S&P Capital IQ

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Kemper Corporation NYSE:KMPR

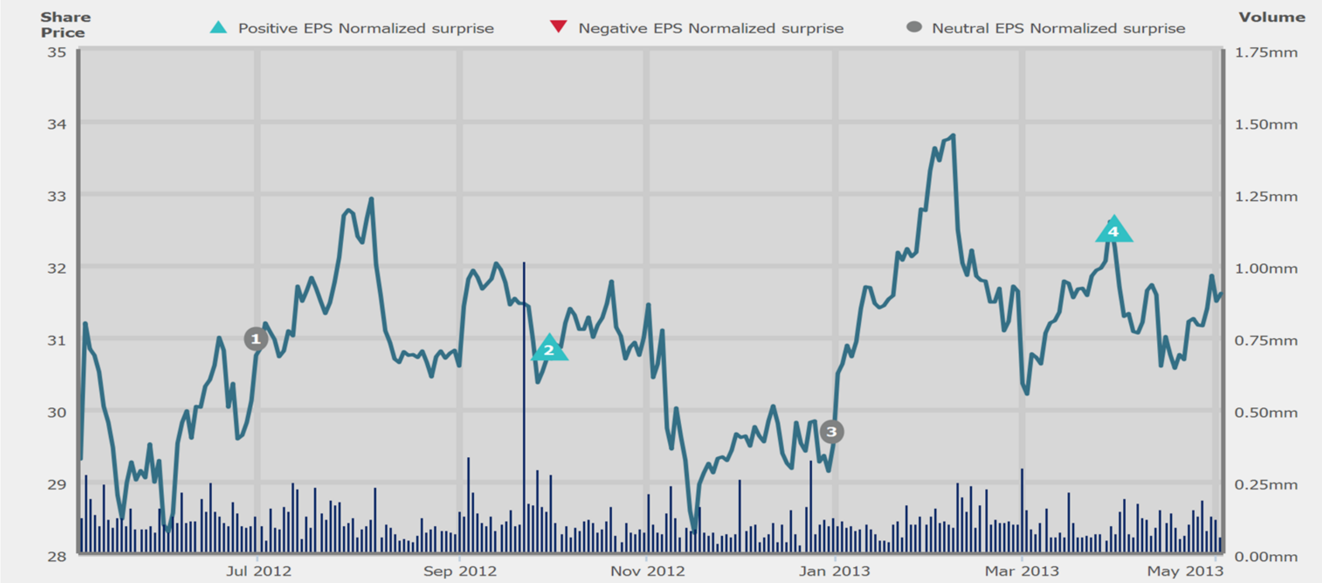
FQ2 2013 Earnings Call Transcripts

Friday, August 02, 2013 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2013-			-FQ3 2013-	-FY 2013-	-FY 2014-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.27	0.55	▲103.70	0.39	2.07	2.25
Revenue (mm)	585.63	588.90	▲0.56	584.19	2345.25	2327.53

Currency: USD
Consensus as of Aug-02-2013 7:41 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2012	0.10	(0.01)	NM
FQ3 2012	0.33	0.42	▲27.27 %
FQ4 2012	0.06	(0.06)	NM
FQ1 2013	0.52	1.00	▲92.31 %

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Call Participants

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Miranda Davidson

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Presentation

Operator

Good morning, ladies and gentlemen, and welcome to Kemper's Second Quarter 2013 Earnings Conference Call. My name is Stephanie, and I will be your coordinator today. [Operator Instructions] As a reminder, the conference is being recorded for replay purposes. I would now like to introduce your host for today's conference, Ms. Diana Hickert-Hill, Vice President, Investor Relations and Corporate Identity. Ms. Hickert-Hill, you may begin.

