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AFG - Q1 2020 American Financial Group Inc Earnings Call

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OVERVIEW:

Co. reported 1Q20 core net operating earnings of $171m and net loss per share of $3.34.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the American Financial Group 2020 First Quarter Results Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions)

It is now my pleasure to introduce Assistant Vice President, Investor Relations, Diane Weidner.

Diane P. Weidner - *American Financial Group, Inc. - Assistant VP of IR*

Good morning, and welcome to American Financial Group's First Quarter 2020 Earnings Results Conference Call. We hope you and your loved ones are healthy and safe in these extraordinary times.

We released our 2020 first quarter results yesterday afternoon. Our press release, investor supplement and webcast presentation are posted on AFG's website under the Investor Relations section. These materials will be referenced during portions of today's call.

I'm joined this morning by Carl Lindner III and Craig Lindner, Co-CEOs of American Financial Group; and Jeff Consolino, AFG's CFO.

Before I turn the discussion over to Carl, I would like to draw your attention to the notes on Slide 2 of our webcast. Some of the matters to be discussed today are forward-looking. These forward-looking statements involve certain risks and uncertainties that could cause actual results and/or financial condition to differ materially from these statements. A detailed description of these risks and uncertainties can be found in AFG's filings with the Securities and Exchange Commission, which are also available on our website.

We may include references to core net operating earnings, a non-GAAP financial measure, in our remarks or in responses to questions. A reconciliation of net earnings attributable to shareholders to core net operating earnings is included in our earnings release. And if you're reading a transcript of this call, please note that it may not be authorized or reviewed for accuracy, and as a result, it may contain factual or transcription errors that could materially alter the intent or meaning of our statements.

Now I'm pleased to turn the call over to Carl Lindner III to discuss our results.

Carl Henry Lindner - *American Financial Group, Inc. - Co-President, Co-CEO & Director*

Well, good morning. The past 2 months have been an exceptionally challenging time for all of us. COVID-19 pandemic has had profound implications across the globe, requiring us to adjust to new ways of working and interacting with each other. Our thoughts and prayers remain with all those affected by the virus and the individuals caring for them. We're especially grateful for the guidance of health officials and government leaders at the local, state and federal levels. Their actions have been instrumental in protecting health and promoting safety in these unprecedented times. We're also very thankful to those serving and caring for others, including healthcare professionals, first responders, military, and food service personnel and other essential workers.

Our foremost priority during this time is to protect the well-being of our employees while continuing to provide the secure, trusted service and support on which our agents and policyholders rely. We've invested a significant amount of time developing, testing and implementing our business continuity plans, which have proven effective in enabling us to successfully navigate these challenges and stay focused on our priorities.

We entered the year in the strongest financial position in our company's history, and our liquidity and excess capital afford us the flexibility to effectively address and respond to the uncertainties presented by COVID-19. We will explore some of these uncertainties and considerations in more detail on today's call.

So I'd like to start with a few summary comments about the implications of COVID-19 on our business overall. The macro impacts of COVID-19 will affect our insureds and impact our results. It will take some time to fully understand the implications of this pandemic to our business. Many of our policyholders are struggling to adapt to the economic headwinds that are impacting their operations. As the economy contracts, the exposure bases that affect our Property & Casualty businesses will change. For many, there will be lower employee counts, decreased payrolls, fewer miles driven, and reduced sales as overall economic activity declines. COVID-19's impact will be felt beyond the first quarter results we're sharing today.

Later in the presentation, you'll see that we've factored these considerations into our 2020 premium guidance. In some of our lines, like commercial auto, these economic factors will translate into lower claims frequency, while for others, there could be an increase in claims frequency as a result of COVID-19. How claims ultimately play out will take time to fully discern.

There's a lot -- there's been much written about business interruption insurance. As these claims are presented, we're investigating each claim. Like most others in the industry, our policies require direct physical damage to covered property for business interruption coverage to apply. In addition, the vast majority of our property policies also contain virus exclusions. We note that there are efforts to impose retroactive business interruption insurance through government decrees or legislation. Efforts to impose retroactive business interruption coverage are ill-considered, unconstitutional and would be destabilizing to the insurance industry. Imposing business interruption coverage after the fact is not what any insurer bargained for when underwriting or pricing these risks or issuing these policies.

With respect to workers' compensation, the impact is evolving. States are grappling with whether they're going to impose certain compensability presumptions with respect to COVID-19. How these considerations play out could impact our exposure. In some instances, these presumptions being proposed are overly broad and would undermine a fact-based assessment of how a workplace injury might have occurred. Other states are considering presumptions that are more narrowly crafted.

The virus remains active and as Americans begin to return to work, the full impact of how this virus will resolve itself remains an unknown. While we're seeing some workers' compensation COVID-19 claims being presented, because many employees have been furloughed or are working from home, the impact of these claims is offset due to reduced numbers of workplace injuries in some sectors.

The impact of COVID-19 is likely to be state-specific and probably industry-specific. Less than one half of one percent of our workers' compensation gross written premium relates to coverage for first responders and approximately 6.5% relates to coverage for healthcare workers, first responders and nursing homes combined.

Importantly, we expect as a company to continue to have significant excess capital and liquidity throughout 2020 and beyond. Specifically, our insurance subsidiaries are projected to have capital at or in excess of the levels expected by rating agencies in order to maintain their high current ratings and we have no debt maturities before 2026. We are financially strong and well-positioned to respond to the challenges presented by COVID-19. Jeff will review this more during his remarks.

Now I'd like to turn to an overview of our first quarter results on Slide 4 of our webcast. AFG reported core operating earnings of $1.88 per share in the first quarter of 2020 compared to $2.02 per share in the first quarter of '19. Annualized first quarter core return on equity was 13.2%. These first quarter 2020 results are at the upper end of the guidance provided in our pre-release issued on April 15. The year-over-year decrease in core operating earnings was a result of negative adjustments to the company's $2.2 billion of investments that are marked-to-market through core operating earnings.

