S&P Capital IQ

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CNA Financial Corporation NYSE:CNA

FQ1 2014 Earnings Call Transcripts

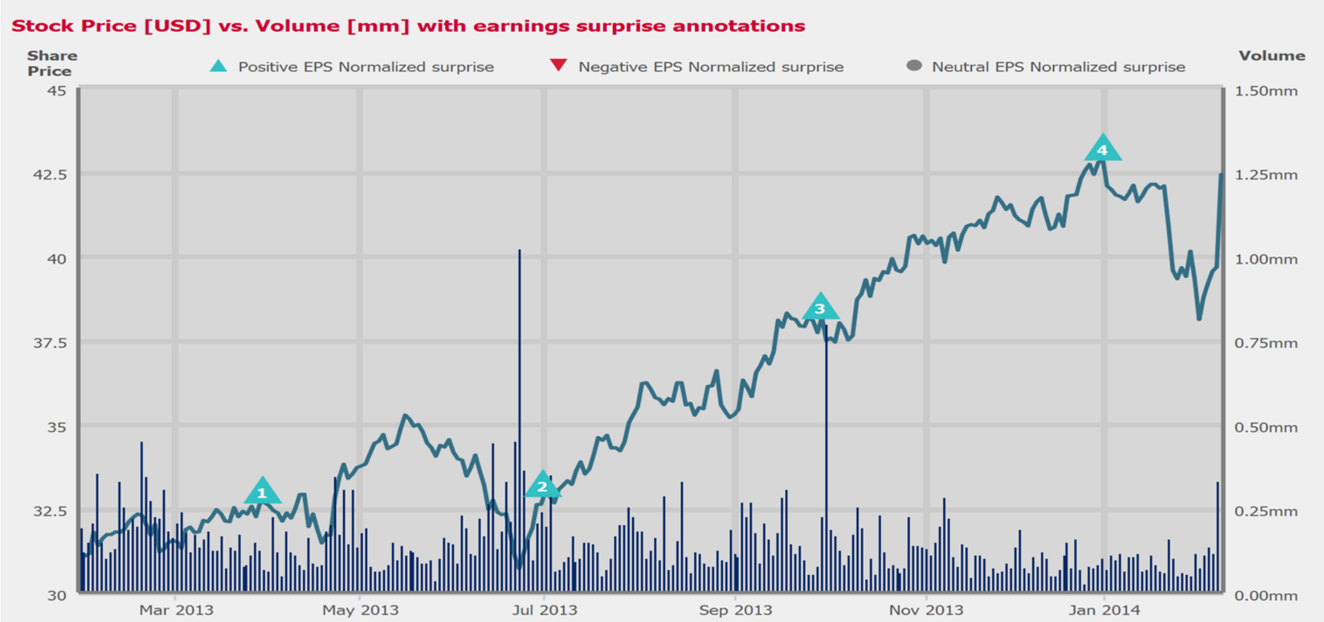
Monday, April 28, 2014 2:00 PM GMT

S&P Capital IQ Estimates

	-FQ1 2014-			-FQ2 2014-	-FY 2014-	-FY 2015-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.83	0.70	▼(15.66 %)	0.86	3.52	3.90
Revenue (mm)	1861.00	1767.00	▼(5.05 %)	1762.50	8087.00	8421.50

Currency: USD

Consensus as of Apr-17-2014 12:16 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ1 2013	0.71	0.86	▲21.13 %
FQ2 2013	0.64	0.75	▲17.19 %
FQ3 2013	0.76	1.00	▲31.58 %
FQ4 2013	0.87	1.24	▲42.53 %

Call Participants

EXECUTIVES

D. Craig Mense
Chief Financial Officer and Executive Vice President

James M. Anderson
Senior Vice President of Financial Planning & Analysis and Corporate Development

Thomas F. Motamed
Former Chairman and Chief Executive Officer

ANALYSTS

Adam Klauber
William Blair & Company L.L.C., Research Division

Jay Adam Cohen
BofA Merrill Lynch, Research Division

John Thomas

Joshua David Shanker
Deutsche Bank AG, Research Division

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

Ronald David Bobman
Capital Returns Management, LLC

Presentation

Operator

Good day, and welcome to the CNA Financial Corporation's First Quarter 2014 Earnings Conference Call. Today's call is being recorded. At this time, I would like to turn the conference over to James Anderson. Please go ahead.

