S&P Capital IQ

CONTENTS

CNA Financial Corporation NYSE:CNA

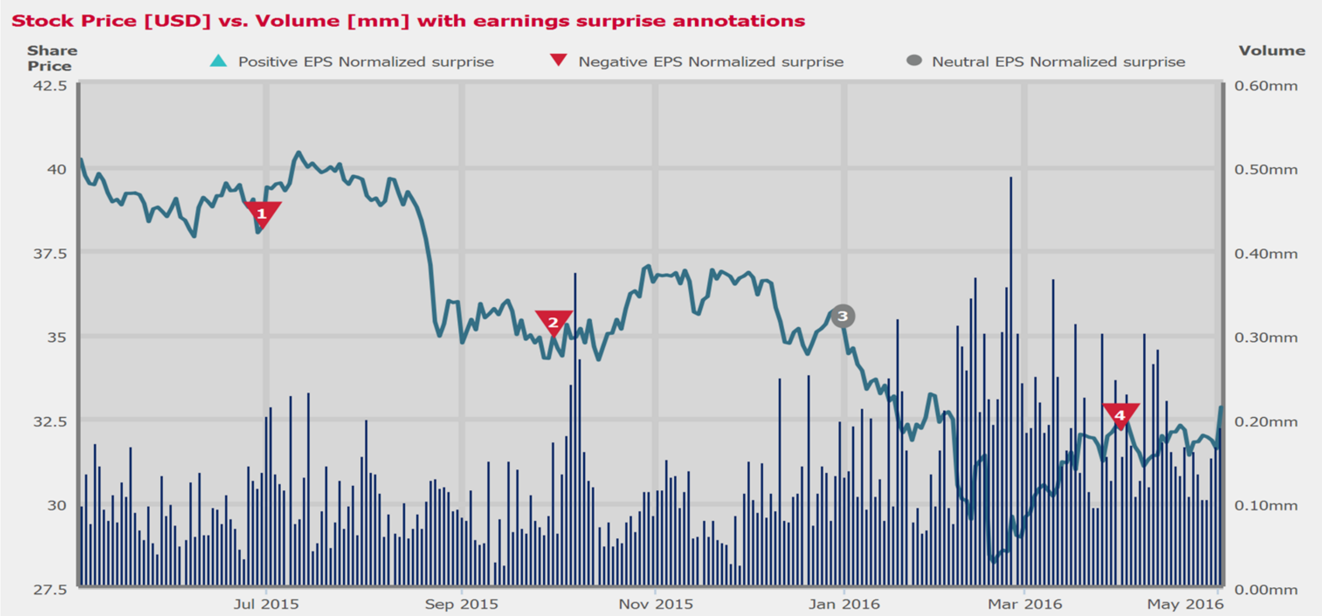
FQ2 2016 Earnings Call Transcripts

Monday, August 01, 2016 2:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2016-			-FQ3 2016-	-FY 2016-	-FY 2017-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.71	0.74	▲4.23	0.74	2.58	3.18
Revenue (mm)	2328.00	-	▲0.17	2304.00	9196.00	9265.00

Currency: USD
Consensus as of Aug-01-2016 12:43 PM GMT



	- EPS NORMALIZED -		
	CONSENSUS	ACTUAL	SURPRISE
FQ2 2015	0.79	0.49	▼1 (37.97 %)
FQ3 2015	0.78	0.77	▼2 (1.28 %)
FQ4 2015	0.89	(0.19)	NM
FQ1 2016	0.62	0.34	▼3 (45.16 %)

Call Participants

EXECUTIVES

D. Craig Mense
Chief Financial Officer and Executive Vice President

James M. Anderson
Senior Vice President of Financial Planning & Analysis and Corporate Development

Thomas F. Motamed
Former Chairman and Chief Executive Officer

ANALYSTS

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Jeffrey Paul Schmitt

Joshua David Shanker
Deutsche Bank AG, Research Division

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

Presentation

Operator

Good day, everyone, and welcome to the CNA Financial Corporation Second Quarter 2016 Earnings Call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Mr. James Anderson. Please go ahead, sir.

