S&P Capital IQ

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Cincinnati Financial Corporation NasdaqGS:CINF

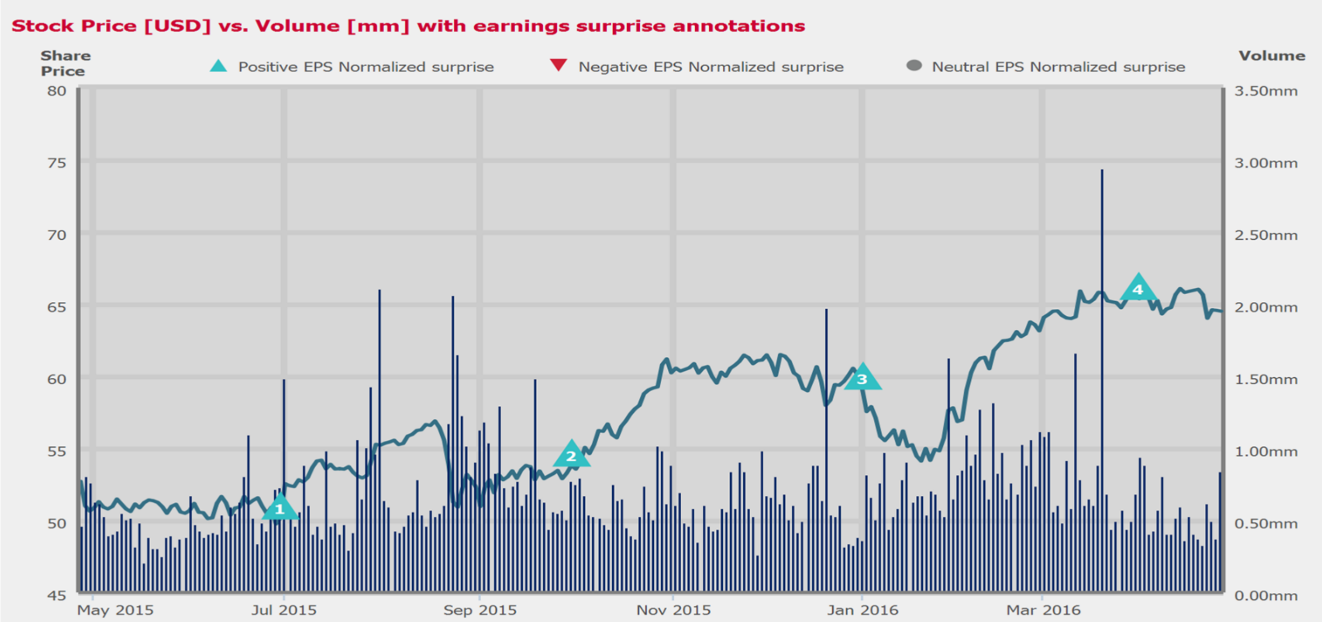
FQ2 2016 Earnings Call Transcripts

Wednesday, July 27, 2016 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2016-			-FQ3 2016-	-FY 2016-	-FY 2017-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.39	0.57	▲46.15	0.69	2.98	2.98
Revenue (mm)	1334.00	1371.00	▲2.77	1355.00	5425.00	5663.00

Currency: USD
Consensus as of Jul-27-2016 10:34 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2015	0.41	0.83	▲1 102.44 %
FQ3 2015	0.65	1.04	▲2 60.00 %
FQ4 2015	0.87	1.10	▲3 26.44 %
FQ1 2016	0.72	0.89	▲4 23.61 %

Call Participants

EXECUTIVES

Dennis E. McDaniel
Vice President, Investor Relations Officer and Vice President of the Cincinnati Insurance Company

Jacob F. Scherer
Former Chief Insurance Officer

Martin J. Mullen
Chief Claims Officer of the Cincinnati Insurance Co. and Senior VP of the Cincinnati Insurance Co.

Michael J. Sewell
Chief Financial Officer, Senior Vice President and Treasurer

Steven J. Johnston
Chief Executive Officer, President, Director and President of Cincinnati Life Insurance Company

ANALYSTS

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

Joshua David Shanker
Deutsche Bank AG, Research Division

Michael Zaremski

Presentation

Operator

Good morning. My name is Shannon, and I will be your conference operator today. At this time, I would like to welcome everyone to the second quarter 2016 earnings conference call. [Operator Instructions]

It is now my pleasure to turn today's call over to Mr. Dennis McDaniel, Investor Relations Officer. Mr. McDaniel, you may begin your conference.

