S&P Capital IQ

CONTENTS



# Kemper Corporation NYSE:KMPR

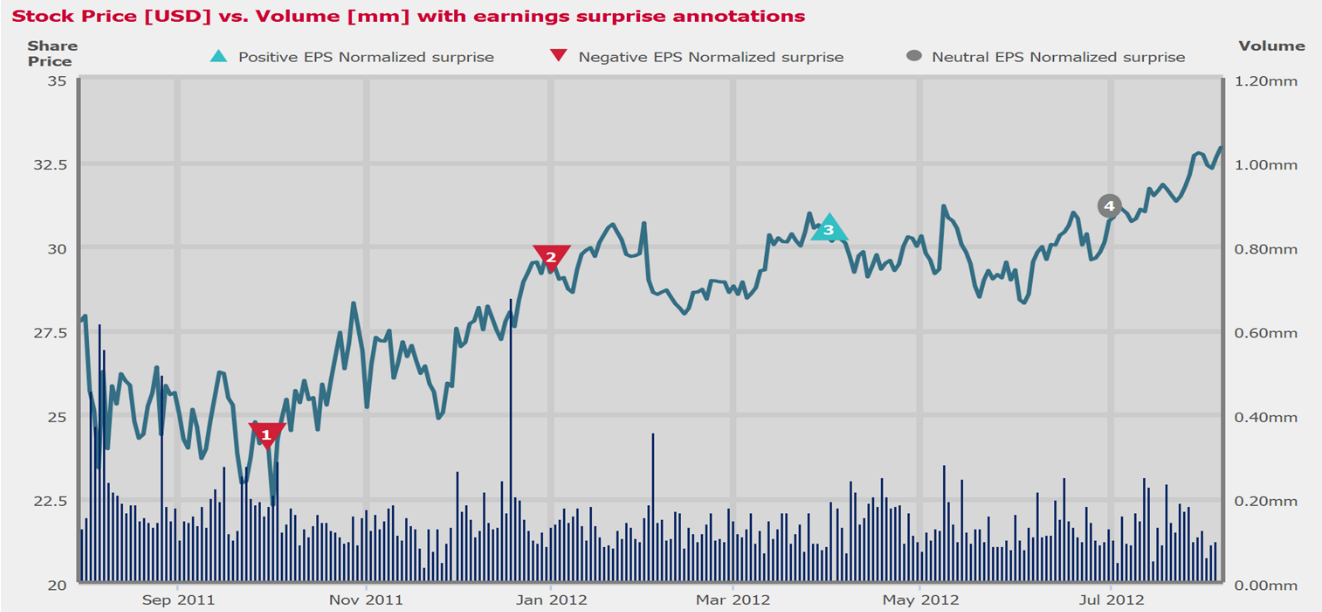
## *FQ3 2012 Earnings Call Transcripts*

Friday, November 09, 2012 4:00 PM GMT

## S&P Capital IQ Estimates

| | -FQ3 2012- | | | -FQ4 2012- | -FY 2012- | -FY 2013- |
|---|---|---|---|---|---|---|
| | CONSENSUS | ACTUAL | SURPRISE | CONSENSUS | CONSENSUS | CONSENSUS |
| **EPS Normalized** | 0.33 | 0.42 | ▲27.27 | 0.52 | 1.39 | 2.13 |
| **Revenue (mm)** | 614.31 | 645.60 | ▲5.09 | 616.35 | 2442.05 | 2483.26 |

Currency: USD
Consensus as of Oct-16-2012 11:28 AM GMT




**- EPS NORMALIZED -**

| | CONSENSUS | ACTUAL | SURPRISE |
|---|---|---|---|
| **FQ3 2011** | 0.51 | 0.16 | ▼1 (68.63 %) |
| **FQ4 2011** | 0.70 | 0.42 | ▼2 (40.00 %) |
| **FQ1 2012** | 0.53 | 0.60 | ▲3 13.21 % |
| **FQ2 2012** | 0.10 | (0.01) | NM |

# Call Participants

## EXECUTIVES

**Dennis R. Vigneau**
*Former Chief Financial Officer and Senior Vice President*

**Diana J. Hickert-Hill**
*Vice President of Investor Relations & Corporate Identity*

**Donald G. Southwell**
*Former Chairman, Chief Executive Officer and President*

**James Allen Schulte**
*Former Group Executive of Property & Casualty Group*

## ANALYSTS

**Miranda Davidson**

**Paul Newsome**

# Presentation

**Operator**

Good morning, ladies and gentlemen, and welcome to Kemper's Third Quarter 2012 Earnings Conference Call. My name is Sean, and I will be your coordinator today. [Operator Instructions] As a reminder, this conference is being recorded for replay purposes. I would now like to introduce your host for today's conference, Ms. Diana Hickert-Hill, Vice President, Investor Relations and Corporate Identity. Ms. Hickert-Hill, you may begin.

