S&P Capital IQ

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American Financial Group, Inc. NYSE:AFG

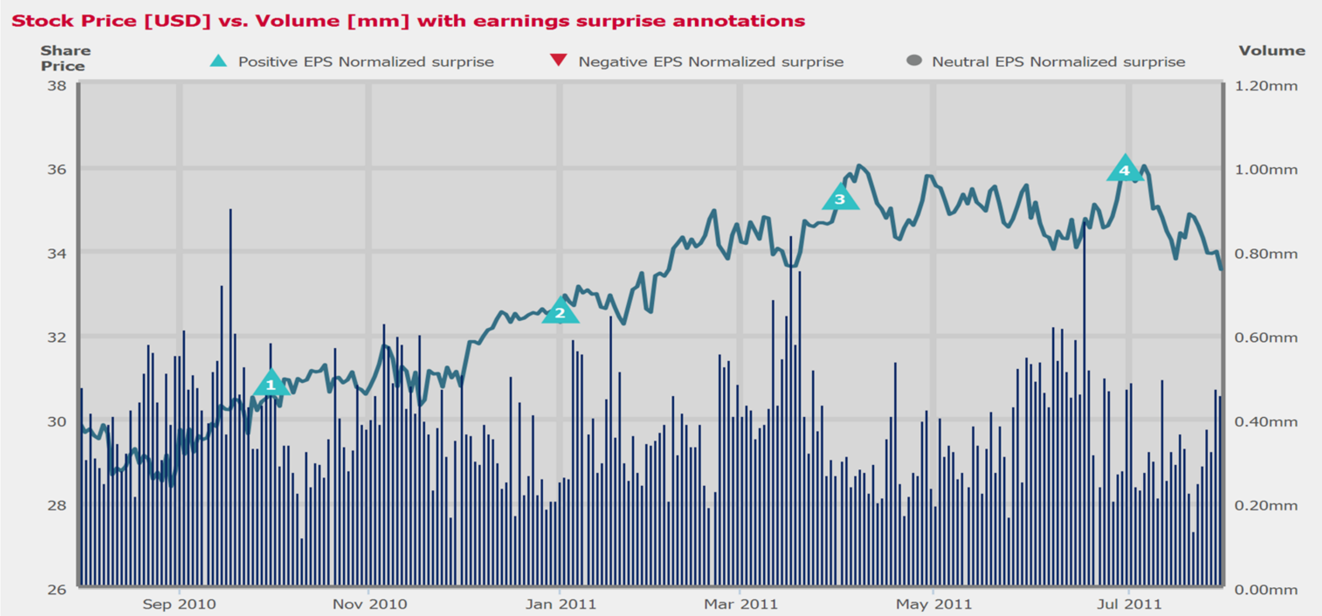
FQ3 2011 Earnings Call Transcripts

Wednesday, October 26, 2011 3:30 PM GMT

S&P Capital IQ Estimates

	-FQ3 2011-			-FQ4 2011-	-FY 2011-	-FY 2012-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.82	0.90	▲9.76	0.94	3.32	3.71
Revenue (mm)	795.68	835.00	▲4.94	794.67	2952.93	2908.60

Currency: USD
Consensus as of Oct-26-2011 1:03 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2010	1.01	1.07	▲1 5.94 %
FQ4 2010	0.97	1.03	▲2 6.19 %
FQ1 2011	0.79	0.81	▲3 2.53 %
FQ2 2011	0.56	0.78	▲4 39.29 %

Call Participants

EXECUTIVES

Carl H. Lindner
Co-Chief Executive Officer, Co-President and Director

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

S. Craig Lindner
Co-Chief Executive Officer, Co-President and Director

ANALYSTS

Amit Kumar
Macquarie Research

Jay Adam Cohen
BofA Merrill Lynch, Research Division

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

Presentation

Operator

Good morning. My name is Tina and I will be your conference operator today. At this time, I would like to welcome everyone to the American Financial Group 2011 Third 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, Senior VP of American Financial Group. You may begin.

