Corrected Transcript

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Lincoln National Corp. (LNC)

Q1 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and thank you for joining Lincoln Financial Group's first quarter 2021 earnings conference call. At this time, all lines are in listen-only mode. Later we will announce the opportunity for questions and instructions will be given at that time. [Operator instructions]

Now, I'd like to turn the conference over to the Vice President of Investor Relations, Al Copersino. Please go ahead, sir.

Albert S. Copersino
Vice President, Head of Investor Relations, Lincoln National Corp.

Thank you, Katherine. Good morning and welcome to Lincoln Financial's first quarter earnings call. Before we begin, I have an important reminder. Any comments made during the call regarding future expectations, deposits, expenses, income from operations, share repurchases and liquidity and capital resources are forward-looking statements under the Private Securities Litigation Reform Act of 1995.

These forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from current expectations. These risks and uncertainties include those described in the cautionary statement disclosures in our earnings release issued yesterday, as well as the details in our 2020 annual report on Form 10-K, most recent quarterly reports on Form 10-Q, and from time to time in our other filings with the SEC.

These forward-looking statements are made only as of today, and we undertake no obligation to update or revise any event to reflect events or circumstances that occur after this date.

We appreciate your participation today, and invite you to visit Lincoln's website, www.lincolnfinancial.com, where you can find our press release and statistical supplement, which includes full reconciliations of the non-GAAP measures used on this call, including adjusted return on equity and adjusted income from operations or adjusted operating income to the most comparable GAAP measures.

Presenting on today's call are Dennis Glass, President and Chief Executive Officer, and Randy Freitag, Chief Financial Officer and Head of Individual Life. After their prepared remarks, we will move to the question-and-answer portion of the call.

I would now like to turn the call over to Dennis.

Dennis R. Glass

President, Chief Executive Officer & Director, Lincoln National Corp.

Thank you, Al. Good morning everyone. Lincoln had a strong start to the year against an improving, but still challenging environment. We have continued to execute our reprice, shift and add new product strategy, manage expenses, improve the customer experience and maintain a strong balance sheet.

First quarter earnings were affected by elevated pandemic related claims in our life and group businesses, though this was partially offset by another quarter of strong returns from our alternative investment portfolio. We are pleased with their earnings power Lincoln showed in the quarter and the outlook for our business is positive.

Now, let me touch on the major initiatives that are helping bolster our franchise and earnings power. First, as a result of our proactive and disciplined repricing actions, we are achieving targeted returns in each of our businesses. As a result of our reprice, shift and add new product strategy, and the fact that several peers followed our repricing actions, our sales pipelines have begun to expand, and we expect continued sales recovery in the upcoming quarters.

We're introducing eight new products in the first half of this year, which increase consumer choice, broaden the product portfolio, and enable our participation in more market segments. Our new product strategy also gives us a great deal of optionality. If interest rates remain low, our newly launched products will remain attractive, given their strong consumer value propositions, driven by their innovative product design. If rates continue to rise, in addition to these newer products, some offerings already on our shelf would once again resonate with consumers, and that would also be beneficial to Lincoln's sales results.

Second, we're focused on actions to increase productivity across our manufacturing, operations, and distribution organizations, while enhancing the customer and partner experience. We continue to report declining expense ratios in most of our businesses, while at the same time investing in client-facing digital tools. Our demonstrated expense management capabilities will guide us as we start another meaningful expense savings program later this year.

Third, we have successfully focused on improving the balance sheet. Both our RBC ratio and cash at the holding company have increased and remain above target, giving us the confidence to increase our share repurchase pace.

Furthermore, as we evaluate risk transfer deals, we would expect for this to provide additional upside potential to our capital deployment, if finalized.

Now turning to the business segments. Starting with Annuities, we continue to successfully leverage our industry-leading manufacturing capabilities to create new customer value propositions and expand our already broad product portfolio.

Last year, we established ourselves as a leader in indexed variable annuities. This year, we're seeing growth in both IVAs and traditional variable annuities without living benefits, with total sales of non-living benefit VAs up 44% versus the prior-year quarter and 9% sequentially.

Growth in these products, combined with continued market demand for guaranteed living benefits, led to total VA sales growth both versus the prior-year quarter and sequentially. We had projected sales to begin the year at a similar pace to that seen in the fourth quarter, and build over the course of the year as we benefit from products introduced both this year and last, and we are pleased to see that sales growth is ahead of our expected pace. In fact, this was the first quarter in a year that we saw sequential sales growth across all product categories in the Annuities business.

While we experienced negative net flows in the quarter, this is a direct result of management's actions to maintain rigorous return standards and to allow us to continue to direct capital to the highest and best use.

