S&P Global
Market Intelligence

American Financial Group, Inc. NYSE:AFG

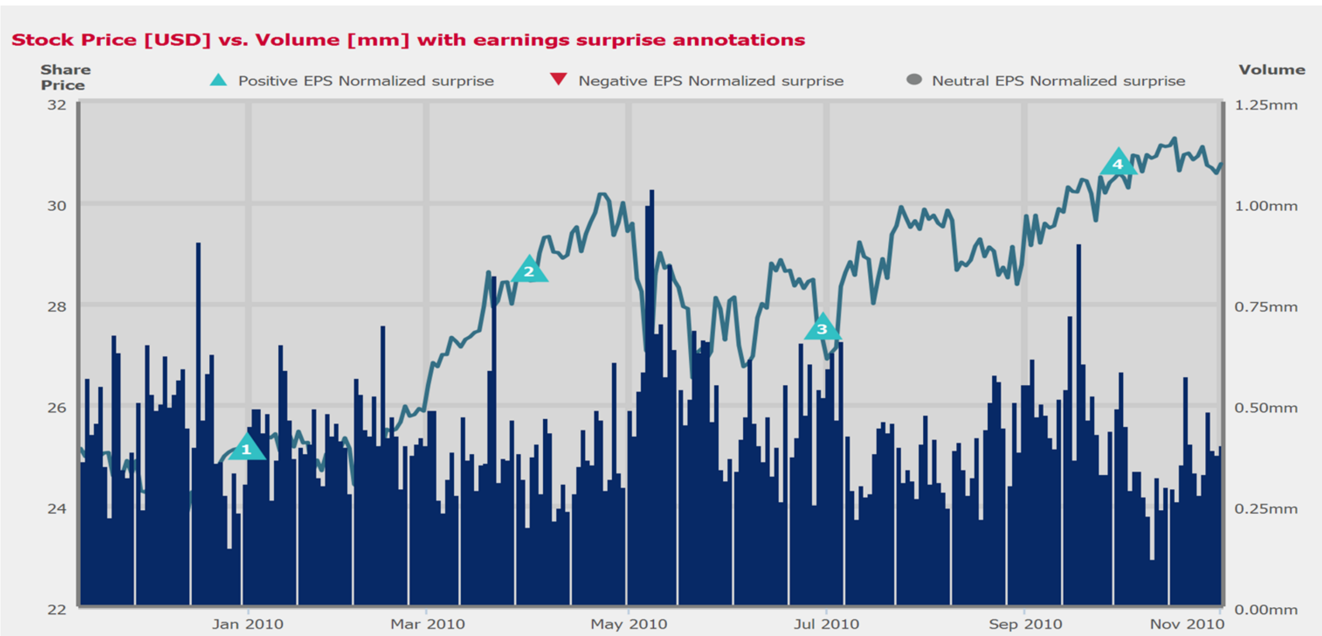
FQ4 2010 Earnings Call Transcripts

Friday, February 04, 2011 4:30 PM GMT

S&P Global Market Intelligence Estimates

	-FQ4 2010-			-FQ1 2011-	-FY 2010-		
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL	
EPS Normalized	0.97	1.03	▲6.19	0.86	3.84	3.92	
Revenue (mm)	721.10	1156.00	▲60.31	639.80	2660.10	4497.00	

Currency: USD
Consensus as of Feb-04-2011 2:19 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2009	0.94	1.04	▲10.64 %
FQ1 2010	0.83	0.91	▲9.64 %
FQ2 2010	0.60	0.91	▲51.67 %
FQ3 2010	1.01	1.07	▲5.94 %

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EXECUTIVES

Carl Lindner III

Keith Alan Jensen
Former Senior VP & CFO

ANALYSTS

Amit Kumar
Macquarie

Jay Cohen
Bank of America Merrill Lynch

Presentation

Operator

God morning, my name is Latonya and I will be your conference operator today. At this time, I would like to welcome everyone to the American Financial Group 2010 fourth quarter and full year earnings conference call.

All lines have been placed on mute to prevent any background noise. After the speakers' remarks there will be a question-and-answer session. (Operator Instructions) I would now like to hand the floor to Mr. Keith Jensen, Senior Vice President of American Financial Group. Thank you Mr. Jensen, the floor is yours.

