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Lincoln National Corp. (LNC)
Q1 2017 Earnings Call
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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and thank you for joining Lincoln Financial Group's first quarter 2017 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 to conference over to the Senior Vice President of Investor Relations, Chris Giovanni. Please go ahead, sir.

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

Thank you, Amanda. Good morning and welcome to Lincoln Financial's first quarter earnings call. Before we begin, I have an important reminder. Any comments made during the call regarding future expectations, 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 to you 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 comparable GAAP measures.

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

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

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

Thank you, Chris, and good morning, everyone. As I noted in my closing comments on our year-end conference call, we entered 2017 with a lot of positive momentum. Looking at first quarter results, this was clearly evident as we reported record operating earnings and EPS aided by positive one-time tax adjustments, book value per share increased double digits and our ROE exceeded 12% excluding the noted tax items.

These were high-quality results as all four of our businesses delivered significant year-over-year earnings growth. Looking forward, I'm confident our franchise and actions can drive both near and long-term growth. In the near term, we are well positioned to drive organic growth through our multi-channel distribution model where we benefit from industry-leading shelf space and our broad set of customer solutions.

Notably, first quarter sales growth was strong in most of our businesses including sequential growth in annuity sales for the first time in nearly two years. Disciplined expense management remains a core strength and with revenues up 5% over the prior-year quarter, we should continue to have positive operating leverage.

Account values continue to grow, driving earnings tailwinds to our capital market-sensitive businesses. The first quarter is also typically our lowest earnings quarter for the mortality and morbidity businesses. As a result, we are set up well for subsequent quarters.

Lastly, our balance sheet remains strong and statutory capital is at an all-time high. This, coupled with consistent capital generation, will enable capital deployment to remain robust. Longer term, I also see significant opportunities. Demographic trends and individuals shouldering more responsibility for their financial security make our financial protection product solutions and retail-centric model more relevant and more valuable than ever.

Last quarter we announced our digital initiative, which is targeted at improving our customer experience. As we noted, we also expect significant cost savings over time as well as potential revenue enhancements. While interest rates remain low, we have continuously repriced our products to reflect this environment. And we have no further new business pricing changes scheduled. However, at some point, interest rates will increase. Although we are already seeing spread compression abate, higher rates would accelerate this trend. But just as important, will provide more flexibility in terms of our ability to offer consumers an even better value proposition for our products.

Finally, we have a strategic focus to decrease the percentage of sales from products with long-term guarantees and to increase the percentage of earnings coming from mortality and morbidity businesses. Both of these strategies are seeing favorable results which will lead to further diversification in our sources of earnings. So a lot to be excited about, much of which is within our control and a long runway of opportunities.
Now turning to our business segments starting with Annuities, an 8% increase in average account values resulted in double-digit earnings growth for our annuity business while results were further bolstered by one-time tax adjustments. As we all know, annuity sales for Lincoln and the industry had been dampened for a variety of reasons including confusion in the marketplace around the DOL fiduciary rule. However, even in the current environment, we are regaining sales momentum based on our historical strategy of leveraging distribution with product actions.

Importantly, this strategy is entirely in our control and we began to see early successes in the first quarter. Total annuity sales in the quarter were $2 billion, an 11% increase from the fourth quarter with growth in both fixed and variable annuities. This quarter's progress was driven by product enhancements that have been well received in the marketplace. As a result, throughout the first quarter, we saw monthly sales increases. Looking forward, momentum should continue, as leading sales indicators are strong, and we will benefit from another product introduction scheduled for the second quarter.

Let me briefly touch on some specific product stories from the quarter. We saw VA sales without living benefits increase sequentially and 26% from the prior-year quarter. Guaranteed VA sales saw monthly increases, as we added products with more investment choice and flexibility while we further penetrated the nonqualified market where we have a competitive advantage with i4LIFE.

Lastly, fixed annuity sales increased 37% sequentially, as higher interest rates are helping our consumer-friendly shorter surrender charge index annuities sell well in the bank and financial advisor channels. It is also worth noting that, in addition to higher volumes, new business returns have also improved sequentially.

As we noted on last quarter's call, we are also broadening our product portfolio to capture trends towards fee-based compensation and passive investments. Near-term, adoption will likely be slow, though we believe both have significant long-term growth opportunities. So, strong quarter for the annuity business. We are very encouraged by our sales momentum, and we remain confident in our ability to navigate the evolving marketplace and further build sales.

In Retirement Plan Services, we are pleased to see double-digit increases over the prior-year quarter in earnings, deposits, and net flows, as our strategy and franchise continues to drive positive results. Deposits in the quarter of $2.3 billion were up 26% from a year ago. First-year sales more than doubled to $800 million as we delivered strong results in both our small and mid-to-large markets, aided by continued success from recent product launches, combined with increased wholesaler productivity.

