S&P Global
Market Intelligence

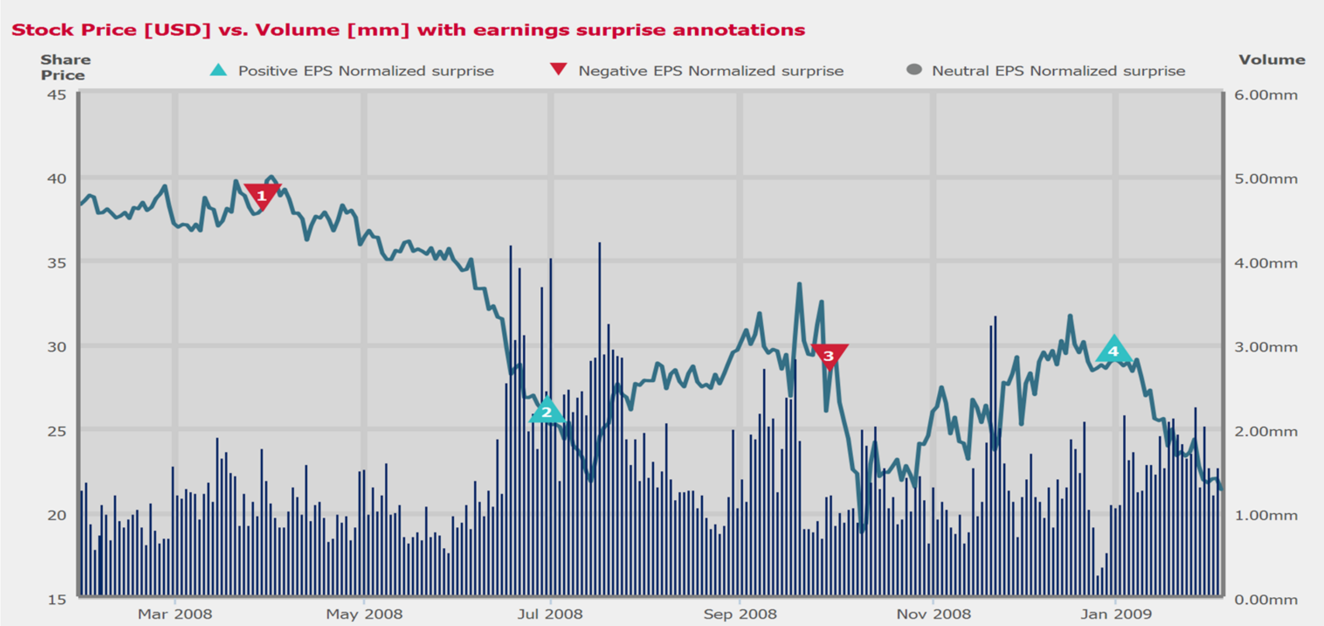
Cincinnati Financial Corporation NasdaqGS:CINF
FQ1 2009 Earnings Call Transcripts

Thursday, April 30, 2009 3:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ1 2009-			-FQ2 2009-	-FY 2009-	-FY 2010-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.20	0.23	15.00	0.43	1.65	2.12
Revenue	-	-	(1.68 %)	-	-	-
Revenue (mm)	905.23	890.00	-	910.23	3639.23	3712.33

Currency: USD
Consensus as of Apr-30-2009 2:32 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ1 2008	0.71	0.66	1 (7.04 %)
FQ2 2008	0.28	0.42	2 50.00 %
FQ3 2008	0.50	0.45	3 (10.00 %)
FQ4 2008	0.52	0.57	4 9.62 %

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EXECUTIVES

Dennis E. McDaniel
VP & Investor Relations Officer

Kenneth William Stecher
Non-Executive Chairman of the Board

Martin Francis Hollenbeck
Chief Investment Officer, Senior VP, Assistant Secretary & Assistant Treasurer

Steven Justus Johnston
President, CEO & Director

ANALYSTS

Dan Schlemmer
FPK

J.F. Scherer

Michael Phillips
Stifel Nicolaus

Paul Newsome
Sandler O'Neill & Partners

Presentation

Operator

Good morning. My name is Ken and I will be your conference operator today. At this time I would like to welcome everyone to the Cincinnati Financial first quarter earnings call. (Operator Instructions) Now I would like to turn the call over to Mr. Dennis McDaniel. Sir?

