S&P Global
Market Intelligence

American Financial Group, Inc. NYSE:AFG

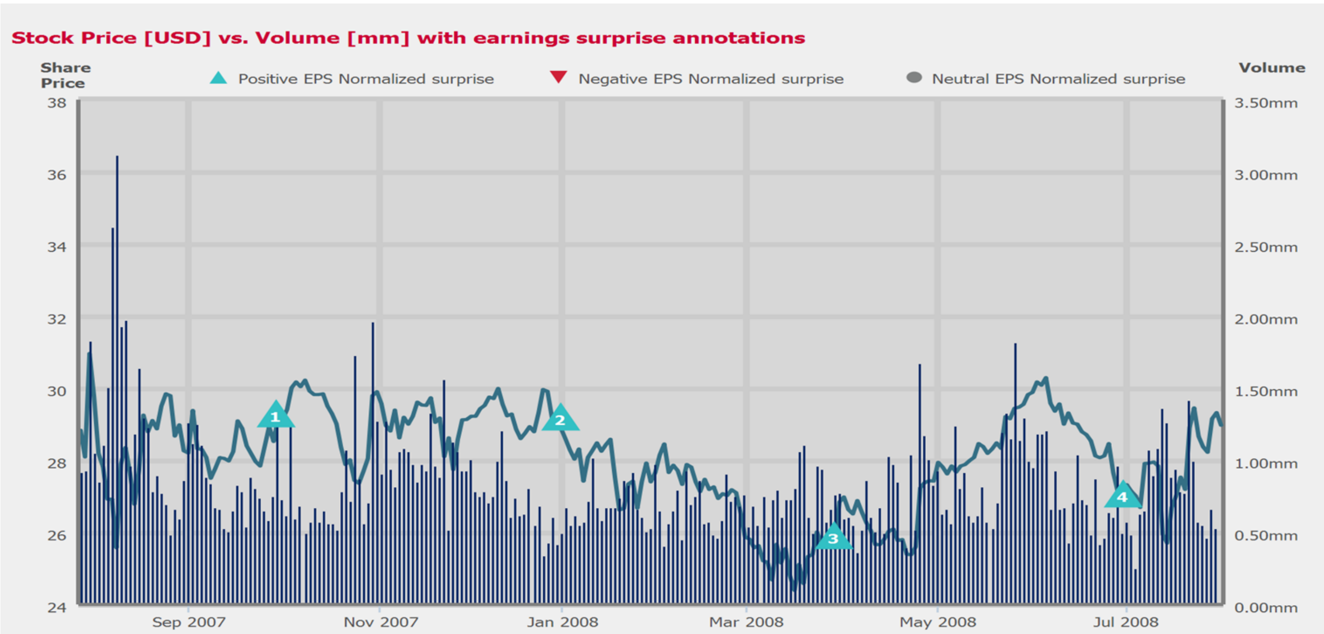
FQ3 2008 Earnings Call Transcripts

Tuesday, October 28, 2008 3:30 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2008-			-FQ4 2008-	-FY 2008-	-FY 2009-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.95	0.98	▲3.16	0.99	3.98	3.68
Revenue	-	-	▲26.58	-	-	-
Revenue (mm)	672.00	850.60	-	-	2799.50	2814.80

Currency: USD
Consensus as of Oct-27-2008 12:08 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2007	0.85	0.97	▲14.12 %
FQ4 2007	0.94	1.21	▲27.37 %
FQ1 2008	0.89	1.09	▲22.47 %
FQ2 2008	0.90	0.96	▲6.67 %

Table of Contents

Call Participants

EXECUTIVES

Carl H. Lindner III

Keith Alan Jensen
Former Senior VP & CFO

ANALYSTS

Amit Kumar
Fox-Pitt, Kelton Cochran Caronia Waller

Marvin Weinstock
Maxim Group

Unidentified Analyst

Presentation

Operator

Good morning. My name is Sasha and I will be your conference operator today. At this time, I would like to welcome everyone to the Third Quarter 2008 American Financial Group's Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question and answer session. [Operator Instructions]. Thank you.

I would now like to turn the call over to Mr. Keith Jensen, Senior Vice President. Please go ahead sir.

Keith Alan Jensen
Former Senior VP & CFO

Thank you. Good morning. I'm here with Carl Lindner the 3rd, Co-CEO of American Financial Group and we're pleased to welcome you to American Financial Group's 2008 third quarter earnings results conference call.

