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Horace Mann Educators Corp. (HMN)

Q1 2015 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Greetings and welcome to the Horace Mann First Quarter 2015 Earnings Conference Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

I would now like to turn the conference over to Ryan Greenier, Vice President of Investor Relations. Thank you. Please go ahead.

Ryan E. Greenier
Vice President-Investor Relations

Thank you, Brenda, and good morning, everyone. Welcome to Horace Mann's discussion of our first quarter results. Yesterday, we issued our earnings release and investor financial supplement. Copies are available on the Investors 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, Senior Vice President of Property and Casualty; Matt Sharpe, Executive Vice President of Annuity and Life; and Steve Cardinal, Executive Vice President and Chief Marketing Officer are also prepared for the Q&A 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 statement includes 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 measures are available in the supplemental section of our press release.

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

Marita Zuraitis

President, Chief Executive Officer & Director

Thanks, Ryan, and good morning, everyone, and welcome to our call. After yesterday's market close, Horace Mann reported first quarter operating income of $0.72 a share, a strong start to 2015, despite the impact of severe winter weather in the Northeast. P&C results were strong with a combined ratio of 90.4%. Annuity results were solid with strong sales and deposits, leading to an 8% increase in assets under management.

From an earnings perspective, disciplined spread management is helping offset the impact of spread compression. We experienced an elevated level of mortality losses in the life segment, very similar to the first quarter of last year. In total, the quarter's results were a strong start to the year. Book value per share excluding net unrealized gains ended the quarter at $26.13, an 8% increase on an annual basis.

And in addition to continuing to produce solid growth in book value in the first quarter, we increased the dividend for the seventh consecutive year. This increase of 9% resulted in an annualized dividend of $1 per share. While we are in the very early stages of building out our strategic marketing initiatives, we continue to experience strong momentum in annuity, life and auto.

Annuity sales were up almost 30% year-over-year. Fixed indexed annuities continue to be a powerful contributor, with about 35% of our sales coming from that new product. This addition to the product line has helped us reach new educator customers, as well as reaching deeper into existing customer households. Life sales continue to grow at a double-digit pace, and like annuities, the increased sales reflect both higher agent productivity and a greater number of agents selling Horace Mann products.

Auto sales were up 7% in the quarter. When we unpack the sales numbers, we like the trends. We're seeing increases in states that we have targeted for growth and we like the demographics of the educators that we're attracting. These sales coupled with a modest increase in auto retention resulted in an increase in auto PIF count year-over-year. While PIF only grew by nearly 800 policies, this is the first year-over-year increase since 2008 and it is an indication that we're on the right path to achieve our goal of profitably growing auto PIF in 2015.

The strong sales results in all three segments demonstrate that our growth initiatives are gaining traction. We clearly experienced an elevated level of weather-related losses in the quarter, and Dwayne will provide you with more details. From my perspective, the weather patterns in this year's first quarter were unusual. Snow levels hit records, and the industry experienced a significant number of named cats in the quarter. Specifically, there were nine declared catastrophes in the quarter spread across 26 states over 48 days.

Given this heightened activity, we analyzed the numbers, looked at the duration and the geographic spread of the named cats, reviewed underlying loss activity and concluded that we are still seeing a trend of margin improvement in the property line. And importantly, we concluded that, taken as a whole, the property results in the quarter were solid. Within auto, we experienced two points of underlying loss ratio improvement in the quarter, largely due to targeted rate actions, as well as underwriting and product enhancements.

From a product perspective, the fixed indexed annuity product is filling an important retirement savings need within the educator marketplace, and our Indexed Universal Life product is on track for launch later this year. Within P&C, we continue to roll-out more sophisticated product refinements across more territories. This improved segmentation better captures the characteristics of preferred educator households and results in a more attractive new business pricing.

We are taking a state-by-state approach, identifying profitable geographies and taking an integrated approach with both product and marketing efforts to drive profitable new business volume. We continue to improve our distribution capabilities to help support continued sales growth. We remain focused on improving the quality and productivity of our agency force.

