Company Name: Horace Mann Educators
Company Ticker: HMN US
Date: 2016-11-01
Event Description: Q3 2016 Earnings Call

Market Cap: 1,467.99
Current PX: 36.55
YTD Change($): +3.37
YTD Change(%): +10.157

Bloomberg Estimates - EPS
Current Quarter: 0.610
Current Year: 1.950
Bloomberg Estimates - Sales
Current Quarter: 279.000
Current Year: 1110.000

Q3 2016 Earnings Call

Company Participants

- Ryan E. Greenier
- Marita Zuraitis
- Dwayne D. Hallman
- William J. Caldwell

Other Participants

- Robert Glasspiegel
- Meyer Shields

MANAGEMENT DISCUSSION SECTION

Operator

Greetings, and welcome to the Horace Mann's Third Quarter 2016 Earnings Conference Call. At this time, all participants are in listen-only mode. A question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Ryan Greenier, Vice President of Investor Relations for Horace Mann. Please go ahead, sir.

Ryan E. Greenier

Thank you, Kevin, and good morning, everyone. Welcome to Horace Mann's discussion of our third quarter results. Yesterday, we issued our earnings release and investor financial supplement. Copies are available on the Investor page of our website.

Our speakers today are Marita Zuraitis, President and Chief Executive Officer; and Dwayne Hallman, Executive Vice President and Chief Financial Officer. Bill Caldwell, Executive Vice President of Property & Casualty; and Matt Sharpe, Executive Vice President of Annuity & Life are also available for the question-and-answer session that follows our prepared comments.

Before turning it over to Marita, I want to note that our presentation today includes forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. The company cautions investors that any forward-looking statements include risks and uncertainties and is not a guarantee of future performance. These forward-looking statements are based on management's current expectations, and we assume no obligation to update them. Actual results may differ materially due to a variety of factors, which are described in our press release and SEC filings.

In our prepared remarks, we may use some non-GAAP financial measures. Reconciliations of these measures to the most comparable GAAP measure are available in the supplemental section of our press release.

And now, I'll turn the call over to Marita Zuraitis.

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Marita Zuraitis

Thanks, Ryan, and good morning, everyone, and welcome to our call. After yesterday's market close, Horace Mann reported third quarter operating income of $0.58 per share. Investment results were strong across all three operating segments, and life mortality was modestly favorable to actuarial models.

Weather patterns remained challenging and the P&C segment was impacted by an elevated level of convective storm activity in the quarter. In auto, we had 3.4 points of catastrophe losses, mainly related to flooding in Louisiana that occurred in August. In addition, we saw a number of sizable convective storms across the Northern Plain states that resulted in hail and other physical damage to both auto and property exposures.

The majority of the 3.9-point increase in the underlying property loss ratio was related to these storms. And this adverse weather contributed to an increase in underlying auto comprehensive frequency in the quarter. Outside of the challenging weather patterns, we continue to see an elevated level of auto collision frequency and physical damage loss severities.

On a year-to-date basis, operating earnings are $1.45, $0.13 lower than prior year. Through the end of the third quarter, catastrophe losses continued to run above the previous year and now are 2.2 points or $0.19 higher. And we expect this to increase, given the fourth quarter impacts of Hurricane Matthew.

In addition, on an underlying basis, the P&C combined ratio of 92.8 points was 2.3 points higher than the prior year, which reflected adverse weather as well as the macro challenges impacting auto loss trends. We, like the rest of the industry, are addressing these challenging trends such as distracted driving, higher repair cost and increased miles driven with additional rate, enhanced claim practices, and tighter underwriting.

That said, these trends are likely to be the new normal until a more comprehensive solution is found to address distracted driving. We will remain aggressive in our rate plan and respond quickly to any changes in loss cost trends to ensure we are taking enough rate to improve profitability. We are on track to exceed our original auto rate plan by 1 point or so, and are looking for opportunities to accelerate rate actions.