The COVID-19 pandemic has had widespread financial and economic impacts, including a significant decrease in both equity and credit markets, which adversely affected returns on AFG's marked-to-market investments. Excluding the impact of mark-to-market investments, AFG's first quarter 2020 core net operating earnings increased $21 million or $0.23 per share year-over-year.

Turning to Slide 5, you'll see that the first quarter 2020 net loss per share of $3.34 included $5.22 per share in losses attributable to after-tax non-core items, which Jeff will speak to later in the call.

Last month, we provided full year 2020 core net operating earnings guidance per share -- earnings per share guidance, excluding earnings or losses from investments marked-to-market through core operating earnings, given the uncertainty of the implications of COVID-19 and the resulting volatility in the financial markets. AFG continues to expect its 2020 core net operating earnings per share excluding mark-to-market investments to be in the range of $6.45 to $7.25. Craig and I will discuss our guidance for each segment of our business in more detail later in the call.

We are pleased with the performance of our core operating businesses during the first quarter of 2020 amid the challenges introduced by the COVID-19 pandemic. We believe our underlying results demonstrate the strength of our portfolio of diversified specialty insurance businesses and the contributions of the exceptional employees who are part of the AFG family. We thank God, our talented management team and our great employees for our continuing ability to provide our essential business functions in these difficult times.

Now I'd like to turn our focus to our Property & Casualty operations. Please turn to Slide 6 and 7 of the webcast, which include an overview of first quarter results. Our Specialty Property and Casualty Group performed exceptionally well during the quarter with excellent underwriting margins, healthy year-over-year growth in net written premiums and very strong renewal pricing that's exceeding our objectives. As you'll see on Slide 6, gross written premiums were down 1%, net written premiums were up 2% in the 2020 first quarter compared to the prior year quarter, primarily as a result of the run-off of Neon. Excluding the impact of the Neon runoff, gross and net written premiums increased 11% and 7%, respectively, year-over-year.

Core operating earnings in the AFG's property insurance operations were $181 million in the first quarter of 2020 compared to $185 million in the prior year period, a decrease of 2%. Absent the impact of mark-to-market investments, first quarter 2020 pretax core operating earnings in the AFG's P&C insurance segment increased $1 million when compared to the prior year period.

The Specialty Property and Casualty insurance operations generated an underwriting profit of $89 million in the 2020 first quarter, compared to $88 million in the first quarter of 2019. Higher underwriting profitability in our Specialty Casualty and Specialty Financial Groups was partially offset by lower underwriting profit in our Property and Transportation group. The first quarter 2020 combined ratio of 92.2% improved 0.3 point from the prior year period. First quarter 2020 results include 4.2 points of favorable prior year reserve development, compared to 4 points in the prior year period. Catastrophe losses were 0.8 points of the combined ratio in the first quarter of 2020. By comparison, catastrophe losses added 1.1 points in the prior year period.

We continue to carefully monitor claims and loss trends related to the COVID-19 pandemic. Numerous legislative and regulatory actions, as well as the specifics of each claim contribute to a highly fluid, evolving situation. Our first quarter 2020 results include approximately $10 million in claims reserves and IBNR designated for estimated COVID-19-related losses. We expect to see more claims and gain greater clarity during the second quarter.

We have insignificant exposures to event cancellation, travel and accident -- our travel and accident and health, as well as other first-party coverages. It's too early currently to know the impact on some of our lines of business such as D&O, surety and trade credit.

Turning to pricing, we continue to see strong renewal rate momentum. Average renewal pricing across our entire Property and Casualty Group was up approximately 7% for the quarter. And if you exclude workers' compensation, our workers' comp business, renewal pricing was up approximately 11% in the first quarter. Renewal pricing in our Specialty Property and Casualty Group overall is the highest we've achieved in over 5 years, meeting or exceeding our expectations in each of our Specialty Property and Casualty subsegments.

Now I'd like to turn to Slide 7 to review a few highlights from each of our Specialty Property and Casualty business groups. The Property and Transportation Group reported an underwriting profit of $27 million in the first quarter of 2020 compared to $39 million in the comparable prior year period. Lower crop earnings were the driver of the lower underwriting profit in the quarter. First quarter 2020 gross and net written premiums in this group were 13% and 12% higher, respectively, than the comparable prior year period.

New business opportunities in our transportation, property and inland marine and ocean marine businesses, as well as new premiums from the addition of the Atlas paratransit business, were partially offset by declines in passenger transportation premiums caused by the COVID-19 pandemic. Overall, renewal rates in this group increased 6% on average in the first quarter. I'm pleased with the rate strengthening in our commercial auto liability and aviation businesses and in our Singapore branch.

The Specialty Casualty Group reported an underwriting profit of $52 million in the 2020 first quarter compared to $36 million in the comparable 2019 period. Higher profitability and our executive liability and workers' compensation businesses, as well as 2019 Neon underwriting losses impacting prior year core operating results, contributed to the higher year-over-year underwriting profitability.

Higher year-over-year adverse development in our E&S lines and public sector businesses partially offset these results. Underwriting profitability in our workers' comp business continues to be very strong. These businesses reported higher year-over-year underwriting profit, primarily as a result of higher favorable prior year reserve development.

Gross and net written premiums for the first quarter of 2020 decreased 7% and 6%, respectively, compared to the same period in '19, primarily due to the run-off of Neon. If you exclude the impact of Neon, gross and net written premiums for the first quarter of 2020 were up 13% and 4%, respectively, when compared to the same period in 2019. Higher cessions in our E&S business and excess liability businesses impacted net written premiums.

With the exception of workers' comp, the majority of our businesses in this group achieved strong renewal pricing and reported premium growth during the first quarter. Growth in our excess and surplus lines and excess liability businesses, primarily the result of rate increases, new business opportunities and higher retentions on renewal business, was the primary driver of the higher premiums. Lower premiums in our workers' comp business partially offset this growth.

