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Lincoln National Corp. (LNC)

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CORPORATE PARTICIPANTS

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

OTHER PARTICIPANTS

Alex Scott
Analyst, Goldman Sachs & Co. LLC

MANAGEMENT DISCUSSION SECTION

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Right. Sorry. I think, we'll go ahead and get started here. Yeah, first I'd like say welcome and thank you for being here, Dennis Glass.

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

Thank you for inviting us. We're delighted to be here.

QUESTION AND ANSWER SECTION

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

Yeah. So, I've got Dennis Glass, CEO and President of Lincoln, maybe if I could just start with a higher level question around business mix. Following the Liberty Mutual acquisition, are you happy with where the business mix stands today in the different contributing businesses, and where do you see the growth opportunities going forward?

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

A

Yeah. Let me step back, Alex, in the context of big picture strategy.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

Yeah. Yeah. Go ahead.

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

A

Yeah, three or four years ago, we set out to accomplish what I refer to as two overarching strategies, one of which was to change the mix of our new business sales from products that had guarantees, such as GUL and guaranteed lifetime income, which we still like both products. Two more products that were on the shorter term end of the liability structure. So in five years, we went from, just round figures total company, something like 30% of our products were non-guaranteed products and 70% were guaranteed. We put that upside down organically over the last five years.

And today, I think, last quarter year-to-date only 20% of the sales that we make in this year have long-term guarantees and about 80% are short-term guarantee business. Now on that strategy, it was helped by the Liberty acquisition, because all of those sales are in the shorter end of the spectrum of the duration. So that was one overarching strategy. The other overarching strategy was to emphasize from a source of earnings perspective. All the insurance companies generate earnings three ways these are assets under management, spread earnings and then mortality and morbidity.

And we were sort of the middle-20s on mortality and morbidity and we were able to move it up with the Liberty acquisition to sort of 30% – 33%. So, we've achieved those two overarching strategies, which put us in a very good position to continue to grow the business and in a profitable way, obviously. So, we're excited about that.

So that's the business mix part of the question, in terms of where we see growth opportunities, let me set that up again between low interest rates and what products work better in low interest rates and what products work – don't work as well. And the products in our RPS business and in our Group business aren't as significantly impacted by low interest rates as some of the products in our Annuity and Life Insurance business. So we see a good growth in RPS in the segments of with the market that we participate in there. The government segment, the health segment, small-case 401(k). We've introduced a really strong product concept is sort of a takeoff on target-date funds and that's driving sales across those segments, so that's good.

In the Group business, we're seeing very good growth, very good pricing. We're emphasizing a lot the voluntary business where the margins are little bit better. We're seeing good growth there. So, in those two businesses and I say all of our businesses also suggest that they're in the 5% to 7%, in the middle-single digit-growth perspective or growth potential.

Now, if you come over to the individual businesses, Life and Annuity, and let me set the stage on this, low interest rates are a headwind and I'll just say a headwind will overcome those. But the strategy is around repricing products that aren't achieving their hurdle rates, shifting the emphasis of sales to products that are already achieving their hurdle rates; and then in the longer-term adding new products.

So, let's talk about repricing and redesign; we've done a lot of that over the years, take guaranteed universal life for example that used to be 66% of our sales when we were selling $700 million a year. Today, it's 4%, 5% of our sales, where we're going to be $850 million in total sales. So that was a shift away from our product that just – as interest rates continue to decline, just didn't provide the right return for our shareholders. So, that's an example of a shift.

More recently in the variable annuity business, we're seeing a little bit of a slowdown in guaranteed lifetime income product sales; but overcoming that slowdown is this new product that we introduced in the market for a little while, it was new for us over the last 18 months, index variable annuity. And that's doing extremely well, not only absorbing the decline in guaranteed lifetime income, but actually increasing sales.

So, I think all the businesses have the potential to grow in that middle-single-digit plus or minus range over time. And of course, the way, we get to our 8% to 10% is other components of growth, share buybacks as an example. So, in general, we're pretty optimistic that the business model that we have and the franchise strength that we have will continue to produce good returns, good growth.

Alex Scott Q
Analyst, Goldman Sachs & Co. LLC

So maybe if I can dig a little more into the Annuities piece of the growth...

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

Yeah.

