Cincinnati Financial Corporation

NasdaqGS:CINF

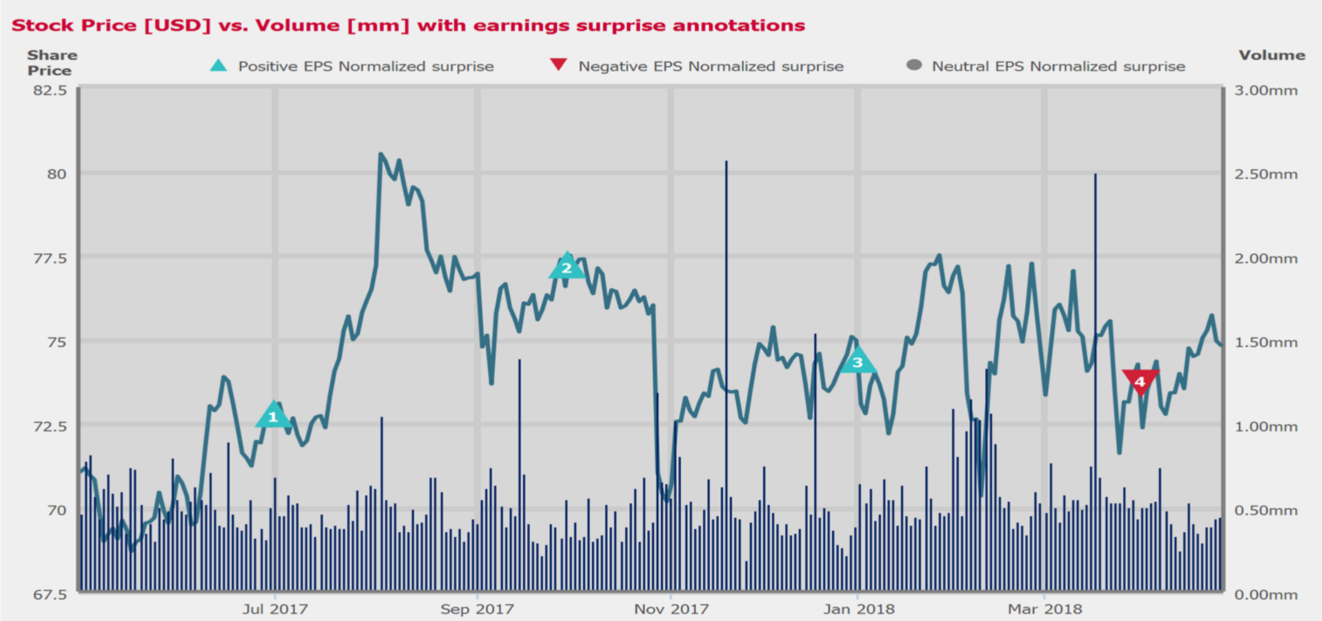
FQ2 2018 Earnings Call Transcripts

Friday, July 27, 2018 3:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2018-			-FQ3 2018-	-FY 2018-	-FY 2019-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.55	0.81	▲47.27	0.80	3.09	3.35
Revenue (mm)	1433.43	1558.00	▲8.69	1465.00	5620.00	6083.05

Currency: USD
Consensus as of Jul-27-2018 10:37 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2017	0.50	0.64	▲28.00 %
FQ3 2017	0.51	0.58	▲13.73 %
FQ4 2017	0.85	0.93	▲9.41 %
FQ1 2018	0.80	0.72	▼(10.00 %)

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Call Participants

EXECUTIVES

Dennis E. McDaniel
VP & Investor Relations Officer

Jacob Ferdinand Scherer
Executive VP & Director

Michael James Sewell
CFO, Principal Accounting Officer, Senior VP & Treasurer

Steven Justus Johnston
President, CEO & Director

ANALYSTS

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Michael David Zaremski
Crédit Suisse AG, Research Division

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Presentation

Operator

Good morning. My name is Emily, and I will be your conference operator today. At this time, I would like to welcome everyone to the Second Quarter 2018 Earnings Conference Call. [Operator Instructions] Thank you. Mr. Dennis McDaniel, Investor Relations Officer, you may begin your conference.

Dennis E. McDaniel
VP & Investor Relations Officer

Hello. This is Dennis McDaniel at Cincinnati Financial. Thank you for joining us for our Second Quarter 2018 Earnings Conference Call. Late yesterday, we issued a news release on our results along with our supplemental financial package, including our quarter-end investment portfolio. To find copies of any of these documents, please visit our investor website, cinfin.com/investors. The shortest route to the information is the quarterly results link in the navigation menu on the far left.

