S&P Global
Market Intelligence

CNA Financial Corporation NYSE:CNA
FQ2 2019 Earnings Call Transcripts

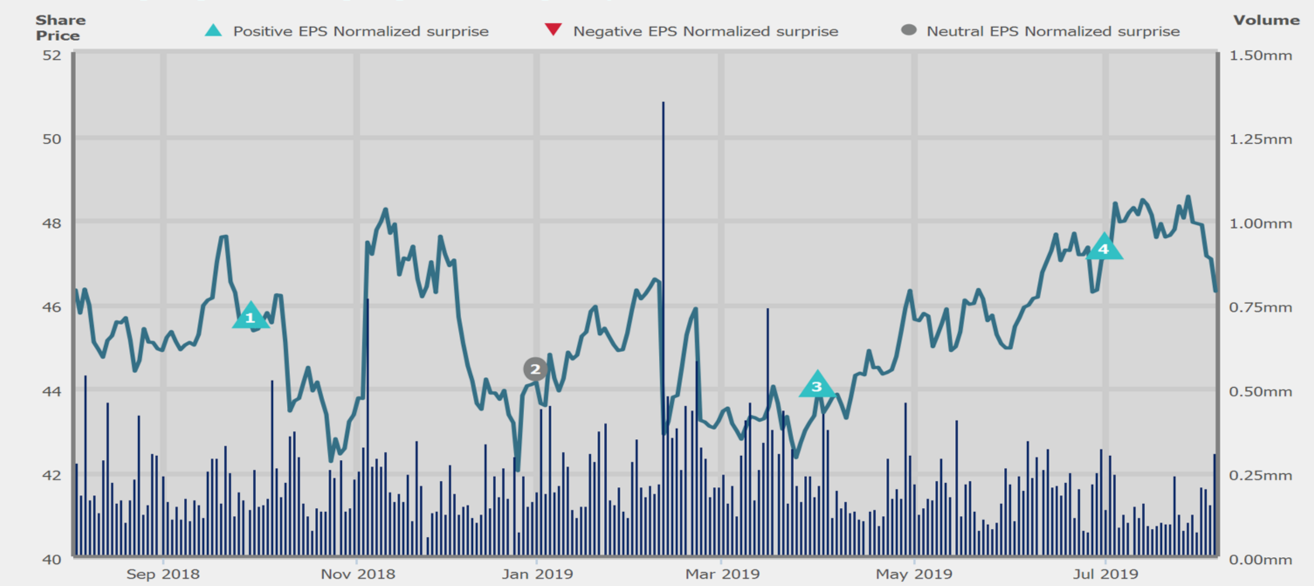
Monday, August 05, 2019 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2019-			-FQ3 2019-	-FY 2019-	-FY 2020-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.02	1.08	▲5.88	0.97	4.14	4.10

Currency: USD
Consensus as of Jul-12-2019 8:08 AM GMT

Stock Price [USD] vs. Volume [mm] with earnings surprise annotations



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2018	1.10	1.17	▲1 6.36 %
FQ4 2018	0.93	(0.08)	NM
FQ1 2019	1.08	1.17	▲2 8.33 %
FQ2 2019	1.02	1.08	▲3 5.88 %

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Call Participants

EXECUTIVES

Dino Ennio Robusto
Chairman of the Board & CEO

James Michael Anderson
Executive VP & CFO

ANALYSTS

Gary Kent Ransom
Dowling & Partners Securities, LLC

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Joshua David Shanker
Deutsche Bank AG, Research Division

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Presentation

Operator

Good morning, and welcome to CNA's discussion of its 2019 second quarter financial results. CNA's second quarter earnings release, presentation and financial supplements were released this morning and are available via its website, www.cna.com.

Speaking today will be Dino Robusto, CNA's Chairman and Chief Executive Officer; and James Anderson, CNA's Chief Financial Officer. Following the prepared remarks, we will open the line for questions.

Today's call may include forward-looking statements and references to non-GAAP financial measures. Any forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from the statements made during the call. Information concerning those risks is contained in the earnings release and in CNA's most recent 10-K on file with the SEC. In addition, the forward-looking statements speak only as of today, Monday, August 5, 2019. CNA expressly disclaims any obligation to update or revise any forward-looking statements made during this call.

Regarding non-GAAP measures, reconciliations to the most comparable GAAP measures and other information have been provided in the financial supplements. This call is being recorded and webcast. During the next week, the call may be accessed on CNA's website.

