in the past you have come out with -- at least a soft quantification of your excess capital. The last statement was around $400 million. Can you update that for us, where you stand now? What do you think?

**Keith Vincent**

Yes at the beginning of the conference call we indicated that it was at about $460 million at the end of the first quarter.

**Jay Cohen**
*Banc of America/Merrill Lynch*

Great. Sorry I missed that. That's all I have.

**Operator**

(Operator Instructions). There are no questions at this time.

**Carl Lindner III**

All right. Well thank you very much for joining us this morning. We will look-forward to releasing our second quarter results. Have a good day.

**Operator**

This concludes today's conference call. You may now disconnect.