S&P Capital IQ

CONTENTS



# American Financial Group, Inc. NYSE:AFG

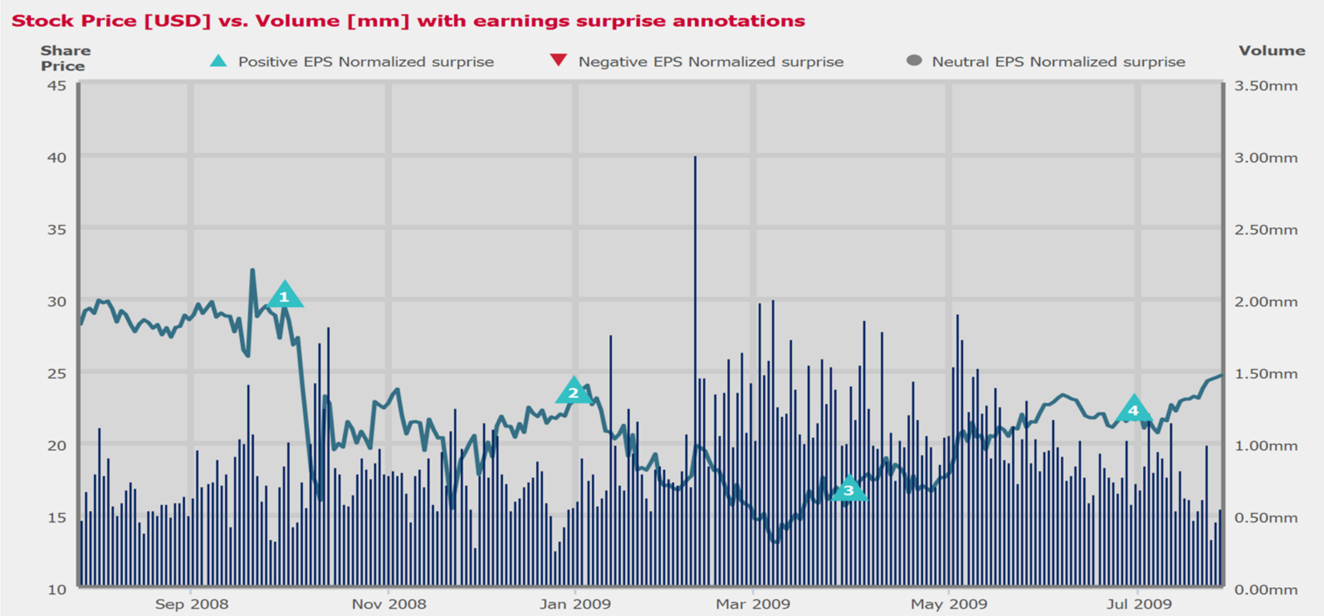
*FQ3 2009 Earnings Call Transcripts*

Tuesday, October 27, 2009 3:30 PM GMT

## S&P Capital IQ Estimates

| | -FQ3 2009- | | | -FQ4 2009- | -FY 2009- | -FY 2010- |
|---|---|---|---|---|---|---|
| | CONSENSUS | ACTUAL | SURPRISE | CONSENSUS | CONSENSUS | CONSENSUS |
| **EPS Normalized** | 0.88 | 1.07 | ▲20.22 | 0.82 | 4.00 | 3.78 |
| **Revenue (mm)** | 853.60 | 622.00 | ▼(27.13 %) | - | - | - |

Currency: USD
Consensus as of Oct-27-2009 11:03 AM GMT




- EPS NORMALIZED -

| | CONSENSUS | ACTUAL | SURPRISE |
|---|---|---|---|
| **FQ3 2008** | 0.95 | 0.98 | ▲1 3.16 % |
| **FQ4 2008** | 0.94 | 1.04 | ▲2 10.64 % |
| **FQ1 2009** | 0.98 | 1.11 | ▲3 12.12 % |
| **FQ2 2009** | 0.92 | 1.01 | ▲4 9.78 % |

