S&P Capital IQ

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CNA Financial Corporation NYSE:CNA

FQ3 2011 Earnings Call Transcripts

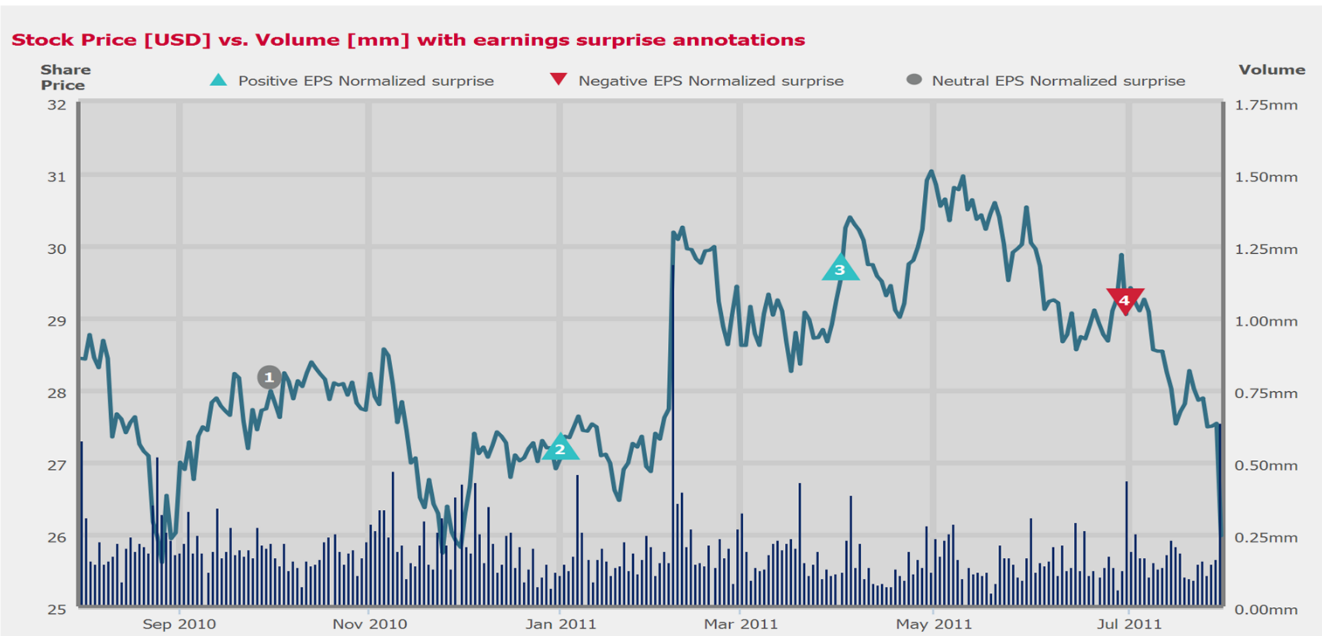
Monday, October 31, 2011 2:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2011-			-FQ4 2011-	-FY 2011-	-FY 2012-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.26	0.34	▲30.77	0.66	2.06	2.65
Revenue (mm)	1790.97	1586.00	▼(11.44 %)	1906.82	7498.79	7788.98

Currency: USD

Consensus as of Oct-22-2011 7:16 AM GMT



	- EPS NORMALIZED -		
	CONSENSUS	ACTUAL	SURPRISE
FQ3 2010	(0.40)	(0.66)	NM
FQ4 2010	0.67	1.09	▲62.69 %
FQ1 2011	0.68	0.80	▲17.65 %
FQ2 2011	0.49	0.43	▼(12.24 %)

Call Participants

EXECUTIVES

D. Craig Mense
Chief Financial Officer and Executive Vice President

Nancy M. Bufalino
Former Assistant Treasurer

Thomas F. Motamed
Former Chairman and Chief Executive Officer

ANALYSTS

Amit Kumar
Macquarie Research

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Robert Ray Glasspiegel
Langen McAlenney

Ronald David Bobman
Capital Returns Management, LLC

Presentation

Operator

Good day, and welcome to the CNA Financial Corporation's Third Quarter 2011 Earnings Conference Call. Today's call is being recorded. At this time, I'd like to turn the conference over to Nancy Bufalino. Please go ahead.