With that, I'll turn the call over to CNA's Chairman and CEO, Mr. Dino Robusto. Please go ahead, sir.

Dino Ennio Robusto
Chairman of the Board & CEO

Thank you, Allison. Good morning, everyone. I'm pleased to share our second quarter results with you today, a good result reflecting strong execution across the board. Core income for the second quarter was $294 million or $1.08 per share, up 9% over the prior year quarter.

Core return on equity was 9.9%. This result reflected improved underlying underwriting performance, continued pricing momentum, good investment performance and continued stable performance of our runoff long-term care business.

For the quarter, the P&C underlying combined ratio was 94.6% compared with last year's second quarter result of 95.3%. The underlying loss ratio of 60.8% improved a little more than 0.5 point from the prior year. The all-in combined ratio of 95.7% included 2.2 points of catastrophes and 1.1 points of favorable prior period development.

Our expense ratio in the quarter was 33.4%, nearly 0.5 point better than the first quarter. We generated robust growth in the U.S. segments with gross written premium, excluding third-party captives, up 10%, and net written premium up 8%.

Growth was particularly strong in our Commercial segment, while International's net written premium was down 8% in the quarter, driven by our Lloyd's syndicate, which was down 23% resulting from our reunderwriting efforts that will continue throughout the year as we have previously discussed.

We continue to effectively manage the rate retention dynamic, achieving higher rate increases in each business unit and doing so with steady retentions in the U.S. In the second quarter, rate for P&C overall was 4%, up 1 point from the first quarter with Commercial and Specialty each up 1 point and International up 2 points from the first quarter. If we drill it down a little more, pushing for rate increases is a quintessential priority for us.

In our Specialty business unit, rate was up 4% and up 8% outside of our professional E&O program business, which we refer to as [Affinity]. In our health care business, which has experienced higher severity trends as we have referenced on several prior calls, rate increased further to 14 points compared with 10 points in the first quarter. Public company D&O rate increases showed similar momentum, up 15 points in the second quarter compared with 11 points in the first quarter. And importantly, even in the context of the positive rate movement, Specialty's overall retention was steady at 88%.

Overall, Commercial rate was up 5%, excluding workers' compensation, and 3% all-in, each 1 point higher than the first quarter while retention was steady at 85%. Commercial's rate included umbrella up 7%, and Commercial Auto as well as Property were also up 7%. International rate was up 7% compared with 5% in the first quarter, and retention was 67%, again, reflecting our reunderwriting efforts.

The 4 points of rate overall in the second quarter exceeds our long run loss cost trends. As mentioned before, it is a good result, but obviously needs to be sustained before we recognize any meaningful margin improvement as a result of this dynamic.

Overall, in the pricing environment, I'd reinforce the comment I made last quarter, is that pricing continues to migrate from being a headwind to now a tailwind and that change is appropriate, given that the headwind period lasted several years when price changes fell below long-run loss cost trends. It is encouraging that this tailwind is also beginning to include improvements in terms and conditions beyond price in areas where it is needed most.

For larger property schedules, there is a broader adoption of higher deductibles, in particular, for catastrophe perils. In medical professional liability, specifically aging services, higher deductibles are more readily adopted to mitigate frequency exposures, and we are successfully tightening coverage language in tougher judicial jurisdictions.

During a headwind period, these terms and conditions tend to be slowly relaxed, negatively affecting the portfolio, given the simultaneous deteriorating rate environment. And at some point, the clawing back of price as well as terms and conditions begins, this time around starting a few quarters ago, in order to secure the risk-adjusted return required. But this restorative process requires more time for both CNA and the industry, which is why I am optimistic that the environment will continue to support pricing above long-run lost cost trends.

Turning to the other elements of the quarter. New business in the U.S. was up 13% in the second quarter, which was somewhat influenced by a few large accounts we have been working on for over a year and were successful in securing in the second quarter. As I have mentioned in the past, securing high-quality sophisticated accounts can take more than 1 renewal cycle to win. Indeed, I have specifically referenced on prior calls when we struck out on certain larger accounts the first time around.

The main point here is that although new business success will fluctuate quarter-to-quarter, I am very pleased with this key tenet of our strategy which is getting increasing access to the best business. In addition to this tenet, on past calls, I have talked about several other vectors of success we are pursuing in order to achieve top quartile underwriting performance, including institutionalizing deeper underwriting expertise and reenergizing relationships with our distribution partners amongst others.