Recurring deposits increased 4% to a record $1.5 billion, as the combination of our high-touch model and our new digital functionality, like Click to Contribute, encourages participants to save more in their retirement plans. For the quarter, net flows totaled $116 million, up nearly 50% from last year's first quarter. This marks our fifth consecutive quarter of positive net flows. During the quarter, we did have one large relationship terminate, though our higher sales levels were sufficient to overcome this termination. Looking forward, we expect this year's net flows to exceed 2016. Bottom line, we remain confident in growth opportunities for our RPS business, and our strategy positions us well to drive future earnings.

Turning to Life Insurance, earnings improved significantly from the prior year, as variable investment income recovered and mortality was favorable relative to the prior year and typical seasonality. Our sales were also excellent. Total individual Life Insurance sales in the quarter were $158 million, a 20% increase from the prior-year quarter. In aggregate, expected new business returns for the quarter were at the top end of our targeted range of 12% to 15%, reflecting a series of pricing changes over the past several quarters.
We continue to benefit from our broad product portfolio and our tilt towards products without long-term guarantees. As examples, our term sales increased 8% compared to the prior-year quarter, while our UL sales declined 6%, driven by pricing actions we took on GUL late last year. Our VUL sales increased 24%, as sales in last year's first quarter were negatively impacted by market volatility.

MoneyGuard sales followed a record 2016 with further growth in the first quarter, as we are benefiting from our multi-channel distribution approach and continued demand for linked benefit products, as highlighted by industry sales growth of nearly 20% in 2016. Given our leadership position in linked benefit products and reduced market availability of long-term care funding solutions, we believe we have some additional pricing power. As a result, we recently adjusted prices, which will improve returns.

Lastly, we continue to remain opportunistic with respect to executive benefit sales, which contributed $23 million to total life sales. So our life business got off to a great start this year. Looking forward, our sales pipeline remains strong, and given our product breadth and the strength of our distribution, we remain optimistic about our ability to further grow the business.

Turning to Group Protection, in what is typically our lowest earnings quarter due to higher seasonal DAC amortization, earnings grew over the prior-year period, as amortization expenses declined and loss ratios remained favorable. I had noted in recent quarters that premium growth will be important as we look to drive the next leg of margin improvement. Therefore, I am pleased that premiums grew over the prior-year period for the first time since 2014, and we expect annual premium growth this year, driven by improving persistency and sales growth.

In the first quarter, we continued to experience improving persistency trends, total block persistency rates increased over 5 percentage points from the prior-year quarter, primarily driven by improved renewal persistency which reached the top end of our 70% to 75% targeted range for life and disability coverages. While sales decreased 3% from the same period last year, I would note first quarter represents the smallest contribution to full-year sales and we have a strong pipeline heading into the second quarter. Importantly, our pricing remains disciplined and our outlook for sales growth over the remainder of the year is aligned with our long-term target of mid single-digit increases.

So in summary, we are pleased with the positive business fundamentals and look forward to moving past the typical first quarter DAC amortization. We expect to benefit from further premium growth, favorable loss ratios and, therefore, stronger earnings over the remainder of the year.

Shifting to investment results, after an $8 million loss in the prior quarter, alternative investments had an outstanding quarter as both our private equity and hedge fund investments contributed to our 15% pre-tax annualized return. In terms of new money, we invested over $3 billion in the quarter at an average yield of 4.2%, 50 basis points higher than in the fourth quarter as we benefited from higher treasury rates and asset mix. Notably, our fixed-income portfolio yield was unchanged compared to year-end at 4.79%. Overall, the investment portfolio remains in great shape, high quality and broadly diversified. Below investment-grade assets represent less than 5% of our fixed-income portfolio, down 60 basis points sequentially due to maturities and prepayments.

So in closing, I am pleased with the start to our year, which includes record operating earnings and solid sales trends. As I look forward, I remain confident that our key strategic objectives – manufacture primarily retail products, target the fastest growing segments of the broader U.S. market, maintain industry-leading risk management, utilize digital to drive a differentiated customer experience and increased efficiencies, and actively
direct capital to the highest and best uses – will drive long-term sustainable growth. More importantly, our simple, clear, and straightforward business model has a track record of financial success and earnings stability and we see clear near and long-term opportunities to drive further shareholder value.

I will now turn to call over to Randy.

Randal J. Freitag
Chief Financial Officer, Lincoln National Corp.

Thank you, Dennis. Last night, we reported income from operations of $442 million, or $1.92 per share, for the first quarter, compared to $1.26 per share in the prior year. As we noted in the earnings release, the current quarter benefited $0.19 from one-time tax adjustments.