Nancy M. Bufalino
Former Assistant Treasurer

Thank you, Katie. Good morning, and welcome to CNA's third quarter 2011 earnings call. Hopefully, you've had an opportunity to review our press release, which was released early this morning along with our financial supplement. Both can be found on the CNA website at www.cna.com. On the call this morning are Tom Motamed, our Chairman and Chief Executive Officer; and Craig Mense, our Chief Financial Officer. Following Tom and Craig's remarks about the quarterly results, we will open it up for your questions.

Before turning it over to Tom, I would like to advise everyone that during this call, there may be forward-looking statements made and references to non-GAAP financial measures. Any forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from the statements made during this call. Information concerning those risks is contained in the earnings release and in CNA's most recent 10-K and 10-Q on file with the SEC. In addition, the forward-looking statements speak only as of today, Monday, October 31, 2011, and CNA expressly disclaims any obligation to update or revise any forward-looking statements made during this call. Regarding non-GAAP measures, reconciliations to the most comparable GAAP measures have also been provided in our most recent 10-K and 10-Q, as well as the financial supplement. This call is being recorded and webcast. During the next week, the call may be accessed again on CNA's website.

Now I will turn the call over to CNA's Chairman and CEO, Tom Motamed.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Thank you, Nancy. Good morning, everyone, and thank you for joining us. Before Craig provides you with details of our operating and financial performance, I would like to share with you some of the reasons I am so optimistic about many of the initiatives we have underway at CNA.

Everyone knows the third quarter was yet another quarter of significant natural catastrophe losses for the industry. Despite that fact, CNA delivered a combined ratio of 99.1%, which included only 3.1 points of catastrophes. Catastrophes are part of the business, and we continue to believe we are effective in managing these exposures. The operational strategies and people we put in place a few years ago are beginning to pay off. We are delighted that our net premiums -- net written premiums grew 8% in the quarter, 10% in Commercial and 6% in Specialty. Exposure growth for the quarter was positive for both Commercial and Specialty. We are seeing additional audit premiums in Commercial as opposed to return premiums a year ago.

Rates were slightly positive in Specialty for the second quarter in a row and Commercial rates continue their climb for the fourth consecutive quarter. In addition to rate actions, we continue to shed lower quality risks to improve our underwriting margins. Favorable prior year development lowered our third quarter combined ratio by 5 points. Our track record of favorable development now extends over 19 consecutive quarters.

Excluding the impacts of favorable reserve development in catastrophe losses, our combined ratio improved to 101% in this year's third quarter from 103.7% in last year's comparable period. This margin improvement was driven by the continued improvement in our net accident year noncat loss ratio in commercial lines, down fully 3 points from a year ago to 69.8%. The ratio for the first 9 months of 2011 was 70.1%, 2 points below full year 2010.

With that, I will now turn it over to Craig. Craig?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Thanks, Tom. Good morning, everyone. In the third quarter, CNA's net operating income was $91 million and operating return on equity of 3.4%. Operating income available to common shareholders was $0.34 per common share. All the year-over-year comparisons are favorable, given that last year's results included the impact of the asbestos and environmental pollution Loss Portfolio Transfer with National Indemnity Company.

The quarter's -- this quarter's earnings were significantly influenced by our limited partnership investment results and, to a lesser extent, catastrophe losses. There's one other small item I would also like to bring to your attention related to our agreement to sell our 50% ownership share in First Insurance Company of Hawaii. Because of the timing of the transaction, which affects the tax treatment applied to those undistributed earnings, we increased income tax expense by $22 million, which reduced third quarter operating EPS by $0.08 per common share. On anticipated closing in the fourth quarter, we would expect to record a modest realized capital gain.

The quarter's results do reflect our continued progress towards our longer-term goals of improved margins, scale, earnings consistency and financial stability. Third quarter net income was $75 million and included after-tax realized capital losses of $16 million. The realized capital losses included impairment losses of $50 million after-tax and were driven by intent to sell decisions, which are part of our ongoing portfolio management.

