S&P Capital IQ

CONTENTS

Kemper Corporation NYSE:KMPR

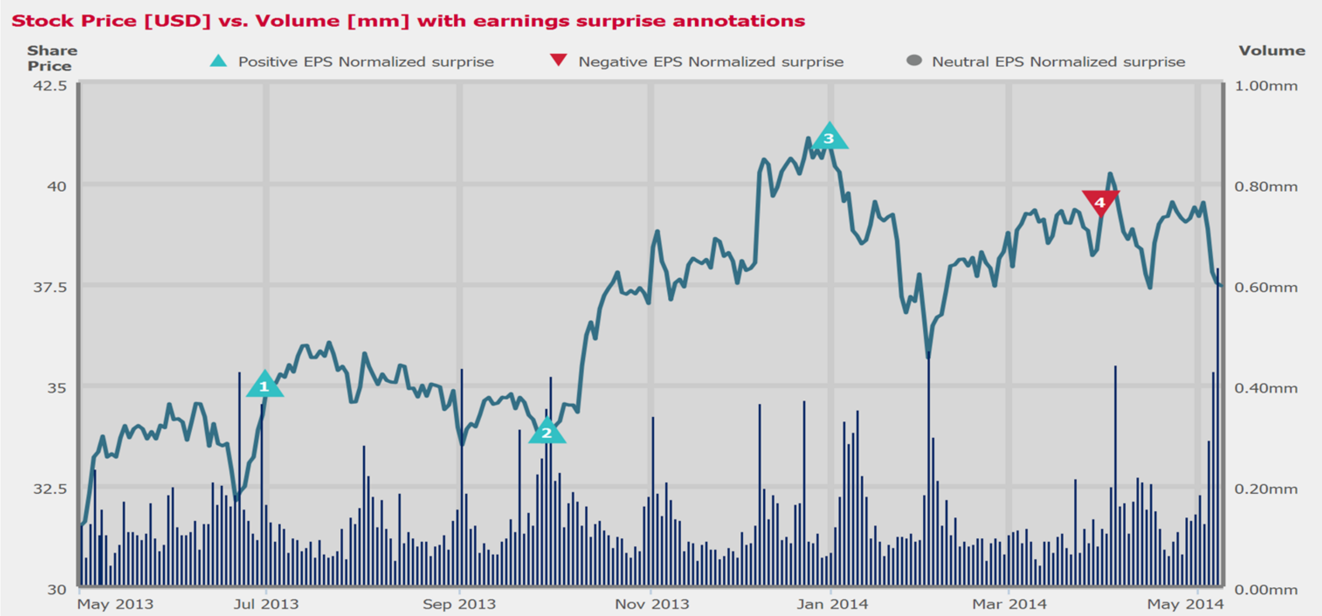
FQ2 2014 Earnings Call Transcripts

Friday, August 08, 2014 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2014-			-FQ3 2014-	-FY 2014-	-FY 2015-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.26	0.18	(30.77 %)	0.53	1.84	2.75
Revenue (mm)	547.12	543.10	(0.73 %)	544.45	2182.10	2177.10

Currency: USD
Consensus as of Aug-08-2014 8:19 AM GMT



	- EPS NORMALIZED -		
	CONSENSUS	ACTUAL	SURPRISE
FQ2 2013	0.27	0.55	103.70 %
FQ3 2013	0.40	0.69	72.50 %
FQ4 2013	0.60	0.83	38.33 %
FQ1 2014	0.65	0.56	(13.85 %)

Call Participants

EXECUTIVES

Denise Idell Lynch
Former Property & Casualty Group Executive

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

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

Edward J. Konar
Former Vice President and Life & Health Group Executive

Frank Joseph Sodaro
Former Senior Advisor

ANALYSTS

Adam Klauber
William Blair & Company L.L.C., Research Division

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

Matthew John Carletti
JMP Securities LLC, Research Division

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

Presentation

Operator

Good morning, ladies and gentlemen, and welcome to Kemper's Second Quarter 2014 Earnings Conference Call. My name is Kevin, and I'll be your conference coordinator today. [Operator Instructions] As a reminder, this conference is being recorded for replay purposes.

I would now like to introduce your host for this 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, everyone, and thank you for joining us. This morning you will hear from 4 of our business executives, starting with Don Southwell, Kemper's Chairman, President and Chief Executive officer; followed by Denise Lynch, Kemper's Property & Casualty Group Executive; Ed Konar, Kemper's Life and Health Group Executive; and Frank Sodaro, Kemper's Senior Vice President and Chief Financial Officer.