The nice thing about working in a niche market is that we can leverage big data to learn more about all of our potential customers. We are developing the capabilities to arm agents with very tailored information on the educator customers within the schools they serve. This data is more than just contact information. It provides a more holistic view of a potential educator customer's protection and retirement needs. It'll help our agents more effectively move educators from working with a competitor to becoming a Horace Mann customer.

In addition to improving lead generation capabilities for our agents, we are also providing agents with corporate marketing support that includes targeted push advertising to generate interest in Horace Mann and our products. We are focusing these efforts in targeted states where we have historically had strong P&C combined ratios, a good agent network and attractive financial services opportunities. In addition, we continue to be pleased with the initial results of our inside sales team located in our customer contact center. They are successfully reaching new and existing educator customers, and they have potential to increase production over time.

In terms of infrastructure improvements, we successfully implemented the third stage of a four-part upgrade to our life system. The first phase was to improve the agent and customer experience through the introduction of our electronic application. In the second phase, we implemented a new underwriting system, which automated and enhanced many of the underwriting processes and also introduced new straight-through processing functionality. The third phase, which is just completed, allows us to issue new business on a new administrative platform, and this was a critical phase for us.

The new administrative platform gives us the capability to issue new products like the Indexed Universal Life product, which is expected to launch, like I said, later this year. The fourth and final stage of the life system upgrade is the migration of the in-force block to the new system, which we expect to be completed in 2016. We expect these improvements to drive future success, as our life business continues to grow and we improve our scale in this line.

Before turning the call over to Dwayne, I'll also comment on the proposed Department of Labor fiduciary standards. Given our sizeable presence within the educator retirement space, we've been subject to a complex regulatory environment for decades. While the majority of our existing product lines would generally fall outside the proposed regulations, we've been monitoring the developments closely and are well positioned to quickly implement any necessary compliance or infrastructure changes that may be required.

Helping all educators secure their long-term financial future is the cornerstone of Horace Mann's value proposition. Part of doing this successfully within the educator market is offering products tailored to meet their specific needs, providing distribution alternatives that align with how they choose to buy, all supported by modern efficient infrastructure. The strong start to 2015 makes me confident that we're on the right path to become the company of choice for all educators to help them protect their short-term risk and prepare for their long-term financial futures.

And with that, I'll turn the call over to Dwayne.

Dwayne D. Hallman

Chief Financial Officer & Executive Vice President

Thanks, Marita, and good morning. First quarter operating income of $0.72 per diluted share was a strong result, largely due to favorable results in the property and casualty and annuity segments. P&C after-tax income of $17.6 million was about $4 million higher than the prior year quarter, despite a higher level of catastrophe losses.

On a reported basis, the combined ratio improved 3.3 points to 90.4%, reflecting continued improvement in both our auto and property underlying results and the impact of a reduction in incentive compensation accruals of $3 million after-tax, which primarily impacted the P&C segment and in particular the expense ratio.

The expense ratio decreased 2.2 points compared to prior year, of which 1.5 points was related to the accrual adjustment. So on an adjusted basis, the expense ratio was approximately 27%. Given the obvious overweight in the quarter and to better put the adjustment in perspective, on a full-year basis, the adjustment is equivalent to just slightly more than 0.25 point on the expense ratio.

Catastrophe losses were 7.1 points, an increase of 2.7 points from last year on significant winter weather activity. Like Marita mentioned, we saw an increase in the duration and frequency of catastrophe activity. Much of the more severe cat activity was in the Northeast, an area where we have strong educator customer presence. As a result, we experienced a higher level of cat-related losses than we would have otherwise anticipated.

Looking at the underlying results in property, we did see solid margin improvement, particularly in areas of the country that experienced more typical first quarter weather. The underlying property combined ratio of 66.3% was 10 points better than the prior year. When you combine this result with the catastrophe experience and looking at property in total, the combined ratio was 83.4%, almost six points better than the prior year period. This improvement was primarily due to rate actions and lower reinsurance costs, as well as 3.6 points of favorable reserve development related to better than expected non-cat and severity trends for recent accident years.