On this call, you'll first hear from Steve Johnston, President and Chief Executive Officer; and then from Chief Financial Officer, Mike Sewell. After their prepared remarks, investors participating in the call may ask questions. At that time, some responses may be made by others in the room with us, including Chairman of the Board, Ken Stecher; Chief Investment Officer, Marty Hollenbeck; and Cincinnati Insurance's Chief Insurance Officer, J.F. Scherer. Also, Chief Claims Officer, Marty Mullen; and Senior Vice President of Corporate Finance, Theresa Hoffer.

First, please note that some of the matters to be discussed today are forward looking. These forward-looking statements involve certain risks and uncertainties. With respect to these risks and uncertainties, we direct your attention to our news release and to our various filings with the SEC. Also, a reconciliation of non-GAAP measures was provided with the news release. Statutory accounting data is prepared in accordance with statutory accounting rules and therefore is not reconciled to GAAP.

And now, I'll turn the call over to Steve.

Steven Justus Johnston
President, CEO & Director

Good morning, and thank you for joining us today to hear more about our second quarter results.

Net income for the second quarter of 2018 more than doubled the same period a year ago. While this year's new accounting requirement for changes in the fair value of equity securities represented a large portion of the increase, operating income, which is independent of that change, also rose significantly, up 24%.

Our 97.2% property casualty combined ratio for the second quarter of this year was 1.1 points better than a year ago and reflected benefits of diversifying our business in recent years. Our commercial line segment experienced a combined ratio below 95%. Our excess and surplus lines segment and Cincinnati Re had excellent results, each with the second quarter 2018 combined ratio below 80%. Our life insurance subsidiary also had an excellent quarter, reporting a 42% increase in net income or 31% on an operating income basis.

Our personal lines segment reported a down quarter, reflecting reserve increases in part due to a 53% year-to-date increase and large losses of $1 million or more per claim. Our all lines accident year 2018 combined ratio before catastrophe losses is roughly 2 points higher than accident year 2017, both measured as of June 30 of the respective accident year. However, on a paid basis, the ratio is nearly the same for each of those 2 periods.

Despite that fairly stable level of paid amounts experienced by each of our major lines of business, management's best estimate of ultimate loss and loss expense ratios and related reserves maintains a prudent amount of IBNR, including elevated levels for 2 lines in particular: homeowner and commercial casualty. As more data becomes available, we'll adjust estimates for reserves up or down as appropriate.

One of the benefits of stable paid ratios as we profitably grow our insurance business is that it increases the float, helping to fuel cash flow for our investment portfolio. Mike will elaborate on that in a moment.

Consolidated premium growth was much better in the second quarter of 2018 than it was in the first quarter. Our commercial line segment rebounded from a 1% decrease in net written premiums to a 5% growth in the second quarter of 2018. Each of our other insurance segments experienced second quarter premium growth ranging from 5% to 7%. Importantly, our internal reports and observations suggest that this growth is healthy. Our underwriters continue to obtain relatively higher renewal pricing on businesses where our models and judgment indicate it's needed, segmenting our portfolio of accounts through careful underwriting of risks covered by individual policies.

Average pricing remained mostly steady, including overall commercial lines estimated average price increases similar to the first quarter, with commercial auto remaining at the high single-digit range. Estimated average premium rate changes for personal lines in total and for both personal auto and homeowner were somewhat higher than the first quarter of 2018, with personal auto average rate increases near the high end of the high single-digit range.

As we reported in our 10-Q, effective July 1, we added a new component of reinsurance protection from catastrophe losses with an excess of loss treaty providing coverage for up to $50 million in aggregate. It includes coverage of $50 million in excess of $125 million per occurrence for combinations of business written on a direct basis and by Cincinnati Re and $25 million in excess of $32 million for catastrophe events affecting only Cincinnati Re. It also provides additional coverage for earthquakes, brushfires or wildfires in certain Western states after a per event loss retention of $10 million.

Our primary measure of long-term financial performance, the value creation ratio was 1.6% for the second quarter of 2018. The component of net income before investment gains or losses contributed 1.7 percentage points, an improvement of 0.2 points versus a year ago. And investment gains in our equity portfolio contributed 1.0 percentage points, enough to offset a negative 0.8 point contribution from the fixed maturity portfolio.