Keith Alan Jensen
Former Senior VP & CFO

Thank you. Good morning and welcome to American Financial Group's 2010 fourth quarter earnings results conference call. I'm joined this morning by Carl Lindner III Co-CEO of American Financial Group. If you are viewing the - webcast from our website, you can follow along with the slide presentation if you'd like.

Certain statements made during this call are not historical facts and may be considered forward-looking statements and are based on estimates, assumptions and projections, which management believes are reasonable but by their nature subject to risks and uncertainties. Factors which could cause actual results and/or financial conditions to differ materially from those suggested by such forward-looking statements include, but are not limited to those discussed or identified from time to time in AFG's filings with the Securities and Exchange Commission, including the annual report on Form 10-K and the quarterly report on Form 10-Q.

We do not promise to update such forward-looking statements to reflect actual results or changes and assumptions or other factors that could affect these statements. Core net operating earnings is a non-GAAP financial measure, which sets aside items that are generally not considered to be part of ongoing operations, such as net realized gains to losses on investments, the effect of accounting changes, discontinued operations, significant asbestos and environmental charges and certain other non-recurring items.

AFG believes that non-GAAP measure to be a useful tool for analysts and investors in analyzing ongoing operating trends and will be discussed from various periods during this call. A reconciliation of net earnings attributable to shareholders to core net operating earnings is included in our earnings release.

Now, I am pleased to turn the call over to Carl Lindner III to discuss our results.

Carl Lindner III

Good morning and thank you for joining us. We released our 2010 fourth quarter and full year results yesterday afternoon. Although less than our record results last year in '09 our overall core net operating earnings were solid. Throughout the recent economic cycle Craig and I have been pleased that we achieved solid operating results in specialization and segmentation of businesses.

We want to thank God for his blessings and thank our talented management team and employees for their efforts this year and for the financial strength that allows us to pursue the plans for our organization to benefit our customers, agents, shareholders and employees over the long haul.

I am assuming that everyone on today’s call has reviewed our earnings release and the supplementary materials posted on the website. I will review a few highlights and focus today’s discussion on key issues. I will also discuss our outlook for this year.

Let us start by looking at our 2010 results summarized on slides three and five on the webcast. Net earnings were $4.33 per share for the year. This included realized gains of $0.41 per share which included

$0.15 per share from the sale of portion of our remaining interest in Verisk Analytics during the third quarter. Our core net operating earnings were $433 million or $3.92 per share compared to the prior year's record results of $493 million or $4.23 per year - per share.

A decrease of $104 million in pre-tax core earnings as compared to 2009 was primarily due to lower property and casualty investment income, a lower favorable development in our run-off RVI business, crop earnings that although very strong where less than 2009 record levels and catastrophe losses that where significantly greater than in the prior year. These items were partially offset by increasing earnings of our annuity and supplemental insurance business.

The core operating return on equity for 2010 was approximately 11%. Annualized average return on equity on a comparable basis over a five-year period was approximately 14%. One of our important strategic objectives is to deploy our excess capital in a way that enhances shareholder value. To that end, we continued our share repurchases and purchased 2.9 million shares of our common stock at an average price of $31.39 per share during the 2010 fourth quarter.

For context the total shares repurchased during 2010 represent about 9% of AFG's outstanding shares at the beginning of the year. The average price for the shares we purchased during 2010 was $28.46 per share or approximately 80% of year-end 2010 tangible book value per share. We feel this remains an effective means of increasing shareholder value. We returned capital to shareholders through $292 million in share repurchases and $63 million in dividends.

As of February 3, 2011 there were 2.4 million shares remaining under our current repurchase authorization. Management intends to recommend an extension of this authorization at our next board meeting. As you'll see on slides four, AFG's book value per share excluding appropriated retained earnings and unrealized gains and losses on fixed maturities, increased to $37.54. An increase of 14% from the $32.92 per share reported at year-end 2009.

Tangible book value on a comparable basis was $35.24 at year-end 2010 up 15% from year-end 2009. Our capital adequacy, financial condition and liquidity remain strong and are key areas of focus for us, especially as economic uncertainty continues. We've maintained capital on our insurance businesses at levels - at levels that support our operations by an excess of amounts required for our rating levels. At the end of the year cash at the parent company was approximately $375 million with excess capital of $850 million.

The summary of core operating results for the fourth quarter and full year appears on slide five. On slide six you will see summary results for our specialty property casualty operations. We continue to focus on pricing our business to achieve appropriate returns. Accordingly we have adjusted our planned premium levels to be consistent with what we feel acceptable returns are.