Turning to auto, the underlying loss ratio was 69.8%, a two-point improvement over the prior year, driven by continued margin expansion. Both auto frequency and severity trends were favorable in the quarter. Auto loss reserves continued to develop favorably, with $2 million or 2.3 points recorded this quarter mainly related to auto bodily injury. Our mid single-digit rate increases for both auto and property continue to outpace loss cost trends and we are on track to achieve our goal of modest improvement in the underlying P&C loss ratio over the course of 2015.

P&C written premiums increased 2.4% to $140.5 million, largely on rate actions. Written premium for auto was up almost 4%, offsetting a 1% decline in property, largely due to the Florida non-renewal program. We're on track to complete this program in the second quarter and are obviously seeing the impact on the property retention ratio, which declined slightly to 88%. Auto retention improved modestly to 85%.

In addition to the exposure management actions in Florida, we are ensuring we have the right mix of defense across our entire property book. This may result in some PIF pressure in the next few quarters, as targeted underwriting actions begin to take hold. We expect over time our property offense will emerge in a more meaningful way, similar to what we're beginning to see in auto. In the annuity segment, operating income excluding DAC unlocking was $12.4 million, in line with the prior year quarter.

Assets under management grew 8% to $5.8 billion, driven by persistency remaining above 94% and continued strong sales. The annualized net interest spread of 194 basis points declined 10 basis points from year-end, in line with our expectations. We continue to be disciplined in crediting rate management and are finding opportunities to put money to work at attractive risk-adjusted returns despite the challenging interest rate environment. That said, we continue to expect the annualized net interest spread to decline to the mid-180 basis points by year-end.

In the life segment, operating earnings excluding DAC unlocking declined 15% to $3.3 million. As Marita mentioned, mortality costs were elevated in the first quarter, similar to our experience last year. We did not see anything unusual in the mortality events during the quarter that would challenge our assumptions that the longer term mortality experience wouldn't revert back to an actuarial trend line. In addition, net investment income declined modestly, reflecting the impact of the lower reinvestment rates.

Consolidated net investment income increased slightly to $83.3 million due to higher asset balances in the annuity segment and continued strong investment portfolio performance. Although we saw a decline in interest rates and spreads in the quarter, we exceeded our new money reinvestment rate assumption of 3.75%. We continue to look for opportunities in conservative asset classes like investment grade corporates, taxable munis and high quality asset-backed securities. Assuming a continued low interest rate environment, we expect yields to remain pressured as we move through 2015 in line with earnings guidance.

Overall, on a reported basis, book value increased from year-end to $34.28, as lower interest rates and tighter spreads increased the net unrealized gain position to $592 million at the end of the quarter. We continue to build book value excluding net unrealized gains on investments at a favorable rate. Compared to the prior year, the strong first quarter results contributed to an 8% increase in book value per share excluding net unrealized gains on investments, which ended the quarter at $26.13.

Looking at results over a longer period of time, the five-year compounded annual growth rate in Horace Mann's adjusted book value per share plus dividends was over 11% through the first quarter. The first quarter was a strong start to 2015. We are seeing early signs of success to profitably grow the P&C business. Our annuity book continues to successfully navigate the challenging interest rate environment and sales for that segment continued to exceed expectations. And we are seeing solid contributions from our life business.

We are confident in our ability to continue to generate strong growth in both earnings and book value per share. As our initiatives gain momentum, we expect to accelerate the pace to find more educator households and win more business with our existing customers. We know from experience that as we place more products in a household, we see benefits to our already strong retention levels. As a result, we are looking to extend our reach into the household as part of our keep more initiatives and drive cross-line sales higher. As we successfully execute on our strategy, we are confident we can increase the number of educator households that we serve and continue to profitably grow.

