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# Horace Mann Educators Corp. (HMN)

Q1 2016 Earnings Call

# CORPORATE PARTICIPANTS

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Marita Zuraitis
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# OTHER PARTICIPANTS

Robert Glasspiegel
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Sean Dargan
*Macquarie Capital (USA), Inc.*

Christine A. Worley
*JMP Securities LLC*

# MANAGEMENT DISCUSSION SECTION

**Operator**: Greetings and welcome to the Horace Mann First Quarter 2016 Earnings 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.

It is now my pleasure to introduce your host, Mr. Ryan Greenier, VP of Investor Relations. Thank you, you may begin.

## Ryan E. Greenier
*Vice President-Investor Relations*

Thank you, Adam, and good morning, everyone. Welcome to Horace Mann's discussion of our first quarter 2016 results. Yesterday, we issued our earnings release and investor financial supplements, 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, Executive Vice President of Property and Casualty; and Matt Sharpe, Executive Vice President of Annuity and 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 Legislation Reform Act of 1995. The company cautions investors that any forward-looking statements include risks and uncertainties and are not guarantees 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. Good morning everyone and welcome to our call. After yesterday's market closed Horace Mann reported first quarter operating income of $0.62 per share, which is a good start for the year. Sales were solid in all three business segments and we're seeing strong sales momentum in auto and life insurance. We, like the rest of the industry saw an elevated level of losses from convective storm activity in the quarter.

The early spring generated damaging wind and hail across Texas and the Southeast and resulted in nearly $13 million or 8.3 points of catastrophe losses. This was the highest level of first quarter catastrophe losses we've seen in our history. Yet despite a challenging weather quarter, we reported a combined ratio of 93.8% a strong result. And on an underlying basis the combined ratio was 86.8 points a very strong result. This confirms that we're on the right path and we're moving closer to our profitability targets.

We've improved underwriting, refined our pricing segmentation, eliminated Florida homeowners' exposure and reduced other coastal concentration. This focus has resulted in very favorable property results. To report a combined ratio of 82.1% in a heavy weather quarter is encouraging.

Turning to auto, we're seeing early signs of improvement. While the combined ratio of 99.8% is higher than our target, we are starting to see stabilization in the severity trends that began to emerge in the second quarter of last year. We took early and decisive action to increase rates, tighten underwriting and further enhance our claim practices to improve profitability.

We are on track to meet or exceed our auto rate plan for 2016, the mid-single-digit rate increases combined with other initiatives to improve profitability, should result in 1 to 1.5 point improvement in the full year underlying auto loss ratio. As a result, we remain confident that we will see margin expansion in the second half of the year.

And despite the rate increases, we're not seeing disruption to our in force book. Auto retention remained stable at nearly 85% and our sales momentum is strong. Auto sales increased 13% from the prior year. The new business mix is exactly the type of customers we want to attract to our value proposition, cross-sold educator business with a preferred underwriting profile.

In total, the P&C business is growing profitability and while we have some headwinds related to weather, the actions we are taking bode well for continued improvement in the future. In annuity, results excluding DAC unlocking were in line with our expectations for the quarter, net interest margins continue to compress, reflecting the persistent low interest rate environment.

Sales were more than $70 million in the quarter a solid result but lower than the prior year. The decline was primarily due to a non-reoccurring change in the company's employee retirement savings plans in 2015. The combination of solid sales as well as persistency that is nearly 95% resulted in a 3% increase in assets under management, which now exceeds $6 billion for the first time in the company's history.

In the life segment, earnings reflected a normalized level of mortality compared to the adverse results we saw in the first quarter of last year. And sales increased by $1 million largely due to the favorable reception of our new

Indexed Universal Life product. Overall results in the quarter were a good start to the year despite the challenging weather and macroeconomic environment.

We continue to deliver on our strong track record of sustained shareholder value creation. Book value per share excluding the impact of unrealized gains on investments grew by 3.5% to $27.05. We increased shareholder dividend by 6% at our March board meeting to an annual $1.06 per share and we repurchased nearly 0.5 million shares in the quarter.

Our efforts to profitably grow our business by attracting more educators to our unique value proposition are working and sales in all three businesses remain strong. The driving force behind our success is the relentless focus on putting the educator at the center of everything we do. By solving for the issues that educators face, we become their preferred insurance and financial services company.

Before I turn the call over to Dwayne, I want to comment on the finalized Department of Labor regulations. Our model of helping educators develop a holistic goal-based financial plan that protects what they have today and helps them secure their long-term financial future is built around doing the right thing for our educator customers. And we believe the spirit of the finalized DOL regulations will increase transparency around cost, benefits and value to the customers and therefore is aligned with our unique value proposition.

