02-Nov-2018

Lincoln National Corp. (LNC)

Q3 2018 Earnings Call

CORPORATE PARTICIPANTS

Christopher A. Giovanni
Senior Vice President, Investor Relations, Lincoln National Corp.

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

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

OTHER PARTICIPANTS

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Erik James Bass
Analyst, Autonomous Research US LP

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

Thomas Gallagher
Analyst, Evercore ISI

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Randy Binner
Analyst, B. Riley FBR, Inc.

John Bakewell Barnidge
Analyst, Sandler O'Neill & Partners LP

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Joshua Shanker
Analyst, Deutsche Bank Securities, Inc.

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning and thank you for joining Lincoln Financial Group's Third Quarter 2018 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 would like to turn the conference over to the Senior Vice President of Investor Relations, Chris Giovanni. Please go ahead, sir.

Christopher A. Giovanni
Senior Vice President, Investor Relations, Lincoln National Corp.

Thank you, Crystal. Good morning and welcome to Lincoln Financial's third quarter earnings call. Before we begin, I have an important reminder. Any comments made during the call regarding future expectations, trends in 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 are described in the cautionary statement disclosures in our earnings release issued yesterday and our reports on Forms 8-K and 10-Q filed with the SEC. 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 of the non-GAAP measures used in the call, including income from operations and return on equity to their most capable 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.

And 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. Well, 2018 continues to be an outstanding year, as third quarter adjusted operating earnings and earnings per share were records, with EPS up 15% from the prior-year quarter. Additionally, book value per share increased 8% and return on equity was 14.5%.

This quarter's strong results were also broad-based and highlight the power of our retail franchise, which brings together a comprehensive and growing product portfolio, along with expanding distribution. Targeted management actions are further enhancing our results with annuity net flows close to turning positive, group results benefiting from our Liberty acquisition, strategic investments improving expense efficiencies and future growth opportunities, and capital deployment remaining ever important.

As you know, during the quarter, we also completed our comprehensive annual assumption review, which had a negligible impact on our financials, consistent with past years. Overall, the balance sheet remains strong and the complementary nature of our businesses and sources of earnings enable us to consistently generate a significant amount of free cash flow. We are returning this capital to shareholders through an active share buyback program and growth in dividends, including last night's announced 12% increase in the common stock dividend.

Now, turning to our business segments, starting with Annuities. Earnings results were strong as we continued to benefit from our high-quality and predictable in-force business combined with equity market tailwinds. Annuity sales were robust as our strategy of adding new products and expanding distribution continues to show meaningful progress. This quarter, new products and expanded distribution represented 39% of annuity sales.

Total annuity sales increased 61% to $3.1 billion, and third quarter sales, which are typically weaker due to seasonality, improved sequentially for the first time since 2010. In addition to stronger sales, we are also getting a higher rate of return on new business, given the improving interest rate environment. Net outflows showed further improvement and totaled just $81 million in the quarter. I remain optimistic we will return to positive net flows in the fourth quarter.

This quarter's variable annuity sales were strong, up 43% compared to the prior-year quarter and also broad-based, with guaranteed and non-guaranteed products and all distribution channels delivering at least 20% growth. Guaranteed VA sales increased 48%, but represented less than half of total annuity sales, highlighting the expansion and increased diversification of our product portfolio.

Our newest product, Lincoln Level Advantage, an indexed variable annuity, has been our most successful product launch ever. Level Advantage sales totaled $266 million in the quarter and we continue to ramp up sales with the addition of new distribution partners. Fixed annuity sales more than doubled to nearly $200 million (sic) [$900 million], resulting from significant growth in the bank and broker-dealer channels. In addition, we recently entered a new distribution channel, independent marketing organizations, and we are seeing early success.

I'm also happy to announce that, in January, we will further advance our distribution strategy by entering yet another new channel, the property and casualty distribution channel via a relationship with Allstate. This relationship gives Allstate's more than 10,000 selling agents access to Lincoln's suite of fixed and variable annuity solutions. This additional scale should initially add approximately 5% to annuity sales growth. Looking forward, the sales outlook remains positive, given our strategy of significant distribution and product expansion, combined with LIMRA's forecast for industry sales growth to continue in 2019.

Longer term, growth prospects are compelling. A recent survey of financial advisers showed the percentage of advisers that believe their clients are underinvested in annuities, nearly doubled to 37%, up from 19% just four years ago. The demographic backdrop also creates considerable opportunities with investable assets projected to more than double by 2030 and the 65 years and older age cohort, which is a sweet spot for lifetime income, expected to grow 40% over that period versus 2% growth in the under-65-year olds. So, a strong quarter for the Annuity business and near- and long-term growth prospects are very promising.