In 2021, we expect the earnings to continue to benefit from our high-quality in-force book that generates consistent cash flows and returns and provides excellent value for customers.

In Retirement Plan Services, we once again reported strong results, driven by our digitally optimized model. This model, where high-tech enables high touch, differentiates us in the virtual environment.

Our innovative product development capabilities are driving results, and we are excited about the continued success of our target-date fund alternative, YourPath, as well as the recent launch of Income America, an innovative and simplified income solution for retirement plan participants.

Although total deposits were down slightly compared to the very strong prior-year quarter, we are optimistic looking forward given our robust sales pipeline. We reported positive net flows once again this quarter. And while flows can be lumpy, we expect this momentum to persist as we remain well positioned in our target markets.

It was another excellent quarter for the retirement business, and we expect to benefit from the tailwinds of an improved economic backdrop, our ongoing investments in the customer experience, and our expanding set of solutions aimed at helping Americans secure their retirement.

Within the Life Insurance business, we are positioning ourselves for growth through product innovation and distribution expansion. Sales in the quarter were flat sequentially, but we expect will ramp up over the course of the year as we begin to reap the benefits of solutions we've recently launched into the market. We're seeing good momentum with some key new product rollouts. Our expanded VUL offerings continue to gain shelf space and our innovative MoneyGuard Market Advantage product is appealing to new market segments.

Additionally, we are beginning to attract a broader range of advisers with nearly a quarter being producers who had not previously sold a MoneyGuard product. These new products, coupled with our existing life offerings and the industry's strongest distribution force, position Lincoln for long-term success at attractive returns.

Additionally, we are expanding our strong distribution network by adding our life insurance products to the shelf of a large P&C insurer where we have an existing annuity distribution partnership. We are seeing good early momentum, particularly with our term excel solution, which is a fully digital experience and is enabling us to reach a different customer segment.

I'm pleased with the solid results the Life Insurance business reported. I am also excited that Lincoln is introducing products with new value propositions that are resonating with customers and helping to drive future growth.

Lastly, on Group Protection. Premiums rose more than 2% over the prior-year quarter and nearly 7% sequentially, driven by improved persistency, price increases and organic growth resulting from the economic recovery.

Sales in what is typically a seasonally smaller quarter were down versus the strong prior-year quarter. However, underlying drivers were positive as two-thirds of our sales were employee paid products.

As we communicated last quarter, we are taking actions to increase Group Protection margins. We are already seeing improved results as factors such as pricing actions, higher persistency and investments in our claim organization have put our margin, excluding the pandemic and excess alternatives income, in the lower end of our targeted range. We continue to expect further expansion building gradually towards the upper end of our 5% to 7% margin target.

Briefly on investment results. As I mentioned earlier, our portfolio is performing quite well. Overall credit quality remains high and has continued to improve in recent years, driven by our high-quality new money purchases and proactive derisking. 96% of our fixed income assets are investment-grade, with 59% rated A or higher.

Our well-diversified commercial mortgage loan book has continued to perform well during the pandemic, with virtually no credit losses and minimal loan modifications. Additionally, our alternatives performance was once again strong, driven by our portfolio construction that emphasized buyout and growth equity strategies, with a quarterly return of 8% significantly exceeding our long-term target quarterly return of 2.5%.

In closing, I would note, sales momentum is building at attractive returns, driven by new product introductions that resonate with our customer and expanded shelf space across distribution channels.

Continued equity market tailwinds should boost earnings from fees on assets under management in the Annuities and RPS businesses. The outlook for the Life Insurance business is strong as our new products are starting to take hold in the market. Group Protection's underlying profitability is experiencing an ongoing recovery.

Expense savings initiatives will continue to contribute to earnings growth. And our robust balance sheet, high-quality investment portfolio, strong free cash flow generation and capital ratios, as well as the opportunity to execute risk transfer deals all leave Lincoln in an excellent position to fund expected sales growth, while increasing our capital deployment.

Based on these positive trends, 2021 is shaping up to be a successful year, and I expect will improve on this quarter's results.

I will now turn the call over to Randy.

Randal J. Freitag

Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

Thank you, Dennis. Last night, we reported first quarter adjusted operating income of $350 million or $1.82 per share. There were no notable items within the current or prior-year quarter. However, this quarter's result was impacted by a number of items.

First, pandemic-related claims reduced earnings by $222 million or $1.15 per share. Second, results benefited from strong performance in the alternatives investment portfolio, boosting earnings by $84 million or $0.43 per share above target. Third, there was $11 million or $0.06 per share of unfavorable tax adjustments. Finally, within the Other Operations segment, there was $11 million or $0.06 per share of expense variability related to elevated deferred compensation costs resulting from the increase in Lincoln share price during the quarter.

