S&P Capital IQ

CONTENTS

Kemper Corporation NYSE:KMPR

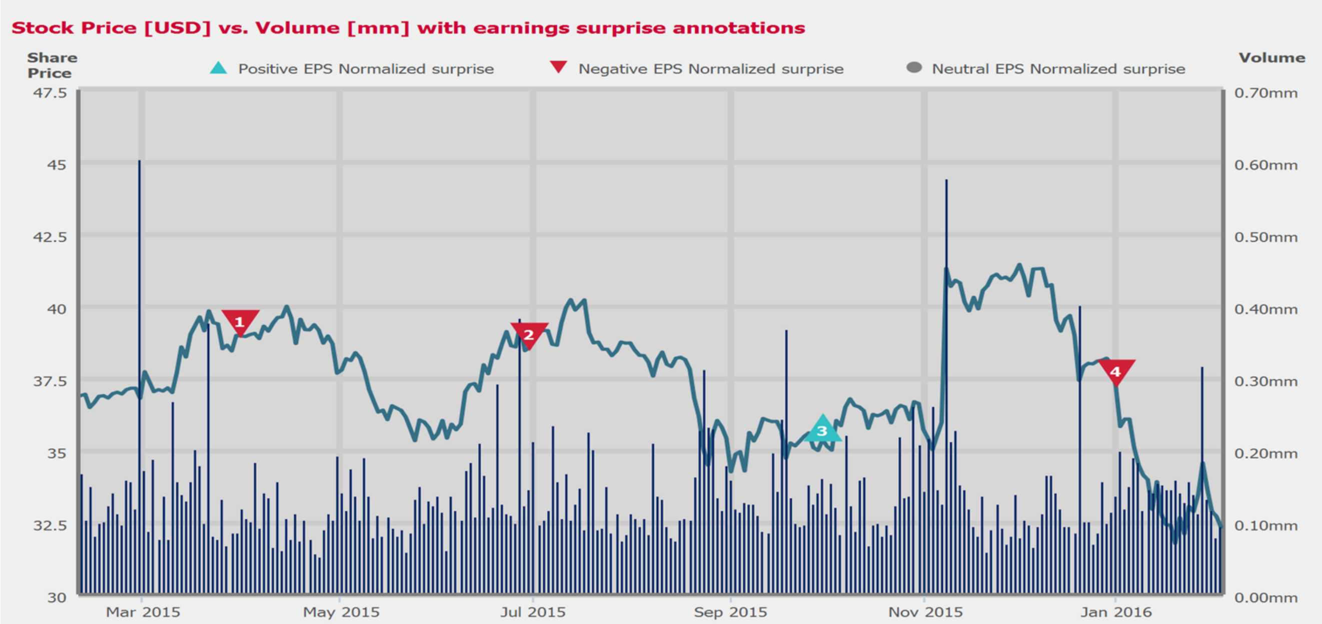
FQ1 2016 Earnings Call Transcripts

Friday, May 06, 2016 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ1 2016-			-FQ2 2016-	-FY 2016-	-FY 2017-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.03	(0.01)	NM	0.26	1.32	2.08
Revenue (mm)	588.78	611.30	▲3.82	602.19	2431.81	2439.97

Currency: USD
Consensus as of May-05-2016 11:58 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ1 2015	0.52	0.42	▼1 (19.23 %)
FQ2 2015	0.49	0.13	▼2 (73.47 %)
FQ3 2015	0.56	0.71	▲3 26.79 %
FQ4 2015	0.59	0.09	▼4 (84.75 %)

Call Participants

EXECUTIVES

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

Frank Joseph Sodaro
Former Senior Advisor

John M. Boschelli
Chief Investment Officer and Senior Vice President

Joseph P. Lacher
Chief Executive Officer, President and Director

ANALYSTS

Amit Kumar
Macquarie Research

Christine Amanda Worley
JMP Securities LLC, Research Division

Jon Paul Newsome
Sandler O'Neill + Partners, L.P., Research Division

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

Presentation

Operator

Good morning, ladies and gentlemen, and welcome to Kemper's First Quarter 2016 Earnings Conference Call. My name is Candace, and I'll 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, Kemper's 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 2 of our business executives, starting with Joe Lacher, Kemper's President and Chief Executive Officer; followed by Frank Sodaro, Kemper's Senior Vice President and Chief Financial Officer.