We continue to build on the strength of our balance sheet and improve our financial flexibility. All key capital adequacy metrics remain at or above our target levels, and our liquidity profile remains strong. Book value per common share increased 2% from the end of the second quarter of 2011 to $43.85 per share. The increase was driven by earnings and improvement in the market value of our investment portfolio.

At the end of the third quarter, our investment portfolio's pretax net unrealized gains stood at approximately $2.6 billion, an increase of approximately $750 million from the end of the second quarter. Approximately 3/4 of the quarterly change in our unrealized gains was generated by the longer-term assets supporting our Life & Group segment. A substantial portion of these mass portfolio gains were offset by additional reserves also recognized in other comprehensive income.

Our common shareholders' equity excluding other comprehensive income was $10.9 billion or $40.56 per common share at September 30, 2011, up slightly from the end of this year's second quarter. Our statutory surplus was $9.8 billion as compared to $10.1 billion at the end of this year's second quarter. The decrease was largely driven by $150 million repayment of the $1 billion surplus note originally issued in 2008. This latest surplus note repayment leaves an outstanding balance of $250 million at the end of the third quarter. Our primary insurance company continues to maintain approximately $1 billion of dividend capacity. Cash and short-term investments held at the holding company level increased to slightly over $320 million. The full $250 million of our credit facility also remains available to us.

In the third quarter of 2011, operating cash flow excluding trading activity improved to approximately $400 million. Additionally, we received approximately $600 million of cash principal repayments through paydowns, bond calls and maturities. We continue to sustain our disciplined reserving practices.
Our Property & Casualty business segment benefited from $90 million of pretax favorable prior year development. Favorable development in Commercial was driven by noncash property in accident years 2008 through 2010. In Specialty, favorable development was driven by medical professional liability in accident years 2008 and prior.

Net operating income during the third quarter included pretax net investment income of $394 million as compared to $581 million in the prior year period. The decrease was primarily due to our limited partnership investments. These investments produced third quarter pretax losses of $93 million in 2011 as compared to pretax income of $68 million in 2010. Our LP losses were driven by negative equity market returns, widening credit spreads and overall capital market volatility. I would point out that while the loss is disappointing, these investments continue to perform as we would expect and bring diversification to the overall portfolio with less volatility and higher absolute returns on equities. As an aside, these investments produced third quarter negative return of approximately 4%, while the S&P 500 total return was a negative 14%. Year-to-date, our LP investment return was approximately 1% as compared to a negative 9% for the S&P 500. Over the last 10 years, our LP investments have produced an annualized return of approximately 8%. This compares to 3% total returns for the S&P 500.

Fixed maturity security income declined 3% as compared to the third quarter 2010, reflecting today's lower market yields. With respect to our holdings, you will notice that we have included information in our financial supplement outlining our European sovereign debt, financial institution and overall exposure. Securities in this category are in a net unrealized gain position with no significant concentration in countries with troubled economies. We made relatively minor changes to our investment portfolio sector allocations this quarter. Overall, our investment portfolio remains well-diversified, liquid, high-quality and aligned with our business objectives. The current allocation of the asset is in line with our established longer-term targets.

The average credit quality of the fixed maturity portfolio remained at A. The fixed income assets, which support our long-duration life-like liability, had an effective duration of 11.4 years at quarter end, essentially unchanged for the end of this year's second quarter and in line with portfolio targets. We did act to further shorten the effective duration of the fixed income assets which support our traditional P&C liabilities to 4.0 years at quarter end, down from 4.4 years at the end of this year's second quarter and 4.5 years at 2010 year end.

Our capital management activities included the previously mentioned agreement to sell our 50% ownership interest in First Insurance Company of Hawaii to Tokio Marine. We expect the sale to close in the fourth quarter with proceeds of approximately $165 million. Finally, we announced a quarterly common stock dividend of $0.10 per share in line with the past 2 quarters. With that, I will turn it back to Tom.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Thanks, Craig. All in all, the third quarter was marked by continued improvement in the fundamentals of our core Property & Casualty Operations. The highlights were: net written premium growth of 8%, driven by rate increases and new business in targeted customer segments as well as exposure growth and positive audit premiums; improvement in our Commercial segment's net accident year non-cat loss ratio, driven by rate increases, shedding lower quality risks and mixed shifting to more profitable business; continued attractive returns from our Specialty business; manageable catastrophe losses in a quarter of heavy industry-wide losses through the continued disciplined catastrophe management process; a steady run rate expense ratio with increased efficiencies, funding our investments to drive growth and profit. With that, we'll take your questions.

