S&P Global
Market Intelligence

American Financial Group, Inc. NYSE:AFG

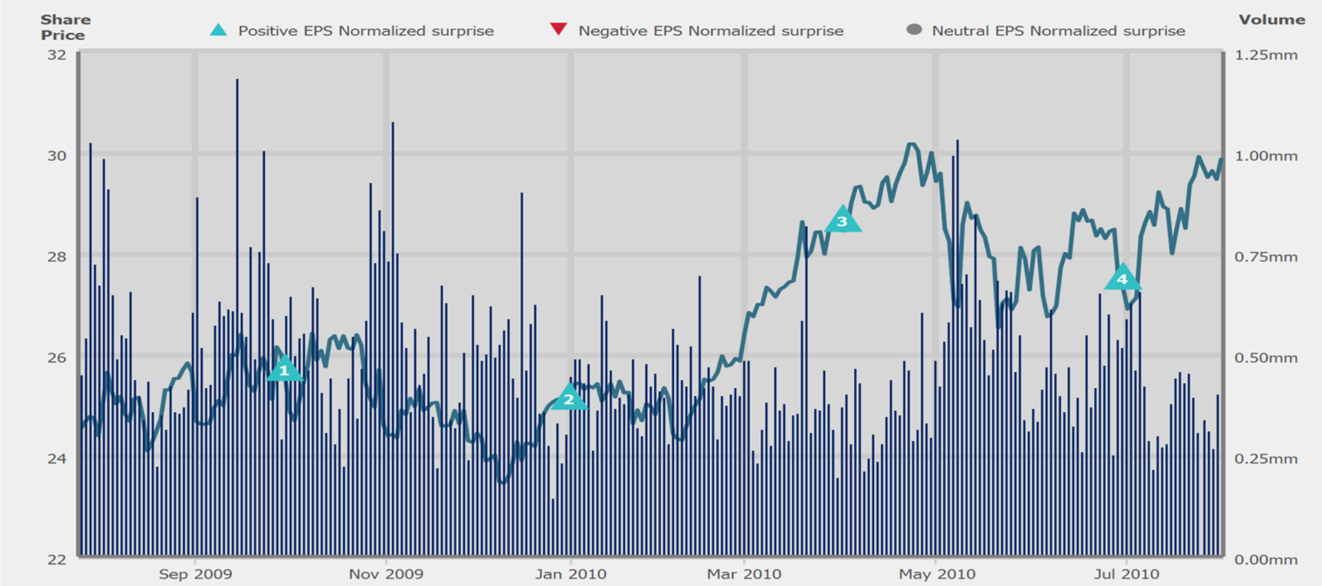
FQ3 2010 Earnings Call Transcripts

Tuesday, November 02, 2010 3:30 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2010-			-FQ4 2010-	-FY 2010-	-FY 2011-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.01	1.07	5.94	0.96	3.87	3.58
Revenue (mm)	715.37	1255.00	75.43	732.21	3024.51	2827.64

Currency: USD
Consensus as of Nov-02-2010 12:45 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ3 2009	0.88	1.07	1 20.22 %
FQ4 2009	0.94	1.04	2 10.64 %
FQ1 2010	0.83	0.91	3 9.64 %
FQ2 2010	0.60	0.91	4 51.67 %

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Call Participants

EXECUTIVES

Carl Lindner III

Keith Alan Jensen
Former Senior VP & CFO

Stephen Craig Lindner
Co-President, Co-CEO & Director

ANALYSTS

Amit Kumar
Macquarie Research Equities

Jay Cohen
Bank of America Merrill Lynch

Presentation

Operator

Good morning. My name is [Cassandra] and I will be your conference operator today. At this time, I would like to welcome everyone to the American Financial Group 2010 third quarter 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). Thank you. Now I would like to turn the call over to Keith Jensen, Senior Vice President. You may begin.

Keith Alan Jensen
Former Senior VP & CFO

Thank you very much. Good morning and welcome to American Financial Group's 2010 third quarter earnings results conference call. I'm joined this morning by Carl Lindner III and Craig Lindner, Co-CEO's 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.

The 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 that are 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 in 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 or losses on investments, the effects of accounting changes, discontinued operations, significant asbestos and environmental charges and certain other non-recurring items.

