06-Feb-2020

Lincoln National Corp. (LNC)

Q4 2019 Earnings Call

CORPORATE PARTICIPANTS

Christopher A. Giovanni
Senior Vice President-Investor Relations, Strategic Planning & Corporate Treasurer, Lincoln National Corp.

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

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

OTHER PARTICIPANTS

Jimmy S. Bhullar
Analyst, JPMorgan Securities LLC

Erik Bass
Analyst, Autonomous Research

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

Thomas Gallagher
Analyst, Evercore ISI

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Elyse Greenspan
Analyst, Wells Fargo Securities LLC

Alex Scott
Analyst, Goldman Sachs & Co. LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning and thank you for joining Lincoln Financial Group's Fourth Quarter 2019 Earnings Conference Call. At this time, all lines are in a listen-only mode. Later, we will announce the opportunity for questions and instructions will be given at that time. [Operator Instructions]

Now, I would like to turn the conference over to Corporate Treasurer, Chris Giovanni. Please go ahead, sir.

Christopher A. Giovanni

Senior Vice President-Investor Relations, Strategic Planning & Corporate Treasurer, Lincoln National Corp.

Thank you, Catherine. Good morning and welcome to Lincoln Financial's fourth quarter earnings call. Before we begin, I have an important reminder. Any comments made during the call regarding future expectations, trends and market conditions, including comments about sales and 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 those detailed in our 2018 Annual Report on Form 10-K, most recent Quarterly Report 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 them to reflect events or circumstances that could 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 include a full reconciliation to the non-GAAP measures used in the call, including adjusted return on equity and adjusted income from operations or adjusted operating income to their 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, Chris, and good morning, everyone. Our dynamic business model and continued execution produced record adjusted operatings per share in the fourth quarter, results consistent with expectations we communicated during our third quarter call. For the quarter, we grew adjusted EPS 12%, increased book value excluding AOCI to over $71, a record, and our adjusted ROE was nearly 14%.

Over the course of the year, we further advanced strategic priorities and leveraged the benefits of our business model and risk management culture to drive profitable top line growth, successfully executed our expense initiatives and maintained a high-quality balance sheet, all of which positioned us for continued financial success.

Let me touch on each of these. First, on profitable top line growth. Strategic product actions drove sales gains, as new products such as our indexed variable annuity and our proprietary target-date retirement product YourPath complemented our best-in-class product portfolio. We also leveraged our powerful distribution franchise to reach new customers.

We now have more than 99,000 producers that sold a Lincoln product over the past 24 months, up 8% from the prior year, as we participate in more distribution channels such as property and casualty and gain momentum in other channels such as independent marketing organizations. This combination of product and distribution expansion resulted in strong growth in the fourth quarter and the full year.

Specifically, the Annuities business delivered positive net flows every quarter of 2019, including positive flows in both variable and fixed annuities in the fourth quarter. Life sales exceeded $1 billion for the year, as we benefited from our broad product portfolio and in the fourth quarter we capitalized on upcoming regulatory changes.

Group Protection sales increased for the full year and in the quarter, as we leveraged our broader capabilities to enhance our overall offering to all employer-size segments. And RPS generated positive net flows for the quarter and year, marking its fifth consecutive year of positive flows. These strong top line results contributed to operating revenue growth in every business segment during both the fourth quarter and the full year.

Importantly, we stay disciplined, with product re-pricing occurring throughout the year. And we continued to shift the shift of our sales mix towards shorter-duration products which are less sensitive to interest rates. We are fiercely focused on growing the top line on terms attractive to our shareholders.

Though expenses were elevated in the fourth quarter due to strong sales volumes and seasonality, we continued to successfully execute on two significant expense saving programs during the year. First, our digital initiative is progressing well, as savings offset investments in 2019, consistent with our plan, and we expect net savings to ramp up this year. Second, we are well on our way to achieving our target of $125 million in expense savings from the Liberty acquisition by the end of 2020.

Lastly, on our high-quality balance sheet. Prudent assumptions, active risk management and disciplined capital management have long been evident at Lincoln. In 2019, we made appropriate adjustments to our assumptions, maintained disciplined asset liability matching, and utilized significant cash flow to both invest in opportunistic growth and return capital to shareholders. As we entered 2020, our capital ratios are strong and our balance sheet is well positioned.

Now turning to the business segments, starting with Annuities. Our strategic decision to broaden the product portfolio and participate in more segments of the marketplace enables us to meet varying customer needs, expand distribution, improve our organic growth rate and maintain a diversified sales mix.

For the full year, total sales increased 17%, and net flows were positive for the fifth consecutive quarter, including in both variable and fixed annuities in the fourth quarter. Full-year net flows were positive for the first time since 2015. Our growth rate has improved by more than 4 percentage points in just two years, as we successfully launched new products and increased total producers by 11% while re-pricing where needed.