Our rate actions do not appear to be significantly impacting retention, which remains strong at 84%. In addition to overall rate, we are enhancing claim practices with an eye towards improving efficiencies and our customers' experience, while also reducing claim cost. From an underwriting perspective, we are refining our process to ensure we provide competitive pricing for preferred risks in profitable geographies, while taking appropriate rate actions to improve profitability in segments and geographies that are more challenging.

We continue to find opportunities to profitably grow auto. We are targeting specific geographies, customer segments and cross-sell initiatives to help drive growth momentum in areas with the strongest profitability. And we feel good about our new business mix.

Adverse weather has weighed on auto results for most of 2016, and we expect that trend to continue into the fourth quarter. Historically, our underlying auto loss ratio is elevated by 5 to 6 points in the fourth quarter, typically due to wet driving conditions in some of our larger auto markets in the Southeast, as well as impact of snow and ice in the Midwest and Northeast.

Within property, we continue to pursue appropriate rate increases, while improving underwriting and pricing segmentation to ensure consistent solid underlying results. Property results can be volatile, given weather patterns, so a disciplined approach to rate-taking and a tight underwriting process is critical for success in this line. In total, for our combined P&C book, we expect the underlying combined ratio to be 1.5 to 2.5 points higher for the full year of 2016 compared to the prior year.

Turning to our retirement business, annuity profitability has been a bright spot this year, given strong investment portfolio performance despite the challenging interest rate environment. Assets under management grew 8% and now total $6.3 billion. Sales momentum remains solid and persistency remains at nearly 95%.

Our captive agent sales of our products are increasing. Because our products are designed to meet the unique retirement savings needs of educators, we are somewhat insulated from broader sales trends in the annuity marketplace. As a result, we continued to successfully grow our annuity business despite the challenging interest rate environment. In addition, we are successfully launching our new group retirement product, Retirement Advantage, in more school districts.

We are moving forward to prepare for the implementation of the Department of Labor fiduciary regulations and continue to approach the changes thoughtfully. As I mentioned in our last earnings call, we are working on harmonizing our agency compensation model, making some product refinements, and improving our infrastructure and online capabilities to deliver a consistent experience across all product types, including 403(b) and IRA business.

We're making good progress and we are confident that our captive distribution force, leadership position in the educator space, and specialized knowledge of state teacher retirement programs and benefits help position us to be successful in continuing to serve our educators in a holistic manner.

The life segment continues to grow nicely and sales are up 45% for the first nine months of the year. Sales increased across most of our life products and we are seeing encouraging growth in sales from our new Indexed Universal Life product, introduced last year which now comprises about a fifth of our total life sales.

We are investing in agent training, cross-sell initiatives and marketing campaigns, as well as infrastructure improvements to support sales growth in this segment. On a year-to-date basis, life earnings are tracking better than both expectations and prior year, largely due to lower mortality costs and favorable investment income.

We remain committed to refining our products and program offerings to ensure we are helping educators solve the financial issues they face, utilizing our unique approach to help educators find additional funds that can be redeployed to retirement savings. We have historically done this through our DonorsChoose.org crowd-funding partnership and enhanced discounts for educators on auto, property, and life insurance products.

As an example of our unique solution-based approach, I am pleased to announce a new innovative program that is making a significant difference to educators struggling with student loan debt. Earlier this year, we launched Horace Mann's Student Loan Solutions, which provides a comprehensive suite of solutions for educators to address student loan debt. We help guide educators through federal student loan forgiveness and repayment programs, and have partnered with a third-party financial institution that is a top-five private student loan originator to provide Horace Mann branded refinancing options.

This program will allow us to help educators gain loan forgiveness for qualified loans, as well as the ability to refinance their loans at a lower interest rate, creating meaningful savings in their monthly loan payments. And importantly, we are showing educators opportunity to redirect those savings to help achieve their long-term financial goals, like retirement, by helping them build a holistic long-term plan which generally includes a 403(b) annuity.