We've been preparing for the finalized regulations for some time, the changes we've made over the past few years to modernize our infrastructure and enhance our product platform allow us to be nimble in our adoption of the final regulations. As a result, over the next 12 months we continue to improve policies and procedures around how we deliver advice. We are also further refining our product set and making additional enhancements to distribution.

Our captive distribution model allows us to quickly pivot to the new regulatory environment. In addition, our leadership position within the 403(b) market which is not in scope of the new DOL regulations, as well as the conservative and loyal nature of the educators we serve, position us to be the advisor of choice for educators and their families. While our relationship with an educator often starts with a 403(b) savings plan, it deepens over time as we extend our reach into the educator household with our multi-line product offering. In total, the combination of having the right product platform, a captive distribution model and a leadership position in our educator niche creates a competitive advantage in this changing environment.

And finally, I want to mention that we're very pleased with AM Best's upgrade of the P&C companies in March. The upgrade to A rating moves the P&C companies to the same ratings level of our life operations and reflects our strong capital position, disciplined and conservative financial practices, and profitable operations.

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 $0.62 per diluted share was $0.10 lower than the strong result in the prior year quarter. $0.07 of the difference reflects the non-recurring expense benefit in the prior year period related to reduction in incentive compensation accruals. The remainder of the difference was primarily due to a lower level of favorable prior year reserve development. As well as the significant catastrophe impacts that Marita mentioned.

P&C after-tax income of $13.8 million was about $4 million lower than the prior year quarter. On a reported basis, the combined ratio increased 3.4 points to 93.8%, reflecting higher catastrophes and expenses as well as a lowered level of favorable prior year development. The expense ratio increased 1.8 points to 27.3%. The majority of the increase was related to the 2015 expense benefit that I just mentioned.

Favorable prior year reserve development was 1.4 points lower in the current period. Given the elevated auto severity trend we saw in 2015, we continue to be conservative with ultimate loss estimates. And accordingly did not have any prior year releases in auto, compared to the 2.3 points of favorable development a year-ago. Within property, we continue to see prior year loss emergence develop favorably and had a similar level of favorable development in the first quarter compared to last year.

On an underlying basis, we saw 1 point improvement in the total P&C loss ratio to 59.5% as strong property results more than offset the elevated severity trend we are seeing in auto. Initiatives to improve property profitability have taken hold and the underlying property loss ratio improved by 6.3 points to a very strong 35.9%. The underlying auto loss ratio deteriorated 1.4 points compared to last year's first quarter. As the results reflect physical damage severity trends that remained elevated.

We began to see severity trends emerge in the second quarter of last year and importantly these severity trends appear to be stabilizing. We remain on track for our mid-single-digit auto rate plan and as a result, we would expect to see margin expansion emerge in the second half of the year.

From a catastrophe perspective, total P&C losses of 8.3 points were 1.2 points higher than the elevated level we saw in the first quarter of last year. Much of the catastrophe activity was concentrated in Texas and in the Carolinas with significant events in late March.

P&C written premiums increased 4% to $146.7 million, reflecting rate actions and strong sales performance. Auto sales were up 13% in the quarter and property sales were another bright spot growing 9%. And despite the rate increases in both auto and property, retentions are holding at nearly 85% in auto and 88% in property.

In the annuity segment, operating income excluding DAC unlocking was $10.7 million a $1.7 million decline compared to the prior year quarter. The annualized net interest spread of $183 million benefited from strong investment prepayment activity in the quarter but continues to decline due to the prolonged low interest rate environment.

In addition, we saw a $2 million increase in operating expenses compared to prior year. The increase reflects costs related to modernization and infrastructure investments and the impact of the 2015 non-recurring incentive compensation accrual reduction. Assets under management increased 3% compared to a year-ago, reflecting continued strong persistency, as well as a healthy level of deposits in sales.

The decline in single premium and rollover deposits sales compared to prior year was primarily related to the non-recurring changes in the company's employment retirement savings plan. In the life segment, operating earnings excluding DAC unlocking increased 15% to $3.8 million. The increase was driven by lower mortality cost in the current period.

Consolidated net investment income increased $1.4 million to $84.7 million due to higher asset balances in the annuity segment. Alternative returns were essentially zero in the quarter. They are below our target of 6% annualized return. We continue to find opportunities in conservative asset classes like investment grade corporates, taxable munis and high-quality asset backed securities. And although we saw a decline in interest rates and spreads in the quarter, we achieved our target new money reinvestment rate of 4%.

We expect yields to remain pressured as we move through 2016 in line with our earnings guidance. Overall, on a reported basis book value per share increased to $33.11 compared to year-end as lower interest rates and tighter spreads increased the net unrealized gain position to $430 million. We continue to build book value excluding net unrealized gains on investments at a favorable rate. Compared to a year-ago book value per share excluding net unrealized gains on investments increased by 3.5% and ended the quarter at $27.05.