We will make a few opening remarks to provide context around our second quarter result. We will then open up the call for a question-and-answer session.

During this interactive portion of the call, our presenters will be joined by John Boschelli, Kemper's Vice President and Chief Investment Officer.

After the markets closed yesterday, we issued our press release and financial supplement. In addition, we filed our Form 10-Q with the SEC, and you can find these documents on the Investors section of our website, kemper.com.

Please note that our discussion today may contain forward-looking statements. Our actual results may differ materially from these statements. For information on potential risks associated with relying on forward-looking statements, please refer to our Form 10-K filed with the SEC on February 14, 2014, as well as our second quarter 2014 Form 10-Q and earnings release.

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

And finally, all comparative references will be to the second quarter of 2013, unless we state otherwise.

Now I will turn the call over to Don Southwell.

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

Thank you, Diana. Good morning, everyone, and thanks for joining us on our call this morning. I'll begin with a few high level comments, then Denise and Ed will update you on their businesses' performance. Frank will then cover financials, capital and liquidity. I'll close with a few remarks on our capital deployment plans and progress before we go into the question-and-answer session.

With that, let's start with a total view. Second quarter results were mixed, with important progress in key areas overshadowed by significantly higher catastrophe losses. So even as net income was down by $25 million to $9 million, we had significant improvement in our Property & Casualty underlying performance.

Our Life and Health segment earnings were lower in the quarter, but we are making progress in key growth initiatives. Ed will cover these topics in more detail.

Before we do these business reviews, I'll provide some perspective on our investment portfolio, where once again, we are seeing impressive results in a challenging investment environment.

Our total return was positive for both the quarter and year-to-date, coming in at about 3% and 6%, respectively. While up sequentially, our net investment income was $2 million lower than last year, primarily from lower income from equity method investments.

For the year, we have purchased more than $180 million of investment-grade bonds, with a pretax equivalent yield of 4.8%. We also purchased more than $80 million of noninvestment grade bonds to replace redemptions to date. We plan to put a majority of our new money in investment grade municipal and corporate bonds, along with higher-yielding private investments. However, we do not expect a material change in our overall noninvestment-grade fixed income allocation.

Now I'll turn the call over to Denise to discuss our Property & Casualty segment results.

Denise Idell Lynch
Former Property & Casualty Group Executive

Thanks, Don. This is the first full quarter our Property & Casualty insurance segment has operated in a new organizational structure, and I'm pleased to report that we have made solid progress following the realignment.

We continue to receive positive feedback from our independent agents. Many of whom want access to our full suite of products. In just 1 quarter, we cross-appointed 125 existing agents, creating an opportunity for both Kemper and our agents to grow our businesses together.

In addition, we improved employee productivity and built or deepened capabilities in marketing research, customer experience and predictive analytics.

We continue to look forward to benefiting from the opportunities the new organization enables.

Turning to results for the quarter, we reported a net operating loss of $1 million, down from net operating income of $19 million. This change was largely driven by higher catastrophe losses and a higher expense ratio that overshadowed our underlying loss improvements. We experienced 13 catastrophes during the second quarter, resulting in an after-tax loss of $40 million, making this the second-most costly catastrophe quarter in at least a decade.

The top line was pressured, with net written premium down 12%. The lower levels of new and renewal business were a result of softening auto market conditions, our deliberate actions to reduce volatility from weather, and our efforts to improve the overall quality and price adequacy of our book of business.

As I highlighted last quarter, we are focused on improving both new sales and retention throughout 2014 by, one, engaging existing agents to increase monoline and packaged sales; two, generating sales through newly appointed agents and by cross-appointing agents with both preferred and nonstandard product access where appropriate; three, increasing hit ratio and price adequacy through improved rate segmentation; and four, improving the agent experience.

The actions to improve new business production and retention are measured and consistent with our commitment to improve profitability. We expect gradual improvement in net written premium throughout the year.

Now I will provide some color on our lines of business. Private passenger auto experienced the most significant revenue pressure. Thus, net written premium declining 14%, both new sales and retention were down. The loss in LAE ratio improved 2 points, primarily from higher favorable reserve development and from a 3-point improvement in the underlying loss and LAE ratio, offset by higher catastrophe. The underlying loss in LAE ratio of 72% is the lowest in the last 12 quarters and reflects improved pricing and underwriting discipline. Our average earned premium increased more than 4% and exceeded loss cost trends.