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

Thank you. Good morning. This is Keith Jensen and we are pleased to welcome you to American Financial Group's 2011 third quarter earnings results conference call. I'm joined this morning by Carl Lindner III, and Craig Lindner, Co-CEOs of American Financial Group. 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 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 the 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 non-GAAP financial measure which sets aside significant items that are generally not considered part of ongoing operations such as net realized gains or losses on investments, the effect of accounting changes, discontinued operations, significant asbestos and environmental charges, and certain other non-recurring items.

AFG believes that this non-GAAP measure to be useful for analysts and investors in analyzing the ongoing operating results 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 H. Lindner
Co-Chief Executive Officer, Co-President and Director

Good morning, and thank you for joining us. Craig and I started out by thanking God for the life of AFG's Founder and Chairman, Carl H. Lindner Jr. And we'd like to thank you all for all your prayers and condolences in connection with the passing of our dad, Carl H Lindner Jr. We're humbled by the outpouring of love from his many friends from Cincinnati and across the country, not to mention as many tributes and fond memories shared with us over the past week. Until his final days, our dad shared his passion for his business with employees throughout the AFG organization. Carl's presence in our corporate offices and boardroom will be missed tremendously. His incredible legacy carries on to the many people whose live he has dramatically touched over the years.

Yesterday afternoon we released our 2011 third quarter results. Despite a challenging quarter for the industry, Craig and I are very pleased to report solid operating results that are consistent with our expectations. Core net operating earnings for the third quarter were down $0.17 per share from the comparable 2010 period. We are proud of the insurance professionals that remain disciplined in the underwriting and product pricing decisions. This mind-set particularly right now is essential given the continued low interest rate environment and national and global economic uncertainty. I am assuming that the participants on today's call reviewed our earnings release and supplemental materials posted on our web site.

I will review a few highlights and focus today's discussions on key issues. I will also briefly discuss our outlook for the remainder of 2011. But let's start by looking at our third quarter results summarized on slides 3 and 4 of the webcast.

Net earnings per share were $0.94 for the quarter which included realized gains of $0.04 per share. Lower earnings and our insurance operations and lower realized gains were partially offset by the effect of share repurchases. Year-to-date earnings per share $2.24 a share.

Core net operating earnings for the third quarter were $91 million or $0.90 per share compared to the prior year's results of $117 million or a $1.07 per share. Net operating earnings per share for the first nine months were 14% less than the 2010 results. Lower underwriting profit and lower investment income in our Specialty Property and Casualty insurance operations were partially offset by increased earnings in our annuity and supplemental operations during the 9 month period.

Nine month annualized core operating return on equity was approximately 9%. One of the important strategic objectives is to deploy our excess capital and -- and enhance its shareholder value. We've continued our share repurchases and purchased 2.6 million shares of our common stock at an average price of $32.25 per share during the third quarter. The average purchase price was approximately 83% of book value per share as of September 30, 2011. We feel this remains an effective means of increasing shareholder value. There are approximately 5 million shares remaining under our current repurchase authorization.

In addition to share repurchase and dividends, we continue to seek other alternatives for the deployment of excess capital. We strive for healthy profitable organic growth and continue to look for opportunities to expand our specialty niche businesses through startups or acquisitions where it makes sense to do that.

As you will see on slide 4, AFG's book value per share excluding appropriated retained earnings net realized gains and losses on fixed maturities increased 4% since year end to $39.9. Tangible book value on a comparable basis was $36.72 at September 30, 2011, up 4% from year end 2010.

I am pleased to say that our capital adequacy, financial condition and liquidity remain strong in the key areas of focus for us. We have maintained capital on our insurance businesses at level that support our operations are in excess of amounts required for rating levels. At the end of the third quarter our excess capital was approximately $725 million which included cash at the parent company of $315 million.

On slide 5 you will see summary results for our specialty property and casualty operations. The property and casualty specialty insurance operations generated an underwriting profit of $56 million in the third quarter compared to $68 million in the third quarter of last year.

Results for the 2011 third quarter included an increase of $19 million in favorable reserve development. Losses from catastrophes totaled $13 million in the third quarter of 2011 primarily resulted to hurricane Irene. Catastrophe losses in the third quarter of 2010 were $6 million. Once again, our catastrophe losses were modest despite significant weather-related losses reported by the industry during the quarter.