Adding these items together, it was, no doubt, an extremely strong quarter that highlights our underlying earnings power.

Net income totaled $225 million or $1.16 per share, with the difference between net income and adjusted operating income primarily being driven by $144 million non-economic loss from variable annuity non-performance risk. The VA hedge program performed exceptionally well, with 99% effectiveness in the quarter.

Moving to the performance of key financial metrics compared to the prior-year quarter. Adjusted operating revenue increased 6%, with operating revenue growth in each of our four business segments. Average account values increased 15%. The expense ratio declined in all businesses except Group Protection, where it remained flat. And book value per share, excluding AOCI, stands at $72.36, an all-time high.

Now, turning to segment results, starting with Annuities. Operating income for the quarter was $290 million, compared to $261 million in the prior-year quarter. The increase was primarily due to higher account values driven by growth in the equity markets as favorable alternatives investment income was offset by $9 million of the unfavorable tax adjustment that I noted upfront.

Average account values of $160 billion increased 16% year-over-year and 6% on a sequential basis, as equity market strength over the past year more than offset negative net flows. This contributed to a 7% increase in operating revenues in the quarter.

Base spreads, excluding variable investment income, were down 18 basis points sequentially, primarily driven by non-economic change in the spread calculation methodology.

G&A expenses, net of amounts capitalized, decreased 3% from the prior-year quarter, leading to a 100 basis point improvement in the expense ratio.

Return metrics remained solid despite fewer fee days in the quarter, with return on assets coming in at 72 basis points and return on equity at 22.9%.

Risk metrics on the VA book continue to demonstrate the quality of our in-force business with the net amount at risk at 64 basis points of account values for living benefits and at 36 basis points for death benefits.

Growing account values, a quality book of business and expense discipline are all indicators of strong future performance from the Annuity business.

Retirement Plan Services reported operating income of $57 million compared to $40 million in the prior-year quarter, driven by higher account values, expense management and favorable alternative investment performance, which more than offset spread compression and $2 million of the unfavorable tax adjustment.

Deposits totaled $2.6 billion and net flows continue to be positive with $347 million in the quarter, consistent with recent periods. These positive flows, combined with favorable equity markets, drove average account values up 18% over the prior-year quarter.

G&A expenses net of amounts capitalized were down 4% compared to the prior-year quarter, driving a 320 basis point improvement in the expense ratio. Base spreads, excluding variable investment income, compressed 12 basis points versus the prior-year quarter, back in line with our stated 10 to 15 basis point range as crediting rate actions take hold.

The Retirement business started the year with strong results, including a 25 basis point ROA with continued momentum in flows and expense management serving as positive drivers going forward.

Turning to Life Insurance. We reported operating income of $107 million. While down from $171 million in the prior-year quarter due to the pandemic, these results were solid and reflect strong underlying business drivers. This quarter's earnings included $132 million of excess pandemic-related mortality, partly offset by $59 million of favorable alternative investment experience.

Underlying earnings drivers continued to show growth, with average account values up 10% and average life insurance in-force up 8% over the prior year.

G&A expenses, net of amounts capitalized, decreased 2% from the prior-year quarter, leading to a 60 basis point improvement in the expense ratio. Base spreads declined 2 basis points compared to the prior-year quarter, better than our 5 to 10 basis point expectation.

Outside of the impacts from the pandemic, the Life Insurance business had a strong quarter and key growth drivers remain positive. We expect pandemic headwinds to decline over the course of the year as vaccines are more widely rolled out. This combination of underlying growth and improving mortality results positions us nicely for improved results looking forward.

Group Protection reported a loss from operations of $26 million compared to operating earnings of $40 million in the prior-year quarter, with the decrease driven by $90 million of pandemic-related claims, with $61 million of direct COVID-19 mortality, $7 million of morbidity, and $22 million of indirect mortality. This was partially offset by $6 million of favorable alternative investment experience.

The reported total loss ratio was 86.8% in the quarter, 1 percentage point better sequentially as an increase in the life loss ratio was more than offset by improvement in the disability loss ratio. Excluding pandemic-related claims from both periods, the total loss ratio was 76.6% for the quarter, down 2.3 percentage points sequentially.

Expense ratio remained flat year-over-year as increases in G&A expenses, net of amounts capitalized, related to investments we have made in our claims organization were offset by premium growth.

Excluding pandemic-related claims, the business had solid results which, as Dennis mentioned, put us back in the low end of our target margin range. While pandemic impacts continue to be a headwind, we are optimistic about the outlook for the business as improving unemployment rates, coupled with vaccine rollouts, should provide tailwinds going forward.

