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HMN - Q1 2014 Horace Mann Educators Corp. Earnings Conference Call

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PRESENTATION

Operator

Good morning. My name is Brianna, and I will be you conference operator today. At this time I would like to welcome everyone to the Horace Mann first quarter 2014 earnings conference call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session.

(Operator Instructions)

Ryan Greenier, Vice President of Investor Relations, you may begin your conference.

Ryan Greenier *- Horace Mann Educators Corporation - VP of IR*

Thank you Brianna, and good morning everyone. Welcome to Horace Mann's discussion of our first-quarter 2014 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. Steve Cardinal, 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 wanted 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 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 these statements. 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 supplement section of our press release. Now I will turn the call over to Marita Zuraitis.

Marita Zuraitis *- Horace Mann Educators Corporation - President & CEO*

Thanks, Ryan. Good morning, everyone, and welcome to our call. After yesterday's market close, Horace Mann reported first-quarter operating income of $0.65 per share, a strong result, reflecting continued profitability improvements in P&C, notwithstanding some winter-weather-related losses, as well as higher annuity investment income. Importantly, top- and bottom-line results were strong in all three of our segments.

The P&C underlying combined ratio improved 3.3 points to 92.1%, driven by continued margin expansion in auto. Written premiums continue to climb, up 4%, largely on rate actions, and reserves continue to develop favorably. Ex-DAC, annuity earnings increased 23%, reflecting the 10% increase in assets under management, as well as higher-than-anticipated net investment income.

Annuity sales increased 19%, with both Horace Mann and independent agents posting sales increases over the prior year. While our new fixed-indexed annuity introduction is off to a good start, we saw strong sales in all of our annuity product offerings, supported by a new electronic application for annuities. Life sales continue to grow, and we are encouraged by our agents' increasing ability to sell Horace Mann products. Earnings for the life segment declined, reflecting a higher level of mortality in the quarter, partially offset by an increase in net investment income.

All together, the results were a strong start to 2014, and contributed to an 8% annual increase in book value per share, which ended the quarter at $24.27, excluding net unrealized gains on investments. We are making progress on initiatives that support the multi-year strategy to further improve profitability and accelerate organic growth. These activities position Horace Mann to become a larger, more dominant player in the educator space.

From a product perspective, we had an exciting first quarter. As I mentioned earlier, we launched the Horace Mann fixed-indexed annuity product. Over the last few months we have significantly increased the number of agents that are trained and have the ability to write fixed-indexed annuities. We are very optimistic that the new FIA product will provide new opportunities to grow Horace Mann business.

In the P&C segment, we are pleased to see continued profitability improvements, largely driven by rate actions over the last couple of years. Our 2014 rate plan of mid-single digits in auto and property remains on track. We are focused on ensuring we have the appropriate rate for each cohort of business across the 46 states where we underwrite P&C. As we prioritize our efforts, we are refining our price points for new educator business in some states where we already have strong underwriting margins. In addition, we continue to implement rate, underwriting actions, and further segmentation in states and territories where we desire to improve profitability.

From a distribution perspective, we are focused on improving the quality and productivity of our agency force. We have begun to introduce higher-quality standards in order to improve both customer experiences and agent productivity. These higher standards resulted in an increased turnover in the first quarter, as we focused on reducing some of the lower-tier performers.

While we anticipate the agent count may further decline in the second quarter, we still expect agent count at the end of the year to be flat to year-end 2013. We are focused on improving agent training, particularly for life and annuity products, and providing better support; and as a result, do not expect the fluctuation in agent count to have a negative impact on our business.

From an infrastructure perspective, we are moving our systems, processes, and talent initiatives forward. We continue to attract top talent from across the industry. We have successfully filled a number of strategic positions within P&C and our annuity and life operations, with individuals that bring general market expertise and sophistication. We're confident that the mix of existing and new talent will drive our desired strategic results.

Before turning the call over to Duane, I want to mention that we were named to the Forbes Most Trustworthy Company list for the second year in a row. This distinction reflects the way we run this business day in and day out. We've demonstrated that we are committed to doing the right thing by our customers, shareholders, employees, and agents.

This quarter's results further indicate that we have a solid foundation, and we're on the right track to implement our multi-year strategy to profitably grow our business, and become a larger, more dominant player in the educator space. We strive to be the Company of choice for educators, as we look to protect their short-term risks, and secure their long-term financial future. With that, I'll turn the call over to Dwayne.

