American Financial Group, Inc. NYSE:AFG

FQ4 2007 Earnings Call Transcripts

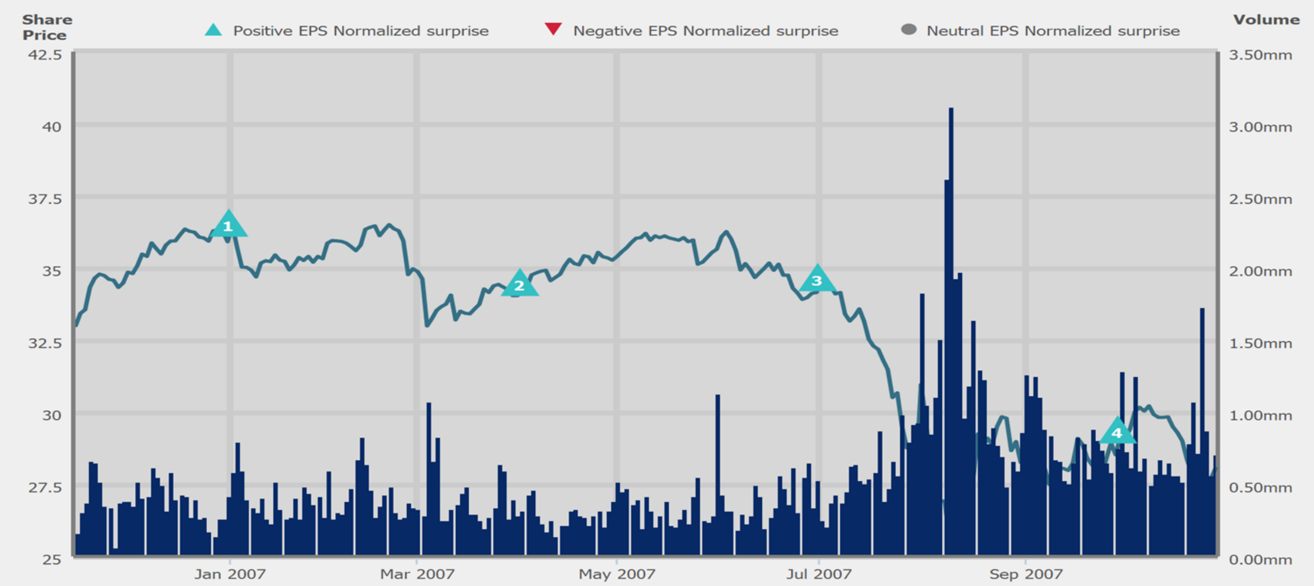
Monday, February 11, 2008 7:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ4 2007-			-FQ1 2008-	-FY 2007-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.94	1.21	▲27.37	0.91	3.79	3.94
Revenue	-	-	▲(0.26 %)	-	-	-
Revenue (mm)	673.67	671.90	-	688.40	2704.33	2702.70

Currency: USD
Consensus as of Feb-11-2008 10:12 AM GMT

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



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2006	0.82	0.85	▲1 3.66 %
FQ1 2007	0.84	0.91	▲2 8.33 %
FQ2 2007	0.82	0.93	▲3 13.41 %
FQ3 2007	0.85	0.97	▲4 14.12 %

COPYRIGHT © 2018 S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved
spglobal.com/marketintelligence

Table of Contents

COPYRIGHT © 2018 S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved

Call Participants

EXECUTIVES

Carl H. Lindner III

Keith Alan Jensen
Former Senior VP & CFO

ANALYSTS

John Gwynn
Morgan Keegan

Copyright © 2018 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

Presentation

Operator

Good day ladies and gentlemen, and welcome to the Fourth Quarter 2007 American Financial Group Earnings Conference Call. My name Shiquana and I will be your coordinator for today. At this time, all participants are in a listen-only mode. We will facilitate a question-and-answer session towards the end of this conference. [Operator Instructions].

I would now like to turn the presentation over to your host for today's call, Mr. Keith Jensen, Senior Vice President. Please proceed sir.

