S&P Capital IQ

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CNA Financial Corporation NYSE:CNA

FQ2 2012 Earnings Call Transcripts

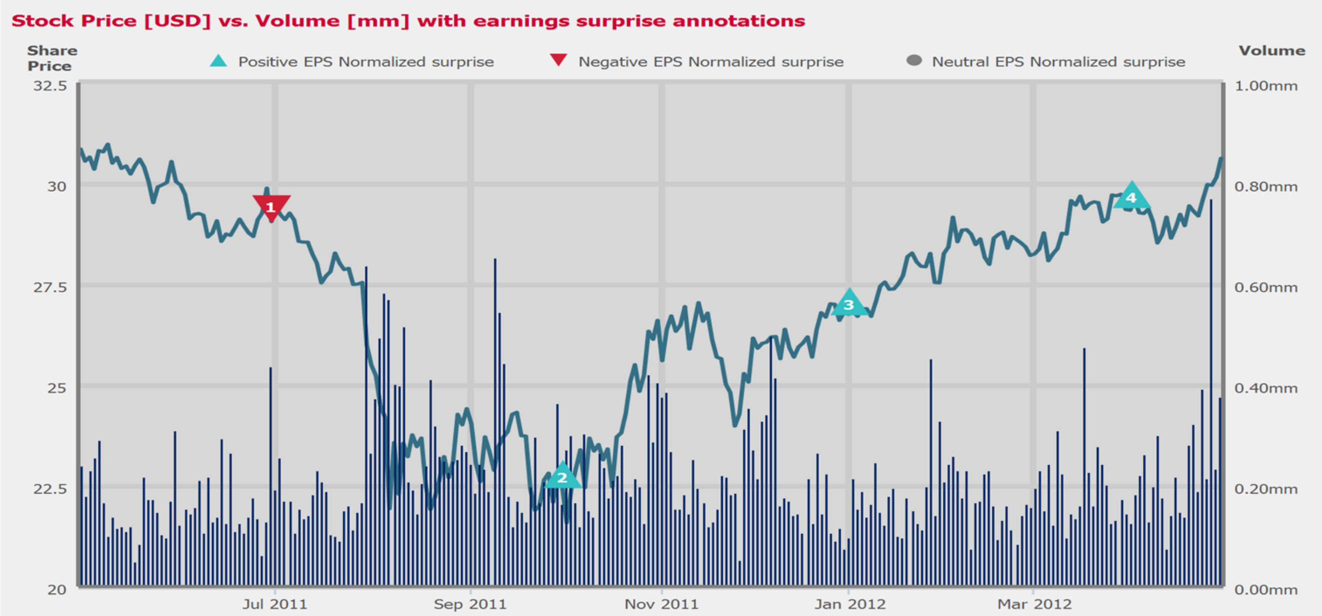
Monday, July 30, 2012 2:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2012-			-FQ3 2012-	-FY 2012-	-FY 2013-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.59	0.56	(5.08 %)	0.66	2.85	3.03
Revenue (mm)	1930.12	-	15.23	1987.04	7884.51	8372.49

Currency: USD

Consensus as of Jul-30-2012 1:28 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2011	0.49	0.43	(12.24 %)
FQ3 2011	0.26	0.34	30.77 %
FQ4 2011	0.69	0.71	2.90 %
FQ1 2012	0.69	0.84	21.74 %

Call Participants

EXECUTIVES

D. Craig Mense
Chief Financial Officer and Executive Vice President

Marie Hotza

Thomas F. Motamed
Former Chairman and Chief Executive Officer

ANALYSTS

Amit Kumar
Macquarie Research

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Ronald David Bobman
Capital Returns Management, LLC

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the CNA Financial Corporation's Second Quarter 2012 Earnings Call. Today's call is being recorded.

At this time, I'd like to turn the conference over to Ms. Marie Hotza of Investor Relations. Please go ahead, ma'am.