If you are viewing the webcast from our website, you can follow along with the slide presentation if you'd like. Certain statements made during this call are not historical facts and may be considered forward-looking statements based on estimates, assumptions and projections which management believes are reasonable, but by their nature subject to risks and uncertainties. The factors which could cause actual results to differ materially from those suggested by such forward-looking statements include but are not limited to those discussed or identified from time to time in AFG's filings with the Securities and Exchange Commission, including the Annual Report on Form 10-K and quarterly reports on Form 10-Q. We do not promise to update such forward-looking statements to reflect actual results or changes in assumptions or other factors that could affect these statements.

Core net operating earnings is a non-GAAP financial measure which sets aside items that are not considered to be part of ongoing operations such as realized gains or losses on investments, effects of accounting changes, discontinued operations, significant asbestos and environmental charges and certain other recurring items. AFG believes it to be a useful tool for analysts and investors in analyzing ongoing operating trends and will be discussed for various periods during this call. A reconciliation of net earnings to core net operating earnings is included in our earnings release.

Now I'm pleased to turn the call over to Carl Lindner the 3rd, Co-Chief Executive Officer of American Financial Group.

Carl H. Lindner III

Good morning and thank you for joining us. We released our 2008 third quarter results yesterday afternoon. I'd like to start by covering some highlights on slide 3 of the webcast.

Core net operating earnings per share for the quarter were $0.98 compared to $0.97 in the 2007 third quarter. Improved results in our annuity and supplemental insurance operations, and higher investment income were offset by lower underwriting results in our property and casualty operations, largely driven by catastrophe losses.

Record core net operating earnings for the first nine months of 2008 were $3.03 per share compared to $2.81 per share for the comparable 2007 period. Net earnings were $0.18 per share compared to $0.93 per share in the 2007 third quarter.

Our 2008 third quarter results were impacted by net realized losses on investments of approximately $94 million or $0.80 per share after tax. These charges include other than temporary impairments as well as realized losses on sales of investments, primarily in the financial sector.

Our insurance operating results for the quarter and through nine months of the year remain strong. We remain on target to meet the company's 2008 operating objectives.

We're particularly pleased with the results in our annuity and supplemental insurance businesses, which benefited from increased spreads in the annuity lines during the quarter. Our concentration in fixed annuities is particularly advantageous in the current investment environment.

Through the first nine months of 2008, our record core earnings per share are 8% above the 2007 period and our annualized core operating return on equity was 16%. Our capital adequacy, financial condition and liquidity remain very strong as evidenced by Standard & Poor's recent report affirming the stable outlook our investment grade debt ratings and our insurance operations financial strength ratings.

We have focused on maintaining appropriate liquidity and anticipate continuing to generate cash through our operating net income. Our book value per share of $27.74 excluding unrealized gains and losses on fixed maturities was up 4% compared to $26.75 per share at the end of the 2007 third quarter. Book value per share including all unrealized gains and losses on investments was $24.05 compared to $26.8 at the end of the third quarter a year ago.

Turning to slide 4, I'd like to review the results of our specialty and property and casualty operations. Overall, underwriting profit in the 2008 third quarter of $72 million was 31% lower than the same period a year ago. The combined ratio increased five points to 91.5% as higher catastrophe losses, mostly from the wind-related storm damage from Hurricanes Gustav and Ike, higher losses from run off operations more than offset an increase in favorable reserve development. We recognized approximately $57 million in favorable reserve development in the third quarter, $31 million more than in the comparable period in 2007.

Our underwriting profit and combined ratio through the first nine months of 2008 reflects the effects of more competitive market conditions, that our results and returns are in line with our expectations.

I am encouraged by the stability of our overall rate levels. Excluding the effect of California workers' comp, average renewal rates in the other specialty operations through the 2008 third quarter were down about 3% compared to renewal rates from the same prior year period.

Gross and net written premiums were up significantly for the quarter, mostly as a result of higher premiums in our crop operations. Gross investment income related to our property and casualty operations is up approximately 14% through the end of the third quarter as we have benefited from higher interest rates in this segment's portfolio.

Now I'd like to review the third quarter and nine month results for each of our specialty business groups on slides 5 and 6.