In Retirement Plan Services, earnings increased 14% over the prior-year quarter. Deposits in the quarter of $3.3 billion were up 74% from a year ago, and first-year sales of $2 billion nearly tripled. The sale of $1 billion healthcare plan is included in these results. Without this plan, sales still increased 50%. Recurring deposits also increased 9% as a result of higher employee contribution rates and increases in participation.

Net flows totaled $1.4 billion compared to $442 million in the prior-year quarter. Over the past 12 months, flows have exceeded $2.8 billion and we have achieved positive net flows for 11 straight quarters. Sales and net flows can be lumpy quarter-to-quarter, but these impressive results are being driven by the strength of our high-touch and high-tech business model, which positions us to effectively compete in our target markets. We remain confident in growth opportunities for the RPS business.

Turning to Life Insurance, earnings increased 45%. Total Life Insurance sales in the quarter of $167 million were down 6%. On the positive side, we saw 7% growth in core life, led by strong VUL sales. This was offset by a decline in MoneyGuard and also Executive Benefits sales, which can be lumpy quarter to quarter. On a sequential basis, sales improved 3%, consistent with comments made last quarter, pointing to expected sales momentum in the second half of the year.

In aggregate, expected new business returns exceeded our target levels. Given these strong returns, higher interest rates and ability to leverage industry-leading product and distribution capabilities, we have initiatives in place to improve our competitive position, sales diversification, and growth as we enter 2019. This leaves the Life business well-positioned in the marketplace.

Turning to Group Protections, earnings of $63 million increased significantly, which resulted in a 6.2% after-tax margin. Premiums more than doubled, driven by the acquisition, continued sales growth, and strong persistency results. During the quarter, sales increased 68%, again, primarily attributable to the acquisition, which resulted in growth in the Life and the Disability product lines in both employer- and employee-paid sales.

As we enter the fourth quarter and the important January 1 renewal season, we are optimistic about our ability to grow premiums as we sustain persistency trends, while also achieving modest rate increases. Additionally, we expect to effectively compete for new business opportunities across all case sizes, given our increased scale, broader distribution, access, and expanded capabilities.

In summary, we are pleased with another quarter of strong results and the integration remains on track as we focus on delivering upside to the key financial metrics highlighted when the acquisition was announced.

Shifting to investment results, solid performance from private equity portfolio led to a 13% pre-tax annualized return on alternative investments. We have invested new money at an average yield of 4.3% in the quarter and the fixed income portfolio yield declined 1 basis point from the second quarter.

It is also worth noting that we are currently investing new money near the 4.6% portfolio rate. While we still have some higher-yield assets running off through 2019, at current interest rate levels, spread compression will largely abate in 2020. You may recall that spread compression has been a 2% to 5% annual headwind to EPS growth in recent years, so removing this will be a big help. Overall, the investment portfolio remains in great shape. Credit losses are minimal and below-investment-grade assets represent less than 4% of our fixed income portfolio.

While credit remains benign and we are not forecasting a change in the current environment, we have been doing some proactive derisking within sectors and securities that have greater risk of deterioration in a stressed environment. I'm confident the investment portfolio and balance sheet are well positioned.

Before turning over to Randy, I'd like to make a few comments and observations regarding the effectiveness and resiliency of our retail-centric business model, which has demonstrated a track record of success that I believe remains underappreciated. I would note that over the past five years, financial metrics have been very strong.

Just a few: EPS has grown at a 12% annual growth rate with growth each and every year in EPS, excluding notable items. These results have come after absorbing more than $200 million of spread compression. Additionally, our annual assumption reviews have been non-events, with a cumulative impact during this period of just under $100 million or less than 1% of book value. Book value per share has grown at a 9% rate and ROE has expanded to 13.5% year-to-date. Net income has represented 93% of operating income.

Looking at capital management, since 2012, we have deployed a $6.5 billion of capital through buybacks, dividends, and M&A, which represents 72% of operating earnings. Importantly, we have achieved all these results, while taking on less risk and improving the strength of our balance sheet and capital position. We have tilted our new business away from products with long-term guarantees and increased the portion of earnings coming from traditional insurance risks. In terms of balance sheet quality, debt leverage has decreased 2 points and investment leverage has declined. Finally, statutory capital has increased nearly $2 billion.

We remain focused on executing our strategy, which will enable us to continue to report solid financial results. We believe the share price will ultimately reflect our proven track record and an ability to sustain our performance.

In the meantime, we are looking at opportunities to take advantage of the current low valuation, such as monetizing some portion of our in-force business. The environment for block reinsurance transactions looks to be good. And if a deal makes sense, it would enable us to generate and free up capital to use for a significant share buyback program on top of our normal free cash flow guidance.

So, in closing, we are pleased with the quarter's record earnings and believe our valuation has significant upside, given our proven long-term success, current momentum, and positive financial outlook.

I will now turn the call over to Randy.