Dennis E. McDaniel
Vice President, Investor Relations Officer and Vice President of the Cincinnati Insurance Company

Hello, this is Dennis McDaniel from Cincinnati Financial. Thank you for joining us for our Second Quarter 2016 Earnings Conference Call.

Late yesterday, we issued a news release on our results along with our supplemental financial package, including our quarter-end investment portfolio. To find copies of any of these documents, please visit our investor website, cinfin.com/investors. The shortest route to the information is the Quarterly Results link in the navigation menu on the far left.

On this call, you'll first hear from Steve Johnston, President and Chief Executive Officer; and then from Chief Financial Officer, Mike Sewell. After their prepared remarks, investors participating on the call may ask questions.

At that time, some responses may be made by others in the room with us, including the Cincinnati Insurance Company's Executive Committee Chairman, Jack Schiff Jr.; Chairman of the Board, Ken Stecher; Chief Insurance Officer for Cincinnati Insurance, J.F. Scherer; Principal Accounting Officer, Eric Mathews; Chief Investment Officer, Marty Hollenbeck; and Chief Claims Officer for Cincinnati Insurance, Marty Mullen.

Second, please note that some of the matters to be discussed today are forward-looking. These forward-looking statements involve certain risk and uncertainties. With respect to these risks and uncertainties, we direct your attention to our news release and to our various filings with the SEC. Also, a reconciliation of non-GAAP measures was provided with the news release. Statutory accounting data is prepared in accordance with statutory accounting rules and, therefore, is not reconciled to GAAP.

Now I'll turn the call over to Steve.

Steven J. Johnston
Chief Executive Officer, President, Director and President of Cincinnati Life Insurance Company

Thank you, Dennis. Good morning, and thank you for joining us today to hear more about our second quarter results. We are pleased to report satisfactory operating performance despite second quarter catastrophe loss effects that were slightly higher than our long-term average. Thanks to the steady efforts of our associates to support the local independent agents who represent Cincinnati Insurance, we still managed to generate a modest operating -- modest underwriting profit in the second quarter, and our first half 2016 consolidated property casualty combined ratio of 95.4% is within a 0.5 point of the first half of last year.

We are encouraged by improving underwriting results before the effects of catastrophes, and believe we will see ongoing benefits from our various initiatives focused on profitability.

Rising investment income and robust portfolio valuations at quarter-end were another bright spot for recent performance. Higher investment income for the first half of 2016 offset a small decrease in property casualty underwriting profit leading to a 3% increase in operating income. Mike Sewell will comment further on that in a moment.

First, I'll highlight some important points about our insurance operations. Each of our segments continued to grow satisfactorily, as we earn quality new business produced by our agencies. Pricing was generally consistent with the first quarter. However, personal auto was an exception with average renewal rate percentage increases moving from the mid-single-digit range to the high single-digit range. We believe that improved pricing for both our personal and commercial auto, along with other initiatives, will improve our results for those lines of business.

Expansion of our reinsurance assumed operation, known as Cincinnati Re, also continues to progress nicely. Cincinnati Re generated an underwriting loss of just under $1 million for the second quarter as a result of a $4 million estimated share of losses from the Fort McMurray Canada wildfire affecting the industry, plus what we believe is appropriate reserving for a diverse portfolio of reinsurance treaties.

We are also satisfied with the progress of expanding the personal lines products and services we offer to our agencies' higher net worth clients. Nearly 1/4 of the total $59 million in personal lines new business written premiums for the 6 -- first 6 months of 2016 came from high net worth policies. We reported an underwriting profit for each of our property casualty segments in the first half of 2016. As in most years, we anticipate the second half to be better than the first.

Our commercial line segment produced a combined ratio just over 95% for the first half of the year, while that ratio for our excess and surplus segment was just under 75%.

Our life insurance subsidiary, including income from its investment portfolio, also experienced another good quarter and first half of the year. For the first 6 months of 2016, earned premiums grew 11%, and net income for our life insurance subsidiary rose 10% compared with last year.