Question and Answer

Operator

[Operator Instructions] We'll go first to Jay Cohen with Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

A couple of questions. The first is on the change in price, premium rates on the Commercial side, up 2% you had mentioned, I guess, which is consistent with what you had been seeing earlier in the year. Did you get any sense during the quarter if things progressively change, hopefully got better during the quarter? Because others have mentioned that. I'm wondering if you had seen that.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes. I think, Jay, the first thing is if you look at the first quarter in Commercial, rates were up 1.2%, in the second quarter 1.8% and this quarter, 2.4%. So we see rates continuing to get stronger in Commercial. All of our U.S. businesses by line at positive rate in this quarter, we had slightly negative rates in Canada and Europe. But overall, very solid and we think it's building, developing, whatever you want to describe that. But we're pretty pleased with what's happening on with rates now. Exposure has picked up as well, so we had positive exposure. So we report pure rate, some companies report price. So if you took the rate and exposure to it, it's more near 3.5 points. So we think it's moving in the right direction.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

And then I guess, the question was September hopefully was better than what you saw in July, let's say?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes, that would be true. And August is kind of a low month. It's not a big premium month. So you have variability by month.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Right. On the portfolio, I'm wondering on the mortgage side if you're seeing prepayments play a role in how it shapes your portfolio at all.

Richard Waldo Scott
Loews Corporation

Yes, this is Richard Scott. Let me respond to that. Within the agency portfolio, we made a decision relatively early in the game that we would avoid height[indiscernible] coupons. And so the bulk of what we own at this point is 3.5, 4, 4.5 at most type coupons. Secondly, a lot of our agency exposure is actually in CMO forms, where we have at least an added element of prepayment stability. So if you look at prepayment rates, they picked up a little bit generally across the industry with absolute rates being very low, but we have not had a significant impact on the portfolio from that to date.

D. Craig Mense
Chief Financial Officer and Executive Vice President

So Jay, this is Craig. If you're look at fixed income, there is a small tick down as a result of -- that you're seen in fixed income as a result of prepayment, but it's a pretty small number.

Operator

We'll take our next question from Bob Glasspiegel with Langen McAlenney.

Robert Ray Glasspiegel
Langen McAlenney

With you starting to show some premium growth, wondering where we should be thinking about the expense ratio trending from 31.9% level of Q3? Is that a good run rate? Or are we still investing for growth? Or do we have the infrastructure where you want it?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

We'll try to answer those. First of all, we do believe we have the investments in place relative to growing our business, so we don't expect to invest a lot more in that area, number one. Number two, when you look at the expense ratio, and I think Craig has said this on prior quarters, you got to think of a little higher, it's probably in the 33% range as the run rate. But clearly as we keep our controllable expenses in line and we grow the business, you will expect that the expense ratio naturally will go down. So yes, we believe -- we have never believed that we have an expense problem. We always have believed that we had a growth problem. And we think we are dealing with the growth problem in a measured way and we believe that over time the expense ratio will go down.

Robert Ray Glasspiegel
Langen McAlenney

Okay. You did a really good job of matching your portfolio on the life side to what's happened. On the long-term care business, there's still this sort of ongoing cash flow, which is tough to match[indiscernible]. What does the current interest rate environment play to that business and...

D. Craig Mense
Chief Financial Officer and Executive Vice President

Bob, this is Craig. I mean, if you look at that at the life business in total, you can see that we're adding about $200 million to invested assets a quarter. And certainly, the current investment environment produces more of a long-term threat than any kind of immediate threat, so we're -- the portfolio is very well-matched and we're above the hurdles there [indiscernible] and the liabilities at present. It's really more of a question for ourselves than others to answer about how long do you expect the current environment to persist. But it's not an immediate issue.

Robert Ray Glasspiegel
Langen McAlenney

So what's your current spread there?