James M. Anderson
Senior Vice President of Financial Planning & Analysis and Corporate Development

Thank you, Lori. Good morning, and welcome to CNA's discussion of our 2016 second quarter financial results.

By now, hopefully, all of you have seen our earnings release, financial supplement and presentation slides. If not, you may access these documents on our website, www.cna.com.

With us on this morning's call are Tom Motamed, our Chairman and Chief Executive Officer; and Craig Mense, our Chief Financial Officer. Following Tom and Craig's remarks about our 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 the call.

Information concerning those risks is contained in the earnings release and in CNA's most recent 10-Q and 10-K on file with the SEC. In addition, these forward-looking statements speak only as of today, Monday, August 1, 2016.

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 and other information have also been provided in the financial supplement. This call is being recorded and webcast. During the next week, the call may be accessed on CNA's website.

With that, 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, James. Good morning, everyone, and thank you for joining us today. I am pleased to report what I view as very solid and steady results this quarter.

In the second quarter, CNA produced net operating income of $201 million, compared with $132 million in the second quarter of 2015. Operating return on equity was just under 7%.

Our Property & Casualty business had another solid quarter with a combined ratio of 97.4%, an improvement of 1 point compared with the prior year quarter. This was driven by a favorable prior-year loss development across all of our Property & Casualty segments and achieved despite a higher level of catastrophe losses and a higher-than-expected number of large losses in International.

Specialty continues to produce outstanding results in a competitive environment. The second quarter combined ratio of 85.4%, nearly a 6-point improvement compared with the second quarter of 2015, driven by a favorable prior-year loss development, coupled with a stable accident year loss ratio. The underlying combined ratio was 94%.

Specialty rates increased 1% in the second quarter, with retention of 86%. Net written premiums grew 3% in the quarter, aided by healthy retention, positive rates and a modest level of new business, reflective of our disciplined approach to the market.

Commercial continues to make good progress. The quarter's combined ratio of 103.5% was 4 points better than the second quarter of last year, helped by a modest amount of favorable prior-year loss development. Catastrophes of 8 points were in line with the prior-year quarter. The underlying combined ratio for Commercial was 97.7%, with an underlying loss ratio of 61.6%, 1 point lower than the prior-year quarter and steady with where we ended the full year 2015.

Commercial rates were flat for the quarter. Retention improved 4 points to 83% and net written premium was up 3%, while new business was steady.

We had a challenging quarter in International with a number of large losses in Europe and Hardy, primarily in political risk, property and financial institutions. Canada continues to perform very well. Catastrophe losses added 10.6 points to the loss ratio, driven by the Fort McMurray wildfires.

International's second quarter combined ratio was 118.6%, including 7 points of favorable reserve development. The underlying combined ratio was 115.3%. International net written premiums decreased 22% in the quarter compared with the prior-year quarter. Excluding the effect of foreign currency exchange rates and the timing of reinsurance spend, the decrease was 12% due to lower retention and rate.

With that, I'll turn it over to Craig.

D. Craig Mense
Chief Financial Officer and Executive Vice President

Thanks, Tom. Good morning, everyone.

CNA produced another quarter of steady results and demonstrated steady overall progress. This characteristic was especially true for all our U.S.-based businesses as well as for our investment results. Our International segment results were disappointing.

Our core Property & Casualty Operations produced net operating income of $229 million compared with $237 million in the prior-year quarter. Our second quarter calendar year Property & Casualty loss ratio was 63%, nearly a 2-point improvement as compared to the second quarter of 2015, despite a higher level of catastrophe losses. The underlying loss ratio was 63.9%, above where we ended full year 2015 and reflective of the elevated level of large losses in our International segment.

Our U.S.-based Commercial and Specialty businesses generated significantly improved underwriting profit through stable underwriting loss ratios and favorable prior-year development. Importantly, the underlying loss ratios in both our Commercial and Specialty segments were consistent with where we ended full year 2015.

The meaningful level of prior-year loss reserve development was relatively broad-based and reflected improvements in more recent accident years. This was especially true in the Commercial segment and a reason for optimism as we navigate through today's competitive environment.

Our second quarter Property & Casualty expense ratio was 34.2%, a 1-point improvement compared with the first quarter of this year and consistent with our full year 2015 result.