Randal J. Freitag

Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

Thank you, Dennis. Last night, we reported adjusted income from operations of $510 million or $2.34 per share for the third quarter, a 15% increase from the prior year. As we noted in the earnings release, the current quarter included net unfavorable items of $0.01 related to our annual review of DAC and reserve assumptions, while the prior year quarter benefited $0.09 from tax adjustments. Excluding notable items, EPS increased 21% year-over-year.

This year's annual review of DAC and reserve assumptions had a series of modest plusses and minuses, including favorable impacts in Annuities and Group Protection, offset by slightly unfavorable impacts in Life and RPS. When viewed in total, the assumptions underlying our balance sheet continue to be sound and the modest financial impacts highlight the quality of our in-force business, which differentiates Lincoln from many of our competitors. It is also worth noting that we did not unlock the reversion to the mean corridor, which still provides a cushion against declines in the equity markets.

Moving to the performance of key financial metrics. Underlying trends were strong as all four businesses generated revenue growth, coupled with good expense management which, when combined with benefits from tax reform, resulted in our Group, RPS, and Life Insurance segments reporting double-digit increases in operating earnings. Excluding notable items, Annuities also reported double-digit growth.

Consolidated net flows of $2.4 billion continue to increase, and when combined with equity market growth, average account values increased 7%. Book value per share, excluding AOCI, grew 8% to over $66, while adjusted operating return on equity was strong at 14.5%. Our balance sheet and capital generation continue to be sources of strength, enabling us to return $247 million to shareholders in the quarter. Lastly, net income of $490 million or 96% of operating income further highlights the strength of the quarter.

Now, turning to segment results, starting with Annuities. Reported earnings for the quarter were $302 million, up 9% from the prior year quarter. Earnings growth was driven by higher fee income with average account values up 5% over the past year to $139 billion, as equity market strength more than offset negative net flows. Annuity earnings benefited $13 million from this year's annual assumption review, compared to $15 million last year. This is the latest in a very long string of modest and favorable unlocking impacts in the Annuity business due to little variation between assumptions and actual experience.

In fact, over the last decade, the sum total of impact to operating earnings has been positive $21 million or less than one-third of 1% of the $7.5 billion of annuity earnings that we have reported over that same period. Not only is that unprecedented performance, but I believe it is completely underappreciated by the marketplace.

Annuity net flows were close to turning positive in the quarter with net outflows of just $81 million, compared to $841 million in the prior year quarter. Total operating revenue increased 4%, while G&A expenses, net of amounts capitalized, increased just 2%. Return metrics were strong with ROA at 87 basis points and an ROE of 24%, while our risk profile remains low with the net amount at risk for both living and death benefits below 0.6%. So, great results for the annuity business with another quarter of high-quality earnings and net flows that are set to turn positive, leaving us well positioned to build on this success.

In Retirement Plan Services, we reported earnings of $40 million compared to $35 million in the prior year. The earnings increase is attributable to benefits from tax reform, higher fee income, and expense management. Net flows of $2.8 billion over the trailing 12 months, combined with favorable equity markets, drove average account values to $71 billion, up 12%.

G&A expenses net of amounts capitalized decreased 3% year-over-year, resulting in an approximate 90 basis point improvement in the expense ratio. Base spreads excluding variable investment income compressed 9 basis points versus the prior year, while ROA was 24 basis points, excluding a modest $2 million negative impact from the annual assumption review. So, a solid result for the Retirement business, highlighted by robust net flows, which are helping drive asset and revenue growth, coupled with continued strong expense management.

Turning to our Life Insurance segment. Earnings of $176 million increased from $121 million in the prior-year quarter, driven by solid revenue growth, favorable mortality, lower expenses and benefits of tax reform. The current quarter included a $20 million negative impact from the annual assumption review, largely consistent with the prior year. Growth and earnings drivers remained steady, with average account values up 6% and average Life Insurance in-force up 4%. A 9% increase in operating revenue, combined with a 5% decrease in G&A expenses, net of amounts capitalized, drove a 100 basis point improvement in the expense ratio.

Base spreads, excluding variable investment income, were down 19 basis points year-over-year due to a one-time negative impact on policy loan income. In the near-term, we expect spreads to compress approximately 5 basis points on an annualized basis. So, a great quarter for the Life business, highlighted by favorable mortality experience and strong earnings growth.

Group Protection reported $63 million in earnings compared to $41 million in the prior year quarter, with the increase in earnings primarily from the acquisition of Liberty. The after-tax margin was 6.2% or 5.5%, when excluding a $7 million benefit from the annual reserve review. Non-medical earned premiums were $1 billion, up 102% from the prior-year quarter. This increase was the result of both the acquisition and continued momentum in key premium growth drivers, namely sales and persistency.

Overall, risk results remained favorable. The non-medical loss ratio of 73.6% is consistent with the second quarter when factoring in a full quarter of Liberty results. As a reminder, the increase in the loss ratio compared to the prior-year quarter merely reflects the impact from the acquisition as we combined two blocks of business with loss ratios that are different based on case sizes.