Marie Hotza

Thank you, Lea. Good morning and welcome to CNA's discussion of our second quarter 2012 financial results. With us on this morning's call are Tom Motamed, our Chairman and Chief Executive Officer; and Craig Mense, our Chief Financial Officer. Following Tom's and Craig's remarks about the quarterly results, we will open it up for your questions.

Before turning it over to Tom, I would like to advise everyone that during this call, there may be forward-looking statements made 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 this call.

Information concerning those risks is contained in the earnings release and in CNA's most recent 10-K and 10-Q on file with the SEC. In addition, the forward-looking statements speak only as of today, Monday, July 30, 2012. 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 have also been provided in our most recent 10-K and 10-Q, as well as in the financial supplement. This call is being recorded and webcast. During the next week, the call maybe accessed on CNA's website.

Now I will turn the call over to CNA's Chairman and CEO, Tom Motamed.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Thank you, Marie. Good morning, everyone, and thank you for joining us today. I would like to start by saying that I am very encouraged by a number of positive trends that we believe are well established across our businesses. We are pleased by the growth momentum across both our Property & Casualty businesses. Excluding the effects of last year's sale of First Insurance Company of Hawaii, net written premiums increased 5% this quarter consistent with the level of increase in our first quarter of this year. We are now achieving rate increases across all lines. The aggregate 6% rate increase in the quarter was up from the 4% we reported in the first quarter and well above the 1% achieved in last year's second quarter.

The second quarter Property & Casualty non-cat accident year loss ratio of 67.3% improved more than 2 points from last year's second quarter and was 1.5 points lower than where we ended 2011. As you know, catastrophe losses were again a big story for the industry in the second quarter. While CNA incurred significant wind and thunderstorm losses of $68 million, we believe that our 4.4 points of catastrophe losses reflect well on our disciplined approach to catastrophe management.

Our Specialty business continued to deliver solid underwriting results with a second quarter combined ratio of 94.4. Specialty sustained its growth momentum with a 5% increase in second quarter net written premiums. Specialty continues to build upon its positive rate trend. A 5% increase in the second quarter was 2 points better than this year's first quarter, while retention held steady at 86%.

Specialty's non-cat accident year loss ratio improved modestly this quarter to 67%, as rate increases achieved over the last 5 quarters begin to earn into the results.

In Commercial, our second quarter combined ratio was 108.1 this year. Catastrophes represented 8 points of Commercial's combined ratio and this year's second quarter. Excluding catastrophes and development, Commercial's second quarter combined ratio improved to 102.9 from 107.6 last year. We are pleased with Commercial's continued growth. Excluding First Insurance Company of Hawaii, net written premiums increased 5%.

Commercial continued a positive rate trend that began in late 2009. The 7% rate increase in the second quarter represented a 2-point improvement over this year's first quarter. Retention decreased slightly reflecting rate, account period and other underwriting actions geared toward improving profitability. Our efforts to improve Commercial's margins are reflected in the consistently improving non-cat accident year loss ratio which is now 3 points lower than second quarter 2011 and has sequentially improved more than 2.5 points from where we ended 2011.

With that, I'll turn it over to Craig.

D. Craig Mense
Chief Financial Officer and Executive Vice President

Thanks, Tom. Good morning, everyone. The second quarter was marked by a meaningful progress toward our longer-term objectives. Improved underwriting margins across our core P&C businesses, driven by both broad-based rate increases and underwriter risk selection, as well as steady revenue growth, were significant positives.

In July, we completed the acquisition of Hardy Underwriting Bermuda. The acquisition aligns well with our specialized approach to underwriting. The integration work is now well underway and we remain excited about our prospects.

In addition, we trust you saw Moody's recent announcement about CNA. In addition to upgrading our senior unsecured credit rating, Moody's affirmed our financial strength rating and revised the outlook on our financial strength ratings to positive from stable.

In the second quarter, CNA's net operating income was $152 million and operating return on equity of 5.4%. Our year-to-date operating ROE is now just under 7%. Operating income available to common shareholders was $0.56 per share. Period-over-period comparisons were favorable driven by improved accident year underwriting results in our core P&C operations and lower losses in our runoff businesses. Second quarter net income also improved from the prior year to $166 million or $0.62 per share.