We continue to maintain our long-term focus and to invest in the business. We remain committed to becoming among the very best at selecting, pricing and managing risk. We also remain mindful of the need to improve our expense competitiveness over time.

Life & Group produced a $4 million net operating loss in the quarter, much improved from a $24 million loss in the second quarter of last year. This quarter's modest loss reflects outcomes generally in line with our reset assumptions and was relatively consistent with our first quarter result this year.

Our Corporate segment produced a net operating loss of $24 million. Net investment income was $502 million in the second quarter, another steady result as compared to the prior year. Income from limited partnership investments was $46 million, a 1.8% return, compared with $48 million, which was a 1.6% return in the prior-year period.

Income from our fixed maturities securities in the second quarter was $449 million, consistent with the prior-year period, as modest growth in our invested asset base offset slightly lower book yields. Our investment portfolio of net unrealized gain stood at approximately $4 billion at quarter-end, an increase of $1 billion since the end of the first quarter, reflecting the decrease in market yields.

The composition of our investment portfolio is relatively unchanged. Average credit quality of our fixed maturity portfolio remained at: a, fixed income assets that support our traditional Property & Casualty liabilities at an effective duration of just over 4 years at quarter-end in line with portfolio targets; the effective duration of the fixed income assets which support our long-duration Life & Group liabilities was 8.7 years at quarter-end, reflective of the market's low interest rates, expected bond call activity and our tactical decisions that will continue to be assessed in light of capital market conditions and opportunities.

At June 30, shareholders' equity was $11.9 billion and book value per share was $43.94, an increase of 4% since March 31. Book value per share, excluding accumulated other comprehensive income, was $43.16. Statutory surplus at June 30 was an estimated $10.6 billion for the combined insurance operating companies, relatively consistent to where we ended last year.

We continue to maintain ample dividend capacity and significant financial flexibility. Cash and short-term investments at the holding company were approximately $441 million at quarter-end. We continue to target cash at the holding company equal to approximately 1 year of our annual net corporate obligations.

In the second quarter, operating cash flow was $279 million. Cash principal repayments through paydowns, bond calls and maturities were approximately $750 million. We continue to maintain a very conservative capital structure. All our capital adequacy and credit metrics are well above our internal targets and current ratings.

With that, I will turn it back to Tom.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Thank you, Craig. In conclusion, the market looks much like it did in the first quarter and our strategy remains unchanged. We will continue to focus on portfolio management and margin improvement, which is evident in our results we shared with you today.
With that, we will be glad to take your questions.

Question and Answer

Operator

[Operator Instructions] We'll go to Bob Glasspiegel with Janney.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

A couple quick questions on International. Could you quantify how many points you would characterize unusual large losses contributed to the quarter? And also just some commentary on how Brexit is going to impact your strategy there.

D. Craig Mense
Chief Financial Officer and Executive Vice President

I'll let -- Bob, this is Craig. I'll tell you that the unusual level of large losses add about 16 points to the International loss ratio this quarter. I'll let Tom answer your question about Brexit.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes. So first of all, our European subsidiary is based in London. So with that, we are evaluating what options are out there for us going forward. I would also make the point, Bob, 2% of our premiums are on Continental Europe. It's a very small percentage. Most of our business is U.K. and Hardy, and then Canada, of course. So we are looking at options and it's a ways off, but we'll figure it out.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

You said Canada had a good quarter despite the wildfires? Or were you talking ex wildfires?

D. Craig Mense
Chief Financial Officer and Executive Vice President

No, despite the wildfires.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

Okay. So it was -- it performed in line even with the pressure? And how much was the wildfire?