**Diana J. Hickert-Hill**
*Vice President of Investor Relations & Corporate Identity*

Thank you, operator. Good morning, and thank you for joining us. After the market's close yesterday, we filed our Form 10-Q with the SEC and issued our press release and financial supplement. You can find these documents on the Investors section of our website, kemper.com. This morning, you will hear from 3 of our business executives, starting with Don Southwell, Kemper's Chairman, President and Chief Executive Officer; Jim Schulte, Kemper's Property & Casualty Group Executive; and finally, Dennis Vigneau, Kemper's Senior Vice President and Chief Financial Officer.

We will make a few opening remarks to provide context around our third quarter results. We will then open up the call for a question-and-answer session. During this interactive portion of the call, our 3 presenters will be joined by John Boschelli, Kemper's Vice President and Chief Investment Officer; and Ed Konar, Kemper's Life and Health Group Executive.

Please note that our discussion today may contain forward-looking statements. Our actual results may differ materially from these statements. Please refer to our Form 10-K filed with the SEC on February 17, 2012, as well as our third quarter 2012 Form 10-Q and earnings release for financial information on potential risks associated with relying on forward-looking statements.

This morning's discussion also includes non-GAAP financial measures that we believe may be meaningful to investors. In our 10-Q, supplement and earnings release, non-GAAP financial measures have been reconciled to GAAP where required in accordance with SEC rules.

Now I will turn the call over to Don Southwell.

**Donald G. Southwell**
*Former Chairman, Chief Executive Officer and President*

Thank you, Diana. Before I get into the results for the third quarter, I want to comment on Super Storm Sandy. Many people were affected by this storm, and we hope that those dealing with the aftermath are getting their lives back on track. I'm proud to tell you our customer service and claims professionals are hard at work assisting our customers as they deal with this devastation. We are committed to fulfilling our promises to our customers, answering their questions and paying for their covered losses. This is part of the Kemper value proposition and we do this well. We're still determining financial estimates for the storm, but we do expect it to be material for our fourth quarter results. We'll provide an update to the market when we have further details.

As you've heard in the introductions, I've asked Jim Schulte to provide an update on our Property & Casualty businesses. I'll focus my remarks on just 3 topics: first, our view of our overall performance; second, an update on our Life and Health and investment performance; and third, our status and thoughts on capital.

To start with, views on our overall third quarter performance. We continue to make good progress on many fronts in the quarter. We have been implementing rate increases and tightening our underwriting as we focus on improving margins. These activities, coupled will lower catastrophes in the quarter, helped deliver improved results, but we have more work to do.

Moving on to our Life and Health business and investment update. In the Life and Health segment, the top line remained relatively steady as we continued our shift away from dwelling and hospitalization products. We also delivered solid bottom line performance.

I am pleased with our Reserve National team's performance as it continues to shift to supplemental and specialty products. These products are less affected by national health care reform than are the traditional hospitalization products that we stopped selling last year. Our investment portfolio delivered another quarter of solid performance. Our yields are holding up well considering the declining interest rate environment. They were in line with our expectations for both the quarter and year-to-date. Dennis will provide more detail on our investment performance and the gains we took in the quarter as we adjusted our portfolio.

And finally, moving to capital. We finished the quarter in a strong position. We remained disciplined as we allocate capital according to our overall strategy of: One, funding profitable organic growth; two, considering acquisitions that have a clear fit and make our existing businesses stronger; three, maintaining our competitive dividend; and four, repurchasing shares.

On this last point, we repurchased $20 million worth of shares in the quarter, bringing the year-to-date total to just over $60 million. We continue to be opportunistic on this front and expect to stay well within our guidance of up to $100 million worth of share repurchases this year.

In July, we announced that we were evaluating strategic actions for the Kemper Direct segment and stopped direct marketing activities. Since that announcement, we've considered several opportunities presented by interested parties. We're still on track to complete our evaluation by year-end. In our analysis, we compare each opportunity to the expected profits we would generate from maintaining the business. We will choose the option that delivers the best returns for our shareholders, and we will update you when our evaluation process is complete.