P&C operations produced net operating income of $163 million in the second quarter as compared to $151 million in the prior year period. Lower catastrophe losses and improved non-cat accident year loss experience more than offset a decrease in investment income. We have modest amount of favorable prior year development in the quarter on par with last year's second quarter.

Our Non-Core Life & Group segment produced a small profit this quarter and a loss in the corporate segment narrowed. The current quarter's results include several favorable items, apart from which our runoff businesses continued to perform as expected.

CNA continues to build on a solid foundation of financial strength and stability. Our capital adequacy metrics remain at or above our target levels, and our liquidity profile remains very strong. Book value per common share increased to $45.34 per share, up 2% from the end of the first quarter. The increase reflects earnings and improvement in our investment portfolio's net unrealized gains addition.

Our investment portfolio's pretax net unrealized gain stood at approximately $3.5 billion at quarter end, an increase of approximately $470 million from the end of the first quarter 2012.

Approximately $330 million of this quarterly change was generated by the longer-term assets supporting our Life & Group segment. The impact of those gains were offset by additional shadow reserve adjustments that were also reflected in other comprehensive income.

Our common shareholders equity, excluding AOCI, was $11.3 billion, or $42.12 per common share, up approximately 1% from the end of the first quarter. Our statutory surplus stood at $10 billion at quarter end, essentially unchanged from the end of the first quarter.

During the quarter, our primary insurance operating company repaid the $150 million remaining balance on the surplus note issued in 2008. We continue to maintain more than $800 million of dividend capacity at the insurance operating company level.

Cash and short-term investments at the holding company level were approximately $410 million at quarter end. We continue to target cash at the holding company equal to about 1 year of our annual net corporate obligation. We have a small amount of corporate debt, $70 million, that matures in August, that we intend to retire. Our liquidity profile also includes a $250 million 4-year revolving credit facility.

In the second quarter of 2012, operating cash flow excluding trading activity, was approximately $340 million, up slightly from this year's first quarter. Additionally, we received approximately $900 million of cash principal repayments through pay downs, bond calls and maturities.

Net investment income was $470 million pretax in the second quarter, as compared to $517 million in the prior year period. The decrease was driven by our limited partnership investments, which produced second quarter pretax losses of $35 million in 2012, as compared to pretax income of $11 million in 2011.

As a point of reference our LP investments produced a negative return of approximately 1.4% in the; second quarter, while the S&P 500 total return was a negative 2.8%. Year-to-date, our LP investment return was approximately 4.2% as compared to 9.5% for the S&P 500 total return.

Net investment income from our fixed maturity securities in the second quarter was $505 million pretax, essentially flat with the prior year period as a higher level of invested assets offset decreased yields.
We made relatively minor changes to our investment portfolio of sector allocations this quarter. The investment grade corporate bond sector continues to represent the largest component of our invested assets.

Overall, our investment portfolio remains well diversified, liquid, high quality and aligned with our business objectives. The average credit quality of our fixed maturity portfolio remained at A. Fixed income assets, which support our long-duration life-like liabilities, at an effective duration of 11.7 years at quarter end, unchanged from the prior quarter end and in line with portfolio targets. The effective duration of the fixed income assets, which support our traditional P&C liabilities, was 3.9 years at quarter end, down from 4.2 years at the end of this year's first quarter.

With that, I will turn it back to Tom.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Thank you, Craig. Before we open it up for questions, I would like to summarize our second quarter highlights.

Rate increases of 6% with increasing rate momentum across all lines; sustained growth of net written premiums at 5%, excluding last year's sale of First Insurance Company of Hawaii; meaningful progress on margin improvement, particularly in our Commercial segment; increased net operating and net income of $152 million and $166 million respectively; increased book value per share of $45.34, up 6% from year end 2011; lastly, we declared a quarterly dividend of $0.15.
With that, we would be glad to take your questions.

