S&P Capital IQ

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Cincinnati Financial Corporation NasdaqGS:CINF

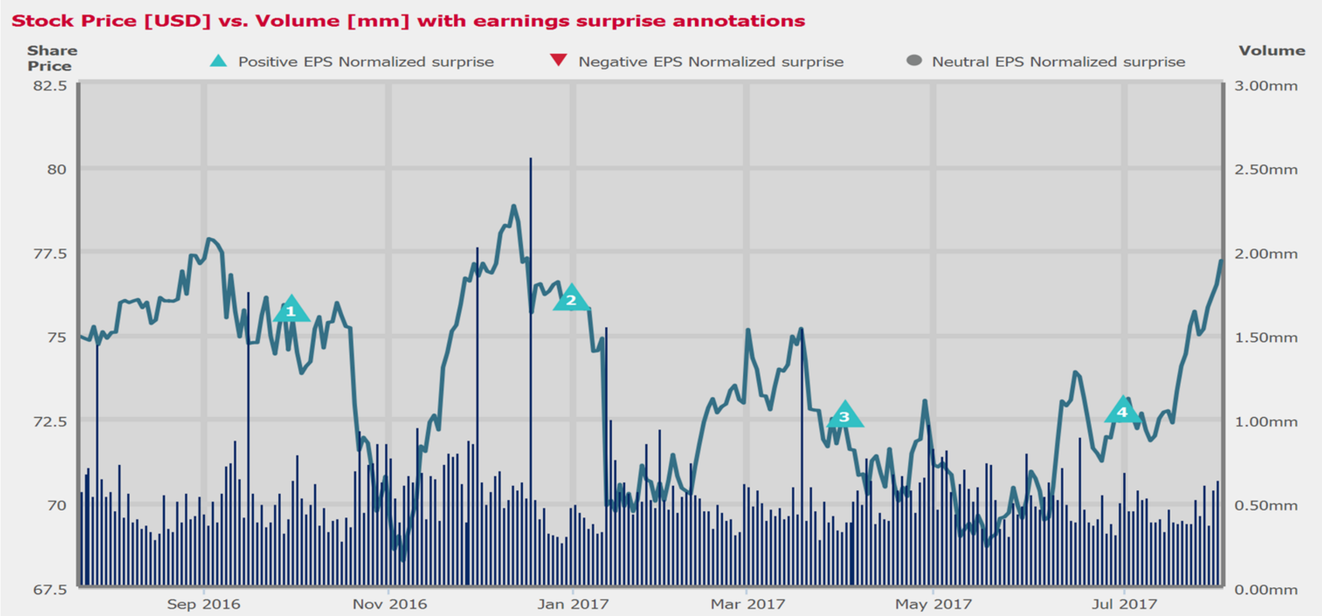
FQ3 2017 Earnings Call Transcripts

Friday, October 27, 2017 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2017-			-FQ4 2017-	-FY 2017-	-FY 2018-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.51	0.58	▲13.73	0.89	2.67	3.08
Revenue (mm)	1419.80	1412.00	▼(0.55 %)	1427.00	5748.00	5882.25

Currency: USD
Consensus as of Oct-27-2017 3:57 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ3 2016	0.78	0.86	▲1 10.26 %
FQ4 2016	0.65	0.75	▲2 15.38 %
FQ1 2017	0.51	0.59	▲3 15.69 %
FQ2 2017	0.50	0.64	▲4 28.00 %

Call Participants

EXECUTIVES

Dennis E. McDaniel
Vice President, Investor Relations Officer and Vice President of the Cincinnati Insurance Company

Jacob F. Scherer
Chief Insurance Officer and Executive Vice President

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

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

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

ANALYSTS

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

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

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Presentation

Operator

Good morning. My name is James, and I will be your conference operator today. At this time, I'd like to welcome everyone to the third quarter 2017 earnings conference call. [Operator Instructions] Dennis McDaniel, Investor Relations Officer, you may begin your conference.

Dennis E. McDaniel
Vice President, Investor Relations Officer and Vice President of the Cincinnati Insurance Company

Hello. This is Dennis McDaniel from Cincinnati Financial. Thank you for joining us for our third quarter 2017 earnings conference call.

Late yesterday, we issued a news release on our results along with our supplemental financial package, including our quarter-end investment portfolio. To find copies of any of these documents, please visit our investor website, cinfin.com/investors. The shortest route to the information is the Quarterly Results link in the navigation menu on the far left.

On this call, you'll first hear from Steve Johnston, President and Chief Executive Officer; and then from Chief Financial Officer, Mike Sewell. After their prepared remarks, investors participating on the call may ask questions.