D. Craig Mense
Chief Financial Officer and Executive Vice President

We haven't disclosed that, Bob.

Robert Ray Glasspiegel
Langen McAlenney

Okay. But you said you're in a comfortable spread. Was that the word or positive spread? How did you characterize it?

D. Craig Mense
Chief Financial Officer and Executive Vice President

I'd say comfortable.

Operator

We'll take our next question from Amit Kumar with Macquarie Capital.

Amit Kumar
Macquarie Research

Just going back to the discussion on pricing, can you talk about new pricing versus renewal business pricing? And what is your expectation of margin improvement in both Specialty and Commercial going into 2012?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Well, no one can predict the future, but clearly, we are going to continue to push rates. As I said earlier, we've seen very good rate improvements in Commercial. And Specialty now has 2 quarters of positive rates, so we will continue to push on that. When we get to pricing, what I'd say, first of all, we're talking about the U.S. And Specialty in the third quarter, what we found was new business pricing was slightly stronger than our renewal pricing. Now it varies by product, but in the aggregate, it was stronger. So I think we're pretty pleased with what we're seeing in the Specialty area. One thing to remember, if you look at the D&O business, I think that has been a pretty tough road for every carrier out there. But we have a very diverse Specialty business between all the professional services, healthcare, et cetera, so we have an advantage there and we think, overall, we're able to get price stronger than our renewal book. Once again, in Commercial, it does fluctuate. We would say it's a little bit less for new. And I mean, a little bit. But the other thing you have to look at is the quality of the new business that we're bringing in is far better than the old renewal book that I inherited a few years ago. So clearly, you cannot make an exact comparison because we have changed the mix. We have changed the customer segments. We've done a lot to re-profile the book in Commercial, so I'm not concerned that the pricing might be a little bit less than the renewal book. The renewal book needs more rates. But the new business that we're bringing on, we believe, we're bringing on at better pricing, better terms and conditions.

Amit Kumar
Macquarie Research

All right, that's actually helpful. Just on the flip side, on the capital management issue, in terms of capital allocation and excess capital, I know we've talked about a special dividend in the past. And at that time you had said that, that's a fourth quarter discussion topic. I'm just wondering where do we stand on that discussion now and does the change in the market condition -- the rates we're getting now, is it more likely now that you might deploy the capital? Or are we still talking about revisiting the special dividend question later on?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Well, Amit, this is Craig. I'd say, first, I'll just remind you that we don't comment on future capital actions on the call until we make a decision. Second, all those capital discussions that we've had in the past on these calls whether they're increasing, and I do this kind of in order of preference here, increasing the common shareholder dividend, whether it's considered a special dividend. Although I think we said on previous calls is that one-time special dividend we didn't think has that significant of an impact. So it has a lesser importance to increasing the common shareholder dividend. I know we talked about buying back shares and why we didn't think that was a realistic option, given the float and the ownership. We still continue to look at things we might do with the runoff businesses. And of course, we have strategic options with potential acquisitions that might help scale, strategic bolt-on that might help scale. So at the moment, all those things are open to us and at the moment, we feel happy to have them remain open. And I think then the other thing is to just reemphasize that we're really more focused on improving the numerator than anything. So what's most important is improving the earnings in the Property & Casualty business and acting to continue to mitigate it, if not eliminate the losses from the Life & Group runoff. As I'm sure you can appreciate all those things, then would give us more confidence to act on all the capital options.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Amit, this is Tom. I'd just say that Craig gave you a very thorough response to your question. The good news here is we have many more options today than we had a few years ago, so we will be judicious about what we choose to do. And quite honestly, as Craig said, we have been focused on getting the P&C operational piece in an improvement mode, so it's great to have options. And we'll choose some of those options at the right time.

Amit Kumar
Macquarie Research

Got it. And just one other numbers question. On Page 11 of your supplement in the prior year development section, can you remind us why the prior year premium development number is so high compared to past quarter?

D. Craig Mense
Chief Financial Officer and Executive Vice President

It's really a reevaluation in the Specialty business this quarter of the reserves. They were associated with some of scale business in the medical liability product.

Amit Kumar
Macquarie Research

And this is a one-time? Okay, that's very helpful.