Underwriting profit for the first 9 months of 2011 was $141 million compared to $214 million in the comparable 2010 period. Favorable reserve development in our specialty property and casualty operations was $92 million for the first 9 months of 2011 compared to $122 million in the same period in 2010. The decrease in favorable development was attributed primarily to our run off automobile residual value insurance business and a specialty casualty program book of business.

Gross written premiums increased 24 and 30% respectively during the third quarter and 16% and 18% respectively during the first 9 months. Gross premiums in 2011 included higher premiums in our property and transportation segment, particularly our crop and transportation businesses. The growth in net premiums also reflects the impact of a third quarter 2010 reinsurance transaction in our Specialty Financial group.

Overall average renewal rates for the first 9 months were flat compared with the prior year period. We are pleased, however, that a few more of our businesses achieved price increases during the third quarter though the market continues to remain competitive.

The decline in gross investment income related to our property and casualty operations was consistent with the expectations and due to decreased holdings in higher yield investments and generally lower reinvestment rates as we have discussed in our prior calls.

Now let me discuss a few highlights from each of our specialty business groups on slide 6. Property and transportation group recorded an underwriting profit of $5 million in the 2011 third quarter, $36 million lower than the 2010 third quarter. Lower crop profits, high catastrophe losses and lower underwriting profits in the transportation businesses contributed to the results.

Underwriting profit in the first 9 months of 2011 decreased approximately $43 million from the comparable 2010 period. Most businesses in this group had strong under writing margins through the first 9 months of 2011. Average renewal rates for this group during the fires 9 months of this year were flat compared to the prior year period.

As respects to our crop business, corn and soybean harvests are under way. Approximately 65% of the nation's corn crop answer approximately 80% of the soybean crop has been harvested. Reports from the field indicate that yields are variable. Commodity pricing for corn and soybeans is tracking favorable as to corn. The corn harvest price is currently 4% above the spring discovery pricing, soybeans are down approximately 10% well within the policy deductible. Proposals surrounding cuts and federal funding for the crop insurance program appear to be in a favorable position. Two agricultural committees have been supportive of crop insurance as a component of the USDA's budget. As funding for various provisions of the farm safety net are evaluated to identify possible cuts, we believe that the funding for other USGA programs and the direct payment plan to farmers seems to be at a higher risk for cuts than the crop insurance program. We will know more as the super committee reports the recommendations later in November.

Our specialty casualty group recorded an underwriting profit of $20 million in the 2011 third quarter compared to an underwriting loss of $13 million in the third quarter of last year. The increase in underwriting profit was primarily attributable to significant reduction in prior year adverse reserve development.

Improved results in our general liability, excess and surplus and California comp businesses were offset somewhat by lower underwriting profits in the targeted markets operations. Specialty casualty underwriting profits for the 9 months of '11 was 43 million, approximately $14 million higher than comparable 2010 period.

Higher underwriting profit in our P&S lines and improved prior year favorable reserve year development more than offset underwriting losses in a block of program business. Host businesses in this group produced strong underwriting profit margins in the first 9 months of 2011. Average renewal rates for this group during the first nine months of 2011 were up 1% compared to the prior year period. We've had minimal claims arising from our political risk business in the Middle East and North Africa and we don't currently expect significant losses to be incurred as a result of these events at this point.

Specialty Financial group reported underwriting profit of $23 million for the third quarter of 2011 compared to $36 million for the same period a year ago. Higher catastrophe losses in our financial institutions business and lower prior year favorable RVI reserve development impacted 2011 results. Additionally, third quarter 2010 results reflect pre-tax income of approximately $8 million in connection with a reinsurance transaction involving a sale of unearned premiums related to our automotive lines of business.

Specialty Financial underwriting profit was $46 million for the nine month period, compared to $91 million in the same 2010 period, primarily the result of lower favorable RVI reserve development and the 2010 reinsurance transaction. Almost all lines of business in this group produced strong underwriting margins during the first 9 months of this year. Average renewal rates for this group during the first 9 months of 2011 were down 1% compared to the prior year period.

Now I'd like to move on to review of our annuity and supplemental insurance group on slide 8. Annuity and supplemental insurance group generated pre-tax core operating earnings in the first 9 months of

'11 that was 6% higher than the first nine months of '10. However, for the third quarter, pre-tax core operating earnings were 16% lower than in the comparable 2010 period.