AFG believes this non-GAAP measure to be a useful tool for analysts and investors in analyzing ongoing operating trends and will be discussed for 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 third quarter results yesterday afternoon. Our overall core operating earnings are excellent and we're making solid progress towards our operations goals for 2010.

I'm assuming that the participants on today's call reviewed our earnings release and the supplemental materials posted on our website. I'll review a few highlights and focus today's discussion on key issues. I'll also discuss our outlook for the remainder of 2010. Let's start by looking at our 2010 third quarter results summarized on slides 3 and 4 of the webcast.

Net earnings were $1.21 per share for the third quarter. Realized gains related to AFG's non-agency residential mortgage backed securities from the sale of a portion of our common stock, investment in [de-risk] analytics were partially offset by a goodwill write-off relating to a marketing subsidiary and our supplemental insurance operations. I'll talk more about each of these transactions later.

Our third quarter core net operating earnings were $117 million, down 6% from the record prior year period. Core net operating earnings per share were $1.07 in each year as a result of share repurchases in

2010. These results reflect improved earnings in our annuity and supplemental insurance operations which were more than offset by lower property and casualty underwriting profit and lower investment income in our property and casualty operations.

Core net operating earnings for the third quarter and first nine months include approximately $15 million in after-tax income related to the ceding of unearned premium and certain runoff automotive related lines of business and certain real estate transactions.

Annualized nine month core operating return on equity for 2010 was approximately 11%. One of our important strategic objectives is to deploy our excess capital in a way that enhances shareholder value. To that end, we purchased $1.7 million shares of our common stock at an average price of $29.11 per share during the third quarter of 2010.

To provide context, the total shares repurchased in the first nine months of 2010 represent about 6% of AFG's outstanding shares at the beginning of the year. The average price of shares repurchased during the first nine months of 2010 was $27.30 per share. We believe the purchase of shares below book value is an appropriate means of increasing shareholder value.

In August 2010 our board of directors increased our share repurchase authorization by 5 million shares. At the end of the third quarter there were 5.6 million shares remaining under our current repurchase authorization.

During the third quarter we announced an increase in AFG's annual dividend from $0.55 to $0.65 per share of common stock. The new dividend rate effective with last week's quarterly payment represents an 18% increase over the annual rate paid earlier in 2010. We believe that this increase clearly reflects our confidence and the company's strong financial condition and liquidity as well as its prospects for long-term growth. This is the sixth consecutive year that we've announced an increase in our dividend.

We continue to seek opportunities to grow our specialty niche businesses, particularly when expected investment returns provide a potential to enhance long-term shareholder value. The third quarter acquisition of Vanliner Insurance Company by our 53% owned subsidiary National Interstate is an excellent example of this type of investment.

As you will see on slide 4, AFG's book value per share, excluding appropriated retained earnings and unrealized gains and losses on fixed maturities, increased to $35.99, an increase of 9% from the $32.92 per share reported at the end of 2009.

Tangible book value on a comparable basis was $33.72 at September 30, 2010, up 10% from year-end 2009. Our capital adequacy, financial condition and liquidity remain strong and our key areas of focus for us, especially as economic uncertainty continues.

We've maintained capital in our insurance businesses at levels that support our operations and are consistent with amounts required for our rating levels. In September we issued $132 million of 7% senior notes due 2050. The proceeds of this offering are being used for general corporate purposes. This offering also provides us with additional financial flexibility and liquidity at a time when the markets support a reasonably priced, long-term debt offering.

It also allows us to respond appropriately to unforeseen needs as well as great opportunities that may arise. At the end of the quarter, available cash at the parent company was approximately $350 million. We anticipate continuing to generate additional capital and cash through operations during the remainder of this year and expect excess capital greater than $600 million at year-end.

Before moving to a discussion about the results in each of our insurance operations, I'd be remiss in not mentioned the upgrade we received from S&P a few weeks ago. Standard & Poors raised its financial strength ratings for AFG's core insurance subs from an A to an A plus. We believe this action reflects the consistent efforts of our management team and employees to achieve strong operating performance and to maintain solid capital adequacy and appropriate financial leverage.

Let's now turn our discussion to our specialty property and casualty businesses. On slide 5 you'll see summary results for these operations. Overall, underwriting profits in the 2010 third quarter were solid, generating a combined ratio of 91%, eight points higher than the prior year period. Lower favorable reserve development was a key factor in the increased combined ratio.