At that time, some responses may be given by others in the room with us, including Chairman of the Board, Ken Stecher; Chief Investment Officer, Marty Hollenbeck; and Cincinnati Insurance's Chief Insurance Officer, J.F. Scherer; Chief Claims Officer, Marty Mullen; and Senior Vice President of Accounting, Theresa Hoffer.

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

Also, a reconciliation of non-GAAP measures was provided with the news release. Statutory accounting data is prepared in accordance with statutory accounting rules and therefore, is not reconciled to GAAP.

And now, I'll turn the call over to Steve.

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

Thank you, Dennis, and good morning. Thank you for joining us today to hear more about our third quarter 2017 results. While the past quarter presented challenges, we see several positives regarding future prospects for improved operating performance. First, our third quarter and 9-month 2017 property casualty combined ratios stayed just under 100%, putting us in a good position to earn an underwriting profit for the sixth consecutive year, consistent with one of our primary long-term objectives.

Second, we reported a 9-month current accident year combined ratio before catastrophe losses of 91.9%. While that was 0.7 point higher than accident year 2016 at 9 months, the higher ratio for losses of $1 million or more for claim largely contributed to that variance. And we know large losses tend to vary particularly over relatively short-term periods.

We also gained confidence from internal reports and observations that our underwriters continue to obtain relatively higher renewal pricing on expiring policies that our models and judgment indicate have relatively weaker pricing. That's an ongoing result of segmenting our portfolio of accounts through careful underwriting of risks covered by individual policies.

I'll take a moment to comment on Cincinnati Re, our reinsurance-assumed operation. Following a very favorable contribution to profit during the first 2 years since its inception, Cincinnati Re experienced a quarter of sizeable catastrophe loss effects, which happen from time to time in the reinsurance industry. That loss experience was consistent with our models and projections for significant catastrophe events.

Our underwriters and analysts are experienced subject matter experts who understand how to balance qualitative and quantitative aspects of reinsurance decision-making. So far in 2017, we've assessed nearly 500 potential reinsurance transactions, declining approximately 80% of them, a rate consistent with the prior 2 years.

History shows that the tendency for affirming reinsurance premium rates, following periods similar to the recent spike in industry losses, translates into near-term opportunity and we are well prepared to take advantage of it. We recognize the long-term benefits of risk diversification, and Cincinnati Re should continue to help diversify our business and smooth results over time.

Turning to premium growth. We continue to grow premiums in a disciplined fashion for each of our insurance segments. While overall premium growth for our commercial line segment slowed during the third quarter of 2017, renewal-written premiums continue to rise, and we reported a combined ratio of 95.2%.

Overall, commercial line's estimated average price increases were similar to the second quarter with higher pricing for commercial auto, the notable exception.

For our personal lines segment, third quarter premium growth continued at a nice pace. The personal lines 2017 combined ratio before catastrophe effects improved for both the third quarter and first 9 months, partially offsetting the higher level of catastrophe losses for both periods.

Estimated average premium rate increases for personal lines in total were slightly higher than in the second quarter of 2017, with personal auto average rate increases reaching the high single-digit range.

Our excess and surplus lines segment reported another strong quarter of underwriting profit and premium growth, and has a 9-month 2017 combined ratio of under 70%.

Our life insurance subsidiary again made a good contribution to net income, growing third quarter 2017 term life insurance earned premiums by 5% and helping to diversify our earning sources.

Our primary measure of financial performance, the value creation ratio, was 3.1% for the third quarter and 10.3% for the first 9 months of the year. We're still on pace for another year that reaches our long-term target of a 10% to 13% annual average.

Despite the third quarter being a challenging one in terms of operating results for us and the P&C industry, we continue to embrace opportunities every day to deliver long-term value to shareholders and outstanding service to the agencies that represent the company and their clients.

Next, our Chief Financial Officer, Mike Sewell, will highlight investment results, reserve development and other key areas of our financial performance and financial condition.

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

Great. Thank you, Steve, and thanks to all of you for joining us today. Third quarter 2017 was our 17th consecutive quarter of investment income growth, rising 3% for the quarter and 2% for the first 9 months of the year. Dividend income was up 10% for the quarter, and interest income was up 1%. The double-digit growth in dividend income will make a tough comparison in 2018.

Since the beginning of 2014, we have reported quarterly dividend growth ranging from 2% to 19%. Such variability can result from irregular patterns for dividend payments such as special dividends that can occur any time. For our portfolio, they tend to occur in the fourth quarter.