Higher third quarter earnings due to asset growth and lower expenses were more than offset by the impact of the third quarter 2011 decrease in the stock market and to a lesser extent the accounting impact of lower interest rates on the company's fixed income, fixed index annuity operations.

A 14% decline in the S&P 500 index during the third quarter of 2011 had a negative impact on variable and fixed index annuity results for approximately $8 million. Fixed index annuity results for the 2011 third quarter were also adversely impacted by approximately $4 million due to a decline in interest rates. We expect much of the negative impact will reverse overtime.

As a point of reference, there is no impact on earnings in the third quarter of 2010 because the positive impact on 11% increase in the S&P 500 is offset by a decline in interest rates. AFG performs a review or a unlocking of its major actuarial assumptions throughout the year that were more comprehensive review in the fourth quarter including management's expectation of long-term reinvestment rates.

Given current conditions, the effect of any such fourth quarter unlocking is not expected to be material to AFG. Excluding the potential impact of any unlocking, AFG now expects that full year 2011 annuity and supplemental core operating results will be 12% to 15% higher than 2010 down from the earlier guidance of 15% to 20%. In the annuity business -- again that was 12% to 15% higher than 2010 down from the earlier guidance of 15% to 20%.

In the annuity business, profitability is largely dependent on earning the spread between income earned on invested assets and amounts credited on annuity liability. AFG spread continues to be excellent and has exceeded our expectations despite the recent interest rate environment. At the same time, duration of our annuity assets from liability very closely matched to September 30, 2011.

Furthermore, in a declining and/or low interest rate environment, AFG receives some protection from spread compression due to the ability to lower crediting rates subject to contractually guaranteed minimum interest rates. We began selling new policies with GMIRs below 2% in 2003. Almost all new business has been issued with the 1% GMIR since late 2010.

At September 30, 2011, the average crediting rate of all of our annuities was approximately 3.2% while our average GMIR was approximately 2.6%. This margin provides AFG the flexibility to lower its crediting rates by up to 60 basis points on average in the future should market interest rates continue to remain low for a long period of time.

Statutory premiums of $992 million and $2.8 billion in the 2011 third quarter and first 9 months were 20% and 40% higher, respectively, than the comparable periods in 2010. The third quarter results reflect increased sales of fixed index annuities in the single premium market due primarily to the introduction of new products and features. 9 month results also reflect higher fixed index annuities sales, as well as increased sales of annuities through banks, resulting from the addition of several new banks to the distribution network. Sales of annuities have slowed since early September as we lowered crediting rates in response to the significant decrease in market interest rates.

Now please turn to slide 9 for a few highlights regarding our investment portfolio. Here in the third quarter of 2011, AFG recorded net realized gains of $5 million compared to $15 million in the prior year period. Net unrealized gains on fixed maturities were $465 million, an increase of $139 million since December 31st, 2010. The vast majority of our investment portfolio is held in fixed maturities with approximately 90% rated investment grade and 96 with a designation of NAIC 1 or 2.

As discussed last quarter, the continued run off and disposition of securities in our non-agency RMBS portfolio, as well as generally lower reinvestment rates has resulted in continued pressure on investment income in our property and casualty business. We provided additional detailed information on the various segments of our investment portfolio and the investment supplement on our website.

Now I would like to finish off with our outlook for 2011. As mentioned before, our 2011 core net operating earnings guidance remains in the range of $3.30 to $3.70 per share. We expect results to be consistent with the guidance provided in our call last quarter with a few minor adjustments. We now expect growth in net written premiums in our specialty property and casualty operations to be in the range of 11% to 14%, up from 9% to 13% estimated earlier.

We estimate our overall specialty property and casualty combined ratio to be in the range of 90% to 93%, up slightly from the last estimate of 88% to 92%. We now estimate our property and transportation net written premiums to increase 20% to 24%, up from our previous guidance of 18% to 20%. It is our expectation that our crop insurance operations will be solidly profitable this year but slightly below our expectations.

