S&P Global
Market Intelligence

CNA Financial Corporation NYSE:CNA
FQ1 2019 Earnings Call Transcripts

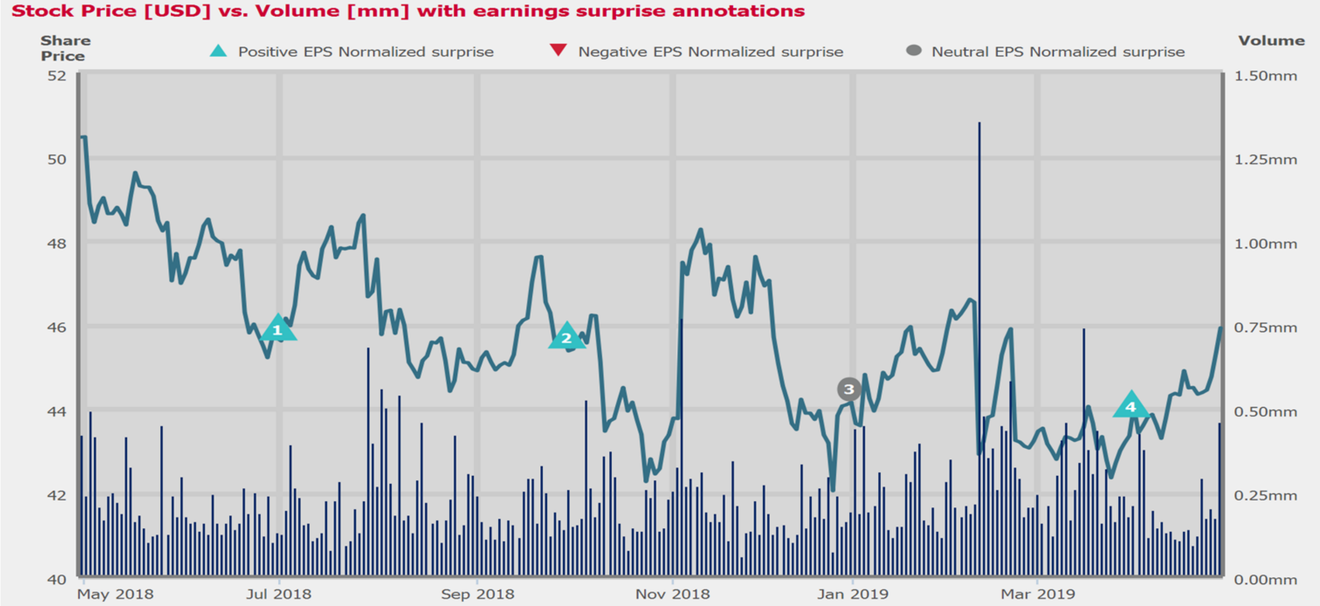
Monday, April 29, 2019 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ1 2019-			-FQ2 2019-	-FY 2019-	-FY 2020-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.08	1.17	8.33	0.99	3.98	4.11
Revenue (mm)	-	1806.00	-	-	-	-

Currency: USD
Consensus as of Apr-29-2019 12:26 PM GMT

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



	- EPS NORMALIZED -		
	CONSENSUS	ACTUAL	SURPRISE
FQ2 2018	0.98	0.99	1 1.02 %
FQ3 2018	1.10	1.17	2 6.36 %
FQ4 2018	0.93	(0.08)	NM
FQ1 2019	1.08	1.17	3 8.33 %

Table of Contents

Call Participants

EXECUTIVES

Dino Ennio Robusto
Chairman of the Board & CEO

James Michael Anderson
Executive VP & CFO

ANALYSTS

Gary Kent Ransom
Dowling & Partners Securities, LLC

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Joshua David Shanker
Deutsche Bank AG, Research Division

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

Presentation

Operator

Ladies and gentlemen, good morning, and welcome to CNA's discussion of its 2019 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 James Anderson, 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 non-GAAP financial measures. Any forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from the statements made during the call. Information concerning those risks is contained in the earnings release and in CNA's most recent 10-K on file with the SEC.

In addition, the forward-looking statements speak only as of today, Monday, April 29, 2019. CNA expressly disclaims any obligation to update or revise any forward-looking statements made during this call. Regarding the non-GAAP measures, reconciliations to the most comparable GAAP measures and other information have been provided in the financial supplement. This call is being recorded and webcast. During the next week, the call may be accessed on CNA's website.