So, it was another very strong quarter for the Group business. The after-tax margin is already within our targeted range, and we are optimistic about our ability to provide further margin upside over time as we execute on our repricing program and deliver expense savings.

Turning to capital and capital management. Statutory surplus came in at $9.3 billion, and the RBC ratio ended the quarter at approximately 460%. Holding company cash remains above our $450 million target. During the quarter, we returned $247 million to shareholders, including $175 million of share repurchases, consistent with our free cash flow guidance. Year-to-date, we have allocated nearly $2 billion towards M&A, buybacks, and dividends, and expect to be active in the fourth quarter.

So, wrapping things up, another excellent quarter. We reported record EPS as we combined growth in pre-tax earnings, capital management, and benefits from tax reform to drive a 15% increase in EPS from the prior year. High-quality results, as all four businesses delivered revenue and earnings growth. This year's annual review, once again, confirmed the quality of the assumptions underlying our balance sheet, as there was almost no impact on earnings. And finally, key shareholder metrics were solid as book value per share increased 8% and ROE came in at 14.5%.

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

Christopher A. Giovanni
Senior Vice President, 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 only one follow-up, and then requeue with additional questions.

With that, let me turn it over to Crystal to begin Q&A.

QUESTION AND ANSWER SECTION

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

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Q

Hi. Good morning. I had a question first just on Dennis' comments on sort of potentially monetizing part of the in-force block and using the proceeds for buybacks. Is this something that you've looked into in detail or are you sort of in the preliminary stages? And just some thoughts around what blocks you'd consider reinsuring and where you are in the whole process.

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

A

Jimmy, just like in M&A, we're not going to get into the details about anything specific. We're aware of – let me just say it this way, we're aware of the marketplace for the sale of blocks. Of course, being aware means we've talked to different parties. So, I would say, we have the general understanding of the potential. Of course, going from a general understanding to a specific deal that made sense is what has to happen. In terms of what type of blocks, we would think that the simpler product, the better the price, then the easier execution. One example of that would be fixed annuities, although I think there are other liability block sales that are possible.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Q

Okay. And then just on – if I could ask one more just on the Group Benefits market. Could you just talk about how the competitive environment is there? And as you've looked more into the Liberty Mutual block, what's your view of the overall block in terms of pricing adequacy and your ability to achieve the expense savings that you'd guided to previously?

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

A

Yeah, the Group market competitive environment, I would say, is solid. There doesn't seem to be anyone that's pricing at unrealistic levels. I think there has been a little bit of evidence that there's a little less movement in the marketplace, which means may be a fewer opportunities. But we're pretty optimistic, overall, about our sales across our markets; small, mid, and large, and we're having good results this year. With respect to the Liberty block itself, I would say that, as we discussed, they had started a repricing initiative some 24 months ago, and in terms of premium – excuse me, in terms of the results that they're getting on increases were in line and that's pretty good. And I would also say that we're slightly ahead of the persistency expectations on the renewal block. So, it's going very well.

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

Jimmy, on the last part of your question, we're very confident in our ability to deliver those expense synergies we talked about. As a reminder, we talked about $100 million. In fact, I think we'd expect to, over time, move a little above that, even though we're not going to highlight a specific number yet. So, we're very confident in our ability to deliver those expense savings. I think you're seeing those already, and I think you'll continue to see them into 2019, which should be very supportive of the margin. And over the longer term, I'd say those expense synergies are one of the reasons when you think about longer-term profitability in this business. We've always talked about it as a 5% to 7% business, but I'd really see us in the upper half of that range over time. So, yeah, feeling very good about that business, Jimmy.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC
Q

Thank you.

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

Erik James Bass
Analyst, Autonomous Research US LP
Q

Hi. Thank you. I want to focus a little bit on the benefits from higher interest rates. I know we typically focus on the impact of rates on spreads, but you're also seeing evidence that higher rates are boosting new business growth, I guess, most – particularly in annuities. And is there any benefit that you're seeing to your new business margins?

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

Well, the answer to that is business by business, but we have been saying now for some time that the biggest benefit of rising interest rates for Lincoln and for the industry is the ability to drive more value into each of our products. And Erik, as you pointed out, this is clearest right at this moment in the context of the annuity business, I also mentioned in my remarks that higher rates will help us improve pricing for the consumer in the Life business. And so, that'll be a positive. And I'd go on to say that it makes sense to get higher sales, but it also makes sense to get better results for the shareholders. And so, it's a combination of those two outcomes that we're looking for.

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

Erik, just to expand a little bit on the Life business, we had repriced our entire portfolio in a much lower rate environment. And so, just factually, if you look at the returns we're getting today, they're as high as they've ever been in the Life Insurance business. So as we reprice that entire portfolio into this new interest rate environment, I definitely expect that that's going to be supportive of a stronger value proposition for the consumer. So, feel very good about what rates mean for Life Insurance sales going forward.