We expect this program to be very successful in helping many millennial educators get a head start on supplemental retirement savings and have seen significant interest from school districts to address one of their largest recruitment issues that they are facing. The average student loan debt of new educators is around $35,000, which in many cases is close to their annual pre-tax salary. As a result, many young educators work second jobs or leave the profession in search of a higher-paying job to pay back their debt.

This creates recruitment, productivity, and retention challenges for our districts. Horace Mann's new innovative solution is connecting with school superintendents and business officials as a tool to address challenges in their district, and as a result, is expanding school access and reinforcing the unique value proposition of the Horace Mann brand.

In addition to ensuring we have the right solutions to address the unique needs of educators, we continue to build and improve distribution options to allow educators to begin their customer journey with us through their desired channel, while also building the required infrastructure to support an improved customer and agent experience.

I am confident we're making the right investments in our business to accelerate profitable growth, enhance the Horace Mann brand, and increase the number of educator households and school districts that do business with us. Given our solid sales results across all of our product lines, I'm confident we're on the right path.

Thanks. And now I'll turn the call over to Dwayne.

Dwayne D. Hallman

Thanks, Marita, and good morning. Third quarter operating income of $0.58 per diluted share was $0.08 higher than the prior year, with the increase coming from stronger investment results across all operating segments. As Marita mentioned, adverse weather impacted P&C results in the quarter and we've experienced upward frequency trends along with elevated loss severities.

The P&C segment had after-tax earnings of $6.7 million, compared to $11.2 million in the prior-year period. On a reported basis, the quarter's combined ratio increased 6 points to 101.5%. 2 points of the increase was attributable to higher catastrophe losses and 1.5 points was related to lower prior-year reserve releases, both of which were largely within the auto line. The remainder of the increase was related to higher non-cat hail and convective storm damage frequency, and we continued to be affected by auto loss severities that remained elevated.

The underlying auto combined ratio for the quarter included about 1 point of current accident-year reserve strengthening related to the elevated loss trends we've been discussing. It's important to note that, on a developed basis, the underlying auto results for the third quarter were very similar to year-to-date results, with the underlying combined ratio in all three quarters around 104%. On a year-to-date basis, the P&C combined ratio was 102.4%. Like the current quarter results, nearly two-thirds of the deterioration was related to higher catastrophe losses and lower prior-year reserve releases.

Similar to the first half of the year, we are taking a cautious stance on auto, given the elevated severity and frequency trends we are experiencing. However, property reserves continue to develop favorably. The total P&C underlying loss ratio was running about 1.5 points higher than the prior year. An uptick in physical damage and comprehensive frequency, combined with an elevated severity trend, has resulted in roughly 3 points of deterioration in the auto underlying loss ratio. On a year-to-date basis, the underlying property loss ratio improved over 2 points, somewhat offsetting the auto pressure.

Auto trends remain challenging, and like Marita said, we are aggressively pursuing rate actions and are on track to end the year ahead of our original overall rate target of mid-single digit. The year-to-date expense ratio of 27.2% remains in line with our expectations for the full-year expense ratio. P&C written premiums increased 5% to $169.8 million for the quarter, largely on rate actions and, to a lesser extent, higher new business production. For the quarter, auto sales were up 3% compared to the prior year and property sales increased 2%.

In the annuity segment, operating income excluding DAC unlocking was $15.6 million, $5.7 million higher than the prior-year quarter. Approximately $1.5 million of the increase was related to lower-than-expected income taxes due upon finalizing the 2015 tax return. The remainder of the increase was largely related to higher net interest margins, which increased as a result of additional assets under management, and a 10-point increase in our net interest spread, which ended the quarter at 195 basis points.

We are aggressively managing the overall spread compression through crediting rate actions and investment allocations to maximize risk-adjusted returns. In addition to any investment portfolio actions, we benefited from another quarter of elevated prepayment activity in our fixed income holdings, which contributed about 10 points to our net interest spread, as well as our outperformance on our alternative investment portfolio. We are pleased with both our absolute and relative investment returns in this challenging rate environment and aim to capitalize on investment opportunities to maximize risk-adjusted returns.