Our most successful new product has been our indexed variable annuity, which helped drive a 45% increase in sales of VAs without living benefit guarantees. As a result, we had a very balanced sales mix for the full year, as VAs with living benefit guarantees, VAs without living benefit guarantees and fixed annuities, each represented approximately one-third of total annuity sales. This year, we expect to further shift to VAs without guarantees, as we continue to expand shelf space and new producers.

So, another strong quarter and year for the Annuities business, as growth metrics are clearly benefiting from our broad set of consumer solutions, our multi-channel distribution model and consistent market presence. When combined with prudently adjusting pricing and product features which respond to lower interest rates, appropriate assumptions and industry-leading hedge program, we are well positioned to deliver strong operating results.

In Retirement Plan Services, we have a competitive advantage in our target markets as a result of our high-touch, high-tech, digitally-focused service model. This model distinguishes us from our competitors, attracts new customers, and drives higher participation and contribution rates, resulting in strong retention and sales growth. In the fourth quarter, first-year sales increased 47%, with growth across all target markets. Distribution expansion and YourPath, our proprietary alternative to target-date funds, continue to differentiate us in the marketplace.

Recurring deposits also increased 8% for the quarter and the full year, with strong growth in both the small and mid/large markets. Net flows were once again positive in the quarter and totaled more than $0.5 billion for 2019. Overall, it was a strong quarter and year for the retirement business and we are well positioned to compete in our target markets.

Turning to Life Insurance, sales momentum has strengthened in recent quarters, as we have expanded distribution and focused on fast-growing industry segments. This led to total Life Insurance sales exceeding $1 billion for the full year, boosted by a particularly strong fourth quarter, as we opportunistically increased sales at attractive returns.

Specific areas that drove strong growth include IUL, where we are benefiting from product actions taken earlier in the year, a fast-growing IUL market, and greater focus in segments of the market where we were underrepresented. As a result, our sales more than doubled for the quarter and the full year.

MoneyGuard sales also more than doubled in the quarter and were up 32% for the year, ahead of price increases, reflecting new principle-based reserving changes and lower interest rates. And lastly, Executive Benefit sales, which can be lumpy, were particularly strong for most of the year, ahead of the transition to a new mortality table.

Additionally, our network of producers has increased 8% over the past year, which contributed to our strong growth. As we entered this year, we anticipate sales levels to decline, given 2019 strong sales, continued focus on maintaining appropriate returns on capitals and we operate under new principles-based reserving.

Turning to Group Protection, we continue to capitalize on the competitive advantages created by the acquisition and effectively execute on strategic objectives, including leveraging our larger book of business and expanding capabilities to cross-sell additional lines of coverage.

Sales increased 9% in the fourth quarter compared to the prior year and 30% for the full year, with strong growth in both the employer- and employee paid markets. When combined with solid retention, premiums once again increased sequentially. Looking forward, maintaining disciplined pricing and achieving the expense efficiencies I noted upfront are important levers that will enable us to continue to achieve attractive margins.

Briefly on investment reserves, we invested new money in an average pre-tax yield of 3.6% during the quarter and 4% for the full year, both more than 180 basis points over the average 10-year Treasury rate. We continue to find good value in purchasing high-quality, less liquid assets such as mortgage loans, structured securities and privates, where we achieved attractive illiquidity premiums and have ample room to grow. These strategies have also further diversified the portfolio with public corporate bonds decreasing as a percentage of invested assets.

Additionally, we remain focused on selective de-risking. And for the full year, we reduced our holdings of lower rated BBB's and below investment grade bonds by 2%. The alternative investment portfolio achieved a 7% pre-tax annualized return for the quarter and sharply recovered following the write-down of a large private equity holding in the third quarter. We continue to target a long-term pre-tax return of 10% and expect solid results in the first quarter of 2020.

In closing, I am pleased with the strong end of the year and our continued execution. Low interest rates remain a headwind, but we have successfully dealt with this for many years. We expect incremental spread compression to be mitigated by our normal expense discipline and additional initiatives such as digital programs, combined with growth. On the product front, we'll continue to re-price products where necessary, shift emphasis to existing products that are meeting or exceeding return requirements, and add new well-priced products.

Again, all actions we have successfully implemented in the past. To the extent sales or net flows decline in the short run because of our disciplined pricing actions, we expect to redirect capital to additional share buybacks. I am confident our business model and action-oriented management team can sustain our track record of excellent financial performance and add further shareholder value.

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 fourth-quarter adjusted operating income of $482 million or $2.41 per share, a record, and up 12% over the prior-year quarter. There were no notable items within the current or prior-year quarter. However, there were a few items driving some variability both up and down, and I will touch on those in the business segments.

But let me briefly note that expenses were elevated in the quarter due to a number of items, including strong sales, costs associated with ending our Liberty transitional service agreements and typical volatility in the fourth quarter.

Touching on the performance of key financial metrics in the fourth quarter compared to the prior-year quarter. Adjusted operating ROE increased 40 basis points to 13.9%. Book value per share, excluding AOCI, increased 5% to $71.27, an all-time high. Every business segment reported an increase in operating revenues and operating income. And consolidated net flows increased 36%.

