S&P Capital IQ

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American Financial Group, Inc. NYSE:AFG

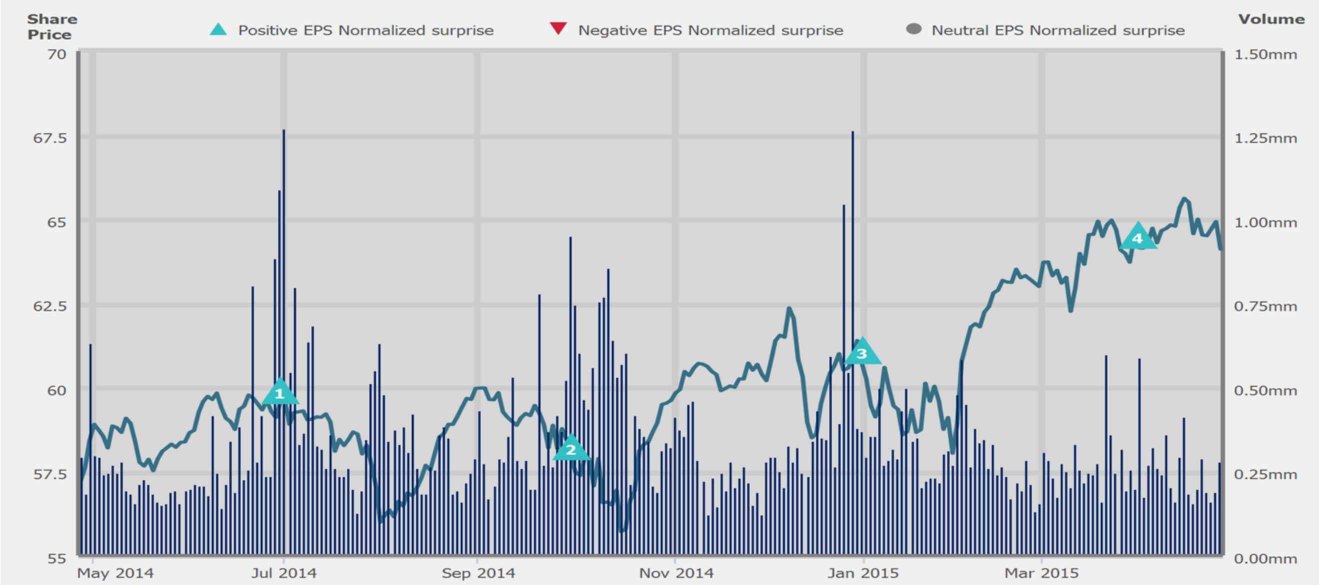
FQ2 2015 Earnings Call Transcripts

Wednesday, August 05, 2015 3:30 PM GMT

S&P Capital IQ Estimates

	-FQ2 2015-			-FQ3 2015-	-FY 2015-	-FY 2016-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.19	1.28	▲7.56	1.49	5.50	5.57
Revenue (mm)	-	985.00	-	-	-	4426.89

Currency: USD
Consensus as of Aug-05-2015 12:49 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2014	0.95	1.07	▲1 12.63 %
FQ3 2014	1.16	1.40	▲2 20.69 %
FQ4 2014	1.29	1.35	▲3 4.65 %
FQ1 2015	1.12	1.25	▲4 11.61 %

Call Participants

EXECUTIVES

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

Diane P. Weidner
Assistant Vice President of Investors Relations

Joseph E. Consolino
CFO, Executive VP, Director and Chairman of the Board of Neon Capital Ltd

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

ANALYSTS

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Ryan J. Byrnes
Janney Montgomery Scott LLC, Research Division

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the American Financial Group 2015 Second Quarter Results Conference Call. [Operator Instructions] As a reminder, this conference is being recorded.

I would now like to turn the conference over to Diane Weidner, Assistant Vice President, investor Relations. Please go ahead.

Diane P. Weidner
Assistant Vice President of Investors Relations

Thank you. Good morning, and welcome to American Financial Group's Second Quarter 2015 Earning Results Conference Call. I'm joined this morning by Carl Lindner III and Craig Lindner, Co-CEOs of American Financial Group; and Jeff Consolino, AFG's Chief Financial Officer. 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 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 to be part of ongoing operations, such as net realized gains and losses, discontinued operations and certain nonrecurring items.

AFG believes this non-GAAP measure is 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.

If you are reading a transcript of this call, please note that it may not be authorized or reviewed for accuracy. Thus, it may contain factual or transcription errors that could materially alter the intent or meaning of our statements.