We will make a few opening remarks to provide context around our first quarter results. We will then open up the call for a question-and-answer session. During the interactive portion of the call, our presenters will be joined by John Boschelli, Kemper's Senior Vice President and Chief Investment Officer.

After the markets closed yesterday, we issued our press release and financial supplement. In addition, we filed our Form 10-Q with the SEC. 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 risks associated with relying on forward-looking statements, please refer to our 2015 Form 10-K filed with the SEC as well as our first quarter 2016 earnings release and Form 10-Q.

This morning's discussion includes non-GAAP financial measures that we believe may be meaningful to investors. In our supplement and earnings release, we 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 first quarter of 2015, unless we state otherwise.

Now I will turn the call over to Joe.

Joseph P. Lacher
Chief Executive Officer, President and Director

Thank you, Diana. Good morning, everyone, and thank you for joining our call today. Before I go into details on the first quarter results, I want to update you on a few key topics. As I communicated in our last earnings call, the leadership team and I are in the midst of a deep dive analysis of the company, evaluating different aspects of our business model as part of our mission to deliver improved results. The output of this process will be our refocused strategy, which we plan to share with you later this summer, sometime after we release our second quarter earnings. As a result, we'll limit today's comments to our first quarter and defer discussion on strategy-related topics.

Looking at Kemper in total, we finished the first quarter with a $2 million net loss and a $1 million net operating loss. Revenues in the quarter totaled $611 million, up largely from the acquisition of Alliance United. Obviously, we're disappointed from a bottom line perspective. While we made progress in several areas, 2 key items were a drag on our results. Elevated catastrophes and continued loss pressure in the Alliance United business. Because the cat losses affect both segments, I'll review them now before I go into a discussion on each of the businesses.

Catastrophe losses totaled $39 million, including $2 million from the Life & Health business. Like most of the industry, we saw a high volume of storm activity during quarter, with a dozen catastrophic events, the most significant occurred on March 23 in Texas, where hail damage caused $27 million in catastrophe losses.

April continued to be active on the weather front, especially in Texas, one of our larger states. At this point, we estimate the second quarter cat losses to be in the range of $35 million to $45 million. If the second quarter level turns out to be higher than the top end of that range, we'll update you again.

Despite the short-term spike in cats, we're comfortable with our long-term pricing expectations, and we do not anticipate fundamentally changing our pricing or underwriting actions in the impacted areas.

I'll turn now to discuss our Property & Casualty segment results. In total, earned premiums for the segment totaled $396 million, an increase of $108 million from last year. Excluding the $120 million lift from Alliance United, earned premiums decreased by $12 million, as lower unit volume offset a modest increase in average earned premium.

We reported a net operating loss of $13 million, down from the net operating earnings of $13 million a year ago, driven by the elevated cats and Alliance United loss pressure. On a positive note, the legacy lines' underlying loss ratio improved 2 points to 67.2%. Since we added Alliance last April, it makes total P&C comparisons versus prior year a challenge. In addition, this business intentionally runs at a higher loss ratio and a lower expense ratio than our legacy businesses that distort aggregate ratios. As a result, we'll talk about Alliance United and legacy lines separately in our comments.

Alliance United had a net operating loss of $8 million, which included prior year reserve development of $4 million after tax. Given the industry's challenges with frequency patterns in California, this quarter's results were not entirely a surprise. For context, I'll update you on a number of challenges we discussed about Alliance United last quarter.

First, we saw elevated frequency levels, a need for increased rates, high levels of new business volume and a claims department that was somewhat understaffed. I'll walk through a status on each of these items. On frequency, the trends in California continue to be elevated for the industry. We continue to experience the elevated loss trends that many of our competitors have cited. Frequency, particularly in liability, remains pressured.

Relative to rate, in early April, we began implementing a nearly 7% rate change on our millennium product, which represents roughly half the book of business. The filing included a new class plan to get the rate where it's needed the most. We subsequently filed for a nearly 7% rate increase on our gold product, covering the other half of our book, which is pending.

It'll take a few pricing cycles to achieve acceptable returns, so we anticipate quickly filing for additional rate increases on both products. We're complementing our rate filings with various underwriting and agency management actions.

Turning to production. The Alliance United products tend to have a high level of seasonality, with sales in the first half of the year significantly higher than sales in the second half. Because of the recent loss trends and timing of rate approvals, we significantly slowed our new business. What would have typically been a 20% increase in new business app sequentially was actually a 16% decrease from the fourth quarter. That's a very significant shift. We'll continue to manage sales flow as we implement needed rate actions.

