S&P Capital IQ

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Cincinnati Financial Corporation NasdaqGS:CINF

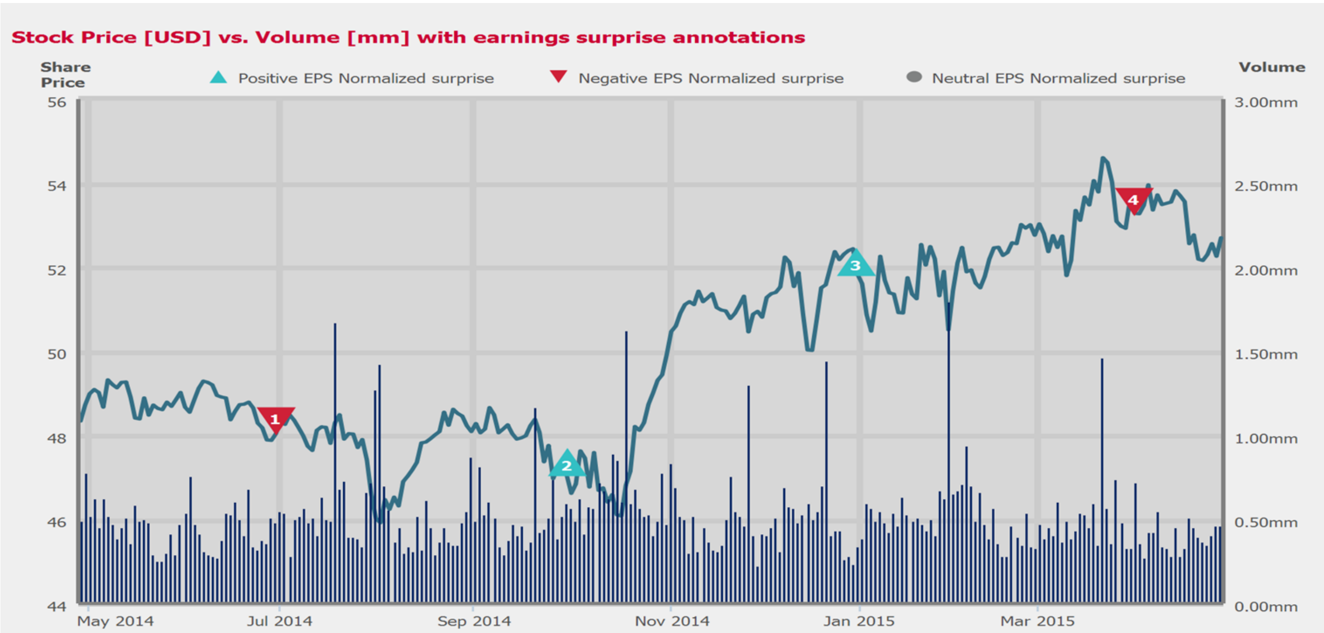
FQ2 2015 Earnings Call Transcripts

Wednesday, July 29, 2015 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2015-			-FQ3 2015-	-FY 2015-	-FY 2016-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.41	0.83	102.44	0.52	2.36	2.45
Revenue (mm)	-	-	-	-	-	5232.00

Currency: USD
Consensus as of Jul-14-2015 11:58 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2014	0.51	0.46	1 (9.80 %)
FQ3 2014	0.72	0.85	2 18.06 %
FQ4 2014	0.83	0.89	3 7.23 %
FQ1 2015	0.72	0.59	4 (18.06 %)

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 Francis Hollenbeck
Chief Investment Officer, SVP, Asst. Secretary, Asst. Treasurer and President of CFC Investment Co.

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

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Presentation

Operator

Good morning. My name is Steve, and I will be your conference operator today. At this time, I would like to welcome everyone to the second quarter 2015 earnings conference call. [Operator Instructions]

Investor Relations Officer, Dennis 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 of Cincinnati Financial. Thank you for joining us for our second quarter 2015 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.