D. Craig Mense
Chief Financial Officer and Executive Vice President

The wildfire was about $20 million in total, and about half was from Hardy and half was from Canada.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

Got it. And last question. Could you give us a little color on where the -- you said it was more recent accident year. What drove the reserve releases?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Well, a little bit different in both. What I said -- and maybe I would want to emphasize, it was broad-based. So in Specialty, it was across a lot of different products, mostly professional liability products, including medical and professional. And it spanned accident years '08 through '14. So -- and the way we -- and part of it is how we approach reservings. We try to be mindful of what the impact on volatility or variability is in Specialty, and it just turned out that, really, the emerging frequency across all those years and we had a few favorable claim outcomes. All of those things added up to a pretty significant dollar total. In Commercial, likewise, I'd say, it's several products. But over accident years '10 through '14, but most of it, '12, '13 and '14. And I think we really give some credit there -- or kind of the reason there is that we've also been cautious about it. You know we've been investing very heavily in talent and in new tools and improving our execution, and we haven't reflected what we anticipated the positive impacts of that to be until we saw those results begin to really manifest themselves in the loss ratio. So what you're seeing now is really a manifestation of a lower frequency which we would say is underwriting-driven, so underwriting pricing reselection and client management-driven. And that's the reason for my optimistic remark as well in the script.

Operator

We'll go next to Josh Shanker, Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

Just following up on Bob's question about International. Can we talk about how many unusual losses were in that 16%? How often you would expect a confluence of a number that many large events hitting in one single quarter? And whether this has caused you to ask any questions about the risk management sector?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

I think, first of all, if you look at the business at Hardy, where a lot of these losses that came from, it's a volatile business. They do have ups and downs. Unfortunately, we got a couple of losses in the same quarter. We'd like to think that, over time, that will balance out. But that's the nature of the business when you're writing trade credit and political risk and some of the other things that they do in Hardy. So the fact is, it was a tough quarter. We'd like to think that's not going to be every quarter. But political risk trade credit is really a pretty small portion of the book, but things are a little tumultuous over there these days. So I don't think that changes our attitude about wanting to do business in the Lloyd's marketplace or the continent or the U.K. And they -- it is a smaller portion of our business, so it is going to show some fluctuations on the loss ratio side because it doesn't have the scale of the U.S. business or U.S. Specialty or U.S. Commercial.

Joshua David Shanker
Deutsche Bank AG, Research Division

And if I think about what -- what is the target combined ratio for the small- and middle-sized attritional loss as part of International's mandate? I mean, is this a business that we should think operates at a 80% combined ratio with standard deviation of 15% depending on the impact of large losses? Or I mean, how are you guys thinking about the large loss portfolio versus the attritional loss portfolio?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Well, I think you have to look at it in different pieces. If you look at the U.K. business, we think that's usually pretty stable. We like that business. It doesn't have the volatility that Lloyd's has. So I think if we look at the Lloyd's business, we think that's going to trade at a higher combined ratio at this point in time. Continental Europe, pretty stable, although they did have the financial institution loss on the continent. So I think we realized they're 3 very different businesses. And our objective is, over time, to make them all more profitable and get a little more scale. So I don't know that I can answer your question exactly, Josh.

Joshua David Shanker
Deutsche Bank AG, Research Division

Well, that's all right. I'm sorry, I mean, I guess, you're trying to gerrymander me into my own answer, I guess. Is it possible...

Thomas F. Motamed

Former Chairman and Chief Executive Officer

Well, I would think -- think of it this way. If you look at the markets that trade in Lloyd's, it has been a market that suffered from rate decreases for quite -- probably 2 years now. So rates have been going down there. It's extremely competitive. There are new entrants. It's a tough market. The Lloyd's market is very tough. It doesn't look like it's getting better. So I think that's the reality. It's not a CNA issue. I think it's a Lloyd's issue, and I think that that's probably going to continue with what's going on over there, so.

Joshua David Shanker
Deutsche Bank AG, Research Division

Well, I guess, in terms of like thinking about, if the possibility of hitting a 115%, 120% is a reality in this market, can we envision that there's also quarters where we will see, even in this kind of market, combined ratios in the 80s given the volatility? I mean, there should be a trade-off there. So if a 120% is possible, then maybe an 80% or 85% should be possible, too, but in this market, maybe that's not possible.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

I don't think you're going to see 80% combined ratios coming out of the Lloyd's marketplace. I just don't see that. Now what you're hoping is you don't have 3 or 4 115s, right? It's -- maybe you have 115% one quarter, and you can get things down to 100% or 90% -- in the 90s. But I don't -- I think you're kidding yourself if you're thinking it's a 80s business with an occasional 110%, 115%. I don't see that.