Excluding notable items, EPS increased 37% year-over-year as all four of our businesses delivered double-digit growth. Beyond items that cause typical variability quarter-to-quarter, I would note a couple items that impacted the current quarter. First, within Other Operations, the adoption of stock compensation accounting guidance will now cause some variability in our taxes, with the biggest impact likely occurring in the first quarter of each year tied to vesting schedules. In the current quarter, this increased earnings by $9 million. Next, within our Group business, earnings were reduced by $13 million as DAC amortization was higher than our typical quarterly run rate.

Now, shifting to key performance metrics. Operating revenue increased 5% in the quarter, driven by a 9% increase in average account values and strong sales results over the past year from our mortality and morbidity businesses. Book value per share excluding AOCI grew 10% to $58.37, an all-time high. Reported operating ROE was 13.6%. When adjusting for notable items, ROE was 12.2%, 20 basis points above our annual ROE in 2016. Finally, our balance sheet strength and solid capital generation enabled us to return $266 million to shareholders in the quarter. Net income results for the quarter largely mirrored operating earnings as both credit performance and hedge program results were excellent.

Now, I’ll turn to segment results, starting with Annuities. Reported earnings for the quarter were $281 million. Excluding the benefit of one-time tax adjustments, earnings totaled $240 million, up 10% from the prior year quarter. Earnings growth was driven by higher fee income from an 8% increase in average account values, as equity market strength over the past year has more than offset negative net flows.

Operating revenues increased 2%, even with one less fee day in the current quarter, and the prior year benefiting from more fixed income annuity deposits. Excluding notable items, return metrics remained strong, as ROE came in at 21% and our ROA was 75 basis points, up one basis point versus the prior year.

Our strategy of consistency and selling on our terms has produced differentiated results and a high-quality book of business. One way to highlight this is looking at net amount at risk, which sits at less than 0.8% of account value for both our living and death benefits, truly outstanding risk results on an absolute basis and relative to our peers. So a solid quarter for the annuity business and with end of period account values 1% above the quarterly average, we enter the second quarter with a tailwind.

In Retirement Plan Services, we reported earnings of $37 million, up from $31 million in the prior year. Excluding $2 million from tax adjustments in the current quarter, the earnings increase is attributable to growth in fee income from higher account values and expense management.
Positive net flows of $603 million over the trailing 12 months, combined with favorable equity markets, resulted in a 12% increase in average account values, while end of period account values reached a record $61 billion.

G&A expenses net of amounts capitalized increased just 1%, trailing revenue growth of 6%. As a result, the RPS expense ratio decreased approximately 100 basis points. Base spreads excluding variable investment income compressed 16 basis points versus the prior year quarter, slightly above our expectation for spreads to decline by 10 to 15 basis points. Looking forward, we expect to be at the low end of that range.

For the quarter, our ROA was 24 basis points, excluding notable items, consistent with recent quarters. So a good start to the year for our retirement business, highlighted by double-digit growth in deposits, net flows, and assets, all of which led to excellent earnings and positions the retirement business for continued momentum.

Turning to our Life Insurance segment, earnings of $130 million increased substantially from $75 million in the prior year quarter, primarily attributable to a recovery in variable investment income, combined with favorable mortality relative to the prior year quarter and typical seasonality.

While these two items always cause variability, I would estimate that relative to our assumptions, each added about $5 million to this quarter's earnings. Earnings drivers remained solid for the quarter, with average account balances in Life Insurance and in-force both up 5%. Revenues were up more than driver growth, primarily due to the recovery in variable investment income.

Shifting to spreads. Base spreads excluding variable investment income were down 7 basis points year-over-year, within the 5 to 10 basis point range we have discussed. Similar to RPS, we would expect to be at the low end of that range in 2017. So a great quarter as variable investment income recovered and we experienced more favorable mortality relative to last year's first quarter. Our outlook for earnings, driver growth and seasonality remain consistent with comments I made last year, all of which support long-term earnings growth for our Life business.

Group Protection earned $7 million compared to $5 million in the prior year quarter, with both periods impacted by accelerated DAC amortization. As a reminder, with the first quarter representing our heaviest renewal period, the amortization impact is greatest in this period but decreases in subsequent quarters. As I noted upfront, the acceleration of amortization reduced earnings by approximately $13 million when compared to our typical quarterly run rate for amortization.

Our non-medical loss ratio of 71% continues to be strong but was up 140 basis points compared to very favorable results in the prior year. Recall last year I noted our loss ratio had 1 to 2 points of favorable variability, primarily from our disability block. Therefore, similar to last year, loss ratios were solid across all of our businesses.