Finally, talk about claims staffing gap in our last call. I'm pleased to report that we've made substantial progress. Since acquiring Alliance United, we've added more than 100 claims personnel, an increase of 28%. We have plans to add at least 80 more to reduce our pending claims count as quickly as possible. And in addition, we successfully launched Alliance United claims processing on our Guidewire claims platform last week, and we'll continue to expand our capabilities.

Last quarter, we told you about a series of issues that were driving the profitability challenges, and we made significant progress on all fronts. We believe that Alliance United's business is fixable and will take a couple of pricing cycles to get the results we want. While we're disappointed about the current profitability level, we still feel good about the strategic value of this acquisition.

Turning now to our legacy nonstandard auto lines. We saw improved profitability, but we're not yet in the earnings level we seek for this line. Earned premiums were $77 million, up $3 million, as higher average earned premiums offset a modest decline in policies in force. Strong new business and higher average rate drove net earned premium up 8% while we continue to implement rate and underwriting actions.

The underlying loss and LAE ratio improved 1 point to 79.5%, as the increased rates we've been taking were able to outpace elevated frequency trends. Catastrophe losses, which are typically negligible in this line, totaled 2 points in the quarter as a result of heavy hail damage.

In our preferred auto and home lines, overall, it's a pretty good story. Underlying profitability improving, new business volume rising and retention increasing. While our revenue for these lines are still down over the prior period, we're seeing the rate of decline slow. The preferred auto book earned premiums were $106 million, down 8% as policies in force declined. The decline was partially driven by the runoff of our Kemper Direct book that continues to erode at about 20% per year. In our ongoing agency book, we saw policy retention continue to recover, improving 4 points to 84%, and new policies written increased over the period -- prior period by 7%. The combination of the seasoning of our in-force book and segmented rate actions led to an improvement in the underlying loss ratio of 1.5 points to 69.1%. Loss trends have been relatively benign in this line.

In our homeowners line, earned premiums were $68 million, down 6%. On the ongoing agency book, we saw improvements in retention, up 4 points to 83%, and new policies written up 13.5%. The big story in the quarter was catastrophes, as I mentioned earlier. A significant amount of the quarter's cat activity centered around Texas, which is one of our largest states. We expect catastrophe losses to vary significantly over time. The first quarter's activity, while elevated, was not out of line with our long-term pricing expectations. We do not anticipate fundamentally changing our pricing or underwriting as a result of these cats. We continue to see severity pressure broadly in this line, although frequency is down. Underlying loss ratio improved 3 points to 51.7%, driven by both seasoning of our in-force book and segmented rate actions.

So when we look at our property and casualty business in total, we're encouraged by the improving underlying results as well as new business and retention trends in preferred auto and home. While we have more work to do, the book is stabilizing. Our nonstandard auto book now makes up roughly half of our P&C premium, so our continued focus on corrective actions is critical to restoring and improving profitability. We understand the issues with this business and they're fixable. Increased claims staffing and implementing aggressive rate and underwriting actions are key to improving these results.

I'll turn now to the Life & Health segment, where we reported net operating income of $20 million, up $4 million. I'll note that last year, we had a $5 million after-tax deferred premium reserve adjustment. Excluding the adjustment results in our life insurance lines we're stable for the quarter. Outside of life, higher A&H claims and cat losses were offset by higher net investment income. This segment continues to produce stable earnings and cash flow to the parent company.

Now I'll turn the call over to Frank.

Frank Joseph Sodaro
Former Senior Advisor

Thanks, Joe, and good morning, everyone. Today, I'll cover Kemper's consolidated performance, capital and parent company liquidity. For the first quarter, Kemper's net loss was $2 million or $0.04 per share compared to net income last year of $14 million or $0.26 per share. Net operating loss was $1 million or $0.01 per share compared to net operating income last year of $22 million or $0.42 per share.

Catastrophe losses impacted earnings by $0.49 per share in the first quarter of 2016 compared to $0.13 last year. Total revenues increased $112 million, as roughly $120 million of earned premiums from Alliance United were partially offset by lower earned premiums from our legacy P&C lines. Earned premiums from our Life & Health group were relatively flat after taking into account the $8 million deferred premium adjustment booked last year.

