American Equity Investment Life Holding Company
2Q17 Conference Call

Julie LaFollette, Director – Investor Relations

Good morning, and welcome to American Equity Investment Life Holding Company's conference call to discuss second quarter 2017 earnings. Our earnings release and financial supplement can be found on our website at www.american-equity.com. Non-GAAP financial measures discussed on today's call and reconciliations of non-GAAP financial measures to the most comparable GAAP measures can be found in those documents.

Presenting on today's call are: John Matovina, Chief Executive Officer; Ted Johnson, Chief Financial Officer; and Ron Grensteiner, President of American Equity Investment Life Insurance Company. Some of the comments made during this call may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act.

There are number of risks and uncertainties that could cause actual results to differ materially from those expressed or implied. Factors that could cause the actual results to differ materially are discussed in detail in our most recent filings with the SEC. An audio replay will be made available on our website shortly after today's call. It is now my pleasure to introduce John Matovina.

John Matovina, CEO

Thank you, Julie. Good morning everyone, and thank you for joining us.

We followed solid first quarter earnings with stronger results in the second quarter of 2017, reporting non-GAAP operating earnings of $63.7 million or $0.71 per share. On a dollar basis, this was the second highest quarter of operating earnings in the company's history, and it was the third highest on a per share basis. The only prior quarters that had better operating earnings on a per share basis were quarters in which there was a substantial positive impact from unlocking of assumptions for deferred policy acquisition costs and deferred sales inducements.

As a reminder, the three key areas that drive our financial performance are:

- growing invested assets and policyholder funds under management;
- generating a high level of operating earnings on the growing asset base through investment spread; and
- minimizing impairment losses in our portfolio.

For the second quarter of 2017:

- we delivered 2.0% growth in policyholder funds under management;
- on a trailing twelve month basis, generated an 11.6% non-GAAP operating return on average equity excluding the impact of assumption revisions in the third quarter of 2016; and

- our investment impairment losses - after the effects of DAC and income taxes - were just 0.02% of average equity.

The growth in our policyholder funds under management was driven by $1.2 billion in gross sales, down substantially from record sales of $2.1 billion in the second quarter of 2016, but up 9% from first quarter 2017 sales of $1.1 billion. The June 9th applicability date for the Department of Labor Fiduciary Rule came and went without much fanfare. Changes to agent sales practices required by Prohibited Transaction Exemption 84-24, including disclosure of commissions and adherence to the Impartial Conduct Standards, proved to be manageable.

The interest rate environment remains our biggest challenge as rates have seesawed since the end of the first quarter. We had a modest increase in our investment spread in the second quarter as we were able to offset the negative impact of investing new premiums and portfolio cash flows at yields below our portfolio rate with reductions in our crediting rates and a slightly larger over hedging benefit.

Our low level of investment impairment losses once again reflects our commitment to a high quality investment portfolio.

I'll be back at the end of the call for some closing remarks, but now I'd like to turn the call over to Ted Johnson for additional comments on second quarter financial results.

Ted Johnson, CFO

Thank you, John. As we reported yesterday afternoon, we had non-GAAP operating income of $63.7 million or $0.71 per share for the second quarter of 2017 compared to non-GAAP operating income of $50.1 million or $0.60 per share for the second quarter of 2016.

Our weighted average diluted share count was 8.3% higher in the second quarter of 2017 compared to the second quarter a year ago primarily due to the settlement of two equity forward sales agreements through the issuance of 5.6 million shares of our common stock in the third quarter of 2016.

Investment spread for the second quarter was 272 basis points – up 1 basis point from the first quarter of 2017 as a result of a 3 basis point decrease in the average yield on invested assets and a 4 basis point decrease in the cost of money.