Property and Transportation group, our largest group, generated solid underwriting profit through the first nine months of the year. Its third quarter results were impacted by catastrophe losses primarily within Great American's Property & Inland Marine division and lower underwriting profit in our crop operations, which were offset somewhat by higher favorable reserve development. Apart from the catastrophe losses, this group produced exceptionally strong profitability in the 2008 third quarter.

Gross and net written premiums increased significantly for the quarter and year-to-date in 2008 largely due to higher spring commodity prices which benefit our crop operations. These increases more than offset the volume declines in Great American's Property & Inland Marine operations resulting from softer market conditions. We expect to recognize additional underwriting profit in our crop operations in the fourth quarter. Crop yields and variations in commodity pricing are key factors in determining ultimate profitability in these operations. This group's average renewal rates for the first nine months of the year were about 3% below the same period a year earlier.

Let's move on to the Specialty Casualty group. This group continued to produce strong underwriting profits in the 2008 third quarter and nine month periods. The improvement in the combined ratio for the third quarter reflects better underwriting results in our executive liability and targeted markets operations and higher favorable reserve development.

Through the first nine months of the year, the combined ratio increased almost three points as the improved results in our executive liability and targeted markets operations were more than offset by lower underwriting results in the general liability and excess and surplus lines as well as by lower favorable reserve development.

Decreases in gross written premiums through the third quarter were driven primarily by volume reductions in our excess and surplus lines, reflecting continuing competitive pressure in those commercial casualty markets and lower general liability premiums, resulting from the softening in the homebuilders market. These declines were partly offset by additional premium from the Marketform Group, which was acquired in the 2008 first quarter.

Net written premiums for the 2008 third quarter and year-to-date increased over 2007 periods as additional premium volume from Marketform and higher premium retention helped to offset the premium declines in the general liability and E&S lines. This group's overall average renewal rates for the first nine months of 2008 were about 4% lower than the 2007 period.

Moving on to the Specialty Financial group, they reported a small underwriting loss for the third quarter. These results were driven in large measure by underwriting losses in our run-off auto RVI operations. Residual value insurance losses resulted from declines in used SUV and luxury car prices, reflecting the impact of higher fuel prices over the past 12 months. This group remained profitable on a year-to-date basis as improvements in our surety and fidelity and crime operations and higher favorable development helped to offset lower underwriting results in the RVI and financial institutions business.

Gross written premiums for the quarter were down 3% from the 2007 period, primarily from declines in our lease and loan and financial institutions businesses. And this group's average renewal rates through the first nine months were about 2% lower than in the year earlier.

Our California workers' comp business has generated excellent profitability through the first nine months of this year. The group's combined ratio for the 2008 third quarter was up two points from the 2007 third quarter while the 2008 year-to-date combined ratio was virtually unchanged from the 2007 period.

Favorable reserve development was higher in the 2008 third quarter and nine month periods. The improved claims environment resulted... resulting from the California workers' comp reform legislation has continued to benefit our insureds as well as our results and those of the industry. And due to the long-term, long tailed nature of this business, we remain conservative in our reserving until a higher percentage of claims have been paid and the full impact of California reform can be determined.

Gross and net written premiums increased for the quarter as increased sales of our new excess workers' comp products offset the effects of continued lower rates in our traditional workers' comp business.

Our average renewal rates were down approximately 13% in the third quarter. This past Friday, California Insurance Commissioner, Poizner, approved a 5% rate increase effective January 1, 2009. Preliminarily, we'd expect that Republic Indemnity, our California workers' comp subsidiary will file for a similar rate increase.

Now I'd like to move on to a review of our Annuity and Supplemental Insurance Group on slide 7. The Annuity and Supplemental Insurance group generated core operating earnings before income taxes for the 2008 third quarter that were 42% higher than the same period a year earlier. The increase reflects higher earnings in the Annuity operations primarily as a result of improved spreads on fixed annuities. In addition, earnings in our Supplemental Insurance business were higher than last year, due primarily to favorable results in our long-term care business. These increases were partially offset by lower earnings in our variable annuity and run-off life operations.

Core operating earnings before income tax, this is for the first nine months of 2008, improved 15% over the same 2007 period as higher earnings attributable to the fixed annuity and supplemental insurance operations were partially offset by earnings declines in our variable annuity and run-off life operations. We continue to work toward improving the Annuity and Supplemental Insurance Group's return on equity and are encouraged by our improved results in this group.