Diana J. Hickert-Hill
Vice President of Investor Relations & Corporate Identity

Thank you, operator. Good morning, everyone, and thank you for joining us. This morning, you will hear from 3 of our business executives, starting with Don Southwell, Kemper's Chairman, President and Chief Executive Officer; followed by Denise Lynch, Kemper's Property & Casualty Group Executive; and finally, Frank Sodaro, Kemper's Senior Vice President and Chief Financial Officer.

We will make a few opening remarks to provide context around our second quarter results. We will then open up the call for a question-and-answer session. During this interactive portion of the call, our 3 presenters will be joined by John Boschelli, Kemper's Vice President and Chief Investment Officer; and Ed Konar, Kemper's Life and Health Group Executive.

After the markets closed yesterday, we filed our Form 10-Q with the SEC and issued our press release and financial supplement. You can find these documents on the Investors section of our website, kemper.com. Please note that our discussion today may contain forward-looking statements. Our actual results may differ materially from these statements. For information on potential risk associated with relying on forward-looking statements, please refer to our Form 10-K filed with the SEC on February 15, 2013, as well as our second quarter 2013 Form 10-Q and earnings release. This morning's discussion includes non-GAAP financial measures that we believe may be meaningful to investors. In our supplement and earnings release, we have defined and reconciled non-GAAP financial measures to GAAP, where required, in accordance with SEC rules. And finally, all comparative references will be to the second quarter 2012, unless we state otherwise.

Now I will turn the call over to Don Southwell.

Donald G. Southwell
Former Chairman, Chief Executive Officer and President

Thank you, Diana. Good morning, everyone, and thanks for your interest in Kemper. Today, I'll discuss our overall results for the quarter. I'll also cover specifics on our Life and Health group and on our investment performance. Denise will provide more color on the Property & Casualty groups results, and Frank will review details on our financial results, capital and liquidity. Then I'll wrap up with comments on our capital deployment priorities.

So starting with our results. In total, Kemper had a strong second quarter. Our Property & Casualty underlying results improved across all segments, as did overall earnings. While cats were lower than last year, weather was still active. We based our plans on a higher level of cat activity so the second quarter results were within our plan. We generated $34 million of net income in the quarter, up from $2 million. On a net operating income basis, we earned $32 million compared to a $1 million loss. We're happy with our progress, yet we have more work to do.

Our Property & Casualty Group delivered strong improvement. Although some of this was the result of favorable development, we also improved our underlying performance. I'm pleased with the focus our team has on executing our operational plans and we remain committed to taking further action to improve fundamentals. Denise will cover our performance and plans in more detail.

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On the Life and Health side, earnings were up about 4%. For the life insurance line, mortality was more in line with historical levels. Investments were stable and we are encouraged by the recent rise in interest rates.

Our Reserve National business had mixed results. Income was lower in the quarter due to higher morbidity and higher expenses. Much of the expense increase involves expanding into new products and new distribution. The first of these expansion efforts, which we call senior solutions, is in the initial stages of rollout and is off to a fast start. We have more than 2,000 new brokers making sales to date, primarily with life products.

Of course, startup expenses for these new ventures put some pressure on our short-term results, but we believe they will prove to be a wise investment for future earnings.

The total Life and health group's year-to-date results are about $6 million behind the first half of 2012. At this point, we expect the second half of 2013 Life and Health earnings to be at about the same level as the second half of 2012.

Turning to investments. The portfolio delivered another quarter of stable results. We are encouraged by the recent rise in interest rates and we consider this to be a step in the right direction. These increases are ahead of the pace projected in the Federal Reserve base case scenario, which we continue to use for our planning purposes.

In July, we successfully completed the sale of the Kemper building, home of our corporate office here in downtown Chicago. We entered into a long-term lease agreement with a buyer for our office space and retained the naming rights and Kemper signage on the building. This sale resulted in a pretax gain of approximately $45 million, which we will report in our third quarter results.

In addition to producing a nice gain, this sale is consistent with our plans to decrease the real estate exposure in our investment portfolio.