While investment prepayment activity and alternative returns can be volatile from quarter-to-quarter, given our strong performance on a year-to-date basis, we now expect to end the year with a net interest spread in the mid- to low-190s basis points.

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Partially offsetting the year-to-date increase in annuity income was more than $2 million in higher operating expenses, which included non-capitalized infrastructure investments. We expect the expenses to remain elevated through the end of the year, as we move forward with our infrastructure improvements to modernize our systems and support the new DOL regulations.

Annuity assets under management grew 8% to $6.3 billion, driven by persistency remaining above 94% and solid sales and deposits. In the life segment, operating earnings excluding DAC unlocking improved $1 million to $4.6 million on lower mortality cost and higher investment income.

Consolidated net investment income increased 17% to $94.9 million for the quarter, due to strong investment portfolio performance and higher asset balances in the annuity segment. While the bulk of the benefits of elevated prepayment activity and strong returns on our alternative portfolio were in the annuity segment, P&C investment income was nearly $3 million higher and the life segment investment income increased by more than $1 million.

Despite the challenging interest rate environment, we continue to be disciplined in putting money to work at attractive risk-adjusted returns and we were able to achieve a 4% reinvestment rate in the quarter.

Overall, on a reported basis, book value per share was $35.94 and included a net unrealized gain position of nearly $600 million at the end of the quarter. Book value excluding net unrealized gains on investments continues to grow, ending the quarter at $27.54, a 4% increase compared to last September.

Through the first nine months of the year, overall operating earnings were $1.45, $0.13 below the prior year. As we typically do at the end of the third quarter, we are updating our guidance estimate to reflect these results as well as to include our expectations for the final quarter of the year. As a result, we now expect operating earnings per share to be between $1.80 and $1.90 per share. This guidance range includes a preliminary estimate of Hurricane Matthew-related catastrophe losses of between $9 million and $11 million on a pre-tax basis.

North Carolina represents our largest share of incurred losses from this event, with additional losses in South Carolina and Georgia. Losses in Florida were limited to auto comprehensive claims, given our multi-year Florida homeowner non-renewal program, which was implemented to help mitigate the overall impact of an Atlantic hurricane such as Matthew.

From a combined ratio perspective, when you include our preliminary estimate of Hurricane Matthew losses, our full-year catastrophe load is now in the 9-point to 10-point range, meaningfully higher than the roughly 6 to 6.5 points we included in our original full-year guidance estimate.

In addition, we've updated our auto frequency and severity loss estimates for the fourth quarter to be reflective of the current trends we are experiencing, and as a result, now expect the full-year underlying combined ratio to be between 93 and 94 points.

We expect underlying auto combined ratio to be 3 to 4 points worse compared to the prior year, somewhat offset by about a 1-point improvement in underlying property. Our revised guidance range assumes more normalized investment returns in all segments and life mortality to be in line with actuarial models.

While we cannot control the challenging macro trends we are facing in auto or the adverse weather we experienced thus far in 2016, we can control underwriting, rate setting, and claim processing efficiencies. We are working diligently to implement additional initiatives focused on improving auto margins, and monitoring very positive underlying property results closely, taking additional actions when necessary. We are also seeing good sales momentum in all of our business lines.

Importantly, our true multi-line business model continues to prove beneficial in times of increased volatility. We're successfully attracting more educators through our unique value proposition and are encouraged by the enthusiasm of our agents, school district and association partners, and are confident we are on the right track to being the company of choice to help the nation's educators protect what they have today and prepare for a successful tomorrow.

I'll now turn the call over to Ryan to start the Q&A.

Ryan E. Greenier

Thanks, Dwayne. Kevin, please open up the line to begin the Q&A portion of the call.

Q&A

Operator

Surely. [Operator Instructions] Our first question today is coming from Bob Glasspiegel from Janney. Please proceed with your question.

<Q - Robert Glasspiegel>: Good morning, Horace Mann.