Dennis E. McDaniel
VP & Investor Relations Officer

Hello. This is Dennis McDaniel, Cincinnati Financial's Investor Relations Officer. Thank you for joining us for our first quarter 2009 conference call. This morning we issued a news release on our results along with our supplemental financial package. We also filed our quarterly report on Form 10-Q. If you need copies of any of this material, please visit our investor website, www.cinfin.com/investors. The shortest route to the information is in the far right column via the quarterly results quicklink.

On the call you will hear from Ken Stecher, President and Chief Executive Officer, and Steve Johnston, Chief Financial Officer. After their prepared remarks, we will open the call for questions. At that time, some responses may be made by others in the room with us. That includes Chairman Jack Schiff Jr.; Executive Vice President J.F. Scherer of Sales and Marketing; Principal Accounting Officer Eric Mathews; and Senior Vice Presidents Marty Hollenbeck, Investments, and Marty Mullen, Claims.

First, please note that some of the matters to be discussed today are forward-looking. These forward-looking statements involve certain risk 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, reconciliation of non-GAAP information as record by Regulation G was provided with the release and is also available on our website. Statutory data is prepared in accordance with Statutory Accounting Rules and therefore is not reconciled to GAAP. With that, let me turn the call over to Ken.

Kenneth William Stecher
Non-Executive Chairman of the Board

Thank you, Dennis. Welcome and thanks to all of you for joining us today. First quarter financial results were not good. There is simply no escaping that fact. Steve will discuss main drivers of results for the quarter, including details on catastrophes and our reserve development on old business. I'll focus on areas we are working on now to improve future financial performance.

Historically, we have successfully operated in soft markets as well as hard markets. But at this time we also have to contend with economic conditions that have not been experienced since our Company was founded. Just the same, we are confident we can deliver strong performance over the long term for several reasons. First, our strong agent relationships help offset some of the negative effects of the continuing soft market. Agents generally give us their best quality risk with higher profit margins, providing more pricing flexibility during soft markets. Recent sales meetings reinforce the Cincinnati value proposition.

Agents can sell our superior claims service in our multiyear policies, which offer some price protection for policyholders. That is becoming more attractive as industry watchers predict that pricing trends are beginning to shift.

The partnership approach between our Company and our independent agents is becoming a more important differentiator in this market and as the markets and the economy improve, we expect it will bring opportunities to us. We're supporting that partnership with improved technology that will make it easier to attract our agents' best new business.

Technology upgrades are a major focus of our near-term strategy. I meet regularly with our technology project leaders and also like to walk through the area where system developers are working on details.

Our new system to process commercial packages and commercial auto should give our agents the efficiency they need and the support they need for strong front-line underwriting. It will give agents capabilities such as real-time policy quoting and issue, single point of entry, and flexible payment options including direct bill, similar to recent upgrades to our personal lines system. We expect agencies in 11 states to have the system before year-end.

Secondly, we believe we can improve long-term performance because our local market presence has always allowed us to be more selective in pricing many risks compared with competitors that lack such specific knowledge of the risk.

Going forward, our recent introduction of new predictive modeling tools should further assist our underwriters, enhancing pricing sophistication and improving results, especially for the challenging workers compensation line.

The third reason we are confident is that we are comfortable with our new business growth. We remain willing to decline under-priced business, both new and renewal. Many accounts are renewing with flat pricing or modest increases compared to the expiring policy premium. But others with significant profit margins renew with lower pricing due to competitive pressures, particularly larger sized accounts.