As a result, we expect the combined ratio in the property and transportation group to be in the range of 92% to 96%, up from the 87% to 91% originally projected. Net written premiums in our Specialty Financial Group are expected to be up 20% to 24%, a decrease from our previous estimate of 24% to 28%. And as previously mentioned pre-tax operating earnings in our annuity supplemental group are expected to increase 12% to 15% over the 2010 results slightly lower than our original estimate of increase of 15% to 20%.

In summary of our 2011 guidance is outlined on slide ten for your convenience. These 2011 expected results exclude the potential for a significant catastrophe crop losses, significant adjustments that asbestos and environmental reserves, large gains or losses from asset sales impairments and unlocking adjustments related to annuity deferred acquisition costs.
Thank you. And now we would like to open the lines for any questions.

Question and Answer

Operator

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

Amit Kumar
Macquarie Research

Just may be going back to the discussion on crop, I think I heard you mention that you expected it to be slightly below expectations. I'm just wondering based on what we know so far, and I guess Q2 and Q3 are the main quarters in terms of losses and earned premiums, can you just sort of expand on that comment and what could be the possible sort of range of expectations at this point for the 2011 crop here?

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

First of all, Amit, we have our estimates baked into our guidance to start with.

Carl H. Lindner
Co-Chief Executive Officer, Co-President and Director

And in addition, I think you mentioned that the majority of the profits are recognized in the second and third quarter. That's not correct. It's third and fourth quarter, with fourth quarter traditionally having been heavier because at that point, you finalized your understanding and knowledge your yields and you'd pass the measurement period for pricing which takes place through the month of October. So, I would expect as in most other years that we'll really have much firmer view in the fourth quarter. At this point we're really very interested in earnings recognition process.

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

Yes. As I mentioned before, with two thirds of the crops harvested and, you know, almost through the price discovery period in October, you know, we are kind of throwing out our best assessment at this point, which will be firmed up as Keith mentioned. And that's -- we're going to have a solidly profitable full year. It's going to be slightly lower than our expectations. That's kind of baked into our year end estimate of our guidance.

Amit Kumar
Macquarie Research

And I had thought that you -- you do pick up the buckets and the ranges and the loss picks in the earlier part of the year. That was my thought process that you sort of -- there was a deadline where you had to pick out the buckets and hence you had a clearer view of what the range might be?

Carl H. Lindner
Co-Chief Executive Officer, Co-President and Director

Let me just interrupt you for a second. Actually in the first 2 quarters of the year for the crop year we don't recognize any income because at that point planting in many cases hasn't been completed. So we're really are not choosing currently year amounts in any way shape or performance how you get into third quarter.

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

Any crop profits that are in the first half relate to a development on the favorable development from the prior year.

Amit Kumar

Macquarie Research

And sort of moving on, in terms of the premium impact from Vanliner, does that sort of normalize going forward? Obviously you had meaningful growth in the past quarters. Do we see that premiums sort of trend down or, what is the thought process there?

Carl H. Lindner
Co-Chief Executive Officer, Co-President and Director

Vanliner, if you remember, was an acquisition we made midyear last year. So, for the first 12 months of ownership we had year-to-year comparison. In addition, when we bought Vanliner it had about 160 million in premium, about 60 of which was in traditional trucking business, almost all of that has been run off and non-renewed. And so, the baseline would be in the 90 to 100 range and we hope and expect that we'll see growth in that. The dramatic growth you've seen this year as a result of that extra 100 million of premium over a 12 month period.

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

Let's look back to a more normal growth track. I think their management team is excited though about the opportunities to leverage moving to storage and captive area and that we enjoy because a lot of that happening but we think there is good possibilities there.

Amit Kumar
Macquarie Research

Can you comment about your exposure to club deals? One of the companies in your space had meaningful adverse development from professional liability exposure to a private equity hedge fund and investment managers. Can you talk about your exposure to that line and do you have any club deals in your professional liabilities?

Carl H. Lindner
Co-Chief Executive Officer, Co-President and Director

Talking about exposure to hedge funds?

Amit Kumar
Macquarie Research

Yes. Yes.

Carl H. Lindner
Co-Chief Executive Officer, Co-President and Director

If we could get back to you on that. That really hasn't come up as a red flag to us one way or the other. Generally we got and you are probably right some of that business but, there is nothing that has really been a red flag to us at this point.