Dwayne Hallman - *Horace Mann Educators Corporation - EVP & CFO*

Thanks, Marita. Good morning, everyone. First-quarter operating income of $0.65 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 $14 million was almost $4 million higher than the prior-year quarter. On an underlying basis, the combined ratio improved 3.3 points to 92.1, led by a five-point improvement in the underlying auto loss ratio, which was 71.8 for the quarter. The total P&C expense ratio of 27.7 was in line with full-year 2013 results, and consistent with our earnings guidance. Catastrophe losses were 4.4 points in the quarter, only modestly higher than the prior year.

Within auto, we are seeing the benefit of rate actions taken over the last couple of years. Margins continue to expand as rate increases out-pace loss cost. While the first-quarter winter weather impacted collisions and physical damage coverages, we saw improved liability experience compared to prior year.

Our auto BI loss estimates for the first quarter of 2014 are a few points better than our initial 2013 estimates, which ultimately developed favorably over the course of 2013. In addition to providing some benefit to our current accident year loss ratio, the favorable BI loss trends also resulted in overall continued favorable prior-year reserve development. We believe changes we've made in the claim operations are also contributing to some of this improvement. But at the same time, we are mindful of the longer-tail nature of liability lines, and the overall industry severity trends in our loss estimate selections.

In regards to property, the underlying loss ratio was comparable to prior year, even including winter-weather impacts. In the quarter, both increases in average premium per policy, and reductions in catastrophe reinsurance costs provided offsets to the non-cat weather-related losses.

We continue to reduce the concentration and number of high-risk property exposures, and are in the process of materially reducing and nearly eliminating our Florida homeowners business. We plan to non-renew approximately 5,000 policies over the course of 2014 and early 2015. Our Florida agents are working with various Florida writers to place our customers' property business. This allows us to retain the customer relationships in other Horace Mann products.

In addition, we have modest property non--renewal programs in various coastal states to further reduce catastrophe exposure. These actions will likely result in some pressure on retention ratios and PIF counts, but they are clearly the right decisions from a profitability and exposure-management perspective.

P&C written premiums increased 4% to $137.2 million, largely on rate actions, and some reduced reinsurance cost. Retention remained in line with the prior year, at 85% in auto and 89% in property. New P&C sales were over $20 million, a slight decline from the prior year. While we are pleased with yet another quarter of solid P&C results, we remain focused on achieving our mid-90%s target, which is comprised of a high 90%s result in auto, and a low 90%s in property over the course of a full year.

Turning to annuity, operating income excluding DAC unlocking was $12.4 million, a 23% increase over the previous year. Assets under management grew by 10% from a year ago, reflecting strong sales, equity market appreciation within the variable annuity book, and strong deposit persistency. The annualized net interest spread for the quarter was 214, a sizable increase over 2013.

During the first quarter, we experienced an elevated level of asset-backed security pre-payments, which we don't expect to continue over the remainder of the year. Excluding these elevated pre-payments, the net interest spread would have been approximately 196 basis points, still a bit better than our expectations, and generally in line with full-year 2013. On a normalized basis, this out-performance was largely driven by stronger returns in our alternative investment portfolio.

In the life segment, operating earnings declined 9% to $3.9 million. While an elevated level of mortality losses in the first quarter isn't unusual, this quarter's results were obviously higher compared to the favorable experience in the prior year. Partially offsetting this increase was higher net investment income, which was also favorably impacted by pre-payments. Life sales continue to be strong, up 6% over the prior year.

Net investment income was $83 million, up 7% from prior year, due to higher (inaudible - background noise) balances in the annuity segment, and the elevated pre-payment activity. Although we saw a decline in interest rates and spread tightening in the quarter, we essentially achieved our new money reinvestment target of 4.25%. We continue to look for opportunities in conservative asset classes, like investment-grade corporates, municipals, and high-quality, asset-backed securities. Assuming a continued low-rate environment, we expect to see continued pressure on portfolio yields as we move through 2014.

In total, the Company's solid first-quarter results generated an 8.4% increase in book value per share, excluding net unrealized gains on investments, which ended the quarter at $24.27. On a reported basis, book value increased from year end to $29.47, as the decline in interest rates and tighter spreads increased the net unrealized gain position, which was $376 million at the end of the quarter. We continue to build book value excluding net unrealized gains on investments at a favorable rate. Our cumulative annual growth rate has been 10% for the past five years, and we continue to pay shareholders a compelling dividend.