Net investment income decreased $4 million for the quarter, primarily from the impact of our alternative investments. Alternative investment income was positive for the quarter, but down from last year due to a few large investments that underperformed.

Our alternative investment base was on average $150 million higher in the first quarter of 2016 versus the first quarter of last year as we increased our hedge fund holdings at the parent company. The increased income from this higher base was more than offset by lower investment yields.

Total return was strong at 2.6% in the quarter, driven by increased values of our fixed maturities related to the drop in interest rates. Our pretax equivalent annualized book yield was 4.6% for the first quarter of 2016 compared to 5% last year.

The Property & Casualty segment reported a net operating loss of $13 million for the quarter compared to net operating income of $13 million last year. This decline was primarily from higher catastrophes and Alliance United's results, which included $4 million of after-tax of adverse reserve development. Results also included a 2-point improvement on our legacy lines' underlying loss, but this was offset by lower levels of favorable reserve development on our legacy book and lower investment income.

As for Alliance United's reserve development, the combination of significant growth and the increased frequency resulted in an understaffed claims department, and ultimately led to an increase in the pending claims inventory. Historically, older claims are more likely to close with a payment and have higher severity. The combination of these items drove our adverse reserve development in this line. As Joe mentioned earlier, we have made it a priority to add claims adjusters to reduce the number of pending claims.

Net operating income for our Life & Health segment was $20 million for the quarter compared to $16 million last year. Results increased primarily from the $5 million after-tax adjustment to deferred premium reserves in the first quarter of 2015. Excluding this adjustment, results were fairly flat as higher A&H claims and catastrophe losses were offset by higher investment income.

Net operating loss from Corporate and Other was essentially flat for the quarter as lower net investment income was offset by lower pension expense.

I'll now cover book value, capital and parent company liquidity. Book value per share was $39.92 at the end of the quarter, up 3% from last -- from year-end, largely from the impact of lower market yields on our fixed maturity portfolio, partially offset by dividends paid. Book value per share excluding unrealized gains on fixed maturities was $34.97, essentially flat from year-end.

Statutory surplus levels in our insurance companies remain strong, and we estimate that we'll end the year with risk-based capital ratios of approximately 385% for our Life & Health group and 315% for our legacy P&C group.

During the first, we repurchased 140,000 shares of common stock for a total cost of $4 million or $27.13 per share. Including dividends, we returned $16 million of capital to shareholders in the quarter. This week, the board approved a dividend of $0.24 per share. We estimate that we ended the quarter with more than $225 million of excess capital, and from a liquidity perspective, the parent company held cash and investments of about $300 million, while our $225 million revolver remained undrawn.
I'll now turn the call over to the operator to take your questions.

Question and Answer

Operator

[Operator Instructions] And our first question comes from Steven Schwartz of Raymond James.

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

A few here. First, Joe, you mentioned the hiring of -- well, in the first -- at the end of the fourth quarter, you mentioned that you needed more claims personnel. You mentioned that you hired another 100 and you're looking to hire another 80. Sounds to me like those are significant numbers. I'm trying to figure out, are those -- is that the base -- will that get you to the base that you need or is some of this just catch-up on the claims that were behind?

Joseph P. Lacher
Chief Executive Officer, President and Director

Great question, Steve. And let me clarify a little bit. We've added 103 since the acquisition, I believe 67 of them came last quarter. So the bulk of them came in this past quarter. So we clearly recognized we were a bit understaffed. Part of that probably started out at acquisition that we misread what we needed. Part of that was from the higher frequency and part of it was from the growth. So as the business has grown, as you'd expect, you need more claims personnel. Frequency popping more than expected pushed that as well. So we believe we need another 80 to get to what we need to cover the current levels and potential growth. So that should get us to where we're actually slightly overstaffed, and we'll let attrition work its way down.

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

Okay. That's good. And then another issue I want to ask about, you didn't touch on it. I mean, I understand the issue with the Social Security master death file, but I was wondering if you wanted to talk to that, given that this is a new position for you and how you might go about dealing with that?

Joseph P. Lacher
Chief Executive Officer, President and Director

Sure. And help me, Steven, to make sure I go at it because it can be a broad issue. Are there specific areas that you'd like me to poke at?

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

No, just I think talking about how you view this. Look, I understand the issues that the products weren't priced for this. But 60 Minutes, I mean, it's just -- the public perception of this, where do you go from here?