# Call Participants

## EXECUTIVES

**Carl H. Lindner**
*Co-Chief Executive Officer, Co-President and Director*

**Keith A. Jensen**
*Former Chief Financial Officer and Senior Vice President*

## ANALYSTS

**Amit Kumar**
*Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division*

**Jay Adam Cohen**
*BofA Merrill Lynch, Research Division*

# Presentation

**Operator**

Good morning. My name is Sandrel, and I will be your conference operator today. At this time, I would like to welcome everyone to the American Financial Group 2009 Third Quarter Earnings Conference Call. [Operator Instructions] And now, I'd like to turn the conference over to Mr. Keith Jensen, Senior Vice President of American Financial Group. Please go ahead, sir.

**Keith A. Jensen**
*Former Chief Financial Officer and Senior Vice President*

Thank you very much and welcome. I'm here this morning with Craig Lindner and Carl Lindner III, Co-CEOs of American Financial Group. I'm pleased to welcome you to the American Financial Group 2009 Third Quarter Earnings Results Conference Call. If you're viewing the webcast from our website, you can follow along with the slide presentation if you'd like.

Certain statements made during this call are not historical facts and may be considered forward-looking statements and are based on estimates, assumptions and projections, which management believes are reasonable, but by nature subject to risks and uncertainty. The factors which could cause actual results or financial conditions to differ materially from these 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 our annual report on Form 10-K and quarterly reports on Form 10-Q. We do not promise to update such forward-looking statements to reflect the actual results or changes in assumptions or other factors that could affect those statements.

Core net operating earnings is a non-GAAP financial measure, which sets aside items that are generally 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 other non-recurring items. AFG believes this non-GAAP measure to be a useful tool for analysts and investors in analyzing ongoing operating trends and will be discussed for various periods during this call. A reconciliation of net earnings attributable to shareholders to core net operating earnings is included in our earnings release. Now I'm pleased to turn the call over to Carl Lindner III, Co-Chief Executive Officer of American Financial Group to discuss our results.

**Carl H. Lindner**
*Co-Chief Executive Officer, Co-President and Director*

Good morning, and thank you for joining us. We released our 2009 third quarter results yesterday afternoon. AFG has again posted record operating results, even as we are faced with an economic downturn and competitive market conditions. We also announced yesterday an increase in AFG's annual dividend to $0.55 per share beginning in January of 2010. This dividend will be the fifth consecutive annual dividend increase for the company and represents a 6% increase over the dividend paid in 2009. We believe it underscores the confidence of the board and management in the company's business and long-term financial outlook.

We thank God for his blessings and we're grateful for our management team for their excellent work during this time of economic challenge. We believe that the depth and breadth of AFG's specialty insurance expertise has enabled us to deliver high-caliber service to our policyholders and agents and produce long-term value to our shareholders.

I'm assuming that the participants on today's call reviewed our earnings release and the supplemental materials posted on our website. I'll review a few highlights and focus today's discussion on key issues and our outlook for the remainder of 2009 and 2010.

Our record third quarter and year-to-date core net operating earnings per share were up 9% and 5% from the same 2008 periods, reflecting improved underwriting results in our Specialty Property & Casualty Operations. We have an annualized return on equity of about 16%, including realized gains and losses for the first nine months of this year. Our net earnings of $1.09 per share for 2009 third quarter and $3.07 for the first nine months of 2009 were also substantially higher than the prior-year periods, primarily because of improved core earnings and realized gains on investments, which include the offsetting effect of impairment charges.

Earlier this month, we announced the fourth quarter after-tax realized gain of approximately $50 million or $0.42 per share on the sale of our 35% of our holdings in Verisk Analytics. We're very pleased with our returns on this investment and continue to hold approximately $6.7 million shares of Class B common with the cost basis of approximately $24 million. Class B common shares are convertible into Class A shares on a share-per-share basis after the expiration of holding periods and had a market value of $191 million at yesterday's closing price.