Amit Kumar
Macquarie Research

Capital management, we have seen in the past that you raised the dividend, you talked about buyback, you have exceeded capital of 725 million. How do you view like a change in the dividend policy or a special dividend or acquisitions going forward? Where would you be in those options?

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

I think we are going to continue with our stock selling where it is in relation to book value, I think share repurchase will continue to be a focus also, acquisitions. We certainly have taken our dividend up, 12.5% compounded over 5 years. We will continue to also look at that. As far as special dividend, there aren't any plans on the table to do that right now, but, I mean, it's with everything, and we are always continually looking for what the highest and best use of capital are.

Operator

Your next question comes from Matt Rohrmann of Keefe, Bruyette & Woods.

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

Following up on the capital management question, Carl, obviously trading below book value. Any buy backs immediately accretive is trading at book value, is that sort of a hard inflexion point terms of how aggressive you'd be with the buy back on a quarter-to-quarter basis?

Carl H. Lindner
Co-Chief Executive Officer, Co-President and Director

I think, I think as long as our stocks trading at a pretty good discount the book value, it's very attractive. That said, you know, acquisition opportunities that were accretive and add to the franchise value of the company could also be just as important in that. So...

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

And then just going to the ANS business for a second, obviously growth has been strong all year, slowed as crediting rates have come down a little bit. You guys have done a great job working with your -- setting up your bank partnerships to drive that growth. As growth starts to slow from such a strong pace, would you tend to be more open now to looking at increasing the number of partnerships going forward to support that growth?

S. Craig Lindner
Co-Chief Executive Officer, Co-President and Director

This is Craig. We are always looking for opportunities to add high quality distribution partners. So the answer to that is yes.

Operator

[Operator Instructions] Your next question comes from Jay Cohen of Bank of America.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

First is just to get a sense of the new money yields relative to the portfolio yields, where are you putting new money these days and what kind of yields are you seeing?

S. Craig Lindner
Co-Chief Executive Officer, Co-President and Director

Jay, this is Craig. We are putting new money in a variety of things. It's principally high grade corporate bonds. But we have gotten more active, our real estate group has gotten more active in originating some direct -- directly originated commercial loans. And we found some interesting opportunities in the last 6, 9 months and have been able to put some money in pretty attractive yields I think on the real estate loans that we have made. I'm going to just guess that we have an average yield of 6.5%.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

On the real estate?

S. Craig Lindner
Co-Chief Executive Officer, Co-President and Director

On real estate. The biggest part of new money that was going into high grade, principally corporate bonds and they were getting probably on average, I'm going to guess, 125 on treasuries or some number like that. We were very underweight on the light [ph] side and commercial mortgage loan exposure. So we have taken up our exposure in commercial mortgage backed securities and the specifically the senior most tranches with lots of support against the cost of equity and we kind of picked our time when the market was in disarray and got some pretty attractive yields on those investments. I'm just going to take a guess of 2.25, 2.50 off treasuries, something in that neighborhood.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

And in the property and casualty side, probably the biggest change over the last year, year and a half has been going from underweight annuities to high quality annuities to more of a market weight. We feel like we really purchased them at the right time.

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

Second question, you referenced your willingness to look at M&A opportunities. And historically you have been pretty opportunistic and pretty good at finding those opportunities. My question is, are you seeing more deals became available in the market because of some of the stress in the system?

Carl H. Lindner
Co-Chief Executive Officer, Co-President and Director

I don't think we are seeing more deals at this point. We always see a steady stream. We always have a steady stream of things what we're looking at. I don't think -- Keith what's yours?

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

There is not an increase. As Carl said, there is a steady stream. If you look over the last 2 years you'll see things line Vanliner, Powers and Lions deal, where they were large enough to hit the radar screen externally but we also find it's very advantageous deals that are -- that pretty a few million dollar range to add on to books of business quite profitably.

Operator

And there are no further questions at this time.

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

Well, thank you all for joining us. We appreciate you taking your time this morning. And we look forward to reporting on the full year results in January.

Operator
This concludes American Financial Group 2011 Third Quarter Earnings Conference Call. You may now disconnect.