Our primary measure of financial performance, the value creation ratio, was again strong at 4.6% for the second quarter and 10.5% for the first half of 2016. Generally higher valuations in securities markets augmented the contribution of our operating performance. While we're pleased with ongoing good performance, we understand the need to remain focused on underwriting profitability and growth. We'll do that as we seek to continually improve performance.

I'll now ask our Chief Financial Officer, Mike Sewell, to share his highlights for other areas of our financial performance.

Michael J. Sewell
Chief Financial Officer, Senior Vice President and Treasurer

Great. Thank you, Steve, and thanks for all of you for joining us today. I'll open with highlights of second quarter investment results. It was another stellar quarter for investments, including 6% growth in pretax investment income and 7% on an after-tax basis. We also experienced increases in the fair value and unrealized gains positions of both our equity and bond portfolios. We ended the second quarter of 2016 with a net unrealized gain of nearly $2.7 billion before taxes, including more than $2 billion for our common stock portfolio that reached more than $5 billion in fair value.

For our bond portfolio, interest income, again, grew 4% in part due to net purchases of $309 million, over the past 4 quarters. The bond portfolio's pretax average yield reported at 4.64% for the second quarter and 4.65% for the first half of 2016 matched the year-ago periods.

Taxable bonds purchased during the first 6 months of 2016 had an average pretax yield of 4.5%, 8 basis points higher than we experienced a year ago.

Tax-exempt bonds purchased average 3.01%, 33 basis points lower than a year ago. Our bond portfolio's effective duration at June 30 was 4.8 years, up slightly from 4.7 years at year-end.

Cash flow from operating activities continued to fuel the investment income growth. Funds generated from net operating cash flows for the first half of 2016 rose 4% compared with a year ago to $490 million and helped generate $292 million of net purchases of securities for our investment portfolio.

As always, we work to carefully manage our expenses at the same time of strategically investing in our business. Our first half of 2016 property casualty underwriting expense ratio rose 0.2 percentage points compared with a year ago.

Our loss reserves continued to experience favorable development, as we apply a consistent approach to setting overall reserves. For the first 6 months of 2016, favorable reserve development benefited our combined ratio by 5 percentage points compared with 4.4 points for the same period last year and similar to the 5.2-point rolling average for the prior 4 quarters.

Reserve development so far in 2016 continued to be spread over most of our major lines and over recent accident years, including 55% for accident year 2015 and 22% for accident year 2014.

Overall reserves, including accident year 2016 and net of reinsurance, rose $229 million in the first half of 2016, including $133 million for the IBNR portion.

Our capital strength, liquidity and financial flexibility continued at healthy levels. Our capital remains ready to support future profitable growth of our insurance operations and other capital management actions, such as returning capital to shareholders.

As usual, I'll conclude with a summary of contributions during the second quarter to book value per share. They represent the main drivers of our value creation ratio. Property casualty underwriting increased book value by $0.04. Life insurance operations added $0.07. Investment income other than life insurance and reduced by noninsurance items contributed $0.47. The change in unrealized gains at June 30 for the fixed income portfolio, net of realized gains and losses, increased book value per share by $0.72. The change in unrealized gains at June 30 for the equity portfolio, net of realized gains and losses, increased book value by $0.59. And we declared $0.48 per share in dividends to shareholders. The net effect was a book value increase of a $1.41 during the second quarter to a record $42.37 per share.

And now I'll turn the call back over to Steve.

Steven J. Johnston
Chief Executive Officer, President, Director and President of Cincinnati Life Insurance Company

Thank you, Mike. As you can see, we have a lot of positive trends carrying us into the second half of the year. Our book is on incremental improvement is adding up and delivering great results that are worth noticing.

In the last few months, Moody's, S&P and Fitch have all affirmed our strong financial strength ratings maintaining their stable outlooks. Fortune Magazine also took notice of our progress this year, as we joined the ranks of the Fortune 500 in June.

As we work together with our agency partners to maintain this momentum, we're confident that we'll continue to produce value for shareholders in the near term and for the long term.

We appreciate this opportunity to respond to your questions and also look forward to meeting in person with many of you during the remainder of the year.

I'll also note that many of you know Eric Mathews, who we announced last fall, will be retiring on July 29 after nearly 40 years with the company. We thank Eric for his leadership of our accounting operations and wish him the best. Senior Vice President, Theresa Hoffer, will participate in future earnings conference calls instead of Eric. As a reminder, with Mike and me today are Jack Schiff Jr., Ken Stecher, J.F. Scherer, Marty Mullen, and Marty Hollenbeck in addition to Eric Matthews.
Shannon, please open the call for questions.