James M. Anderson
Senior Vice President of Financial Planning & Analysis and Corporate Development

Thank you, Greg. Good morning, and welcome to CNA's discussion of our 2014 first quarter financial results. By now, hopefully all of you have seen our earnings release, financial supplement and presentation slides. If not, you may access these documents on our website, www.cna.com, under the Investor Relations menu.

With us on this morning's call are Tom Motamed, our Chairman and Chief Executive Officer; and Craig Mense, our Chief Financial Officer. Following Tom and Craig's remarks about our quarterly results, we will open it up to your questions.

Before turning it over to Tom, I would like to advise everyone that during this call, there may be forward-looking statements made and references to non-GAAP financial measures. Any forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from the statements made during the call. Information concerning those risks is contained in the earnings release and in CNA's most recent 10-K on file with the SEC.

In addition, the forward-looking statements speak only as of today Monday, April 28, 2014. CNA expressly disclaims any obligation to update or revise any forward-looking statements made during this call.

Regarding non-GAAP measures, reconciliations to the most comparable GAAP measures have also been provided in the financial supplement. This call is being recorded and webcast. During the next week, the call may be accessed on CNA's website.

I would also like to remind you that presentation slides have again been posted on our website to provide additional perspective on our financial and operating trends.

With that, I will turn the call over to CNA's Chairman and CEO, Tom Motamed.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Thank you, James. Good morning, everyone, and thank you for joining us today. In the first quarter of this year, CNA produced operating income of $190 million compared with $225 million in the first quarter of 2013. Current accident year non-catastrophe underwriting results improved over prior year, but were offset by higher winter-related catastrophes and lower limited partnership investment income.

Our Property & Casualty combined ratio was 101.6% for the quarter, in line with last year's first quarter. Catastrophes affected the loss and combined ratios by 4.5 points as compared with 2.4 points in the first quarter of 2013. Our Property & Casualty combined ratio, excluding catastrophes and development, was 97.2%. This was almost a 4-point improvement as compared with the first quarter of 2013. This includes just over a 3-point improvement in our loss ratio and a 0.7-point improvement in our expense ratio. Our results in the first quarter are consistent where we ended full year 2013.

Property & Casualty net written premium was flat in the quarter as rate increases were offset by lower retention in Commercial, resulting from underwriting actions, including exiting classes outside of our appetite, as well as continuing to focus on underwriting and pricing actions to improve profitability.

We continue to seek and achieve rate increases exceeding the loss cost trends. Commercial rates increased 6% in the quarter, with retention in the mid-70s. Specialty rates increased 4%, and retention remains strong in the mid-80s. With that, I will turn it over to Craig.

D. Craig Mense
Chief Financial Officer and Executive Vice President

Thanks, Tom. Good morning, everyone. As Tom mentioned, first quarter net operating income was $190 million or $0.70 per share, and the operating return on equity was 6.3%. Our reported net income of $13 million includes a $214 million impairment charge related to the pending sale of our life subsidiary, Continental Assurance Company, which we announced last quarter. The results of that business, as well as the impact of the impairment charge, are now being reported as a discontinued operation. We still expect to close this transaction sometime in the second quarter.

The majority of our businesses, as well as our balance sheet strength, reflect our continuous improvement. We are pleased with the ongoing progress in our Specialty, Hardy and Long-Term Care businesses, as well as our investment results and capital management activities.

Our results in certain parts of Commercial lines are not what we expected. Continued loss cost pressure on auto and certain classes within our small business segment slowed our overall progress. Our middle market business and customer segment strategies are taking hold and are making meaningful positive contributions to our progress.

Our core P&C operations produced net operating income of $219 million in the first quarter compared with $257 million in the first quarter of 2013. The decrease was primarily the result of lower limited partnership investment income and winter-related catastrophe losses.

Our first quarter P&C operations loss ratio, excluding catastrophes and development, was 64%, a 3 point improvement as compared with last year's first quarter and consistent with our reported full year 2013 results.