We were pleased to see a partial recovery evaluation at our equity portfolio following the downturn experienced in the first quarter of the year. We'll continue to place much of our focus on the profitable growth of our insurance business. That focus has served us well in the past and will help us create shareholder value over time.

Next, our Chief Financial Officer, Mike Sewell, will provide insights on a few other important elements of our financial performance and financial condition.

Michael James Sewell
CFO, Principal Accounting Officer, Senior VP & Treasurer

Thank you, Steve, and thanks to all of you for joining us today. Second quarter 2018 was our 20th consecutive quarter of investment income growth, up 2%, including 5% for dividend income.

As we reported, overall investment gains for the second quarter were favorable at $25 million before tax effects. That included a $105 million increase in our equity portfolio, partially offset by a $78 million decrease from our bond portfolio. We ended the quarter with a net appreciated value of nearly $3.1 billion, including $84 million in our bond portfolio.

As we highlighted last quarter, new accounting standards required that in 2018, in future years, changes in fair value of equity securities will be reported as part of net income instead of other comprehensive income. And we noted that our value creation ratio was unchanged by the new accounting. The second quarter 2018 net income effect of fair value changes of equity securities we still own was a favorable $80 million, a sharp reversal of the unfavorable $156 million we experienced in the first quarter of 2018.

Drilling down a little more on interest income from our bond portfolio, the pretax average yield was 4.28% for the second quarter of 2018, down 14 basis points from last year's second quarter, as many of our higher-yielding bonds continue to be called or redeemed as they reach their maturity date.

Second quarter 2018 interest income grew 1%, in part due to $226 million in net purchases of bonds in the first 6 months of this year. Taxable bonds purchased during the second quarter 2018 had an average pretax yield of 4.68%, 93 basis points higher than we purchased for last year's second quarter. Tax-exempt bonds purchased just averaged 3.72%, up 39 basis points from a year ago.

Cash flow from operating activities continued to provide funds for our investment portfolio. Funds generated from net operating cash flows for the first 6 months of 2018 totaled $464 million, up $19 million or 4% for the same period a year ago.

Turning to underwriting expense ratio. Careful management of expenses continues to be a priority as is investing strategically in our business. Our second quarter 2018 property casualty underwriting expense ratio decreased by 0.5 percentage points versus the second quarter of 2017.

Regarding loss reserves, our consistent approach to setting overall reserves again resulted in property casualty net favorable development on prior accident years. Second quarter 2018 favorable reserve development benefited our combined ratio by 2.6 percentage points and the 6-month 2018 benefit of 3.3% match the same period last year. Our commercial casualty line of business experienced $14 million of favorable reserve development. Most of our major lines of business have experienced favorable reserve development in the first 6 months of 2018.

On an all lines basis by accident year, it included 38% for accident year 2017, 15% for accident year 2016 and 47% for 2015 and prior accident years. In terms of capital management, during the second quarter, we repurchased nearly 1.6 million shares at an average price per share of $70.57. Related to that and opportunities to modestly grow our commercial leasing and financing subsidiary, we used a small portion of capacity available from our $225 million line of credit. Our financial strength and financial flexibility remain excellent.

As usual, I'll conclude with a summary of second quarter contributions to book value per share. They represent the main drivers of our value creation ratio. Property casualty underwriting increased book value by $0.17. Life insurance operations added $0.10. Investment income other than life insurance and reduced by noninsurance items contributed $0.39. Net investment gains and losses for the fixed income portfolio decreased book value per share by $0.38. Net investment gains and losses for the equity portfolio increased book value by $0.51. And we declared $0.53 per share in dividends to shareholders. The net effect was a book value increase of $0.26 during the second quarter to $48.68 per share.

Now I'll turn the call back over to Steve.

Steven Justus Johnston
President, CEO & Director

Thanks, Mike. We're encouraged by our second quarter results, as we see several positive trends that are building momentum. While there's still work to be done, we have confidence in the future because of the outstanding independent agencies that represent our insurance companies and because of our capable, dedicated associates who deliver excellent service daily to our agents and their clients.
We appreciate this opportunity to respond to your questions and also look forward to meeting in person with many of you during the remainder of the year. As a reminder, with Mike and me today are Ken Stecher, J.F. Scherer, Marty Mullen, Marty Hollenbeck and Theresa Hoffer. Emily, please open the call for questions.