Keith Alan Jensen
Former Senior VP & CFO

Thank you very much. I'm joined by Craig Lindner and Carl Lindner III the Co-CEOs of American Financial Group. I'm pleased to welcome to American Financial Group's fourth quarter and full year earnings results conference call. If you're viewing this webcast from our website, you can follow along with slide presentation if you would like.

Certain statements made during this call are not historical facts and may be considered forward-looking statements, are based on estimates, assumptions, and projections which management believes are reasonable, but by their nature are subject to risks and uncertainty. 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 the quarterly report on Form 10-Q.

We do not undertake to update such forward-looking statements to reflect the 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 net realized gains or losses on investments, the effects of accounting changes, discontinued operations, significant asbestos and environmental charges and certain other significant non-recurring items. AFG believes it to be a useful tool for investors and analysts 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 press release.

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

Carl H. Lindner III

: Good afternoon and thank you for joining us. We released our 2007 fourth quarter and full year results this morning. I'd like to start by covering some highlights from last year on slides 3 and 4 of the webcast.

2007 was another record operating year for American Financial Group with core net operating earnings of 28% over our 2006 record results. Our 2007 core net operating earnings generated a return on equity of 16%. Our outstanding results reflect continuing execution of our long-term strategy and our consistent focus on financial and pricing discipline and profitable growth.

Craig and I want to thank our talented management team and employees for their efforts and contributions and we want to thank god for blessing AFG this past year. Our 2007 net earnings were dampened by second quarter charges to strengthen our A&E reserves and fourth quarter write-downs in our equity portfolio.

Our 2006 net earnings included major gains from real estate sales which did not occur last year. I would like to note that AFG's 2007 net earnings generated a return on equity of about 13%. And over the last five years that has averaged 14%. Our Specialty, property and casualty group's underwriting profit reached another all time high, benefiting from very favorable reserve development, unusually strong crop results and a benign cat year.

Copyright © 2018 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

During 2007 favorable development was nearly $100 million or 4 points, including a major A&E charge, compared to $57 million or about 2 points in 2006. As a result of our favorable operating results, we have generated significant amounts of excess capital. One of our important strategic objectives is to deploy our excess capital in a way that enhances shareholder value.

To that end, in 2007, we completed the buy-in of the minority shares of Great American Financial Resources. In addition, we took advantage of the opportunity provided by the decline in our stock price during the second half of 2007 to purchase 2.2 million shares of our common stock at an average price of $29.23 per share during the 2007 fourth quarter, bringing our total repurchases for the year to 6.9 million shares at an average price of $28.70.

In January of this year we completed the previously announced acquisitions of Marketform Group, a Lloyd's insurer, and Strategic Comp, a leading provider of workers' compensation programs. Marketform is an integrated Lloyd's insurer that specializes in non-U.S. medical malpractice markets and will enable us to leverage several of our specialty lines in other parts of the world. Strategic Comp expands our base of expertise in the workers' comp arena, using a high deductible product approach.

We expect both of these acquisitions to have a very positive effect on our future growth and profitability. We also increased our 2008 common stock dividend by 25%, reinforcing our confidence in the company's long-term financial outlook. We are pleased with our growth and book value in 2007 continuing the trend we've experienced over the past several years. Book value per share excluding unrealized gains on fixed maturities was 9% above year-end 2006, and over the past five years, its annual compounded growth was 14%.

Turning to slide 5, I'd like to review the results of our ongoing specialty operations. Underwriting profit in the 2007 fourth quarter was nearly double the amount in the 2006 fourth quarter, and the combined ratio improved nearly 13 points. For the year, underwriting profit was up 57% with a 6 point improvement in combined ratio.

Our crop insurance operations had a record year with results considerably higher than our previous record. While we believe we're positioned to continue growing the profitability of this business, 2007 was clearly an unusually profitable year.