The average renewal rates in the specialty operations during 2010 were flat compared to the prior year. Competitive pressures and lower spring agricultural commodity prices contributed to the declines in gross written premiums during 2010. These declines were partially offset by premiums resulting from the third quarter 2010 acquisition of Vanliner, premium growth from market form and higher fall agricultural commodity prices.

Net written premiums for the full-year increased primarily as a result of return is historically lower level of sessions under our crop core share agreement. Gross investment income related to our property and casualty operations was down about 19% in 2010, when compared to the prior year. This is primarily due to; decreased holdings and higher yielding investments and generally lower reinvestment rates as we discussed during the last quarter's call.

Now I would like to discuss a few highlights from each of our specialty business group on slide seven and eight. The property and transportation group reported 2010 underwriting profits that were about 40% lower than in '09. Favorable crop yields contributed to strong results in our crop operations for the year however the results were lower than the record profitability that we had in 2009.

Additionally during 2010, this group incurred catastrophe losses due primarily to Midwest storms. These losses were approximately $30 million greater than the catastrophe losses in the prior year. Sustained competitive market conditions and lower favorable reserve development also contributed to the year over year decline in underwriting profit. We are pleased that almost all of our property and transportation businesses reported strong underwriting profits for the year.

Average renewal rates for this group during 2010 where slightly down compared to the prior year period. Our specialty casualty group reported underwriting profits for 2010 that were 25% lower than 2009. The decrease was due to lower profitability in our general liability operations primarily those that served the homebuilders market as well as in our California workers comp business.

These decreases were offset by somewhat improved results in our executive liability, targeted markets in excess and surplus lines operations. Majority of businesses in this group again produced excellent underwriting profit margins for the year. 2010 was impacted by underwriting losses in market form primarily the result of deterioration in the Italian med mall reserves. We didn’t require any reserve increases in the fourth quarter of 2010. Average renewal rates for this group during 2010 were flat compared to the prior year period.

Specialty financial group reported lower underwriting profits during 2010, reflecting lower favorable reserve development particularly in our run-off automobile residual value insurance operations that was $50 million less in the prior year. At a remaining leases associated with this business are de minimis at this point. All other businesses in this group produced excellent underwriting profit margins for the year. Average renewal rates for this group were flat during 2010.

And I would like to move on to the review of our annuity and supplemental insurance group on slide nine. Full year 2010 core operating earnings before income taxes were 21% higher than in 2009 due to expense savings and improved result in our fixed annuity and supplemental businesses, driven by wider spreads and higher growth in our fixed annuity operations. These improvements were offset somewhat by lower earnings in our variable annuity business.

Results for the 2010 fourth-quarter included a $25 million pre-tax charge related primarily to the write-off of deferred acquisition costs in our fixed annuity business. This charge was recorded in connection with our review of major actuarial assumptions and included management's expectations of future interest rates and changes in future annuitisation assumptions.

Results in the fourth quarter of 2009 included a $13 million debt write-off that was also related to the fixed annuity business. Statutory premiums increased considerably over 2009 periods due to higher sales the single premium annuities sold through banks and indexed annuities. In fact the American Bankers Insurance Association recently announced that AFG is wholly owned subsidiary with the American Financial Resources ranked in the top five and fixed annuity sales by banks and other depository institutions for the third quarter of 2010.

We continue to experience strong persistency in our annuity businesses and remained committed to product designs that reward policy holders and agents for long-term persistency.

Now let’s turn to slide 10 for a few highlights regarding our investment portfolio. During 2010 we recorded after-tax after-DAC net realized gains of $46 million compared to $26 million in 2009. We are pleased there our $3 billion non-agency RMBS portfolio has generated an annualized total return since year-end 2007 that is significantly outperformed other fixed income indices over the same period.

After-tax, after-DAC net realized gains were $475 million at December 31, 2010. This number reflects an after-tax, after-DAC unrealized gain on fixed maturities of $326 million. The vast majority of our investment portfolio was held in fixed maturities with approximately 91% rated investment grade and 95% with a designation of NAIC-1 or 2. With much of the growing concerns surrounding insolvency issues in various municipalities,

I would like to take a moment to talk about our municipal investment portfolio which we outlined on slide 11. Our investment strategy for municipal securities has been consistent for many years. Our municipal bond portfolio is high-quality with approximately 95% rated NAIC 1. Portfolios well diversified across the states of issuance and individual issuers. Our holdings of state general obligation securities of California, Illinois, New Jersey and New York represent only 2% of our municipal bond portfolio.