Our equity portfolio experienced another quarter of growth in unrealized gains, up 7% for the quarter to more than $2.7 billion. The bond portfolio's pretax average yield was 4.43% for the third quarter of 2017, down 20 basis points from last year's third quarter. That yield decline reflects the effect of higher-yielding bonds that continue to be called or that mature. While we reported another quarter of interest income growth, the third quarter 1% growth rate is well below the recent peak of 4% we reported for each of the first 2 quarters of last year.

Taxable bonds purchased during the third quarter 2017 had an average pretax yield of 3.81%, and purchased tax-exempt bonds averaged 3.15% for a blended yield of 3.55%, while bond portfolio effective duration did not change.

Cash flow from operating activities continued to provide funds for our investment portfolio. Funds generated from net operating cash flows for the first 9 months of 2017 totaled $746 million, down $89 million or 11% for the same period a year ago. A $103 million increase in catastrophe losses and loss expenses paid this year was a key contributor to the decrease.

Once again, we carefully managed expenses during the quarter while at the same time investing strategically in our business. Our third quarter and 9-month 2017 property casualty underwriting expense ratios improved somewhat from comparable 2016 periods.

Moving to loss reserves. Our consistent approach of setting overall reserves again resulted in net favorable development on prior accident years. For the third quarter of 2017, favorable reserve development benefited our combined ratio by 1.6 percentage points, somewhat lower than a typical quarter in recent years.

Development for each of our major lines of business was favorable with the exception of auto and also commercial casualty, which is our largest line of business.

Reserve development for commercial casualty was essentially flat for the third quarter of 2017 as we reported a net unfavorable amount of less than $1 million. Paid losses and loss expenses were higher than in any quarters since the beginning of 2015 and part due to an increase in large losses.

On a case-incurred basis, the ratio of losses and loss expenses was approximately 2 percentage points better than the first half of 2017, but it remains approximately 4 points worse than the average for the prior 2 years. After considering these trends for commercial casualty, we maintained our consistently prudent approach of setting reserves, including IBNR reserves that resulted in basically no favorable or unfavorable prior accident year development for the quarter in a 9-month current accident year loss, and loss expense ratio approximately 2 percentage points higher than the full year 2016.

Our commercial casualty third quarter 2017 loss and loss expense ratio of 63.2%, combined with an estimated underwriting expense ratio of 32 points or so, indicates an estimated combined ratio of approximately 95%. In total, favorable reserve development for the first 9 months of 2017 continued to be spread over most of our major lines of business and over several accident years, including 53% for accident year 2016, 7% for accident year 2015, 19% for accident year 2014, and 21% for 2013 and prior accident years.

Regarding capital management, our approach and financial strength remains stable. We have excellent financial flexibility, including September 30 holding company cash and marketable securities that rose 16% from the year-end 2016.

To conclude, I'll summarize third quarter contributions to book value per share. They represent the main drivers to our value creation ratio. Property casualty underwriting increased book value by $0.04. Life insurance operations also added $0.04. Investment income other than in life insurance and reduced by noninsurance items contributed $0.54. The change in unrealized gains at September 30 for the fixed income portfolio, net of realized gains and losses, increased book value per share by $0.05. The change in unrealized gains at September 30 for the equity portfolio, net of realized gains and losses, increased book value by $0.72, and we declared $0.50 per share in dividends to shareholders. The net effect was a book value increase of $0.89 during the third quarter to a record $45.86 per share.

And now, I'll turn the call back over to Steve.

Steven J. Johnston

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

Thanks, Mike. Before we open the call for questions, I'd like to thank our associates who worked relentlessly to respond to our agents and policyholders affected by hurricanes Harvey and Irma. With our claims team leading the way, associates from all across the company jumped into action to help wherever they could. Storms of this magnitude leave widespread damage in the community, and widespread concern about how to get back to normal. This is when our associates shine, calming those fears, upholding the reputation of our agents, and delivering on the value of a Cincinnati Insurance policy.

The start of the fourth quarter didn't bring much relief to our country as communities continued to experience devastating loss from both Hurricane Nate and the California wildfires. Our hearts go out to the families and businesses, including our own policyholders affected by these events.

In terms of losses, we estimate insured losses for our company will be less than $1 million for each of these fourth quarter events. We appreciate this opportunity to respond to your questions and also look forward to meeting in person with many of you during the remainder of the year.
As a reminder, with Mike and me today, are Ken Stecher, J.F. Scherer, Marty Mullen, Marty Hollenbeck and Theresa Hoffer. James, please open the call for questions.