Now I'll turn the call over to Jim to provide color on the quarter's P&C results and actions to improve profitability.

**James Allen Schulte**
*Former Group Executive of Property & Casualty Group*

Thank you, Don. Kemper's third quarter overall Property & Casualty results improved when compared to the same period last year, as well as sequentially. A better overall weather environment, coupled with strategic actions we've implemented, contributed to the bottom line improvement. Severity was up in the personal auto market and the market is becoming more aggressive on rates. Overall, the P&C group's underlying combined ratio was 101%, which was better than the second quarter of this year but up 0.5 percentage points compared to the same period last year. We have implemented planned price increases across our P&C businesses and selectively have reduced exposure, especially in homeowners.

We're seeing early indications that the actions are beginning to take effect. I'll walk through each of our P&C businesses, starting with Direct. As we continue to evaluate our options in our Direct segment, we have begun to execute plans to optimize the value of the in force book of business. We stopped the direct marketing spend early in the quarter and initiated additional expense reductions consistent with the change in strategy. We are reducing infrastructure costs by consolidating programs and system platforms. In addition, we are reducing staff levels in line with top line projections. New business sales came in slightly above expectations in the quarter, primarily from affinity and worksite lines, as well as residual sales from a previous direct marketing campaign.

Our previously announced actions to limit business in Michigan, Florida and New York continue as planned. About 80% of the Michigan business has run off the books since the beginning of the year. We continue to focus -- to improve the bottom line results by taking rate actions in line with full indications, as well as tightening underwriting. By year-end, we will have filed for rate increases of 5% in auto and 12% in home. These rate changes will earn in over the next 6 to 12 months.

Moving to our largest P&C business, Kemper Preferred, our focus remains on the bottom line in attracting new and renewal business in our most profitable customer segments. We are optimizing our mix and emphasizing our auto and home package product. Year-over-year, our package premium rose by 6%.

Our strategy to increase homeowners pricing is going well. Specifically, we filed rate increases and received approval in 30 states through October. By year-end, we expect to achieve a countrywide average filed rate increase of about 11% on homeowners. This is 2.5 points above our original expectations for the year. We are also taking additional pricing and underwriting actions to refine our risk and profit profile. Some of these steps include increasing homeowners' deductibles, especially in states with tornado and hail exposure, enhancing pricing segmentation and selectively reducing homeowners' exposures in certain states. Catastrophe losses in the third quarter for homeowners were significantly less than last year's losses, although on a year-to-date basis, are still above our desired levels. We continue to take actions to reduce exposures in the highest catastrophe-prone areas. And finally, we expect the marketplace pricing to continue its upward trend in homeowners.

Moving to auto. By year-end we expect to achieve a countrywide average filed rate increase of about 8%. This is a full 2 points above our original expectations for 2012. We have been implementing other pricing and underwriting actions and initiatives and expect them, along with filed rate increases, to produce improved loss ratios in 2013.

Turning now to Kemper Specialty. Non-standard auto market continues to show signs of firming, especially in our larger states. We are pursuing full indicated rate actions and, by year-end, expect to achieve a countrywide average filed rate increase of approximately 11% for the personal auto line. In addition, we are further refining our segmentation and expect these actions to improve profitability. At the same time, these actions may have a modest negative impact to our top line production and our policies in force.

So to summarize, we continue to address our challenges head on, we are committed to continued improvement in profit in each of our lines, and I feel good about the plans we have in place.

With that, I'll turn it over to Dennis to discuss the financials.

**Dennis R. Vigneau**
*Former Chief Financial Officer and Senior Vice President*

Thanks, Jim, and good morning, everyone. As you have heard, the third quarter results showed improvement in several areas. This morning, I'll share further insights on where our actions are beginning to improve financial results, as well as highlight a few areas that remain challenging as we head into 2013.

Beginning with Kemper's consolidated revenues and earnings. Reported revenues for Kemper were $646 million in the third quarter, up about 6% from last quarter and 9% over last year. Earned premiums were $527 million in the quarter, down slightly from the third quarter of 2011 earned premiums of $543 million. This change is largely from actions taken in the Direct business to improve profitability. Kemper's Life and Health segment reported stable earned premiums of $160 million. Consolidated net investment income for the company was $70 million in the third quarter and included $1 million loss from equity method investments. In the third quarter of last year, Kemper reported net investment income of $59 million. This result included a $14 million loss from equity method investments.