Approximately 70% of the portfolio is held in revenue bonds while the remaining 30% is in general obligation bonds. While we have provided additional detailed information on the various segments on our investment portfolio in the investment supplement on our website.

Now I would like to cover our outlook for 2011 on slide 12. Our 2011 core net operating earnings guidance is $3.30 to $3.70 per share. We expect to maintain adequate in our specialty property and casualty operations because of our strong underwriting culture and expect to achieve a combined ratio of between 88% and 92%.

We expect net-written premiums in our specialty property and casualty operations to be 7% to 11% higher in 2010. The property and transportation group is expected to produce a combined ratio in the 87% to 91% range. Guidance assumes normalized crop earnings for the year and also a reduction of approximately $20 million in crop operating results as a result of the 2011 standard reinsurance agreement or SRA.

Guidance assumes that the current corn and soya bean prices hold through the February discovery period. We expect this group's net-written premiums to increase by approximately 9% to 13% mostly as a result of projecting higher spring, commodity prices and National Interstate's acquisition of Vanliner.

We expect the specialty and casualty group to produce a combined ratio in the 92% to 96% range and anticipate net-written premiums to be down 1% to 5%. We plan to generate about $50 million in premium in Equine, species, inland Marine, ocean Marine and political risk coverage's through our market formed subsidiary in 2011 and increase of about $10 million over 2010.

We look for the specialty financial group's combined ratio to be between 80.88% because of the seeding of the unearned premium associated with certain of our non-RBI automotive related businesses during 2010 and we project net-written premiums to be up 28% to 32% in this group. As we talked about last quarter, the continued run-off and disposition securities in our non-agency RMBS portfolio as well generally lower reinvestment rates will result in continual pressure on investment income.

We estimate that 2011 investment income in AFG's property and casualty segment will be about 10% lower than 2010. Our investment focus is to achieve appropriate risk-adjusted returns with a total return orientation. Based on recent market conditions and trends, we expect 2011 full-year core pre-tax operating earnings in our annuity and supplemental insurance group to be 15% to 20% higher than last year. Given a growth expected in 2011 in the annuity and supplemental insurance business, the segments investment income is expected to exceed that of the current year.
These 2011 expected results exclude the potential for significant catastrophe and crop losses, significant adjustments to A&E reserves, large gains or losses from asset sales and impairments and unlocking adjustments related to the annuity deferred acquisition cost. Now we would like to open the lines for any questions, thank you.

Question and Answer

Operator

Thank you (Operator instructions) And your first question comes from the line of Amit Kumar with Macquarie.

Amit Kumar
Macquarie

Thanks and good morning congrats on the quarter. I just have two questions; one is the bigger picture question and the second one is on guidance. Some of the larger commercial companies such as Travelers, Chubb and (inaudible), have talked about modest exposure improvement and rates being flat to modestly down. Can you sort of talk about, what your expectation is for rates and exposure for 2011?

Carl Lindner III

Sure, I think on the property and casualty side, our goal is to try to nudge prices upwards. Realistically with the current competitive conditions if we can end up the year flat that would probably be a pretty good result. I am optimistic that you either may see some pricing traction and maybe later on this year. As far as exposures, worker's comp business is probably, the place where we have seen, some slight change, there's been three months of a small - small single-digit increase in payrolls if you include January. With that said unemployment went up in California, I think to 12.9% here recently, so it is still a tough economic situation in the State of California. And I think on other businesses like Home Builders and then on liability I think we have seen some stabilization in payrolls probably don't see quite, we don't see it quite as much as - as far as any small increases as what we see in the comp side of our business.

Amit Kumar
Macquarie

Got it, that's helpful, and then just quickly moving on to guidance and then I will re-queue. In terms of maybe just starting from the top, the property and transportation expectation can you sort of break out the expectation from Vanliner for 2011. I know you mentioned the crop change of $20 million or so but can you just remind us what that number is.