Average yield on invested assets was 4.45% in the second quarter. The average yield continues to be unfavorably impacted by the investment of new premiums and portfolio cash flows at rates below the portfolio rate. However, investment income and the average yield on invested assets continue to benefit from non-trendable investment income items which added eight basis points to the second quarter average yield on invested assets compared to ten basis points from such items in the first quarter of 2017. Non-trendable investment income in the second quarter of 2017 included seven basis points from fees from bond transactions and prepayment income and one basis point from an acceleration of the rate of paydowns on residential mortgage-backed securities.

The average yield on fixed income securities purchased and commercial mortgage loans funded in the second quarter was 3.96% compared to 4.13% in the first quarter of 2017 and 3.95% in the second quarter of 2016. In July, we invested new money at 4.38%. The higher rate in July reflects an increase in the amount of NAIC 2 rated structured assets purchased during the month.

The aggregate cost of money for annuity liabilities was 173 basis points compared to 177 basis points in the first quarter. This decrease reflects continuing reductions in crediting rates on in-force policies and a lower cost of money on new deposits. The benefit from over hedging the obligations for index linked interest was six basis points in the second quarter of 2017 compared to five basis points in this year's first quarter.

As you're aware, we have been working to counteract the impact of lower investment yields by reducing the rates on our policyholder liabilities. We expect that we will continue to achieve reductions in our cost of money through renewal rate reductions that will be implemented on policy anniversary dates over the remainder of this year. We continue to have flexibility to reduce our crediting rates if necessary and could decrease our cost of money by approximately 46 basis points if we reduce current rates to guaranteed minimums. This is down from 49 basis points at the end of the first quarter.

Interest expense on notes and loan payable for the quarter was $8.7 million, up from $7.7 million in the first quarter. Interest expense increased by $1.1 million due to the issuance of $500 million of 5.000% Notes due in 2027. Repayment of our outstanding term loan during the quarter lowered interest expense by $110,000. However, repayment of the term loan also resulted in a $428,000 loss on extinguishment of debt for the write-off of the term loan's remaining debt issuance costs. Due to the redemption of the $400 million of 6.625% Notes due in 2021 last month, third quarter operating results will include an $18.4 million loss on extinguishment of debt consisting of $13.3 million of redemption premium and the write-off of $5.1 million of debt issuance costs.

Other operating costs and expenses in the first quarter were $26.0 million. On a sequential basis, other operating costs and expenses decreased $1.6 million primarily due to a $1.4 million reduction in the liability for payments expected to be made pursuant to the retirement agreement with our former Executive Chairman.

Our effective income tax rate in the quarter was 34.2%. This rate benefited by 61 basis points for a reduction in our estimated tax rate for 2017 due to a decrease in projected pre-tax income from the non-life subgroup as a result of the previously mentioned $18.4 million of loss on extinguishment of debt that will be recognized in the third quarter. The change in accounting for stock compensation benefited our effective tax rate by 37 basis points in the second quarter compared to 139 basis points in the first quarter of this year.

Our estimated risk-based capital (RBC) ratio at June 30, 2017 is 366%, up from 353% at the end of this year's first quarter. The increase in the RBC ratio included six (6) points from a decline in required capital for production which we estimate using trailing 12 month sales. The increase in our adjusted statutory capital and surplus exceeded the increase in required capital from growth in assets and reserves and accounted for the remainder of the second quarter increase in our RBC ratio.

Now I'll turn the call over to Ron to discuss sales, marketing, and competition.

Ron Grensteiner, President – American Equity Investment Life Insurance Co.

Thank you, Ted. Good morning, everybody.

As we reported yesterday, gross sales for the second quarter of 2017 were $1.2 billion. This is down from record sales of $2.1 billion in the second quarter of 2016 but up 9% compared to sales in this year's first quarter. As a reminder, second quarter 2016 sales benefited from $551 million of non-core multi-year guaranteed annuity sales of which 80% was coinsured.

Net sales for the quarter were $1.1 billion compared to $1.5 billion a year earlier and $1.0 billion in the first quarter of 2017. As was the case in first quarter, nearly all the sales in the second quarter were fixed index annuities. Beginning this year, we are retaining 50% of all Eagle Life fixed index annuity sales, up from 20%, previously.