Interest and other corporate expenses increased from the third quarter period, primarily due to increased borrowing costs and expenses associated with their employee benefit plans. As you'll see on Slide 4, AFG's book value per share, including all unrealized gains and losses on investments increased to $31.49, as a result of the strong earnings performance and a significant improvement in the market value of our investment portfolio. This represents an increase of 46% from the $21.54 per share reported at the end of 2008. Intangible book value was $29.17 at September 30, 2009, up 53% from year-end 2008.

Our capital adequacy, financial condition and liquidity remain strong and are key areas of focus for us, especially in these times of economic uncertainty. We've maintained capital on our insurance businesses at levels that support our operations and are consistent with amounts required for our rating levels.

We are pleased to have completed a $350 million debt offering earlier this year. We used the proceeds of this offering to repay an outstanding indebtedness on our bank line. While we're paying a higher rate of interest as compared to the rates of the bank line, prudent capital management remains a priority and we see this new debt as an additional source of financial flexibility and liquidity. Our leverage of 19%, remains well below the levels committed to the rating agencies in the market.

At the end of September, available liquidity at the parent company was in excess of $500 million, based on borrowings available under our bank line and cash and securities held at the parent company. We anticipate continuing to generate additional capital and cash through operations through the remainder of 2009.

Our cash and cash equivalents of $1.4 billion in our insurance companies, along with our annuity groups, membership in the Federal Home Loan Bank of Cincinnati, provide us with great liquidity to meet any unexpected events.

We're pleased that earlier this month Standard & Poor's changed our rating outlook from stable to positive. We believe this change is, in part, recognition of our strong operating earnings and the strength of our balance sheet and capitalization.

Now turning to Slide 5, you'll see summary results of our Specialty Property & Casualty operations. Overall, underwriting profits in the 2009 third quarter were excellent, generating a combined ratio of 83%, a nine-point improvement over the third quarter of '08. The largest components of this improvement included $51 million of improved underwriting profit from our run-off automobile residual value insurance operations, as a result of significant improvement in used car values during the first nine months of the year. And $30 million of increased profitability in our crop operation resulting from strong crop yields and favorable trends in commodity prices.

These favorable results were partially offset by reduced underwriting results in several of our other businesses. We remain satisfied with the underwriting profits of most of our Specialty businesses and we achieved accident year returns in the mid-teens.

We continue to focus on pricing our business to achieve appropriate returns. The average renewal rates in the Specialty operations in the first nine months of 2009 were up slightly from the prior-year period. The decrease in net written premiums for the third quarter that were primarily the result of changes in our reinsurance for the Crop business. We have an agreement under which we seeded 90% of our net premium as compared to 50% in 2008. We are considering returning to the prior level of sessions for

2010, around 50%. A related profit-sharing component allows us to benefit from the favorable results in this business.

Soft market conditions and planned volume reductions in certain product lines also contributed to the premium declines. The economic downturn has impacted premium levels as some of our insured several lower premium base, such as in our California Workers' Comp business. Also affected are our general liability and property lines that serve homebuilders who are rebuilding fewer properties. Some of these business owners also choose to reduce coverage in tough economic times.

Excluding crop, the overall decrease in net premium written premium for the quarter was about 11%. Gross investment income related to our Property & Casualty Operations was up approximately 4% for the quarter when compared to the same period last year, as we have benefited from higher yields in this segment's portfolio.

Now I'd like to discuss a few highlights from each of our Specialty Business groups on Slides 6 and 7. Property and Transportation group generated excellent underwriting results during the third quarter and first nine months of 2009, reporting increased underwriting profit and improvements in the combined ratio. Higher underwriting profits were driven primarily by improved results in our crop operations and lower catastrophe losses in our Property & Inland Marine operations. According to data provided by the USDA, average corn and soybean yield estimates are running about 7% higher than last year's yield. Harvested corn and soybean crops, however, are lower than normal for this time of the year. Not withstanding some of the uncertainties surrounding a late harvest, we expect to have a very favorable crop results for the year.

