S&P Capital IQ

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CNA Financial Corporation NYSE:CNA

FQ3 2015 Earnings Call Transcripts

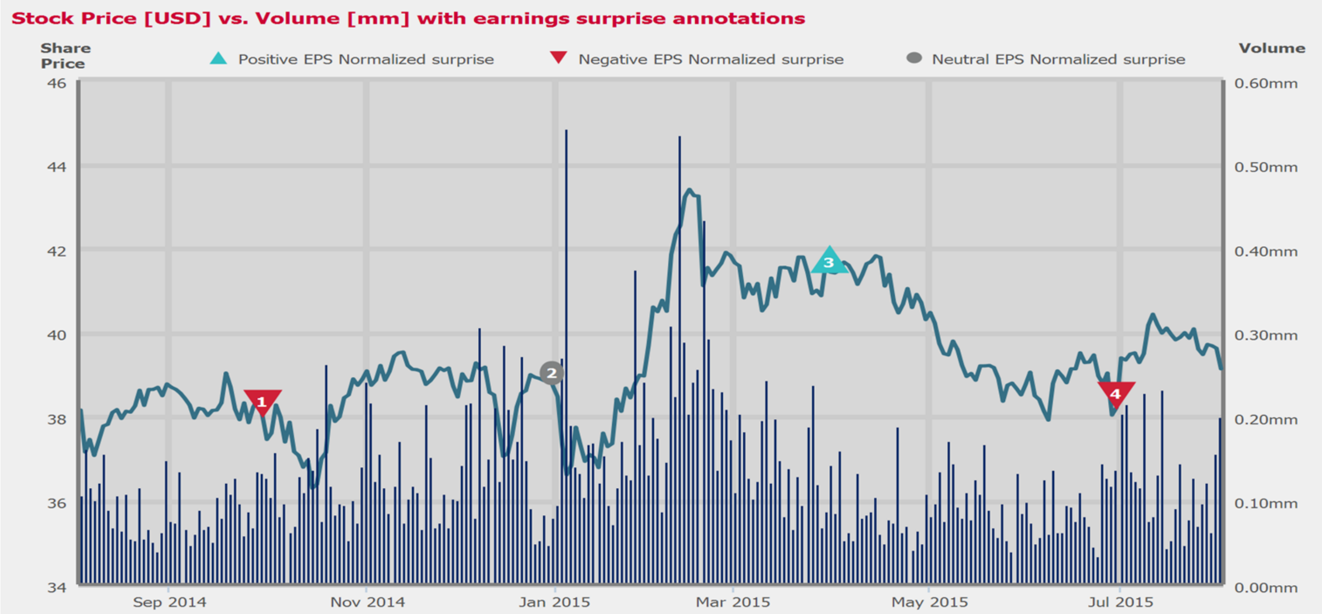
Monday, November 02, 2015 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2015-			-FQ4 2015-	-FY 2015-	-FY 2016-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.78	0.77	(1.28 %)	0.85	3.03	3.42
Revenue (mm)	-	-	-	2367.00	9368.00	6814.00

Currency: USD

Consensus as of Nov-02-2015 1:06 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2014	0.78	0.68	1 (12.82 %)
FQ4 2014	0.76	0.76	2 0.00 %
FQ1 2015	0.81	0.83	3 2.47 %
FQ2 2015	0.79	0.49	4 (37.97 %)

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

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

Amit Kumar
Macquarie Research

Jay Adam Cohen
BofA Merrill Lynch, Research Division

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, and welcome to the CNA Financial Corp's Third Quarter 2015 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, Cassandra. Good morning, and welcome to CNA's discussion of our 2015 third 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 in 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, the forward-looking statements speak only as of today, Monday, November 2, 2015. 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 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 it 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. In the third quarter, CNA produced net operating income of $210 million compared with $182 million last year. The increase was driven by significantly higher underwriting income, which was partially offset by lower limited partnership investment income. Our Property & Casualty operation had a great underwriting quarter, with a combined ratio of 85.7%, more than 10 points better than last year's third quarter, and our lowest quarterly combined ratio in more than a decade. The improvement was driven by favorable prior year loss development in all Property & Casualty segments and a 3-point improvement in our underlying Commercial loss ratio. We also benefited from a benign catastrophe quarter.

Excluding catastrophes and development, the Property & Casualty combined ratio was 95.5%, 0.7 points better than the prior year quarter.