Our first quarter expense ratio was 33.1%, a 0.7 point improvement from the prior year period. And again, consistent with our full year 2013 results, reflecting our ongoing expense management efforts and a lower level of underwriting expenses.

Specialty's first quarter combined ratio, excluding catastrophes and development, was 93.9%, 4 points better than last year's first quarter and modestly better than the full year 2013 results. The reported combined ratio was 94.4%, which included 1.4 points of cat losses and just under 1 point of favorable development.

The loss ratio, excluding catastrophes and development, was 63.7%, 3 points lower than last year's first quarter and slightly below the full year 2013 results. The improvement was driven by rate increases in excess of loss trends, as well as targeted underwriting actions that continue to refine the portfolio mix.

Commercial's first quarter combined ratio, excluding catastrophes and development, was 101.2%, almost 3 points better than last year's first quarter. The loss ratio, excluding catastrophes and development, was 66.9%, an improvement of almost 2 points over the prior year's period, but 1 point above full year 2013.

Non-cat weather and other large first-party losses added approximately 1.5 points to the reported loss ratio. The reported combined ratio of 109.8% included 7.5 points of catastrophe losses and compares with the prior year period's 106.8%, which had 4.6 points of catastrophe losses.

Hardy reported net operating income of $7 million in the first quarter with a combined ratio, excluding catastrophes and development, of 88.6%, as both the underlying loss ratio and expense ratio improved compared with the first quarter 2013 and the full year. The reported combined ratio was 87.1%, which included a small amount of favorable prior period development items.

Hardy's first quarter expense ratio includes almost 4 points of onetime items. The run rate expense ratio is now in the mid-40s. Hardy continued to produce a modest amount of organic net written premium growth and also benefited from a reduced level of reinsurance spend.

The Life & Group segment produced $2 million of net operating loss in the quarter, slightly better than the first quarter of 2013, primarily driven by higher net investment income due to a higher invested asset base. The results were helped by the ongoing positive impact of our rate increase actions. Morbidity was generally favorable, while persistency was unfavorable to recent quarters' results.

Our corporate segment, which primarily includes corporate expenses, reported a $27 million first quarter net operating loss, consistent with the prior year's first quarter. It includes a small $2 million benefit from the recognition of the deferred gain established last quarter related to the NICO retroactive reinsurance transaction.

Our balance sheet continues to reflect CNA's financial strength and stability. Book value per share decreased 1% in the first quarter to $46.61 per share. Excluding accumulated other comprehensive income, book value was $44.05 per share, down 3% from year end 2013. The decrease was driven by our previously announced $1 a share special dividend and $0.25 a share quarterly dividend, as well as the negative impact of the CAC sale.

Our investment portfolio's pretax net unrealized gains stood at approximately $2.5 billion at quarter end, an increase of approximately $600 million from year end 2013. Our statutory surplus at quarter end was $11 billion, and we continue to maintain significant dividend capacity at the insurance operating company level.

As previously announced, we completed a $550 million debt offering in February, with the proceeds earmarked to retire senior notes maturing in December of this year. The coupon on the new debt is 3.95%, 190 basis points lower than the existing debt.

Cash and short-term investments at the holding company level were approximately $1 billion at quarter end, up significantly due to the proceeds from the debt offering. In the first quarter, operating cash flow, excluding trading activity, was approximately $150 million. Cash principal repayments through paydowns, bond calls and maturities were approximately $850 million.

Net investment income was $526 million pretax in the first quarter. Limited partnership income of $73 million was a solid 2.7% return this quarter, but lower than the exceptional return in the same period last year.

Income from our fixed maturity and other securities, excluding LPs in the first quarter, was $553 million pretax, down slightly from the prior year period. More importantly, you will note that we generated $324 million of after-tax income from these securities, which is above the level of first quarter 2013, reflective of the opportunity that we saw and seized last summer in the tax-exempt municipal bond market. Our actions have enabled us to sustain an after-tax book yield of 3.5% on this part of the portfolio.