Now I'll turn the call over to Denise, to provide color on the quarter's P&C results and her team's actions to improve profitability.

Denise Idell Lynch
Former Property & Casualty Group Executive

Thank you, Don. The Property and Casualty group's underlying results improved in the second quarter and year-over-year. We're focused on improving results through aggressive actions, such as rate increases, improved underwriting discipline and product line management. We like the direction of the Property & Casualty results and also acknowledge more work remains to be done. Four key highlights for the quarter include: First, the Property & Casualty combined ratio improved almost 15 points to 98.9% in the quarter. The underlying combined ratio improved by more than 5 points to 96.5%; second, while weather was active in the quarter, catastrophe events were not as severe as the last few years; third, we are making progress with the actions to improve pricing, product management and analytics capabilities, and we will continue to invest in these areas; and fourth, the direct runoff is selling well. While the quarter exceeded our expectations, we expect earnings for the rest of the year to be more in line with the second half of 2012.

Let's start our detailed review by looking at our largest business, Kemper Preferred. We're improving our results, in part, by improving our mix of business. Our Package Plus product, the premier offering for our target market, made up 60.5% of all new sales in the quarter and is running almost 4 points better on policyholder retention and monoline business.

The homeowners' line is showing strong improvement, net written premium was flat at $85 million, while earned premium grew 5%. The combined ratio of 101.6% for the quarter is a 34-point improvement and is due to a 24-point reduction in the catastrophe loss ratio and a 12-point improvement in the underlying loss and LAE ratio, which is at 52% for the quarter.

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The homeowners' line also benefited from favorable catastrophe and non-catastrophe reserve development. Our focus on improving the homeowners' portfolio is gaining momentum, with our average earned rate change of 8.4%, well ahead of stable loss trends. We are on pace for 14% filed rate increase for 2013, up from our original 10% plan. More work remains to be done and we will continue to implement the appropriate actions to improve and sustain the performance of the homeowners book of business.

In the auto line, net written premium was $127 million, down 5%. The decline is largely attributed to the purposeful management of new business. Earned premium was flat. The combined ratio was 103.7%, about 0.5 point improvement. This was driven by less catastrophe losses and more favorable reserve development, offset by a 1.7 point deterioration in the underlying loss and LAE ratio. We are disappointed with the performance of the auto book of business. We understand the issues and are working aggressively on them.

While the average earned rate increase was 3%, this is the second quarter the peer premium has increased mid single-digits, largely driven by higher severity and bodily injury, and to a lesser extent, in collisions. We continue to work on price adequacy with improved price segmentation and filed rate increases, which will be about 9% for 2013.

Now turning to Kemper Specialty. Kemper Specialty targets personal and commercial auto insurance consumers who have difficulty obtaining automobile insurance through the standard and preferred markets for a variety of reasons. I'll cover the results for Specialty's personal and commercial auto products for the quarter.

For personal auto, net written premium decreased 7% to $81 million, as new business declined in response to the rate increases taken across the country. Earned premium declined 9%. The combined ratio improved 14 points to 103%, as a result of less adverse development, improved underlying loss in LAE and lower catastrophe losses. Underlying results improved as the rate increases and price segmentation advancements led to an average earned rate increase of 7%, outpacing the moderating peer premium trends. We are ahead of our original filed rate plan, and now expect to file almost 9 points of rate increase in 2013.

Briefly turning to Kemper Specialty's commercial auto results. Net written premium increased 19% to $14 million, led by strong new business. Earned premium increased 25%. The combined ratio deteriorated 72 points to 116.8%, due to substantially less favorable reserve development and deterioration in the underlying combined ratio of 31 points to 120.6%. The underlying combined ratio deteriorated largely as a result of several large losses across the book. We remain on pace to file 7% rate increases in 2013. We also continue to tighten underwriting guidelines related to unprofitable volatile classes of vehicles, and are in the process of non-renewing a segment of these risks.