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. Now we released our 2015 second quarter results yesterday afternoon, and I'm assuming that our participants have reviewed our earnings release and the investor supplement that's posted on our website.

Craig and I are pleased to report second quarter core net operating earnings per share of $1.28, a 20% increase from the comparable prior year period. These results reflect higher underwriting profit and higher net investment income in our Specialty Property and Casualty operations, and higher core operating earnings in our Annuity and Run-off Long-term Care and Life segments. These results also represent the highest second quarter core net operating earnings per share in AFG's history. This is the fifth consecutive quarter that we've achieved new quarterly highs in AFG's core earnings per share.

This morning, AFG's common stock traded in excess of $70 for the -- per share for the first time in the company's history. With 15% growth in share price so far this year, AFG ranks near the top in year-to-date price performance of over 40 insurance companies covered by Dowling & Partners. Craig and I thank God and our talented management team and employees for helping us to achieve these exceptional results.

Annualized core operating return on equity was 10.9% for the 2015 second quarter compared to 9.6% for the second quarter of 2014. Net earnings per diluted share were $1.57 and include a $0.29 per share gain on the previously announced sale of Le Pavillon Hotel.

During the quarter, we repurchased $47 million of AFG common shares at an average price per share of $63.91. We also increased AFG's 2015 core operating earnings guidance to $5.25 to $5.55 per share, which is up from the range of $5.10 to $5.50 per share estimated previously.

And Craig and I will discuss our guidance for each segment of our business later in this call. Before we transition to a review of our operating results, I wanted to note that Ward Group recently recognized AFG's Specialty Property and Casualty insurance and Annuity operations within its 2015 Ward's 50 top performers list based on superior performance over the past 5 years and benchmark measures of safety and consistency. The report ranked nearly 3,000 property and casualty insurance companies and nearly 800 life and health insurance companies domiciled in the U.S. We're pleased to be recognized in this manner for the ninth consecutive year.

It's certainly been an eventful quarter in the insurance industry overall. Recent merger and acquisition activity has produced attractive valuations for quality specialty insurance businesses that really helped to showcase the value of AFG's businesses, our organization structure and our unique culture.

Now let's take a closer look at AFG's results for this quarter. Please turn to Slides 4 and 5 of the webcast, which include an overview of results in our Specialty Property and Casualty operations. Beginning on Slide 4. You'll see that gross and net written premiums were up 2% and 3%, respectively, in the 2015 second quarter compared to the same quarter a year earlier. Although the marketplace has become more competitive, we're still finding opportunities to grow our Specialty Property and Casualty businesses.

Underwriting profit was $51 million in the 2015 second quarter compared to $29 million in the second quarter of 2014. Each of our Specialty Property and Casualty groups reported improved year-over-year underwriting results.

The second quarter 2015 combined ratio of 94.9 improved by 2 points from the comparable prior year quarter and included 1.1 points of favorable prior year reserve development and 1 point in catastrophe losses. Nearly half of our property and casualty businesses reported pricing increases during the second quarter, resulting in an overall renewal rate increase of about 1%. It's the 15th consecutive quarter that we reported overall price strengthening.

With that, I'd like to turn to Slide 5 to review a few highlights from each of our Specialty Property and Casualty business groups. Although our Property and Transportation Group reported a year-over-year improvement in underwriting results in the second quarter, we were disappointed with this group's reported combined ratio of 104%. Improved underwriting results in our National Interstate subsidiary were partially offset by lower accident year profitability and adverse prior year reserve development. The adverse development during the quarter was primarily in our property and inland marine businesses as well as in a custom bond book of business within our ocean marine operations and in our other transportation businesses.

Early indications are favorable with regard to our crop insurance book, despite reductions in corn and soybean yield estimates resulting from excess moisture in the eastern corn belt, particularly in Indiana, Ohio and Missouri. While we expect some challenges there, conditions in the western corn belt are favorable, but changing perspectives on crop yields and speculation about potential reduced demand for commodity exports, there've been fluctuations in commodity pricing since the spring discovery period.

Right now, corn pricing is down high single digits and soybeans are down low single digits from established spring discovery prices, which is just fine. While it's too early to speculate about crop insurance results, our overall outlook remains positive.

In Property and Transportation Group, we continue to focus on adequate pricing. Overall, renewal rates increased 5% on average for the quarter with National Interstate achieving a 7% rate increase.

With a heightened focus on disciplined pricing and underwriting, gross and net written premiums for this group were up 2% and 3%, respectively, during the second quarter of 2015.

Definitely pleased with the underwriting profitability of our Specialty Casualty Group as nearly all the businesses in this group achieved strong underwriting margins.

