S&P Global
Market Intelligence

American Financial Group, Inc. NYSE:AFG

FQ4 2012 Earnings Call Transcripts

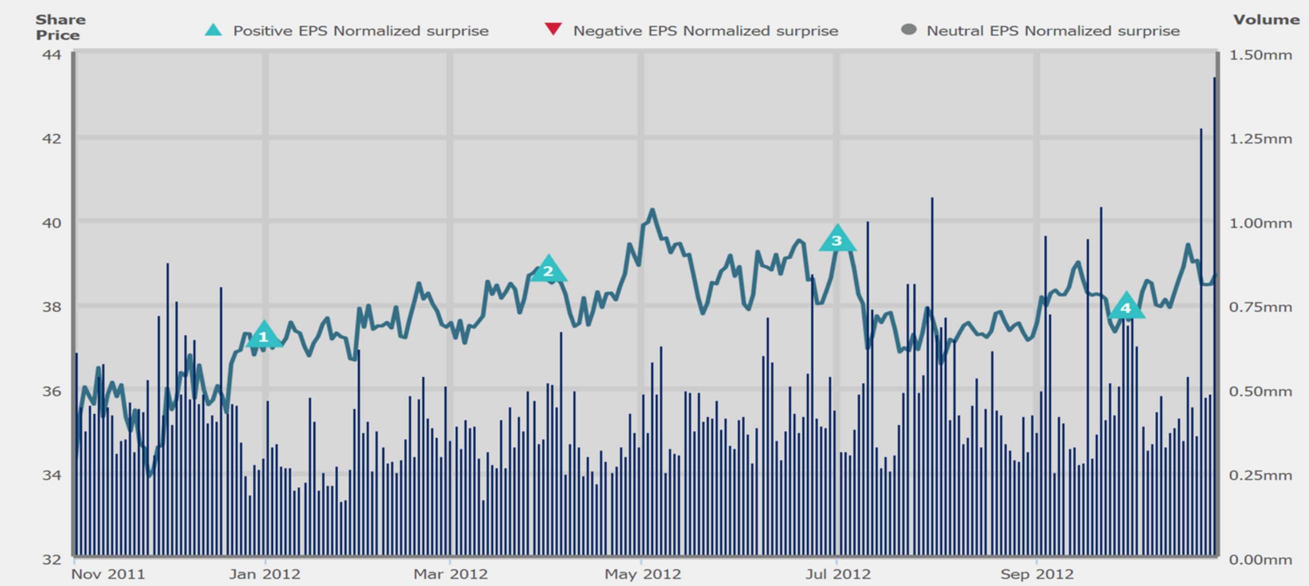
Tuesday, February 12, 2013 4:30 PM GMT

S&P Global Market Intelligence Estimates

	-FQ4 2012-			-FQ1 2013-	-FY 2012-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.67	0.67	▲0.00	0.77	3.26	3.27
Revenue (mm)	870.94	756.00	▲(13.20 %)	720.30	3394.94	2847.00

Currency: USD
Consensus as of Feb-12-2013 1:28 PM GMT

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



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2011	0.94	1.06	▲1 12.77 %
FQ1 2012	0.78	0.86	▲2 10.26 %
FQ2 2012	0.79	0.91	▲3 15.19 %
FQ3 2012	0.60	0.82	▲4 36.67 %

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Call Participants

EXECUTIVES

Carl Henry Lindner
Co-President, Co-CEO & Director

Keith Alan Jensen
Former Senior VP & CFO

ANALYSTS

Amit Kumar
Macquarie Research

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Ryan J. Byrnes
Langen McAlenney

Unknown Analyst

Presentation

Operator

Good morning. My name is Tina, and I will be your conference operator today. At this time, I would like to welcome everyone to American Financial Group 2012 Fourth Quarter Earnings Conference Call. [Operator Instructions]

Kevin Jensen (sic) [Keith Jensen], you may begin your conference.

Keith Alan Jensen
Former Senior VP & CFO

Thank you. Good morning. And welcome to American Financial Group's Fourth Quarter 2012 Earnings Conference Call. I'm joined this morning by Carl Lindner III; and Craig Lindner, Co-CEOs of American Financial Group. If you are hearing 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 their nature subject to risks and uncertainty.