Erik James Bass
Analyst, Autonomous Research US LP

Q

Thank you. And given your strong sales growth in Annuities and the associated new business strain, is there any change in your expectation for free cash flow as we move into 2019?

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

A

No, none at all, Erik. I think one point I'd make, we had very strong capital growth this quarter, up a couple hundred million to $9.3 billion. But you saw the RBC ratio still relatively flat, and that's really reflective of that strong annuity growth. I know when you put annuity business on in the first year, you tend to get large capital growth because of the first year contribution as a percentage of premium. So, despite that growth, we were able to maintain an RBC ratio because of the strong capital-generating capabilities of our business.

Erik James Bass
Analyst, Autonomous Research US LP

Q

Great. Thank you.

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

A

You bet.

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

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

Q

Hi, thanks. Good morning. Could you give us some sense of where you view the run rate quarterly earnings for Life Insurance at this point?

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

A

Ryan, let's look at this quarter. We made $176 million. There are some things in there that didn't pan out we talked about, we had an unlocking negative of about $20 million. But on the other side, we had good mortality experience. I'd sort of match those two items up against each other. Additionally, we had good performance from our alternative portfolio. But on the other hand, and as I mentioned in my script, we had a sort of a one-time headwind in policy loan income, and I'd match those two items up together. So when I look at the quarter, $176 million, I think it's the number. It was a good quarter, feel good about it. Very reflective of where we should be in the Life Insurance business.

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

Q

Thanks. And then, on expenses. At the Investor Day last year, you laid out the trajectory of your digital initiatives over few years. Could you give an update on that just in terms of 2018? Is it tracking in line with what you expected? And then, would you still expect the net impact in 2019 to be more breakeven?

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

A

Yeah, absolutely, Ryan. So, we talked about a range this year of $70 million to $80 million of benefits – of expenses, excuse me, and about $40 million of benefits in the businesses. Looks like we're tracking at the lower end of that spend range, but the savings are running right in line with what we said. And you're really seeing that. As I mentioned, in the businesses, you see actual outright decreases in expenses despite the fact that they're all growing.

So, spot-on with this year. And as we look into next year, very similar to what we said before, we should be more of a breakeven proposition next year. Beyond that, you'll start to see the investments trail off and the benefits continue to grow. So, we get to that ultimate $90 million to $150 million of net benefit to the bottom line.

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

Q

Great, thanks a lot.

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

A

You bet.

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

Thomas Gallagher
Analyst, Evercore ISI

Q

Good morning. Just want to come back to Jimmy's question on the thought process behind potentially monetizing some of your in-force to buy back stock, Dennis. Is that because you see a big arbitrage opportunity currently? Like, you could – between the price you would get capital freed up, you'd get a double-digit PE. You'd be able to buy back your stock at 6 or 7 times. Is there a big opportunity like that in the market today or is it something else? Is that not the case?

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

A

Tom, without getting into specifics, it's the idea that we're trading at a low level, couple days ago, at $57, which is hard to candidly understand, given the performance of the company, combined with the fact that there is a better market for block sales that's been evolving for some time now. So to the extent that those two can cross over, that we have a low share price and we can sell the block on a favorable basis and it makes sense for our shareholders, that's sort of what we're thinking right now.

In terms of what are some of the other considerations, we'd like to think that any transaction we do is accretive to things like EPS, book value and ROE. So, that's sort of what's in the back of our mind. I think it's just – I'd characterize it as sort of another arrow in the quiver of opportunity for us to do shareholder-positive activities. But I'd say it's just another possibility and that my main focus and the management team's main focus is continue to build the kind of results on an ongoing basis that you've seen for the last five years, positive results and, of course, the best quarter in the history of the company to-date.

Thomas Gallagher
Analyst, Evercore ISI

Q

Understood. And then, just a follow-up for Randy. I know last quarter, Randy, you had said you feel good about variable annuity reform in terms of where you're likely to end up or where it's ending up. Can you comment on where that – is it finalized now? And also, any I guess quantitative or qualitative comments you can get about how the new standards might impact LNC.

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

A

Tom, our thoughts on that whole process haven't changed at all. I applaud the NEIC for seeing an area that needed to be fixed, improved, and going through a very disciplined process to make that happen. In terms of the final proposal, the things that we think are very supportive. I think there's a better alignment between your capital and your reserve calculation. I think the hedge accounting for the derivative instruments is very favorable, and I think the fact that the standard scenario is much more targeted.

Those are all very positive outcomes. Of course, there are some things that I'd prefer came out a little different. So, for instance, I think some of the assumptions in the standard scenario around policyholder behavior, revenue-sharing, those sorts of things are a little conservative, just as an example. But all in, this is a very good move for the industry, I think a very good move for the regulatory communities. So, I think it's a win-win for both sides. We're supportive, continue to see it not having an impact on Lincoln.