I'm especially pleased with the profitability within our workers' compensation and excess and surplus businesses, which helped to offset underwriting losses in mid-continent's general liability business and in our international operations.

Gross and net written premiums for the second quarter of 2015 were both up slightly when compared to the second quarter of last year. About half of the businesses in this group reported growth during the quarter, particularly our excess and surplus businesses. This growth was partially offset by lower premiums in our general liability business, primarily the result of re-underwriting efforts within the Florida homebuilders market and the slowdown in the energy sector as well as lower premiums in our international business where we're continuing to focus on improving underwriting profitability.

Pricing in this group was down about 1% on average for the quarter, due primarily to lower renewal pricing in our workers' compensation businesses, particularly in Florida.

As mentioned before, use of predictive analytics has enabled us to more accurately price this business, which has helped us to "find and retain" a higher percent of business that's producing targeted returns, notwithstanding the lower pricing environment.

If you exclude our workers' comp businesses, pricing in the Specialty Casualty Group was up about 1% on average for the quarter.

Now our Specialty Financial Group reported outstanding profitability this quarter. Every business in this group achieved excellent underwriting margins during the quarter, producing an overall calendar year combined ratio of 81%.

Higher underwriting profits in our fidelity and crime and surety and trade credit businesses were the driver of the improved results. Higher premiums in our financial institutions business helped this group achieve a double-digit increase in net written premium during the quarter. Pricing in this whole group was flat for the quarter.

So please turn to Slide 6 for a summary view of our 2015 outlook for the Specialty Property and Casualty operations. Our overall premium guidance remains unchanged with an expectation that growth in net written premiums will be in the range of 4% to 8%. Our combined ratio guidance is also unchanged and is expected to be between 92% and 94%.

We now expect net written premiums in our Property and Transportation Group to be down 1% to up 2%, which is a decrease from our original estimate of flat to up 4%. We've changed the guidance for the combined ratio for this group to 96% to 99%, up from the range of 94% to 98% estimated previously.

Our premium guidance for the Specialty Casualty Group remains unchanged with growth in net written premiums expected in the range of 8% to 12%. We did narrow our combined ratio guidance a bit to be in a range of 91% to 94% from 90% to 94% estimated previously.

We now expect premiums in our Specialty Financial Group to be 3% to 7% higher than the prior year, which is an increase from the growth of 1% to 5% estimated previously.

The outlook for the combined ratio for this group has been changed to 81% to 84%, several points better than our original estimate of 86% to 90% based on strong results through the first 6 months of the year.

Additionally, we expect our Property and Casualty investment income to grow by 8%, an increase from the growth of 5% estimated previously. We continue to expect overall Property and Casualty renewal pricing to be flat to up 2%.

Now I'm going to turn things -- the discussion over to Craig to review the results in our Annuity segment and AFG's investment performance.

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

Thank you, Carl. As you'll see on Slide 7, we are increasing our annuity earnings guidance both before and after the impact of fair value accounting. The recent rise in interest rates provided an opportunity for us to extend the duration of our portfolio and become more fully invested.

As a result, our portfolio yield at the end of the second quarter is nearly the same as it was at the end of last year despite the relatively low interest rate environment and the runoff of older investments with higher yields.

The combination of higher invested assets and higher yields is driving our increased earnings guidance, and we now expect full year 2015 core pretax annuity operating earnings to be in the range of $300 million to $345 million, an increase from the range of $310 million to $340 million estimated previously.

Similarly, we now expect full year 2015 core pretax annuity operating earnings before the impact of fair value accounting to be in the range of $340 million to $350 million, an increase from the range of $330 million to $340 million estimated previously.

You'll also see on Slide 7 that based upon our recent sales trends, we now expect the full year 2015 annuity premiums will be consistent with the $3.7 billion level of sales achieved in 2014. Significant changes in interest rates and/or the stock market from our expectations could lead to additional positive or negative impacts on the Annuity segment's results.

Taking a look at results into second quarter, you'll see on Slide 8 that core pretax annuity operating earnings were $88 million or 5% higher than the prior year period.

Interest rates rose significantly, resulting in large favorable impact on earnings. This favorable result was partially offset by the impact of a stock market decrease during the quarter.

Conversely, in the second quarter of 2014, interest rates generally decreased versus AFG's assumption that they would rise. This difference had a negative impact on AFG's 2014 second quarter earnings.

Variances from expectations of certain items such as projected interest rates, option costs and surrenders as well as changes in the stock market, have an impact on accounting for fixed-indexed annuities. These accounting adjustments are recognized through AFG's reported core earnings.