Finally, net income per share was $2.15, with the decrease relative to operating EPS driven by a loss from variable annuity non-performance risk. When adjusting for this non-economic impact, net income was 101% of adjusted operating income.

Now turning to segment results, starting with Annuities. Reported operating income for the quarter was $269 million, compared to $258 million in the prior-year quarter. The increase in earnings was primarily driven by higher account values from equity market growth and positive net flows. Operating revenues increased 6% from the prior-year quarter and 5% for the full year.

As I mentioned earlier, expenses were higher in the quarter due to a 13% sequential increase in sales and typical fourth quarter seasonality. You will note that base spreads, excluding variable investment income, came down in the quarter, driven by our mix of business. However, fixed annuities earnings growth was in line with account value growth. Looking forward, I would expect spreads to be consistent with this quarter's result, subject to our sales mix.

Return metrics remained solid in the quarter with ROA at 78 basis points and a 22% ROE, both largely consistent with the full year when adjusting for notable items. Risk metrics also remained strong as net amount of risk as a percent of account value sits below 80 basis points for living benefits and 40 basis points for debt benefits. So, another very good quarter and year for the Annuities business. With end-of-period account values 3% higher than average account values and positive organic growth, we are well positioned to continue delivering strong financial performance.

In Retirement Plan Services, we reported operating income of $47 million, compared to $45 million in the prior-year quarter, with the increase in earnings primarily driven by higher average account values. Net flows totaled $422 million for the quarter and $620 million for the full year. When combined with strong equity market performance, average account values increased to $76 billion in the quarter, up 10% compared to the prior quarter.

G&A expenses, net of amounts capitalized, were flat compared to the prior-year quarter and down slightly for the full year, which drove a 60 basis point improvement in the expense ratio in 2019. Base spreads, excluding variable investment income, compressed 13 basis points versus the prior-year quarter, consistent with our expectations. ROA came in at 25 basis points in the quarter, 1 basis point above the full-year average. The retirement business ended the year with strong results, and momentum in sales and expense management should serve as positive drivers going forward.

Turning to our Life Insurance segment, operating income of $179 million increased 2% from the prior-year quarter, driven by continued growth from the business and favorable mortality relative to the prior-year quarter, offset by lower variable investment income. Underlying earnings drivers were strong, with average account values up 6% over the prior-year quarter and average life insurance in force up 10%. Base spreads, excluding variable investment income, were down 6 basis points compared to the prior-year quarter, consistent with our expectations.

In the fourth quarter, mortality was in line with our expectations for the quarter. For the full year, mortality came within 1 percentage point of our annual expectation, a solid result. As we move into the first quarter, I would remind you that we typically expect seasonally higher mortality early in the year and more favorable mortality in the back half of the year.

During the quarter, amortization expenses were favorable to our expectation, but this was offset by higher G&A expenses net of amounts capitalized primarily related to strong sales growth. Over the course of the year, the Life business produced steady driver growth and culminated the year with very strong sales, positioning the business well as we entered 2020.

Group Protection reported operating income of $54 million, up 8% from the prior-year quarter, driven by premium growth and a more favorable overall loss ratio, which came in at 74.4% compared to 75.8% in the prior-year quarter. This quarter's loss ratio included a net benefit of approximately $4 million compared to a more normal quarter, as a higher disability loss ratio, driven by fourth quarter seasonality and an increase in severity, impacted earnings by $15 million. This was more than offset by a favorable Life loss ratio, driven in part by management actions that helped improve claims efficiency.

G&A expenses increased 5% over the prior-year quarter, as we incurred $9 million of one-time costs associated with the exit of the Liberty transitional service agreements and other non-recurring expenses. For the full year, the expense ratio improved 60 basis points, as we benefited from integration synergies, and I expect the expense ratio to continue to trend down. The after-tax margin was 5.2% in the quarter, and 5.8% for the full year, both up 30 basis points over the comparable periods. Looking forward, we expect to sustain attractive margins as we execute on our growth and expense saving initiatives.

Turning to capital and the capital management. We ended the year with $9.7 billion of statutory surplus and an RBC ratio of approximately 435%, which includes 25 RBC points from non-economic goodwill associated with the Liberty acquisition that will go away at the completion of a legal entity merger. Holding company cash exceeded $700 million, as we prepare to pay off our upcoming February debt maturity. We continue to target $450 million of cash at the holding company.

During the quarter, we returned $173 million of capital to shareholders and $938 million for the full year. Fourth quarter buybacks of $100 million were slightly below our recent quarterly average, as we opportunistically allocated more capital to new business with attractive returns. Looking ahead to 2020, we expect capital return to shareholders to be at least $900 million.

To conclude, we reported record adjusted operating EPS in the fourth quarter, a 13.9% adjusted operating ROE and book value excluding AOCI increased 5% to over $71 per share, an all-time high. While our annual third quarter assumption review impacted our full-year results, we continued to see solid drivers of EPS growth including strong sales and positive net flows which contributed to an increase in operating revenues for every business segment.

