S&P Global
Market Intelligence

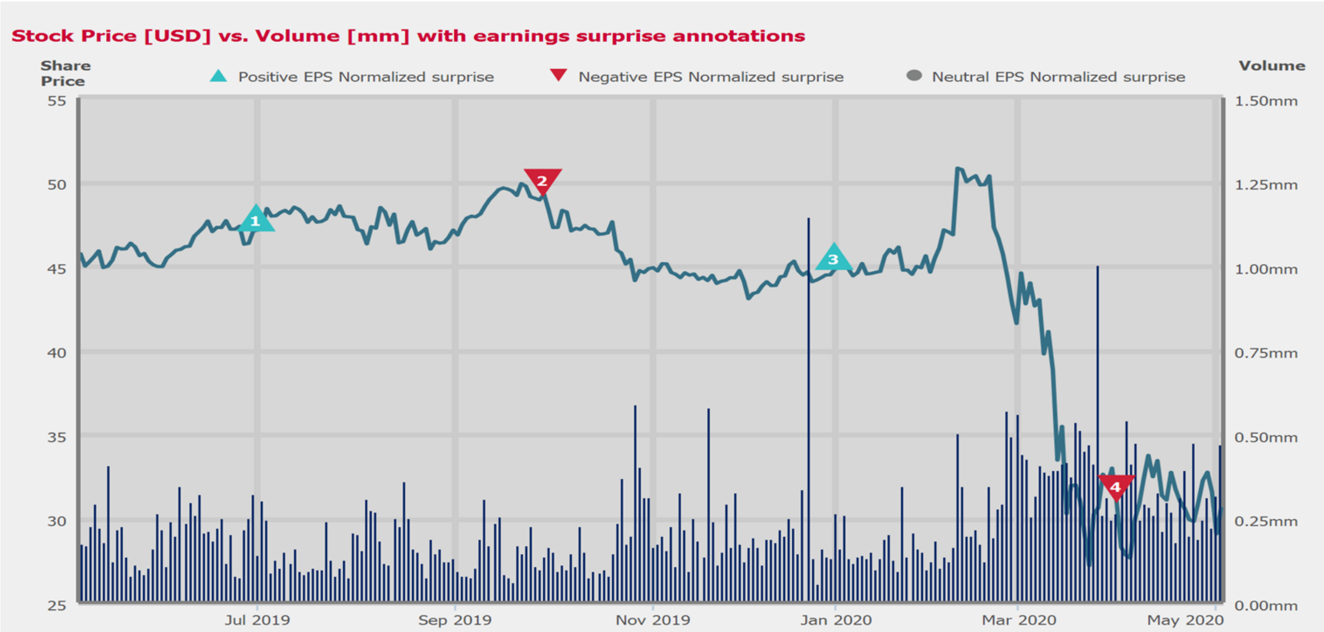
CNA Financial Corporation NYSE:CNA
FQ1 2020 Earnings Call Transcripts

Monday, May 04, 2020 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ1 2020-			-FQ2 2020-	-FY 2020-	-FY 2021-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.56	0.40	(28.57 %)	0.97	3.65	3.85

Currency: USD
Consensus as of Apr-03-2020 10:53 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2019	1.02	1.08	5.88 %
FQ3 2019	1.02	0.37	(63.73 %)
FQ4 2019	0.93	0.97	4.30 %
FQ1 2020	0.56	0.40	(28.57 %)

Table of Contents

Call Participants

EXECUTIVES

Albert Joseph Miralles
Executive VP & CFO

Dino Ennio Robusto
Chairman & CEO

ANALYSTS

Jeffrey Paul Schmitt
William Blair & Company L.L.C., Research Division

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

Presentation

Operator

Good morning, and welcome to the CNA's discussion of its 2020 first quarter financial results. CNA's first quarter earnings release, presentation and financial supplement 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 Al Miralles, CNA's Chief Financial Officer. Following their prepared remarks, we will open the line for questions.