Turning to capital and capital management. We ended the quarter with $10.7 billion of statutory surplus and estimate our RBC ratio at 464%, up 13 percentage points from year-end. As a reminder, this includes 24 percentage points from non-economic goodwill associated with the Liberty acquisition that we expect will go away by year-end.

Cash at the holding company stands at $758 million, above our $450 million target as we have prefunded our $300 million 2022 debt maturity.

We deployed $105 million towards buybacks this quarter, slightly above the $100 million we targeted. Given our strong capital position, improving capital market and health trends and our positive business outlook, we expect share repurchase in the second quarter to be approximately $150 million, in line with pre-pandemic levels.

To conclude, this quarter's results included a large impact from COVID-19, but we expect these headwinds to abate over the remainder of the year.

Looking past that, we see strong underlying earnings and several positives. Revenue growth in all four businesses, a positive outlook for sales looking forward, record end-of-period account values providing a tailwind to earnings, continued strong expense discipline across the company and a strong capital position, which is contributing to our ability to invest in growth and increase our capital return to shareholders.

With that, let me turn the call back over to Al.

Albert S. Copersino

Vice President, Head of Investor Relations, Lincoln National Corp.

Thank you, Dennis and Randy. We will now begin the question-and-answer portion of the call. As a reminder, we ask that you please limit yourself to one question and one follow-up and then requeue if you have addition questions. With that, let me turn the call over to Katherine to begin Q&A.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] . Our first question comes from Elyse Greenspan with Wells Fargo. Your line is open.

Elyse Greenspan
Analyst, Wells Fargo Securities LLC

Q

Hi, thanks. Good morning. My first question, you guys last quarter spoke of your willingness to consider some type of risk transfer transactions with both your Annuity and your Life business. Have thoughts or desires changed over the past quarter related to your willingness to consider transactions? And then could you just update us on a sense of timing or size of deals that you're potentially considering?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yes. Elyse, thank you for that question. And you're absolutely right. In terms of block sales, we're looking at across our individual life and individual annuity books of business. There is an active market for both of those. Timing is always very difficult to speak to because they're complex transactions. But we're – we have a lot of resources behind this idea and probably we'll continue to have resources behind this kind of activity for some time.

The other area that we're looking at is flow transactions. And just broadly speaking, and we've mentioned this a couple of times, so you know this, we have done more – or as many flow transactions both in the living benefit space and in the fixed annuity space as most companies have. We, of course, have done a block transaction already with the fixed annuity business.

So, we remain active, remain optimistic. There's a lot of participants in the marketplace. Randy, do you want to add to those comments, please?

Randal J. Freitag
Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

A

Elyse, thanks for the question. Probably reiterating a bit of what Dennis said, but there's – if you think about the block sale marketplace, we continue to see a lot of interest on the buy side. It's actually – regularly receive inbound calls.

We know we have a very large block of in-force business across the life annuity business that that buyer base is interested in. And we believe the in-force value is not fully reflected in our share price.

And so, that gives you the underlying thesis for why we are, as Dennis said, allocating significant resources to see if something makes up. So, Elyse, we continue to be very interested in the idea and actively working on it. But I agree with Dennis, it's always difficult to talk about timing.

Elyse Greenspan
Analyst, Wells Fargo Securities LLC

Q

Okay, Great. And then my second question is on the group business. You commented that you're working towards the upper end of the 5% to 7% margin target. So just wondering. I had a couple, I guess, questions there.

Just if you – given that, it seems like results ex on COVID and ex VII came in within that range and a little bit better than what might have been expected and where you were trending. So, can you just give us an update on when you might kind of get towards the upper end of that range?

And I'm assuming that also assumes that, once we get out of COVID, the indirect mortality, so the $22 million that you saw in the quarter that that would all kind of go away and normalize once we're done with the pandemic?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yeah. Elyse, it's hard to predict exactly when that top end of the margin will be achieved. In my script, I said moving from 5% to 7% gradually. I mentioned a couple of initiatives underway, which – some repricing going on as business comes up for renewal, strengthening pricing in some of our new business segments. Those take time to enter into the margin because it's new business or renewals for in-force business.

And then we have cost initiatives that are underway. And those also – to do that type of thing effectively and to be able to get those numbers, somebody's name on them and into our planning process where we can be confident that we'll achieve the expense savings, that takes time. So, I think just over time without getting into a quantification of that. But it's going to build gradually. And so, we're going to start seeing some of that improvement.

Randal J. Freitag
Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

A

Elyse, I'll just add a little bit to that, right? It might be beneficial to think about what's happened over the last year. And if you think about the first quarter of last year, we made $40 million. This year, we lost $26 million. But we also know that this year in the first quarter, we had about $90 million of pandemic-related impact, right?