End-of-period account values exceeded average account values, which provide a tailwind to future earnings. Expense saving programs leave us well positioned to achieve meaningful run rate savings in 2020 and beyond. $640 million in buybacks brought our share count down 5% for the year, consistent with the average reduction over the past five years.

We also announced an 8% increase to our shareholder dividend for 2020. And looking forward, we will continue to focus on diligently returning capital to shareholders, while investing in new business when attractive returns can be achieved. Bottom line, we are well positioned to deliver strong financial results.

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

Christopher A. Giovanni

Senior Vice President-Investor Relations, Strategic Planning & Corporate Treasurer, 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 only one follow-up and then re-queue if you have additional questions.

With that, Catherine, will you please open up Q&A?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question comes from Jimmy Bhullar with JPMorgan. Your line is open.

Jimmy S. Bhullar
Analyst, JPMorgan Securities LLC

Q

Hi. Good morning. First, for Randy, can you quantify the extra expenses you might have had this quarter because of the transition off of the TSAs with Liberty in the Group business?

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

A

Hey, Jimmy. As I mentioned in my script, about $9 million after-tax, so roughly $11 million or so of pre-tax elevated one-time expenses...

Jimmy S. Bhullar
Analyst, JPMorgan Securities LLC

Q

And those were down year over year?

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

A

...some of which or most of which were associated with the exit from that TSA.

Jimmy S. Bhullar
Analyst, JPMorgan Securities LLC

Q

Okay. And those you're expecting to be gone beginning in 2020, right?

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

A

Yes.

Jimmy S. Bhullar
Analyst, JPMorgan Securities LLC

Q

And on buybacks, just I think this is the weakest quarter you've had in buybacks or the lowest amount in the last seven quarters since you resumed buybacks. Any reason for why the amount dropped to $100 million?

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

A

Jimmy, we had very clear visibility that we were going to have very strong sales in the fourth quarter and we also had very clear visibility that the returns we were going to get on those new sales were going to be very strong. And so we made the decision to allocate a little more capital in the quarter to new business than we did to buybacks.

Now, as I mentioned in my script, when you move into the first quarter and into 2020, we fully expect to be back from a buyback standpoint in line with our historic practices. As I mentioned, at least $900 million of capital returned is our expectation for 2020 to shareholders, with the dividend increase I mentioned. Shareholder dividends will be just a little over $300 million. What's the implication of that? At least $600 million of buybacks or $150 million on average a quarter, which is where we have been running.

And keeping as – I used at least because, as we have been doing for nearly a decade, we're going to do everything we can, especially when we see an environment that exists like it does today, which is a share price that, objectively, is well below book value and, subjectively, from our standpoint is well below where it should be based upon both past performance and what we expect going forward. You can fully expect that we're going to do everything we can to, as I mentioned, do at least $900 million of total capital return to shareholders in 2020.

Jimmy S. Bhullar
Analyst, JPMorgan Securities LLC
Q

And in the past, you've done – like, at least in 2019, you did a little bit more early in the year and then it tapered off as the year went on. Would you try to be more opportunistic and do more buybacks, given your capital position early, or should we expect them to be more sort of flat lined throughout the year?

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

I think as we have always, Jimmy, and we have had this discussion coming into any year in the past, I'd start out with the average ratably over the year and then understand that when we believe the opportunity arises, we're going to do everything we can to accelerate when we believe it makes sense. And as I mentioned, we believe with the share price where it is today, that it makes sense. So we're going to do everything we can to the extent we are going to accelerate above the $900 million to do what we believe it's opportunistic.

Jimmy S. Bhullar
Analyst, JPMorgan Securities LLC
Q

Thank you.

Operator: Thank you. Our next question comes from Erik Bass with Autonomous Research. Your line is open.

Erik Bass
Analyst, Autonomous Research
Q

Hi. Thank you. Can you just talk a little bit more about the outlook for expenses in the Group business as we head into 2020 and how much room is there to bring those down now that you've exited the TSAs? And will we start to see that immediately in the first quarter or will it come through over the course of the year?

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

Well, the one-time non-recurring expenses I mentioned, they're gone, right? We wouldn't expect them to repeat I should say in the first quarter. So, take those out right away. Broadly speaking, in my script, I mentioned that we expect expense ratios to continue to trend down in 2020 relative to where they were in 2019, and that's what I would use when you think about where expenses will be in the Group business.

If you go back to the first quarter of 2019, I believe our expense ratio came in at 13.7%. And absent non-recurring expenses like occurred in the fourth quarter, we'd expect to improve over that level.

Erik Bass
Analyst, Autonomous Research

Q

Got it. And if given the opportunity to bring down expenses, would then it'd be reasonable to expect you to be at the upper end of the kind of the 5% to 7% target range for margins?

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

A

You know Erik, we came in at 5.8% for the year. That was 30 basis points better than we were the preceding year. It's obviously well ahead of where we thought we would be when we closed the acquisition of the Liberty business. From an integration savings standpoint, we exited 2019 in line with our $100 million expectation. And as we look through 2020, we'd expect that to ultimately grow to roughly $125 million. I'd expect that to occur ratably over the years.