Thomas Gallagher
Analyst, Evercore ISI

Q

Got it. So, Randy, no changes to cash flow or any of the metrics that you've been experiencing for that business?

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

A

No change whatsoever.

Thomas Gallagher
Analyst, Evercore ISI

Q

Thank you.

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

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Thanks. Good morning. I wanted to circle back on the block transaction ideas one more time. Dennis, you talked about simpler blocks being more likely, but is there any thought to potentially proving out the value of some of the more complicated blocks that you have that are probably weighing on your valuation, be it VAs or MoneyGuard?

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

A

Again, everything's on the table in terms of what might make sense for the company, but, Suneet, I guess I'd be a little hard-pressed to say I want to sell this to prove the market that. I mean, we've got good results. The market's eventually going to catch up to the strength of each of our businesses. So, I don't necessarily think that would be a good objective for us. I'd rather just...

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Got it. And then...

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

A

Yeah, go ahead.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Understood. That's fine. I wasn't thinking the whole thing, I was just thinking pieces of it, but I understand your point. Separately, I guess on Liberty, now we've had two quarters in a row where the margin has been – the overall business has been above your target. So as we think back to the original expectations that you set out, can you give us a sense of what's breaking the right way? Is it pretty much across the board or is there anything in particular that you'd highlight with the benefit of hindsight you were just too conservative on?

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

A

Suneet, it's Randy. I think we're having very good loss experience. As we mentioned, persistency is running better than we thought. And as I also noted, we see additional incremental expense save possibilities as we bring these two great businesses together. So to repeat what I said earlier, when that all drops to the bottom-line, we had a normalized margin this quarter of 5.5%. As you move into 2019, we get incremental expense synergies that are very supportive of that level of margin in the 5.5% range. Even in a world where losses – loss experience would degrade a little bit. Should loss experience continue to perform at this very strong level, I think there's even upside in 2019 to that sort of level.

Over the longer term, once again, based upon things like the strong expense synergy outlook that we see, I see us with the ability to move into the upper half of that 5% to 7% range, which we've talked about for this business for a very long period of time. So, things have been running very favorable, Suneet, not too dissimilar from a loss standpoint from what you've seen from other group players. And I think there's a good opportunity for that to continue.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

All right. Thanks.

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

A

You bet.

Operator: Thank you. Our next question comes from Randy Binner from B. Riley FBR. Your line is open.

Randy Binner
Analyst, B. Riley FBR, Inc.

Q

Hi. Good morning. Thanks. I just wanted to confirm that as part of the assumption review that there's no changes for long-term care items around MoneyGuard. I mean, I think I know the answer to that's no, but also wanted to confirm that the sensitivities, Randy, that you had laid out in a prior call are unchanged as a result of the review this quarter.

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

A

Randy, the answer to that we gave before has not changed at all. There's a significant amount of sufficiency in the reserves. My recollection is there's about $1.9 billion. Even if you stressed every one of the major inputs in a very significant way, such as taking lapses to zero, increasing incidence by 25%, you still had sufficiency in the reserve. As part of the assumption review, I'd say, that was validated. So, inside of that Life result, MoneyGuard was actually a very small positive when we updated all the assumptions. So, Randy, nothing has changed about that product from what we've said before. It is a high-quality, high-return product with a great risk/reward profile.

Randy Binner
Analyst, B. Riley FBR, Inc.

Q

And so those comments are in the backburner as a follow-up, going forward is, I mean, any change to pricing in the product or kind of how it's received in the market? I mean, I think sales are up a little bit this quarter, but that happens in normal fluctuation. But I mean, have you repriced it? When you think about distribution, do they look at that and other LTC products differently now that LTC's been more in the press this year?

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

A

We're actually seeing a lot more entrants into the marketplace. I think there have been a couple more companies that have actually entered the space. So, you're seeing more competition, I think, as other companies realized that this is a very attractive space where there's a lot of consumer demand and there's strong return possibilities to sell this product. So, year-over-year, we did see a little bit of sales pressure and we repriced this product last year. The fact is, we repriced this product when rates were at an all-time low, which means that today, similar to my overall comment on Life sales, we are getting very, very robust returns and I think that will be very supportive of how we can think about any pricing actions that we take in 2019, as we once again look to reprice this along with our entire Life portfolio as we implement principles-based reserves across all of our Life business.

Randy Binner
Analyst, B. Riley FBR, Inc.

Q

That's great. Just one more quick one, though, on the new entrants in the LTC area, are they using kind of a UL-based product like MoneyGuard or are they entering with kind of more traditional protection products?

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

A

I think you're seeing it all over the space. I think I saw an entrance actually putting it on the back of an IUL product. So, I think you're seeing it all over.

Randy Binner
Analyst, B. Riley FBR, Inc.

Q

Thanks.

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

A

You bet.