Renewal pricing for this group was up 8% during the first quarter. Excluding our workers' comp businesses, renewal rates in this group were very strong and up nearly 17.5%. Renewal rates in our Specialty Casualty Group overall and renewal rates adjusted to exclude the impact of workers' comp are the highest that we've seen in more than 5 years.

Specialty Financial Group reported an underwriting profit of $17 million in the first quarter of 2020, compared to $13 million in the first quarter of 2019. Higher year-over-year underwriting profitability in our financial institutions business was partially offset by lower underwriting profitability in our fidelity and crime operations. Nearly all businesses in this group continued to achieve excellent underwriting margins.

First quarter 2020 gross written premiums were down 1% and net written premiums were up 3%, respectively, when compared to the prior year period. And renewal pricing in this group was approximately up 5% for the quarter. We're very excited that the Surety & Fidelity Association published their 2019 industry rankings last week, placing Great American as the third largest writer of crime insurance in America. Congratulations to our Fidelity and Crime team for attaining this market leadership.

Now if you would, please turn to Slide 8 for a summary view of our 2020 outlook for the Specialty Property and Casualty operations. In light of the challenges and uncertainties presented by the COVID-19 pandemic, we've conducted a detailed review of our expectations and other key financial and operating items for each of our Specialty Property and Casualty businesses.

Based on the current expectations of the impact of COVID-19 and our results through the first 3 months of 2020, we now expect Property and Casualty pretax core operating earnings, excluding the impact of investments marked-to-market through core operating earnings, in the range of $630 million to $690 million. And we continue to expect an overall 2020 combined ratio for the Specialty Property and Casualty Group overall between 92% and 94%.

We do expect COVID-19 to have an adverse impact on property and casualty premiums, as the exposure bases that affect our Property and Casualty businesses will change as overall economic activity declines. Net written premiums are now expected to be 14% to 8% lower than the $5.3 billion reported in 2019, primarily due to the runoff of Neon. Excluding the impact of Neon, we expect net written premiums to be a range that is 7% to 1% lower than results reported in 2019. And then if you exclude Neon and workers' comp, our guidance is in the range of down 4% to up 2%.

Looking at each segment, we continue to estimate a combined ratio in the range of 92% to 96% in our Property and Transportation Group. Net written premiums for 2020 are now estimated to be 5% lower to 1% higher than 2019. And this guidance reflects the impact of return of premium in many of our transportation businesses as insured units were taken out of service in response to state and local stay-at-home orders and the closing of businesses. We continue to expect our Specialty Casualty Group to produce a combined ratio in the range of 90% to 94% in 2020. Our guidance assumes continued strong renewal pricing in our E&S, excess liability and several of our longer-tail liability business.

Neon accounted for $401 million in net written premiums in 2019. As a result of this business being placed into runoff, we expect net written premiums in the Specialty Casualty Group to be down 23% to 17% in 2020. Excluding the impact of Neon -- the Neon runoff, we expect premiums in this group to be 8% to 2% lower than our prior year results. And when you exclude Neon and workers' comp, we expect premiums to be in a range of down 3% to up 3%.

Our guidance for this group includes the expectation that net written premiums in our workers' compensation businesses will be down in 2020 as a result of mid-term premium and other adjustments resulting from lower payrolls in our workers' comp businesses and the impact of lower rates, as well as return of premium provisions for other businesses that were forced to shut down during the pandemic.

Specialty Financial Group combined ratio is now expected to be in the range of 87% to 91%, up slightly from our initial range of 86% to 90%. We now expect net written premiums to be 12% to 6% lower than 2019 premiums. Our guidance for this group includes the expected impact of various state regulations regarding moratoria on policy cancellations and placement of forced coverage in our financial institutions business.

Given the uncertainties of the implications of COVID-19 and the resulting volatility in the financial markets, we're not providing guidance for P&C net investment income. Our previous guidance assumed an annualized return of 10% on investments marked-to-market through core earnings, approximating the return earned in 2019. Based on the results through the end of April, we expect overall Property and Casualty renewal pricing in 2020 to be up 5% to 8%, an improvement from the range of 3% to 5% estimated previously. And excluding workers' comp, we expect renewal rate increases to be in the range of 8% to 11%, an increase from the range of 5% to 7% estimated previously.

I'll now turn the discussion over to Craig to review the results in our Annuity Segment and AFG's investment performance. Thank you.

Stephen Craig Lindner - *American Financial Group, Inc. - Co-President, Co-CEO & Director*

Thank you, Carl. In addition to your introductory comments expressing our gratitude for those on the front lines caring for others, I would like to thank our employees who continue to amaze us with their dedication and creativity. I'd also like to thank our distribution partners. Various state and local responses to the pandemic have created challenges for them as they have traditionally placed a priority on face-to-face interaction with clients for sales and account servicing.

While sales have decreased as a result of stay-at-home orders and other restrictions, our annuity distribution partners are developing new ways to interact with their clients to best serve them and to help them achieve their goals to plan for secure financial futures in retirement. To that end, we are supporting their e-commerce initiatives, offering new products and adding new features to existing products. These new features and products are designed to offer agents and consumers additional options to choose from in a volatile stock market environment while still earning appropriate returns for American Financial Group.

We have made adjustments to annuity credited rates to ensure that we achieve appropriate returns on new business, and we are very pleased with the industry's current discipline in pricing. We have recently taken actions on renewal rates on in-force business near or after the end of the surrender charge period, which will have a positive impact on our core operating earnings. We are also acting on opportunities in our investment portfolio.

I'll start with a review of our annuity results for the first quarter beginning on Slide 9. Statutory annuity premiums were $1.2 billion in the first quarter of 2020, compared to $1.4 billion in the first quarter of 2019, a decrease of 13%. However, sales in the first quarter of 2020 represent a 6% increase over sales in the fourth quarter of 2019 and reflect a sequential increase in all of the Annuity Segment's major channels.