First, please note that some of the matters to be discussed today are forward-looking. These forward-looking statements involve certain risks and uncertainties. With respect to these risks and uncertainties, we direct your attention to our news release and to the 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

Good morning, and thank you for joining us today to hear more about our second quarter results. Overall, it was a strong quarter. Our results reflect well on our strategy and on the efforts of our associates and agents. We continue to see ongoing benefits from executing on the fundamentals while enhancing performance through various initiatives.

Together, our underwriting programs and investment philosophy translated into substantial underwriting profit in our eighth consecutive quarter of investment income growth. Disciplined underwriting and pricing on each policy was aided by more favorable weather than in the second quarter of last year. Together, they led to a second quarter 2015 consolidated property casualty combined ratio of 92.4%. Our first half 2015 combined ratio before catastrophe effects was 89.1%, improving on that ratio from both full year 2014 and 2013.

As we further segment our business, we use pricing precision tools and informed underwriting judgment to select and retain policies at prices we believe provide an appropriate return for the risk we assume. We continue to earn quality new business from our agencies, especially in areas we've been emphasizing, such as Personal Lines products and services for our agencies' higher net worth clients. We are on track to release Executive Capstone, our new suite of high-net-worth insurance products, in New York this quarter.

We're also on track with progress for an initiative we announced early in the second quarter, expansion of reinsurance assumed, which we refer to as Cincinnati Re. We have an experienced executive leading the effort, and we are developing a small team of excellent people to help execute our plans. We aim to be very disciplined in this expansion, particularly during tough reinsurance market conditions. We have already entered into a few treaties that will be reported during the third quarter, generating approximately $15 million in diversifying written premium in 2015.

Overall pricing for the second quarter was very similar to the first quarter, with average renewal price increases for Commercial Lines continuing at percentages near the middle of the low single-digit range. That average includes the muting effect of 3-year policies that were not yet subject to renewal during the second quarter. For commercial property and commercial auto policies that did renew during the second quarter, we continue to obtain meaningful price increases with both lines averaging in the mid-single-digit range.

Our Personal Auto policies average renewal price increase is near the low end of the mid-single-digit range, while homeowner policies were a little higher in that range. For our Excess & Surplus Lines segment, second quarter 2015 average renewal price percentage increases were also near the low end of the mid-single-digit range. The E&S segment continues to perform very well, producing another quarter with combined ratio below 80% and double-digit growth in net written premiums. Our Life Insurance subsidiary, including income from its investment portfolio, also had another good quarter, a double-digit growth in profit in the second quarter brought our 6-month result in line with last year's first half.

I'll conclude with a couple of points that I think are important for all company stakeholders to keep in mind. First, our primary measure of financial performance, the value-creation ratio, is by design long term in nature. So we're not alarmed when that measure falls short of target in the short term due to securities market volatility. Our insurance business is in excellent shape. We have confidence in all of our associates and the relationships we build with independent agencies and in the ongoing benefits of our strategic initiatives that aim to continually improve performance.

Second, those studying this industry over the years have seen other times where merger and acquisition activity generated excitement and speculation. We believe our proven successful strategy will continue to deliver long-term value to all stakeholders. Looking forward to the next few years, our vision includes continuing to profitably grow the company with our agency-centered model.

I will now ask our Chief Financial Officer, Mike Sewell, to highlight other aspects of our recent financial performance.

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

Great. Thank you, Steve, and thanks to all of you for joining us today.

First, I'll highlight some important aspects of our second quarter investment results. We had another quarter of investment income growth with an increase of 3%. All 48 common stocks in our core portfolio increased their annual regular dividend over the 12-month period of July 2014 through June 2015. The median dividend increase for those stocks was 7.7%. For our fixed maturity portfolio, interest income rose despite declining average yields, in part due to the first half 2015 net purchases totaling $311 million.

The bond portfolio's second quarter 2015 pretax average yield, reported at 4.64%, was 12 basis points lower than a year ago. Taxable bonds purchased during the second quarter had an average pretax yield of 4.48% while tax-exempt bond purchases averaged 3.43%. In both cases, those yields are higher than those we experienced a year ago and in the first quarter of this year. Our bond portfolio's effective duration at June 30 was 4.8 years, up from 4.4 years at year-end. The increase was due primarily to the impact from rising interest rates on our callable bonds and not a change in strategy.