Our low single-digit private passenger auto loss cost trends are mostly consistent with the industry. In the last year, bodily injury frequencies have declined, while bodily injury severities have increased, both consistent with the industry. Property damage and collision loss costs have escalated, also consistent with industry trends.

In commercial auto, net written premium was up 6%, while 4 points better than prior year, the loss in LAE ratio was 89%. The underlying loss in LAE ratio improved 12 points to 85%. This remains an area of focus as we work to improve profitability.

In homeowners, net written premium was down 7% from both lower new sales volume and retention. As I mentioned already, this was a costly catastrophe quarter. Current year catastrophes contributed 64 points to the homeowners' calendar year loss and LAE ratio of 104%. However, the homeowners' underlying loss in LAE ratio improved 5 points to 48%, making it one of the best underlying loss in LAE ratios in the last 12 quarters. The average earned premium was up 9% and exceeded loss cost trends.

We are pleased with the continued progress we are making as a result of our focused profit improvement activities.

Looking at our overall performance, we feel good about: One, continued progress in underlying loss and LAE, with average earned premium exceeding loss cost trends in private passenger auto and homeowners; two, improved expense management; three, successfully realigning the Property & Casualty segment to create new opportunities for profitable growth; and four, the effectiveness of the Kemper Direct runoff.

We remain focused on continuing to improve profitability while restoring growth where and when appropriate.

Now I will turn the call over to Ed.

Edward J. Konar
Former Vice President and Life & Health Group Executive

Thank you, Denise, and good morning, everyone. As Don indicated earlier, our Life and health segment earnings were pressured in the second quarter. We reported $16 million in net income, down $4 million. This decline is primarily due to a drop in premium revenue, an increase in insurance expenses, as well as a decrease in net investment income, partially offset by lower benefit payments.

Premium revenue for the quarter was down 4% from the previous year, primarily from a decrease in accident and health insurance premiums. Most of the A&H drops is due to the non-renewal of a portion of Reserve National's older hospitalization policies, which are required to be non-renewed this year in accordance with the new national healthcare law. In addition, many of these hospitalization policyholders also owned other Reserve National supplemental policies, which they allowed to lapse when the mandatory hospitalization non-renewal occurred.

Life premiums decreased 1% in the quarter, with a decrease in Kemper Home Services Life Premium and partially offset by an increase in the life premiums from Kemper Senior Solutions.

Insurance expenses increased despite the decrease in earned premiums. While Kemper Home Service commissions decreased along with lower premium, this was more than offset by higher other insurance expenses at Kemper Home Service, as well as increased spending to grow our Kemper Senior Solutions and Kemper Benefits Businesses.

Kemper Senior Solutions offers life and home healthcare products distributed through independent agents and brokers. While we are still on the early stages of this business, to date, we've appointed 17,000 agents and generated $3 million of earned premium in the quarter.

Kemper benefits offers a variety of supplemental health and accident products on a voluntary basis to employees through their employer. We are pleased with the market reception to our product offerings and quote activity, and initial sales levels are very respectable, particularly for a startup operation. We look forward to increased momentum for this business as the traditional open enrollment period gets underway in the second half of the year.

The last point I'd like to make is that net investment income decreased 4%, primarily due to lower investment income from equity method investments.

And now I'll turn the call over to Frank.

Frank Joseph Sodaro
Former Senior Advisor

Thanks, Ed, and good morning, everyone. Today, I'll cover Kemper's overall second quarter 2014 performance, capital and parent company liquidity. We reported net income of $9 million or $0.17 per diluted share, compared to $34 million or $0.59 per diluted share last year. Our net operating income was $10 million or $0.18 for the quarter, compared to $32 million or $0.55 last year.

Total revenues were $543 million for the quarter, a decrease of $46 million, which is almost entirely due to the drop in earned premiums. About 20% of the $36 million decline in Property & Casualty earned premium was from the continued runoff of our direct-to-consumer business. Life and Health earned premiums decreased $6 million to $153 million.

Consolidated net investment income was $73 million in the quarter, a decrease of $2 million, driven by lower net investment income from equity method investments.

The second quarter annualized pretax equivalent book yield on average invested assets was 5%, down approximately 30 basis points from last year.