Overall, we are making progress toward our objective of a 4 to 5 point improvement in Kemper Specialty's underlying combined ratio in 2013.

Now I'll update you on Kemper Direct. The runoff of the direct to consumer business continues to go well. Net written premium at $28 million was down 23% with new business flowing and retention performing about as expected during this runoff period. Earned premium was down 28%.

The combined ratio improved 47 points to 74% due to favorable reserve development, improved underlying results, lower catastrophe losses and lower expenses. The underlying loss in LAE ratio improved 19 percentage points. The favorable reserve development was mostly from bodily injury and Michigan ticks. Indirect, we continued to: One, take rate actions in line with indications, as well as other underwriting actions to manage profitability through the runoff; two, manage our expense structure as the premium declines; and three, market our affinity and work site programs through our Kemper select channel.

To summarize the Property & Casualty Group, we are pleased with the progress in many areas, but have more work to do. The Kemper Property & Casualty teams are focused, skilled and committed to achieving improved results and continue to drive towards a 3 to 5-point improvement in the underlying combined ratio in 2013.

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Now I'll turn the call over to Frank.

Frank Joseph Sodaro
Former Senior Advisor

Thanks, Denise, and good morning, everyone. Today, I'll cover Kemper's second quarter 2013 performance and parent company capital and liquidity. As Don mentioned, overall, we had another strong quarter with net income of $34 million or $0.59 per share, up from $2.3 million or $0.04 per share. Kemper had net operating income of $32 million for the current quarter compared to a $1 million net operating loss last year. Total revenues were $589 million for the quarter, a $20 million decrease driven by lower earned premiums. This change was in line with our expectations and mainly the result of actions we took in Kemper Direct and Kemper Specialty.

Consolidated net investment income across the portfolio remained steady at $75 million. Equity method investments earned $4 million for the quarter, an increase of $3 million. The second quarter annualized pretax equivalent book yield on average invested assets was 3 -- 5.3%, down about 35 basis points. The market value of our fixed maturity investments declined about $150 million after-tax due to the increase in interest rates and credit spreads. However, we welcome this increase in yields as our average investment rate fixed maturity reinvestment rate increased about 13 basis points in the quarter. As Don mentioned, the third quarter will include a pretax gain of about $45 million from the sale of the Kemper building.

I'll now discuss the details of each of our businesses starting with P&C. Kemper Preferred reported net operating income of $11 million for the quarter, up from a net operating loss of $10 million. Overall, Preferred's combined ratio was 99.7% for the quarter, an improvement of nearly 15 points, largely due to lower catastrophe losses, higher favorable reserve development and improved underwriting results. The underlying combined ratio was 94.1%, more than 2 points improvement as improvements in the homeowners line and other lines were partially offset by an increase in the auto line.

Preferred's net written premiums were $226 million in the quarter, $7 million lower than last year. Net earned premiums were $222 million in the quarter, up from $218 million, and the 6% drop in policies enforced was offset by the higher premium rates Denise mentioned earlier. Overall, premium retention was 87.4%.

Now turning to Kemper Specialty. We reported net operating income of $1 million for the second quarter compared to net operating loss of $3 million last year. The combined ratio in Kemper Specialty improved nearly 5 points to 104.9%. This was primarily due to a 3-point improvement in the underlying combined ratio. Specialty's net written premiums were $95 million in the quarter compared to $99 million last year, and net earned premiums were $101 million compared to $107 million last year. These results are in line with our expectations, given the level of rate actions we have implemented and are driven by lower personal auto and new business volumes, with total policies enforced down 16%. This was partially offset by higher personal auto average earned premium rates and higher commercial auto volume.

Now I'll turn to Kemper Direct. I'll remind you that it was in July 2012, we announced we were ceasing direct marketing activities in the Direct segment, so this is the last quarter in which we compare the full-scale operations in the prior period.