Alex Scott Q
Analyst, Goldman Sachs & Co. LLC

...that you mentioned. I think over the last couple of years there's been some initiatives around expanding wholesalers and some work you've done on distribution that has resulted, and I think, really better momentum to your Annuities business than probably, anybody else from a flow standpoint. Now, I'd just be interested to hear how much – looking forward how much benefit are you getting from that? And how does that sort of balance out with the interest rates do you think you can still grow and achieve?

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

So, the answer to the question is yes. Let's go back three or four years, three or four years ago, I think distribution in our independent distribution partners and our own strategy really was around being the guaranteed lifetime income annuity company. We decided again three years ago, strategically that was too narrow of a focus, but we decided to participate in other segments of the market. So, we didn't do much in the fixed annuity business, three or four years ago. And because of that strategy change, we do today.

And one of the things that people talk about when they talk about the strengths of Lincoln's franchise is the very significant amount of distribution that we have. So, I think every 24 months something on a order of 90,000 different consultants, advisors, independent agents choose Lincoln. And so with that vast number of people that sell our products and behind that 90,000 is probably a 100 customers for every one of those 90,000. So, you can see, we're selling into a large pool of consumers all of whom have different needs. And so, we have to shift away from a product that's not getting returns into a different product. There's this big opportunity with the people that know and sell Lincoln. So that's why we're able to do shifts in our product mix successfully, the strength of distribution.

Now to your point though, different distribution organizations may have different focuses. And so, it may take us time to build the distribution that is the appropriate distribution for a particular product. An example of that would be, we are doing a lot more fixed indexed annuity, a lot of that's done in the bank channel. And so, we've expanded our bank channel partner distributors quite substantially.

So, the franchise is built around really good product development capabilities and really, really good distribution. And so, as market conditions change or consumer preferences change, we always have an audience to sell as we shift, and it's worked out pretty well for us. I'll repeat what I've just said. If you look at guaranteed universal life, and I'm going back to my grandfather's company, which in 2006, 2005 when we merged old JP and old Lincoln, again, I think we were selling $700 million of life insurance, 66% of that was guaranteed universal life. Today, we sell $850 million of life insurance, pretty close to the number one seller of life insurance in the United States and only 5% of that will be guaranteed universal life. And so, we've demonstrated an ability to shift again for consumer value reasons or preferences as well as capital markets' effect on return on capital.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

And the next one, I have to you is, on some of the investments that you've made in the strategic initiative, I guess, the digitization of some of the elements of your business. Can you provide an update on where that stands? So, I think you've been investing for a little while and I think there's some benefits that are beginning to come through. So, we'll just be interested on any color you can provide about it?

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

A

Yeah. Let me tell you, how we started that, sort of three things that came together at one point in time, about three years ago. One, we're seeing spread compression and we had to ask ourselves questions, for the benefit of our shareholders, how are we going to replace those earnings? Because you can't just let it disappear and not react to it. So, we had that issue. And it was – we saw about $150 million of earnings over a three or four-year period, disappearing from spread compression.

The second issue was digital experience and consumers mostly from the born-digital companies, Amazon, Uber, companies like that were setting the customer experience expectations for all industries. So, we were no longer competing against Nat or Pru on a customer experience. We're competing against Uber, Amazon and companies like that. So, that was the second issue.

And the third issue, we had already in some of our business lines decided that we're having good digital investment and results. And so, with those three things in mind, we decided to invest several hundred million dollars to accelerate the digital program. And that is achieving two things. One, the customer experience was improving dramatically and we're cutting costs down. So, on the digital cost saves and there are some other saves in this number, we're about – again, my experience in doing deals and making investments to change run rates permanently. You have to invest about a $1 to $2 to get a $1 worth of run rate savings.

And so trying to get to $150 million of run rate savings out of our digital program is going to cost about $150 million. So in the stage of this program, we've been sort of breakeven on investment and savings this year, but next year, we'll get $40 million net difference between savings on a run rate and investment. We'll get another $40 million, a year after that which takes it to $80 million and they will get another $40 million the year after that, which will take it to $120 million. So, we've given guidance of around $90 million to $150 million, what I've just said sort of as we exit 2021 and go into 2022, we think we'll be at a $120 million, so that's worked very well.