We were able to find opportunities to execute on the share re-purchase program in the quarter, and repurchased over 135,000 shares. Since its inception, we have re-purchased almost 1.4 million shares at an average price of $18.47. We have $24.5 million remaining on authorization, and will continue to be opportunistic in our approach.

First quarter was a solid start to 2014. We expect our successful execution on initiatives to enhance product, distribution, and infrastructure will result in increased brand awareness and marketability within the educator space. We are confident we are on the right path, and should continue to generate solid growth in both earnings and book value. Thanks. I'll now turn it over to Ryan to start the Q&A.

Ryan Greenier - *Horace Mann Educators Corporation - VP of IR*

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Bob Glasspiegel, Janney Capital

Bob Glasspiegel - *Janney Capital Markets - Analyst*

Good morning, Springfield. A couple of numbers questions to start off. How much did mortality negatively impact you, and how big of a positive was pre-pays in annuity?

Dwayne Hallman - *Horace Mann Educators Corporation - EVP & CFO*

Bob, mortality losses are up about $1 million from prior year in the quarter. On the pre-payment activity in total, it was just over $2 million. That was roughly 70% in the annuity segment and 30% in life.

Bob Glasspiegel - *Janney Capital Markets - Analyst*

Okay, thank you. Marita, on the agent productivity, it seems like you're implying that there's been sort of a step-up in performance standards versus the history. What element -- is there a common characteristic of the agents that you're not keeping? Were they employee agents? Was it a lot of technology expertise, or just something else that would drive the culling today?

Marita Zuraitis - *Horace Mann Educators Corporation - President & CEO*

Yes, Bob, thanks for the question. Let me give you a full response to the question. When we go back to agent count, our first half of the year is typically lower than our second half of the year, if you go back and look historically. I think it's more than an implication of improved productivity and quality standards. We actually have numerically upped the productivity and quality standards that we're holding our agents towards. Not only that, but we're learning what good looks like. As we push on those, we're using those same standards as we appoint new agents, and we bring new agents on to the Horace Mann business, if you will. We're learning from that.

Like we said, the net result in agency count is going to be relatively flat at the end of the year when we look at that all together. More importantly, I think as we push on these strategic initiatives, it really is helping the agents be more productive. When you think about product, if you have good agents and you give them more to sell, they tend to be more productive. We saw that with the introduction of the FIA product. From a distribution perspective, better training, better sales support also makes them more productive.

From an infrastructure standpoint, improving our pipes, improving our efficiency. You saw that with the new electronic application that we put out this quarter. I think the agents have visible signs of how with product distribution and infrastructure we are improving their ability to be more productive, and I think they have stronger confidence and a little more belief, if you will, in their ability, and our ability to help them be more productive.

Bob Glasspiegel - *Janney Capital Markets - Analyst*

Okay, thank you for the thoughtful answer. My last question would be you went into the year looking for in the guidance of one- to two-point underlying improvement. It sounded like in the text both you, Marita and Dwayne, sort of indicated auto's improvements a little bit more than we're looking for, and it led to sort of a three-point-plus underlying improvement, overall. The fact that you didn't revise guidance -- you normally don't after the first quarter, I understand that. It seemed like the speech implied that you were ahead of plan and the guidance could be conservative with what you know today. Is that a fair read?

Marita Zuraitis - *Horace Mann Educators Corporation - President & CEO*

Yes, it is a fair read. I can turn it over to Duane for more specifics. But before I do that, we had a solid first quarter. But we also know that we have three more quarters left to the year. Let me have Dwayne give you some more details.

Dwayne Hallman - *Horace Mann Educators Corporation - EVP & CFO*

Thanks, Bob. Yes, I wish I could take the first quarter and annualized it, but unfortunately we can't. Keep in mind our second and third quarters are -- and especially the second quarter -- tend to be our highest cat experience. Although we're out of the gate with a good number, maybe auto's slightly better than what we expected. As you know, we always talk about keep an eye on our year-to-date numbers. At this point we wouldn't -- we don't see auto going a different direction despite the solid first quarter, but we still got a long way to go to the year.

Bob Glasspiegel - *Janney Capital Markets - Analyst*

Well, we're off to a slow start in tornadoes in April. My professing that probably is sounding the gong for May and June. Thank you.