Today's call may include forward-looking statements and references to the 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 our earnings release and in CNA's most recent SEC filings. In addition, the forward-looking statements speak only as of today, Monday, May 4, 2020. 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 weeks, the call may be accessed on CNA's website. If you are reading a transcript of this call, please note that the transcript may not be reviewed for accuracy, thus it may contain transcription errors that could materially alter the intent or meaning of the statements.

With that, I will turn the call over to CNA's Chairman and CEO, Dino Robusto.

Dino Ennio Robusto
Chairman & CEO

Thank you, Jennifer. Good morning. It is very good to be with you today, and I hope you and your families are coping well in this difficult time.

As our nation and the world address the challenges brought by COVID-19, I am honored to be a part of an industry that continues to meet its commitments and provides some certainty in these uncertain times. During this crisis, our industry will be resilient and remain a strong factor in the recovery of the U.S. and world economy. On behalf of all of our employees, CNA acknowledges and thanks the first responders and health care workers for the selfless and courageous efforts they advance every day, and we are grateful for all essential workers who continue to go to work each day, providing key services and goods we all depend upon.

I am grateful to CNA employees who have embraced this new work environment and continue to manage our business and operations effectively. And I would also like to acknowledge our government leaders across the nation who are working tirelessly to keep our citizens safe and to respond to this pandemic.

We will now turn to the quarter results, and following that, I will add my early thoughts on how the industry issues surrounding COVID-19 relate to our portfolio. Our first quarter results continued to reflect strong underwriting performance, accelerated price increases and robust growth in our U.S. operations. Offsetting the strong underlying underwriting performance were losses in our investment portfolio due to the economic impacts of COVID-19.

Core income for the quarter was $108 million or $0.40 per share. The P&C combined ratio for the quarter was 97.5%. Cat losses were $75 million pretax, which included $13 million due to COVID-19. The underlying combined ratio was 93.9% to reflect a 1 point improvement from the first quarter of 2019. The underlying loss ratio was 60.4% in the first quarter, which is a slight improvement from the first quarter of 2019. The expense ratio was 33.1% in the first quarter. This is little more than 0.5 point lower than both Q4 and the prior year quarter and is largely due to stronger net earned premium. As we have discussed in prior calls, one tenet of our strategy has been to hold the numerator in the expense ratio flat even while we invest in talent, technology and analytics, and leverage growth to reduce the ratio. This strategy has continued to positively impact our results while positioning us well for the future.

Gross written premium growth ex captives in the U.S. was plus 8% for the quarter. Net written premium growth was plus 6%. For P&C overall, the growth numbers were plus 6% and plus 3%, respectively, both of which were impacted by the re-underwriting in International, which, as we have mentioned before, will be largely completed this year. Gross written premium growth was plus 2% in our Specialty segments ex captives. Strong growth in financial institutions and management liability was largely offset by underwriting actions in our aging services portfolio. Commercial gross written premium growth was very strong at plus 14%. Our International segment had gross premium decline of 5%.

Our rate and retention dynamic is exactly as planned. We are achieving the strongest level of rate increase in parts of our portfolio that are in most need of rates, and our retention is strongest in the most profitable cohorts of our business. Rate increases were 8% in the quarter, up 1 point from the fourth quarter. This continues the pattern of stable growth in rate increases over the last 2 years, and we are very happy to see continuation of larger rate increases in virtually all segments. Retention was 82% this quarter, 2 points lower than the fourth quarter, largely due to our international aging services strategies, while new business in the quarter grew by 3% year-over-year.

I have periodically emphasized our success in recruiting top talent, and this was particularly true in the first quarter. In addition to our new CFO, Al Miralles, who I will introduce shortly, you will have seen our press releases over the past 2 months as we named Bob Hopper to be our next Chief Actuary, and Dan Franzetti to be our new Chief Claims Officer. Both are top industry veterans and with deep expertise in their respective field. We are also pleased to highlight that Mahmood Khan has joined us as our Chief Information Security Officer. He brings more than 20 years of experience in cybersecurity with deep cloud application security.