Even though gross and net written premiums declined in the 2007 fourth quarter compared to the same quarter a year earlier, the 2007 full year premiums were 2% higher than in 2006. Premium growth was impacted by significant rate declines in California workers' comp, a softening market conditions within certain of our specialty casualty group operations and the impact of the RVI and earthquake-exposed excess property operations, previously placed in the run-off.

Excluding the impact of California workers' comp on the run-off businesses, our actually 2007 net written premiums were up about 6% over 2006. I'm pleased that we've been able to maintain adequate rates in this competitive environment. Apart from the rate decreases in the California workers' comp business, average renewal rate levels in our other specialty operations were down about 2% in 2007. We're pleased that all of our businesses performed very well.

Now I'd like to review the results for each of our specialty business groups on slide 6 and 7. Property and Transportation group produced outstanding profitability in 2007. The group's 2007 fourth quarter underwriting profit was double the amount in the 2006 fourth quarter with a 16-point improvement in the combined ratio. Underwriting profit for the year was 41% higher than 2006, with a four-point combined ratio improvement.

As I indicated earlier, our crop division produced phenomenal underwriting profits reflecting additional earnings contribution from the 2005 Farmers Alliance acquisition and favorable crop prices and yields. Now we were blessed with no major catastrophe losses.

Our property and inland marine and transportation businesses also generated improved results. The group's average renewal rates were down slightly for 2007. Our Specialty Casualty group's underwriting profitability increased significantly in 2007. Its 2007 fourth quarter combined ratio improved about 6 points over the same quarter a year earlier. This resulted primarily from favorable reserve development,

Copyright © 2018 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

improved results in the executive and professional liability operations and in our targeted insurance programs.

The full year combined ratio improved 10 points, driven by favorable development in our Mid-Continent subsidiary's general liability operations and our American Empire Access and Surplus Lines. This group experienced declines in gross and net written premiums in 2007, reflecting stronger competition in our excess and surplus lines business and softening in homebuilders market that affects general liability coverages. Keeping rates at level that support our profit objectives contributed this group's excellent underrating results.

Average renewal premiums for the overall group declined about 3% for the year. Specialty Financial group's combined ratio for the 2007 fourth quarter improved 20 points compared to the 2006 fourth quarter and for the year, improved nearly 16 points compared with 2006.

These improvements resulted primarily from the lower losses in a run-off automobile RVI business. Excluding the effect of RVI, the group's combined ratio would have been about 89% for 2007, comparable to 2006. Each of the business units within this group produced solid underwriting profits for the year.

Net written premiums for 2007 increased primarily due to the growth in financial intuitions, lease and loan, and fidelity and surety operations as well as a decrease in premiums ceded under reinsurance agreements in the lease and loan businesses. The increase was partly offset by lower premiums resulting from the run-off of the RVI business.

Average renewal rates in this group were down about 1% for the year. Our California workers' comp business produced excellent profitability in 2007 on lower premium levels. The increases in the combined ratio for the 2007 periods reflect the impact of significant rate reductions, which have been responsive to improving claims environment resulting from the California workers' comp reform legislation.

Favorable reserve development due to improved frequency in severity claims continued during 2007. Due to the long-tail nature of this business, we continue to be conservative in recognizing the benefits from the reform legislation, until a higher percentage of claims have been paid and the ultimate impact of reforms can be determined.

We are pleased that the reforms are working to decrease the overall cost of workers' compensation to the California economy. Renewal rate decreases averaged about 22% during 2008. We're encouraged that the California's workers comp... that the California Workers' Comp Rating Bureau, the WCARB has recommended 4% to 5% rate increases. Although this increase was not instituted by California's insurance commissioner, we expect rates to stabilize in this market.

Now let me review our Annuity and Supplemental Insurance group on slide 8. Higher earnings in the fixed annuity operations were more than offset by the impact of higher mortality in the run-off life operations. The 2007 fourth quarter results included a $9.4 million write-off of deferred acquisition costs as a result of increasing future mortality assumptions in the run-off life operations.

Supplemental insurance operations reflect a full year of earnings from the Ceres Group which was acquired in August 2006. However, supplemental lines were negatively impacted by higher lapses and lower Medicare premiums in 2007, due primarily to increased competition from the government sponsored Medicare Advantage product.