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

Ryan E. Greenier

Vice President-Investor Relations

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

QUESTION AND ANSWER SECTION

Operator: Certainly. [Operator Instructions] And our first question comes from the line of Sean Dargan with Macquarie. Please go ahead with your question.

Sean Dargan
Macquarie Capital (USA), Inc.

Q

Hi, thank you. I actually wanted to follow-up on the DOL fiduciary duty proposal. I just wanted to maybe try to frame what's at risk here. So, 63% of your annuity AUM is 403(b). Would the 403(b) plans or the agents who sell them be exempt from this proposal?

Matthew P. Sharpe
Executive Vice President-Annuity & Life Division

A

Good morning, Sean. It's Matt. How are you?

Sean Dargan
Macquarie Capital (USA), Inc.

Q

Good. Thanks.

Matthew P. Sharpe
Executive Vice President-Annuity & Life Division

A

The Department of Labor regulations apply to ERISA qualified plans, and the 403(b) plans that we sell are outside of the ERISA regulatory framework. So, we do not believe that our 403(b) sales would or our plans would be impacted by the Department of Labor regulations.

Sean Dargan
Macquarie Capital (USA), Inc.

Q

Okay. And would not the agents who would be, I guess, giving advice, would they – would the compensation that they get for sale of those plans have to change?

Matthew P. Sharpe
Executive Vice President-Annuity & Life Division

A

So, that part of it, we don't know at this point in time. I would say it's too soon to be able to tell you exactly what's going to happen, because they are proposed regulations. But let me elaborate a little bit. The way the proposed regulations, as we understand them apply, they would apply to the IRA space [ph] exclusively (19:44). And when you look at the 403(b) space not being covered by ERISA, we don't believe that they would be covered by it. So consequently, our business model would not have to evolve or shift based on that understanding of the regulations. So at this point, we don't see a change.

Sean Dargan
Macquarie Capital (USA), Inc.

Q

Okay. And then, so 29% of the annuity AUM appear to be non-403(b) qualified assets. Can you just maybe walk us through how an agent gets comped when he or she handles an IRA rollover and what might have to change based on your readings of the DOL proposal?

Matthew P. Sharpe
Executive Vice President-Annuity & Life Division
A

About 20% of our AUM is actually in the IRA space, and the product woks the same way in the IRA space that it does in the 403(b) space. If the rules and regulations around handling IRA and IRA rollovers were to migrate or change, then we would have to modify our compensation structure and our advice structure to serve that segment of the marketplace. And we're unclear at this point in time exactly how this going to manifest itself, but it would have to shift at those regulations as proposed, go all the way through.

Marita Zuraitis
President, Chief Executive Officer & Director
A

And as Matt said – this is Marita. We've been following it closely, and Matt and his team are prepared to migrate as they need to migrate. Like I said in the script, we live in a very highly regulated controlled space. So this isn't something that would be difficult for us to shift towards as we learn the specificity with these particular regulations.

Sean Dargan
Macquarie Capital (USA), Inc.
Q

Okay, thank you very much.

Operator: Our next question comes from the line of Vincent DeAugustino with KBW. Please go ahead with your questions.

Vincent M. DeAugustino
Keefe, Bruyette & Woods, Inc.
Q

Hi, guys. Good morning, everyone.

Dwayne D. Hallman
Chief Financial Officer & Executive Vice President
A

Good morning, Vincent.

Vincent M. DeAugustino
Keefe, Bruyette & Woods, Inc.
Q

Can we touch base on the customer contact center's role in driving growth? I'm assuming where you have agents in place that this would be a very complementary process with your agents with referrals and helping with some of the logical adjacency products as you call them. But what I'm more curious about is in states and school districts, where you're not well represented, what's the strategy in really taking the customer care center into new regions and how do you kick that off and get traction and build awareness?