Today, I want to comment on our drive to enhance our specialization approach as we are not interested in being all-things-to-all businesses as a generalist commercial insurer. This includes prioritizing certain industry segments and exposures and bringing to bear an expert value chain of deep technical talent, tailored products and services and strengthening relationships with those agents and brokers that also seek to provide their clients this added value solution set.

This approach is a significant reason behind the long-standing performance we enjoy in our Specialty business. Our customized expert value proposition for very different businesses, such as [Affinity], Surety, Warranty and health care creates a meaningful competitive advantage that has allowed us to generate excellent margins over the long run.

In the past year, we have accelerated the evolution of our Commercial business units along the same path of enhanced specialization. We are targeting our investments and resources to those segments where we can better capitalize on our brand and expertise, and where agents and brokers have told us they value our approach and would like to see an even stronger commitment by CNA. One example of this is our Construction business, our most mature industry segment, where we have deep underwriting expertise, customized risk control services and specialized claims capabilities.

And recently, you would have seen the announcement that we added a new Head of Construction, Song Kim, who is a proven industry expert in this business and reflects our targeted investment in resources.

This same acceleration towards specialization is happening with our middle market business, where we have previously spoken about our focus on specific industry segments like technology and professional services, amongst others, and we are looking to develop more specialty such as the recently added cultural institutions.

Other areas of priority specialization within Commercial are marine, our small business operation and our Property & Casualty national accounts unit that provide targeted P&C coverages for larger clients.

In this latter area, we also recently announced the addition of David Haas, an industry expert to head our National Accounts Casualty unit.

Finally, our London-based operation is also migrating to a more specialized focus, where they will target similar segments and exposures building upon the expertise housed within our Specialty and Commercial business units. This is happening simultaneously to the reunderwriting process, so it will take time to develop and show up in the results.

Now keep in mind, our drive towards greater specialization like all of the tenants of our strategy to achieve sustained top quartile performance will proceed with a deep sense of urgency, yet our fundamental focus and actions are guided by the fact that we are playing for the long term. And now I'll turn it over to James.

James Michael Anderson
Executive VP & CFO

Thanks, Dino, and good morning, everyone. Our Property & Casualty Operations produced core income of $298 million in the second quarter. Pretax underwriting profit was $72 million and underlying underwriting profit was $93 million.

Moving to each of our P&C business units. Specialty's second quarter underlying combined ratio was 93.2%, including an underlying loss ratio of 59.9%. Specialty's overall combined ratio of 90.7% included 2.6 points of favorable prior period developments. Specialty's gross written premium ex third-party captives grew a healthy 6% in the quarter.

Our Commercial segment's underlying combined ratio was 94.9% in the quarter. The underlying loss ratio of 61.7% included a little less than 0.5 point of onetime costs related to the actions taken within our claim departments that I mentioned last quarter as some of the costs continued into April.

The second quarter overall combined ratio for Commercial was 99.7%, including approximately 5 points of catastrophe losses and a minimal amount of favorable reserve developments.

Commercial's gross written premium ex third-party captives grew 13% in the quarter. The underlying combined ratio for our International segment was 97.4% in the second quarter. The all-in combined ratio was 97.5% with a minimal amount of catastrophe losses or prior period development affecting results. Our P&C expense ratio of 33.4% is representative of our current annual run rate.

Now let me take a minute to talk about our prior period development in the quarter. Specialty's 2.6 points of favorable prior period development was primarily in accident years 2017 and prior, driven by Surety, [Affinity] and Warranty and partially offset by healthcare been slightly adverse.

Commercial had a minimal amount of net favorable reserve development as favorable development in workers' compensation and property was offset by unfavorable umbrella and the normal unwinding of our discounted workers' compensation claim reserves. In the businesses where we had adverse development, namely health care and to a lesser extent umbrella, we continue to see aggressive clean-up attorney actions leading to higher severity outcomes. As a result, we've been taking more aggressive underwriting actions with regard to pricing and terms and conditions to improve the margins on those businesses. As Dino mentioned, our execution to-date has been very encouraging.

Our Life & Group segment produced $7 million of core income in the quarter. Long-term care morbidity experience continues to be consistent with our reserve assumptions, while persistency was the driver of the positive results.