Joshua David Shanker
Deutsche Bank AG, Research Division

No, no, no. What I'm saying that the volatility that I'm just as likely maybe to show up with a 120% as I am in 80% in a unusual quarter, I guess, is how I'm sort of thinking about it. But maybe that's too much to...

Thomas F. Motamed
Former Chairman and Chief Executive Officer

It's not like an EKG where it's up and down, all right? So I think we'd like to see it get closer to 100% overall. But 115%, we're not happy with that.

Joshua David Shanker
Deutsche Bank AG, Research Division

And in terms of -- as the business that you're going to leave in about 6 months, a little less than that actually, can we conceive of the reserve situation getting to a point where you're looking to have the reserves have a steady sort of trend depending on where the market is going? It seems like I try and forecast reserve, at least for CNA, good luck to me, I mean, good luck for any company, but they're pretty volatile and that's a result of trying to get the book in order which there's a number of things changing all the time. Should it be less volatile in time? Or is this sort of normal visibility?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

I would say we're comfortable with reserves, and we're comfortable that we've had now a couple quarters of reserve releases in Commercial. Specialty has been consistent in that regard. This is not the serial reserve company that somebody knew in the past. This is a much different place. We're very comfortable with the reserve. Sure, there are ups and downs periodically, but we think we're really doing a nice job on the reserve side and we're comfortable.

D. Craig Mense
Chief Financial Officer and Executive Vice President

And Josh, this is Craig. I'd say, over the last 10 years, our reserve history has been remarkably consistent in terms of favorability most of the time. We don't get it right all the time, but pretty remarkably consistent in that we do see some small amount of favorable reserve development because of the approach we have taken.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

And I think the point that Craig made a little bit earlier, you're seeing reserve releases now from more current accident years. If you went back a few years ago, the older accident years, it's more consistent now, so we're pleased.

Operator

We'll go next to Jay Cohen with Bank of America.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

I guess starting on the International side. Can you maybe put a little color around 1 or 2 of these large losses? When you say trade credit political risk, what exactly happened that gave rise to the loss?

D. Craig Mense
Chief Financial Officer and Executive Vice President

It's -- I mean, I don't know if you understand the trade credit business. But essentially, we are -- what's giving rise to the loss is the commodity depressed prices, guarantees made about deliveries or prices of those commodities and failures of the companies to transact or complete those businesses. So that's really a function of the currency in emerging markets and commodity pricing and the impact to that business and the guarantees made in that business.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Got it. And on the financial institutions loss, this is a liability-type product?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Well, there -- actually, there are several there, Jay. So it is financial institutions, some are director's and officer's liability and there also is one large fidelity crime loss. So it's relatively -- there are a handful of large losses with different characteristics across that portfolio.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Got it. And then on the International premiums, it makes sense that you'd see the shrinkage given the market conditions. It did seem to really step down this quarter versus the last several. Are you reacting more aggressively to the competitive environment?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Well, I think, remember also -- and you want to be able to see that some in the commentary and in the press release that there's a bit of a timing difference in the reinsurance spend at Hardy which reduced the net written premium by about 10% this quarter. You might remember the last quarter, we're explaining that it wasn't quite as high as it looks. So some of it is that. But even when you take currency impacts away and you take that reinsurance timing away the top line, on a local basis, it will be down about 10 points -- 10 or 12 points. And that is the function of the market rates and the market and retention in the market and then our reaction to the rationality or lack of rationality in the market. I think also, remember that at Lloyd's, one of our bigger sectors was energy, and energy has been under no significant pressure, both from just the assets that are being insured, declining, less purchasing from those eventual customers and then kind of competitive environment of that. So there's a lot of different things going on which are why Tom was saying what he's saying about the relative stress now ongoing at Lloyd's.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Yes. Yes, you're not alone there certainly. And then the last question, given the ongoing favorable development, how are you adjusting your current accident loss year ratio picks? Has that allowed you to just use a somewhat lower pick? Maybe not as low as the reserves might indicate, but some of the lower pick anyway?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Well, we do adjust our current picks based on how we see the base loss ratio improve. So that is a factor in how we look at things. I wouldn't say that we adjusted anything this quarter. I mean, we take it into consideration. And as we go along, we try not to act too quickly on the current accident year, particularly in this rate environment, right, until we're a little further in the year and then we can see how all the different components that might drive how it's going to -- the outcome is a little more settled in. But certainly, that is a positive factor and will be a positive factor as we're going forward.