Marita Zuraitis
President, Chief Executive Officer & Director
A

Yeah. It's a great question. Obviously, for us, the customer care center was predominantly for service to service the educator clients, to do as much for them, so the agents really could focus more and more their time on sales. So that first piece I think has been helpful with the traction, as the service center takes on more of the mundane things and service that an agent would previously do. They've got more time to go out and sell and cross-sell.

In addition to that, the sales that we're seeing coming out of the call center are pretty interesting. A couple of examples, as new auto customers reach out and look for a quick quote in auto, we may start with an auto sale directly from the call center and then that customer, if they chose to take the auto quote can then be referred to an agent for the cross-sell to sell the life, to sell the annuity.

On the other side of the house, if we have an existing customer that's calling in to add an auto or an endorsement or some sort of service on their billing or their account and the call rep, because of the technology, notices that they don't have life insurance. They can ask a simple question like when was the last time somebody reviewed your life insurance needs and then take that lead and give it to the agent to close the life sale. And we've seen that as well come out of the call center. So although the signs are early, I do think it's going to be a good source for additional growth as we move forward and add more and more capabilities into our call center.

Vincent M. DeAugustino
Keefe, Bruyette & Woods, Inc.
Q

Okay. You guys have been one of the few insurers to successfully, let's call it, dance through being a multi-line insurer on both P&C and life and annuity. Is it plausible to think that you could execute similarly on being both a direct and captive insurer as well?

Marita Zuraitis
President, Chief Executive Officer & Director
A

Yeah. The D word is a hard one. You noticed that I didn't say a direct channel. This is complementary to our EA model. This is letting agents do what agents do extremely well, and then letting an efficient call center with some scale do what they can do very well, and leverage the technology and the operational efficiencies that are available in the market today. So, you noticed in my example I didn't say find a customer, cross-sell a customer and retain a customer all in one transaction from a direct center.

This is really in complement with our agency model. I think more and more they can start the transaction. I think more and more they can cross-sell the transaction. But at the heart of our model is an adult and a trusted advisor at the point-of-sale who can do what we do so well in the schools that we serve. So I don't say direct as a separate channel. But I do think there are things they can do more aggressively over time to take on more and more of that transactional burden, if you will.

Vincent M. DeAugustino
Keefe, Bruyette & Woods, Inc.
Q

Okay, thank you very much for that, Marita. And then I guess shifting over to auto. I'm sure you guys pay pretty close attention to what competitors' rate filings look like, but does it feel like there's more room to get a little bit more of an auto rate increase in this environment right now?

William J. Caldwell
Senior Vice President-Property & Casualty
A

Hey, Vincent, it's Bill Caldwell. We continue to monitor. As you've seen, we've had favorable frequency and severities in the quarter year-over-year. We're still targeting low single-digits for auto rates, but we continue to monitor that. As we see opportunities, we'll take them. But it hasn't emerged in our book as of yet.

Vincent M. DeAugustino
Keefe, Bruyette & Woods, Inc.
Q

Okay. And then just in the script, you guys had mentioned just really liking the demographic, how you're picking up some new auto sales. And so, I'm curious if that speaks to the traction on the younger educator side or if that means a good demographic is in better preferred risk traction?

William J. Caldwell
Senior Vice President-Property & Casualty

A

Hey, Vincent, it's Bill again. It's really around the underwriting profile, so that could come at all ages. When we look at the new business we're bringing on, it's really in our targeted states, where we found profitable markets, good favorable regulatory environments and a strong agency presence and came in with more attractive rates for preferred educators. So, that could be [ph] either tier (26:48), their credit score, their [ph] more cross-sold (26:51). So, just across the board, we've introduced a better price point for those risks and we're seeing high penetration in the segments.

Vincent M. DeAugustino
Keefe, Bruyette & Woods, Inc.

Q

Okay, all right. Well, thanks for all the answers, guys. Best of luck. Thank you.

Marita Zuraitis
President, Chief Executive Officer & Director

A

Thank you.

William J. Caldwell
Senior Vice President-Property & Casualty

A

Thank you.