We recorded $39 million in adverse reserve development in our MarketForm operations and lower favorable reserve development in our run-off residual value insurance operations. We continue to focus on pricing our business to achieve appropriate returns, reduce top line growth in some of our lines as evidence of our commitment to walk away from business that won't generate appropriate returns.

Our mix of specialty property and casualty businesses is advantageous as results in several of our operations don't correlate with the overall property and casualty insurance industry. This allows us to focus on running a profitable business in each niche area even when we have to compromise premium volume to do so.

Average renewal rates in the specialty operations during the first three quarters of 2010 were flat compared to the prior year. A continuing soft market and competitive pressures, depressed economic conditions and lower agricultural commodity prices contributed to declines in gross written premiums during the first nine months of this year.

Net written premiums for the third quarter and first nine months increased, however, as session under our crop quoted share agreement returned to historical levels. These increases offset the decline in premium resulting from the reinsurance transaction in our specialty financial group.

Gross investment income related to our property and casualty operations was down approximately 22% for the third quarter of 2010 when compared to the same period last year primarily as a result of decreased holdings and higher yielding investments and generally lower reinvestment rates.

Now I'd like to discuss a few highlights from each of our specialty business groups on slide 6 and 7. Property and transportation group reported third quarter 2010 underwriting profits that were about 12% lower than the comparable 2009 period. The decline in underwriting profit was driven primarily by lower favorable reserve development and continued competitive market conditions.

Strong crop yields contributed to results in our crop insurance operations that were consistent with the quarter last year. Average renewal rates for this group for the first nine months were down slightly compared to the prior year period. Our specialty casualty group reported lower underwriting profits for the third quarter 2010.

The decrease in underwriting profit was attributed primarily to $39 million in an adverse reserve development and market forms run-off Italian Public Hospital business as a result of a few more adverse legal rulings and increased severity in the claims in this line of business.

Additionally, lower underwriting profits in our general liability operations, primarily those that serve the homeowner's industry, excess and surplus lines in our California Worker's Comp businesses were offset somewhat by improvements in our targeted markets operations during the 2010 third quarter.

Although 2010 third quarter underwriting profits for most of the businesses in this group were at levels lower than the prior year, the vast majority of them produced satisfactory underwriting profit margins.

Average renewal rates for this group in the first nine months were up slightly compared to the prior year period. Specialty financial group posted higher underwriting profits in the third quarter reflecting pre-tax income of approximately $8 million in connection of the reinsurance transaction involving certain non-RVI automotive lines of business.

Additionally, improvements in underwriting income in our financial institution business and the run-off lease and loan operations more than offset lower favorable reserve development in our run-off automobile residual value insurance operations.

All other businesses in this group produced excellent underwriting profits. Average renewal rates for this group were flat in the first nine months of 2010. The reinsurance transaction was the primary cause of a decrease of approximately $100 million in net premiums for this group. Now I'd like to move on to a review of our annuity and supplemental insurance group on slide 8.

Annuity and supplemental insurance group generated pre-tax core net operating earnings for the third quarter of 2010 that were approximately 26% higher than the comparable period in 2009. These results are primarily the result of higher operating earnings in our fixed annuity and supplemental insurance businesses, which were partially offset by lower earnings in our variable annuity operations.

As I mentioned earlier, we recorded an after-tax realized loss of $22 million as a result of a goodwill impairment associated with the sale of a supplemental health insurance career agency. This charge is included in AFG's realized gains and losses on subs.

Third quarter and nine month statutory premiums increased considerably over the same periods last year due to increased sales of single premium annuities. These sales were offset somewhat by lower sales in the 403B annuity market. We continue to experience strong persistency in our annuity businesses. We continue to move toward product designs that reward policy holders and agents for long-term persistency.

Now please turn to slide 9 for a few highlights regarding our investment portfolio. During the third quarter of 2010 we recorded after-tax, after-DAC net realized gains and securities of $37 million compared to $6 million in the comparable 2009 period. This amount includes $17 million from the sale of a portion of AFG's common stock investment Verisk Analytics.

We continue to own approximately 5.7 million shares of Verisk, class B common shares that are convertible into class A shares on a share-per-share basis after the expiration of holding periods. At September 30, the pre-tax unrealized gain on our Verisk investment was about $125 million. Additionally, $15 million of the third quarter gains are related to AFG's non-agency residential mortgage back securities.