Operator

[Operator Instructions] We'll take another question from Ron Bobman with Capital Returns.

Ronald David Bobman
Capital Returns Management, LLC

First question today. I actually have a question and a comment. What renewal policy retention is due for Commercial and Specialty this quarter as compared to the preceding quarter? And I had a comment.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

In Commercial, the retention was 78.6% compared to the third quarter of 2010, it was 80.9%. We are pleased with that. We will even continue to sacrifice retention to get more rates. So the number going down to us suggests we're pushing rate harder and the numbers support that. If you look at Specialty third quarter, the third quarter, basically, it's flat, 86% this year in the third quarter, 86.3% last year's third quarter.

Ronald David Bobman
Capital Returns Management, LLC

How about compared to the second quarter this year? I'm sorry I don't have it on my fingertips.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes. Second quarter, Commercial was 78.8%. This quarter, 78.6%. And Specialty was 85.9% in the prior quarter, 86% this quarter.

Ronald David Bobman
Capital Returns Management, LLC

And my comment is I think that the -- just as a comment. You get what you pay for. I think the valuation on the stock [indiscernible] multiple is it's fairly pathetic. And I think given the capital position of the company, that you should ignore the significance of the float and the magnitude of the valuation discount is just too severe to prioritize the magnitude of the float. And I guess, I would just say the valuation discount is too severe given the progress that's been made with this company and the caliber of management for you to ignore a more aggressive capital action with respect to buying back your stock. It's just too compelling.

Operator

We'll take a follow-up from Amit Kumar with Macquarie Capital.

Amit Kumar
Macquarie Research

Just a set of cleanup questions. First of all, can you talk about the DAC adjustment, if any, you should expect going into 2012?

D. Craig Mense
Chief Financial Officer and Executive Vice President

You shouldn't expect anything significant. And when you see the Q, you'll see that we actually do have some disclosure there. So we haven't completed our work. But we would expect when we do conclude, that we would adopt it retrospectively. And the one-time charge to equity would be something in the $50 million to $85 million after-tax, so $0.20 to $0.30 a share.

Amit Kumar
Macquarie Research

Got it. That's helpful. And the only other question is just on the broader discussion on LPs and investment income. Is there any lag? Or just based on the market rally or, I guess, the turnaround we have seen, does the this $93 million, does a part of it reverse? Or is there any lag in the reporting of LP investments?

D. Craig Mense
Chief Financial Officer and Executive Vice President

No, I think what you should expect, and what we said in the past, is that our LPs, our alternative investments, are largely hedge funds and they largely reflect current market value. So something like 85% of those investments are on a 1-month or less lag. So that means that the third quarter's results, that $93 million loss reflects the third quarter market. And the fourth quarter likewise ought to reflect the fourth quarter market. So we would expect some bounce-back given the current environment. But this is early on, all right, before we get there. So I think I'd refrain from speculating. But it is important to note that they're very much on a current reporting.

Amit Kumar
Macquarie Research

Basis. Okay, that's all. And just one other thing, was there any reinsurance adjustment? Or did you renew your reinsurance treaty in Q3?

D. Craig Mense
Chief Financial Officer and Executive Vice President

No. Our next big treaty is a cat, which is in the fourth quarter. I think maybe what you're seeing, which is definitely helping the growth in commercial lines, is that you recall that we said one of the big improvements we made was to property underwriting when Tom got here. Well, that's also improved our ability to reduce our cost of reinsurance on property, which has pretty meaningful impact to net written premium this quarter. So we're getting the benefit of those reduced reinsurance costs.

Amit Kumar
Macquarie Research

And your treaty renews in Q4. Is that what you said?

D. Craig Mense
Chief Financial Officer and Executive Vice President

I'm sorry, say that again, Amit?

Amit Kumar
Macquarie Research

The reinsurance treaty, it renews in Q4?

D. Craig Mense
Chief Financial Officer and Executive Vice President

January 1.

Operator

With no additional questions in the queue, that does conclude CNA Financial's Third Quarter 2011 Earnings Conference Call. We appreciate your participation.

Thomas F. Motamed
Former Chairman and Chief Executive Officer
Thank you.