Our Specialty segment had another outstanding quarter, with a combined ratio of 74.4% compared with 80.8% in the prior year quarter. The improvement was driven by higher favorable prior year loss development, with the majority of development coming from surety.

Excluding catastrophes and developments, the combined ratio was 92.5%, up 1 point, primarily due to an increase in the expense ratio. Specialty rate was relatively flat and retention continued to be strong at 86%. Specialty's net written premium was down 4%, as we continue to believe that most of the new business opportunities that are coming into the market are inadequately priced for the exposures.

We continue to make steady progress in Commercial. The combined ratio of 95.8% was nearly a 15-point improvement over the prior year quarter. It was helped by moderately favorable prior year loss development, a low level of catastrophes and, most importantly, a 3-point improvement in the underlying loss ratio. Our ongoing improvements in risk selection and pricing strategies continue to drive the loss ratio lower.

Excluding catastrophes and development, the combined ratio was 95.6%, which was a 2.5 point improvement over the prior year quarter. Commercial rates increased 2% and retention improved to 76%. Our core middle market's business, which represents more than 50% of our Commercial writings achieved 83% retention again this quarter.

Our International segment also had a good quarter, with a combined ratio of 90.4%, an 8.6-point improvement over the prior year quarter, driven by higher favorable prior year loss development. Excluding catastrophes and development, the combined ratio was 106%. Two large losses added $25 million or 12 points to the current accident year loss ratio. Excluding the effect of foreign currency exchange rates, net written premiums increased 5% for the quarter compared with the prior year quarter. International rates decreased 1% and retention was 73%.

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

D. Craig Mense
Chief Financial Officer and Executive Vice President

Thanks, Tom. Good morning, everyone. As Tom indicated, CNA delivered a strong financial result in the quarter, powered by much-improved underwriting profitability. Operating earnings were $0.77 per share, up 13% from last year, with operating return on equity of 6.9%. Net operating income in our Property & Casualty operations was $263 million, up 9% from last year, driven by especially strong underwriting performance.

As you'll recall, we believe that an important measure of our continuous improvement is our year-to-date underwriting results as compared to where we ended full year 2014. P&C's underlying loss ratio of 62% is almost 1 point better than our full year 2014 result, driven by Commercial's over 2-point improvement.

Life & Group produced a $30 million net operating loss in the quarter compared with a $42 million loss last year. The current quarter loss was driven by continued unfavorable morbidity relative to expectations. While the prior year quarter loss included a $34 million after-tax charge attributed to a reinsurance transaction tied to the sale of our life business. Net investment income was depressed by a limited partnership loss of $93 million. Our LPs this quarter produced a negative 3.2% return, approximately half of the negative 6.4% return of the S&P 500.

While the loss from the LP portfolio was disappointing, these investments continue to perform as we would expect. They provide diversification to the overall portfolio, with less volatility and higher risk-adjusted returns and equities. On a year-to-date basis, CNA's LP portfolio has generated a positive 2.2% return. The S&P 500 was down 5.3% over the same period.

Our fixed income portfolio remains stable and generated after-tax income of $326 million for the quarter, essentially unchanged for the prior year period. Our investment portfolio's net unrealized gains stood at approximately $2.6 billion at quarter end, a slight decrease from the end of the second quarter. At September 30, shareholders' equity was $12.3 billion and book value per share was $45.38. Excluding accumulated other comprehensive income, book value per share of $45.16 has increased 4.4% from year-end 2014, adjusted for dividends. Statutory surplus at September 30 was an estimated $11 billion for the combined insurance operating companies, and we continue to maintain more than adequate dividend capacity.

Cash and short-term investments at the holding company were approximately $464 million at quarter end. We continue to target cash at the holding company equal to approximately one year of our annual net corporate obligations.

In the third quarter, operating cash flow, excluding trading activity, was $489 million. Cash principal repayments through pay downs, bond calls and maturities were approximately $800 million. Fixed income assets that support our long-duration Life & Group liabilities had an effective duration of 10.3 years at quarter end. The effective duration of the fixed income assets that support our traditional P&C liabilities, was 4.4 years at quarter end. These durations are both in line with portfolio targets. 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. Before we take your questions, I would like to close by saying we are quite pleased with the quarter and particularly with the increased contributions by underwriting. We will continue to maintain our focus on improving margins through portfolio management as well as being selective on new business opportunities.
Thank you, again. We will now take your questions.