Looking at results over a longer period, the 5-year compounded annual growth rate in Horace Mann's adjusted book value per share plus dividends was over 10% through the first quarter. We were quite active with our buyback program during the first quarter. Our 10b5-1 plan served us well as we benefited from equity market weakness in January and February.

We repurchased 474,000 shares during the quarter at an average price of $30.48. We continue to deploy excess capital opportunistically and we will capitalize on periods of market volatility. Despite a first-quarter record for catastrophe losses, results were strong. We are clearly on the right track to grow profitably in the P&C business and expect auto margins to improve in the second half of the year.

We continue to successfully attract assets to the annuity business to mitigate the earnings impact of spread compression. And we are seeing clear signs of life in our life business. The combination of fine-tuning our offense while also maintaining our strong defense will serve us well as we execute on our vision to be the preferred insurance and financial service provider to K through12 educators.

Now, I will turn the call over to Ryan to start Q&A.

## Ryan E. Greenier

*Vice President-Investor Relations*

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

# QUESTION AND ANSWER SECTION

**Operator**: Thank you. [Operator Instructions] Our first question comes from the line of Bob Glasspiegel from Janney. Please go ahead.

Robert Glasspiegel
*Janney Montgomery Scott LLC*
Q

Good morning, Horace Mann.

Marita Zuraitis
*President, Chief Executive Officer & Director*
A

Hey, Bob.

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

Good morning, Bob.

Robert Glasspiegel
*Janney Montgomery Scott LLC*
Q

Marita, you talked about a headwind of whether were you referring to Q1 or April, I couldn't tell if that was looking back or just looking ahead?

Marita Zuraitis
*President, Chief Executive Officer & Director*
A

Yes, I'd like to say it was just Q1 but obviously we're all seeing these storms continue in April. The scripting comment was related to Q1, but just looking at the cat that PCS has already declared there is already activity in April.

Robert Glasspiegel
*Janney Montgomery Scott LLC*
Q

So it's above normal for the quarter already or you would need sort of a little bit better, May, June, to be within your sort of cat load expectations and has it got to the point where you need to factor this into pricing to a greater extent?

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

Bob, I'll take the – this is Dwayne, I'll take the first part of that. As you know, our second quarter tends to be our highest cat quarter of the year excluding the hurricanes...

Robert Glasspiegel
*Janney Montgomery Scott LLC*
Q

Right.

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

A

So our load is in the second and third quarter. We had a high second quarter of last year. As, Marita just mentioned, April appears to be coming out of the gate for the industry at a similar level. But as far as looking at the whole year cat activity, we tend to get through the first and second quarters, see where we stand and then monitor the hurricane activity in third quarter. So we're not ready to declare that the 2016 is an adverse cat year in total, but the second quarter does tend to be elevated and we'd certainly look at it and make a call after that.

Marita Zuraitis
*President, Chief Executive Officer & Director*

A

And on the second piece of that as it relates to pricing, we clearly mentioned it in the script with the kind of underlying as well as total P&C combined ratios or ratios that we're pushing in property there is obviously a lot of room there with that profitability. What we're seeing though as when you look at the rate filings in property of a lot of our competitors, there are some pretty significant filings in the double-digit category that are being made in a lot of these affected states which I think certainly bodes well for our continued high retention and for us to continue to be very profitable in this property line.

A lot of this comes from the type of property business we have, I mean, I always go back to our educators, tend to take care of their homes well, the renters that we have a conservative population, so you've got good underlying profitability. And the one thing that these storms will do is our competitors will need to continue to increase rate to remain profitable in some of these geographies that are getting pretty hard-hit.

Robert Glasspiegel
*Janney Montgomery Scott LLC*

Q

On the auto side, I mean certainly some other competitors are joining you, seeing the severity issue where I think you saw it ahead of many others. So that gives you an environment there as well to continue to push rate?

Marita Zuraitis
*President, Chief Executive Officer & Director*

A

Yes, I think that's right. Of course, we're clearly seeing that.

Robert Glasspiegel
*Janney Montgomery Scott LLC*

Q

A small question on annuities, the tax rate came down, was there anything unusual there?

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

A

Bob, this is Dwayne. There was nothing unusual in the rate.

Robert Glasspiegel
*Janney Montgomery Scott LLC*

Q

Is it going to be a lower rate prospectively or is it more just a one-time blip?

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

A

For the full year, it will be at consistent rate to prior year.

Robert Glasspiegel
*Janney Montgomery Scott LLC*

Q

Okay. Thank you very much.

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

A

Thanks, Bob.

Marita Zuraitis
*President, Chief Executive Officer & Director*

A

Thanks, Bob.