Operator

[Operator Instructions] We'll go next to Jeff Schmitt with William Blair.

Jeffrey Paul Schmitt

A question on the Commercial book. It looks like small business rates are holding up well. The middle market book is down so the second straight quarters went negative. Could we get a sense on how much of the book is broken between the 2 small business in middle market?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Well, small is about 20% of the total Commercial line segment.

Jeffrey Paul Schmitt

Okay. And are you seeing rate pressure there kind of across the board? Or are you seeing any lines deteriorating more?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

No, rates are up in small business. And we tier our business 1 to 5. And all of the tiers are up. Some are high single digit, some are low single digits. But small business, we're seeing good rate increases.

Jeffrey Paul Schmitt

I meant for middle market there, I'm sorry.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Oh, well, what's the question on middle market?

Jeffrey Paul Schmitt

Well, it's gone negative here now for the second straight quarter. And I was just wondering if that's kind of broad across business lines or is there any...

Thomas F. Motamed

Former Chairman and Chief Executive Officer

The package business is off low single digits, and that would be a big driver of the middle market.

Jeffrey Paul Schmitt

And then the expense ratio for that book is up. I think it's for like the seventh straight quarter. Is that mainly being driven by investments in the business? Or where does that tap out at?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes, investments in the business.

Jeffrey Paul Schmitt

I mean, is this at 38%, 39% -- I mean, is there much more...

D. Craig Mense
Chief Financial Officer and Executive Vice President

I think what you saw is that it's actually down this quarter from last, all right? So it has been up year-over-year, but down this quarter a little bit from last and a little bit more consistent. As I said, overall, we think the expense ratio -- we're going to continue to invest in the business because we think, long term, this is a game of how well are you -- how good are you with quantifying, selecting and managing risk. And we are very mindful of where our competitive position is as compared by the accident year loss ratio to peers. And I see -- and I think you will see, if you look at it, how much we've closed that gap if not completely closed that gap. So that's -- that is a significant positive factor for the business trading forward. And you expect us to be mindful of that expense ratio on competitiveness, which is about 2 or 3 points now. But essentially, we arrested any increase this quarter from last. And what I said in my remarks, as we expected, we expect it to be closer to that where we began the year, around 34%, 34.5% when we ended the year.

Operator

[Operator Instructions] We'll go next to Meyer Shields with KBW.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Is there any useful rule of thumb in terms of saying that when you've got loss ratio improvement of x points divvying off any expense in terms incentive compensation in the expense ratio? Was there any -- is that a driver at all in this quarter?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

I'm sorry. We're having a hard time -- I'm having a hard time hearing you or understanding the question.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. I'm wondering whether the successes that you're showing on the loss ratio in Commercial and in Specialty, does that come -- does that imply a higher expense ratio for incentive compensation at all?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

No. Not in the semi. Depending on how will we do, we could have some impacts there. But if it is, it would be onetime. It would be incremental. I don't think it would be particularly noticeable. And I wouldn't -- but we do -- certainly do reward our underwriters for their performance or outperformance against expectations.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Okay, that helps. I think, Tom, you mentioned the improvement in frequency as a function of underwriting -- internal underwriting. Is there anything changing in the external environments in terms or frequency or severity, particularly on the liability side getting worse?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

I don't know. I think the only thing is management liability looks pretty bleak to me from a claim standpoint, and the market continues to push rates down. It doesn't make any sense at all. But I think management liability is a bit troubled, particularly the large public stuff. So that would be the only other thing. I mean, we look at our claim counts and new claims were down 5%. Our outstanding claims are down 5%. That's been going on for a while, and that's part of the portfolio management. I think we're doing a good job managing frequency.

Operator

That will conclude the question-and-answer session. I would like to turn the conference over to Mr. Tom Motamed for any additional or closing remarks.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Thank you, everybody. We'll see you next quarter.

Operator
That will conclude today's conference. Thank you all for your participation.