Question and Answer

Operator

[Operator Instructions] Your first question comes from the line of Arash Soleimani with KBW.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

So first question I had was on the workers' comp side. I saw that the growth there was negative in the last few quarters, but it was positive this quarter. Just wanted to see if that's something that we should expect going forward. And what drove the growth there?

Jacob Ferdinand Scherer
Executive VP & Director

This is J.F. We're experiencing what a lot of carriers are experiencing, the net rate decreases have moderated our growth. We're not -- as we've said in the past, we're not an aggressive writer of work comp. It comes along with the package business that we've gotten. We simply experienced some good new business growth overall in our commercial line segment, and the workers' comp came along with it. So we were pleased by that. We're not afraid of comp, but I don't think you'll see anything drastically different moving forward.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

And is it fair to expect the core loss ratios there to continue being elevated year-over-year, just given the pricing environment in that line of business?

Jacob Ferdinand Scherer
Executive VP & Director

Yes, it's tough to keep up within that rate decreases that we're seeing there. On the other hand, I think we continue to see improvements on our loss cost from the initiatives we have in the claims area as well as loss control. So we're comfortable with how we're doing in comps. It's actually doing fairly well for us. So we're pleased with the outcome.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

And on the commercial casualty side, it looked like the core loss ratio there was better than it's been in the last 2 quarters and you had favorable development this quarter as well. So is that just simply a factor of the initiatives you've been taking on the underwriting side bearing fruit and should we continue to see that type of sequential improvement?

Steven Justus Johnston
President, CEO & Director

Yes, we're pretty pleased with how things are going on the commercial casualty. The loss activity we've seen has been a bit more on the umbrella area, some large claims. Most of those claims have been associated with commercial auto. So what we're spending a lot of time doing in addition to increasing rates on the commercial auto line itself is being a lot more careful about the underwriting side of things relative to scrutiny of drivers, more loss control activity in the commercial auto area. And we think that, that will pay off over time.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

And just last question. I know you mentioned in the prepared remarks, but on the homeowner side, can you just go into a bit more detail about the trends there and what drove the core loss ratio in the reserve development?

Steven Justus Johnston
President, CEO & Director

Well, once again, in homeowners, severity is the issue there. We've just seen an increase in the dollar value of the $1 million and higher claims that we have. We've taken a look at all the claims that have occurred, reviewed them, done postmortem on all of it. There's a lot of variability in these large claims. So for example, in looking back, full year 2015, $1 million-plus claims doubled over '14 and then in '16 was down 73%. So as we take a look at what's going on there, I would say, first of all, we're quite pleased with the initiatives we've got going in homeowners, our entry into high net worth. The severity of the claims that we're seeing doesn't worry us. We've just experienced a little elevated levels of that here of late. But all in all, looking forward, we're pleased with how things are going, and we think all the initiatives, including rate increases and better inspection protocols, will continue to pay off for us.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

And when you say the $1 million-plus, are these claims on the high net worth side then? And if so, can you just maybe briefly talk about the profitability of the high net worth book versus the standard homeowners' book?

Steven Justus Johnston
President, CEO & Director

Yes, when we talk about it, it's on both sides of it. And we have seen overall some elevated high net worth claims. And most of these are fire losses, by the way. But we're writing more high net worth and the homes are more valuable. But, for example, in the first quarter of the year, we had an increase of $12 million in these large claims and only 20% were from high net worth. So once again, these are highly variable. What we're seeing on the high net worth side in terms of -- in particular of the new high net worth business for writing in some of the newer states, it's progressing as we would have hoped it to. So no alarm bells are ringing here relative to what's going on there. We're just -- we're seeing some variability and we're monitoring that as it goes on. As a result of it, though, we take a prudent approach in terms of how we're reserving. So the losses occurred, as you would expect out of us, we're very prudent and conservative about how we're reserving. We will continue to do that, and then we'll see how things play out.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

And what's the premiums in force currently for high net worth?

Steven Justus Johnston
President, CEO & Director

On the homeowner side, it's -- direct written premium through 6 months is about $83 million.

Operator

Your next question comes from the line of Scott Heleniak with RBC Capital Markets.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Just a quick question first on capital management. So you guys had some buybacks in the quarter. You do those from time to time. Can we expect to see those more frequently? I know that's obviously dependent on what happens with the stock. But how are you looking at those now versus in the past? And how you weigh that up with uses of capital, including special dividends over time?