Cash flow from operating activities again contributed to investment income growth. Funds generated from net operating cash flows for the first half of 2015 rose 34% compared with a year ago to $470 million and helped generate $394 million of net purchases of securities for our investment portfolio. Paying $46 million less for catastrophe losses compared with a year ago helped drive the increase in operating cash flow for the first half of this year. We are still carefully managing our expenses. While we continue to strategically invest in our business, we kept the second quarter and first half property casualty underwriting expense ratios essentially flat compared with prior periods.

Moving to loss reserves. I'll first remind you that our approach to setting overall reserves remains consistent with the past. We continue to aim for net amounts well into the upper half of the actuarially estimated range of net loss and loss expense reserves. For the first half of 2015, favorable development on prior accident years at 4.4% was essentially in line with 4.8% from the first half of last year. As we noted in our news release, we again prudently added IBNR reserves to our Commercial and Personal Auto lines. At the same time, we were pleased to see another quarter of improvement in the case incurred loss ratio for those lines. Our 6-month 2015 net favorable development was again spread over several accident years, including 41% for accident year 2014, 23% for accident year 2013, 32% for accident year 2012 and 4% for all older accident years in aggregate.

Our stellar capital strength includes liquidity and financial flexibility. Cash and marketable securities for our parent company at June 30 totaled nearly $1.8 billion, up slightly from year-end. Our strong capital is vital for ongoing growth of our insurance operations as well as other capital management actions, such as returning capital to shareholders. During the second quarter, we used $74 million for cash dividends to shareholders. We also used $20 million to repurchase of 400,000 additional shares at an average cost of $50.90 per share. Similar to our share repurchases in 2014, it was a maintenance-type action intended to partially offset the issuance of shares through equity compensation plans.

I'll end my prepared remarks, as usual, by summarizing the 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 $0.51. Life insurance operations added $0.07. Investment income other than life insurance and reduced by noninsurance items contributed $0.29. The change in unrealized gains at June 30 for the fixed income portfolio, net of realized gains and losses, decreased book value per share by $0.71.

The change in unrealized gains at June 30 for the equity portfolio, net of realized gains and losses, decreased book value by $0.32. And we declared $0.46 per share in dividends to shareholders. The net effect was a book value decrease of $0.62 during the second quarter to $39.60 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

Thanks, Mike. In closing our prepared remarks, I have to say that we have a lot of positive momentum going as we move into the second half of the year. In addition to these strong results, we had positive news from 2 rating agencies that rate our company. In June, Standard & Poor's Rating Services raised its financial strength and credit ratings on our standard market and life insurance subsidiaries to A+ from A with a stable outlook. S&P cited our improved underwriting performance and efforts to continue building strong relationships with our agency partners.

2 weeks ago, Fitch Ratings affirmed the A+ insurer financial strength rating of our standard market and life insurance subsidiaries, maintaining its stable outlook. We are confident that Cincinnati Financial is on the right track to deliver shareholder value far into the future. 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.
As a reminder, with Mike and me today are Jack Shchiff Jr., Ken Stecher, J.F. Scherer, Eric Matthews, Marty Mullen and Marty Hollenbeck. Steve, please open the call for questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Paul Newsome with Sandler O'Neill.

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

This is probably a question for Mike. I noticed it looks like a fairly sizable increase in, at least, amount of reserve releases in the commercial business in the second quarter in every -- for the last, well, 3, maybe 4 years. Is there -- are there any studies or events that happened during the quarter that would account for that pattern?

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

Let me kick it off, Paul, and then we'll see if Steve wants to jump in. We do, do studies really every quarter. We're using the same actuaries. We're following a consistent approach. They're really looking at everything, Commercial Lines, Personal Lines, E&S. And so full studies done each quarter, looking at the paid losses as they come in. And then in addition to that, annually, we do have -- the external auditors are reviewing the reserves and opining on the financials in total. So we do have a process that we follow. We've got controls around that process and we believe it's a consistent process that really we've been following for years. I don't know, Steve, if you have anything to add on to that, but...

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

Mike, I think that was well put, and I don't have anything to add.

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

So I guess I'm really asking why there's a seasonality to, certainly, the second quarter?