So absent anything else happening, $40 million last year, new negative $90 million item, you would've expected this to be around negative $50 million and we outperformed that by about $24 million. About a quarter of that is the strong alts performance I mentioned. But the other three-quarters is improvement in underlying profitability of the business, and that's reflective of renewal price increases, the strong work of the claims team. And we've talked about the investments we're making there. So that's an indication of what we can do in just a year's time. So I hope that helps, Elyse.

Elyse Greenspan
Analyst, Wells Fargo Securities LLC

Q

Yes. But then just on – you would expect, right, that $22 million of the indirect mortality, right, that that would kind of go away once we're out of the pandemic?

Randal J. Freitag
Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

A

Yes, we do, Elyse. This is an interesting topic. We spend a lot of time looking at the overall mortality experience. And so, the question is, why do you believe that indirect component is related to the pandemic. There are a number of aspects of that.

The first thing we look at is just what is the nature of COVID-19. The nature of COVID-19 is that, while it is more impactful than the flu, it acts like the flu and that it hits people with comorbidities harder. So that's just the nature of COVID-19. We also know that when we look inside of our experience, where this indirect component is coming, is coming in areas where you would expect the comorbidities to emerge, respiratory and cardiac, which is just like the flu.

We also know that when it comes to comorbidities, it's oftentimes the case, and we see this with the flu, it's not – flu is rarely noted on the death certificate as the cause of death, but it's oftentimes what starts the process. So everything that we know about COVID-19, all of our experience is what leads us to really assess this indirect component as related to the pandemic and something we believe will go away when we get this pandemic behind us in the country.

Elyse Greenspan
Analyst, Wells Fargo Securities LLC

Q

Okay, that's helpful. Thanks for the color.

Randal J. Freitag
Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

A

Yes.

Operator: Thank you. Our next question comes from Tom Gallagher with Evercore. Your line is open.

Thomas Gallagher
Analyst, Evercore ISI

Q

Thank you. Dennis, maybe just to start, a follow-up on Elyse's question on risk transfer. I guess, when you first mentioned considering risk transfer, Lincoln share price was in the 30s; now it's in the 60s. And realizing you started from a very depressed level to just now, still depressed, but less depressed level. When you think about – and I realize you're still working on it, but I presume you have some indication of pricing among the various blocks, but is there still a big positive arbitrage when you think about execution price relative to where your stock is? Any color on that would be helpful.

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yes. Tom, you're hitting squarely the issue as to why we would do a block sale, which is to direct capital out of that business, Life or Annuities, and into share buybacks. And so, both sides of the equation have to work. Where the price is today, based on our valuations of the different blocks, it still works pretty well. And so, we're continuing to pursue it.

Thomas Gallagher
Analyst, Evercore ISI

Q

That's clear. And, Dennis, would you say, again, more high level just from a pricing standpoint, is the pricing most attractive on the life side or the variable annuity side or the fixed annuity side?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

It varies. Right now, we're sort of focused on individual life because we've already done a big fixed annuity block. We're also looking at variable annuity. But, again, that's a much more complex transaction. Fewer players would be available on the life side. So, again, we're looking at everything. What's the buyer's discount rate expectations is obviously important. In other words, what are they going to want as a return.

So I would just say that it's fluid and very fact-dependent. But as Randy just said, we have pretty large number of blocks on the individual life side that have value in them. Those blocks have the characteristic, typically, of the reserves being backed by our general account and, therefore, people who have an asset capability would be buyers. So a lot of considerations, Tom.

Randy, do you want to add or subtract from that, please?

Randal J. Freitag
Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

A

No, Dennis, I think you covered it quite nicely.

Thomas Gallagher
Analyst, Evercore ISI

Q

Okay. Thanks, guys. Appreciate the color.

Operator: Thank you. Our next question comes from Humphrey Lee with Dowling & Partners. Your line is open.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Good morning and thank you for taking my questions. My first question is related to Life Insurance. So if we were to back out the COVID-19 claims and the strong VII in the quarter, I think that would get you to $180 million for the quarter, which seems pretty strong for a normal Q1, but can you talk about some of those drivers that led you to the $180 million?

Randal J. Freitag
Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

A

Humphrey, thanks for the question. It is a strong quarter. It's a little stronger than in the first quarter last year, which was $171 million, which was also a strong quarter. I think it's a big business, Humphrey. And I think it's fair to say that when you think about the pluses and minuses that go on inside of any big business, that in the life business, most of those items fell positive this time, and that leads to a strong quarter above your expectations.