Our first quarter of 2009 new business stemmed from our 2008 agency, geographic, and product expansions; and there are advantages to this approach. In new states or agencies many of the accounts we receive are ones that the agent has controlled long enough to really understand the risk. Those accounts generally are more attractive to us than new risk that the agent has won from another agent. Profit margins tend to be better on more established risk.

29% of first-quarter overall new business premium growth is from our surplus lines operations started in January 2008. 40% of commercial lines new business was from agents appointed since January 2008 and 1/3 of personal lines new business is from states where we started or expanded personal lines offerings since January 2008. Studies have shown that business written on an account basis covering most or all of the risk profile is more profitable in the long run than individual policies covering only part of the policyholders' risk profile.

Offering surplus lines allow us to write $4 million of standard market commercial new business that we may not have otherwise written. For personal lines, 2/3 of our new homeowner business included the policyholder's auto. Better catastrophe spread of risk is another benefit of our geographic expansion. As part of our personal or commercial lines expansion, we've recently entered six Western states. On average, the five-year industry ratio for catastrophe losses across all lines in those states is about 3 points better than our average catastrophe ratio from our historical book of business with a smaller geographic footprint.

In the first quarter of 2009, we also began marketing our personal lines products in Idaho and South Carolina.

Now I'd like to comment on our financial strength and flexibility. We are comfortable with our repositioning of our equity portfolio, and Steve will elaborate on this. Our fixed maturities portfolio remains high quality and it fully covers insurance liabilities. As announced earlier, our Board decided to hold off for now on increasing the annual indicated shareholder dividend.

Excellent liquidity at the Parent Company and the earnings potential of the subsidiary companies continue to provide capital flexibility for shareholder dividends despite relatively weak earnings during first quarter of 2009. If financial markets stabilize, that obviously improves that flexibility, even more so if financial markets improve somewhat. With more than $500 million in cash and cash equivalents, plus strong statutory surplus, we also have ample capacity for future growth of insurance operations.

Now I will turn it over to Steve to discuss specifics of the first quarter results. Steve?

Steven Justus Johnston
President, CEO & Director

Thank you, Ken. The property and casualty combined ratio was 107.5%, representing an underwriting loss of $55 million. Two lines of business, homeowners and workers compensation, added approximately 13 percentage points to the overall combined ratio. As previously announced, the homeowners line was most affected by the cats. It accounted for $36 million of our $53 million in catastrophe losses. In total, three storms contributed 7.2 points to the overall combined ratio. In addition, reserve increases on prior accident years contributed 0.9 points to the first quarter combined ratio.

Nothing has changed in terms of our reserving philosophy, and we continue to target total reserves to be in the upper half of the actuarial range. A $20 million increase to prior years' workers compensation reserves was the largest driver, adding 2.7 points to the overall combined ratio. In terms of accident years for workers compensation reserve development, $8 million was added to accident years 2006 through 2008, and $12 million was added to accident years prior to 2006.

Workers compensation is a volatile, long-tailed line that requires a cautious, conservative approach. Our actuaries' analysis of loss payment trends caused them to increase the assumption for the calendar year inflation trend by 9/10 of 1 percentage point. While this is a relatively small change in assumptions, it had a large impact because of the long-tail nature of workers compensation.

As Ken mentioned, we continue to diversify and reduce risk in the investment portfolio. During the first quarter, we sold all of our remaining bank stocks, including the remaining 12 million shares of Fifth Third Bancorp. Those sales reduced the weighting of the financial sector in the stock portfolio to 2.9% at March 31, 2009, down from 12.4% at year-end 2008 and 56.2% at year-end 2007.

The $2.3 billion equity portfolio represented 26.2% of the total investment portfolio at quarter end and that's down from 32.9% at year-end 2008 and 51.2% at year-end 2007. Also, common stocks now represent less than 50% of the property-casualty company's statutory surplus.