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

I guess -- this is Steve. I don't know. Basically, when it comes to prior year reserve development, as Mike described, it's a consistent process. Our actuaries are looking at their best estimate of accident year ultimate losses. To the extent they decrease their estimate of an ultimate accident year loss on prior years, that would result in favorable development. I think we're careful to point out in the first quarter call that there isn't a lot of activity at that point because there's been such a short time and such lack of additional information since they did the full year review. But I think it's just a matter of our actuaries doing their best to get a best estimate of ultimate accident year losses at each of the financial close periods.

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

Paul, maybe I'll add one another comment. Related to the Commercial Lines specifically, the releases this year were, I'm going to say, fairly -- I mean, we had releases for accident year '14, '13, '12. There were releases in total in addition to all accident years prior to that, with accident year '14, '13, and '12 being, let's say, somewhat consistent, kind of between the $15 million to $25 million range for each of those accident years. So there's no necessarily spikes in one certain year versus another.

Operator

Your next question comes from the line of Josh Shanker with Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

I'm not going to let you guys off the hook so easily. Paul is much more of a gentleman than I am. Workers' compensation, I know you're trying to give best estimate, $40 million in reserve releases. This is a long-tail line of business. Tell me what happened during the quarter, please, that caused such a change in your outlook on that business.

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

I guess with a long-tail line, as you would expect, it takes not that much of a change in the assumption with the payments that stretch out for so long to result in higher changes in the estimate. So I think it's just the result of a lot of hard work that's going on in the claims department and the underwriting department and it's being reflected in the actuaries' view of accident year ultimate losses in terms of original assumptions versus revised assumption as they gather more information.

Joshua David Shanker
Deutsche Bank AG, Research Division

And so I mean, in terms of, as you say, information about claims progress on the severity side, on the frequency side, what accident years are affected? I mean, look, you guys always tend to have reserves in workers' comp. That's definitely clear. You have a very, very conservative approach to this. It just seems outsized in nature. I know you're consistent, but understanding the methodology would help us out a lot. Is there anything you can point to in particular in that line that made you more optimistic during the quarter?

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

Josh, I just think they're looking at paid losses, how they're developing. They're using multiple regression methodologies. They're using standard methodologies. They're testing their assumptions currently versus assumptions that they've set before and coming up with a best estimate. And I think in total, reserves in terms of favorable development at this point in time this year, are pretty much in line with where they were at the same point last year. I think we're trying our best to keep reserve margins -- our reserve margin consistent, and it's just reflecting that the best estimate of our actuaries.

Joshua David Shanker
Deutsche Bank AG, Research Division

Well, it looks excellent, and I applaud your efforts. If we go back about a year ago and 2 years ago, you guys were on an aggressive sort of scouting of your properties, analyzing roofs and whatnot for the re-underwriting year. That became a huge benefit. One of the things that we've been hearing a lot about is drone technologies and the extent to which you can get aerial views. Do you think that Cincinnati could benefit and lower their expense ratio by doing regular roof analyses via remote-operated units?

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

Josh, this is Marty Mullen. Actually, we already have a team formed to analyze the effectiveness and the values of the drone technology in underwriting loss control for those inspections as well and in claims. And so we're pretty excited about the opportunities with that technology and what it can bring to the industry for commercial inspections on property during the new business cycle and also in claims, certainly, in storm situations to provide initial data, confirm measurements and actually confirm loss cost estimates as well.

Joshua David Shanker
Deutsche Bank AG, Research Division

Is that in development? Or have you begun to use it?

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

We haven't started using it yet. We have teams investigating the opportunity to file the appropriate paperwork. As you know, that has to be filed and approved before you can implement the technology. But we're encouraged with our progress and looking forward to the opportunities certainly before the end of the year.

Joshua David Shanker
Deutsche Bank AG, Research Division

Great. And finally, can you tell me a little bit about your relationship with Google Compare and what kind of loads you're seeing from that new channel?

Jacob F. Scherer
Former Chief Insurance Officer

Josh, this is J.F. We don't have a relationship with Google Compare. We're not a fan of comparative raters, to be honest with you.