While our overall portfolio allocations did not change significantly in the first quarter, we did continue to increase our allocation to the tax-exempt municipal bond market. The investment-grade corporate bond sector continues to represent the largest component of our invested assets. The average credit quality of our fixed maturity profile -- portfolio remained at A. The fixed income assets that support our long-duration lifelike liabilities had an effective duration of 11.5 years at quarter end. The effective duration of the fixed income assets, which support our traditional P&C liabilities, was 4.3 years at quarter end. These durations are both in line with portfolio targets.

Overall, our investment portfolio remains well diversified, liquid, high-quality and aligned with our business objectives. With that, I will turn it back to Tom.

Thomas F. Motamed
Former Chairman and Chief Executive Officer
Thanks, Craig. Before we open it up for questions, I would like to make some final comments. As Craig said, our steady progress is evident across the majority of our businesses. We are pleased with our progress in Specialty and Hardy and with our capital position and investment income. We know we have to work -- we have work to do in Commercial. We remain focused on the disciplined execution of our articulated business strategy and are committed to driving further improvement in our results. With that, we'd be glad to take your questions.

Question and Answer

Operator

[Operator Instructions] And we'll take our first question from Bob Glasspiegel with Janney Capital.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

I was wondering if you could expand on what sort of has changed in Commercial auto within the small business segment that's causing some pressures.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

I think the industry is acknowledging that Commercial auto is a class that's not doing very well. And the fact is, for us, that would be middle market as well as small, but particularly in the smaller area. I think the good news is we're refining our underwriting and pricing strategies there, Bob. We're getting double-digit rate in small on Commercial auto. So we believe a combination of strict underwriting guidelines and pricing, as well as rate increases, is going to have the impact of turning that around over time.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

If I could follow up just with a numbers question for Craig. I've seen the Life & Group Non-Core in Page 8, you had a $32 million pretax loss and $30 million of tax benefits. Anything driving the sort of higher tax credit rate this quarter?

D. Craig Mense
Chief Financial Officer and Executive Vice President

That's just the reflection of the investment portfolio which, if you recall, is more heavily weighted to tax-exempt municipals.

Operator

And our next question comes from Jay Cohen with Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

One number that looked a little worse than we have been seeing was the favorable development in the Specialty segment. And I'm wondering, is there -- maybe it's -- let me move back a little. It looks like there may be some seasonality there where the first quarter tends to have a lower reserve release. Is that what's going on? Or is there any underlying change what you're seeing from a claims standpoint in that segment?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

I think you're right in what you said, Jay. First quarter typically is lighter. We had a big fourth quarter reserve releases in Specialty. It's seasonal. The fact is we don't look at every line, every class every quarter. And Specialty tends to be more towards the end of the year than the beginning of the year.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

And I guess on the Commercial business, you had some -- a very modest amount of adverse development, but it was adverse. Can you give us kind of a glimpse into what's happening with the various classes of business from a reserve standpoint? Is that more in the Commercial auto side you're seeing some pressure in those reserves?

D. Craig Mense
Chief Financial Officer and Executive Vice President

I mean, Jay, I could give you just a little bit of color there. Yes, there was some adverse in Commercial auto in the more recent accident years. And -- but that was largely offset by some favorable development we had in Property mix with Property cats from '13, as well as general liability in some older years. And what you're really seeing there is just the residual of what's left in the workers' comp tabular discount online. So I would say -- I would characterize that result as flat for the quarter.

Operator

[Operator Instructions] Next, we'll hear from Josh Shanker with Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

I'm going to dig in a little further on the Commercial auto. Can you talk a little about what combined ratio you're running after for that business right now is? And I think that's probably about $300 million, $400 million of premium, annually. Can you give us some color on that?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes, hold on. On an accident year basis, it's running about at 121% and 159% on a calendar year.

Joshua David Shanker
Deutsche Bank AG, Research Division

And how much premium is that?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Hold on. We have to get that.

D. Craig Mense
Chief Financial Officer and Executive Vice President

So it's about -- it's less than 10%. It's around 10% of our 8.5 Commercial sale.

Joshua David Shanker
Deutsche Bank AG, Research Division

And can we also sort of scale the small business? That's not really a reporting category you have. So I'm not sure exactly what you can tell me there, but I'd be interested to know how you guys think about that as well.