Operator: Thank you. Our next question comes from John Barnidge from Sandler O'Neill. Your line is open.

John Bakewell Barnidge
Analyst, Sandler O'Neill & Partners LP

Q

Thank you. Taxes come in towards the low end of guidance and was actually below it in two of the three quarters this year. Now that we're almost completing a year post-tax reform, do you have any updated thoughts on where you see it longer term? And I get it can be wonky quarter-to-quarter.

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

A

No, I think 15% to 17% is the range we gave at the beginning. I think it still represents a reasonable range. We're just a tick below that. I think we came in at 14.9% for the quarter. So, I think 15% to 17% over time still reflects a reasonable range expectation.

John Bakewell Barnidge
Analyst, Sandler O'Neill & Partners LP

Q

Okay. And then a follow-up. Your sales volume has been fantastic. It may be a bit of an understatement. Clearly, there has been strong client win from product depth and breadth. How much of this lift do you think is coming from wage and benefits inflation from a strong economy? I know there's like a general concern that we're at the end of the cycle. Are you seeing any of that in the sales distribution that we are, or can you counter that as well, and show they're strengthening?

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

A

John, is that a question specific to a single business or is that a...

John Bakewell Barnidge
Analyst, Sandler O'Neill & Partners LP

Q

No, generally.

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

A

...broad.

John Bakewell Barnidge
Analyst, Sandler O'Neill & Partners LP

Q

Broad.

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

Yeah. I think the results that you're seeing in the Group business can be related to the – some of the lower loss ratios can be somewhat tied to a stronger economy. I think we're seeing in our RPS business more employee participation in 401(k) plans and a higher percentage of savings going into the 401(k) plans. So, I think in bits and pieces you can see the benefit of the stronger economy across our products. But it's sort of at the margin. I don't think we see anything really driving it more so than just at the margin.

John Bakewell Barnidge
Analyst, Sandler O'Neill & Partners LP
Q

Thank you.

Operator: Thank you. Our next question comes from Josh Shanker from Deutsche Bank. Your line is open.

Christopher A. Giovanni
Senior Vice President, Investor Relations, Lincoln National Corp.
A

Josh, I think your line is mute.

Operator: Please check that your line is not on mute. And we'll move on to our next caller. Our next question comes from Humphrey Lee from 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. In Group Protection, you've talked about persistency being a little better than you expected, sales continue to be strong, and based on your comments, the strong economy is helping. So, maybe kind of when we put all of these into a top-line expectation, how should we think about the premium growth, at least for 2019?

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

Yes, a good question. And all the predicates to your question are correct. As we look into 2019, our premium growth is in part – not in part, excuse me, our premium growth is probably in the lower-single digits, the way we're thinking about it right now. And that has upside to it, because in that comment we're assuming some shop lapses that we haven't seen yet, but we continue to assume it. We get out a year or so and we're back to our 5% to 7% premium growth expectations.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC
Q

Okay. Got it. And then, moving on to Annuities, you talked about the new relationship with Allstate and then also the expectation for the new kind of indexed variable annuity product being – you expect stronger kind of momentum to continue. But how should we – like while net flows is expected to turn positive in the fourth quarter, but how should we think about the net flows in 2019 as the new product continue to take shape and then with the new channel coming through?

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

A

Well, trying to predict sales for 2019 is something that we wouldn't ordinarily do. But just factually, if we see the kind of results from the Allstate distribution that we expect and if the growth in the indexed VA continues, everything else being equal, that would add 10% to this year's sales growth. And so, we think that's pretty positive. Now, those are just sort of the math based on our expectations. But it gives you a sense of how important these two relationships are.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Yeah. Yeah. Got it. I'm not going to hold you to that, but at least that's helped me to think about how to kind of think about 2019. Thank you.

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

A

[ph] Sure (52:27).

Operator: Thank you. And our next question comes from Josh Shanker from Deutsche Bank. Your line is open.

Joshua Shanker
Analyst, Deutsche Bank Securities, Inc.

Q

Let's try it this time. Hi there.

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

A

Hi, Josh.

Joshua Shanker
Analyst, Deutsche Bank Securities, Inc.

Q

Sorry. So, I wanted to follow-up on Erik Bass' question. You talked about the RBC ratio staying the same despite the growth. If we're looking out three, four, five years as the annuities sold without living benefits becomes an increasing portion of the portfolio, what does that mean for margins, for capital consumption, for fees generated on the overall portfolio? How are the moving pieces of the annuity segment going to be looked different, I guess, as we go enough years into the future given the composition change?

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

A

Josh, when you look out over a reasonable period of time, I think the metrics that you see inside of the annuity business, whether that's ROAs or ROEs, we expect to continue over the longer term. Yes, we are selling a little more in VAs without guarantees, which has a similar return, but a little lower ROA profile. But the reality is we have $139 billion of in-force, which is very supportive over a reasonable period of time, let's call it, three years. So, I think that we feel like the return levels both from an ROA/ROE standpoint over the next two, three years are supported by that.