In the quarter, we reported net operating earnings of $8 million compared to net operating loss of $3 million last year with a 73.6% combined ratio this year compared 121% last year. Kemper Direct's improvement came on 2 main fronts. First, the underlying combined ratio improved by more than 25 points to 94.9%. And second, we experienced favorable reserve development of $8 million pretax this quarter compared to $2 million favorable development last year.

Losses improved in the quarter with lower frequency and lower severity. The expense ratio was particularly favorable in the second quarter coming in at 27.7% versus 34.4%, due to reduced marketing and other underwriting costs. While we expect the expense ratio to increase throughout the remainder of 2013, we do not -- or we do expect the overall 2013 expense ratio to come in lower than 2012.

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Kemper Direct's net earned premiums were $32 million for the current period, down from $44 million and in line with our expectations. Auto and Home average earned premium rates increased in the second quarter by 4% and 15%, respectively, but were more than offset by lower volume. With the reduction in premiums and the runoff of reserves, we currently allocate about $145 million of capital to support this business.

Shifting to the Life and Health segment. Net operating income overall was $20 million in the quarter, an increase of $1 million. Earned premiums for the segment were $159 million, down $2 million and net investment income remained steady at $32 million after tax. The Life business experienced $3 million lower cat losses on the property insurance products sold through our home service agents. This was offset by $2 million higher morbidity with Reserve National's health products, in addition to the startup expenses Don mentioned.

Finally, I'll discuss book value, capital and parent company liquidity. Book value per share was $35.14 at the end of the quarter, down year-over-year and from yearend, due to the impact of higher interest rates and credit spreads in our fixed maturity portfolio. Book value per share, excluding unrealized gains on fixed maturities, was $31.91, up 6% year-over-year and 4% from yearend. Statutory surplus levels in the insurance companies remain strong and we expect to end the year with risk-based capital ratios of approximately 480% for the Life and Health Group, and 340% for the Property & Casualty Group. We currently have an ordinary dividend capacity of about $180 million from our insurance companies and we are still targeting $95 million of dividends from these companies to the holding companies in 2013.

And finally, from a liquidity perspective, the holding company ended the quarter with cash and investments of about $125 million, and our $325 million revolving credit line remains undrawn.

And now, I'll turn the call back to Don.

Donald G. Southwell
Former Chairman, Chief Executive Officer and President

Thank you, Frank. Thanks, Denise. I'll wrap up our prepared remarks with a few comments on our capital deployment plans. We continue to be in a strong capital position and our long-term capital deployment priorities remain unchanged. These include: one, funding profitable organic growth; two, strategic acquisitions; and three, returning capital to shareholders, both through share repurchases and dividends.

Also unchanged are our short-term capital priorities. As we indicated in our first quarter call, we do not plan to fund organic growth while we reposition for profitability in 2013. Despite the considerable progress and profitability, we have more work to do. we also want to see continued operational improvements before making an acquisition, although we are keeping some powder dry for the future.

So returning capital to shareholders remains our capital priority this year. We have maintained our competitive dividend and continue to buy back shares opportunistically. In the second quarter, we repurchased $42 million worth of shares, bringing our total to 1.5 million shares repurchased in the first half of 2013, to about $48 million.

Last quarter, we stated our goal to achieve a double-digit ROE by the end of 2015 on a run rate basis, and we outlined a path with 4 main elements: First, continued improvement in our P&C combined ratio; second, full deployment of available capital; third, increases in interest rates consistent with the Federal Reserve baseline scenario published in November 2012; and fourth, normalize catastrophe losses. Progress in 2013 has been consistent with our plans to reach that goal.

So in closing, I'm pleased with our overall results in the quarter and year-to-date. Our underlying performance continues to improve and our actions are aligned to drive further progress.
At this time, I'll turn the call back over to the operator so we may take your questions. Operator?