Turning back to Al, I want to welcome him to our analyst call. You will recall that we announced that Al Miralles had moved from being our Chief Risk Officer to being our CFO. In addition to his CRO expertise, Al has a strong background in investments and finance, and he has also managed our runoff long-term care business for several years. Having worked with Al since I arrived at CNA, I am confident you will value interfacing with him.

And with that, Al will provide more detail on our segment results as well as our investment results.

Albert Joseph Miralles
Executive VP & CFO

Thank you, Dino, and good morning, everyone. I'm happy to be here today and assume the CFO role at CNA. Clearly, these are interesting times to step into the position and my experience in CNA during my first role, overseeing investments in treasury, have prepared me well for this challenging period.

Our Property & Casualty Operations produced core income of $122 million in the first quarter. Pretax underlying underwriting profit was $107 million. This was the fourth successive quarter with pretax underlying underwriting profit mix of $90 million. The P&C combined ratio was 97.5% this quarter. This includes 4.3 points of catastrophe loss and favorable prior period development of 0.7 points. Our catastrophe losses includes the impact of COVID-19, which amounted to $13 million pretax or 0.7 points of loss ratio within our cat losses. The underlying combined ratio was 93.9%, the [fifth] consecutive quarter of underlying combined ratios below 95%. The underlying loss ratio was 60.4% and the expense ratio was 33.1%.

In terms of our operating segments, the combined ratio for Specialty was 91.3% this quarter. This is a 1 point improvement compared to first quarter 2019. The combined ratio includes favorable prior period development of 1.5 points and 1.1 points from catastrophe losses. The favorable prior period development is largely driven by favorable outcomes in surety, predominantly for accident years 2017 and prior. The underlying combined ratio for Specialty was 91.7% this quarter, 1.8 points of improvement compared to first quarter 2019. The underlying loss ratio is 59.5% and the expense ratio was 32%. Expense ratios improved by 0.8 points compared to first quarter 2019, largely due to growth in net earned premium. The gross written premium growth ex captives was 2% in Specialty for the quarter and was negative 1% on a net written basis. Rates continue to increase at 9%, up from 8% last quarter. Retention was 84% this quarter, which was down 1 point compared to last quarter and down 4 points compared to full year 2019. This is largely due to a drop in retention in our health care business relating to aging services. New business volume was down in the quarter largely due to health care.

The combined ratio for Commercial was 101.9% this quarter. This is 0.6 points higher than first quarter 2019. The combined ratio includes 7 points of catastrophe loss and negligible prior period development. The cat losses are largely due to 2 events: the Nashville tornado in early March; and the storms across Arkansas, Missouri and other states in late March.

The underlying results were very strong on multiple fronts for Commercial as the underlying combined ratio was 94.9% this quarter, 1.6 points of improvement from first quarter 2019. The underlying loss ratio was 61.1% and the expense ratio was 33.2%. The expense ratio has improved by 0.6 point compared to first quarter 2019 and the loss ratio by 1 full point.

Gross written premium growth ex captives was 14% in Commercial for the quarter and the net was 12%. The rate change was particularly strong in the quarter at 8%, up about 3 points from last quarter. Retention was a healthy 85%. New business growth was quite strong again this quarter at 21% and was broadly distributed across target market segments.

The combined ratio for International was 99.9% this quarter. This is a 2-point improvement compared to first quarter 2019. The underlying combined ratio for International was 95.7% this quarter. The underlying loss ratio was 60.3% and the expense ratio was 35.4%. The expense ratio has improved by approximately 2 points compared to first quarter and full year 2019, largely due to lower acquisition costs. The gross written premium declined 5% in International for the quarter. Net written premium declined 15% for the quarter. The large differential between gross and net change was due to the timing of a reinsurance treaty renewal. Rate change was strong again this quarter at 8%. Retention was 72% this quarter, which is consistent with most of 2019, reflecting our re-underwriting strategy.

Our Life & Group segment produced $4 million of core income in the quarter. These results and the underlying drivers were consistent with our breakeven expectations. And finally, our Corporate segment produced a core loss of $18 million in the first quarter.