Turning to slide 10 you'll see that in a period of unprecedented turmoil in the mortgage markets our $3 billion non-agency RMBS portfolio has generated an annualized total return of approximately 15% since year-end 2007, significantly outperforming fixed income industries over the same period.

Importantly, 93% of this portfolio is currently rated NAIC-1. The continued run-off and disposition of securities in a non-agency RMBS portfolio as well as generally lower reinvestment rates will likely result in continued pressure on investment income.

We estimate at 2011 investment income in AFG's property and casualty segment will be approximately 10% to 15% lower than in 2010. The anticipated impact of the reduction in our non-agency RMBS portfolio is much less for annuity and supplemental insurance business. In addition, lower reinvestment rates can be partially offset by the ability to reduce crediting rates on the company's in-force business.

Given the growth expected in 2011 in the annuity and supplemental business we expect this segment's earnings will exceed that of the current year. Our investment focus continues to be on achieving appropriate risk adjusted returns for the total return orientation.

After-tax, after-DAC net unrealized gains were $603 million at September 30, 2010. This number reflects an after-tax, after-DAC unrealized gain on fixed maturities of $491 million. The vast majority of our portfolio is held in fixed maturities with approximately 91% being rated investment grade and 95% with a designation of NAIC-1 or 2.

We have provided additional detailed information on the various segments of our investment portfolio and the investment supplement on our website.

Now I'd like to cover our outlook for the remainder of 2010 on slide 11. Based on the results the first nine months of the year we've revised our 2010 core net operating earnings guidance to $3.70 to $3.90 per share. We expect to maintain adequate rates in our specialty property and casualty operations because of our strong underwriting culture and expect to achieve a combined ratio of about 87% to 89%.

We expect net written premiums in our specialty property and casualty operations to be 1% to 4% higher than 2009 levels. The property and transportation group is expected to produce a combined ratio in the

85% to 88% range. Guidance assumes better-than-average crop earnings for the year but lower than our record 2009 results.

We expect this group's net written premiums to increase by approximately 28% to 32% primarily as a result of higher retention in our crop operations and National Interstate's acquisition of Vanliner.

We expect the specialty casualty group, which includes our California Comp business, to generate solid underwriting profit with a combined ratio in the 92% to 96% range. We anticipate net written premiums will be down 3% to 7%.

We look for specialty financial groups combined ratio to be between 75% and 79%. Because of the ceding of the unearned premium associated with certain of our non-RVI automotive related lines of business, we project net written premiums to be down 28% to 32%.

Based on recent market conditions and trends, we expect 2010 full-year core pre-tax operating earnings in our annuity and supplemental insurance group to be 15% to 20% higher than in 2009.

These 2010 expected results exclude the potential for significant catastrophe in crop losses, significant adjustments to asbestos environmental reserves, large gains or losses from asset sales or impairments and unlocking adjustments related to annuity-deferred acquisition costs.
We do intend to provide core net operating guidance for 2011 when we report AFG's fourth quarter and full-year results. Now we'd like to open the lines for any questions. Thank you.

Question and Answer

Operator

(Operator Instructions). Your first question comes from the line of Amit Kumar - Macquarie Research Equities.

Amit Kumar
Macquarie Research Equities

Maybe just going back to the discussion on adverse development and Marketform, I'm looking for some specific numbers. First, can you tell us what portion of the overall segment is the public hospital and medical malpractice? Secondly, I would like to know what were the carried reserves previously so that we can figure out what is the change in percent based on the reserve addition?

Carl Lindner III

Amit, this is Carl. When you look at the net written premiums for nine months in our specialty casualty business they're about $676 million, so on an annualized basis that's $900 million. The MarketForm business of that is $140 million approximately for the year and the overall net mal business is about $35 million. So overall it's $35 million of $900 million plus, a very small part of it.

We got out of the Italian, that mal part of the business a number of years ago. That's where the development's coming from. It was pretty much the Italian Public Hospital part of that. That mal business we do that's remaining is spread around to other countries outside of the United States, Australia, for instance, and Spain. So we're not really involved in the Italian med mal part. So net mal overall, when you look at it as a percent of what we're doing in the specialty casualty is pretty small.

Amit Kumar
Macquarie Research Equities

What were the reserves previously? You had a similar charge in Q4 of '09. I'm wondering what were the reserves at that time? What are the reserves as of today? I guess, what I'm trying to ask is based on the reserves, we can get some comfort that this is the end of these reserve additions.