Now I'll discuss the financial results of each of our businesses starting with P&C. The Property & Casualty insurance segment reported a net operating loss of $1 million for the quarter, compared to net operating income of $19 million last year.

Overall, the P&C segment's combined ratio increased nearly 9 points to 107.6% for the quarter, due to higher catastrophe losses and a higher insurance expense ratio, partially offset by improved underlying loss and LAE results.

The underlying loss in LAE ratio improved 3.6 percentage points to 66%, primarily from higher average earned premium rates in personal auto and homeowners.

Despite a $5 million drop in total insurance expenses, the expense ratio increased 1.4 percentage points to 28.3% in the second quarter, driven by the lower premium base.

I will now shift to the Life and Health insurance segment. Net operating income was $16 million for the quarter, compared to $20 million last year. In the second quarter, net investment income decreased $2 million, compared to last year. Insurance expenses increased $2 million, as higher startup cost related to our growth initiatives and higher legal expenses were partially offset by lower home service agent commissions.

I will now cover book value, capital and parent company liquidity. Book value per share was $39.98 at the end of the quarter, up more than 8% from year end, largely from the impact of lower market yields on our fixed maturity portfolio and net income. Book value per share, excluding unrealized gains on fixed maturities was $35.32, up 2% from year end.

Statutory surplus levels in our insurance companies remain strong. And we estimate that we will end the year with risk base capital ratios of approximately 415% for our Life and Health group and 345% for our Property & Casualty group.

Overall, we estimate that we ended the quarter with more than $250 million of excess capital.

During the quarter, the Property & Casualty group paid a dividend of $100 million to the holding company, and we are considering taking an additional ordinary dividend of up to $38 million during the remainder of the year. We plan for the Life and Health group to pay a dividend of about $80 million during the second half as well.

Turning to liquidity. At the end of the quarter, the parent company held cash and investments of about $300 million, and our $225 million revolving credit line remained undrawn.

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

Donald G. Southwell

Former Chairman, Chief Executive Officer and President

Thanks, Frank. As you just heard, our capital position continued to strengthen. Our long-term capital deployment priorities remain as follows: first, funding profitable organic growth; second, strategic acquisitions; and third, returning capital to shareholders, both through share repurchases and dividends.

We are selectively funding organic growth in certain areas, yet in total, premium revenues are declining in 2014. As a result, organic growth will not use capital this year.

As for our second priority, we routinely evaluate opportunities for strategic acquisitions and are keeping some powder dry.

Turning to our third priority, returning capital to shareholders, we substantially completed our $300 million share repurchase authorization in July. In addition, this week, we received board approval for a new $300 million share repurchase authorization.

In the second quarter, our share repurchases totaled $68 million at an average price of $35.72. Additionally, we maintained our competitive dividend, paying $13 million in the quarter.

We have a higher level of capital at the parent than we typically hold. This creates flexibility, but it also creates challenges to the denominator of the ROE, as we continue on our path to achieving a double-digit ROE.

We remain committed to improving our top and bottom line results, and we're optimistic about our long-term prospects.
With that, I'll turn the call back over to the operator, so we may take your questions. Operator?

Question and Answer

Operator

[Operator Instructions] Our first question comes from Paul Newsome with Sandler O'Neill.

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

I want to ask a couple of questions about the lapsation on the Life side with the A&H products. And if you could give us some sense of whether or not we'll see some more of those sort of ObamaCare-type products being forcibly lapsed.

Edward J. Konar
Former Vice President and Life & Health Group Executive

Yes, Paul, this is Ed Konar. Yes, I'd be happy to expand on that a little bit for you. Coming into 2014, we had about $15 million of annualized premium on a block of policies that had to be non-renewed in accordance with ObamaCare. And those non-renewals occur on the policy anniversary date. So for the first half of the year, approximately half, give or take, of those policies had to be non-renewed. So we will have some additional non-renewals for the balance of the year.

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

Are there additional blocks that will be non-renewed after this year?

Edward J. Konar
Former Vice President and Life & Health Group Executive

No. That's the only one that has to be non-renewed.

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

And then -- and sort of relatedly, can you talk about the expense levels? I was little bit surprised to see an elevated level of expenses for the sort of new product efforts. It sounds like -- my understanding is you've been working on this for a while, and I'm curious as to why we're seeing the elevated expenses now, as opposed to -- I assume there's a fairly run rate effort because I assume you've been incurring these expenses along the way.