But I also think it's fair to point out that, across the broader Lincoln, for instance, in the Annuity business, I think it's fair to say that the items fell a little negative. So I think when you think across the broad organization, we're very happy and comfortable with the numbers. But, yes, I think it's fair to say just inside of Life alone that it was just a strong quarter where things went the way of the Life business.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

So, like, did you see maybe non-COVID-19 mortality being favorable or like how should we think about it in terms of – like, I think in the past year, you shared the kind of actual versus expected for your Life business. If you were to exclude COVID, like, what would that be in terms of the actual to expected?

Randal J. Freitag
Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

A

What we believe based upon probably us reading the same stuff you read, Humphrey, is that we didn't see the normal seasonality – elevated mortality seasonality that we see in the first quarter. We saw mortality on an underlying basis, more like we would see in the second quarter, the upcoming second quarter. So, that's our best estimate.

But once again, what typically drives seasonality in the first quarter, the biggest driver is the flu. We believe, we read the same articles as you do, that it was a very light flu season. Because I noted in response to an earlier question, flu is actually rarely noted on the death certificate as a cause of death. So, we're hypothesizing a bit. But we believe we didn't see the normal level of seasonality in the first quarter that we do in a typical year.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Okay. Got it. And then my second question is, looking at the other segments, I was under the impression that the strategic digitalization expenses were done last year, but it kind of came through – I think it was like $13 million this quarter. Should we expect any kind of additional spend in the balance of the year? And then also, I think in Dennis' prepared remarks, you talked about expecting a meaningful expense saves program to be announced later this year. So, I guess, [indiscernible] (00:41:24) should we expect any kind of these type of integration or strategic spend kind of in 2021?

Randal J. Freitag
Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

A

Humphrey, I apologize if we weren't clear in this. We have a couple more years of the original project ambition or strategic digitization expense. What we expect is that the net benefit, which has been growing about $40 million a year, we'll grow that $40 million. So, yes, there's expenses, but the benefits, and you see that, three of our businesses actually had their expenses decline year-over-year and group was flat as we invested in claims.

So, yes, there is still some expense, but the benefits are growing. The net of those two items should be roughly an incremental $40 million of benefit. This year, we think we have about one more year of that net benefit growth across the organization, which will get us into the range that we originally guided to a number of years ago of $90 million to $150 million of net benefits from that original program. And then, as you know, and as Dennis talked about a bit, we are very focused on other opportunities across the organization.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Got it. Thank you.

Operator: Thank you. Our next question comes from Ryan Krueger with KBW. Your line is open.

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Hey, good morning. I had a follow-up on that. The other expense opportunity that you're embarking on later this year, is that related to efforts to preserve the $100 million of saves that you generated last year? Or is that something new that would be in addition to what you've talked about before?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Ryan, again, it's hard to keep all these numbers clear for the benefit of yourself and others on the phone, but sort of the amount that Randy talked about is separate from the new program. The $100 million that we captured in 2020 and then is expected to stay in 2021 remains there. And then the savings program would add to those two items.

And we're talking about it. You've seen other companies speak to large-scale expense reductions. It's the right thing to do. But we never actually size these numbers for our investors until we're prepared literally to put them into a financial forecast with someone's name behind them, when are they going to emerge, how much it's going to cost. And we're not going to be in a position to do that until the second half of 2021 to publicly bring that incremental savings into some type of estimate.

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Got it. That makes sense. Thanks. And then, I guess, Randy, on the annuity ROA, I guess it was lower than the typical range. I think you may have alluded to some things going against you, but any thoughts on where you'd expect that to trend going forward?

Randal J. Freitag
Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

A

Ryan, as I noted, when you think about all the businesses, I'd say on balance, in the Annuity business, it was a quarter where things fell a little negative, sort of those pluses and minuses, and that hurt the ROA a little bit.

The other thing I'd point out is that the first quarter of the year in the annuity business is always the quarter with the fewest number of fee days. And in fact, we actually have one fewer fee day this year than last year because last year was a leap year. So, that typically makes the ROA in the first quarter lower than the other quarters of the year. Looking forward, we'd expect this to grow back into where we've been running for some time, which is in the upper 70s, mid to upper 70s.

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Got it. Thank you.

Operator: Our next question comes from Jimmy Bhullar with JPMorgan. Your line is open.

Jimmy S. Bhullar
Analyst, JPMorgan Securities LLC

Q

Hi, good morning. First, I just had a question on the retirement business. And your flows have, obviously, been pretty strong for the last several quarters. Can you talk about what's driving that? And what are you seeing in terms of trends on deferrals matching contributions and how that's changed over the past year or so?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yeah. Jimmy, I'm not – deferrals and matching contributions dropped in 2020 because of COVID, the difficulty in small businesses. And actually, those are beginning to come back with the improving economy. So, that's a positive.