Turning to Slide 10, you'll see the components of pretax annuity core operating earnings. First quarter 2020 pretax annuity core operating earnings before certain items increased 5%. We believe this increase demonstrates the strong fundamentals of our annuity business. Earnings from investments marked-to-markets through core operating earnings vary from quarter to quarter based on the reported results of the underlying investments. As discussed earlier, the COVID-19 pandemic has had widespread financial and economic impacts, including a significant decrease in both equity and credit markets, which impacted returns during the first quarter of 2020 on the Annuity Segment's $1.3 billion of marked-to-market investments. Although the Annuity Segment's return on these marked-to-market investments was slightly negative in the first quarter of 2020, the cumulative return on these investments over the past 5 calendar years was approximately 10%.

Turning to Slide 11, you'll see that our quarterly average annuity investments and reserves both grew approximately 8% year-over-year.

Please turn to Slide 12 for a summary of the 2020 outlook for the Annuity Segment. While AFG continues to expect an attractive return on its marked-to-market investments over the long term, due to ongoing volatility and uncertainty, it is difficult to forecast the marked-to-market returns for the Annuity Segment in 2020. Pretax annuity core operating earnings, excluding the impact of marked-to-market investments, are expected to be in the range of $280 million to $310 million. By comparison, annuity core operating earnings, excluding marked-to-market [investments] (added by the company after the call), were $298 million in 2019.

Our guidance reflects the impact of lower interest rates, in particular, the impact of lower short-term rates, which will have a negative impact on the Annuity Segment's approximately $4 billion net investment in cash and floating rate securities. This guidance also reflects recent opportunistic purchases of fixed income securities, which have a positive impact on core operating earnings.

While COVID-19 had a limited impact on premiums during the first quarter, the pandemic is expected to have a much bigger impact on sales in the second quarter, and possibly beyond. Subject to much uncertainty, our current best estimate is that 2020 Annuity sales will be between $3.3 billion and $4 billion and result in 5% to 7% growth in average investments and reserves in 2020.

Furthermore, in addition to our strong capital position and our strong underlying fundamentals, we have the ability to lower the crediting rate on $31 billion of annuity reserves by an average of 118 basis points. And as a result of prudent pricing, AFG has sold fewer annuities with guaranteed living benefits than many of its peers. At March 31, 2020, less than 13% of AFG's annuity reserves contained these guarantees.

Please turn to Slide 13 for a few highlights regarding our $53.2 billion investment portfolio. AFG entered the crisis precipitated by the COVID-19 pandemic with a record level of consolidated cash and cash equivalents totaling nearly $3 billion at the end of February 2020. This record amount of cash allowed us to take advantage of investment opportunities that arose during the month of March and continue through today. In addition, coming into the crisis, AFG's non-investment-grade corporate bond exposure was near the lowest in our company's history. At March 31, 2020, our NAIC 3 through NAIC 6 corporate bond exposure was $1.2 billion at market and represented only 2.2% of AFG's consolidated total investments. We believe this is substantially less than our peers when expressed as a percentage of total investments. Importantly, our non-investment grade corporate bond exposure is well-diversified across industries and is focused on the higher quality end of the non-investment grade universe with approximately 81% rated NAIC 3.

Turning to our [total] (added by the company after the call) fixed maturity portfolio as shown on Slide 14. Our portfolio continues to be high quality with 91% rated investment-grade and 97% with an NAIC designation of 1 or 2, its highest two categories. We have added a few appendix pages to our investor supplement this quarter that we thought would be helpful resources. Specifically, we added more details about our fixed maturity portfolio, including NAIC ratings and detail on our industry exposures within our corporate bond portfolio.

We have also provided more detailed information about our asset-backed [securities] (added by the company after the call) portfolio by collateral type. You'll see here that nearly 100% of our asset-backed securities portfolio was rated NAIC 1 or 2 at March 31, 2020. We believe these additional exhibits highlight the high quality of our fixed income portfolio.

Principally, as a result of the downturn in the equity markets during the first quarter, AFG reported first quarter 2020 net realized losses on securities of $435 million after-tax and after deferred acquisition costs. This compares to net realized gains on securities of $145 million in the first quarter of 2019. Approximately 200 -- I'm sorry, approximately $423 million of the realized losses recorded in the first quarter of 2020 pertain to equity securities that AFG continued to hold at March 31, 2020. Primarily as a result of improvement in equity markets, AFG recognized net realized gains on securities of approximately $100 million after-tax and after DAC during the month of April.

As of March 31, 2020, net unrealized gains on fixed maturities were $16 million, after-tax and after DAC, a decrease of $846 million since year-end. Given the recovery in asset values during the month of April, net unrealized gains on our fixed maturity portfolio were nearly $400 million after-tax and after DAC at April 30, 2020.

I will now turn the discussion over to Jeff, who will wrap up our comments with an overview of our consolidated first quarter 2020 results and share a few comments about capital and liquidity.

Joseph E. Consolino - *American Financial Group, Inc. - Executive VP, CFO & Director*

Thank you, Craig. Slide 15 summarizes AFG's first quarter consolidated core operating earnings. AFG reported core EPS of $1.88 in Q1 2020. Core net operating earnings in the quarter were $171 million. The year-over-year decrease in core earnings in the 2020 first quarter was primarily the result of negative adjustments to our $2.2 billion of investments that are marked-to-market through core operating earnings. We had given you an early indication of this in our April 15 pre-announcement, where we reported that the company now believes the return on marked-to-market investments in 2020 will be significantly lower than its previous expectations.

AFG's limited partnerships and similar investments are accounted for using the equity method and reported on a one-quarter lag. The second quarter returns for these investments are going to reflect March 31, 2020, valuations provided by third-party sources and will incorporate the downturn in financial markets during the first quarter.

Our first quarter 2020 results include approximately $10 million in claims reserves and IBNR designated for estimated COVID-19-related losses. Different companies have taken different approaches to categorizing COVID-19-related items in their financial reporting. In terms of the geography of where we are recording the impact of COVID-19, we are not currently recording COVID-19 in cat losses and we will not exclude COVID-19 impacts from core operating earnings.