Commodity pricing for corn has held up nicely since the February base pricing, while soybeans are up about 14%. Given that the majority of our business is written with the deductible for the farmer of 25% or greater, we think pricing-related losses will be minimal this year. This group's average rates on renewal for the first nine months of the year were down slightly when compared to the same period a year earlier.

Moving on to our Specialty Casualty group, this group continued to produce strong underwriting profits in the third quarter and the first nine months, but at lower levels than 2008. Improved underwriting results in our executive liability operations were more than offset by lower underwriting profits in our excess and surplus funds, general liability and targeted markets operations. Average renewal rates for the first nine months were flat compared to 2008.

Significant competitive pressure in the excess and surplus lines continues and seems to be showing a little sign of abating. Some of these businesses moved back to standard lines in the wake of soft market conditions and rates in the non-admitted market are at fraction of what they were in the hard market in 2000. We continue to see aggressive competition from tax-advantaged Bermuda companies, yet we have focused on maintaining our underwriting discipline to generate healthy returns in these lines of business and to deliver high-quality service to our policyholders.

Specialty Financial group reported excellent underwriting profits for the third quarter and first nine months, driven by the improved results in our run-off RVI business. Our remaining RVI reserves relate primarily to Canadian RVI contracts with Honda that terminate through the end of 2010. If frequency and severity continue at current levels, we would expect additional favorable development.

The foreign trade credit operations achieved significant rate increases for the first nine months of 2009. Average rate renewal rates for the other businesses in this group were flat. Our California Workers' Comp business reported a small underwriting loss for the third quarter and first nine months of 2009. Underwriting results were affected by lower prices, due to a competitive environment.

We are seeing some increases in severity trends in this business, primarily related to increases in medical costs. We are encouraged to see rates strengthening in this part of our business, as our average renewal rates in California are up 6% for the quarter.

The WCIRB [Workers' Compensation Insurance Rating Bureau] has recommended a 22.8% increase in pure premium rates effective January 1, 2010, based on 2009 loss experience and anticipated loss costs from recent court decisions about the permanent visibility rating schedule and is subject to administrative review. We do believe that more rate is needed to achieve appropriate returns in this part of our business.

Now I'd like to move on to a review of our Annuity and Supplemental Insurance group on Slide 8. Profitability of the fixed annuity line has benefited from the impact of increased spreads during 2009. Our Annuity and Supplemental Insurance operations helped us fulfill our specialization strategy and balance the ebbs and flows of the overall property and casualty insurance market cycles.

The Annuity and Supplemental Insurance group generated pretax core operating earnings for the third quarter that were approximate 5% lower than the comparable period in 2008. However, the first nine months of these earnings are 6% above the same 2008 period. Increased spreads in our fixed annuity lines have been a primary contributor to these results. Lower operating earnings in our supplemental insurance operations more than offset these improvements in the third quarter.

We continue to experience strong persistency in our Annuity business. For the first nine months of 2009, surrenders in our fixed annuity block are unchanged over the same period last year, as many of our annuities are designed with surrender-protection features. We continue to move to our product designs that reward policyholders and agents for long-term persistency. We believe the focus on healthcare reform and Medicaid cost reduction could expand demand for our supplemental health products.

Statutory premiums for the third quarter of 2009 were lower than those in the third quarter of 2008, primarily due to the lower sales of indexed annuities in the single premium market. The decrease in premium is consistent with our strategy of exercising financial discipline and the pricing of our annuity products.