As Dennis noted, we are encouraged by year-over-year increase in premiums. We expect this to advance our margins in 2017 and for future premium growth to further improve our margins.

Let me discuss our capital position and capital management before we turn to Q&A. First, in capital, we are extremely well-positioned as our statutory surplus stands at $8.9 billion. We estimate our RBC ratio ended the quarter at nearly 500%, up nicely from our year-end RBC of 489%. Our capital and liquidity profile was further bolstered by $551 million of cash at the holding company.
This quarter, we repurchased $200 million of Lincoln shares. And when combined with our shareholder dividend, we deployed 60% of our operating earnings, above our long-term target of 50% to 55% but consistent with our guidance for 2017.

We have a proven ability to generate free cash flow and a track record of getting that cash back to shareholders. This remains an important priority. To this point, we implemented a 10b5-1 trading program, enabling us to better spread our repurchases over the course of a quarter. Through yesterday, we have repurchased $76 million in the quarter.

So wrapping things up, an excellent quarter for Lincoln. We reported record operating EPS in a quarter that is historically one of our weakest. Earnings quality was high as all four of our businesses delivered double-digit growth and net income represented 98% of operating earnings.

Sales were particularly strong in the life and retirement businesses, and we are seeing sales momentum in our annuity business. Operating revenue grew 5%, book value per share increased 10%, our ROE excluding notable items was strong at 12.2%; and finally, capital generation and deployment remain important parts of our shareholder value creation.

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

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

Thank you, Dennis and Randy. We will now begin the Q&A portion of the call. As a reminder, we ask that you please limit yourself to one question and only one follow-up, and then please re-queue if you have additional questions.

Amanda, can we please begin Q&A.
QUESTION AND ANSWER SECTION


Erik J. Bass
Analyst, Autonomous Research

Hi. Thank you. In the life business, you're seeing solid growth in the in-force, and it looks that you're gaining share. And in addition, I think you mentioned that new business returns were at the high end of your range, so I was just hoping you could talk more about your competitive position within the market and what's driving the growth?

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

Let me talk about the market, competitive position in general first. I think it's a fairly solid market. We don't see any people reaching for business through pricing actions. And certainly, we're not reaching for business through pricing actions. I mentioned that our sales growth came from, for example, variable universal life, which was up 24% over the first quarter. That has to do with VUL sales being a little depressed in the first quarter of last year because of the volatility in the equity markets and people not wanting to pull the trigger on products that were equity-based.

We also mentioned MoneyGuard, we're just a leader in that business. Equity-linked products growing at 20%, we're a leader, we're growing a little bit faster than that. So it stems from having good growth in a couple of products this quarter over prior quarter but, more importantly, on a long-term basis, having a pretty broad portfolio, so as consumer preferences change, we can offer another solution. And I would use VUL as an example of that. In the first quarter last year, it wasn't a strong preference for the reason I mentioned, but this year it is. So I come back to distribution strength, shelf space and broad product solutions as the answer to your question.

Erik J. Bass
Analyst, Autonomous Research

Okay. Thank you. And you've talked in the past about potential interest in group benefits M&A, so just hoping you could discuss how you think about a larger deal that could materially shift your business mix? And how much capital capacity you would have for potential M&A, including any potential debt capacity?

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

Yes, as I mentioned in my remarks, we have a strategy of increasing the percentage of our earnings that come from our mortality and morbidity businesses. This quarter, that percentage is about 25%. Over time, we'd like to see it grow to 30%, 33%. So we've made some progress on that objective organically, principally because of recovery in the Group business and again this quarter, good results in the Life business.

So when I think about M&A broadly speaking, and we've discussed this publicly a number of times, probably our first choice would be the Group business, which would help with that target source of earnings from morbidity and mortality. And but again, I'm going to turn over the second half of that question to Randy. We are going to be very disciplined about any transaction we do. We're not reaching for any transactions by paying a high price, as we
say, have said and I said again this morning, we're very careful about the return on the capital that we deploy. So if we do go after a transaction, we will be disciplined about it, as we have been in the past.

Randy, you want to add?

Randal J. Freitag  
Chief Financial Officer, Lincoln National Corp.

Yes, Eric, in terms of capacity, as I've mentioned in the past, in the context of an acquisition, I believe inside of our nearly $9 billion of statutory capital, we have roughly $500 million to $750 million of capacity inside there, once you get in the context of an acquisition. I also think in the context of an acquisition on the leverage front, there is some capacity that we would have – once again an acquisition that delivers cash flow to the holding company opens up some capacity, I think probably in the $300 million to $500 million range.

Separate from that, we obviously have been and will continue to generate a significant amount of free cash flow, and we've deployed well over $1 billion last couple of years and share buybacks have represented nearly $900 million both last couple of years. Obviously, we did $200 million this quarter. So I'd point to those items when you think about potential capacity.