<A - Marita Zuraitis>: Good morning, [ph] Bobby (21:56).

<A - Dwayne D. Hallman>: Hey, Bob.

<Q - Robert Glasspiegel>: Quick question – series of questions on auto. If you do a Venn diagram intersection, non-cat weather is part of the drive up in frequency and severity, and clearly you're saying there's something on top of it. How would you assess in the quarter the mix between those two in driving frequency and severity trends?

<A - William J. Caldwell>: Hey, Bob. This is Bill Caldwell. Hey.

<Q - Robert Glasspiegel>: Good morning, Bill.

<A - William J. Caldwell>: Were you [ph] able to question (22:29)

<Q - Robert Glasspiegel>: Yeah.

<A - William J. Caldwell>: Just to talk about how we bucket these kind of losses, when you think about the hail we saw in the Midwest, if you think about the Louisiana flooding, when those events cause flood damage or hail damage, cosmetic damage to a vehicle, that goes into the catastrophe bucket. So, when we think about that same vehicle that's rear-ended in a collision or unfortunately hits a guardrail, that goes into ex-cat.

So it's really hard to pull out what goes into the ex-cat weather bucket versus – well, the cat stuff is easier because it's coded what would be a normal accident versus weather. But what we do know is that frequency and severity is increasing because of these adverse weather trends. And we don't ignore it. So there is not poor accounting here. When I see these trends, they go into our pricing models and we react as quickly as they happen, and it would just mean increased rate activity as we go forward.

<Q - Robert Glasspiegel>: I guess I was asking which is a bigger pressure, non-cat weather which we can argue about whether that's recurring or not recurring, or a stair step bump up in frequency and severity this quarter versus what we saw in prior quarters...

<A - Marita Zuraitis>: Yeah...

<Q - Robert Glasspiegel>: ...which is a bigger pressure?

<A - Marita Zuraitis>: Very hard to quantify, but obviously that both exist. Very hard to quantify.

<Q - Robert Glasspiegel>: Okay. Let me take another attack at this. You're ahead of where you thought you'd be on rate increases but the underlying trend is more than you thought it was going to be going into the quarter. So I guess the question is, are we chasing our tail? Have we made progress at it? Are we ahead of the tail today in the rate that we're getting? Do we think margin in auto will expand a year from now with the rates that you're taking now, or do you need more rate?

<A - William J. Caldwell>: Yeah. Bob, I can say we'll be taking more rate. We evaluate these trends as they happen. When I look at the course of the year, it tends to be one month in each quarter which really helps pinpoint the weather issue. If you remember, last quarter we talked about April being a bad weather month, first quarter was March, this quarter was September.

So, outside of those months, we're seeing our rate actions exceed loss trends. But, unfortunately, there's been some adverse weather that's been holding us back a bit. But we will continue to take rate as needed. We continue to focus on our underwriting processes and we've tightened the screws on our payments processes.

We typically don't give guidance in the third quarter for what next year will look like, but I would expect to have the same conversation, something in the range – we talked about 6% rate this year, we'll probably exceed that by 1 point or so, probably something similar in that range, as our overall goal is continually to exceed loss trends with rate actions.

<A - Marita Zuraitis>: Yeah. This is Marita. I think Bill is absolutely right. You asked the question interestingly when you said are we chasing our tail. Maybe not, but we're clearly chasing a trend. And it's not only our trend, but it's the industry trend. And when you go back several quarters, we talked about seeing it, we talked about getting rate. Did we get enough? Maybe not. We accelerated it. We'll continue to accelerate if we need to accelerate.

But as you know, we typically run 3 to 5 points better than the industry from an auto perspective and I am confident that when you do the sum of the tapes, for 2016, we'll continue to have outperformed the industry in auto.

<Q - Robert Glasspiegel>: Okay. So do you think you're in good shape to be on top of the trends with what you're doing today? Is that the bottom line?