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Question and Answer

Operator

[Operator Instructions] Our first question comes from Miranda Davidson with Raymond James.

Miranda Davidson

I was wondering if we could talk a little bit more about Direct? If I remember correctly, you were getting out of everything but the affinity group. Can you add some color as to where you are in that process?

Denise Idell Lynch
Former Property & Casualty Group Executive

This is Denise. Thank you very much for the question. The Direct runoff is going very well. We have the direct to consumer runoff that is proceeding as expected. With the renewal book, the new business is down, as we would have expected. The overall direct to consumer business is performing well. The affinity book, we continue to maintain and we'll invest in as we have the opportunity.

Miranda Davidson

Well, margins are looking pretty strong, have you revisited the possibility of potentially selling the segment?

Donald G. Southwell
Former Chairman, Chief Executive Officer and President

Miranda, this is Don. We continually get some inquiries around selling the business. But it is of considerable value to us to keep it both in terms of profits we expect to harvest, as well as some fixed cost coverage, and we don't anticipate a sale.

Miranda Davidson

And one other thing, if I could, regarding the sale of your building, what are your plans for the proceeds, is that also towards the repurchases that you mentioned or did you have something else in mind?

Donald G. Southwell
Former Chairman, Chief Executive Officer and President

It's general corporate money. We've got a considerable amount of liquidity, and it doesn't really affect our repurchases one way or the other. Frank, do you have any comments you want to add?

Frank Joseph Sodaro
Former Senior Advisor

So the only thing I would add is that with the proceeds, we had to pay off a mortgage that was taken out on the building with Trinity. So that will come right off the top. But other than that...

Operator

[Operator Instructions] Our next question comes from Adam Klauber with William Blair.

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

A couple of different questions. Preferred auto. Obviously, you're doing a lot to that business, but the market conditions are still challenged. Do you think we'll see more of a turnaround in the loss ratio in 2014 or are we going to see some evidence in '13?

Denise Idell Lynch
Former Property & Casualty Group Executive

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Thank you for the question. We're working hard in our Preferred business segment to turn around that auto book of business. The quarter, we experienced some adverse peer premium trends, but we are working hard with rate increases. As I mentioned, we're filing about 9% this year on top of the 8% last year. We are working hard on our segmentation and our risk selection and how we're managing our new business flow, consistent with our underwriting guidelines. So what I would say is that we are working hard on this book of business and would expect to see this business improve over time.

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

Okay. Well, what was the -- I'm sorry if you said this before, but what was the retention on that book this quarter versus a year ago?

Denise Idell Lynch
Former Property & Casualty Group Executive

The retention of the auto book of business is actually down slightly compared to where we were a year ago. In the auto book of business, on a premium basis, it's actually holding pretty nicely. But on a policy basis, we're giving up some retention there.

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

Okay. And that's what you'd expect?

Denise Idell Lynch
Former Property & Casualty Group Executive

Right.

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

On the homeowners, clearly, you're beginning to see results. But given that, that's been a challenging line, not just for you, but for the industry, do you think you need to hit that with a fair amount of rate in 2014, on top of what you're already doing this year?

Denise Idell Lynch
Former Property & Casualty Group Executive

Well, it's our expectation to continue to manage that book of business until it meets our desired returns. As we said before, this year, we are expecting to file a pretty substantial rate increase of about 14%, that's higher than our original plan of about 10%. We're managing that book of business with other coverage condition changes, risk selection issues and cat management. And we'll watch the trends there and continue to take the actions that we need to get the results that we expect.

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

Okay. But then, as far as we look at the specialty here, or that non -- what I call nonstandard segment. How's the competition in that market are you seeing? Traditionally, you have some MGAs with a fair amount of capacity. And then, you have some large nationals, you have some regionals. I guess, what are the different competitive forces doing right now?