Although statutory premiums slowed in the 2007 fourth quarter, premiums for the 2007 full year reached a record level of $2 billion, 16% higher than 2006. This increase reflects the substantial growth early in the year and sales of single premium indexed annuities and the higher sales of annuities in the 43B segment, partially offset by lower sales of traditional single premium fixed annuities. In addition, supplemental insurance premiums increased significantly over 2006 due to the previously mentioned 2006 acquisition of the Ceres Group.

During the past year, now there has been a great deal of attention and concerned focus on issues related to the subprime mortgage securities. I would like to take a few minutes to provide an overview of our position.

Copyright © 2018 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

Our investment philosophy with respect to the securities that make up our mortgage-backed securities portfolio has been consistent over many years and very conservative, which has cushioned us against significant market value declines. At December 31st, 2007, mortgage-backed and related securities represented about 27% of the portfolio and 99% of those securities were rated AAA. Investments and non-investment grade securities represented 5% of our investment portfolio.

On slide 9, you can see that investments in securities with subprime asset backed collateral totaled $483 million, less than 3% of our investment portfolio. Over 99% of these investments are rated AAA with fixed rate collateral. Most of these securities are in shorter maturity tranches with the weighted average life of four years. Fair value of $483 million represented approximately 94% of these securities amortized costs so that the subprime portfolio had an unrealized loss of approximately $29 million at year-end. Equity investments represent about 5% of our portfolio.

In the fourth quarter, we recognized an other than temporary impairment of $84 million pre-tax related to our equity investments. Approximately $67 million of the impairment is due to our investment in financial institutions of which are largest is National City. Net investment is related to our sale of Provident Bank a few years ago.

Nat City along with a number by other banks has experienced a significant decline in share price over time. Nevertheless, over the past four years, including this 2007 pre-tax charge, we had a net pre-tax gain of about $165 million associated with the sale of Provident and a 60% reduction in our position in Nat City through subsequent sales of its stock.

There's also been a great deal of attention on securities that are credit enhanced by financial guarantors. If you turn to slide 10, at December 31st 2007, the company owned approximately $855 million of such securities, including $596 million of insured municipal bonds, a $152 million in insured subprime securities. Those were included in the $583 million that I discussed previously... $483million, $8 million in non-insured residential mortgage backed securities and $99 million of insured corporate bonds. 90% of the insured municipal bonds carried an explicit underlying rating with an average rating of A plus and 50% of the insured corporate bonds carried an explicit underlying rating with an average rating of BBB plus.

None of the insured subprime securities or insured residential mortgage backed securities carried an explicit underlying rating.

Based on the current information, we don't believe our risk of loss on the securities without underlying credit ratings would be material to our financial condition. Here is more detail on our investment portfolio at our quarterly investor information posted on our website. We are careful in monitoring our property and casualty insurance operating exposures related to the subprime issues. From a claims perspective, we had very few claims or notices of claims.

We reviewed those claims as well as the potential for loss from other insureds. Based on this review and what we currently know, we have no significant individual losses and don't believe that our aggregate operating losses related to subprime issues are material to our financial condition.

We have also considered the impact that this issue may have on our business going forward. A few of our businesses, most notably homebuilders, mortgage collateral protection, and in the marine, they have some decreases in volume as the housing market softens. We don't expect a financial impact of this softening to be material.

Let's talk about strategic focus. Our overriding goal is to increase long-term shareholder value by using our strong balance sheet and excess capital to intelligently expand our businesses. On slide 11, we've outlined important aspects of our strategy that we believe will be drivers for the future and allow us to achieve that goal.

We're focused on specialty niche markets within the property and casualty insurance, and annuity and supplemental insurance industries where we have significant expertise. We'll pursue appropriate uses of our excess capital including internal growth opportunities, within our existing portfolio of businesses, acquisition and start-up opportunities that meet our specialty strategy, and financial objectives, and opportunistic share repurchases, and changes in dividend levels.