Erik J. Bass  
Analyst, Autonomous Research

Great. Thank you. That's helpful.

Randal J. Freitag  
Chief Financial Officer, Lincoln National Corp.

Yes.

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

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

Hi. Thanks. Good morning. Dennis, I was just hoping you could provide some additional color on the initial reaction to some of your new VA product rollouts that occurred during the first quarter, as well as I think you mentioned an additional product that was going to come out in the second quarter, give some more color on what that would be?

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

Yes, Ryan, we've made a series of product moves that have been well received, some of them this quarter, some of them over the past couple of quarters. Let me focus on the increase in sales of our non-guaranteed VA business, which is up pretty substantially. What we're seeing on that product, and again this comes back to having a lot of products available in the market and changing consumer preferences. We added a death benefit to Investor Advantage, which again is a non-living benefit product, and people just seem to be wanting to lock in some of their equity gains. The death benefit provides for sort of a mortality option for them, so we've seen sales there increase.
When I look at our adjustments on the guaranteed business, guaranteed lifetime benefits, we've made some modest increases in the benefits, maybe 25 basis points, on the payout of one of our core products. We have been able to, because of rising interest rates, increase the investment flexibility. Our value proposition for our financial advisor is to let them have as much flexibility as we can provide to choose good outcomes for their customers. And so, as we provided more financial flexibility, that has helped with sales.

When the product for introduction in the second quarter is in the category of guaranteed lifetime income, and we're just offering another solution in the marketplace as a slightly higher guaranteed payout, but there are slightly lower guarantees in it overall. It's a product that has been successfully sold by our competitors. And again, we think, for a segment of the market, it is potentially going to be popular.

So, again, I come back to distribution, broad product breadth, trying to find additional segments of the market that would add incrementally to our sales, not subtract from sales that we're already making.

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

Great. Thanks. And then a related question. Lincoln saw some improvement in the quarter on annuity sales sequentially, but most of your competitors continued to see fairly meaningful declines in VA sales. I guess, do you think we're getting closer to the point where industry VA sales are bottoming?

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

I think so. If you go back to the fiduciary rule, let me make two comments: one, how can guaranteed lifetime income not be in the best interest of consumers? With the lack of defined benefit plans, more shouldering of financial responsibility on individual consumers, that has got to be a compelling long-term value proposition. So I think it will remain a good product in the marketplace.

The DOL is creating confusion more than anything else, and so you're seeing some of our distribution partners not coming forward with their specific plans, because they are waiting to see what the final rule is really going to be. So I think the whole market — candidly, both qualified and nonqualified business is being affected by the uncertainty created by this rule, and the distribution partners waiting for certainty so they can formalize what their practices and policies are going to be. So I'm hopeful that we'll get to that certainty sooner rather than later, and I think that will help annuity sales overall.

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

Great. Thanks a lot, Dennis.

Operator: And our next question is from the line of Tom Gallagher of Evercore ISI. Your line is open.

Thomas Gallagher
Analyst, Evercore ISI

Good morning. Dennis, just a follow-up on DOL fiduciary rule. From, I guess what's out there right now, it sounds like, following the delay, it may — there's speculation it may go into effect without any major modifications, including private right of action. If that in fact – curious on your perspective, how you think that's going to play out? And if that does remain, does that become kind of a game changer as you think about the impact of that regulation and legal liability risk, etcetera?
Dennis R. Glass  
*President, Chief Executive Officer & Director, Lincoln National Corp.*

I don’t see it as a positive, to have the plaintiff bar being the enforcement arm on a product. But, as we are doing in our own broker-dealer, I think there’s enough room inside of the current fiduciary rule to establish practices that meet and exceed the intent of the rule and still provide for the sale of products that are subject to the right of action.

So I think that the market will adjust to it, and I come back to, at least in our business, guaranteed lifetime income trumps, whether it’s a commission or a fee, and I think it’ll trump the right of action over time. Personally, and we’re public about this, we think that part of the rule should be replaced.

I think you’ve seen less action on this from the DOL — well, I shouldn’t say I think, I know there is less action from the DOL because the Trump administration has not yet gotten their Department of Labor person approved. And I think when that happens, there’s the possibility — I’m not saying anything for certain, but there’s a possibility that the regulation may have another look by the administration.

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Thomas Gallagher  
*Analyst, Evercore ISI*

Okay. Thanks. And then, just on — I guess a question on individual life mortality. We now had — following, we’ll call it, some rocky quarters, going back a couple years ago, you’ve had a string of maybe four or five good favorable mortality quarters in a row. That is pretty different than what the industry experience has been.