Now please turn to Slide 9 for a few highlights regarding our investment portfolio. During the third quarter of 2009, we recorded after-tax realized gains on investments of $3 million, including the offsetting effect of other-than-temporary impairments of $17 million after-tax. After-tax unrealized gains were $127 million at September 30, 2009. Vast majority of our portfolios held on fixed maturities with approximately 92% being investment grade. We have provided additional detailed information on the various segments of our investment portfolio in the investment supplement on our website.

Now I'd like to cover our expectations for the remainder of 2009 on Slides 10 and 11. We have increased our core net operating earnings guidance for 2009 to be between $4.05 to $4.25 per share. Key factors influencing this change, include better-than-expected underwriting results in our crop operations and a favorable development in our run-off RVI operations.

We expect to maintain the adequate rates in our Specialty Property and Casualty operations because of our strong underwriting culture and expect to achieve a combined ratio of about 81% to 83%. That said, we're targeting flat to modest increases in overall average renewal rates for the remainder of the year.

We expect net written premiums in our Specialty Property and Casualty operations to be down 17% to 20% from 2008 levels, primarily due to the increase reinsurance sessions under our crop quota share agreement and the weakness in the economy. Excluding crop, we expect the decline of 6% to 9%.

Based on recent market conditions, we expect full-year core operating earnings in our Annuity and Supplemental Insurance group to be 8% to 10% higher than in 2008, excluding the potential effect that the customary fourth quarter review of deferred acquisition costs. We expect that any resulting DAC write-off will not have a material impact on AFG's earnings guidance for the year. You'll find additional details about our outlook for the Specialty Property and Casualty segments on Slide 11.
Now I'd like to cover our outlook for 2010 on Slide 12. We announced yesterday that we expect our 2010 core net operating earnings to be in the range of $3.10 to $3.50 per share. This guidance is lower than that for 2009, due to the level of favorable reserve development recorded in '09, especially in our run-off RVI business. The above average profitability projected in our crop operations in 2009, a continued soft market and lower investment returns expected in 2010. The 2009 and 2010 expected results, excluded potential for significant catastrophe and crop losses, significant adjustments to A&E and large gains or losses from asset sales or impairments. Now we'd like to open up the lines for any questions. Thank you.

# Question and Answer

**Operator**

[Operator Instructions] Your first question comes from the line of Amit Kumar with Fox-Pitt Kelton.

**Amit Kumar**
*Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division*

Strong results, I guess just going back on your color on the rates, Bill Berkley in his comments this morning, talked about the industry where he suggested that '09 accident year would be 108 to 110 and 2010 will be 110 to 112 and he forecasted that this would eventually lead to price increases of roughly 8% to 10% for 2010 and perhaps even more for 2011. Based on your business segment and what you're seeing out there, would you sort of directionally agree with this forecast or are you seeing something different in your business lines?

**Carl H. Lindner**
*Co-Chief Executive Officer, Co-President and Director*

Well, first of all, let me speak to the industry and Bill's comments about the industry. It's hard to put a precise time on when things are going to happen, but the rubber has to hit the road here, with regards to increasing accident year combined ratios and the need for additional price for the industry. Clearly, we think we're operating with better underwriting results than the industry. So that said, we feel our accident years today for '09, still give us in the mid-teens kind of ROEs, but in California comp, clearly, we need rate. We got 6% a quarter, but we probably need another 10% to 12% on top of that to assure us that we can produce the accident year underwriting profitability in that business that we need long term. In property and transportation, those are kind of unique businesses. The crop business is in a class of its own and doesn't really correlate to allow the other businesses in the industry, which I think is probably a strength for us and that doesn't really correlate to hurricane and cat-exposed property or other businesses. So that business is clearly a lot different and kind of stands on its own, as well as maybe some businesses like equine mortality or financial institutions or financial institution's book in our Specialty Financial part that really is kind of the contra-core economy kind of a business where it's actually growing pretty good. That said, many of our Property and Transportation and Casualty businesses, we need to achieve some rate. I think our 2010 guidance clearly reflects my opinion about prices. We're trying to reflect very reasonable, realistic viewpoint of where accident year combines are going for us and for the industry, in that guidance.