The activity in 2020, again, was a little bit lower because of COVID and people wanting just to sit still and watch and see what was going to happen. And so, we're seeing activity on the new business side return to more what we would expect absent COVID. Not 100%, but closer. So, we have very strong pipelines in the RPS business. We're seeing more contributions, matching contributions coming back into the market. So, overall, it's a pretty favorable environment for our RPS business. And we expect to see that in the numbers in the second quarter, sales and flows so forth.

Jimmy S. Bhullar
Analyst, JPMorgan Securities LLC

Q

Okay. And then, on your comments on risk transfer, it seems like part of your interest is just motivated by the valuation or multiple arbitrage and your multiple being low. And obviously, typically, the simpler a block, the easier it is to transact and you get better prices.

But if you do do something on individual life, as you mentioned, one of the issues would be that your exposure to variable annuities would increase even more, which is – whether it's warranted or not, one of the main reasons for the stock trading at a low multiple. So how does the risk profile of your remaining business figure into your thinking into a potential risk transfer transaction because I think you seem to be hinting that VAs are sort of a low likelihood scenario there?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Jimmy, if we look at the source of earnings, we think about morbidity and mortality as a bucket, we think about fees and assets under management as a bucket, we look at investment spread. And in terms of that view, there's not going to be a material change because of the transaction.

If I step back and maybe add something to your question, which is getting out of guaranteed business and in our individual business is that [indiscernible] (00:49:22). You recall, it's been some time since we focused on those, but company-wide we're focused on kind of 70% of our business being non-guaranteed and maybe up to 30% guaranteed business, long-term liabilities.

In the first quarter, the long-term liability on the sales of non-guaranteed business was 90%. And that was really driven by pricing actions. As interest rates drop, the value proposition or [indiscernible] (00:50:02) living benefits wasn't as strong and some of those sales fell off a little bit. So, big picture, I don't think risk transfer is going to materially change the source of earnings number.

And we're continuing because – I expect to continue to be in that guaranteed versus non-guaranteed range better than the 70/30 for some time to come, again, driven by the level of interest rates, product designs and all the factors that go into the sales mix.

Randal J. Freitag
Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

A

Jimmy, I just may add to that just on the whole topic of variable annuities at Lincoln, I'd point out that the end of the first quarter, $144 billion of liabilities, what is oftentimes overlooked, so maybe we should spend more time on it, is that over 40% of those liabilities, about $60 billion of those liabilities are VAs without any living benefit or IVAs. And that percentage, which is, I think, 42% in the first quarter, is up 5 points over last year, and that's all about where we're selling today. So, you have like a very large shift on a year-over-year basis. And then I would expect that shift to continue if you just look at the existing sales mix. So, let's not conflate that $144 billion with all being something that has a living benefit tied to it.

Jimmy S. Bhullar
Analyst, JPMorgan Securities LLC

Q

And then just maybe one more on the shifts away from guaranteed products that you've undertaken over the past couple of years. It seems like more of a strategic shift. But if the market stays strong and you do get higher interest rates, do you think you'll be back selling more products with the guarantees with the appropriate prices? Or do you intend the shift to be more of a permanent change in your strategy?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yes. The answer to that is you're exactly right. The value proposition for long-term liabilities is dependent predominantly on interest rates. And we don't see, in our forward-looking plans, interest rates rising so much that you'd see a significant change in the mix towards the 70/30 from the 90/10. But that's very dependent on mostly interest rates, but other factors. We certainly wouldn't strategically want to go above the 30% and, I'll repeat, for the foreseeable future, somewhere between the 90/10 and sort of somewhat higher than that, but not significantly.

Jimmy S. Bhullar
Analyst, JPMorgan Securities LLC

Q

Thank you.

Operator: Thank you. Our next question comes from John Barton (sic) [John Barnidge] with Piper Sandler. Your line is open.

John Barnidge
Analyst, Piper Sandler & Co.

Q

Thank you for the color on indirect mortality. A number of participants talked about like death and despair, and then impact from delay in care, particularly Alzheimer's and heart. One talked about death and despair being 20%, the 80% being the remainder. Can you talk about what you're seeing on that side that's probably independent of the indirect mortality?

Randal J. Freitag
Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

A

John, we're not seeing that. So whether you're talking, I don't want to say the word but, suicides or overdoses, those sorts of things, we're not seeing an elevation in those causes of death. As I mentioned, it is in the things that are related to a virus like COVID-19, respiratory and cardiac.

In terms of the delayed care question, as we talk to the doctors here at Lincoln, that is not sort of something that's going to impact mortality in the very near-term. It's something that will impact mortality in a very modest way over the longer-term. And it would probably be more than offset by, as we've talked about on the Life side, the front end of claims that COVID has caused, which will probably benefit us over the next few years.