Michael James Sewell
CFO, Principal Accounting Officer, Senior VP & Treasurer

Yes, great. This is Mike. And doing the buybacks, it's a form of returning capital back to shareholders. With what we've done so far in 2018, it's a little less than 1.8 million shares. If I look back a couple of years, in 2017, we did about 1 point -- or actually did 1.3 million shares. A year before that, a little under 600,000. A year before that, there was 1 million. So we're been saying that we've been doing kind of maintenance, which runs around, I'll say, 1 million shares a year. And so, so far this year, it's a little bit elevated, not by a whole lot. And so it's really something we think about when we look at the time. It depends on the circumstances. We've got the discretion and really been opportunistic about it when we look at the -- what the sale price or price of the shares currently are. So on average, it's been about 1 million shares a year. And we'll just keep our eye on it, and we'll take advantages when the price tells us to take advantage of it.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Okay. And any thoughts on how you weigh that versus special dividends, which you've done from time to time? Is there any underlying factor behind that as to when you'd declare those?

Michael James Sewell
CFO, Principal Accounting Officer, Senior VP & Treasurer

That's -- there's a couple of others -- 2 uses right there of using our capital. There's 5 uses, but the 2 of them you just hit on was dividends and buybacks. So the dividends, we -- obviously, we think, about that every quarter. It's a board decision. So we talk about it at the board. The board kicks around. There has been a special dividend 2 of the last 3 years. And we do say that it's called a special dividend for a reason. It's special, but it's actively discussed at the board meetings. And it's circumstances, again, based on how the company is doing and where we think we're headed.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Okay. That's fair enough. Then I had a question too on personalized pricing. I think you mentioned that improved Q2 versus Q1. I wanted to see if that was both on the homeowners and auto side? And is your outlook that, that will accelerate further in the second half of the year, because it certainly depends on the company, but some companies are actually talking about rates decelerating for them and you guys -- sounds like you guys are seeing the opposite a little bit?

Steven Justus Johnston
President, CEO & Director

Yes, as far as our rate increases are concerned, we would anticipate that the increases that we've been talking will continue on, both in home and auto, and for that matter, in commercial auto as well. Commercial auto is at the upper end of the single-digit range. And that's -- in the second quarter, that's on top of a similar type of rate increase of the second quarter last year. So we're pretty comfortable with our strategy on rate increases. They are sticking. Our retention is -- continues to be in the areas that we want it to be in. So we're pleased with the strategy there.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Okay. And then just my last question just on the expense ratio improvement for the quarter. I know that Q1 was -- you had the impact of the higher deferred acquisition cost. And I think you mentioned that you thought the expense ratio would come somewhere around the low 31s. It was a little bit better than that this quarter. So wondering if you had any comment on where that might be tracking for the rest of the year.

Michael James Sewell
CFO, Principal Accounting Officer, Senior VP & Treasurer

No, you're exactly right. I did make that comment the first quarter that we thought it would be pretty close to 31.1%, which is where we ended up 2017. That's still -- we typically don't give out lot of guidance. But I think that's probably fair if you've -- you're building out your models. This quarter being a little bit, I'll say, lower at 30.5%, there's some timing of when we spend things. We're continuing to invest lot of things going on in IT, innovation, predictive modeling. And so I could see it still being around that, maybe a little bit lower. But I would not take 30.5% as an indication that the next 2 quarters will be the same.

Operator

[Operator Instructions] Your next question comes from the line of Mike Zaremski with Crédit Suisse.

Michael David Zaremski
Crédit Suisse AG, Research Division

Regarding the reinsurance program you spoke to, and I haven't gone to the 10-Q yet, so maybe there's info there. But should -- how should we be thinking about that impacting the income statement, if you do think it has a kind of material impact in the near term?