Carl Lindner III

I mean, we think -- we do our reserve evaluations inhouse quarterly and we go outside on our MarketForm business at least a couple times a year. At this juncture we think we're properly reserved. It's possible that there could be some further development there. But the farther away that we get from the business, Amit, I think our confidence goes up higher.

We think we're properly reserved today. I suppose there could be some possibility of further development but let's keep in mind also in the whole scheme of things our overall specialty casualty favorable development, net of MarketForm, is $47 million for the year.

So, again, when you gauge that based off of our overall net favorable development in our specialty casualty segment, again, we think that's still pretty strong when you put MarketForm or this business in the context of our whole business there from a reserve standpoint.

Amit Kumar
Macquarie Research Equities

Do you have the number in terms of the reserves, a dollar number for the reserves backing this book?

Keith Alan Jensen
Former Senior VP & CFO

We don't have it at this point right with us. That's not been something we've disclosed. We can go back and look at that and provide that supplementally.

Amit Kumar
Macquarie Research Equities

Just one more question and I'll requeue. You talked about the buyback. I'm just wondering, you have the NAT ownership at 52.5%. You have reached a common dividend. When you sort of look forward, how do you rank these opportunities?

Is it just sort of doing a buy back, maybe no special dividend, maybe looking at entity of ownership? I do realize it is doing it at a premium to book. How do you view these options going forward, maybe more so in the background of CNA, making an offer for its subsidiary? How do you view your ownership in NAT going forward?

Carl Lindner III

Well, we never take a cookie cutter approach in how we do our business. Basically the ownership structure is pretty close to when we founded the business, National Interstate, today. I believe you're talking about National Interstate, aren't you?

Amit Kumar
Macquarie Research Equities

Yes, yes.

Carl Lindner III

Yes, so, I mean, our ownership structure is pretty close to when we founded the company where we had a majority ownership in that. We took the company public in order to give liquidity and property evaluation to all. So we're pretty much in the same position as when we started.

As far as how we allocate excess capital or how we decided to use excess capital, our own stock, which trades at a significant discount to book value today, is extremely attractive. That's one reason why we've repurchased the number of shares that we have.

The Vanliner transaction, within National Interstate, again as an example of the type of transaction that we're out there looking to do, that transaction was done at tangible book value with reserve guarantees and we were able to add on to National Interstate's business with a specific new niche in the moving and storage part of that.

The returned opportunities for that business we felt were comparable to repurchasing our stock and would add substantial franchise value to National Interstate and AFG. That's kind of how I think Craig and I look at opportunities, which is the highest and best use short term and long term for the capital and what will provide the best returns and what will add to franchise value in that?

So we're continually looking for things to acquire and businesses to start up. Our environmental liability business, even though it's two years old, we'll probably do $30 million of business in that entity. We started that business up a couple years ago. We like the return prospects for that business and we allocated capital to them.

Amit Kumar
Macquarie Research Equities

Anyone with a special dividend?

Carl Lindner III

Well, we just increased our annual dividend by about 18%. We're continually discussing all the different options in that. I think we've obviously chosen to repurchase shares and increase the dividend, at least at this point.

Operator

(Operator Instructions). Your next question comes from the line of Jay Cohen - Bank of America Merrill Lynch.

Jay Cohen
Bank of America Merrill Lynch

Question, I guess on loss reserves and maybe in the specialty casualty business, excluding MarketForm in the quarter, what were you seeing from a reserve movement standpoint from prior years by line? Just give us some color on that. Maybe the bigger picture, what are you seeing from a claims standpoint, as far as the severity or frequency of claims?

Keith Alan Jensen
Former Senior VP & CFO

If I remember your question properly, Jay, you wanted to know in specialty casualty what are some of the headlines in terms of reserve development in terms of the lines of business?

Jay Cohen
Bank of America Merrill Lynch

Yes, excluding MarketForm obviously.

Keith Alan Jensen
Former Senior VP & CFO

The places where we've seen significant reserve development, we've seen it in a legal and professional liability book that is in run-off. We've seen it in our excess and surplus lines. There's been some meaningful, favorable development and in our D&O business. Those would be the ones that had a rough and dirty $10 million or so of development in the quarter.

Jay Cohen
Bank of America Merrill Lynch

Favorable?