Question and Answer

Operator

[Operator Instructions] Your first question comes from the line of Josh Shanker from Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

I wanted to ask a little about technique in reserving for personal lines versus commercial lines. Commercial lines have a tendency, almost consistently, to be quite redundant over a very long period of time, and personal lines tend to whipsaw in both directions. I realize that, obviously, commercial liability like workers' comp is longtailed in nature, and that might have something to do with that. But given your conservatism, how you think about things, why is there -- are these 2 different sort of tracks that they're on?

Michael J. Sewell
Chief Financial Officer, Senior Vice President and Treasurer

Josh, this is Mike Sewell, and that's a great question, and hopefully, you mentioned whipsaw. I'm not sure I probably would have defined it that way. We do follow a consistent approach with -- our actuaries, not changing how we do the reserves and look at them. But from time to time, we will have, I'll call them, refinements to the process as more information becomes available and so forth. I think probably your comment might be specifically related to the personal lines and how maybe that fluctuated a little bit from the first quarter of this year to the second quarter, and how -- maybe the second quarter was probably a little bit more in line with 2015 and 2014. Really, as we noted in our first quarter 10-Q, I think I may have made some comments in there. We did have a slight refinement on our personal lines business, which was really related to what we call the AOE reserves. And so there were some expenses there that we refined. It moved about $9 million, $10 million worth of reserves from the personal line side to the commercial line side. Had we not made that refinement, you would have actually probably seen the personal lines prior year development in the first quarter really be flat. So because we did that, you saw some favorable development there. And now in the second quarter, really what's running the temperature is the personal auto as well as commercial auto when you look at prior year reserve development. So absent some refinements, I think, we're fairly consistent. We are consistent in the process, and I think the numbers really show that. So I don't know if Steve or anyone else has any additional comments, but that might have been a little long-winded for you.

Joshua David Shanker
Deutsche Bank AG, Research Division

I'll take as much information as I can get. New appointments on new agencies, to what extent, when you're growing, are you finding the appointments are trending in newer territories versus territories that you know well. To what extent is it possible for you to find agencies in territories that you know well that you think you can get a 30% to 40% share of their business out of? How are new adds looking these days?

Jacob F. Scherer
Former Chief Insurance Officer

Joss, this is J.F. In existing territories, we've always taken the approach with the relatively low number of agencies we have to really appoint as few as possible in a particular area. Now with the M&A activity that's occurring and lot of consolidation in agencies from time to time, we would run into a case, where if we needed to augment our agencies in any particular area, the group from which we can choose might be smaller. But fortunately, the desire for agencies that don't represent us to have a contract with us is still high. So we rarely are turned down when we prospect for agencies. And so, I'd say, consequently, and the fact is that there are a lot of agencies that don't represent us in a lot of territories. So that's not a big concern for us, where we've been able to find agencies to appoint 30%, 40% of the volume in an agency is an ambitious target. We certainly want to be consequential to the agency, as you know, we talk about being #1 or #2, after we've been in an agency for 5 years. But we are not seeing any lack of opportunity for us to do that. It's worked out pretty darn well in newer states, particularly with what Will Van Den Heuvel's doing in the high net-worth area between the very good reputation that our agencies have earned for our company and they talk to agencies in some of these newer states for us. The door is pretty wide open for us to appoint agencies, for example, in lower New York, Manhattan, Long Island, we just recently opened New Jersey. California's soon to be opened and really no shortage of agencies to appoint there. So, fortunately, I think across the board, new states and existing states we're in pretty good shape.

Joshua David Shanker
Deutsche Bank AG, Research Division

And on the high net-worth homeowners' initiative, do you get any sense of the previous carrier? Is there any trend on where you're winning that business from?

Jacob F. Scherer
Former Chief Insurance Officer

Well, the opportunities are a result, as everyone knows, from the consolidation of carriers in that line. And so agencies, more than anything, want options they can offer to their policyholders. I just happened to see one come through this morning. It was from a direct writer that we actually wrote the business that frankly hadn't that particular business hadn't been very well attended to, but it's coming across the board. Actually, the direct writers write tremendous percentage of that business. So it's not all uncommon to see that. And then from the usual characters, we're competing pretty favorably against everybody right now. I think what's happening is that agencies when they take a contract with us, they know as part of the approach we take to them is that if we'll agree to appoint fewer agencies, than perhaps brand x might appoint. In return for that, we ask that the agency concentrate on making the relationship with us work. So we're very pleased with the number of at-bats we're getting. I think that's the most important thing. Those agencies aren't forced to put any business with us, but if they are giving us the opportunities, which we're pleased that they are, we're very pleased with the result.