**Operator**: Thank you. Our next question comes from the line of Sean Dargan from Macquarie. Please go ahead.

Sean Dargan
*Macquarie Capital (USA), Inc.*

Q

Thank you. I just wanted to follow-up on the comments about the DOL. I appreciate that you're well positioned. But, the inclusion of fixed indexed annuities are falling under the best interest contract exemption seem to be a surprise to some competitors in the space and I know you wanted to push FIAs as a growth product. I'm just wondering if there are any unexpected costs to you or how you plan on complying with the new rules?

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

A

Good morning, Sean. It's Matt.

Sean Dargan
*Macquarie Capital (USA), Inc.*

Q

Good morning.

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

A

Get closer to the phone, I'm a soft talker. Let me start with our strategy and kind of frame it for you. So, as we've said before [indiscernible] (21:24) K through 12 public educator space using primarily a career sales team and a multi-line approach. We often begin the household relationship with the 403(b) and then extend into the households with our other lines as the needs emerge. This requires our unique value proposition.

With that said, in order to comply with the new regulations for our IRA customers and harmonize how we work with the whole household, we will have to make some changes. Although still evolving, we see the changes in three primary areas. The first one is how advice is delivered, setting up the policies and procedures to standardize our advice model, refining the product set. These are relatively modest changes to our product set, to structure them for an updated feature set and incorporate a different compensation structure.

And then a few distribution refinements focused on the customer experience of the new regulation as well as employer impacts and agency model updates. So we've been very thoughtful and thorough in preparing for the new regulations for some time and the changes we've made over the past few years to modernize our infrastructure and enhance our product platform. As Marita said, are allowing us to react nimbly to the final regulation.

For these reasons, we feel we're well positioned to capitalize on this potentially emerging opportunity. Our agents have close relationships with our educator customers which should serve us particularly well through market disruptions like the DOL changes. But in the end, Sean, an educator comes to us because we are a trusted advisor with specialized knowledge and their retirement programs and benefit. It is this relationship that drives our success. We don't see any change to that.

Will the product mix change? Too soon to tell. The only thing, we can be certain of is the needs of our educator customers that we serve haven't changed and no it doesn't surprise us.

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Sean Dargan
*Macquarie Capital (USA), Inc.*
Q

Okay. And in regards to, I guess looking out for your spread outlook for the rest of the year, some large companies have been hit by negative or unfavorable alternative experience. And it seems that they did not get the uplift from a good marks for hedge funds because they are on a one-month lag. You report your alternative experience in real time, correct?

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

That's correct. So, the underperformance in the fourth quarter for us, we got booked in the fourth quarter. So the first quarter, at least in our alternatives, reflect first quarter activity. So the so-called lift in the March, it certainly helped to recover January and February, but not a lift to the extent that it would get back to our targeted returns.

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Sean Dargan
*Macquarie Capital (USA), Inc.*
Q

Okay. And those targets still hold true for full year 2016?

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

Sean, at this point that's correct.

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Sean Dargan
*Macquarie Capital (USA), Inc.*
Q

Okay, thank you.

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**Operator**: Thank you. [Operator Instructions] Our next question comes from the line of Christine Worley from JMP Securities. Please go ahead.

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Christine A. Worley
*JMP Securities LLC*
Q

Good morning.

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

Good morning.

Christine A. Worley
*JMP Securities LLC*

Q

Just looking at the improvement in the auto loss ratio, can you sort of talk us through how we should be thinking about on the balance what's coming from sort of the flattening of the severity trend and what's coming from rate increases earning in?

William J. Caldwell
*Executive Vice President-Property & Casualty*

A

Hi, Christine. It's Bill Caldwell. I would say, the majority of the improvement is from rates. Like we said on previous calls, we recognized this in the second quarter and acted pretty quickly with rates. We see it in our average written premiums. And the good news is the rate is ticking. When you look at the competitive environment, there's many competitors that are taking rates within our own realm.

So, you get the benefit of the rate plus we're able to maintain our sales and retention momentum. But on the other side of that, we are getting some traction with our loss containment actions to contain that severity. So if you remember, we talked about our use of independent adjusters, early identification of bodily injury and always focusing on cycle time, turning the screws where we can to improve customer experience and cut out the rental days to drive down the severity.

So it's really the combination of those two things and we see that continuing throughout the year. We are still on plan for to exceed our rate plan of 6% and continuing with the cost containment activities.

Christine A. Worley
*JMP Securities LLC*

Q

Okay, great. Thank you very much.

**Operator**: Thank you. Ladies and gentlemen, at this time we have no further questions in queue. I would now like to turn the floor back over to management for closing comments.

Ryan E. Greenier
*Vice President-Investor Relations*

Thank you for joining us this morning on Horace Mann's first quarter earnings call. If there are any further follow-up questions, don't hesitate to reach out to me or Kristi Niles. Thanks.

**Operator**: Thank you, ladies and gentlemen. This does conclude our teleconference for today. You may now disconnect your lines at this time. Thank you for your participation and have a wonderful day.