Excluding the impact of marked-to-market investments, AFG's first quarter 2020 core net operating earnings increased $21 million or $0.23 per share year-over-year. Interest and other corporate expenses were $6 million [lower] (added by the company after the call) year-over-year. Our parent company interest expense increased by $1 million from Q1 2019.

On April 2, 2020, AFG issued $300 million of 5.25% senior notes due in April 2030, issued to increase liquidity and provide flexibility at the parent holding company level. The net proceeds of the offering will be held for general corporate purposes.

Other expenses were $7 million lower year-over-year, primarily as a result of lower expenses associated with employee benefit plans that are tied to the stock market.

Slide 16 reconciles core net operating earnings to net earnings. In the first quarter of 2020, AFG recognized $435 million or $4.81 per share in net after-tax realized losses on securities as a result of the downturn in the financial markets in 2020's first quarter. Annuity non-core items decreased net earnings attributable to shareholders by $30 million or $0.34 per share. Expenses related to the runoff of Neon were $7 million or $0.07 per share.

On Slide 17, you will find a summary of AFG's financial position at March 31, 2020. AFG's balance sheet remains strong, and we maintain solid levels of capital in our insurance businesses to meet our commitments to the ratings agencies. Our liquidity and capital resources provide us with the flexibility to respond to the challenges and uncertainties presented by COVID-19.

In the ordinary course of our business, we examine and model a number of stress scenarios for our company. This is part of our Enterprise Risk Management function and for other regulatory purposes. We have a high level of engagement from our senior management, including our co-CEOs, in this scenario testing. Our teams have created various scenarios to estimate the impact on AFG's excess capital and liquidity. In an extreme stress scenario, we have sufficient capital resources and liquidity to manage through this economic uncertainty without our capital dropping below the levels we have committed to rating agencies in order to maintain our current high ratings levels.

AFG's adjusted book value per share was $55.52 as of March 31, 2020. We returned $40 million to our shareholders in the first quarter with the payment of our regular quarterly dividend. We repurchased $61 million of AFG common stock during the quarter at an average price per share of $74.28. Share repurchases, especially when executed at attractive valuations, are an important and effective component of our capital management strategy.

Parent cash was $190 million at the end of the first quarter. After our April issuance of $300 million principal amount of 10-year, 5.25% senior notes due in 2030, AFG parent effectively held cash of $485 million at the outset of the second quarter. In addition, we maintain an undrawn $500 million credit facility.

Our excess capital stood at approximately $610 million at March 31, 2020. We define excess capital as the sum of parent company cash, excess capital within our insurance subsidiaries and borrowing capacity up to a 22% debt, excluding hybrid subordinated debt to total adjusted capital ratio. Our management team reviews all opportunities for the deployment of capital on a regular basis.

Wrapping up, Page 18 shows a single page presentation of our updated 2020 core earnings guidance. AFG's 2020 core net operating earnings guidance, excluding the impact of investments marked-to-market through core operating earnings, is in the range of $6.45 to $7.25 per share. This is identical to the guidance shared in our April 15, 2020, pre-announcement.

If I may comment on guidance in general, AFG is an objective-driven company. We establish clear objectives in our business for our performance expectations, including our self-expectations for core operating earnings per share. In my opinion, we go farther than most in providing transparency through our guidance in respect of our core EPS expectations and many other key financial and operating items such as premium growth, business profit margins and investment income.

The impact of COVID-19 on companies is evolving rapidly, and its future effects are uncertain. We have seen many companies pare back or withdraw entirely whatever guidance they may have been providing. Our choice is not to go that route, but instead share with you to the best of our current ability, after a rigorous internal process, where we stand on these key financial and operating metrics.

Among the various voices looking for insight into current financial and operating status as well as future operational and financial planning, the SEC has encouraged companies that respond with forward-looking disclosures and would not expect good faith attempts to provide appropriately framed forward-looking information to be second-guessed. So I hope those of you listening to this call appreciate our communication of our current expectations in accordance with our consistent regular practice and appreciate the circumstances under which the guidance was prepared.

Our guidance assumes an effective tax rate of approximately 20% on core pretax operating earnings. AFG's expected 2020 core operating results exclude non-core items such as realized gains and losses, annuity non-core earnings and losses and other significant items that may not be indicative of ongoing operations.

We're now prepared to open the lines for any questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of Greg Peters with Raymond James.

Charles Gregory Peters - *Raymond James & Associates, Inc., Research Division - Equity Analyst*

Good afternoon. I want to, first of all, acknowledge that indeed, you guys are providing a lot of color and guidance around expectations, which is a standout relative to so many of the other companies we follow. And it's appreciated. There's a lot to unpack in your comments. And I thought for the purposes, first, to Carl, can you give us a sense of which lines in your property and casualty business where you're more concerned about potential headwinds from the COVID-19 crisis and evolving disaster in the economy. That would be the first question.

Carl Henry Lindner - *American Financial Group, Inc. - Co-President, Co-CEO & Director*

Yes, Greg, first of all, we're very happy with our operating margins right now, particularly proud of the 92-or-so percent combined ratio and with us continuing with guidance out there with 92% to 94%, particularly in an arena where there are a lot of crashes right now with other companies' results. So I think probably my bottom line perspective is reflected in our guidance of 92% to 94% combined ratio, which really, as Jeff mentioned, we kind of have gone through painstakingly business-by-business and really kind of included a range of what we thought potential loss with the facts that we have today are in our projected profitability.

I mentioned workers' compensation, the premiums. I think probably the biggest premium impact, when we take a look at things, probably is in the area of workers' compensation or passenger transportation and commercial auto, when you look at the percentage changes in that, probably our financial institutions business, as I mentioned, because of the moratoria on canceling or -- mortgage loans or putting a moratoria on allowing more time for mortgage payments, that type of thing. So the premium impacts are probably larger in some of the lines like that.