Statutory premiums for the third quarter of 2008 were 21% higher than the third quarter of 2007. Annuity sales through our new bank distribution channel launched in the second quarter this year as well as increased sales of traditional fixed annuities were partially offset by lower sales of indexed annuities in the single premium market.

Premiums through the first nine months of this year increased 7% over the prior year period. The increase from annuity sales through the bank channel were offset by lower indexed annuity sales. We don't expect any material DAC [deferred acquisition costs] write-offs in our annuity business for this year. We hedge our indexed annuities with highly matched over-the-counter options, so our exposure in that line is minimal.

Furthermore, since our variable annuity business is relatively small and we have very few policies with living benefit or similar riders, we expect any DAC write-off in the variable segment to be immaterial.

Turning to slide 8, our third quarter results include net after-tax realized losses of $46 million on equity securities including after-tax losses of approximately $21 million on sales of preferred and common equity investments in Fannie Mae, Freddie Mac, WaMu, Lehman Brothers and AIG. Also included in realized losses were other than temporary impairments, over half of which were attributable to investments in the communications sector with the remainder primarily related to investments in the financial and transportation sectors.

In addition, we recorded net after-tax realized losses totaling $48 million on fixed maturity investments in the third quarter including after-tax losses of $24 million on the sales of fixed maturities issued by WaMu, Lehman Brothers and AIG.

There continue to be challenges in the global credit markets. These events have resulted in widening spreads between U.S. government bonds and investment grade and high yield bonds to all-time highs. This has affected the values for many of our fixed maturity investments. As of September 30th, AFG had after-tax unrealized loses of $426 million on its fixed maturity portfolio.

Our investments are high quality with investment grade securities representing 94% of our fixed income portfolio. Because of our high quality portfolio and strong liquidity, we have both the ability and intent to hold our fixed income investments to maturity or until they recover in value. We believe over time, values will be restored as spreads to treasuries near to more normal levels.

We recognize the market's interest in issues related to mortgage-backed securities. Our investment philosophy with respect to these securities has been consistent over many years and has been almost entirely focused on the senior tranches of these securities. We believe that we have little risk of a material loss on this portfolio.

We had minimal exposure to other investments that we have received widespread attention recently. We have no credit default swaps. We have less than $34 million of asset-backed CDOs and we have less than $50 million in what would be deemed alternative investments, principally private investment funds. In aggregate, these holdings represent less than 1.5 of 1% of our investment portfolio.

More information about our investment portfolio may be found in our financial and investment supplements which are posted on our website.

Now I'd like to summarize some key aspects of our strategic focus outlined on slide 9. We're a company that's focused on specialty niche markets within the property and casualty insurance and annuity and supplemental insurance industries where we have significant expertise. We'll maintain financial leverage and capital adequacy that's consistent with our rating levels and our commitments to rating agencies in the market.

We remain committed to our strong underwriting culture, pricing discipline and risk management philosophy and continually monitor the adequacy of our rates in all markets. We have and will continue to reduce business volume and lines as needed to achieve appropriate underwriting results.

Our investment group will focus on achieving returns over the long term that outperform various market indices while effectively managing our portfolio risk and we'll evaluate opportunities within our real estate portfolio. Our long-term objective is to achieve operating returns on equity in the range of 12% to 15% along with consistent growth in book value.

So I'd like to reiterate our expectations for the remainder of 2008 and provide an outlook for 2009 on slides 10 and 11.

We now expect net written premiums to be 5% to 7% above the prior year in our specialty, property and casualty operations with a combined ratio in a range of 86% to 88%. Because of our strong underwriting culture, we expect to maintain adequate rates. That said, we anticipate a modest decline in our overall renewal rates in 2008 due to competitive conditions in certain markets. We expect net written premiums in our Property and Transportation group to increase 10% to 14%, fueled primarily by higher crop premiums, which are a result of higher crop... spring crop prices. In addition, some new initiatives in our transportation business will provide premium growth. This group should also maintain its excellent underwriting track record with a combined ratio in a range of 88 to 92.

Our 2008 guidance is based on assumptions that our accident year underwriting results in our crop operations will be 60% lower or approximately $70 million lower than our record 2007 results; still a solid year. The impact from lower average commodity prices will be offset somewhat by insurance deductibles of 25% to 30% and yields that are projected to be at or above historical averages.