Operator

Your next question comes from the line of Paul Newsome from Sandler O'Neill.

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

I wanted to see if you could help us think about the trend in both the commercial and the personal lines of the accident year results, if you exclude the catastrophe losses, the so-called underlying combined ratio. Most folks are talking about commercial lines and at least commercial lines pricing being lower than [indiscernible] inflation and then other mitigating efforts and obviously you have a little different discussion on the personal lines side. I was wondering if you could kind of walk through your thoughts on both of those?

Jacob F. Scherer
Former Chief Insurance Officer

Paul, this is J.F. I think in terms of the rate increases that we're getting on renewals, we're reasonably pleased with what we are seeing. In auto, both in private passenger and commercial autos, those are healthy and getting healthier. So we think that between the underwriting actions that we're taking in those 2 lines of business, plus the rate increases, as you know, we've been pretty aggressive about raising reserves on prior years and pretty conservative this year. We think that things are going in the right direction on auto. Relative to loss cost and all the other lines, there is still a lot of initiatives that are in the works here, loss control, inspections, more specialization by line of business as well as by industry that we think, and then, of course, the segmentation in the analytics that we're employing. We just think we're being better selectors of risks, and we're also addressing loss mitigation issues that's helping with our loss cost. So as it is right now, the improvement you are seeing in the accident year, excluding cats, would be exactly what we would expect it to have happened. And we are pleased with -- really everything is kind of fallen in place, still lot more to do, frankly, though we think there is a lot of improvements we can continue to make in those areas.

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

So do you think that the current -- the trend what we have seen in the last year or 2 will continue to see improvements in the underlying combined ratio?

Steven J. Johnston
Chief Executive Officer, President, Director and President of Cincinnati Life Insurance Company

Paul, this is Steve, and I agree 100% with J.F. he nailed that answer. Just putting it in a little bit of quantitative terms we are getting, rate increase, I think segmentation as J.F. mentioned is working well, that's helping us on the premium side. And there is also, as J.F. mentioned, in terms of the trend, which we look at it as being future trend in terms of the rate [indiscernible] being prospective, so we're looking at and trying to anticipate where loss trends are going in the perspective rating period or pricing period. And the points that J.F. made about the things that are going on the underwriting side, inspection loss control, [indiscernible] we think is making us optimistic about the future of continuing to make improvements. So I think from everything that we can see in the near term anyways, we feel pretty good about our [indiscernible] .

Operator

[Operator Instructions] Your next question comes from the line of Mike Zaremski from BAM Funds.

Michael Zaremski

My first question is on the catastrophe preannouncement. Now you pointed out in the release that this quarter's catastrophe load ended up being close to a normal in terms of the 10-year historical average. I guess, in my seat, I was a little bit surprised. It was around that historical average given your lack of personal lines exposure in Texas. So my question is whether your team at Cinci was surprised by the level of losses this quarter?

Michael J. Sewell
Chief Financial Officer, Senior Vice President and Treasurer

This is Mike. Thanks for the question. We really weren't surprised because it really was falling in line when you're looking at 5-year, 10-year averages. The largest catastrophe, and maybe Marty might be able to talk about that, really was in San Antonio, Texas and having that run up, so we don't have personal lines there. It's only commercial lines, so that might have caught maybe some of the analysts, I'll say, off guard a little bit having that being in there because that was running about $55 million, $56 million. There were some other ones in there that were in the, I'll call it, in the $15 million to $25 million range, but probably not necessarily a surprise when we look at the 5-year, 10-year averages and so forth. But the last couple of years, we've had pretty good catastrophe loss ratios, and so this one being elevated a little bit. So maybe if I turn it over to Marty for some of the details of some of our cats.

Martin J. Mullen
Chief Claims Officer of the Cincinnati Insurance Co. and Senior VP of the Cincinnati Insurance Co.