Question and Answer

Operator

[Operator Instructions] And your first question comes from the line of Arash Soleimani from KBW.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

So just had a couple of questions here. In terms of the commercial casualty line, I just wanted to talk about that a bit more. So I mean, would you say that you're seeing kind of deteriorating trends there? Is -- the severity seemed like it's actually ticking up, or do you think this is more of a temporary issue? I just wanted to get a bit more color about what's happening with that line.

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

Arash, we feel good about the line. As Mike went over, the profitability is holding up well. Within commercial casualty, there are a lot of parts there that are analyzed and moving in different directions. But overall, I think, while we do see some upward trends, we feel confident with the way that we're underwriting and executing -- and are confident in terms of the continuation of the profitability in the casualty line.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

So they're mostly just kind of an uptick in severity. Is that a fair characterization?

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

This is Mike. It's really -- not much [probably] the severity, but it's the -- we had a few more larger losses. And so when you take a look at our losses that are $1 million or more, we had a few more of those during the current quarter. And so we were prudent. We're not necessarily seeing a trend yet, but we were prudent to releasing any IBNR reserves as some of those came through. I would probably say that some of those losses, there's not necessarily a trend, whether it's geographic or with what it is, but maybe I'll ask Marty Mullen if he's got any -- maybe kind of give a little color on the types of those large losses. Marty?

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

Sure. Thanks, Mike. First, the third quarter we had 28 commercial lines claims. 17 of those large claims, which categorized as a $1 million or more, were spread across the commercial lines. And to give you some example, 9 of those were $1 million claims in commercial auto; and of those 9 losses, 8 were in very different states. The same with the general liability. 5 of those large losses of over $1 million were in general liability lines, and again, they were in 5 different states. So the claims are very diverse, spread across our pattern. And I think it's just one of those quarters that you saw a significant increase in those number of claims spread across the country.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

And is that 63%, I mean, is that more or less like a fair run rate to assume for commercial casualty in terms of the core loss ratio?

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

Yes. It may be. It's -- when you take a look at like let's say the last few quarters, it's ticked up a little bit. Again, I'd like to wait to see another couple of quarters, and see where the large losses come in, see how our actuaries -- we're going to follow their consistent approach and how they're setting. But if you look at our loss -- loss expense ratio that's in our supplementary on Page 13, looking at the last so many quarters, it's ranging from a low, kind of in the low 50s, up to the 60 -- up to 63.2. But let's wait and see. It's a long-term line. Let's -- we're going to follow what our actuaries say.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Sure. And just in that same line of questioning, are you seeing an uptick in jury awards at all?

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

Arash, this is Marty. I think we haven't seen a trend in that regard. There are certain jurisdictions that you certainly have to be more careful in making decisions to take a case to trial. And certainly, we're very cognizant of that and prudent in deciding which cases to take to trial, depending on the facts and specific jurisdictions. So I think you still have to be careful in making those decisions in specific areas.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

And just my last one was, for Cincinnati Re, the 1-in-250 net PML looks like it's actually below your 1-in-100 net PML. So I just wanted to see how you guys are accomplishing that.

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

I think that was in the 10-K, and I think it had to do with the change in the loss per change in TVaR -- I'm getting kind of technical there, but in terms of change in risks. So it wasn't necessarily a change in VaR number.

Operator

Your next question comes from the line of Paul Newsome from Sandler O'Neill.

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

I want to ask about the possible expansion of the reinsurance business and specifically, what sort of metrics are you using in terms of ROE or underwriting or whatnot in terms of the volatility measures today to determine whether you want to be on a piece of business versus what you might be doing tomorrow. I'm wondering if there's any change there as well.

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

Good question, Paul. No, it will be a consistent approach. From the beginning, we've been very consistent and not focusing on growth but to try to focus on profitability, to focus on returns with each contract that if, for example, we did not set up a specific company for Cincinnati Re with capital that had to be used for a return, we try to look at each risk individually on the merits. As I've mentioned in my opening comments, we've been very disciplined in the ones that we accept. And a number of measures are looked at and will continue to be looked at, obviously, what we estimate the expected combined ratio would be. We do look at, as we're looking at lack of correlation with our regular business, we will look and try to estimate what you think the change in TVaR, the 1-in-250 year will be in combination with our already existing book in terms of the capital needed -- what type of return we can get on that. We look at rate on lines from a judgment factor. So -- and to me, it really always comes down to the people, and we have a very experienced team there that has been hired and are very confident in their ability going forward to be even in a stronger position than we are now. I think inception to date was probably the worst quarter in memory in terms of reinsurance losses. We're maybe about $13 million in the whole inception to date, and that's something that really, with a good fourth quarter, we could bring it back to breakeven or near breakeven by the end of the year and perfectly positioned, I think, as we move forward into next year.