Denise Idell Lynch
Former Property & Casualty Group Executive

Generally, I'd say that in our non-standard book of business, what we are seeing, our specialty book of business, what we're seeing are firming market conditions. Now naturally, it's variable by geography. But overall, what we're seeing is firming market conditions with most competitors taking rates across the country.

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

Okay. That's helpful. Then, sorry if you said this, but with the sale of the building, are those funds already at the holding company or are they at one of the subsidiaries?

Frank Joseph Sodaro
Former Senior Advisor

They're not directly at the holding company, but they're not in the insurance subsidiaries either. So it's the company right beneath the parent.

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

Okay. And that's what you've said, you mentioned the gain, but as far as actually funds, you mentioned you had to pay off a mortgage. So what's the resulting funds that you actually get after you pay off the mortgage?

Frank Joseph Sodaro
Former Senior Advisor

At the -- what will ultimately become available to parent will be somewhere in the range of $40 million to $45 million.

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

Okay. Somewhat of a gain then?

Frank Joseph Sodaro
Former Senior Advisor

Correct.

Operator

Our next question comes from Gregory Macosko with Lord, Abbett.

Gregory M. Macosko
Lord, Abbett & Co. LLC

Just with regard to the Specialty business. The commercial auto grew pretty nicely on top of the rate expectations that you filed. Now could you give us some color there as to how that Specialty business will balance out or kind of where you expect it to balance between the personal auto and the commercial auto?

Denise Idell Lynch
Former Property & Casualty Group Executive

Yes. The commercial business in our Specialty group is certainly a smaller percent of our overall book of business. Historically, it's been a very good book of business for us, although we acknowledge this has been an unfortunate quarter for us. Where our growth is coming from is in -- we're pleased with where that growth is coming from and we'll continue to concentrate our underwriting and risk selection in the class of the business where that makes the most sense for us.

Gregory M. Macosko
Lord, Abbett & Co. LLC

Okay. And then, I assume this is similar with regard to the auto that -- do you expect a stabilization of that book within the next few quarters? In terms of the premium decline?

Denise Idell Lynch

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Former Property & Casualty Group Executive

We do. In fact, if you look at the quarter compared to the year, we're actually seeing that stabilize. So we do expect that.

Operator

[Operator Instructions] Our next question comes from Matt Carletti with JMP Securities.

Matthew John Carletti
JMP Securities LLC, Research Division

Just a real quick question on capital management. I guess, in the category of high quality problems, the stock's performed very well since the close of the quarter. Can you talk a little bit about kind of your sensitivities to valuation of the stock in terms of your aggressiveness in buying back the shares?

Donald G. Southwell
Former Chairman, Chief Executive Officer and President

Matt, this is Don, and I'll take that and then I'll see if Frank has some commentary to add. Clearly, we've described our posts to buybacks as opportunistic and we do care about the stock price. I like to talk in extremes. At below tangible book, it's a no-brainer. And if we were trading 2x book, we would be hard-pressed to buy. It's the space in the middle where things get a little tougher to make a call. But I guess I would just say that at today's levels, we would still expect good EPS accretion and we do this as an attractive price today. Do you have anything to add, Frank?

Frank Joseph Sodaro
Former Senior Advisor

Not really. I think you really summed it up with just saying we'll remain optimistic at this level.

Operator

And I'm currently showing no further questions. At this time, I will now turn the call back over to Don Southwell for closing remarks.

Donald G. Southwell
Former Chairman, Chief Executive Officer and President

Thank you, operator. I do have just a few closing comments.

We're pleased with our progress to improve profitability in each of our businesses and we do remain focused on the milestones that we outlined earlier for 2013. We're executing well on our plans and we will continue to address any challenges that arise. We fully intend to deliver on the promises we make to our customers and to deliver the shareholder returns that we all seek. So thank you for your time this morning. We'll update you on our progress again next quarter.

Operator
Thank you, ladies and gentlemen, that does conclude today's conference. You may all disconnect, and have a wonderful day.

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