Edward J. Konar
Former Vice President and Life & Health Group Executive

We have 3 initiatives. The first is senior solutions, that's the one that's been around the longest. We started that in late 2012 and that one, the run rate is -- we are getting pretty close to spending on a run-rate basis like you suggested. But 2 of the other businesses, Kemper Benefits and Kemper Dental are more immature, they're newer. And in fact, the bulk of the spending for the quarter was in the Kemper Benefits business, which probably has the biggest potential and has the biggest cost structure associated with it. I'm not 100% what the expenses will be for that business for the balance of the year, but the spending in the second quarter was substantial.

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

So should we expect that, that sort of drag on earnings should continue for a bit?

Edward J. Konar
Former Vice President and Life & Health Group Executive

We'll continue to spend the money, but I think what we'll see is some premium revenue starting to materialize with those businesses.

Operator

Our next question comes from Steven Schwartz of Raymond James & Company -- or Associates.

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

I just wanted to follow up on those actually and then go into something else. The product that is lapsing now, this is not the old MiniMed product, is it? That should be gone by now, no?

Edward J. Konar
Former Vice President and Life & Health Group Executive

No, it is the old MiniMed. And the transition dates and the grandfathering rule for this particular block required that they be non-renewed this year. They're actually some other ones that are grandfathered that don't have to be not renewed. But consumers, now that they have other opportunities in the public exchanges, may opt for other coverages.

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

Okay. You don't have, CMS come out and basically come down on hospital indemnity policies. You have don't have any of that on your books, do you?

Edward J. Konar
Former Vice President and Life & Health Group Executive

No, we have hospital indemnity policies. And I think where they've come down is they don't want sales of those products unless you can demonstrate that the customer has a major medical policy also.

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

Okay. So you're -- yes, you're good with that then.

Edward J. Konar
Former Vice President and Life & Health Group Executive

Yes, yes.

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

Okay. And then on the Kemper Benefits. Could you tell us -- we haven't had a whole lot of information on this. Maybe the type of products you're going to be offering, and who you're going to be offering to? What kind of case sizes or anything like that?

Edward J. Konar
Former Vice President and Life & Health Group Executive

Sure. It's basic plain vanilla worksite, marketing, voluntary employee-type coverage. So accident plans, critical illness plans, first occurrence cancer, first occurrence heart attack, things like that. Also some gap coverages, some hospital indemnity-type coverages where employees can supplement what products their employers offer them in their basic benefit plan offerings. The kind of employers we're targeting is medium to small employers, maybe 50 to 500 lives. Although we've actually seen some interest from companies with slightly larger employee bases of up to a couple, 3,000.

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

Okay. That's interesting. And then I just -- Denise, on your non-cat loss expense. For instance, the underlying loss ratio was obviously very, very good. Congratulations on that. A couple of companies have had noted a very, very high level of non-cat losses in the quarter for various reasons. I take it that did not occur for you?

Denise Idell Lynch
Former Property & Casualty Group Executive

Thank you, Steven. I think our non-cat portfolio our ex-cat portfolio performed better for us and well for us. Having said that, storm activity, non-cat storm was still active. So certainly active and certainly through the year with the tough winter start, with the very cold and long winter that we had. So we feel good about the progress we're making on underlying on home. But there was activity.

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

Okay. And it this past, Denise, you've talked to us about the type of rate increases you're filing for. Can you still talk to that? Are you still filing for rate increases?

Denise Idell Lynch
Former Property & Casualty Group Executive

Yes. We continue to. So as I said, we feel pretty good about the direction that we're moving, but we have more work to do. So really on our private passenger auto line and our home line, we're anticipating filing this year between 7% and 8%.

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

Okay. Great. And then one more, just for Frank. Frank, was the RBC on Life 415% or 450%?

Frank Joseph Sodaro
Former Senior Advisor

It was 415%.

Operator

[Operator Instructions] Our next question comes from Adam Klauber with William Blair.

Adam Klauber
William Blair & Company L.L.C., Research Division

I may have missed this, but in the improvement in the non-cat auto accident, your loss ratio. How much of that was a result of the direct? And how much from the other auto operations?

Denise Idell Lynch
Former Property & Casualty Group Executive

Thank you, Adam. We don't break out by business segment. We're reporting by full P&C segment and then by line of business. So we can't break that out. What I can say though, is that we feel good about private passenger and the direction of really, all the lines of business that make up private passenger for us and the underlying improvement.