The equity portfolio ended the quarter still in a gain position, with $309 million in net unrealized capital gains. As a result of the transformation of the portfolio over the past year, pretax investment income decreased 18.7% quarter-over-quarter to $124 million. I think the impact of the changes is represented well in the chart on page 32 of the Form 10-Q that we filed this morning. Dividend income decreased by $46 million to $27 million, while interest income increased by $20 million or 34.7% to $96 million.

We expect investment income to resume an increasing trend in the second half of the year.

I'd like to add a few words to Ken's comments about our financial strength. Despite the underwriting losses our liquidity, balance sheet, and financial condition remain strong. At the property-casualty subsidiary level, we are writing business at a premium-to-surplus ratio of 0.97-to-1. In addition, we have over $1 billion in assets at the Holding Company, and that provides financial flexibility.

We also have short-term unused borrowing capacity on two lines of credit of approximately $175 million. Our debt-to-total capital ratio is 17.8% and our two non-convertible, non-callable debentures are not due until 2028 and 2034. A key point is that with the changes and improvements we have made on a risk-adjusted basis, we remain financially strong.

As unusual as it may sound, Cincinnati Insurance Company's RBC ratio, measured as the ratio of total adjusted capital to authorized control level risk-based capital, actually improved to 8.3 times at year end 2008 from 7.0 times at year end 2007. So although statutory surplus has declined to $3.4 billion at year end 2008, the increased diversification and reduced risk in our portfolio worked to improve the risk-based capital ratio.

Similarly, Cincinnati Life Insurance Company's RBC ratio improved from 7.7 times at year end 2007 to 8.0 times at year end 2008, and they continue their steady, positive performance.

The key point is on a risk-adjusted basis our current surplus level is better positioned to support our current risk level than was the case at year end 2007. The progress we've made in managing risk adds confidence about our longer term prospects.

We are using a value creation ratio to measure our long term success. More specifically, between 2010 and 2014 we are targeting a 12% to 15% average for the total of our rate of growth in book value per share plus the ratio of dividends per share to beginning book value per share.

As predicted, 2009 is proving to be challenging. Our value creation ratio is minus 5.7% through quarter end, compared with minus 5.4% for the first quarter of 2008. The economy may continue to create challenges for us as well as for others. There is potential for business closings, shrinking payrolls, declines and receipts and other exposure bases. These are difficult times, but we have successfully navigated through tough environments before, guided by our long-term focus on cultivating our agency relationships, making decisions at the local level, providing excellent claims service, adequately reserving, and investing for the long term. We are confident we will continue to do so. Ken?

Kenneth William Stecher
Non-Executive Chairman of the Board

Thanks, Steve. Steve expressed pretty well how we are not letting the challenges distract us from the work we have to do. Our associates and agents are energetic and excited about the improvements and expansions on our horizon. I have to tell you, the mood is upbeat in our offices and in the field, where we recently met person-to-person with agents at our sales meetings.
With that, let me open up the call for questions. Just a reminder that Jack Schiff, J.F. Scherer, Eric Mathews, Marty Mullen, and Marty Hollenbeck are here with Steve and me and are available to respond. Ken, we are ready for questions.

Question and Answer

Operator

(Operator Instructions) The first question comes from Michael Phillips.

Michael Phillips
Stifel Nicolaus

Michael Phillips, Stifel Nicolaus. First question, can we focus a little bit on personal lines and the growth there, not including the new business growth, so kind of the renewal business and then the stuff with agents that have been around since '06, '05, '04? I understand that the focus you're doing now with returning to profitability or getting more profitable business in there and (inaudible). I think you've talked in the past about rate increases for different tiers, and rate decreases for different tiers. But help us think about how overall for the renewal business, what you are doing, I guess, in the near term to help with growth given a pretty favorable rate environment that we are seeing from most of the competitors as well.