As you'll see on Slide 9, AFG's 2015 earnings continued to benefit from growth in annuity assets. Our quarterly average annuity investments and reserves grew approximately 12% year-over-year. The impact of this growth was offset by the runoff of higher-yielding investments. However, American Money Management's outperformance helps to mitigate this impact.

In addition, results in the second quarter of 2015 were negatively impacted by an adjustment to reserves for fixed-indexed annuities with guaranteed lifetime withdrawal benefits as well as higher general and administrative expenses. We do not anticipate a recurrence of these 2 items going forward.

The Annuity segment reported statutory premiums of $899 million in the second quarter of 2015. While this amount was 5% lower than sales in the comparable prior year period, it represents an 11% increase on sales over the first quarter of 2015. Additional information about the components of spreads for AFG's fixed annuity operations can be found in AFG's Quarterly Investor Supplement posted on our website.

In April, we announced a definitive agreement to sell our run-off long-term care insurance business to HC2 Holdings. Included in the sale are United Teachers Associates Insurance Company and Continental

General Insurance Company, the legal entities that contain all of AFG's long-term care insurance business. This transaction will complete our exit from supplemental medical insurance lines of business. The buyer filed for regulatory approvals in early July. The transaction is expected to close in the second half of 2015, subject to customary conditions, including receipt of required regulatory approvals.

Now please turn to Slide 10 for a few highlights regarding our $37 billion investment portfolio. During the quarter, we recognized a gain of $51 million before taxes and noncontrolling interests on the sale of Le Pavillon Hotel. Real estate investments comprised about 2% of our overall portfolio. AFG has a history of buying underperforming or out-of-favor assets, developing and managing them and selling them when we believe the value has been maximized.

AFG recorded second quarter 2015 net realized losses on securities of less than $1 million after-tax and after deferred acquisition costs compared to net realized gains of $7 million in the comparable prior year period.

As of June 30, 2015, unrealized gains on fixed maturities were $457 million after-tax and after DAC and unrealized gains on equities were $130 million after-tax.

As you'll see on Slide 11, our portfolio continues to be high quality with 87% of our fixed maturity portfolio rated investment grade and 97% with an NAIC designation of 1 or 2, its highest 2 categories.

We've provided additional detailed information of the various segments of our investment portfolio in the Quarterly Investor Supplement on our website.

I will now turn the discussion over to Jeff, who will wrap up our comments with an overview of our consolidated second quarter 2015 results and share a few comments about capital and liquidity.

Joseph E. Consolino
CFO, Executive VP, Director and Chairman of the Board of Neon Capital Ltd

Thank you, Craig. Slide 12 recaps AFG's second quarter consolidated results by segment. Core net operating earnings per share in the quarter were $1.28, that's up 20% from a year ago. The $1.28 is based on core net operating earnings in the quarter of $115 million, an increase of $16 million from the second quarter of 2014.

You can see on Page 4 of our Quarterly Investor Supplement a more detailed view of the components of this change.

Taking a look at the P&C segment, core pretax operating earnings. The impact of 3 items produced a year-over-year impact of an improvement of $24 million. P&C underwriting profit increased by $21 million year-over-year. Additionally, P&C investment income rose by $7 million. This is the result of an increase in average P&C invested assets as American Money Management invested the $1 billion in cash received in the Summit acquisition over the 2 quarters following the April 2014 closing. As well, there was an increase in the quarter compared to last year's quarter in partnership income.

Finally, P&C other expenses increased by $4 million as the minority interest recorded in this line rose with National Interstate's return to profitability.

As for the other components of AFG's core net operating earnings, Craig previously covered our Annuity segment earnings, which were $4 million higher year-over-year.

Results in our Run-off Long-term Care and Life segment improved by $6 million from the $2 million loss in the prior year. Interest expense of parent holding company increased $3 million due to our 6.25% hybrid debt offering in September 2014. Other expense was $1 million lower than the 2014 second quarter.

Turning to Slide 13, you'll see a reconciliation of core net operating earnings to net earnings and diluted earnings per share.

As indicated on Slide 14, AFG's adjusted book value per share was $49.63 at June 30, 2015. This was an increase of $1.08 per share during the second quarter.

Tangible book value was $46.73 at June 30, 2015. Our excess capital stood at approximately $870 million at June 30, 2015, and included $215 million in parent company cash.

The pending sale of our run-off long-term care insurance business is expected to generate approximately $110 million in excess capital.

During the quarter, we returned $69 million to our shareholders through dividends and share repurchases. Approximately 3.7 million shares remain under our repurchase authorization as of August 1, 2015. We plan to continue returning excess capital to our shareholders through the course of 2015.