Question and Answer

Operator

[Operator Instructions] And we'll hear first from Amit Kumar with Macquarie.

Amit Kumar
Macquarie Research

My first question relates -- this is probably a numbers question. In the Life & Group Non-Core, you talked about the gain related to a benefit on Life settlement contract. Did you quantify that in the opening remarks? Did I miss that? Or maybe just expand on that a bit more.

D. Craig Mense
Chief Financial Officer and Executive Vice President

This is Craig, Amit. No I didn't mention the number, but it was approximately $8 million after tax was the impact.

Amit Kumar
Macquarie Research

$8 million. So I guess a related question would be how is the mortality shaping up in the third quarter in the sense that could there be something else like this in the third quarter too? Maybe just expand on the mortality trends in third quarter.

D. Craig Mense
Chief Financial Officer and Executive Vice President

Well, remember that, that was a pay out of part of our Life settlement business. We haven't talked about that very much. It's relatively small pieces of runoff business, and to give you some context, I think we have about 500 lives still insured -- excuse me, about -- more like 800 lives are in policies insured in that business and they pass up maybe about $500 million of face value of life insurance there. So if you think about it, most of the policies aren't representing more than $1 million per person. Now, the value of those obviously declines over time as people live. And that's been pretty lumpy business running off, so that's not anything particularly material in the future. And the other things that affected us that business this quarter where we did see improved morbidity as well as improved persistency in the health business. Now, I wouldn't -- you'll also recall that in first quarter, our morbidity trends were negative in health so I wouldn't really draw any conclusion from that. They're pretty steady. We are getting some very small modest improvements because of rate increases and some modest improvement in that businesses as a result of persistency improvements, but very much on the margin.

Amit Kumar
Macquarie Research

Margin? Okay. That's actually very helpful. The second question relates to, I guess, the broader discussion on capital. And this might be a question for Tom. The Hardy acquisition is done now. You've talked about the dividend, the special dividend, other options. I guess, what I'm trying to think is how do you view putting to use excess capital going forward? I mean, do you say to yourself that pricing is getting better or let me focus on the core book? Or are you saying that while there are may be many other properties out there which I should be looking at. Maybe just help us sort of elaborate on that a bit and sort of figure out where you stand on those issues.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

I think, Amit, I'd start with my probably the first conference call that I had when I came to CNA was it's about improving margins in our ongoing operating company business. So clearly, we have been committed to that. We have spent a lot of time, energy, human capital, dollars to make us a better underwriting company and improve margins, and over time, continue to add to surplus. So the reality is that's first and foremost our goal, at the same time, we have our eyes and ears open. So we -- you mentioned Hardy, so just to bring that up again from our perspective, we thought that was a great opportunity that would help us grow our platform around the globe, as well as improve profitability. This is a company that's been our syndicate, it's been out there for 35 years. Historically, combined ratios in the 80s, which is better than CNA, a specialized portfolio, predominantly a short tail business, unlike CNA, which is much more casualty long-tail driven. So we thought that was a great opportunity to once again contribute to scale and margins. So and what we liked about it was what it's what we call bolt on just basically say, "Okay, you've got new owners and here are the expectations and go at it", obviously, with lots of direction and control. So clearly we look for bolt-ons, if there was something like that, we would do it. With the remainder of CNA Surety, a business that we do well, and that's contributing to earnings. So clearly that's our first and foremost objective. Secondly, we did reinstate the dividend, and we have raised it over time. So we will continue to look at that, but no good dividend before it's time. When we're ready, we will be prepared to address that. So other than that, I think we're going to say, Amit, we're playing this pretty close to the vest, and this is about building a better company over time.