Marita Zuraitis - *Horace Mann Educators Corporation - President & CEO*

Thanks, Bob.

Operator

(Operator Instructions)

Vincent DeAugustino, KBW

Vincent DeAugustino - *Keefe, Bruyette & Woods - Analyst*

Just for Matt, I guess to start. Just curious if you might be able to touch on some of the annuity sales environment, as far as kind of breaking down what might be some industry-wide phenomenons versus internal drivers to Horace Mann? I know some of the agent productivity and new product type factors are pretty important to internal things that Horace Mann is doing. But just kind of looking to get some sense on sustainability with the swing from last quarter?

Matt Sharpe - *Horace Mann Educators Corp - EVP, Annuity and Life*

Good morning, Vincent. Thanks for the question. A lot of our productivity has been driven by the introduction of the new fixed-indexed annuity product. Our product line was a little bit out of position prior to the introduction of this product line. The fixed-indexed annuity sales represented about 27% of our total annuity sales for the quarter. That's a pretty big impact in terms of our overall annuity sales. That's driven largely by the fact that our agents sold a third-party product in a very limited way with a few agents. Then we expanded that to a much larger reach, meaning it's available to our entire distribution force.

That also was added with -- we also saw a slight up-tick in the independent agent sales, which was also given by the introduction of the product. That is a fairly big driver in the independent agent market, not having the fixed-indexed annuity side. I would expect the independent agents to have a continued momentum on the career agents or the exclusive agents side. The introduction may be lopsided towards the first half of the year, because it's a brand-new product, and there was pent-up demand for the product in the introduction. But I would expect us to capture the third-party sales that we had last year in the product, which was about $20 million.

The fixed-indexed annuities externally industry-wide continue to be growing at a much faster rate than the book value products that we sold prior to that, although the broad industry view doesn't necessarily translate into our niche. Our niche is not driven necessarily by the same factors, other than the independent agent component that I already talked about.

Vincent DeAugustino - *Keefe, Bruyette & Woods - Analyst*

Okay. A bit of an odd question, and it's quite frankly just because the results pretty much across the board were so good, there's not a lot to nit-pick on. But it's a more big-picture question as far as trends in auto manufacturing. One of the things that had recently come out of a meeting with LKQ that I had, which is a auto parts recycler and after-market type parts supplier. It was that some of the new technology in auto manufacturing -- things like composite and aluminum body panels, the new Ford F-150 is a perfect example of this. The take-away from that was that some insurers might not necessarily be appropriately pricing in loss-cost trends on these types of vehicles, where repair may be more difficult, and you may end up doing replacement and that sort of thing.

I'm just kind of curious from the standpoint of that type of migration, what that might mean for companies like Horace Mann or any auto insurer, where I think the number that was thrown out is there may be a 10% increase in the cost to insure those types of vehicles. I know some of the exotic ones really wouldn't fit your educator focus, but some of these, an F-150, I would imagine, would find its way into one of your households. Any thoughts you might have there in terms of those type of changes would be pretty interesting?

Marita Zuraitis - *Horace Mann Educators Corporation - President & CEO*

There's two things I would say to that. One, the talent that we've been able to attract in P&C, and the sophistication and the analytical ability and the folks that look at these types of trends, I'm happy to have that kind of talent in house. Combined with some of the changes that we've made in the claim department, and some of the initiatives that we're pushing on to get to improved loss analytics on that end of it, as well.

I think up front in the pricing and in the back end on claim, we obviously keep track of these trends to drive a better bottom-line result. I don't know if I have a specific answer to how this will all work out, but I think the goal is you know these things, you factor it into your pricing on the front end, and then you factor it into how you settle claims on the back end.

Vincent DeAugustino - *Keefe, Bruyette & Woods - Analyst*

Okay, great. Thank you very much, and great quarter. Again, not a lot to nit-pick on. Look forward to talking to you soon.

Marita Zuraitis - *Horace Mann Educators Corporation - President & CEO*

Thanks, Vince.

Operator

We have no further questions in queue. I will turn the call back over to Mr. Greenier.

Ryan Greenier - *Horace Mann Educators Corporation - VP of IR*

Thanks for joining us this morning on Horace Mann's first-quarter earnings call. If anyone has any additional questions, don't hesitate to reach out to me. Thanks.

Operator

This concludes today's conference call. You may now disconnect.