D. Craig Mense
Chief Financial Officer and Executive Vice President

Well, you can see the scale in the earnings slide that James referred to earlier, Josh, so you can see the general -- the revenue as well as rate and retention. So you -- I might -- I don't remember exactly that...

Joshua David Shanker
Deutsche Bank AG, Research Division

Okay. That category has shrunk [ph] . And so there's some small Commercial auto in the small business. That's a class as opposed to a line?

Thomas F. Motamed

Former Chairman and Chief Executive Officer

Yes.

Joshua David Shanker
Deutsche Bank AG, Research Division

Yes, okay. And so in terms of thinking about the pace of improvement, if where we are today, where given the rate improvements you're at, how quickly do you think it will take to turn this around, given the pricing you're at right now and the trend involved?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Well, we're taking a pretty hard line on rate increases. Like I said, for small, it's low double digit. Retention, we've really dropped a lot of business there. Retention is kind of just under 60%. So a combination of really getting rid of the bad stuff that we don't think we can fix, plus applying rate for the remainder of the book will be helpful. And we're extremely cautious on what we're writing new and really trying to write the new business at profitable levels. So it's going to take some time to get through it, but I couldn't give you an exact time on that.

Joshua David Shanker
Deutsche Bank AG, Research Division

But would it be incorrect? So even if you could hold loss costs generally flattish, given double-digit rate increases, it would take you a couple of years to get to where you want to be on the Commercial auto?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Well, I'd certainly think, define a couple, 2 to 3, that probably is fine...

Joshua David Shanker
Deutsche Bank AG, Research Division

A couple, 2, yes.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

And I think that really it's the power of written rate turning to earned rate and exceeding loss costs that will drive the margins more favorably. So we're confident that we'll be able to continue to get rate increases in this line.

Operator

[Operator Instructions] And we have a follow-up question from Jay Cohen.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

A couple of questions. The first is, Tom, I'm wondering if you can discuss the competitive conditions in the Commercial segment. I see what your average rate increases are, but if you can put more color around that. And then separately, you talked about non-cat weather and some severe losses affecting the loss ratio. I'm wondering if you could just talk about some of the severe losses, what kind of losses are we talking about?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Okay. On the loss side, obviously, it was a tough winter. Some of it gets cataloged as cat, and we've kind of given you the cat numbers. We did have some non-cat large losses, I guess they probably amounted to

$15 million, so a couple of fires, et cetera, so you have that. And then there's, in general, the fact that you have weather-related losses that are not cats. So we've had some activity there as well as, I think, most people. So a combination of cats, large loss and weather-related claims from the severe winter. And your other question, Jay, was?

Jay Adam Cohen
BofA Merrill Lynch, Research Division

On competitive conditions, Tom.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes. Yes, it's always competitive. But I think what we are seeing and probably have seen for the last 6 months, maybe a little more, is people are very protective of their renewals. They are putting them to bed earlier than not letting them get to the -- get to market, and in fact, maybe cutting their -- or not applying rate to some of them, renewing them flat. So I think people are more protective of the renewal book, which creates less new business opportunities. We have seen less new business opportunities here at CNA. And it's not for not trying. It's clearly people are trying to put their stuff to bed much earlier, so we see that. On new business, I'd say people, when a piece comes out there, people are competitive and writing some of the business in Commercial probably below expiring, in many cases. And everybody has different analytics to predict one account is better than the others, so I think you have some trading when business comes out to the market on a new business standpoint. So -- but that has been going on for a while. I don't think it's anything new. Kind of interesting though when we look at Commercial, the month of March had the highest rate increases in the first quarter compared to January and February. So it's a little lumpy out there, but that's how I would describe it.

Operator

And next, we'll hear from Adam Klauber with William Blair.

Adam Klauber
William Blair & Company L.L.C., Research Division

So when you look through some of the weather noise, it looked like the accident year loss ratio in first quarter, it was better than the first quarter last year. Do you think we'll continue to see accident year improvement throughout this year?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

That's the goal.