Amit Kumar
Macquarie Research

And I agree. Final question I'll requeue. This goes back to the discussion on the pricing momentum. Obviously, you had good rates in this quarter. There is this bigger debate that pricing is flattening. If you look at some of the other carriers, Q2 versus Q1, seemed to have flattened for some of them. I'm curious, as you look towards year end in the absence of, let's say, any hurricane losses for the industry or any other capital-depleting event, how do you think about pricing for year end 2012?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

We continue to be optimistic about the pricing environment. Quite honestly, as we've said earlier in the call, we are seeing momentum in some lines. Some lines are getting double-digit increases, others are in the high single digits, some are in the low single digits. But we are getting rate increases in every line, and we see the momentum continuing. And it has and you see how the written rate has turned into earned rate, that it's now starting to help the underlying net accident year combined ratio x cat, x development. So from our standpoint we still are pushing out there. We believe we can continue to push. I'd say if you want to say it's flattening, be careful what you wish upon yourself, we are not wishing that on us. We continue to push and we think July is any indication, too early to tell, but July was a very good month for us relative to rates. So we are not prepared to accept flattening at this time.

Operator

[Operator Instructions] We'll move next to Jay Cohen with Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

I guess, the first question, more of a numbers question, can you talk about the difference between new money yields as your portfolio is constructed now versus your book yields? I just wanted to get a sense of what kind of the rollover risk here is.

D. Craig Mense
Chief Financial Officer and Executive Vice President

This is Craig. So the -- and you'll see the when you get the Q which we expect to file later -- tomorrow, you'll see the maturity profile in the Q in terms of the time forward. But we -- in the next, just to give you some context, in the next 1.5 years, we've got a little over $4 billion that we would expect that would mature prepay, and the reinvestment rates are anywhere 150 to 200 basis points lower than the book yield that's running off. So now those numbers don't reflect the additional cash flow that's being reinvested which is about $2 billion a year as well. So generally, those are -- those are going to dip the headwind, but not significant and manageable. We do have the maturities starting at '14 and '15 a little higher rate, more like $4 billion a year. So it would begin to become more of a problem in the outer years.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

That's helpful. I guess related to that, you obviously have a very sizable unrealized gain in the portfolio and some of that's in the runoff business but is your strategy regarding recognizing some of these gains changed or realizing some of these gains?

D. Craig Mense
Chief Financial Officer and Executive Vice President

I would say no. I think in that effect that one of the things that we've said repeatedly is that we didn't get overly excited. We had unrealized loss in the portfolio in '08 because we were highly unlikely to need to do anything there nor do we get overly excited about the gain in the portfolio now because that we'd be actually welcome rising interest rates as we reinvest the positive cash flows coming out of the business. Now, keep in mind that the gains, particularly in the Life business, that you'd have to be able to if you're going to sell them over we'll invest them at rates that were -- that didn't create a premium deficiency and given the current yield environment, it's very hard to think about where would be a good point to put money at money to work and meet those expectations.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Yes, I know. that makes sense. And if I can, maybe one bigger picture question for Tom. So, you're clearly making some progress, and your efforts and rates beginning to help you more and you're pushing for rate seemingly pretty hard, I guess, the question is as you look forward, what is -- maybe really it's 2 questions, Tom. What are the key things on your list your management teams list of left to do, and then secondly, what do you see as your greatest risks today as you look at whether it's your income statement or your balance sheet? So what's left to do, what are the greatest risks? Big picture stuff.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

I would say things left to do we'd start with keep doing what we're doing, stay focused on our strategy and our execution. I think the other thing is we have certain segments of our business that we've identified, called them customer segments, which we think can be built out. Some of them are pretty small compared to our competitors, and we think there's a lot of opportunity there to grow out these segments. What I can tell you is that we are pushing hard in these segments, and what we're finding is in the Commercial space where we look at these segments, new business is up 10%, the retention is better, we're just writing better business and more of it. And I would say, as we push harder in these segmented approaches, we have a great opportunity to grow. We've said for a long time that we don't think we have an expense ratio issue. We think we have a scale issue. So we will continue to grow in a very controlled way once again. We kind of like where we are at 5%. We think we could grow higher than that, but we want to do that with a combination of rate increases and new business in the specific segments where we believe we can develop scale and profitability over time. So I would say that's always -- or I should say that's kind of the opportunity, as well as Hardy. We think Hardy is going to give us some pretty good opportunities and specialties that currently we don't have that they have such as energy and aviation and a few other things. So from our standpoint, we see that as something that has to grow profitably over time. As for risk, we kind of look at the glass being half full rather than half empty. So I would say you're always worried about what's going to happen on the investment returns standpoint, I mean everybody has to deal with that. But I don't think that's an issue. That is a CNA issue. I think that's relative to the insurance industry as a whole. But other than that, we see lots of upside. We don't see a lot of downside.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