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

Dino Ennio Robusto
Chairman of the Board & CEO

Thank you, Abbie. Good morning, everyone. I'm pleased to share our first quarter results with you today, which are comparable with the strong performance we were generating prior to the last quarter's outlier result.

Core income for the first quarter was $318 million or $1.17 per share, up 13% over the prior year quarter. Core return on equity was 10.7%, up from 9.3%. This result reflected strong investment performance and a combined ratio of 97.8%, including 3.4 points of catastrophe losses.

For the quarter, the underlying combined ratio was 94.9%, which reflects continued underwriting improvement on last year's full year results of 95.4% and 2017's 95.5%. The P&C underlying loss ratio was 60.7%, one of the lowest levels in a decade as property losses were at expected levels in the quarter, down from the fourth quarter's elevated level and International's loss ratio was significantly improved.

Our expense ratio in the quarter was 33.8%, slightly higher than our run rate, due to the seasonality of our earned premium. We continued to achieve good growth in the U.S. segments with gross written premium up 5%, excluding third-party captives and net written premium was up 2%. In the quarter, International's net written premium was down 12% driven by Lloyd's net premium, which was down 29%. This decrease was anticipated resulting from our re-underwriting efforts in our London-based operations that we have discussed previously.

We continue to effectively manage the rate/retention dynamic, achieving strong rate increases and doing so with improved retentions in the U.S. In the first quarter, rate for P&C overall was up 3%. In our Specialty segment, rate was up 3% and retention was up 4 points to 89%. Importantly, we achieved incrementally more rate where it is needed most. For example, both health care and public company D&O achieved 11 points of rate in the first quarter, up from plus 9 in the fourth quarter.

Overall, Commercial rate was up 4%, excluding worker's compensation and 2% all in, while retention was up 1 point to 85%. Commercial's rate, included umbrella, up 6%, 2 points higher than the fourth quarter. Commercial Auto was up 8% and Property was up 5%, both of these lines were up an additional point from Q4. International rate was plus 5% with retention at 71%, again, reflecting our re-underwriting efforts. I continue to be encouraged by our pricing trajectory in recent quarters and based on what we have seen in April, I am optimistic that we can continue to drive rate above our long-run loss cost trends.

On an earned basis, renewal premium change in the first quarter was up more than 3 points, which already exceeds our long run loss cost trends. Of course, that outcome needs to be sustained in order for it to result in margin improvement, but the good news is, our consistent ability to push for increasingly more rate over the last several quarters in major lines has us encouraged that we are migrating from this outcome being a headwind to a tailwind. While new business in the U.S. was down 5% in the quarter, it was still one of the highest levels of any quarter in recent years. As a result, I continue to be pleased with one of the key tenets of our underwriting strategy, getting access to high-quality new business.

We also continue to institutionalize an enduring expert underwriting culture here at CNA. A more recent example of this effort is our decisive action in re-underwriting our London operation. Our International segment generated an underlying combined ratio of 94.1% in the first quarter, a significant improvement compared with the full year 2018 underlying combined ratio of 103.6%. While our underwriting actions in International are starting to make a difference, this process will be executed throughout the year and, keep in mind, some of the exited lines like political risk will have exposures beyond 2019 because of long-term contracts. Finally, our long-term care business is on solid footing and continues to perform as expected.

I'll now turn it over to James.

James Michael Anderson
Executive VP & CFO

Thank you, Dino, and good morning, everyone. Our Property & Casualty Operations produced core income of $314 million in the first quarter. Pretax underwriting profit was $37 million and underlying underwriting profit was $85 million.

Let me just make a point here with regard to the comparison to the prior year quarter. Traditionally, we would provide commentary regarding 2019's first quarter performance compared with 2018's first quarter, and the press release and earnings presentation provide you with that comparison. However, 2018's first quarter was an outlier in terms of both underlying loss ratio and expense ratio.

With regard to the underlying loss ratio, we had 2 lines: Property and umbrella, where the loss ratios were reevaluated upward after the first quarter last year, causing the full year 2018 loss ratio to be higher than the first quarter and more indicative of current performance. Last year's first quarter expense ratio benefited from a low level of technology spend as we prepared for our new outsourcing arrangement as well as onetime favorable acquisition cost offset. Given these items, we felt that comparing our first quarter underwriting results with the full year of 2018 underwriting results was more indicative of our current trend.