Our Corporate segment produced a core loss of $11 million in the second quarter. Pretax net investment income was $515 million in the second quarter compared with $506 million in the prior year quarter. Our limited partnerships and common equity portfolios produced pretax income of $43 million, a 2.1% return and in line with the prior year quarters.

Pretax income from our fixed income portfolio was $465 million, slightly higher than the prior year quarter. The pretax effective yield on the fixed income portfolio was 4.8% in the quarter, in line with prior periods. Fixed income assets that support our P&C liabilities had an effective duration of 4.1 years at quarter end, in line with portfolio targets.

The effective duration of the fixed income assets to support our Life & Group liabilities was 8.9 years at quarter end.

Our balance sheet continues to be extremely strong. At quarter end, shareholders' equity was $12.1 billion or $44.52 per share, up 6% in the quarter as our unrealized gain position increased to $3.6 billion due to the decline in interest rates.

Shareholders' equity, excluding accumulated other comprehensive income, was $12 billion or $44.08 per share, an increase of 5% from year-end 2018 when adjusted for the $2.70 of dividends per share paid during the first 2 quarters.

In the second quarter, operating cash flow was $227 million. We continue to maintain a very conservative capital structure. All of our capital adequacy and credit metrics are well above our internal targets and current ratings.

In May, we issued $500 million of senior debt at a rate of 3.9% with proceeds used to redeem $500 million of 5.875% notes due in August of 2020. The deal was significantly oversubscribed and came in at spreads comparable to our peers rated a notch higher than our current ratings.

And on the subject of ratings, we were pleased that Fitch upgraded our financial strength rating to A+ and A.M. Best upgraded our issuer credit rating to A+ during the quarter, providing further validation of the strength of our balance sheet and the momentum of our business.

Finally, we're pleased to announce our quarterly dividend of $0.35 per share.

With that, I'll turn it back to Dino.

Dino Ennio Robusto
Chairman of the Board & CEO

Thanks, James. Before we move to the question-and-answer portion of the call, let me leave you with some overarching thoughts on the quarter.

Core income for the second quarter was $294 million, bringing the first half core income to $612 million, the highest level in 12 years. Our 2019 second quarter core return on equity is 9.9%. Our underlying P&C loss ratio was 60.8% for the quarter and 60.7% year-to-date. U.S. net written premium grew 8%. We achieved 4 points of rate in the quarter, 1 point higher than the first quarter, and we are optimistic that the rate environment will continue to be a tailwind.
With that, we'll be glad to take your questions.

Question and Answer

Operator

[Operator Instructions] We'll take the first question from Josh Shanker from Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

Two questions. The first one, you've said that pricing is ahead of loss cost in an aggregate, your Commercial pricing is up 3%, but I guess, up 5% excluding workers' comp. Historically, long-term loss cost trends for the industry has tracked around 4%, 5%. In the past 10 years, the economy's even more sluggish than the long-term, so it's probably been less than that.

But when we talk about pricing up 3% in total, 5% ex workers' comp, is that comfortably ahead of long-term loss cost trends? I mean, it just seems to me that is about the long-term loss cost trend. Maybe you can give me some color on that?

James Michael Anderson
Executive VP & CFO

Yes, Josh, let me see if I can give you a little bit of context here. So when we look at our long-run loss cost trend, you have to keep in mind that it's reflective of our -- the makeup of our portfolio. We have a significant component of our portfolio in our, what we refer to as our [Affinity] business that has a lower-than-normal long-run loss cost trend. Actually, it's around 1%.

So when we look in aggregate at our portfolio loss cost trends, it's about 2.5 points when you factor in that 1 point on what's above -- between 15% and 20% of our portfolio.

So when we look at our overall rates, in Q1, our overall rate was 3%, again. So that was higher than that long-run loss cost trend and then in this quarter, the overall P&C rate is 4%, so both quarters being ahead of that 2.5 points loss cost trend. So hopefully that gives you a little bit of context.

Joshua David Shanker
Deutsche Bank AG, Research Division

That is very helpful. And can you shed some perspective on the Child Victims Act in New York? And how you're thinking about it? How the industry should be thinking about it? And what it means for states outside of New York?

James Michael Anderson
Executive VP & CFO

Sure. So we've been following this legislation, this issue for quite some time. It's not new. We've been considering the potential impact to our reserves all along. And that really -- that consideration continues to be part of how we think about our overall reserve position.