Copyright © 2018 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

During these times of volatile financial markets, it may be smart to keep some of our powder dry as we feel there could be quite a few good opportunities. We remain committed to our strong underwriting culture, pricing discipline and risk management philosophy, and continue to monitor the adequacy of our rates in all markets. We've reduced business volume and lines as needed to achieve appropriate underwriting results.

Our investment group will focus on achieving returns over the long term and outperform various market indices while effectively managing our portfolio risk. We'll leverage the expertise of this group because we plan to pursue opportunities and manage certain types of investment vehicles for sophisticated entities.

Our long-term objective is to achieve returns on equity between 12% and 15% along with the consistent growth in book value. At AFG, we're enthusiastic about this year. Our expectations for 2008 are outlined on slides 12 and 13. Our property and casualty specialty operations to generate net written premium growth in the range of 4% to 7%. In a strong underwriting profit with a combined ratio in the range of 87% to 89%. This investment income is projected to increase between 2% to 4%. Any of our businesses aren't subject to an overall insurance cycle and are affected more by changes in their own specialized markets. Because of our strong underwriting culture we expect to maintain adequate rates. That said, we anticipate a modest decline in our overall average renewal rates in 2008 due to competitive conditions in certain markets.

Now we expect net written premiums in our Property and Transportation group to increase 6% to 9% fueled primarily by improved geographic penetration in our property and inland marine operations, as well as some new initiatives in our transportation businesses. This group should also maintain its excellent underwriting track record with a combined ratio in a range of 85% to 89%. While we expect increasing competitive pressures in certain of our operations and our specialty casualty group, we are projecting growth between 6% and 9% net written premiums.

We are optimistic about growth opportunities in this group, resulting from our recent investment in Marketform, the Lloyd's insurer that focuses on specialty property and casualty insurance products outside the United States, and is a market leader in the non-U.S. med mal market. We believe this acquisition positions us to grow several of our specialty businesses in the international marketplace. Excluding the impact of Marketform, our business in this group is expected to be down mid-single digits.

We also expect the acquisition of Strategic Comp Holdings to provide our workers' comp programs will further expand our penetration and increase our geographic coverage in the workers' comp market. We expect specialty casualty group to generate strong underwriting profit with a combined ratio in the range of 85% to 89%.

The underwriting margins of our Specialty Financial group are expected to continue to improve. We project net written premium growth in the range of 3% to 6% as most of the specialty financial businesses are expected to grow modestly. We'd look for this group's combined ratio to be in the range of 88% to 92%.

As I mentioned earlier, we expect to see rates in the California workers' comp market stabilize. As such, we'd o anticipate that net written premiums will be down 3% to 5% this year. The combined ratio is expected to increase somewhat but should be between 84% and 88%, still producing excellent returns on this business. We previously announced our intent to perform a ground-up internal review of our asbestos and environment exposures every year and a study using an actuarial firm every other year. Accordingly, we'll perform an internal study during 2008.

We expect the core pre-tax operating earnings of our Annuity and Supplemental Insurance group to be 5% to 10% higher than in 2007. Increased competition from the government sponsored Medicare Advantage product will likely continue and impact our supplemental insurance operations. We expect these premiums to be flat to slightly down in 2008.

Now we do expect 5% to 10% growth in annuity sales. We consider excess capital to be parent company cash plus borrowings we could incur while staying below our 24% debt-to-capital target. After taking into consideration capital already used for Marketform and Strategic Comp, we expect to generate around $ 350 million of excess capital during the remainder of the year.

Copyright © 2018 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

We continue to expect our 2008 core net operating earnings to be between $3.75 and $3.95 per share. These expected earnings exclude the potential for significant catastrophe and crop losses, unforeseen major adjustments to A&E reserves and large gains or losses from asset sales.

Now we'd like to open the lines for any questions. Thank you.

Question And Answer

Copyright © 2018 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

Question and Answer

Operator

Thank you. [Operator Instructions]. Your first question comes from the line of John Gwynn with Morgan Keegan. Please proceed.