The factors which could cause actual results and/or financial condition to differ materially from those suggested by such forward-looking statements include, but are not limited to those discussed or identified from time to time in AFG's filings with the Securities and Exchange Commission, including the annual report on Form 10-K and quarterly reports on Form 10-Q. We do not promise to update such forward-looking statements to reflect actual results or changes in assumptions or other factors that could affect these statements.

Core net operating earnings is a non-GAAP financial measure, which sets aside significant items that are generally not considered to be part of the ongoing operations, such as net realized gains or losses, the effect of certain accounting changes, discontinued operations, and certain non-recurring items.

AFG believes this non-GAAP measure to be a useful tool for analysts and investors in analyzing and understanding the 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 to discuss our results.

Carl Henry Lindner
Co-President, Co-CEO & Director

Good morning. As we begin this morning, Craig and I wanted to take a few moments to recognize Keith Jensen, as he prepares to retire at the end of March. Today marks his last earnings conference call as AFG's Chief Financial Officer. In addition to providing sound financial leadership and stewardship, Keith's role at AFG extended well beyond serving as our Principal Accounting Officer.

Throughout all of his many contributions and roles, Keith has exemplified integrity both personally and professionally. Keith, we thank you for your leadership over the past 15 years and we are going to miss working with you each day.

Keith Alan Jensen
Former Senior VP & CFO

Thank you, Carl.

Carl Henry Lindner
Co-President, Co-CEO & Director

We released our 2012 fourth quarter and full year results yesterday afternoon. We are pleased to report strong core net operating earnings in 2012, considering a year with a few headwinds for our company and the industry as a whole, including severe drought conditions, natural disasters and economic challenges due to the continued low interest rate environment.

I'm assuming that the participants on today's call reviewed our earnings release and supplemental materials posted on our website. Let me review a few highlights and focus today's discussion on key issues. I'll also briefly discuss our outlook for 2013. Let's start by looking at our fourth quarter and full year results summarized on Slides 3 and 4 of the webcast.

Net earnings were $0.54 per share for the quarter. These results include a charge of $1.08 per share to write-off deferred acquisition costs and strengthen reserves in our run-off long-term care operation.

This non-core charge was partially offset by realized gains, the settlement of open tax years following a favorable decision in AFG's tax case and a gain resulting from a post-closing adjustment to the cash proceeds from the sale of AFG's Medicare supplement and critical illness businesses.

Net earnings attributable to shareholders for the full year 2012 were a record $5.09 per share.

Core net operating earnings were $0.67 per share for the quarter and $3.27 per share for the year. Improved results in our fixed annuity operations were offset by lower underwriting earnings and lower investment income in our specialty property and casualty insurance operations.

Return on equity was approximately 13% for the year, a good result, as we continue to generate strong core operating earnings, realized gains on our investments, focused our annuity operation and resolve several other non-core matters including our tax case.

Our capital adequacy, financial condition and liquidity remain strong are key areas of focus for us. We maintain sufficient capital in our insurance businesses to meet our commitments to the rating agencies in support of our current rating levels.

Our excess capital was approximately $625 million at December 31, 2012, which included cash at the parent company of approximately $279 million. We've continued to deploy our excess capital in ways that enhance shareholder value. We repurchased $100 million of our common stock during the fourth quarter at an average price that was 91% of the December 31, 2012 adjusted book value per share. Share repurchases were $415 million during 2012.

As of February 8, there were approximately 2.6 million shares remaining under our repurchase authorization. We intend to seek an additional authorization at the next scheduled Board meeting. We will continue to make opportunistic repurchases when AFG's shares are trading at an attractive valuation of book value.

Since the beginning of 2008, we have repurchased 35.5 million shares of AFG's stock at an average price that was 86% of our average adjusted book value per share over that period.

Dividend payments and share repurchases have enabled us to return nearly $1.5 billion to shareholders over that same period. AFG's annual total 5 year shareholder return calculated based on price appreciation plus dividends was 8.8%, compared to 1.7% for the S&P 500 and 0.7% for the S&P Property & Casualty Insurance Index. We are extremely pleased with this performance.

In addition to share repurchases and dividends, we've invested excess capital when we see the potential for healthy, profitable organic growth such as the broad range of opportunities we pursue to grow our specialty casualty property and casualty businesses this past year.

Start up of our public sector division this year also provided channel to expand our products into new markets. We're always looking for ways to expand our specialty niche businesses through startups or acquisitions.