Joseph P. Lacher
Chief Executive Officer, President and Director

Okay. Happy to. First of all, we actually agree with much of what 60 Minutes reported. There were a set of practices that a number of well-known life insurance companies use, where they were using a death master file to stop payments to annuitants from a fraud perspective. Annuitants who passed away and hadn't mentioned it. And then they subsequently weren't paying those same policyholders the life claim. That's a problem. And we agree with the issue that, that's a problem. And those -- many of those companies have settled with regulators accordingly. And they paid fines and penalties. And they've done all the things to fix that practice. We never participated in that practice. We did not use a DMF to stop annuitants -- annuitant claims. And as a result, we didn't have knowledge of death and not pay a life claim. So we're just not in that position. The position the company has taken over the last couple of years, on one end is completely reasonable. We were pressed with regulators who were asking us to pay the same fines and penalties and take the same punitive business practice changes that those folks who had done these unseemly things had done. And we sort of had a point of view that said, you get fines and penalties and punishment when you've done something wrong, but not when you haven't. That being said, the world is a little bit different now. There are some relatively accessible sources of information that can be used to potentially help consumers. And we're going to look at and explore that issue. And we have been willing to look at it and explore the issue of how we can do that. Our challenge has been that many of the regulators haven't wanted to find a middle ground that says, what do people -- what do companies that didn't employ these bad practices, what can they do that's sort of a reasonable middle ground? And we may end up at a point, Steven, where we have to act unilaterally to do something. And we'll contemplate that and figure it out going forward.

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

Okay. And then could you just talk with regards to Alliance United, maybe the difference between the millennium product and the gold product?

Joseph P. Lacher
Chief Executive Officer, President and Director

They're 2 different products. We deploy them in the marketplace. They target slightly different consumer groups. They sometimes are more active in different geographies. I wouldn't think of them as fundamentally different, like you might think of a preferred or a nonstandard product. We deploy them tactically a little bit differently.

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

Okay. All right.

Joseph P. Lacher
Chief Executive Officer, President and Director

They're not fundamentally conceptually targeting a radically different segment of the market.

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

Okay. All right. I appreciate it.

Joseph P. Lacher
Chief Executive Officer, President and Director

We got a millennium product rate filed and approved, and that's in process. We talked about that last time. We've changed the mode of how we're working with the insurance department with our gold product. And we think we'll move that process through more quickly than we saw last time. So we're confident about that. We're hopeful that will be a third quarter type item. And we've seen some market activity that suggest, given the frequency out there and the profitability levels that California may be receptive to more than one rate change a year. And we will respond with both products accordingly.

Operator

And our next question comes from Paul Newsome with Sandler O'Neill.

Jon Paul Newsome
Sandler O'Neill + Partners, L.P., Research Division

Apologize ahead of time, I got so many calls, I get a little confused sometimes. Did I hear you mention anything about second quarter catastrophe losses? And if you didn't, any early read on whether or not you were hit by the losses in Texas that we saw, I guess, mostly around San Antonio and Dallas?

Joseph P. Lacher
Chief Executive Officer, President and Director

Yes, we were. We did mention briefly something about the second quarter catastrophes. We were impacted by the storms in Texas. And our suggestion was, we're looking and estimating that will be between $35 million and $45 million for the second quarter. And if something causes us to go above the top end of that range, we'll come back out with another announcement.

Jon Paul Newsome
Sandler O'Neill + Partners, L.P., Research Division

Does that -- 2 type of quarters with -- of cats, do you think that's an issue from a cash flow -- near term cash flow perspective?

Joseph P. Lacher
Chief Executive Officer, President and Director

No, I don't see any issue for near term cash flow at all. And as we said, we don't see anything that is really suggesting that we do anything different from an underwriting or a pricing perspective.

Jon Paul Newsome
Sandler O'Neill + Partners, L.P., Research Division

And my last separate question is, you hired some senior folks. I think we saw someone hired for the life side. Do you have your senior team together at this point or are you still out there trying to fill it out and round it out?

Joseph P. Lacher
Chief Executive Officer, President and Director

Yes, we're still in process, Paul. We mentioned, after last quarter, that we got an interim role, where Joe Metz and I are working with our property and casualty business and we're in the process of getting a more final solution there.

Operator

[Operator Instructions]

And our next question comes from Amit Kumar of Macquarie.

Amit Kumar
Macquarie Research

Just a few follow-ups to the previous question. First of all, just going back to the discussion on the story in 60 Minutes and your view that you'll be changing practices. Could that or would that result in any financial impact we should be prepared for going forward?