So, you're going to get some benefit from additional integration-related savings. But I think we're very happy with the year's results. And as we talked about earlier, over time our expectation for our Group business is 5% to 7%. We said with the additional scale that we've achieved with this acquisition that we believe over time that we can perform in the upper half of that range.

So I think I'll leave it at that. We will have some additional integration savings in 2020 and we believe that over time we should perform in the upper half of that 5% to 7% range.

Erik Bass
Analyst, Autonomous Research

Q

Got it. Thank you.

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

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

Q

Hi. Good morning. I guess, Randy, following up on your comment on the stock price, I know I've asked you this before, but clearly the market's view of variable annuity value differs greatly from I think your own view of the value of your block. I guess, would you reconsider any sort of a third-party transaction just for a small piece of the block to prove out third-party value is higher than the market thinks it is? And I guess, related to that, it does seem like there's a lot more VA buyers now than there used to be. So, just wanted to hear your perspective on that.

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

A

Hey, Ryan. This is Dennis. And it's a good question. We've touched on it quite a bit over the last couple of years. The first thing is that our book is cleaner, better, and more profitable than the rest of the industry and we continue to grow it on a basis consistent with that. So we're very comfortable with our VA business from an economic perspective.

Now, to the broader question, will we continue to look at the sale of blocks of business including VAs? Yes, but we're going to do that on an economic basis. I get the point of sort of trying to use a VA block to give more comfort to the Street about how it's valued, but we're more driven by economics and we'll consistently be driven by economics. Does it make sense to sell something, use those proceeds in a more attractive way as we did with the Athene transaction?

I'll tell you I'm a little skeptical of the idea of revaluation as being a motive. Over my years in the business, certainly in the M&A sphere, I really never have counted on revaluation as a benefit from a action. We premise it on are the economics right for our shareholders.

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

Q

Understood. Thanks, Dennis. And then, for Randy, I assume this is the case based on your capital management guidance of at least $900 million, but do you still view free cash flow in that same $850 million to $950 million range for 2020?

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

A

Yeah, Ryan. We're largely in that range. I mean it continues to grow a little bit with the growth of the company and that's why I said the at least $900 million as opposed to the $850 million to $950 million that we talked about before.

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

Q

Okay. Got it. Thank you.

Operator: Thank you. And our next question comes from Thomas Gallagher with Evercore ISI. Your line is open.

Thomas Gallagher
Analyst, Evercore ISI

Q

Thanks. Dennis, just a follow-up to Ryan's question. Not approaching it from the variable annuity side, but more from the Individual Life side. Voya transacted at, by our calculation, about a 9 to 10 times valuation when they sold their Individual Life block and that was a block in runoff that, at least in my view, was inferior to the quality of Lincoln's block. So you have a private market value that I think shows a pretty good number relative to certainly what I think your Life block's being valued at.

So I guess my question is, would you consider maybe even like a partial reinsurance deal, an in-force treaty or something like that, for your Life Insurance business if there is that kind of, I would call it, considerable arb that may exist in the market on Life Insurance? That's my first question.

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

A

Tom, absolutely. We have an M&A group. We're in the flow of the market, if you will, for all these types of transactions. And if we find something that we can execute on in any of our businesses, where we can, to use your term, arbitrage the public versus the private market for the benefit of our shareholders, absolutely we'll do that.

Thomas Gallagher
Analyst, Evercore ISI

Q

Got you. And then, my other question is, Randy, the comment you made about the attractiveness of Life Insurance sales in the quarter and how that was – you viewed that as like an attractive opportunity and a reason to pivot capital deployment to Life Insurance.

I guess my question is, if you're in the process of raising prices, doesn't that imply that's going to be a lower returning slug of Life sales in terms of the MoneyGuard and other significant Life sales? Or how do you kind of reconcile the fact that you're in the process of, I presume, meaningfully raising prices yet you're saying there was an attractive IRR opportunity in the quarter?

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

A

Tom, thanks for the question. The fourth quarter, when it comes to Life Insured sales, is what I would describe as the perfect selling environment for a company with among the strongest capabilities in the Life Insurance space in the business. And so, let me dig into that a little bit, what do I mean by the perfect selling environment.

I mean that there was a number of reasons for consumer demand to be very strong, driven by regulatory changes that were driving some price increases or a different value prop for consumers. And on our side, there were a couple of items, including the existence of very strong returns on the products, along with a couple of initiatives that we had put in place which contributed to the very strong sales growth.

Really need to go product-by-product to understand the phenomena and how it impacted the quarter. So, let's start with the executive benefits business, which was up significantly in the quarter. This is a business that is an accumulation-focused business. With the change in the underlying mortality table in 2020, what happens to accumulation products is that they have less capability to put in dollars. For each unit of Life Insurance, you can put in less dollars. So the value prop changes, so there is a huge factor that companies have to take into account. And what you saw is a lot of companies accelerating their plans to establish these big cases. We benefited from that at very attractive returns.