As Dino mentioned, our expense ratio of 33.8% is slightly above our current annual run rate. When we look at the components of the expense ratio, our acquisition ratio is at a normalized level, but our underwriting ratio is 3/10 higher than the full year 2018's 13.4%. The numerator of that ratio, dollars of underwriting expense, is on par with 2018's quarterly average, but the denominator of net earned premium has some seasonality to it and is lower in the first and second quarters than it is in the third and fourth. In addition to this seasonality, an increased level of reinsurance spend this year is muting our net premium growth and therefore, affecting the expense ratio.

Moving to each of our individual P&C segments. Specialty's underlying combined ratio for this quarter was 93.5%, including an underlying loss ratio of 60.5%. Specialty's overall combined ratio for the quarter was 92.3%, including 1.8 points of catastrophe losses and 3 points of favorable prior period development, primarily in accident years 2017 and prior, driven by favorable frequency in both Surety and financial institutions. Specialty's gross written premium ex third-party captives grew 4% in the quarter.

Our Commercial segment's underlying combined ratio in the quarter was 96.5%. The underlying loss ratio was 62.1%, including about 0.5 point of severance expense related to actions taken within the claim department as we reorganized to better manage our loss adjustment expenses. On a normalized basis, Commercial's underlying loss ratio in the first quarter was slightly above 61%, in line with the full year 2018 results and materially improved from the fourth quarter. The first quarter overall combined ratio for

Commercial was 101.3%, including approximately 5 points of catastrophe losses and about 0.5 point of favorable reserve development. Commercial's gross written premium ex third-party captives grew 6% in the quarter.

The underlying combined ratio for our International segment was 91 -- 94.1% in the first quarter. The all-in combined ratio was 101.9% in the quarter, including a little more than 2 points of catastrophe losses and 5.5 points of unfavorable prior period development, the latter of which equates to $14 million as entirely related to 2018 catastrophe events. Nearly all of the development came from lines we're exiting, further affirming the re-underwriting strategy that we have implemented.

Our Life & Group segment produced $10 million of core income in the quarter. Long-term care morbidity experience continued to be consistent with our reserve assumptions, while persistency was the driver of our positive results. Our Corporate segment produced a core loss of $6 million in the first quarter, benefiting from amortization of the asbestos and environmental deferred gain.

Pretax net investment income was $571 million in the first quarter compared with $490 million in the prior year quarter. The change was driven by our limited partnership and common equity portfolios, which produced pretax income of $96 million, a 4.5% return. While this is a welcome result following last quarter, we are still moving down a path to reduce our hedge fund exposure this year. In the first quarter alone, we redeemed $160 million from hedge funds and redeployed it into our fixed income portfolio.

Pretax income from our fixed income portfolio was $465 million in the quarter, slightly higher than the prior year quarter. The pretax effective yield on the fixed income portfolio was 4.8%, again, slightly higher than prior periods. Fixed income assets that support our P&C liabilities had effective duration of 4.2 years at quarter end, in line with portfolio targets. The effective duration of the fixed income assets to support our Life & Group liabilities was 8.7 years at quarter end.

Our balance sheet continues to be extremely strong. At quarter end, shareholders' equity was $11.5 billion or $42.19 per share, up from the year-end 2018 as an increase in our unrealized gain position more than offset the large dividend paid in the quarter. Shareholders' equity, excluding accumulated other comprehensive income, was $11.8 billion or $43.38 per share, an increase of 3% from year-end 2018 when adjusted for the $2.35 of dividends per share paid during the quarter.

Our investment portfolio's net unrealized gain was $2.6 billion at quarter end. In the first quarter, operating cash flow was $287 million. We continue to maintain a very conservative capital structure. All of our capital adequacy and credit metrics are well above our internal targets and current rating. And we are pleased to announce our regularly quarter -- our regular quarterly dividend of $0.35 per share.

With that I'll turn it back to Dino.

Dino Ennio Robusto
Chairman of the Board & CEO

Thanks, James. Before we move to the question-and-answer portion of the call, let me leave you with some overarching thoughts on where we are in our pursuit of being a top quartile underwriter. The foundation of underwriting excellence is the loss ratio, particularly the underlying loss ratio, and it has been our top priority over the last 2 years. This quarter's 60.7% underlying loss ratio was squarely top quartile performance and reflects the quality of our execution. Moreover, the rate we are achieving today is offsetting our long run loss cost trends, which is starting to mitigate the headwind that has faced us in recent years, and I remain encouraged by the trajectory of pricing and the overall terms and conditions we can achieve in the market.