Highlights of AFG's core operating results appear on Slide 5. As you'll see on Slide 6, AFGs book value per share excluding appropriated retained earnings and unrealized gains and losses on fixed maturities, increased 10% from the prior year and to $42.52. Tangible book value on a comparable basis was $40.04 at year-end 2012. Five-year compounded growth and adjusted book value per share is approximately 11%.

On Slide 7, you'll see summary results for our specialty, property and casualty operations. Property, casualty, specialty insurance operations reported an underwriting profit of $15 million for the fourth quarter 2012 and generated a combined ratio of 98, a 10 point increase from last year's fourth quarter or 2011 fourth quarter.

The combined ratio was 95 for the full-year 2012, 3 points higher than at 2011. Crop losses resulting from the Midwest drought and catastrophe losses, primarily Superstorm Sandy were the primary drivers of the lower profitability.

Gross and net written premiums increased by approximately 16% and 17%, respectively during the fourth quarter, due primarily to higher premiums in our Property and Transportation and Specialty Casualty groups. Full year 2012 net written premiums were up 6%, slightly higher than the top end of our guidance. This growth was driven mainly by higher premiums in our Specialty Casualty group.

We're excited to see continued price strengthening in most of our property and casualty businesses. And we achieved a 4% overall renewal rate increase in the fourth quarter, which was a sequential improvement in our overall pricing, with nearly 2/3 of our property and casualty businesses reporting pricing increases.

We continue to focus on appropriate pricing on all of our property and casualty lines of business to achieve healthy returns on equity. It is central for us and the industry overall particularly in light of the continued low interest rate environment.

Loss cost trends are stable, appear to be benign across our portfolio businesses. I'm encouraged to see these trends as they will help to drive meaningful growth and value creation in our business over time.

Now, I'd like to discuss a few highlights from each of our specialty business groups on Slides 8 and 9. Specialty, Property and Transportation group, our largest segment, reported lower profitability in the 2012 fourth quarter and full year.

The aforementioned crop losses resulting from the Midwest drought and higher cap losses caused by Superstorm Sandy were the primary factors driving these results. These events combined resulted in less than $45 million in pretax losses for AFG during 2012, largely because of our strategic use of reinsurance.

Full-year 2012 underwriting profit in this group was approximately $19 million. Higher premiums in our transportation operations and additional winter wheat premium in our crop operations contributed to the increases in gross and net written premium in the group during the fourth quarter of 2012.

Gross and net written premiums for the full year of 2012 were impacted by lower spring agricultural commodity prices for corn and soybeans, which have the effect of reducing crop insurance premiums. The decrease in net written premium was more than offset by the growth in our transportation business.

Overall renewal rates in this group increased 4% in the fourth quarter of 2012, following a 4% increase achieved in third quarter. And for the whole year, the average rate increase for this group was about 3%.

Specialty Casualty Group reported higher underwriting profits in the fourth quarter and full year periods. Improved accident year results in several of our operations were partially offset by lower favorable development in our executive liability and excess and surplus businesses.

Increased favorable reserve development in our general liability lines also contributed to higher profitability for this group during the 2012 full year. The majority of our businesses in this group produced strong underwriting profit margins during 2012.

Gross and net written premiums grew by double-digit percentages in both the fourth quarter and full year 2012, illustrating the broad-based opportunities we've seen in many of our lines of business. This growth was primarily the result of more business opportunities in our excess and surplus operations, growth in our workers' compensation and agency captive insurance businesses, and market hardening in many of our other Specialty Casualty operations.

Pricing in this Specialty Casualty group was up 6% for the quarter, a sequential improvement from the third quarter and continuation of the momentum that we've seen in this group during the year. The average rate increase for this group during the whole year was 4%.

Specialty Financial Group reported a slight improvement in underwriting profit in the fourth quarter primarily due to increased favorable reserve development. Full-year 2012 results reflect a 5 point increase in the combined ratio, primarily due to lower profitability in our financial institutions, surety and foreign credit businesses. Almost all businesses in this group produced strong underwriting profit margins during 2012.

For the quarter, gross and net written premiums were up 9% and 7% respectively as a result of higher premiums in our financial institutions and trade credit operations. Increases in gross written premiums were due to higher premiums in our financial institutions business, as well as growth in a service contract business. All of the premiums in the service contract business are ceded under reinsurance agreements. Pricing in the Specialty Financial Group was flat in the fourth quarter and for the full year.