Pretax net investment income was $329 million in the first quarter compared to $571 million in the prior year quarter. The change was driven by our limited partnership and common equity portfolios, which produced pretax losses of $125 million compared to pretax income of $96 million during the same period last year. Pretax net investment income from our fixed income portfolio was $449 million for the quarter compared to $465 million in the prior year quarter. The pretax effective yield on our fixed income holdings is 4.6%, and this portfolio continues to provide stable earnings. In addition, pretax investment losses for the quarter were $260 million compared to $31 million gain for the prior year quarter. These losses were primarily driven by the mark-to-market of our nonredeemable preferred stock investments in addition to credit impairments of certain fixed income holdings.

Our unrealized gain position on our fixed income portfolio stood at $2.1 billion at the end of the quarter, down from $4.1 billion at year-end. The change in unrealized was primarily driven by the broad increase in credit spreads across the market, predominantly impacting the value of our corporate bond holdings. While we hold a diversified fixed income portfolio with an overall A credit rating, the significant deterioration across markets adversely impacted our portfolio value during the month of March. As these markets have shown signs of stability in the month April, credit spreads have broadly declined, favorably impacting the value of our fixed income portfolio. As of the end of April, the unrealized gain on our fixed income portfolio increased by approximately $900 million on a pretax basis to nearly $3 billion. Likewise, rebound in the broader markets have increased the value of our limited partnership, common equity and nonredeemable preferred stock investments.

Fixed income assets that support our P&C liabilities had an effective duration of 4.1 years at quarter end, in line with our portfolio targets. The effective duration of the fixed income assets that support our Life & Group liabilities was 8.7 years at quarter end. Slides 14 and 15 in the earnings presentation will provide you additional details of the investment results and the composition on the investment portfolio.

Our balance sheet continues to be extremely strong. At quarter end, shareholders' equity was $10.4 billion or $38.18 per share, reflective of both the decrease in our unrealized gain position and the payment of the special dividend during the quarter. Shareholders' equity, excluding accumulated other comprehensive income, was $11.4 billion or $42.12 per share, a decrease of 1% from year-end 2019 and adjusted for the $2.37 of dividend per share paid during the quarter.

We continue to maintain a very conservative capital structure with a low leverage ratio and a well-balanced debt maturity schedule. At quarter end, all of our capital adequacy and credit metrics remain above target levels supporting our credit ratings. Slide 12 of the earnings presentation provides additional information on our balance sheet metrics.

In the first quarter, operating cash flow was $212 million. In addition to our positive operating cash flow, we continue to maintain liquidity in the form of cash and short-term investments. As well, we maintain ample liquidity within our investment portfolio and have access to both a revolving credit facility and an FHLB line of credit. I will remind you that our long-term care policies do not have any cash value and thus policy surrenders do not constrain our liquidity position. Overall liquidity position remains strong, with positive operating cash flow and sufficient liquidity holdings to meet obligations and withstand significant business variability. Slide 13 of the earnings presentation provides additional detail with respect to our liquidity profile.

And finally, we're pleased to announce a regular quarterly dividend of $0.37 per share.

With that, I will turn it back to Dino.

Dino Ennio Robusto
Chairman & CEO

Thanks, Al. Before we move to the question-and-answer portion of the call, let me provide some perspective on the pandemic and our portfolio.

The claim notices we have received to date are mainly business interruption notices related to our property forms. So let me start here. Our property policies require direct physical damage to the property from a covered peril for coverage to attach. And our property policies, whether issued in the U.S. or international, all have exclusions barring coverage for viruses. There are a very few policies where coverage may exist on small participations in our Lloyd's operation, but the total limit exposed is de minimis. So with respect to business interruption, our property policy exclusionary language does not provide coverage for COVID-19, and as such, we never collected premiums for it.

Now let me turn to an area that I have commented on during several of these calls: aging services. And I wanted to first remind you of the composition of our book. Our aging services is predominantly a medical malpractice, professional liability book with some property coverage and a small amount of auto. Importantly, we write essentially no workers' comp coverage. It is less than 1% of our work comp premium volume, and it is written over very large deductibles. This is also true for our broader health care business beyond aging services, which is also a professional liability portfolio with minimal workers' comp exposure to frontline health care providers. Additionally, we don't write coverage for first responders.