That said, when you reflect on our premium guidance, it impacts each of our different businesses and each of our segments. So -- I mean, overall, the biggest impact has been on the asset or the balance sheet side of things on our equity portfolio and some of our marked-to-market investments in that.

So I think I said what -- our perspective, the majority or the vast majority of our property policies have pandemic virus exclusions and that. And workers' comp, where I think I mentioned percentages on -- in workers' comp, less than one half of one percent of our business is first responders and less than -- around 6.5% if you include healthcare workers, first responders and nursing homes combined, as far as impact to our workers' comp business and particularly changed presumptions in a number of states that relate to that part of our business. So I mean, those are probably the -- right now, the areas of our business that -- where maybe the impact is the greatest.

Charles Gregory Peters - *Raymond James & Associates, Inc., Research Division - Equity Analyst*

Thank you for that answer. I'd like to pivot to Craig. And I was looking at Slide 11 of your investor slide deck where you disclose the net interest spread and the core operating net spread. And I was trying to reconcile the comments and the realities of, I guess, the marked-to-market, some of the marked-to-market adjustments coming back through April. And I guess, what I'm looking for is just some ideas on how you think that spread, either the net interest spread or the core operating spread, is going to move around through the balance of the year considering the volatility of the marketplace?

Stephen Craig Lindner - *American Financial Group, Inc. - Co-President, Co-CEO & Director*

Sure. And Greg, when I referred to recovery of asset values on marked-to-market, I was specifically speaking of common stock investments that we manage. And to a larger extent, I was speaking to the fixed income securities in our portfolio. I was not addressing the marked-to-market, which is -- which you see on this line on the spread line, the investments marked-to-market. Those are typically private equity, a lot of things that are managed by others that are marked-to-market and flow through the investment income as opposed to the realized gain line. So we have not gotten many marks on -- 86% of our marked-to-market investments that flow through investment income are reported on a one-quarter lag, and we have gotten very few marks on first quarter valuations. So it's impossible for me to give you guidance on that.

I think given that the stock market was down by 20% in the first quarter, I would -- my expectation would be a negative number on marked-to-market that we report on this segment that actually flows through investment income. But I really can't give you an accurate projection of that given that we have very few marks. There are certain parts of the portfolio that are -- of that portfolio that are holding up very well. We have a significant investment in multifamily, as an example. That's one of the bigger segments of investments in that category and that has held up very well. The collections last month were in excess of 97%. And right now, this month, we're trending at a similar type level. So those valuations -- the returns on those investments are holding up very well. Hard for me to predict what the value on more traditional private equity investments will look like because we've -- we just haven't gotten any result -- we've got very few results at this point in time.

Certainly, with the lower interest rates impacting our cash and floating rate securities, I mean, that's going to have a negative impact. Marked-to-market for the year isn't going to -- in my opinion, is not going to hit our kind of historical 10% type level. So that will impact the spreads for the year. At least partially mitigating that is our ability to make reductions in the credited rates on the in-force.

As we've talked before, Greg, we have a model in our annuity business that's quite a bit different than many others. We have a very low cost of putting business on the books. And so we've been able to achieve our targeted rates of return without significant changes in renewal rates on the in-force. Now because of that, we have 118 basis points of difference between the current credited rate and the GMIRs. I'm not aware of another company that has a spread that's as wide as that. We are now, in this low interest rate environment, taking more aggressive action on adjusting the credited rates on in-force and the decisions that we've made already that we're implementing -- we will be implementing it over the next 12-month period of time at the anniversary of the FIAs. It will have a positive impact, we're estimating, of around 16 basis points to the cost of funds, if all that business stays on the books. It won't. We'll have some surrenders, but really a very meaningful impact on the cost of funds. We are going to continue to take action on in-force to over time manage to appropriate rates of return on our annuity block.

Another factor that I think really differentiates us from many others in the annuity business is we have a very low percent of our reserves that have lifetime income riders. It's only 13% of our reserves that have lifetime income riders. I think -- in the early stages or up until very recently, I think that the market really mispriced those riders. We had much more disciplined pricing. And therefore, the percentage of business sold with riders is extremely low for us. And the big significance of that is -- when you're in a low interest rate environment is when we lower credited rates on the in-force, it is a true benefit on all the business that doesn't have riders. By the way, in our 118 basis point number on $31 billion of reserves, we exclude the proportion of reserves that has riders. If business has a rider, if reserves have riders and the policyholders end up exercising those riders, which I think a big percent will, it really doesn't do any good. There's no benefit in reducing the credited rate if they exercise those lifetime income riders. So I really like our position. I really like our ability to adjust rates and have a very meaningful impact on the returns over time on our in-force.

Charles Gregory Peters - *Raymond James & Associates, Inc., Research Division - Equity Analyst*

That's excellent color, Craig. I appreciate. I have a follow-up question on that. I'm trying to reconcile your annuity operations with some of the other publicly traded peers. And on Page 14 of your supplement, it looks like the cost of funds is running higher. I see this 252 mark. And I'm just wondering if you're putting your hedging and other factors into other liability costs. I'm wondering why it's running a little bit higher.

Stephen Craig Lindner - *American Financial Group, Inc. - Co-President, Co-CEO & Director*

It's running a little bit higher because we have not made any significant changes to the in-force. You're going to see that change going forward as we are more aggressive, Greg, in adjusting the credited rates on business that has been on the books for 5 years or more.

Charles Gregory Peters - *Raymond James & Associates, Inc., Research Division - Equity Analyst*

Got it. That makes sense. Okay thank you for that answer. And just the final question. And again, I realize you've provided a lot of comments on the call. I really appreciate the detail in the supplement regarding the additional detail around the investment portfolio. I was wondering, just for the purpose of this call, if you could highlight some of the areas in the investment portfolio, as we're sitting here in early May, where you continue to see some elevated risk due to market volatility. And you've already addressed the private equity stuff, which is reported on a quarter lag. So maybe you could talk about your sector exposures to energy or retail or something like that? Any additional color there would be helpful.