Of course, sustained top quartile performance requires us to further improve our expense ratio, beyond the roughly 2-point improvement we have achieved over the past 2 years. And there is more improvement to be had as we continue to grow our book, while managing the numerator by balancing continued investment in talent and technologies with finding operational efficiencies. Indeed, our U.S. gross written premium grew 5%, both last year and in the first quarter of this year, while our underwriting expenses were down over that time period. Although our incremental reinsurance spend is currently muting additional improvement in the expense ratio by lowering the earned premium growth, this is temporary and a trade we are willing to make at this time to support expanding new growth segments and to reduce potential volatility.

Bottom line, our very strong underlying loss ratio together with our demonstrated ability to grow profitably, while improving the expense ratio, we feel confident in our ability to achieve top quartile performance on a sustained basis.
With that, we'll be glad to take your questions.

Question and Answer

Operator

[Operator Instructions] And we will take our first question from Jay Cohen with Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

It was pretty straightforward. I just wanted to ask, I guess, on the Corporate segment, do you view the 1Q number as a reasonable basis going forward? Is that fairly normalized at this point?

James Michael Anderson
Executive VP & CFO

I would say, Jay, this is James, thanks for the question. We -- that's probably a little bit better than the normal run rate, but not significantly.

Operator

And we will take our next question from Josh Shanker with Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

I'm wondering, James, if you can speak about CNA, in particular, but maybe the industry or you can speak out to CNA. If we look at the -- some of the price improvements that you're having, particularly in property lines, how much of that potentially would be given back in a higher cost of reinsurance? I realize we haven't seen many of renewals yet, but maybe you have some thoughts there?

James Michael Anderson
Executive VP & CFO

Well, I think, Josh, we have not renewed our property reinsurance yet. We would expect that there's going to be pressure there, but I don't think it will overwhelm the amount of rate that we're getting on a primary basis. So maybe on the margin, it has a muting effect, but overall, it won't.

Joshua David Shanker
Deutsche Bank AG, Research Division

And on Commercial Auto, I feel like we're in year 3 of material price increases. Where are we in terms of getting that line? And again, it can be as CNA or can be the industry. Where are we in terms of sort of triaging what's happened there?

James Michael Anderson
Executive VP & CFO

I think, Josh, where we're getting right now, we're well ahead of our loss cost trend. But we were starting from a spot where the combined ratio was too high. So we are making progress on it, but we still have a way to go before we're comfortable getting the appropriate return on that business.

Joshua David Shanker
Deutsche Bank AG, Research Division

Do you think by year-end Commercial Auto rate increases will stabilize or it's going to be strong for a while?

James Michael Anderson
Executive VP & CFO

I suspect that it's going to continue, Josh. I mean, I don't think we're the only ones thinking that we need to get the combined ratio down further than where it is today. So that's certainly where we're pushing at the moment.

Dino Ennio Robusto
Chairman of the Board & CEO

It's progressively increasing, Josh, right? It was 7% in the fourth quarter, it's 8% in the first quarter, and so that's a good sign. And early read on in April is the momentum continues.

Operator

We will take our next question from Gary Ransom with Dowling & Partners.

Gary Kent Ransom
Dowling & Partners Securities, LLC

I had a question on the rates also. Just trying to think through your comments about the rate being ahead of loss trend. At this point, on the loss trend side, are you seeing that still remain relatively consistent with where it's been?

James Michael Anderson
Executive VP & CFO

Yes. Gary, I think overall loss cost trends are very stable. So we're not seeing any change there, and we focus on the long-run loss cost trend. So we do see variation in the shorter term, but long run loss cost trends remain stable.

Gary Kent Ransom
Dowling & Partners Securities, LLC

So when we think about the rates where you gave several examples of accelerating rates, yet, the overall number is still relatively flat. Is that just because of the worker's comp declining?

Dino Ennio Robusto
Chairman of the Board & CEO

Yes, Gary, it's Dino. I mean, this -- it's a good question. You have to -- when you look at it at that level, you really got to [unmask] what's happening underneath. You really have to take a look at our portfolio and the various segments. If you look at -- let's take Specialty as an example. Within Specialty, as you probably know, there's a very large program book of professional E&O that's been very, very profitable for us for a decade. This -- these programs are actuarially priced, experience based. They also have multiyear parameters in them. They don't undulate, lockstep with market pricing on individual accounts. And because of its size, it can mask the movements quarter to quarter in other lines of business in Specialty, particularly in this case, as they've been going up. So you have to sort of put that aside. If you put our affinity programs aside in Specialty, pricing is up 6% in the first quarter, up from plus 5% in the fourth quarter. So the other lines are going up, and then we gave you some of the examples of health care and public D&O. So on the Specialty side, it really is a function of our portfolio and, in particular, the very large program book.