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

And similar related question. I think hard markets are primarily created by changes in perceived risk that change underwriting methods whether they be terms and conditions or pricing or whatnot. But there's usually something out there that says, "I need to change how I do my underwriting prospectively." Is there anything on the horizon, from your perspective that would make you change as how you think about your underwriting? And if so, doesn't that mean that there won't be a hard market? If not -- if they're not going to change underwriting standards, wouldn't that preclude a hard market?

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

Well, I think that as we look going forward, the same approaches will be used as I just went over. I do think it has been a wake-up call in terms of appreciation of risk. We had 3 hurricanes, 2 earthquakes. Now we've had a fourth storm in May, we got wildfires and there -- I think there is just a little bit of a renewed appreciation of what can happen all at the same time. And I think also, it's been a long time since there was an event in Florida. Things have changed there over that period of time in terms of what we're seeing with assignment of benefits and a recognition of what that can bring, different players settling claims, and maybe a better appreciation of the degree of adjusters that are available to settle the claims and what that means. So I think that there is a kind of a wake-up call in terms of everybody understanding or being reminded of the type of risks that's out there. But I do say, in terms of our approach, it's going to be very consistent to what we have done. But we will recognize these factors.

Operator

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

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Just a question, a follow-up on reinsurance. It sounds like pricing is probably going to improve there. That's at least what everyone's kind of talking about. So just wondering how that might change your appetite. I know you mentioned it -- some comments on the call about that. And specifically, your appetite for property, property reinsurance, I know the book has been sort of 50-50 property versus casualty. But if you could talk about some of the growth you might see there if we do see better pricing and your appetite there.

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

Yes. And to the disciplined approach, Scott, actually over time, we started out it was about 50-50. But now, we're more casualty-oriented than we are property, I think, here more recently. It's a good bit over 50% in the casualty lines. So again, I think we'll look in terms of -- does it diversify, how correlated it is. We'll run through everything we can to understand the risk quantitatively and qualitatively and really be a no pressure to grow. It will be interesting to see how the firming takes place. I am confident that there will be firming. I think we're -- it'll be interesting to see as how broad is the firming relative to contracts that had losses versus contracts that didn't. How long might that firming last with the capital that is out there, how might it move from the property to the casualty. I think there are a lot of unknowns. But I do think and agree with the kind of the consensus that we will be in a firming market here, certainly for the short to midterm.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Okay. And so would you say property is -- what percentage of the reinsurance book would you say that is now around?

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

Do you have that number?

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

Yes. The property right now for 2017 year-to-date, the property is 38%. Casualty is 53% and specialty is 9%.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Okay. Great. And then just switching to the high net worth, personal lines unit. Can you talk about where that is tracking versus your expectations and what you're expecting in 2018? You expect to continue to roll that out to new states or kind of just working on penetrating where you are mostly?

Jacob F. Scherer
Chief Insurance Officer and Executive Vice President

Yes, Scott. This is J.F. Things have gone as planned and we're pleased with how it's going. In personal lines, we were up 34% new business this year, for example. High net worth was up, not surprisingly a big percentage, almost 90%. California's up and running very nicely. We're pleased with the reception we got out there. Massachusetts just went live. And Washington state, in August, went live. So we're now in all of the parts of the country that are centers of high net worth: Long Island, New York; Westchester County; New Jersey; Massachusetts; Texas; and California. We'll continue to open other states that would be the kinds of states where secondary residences would be located: Colorado, Montana, Wyoming, places of that nature -- Hawaii. So I think in terms of setting the infrastructure up, we're in good shape. Out west, for example, you heard Steve mentioned that we did not suffer many wildfire losses. We had some exposure in those areas, but we've also established our wildfire defense services that will go out and protect individual homes with specific care. So we're pleased with the work that we've done there. So I think between our reputation as a company with agencies and Will Van Den Heuvel's reputation in the industry, we've been able to get into all the agencies that we would like to get into. We're consistent approach there relative to a relatively few number of appointments. And we have a fairly, thankfully, a fairly long list of agencies that do want to do business with us, but we're committed to the initial appointments. So I think we're obviously pleased. The premiums coming in well. We're pleased with the quality of the business that we -- we're writing there. So I'd say it's been a great start.

Operator

And there are no further questions at this time. I'd like to turn the call back over to Steve Johnston.

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

Thank you, James. And thanks to all of you for joining us today. We look forward to speaking with you again on our fourth quarter call. Thank you, and have a great day.

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