Now, I'd like to move on to review our Annuity and Supplemental Insurance Group on Slides 10 through 13. For the sale of our Medicare supplement and critical illness businesses and because of our continued focus on our fixed annuity business, we've reported these results in more detail this quarter. As such, I will discuss our ongoing results in 2 groups, annuities and runoff operations.

I will also comment on the contribution of our former Medicare supplement and critical illness businesses through the date these operations were sold in August of this year. The Annuity Group reported core operating earnings before income taxes of $68 million in the fourth quarter of 2012 compared to $58 million in the 2011 period.

Pretax earnings for fourth quarter 2012 include a pretax charge to earnings of $13 million due to a review or and unlocking of the company's major actuarial options in its fixed annuity business. That was compared to $1 million in the fourth quarter of 2011.

Fixed annuity, statutory premiums of $545 million in the 2012 fourth quarter were 9% lower than the fourth quarter of 2011. The continued low interest rate environment was a key factor in actions taken during 2012 to lower crediting rates and agent commissions on several of our products, which resulted in an expected slowdown in sales.

For the full-year 2012, the annuity group reported record pre-tax core operating earnings that were 36% higher than in the prior year. This growth in earnings is largely attributable to our ability to maintain spreads on a larger base of invested assets. These results include the $13 million pre-tax unlocking charge reported in the fourth quarter.

Fixed annuity statutory premiums were $2.9 billion in 2012, compared to $3 billion in 2011. As a result of strong sales in the past 3 years, AFG's fixed annuity reserves have grown from $11 billion at the beginning of 2012 to nearly $18 billion at year end 2012.

Our run-off operations include run-off blocks of life and long-term care insurance, which net of reinsurance, amount to less than 3% of AFG's total assets. As previously discussed, fourth quarter 2012 results for these run-off operations include a non-core after-tax charge of $99 million related to loss recognition in our long-term care business.

This charge is primarily due to lower projected future investment rates resulting from the continued low interest rate environment, as well as changes in claims, expense and persistency assumptions. AFG's periodic internal review of its closed long-term care block was supplemented with an external study by an actuarial firm.

As we previously indicated, even after the impact of the year-end study, our long-term care subsidiaries remain adequately capitalized and did not require a capital contribution from AFG. Excluding the non-core charge, these runoff operations reported a core pre-tax operating loss of $12 million in the 2012 fourth quarter, compared to a core pre-tax operating loss of $6 million in the same period in 2011.

Both periods included additional long-term care reserve strengthening related primarily to existing open claims as a result of the company's periodic review. For the year, these run-off lines had a core pre-tax operating loss of $4 million in 2012, compared to core pre-tax operating earnings of less than $1 million in 2011.

AFG's Medicare supplement and critical illness businesses contributed pre-tax core operating earnings of $28 million through the date that these operations were sold in August of 2012, compared to $34 million for the full year of 2011. Including post-closing adjustments, sales proceeds totaled $326 million, resulting in a non-core, after-tax gain of $114 million on the sale.

Over the past 36 months, we've maintained our focus on products we know well and where we see the best opportunities to produce improved returns in our business. Growth in our fixed and indexed annuity premiums accompanied by pricing discipline and exceptional investment results have collectively been instrumental in achieving compounded growth and pre-tax core operating earnings of 26% in our annuity group over the past 3 years.

On Slide 13, we've outlined the components of the reinvestment rate assumptions factored into our models for both annuity DAC unlockings and long-term care loss recognition testing. Rates for annuity unlockings are derived primarily from 10-year bond yields where rates for the long-term care loss recognition are derived primarily from average yields on a 10, 20 and 30 year bonds and mortgage investments.

Now, please turn to Slide 14 for a few highlights regarding our investment portfolio. AFG recorded fourth quarter net realized gains of $36 million after-tax and after deferred acquisition costs, compared to $31 million in the comparable prior year period.

After-tax, after-DAC realized gains for the full year were $128 million, compared to $45 million in the same period in 2011. Unrealized gains on fixed maturities were $719 million, after tax, after-DAC, at December 31, 2012, an increase of $260 million since year end 2011.

Our portfolio continues to be high quality, with 86% of our fixed maturity portfolio rated investment grade and 96% with a National Association of Insurance Commissioners' designation of NAIC 1 or 2, its highest 2 categories.

During 2012, Property & Casualty investment income was 6% lower than in the prior year, in line with our expectations. We have provided additional detailed information on the various segments of our investment portfolio in the investments supplement on our website.