J.F. Scherer

Michael, this is J.F. We are getting the growth as we stated from agents we've appointed in newer states and also agencies that up to this point had been commercial lines only appointments for us. But we are seeing nice growth really across the board in all states from all agencies. There hasn't been a change in the strategy or approach. We have in fact reduced the rates on the better insurance scores, raised rates on worse insurance scores; and we will continue to do that. Later this year we are seeing the opportunity to raise base rates across the board in the homeowner line of business.

So from a strategy standpoint, as you can tell from the increase in new business and personal lines, we are seeing a nice increase from all agencies across all states but it is continuing to fine-tune the scoring methods.

Kenneth William Stecher
Non-Executive Chairman of the Board

Mike, this Ken Stecher. I would like to just add a little color too on the comment, we are targeting personal lines in Arizona, Idaho, Montana, and Utah. As I said in my comments, the catastrophe exposure there historically has been dramatically less, and it is part of the geographic diversification that we are stressing. We think that that will help stabilize the book a little bit. Obviously, it's going to take a while till that is completely accomplished because we have such a huge book in the Midwest currently.

Michael Phillips
Stifel Nicolaus

I think you mentioned recently the amount of technology spend you expect to kind of flow through in 2009. Has that number changed any recently? I think you said somewhere between $50 million and $60 million, I think.

Kenneth William Stecher
Non-Executive Chairman of the Board

That number is still pretty firm. It may come in a little better, but we have not really publicly changed our outlook. What we have found is we were able to accomplish a little more with internal resources, had less need for contractors. So the potential there is to save us some dollars. But right now we're still sticking with the $50 million number, Mike.

Michael Phillips
Stifel Nicolaus

Now I may not be looking at this correctly. If I look at your investment holdings that you put out earlier for the first quarter, not the equity but the bond holdings, and compare that to last quarter, it looks like the unrealized losses improved by around $100 million for the bond portfolio this quarter. Am I reading that right? And if so, what's behind that?

Martin Francis Hollenbeck
Chief Investment Officer, Senior VP, Assistant Secretary & Assistant Treasurer

Michael, this is Marty Hollenbeck. Yes, that is a fair read. That's driven largely by we have been very aggressive buyers of new issues in the first quarter, which pretty much across the board tightened after new issues. That's probably the biggest driver. We bought $500 million in corporate bonds the first quarter.

Operator

The next question comes from Paul Newsome from Sandler O'Neill and Partners.

Paul Newsome
Sandler O'Neill & Partners

Good morning. I was hoping you could go into a little bit more detail on the workers comp charge. You covered it quite a bit, but a lot of your peers are not having similar problems. I was wondering if you could kind of think about or may be different, to give you an issue today that others don't seem to be having right now.

Kenneth William Stecher
Non-Executive Chairman of the Board

That's a good question, Paul. I think for one it's just a cautious approach to workers comp. It is a volatile line, it's got a long tail. I think that our actuaries are doing a good job in terms of the statistical basis that they look at the reserves. They focus on paid development and they do a multiple regression that regresses over the accident year, the development year, and the calendar year. I think that regression over the calendar is not unique, but I think it's an area that we particularly focus on and did pick up what turned out to be less than 1% or 0.9 of a percent in the calendar year trend. They look at 30 years of accident years. So when you take what seems to be a relatively small change in calendar year inflation and put it over that whole line and all those accident years I think is what generated the development. But again I guess I would just like to focus on the cautious nature that we're looking at this volatile line.

Paul Newsome
Sandler O'Neill & Partners

Separately, how do you think about cat load? Given that we have had a really remarkably long string of bad Midwestern weather. Have you increased it? Can you push through prices, through the regulators, to allow you to increase it? It does seem like just given what we've seen for a couple years now here in cat loads that the business could use some extra pricing.

Steven Justus Johnston
President, CEO & Director

Yes, that's another good point. I mean these weather-related losses have been extreme in the recently weeks. I don't sense that we've had regulatory pushback in terms of rate filings, at least in the Midwest. I mean Florida would be a different issue, obviously. But in terms of the catastrophe losses that have taken place more recently.