John Gwynn
Morgan Keegan

Thank you. Keith or Carl, the drop in the expense ratio in property and transportation, is that a function of the crop business or it's a drop in the fourth quarter?

Keith Alan Jensen
Former Senior VP & CFO

It is a function of crop business. John, the way that works with a reinsurance arrangement, some profit sharing features as we have strong profit years that will be charged against expense.

John Gwynn
Morgan Keegan

Okay. But it's not a change in the ceding commission or anything?

Keith Alan Jensen
Former Senior VP & CFO

No, it's not.

John Gwynn
Morgan Keegan

Okay, great. On GAFRI the acquisition of the minority interest, did that have an impact on statutory surplus?

Keith Alan Jensen
Former Senior VP & CFO

No, that didn't.

John Gwynn
Morgan Keegan

Okay. Is GAFRI still stacked under Great American?

Keith Alan Jensen
Former Senior VP & CFO

No, it's not. It's been dividend out from n Great American is directly under American Financial Group. What that has done is enabled us to have a smoother capital flow without having to take two steps through regulated entities.

John Gwynn
Morgan Keegan

Right. And is s that also the reason that stat surplus was well... stat surplus is a consolidated number, right? On your supplement?

Keith Alan Jensen
Former Senior VP & CFO

Yes, it is.

Copyright © 2018 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

John Gwynn
Morgan Keegan

Why was that down?

Keith Alan Jensen
Former Senior VP & CFO

That would be down because you wouldn't have the double count from the statutory surplus of GAFRI under GAI.

John Gwynn
Morgan Keegan

Okay. And Keith, as I keep wondering on crop insurance, it looks like the expense reimbursement adjustment contained in the whatever bill is going to come out of this, this committee is really not very a material item. Is that a correct interpretation?

Keith Alan Jensen
Former Senior VP & CFO

That's where the... there are two proposals as a Senate version and a House version. The Senate version is proposing a 2% reduction in the administrative and overhead expense allowance. The House version is proposing players [ph]. And for the larger players that really is not a significant amount. I think what it tends to be is a barrier for people getting into the business on the small end because they don't have the economies of scale.

John Gwynn
Morgan Keegan

Okay right. Thanks a lot.

Operator

[Operator Instructions]. At this time there are further questions, I would now like to turn the call back over to Mr. Keith Jensen for closing remarks.

Keith Alan Jensen
Former Senior VP & CFO

Thank you very much and we'd express our appreciation to all of you for joining us today. And we look forward to reporting to you at the end of the next quarter. Thank you. Have a good day.

Operator
Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect and have a good day.

Copyright © 2018 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

Copyright © 2018 by S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved.

These materials have been prepared solely for information purposes based upon information generally available to the public and from sources believed to be reliable. No content (including index data, ratings, credit-related analyses and data, research, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of S&P Global Market Intelligence or its affiliates (collectively, S&P Global). The Content shall not be used for any unlawful or unauthorized purposes. S&P Global and any third-party providers, (collectively S&P Global Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Global Parties are not responsible for any errors or omissions, regardless of the cause, for the results obtained from the use of the Content. THE CONTENT IS PROVIDED ON "AS IS" BASIS. S&P GLOBAL PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Global Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages. S&P Global Market Intelligence's opinions, quotes and credit-related and other analyses are statements of opinion as of the date they are expressed and not statements of fact or recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P Global Market Intelligence may provide index data. Direct investment in an index is not possible. Exposure to an asset class represented by an index is available through investable instruments based on that index. S&P Global Market Intelligence assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P Global Market Intelligence does not act as a fiduciary or an investment advisor except where registered as such. S&P Global keeps certain activities of its divisions separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain divisions of S&P Global may have information that is not available to other S&P Global divisions. S&P Global has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P Global may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P Global reserves the right to disseminate its opinions and analyses. S&P Global's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription), and may be distributed through other means, including via S&P Global publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.
© 2018 S&P Global Market Intelligence.