Joshua David Shanker
Deutsche Bank AG, Research Division

I thought -- I'm sorry, I thought you were listed as one of their vendors on their site, but I guess that's a mistake.

Jacob F. Scherer
Former Chief Insurance Officer

No, no, we're not. We're -- we don't have a relationship with them.

Operator

[Operator Instructions] Your next question comes from the line of Scott Heleniak with RBC.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Just wondering if you could -- now it's been a quarter since we announced the new reinsurance, reinsurance assumed. Wondering if -- and you announced a couple new hirings yesterday as well. Wondering if you had an update or you could share a little more on where you see that business heading and particularly areas it might focus on.

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

Sure. Scott, this is Steve. We're hiring some very good people, very talented people. We're very happy with that. We are going to be very cautious as we move forward. We know it's a tough reinsurance market. But as we look out here, I mean, just with the domestic reinsurance market, I think there's something like $70 billion in premium volume. I kind of joked with the guys that we've now captured $15 million of it. I think that despite an overall tough market, with talented people, if we can look at it one treaty at a time and we can put ourselves in a position to -- especially utilizing the strong capital position, the A+ rating that we're in, we can really differentiate and write those policies where we have good profit potential, good expected risk-adjusted returns, again being very careful but putting our capital to work to generate more growth, more...

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

But could that be in property or casualty?

Steven J. Johnston

Chief Executive Officer, President, Director and President of Cincinnati Life Insurance Company

Yes. We are not going to limit it to property or casualty. We're going to just look for the best opportunities treaty by treaty.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Okay, that's fair. And then just on Personal Lines. I was wondering if you can elaborate on something. On the press release, you talked about you're benefiting from agents broadening their underwriting appetite there. And just wondering if you could comment on that. Does that mean because you're simply writing more Personal Lines in more states and you have more products to offer, such as high net worth? Just wondering if you could kind of flesh out that comment.

Jacob F. Scherer
Former Chief Insurance Officer

Yes. Scott, this is J.F. Yes, I think what we intended to communicate there was that, because of the high net worth focus that we now have and expanding our appetite, not necessarily the agents' appetite, we're able to offer a lot more products to our current agency force throughout the country. And the business we're writing in the high net worth category has gone up quite a bit, as you would expect that it would. Additionally, we are expanding. Steve mentioned in his remarks that we'll be opening up operations in the Greater New York City area in September, introducing our high net worth approach, and we'll be consistent with the way we've done things historically throughout the country. We're only going to appoint a few agencies. Our aim will be to earn a portion of their business that would be significant enough that we'd deem it to be successful in that area. We are pleased -- not unlike Cincinnati Re, we're very pleased with the work that Will Van Den Heuvel is doing to introduce us to that greater appetite. And he's brought along a lot of very talented people that'll enable us to, not only in New York but across the country, do a better job in the high net worth area.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Okay. So the -- and along those lines, the comment about you're tracking larger Personal Lines account, is that just -- is that high net worth customers? Or is that bundling and/or a combination?

Jacob F. Scherer
Former Chief Insurance Officer

No, not necessarily bundling. As a company, we always would write package, if you will, the auto, the umbrella, the homeowners. So that's no different there. We really don't write monoline business. But when we talk about larger customers, we're talking about high net worth, yes.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Okay. In the Personal Lines?

Jacob F. Scherer
Former Chief Insurance Officer

Yes, in the Personal Lines.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Great, okay. And then the only other question I have was -- there's been an uptick in the realized gains this year, I guess over $100 million or so. So could you talk about some of the areas you're reducing exposure? And is any of that just portfolio repositioning ahead of what might happen with the Fed next? Just any thoughts on that?

Martin Francis Hollenbeck
Chief Investment Officer, SVP, Asst. Secretary, Asst. Treasurer and President of CFC Investment Co.

This is Marty Hollenbeck. That really is more -- we manage -- we're generally buy-and-hold but in the equity portfolio we do, on occasion, reconfigure it and that's really the primary driver of that. We sold a few positions awaiting deployment on some of it. But it's -- doesn't represent any kind of a real strategic change.

Operator

[Operator Instructions] There are no further questions at this time. Mr. Johnston, I turn the call back to you.

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

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

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