Now remember, our claim department has been handling these types of claims for years. So we're well positioned to deal with whatever may come. But we're going to have to wait and see how much new claim activity is generated from New York and from any of the other states as a result of these statutes. Let me just say, as I sit here today, I feel really good about our overall reserve strength.

Joshua David Shanker
Deutsche Bank AG, Research Division

In your initial reserves that you had set, let's say, prior to the beginning of this year when the law changed, did you have reserves up for an assumption that there was a probability that the statute of limitations would be waived?

James Michael Anderson

Executive VP & CFO

Look, I'm not going to get into the specifics on how we would split IBNR into different buckets, but I'd just reiterate what I said. We've been factoring this into our thinking over time.

Operator

We'll now take the next question from the line of Gary Ransom from Dowling & Partners.

Gary Kent Ransom
Dowling & Partners Securities, LLC

I wanted to ask a little bit about expenses. The expense ratio in Specialty was up about 1 point and split more or less equally between acquisition and underwriting. And when I look at Commercial, the other underwriting expense ratio is up a little bit there too. I just wondered if you can give us a sense of what's going on and especially in light of the various expense initiatives you have underway.

James Michael Anderson
Executive VP & CFO

Sure, Gary. On Specialty, specifically, we did, in the quarter, have a couple of onetime adjustments to our acquisition cost. So we would expect that not to reoccur going forward.

With regard to the underwriting side, and this would be in terms of both Specialty and Commercial, one of the things that we're seeing is, we've shown good growth on a gross premium basis. It's been a little bit less on a net premium written basis, and then even less as there is a lag as that premium written earns. So one of the things you're seeing there is just earned net written premium being a little lower and lagging what we've been doing more recently. So when we think forward on our expense ratio, we would expect to see some improvement there.

Gary Kent Ransom
Dowling & Partners Securities, LLC

Okay. That's helpful. And just I wanted to shift to loss trends. Thanks for that description of the long-term trends, but one of the concerns in the market today is whether those trends themselves are accelerating even as the rate is accelerating. And I'm wondering if you are thinking about that or how you're thinking about the potential risk involved in the 2.5 suddenly becomes 3.5 or 4?

James Michael Anderson
Executive VP & CFO

Yes, we -- remember, that 2.5 is our long-run loss cost trend. And so when we look at our portfolio, we do it on a very granular basis. And we have parts of that portfolio, health care is an example, where that loss cost trend today is getting close to double digits.

And so clearly, when you're seeing rate increases, for example, in health care of 14% in the quarter, that's being offset by an increased loss cost trends in that business. And on the flip side, as I mentioned [Affinity] and Surety, they have been getting rate increases and not seeing loss cost trends.

So there is a lot of things happening underneath the covers there, and we're monitoring it closely, and there is a heavy correlation where we're getting rate versus what's happening with the short-term loss cost trends.

Gary Kent Ransom
Dowling & Partners Securities, LLC

Okay. And just maybe one last question on workers' comp. There is some signs of change there, meaning maybe rates are bottoming and at a few places starting to go up. Do you have any thoughts on those trends?

James Michael Anderson
Executive VP & CFO

I think from a rate perspective, that is what we're seeing. So we're starting to see rate flattening a bit, maybe starting to get less negative than it has been. So certainly, we're seeing that. I mean, just to put it in the context of loss cost trends there, it's -- we're also starting to see frequency flatten a bit, even as severity has maintained quite a benign spot.

Operator

We'll move on to the next question from Meyer Shields from KBW.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Two CNA questions and then one big picture industry question, if I can. First, I was hoping you could talk us through how much of the Commercial specialization effort, how much can that accomplish in terms of closing the combined ratio gap between the 2 segments?

Dino Ennio Robusto
Chairman of the Board & CEO

I mean, look, it's clearly shown itself to be very, very effective within Specialty. And ultimately, over the last 2.5 years that I've been here, we focused on a host of different underwriting priorities that I've talked to you about. And one of the other things clearly I have become comfortable with in understanding is those segments where we really have some competitive advantage, and the competitive advantage is really across the supply chain. We have good underwriting, we have good capacity, risk control, claims. And so what we want to do is to now funnel more of the investment in resources into those specific areas and we de-prioritized the ones with less advantage. And you clearly saw that happening with the decisions we made on some of the Property and other segments within our underlying -- our International business.