The good news is that when we started this, three years ago, I'd like to use this example, a lot of the way you get cost efficiencies taking people and paper and out of the system and replacing it with optical character recognition and robots. When we started our program, I think it cost $150,000 to install a robot, you know in a customer service area or in some process and that required three head count reductions to justify the sale, I mean, justify the investment. Over three years that $150,000 has come down by half or more. And so, we can go back in and do it again and make more investment digital and increase our run rate savings most probably, it won't happen until later 2021 and 2022, but we're going to do it again, because I think, the economics work better now than they did when we started.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

Interesting. I guess, related it'd just be Liberty Mutual acquisition and some of the integrations occurring there, I think that tied into it in a little bit, but it's also separate in ways as well, so I'd just be interested in any update on how the integration is going, I mean, just from an earnings standpoint, it seems like it's going quite well and how much is the expense synergies and so forth have you realized and how much of a tailwind is that going in the next year?

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

A

Yeah, it's like 25 years at Lincoln, I think I have done 10 deals all of which have been successful. The Liberty acquisition has – had, had great challenges, but has been executed by the Group team, under Dick Mucci and others, just, I mean, we've had mistakes, but not big ones. And so let me talk about couple of pieces that are important to specific answer to your question. And I think, at the time of the announcement of the deal, we've said that we'll get at about a $100 million worth of cost savings over some period of time. We're going to get that $100 million maybe 6 months or 12 months earlier or by the end of this year, we had the first $100 million in our pocket and in the next year, we think we'll get another $25 million. So on the cost save basis, we're going to do better than what we presented when we did the deal.

The second thing when we bought the – when we merged the proprieties and we announced this at the time of the deal of old Liberty was in the process of repricing because they got a little bit of ahead of themselves, it happens to a lot of people in the Group business. And I think, we said it was going to take three cycles of repricing to get the margins that we needed. I think, we did it in one-and-a-half cycles, but we're way ahead on the repricing that we had set out in the original presentations to our investors and we're 25% ahead on cost saves.

And just in terms of integrations when you buy something that's technologically plugged into a different parent, the biggest integration challenge is to unplug from the parent – the old parent into the new parent and that takes years and we just unplugged from the big Liberty Mutual and plugged into all of Lincoln's technology in the past 30 days and, it went very well. And so, that huge integration activity and something that could really mess up an integration, if it wasn't done effectively that's behind us. So that's why, I say of all the things that I've said its challenges, but the execution has been as good as any.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

And so I guess, the point at which you kind of changed the plugs is typically the point at which there are some shock lapses from your comments, I mean is it right to kind of take from that that you're not seeing much of that at the end of this year?

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

A

What happens is people fear, Erik (sic) [Alex], that when you unplug and replug that there's going to be a huge customer service billing problems. And so, the brokers put any company in sort of a penalty box for 18 months or so. Why take on the risk of a company that's going through a major integration when you can sell to somebody else. So, we saw a little bit of that. And when we price the deal, we put shock lapses in. We actually experienced less shock lapse than, I would say, 100%, we are out of the penalty box with our brokers. So again, we'd still be in the penalty box, for example, if plug and a replug thing didn't work, but it did. So, all of the integration risk that was perceived to be a problem by brokers is behind us. And the brokers are treating us just as – we're one new company.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

And then, I guess, just thinking one more of your benefits, just thinking about a higher level pricing, including the existing block. There's been some fear that the margins as strong as they've been that they're maybe not sustainable. Are you seeing any pressure on pricing or has the pricing been pretty stable this year?

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

A

The answer to that question is, it's a remarkably rational pricing environment in the group business, and actually pretty much across all of our businesses. Sometimes, any one of us can get ahead on pricing because we want to enter a new market. And with our eyes wide open, we might take a lower return on sales just to get into that market. So you see logical, aggressive pricing from time to time. Sometimes, you see people just made mistakes as Lincoln did four years ago. We just missed it on pricing. But the industry is in a very rational pricing mode right now, and I don't see that changing.

Now, I will say that from a margin perspective historically, in strong economies and low unemployment, you have better loss ratios on disability, short- and long-term disability because there is no incentive for people to make up a problem because they only get part of what their paycheck would be if they stay working. When they start getting laid off, you're going to see a little bit of pick up in loss ratios just because there is that sort of activity that goes on and people aren't – not suggesting people are bad, they just – things happen when you're not employed though.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

Sure. Okay. So maybe switching over to Life Insurance, I've noticed the term life insurance in-force has been growing at a pretty rapid pace, particularly, just in the last few quarters.