This asset class has a less predictable earnings pattern, but has historically delivered strong lifetime returns and provides diversification benefits to the entire portfolio. Overall, average invested assets were stable and, on a year-to-date basis, the pretax equivalent book yield was 5.6%, consistent with the prior year.

Finally, net realized investment gains in the quarter were $51 million pretax, an increase of $55 million over last year. During the quarter, we repositioned approximately 20%, or $275 million on a book value basis, in our municipal bond portfolio. This opportunistic sale captured a portion of the strong appreciation we've seen over the last several quarters in this portfolio. Overall, we netted a pretax gain of $45 million and boosted Property & Casualty statutory capital by $30 million. Proceeds have been fully reinvested in corporate and agency bonds with an average yield of 3%; as well, we shortened up the overall P&C portfolio duration to align with our actions in the Direct business.

Turning to operating earnings, Kemper's third quarter net operating income was just shy of $25 million or $0.42 per share, compared to $7 million or $0.12 per share reported in the third quarter of 2011. This year-over-year improvement was largely comprised of $20 million or $0.32 per share improvement from lower catastrophe losses, coupled with stable net operating income across the businesses.

Let me shift to some details in each of the business teams. First, in the P&C Group, Kemper Preferred delivered just over $8 million of net operating earnings in the quarter, compared to an $8 million net operating loss in the third quarter of 2011. This improvement of $16 million relates to lower weather-related losses of $21 million, partially offset by $5 million lower favorable development compared to last year. These 2 items contributed to an overall reported combined ratio of 100%, better by 11 percentage points, year-over-year. The underlying combined ratio, which excludes catastrophes and prior-year development, was 97% in the current quarter, consistent with the prior year. Expense ratio was stable, and net investment income increased $1 million over last year.

In terms of top line performance, Preferred's net written premiums increased 2% to $238 million, and net earned premiums were $223 million or 3% higher. Overall premium retention was 89% on both a quarter and on a year-to-date basis. We continue to take significant rate actions in several areas, most notably those cat-prone areas in our homeowners' book.

Shifted to Kemper Specialty, the business reported net operating earnings of $3 million in the third quarter. This was $3 million lower than the same period of 2011. This year-over-year change reflects the benefit of current year development in the third quarter of 2011.

Drilling down into the results, we saw an improvement in the underlying loss ratio for personal auto, but this was offset by higher frequency in our commercial auto book. The expense ratio increased by about 1 percentage point as expected from investments in technology. Kemper Specialty's net written premiums were $104 million in the quarter, about 5% lower than last year. Net earned premiums were $104 million in the third quarter, lower by $7 million versus last year.

Policies in force were 291,000 at the end of September, down 12% over the same period last year, but in line with our expectations and reflective of the significant rate actions taken year-to-date.

Moving to Direct. Business team continues to deliver on its operating plans to improve overall profitability. In the third quarter, the business unit reported net operating earnings of $2 million, up $3 million over the prior year. Both the reported and underlying combined ratio were lower year-over-year as well as sequentially.

Current quarter results included $1 million lower catastrophe losses compared to the prior year, and Direct segment net earned premiums were $40 million in the current period. This is down $14 million from last year, as I mentioned, from the actions taken to reposition the business.

Shifting to the Life and Health segment, the upper income was $19 million for the quarter, flat with last year. This result included higher net investment income of $4 million, predominantly in the equity method investment portfolio, but this increase was offset by $2 million higher weather-related losses and $1 million higher expenses. The Life and Health teams continue to respond to a challenging environment with actions in several areas. For example, we've reduced overall dwelling exposure by 9% since the beginning of 2012, and we've planned a further reduction in overall exposures of another 10% by year-end. All of these actions are, as well, in the most catastrophe-prone areas.

As of last quarter, [indiscernible] price increases we've implemented on Life new business. I'm pleased to say the increase was smoothly absorbed by the agency force. Looking ahead, we do expect the interest rate environment to remain challenging in this business over the medium term, but believe that additional potential price increases provide a buffer against margin compression.

In Reserve National, the expanded supplemental product offerings continue to be well-received by both agents and customers. Overall net earned premiums in the business were stable at $34 million for the quarter. But underlying this stability is a solid 48% increase in new product sales year-over-year that offset a planned 16% run-off in the older generation product offering.