Let's go on to IUL and term. Those products and those strong sales were the results of initiative that we've talked about over the course of the year. We had in the first quarter over the year really in a big way entered the IUL space with a product that was competitive. We actually improved the economics on that product as we moved into the last half of the year by lowering what's called the cap on the product. So, once again, you had execution on initiatives in two product spaces with very attractive returns.

Now you have MoneyGuard. So you mentioned the word fire sale, Tom? What is a fire sale? To me when I think about fire sale, the definition is that you have a price increase coming in the next quarter and you're getting subpar returns in the current quarter. In the case of MoneyGuard, we have our price increase coming in the first quarter, but the returns were still strong in the fourth quarter.

Why is that? It's because a significant piece of the price increase is related to the implementation of PBR, which in the case of MoneyGuard, hurts the product. It requires the product to have more capital put into it upfront. Well, that didn't exist in the fourth quarter of 2019. Now, I admit, some of the price increase was because rates have come down and so that means we weren't – our returns were a little below where they were the quarter before or two quarters before, but they were still attractive returns.

So, Tom, once again, I think a very attractive environment for consumers to buy our products and a very attractive environment overall for us to sell products existed in the fourth quarter. We took advantage of it.

Thomas Gallagher
Analyst, Evercore ISI

Q

That makes sense, Randy. So, more on the MoneyGuard side, statutory strain as opposed to being a lower economic return?

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

A

Yeah. I'll try to explain a little bit why that happened with PBR, because PBR for instance was something that helped the term insurance business. So, why does a product like MoneyGuard get hurt? It happens because MoneyGuard is a relatively long product.

PBR was a great move by the regulators. It was needed, a single formula and it was no longer working for the diversity of products that exist in our industry or wasn't going to work if you look forward. So they came up with PBR, which where a company projects out its cash flow, discounts them back, and establishes a reserve, makes a ton of sense.

One of the downsides of PBR is that the approach they took was to put a margin on each assumption that goes into the projection of those cash flows, as opposed to a margin on the present value. On a product, a longer product like MoneyGuard, that really gives you a significant amount of redundancy when you project out those cash flows into the future and discount those margins on each one of the assumptions. And that's why PBR for a product like MoneyGuard hurt the expected return and was part of the reason we had to raise prices.

Thomas Gallagher
Analyst, Evercore ISI

Q

Got it. Thank you.

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

A

Yeah. It's as simple as our costs are going up in the next quarter and we're going to have to raise prices. Our costs did not increase in the fourth quarter and so we could hold prices.

Thomas Gallagher
Analyst, Evercore ISI

Q

Okay. Thanks guys.

Operator: Thank you. And 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 the expectation for lower sales for Life Insurance in 2020. I was just wondering if you can remind us in terms of the sales trend for every dollar of sales. I think you've given that number for Annuities in the past, but maybe just remind us in terms of how should we think about every dollar of sales strength in the Life space?

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

A

Humphrey, that varies by product, but broadly speaking in 2019 it was roughly $0.50. It's going up a little bit in 2020, because of what I talked about on a product like MoneyGuard and it's one of the reasons you will see sales come down in 2020.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Got it. So I guess in terms of thinking about capital returns sort of historically, and I think you also alluded that in your prepared remarks is that like any kind of sales decline you would anticipate? There is some offset from additional share repurchases. So, for the $900 million of – at least $900 million of capital return, I guess the above $900 million will represent the potential from kind of lower sales trend into 2020?

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

A

It would reflect everything, Humphrey, including whether sales come down more than we expect, whether, as Dennis talked about, we did some sort of block transaction. I mean, there are many ways that capital can be generated or retained at Lincoln. So I think there's a number of factors. And as we have in the past, you can be rest assured that we're focused on everything we can do to, as I mentioned, take advantage of what we believe is a very attractive opportunity to buy our stock back.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Got it. I appreciate the color. And then a question related to Group Protection. So you talked about how some of the benefits from the expense synergy would come along in 2020. Is the $120 million still the expectation? And then also compared to where you are at the end, I guess how much cost savings have you realized at the end of the quarter? So how to think about how the excess savings will emerge in 2020?

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

A

We ended the year in line with our guidance, which was $100 million or so, and we expect to grow that to a run rate of $125 million by the end of the year. For a lack of better, I'd just say, assume that ratably occurs over the year.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Okay. Got it. Thank you.

Operator: Thank you. And our next question comes from Andrew Kligerman with Credit Suisse. Your line is open.

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

Good morning. I – just along the lines of those Life sales that were so incredibly robust in the quarter and then I'm trying to reconcile that a little bit with your allocated capital to the Life segment which has been roughly 8% over the past couple of years. So what were these – maybe you could give us – maybe if you don't want to zero in exactly, maybe give us a range of these very strong returns as I think you said, Randy?

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

A

Andy, we're not going to give the specifics, but I will tell you that they were at or above what we target for the Life insurance business, which is 12% to 15%.