We remain optimistic about growth opportunities in the Specialty Casualty group resulting from our investment in Marketform and the resulting international expansion opportunities. We also expect the Strategic Comp acquisition to further expand our penetration, increase our geographic coverage in the workers' comp market. Therefore, we project 1% to 3% growth in net written premiums. We also expect this group to generate strong underwriting profit with a combined ratio in the range of 78% to 81%.

We are pleased with the performance of our Specialty Financial Group through the first nine months of the year, but are disappointed with the recent results in our run-off RVI business. Overall, we expect underwriting margins for the year to improve over 2007. We look for this group's combined ratio to be in the range of 93 to 96. We project net written premiums to be flat for 2008.

We are pleased with the performance of our California Workers' Comp business in the first nine months of this year. The combined ratio should be between 77% and 80%, providing excellent returns on this business. With the expansion of our excess workers' comp program, we anticipate that net written premiums would be down about 3% to 5% this year. Based on recent market conditions and favorable trends, we expect full year core pre-tax operating earnings in our Annuity and Supplemental Insurance group to be 20% to 25% higher than in 2007. This growth will be driven by meaningful benefits of widening investment spreads in our fixed annuity business. Anticipated earnings growth in the fixed annuity and supplemental insurance lines is expected to be partially offset by lower earnings in the variable annuity and run-off life operations.

Our 2008 core net operating earnings guidance remains at between $3.90 and $4.10 per share.

Looking to 2009, we expect stable net written premiums and a continuation of the healthy underwriting profits in our specialty operations, albeit at a lower level than in 2008. In our annuity and supplemental operations in 2009, we expect solid growth in core operating earnings.

Finally, we've announced that we expect our 2009 core net operating earnings to be in the range of $3.65 to $3.85 per share. This 2009 guidance reflects strong projected earnings growth in our annuity operations and higher investment income in our property and casualty operations. These increases will be offset by the effects of a more competitive property and casualty marketplace. The 2008 and 2009 expected results exclude the potential for extraordinary catastrophe in crop losses and adjustments to any reserves.

Now we would like to open the lines for any questions. Thank you.
Question And Answer

Question and Answer

Operator

[Operator Instructions]. Your first question comes from the line of Amit Kumar with Fox-Pitt, Kelton.

Amit Kumar
Fox-Pitt, Kelton Cochran Caronia Waller

Good morning.

Carl H. Lindner III

Good morning.

Amit Kumar
Fox-Pitt, Kelton Cochran Caronia Waller

I guess, just quickly going back to the discussion on your life operations, and recently there has been a lot of focus on risk-based capital and RBC ratios. If I go back and look at your '07 RBC ratios for your life operations, they seem to be in the I guess 3.30 to 3.50 range. And I was wondering if you could just sort of update that number for us and maybe just talk about what your target range is. That's my first question.

Keith Alan Jensen
Former Senior VP & CFO

As a practical matter... this is Keith Jensen... as a practical matter, what we do, Amit, is target our capital based on the Standard & Poor's capital model, because over time we found that to be a more constrictive capital model than the RBC calculations. So as we manage capital and target how much to have put into each of our businesses, we really use that as our primary measure. And in that regard as you probably know, S&P has been in the process of changing that cap adequacy model. But we have over the past several years and now in this period of transition continued to target 150% of S&P cap adequacy as our target. And so from that perspective, I would expect actually that during the course of this year, the RBC level at the life operation to actually increase a bit because of changes in the S&P model that are driving us to put additional capital in.

Amit Kumar
Fox-Pitt, Kelton Cochran Caronia Waller

Okay. That's helpful. In terms of maybe just expanding the discussion and maybe moving on to the P&C operations, what's the target premium to surplus in the current cycle for you?

Keith Alan Jensen
Former Senior VP & CFO

I'll give you a similar answer to that. We actually don't use a targeted premium to surplus. Again, with the P&C side, we have... very similar to what we do in life, we target to meet the Standard & Poor's and A.M. Best cap adequacy ranges that would be at the level above our current rating, because what we've tried to do is take cap adequacy off the table as a rating factor. So it tended to be at the high end of the ranges.

So for us, premium to surplus is an outcome rather than a target. So whatever the capital that's required under those models becomes the denominator in that calculation and it's really an outcome rather than a target.

Amit Kumar
Fox-Pitt, Kelton Cochran Caronia Waller

And I guess you said high end of the ranges, is that what you said?