Let me wrap up on book value and capital. Book value per share increased in the quarter to $37.78, up from $36.42 at the end of the second quarter. Statutory solvency and surplus levels in the insurance companies remained strong, and risk-based capital ratios were approximately 500% in Life and 305% for the Property & Casualty business. On a combined basis, the insurance operating units have a max ordinary dividend capacity of $175 million for 2012. Year-to-date, the Life business has paid a dividend of $70 million to the holding company, and we plan an additional $20 million to $25 million during the fourth quarter.

In terms of liquidity, the holding company ended the quarter with cash and investments of $215 million, and our $325 million revolving line of credit remains undrawn.

In summary, we are making progress in key areas. We have additional plans in place to continue those improvements and address the challenges we face ahead.
With that, I'll turn the call back over to the operator for questions.

# Question and Answer

**Operator**

[Operator Instructions] I have a question from Paul Newsome with Sandler O'Neill.

**Paul Newsome**

I was wondering what is -- if you could assess the possibility that the dividend capacity out of the insurance companies in the fourth quarter as well as the buyback could be impacted by the Hurricane Sandy losses?

**Donald G. Southwell**
*Former Chairman, Chief Executive Officer and President*

Dennis, you want take that one?

**Dennis R. Vigneau**
*Former Chief Financial Officer and Senior Vice President*

Sure, good morning, Paul. We are certainly monitoring and working through the final tally on Sandy. The dividend capacity that we anticipate and the $20 million to $25 million coming up in the fourth quarter is going to be from the Life company. So I don't think anything would impact that coming up, nor do I, at this point, expect there to be a material impact to the overall capacity as we look forward into 2013 as a result of that.

**Paul Newsome**

Terrific. Do you have any summary statistics? I mean, number of claims, that kind of stuff, for Hurricane Sandy yet?

**Donald G. Southwell**
*Former Chairman, Chief Executive Officer and President*

Paul, we've got some information about Sandy. It was a very wide storm, 60 million people. We've had a number of claims in. We haven't inspected all those claims yet, and we think it will be, certainly towards the end of next week before we get enough claims to maybe start talking about what the financial impact would be. Jim, do you have any numbers of claims to toss out at this point in time?

**James Allen Schulte**
*Former Group Executive of Property & Casualty Group*

Yes. So far, we have roughly 4,000 claims reported, about 75% of that is home claims, 25% auto. On the auto side, as has been reported by some other companies, we are seeing several total losses due to the flooding activity.

**Paul Newsome**

Okay. How is that running versus just roughly what happened with you in Irene?

**James Allen Schulte**
*Former Group Executive of Property & Casualty Group*

It's a totally different storm. Logistics on this storm are much more difficult with the flooding, it's hard to get to various areas. And of course, in the Nor'easter that occurred in the last day or so, that didn't help matters either. So it's been tougher to get out to inspect risk on this one. But we did have our people on the ground in advance of the storm, we have over 100 of our colleagues up in the area, and we are hard at it.

**Donald G. Southwell**
*Former Chairman, Chief Executive Officer and President*

Paul, I understand your desire to get some kind of a handle on this, but it's just too soon to really give you much in the way of helpful information on this, until we get a better handle on that, the size.

**Paul Newsome**

I think what you said ins quite helpful, actually. I'll let someone else ask the question.

**Operator**

[Operator Instructions] Our next question comes from Miranda Davidson with Raymond James.

**Miranda Davidson**

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Guys, I'm calling in for Steven. Do you think of you could talk a little bit about the loss cost trends in auto for the quarter? Are you seeing an uptick in anything?

**Donald G. Southwell**
*Former Chairman, Chief Executive Officer and President*

Jim, do you want take that one?

**James Allen Schulte**
*Former Group Executive of Property & Casualty Group*

Yes. We are seeing some uptick in auto trends that track pretty close to industry trends. We watch Passtrak data, which has a quarter lag and severity is up on Passtrak in virtually every line. And as you know, frequency has tailed off, in general, over the last few years, but we've seen frequency pick up in physical damage in a couple of our business centers.

**Operator**

I am not showing any other questions in the queue at this time.

**Diana J. Hickert-Hill**
*Vice President of Investor Relations & Corporate Identity*

Thank you, operator. If anybody else has any questions, this is Diana and you can reach me after the call.

**Operator**
Thank you. Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the conference. You may now disconnect. Good day.