Sure. Thanks, Mike. Your comment on San Antonio was accurate. It's about a $56 million end of second quarter loss for us in San Antonio all commercial. And everything you read -- San Antonio was not on the map in Texas as far as being a hail risk for the industry. It was supposed to be an area that really wasn't very prolific as far as previous hail events. And so I think it caught everybody by a little bit of a surprise to the extent that the hailstorm hit San Antonio. As a result of that, I think the losses were a little greater in the industry that were probably anticipated for us. We certainly took our share of those commercial losses. That actually was twice the size of any other cat we had for the quarter. And the other ones were mainly midwestern storms related to particularly hail losses in several states over several days. So other than that, there really wasn't anything unusual in the quarter as far as those events.

Michael Zaremski

Okay, that's helpful. And one follow-up, just kind of on the other hand, while catastrophes pushed up the absolute combined ratio. The accident year, excluding catastrophe loss ratio, was the best it's been in 10 years, if my model is right. Can you speak to why it's improved so much, so we can kind of better think about its sustainability? I don't know if there were any unusual items or maybe cats were high and that ate up some of the noncat weather?

Jacob F. Scherer
Former Chief Insurance Officer

Yes, Mike, this is J.F., again. Similar to what we've mentioned with Josh, and I think, Paul as well. I think, the -- there is a momentum going right now for a variety of areas. One of the things we're very pleased with is the predictive modeling and analytics that we've employed, both in personal lines and in commercial lines. That continues to get more and more refined. We're segmenting our book of business better than we have ever had. I think we've done a great job of integrating it with a [indiscernible] little more of standard underwriting [indiscernible] we talked about in the past. Our agents have been great in cooperating with that [indiscernible] for an agent to explain the science part of this to policyholders, but I think we've done a good job there and agencies have come through for us. We've expanded our loss control significantly over the last 5 years, really that last 6 or 7 years. We're inspecting risks that we hadn't inspected in the past. The inspections that we're making are much more in-depth than we have in the past. We're discovering things both good and bad that allow us to make a more informed decision. So we've got an off risk that we shouldn't gotten off of. We have said yes to risks that maybe in the past we would have thought were a little tough in terms of their industry classifications, so that's working out real well. I'd say, in particular, in personal lines, the inspections have also afforded a lift in the area of insurance to value, so we are increasing premiums there, getting a better ratio of premium-to-risk for ourselves there. So it's not one thing, it's a lot of things that are working well. I don't think there's anything particularly unique to what we're doing as to what other comedies are doing. I just think we probably executed pretty well so far in this process. And as Steve said a few minutes ago, there's still, I think, a lot of optimism moving forward we can continue to improve.

Michael Zaremski

Got it. So it sounds like so -- maybe you can remind me. I know you guys have talked in the past about kind of combined ratio goals over time. It feels like things are -- there's more momentum, and things are potentially, I don't want to put words in your mouth, going better than planned a year or 2 ago. Is that the right way to think about things?

Michael J. Sewell
Chief Financial Officer, Senior Vice President and Treasurer

Sure, I think so. With the plans that we've laid out and that we've been working towards, like J.F. just mentioned, we always wanted to be, I'll say in that 95 to 100 combined range. But with interest rates where they are at today on the investment side, we've always been striving to be below 95 combined and really driving everything we can on a current accident year basis, ex cat basis, where we really having to drive it to where we're at today and to keep the momentum going.

Jacob F. Scherer
Former Chief Insurance Officer

I'll just add to that. An example would be that we're pleased with is the introduction of high net worth to our personal lines book of business. That segment of personal lines in the industry has always been much more profitable for us. Though we weren't writing very high net worth, I'd say our book of business previous to Will Van Den Heuvel joining the company was more mass affluent than it was high net worth. But it performed 10 points better than our middle market personal line book of business. So as you can tell from the weighting of new business and high net worth this quarter versus middle market, we're increasing the proportion of high net worth. And so there'd been a lot of deliberate steps that we've taken to position our book of business to perform better than the 95 to 100 that Mike mentioned.

Operator

[Operator Instructions] As there are no further questions on the phone lines at this time, I would return the call to Mr. Steve Johnston.

Steven J. Johnston
Chief Executive Officer, President, Director and President of Cincinnati Life Insurance Company

Well, thank you, Shannon. Excellent job, and thanks for all of you for joining us today. We look forward to speaking with you again on our third quarter call. Thank you.

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