On Slide 15, you can find a single page summary of our 2015 core earnings guidance, which has been increased in line with the increased annuity guidance outlined by Craig.

As a reminder, AFG's expected 2015 results exclude noncore items such as realized investment gains and losses, the loss in the disposition of the run-off long-term care insurance subsidiaries and other significant items that may not be indicative of ongoing operations.
Now, we'll open the lines for any questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Ryan Byrnes with Janney.

Ryan J. Byrnes
Janney Montgomery Scott LLC, Research Division

I had a question on the flat annuity sales for the year, the guidance. Now does that include this $300 million Federal Home Loan advance? And maybe also just give some color on what that is as well?

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

The premium number did not include the Federal Home Loan Bank advance. I think there are times when we can take down Federal Home Loan Bank money at very attractive rates and buy high grade securities and generate pretty attractive rates of return. And from time to time, we take advantage of that opportunity.

Ryan J. Byrnes
Janney Montgomery Scott LLC, Research Division

Okay, great. And then just shifting gears over to the Specialty Financial segment. Obviously, growth there was some of the best we've seen there for quite some time. And just wanted to get a little better color on where that growth is coming from. I think you mentioned financial institution business, but just wanted to get a little more color there, if I could.

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

Yes. This is Carl. In the quarter, our first-placed -- or lender-placed property business had a good growth quarter. One of our subsidiaries in the surety side had a decent quarter. A group called Specialty Equipment Services had some growth in the quarter. So we were pleased that in that particular quarter that we were able to show some growth and increase our guidance for the year.

Operator

[Operator Instructions] Our next question comes from the line of Jay Cohen with Bank of America.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

I was wondering if we could just turn to the Property and Transportation segment. You had mentioned some adverse development, I think it was property and inland marine, and I'm wondering what is driving that.

Joseph E. Consolino
CFO, Executive VP, Director and Chairman of the Board of Neon Capital Ltd

Jay, this is Jeff Consolino. In terms of the adverse developments in our Property and Transportation sector, you'll see in the supplement for that subgroup. It's $6 million adverse in total. Carl's comments indicated that the development was attributable to property and inland marine, custom bond book of business within ocean marine and then our other transportation businesses, i.e. not National Interstate. Starting with transportation, it was one specific case that had some development for our truck division. That was probably half of the $6 million. The custom bond book of business within ocean marine was a similar magnitude. And for property and inland marine, this is again one specific event reserve that we show as increase during the quarter, that came through as adverse development because it was a prior year and those add up to more than the $6 million, but there are obviously some offsets to that elsewhere in the subsegment.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

So nothing systemic at all? These are really seemingly mostly just smaller one-off issues.

Joseph E. Consolino
CFO, Executive VP, Director and Chairman of the Board of Neon Capital Ltd

They are always offsetting in different directions. I would caution you not to read anything into one quarter. When you say nothing systemic, I would say that in the truck segment, that is indicative of severity, which has been affecting the commercial auto sector more broadly for the last couple of years.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Yes, that's fair. Certainly, not alone there. And then in the crop business, can you give us some sense of what kind of combined ratio that was booked at in the quarter or the first half?

Joseph E. Consolino
CFO, Executive VP, Director and Chairman of the Board of Neon Capital Ltd

Jay, this is Jeff again. We generally don't recognize any profit for the current crop year until the second half of the year. So you ought to assume that crop is booked around 100% in Q1 and Q2.

Operator

[Operator Instructions] And I'm not showing any further questions at this time. I'd like to turn the call back to management -- I do apologize, we have a follow-up question from the line of Jay Cohen with Bank of America.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Figuring there's no question, I should throw another one in there. M&A is a hot topic. So I guess, what's your view of -- on the P&C side, what you're seeing from an M&A standpoint? And I know I probably ask this question all the time, but are you guys seeing more opportunities for M&A yourself to put money to work?

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

I think we see a steady stream of opportunities of both talent acquisition, start-ups, acquisitions, some that are private and some that are part of a process in that. I just think it's -- we see a steady stream of opportunities. Clearly, it seems like on the megadeal side, there's a lot more activity going on. So we think it's great. We think it highlights the value of our specialty insurance franchise. And with fewer peer companies in the marketplace, we look forward to attracting some new investors who see value in our business.

Operator

[Operator Instructions] And I'm not showing any further questions. I would like to turn the call back to management for closing remarks.

Diane P. Weidner
Assistant Vice President of Investors Relations

Thank you all for joining us this morning, and we look forward to talking to you again when we share next quarter's results. This concludes our call for today.

Operator
Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program. You may all disconnect. Everyone, have a great day.