Steven Justus Johnston
President, CEO & Director

Yes, thinking around that was we've got 2 relatively new businesses that we're ramping up with Cincinnati Re and our high net worth home. We're very confident in the management of both of those enterprises. But as you grow a business, the premium volume is growing. It starts out smaller, which leads to some variability in results. We've been very happy with both of the -- those organizations. As we were looking at it, starting out with Cincinnati Re -- and we have disclosed this, I think, well in our 10-K and so forth. You could have an event where the 2 combine for more than $100 million. And we've been writing Cincinnati Re in a very diversified fashion in terms of cat losses with the Cincinnati standard. But in the lower return periods, you could have a combination of the 2 starting to add up. And it kind of came to light as we looked at the hurricanes last year. Really there was nothing that jumped out at us in terms of behavior there that was unexpected. We were quite happy with the way it worked out. For example, with Irma, at the 10-K, we had a $52 million loss, $33 million of it coming from the standard CIC, Cincinnati Insurance, $19 million from Cincinnati Re. As we do our modeling, we could see -- and this again is in the 10-K on Page 31, the 1 in a 100-year event for the combined of the 2 would be $173 million, with Cincinnati Re having a marginal contribution of $77 million. If we move up to the 1 in 250-year event, the combined goes up to $413 million. The marginal contribution from Cincinnati Re only goes up to $80 million, showing the diversifying effect. But in those lower-return periods, you could see the number starting to add up. So we thought an aggregate cover would be beneficial. And so we bought Part A of this $50 million aggregate would be $50 million excess of $125 million for the combination of Cincinnati standard and Cincinnati Re. And so we think that's very prudent in managing that volatility in the lower-return periods. As we look further, we also thought, well, the smaller amounts for Cincinnati Re could add up. And so we bought an aggregate on just Cincinnati Re $25 million ex of $32 million. And then on the high net worth side, on the first line side, we thought with earthquakes as a potential in California, the wildfires that we're seeing, the third part of the agreement would be $50 million ex of $10 million per occurrence for earthquakes, wildfires, brushfires in certain of the states out West that would be California, Oregon, Washington and Nevada. Now the aggregate is $50 million. So there's only $50 million available in total for those 3 coverage parts. And we thought the pricing was reasonable and that it's just slightly over $7 million for the entire cover. And so we just thought it was good risk management, good management in terms of managing the volatility that could arise from the ramp-up of these 2 new businesses that we're very confident in.

Michael David Zaremski
Crédit Suisse AG, Research Division

Okay. That's very helpful color. Can we -- can you touch a little bit on commercial auto? I believe it -- reserves trended negatively in last quarter. They were -- they trended -- they were more flattish. Anything jumping out at you that's changed?

Steven Justus Johnston
President, CEO & Director

I think we're continuing to feel good about the progress we're making in commercial auto. In terms of sequentially, the accident quarter improved a bit. It's also down a little bit from where it was same quarter a year ago on the current accident year basis. We did see some adverse development of 3.3 points on the prior accident years this time. And just the way we do reserves, when we've seen some of this adverse development and as we reflect it, we're cautious and I think prudent in the pick of the current accident year's ultimate loss ratio. And that would go for commercial auto and homeowners, as J.F. described. So I think we're taking a prudent approach to the selection of our current accident year picks. But I think we're also confident when we see rates coming in, in the high single-digit range, all the work that's being done by our people in terms of mitigating the loss trend, we feel we're ahead of the game there and are optimistic about the prospects for future improvement in commercial auto.

Michael David Zaremski
Crédit Suisse AG, Research Division

Okay, great. And lastly, if you can -- if I can ask a question about the broader pricing environment, and maybe this should be bifurcated personal lines versus commercial, that's up to you. But are you at all surprised at the -- it feels like there's been more pricing power than I feel some people in the industry expected, at least from those -- from my vantage point, given the results for a lot of participants in the industry have been okay. And so feels like maybe something is a little different this cycle. It feels like there's -- the carriers have been able to both keep retention at healthy levels and push pricing increases at a descent rate and ex comp -- workers' comp obviously. So just kind of curious if you feel at a high level things have changed this cycle versus in the past?

Steven Justus Johnston
President, CEO & Director

Well, I think we've just become better and more skilled at the way we underwrite, the way we handle claims, the way we price. And it's very much on a risk-by-risk, policy-by-policy basis. So sometimes the averages don't cover enough. They don't describe the whole distribution of what's going on risk-by-risk in our underwriting pricing claims departments in terms of just looking into every risk, what can we do to make sure that we understand the potential risk, that we eliminate risk the way we can and that's a win-win for us and the agent and their client, what can we do to mitigate risk that might happen, how can we price it appropriately risk-by-risk using our predictive models, our underwriting judgment, the application of the loss control and all the traditional underwriting measures. And I think by looking at it that granularly, it gives the more appropriate price reflection over time.

Operator

[Operator Instructions] We have no further questions at this time. I will now turn the call back over to Mr. Johnston.

Steven Justus Johnston
President, CEO & Director

Thank you, Emily, and thanks to all of you for joining us today. We look forward to speaking with you again on our third quarter call. Have a great day.

Operator
This does conclude today's conference call. You may now disconnect. Have a great day.