Adam Klauber
William Blair & Company L.L.C., Research Division

Okay. Next question, workers' comp. How is that trending? And again, do you think the accident year workers' comp this year will be better than last year?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

I think there are a couple of things going on in workers' comp here. Number one, we are getting rate increases in excess of loss cost trends, so that will improve margin. We are moving the mix much more into what we would call white collar, which I'd probably describe as companies that have people that really want to go back to work because they're high-wage earners. So we're managing the mix. We're pretty careful on what states we're growing in or not growing in. So it's a multifaceted strategy. Get the rate increases, manage the mix, manage the jurisdictions. But we think we're going to gain on workers' comp. We are seeing improvement there.

Operator

And our next question comes from Ron Bobman with Capital Returns.

Ronald David Bobman
Capital Returns Management, LLC

I got on the call late, so I apologize if this is ground you covered. I was curious to hear your thoughts about what's going on in the cyber market, Tom, sort of broadly. And then any actions or plans for CNA's participation? And then switching to Hardy, if there's any description as far as, does Hardy have a sort of broadening underwriting appetite? Whether it's geography or lines of business that you would describe any of that, I'd appreciate it.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes, I'll start with Hardy. I think Hardy is in a competitive environment in the Lloyd's marketplace. It is quite competitive on pricing, whether that be new in renewal. They did give up about 3 points of rate in the quarter, but I would describe them as sticking to their strategy of the various areas that they want to underwrite in. And I think they really have a great attitude about keeping their powder dry. They're not going to chase the market down. We're constantly talking to them, but they're pretty disciplined. And I think they're not going to chase the market down, they're going to wait for the opportunities. And we're pretty happy with what's going on at Hardy, and they obviously contributed to the results in the first quarter. As far as cyber, we do offer cyber liability. We've been doing that for a while. It is a hot topic, obviously, what you read in the papers and I think for yourselves, right? So companies are buying this product. They're not sure if they're going to have a breach or not. But clearly, it is a hot product and there's a lot of competition for it. There is a lot of people writing cyber. And we would expect that to continue. To me, it's a little bit reminiscent of public D&O back in the early 80s, that we were selling the product and nobody really knew what the coverage was and there weren't many claims. And then all of a sudden, there were claims and people started adjusting terms and conditions and policy language. So I think cyber, quite honestly, is going to develop over time, so we really know what it's all about, et cetera. But it's here to stay.

Ronald David Bobman
Capital Returns Management, LLC

Can I just go back to Hardy just to make sure, because you didn't say, so I assume the answer is no. I didn't think you said. As far as Hardy broadening its geographic list profile or lines of business, no great -- no meaningful changes planned there or currently being undertaken? Like you said, it's sticking to their knitting, the same lines they had been writing historically and largely in the same geographies?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes, that's true. Now the only thing I would give you there is one caveat, and that is Lloyd's is expanding their network. They operate out of Singapore now. And the fact is we have to figure out how we're going to -- if we did go to Singapore for Lloyd's, we've got to figure out how we're going to do that and what product lines. But we're not going to do something we don't know anything about. I can assure you that's the case. So we're going to stick to our core competency, our expertise. If there's business that fits that coming out of the Singapore Lloyd's facility, we'll be interested in entertaining it if it's the right price. This is not about going like a barnburner here, this is cautious.

Operator

And our next question comes from John Thomas with William Blair.

John Thomas

Some of my questions have already been asked already, but could you break down the growth in Specialty? Because that came in at 10% this quarter, and I'm just wondering what lines of business are driving that.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes, that's gross. The net was, let's see...

D. Craig Mense
Chief Financial Officer and Executive Vice President

Minus...

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Minus 1.

John Thomas

And so why were those so different?

D. Craig Mense
Chief Financial Officer and Executive Vice President

It's the Asurion cellphone captive. I think we've talked about it before, but it's probably been a while since we've described it.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

That book is gross, so does not contribute to the net.

John Thomas

Okay. And then your exposure growth this year compared to last year, are you seeing increased business activity lower?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Slightly higher. But I'm telling you, slightly less than 1 point.

Operator

And it appears there are no further questions at this time. Mr. Motamed, I'd like to turn the conference back over to you for any additional or closing remarks.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Thank you very much. See you next quarter.

Operator
And once again, that does conclude today's conference. We appreciate your participation.