Now, I'd like to cover our outlook for 2013 on Slide 15. Our core -- our 2013 core net operating earnings guidance is $3.60 to $4 per share. Our objective is to achieve an increase of 4% to 6% in the specialty groups overall average renewal rates in 2013, and we expect to achieve a combined ratio between 91% and 95%. We estimate net written premiums in our specialty and property and casualty operations to be 6% to 10% higher than 2012 levels.

Property and Transportation Group is expected to produce a combined ratio in the 92% to 96% range. Guidance assumes normalized crop earnings for the year. We expect this group's net written premiums to be up 3% to 7%. This guidance assumes that current corn and soybean prices hold through the February discovery period, and it reflects the opportunities we see for growth in our transportation and property and inland marine businesses.

We expect the specialty casualty group to produce a combined ratio in the 91% to 95% range. We anticipate net written premiums will be up 10% to 14%. Based on indications of market hardening and continued growth in our workers' comp international and excess and surplus businesses.

We expect the Specialty Financial Group's combined ratio to be between 88% and 92%, and we project net written premiums to be flat to up 4% in this group. We also expect 2013 property and casualty investment income to be about 5% lower than 2012.

Based on recent market conditions and trends, we expect 2013 full year core pre-tax operating earnings in our annuity and runoff long-term care and life operations to be 5% to 10% higher than our 2012 results. These 2013 expected results exclude non-core items such as realized gains and losses as well as other significant items that may not be indicative of ongoing operations.
Now, we would like to open the line for any questions. Thank you.

Question and Answer

Operator

[Operator Instructions] Your first question comes from Amit Kumar, Macquarie.

Unknown Analyst

It's [indiscernible] calling on behalf of Amit. My first question is embedded in the guidance, you say there are some items that are excluded, I was wondering do you include any implicit benefit or reserve releases in that 2012 guidance?

Carl Henry Lindner
Co-President, Co-CEO & Director

No, we do not.

Unknown Analyst

You do not. Okay. And then also looking forward to…

Carl Henry Lindner
Co-President, Co-CEO & Director

Can I -- yes, this is Carl. Yes. Our guidance would include our estimates of reserve -- favorable reserve releases in this year.

Unknown Analyst

So it would assume sort of -- would looking at the 2012 reserve releases sort of be indicative of what might be included in that guidance for 2013.

Carl Henry Lindner
Co-President, Co-CEO & Director

We don't really give any guidance on that. We feel good about our overall reserves. We baked in favorable reserve guidance into our earnings.

Unknown Analyst

Okay. And then my next question relates to capital management. Looking forward for 2013 you mentioned sort of the excess capital that you have over rating agencies requirements. Would you expect the return to shareholders over 2013 to be more than 2012? Would $400 million say be sort of a good benchmark to look at for that number?

Carl Henry Lindner
Co-President, Co-CEO & Director

We haven't really defined any guidance or any specific number going forward into this year. Generally, we've been opportunistic purchasers of our stock when it's been an attractive value to book value. It also is based off of our opportunities for growth and for start-ups and acquisitions during the year.

Operator

Your next question comes from Ryan Byrnes, Langen McAlenney.

Ryan J. Byrnes
Langen McAlenney

I just wanted to just drill down little bit on, I guess current loss cost inflation, especially vis-à-vis seeing 4% to 6% rate increase in 2013. Just wanted to see, what kind of, I guess, delta you guys are seeing or expecting?

Carl Henry Lindner
Co-President, Co-CEO & Director

I think 2% to 3% overall probably is -- generally our loss cost trends have been pretty benign. It varies by line but even on California comp, I think we are even seeing kind of low single digit inflation there. So, I think a fair assessment would be kind of 2 to 3 percentage overall.

Ryan J. Byrnes
Langen McAlenney

Okay. So then with the rate increases, obviously you are getting the earn part through but you should be experiencing kind of underlying, I guess, margin expansion with rate increases outpacing loss inflation, is that the right way to think about it?

Carl Henry Lindner
Co-President, Co-CEO & Director

We think -- as that gets earned through, it should have a positive impact.

Ryan J. Byrnes
Langen McAlenney

Okay. And then -- I guess, along those lines, especially in property and transportation combined ratio guidance, it seems, I guess, the range is little elevated compared to previous years, I guess, excluding 2012. Just want to get your thoughts there. Are you guys increasing your loss estimates on crop there or is there anything interesting going on there that I'm missing?