Any thoughts on why your mortality experience has been favorable on a fairly consistent basis here and anything with your mix or I know you had that recapture of the reinsurance transaction. I don’t know if that’s been trending favorable. But any color as to why your experience has been different?

Randal J. Freitag  
*Chief Financial Officer, Lincoln National Corp.*

Tom, this is Randy. I can’t speak to the industry. I think we have always felt and have proven over time that we are excellent assessors of mortality risk. I think we have one of the finest underwriting departments in the land. And those folks are very good at assessing mortality risk and pricing that risk appropriately. And I think you’ve seen that in our results over time.

As we have retained more business, you’re getting a little more variability around our results and you’ve seen that. But I think over time the quality of our ability to assess mortality risk is coming through our results.

In terms of the industry, look, I think that the entire industry is pretty good at understanding mortality. And I think, over time, mortality is going to do what it’s always done, which is improve gradually over time. I fully expect that my children will have a longer expectation of life than I have, for instance. And I expect that their children will have a longer expectation of life than they do. So that’s mortality over time, that’s what we expect, and I think you’ll see that in our results and in the industry’s results.

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Thomas Gallagher  
*Analyst, Evercore ISI*

Okay. And then just finally, Randy, I just wanted to make sure I had the numbers right. When you were asked about potential funding sources for M&A, you had said excess capital in the regulated entities of $600 million to
$800 million, and I missed what you said on [ph] debt (43:38) capacity, and then you have another $800 million to $1 billion of annual cash flow, those would be the three pieces?

Randal J. Freitag  
Chief Financial Officer, Lincoln National Corp.

To be clear, in the regulated entity, and I said this is in the context of M&A, I said $500 million to $750 million, so roughly in line of your numbers. In the context of the leverage capacity, and once again this is in the context of doing acquisition with the proceeds, I would estimate $300 million to $500 million. And then just factually, we have bought back shares over the last couple years at a rate of about $900 million a year. We did $200 million in the first quarter, so we obviously have been generating and we would expect to continue to generate significant free cash flow.

Thomas Gallagher  
Analyst, Evercore ISI

Okay. Thank you.

Randal J. Freitag  
Chief Financial Officer, Lincoln National Corp.

You bet.

Operator: Thank you. Our next question is from the line of Seth Weiss of Bank of America. Your line is open.

Seth M. Weiss  
Analyst, Bank of America Merrill Lynch

Great. Thank you. Just a couple modeling housekeeping questions. First, Randy, the $9 million tax benefit in Other Operations in the quarter, should we expect that to reverse in the subsequent three quarters? And is that seasonality something that we could model out for 2018 and beyond?

Randal J. Freitag  
Chief Financial Officer, Lincoln National Corp.

Sure, Seth. I think it’s a difficult item to model. It reflects the difference in performance really in equity from the assumptions that go into the granting of equity compensation to employees, so it is I think an inherently difficult item to model. I would say that you should expect some seasonality in the number and that the first quarter should be I would imagine the quarter when you would see the most impact.

And that’s because there are two elements of what drives this number. One, you have stock option exercises, which would have a skew into the first quarter because that’s when you cross an anniversary, and that is oftentimes a trigger for some sort of event. And separately, the first quarter would be when all of the performance shares that we grant and the restricted stock that we grant vest, and that would be the event that drives part of the result.

So I think you should see a seasonality in it in the first quarter, but you should see some level each and every quarter. I think the $9 million number we experienced this quarter would be at the very high end of what I would expect in a typical quarter.
Okay, thank you. And then one more modeling one, and just semantics I want to clarify. Your expectations to be at the low end of the range for RPS and Life Insurance and the spread compression, I just want to clarify, that means the beneficial end of the range, is that correct?

Yes, the beneficial range. So, on the case of RPS, that would be the low end of 10 to 15, so closer to 10 than 15. And in the case of Life, closer to 5 than 10.

Great. Just wanted to clarify as we're dealing with negative numbers there. Appreciate it.

No problem.

Thank you. Good morning. Randy, I guess the question is, if I adjust for the one-time tax benefits, and I get that DRD was a big component of that. If I adjust for that, the quarter's underlying effective tax rate on a consolidated basis was just shy of 20%. And the Annuities segment was I think under 15%, maybe even closer to 14%.

In both of those cases, that's below the levels we've seen in the last several years, if not even a little bit longer than that. How do we think about the sustainability of that underlying sort of sub-20% on a consolidated basis, and low to mid-teens for the Annuities segment, as we look forward?

Sure, John, I think the difference is in the Annuities segment itself. So inside of the annuity results, we talked about we had $41 million of what I would call normalizing items, which brought the result down to about $240 million, which is right in line with our expectations for the business.