Question and Answer

Operator

[Operator Instructions] And we'll go first to Amit Kumar of Macquarie.

Amit Kumar
Macquarie Research

Two quick questions. Number one is, I guess, just going back to the broader discussion on underlying margins and improvement in margins. And obviously, this is a very strong quarter. Tom, do you get the sense that there is still a lot of room for that to continue to improve from here? Or are we sort of approaching somewhat of a flatline, just based on, I guess, the market conditions and the previous rate increases, which you have taken?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Well, the question is what does a lot mean. I would say there is potential improvement in our margins. I think that we have been going about this in a very granular way, and we've been grinding it out quarter-over-quarter. So I think there is room for improvement in Commercial. Specialty, the market is pretty tough, but we continue to deliver outstanding results in Specialty, where we're a market leader in many of the Specialty segments we choose to play in. So yes, we are optimistic that we can continue to show improvement. We are getting some rate in Commercial, and we are being very disciplined when it comes to new business. I think many of the tools that we have put in place over time are starting to help us. But it's not just rate. It's risk selection, it's terms and conditions, it's looking at portfolio management, what lines you want to write in what territories. All of those things add up, and we're getting better with that every quarter.

Amit Kumar
Macquarie Research

That is, obviously, great news, because a lot of us have, obviously, waited for quite some time for these results. The second question I had was maybe for Craig. Do you have the LP mark, I guess, reversal, or the number as of Q4 to date? I'm wondering if you have any indication as to where it stands as of now? Or how much of that negative has turned to positive based on your understanding?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Well, October, I would expect October to be a good month, Amit. So just keep in mind that our marks are reflective of the current market at the time. Over 70% of our LPs are marked on a current basis. Another 10% are only 1-month delayed. So you get current marks and you know that October was a good month. So you should expect October was a good month for LPs from us.

Amit Kumar
Macquarie Research

Got it. Okay. The only other question I had was the level of result releases. Maybe I missed it. Did you talk a bit more about that in the opening remarks? Because it was obviously higher than what you've seen in the past? And was that the usual reserves study, which concluded this quarter? Or was there anything else going on?

D. Craig Mense
Chief Financial Officer and Executive Vice President

No, those were the usual reserve studies that we concluded this quarter. I think what drove a lot of the difference was that we saw a favorable reserve development across all 3 business segments. So there was -- we had no asterisks from any business, any that we looked at. And then, of course, in Specialty, this is a quarter that we traditionally look at surety. Surety results were particularly positive, but we also saw very positive results really accident years '12 and prior across the professional and managerial liability book, driven by quite a bit lower large loss development that we anticipated. We had some little small benefit in '14 cat estimates coming out of Commercial. We had no bad news in Commercial. And we had really positive news across the entire portfolio in International. So just really was the consistency of improvement across everywhere.

Amit Kumar
Macquarie Research

Got it. And it was the biggest fee for professional liability which you mentioned, the '12 to '14?

D. Craig Mense
Chief Financial Officer and Executive Vice President

I said '12 and prior professional and management liabilities showed improvement.

Operator

And we'll go next to Josh Shanker of Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

Following up on Amit's question a little bit. If we look through 2008 to 2011, there was a patterning for large reserve leases in the fourth quarter. I assume there was an annual study that was completed in each of those years that caused that to happen. Is the pattern of how you conduct your reserve studies the same today as it was 6, 7 years ago?

D. Craig Mense
Chief Financial Officer and Executive Vice President

No, I think our pattern of reserve reviews has been pretty consistent all the time that I've been here. And I've been here for 11 years. We look at somewhere around 30% or so of our total reserves every quarter. We make a point of looking at the larger product lines at least twice a year in depth. And everything at least once a year. And we're really making a point of making sure that we're more frequently looking at all of our reserves in general. So no, I'd suggest there's no real pattern, no real pattern change...

Joshua David Shanker
Deutsche Bank AG, Research Division

So there's no seasonality to think about going to 4Q or 1Q anywhere except from long-term care?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Well, there is a, as you recall, not so much 4Q but 1Q, after we finish the year end results. We have traditionally not made much of any changes in first quarter. So other than having said that, I would say there's no particular seasonal pattern, too.