Carl Henry Lindner
Co-President, Co-CEO & Director

I don't think so. I think because of the changes in the government really in the crop insurance program over the years, the margins are probably tighter in that business than what they would -- what they've been maybe over the past 5 years in that. So I think it probably reflects that. We had -- it seems like the whole industry's had a lot more in the way of catastrophe claims also. Things that convection types storms and so I -- when we look at our guidance, I think that's kind of reflect in that also.

Ryan J. Byrnes
Langen McAlenney

Okay. Great. And then my last question is, with your crop insurance, I think it's a multi-year deal. Just wanted to see when that expires. If you can say that and then obviously because it sounds like a bunch of reinsurers are aligned [ph] to write more property insurance, especially in 2013. Just want to get your thoughts on it?

Carl Henry Lindner
Co-President, Co-CEO & Director

Keith, I think is ours up in this next -- over the next 12 months or something?

Keith Alan Jensen
Former Senior VP & CFO

Yes, it is next year.

Operator

Your next question comes from Jay Cohen, Bank of America.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Question on the specialty casualty business, you had a little bit of adverse reserve, prior year reserve development. You talked about the E&S business and I think you said executive management as well. And I'm wondering what particular areas are giving rise to it and what you're seeing that's causing modest but adverse development?

Carl Henry Lindner
Co-President, Co-CEO & Director

When you look back at 2012, the run-off of our program business, the run-off that ended up being a lot worse than what we thought throughout the year. If I picked one single area it's probably had the biggest negative impact as far as negative development. Keith, have you got any other perspective on this specialty casualty?

Keith Alan Jensen
Former Senior VP & CFO

I think we had also some continuing modest developments internationally but they were very small compared to prior years.

Operator

[Operator Instructions] You have a follow-up question from Amit Kumar, Macquarie.

Amit Kumar
Macquarie Research

It's Amit Kumar. Sorry for making a, I guess, a late appearance on the call. Did you guys touch upon the California comp market place and the trends you're seeing in that.

Carl Henry Lindner
Co-President, Co-CEO & Director

Well, sure. The California workers' comp market place is clearly turning. In the fourth quarter, we got a double-digit renewal price increase. We got about 11%. We -- with the change in the market, I think, we'd expect to try to get a double-digit 10% plus increase in California comp this year. Our latest estimate around accident year combined ratio for last year is in the 106 to 108 range. So if we can get 10% plus price in 2013, we're moving toward solid ROEs again. Again, probably a -- we have to get to a 98 sort of a latest kind of calculation to get to a 12% return on equity, there in republic [ph].

Amit Kumar
Macquarie Research

Got it. That's helpful. I guess, the only other question…

Carl Henry Lindner
Co-President, Co-CEO & Director

Reserves are adequate. I guess, the other thing I'd say is because of the rate to payroll increase we expect and some market share increase. We're projecting strong double-digit growth for California comp business this year.

Amit Kumar
Macquarie Research

Got it. And the only other, I'm sorry, the only other question I have is on capital management. Clearly, you mentioned a $625 excess capital number? Do you know, in terms of looking for 2013 do you think it exceeds what we have seen for 2012, I guess, that's -- that would be the right way to look at it, right?

Carl Henry Lindner

Co-President, Co-CEO & Director

So, I think, we already answered that question, we don’t have any specific number or guidance on that right now.

Amit Kumar
Macquarie Research

So let me go -- sort of approach this another manner, do you sort of look at returning whatever you have earned in a year? Many companies use the formula where they will say share buyback plus dividends equal to net income? How do you sort of think of that?

Carl Henry Lindner
Co-President, Co-CEO & Director

I think we like to have -- we like flexibility and seeing what acquisitions startups, what the growth is on the table and also where our stock trades at, in relationship to book value or on P/E multiple basis over time.

Amit Kumar
Macquarie Research

What range do you use for the P/E multiple, if you could share that?

Carl Henry Lindner
Co-President, Co-CEO & Director

Well, I don’t think we really have any specific, set in concrete type of parameters of that.

Operator

And there are no further questions at this time. Are there any closing remarks?

Keith Alan Jensen
Former Senior VP & CFO

I will just express appreciation to all of you for joining us on the conference call and for your interest in the company. Thank you and we’ll report at the end of next quarter.

Operator
This concludes today’s American Financial Group 2012 Fourth Quarter Earnings Conference Call. You may now disconnect.