Operator: Thank you. And our next question comes from the line of Bob Glasspiegel with Janney Capital. Please go ahead with your questions.

Bob R. Glasspiegel
Janney Montgomery Scott LLC

Q

Good morning, Horace Mann. The auto results, I just want to periscope into them a little bit further. It seems like the body language is you're now finally declaring victory that it's improving in line with where you want it to improve. Is that a correct read? And I'm a little surprised that you weren't impacted by frequency from lower gas prices or sort of non-cat weather in that line to a greater extent?

Marita Zuraitis
President, Chief Executive Officer & Director

A

Yeah, thanks, Bob. It's Marita. Before I turn it over to Bill, I'd like to say no one is declaring victory. I think about this as a marathon, not a sprint or at least set of wind sprints. We are working hard on both the profitability side of auto as well as the sales side. And I'm confident that we're doing the right things in both areas to improve both the profitability as well as to begin some traction on the sales side. But I don't think we're done and I do feel there continues to be ways in which we can take improved segmentation and improved analytics and apply it to a very unique book of business on the auto side.

Again, we have a homogenous group of auto customers. It's a zero-summed game. We know who they are, they're educators, and their behaviors and loss patterns are different than the general population. It's one of the benefits we have in this homogenous space. You mentioned gas prices and improved economy. Obviously, if you use FasTrak data, and you look at the industry results out there, you see an increase in the miles driven, especially in December into January, and we look at that data. And that would normally lead to an increase in frequency. I'm not sure that in an educator book of business that's going to pull through the same way. It would pull through a generalist book.

These are groups of people that have a very specific schedule. They're in the school building. We know how far they are from school. We know where they're parking their cars, and I'm not sure they can adjust their miles driven the same way a general public might adjust their miles driven. And that might be part of the reason why we don't necessarily follow a generalist trend and a non-homogenous book of business. I'll let Bill comment as well. But I think in all of this. We always have to go back to the fact that we've got a very unique set of homogenous customers that the data is very predictive for us.

William J. Caldwell A
Senior Vice President-Property & Casualty

All right. And just to add a little on that. Although it's intuitive that annual mileage would increase frequency, there's other external factors like car safety and weather that would impact frequency. And as I explained to Vincent, we also have probably more dramatic shifts in our profile than other companies, because we are growing in more attractive segments that come with lower frequencies. And frankly, we're also very aggressive with the re-underwriting and rate actions on those underperforming segments. So, all this combined for our blended frequency, we're actually seeing improvement in the first quarter. But as Marita said, just like last quarter, we didn't overreact to high frequency. We're not over-celebrating the...

Marita Zuraitis A
President, Chief Executive Officer & Director

Exactly.

William J. Caldwell A
Senior Vice President-Property & Casualty

Better frequency this month, a month we're in a wait-and-see game, but we're very optimistic given the mix of business that we're bringing on the books.

Bob R. Glasspiegel Q
Janney Montgomery Scott LLC

If you're still pushing through 5% rate increases in auto, clearly you think there is further to go. The market is allowing you to do that.

William J. Caldwell A
Senior Vice President-Property & Casualty

Right. Right, we still have room to go to hit our long-term targets.

Bob R. Glasspiegel Q
Janney Montgomery Scott LLC

Appreciate it. Thank you.

Marita Zuraitis
President, Chief Executive Officer & Director

A

Thank you.

William J. Caldwell
Senior Vice President-Property & Casualty

A

Thank you.

Operator: Thank you. This concludes our question-and-answer session. I'd like to turn the floor back to Ryan Greenier for closing remarks.

Ryan E. Greenier
Vice President-Investor Relations

Brenda, thanks, and thank you to all that joined us this morning on our first quarter earnings call. If anyone has any additional questions, don't hesitate to reach out Kristi or me. Thank you.

Operator: Thank you. Ladies and gentlemen, this does conclude today's teleconference. You may disconnect your lines at this time and thank you for your participation.