And it sounds like that the run off business isn't presenting any looming risks, if you will, means you can be running off as expected.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

It's been here for a while. This business didn't show up last night. So we've been managing it through the years, we'll continue to manage it. We will continue to look at options and/or solutions for it over time. But as you know, Jay, timing is everything. The right time is not today. It will be sometime in the future, but clearly, we're managing that business more aggressively. We're very pleased with some of the steps we're taking to do a better job in that area. So we keep working on that, waiting for our moment on the stage to do something.

Operator

[Operator Instructions] We'll hear next from Ron Bobman with Capital Returns.

Ronald David Bobman
Capital Returns Management, LLC

And glad to see all the progress that's continuing on rate and retention holding and margins improving, I mean, most importantly. I had a question about Hardy, and I just wanted to ask on sort of the cat exposure front, could you give us some metrics and figures as to what sort of additional cat exposure we're taking on? I don't know if you want to, if you can or you're willing, or if it's relevant to talk about sort of the incremental exposures for a 1 in 100 windstorms in a certain part of the world or a quake or what have you. But I just sort of thinking ahead, there'll be a day when there's a storm on the horizon or a quake happens or a storm hits and we're all going to be sort of wondering what the addition of Hardy to the portfolio means or doesn't mean. But could you help us there, please?

D. Craig Mense
Chief Financial Officer and Executive Vice President

This is Craig. It does add some and we certainly considered that in the purchase and the due diligence. But it doesn't add meaningfully to CNA's 1 in 100 or 1 in 250 numbers. We're still well inside the tolerances we've established in the addition to Hardy, which right now, they still trade on this sort of 25% third-party capital. But even after that you'll do at the end of '13. At least at the moment, and the way their portfolio is constructed, it wouldn't add more than $50 million to our 1 in 100 cat loss, so the volatilities are not meaningful for CNA.

Ronald David Bobman
Capital Returns Management, LLC

So incremental $50 million, and I assume that's the high number. So what peril, what sort of event and that's 1 in 100, Craig?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Yes.

Ronald David Bobman
Capital Returns Management, LLC

And what peril would that be? And can I assume that the other peril, so if you'd -- what peril is that? Windstorm? North Atlantic windstorm?

D. Craig Mense
Chief Financial Officer and Executive Vice President

That's all. All and any, but most to us will be U.S. wind.

Operator

[Operator Instructions] You have a follow-up from Mr. Jay Cohen.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

I just wanted to see in the third quarter, obviously, you closed on Hardy. Will there be any accounting adjustments that need to get reflected in the financials that are material in any way?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Well, I mean we're working through the purchase accounting adjustments now, Jay. And again there'll be some small enough kind of framework detailed in the Q when you see you it tomorrow. And so we are finalizing that. I think what I said last quarter and I'll say it again, so we will begin reporting Hardy, actually as a separate operating segment in the third quarter. I wouldn't expect anything material one way or the other in terms of earnings from Hardy for the second half of this year. And that's because of some of the purchase accounting adjustments related to Hardy in terms of the -- and that amortization, and I would expect it to be modestly accretive to EPS starting in '13. Also of course, there are costs associated with the integration work on the IT, integrated financial system side, that will be under way or already well underway that will happen over the next 6 months and probably into the first half of '13.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

It'll be a separate segment that you'll break it out separately from Specialty and the Commercial business.

D. Craig Mense
Chief Financial Officer and Executive Vice President

That's our intention.

Operator

There are no further questions at this time.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Thank you very much. See you next quarter.

Operator
Ladies and gentlemen, that will conclude today's presentation.