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

Got it. Okay. And then, shifting over to the Annuities segment. On crediting rates, it looks like the normalized yield for fixed annuities came off about 20 bps and your crediting rate actually went up 1 basis point. So the question is, what is your crediting rate flexibility there? And I know there were questions about selling the Life blocks and the variable annuity blocks. So, why don't I throw in the fixed annuity blocks and ask if there's any possibility of doing another Athene like deal?

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

A

Those are two very different halves of that question. So, let me take the first one which is a question about spreads. If you look in the quarter, you'll see that our spread came down in the annuity business, and I mentioned this in my script, but what you see there is really about business mix.

And so, let me dig into what I mean by when I say business mix. There's really three things I'd point out. The first thing is that, post the sale we did to Athene, we have a very young book of business. And the nature of the fixed annuity business is that, in the early years of a policy's life, your targeted spread is a little bit lower and then you grade up modestly over the surrender charge period.

The other thing I'd point out is the products that we sell today in 2019, or we did sell in 2019, have lower targeted spreads than products we have sold in years past. Why do they have lower targeted spreads? Commissions have come down. So, the average commission has come down, which drives a lower targeted spread without changing the economics.

The third thing, nature of the products we sell, FIAs, fixed indexed annuities – excuse me, indexed variable annuities, they can create some inherent volatility that we'd describe as non-economic just in the calculation. It can have to do with when the options pay off or when the anniversaries occur, you can just get some inherent volatility.

What I'd point you to, Andrew, is the earnings on the fixed annuity business and you can see this in our statutory supplement. The earnings grew 38%, while the average account values grew 32%. So I know the reported spread had some noise, but the economics of the business are being maintained as evidenced by that earnings growth.

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

That's helpful. And then the potential divestiture of blocks?

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

A

I don't think, Andrew, we have much more to add than what I said a minute ago, which is we're very focused on maximizing shareholder value. And if we can do that through a sound economic transaction of selling, in any of our business, some of our in-force, we'll do it.

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

Dennis, maybe is it very challenging right now in this low rate environment to do this type of transactions?

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

A

Yeah. Andrew, absolutely. Well, let's put that into perspective. If we sell a block of business, we would expect to buy our shares back. And so the economics are the balancing of where's our share price at the moment...

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay.

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

A

...and what's the price on the block transaction. That's why I come back to economics. And so, those two things have to work together. And when we did the Athene deal, it worked for both parties, but there wasn't much room left in that transaction from either side. So it was a good transaction for both parties.

Our share price is down a little bit from the point that we did that transaction and, likewise, interest rates are down a little bit from when we did that transaction.

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

A

The only caveat I would add to Dennis' response, which is correct, when you think about deployment for smaller size deals, I agree completely. The bigger the deals you do, the more you have to think about do you have to allocate some of the capital to debt reduction for instance.

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

A

Yes. Yeah. Good point.

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

I see. Thanks very much.

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

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.
Q

I'm not going to ask about block deals, but I will ask about interest rates. So I think last quarter, Randy, you talked about a incremental drag of $20 million from low rates. Is that still kind of your view in terms of where we sit today?

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

Yeah. The way I think I got there, Suneet, was if you go back a few quarters and go back to the beginning of the year, we talked about a 2% to 3% headwind to EPS growth from spread compression. And we said at the time we were traveling in the lower end of that range. And move into the end of the year and what we said is we were more in the upper end of that range, and simply 1% of our earnings is about $20 million. I think, as we move into 2020 with rates where they are, I think that fact remains the same. We're travelling in that upper end of the 2% to 3%.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.
Q

Okay. And then the other numbers one I had was on Annuities and the amortization expense there. It looked like it was up maybe $16 million year-over-year. And I know there were some impacts in terms of what happened in the fourth quarter with the markets. But just any sense of how much over the amortization was in the quarter versus what you'd expect on a go-forward basis?

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

Yeah, Suneet. Thanks for the question. If you look at the variable annuity earnings, they're relatively flat. I think they grew $1 million fourth quarter 2019 compared to fourth quarter 2020, despite the fact that account values were up. So I would explain the vast majority of why earnings didn't grow in line with account value as having to do with amortization-related noise. And what was that amortization-related noise? We have a phenomenon in our amortization patterns having to do with how the equity markets perform in a particular quarter.

So, we see when we have very strong equity market performance is that during the quarter you'll have a higher than average amount of policies where their benefit base resets higher, we will then put those policies into our process and the account value will get immediately pulled down by the reversion process. That will create some elevated amortization in that quarter. That was about $4 million to $5 million in the fourth quarter of 2019 of extra amortization. Go back to the fourth quarter of 2018 when the markets were down a lot and you get the opposite phenomenon. So, year-over-year it's roughly $8 million to $10 million.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.
Q

Got it. And then just the last one for Group if I could. Another company in this space had talked about some increased competition, particularly in the voluntary space related to high sort of upfront commissions that may be causing some churn. And I think your voluntary business is a little different, but I just wanted to get a sense of if you're seeing anything like that in terms of commission-driven churn in the voluntary space.