If you were to factor in equity market growth, the negative net flows, the fact that international markets underperform the S&P, when you factor all those things, $240 million is right in line with our expectations. Inside of that result, you would have had some other pluses and minuses.

One of the pluses would have been the fact that, every year in the first quarter, we have a normal truing up of our DRD, as we get actual information in from the funds. That had a positive impact on the annuity business of roughly $8 million.
Now that positive $8 million was – that's a recurring item, by the way, that's going to occur on a regular basis. Never know how big it will be, but this year it happened to be about $8 million. That was offset by the fact that the first quarter of this year had one less fee day than last year, and also the fact that we had some noise in our commissions this quarter, really a swing between fourth and first quarter, which negatively impacted the quarter probably by $4 million to $5 million.

So when you factor that in, that additional just normal DRD true-up that we experienced in the first quarter, if you would add that in also, and Life had couple million of this impact also, you would see that the normalized tax rate, if you want to add them back, would be in the 22% range, which I think would in line with our expectations, all else being equal, for what that number would be as you move forward.

John M. Nadel  
Analyst, Credit Suisse Securities (USA) LLC

Okay, but I think you also just mentioned that the DRD – that $8 million benefit would be ongoing. Is the first quarter reflective of the full year benefit of that? I imagine it's not.

Randal J. Freitag  
Chief Financial Officer, Lincoln National Corp.

Yes, I didn't mean to say it would be ongoing, what I mean to say by that is, this is a normal process.

John M. Nadel  
Analyst, Credit Suisse Securities (USA) LLC

Oh, it's – got it. Okay.

Randal J. Freitag  
Chief Financial Officer, Lincoln National Corp.

Every year, we get the actual information from funds, and we have to true up our estimate that we put up at the end of the year. This, in the case of 2017, that happened to be about an $8 million positive for the annuity business.

John M. Nadel  
Analyst, Credit Suisse Securities (USA) LLC

Got it. That's very helpful. And then, just another – a question on sales, and I'm thinking about the fixed annuity sales. I know it's not that big of a line, but I'm wondering what the composition looks like in that $560 million or so of sales this year versus the $668 million last year. How much of a contributor is the index product?

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

The index product without lifetime guarantees is about $315 million of the total fixed annuity of $562 million. Fixed annuities with lifetime income is about $135 million, so it's all but $100 million of the $562 million.

John M. Nadel  
Analyst, Credit Suisse Securities (USA) LLC

And how did – if I think about the sales growth or decline in the indexed portion of the product, what are you seeing there? Is that also being impacted by DOL sort of overhang?
Dennis R. Glass  
President, Chief Executive Officer & Director, Lincoln National Corp.

Okay, so let me — the fixed index annuities are up 37% versus the prior quarter, most of that coming out of just normal accumulation fixed indexed annuities.

John M. Nadel  
Analyst, Credit Suisse Securities (USA) LLC

Okay.

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

And the higher amount is due to the fact that interest rates are a little better in the quarter versus the prior year, and that product competes with CDs, so we had slightly better advantage. And I’d also say, and I keep underscoring distribution strength, we’ve been building our shelf space over the last couple of years in the bank channel for fixed annuities and in the advisor channel for fixed annuities, so we’re seeing some effect from just better distribution coverage.

John M. Nadel  
Analyst, Credit Suisse Securities (USA) LLC

And would you characterize that product line, particularly the indexed annuity product line, as pretty competitive, Dennis? I ask because American Equities said earlier this morning that price competition there is pretty significant. It’s not just the Bermuda backed NIMs, obviously. Now there’s some real brands competing in the indexed annuity product area, including your own as well as a few others, that that clearly was not the case just a few years ago and prior.

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

Yes. First of all, the firm that you mention is not really in the market that we're in. They're a lower investment grade, their products are higher commission, longer surrender periods, less liquidity. So we continue to price rationally. And again, our improvements, I think in large part, are related to a specific attempt to reshape products over the last couple of years for that bank and financial advisor channel. And again, that means shorter surrender charges, more liquidity for the consumer, and that's a good place for us to be, and I don't think it's affected by the company that you mentioned.

John M. Nadel  
Analyst, Credit Suisse Securities (USA) LLC

Got it. Understood. Thank you so much.

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

Yes. And let me — I was asked a question earlier about the DOL. Actually, the new head of the DOL has been approved, just in the last couple of days. What I meant to say, he hasn't had much time to look at things.
Good morning and thank you taking my questions. Just a question regarding the VA net flows, so for the past year or so, you've been kind of pressured by outflows related to the products that comes with the volatility control fund. So if I were to look at the net flows in this quarter, was the volatility control fund VA continue to be a pressure? And if so, how much of those funds account for the net outflows in the quarter?