Keith Alan Jensen
Former Senior VP & CFO

Yes, it is.

Amit Kumar
Fox-Pitt, Kelton Cochran Caronia Waller

Okay. That's very helpful. And just quickly moving on. Recently, we've seen a lot of chatter coming out of the reinsurers talking about perhaps seeing the first signs of some sort of change coming on the horizon. We've seen different commentary, but I guess the consensus is that at least the signs point in that direction. And obviously there is a lag in terms of how that impacts the primary guys and what happens in that space. I was wondering if you could sort of comment specifically what you might be hearing out there and what is your view on the cycle turn, especially based on what we have seen in the last couple of months.

Carl H. Lindner III

Generally, the property and casualty markets have continued to be very competitive. So the property and casualty industry has... their excess capital has to be impacted a lot by the hurricane losses and by the impairment, the asset write-downs in the third quarter and this year. So I think there is probably a lot less excess capital for the industry to play around with.

I think that makes me enthusiastic about maybe a quick return in property and casualty pricing. And I think capital in this environment is very dear to everyone and certainly our discipline and our approach is going to be to make every dollar of our capital count. And if we don't have businesses that are earning the right returns, we are going to begin to try to nudge pricing.

Amit Kumar
Fox-Pitt, Kelton Cochran Caronia Waller

That's helpful. And I guess final question, in terms of opportunities coming out of AIG, we've seen a lot of smaller or mid level players talk about them. And also, we've seen some of these companies raise the limits on their policies to sort of make them more attractive in at least chasing that sliver. Have you undertaken any specific steps recently to sort of tap on to those opportunities?

Carl H. Lindner III

Not really. We provide pretty large limits in a lot of the businesses that we would compete. And in particularly if we would have capacity in the D&O to provide $25 million plus type of limits, we'd also have that capacity in our excess liability I think probably even up to $50 million in a couple of those lines. So if anything, though, I think with what's going on with AIG, I think there could be a trend or a tendency for insureds and agents to want to use layering of large casualty accounts maybe more than what they have in the past. So I recognize some competitors are bumping limits up, and that may be effective. But I think there will also be a trend of going back to having more insurers just to spread the risk versus less, where you have large D&O limits or large excess liability or umbrella limits going on. So which one wins over, it's hard to say at this point. But I've kind of heard both theories kind of be put out there.

Amit Kumar
Fox-Pitt, Kelton Cochran Caronia Waller

And then are you seeing a meaningful increase in submissions or quotes?

Carl H. Lindner III

Yes. I think we're seeing some increase in submissions related to AIG's problems and frankly probably some others. So we see that as an opportunity. That said, AIG seems to be even more price competitive than what they have been in the past. I'm not sure that bodes well for the Fed's loan if long term if that's the case though.

Amit Kumar

Fox-Pitt, Kelton Cochran Caronia Waller

Okay. That's very helpful. Thanks so much.

Operator

Your next question comes from the line of Abon Shillof [ph] with Maxim.

Marvin Weinstock
Maxim Group

Hello. This is Marvin Weinstock. My question is with our book value over 24 at this point, is there any potential for American Financial buybacks?

Carl H. Lindner III

I think there is always a potential for American Financial stock buybacks. I think right now at this juncture, as Craig and I've said in the past, we're trying to keep powder dry when you have volatile financial markets like this and you also have some potentially unusual opportunities either in the annuity side or in specific property and casualty businesses or even in the investment portfolio. So I think today we're probably erring more towards keeping some powder dry versus share repurchase.

Marvin Weinstock
Maxim Group

Thank you. One other question --

Unidentified Analyst

Hi, it's Abon [ph] here. Just a quick question. As far as our dividend policy goes, we've had a couple of increases recently. Is our dividend secure and any chances of an increase?

Carl H. Lindner III

Craig and I usually do a review towards the end of the year. And as far as any dividend increases in that, we'll... we plan on doing the same review.

Unidentified Analyst

Okay. Thank you. First of all, congratulations under these circumstances, you guys came out with a great report.

Carl H. Lindner III

Thank you.

Operator

[Operator Instructions]. There are no audio questions at this time.

Keith Alan Jensen
Former Senior VP & CFO

All right. Well thank you very much for joining us. We appreciate your attention and we look forward to reporting at year end to you. Thank you and have a good day.

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