Carl Lindner III

Well on the crop side, that related to SRA impact - negative impact on the crop earnings side. Crop premiums, if the current prices hold during the February discovery period, I would think we might see our direct to gross premiums in that go up 30% are so. But we won't actually know until the end of the discovery period and what the actual prices for corn and soya bean are in that. So as far as the crop business - that is our - that would be kind of a best guess in that. Keith, do you want to talk to the National Interstate and Vanliner unit?

Keith Alan Jensen
Former Senior VP & CFO

Sure, as it was disclosed at the time we bought Vanliner, there is a portion of that business that is dedicated to moving and storage and that was our net prime interest. We expect it at that time we would have premiums in the $100 million a year range on an ongoing basis. National Interstate has not reported earnings yet, so it is not appropriate yet for us to give specifics but other than to say that we are within a reasonable range of that expectation.

Amit Kumar
Macquarie

Got it and then just finally one and then I will re-queue, on the annuity and supplemental life side, you talked about changes in expectations of lowering reinvestment rate and changes in future annutization assumptions, can you just talk what those assumptions are and what the changes were? That would be quite helpful.

Keith Alan Jensen
Former Senior VP & CFO

Well the changes are really coming - if you look at the table, it is in the press release, you will see that there has been a significant increase in the production through the bank line and that is the result of two major things that has happened in this past year and we expect to continue fuelling the growth on a go forward basis. First of all was as you know PNC bought National City and so we were able to access in the PNC side we are now their leading provider so that means, there has been a multiple of retail branches that we have able to go into that were not previously available.

And there is a line that we called Bank Indirect which is really, brokers and agents that write business for other banks and so among the bank we have added portfolio this year would be Regions and BB&T. That continues to be an area of emphasis for us and will be a significant driver of future growth. With respect to profitability, we have made some assumptions and you saw that we have taken a charge during this quarter for deferred acquisition costs, and that is due to a change in our expectations of reinvestment rates over the next few years and we have ratcheted those down a bit from what they were in prior years.

That ratcheting down was partially offset by increasing our expectation with respect to expense benefit of changes that we are making in our expenses as well as some changes - I guess those are the two, I'm forgetting one, oh yes, as well as an assumption that there would be a lower crediting rate on a go forward basis that matches somewhat the decrease in that assumption of the reinvestment rates.

Amit Kumar
Macquarie

Got it, that's helpful, I will re-queue thanks.

Operator

Thank you (Operator instructions) And your next question comes from the line of Jay Cohen with Bank of America Merrill Lynch.

Jay Cohen
Bank of America Merrill Lynch

Yes thank you, I guess the question was on your estimates for what you think excess capital is and I think you said $850 million, you got to maybe remind me what - I thought that number was quite a bit lower when you talked about that number in the past, but remind me what have been saying if it is an increase in excess capital, what is the source of that?

Keith Alan Jensen
Former Senior VP & CFO

It is somewhat of an increase, although not dramatic, as I think back, I think in the third quarter we were talking in terms of 600 to 650 a number if I remember right, but excess capital, were really defined that is parent company cash plus the amount that we could borrow against our line of credit and still stay within the 22% commitment on financial leverage that we have made it to the rating agency. Plus any excess capital that is in the insurance companies that could be taken out of the insurance companies and still meet the capital adequacy requirements that rating agencies for the surplus of the insurance companies, so today I got those three components in it Jay.

Jay Cohen
Bank of America Merrill Lynch

I guess what happened - as you continue to buy back stock that excess capital number continues to grow. I remember that being, I think it was $400 million may be three or four quarters ago, then 600, now 850.

Where is the growth coming from, is it in the insurance subs, It's simply not growing and thus freeing up capital?

Keith Alan Jensen
Former Senior VP & CFO

Right, because as you say flat and in terms of the size of your premium you are not creating additional capital demands in more of the earnings flows directly to excess capital.

Jay Cohen
Bank of America Merrill Lynch

Got it, I guess your buybacks have been less than your earnings.

Keith Alan Jensen
Former Senior VP & CFO

Correct.

Carl Lindner III

And to a lesser extent we have, the equities have gone up some and particularly the list -

Jay Cohen
Bank of America Merrill Lynch

Got it, and what is the kind of go forward plan for the investment portfolio at this point?

Keith Alan Jensen
Former Senior VP & CFO

One of the general action, you will see us taking a little bit more of a position in equities, not dramatic but a little bit. We have increased our penetration in municipals. We think that this is an opportunistic time to be buying as long as we are very disciplined in those purchases. We are continuing to have some annual run-off of the mortgage-backed securities which we are taking primarily into higher grade corporates. I don't think we should expect this year a dramatic sort of earth change but those would be the trends that I would expect us to see over the next year.