Joshua David Shanker
Deutsche Bank AG, Research Division

Okay. And of course, a large reserves study coming up in the fourth quarter on long-term care. Can you talk a little bit about the changes in methodology a little bit? Obviously, you can look at the stock, I think, given everything we've seen at Genworth, investors are a little nervous that you changed some tactics on how you analyze long-term care. You could get an adverse result. But I think you said that -- certainly that you would be surprised if there's any dramatic difference between your old methodology and your new methodology. Your methodology is a little bit more granular. Can you kind of talk to that a little bit as we preview what's going to happen in the next couple of months?

D. Craig Mense

Chief Financial Officer and Executive Vice President

Sure, I'm happy to, Josh. I think that -- and I would just change the word. We're not changing our methodology, right. We did have a systems conversion, which enabled us to have a more granular view. And that systems conversion is proceeding as planned. It's near completion. And as I said last quarter, actually, I can even say it more confidently today, I expect no material effect on the reserve position that's going to come out as a result of the change in actuarial systems. Now having said that, we're in the midst of our normal reserve analysis, where we are reviewing all the key assumptions with another year of experience, and that work will continue deep into the fourth quarter. So we're -- and I'd say we're too early to be drawing any conclusions from that work.

Joshua David Shanker
Deutsche Bank AG, Research Division

Can you talk a little about the morbidity trend that you saw in the third quarter?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Well, the morbidity trend in the third quarter is really a continuation of what we've seen in the last several quarters and that's driven really almost entirely by new claim incidents in individual long-term care, which has been at increased levels for several quarters in a row. So none of the other major morbidity components, benefit utilization, duration of long-term claim, claim terminations, all those key factors have been pretty stable over the time. So it's entirely a new claim incidence in individual phenomena.

Joshua David Shanker
Deutsche Bank AG, Research Division

And you don't see a similar trend in the group book, I guess?

D. Craig Mense
Chief Financial Officer and Executive Vice President

That's correct.

Operator

And we'll go next to Bob Glasspiegel of Janney.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

A couple of quick follow-ups to what you were discussing in the first 2 questions from Josh and Amit. On Josh's questions, not to prejudge what the actuarial study will do, but just to understand directional pressures or positives, am I right to assume that pricing is an incremental positive, interest rates might be a negative, and perhaps your commentary that you're seeing several claims -- several quarters of increased frequency that might be a pressure? Do I have the directions right?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

I think you do. So yes, rate increases are generally positive and, certainly, morbidity has been unfavorable over the course of the year. And interest rates, remember, you don't just look at risk-free, you've got to look at where spreads are in components and where we invest. So that's a little bit more, probably neutral to slightly -- in either direction.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

So your new rates are -- your new investment yields are pretty close to what your old assumptions were despite the continued work [ph] because spreads are widening? Is that what you're saying?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

What I'm saying is that you have to pay attention to spreads because that's where we invest, not just risk-free. I guess, I would also go on to say we have -- we're not investing at the rate that of the liabilities, but we are investing over the course of this year above where we would have expected to have been able to invest, just as happened a year ago.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

Okay. Good to hear that I'm focusing on the right variables. On the pricing trend, Tom, I'm probably over-analyzing, but it sounds like you were a little bit more cautious on inability to get new business on where rates are. Is that a fair comment? Or is it just more of the same, nothing's changed in the last quarter? Are you saying the rates are a little bit more competitive on the margin?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

It depends on the line. So where -- when you look at the public and private D&O, for example, the pricing just keeps coming down, down, down. So we don't want to necessarily -- in the marketplace, the marketplace. So we don't necessarily want to follow it down. So we're going to be pretty judicious on what we write there, right? If you look at large property, I think you've heard this on other calls, so the larger accounts are taking big hits on renewable and the new business is very, very competitively priced. So we don't want to be following the market down. We're just going to look for the opportunities that make sense. So it depends on line. But you know what's going on with rates. It's been decelerating for a while. And I think that if you look at the Specialty business in particular, it's pretty competitive out there. A lot of people want to get into that space and it's pretty tough business. They're going to find that out.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

Okay. So as we think about capital needs, you're generating capital, your top line isn't growing. Your leverage ratios are below your target levels. I think you do your special dividend analysis with the year-end results. Is there anything else on the margin that will factor into that decision?

D. Craig Mense
Chief Financial Officer and Executive Vice President

I think, Bob, I'd just say that you should expect us to follow the same deliberate, disciplined thought process that we've followed in the last several years.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

You're generating excess capital still, though, that's the fair way to think about it, right?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

That's correct.