Joshua Shanker
Analyst, Deutsche Bank Securities, Inc.
Q

And on the indexed variable annuity product, as you enter the market there, do you feel like you're taking share? It's a growth market that there's room for everybody. It just needs to be sold to people and they'll buy it. Or do you know out there that there's people who would have sold another indexed variable annuity, and Lincoln was the one able to make that sale?

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

Yeah, I think the indexed variable annuity marketplace is growing, I don't know by what rate. I think just as every time we enter a marketplace, we get a pretty significant share in the annuity business because of the strength of our distribution and quality of our wholesalers. So, I think it's both. And I also think this is a very unique product, sort of a halfway between a VA product and a fixed index product. On the VA side, we have complete upside from the equity markets, and on the fixed index or fixed annuity products, you have a guaranteed floor of zero on the downside. And this is right in between. And I think it's a great product. It's being received very well, and I think it's incremental to the marketplace.

Joshua Shanker
Analyst, Deutsche Bank Securities, Inc.
Q

Okay. Thank you very much.

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

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC
Q

Hey. Good morning. Dennis, I'm very intrigued by your comment about the block reinsurance transactions. You mentioned fixed annuities, it sounds like you would consider Life as well. Maybe you could give us a little color on potential size of a transaction.

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

Yeah, Andrew, if I first could come back to – we knew we were going to get some extra questions on this on the call.

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC
Q

[ph] Of course (56:06).

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

And appropriately so. But I do want to start by reminding everybody that the model that we have in place, the results that we are getting, are things that we are spending our 100% attention on. But there may be a point in time where something makes sense, like the transaction we're talking about. So, again, we're focused on the future, building the business, that's job number one. To specifically answer your question, as we've thought about this, if we could raise sort of $400 million to $600 million, in that range, we think that would probably be meaningful. So, it could be different from that, but as we've thought about it, that's about what we're thinking about.

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

That's helpful, Dennis. And then maybe this one's for Randy on the fixed annuities. It sounds like you – Lincoln has been very creative in developing new distribution relationships and that's probably the driver of the strong fixed annuity sales. But I do get nervous anytime I see an insurance company grow deposits by 130-plus percent. So, the question, Randy, is can you give a little color on the new fixed annuity sales in terms of the types of spreads you're generating, the returns that you expect on those products.

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

A

Andrew, I'm going to let Randy answer that question, but you've given me an opportunity to correct that maybe...

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay.

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

A

To correct something I said in my remarks. I said fixed annuity sales more than doubled to nearly $200 million. I meant to say that fixed annuity sales more than doubled to nearly $900 million.

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

Right, right.

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

A

So, just to get that corrected. Randy, do you want to talk about that?

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

A

Sure. Andrew, one of the things that we did here recently is we split out fixed and variable annuity earnings inside our stat supp. So, you can actually see the earnings we've been getting on the fixed side. And the fixed business has been delivering very strong returns for us over the last five, six years in this very strong economic environment. So, I think that the business we're selling today from a profitability standpoint is consistent with the profitability of fixed annuities we've sold in the past. You know we did do a flow reinsurance deal with Athene, which has been supportive of returns on the fixed annuity business. So, yeah, I think we've been getting strong returns on our fixed annuity book and I think we'll continue to get good, strong, consistent returns on the business we're selling today and what we'd expect to sell in the future.

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

Sounds good.

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

A

Let me just add to what – broaden your question a little bit. We actually calculate every quarter the return that we're getting on our sales in each of our businesses. So, that's predicated on the mix of the business and just at what level your hedge costs are and all the things that go into trying to calculate what your new business returns are. And across the board, we're at our target expectations, across the board in all the businesses in total. And so, I wanted to mention that.

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

Yeah, I mean, Annuities ROE, ex-goodwill and AOCI, is over 20%. I mean is that the ballpark where you're seeing new fixed annuity sales?

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

A

That's the result of the long-term participation in the market and staying in the market through good times and bad times. And that ends up with levels of return – has ended up with levels of return higher than our pricing expectations. Our pricing expectations would be in the middle to higher teens.

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

Perfect. Hey, thanks a lot.

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

A

Thanks, Andrew.

Operator: Thank you. And this does conclude our question-and-answer session for today's conference. For anyone that was unable to ask a question during the call, the company will follow up with you. And I'd now like to turn the conference back over to Chris Giovanni for any closing remarks.

Christopher A. Giovanni
Senior Vice President, Investor Relations, Lincoln National Corp.

Thank you for joining us this morning. As always, we will take your questions on our Investor Relations line at 800-237-2920 or via email at investorrelations@LFG.com. Thank you and have a good day.

Operator: Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program and you may all disconnect. Everyone, have a wonderful day. Speakers, please stand by.