John Barnidge
Analyst, Piper Sandler & Co.

Q

That's fantastic. Thank you for the answer. A related follow-up. I can't help but note you're talking about more detail on a public estimate around cost cut in the second half of 2021 and then juxtapose that with return to office. Another participant talked about a hybrid model for their employees this morning. Is the cost-cutting program going to take into account real estate as well?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

It will. It's a comprehensive look at all questions around cost and effectiveness and execution. To use the term of art, it's a pretty cool program that I think we're going to be able to execute on, in general, both efficiency, but also upgrading skill sets of our employees, possibly some top line opportunities as well.

So on your specific question, we do believe that – and we're referring to this as our long-term employee model – we'll have sort of significantly less people in the office on a daily basis. So there will be some real estate benefit. So it will be in there, in the numbers that we report towards the end of the year. But it's a meaningful number, but that it will be in there. I'll just leave it at that.

John Barnidge
Analyst, Piper Sandler & Co.

Q

Thank you for the answer.

Operator: Thank you. Our next question comes from Suneet Kamath with Citi. Your line is open.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Thanks. Good morning. I wanted to start with the Life Insurance sales. It feels to me that the amount of sort of new product that you guys are rolling out this year might be much, much higher than what's normal, that it just seems to be a lot of activity. So I'm just wondering if you can kind of give us a sense of the pace of the sales improvement. With this much sort of new product coming out your distribution, could it take longer for them to kind of inflect because they're just kind of dealing with so many new products?

Randal J. Freitag
Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

A

Suneet, thanks for the question. I think it's fair to say that Life sales, at least so far, are sort of rolling out exactly as we thought. Dennis mentioned that we sort of bottomed in the fourth quarter of last year. We ended up in the first quarter this year with a number right in line with that number, and we expect to grow from here.

What's driving that is new product introductions, but also changes that other – some of our competitors are making in their prices. And as we said, we believe we went in front of everybody else.

When you think about two big product introductions, for instance, that we had in the first quarter, the MoneyGuard Market Advantage, which is MoneyGuard on a variable platform, and then a reduced guarantee VUL product. The products didn't roll out until the middle of February. In fact, when you look at that MoneyGuard product, it's not on our two biggest MoneyGuard distribution partners yet, and it's already making us, by the way, about 30% of our submit.

So we think we've hit the mark with those products, but it takes a while to get these things on to all the platforms you want. And then you, ultimately, really don't know the success on a Life product for probably six months before you really know whether you hit the mark. Hopefully, that answers your question, Suneet.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Yeah, it does. That's helpful.

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yeah. And, Suneet, let me just add to that. I mentioned in my remarks, sort of separate from the new business that we – the new products that we're putting out. And as Randy said, and as you said, there's certain amount of education and certain amount of shelf space that has to be acquired in other parts of the business. Some of the things that we've done in the past connected with expansion of distribution, we're seeing payoff sort of separate from that issue. And that's this large relationship they have with the – I mentioned with a P&C organization.

And I just want to mention that because the app count initially from that, although small face amounts been pretty good. But the reason that we're able to be effective with that new partner, new partner for life, is because of the investments that we've made in automated underwriting. So, those sales are being digital or digital apps, digital underwriting and digital issue.

And I'd just like to point out that we've been making these comments about our digital program from a cost perspective. But the digital program is really, as we go forward in many areas of the company, is going to permit us to not have to staff up because, in the past, if you didn't have digital issue and apps and things like that in order to improve your customer experience, you just had to add people. But we don't as much now because of the several hundred million dollars that we invested in digital.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Okay. That's helpful. And then just last one. I know it's early days on tax reform, but historically, I think higher taxes have been sort of a catalyst for some of your retail products that have tax benefits. Are you seeing anything in these initial proposals or even just comments coming out of Washington that could impact your demand for your products one way or the other?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yeah. Suneet, we think some of the sales that we have already seen in the non-guaranteed VA are in part motivated by people's concern about changing capital gains, tax rates. We had a product that – i4LIFE, which is a very tax-efficient way to distribute. So, some of the – so we've seen some of it already. But until we know what the final facts are, I'm not – it's hard to predict how much of an impact it will have.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Okay. Thanks.

Operator: Thank you. And that's all the time we have for questions. I'd like to turn the call back to Al Copersino for any closing remarks.

Albert S. Copersino

Vice President, Head of Investor Relations, Lincoln National Corp.

Well, thank you all for joining us this morning. As always, we're happy to take any follow-up questions that you have. You can e-mail us at investorrelations@lfg.com. Thank you all and have a great day.

Operator: This concludes today's conference call. Thank you for participating. You may now disconnect.