The market in each of our distribution channels remained competitive in the second quarter, and we continue to suspect that uncertainty regarding the fast changing Department of Labor conflict of interest fiduciary rule may be distracting from marketing activities and playing a role in lower sales.

Also, as we've stated for a few quarters now, we believe low interest rates and the length of the equity bull market are also proving to be headwinds to sales of guaranteed income products. We have seen a shift in emphasis on the part of independent agents from guaranteed income to accumulation products focused on upside potential. In addition, we believe securities licensed agents are placing increased allocations of client funds into the equity markets. This premise was reinforced by recent discussions with our National Marketing Organization partners.

American Equity's Choice and Eagle Life's Select products are competitive for accumulation. Earlier this year, we introduced an optional market value adjustment rider for these products which allowed us to offer more competitive participation rates. However, American Equity is more well-known for guaranteed income, so we intend to make sure independent agents are aware of the attractive accumulation opportunities available with Choice Series products. At Eagle Life, the addition of the market value adjustment rider has proved to be very beneficial and fixed index annuity sales increased 91% sequentially. Nearly 50% of all Eagle Life's fixed index annuity sales in the second quarter were with the market value adjustment.

Last month, we discontinued our no-fee lifetime income benefit rider and lowered the roll-up rate on certain fee riders. These changes allowed us to reduce the target spread for our bonus fixed index annuities by 15 basis points, and also recognize lower valuation interest rates used to compute statutory reserves for policies issued in 2017 compared to policies issued in 2016. The lower valuation interest rates result in higher statutory benefit reserves on all 2017 product sales that included the lifetime income benefit rider. To date, we have seen three other competitors make downward adjustments – but none that compete in our guaranteed income space. As a result, our guaranteed income is currently less than some of our most important competitors.

Turning to current sales trends, pending business at American Equity Life averaged 2,585 applications during the second quarter and was 2,542 at the end of June compared to 2,526 applications when we reported first quarter 2016 earnings. Pending at American Equity Life today is 2,206 applications with the decline occurring post the July 10th changes in our lifetime income benefit rider.

Pending at Eagle Life stands at 134 applications today, down from 167 when we reported first quarter earnings.

We are continuing to build distribution at Eagle Life. In the second quarter, we added 1 new wholesaler, 2 new selling agreements and 274 representatives. In total, we have 7 wholesaling distribution partners, 55 selling agreements and 5,485 representatives.

With that, I'll turn the call back over to John.

John Matovina, CEO

Thank you Ted and Ron.

We view the second quarter of 2017 as a continuation of the first quarter. We were pleased with the sequential increase in sales and the rebound in fixed index annuity sales from Eagle Life's broker-dealers and banks but recognize that new business remained relatively soft compared to historical levels. However, earnings results were solid, particularly in light of continued interest rate and spread pressure, and investment impairment losses were quite low. While low interest rates remain a headwind to our spread management, we continue to have room to lower liability rates, and we will remain proactive in managing our substantial in-force book of business.

Following the Department of Labor's requests for information last month, we are optimistic that it may further delay the fiduciary rule's January 1, 2018 full implementation date and hopeful that regulations unduly burdening distribution of annuities by independent agents will be substantially revised. However, if the rule remains as is and is fully implemented on January 1, 2018, we would expect disruption of fixed index annuity sales. While the eventual outcome of the Department of Labor fiduciary rule remains uncertain, we remain prepared to respond and grow our business. Our long-term outlook remains favorable due to the growing number of Americans who need attractive fixed index annuity products that offer principal protection with guaranteed lifetime income, and the Department of Labor fiduciary rule won't change this.

Our relationships with our distribution partners are strong with several going back more than 20 years. Our sales and operating platforms are widely recognized as the best in the industry. Our employees are extraordinarily dedicated and provide excellent service to our distribution partners and policyholders. On behalf of the American Equity team, thank you for your time and attention this morning. We'll now turn the call back to the operator for questions.