Now is really the time -- everything is done methodically, was done methodically over the last 2.5 years, Meyer. And so we have to get to certain initiatives, whether it was institutionalizing more of the underwriting culture, building those distribution relationships, enhancing our talent and now, now is the time and the opportunity for us to really prioritize the specialization with additional efforts, some investments and some resources. And I think this is just when you add this tenet, this vector of success to the other ones, I think it's just going to support our glide path to top quartile performance. Because ultimately, it's when you have a competitive advantage of specialization really across the value chain that you can sustain profitability. And I think you see it even within an area like James just referenced of health care, where it is challenged, some of those claims trends, but our market leader position, having been in it for 20 years, we have the clout to be able to execute the new terms and conditions and the pricing that we need for us to stay in that marketplace and continue to see profitability over time. So difficult for me to pin down exactly what the marginal gain is going to be.

Look, when you think about top quartile performance for us, we're at 94.6% or a couple, 3 points away from that, and we think there is a little bit on the loss ratio, particularly as you execute some of this continued rate and terms and conditions and there's some on the expense ratio that James just referenced. But for long-term sustainability, it's going to come from having a value proposition that is important, that transcends price. And so that's sort of the best way I can describe it, Meyer.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

That's very helpful. James -- I think maybe a question for James. I was hoping you could talk a little bit about why the loss trend in [Affinity] is as low as it is?

James Michael Anderson
Executive VP & CFO

Why it is? Listen, we've been in that business for a long time. It is a very homogeneous business with lots of small accounts. And we have a competitive advantage. And we have very strong relationships with our partners in that business and great data. We've been able to service clients well over time. And so I think all those kind of give a fundamental advantage to us, and I don't think there is much more to it than that.

Dino Ennio Robusto
Chairman of the Board & CEO

Yes. And so with that competitive advantage, you can sustain the pricing and the terms and conditions you need to be able to keep it profitable, just as James has indicated.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Right. No, I understand all of that, and that's clearly showing up. I was just wondering what it is about the business trends that produces such low loss trends.

James Michael Anderson
Executive VP & CFO

I don't know if there is any other magic to it, Meyer, besides that.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. No, I can see [how you have] expertise to do it. And then big picture question. It's sort of a follow-on on Gary's question. We've had a lot of really strong profits and rate reductions in workers' compensation. At some point in time, are -- is that going to conflict with normalizing loss trends that the industry is not anticipating?

James Michael Anderson
Executive VP & CFO

Well, I mean, that's always going to be the question, is can the industry and frankly, for us, more importantly, are we making sure that we see any inflection points that come, whether it be in frequency or severity so that we can ensure that we're getting appropriate price when that happens.

Operator

[Operator Instructions] We'll take the next question from Jay Cohen from Bank of America Securities.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Just to switch gears a little bit. I wanted to hear more about the persistency in the long-term care block, which was favorable this quarter. Is that something that just jumps around? Or is that something that you see as maybe being more sustainable?

James Michael Anderson
Executive VP & CFO

Jay, thanks for the question on long-term care. With regard to persistency, that's not something I would put in the camp of something you can count on for a long period of time. It's really closely aligned to us getting rate increases in different states and seeing policyholders make choices, whether they decide to lapse the policy, whether they decide to reduce their benefits and maintain their current rates or actually pay the rate increases.

So what we've seen over the last couple of years is people actually lapsing into, what we would call, no forfeiture status, meaning they're going to take a smaller benefit and not take the rate increase or actually stop paying premium altogether. So we wouldn't expect that to stay at a high level forever, but we're certainly happy to see it for now.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

And what are the average price increases you're achieving now? Probably varies quite a bit by state, by product, but can you give us a sense of what they are?

James Michael Anderson
Executive VP & CFO

It is a wide range by state. I mean, we are getting, in some cases, very high double-digit rates. And when I say high, I mean, in some cases, it approaches 100%, all the way down to things like 10%. So you get very different outcomes depending on the state, depending on whether it's the first rate increase that a policyholder is seeing or whether it's the second or third. So it's a pretty broad range.

But I'll tell you, just overall, regulators have been much more receptive to giving us rate increases as well as the rest of the industry as they realize that they need carrier to write this business to be able to at least breakeven.

Operator

It appears there are no further questions at this time. I'd like to turn the call back to Dino Robusto for any additional or closing remarks.

Dino Ennio Robusto
Chairman of the Board & CEO

No, that's great. Thank you, everyone, and we will see you in another quarter.

Operator
Ladies and gentlemen, this concludes today's call. Thank you very much for your participation. You may now disconnect.