<A - Marita Zuraitis>: Yes. That is the bottom line. But I will also repeat what I said in the script, there's obviously something going on with distraction and it's going to take more than individual companies pushing rate. There needs to be a more comprehensive solution to how much distracted driving is taking place on the road. In the meantime, everybody is going to pay more for their auto coverage.

And we will figure this out. It's a short tail line. We're getting the rate we need. Retention is holding, which means others are pushing that rate as well. We continue to attract new profitable auto business. So it's certainly not at an industry crisis stage. It seems like folks are charging more for auto and people are realizing that they have to pay it. But it's a short tail line and we'll all figure this out and get after it, no doubt about it.

<Q - Robert Glasspiegel>: Very helpful. Thanks, Marita, and everyone.

<A - Marita Zuraitis>: You're welcome.

Operator

Thank you. [Operator Instructions] Our next question today is coming from Meyer Shields from KBW. Please proceed with your question.

<Q - Meyer Shields>: Great. Thanks. Good morning, everyone.

<A - Dwayne D. Hallman>: Morning.

<Q - Meyer Shields>: Can we talk a little bit about frequency and severity between liability coverages and physical damage in auto?

<A - William J. Caldwell>: Sure. So, just to take it back a notch, what we're really seeing is increased accident frequency. So, when there is a collision, there tends to be PD and there tends to be bodily injures, so all boats rise (28:01). I tend to look at PD frequency because that's a real measure of quality. And when our insurer hits something and we pay for it, that's an underwriting. That's kind of an underwriting measure for the quality. And we're seeing that increase slightly, but we continue to see bodily injury and collision arise with that PD frequency.

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When you look at a year where accident fatalities are higher than they've ever been, there's certainly some pressure on the severity side as well for bodily injuries, thinking back to when there are those fatalities where other people in the car tend to be more severely injured. So it's really that balance of frequency and severity, it's just the loss costs for bodily injury are going up more than they have in the past.

<A - Marita Zuraitis>: Yeah. The other thing I'd add to this whole commentary is the fact that we're in a niche segment and we have a group of educators now well over 80% of our book with repeatable driving patterns and 70 years of history in understanding this segment. So, getting our hands around that is obviously something that we're good at and will continue to push.

However, our educators are not immune to these trends. They are driving on the same roads with these folks that are distracted at a much higher level. So, my point is, I feel better about doing this in a homogenous niche of customers that we know extremely well than doing it in the general populous. But they're not immune to the trends because they're obviously driving on the same roads.

<Q - Meyer Shields>: Yeah. That makes a lot of sense. Is there any – this is kind of a goofy question, is there a way of measuring the increase in distraction?

<A - Marita Zuraitis>: I mean, obviously, we're going to keep track of it in our claim files. So, when you go out and do a police report, if there's no skid marks for the vehicle, if the vehicle didn't even attempt to stop, obviously if there's a cell phone on somewhere in the car and they pull the records, you can see those obvious things, but often times you can't necessarily tell. But often times in the claim files you can see if there was a distracted trigger in that claim file. We're obviously seeing an increase with that. But we all know in our hearts that the problem is bigger than what you actually can see and measure.

<Q - Meyer Shields>: Okay. No, that makes a lot sense. And one last question if I can, we're seeing a little bit of an uptick in at least the CPI for medical care. Are you seeing medical cost rising at all?

<A - William J. Caldwell>: Yes. Like I said, we see the cost for claim increasing but also the severity of those claims are increasing, as there's more serious highway accidents due to distracted driving.

<Q - Meyer Shields>: Okay. Thank you very much.

Operator

Thank you. We reached the end of our question-and-answer session. I'd like to turn the floor back over to Ryan for any further closing comments.

Ryan E. Greenier

Thanks, Kevin, and thanks to everyone for joining us this morning on Horace Mann's third quarter earnings call. If there are any further questions, don't hesitate to reach out to me or Kristi Niles. Thank you.

Operator

Thank you. That does conclude today's teleconference. You may disconnect your lines at this time and have a wonderful day. We thank you for your participation today.

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