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

A

Yeah.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

So, just be interested to hear what you're doing there? Like is there anything that's changed that's creating the incremental growth?

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

A

Yeah. So, similar change in strategy in the Life business, regarding the segments of the markets that we're going to participate in, has happened in the Annuity business when we decided to broaden our definition of who we are from just a guaranteed lifetime income into a broader provider of solutions. In the life insurance industry, historically we've sold to a more affluent marketplace which meant an older age marketplace, higher base amounts, estate tax planning, business planning, those kinds of needs. Several years ago, again back to technology, we decided that we're going to go after a different segment which is lower face amounts, millennials, selling through distribution organizations.

One of our partners is headquartered here in New York, Policygenius and their whole business model, start-up, is a Internet-based selling of term insurance, some other products to the millennials. And so, we plugged into them as a distribution partner and we've plugged into other distribution partners who are approaching segments of the market that we weren't in before. So, again it comes back to the combination of product development and distribution strength. And where you want to add sales, sometimes it takes a little longer because you got to build these distribution relationships. But again, one of our strategies is to be so big in the markets that we participate, so if somebody wants to do manufacturer, our name comes up first because we're just the go to company on a lot of products and strategies for our distribution partners. So, that's what's happening with term.

Back to digital, in order to be able to economically enter these low phase markets, you have to go from a person based underwriting program to a machine based underwriting program. And over the last three or four years, we've made substantial progress in being able to automatically underwrite lower face, mostly lower face products. And when you automatically underwrite, there's a whole series of things that we have to do, but fundamentally you have to have a machine, if you will, that will allow you to take the personal underwriting out of it and just do it by the rules that you put into the underwriting algorithms.

And that's been quite helpful. So today, again back to digital and the need for digital over time, we can digitally take an app, underwrite it with the machine and issue it digitally and in many instances, no human involvement in the whole process.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

Maybe moving back to annuities quickly. One of your peers has had ROAs decline a bit, I think specifically related to some of the riders and fee tiers and so forth. So I'd just be interested in hearing, I mean do you think you have any of those issues that would cause a decline in ROA or do you think that that's sort of maybe idiosyncratic and that everything you're seeing from an ROA standpoint suggest more stability.

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

A

On the business – on the product lines where we have higher ROAs and part of that is because they are typically products that require bigger front end investments, so you have more capital, the earnings on the capital along with the other products of the profit pieces give you high ROA. And so on guaranteed lifetime income products as an example, we've been getting 80 basis points of ROA. We don't have any product designs in significance that as they age that ROA necessarily goes down. Actually it's a new question for me and I had to be educated. Apparently, we have some products that have that characteristics, but not very many at all. So from the ROA of a product, guaranteed lifetime income in particular, that 80 basis point is pretty solid, both on the new business basis as well as in-force business.

Now, we are doing some product designs where there's less capital and the ROA would be lower because there's less capital than the 80 basis points, but that just gets into consumer demand and preferences, and so there's products that have lower ROA. But the ones that have – but none of those are affected over time very much either. Once you get the ROA, it should be steady over the life of the contract.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

That's helpful. And then, I guess on statutory cash flow testing, this is sort of the time of year that you're wrapping up all of that work. Given some of the changes that were made on a GAAP basis at 3Q, do you have any update on sort of what we should expect from year end cash flow testing AAT?

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

A

Obviously, I don't know. But let me step back and address the headwinds of low interest rates. Three categories; one, product design and I've talked about our – because some products don't meet their hurdle rates, so it's the reprice, shift emphasis to products that are achieving their hurdles, and to the extent the increased pricing drops volume, add new products. So, we're doing that in the Life business, we're doing that in the individual business and that's really good. So, that's the first big issue of low interest rate product profitability. And I'm very confident that the franchise that we have will overcome those headwinds of low interest rates.