Keith Alan Jensen
Former Senior VP & CFO

Favorable.

Carl Lindner III

MarketForm was really about the only business within our specialty casualty segment that had any meaningful unfavorable development.

Jay Cohen
Bank of America Merrill Lynch

So everything else -- it sounds as if the claims environment, other than what you saw in Italy is not changing dramatically, is that fair?

Keith Alan Jensen
Former Senior VP & CFO

That's fair. I mean, we're continuing to be very pleased with the development in those lines that I named.

Jay Cohen
Bank of America Merrill Lynch

Then, on MarketForm, does the charges you've had to take for reserves change your view of the goodwill associated with that acquisition?

Keith Alan Jensen

Former Senior VP & CFO

Not really. A major portion of the thought process around that acquisition was our ability to take international -- five of our lines of business that had previously been looking toward different opportunities to broaden their global opportunity to sell and that was a major driver in that acquisition, has been a major part of our thought process with respect to the accounting for it.

Carl Lindner III

In fact, we project some $50 million, $60 million of the $140 million I talked about earlier coming from those expansion lines, the ocean marine, equine mortality, certain property and species and fidelity types of risk.

Jay Cohen
Bank of America Merrill Lynch

Then last question, on the crop business, given the increase we've seen in crop prices, as we think about premiums for 2011, assuming things don't change, is it fair to assume you should see a boost in premiums, all else being equal, simply because of the rise in crop prices?

Carl Lindner III

I think that's a fair assumption. The crop prices, all at these levels or even a little bit lower, yes, I think that would mean a positive impact on '11 premiums.

Operator

(Operator Instructions). Your next question comes from the line of Amit Kumar - Macquarie Research Equities.

Amit Kumar
Macquarie Research Equities

Just maybe very quickly, can you just talk about the California comp market and maybe also touch upon the elections which are coming up and what could change or what could not change going forward in terms of rates and other trends?

Carl Lindner III

It's a more competitive market than what it should be today. When you look at the industry I think WCRB is projecting industry results of about 125 combined ratio last year, so that means this year it has to be that or higher; tough economic climate still. Republic, we think for '09 and '10 is probably in the 116% to 118% accident year combined ratio area.

We feel our reserves are solid. In our case, we need to get to a 15% return on equity, combined ratio around 104%. We need to get another 10% to 15% price increase on top of the 8% year-to-date increase that we've got in there.

So competitive market, more competitive than what it should be. If there's any turnaround in pricing, everything points towards California comp as having to be one of the first places where you would think that you would see a turn in pricing.

As far as the political environment, Amit, I think we've got to wait and see what happens some. I suppose if Jerry Brown wins as governor that that could have a slightly negative impact from my perspective on the environment there. But I think it's got to wait and see.

Amit Kumar
Macquarie Research Equities

Maybe just moving on, on October 20, there was a news story regarding Fannie Mae going after some insurance companies, including Great American Financial Resources. I haven't seen any update after that. Do you have an update as to what has developed on that lawsuit?

Carl Lindner III

Yes, I can't -- we don't really comment on pending litigation that much. I can tell you that Fannie Mae recently filed a lawsuit against a number of insurance companies including Great American. It's really one of the property casualty industries and it's related to fraudulent mortgage loans.

In our case, that involves some high layer excess financial institution bonds that were written by our fidelity and crime division. We wrote $20 million part of a $30 million excess of $85 million recover and $5 million, which was part of $50 million excess of $115 million, so pretty high layer excess.

It's alleged that the losses arose from US mortgages alleged fraud on Freddie Mae arising out of 544 loans. The suit's been filed to address whether there's coverage for the claims. It's pretty early for us to make any comment about exposure in that except we pointed out what our gross limits were there.

Amit Kumar
Macquarie Research Equities

Just a final question -- in terms of the life side, the annuity side, has there been a recent test of the DAC, as well as policyholders funds in terms of the underlying assumptions?

Stephen Craig Lindner
Co-President, Co-CEO & Director

That's something I think we always do in the fourth quarter, so we'll have an analysis here very soon.

Operator

There are no further questions at this time. I'll turn the call back over to Mr. Jensen.

Keith Alan Jensen
Former Senior VP & CFO

Thank you very much. We appreciate you taking the time to listen to us this morning and your questions and we look forward to reporting our year-end results. Thank you. Have a good day.

Operator
This concludes today's conference call. You may now disconnect.