Stephen Craig Lindner - *American Financial Group, Inc. - Co-President, Co-CEO & Director*

Happy to do that. As you know, we did give some detail on that in the supplement. We tried to expand detail to help you analyze that. But let's talk energy, since you mentioned that specifically. AFG's fixed income energy exposure is $1.5 billion, which is approximately 3% of investments. 89% of the total exposure is investment-grade rated, NAIC 1 or 2. And 92% of the high-yield exposure is rated BB or NAIC 3. 70% -- 72% of our exposure is in the more stable midstream subsector and well-capitalized integrated subsector. The AFG portfolio is modestly underweight energy compared to the bond indices, but that clearly is an area that we're keeping an eye on today with energy prices being as volatile as they are.

Charles Gregory Peters - *Raymond James & Associates, Inc., Research Division - Equity Analyst*

Are there any other areas of the portfolio you'd like to call out? I called out, I guess, energy, but is there anything -- as I look across the cross section, is there any other area that you want to highlight as an area that you're watching closely?

Stephen Craig Lindner - *American Financial Group, Inc. - Co-President, Co-CEO & Director*

Well, certainly.

Charles Gregory Peters - *Raymond James & Associates, Inc., Research Division - Equity Analyst*

And certainly, I understand you're watching all areas closely. So I don't want to --

Stephen Craig Lindner - *American Financial Group, Inc. - Co-President, Co-CEO & Director*

Yes. Greg, certainly, aviation is something that we're keeping an eye on. We are, we think, pretty well positioned there, given the collateral that we have and the very senior ranking and tranches that we've invested in, but we're certainly keeping an eye on aviation exposures. Our exposure today is $615 million, about 1% of total investments, consisting of $298 million of corporate bonds and $317 million of aircraft asset-backed securities.

Looking at the corporate bond piece, 94% are investment-grade, primarily with North American carriers and approximately 60% are comprised of senior securities that are collateralized by aircraft. Then when you take a look at the asset-backed securities, 98% are in the senior-most position with 97% rated NAIC 1. So we feel pretty good about our positioning there, but we certainly are keeping an eye on that group of investments.

Charles Gregory Peters - *Raymond James & Associates, Inc., Research Division - Equity Analyst*

I've taken up enough time. Thank you for your answers.

Stephen Craig Lindner - *American Financial Group, Inc. - Co-President, Co-CEO & Director*

Sure.

Operator

Our next question comes from the line of Paul Newsome with Piper Sandler.

Jon Paul Newsome - *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*

Just a couple of questions. One is that when we're looking at your guidance for net written premium, how should we think if there's going to be any difference in how that translates into earned premium, given that this is really a function of probably premium audits and stuff. Does that -- does those decreases essentially hit the earned premium faster than it would ordinarily do? And if it wasn't because of the audits?

Joseph E. Consolino - *American Financial Group, Inc. - Executive VP, CFO & Director*

Paul, this is Jeff. I guess, as a first matter, we've heard of some companies, when there is reduced premium or premium givebacks, booking that as loss expense rather than lower premium. I just want to confirm that our approach is going to be to record this in premium income. We would expect that it's possible the exposure base will go down. And as a result, premiums written and premiums earned will come down. And what we're looking at in our guidance is consistent with that. So we'll have to see how it plays out quarter-by-quarter.

Jon Paul Newsome - *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*

Great. On the annuity side of the house, I would imagine that we're going to have another rewrite of what happened with the performance for the indexed products after the financial crisis, which were relatively very, very good. Do you recall how quickly those sales came back because of the better performance after the financial crisis? And why would this be, in your opinion, any different or the same as it was back then from a sales perspective?

Stephen Craig Lindner - *American Financial Group, Inc. - Co-President, Co-CEO & Director*

Yes. Paul, this is Craig. There are a lot of similarities to the 2008, 2009 period and what we're seeing today. I think when the distribution partners are able to kind of get back into action and kind of resume meetings with customers and so forth, my own opinion is there's a real pent-up demand. Now it is going to require the ability to have some face-to-face meetings. Even though they are really changing their sales methods, it really is evolving, and they're using technology and Zoom and FaceTime and so forth, in a lot greater way than they did before. But I think that there is tremendous pent-up demand. I think the indexed annuity product is an excellent product. I think the volatility of the stock market, frankly, is going to cause people who are in retirement or close to retirement to really appreciate the fact that in a given year, you can't go below 0 on an indexed annuity. I think they're going to be very willing to give up some of the upside of the stock market to have kind of no downside below 0 in a given year.

I also think that we're going to see the same thing that we saw in 2008, 2009. I think that there are some companies that are going to be very much capital constrained as a result of this environment. We've already seen some companies withdrawal a number of products or drop credited reach to a level where they're basically sending a message, they're not interested in writing new business. I think it's going to create tremendous opportunities for companies that are well capitalized and able to write business. Frankly, the opportunities on the investment side are the best that we've seen since that 2008 through 2010 period.

And as I look back over a long history of our Annuity business, those types of environments are the times when we really thrive and create the most value. So I can't tell you which quarter is going to be the quarter when things open up again and our distribution partners are unleashed and go do their thing. But I think the strong companies with strong, good business models and excess capital are going to -- I think they're going to create a lot of value in this environment.

Jon Paul Newsome - *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*

Great. Now going to the property casualty side of the house. My personal opinion is hard markets are driven -- the real hard markets are driven by a change in the perception of risk, which translates into underwriters doing something different than they did before. Is there something yet that's emerged in your book on how you're doing business where you're changing the way you're actually doing the underwriting, either not willing to write something or need to change terms and conditions or simply calculating the risk differently? Is there anything that's changed yet in there? And that's it for me. Thanks.