**Amit Kumar**
*Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division*

I guess just related to that, in terms of the competition and I know you talked about that in the opening comments, but are you seeing sort of inflection point where you see that the margins are being eroded for them, and hence they are at the point where they might start pulling back or is the aggression still the same?

**Carl H. Lindner**
*Co-Chief Executive Officer, Co-President and Director*

I think we're in a competitive environment, so not a crazy competitive environment. And generally, when you listen to everybody's earnings reports and generally, everybody -- rates on renewal are fairly stable but there is a -- it's a very competitive for new business. And some large competitors that have been on the road to protecting renewals pretty substantially. And so I'd say that this is a competitive market, very competitive marketplace, not crazy at this point. And I think everybody, I think the industry is on the verge of growing, needing some substantial rate.

**Amit Kumar**
*Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division*

Can you maybe also talk a bit about sort of the claims inflation trends you might be seeing?

**Carl H. Lindner**
*Co-Chief Executive Officer, Co-President and Director*

I don't think we're seeing anything unusual. I think California, the only segment prior, it's a little different California comp were, because of reformed we saw very moderate inflation in the past. I think we're back to a more normal severity or inflation mode in California comp, now that were away from reform.

**Amit Kumar**
*Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division*

And then what's your forecast overall as we head into, maybe coming out of this recessionary environment. When do you see that change or I guess pick up down the road?

**Carl H. Lindner**
*Co-Chief Executive Officer, Co-President and Director*

There's a chance that you could see inflation tick up a couple of years from now, certainly doesn't seem to be any signs right now in any of the industry statistics or in our claims stats net [ph] (33:13). Keep in mind, AFG might be a little bit different in that, 45% of our businesses, short-tale property, transportation, shorter-tale businesses to begin with, so inflation probably doesn't have as big a potential impact on reserves or long term.

**Amit Kumar**
*Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division*

Can you remind us what were the remaining reserves on the RVI book, I think you mentioned in the opening comments that if trends continue, there could be a possibility of additional reserve releases?

**Keith A. Jensen**
*Former Chief Financial Officer and Senior Vice President*

The remaining reserves as of the end of the year were in $50 million range, both domestic and Canadian reserves.

**Amit Kumar**
*Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division*

Can you talk a bit about -- there's news release out there, which talks about the sale of the Premier Dealer Services to PDS Holdings?

**Keith A. Jensen**
*Former Chief Financial Officer and Senior Vice President*

Sure, that is a third party administrator that works, primarily on product in the auto market. It's an area that we have strategically concluded that we're going to disengage from, we've come -- we've discontinued our excess wear and tear and our GAAP product and so this is part of that departure rates [ph] (34:41) It's a very small dollar value for us.

**Amit Kumar**
*Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division*

When you talk about the 2010 guidance, can you sort of give some, in a sort of broad guidelines similar to what you have on Slide 11? What you do for '09? Can you sort of just briefly go through at least some of the lines and talk about 2010?

**Carl H. Lindner**
*Co-Chief Executive Officer, Co-President and Director*

We're kind of right in the middle of our business planning right now. Generally, we released that information but it usually comes with our year-end results.

**Operator**

Your next question comes from the line of Abe Schloss [ph] (35:32) with Maxim Group.

**Analyst**

You announced you're taking $50 million gain on VRSK in the fourth first quarter, and I'm just wondering how you translate that gain, plus the unrealized gain we have in the stock with stock at $28 into our current book value?

**Keith A. Jensen**
*Former Chief Financial Officer and Senior Vice President*

All of that is included in the current book value. If you think of it, we've got about $117 million shares outstanding and on our remaining holdings in Verisk, they would be at a value at yesterday's closing in $190 million range with $25 million of cost basis, so call that 165, so it would be approximately $1.5 of book of value associated.