Joseph P. Lacher
Chief Executive Officer, President and Director

Amit, I'll clarify my question slightly because you went a little further than I did and say that we would be changing practices. I said, we'd be open to it. We're recognizing that there are some abilities to do some things that can be responsive to consumers at a relatively modest expense, operating cost to us if we can find the decedents. That's something we're willing to explore. We are not at a point where we have fully explored those items. We are not at a point where I could estimate what range of dollars that might be. But it's not hard to imagine that if we found a way that we might be able to find the decedents who hadn't reported a claim and assist in that process, what it would ultimately be is some acceleration of the payment of those benefits from what we've seen right now because the folks hadn't filed the claim already. That's just a practical element of what it would be. But we're not aware of what those dollars might be at this point. And ultimately, as we think about it, if a policyholder has passed away, that is a benefit that the policy was designed to pay to them and that would be just normal ordinary course of business. It might have a timing impact, but it's why we sell insurance policies.

Amit Kumar
Macquarie Research

Okay. Fair enough. I guess the second and maybe the third question are somewhat intertwined. I know you -- in the opening remarks, you mentioned that you'll talk about sort of the plan, et cetera, on the next call. I was looking at the historical return on equity profile for the company. And I know that there have been reserve adjustments, et cetera, in the past few quarters. Should we prepare ourselves for some sort of a deep dive adjustment, which might be coming through in the numbers going forward or is this sort of a look-forward plan and hence, we shouldn't be sort of relooking at our earnings estimates?

Joseph P. Lacher
Chief Executive Officer, President and Director

Let me make sure I understand the question. Are you asking that as a result of the strategy, we're going to conclude that we have a balance sheet hole?

Amit Kumar
Macquarie Research

No, I did not say that. I did not say that. Could there be that possibility, i.e., are you looking at -- are you doing some additional deep dive analysis in terms of looking at the reserves, looking at the claims? I know we talked a lot about the claims personnel. But is there some sort of a balance sheet analysis also going on with this plan, which you will talk about on the next call?

Joseph P. Lacher
Chief Executive Officer, President and Director

Let me clarify 2 things. One, we said, is we'll talk about that broader strategy after we do the second quarter earnings. So it will probably be an additional call. Mixing those 2 together probably is not helpful because there's enough to digest on both of them. So we'll do something after the second quarter to make sure we've got that clear. Then, we're very comfortable with the adequacy of our balance sheet. We feel it's strong, and it's in a good position. To the extent we go through a strategic review and contemplate how we're positioned in the marketplace and how we're best positioned going forward, I won't preclude the fact that there may be a restructuring charge associated with that. I'm not, in fact, signaling that there is one. Don't hear that, that way. But that may be partly a result of that. But I think that's more of a narrow issue than you're asking about.

Operator

And our next question comes from Christine Worley of JMP Securities.

Christine Amanda Worley
JMP Securities LLC, Research Division

Most of my questions have been asked and answered, but one sort of cleanup question on the alternative. Do you guys report those on a lag?

John M. Boschelli
Chief Investment Officer and Senior Vice President

Yes, this is John speaking. Yes, it depends on the asset class, but it's different types of lag. So for example, about 15% is no lag, about 30% is 1 month lag and about 55% is a 3-month lag.

Operator

And I'm showing no further questions at this time. I'd like to turn the conference back over to Mr. Lacher for closing remarks.

Joseph P. Lacher

Chief Executive Officer, President and Director

Thank you, Candace. And thank you, guys, for all your interest and questions today. As we stated earlier, our preferred business revenue is stabilizing and the underlying profitability is improving. Our Life & Health segment continue to deliver solid performance. We had 2 items that were pressuring our results this quarter: elevated catastrophes and Alliance United profitability. The volatility due to weather is a normal part of the property and casualty industry and our cat experience this quarter is consistent with our pricing expectations. The challenges in our nonstandard auto book are fixable, and we're taking the appropriate actions to address them. It will take some time to see all the improvement levels that we seek. And our current results do not reflect our potential, nor do they define our franchise. We're a company in transition. We're looking forward to completing our detailed analysis and sharing with you our updated strategy later this summer. In the meantime, you can be assured that we're focused on delivering improved results for both the near term and the longer term. I look forward to updating you next quarter and thanks, again, for your time today.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Have a great day, everyone.