Carl Lindner III

And some selective real estate, increasing our real estate investments on an opportunistic basis.

Jay Cohen
Bank of America Merrill Lynch

And it sounds like - seems like a number of those moves are opportunistic in nature, which I guess does state your past MO from an investment standpoint. That's helpful.

Keith Alan Jensen
Former Senior VP & CFO

All right.

Operator

Thank you. (Operator instructions) And we do have a follow-up question from Amit Kumar with Macquarie.

Amit Kumar
Macquarie

Thanks, just three quick follow-ups, so first of all just going back to the discussion on growth from markets on - I know we have had some reserve additions from that segment operation and now you know you are talking about growing from that, maybe just talk a little bit about what gives you comfort that you won't see some of the issues we have seen in the past regarding the reserve additions.

Carl Lindner III

Again, the reserve changes have been from Italian Hospital business which we haven't been writing for really about two years. Our non -US med mal business is not really substantially growing, where the growth is coming from or in a few business that we have -that we wanted to expend our foot print and where we done very well, historically things like Food Stock, Equine, Fidelity, Species, Ocean Marine, where we’re just accessing the international market where we didn’t have any access what we seeing is, in the past, where we dint have a platform to write those. We have invested in over the past couple of years, we invested in top notch talent underwriting talent in each of those areas, and the real growth in the market form is really coming from those lines, not med mal.

Amit Kumar
Macquarie

This is when you say it's top talent, so essentially it’s the older relationship, which these people have which will result in the growth or do you think.

Carl Lindner III

A lot of these people came out of syndicates that came out of syndicates that were well known and where the individuals were well known with what, good underwriting track records and experience and we’re the largest writer of Equine Mortality in the United States were insistence. But there is a quite a few horses in that-particularly on the thoroughbred side that we weren’t getting access to that Lloyd’s and that market really had access to. So we’ve been able to expand our footprint and use the knowledge base that we already have to access business in other countries that we couldn’t access before. Within them - I believe we probably then one of the top three armored car and casino writers in fidelity and crime in the world.

We have been able to access the world markets some - again Lloyd’s that’s one of their historical specialty, and we have been able to access business that we couldn’t access before. Ocean Marine, we were doing a strategic review of Ocean Marine it was about a year ago or so and there is a kind of startling number when of the - when you look at where the worlds Ocean Marine business is sourced, I think 50%, 60% that was 50% or so was sourced out of Europe in that. And only having a US operation you just didn’t get access to the larger Ocean Marine market, so for us that was really a necessity to gain access to data for a business that is going to grow, a lot of the worlds growth today is outside of the US.

Amit Kumar
Macquarie

Hopefully you're not growing in around Suez Canal right?

Carl Lindner III

There you go.

Amit Kumar
Macquarie

And just two other quick questions one on the capital management, does your guidance and I apologize if I missed this factor and any buy backs.

Carl Lindner III

I think it assumes similar amount of buy backs what we had last year.

Amit Kumar
Macquarie

Okay that's helpful. And just finally some companies have talked about, probably passing the inflection point on the lost trends, can you just quickly talk about the frequency and severity of trends in your minds.

Carl Lindner III

Yeah, I mean we have 25 different business, we could spend a lot of time. California comp again is only 4% so the 5% of business, but that's probably the business and the stable of businesses that we have what we seeing frequency and severity kind of began to pick up after, 4 or 5 great years after reform where it went the opposite direction. Almost couldn't get any lower and that.

And I think that's probably the line business where we've seen a distinct change. Most of our other businesses have excellent profitability and loss cost still seems in pretty benign. I think we've definitely been helped as well as the industry by loss costs, the inflation of lost cost which has been more benign than what all of us would have gone.

Amit Kumar
Macquarie

Got it. Thanks, thanks for all the answers.

Operator

Thank you there are no further questions at this time, I would like to return the floor for closing remarks.

Keith Alan Jensen
Former Senior VP & CFO

Thanks you, we appreciate your taken the time for this morning and we look forward to reporting on our first quarter.

Carl Lindner III

Thank you and have a good day.

Operator
Thank for participating in today's American Financial Group 2010 fourth quarter and full year earnings conference call, you may now disconnect.