**Analyst**

That's in our book value then.

**Keith A. Jensen**
*Former Chief Financial Officer and Senior Vice President*

That's pretax, $1 after-tax.

**Operator**

And your next question comes from the line of Jay Cohen with Bank of America Merrill Lynch.

**Jay Adam Cohen**
*BofA Merrill Lynch, Research Division*

Just to follow up on the Verisk question, so the remaining ownership, that will be mark to market going forward?

**Carl H. Lindner**
*Co-Chief Executive Officer, Co-President and Director*

Yes, that's correct, Jay.

**Analyst**

Assuming the stock stays where it is. I want to switch to the topic of capital, obviously you GAAP equities recovered dramatically, statutory surplus has continued to creep up, premiums shrinking. It looks like just based on simplistic measures that you're getting back to a level of excess capital. I know you guys, think about it relative to the rating agencies, so I'm wondering, how you feel about your capital relative to what is needed from a rating standpoint.

**Carl H. Lindner**
*Co-Chief Executive Officer, Co-President and Director*

We feel real good, we've got, as I mentioned before over $500 million of liquidity. We're at the capital levels we need for the business and that -- so that allows us, so that allows us to do what do best and that's, find things to businesses to add, businesses to acquire. We're always looking. Also, gives us the flexibility to potentially repurchase shares if we feel that as a good investment. And we just increased our common stock dividend, so I think between all those three kind of things, those are the things that we're looking for, as well as the normal organic growth opportunity. So the economy clearly slowed the opportunity for usual organic growth in our line.

**Analyst**

I think other thing, Jay, that I highlighted is we are doing all of the those things that a parent company perspective but in the operating company, from a statutory perspective, the level of capitalization is at the top or above the capital, required for the rating categories depending on whether you're looking at the BCAR or the S&P cap adequacy?

**Carl H. Lindner**
*Co-Chief Executive Officer, Co-President and Director*

I think, Jay, even with the recovery in the market, after such a volatile couple of years in the economy and we want to keep a little powder dry, just for potential opportunities or defensively. Things continue to bounce around a little bit.

**Analyst**

Do you think about opportunities to deploy excess capital? You start trading 80% of reported book value, does that make share repurchase the more attractive alternative, if you're goal is to grow book value per share?

**Carl H. Lindner**
*Co-Chief Executive Officer, Co-President and Director*

I would think so.

**Analyst**

And I'm assuming in your 2010 guidance, there's no share repurchase activity assumed in that guidance?

**Carl H. Lindner**
*Co-Chief Executive Officer, Co-President and Director*

That's correct.

**Operator**

[Operator Instructions] And you do have a follow-up question from Amit Kumar with Fox-Pitt Kelton.

**Amit Kumar**
*Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division*

In terms of your capital levels, are there any segments or a specific lines you would be interested in, in sort of expanding down the road?

**Carl H. Lindner**
*Co-Chief Executive Officer, Co-President and Director*

I think outside of the business as Keith talked about in the auto-related financial insurance product. We're in interested in expanding really pretty much all of our businesses, as the right opportunities come along.

**Amit Kumar**
*Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division*

So no new entities or niches I guess.

**Carl H. Lindner**
*Co-Chief Executive Officer, Co-President and Director*

Sure, we're interested in starting new niche. We started to look in an Environmental Liability business in over the last 12 to 18 months, and we're always starting things up and we're always looking, so pretty good time to look at things.

**Operator**

Thank you, and there are no further questions at this time. I would like to turn the call over to the floor for any closing remarks.

**Carl H. Lindner**
*Co-Chief Executive Officer, Co-President and Director*

Thank you very much. We appreciate you taking the time to be with us this morning, and we look forward to reporting our year-end results early next year. Thank you. Have a good day.

**Operator**
Thank you. Ladies and gentlemen, this does conclude today's conference call. You may now disconnect.