Adam Klauber
William Blair & Company L.L.C., Research Division

But can you give us any sense because -- I mean, I appreciate the new business presentation, it actually makes it easier. But when you were breaking it out, you could see there was a lot of improvement in the direct business, but the other business, you're go-forward business, it wasn't really getting better. I mean, it was getting less worse, but you haven't seen improvement. So that's what I'm trying to get at, is the core business actually showing improvement, or is it really still mainly coming from the direct portion?

Denise Idell Lynch
Former Property & Casualty Group Executive

No. The core business is improving as well as our -- as well as feeling good about our Kemper Direct runoff and how that book business is performing.

Adam Klauber
William Blair & Company L.L.C., Research Division

Okay. That's helpful. Then on the homeowners, are you seeing the environment I mean, getting, I guess, a little more competitive compared to a year ago?

Denise Idell Lynch
Former Property & Casualty Group Executive

I paused there because I think it's probably more local than, I'd say, a broad trend. I'd still say the auto market certainly is more competitive than the home market. Certainly, our other competitors talking about wanting to grow home, so I suppose we hear in the marketplace that home may be softening a bit. But I really think it's more local than that, and it depends where in the country we're talking about, and what type of risks going on the books.

Operator

Our next question comes from Matthew Carletti with JMP Securities.

Matthew John Carletti
JMP Securities LLC, Research Division

I just wanted to ask a question on kind of exposure management efforts. The quarter was obviously had a big impact from cats. If my math's is right, kind of, EPS was reduced by 81% in the quarter and 44% in the half. And when you look at whether it be PCS or some of the kind of industry-wide publications, they're looking at the first half and the second quarter as average or slightly better than average on a 10-year basis. And one of the better cat years or at cat quarters since 2009, 2010, so I guess 2 questions. One is what's different what about your book lies than, say, the broad industry? Were there certain events in certain states that drove your particular losses in the quarter? And then secondly, can you just kind of update us on maybe what inning you think we're in in the exposure management efforts? What you're still doing at this point and how much longer you think it needs to play out until we're -- I know they're never done, but maybe substantially complete in the efforts.

Denise Idell Lynch
Former Property & Casualty Group Executive

Okay. Let me try to take a stab at those. Yes, catastrophe management has been very important to us. We treat it in terms of type of exposures we take on, homes we insure, the coverages, the deductibles, and of course, in terms of pricing. When we look at the second quarter, at Kemper, it was a difficult quarter for us, no doubt about that. There were more than a dozen storms. But there were really a couple storms in particular that were very costly to us. And they -- one happened in April, and another one happened in May. So when I think about catastrophe management, we've been focused hard on hurricane and earthquake. We've also been focused on wind, hale, tornado. But the reality is, some carriers will be hit more significantly than others, depending exactly where a tornado hits or where a certain hailstorm hits. And unfortunately, this was our quarter to get hit with a pretty deep catastrophe in the quarter. So when I say -- when I think about your second question about where are we? I think we are well into the game and improving our and addressing catastrophe management. So improving catastrophe management and addressing it. But there's more work to do and particularly, when we think about severe conductive storm or wind, hail, tornado losses and where our share is and how it's distributed across the country and how we respond with either coverage deductible or price.

Matthew John Carletti
JMP Securities LLC, Research Division

That's very helpful. And then just one quick follow-up on that. You mentioned kind of one storm April, one in May. What was the geography of each of those, the kind of -- the particular state that drove it?

Denise Idell Lynch
Former Property & Casualty Group Executive

Well, in both of those cases, there are multiple states involved in both of them. Several, several states involved. In one storm, the April storm, Texas was probably our hardest hit state, and then in our May storm, well, again, more than 10 states involved with that one. Our hardest hit state was Montana.

Operator

[Operator Instructions] And I'm not showing any further question at this time. I'd like to turn the call back over to Don Southwell, CEO.

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

Thank you, operator. I have just a few closing remarks. In the second quarter, our underlying results improved in the Property & Casualty segment, yet catastrophes, as you just heard, were significantly elevated. Our Life and Health segment profits were lower in part, due to our growth initiatives on the Kemper Senior Solutions and Kemper Benefits businesses. And our investment portfolio continued to deliver good results. We're focused and remain committed to delivering the shareholder returns we all seek. Thank you for your time this morning, and we look forward to updating you again on our next call.

Operator
Ladies and gentlemen, that concludes today's presentation. You may now disconnect. And have a wonderful day.