Moreover, on aging services, as I have said on prior calls, we have been working for some time to obtain the right terms and conditions for the exposures, and we have walked away from accounts when we could not achieve them. Our current professional liability exposure is 26% lower than a year ago and 40% lower since we started to take significant underwriting action.

On the policies we do retain, we have been achieving significant rate, raising deductibles and tightening other terms and conditions. We expect these actions to mitigate our exposure to COVID-19 claims in this portfolio. And to date, we have received relatively few notices from our aging services insureds. But these are early days, and we are monitoring the situation closely. Importantly, a number of these notices are in states that have enacted immunity for health care professionals and facilities, which should limit unwarranted liability claims against this critical industry.

With regards to other health care professional liability segment within our book, a large component of our premium volume comes from non-frontline health care professionals such as physical therapists, counselors, pharmacists and other similar classes. We also have a meaningful dentist program. And it's important to note, across all other health care professional liability segments we have seen significant reduction in reported claims due to shelter-in-place restrictions.

Switching to surety now. As you know, we are a large, successful surety writer, with a balanced portfolio of both commercial and construction risks. Our commercial book includes a sizable portion of smaller compliance-type surety bonds that have historically performed steadily throughout any economic conditions. Our construction portfolio largely consists of a diversified group of financially sound contractors that have long-term relationships with us. To a great extent, most of the contractor accounts in the portfolio participate in parts of the economy that have been deemed essential, so operations have continued, and many of the accounts have expressed having a meaningful backlog of work orders. Given the historical success of our bond team, we believe we're well positioned to withstand the current environment. Of course, the length of the recovery is still difficult to predict, but we should have much more clarity by the time of our second quarter call with respect to any longer-term potential impacts.

A final coverage area I wanted to highlight is trade credit. As I have mentioned on prior calls, this has been a small part of our Lloyd's Syndicate portfolio, and this book was placed in runoff in 2018. We now have less than $7 million in premium remaining. Nevertheless, we expect to see some claim activity from that portion that still remains in our first quarter charge, includes some potential trade credit losses. The first quarter charge also includes a provision for legal and other experts retained by our claims department as we work through this pandemic.

A few last comments. From a rate perspective, although there are a number of unknowns with COVID-19, I do not believe the dynamics that underpin the hardening market over the past 18 months have fundamentally changed. If anything, the outlook for the protracted low interest rate environment has deteriorated. So I think rate movement should continue at the current pace throughout 2020, and we have seen that in April. Now premiums overall will be impacted from the lockdown and economic slowdown, which will likely hurt our top line growth later in the year, and this will also put pressure on our expense ratio. So we will focus on managing every dollar of discretionary expense. However, we do also expect to continue to make necessary investments in talent, technology and analytics as we work through this pandemic. In addition to updating you on loss reserve impacts at the end of the second quarter, we expect to have much more clarity on top line premium impact and expense impact, which we will provide.
With that, we'll be glad to take your questions.

Question and Answer

Operator

[Operator Instructions] And we'll go first to Jeff Schmitt with William Blair.

Jeffrey Paul Schmitt
William Blair & Company L.L.C., Research Division

I may have missed it, but did you say if you have any event cancellation policies at all?

Dino Ennio Robusto
Chairman & CEO

No. That's not a coverage we have. There may be some small, little freebies on some International, but we've looked at all of those and those limits are totally de minimis.

Jeffrey Paul Schmitt
William Blair & Company L.L.C., Research Division

Okay. And then in the Specialty book, about how much of that is D&O? And do you see much risk there for COVID-19?

Dino Ennio Robusto
Chairman & CEO

As we've indicated in the past, Jeff, we -- it's not a large portfolio D&O for us, but it is an area that we have been focused on and we have been growing. And look, I mean it is clear that there's been tremendous stock price drops. And whenever you see that, you're going to see some elevated class action activity. But truthfully, I think this is going to end up being much more of a defense cost scenario. The stock drops were very, very broad based from the pandemic. And I think it's difficult to establish director and officer accountability for the drop.