The second headwind from low interest rates is spread compression. And as I mentioned, the digital program is going to absorb the spread compression – at least the spread compression that we had in our last three-year plan. Interest rates have gone down a little bit more, so we have to do more, but I think we can work on other programs to replace the earnings from a spread compression. And then to your question, the third issue is what happens to your need for increased reserves in low interest rate environments. It's kind of simple but sometimes you just have to sit back and say to yourself this is a complicated industry, but it's not that complicated. You take a premium, you invest the premium, you pay a claim. If interest rates are going down, the premiums have to go up to pay the claim. You're in a guaranteed business, so you can't move the premiums up so you have to make sure that when you put up your reserves, you didn't – that you're pretty conservative.

So, our guidance on this and I think it's very, very good guidance. By that I mean we know the numbers and also I think it ought to be comforting to our investors. There's no cash flow testing challenges to my knowledge at current interest rate levels. There might be a pocket or two worth of problem. Publicly, we've said that if the 10-

year drops to 1%, there is about $350 million of extra capital required to build reserves and if the 10-year goes down to 50 basis points, it's about twice sort of linear, it goes up to $750 million. So if we go from where we are today all the way down to a 50 basis point, 10-year our cash flow testing would require another $700 million of capital, that's one year's cash flow and so it's a very manageable amount of increased capital needs just from – we make $2 billion a year. We have $2 billion at year-end statutory cash flow and so. No, some of that goes – 50% of it goes for product sales, 50% comes back for dividends and share buybacks and that will move around depending on product returns and so forth, but it's just not a – it's a very manageable number.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

Okay. At this point, I'll see if there are any questions from the audience. Do we have any?

Q

Hi. With opioids and obesity and suicide rates like they are, are the actuarial tables wrong? And kind of what are your expectations for mortality trends?

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

A

Yeah. The national statistics that we've seen are what they are, but then you have to, for each company, what markets have you been selling into. So the markets that I just mentioned a short time ago that we sold into from a life insurance perspective, mostly are affluent markets where the opioid crisis is not as great as it is in other segments of the marketplace.

So, our in-force business shouldn't be affected too dramatically by that. And we did say at the end of the third quarter and in part of our unlocking that our old age mortality expectations that we set 10 years ago were a little bit aggressive versus what's happening with old age mortality. And so, we took a charge for that. At the margin, the present value of that change was large, but the actual incremental increase in mortality expense on a yearly basis already in the numbers for the most part, so not a big transaction. Now having said that, who knows where some of these medical issues will pop up. But generally speaking, the demographics that we sold into over the last 20, 30 years is not where the most significant impact is from some of those things that you talked about.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

All right. Maybe if I could ask one last one I guess just thinking through the cash flow, you already talked a little bit about how much statutory earnings you generated and how much is available to the owning company. Could you just talk about sort of priorities for capital deployment and if there is anything like annuity transaction like you did last year or anything like that that would potentially accelerate some of that capital deployment?

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

A

So, let's talk about the deal – the Athene deal that we did. There's two sides for those deals, what is the buyer getting and then what can the seller do with the proceeds? And when we did the Athene deal, there was sort of a match in the marketplace. They could pay enough because where interest rates were at that time that made sense for us to do the deal. Since that time, interest rates have dropped dramatically and so the math on both sides of the equation just doesn't work today.

Yeah. So, we continue to look at things like that, but I don't think there's anything at this moment, could change tomorrow, but right now from a sale of a block of business just the math doesn't work on both sides, and again that could change tomorrow. And how could that change tomorrow? Well, people are buying it, might lower their return expectations because interest rates are down, and may not need as much as they thought they needed last time to do the transaction, but it's a tougher environment. In terms of the $2 billion in available cash for either supporting sales or share buybacks, at the margin that's always a return on capital decision. And Lincoln has cut sales back dramatically where products weren't getting the return and we've used that money to accelerate share buybacks.

So, it's always a discussion inside the company what's in the best interest for our shareholders, do we continue to build sales and cut back on our share buybacks or do we pull sales down a little bit and increase our buybacks. I think – not I think, but the number that we use is that in the individual Life and Annuity business, a 10% increase or decrease in sales absorbs about $175 million worth of capital. To put that into perspective, we – I guess we talked about $850 million to $900 million capital available for share buybacks and dividends, you can either add $175 million or subtract a $175 million from that number based on sales growth. And that's a capital management decision and I think we've been pretty disciplined around those decisions.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Okay. Well, I'll leave it there. Thanks, everybody.

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

Thanks everybody for attending.