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

Yeah. I guess I'm going to jump to a little higher level on that question. And that is that our outflows have ranged from 7% to 10% over the past three or four years. The 8% or 9% that we saw in the first quarter is a little higher, but sort of within the range of what we see over time.

Whenever equity markets rise dramatically, there might be a little bit of consumer reaction to surrendering. But let me come back to the higher point. There's nothing in this first quarter that is dramatically different, matter of fact, it's in the mid-point, mid range of what we've seen over the last several years.

Got it. And then looking at maybe a modeling question, but looking at other operations. So if we adjust for the $9 million of tax benefits, the $22 million still look relatively favorable in the quarter. Was there anything timing related that has kind of taken place in the quarter?

Randal J. Freitag  
Chief Financial Officer, Lincoln National Corp.

Hey, Humphrey. It's Randy. Yeah. I think it's fairly typical. If you think about other operations, you add back that $9 million, you're right, you get to negative $22 million. If you think about next quarter, we're going to lose a substantial portion — I believe, two-thirds of the amortization of deferred gains on the reinsurance. So that will negatively impact that particular segment.

I would say there is a little bit of seasonality in other operations expenses. Branding is oftentimes a little lower in the first quarter and a little higher in the second quarter, but all-in that segment has been running in that negative $25 million to negative $30 million range. So I don't think we're really materially different from that this quarter, once you adjust for the stock-based compensation.
Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Great. Thanks. So a question for Dennis. On prior calls, you've kind of given us your sense of sort of bid-ask in terms of M&A opportunities in the market, obviously, without commenting on any specific deal. Any update there in terms of what you're seeing?

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

Yeah. I think there's a couple of rumors about certain companies divesting of non-core businesses. But, again, in Randy's and mine experience, which goes back decades, it seems to be a pretty low volume of transactions, at least that we would have any interest in. So I would just say it's at the low end of the range from our experience – activity and doesn't mean that that couldn't pick up or doesn't mean that we wouldn't do something. Just answering your question. There's not much that we're seeing that fits what we're interested in.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Got it. And then, I guess, with tax reform back on the table again, we've been getting some questions about the impact of potential estate tax repeal on the life insurers. Can you help us frame maybe how important that – or how big a piece of your life insurance business that would represent and if the estate tax were dramatically reduced or eliminated, what you'd expect in terms of your in-force business?

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

Yes, the amount of our – you mean in-force or sales?

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Well, it'd be helpful if you give us both, actually.

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

We'll have to get back to you on in-force, but the amount of new sales that we have is 10% to 12% from what we could observe as being specifically related to estate tax planning. But let me come back to the whole issue. I'm not sure that the change as it's presented, which is the removal of estate taxes but a tax on the step-up in basis at the transfer of the asset won't actually give the industry a bigger opportunity or tax – now it would be income tax planning.

But right now, just use a simple example, right now if you have a $10 million estate, and you're husband and wife, you could pass that on estate-tax-free and there's no step-up in basis that you are taxed on. If that estate tax goes away, and you have a $9 million step-up in your $10 million estate, now all of a sudden, where you didn't have an estate tax, you now have a tax on $9 million of step-up. So it's not as simple as the estate tax goes away from an industry perspective.
Got it. And then maybe just one last one if I could sneak it in. I think somebody asked you about this before, but just a follow-up on the ETF based VA. Any comments in terms of the progress there? But then more importantly, have you seen any competitors launch similar products following the announcement of your BlackRock related product?

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

As I mentioned in my comments, we've adjusted our products to capture these trends which we think are going to grow in importance over time, the two trends being a little more fee-based compensation than commission-based compensation, and a little more focus on passively managed funds than actively manage funds. Specifically, with respect to our product that we've talked about, it requires a lot of interfacing technology with the broker-dealers that will put it on the shelf.

We've had four or five successes so far with getting it on the shelf and having the technology work but nothing significant in terms of sales, and we wouldn't expect any real significant sales to pop up overnight, but to grow over time. But we do think over time, it will grow to be a valuable product.

Suneet Kamath  
Analyst, Citigroup Global Markets, Inc.

And competitors following suit?

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

Not that we're aware of, but it would seem like something that would – we think it's a good idea.

Suneet Kamath  
Analyst, Citigroup Global Markets, Inc.

All right. Perfect. Thank you.

Operator: Thank you. And this does concludes today's Q&A session. The company with follow up with those listeners with remaining questions later this afternoon. I'd like to turn to call back over to Mr. Chris Giovanni for closing remarks.

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

Thank you all for joining us this morning. As always, we will take your questions on our Investor Relations line at 800-237-2920 or through e-mail at investorrelations@lfg.com. Thank you and enjoy the rest of your day.

Operator: Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program. You may now disconnect.