Jeffrey Paul Schmitt
William Blair & Company L.L.C., Research Division

Right. Okay. And then just the warranty business, are you seeing a pretty big drop-off in demand there? Is that mainly vehicle warranties?

Dino Ennio Robusto
Chairman & CEO

Yes. Yes. It's mainly vehicle warranties. We have -- as you know, we have the large also electronic cellphone programs, but those are all captive, reinsured to captive. So you're seeing obviously some drop-off in the warranty along with the drop-off that you see on sales of new cars, et cetera.

Operator

[Operator Instructions] We'll go next to Meyer Shields with KBW.

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

Great. Thank you very much for the disclosure on your book of business. Did you break down the line -- I'm sorry, did you break the lines of business for which the $13 million charge apply?

Dino Ennio Robusto
Chairman & CEO

I'm sorry. Say again.

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

So the $13 million virus-related charge in the first quarter, did you break down which lines of business that was for?

Dino Ennio Robusto
Chairman & CEO

Yes. So the line of business that we put actually charge for was trade credit. Even though it is on a runoff, we still have, as I said, $7 million. And so what you see there, as we did our reserve reviews of all lines, is the drop in the commodity prices, especially on the oil side, the drop on the oil prices. You know that that's going to put a strain on trade credit until we put up money for trade credit losses. And then the rest is just the legal expert costs that the claims department -- we're typically doing a catastrophe, but clearly it's something of this size. And so the estimation for those costs as we play through the pandemic are also in that amount. It's not any number of like ultimate defense costs for the future. We hope to have a much better picture, Meyer, as we get through the second quarter to be able to put together some other projections there for defense costs.

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

Okay. Fantastic. That's helpful. I was hoping you could sort of wrap up all of your thoughts on workers' compensation in general. I'm wondering, first of all, whether you expect reinsurance to come into play? And second of all, what CNA's stance is on states that are expanding presumptions of compensability?

Dino Ennio Robusto
Chairman & CEO

Yes, okay. So appreciate the question, and obviously complicated at so many different levels. Let's start with reinsurance, if I may, and then I'll give you my sense on some of the regulatory. We do have work comp reinsurance protection for large events. And it provides, Meyer, protection for -- on a follow-the-fortunes basis, by the way. It provides $275 million of protection, excess of $25 million retention. And we get to determine what constitutes an event, and we can then select the consecutive 160-hour time period for combining losses. So some very strong reinsurance protection.

Now look -- so let's get to the presumption doctrines. And as you know, in some states the officials have supported the coverage for -- coverage presumption for both first responders and health care workers. And as I said, frontline health care workers make up a very small part of our work comp portfolio. And I went through that in detail because we do write medical malpractice, and I wanted to be clear that it's not a work comp portfolio. We also -- we have no work comp for first responders.

Now there are a few other states, fortunately relatively few, where a broader presumption for essential workers is being proposed. And look, this would add, in my opinion, significant unpredicted cost to the system overall because those exposures were not underwritten, they were not priced, and ultimately are going to be shouldered by already struggling businesses. So what we are doing is, together with many of the other member companies of the APCIA, is we're working with policyholder groups. And that's very important because the policyholder groups themselves are pushing back, for the obvious reason of the subsequent consequence and availability. And they're pushing back on broad extra-contractual retroactive.

So look, we're going to need to see how that plays out, which is why I suggest that we wait to the second quarter. We obviously have seen a drop in claim counts from workers' compensation because of the lockdown. So then you got to see that. Sort of as a net-net basis, you got to factor in a little bit of the exposure that's going to come in place. And in the meantime, we're going to fight tooth and nail on avoiding very broad presumption because, in the end, it is cutting off your nose to spite your face. And so we'll see how this all shapes out, Meyer. We really do have to wait to see how it shapes out.

Operator

And at this time, there are no further questions.

Dino Ennio Robusto
Chairman & CEO

Okay. Thank you, everyone. Appreciate your time. And please be safe and be healthy.

Operator

This does conclude today's conference. We thank you for your participation.