Operator

And we'll go next to Jay Cohen of Bank of America.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

I wanted to start on the Commercial segment. The accident year loss ratio there dropped really quite a bit, not only from a year ago but from where it had been for the first 3 quarters of the year. My question is, is there any sort of current year development, any true up in the quarter?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Yes, there is. So as we -- I'll be happy to follow up off-line, too, Jay, if it might be helpful to you. But I'm afraid we sometimes confuse people. Recall that we are reflecting both underwriting actions and earn rate above trend as the year progresses, rather than kind of resetting the expectation beginning of the year. So what you're seeing as the -- is the multiplier effect. So if the loss ratio in commercial gets 0.5 point better on a year-to-date basis in the third quarter, it will be multiplied, it would look like 1.5 points essentially. So that's the phenomenon you are seeing. I think if you look back and look at '13, '14, you'd see the same phenomenon. And that is our pattern of improvement recognition that you're seeing, where we're cautious as we move through the year.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

So as we look forward, sort of the base to look at, really, is the 9 months number?

D. Craig Mense
Chief Financial Officer and Executive Vice President

That's correct. That's what I said -- that's what I always try to remind everybody in these calls and else-wise that the best place to look at the level of improvement is to look at the year-to-date number as compared to where we ended the full year '14 or that year before. And there was actually a slide in the earnings deck that I think clearly illustrates that.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Yes. Yes, there is. Second question, given the good underwriting results, should we expect a somewhat higher expense ratio for the fourth quarter for some sort of incentive comp or bonuses?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

We haven't gotten around to thinking anything about that. So no, I wouldn't suggest you anticipate any higher expense ratio.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Okay. And then last question, the very sizable reserve release, I mean, looking at -- taking a step back, does this give us some indication of what's happening in the overall claims environment? Are things more benign than you thought they would be at this point?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Well, I mean, it depends on whether you're focusing on the -- it was really those reserve releases, I think, that were driven more by large losses being less than anticipated. And remember the years that I've referred to, which were '12 and prior, and a lot of that is just the conservatism and the caution with which we would reserve, particularly, professional and management liability lines, given the uncertainty of those outcomes. So we wouldn't say that. In fact, I think we'd say frequency trends in D&O are up the last couple of years. It's part of the reason that we've been more cautious and withdrawing from the public market and up in the medical malpractice arena, which is why we've been cautious in the market. So, and our own view is that other underwriters seem to be chasing yesterday's returns and are behaving, particularly in Specialty, at, it might suggest, almost irrational level of behavior.

Operator

[Operator Instructions] will go next to Adam Klauber of William Blair.

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

Actually, a follow up on some of your comments. Could you talk more about lost trend in some of your key liability lines? I think you're just talking about some of the professional liability, but how are they running in workers' comp? How are they working for some health care practices?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Well, I'd say that relatively unchanged. Our assumptions are still that long-term loss trends are in the 3% to 4% range over time. And that's what we use for reserving and that's really what we use in terms of pricing. Now in the interim, comp trends have been generally benign and continue to be. And we've seen some frequency pickup in the public D&O and some of the health-care lines, as well as actually some severity pickup in health care.

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

Okay. Okay. Than just a follow-up on the LP, is the deterioration more on equity-based investments or fixed-based investments or is it more mixed across the board?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

It's more -- well, recall that we said is that 70% of this -- our LP portfolio are hedge funds. And there is a slight long equity bias to the makeup of the total portfolio and that's what's drove -- what's driving the loss -- or drove the loss last quarter.

Operator

And we'll go next to Meyer Shields of KBW.

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

Just one basic question. A lot of significant mergers either recently closed or being -- seeing progress on them now. Can you talk a little bit about how agents are responding to that? Is there any opportunity there for you?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Agents always express concern when there's change of any type. So the fact of the matter is, they express concern. My experience is, everything goes back to normal after some time. It settles back down. But this has been going on for a long time. Whenever there's a deal, they all have something to say, but they go back to business the following day. So we'll see.

Operator

And there are no further questions from the phone lines. At this time, I will turn the conference back to Tom Motamed for any additional or closing remarks.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Thank you very much. We'll see you next quarter.

Operator
And this does conclude today's conference. We thank you for your participation. You may now disconnect.