On Commercial, it's like you say, Gary, it's -- a lot of it is work comp, which has been negative. I mean, the good news on the work comp, when you take a look at the NCCI rate filing, the decreases are peaking at midyear and then should start to improve. So you need to take a look at that. And on the Commercial ex work comp talks about a little bit of the rounding, it's up a couple of tenths of a point. Within there, also small business is different. It doesn't really undulate like individual accounts. Those are more based on the filings that we do by state and the mix that comes up in any one quarter. So you really do need to take a look a few layers down, and there are some really good trends in there, and it's why we're feeling pretty good about the execution.

Gary Kent Ransom

Dowling & Partners Securities, LLC

Within Specialty, your retention also moved up quite a bit in the first quarter, or at least it's been higher than it's been in a while. Was there something unusual affecting that or was that a normal trend?

Dino Ennio Robusto
Chairman of the Board & CEO

Yes, there is, in that in the first quarter of '18, we had lost a large program that had the threat the retention from its historically high levels and you're not, so the first quarter this year against that quarter has got it back at its normal levels now.

Gary Kent Ransom
Dowling & Partners Securities, LLC

Okay. Great. And just one more too on the pricing. I think in the last quarter, you had a similar level of optimism about January looking ahead into the first quarter as you seem to have now, April looking into the second quarter. Can you tell us how that worked out in the first quarter? Was that -- was your optimism more or less fulfilled with what you were thinking at January?

Dino Ennio Robusto
Chairman of the Board & CEO

Yes, definitely. Gary, again, you think what I said earlier and put aside affinity programs, put aside the work comp, which had the negative, you look at the other lines, whether it's umbrella, it's property, it's auto or, as I said, health care and even, D&O overall, including private, it's up 5 points. In the first quarter, it was 4 points. So that's up. I mean, I highlighted the public D&O because you see a lot more volatility in public D&O and that one had the double digits, but even on the broader. So it did end up playing out as we had anticipated, notwithstanding the drag that you get from the negative rate on work comp. But there again, I mean, we got to put it in perspective, right? It's very profitable. The trends continue to be relatively benign and, in particular, benign relative to our embedded loss cost trends within work comp.

Operator

[Operator Instructions] And we will take our next question from Meyer Shields with KBW.

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

2 or 3 real quick questions. Is there any way of quantifying the savings associated with the severance in claims in the first quarter? In other words, expenses that we should take out for the next 3 quarters?

James Michael Anderson
Executive VP & CFO

Yes. I mean, I would say it's probably a couple of million quarterly run rate, Meyer.

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

Okay. Sorry. So we saw, again, the duration of the fixed income portfolio in Life extend, and I was hoping you could talk about that, just given the broadly flat yield curve. So first, is that coming from the hedge fund sale proceeds? And second of all, if you could take us through the thought process for the longer duration?

James Michael Anderson
Executive VP & CFO

Yes. First, it's not coming from the hedge fund portfolio. The hedge fund portfolio is all in the P&C side. So what we're looking at there is, we've been relatively short against our liability duration in the Life & Group portfolio for quite some time as rates have been coming down, and we're just now trying to position ourselves for the future, we're not going to move up this duration incredibly quickly. In fact, it's very difficult to do even if we wanted to. It's just more a move in that direction based on anticipating getting hopefully rate that turns in the right direction here.

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

Okay. Yes, that will happen hopefully at some point in time. The only part of the rate story that surprised us, more surprising, I should say, was the 3% decrease in small commercial. Is that worker's compensation? Or is there something else in that?

Dino Ennio Robusto
Chairman of the Board & CEO

Yes.

James Michael Anderson
Executive VP & CFO

Yes. It's primarily worker's comp that's driving that.

Operator

And we have no additional phone questions at this time. So I would like to turn the conference back to Mr. Dino Robusto for any additional or closing remarks.

Dino Ennio Robusto
Chairman of the Board & CEO

Well, that's great. Thank you for joining us, and we'll talk to you, again, in a quarter. Thanks very much.

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