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

Not in our markets so far across the board in the Group business and we continue to see fairly rational pricing.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.
Q

Okay. Thanks.

Operator: Thank you. And our next 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 was also on the Group business. We've heard some companies kind of allude to the pretty strong economy leading to pretty good disability results. As you think about your business and more about 2020, I guess are you expecting still pretty good trends in that business?

And also within Group, in the interim remarks, Dennis, I think you mentioned some cross-selling opportunities. Can you just give us a sense of where you sit today versus what you would have expected to come from the cross-sell side of things when you announced the Liberty acquisition?

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

Elyse, good questions. And let me take the latter one first. There's a lot of benefits that come out of the transaction besides cost saves. For example, in the voluntary space, old Lincoln before the merger had more percentage of total sales coming from the voluntary sales than old Liberty did. And so, as we brought the two companies together, we can take sort of some of the advantages that we had or programs that we had at old Lincoln and apply them to the merged company's book. So, that would be an example.

Another example would be that we – old Liberty had much better absence management capabilities and we were able to bring those into our sort of 1,000 to 5,000 employee segment and increase sales there because of the combination. So we continue to see good potential from the combination of the company in a variety of ways.

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

Elyse, on the first part of your question, I agree completely that over time a strong economy and specifically low unemployment should create disability results that are on average better than your longer-term expectations. And that's I think one of the reasons why we have outperformed the expectations that we had when we did the acquisition of the Liberty book of business in 2018.

Now, quarter-to-quarter, you can get some noise. So, as I mentioned, we expect seasonally higher loss ratios in the disability business in fourth quarter and we saw that this year.

Elyse Greenspan
Analyst, Wells Fargo Securities LLC
Q

Okay. That's helpful. And then, in terms of the variable annuity accounting changes, are you guys adopting those as of the start of 2020 or are you guys using a three-year phase in?

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

A

I think you are talking about the statutory changes or the Oliver Wyman-driven VA reform. Yeah, we're going to adopt that on 1/1/2020. As a reminder, we do not expect any impact on RBC or capital and we believe that the statutory reform is good in that it reduces the tails of the statutory noise that you can get. What I mean – what do I mean by noise, I mean statutory can move differently from the economics of the business and the reform has improved that.

Elyse Greenspan
Analyst, Wells Fargo Securities LLC

Q

Okay. Thank you for the color.

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

A

Yes.

Operator: Thank you. And our next question comes from Alex Scott with Goldman Sachs. Your line is open

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

Hey. Thanks for taking it. First one I had was on Group. And I know I guess in 1Q you guys typically have had a little seasonal DAC and I think it's been related in part to some re-pricing of the existing block and then I guess the Liberty Mutual block. And so I was just interested to know if you'd expect that to continue. And also specifically, if sort of the transition off the TSAs would impact persistency and I guess thus the DAC in 1Q as well?

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

A

You are correct. You have a good memory, Alex. That has been improving over the last three years. I think we may have a little bit of excess amortization due to that phenomenon in the first quarter, but it'll be at a smaller level than it was last year.

The other thing I would remind you about is we do have some intangibles associated with the acquisition, some amortizing intangibles, and the amortization of those will step up a little bit in 2020. Chris can give you the exact numbers what it will step up.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

Okay. That's helpful. And then as a follow-up, I guess just on the Annuities segment, I'd be interested if you could talk a little bit about flows. I mean those have held up pretty darn well with the interest rate environment. So I was just interested to know what you're doing that's driving that. Do you think you can kind of continue the positive flows into 2020?

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

A

Yeah. Alex, the flows were positive across all of the different types of products and we've been talking about price changes that could affect the level of sales volume and, consequently, positive or negative flows. And it's hard to predict today whether we'll have positive or negative flows in 2020 from either the VAs without, VAs with guarantees or fixed annuities, because there's some part dependent on what the competition does.

But I guess I would say that, to the extent that we did have a negative flow we come back to from an earnings per share perspective, that would be because sales are lower. We'll take the capital from that reduced sales and we'd expect to buy our shares buybacks. So, from down to the bottom line, EPS growth will be a little indifferent between those two economic outcomes.

We continue to focus on the franchise strength and maintaining a level of sales that's consistent with keeping our quality distribution organization, our quality distribution partners. And so it's a combination of all those things that go into the dynamics around positive or negative flows and where it comes out from a long-term earnings perspective.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

Got it. Okay. Thank you.

Operator: Thank you. And I'm showing no further questions at this time. I'd like to turn the call back to Mr. Chris Giovanni for any closing remarks.

Christopher A. Giovanni
Senior Vice President-Investor Relations, Strategic Planning & Corporate Treasurer, Lincoln National Corp.

Thank you all for joining us this morning. As always, we'll take your questions on our Investor Relations line at 800-237-2920 or through e-mail at investorrelations@lfg.com. Thank you all and have a great day.

Operator: Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect. Speakers, please stand by.