Carl Henry Lindner - *American Financial Group, Inc. - Co-President, Co-CEO & Director*

Well, I guess when you take a look at the change in pricing -- our pricing trend or result from the fourth quarter to the first quarter and then in our pricing guidance, I'd say that's pretty substantial change in pricing. And there's substantial changes in terms also that are kind of going along side-by-side with those pricing trends and that, which would be different business by business and that. Obviously, businesses that have the greatest exposure to COVID, every company is changing their new business outlook or guidelines and that to businesses that are exposed to a live virus and that in any fashion. So clearly, that's a driver. But you almost need to go business by business. And yes, I believe between pricing and term changes, there's quite a bit of significant change that's going on in lots of our businesses.

Joseph E. Consolino - *American Financial Group, Inc. - Executive VP, CFO & Director*

Paul, this is Jeff. I just wanted to add on to what Carl said. When you talk about a hard market requiring people to do something differently, we're different than a lot of companies in terms of the continuity we have from the leaders in our various business units. A lot of these people are veterans of multiple market cycles in their particular market niche, whereas with a lot of companies, you don't have people in the underwriting seats that have any experience in how to write into a hard market. The places where we're seeing the most outstanding rate opportunities and the biggest rate change, our leadership there knows what they can push for and know how to navigate the asking for rate increases and changing the terms and conditions. So I think that we know the playbook, and we've got not only the right people in place with the right experience, but the right incentives for them to take the most out of what the market is giving them.

Carl Henry Lindner - *American Financial Group, Inc. - Co-President, Co-CEO & Director*

I think COVID-19 just adds to, I think, a tightening momentum that already existed. COVID-19 can only increase that from my perspective.

Jon Paul Newsome - *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*

Thanks so much.

Operator

And our next question comes from the line of Larry Greenberg with Janney.

Lawrence David Greenberg - *Janney Montgomery Scott LLC, Research Division - MD of Insurance*

Good afternoon, and thank you. So I'm wondering if you could just elaborate a bit more on the workers' comp environment. And you talked about having received some COVID-related claims, but also seeing fewer, what I would call, traditional claims in comp. And I'm just wondering if some of these proposals to implement the presumptions were to come to fruition, whether that would change your thinking about the outlook for your workers' comp business? Or do you think that the quite low percentage of business that's in healthcare and first responders would really kind of mitigate any potential adverse impact from that?

Carl Henry Lindner - *American Financial Group, Inc. - Co-President, Co-CEO & Director*

I'm still very positive about our workers' comp business. It performed well in the first quarter. And I think our perspective workers' comp business was about 18% of our overall gross written premium last year. '19, we had very good results. For the whole year, clearly, probably expect underwriting margins to be lower. But I think even with COVID-19, I think we still have the opportunity to make a small accident year underwriting profit on our overall workers' comp business and a solid calendar year underwriting profit.

Now -- that assumes that every state doesn't open up, create a presumption of workers' comp coverage for COVID for all business or something. I mean, I don't think that's likely to happen, but that's assuming there isn't some dramatic change there. Probably expect net written premiums to be down about 12% for 2020 because of lower rates, lower payrolls, mid-term adjustments from the COVID-19 impact. Pricing is going to be down mid-single digits, although I think the COVID-19 industry claims clearly could help reverse the downward trend on workers' comp rates potentially going forward.

We feel our reserve position is strong. When we look at our current loss trends in that, our loss ratio trend overall is pretty flat. I think we'll know better in the second quarter and third quarter what -- maybe be better able to answer your question as we kind of experience the second quarter and the third quarter results in that. But I'm still optimistic about our workers' comp business.

California, this -- California, I think, is Republic, I think 15% of our workers' comp business. We have a modest underwriting loss that we're projecting in California right now. So what happens in California around COVID, and they've gone to a broader presumption there. So things like somebody has to use sick leave before a worker is paid any workers' comp and they still must test positive or being diagnosed, for instance, as a positive by a physician within 14 days of the last day worked outside of home. So I'm not -- I think that even could be -- may not be -- it's very difficult right now, say, in California to really gauge the impact of that. But certainly, if we're already projecting a modest underwriting loss on an accident year and a calendar year basis for California workers' comp, COVID-19 losses aren't going to help there. I hope that's helpful.

Lawrence David Greenberg - *Janney Montgomery Scott LLC, Research Division - MD of Insurance*

It is. Thank you. And then in the first quarter, you did have a loss in your marked-to-market for your CLO portfolio. And I imagine that's all recorded on an as quarter basis. Can you give us an indication perhaps on how that portfolio performed in April?

Stephen Craig Lindner - *American Financial Group, Inc. - Co-President, Co-CEO & Director*

I do not have updated numbers for April, Larry. I mean, the underlying loans would have performed better. I mean, you certainly had spread narrowing. Having said that, I don't know that there are a lot of buyers for CLO equity or the most subordinated tranches right now. So my expectation isn't that you're going to see a big turn there anytime soon on the CLOs just kind of given the lack of buyers today in that asset class. There's been a fairly meaningful tightening in the higher-rated tranches, which is where we have by far the largest investment. We -- you can see the detail of the ratings on our CLO securities, and there's been a fairly significant tightening of spreads on the higher-rated portions, which is where we have the vast majority of our investments.

Joseph E. Consolino - *American Financial Group, Inc. - Executive VP, CFO & Director*

Larry, we did start by saying on April 15 and on the call that we wanted to get away from providing guidance with respect to investments marked-to-market through the income statement. So I hope you appreciate this as a sign of how much we enjoy our dialogue with you that we're speculating about that.

Lawrence David Greenberg - *Janney Montgomery Scott LLC, Research Division - MD of Insurance*

I absolutely appreciate that, Jeff. Thank you.

Operator

Thank you. I will now turn the call back over to Diane Weidner for closing remarks.

Diane P. Weidner - *American Financial Group, Inc. - Assistant VP of IR*

Thank you, everyone, for your time and attention this morning as we've shared our first quarter 2020 results, and we look forward to talking with you again next quarter.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating, and you may now disconnect.