To my knowledge, we are not changing the way that we look at cat loads, that we are taking a long-term approach in terms of taking the catastrophe losses out, spreading them over longer periods, and then adding them back in. But I do think your point is well taken, that given this recent experience, it requires a good, hard look.

Paul Newsome
Sandler O'Neill & Partners

Great, thanks, guys.

Kenneth William Stecher
Non-Executive Chairman of the Board

Paul, this is Ken. If I could just go back to your work comp change. Just one of the things you mentioned about maybe our book differently, the one thing I think that we may be late to the game was with predictive modeling on that line of business. And that is something that we have completed the process; we have built a system now. We're going to start utilizing that here in the last half of this coming year, 2009. So hopefully, that will benefit us a little bit in pricing each of those risks accordingly, and hopefully we hope to see some benefits from that going forward.

Operator

(Operator Instructions) And our next question comes from Dan Schlemmer from FPK.

Dan Schlemmer
FPK

Hi, good morning. I was curious if you could give us a little more insight on how you are thinking forward about your portfolio. I guess maybe, I think my understanding, of course you'll correct me if I'm wrong. My understanding is historically, you have somewhat intuitively matched equities with your surplus number; and reserves have been backed by fixed income; and those ratios between those reserves to fixed income have changed substantially just in this quarter. Is this something you think is a permanent change? How are you thinking about, when you would get back into equities? Or what it would take for you to move back towards a higher equity portfolio?

Martin Francis Hollenbeck
Chief Investment Officer, Senior VP, Assistant Secretary & Assistant Treasurer

Dan, it's Marty Hollenbeck. We are still at a little over 25% equities, which is not a number we are always comfortable with. We may take it higher going forward; and then ideally it goes higher on its own as the market depreciates. I think we are not going to go back to the days of very high equity levels. We are going to have a more diverse portfolio. We are going to focus for the near-term on fixed income and increasing investment income. And as we make progress there, we will continue through the course of the year to rework the equity portfolio and continue the process of achieving diversification.

Dan Schlemmer
FPK

Do you have a long-term ratio? Whether it's fixed income versus equity or whether it's just that sort of matching of the reserves to fixed income. Do you have a long-term target that you are aiming for? Or is it going to be more driven by market conditions?

Martin Francis Hollenbeck
Chief Investment Officer, Senior VP, Assistant Secretary & Assistant Treasurer

I would say that market conditions always are a key component. But we will continue to maintain bonds at an adequate level to cover reserves, or some slight excess to that. Sp. we do not have a long-term hard target, to answer your question.

Dan Schlemmer
FPK

Okay. And then separately, the favorable development, you talked through workers comp. What did you have in the quarter, excluding just the workers comp charge, which I think you have covered pretty well?

Steven Justus Johnston
President, CEO & Director

The rest of the numbers would have been favorable development. The workers comp was -- I mean in total, would be favorable. The workers comp was about a $20 million adverse development; and the total was a little over or right around $7 million in adverse development. So, the remainder developed favorably by approximately $13 million.

Dan Schlemmer
FPK

And there wasn't any specific, just more of a general, across lines and across years? There wasn't a specific favorable development that drove the number?

Steven Justus Johnston
President, CEO & Director

I would say that the commercial casualty was probably the strongest in terms of favorable development.

Dan Schlemmer
FPK

All right. Very helpful, thank you.

Operator

This now concludes the Q&A portion of the call. I will now turn it back over to Ken Stecher, for any closing remarks. Go ahead, sir.

Kenneth William Stecher
Non-Executive Chairman of the Board

Well, thank you for all joining us today. We look forward to speaking with you again on our second quarter call on July 30. Have a great day. Thank you.

Operator
This now concludes your Cincinnati Financial first quarter earnings call. You may now disconnect.