American Equity Investment Life Holding Company
Third Quarter 2017 Earnings Conference Call Script
November 7, 2017

Julie LaFollette

Good morning, and welcome to American Equity Investment Life Holding Company's conference call to discuss third-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

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

Our core third quarter financial results remained strong and continued the solid trends we saw in the first half of the year. Non-GAAP operating income for the quarter was $87.2 million or $0.96 per share. Excluding the impact of the actuarial assumption reviews and the loss on extinguishment of debt, our operating income would have been $63.6 million or $0.70 per share.

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 investment portfolio.

For the third quarter of 2017:

- we delivered 1.5% sequential growth in policyholder funds under management; this translates to a 7.1% increase on a trailing twelve month basis;
- on a trailing twelve month basis, generated a 12.3% non-GAAP operating return on average equity excluding the impact of actuarial assumption reviews and losses on extinguishment of debt; and
- our investment impairment losses - after the effects of DAC and income taxes – were less than 0.01% of average equity.

The growth in our policyholder funds under management for the quarter was driven by $915 million in gross sales. Our product offerings have not been as competitive as they've been in prior periods. However, since late June, we've captured higher new money yields on investments which allowed us to enhance our product offerings and competitive positioning in September and October. You'll hear more about these later from Ron.

We had a modest sequential decrease in our investment spread in the third quarter primarily reflecting a lower benefit from bond transactions and prepayment income. The investment spread did benefit from the higher new money yields on investments.

Our low level of investment impairment losses once again reflects our continuing 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 third quarter financial results.

Ted Johnson

Thank you, John. As we reported yesterday afternoon, we had non-GAAP operating income of $87.2 million or $0.96 per share for the third quarter of 2017 compared to a non-GAAP operating loss of $4.7 million or $0.05 per share for the third quarter of 2016.

We had one discrete item in the third quarter of 2017 – an $18.4 million pretax loss on extinguishment of our 6.625% Notes due in 2021 consisting of $13.3 million of redemption premium and the write-off of $5.1 million of debt issuance costs. The loss on extinguishment of debt reduced both net income and operating income by $10.8 million or $0.12 per share.

Third quarter 2017 operating income included a net benefit of $34.4 million or $0.38 per share from revisions to actuarial assumptions. On a pretax basis, the revisions reduced amortization of deferred policy acquisition costs and deferred sales inducements by $75.0 million and increased the liability for future payments under lifetime income benefit riders by $21.6 million for a net pretax increase in operating income of $53.4 million. Revisions to actuarial assumptions in the third quarter of 2016 increased amortization of deferred policy acquisition costs and deferred sales inducements and the liability for future payments under lifetime income benefit riders by $81.6 million and reduced operating income by $52.6 million or $0.60 per share.

The third quarter unlocking of deferred policy acquisition costs and deferred sales inducement assumptions was primarily driven by higher than modeled account values – which translates to increased projections of expected gross profits in future periods.

The increase in the liability for future payments under lifetime income benefit riders was driven by changes to our account value growth projections. Although interest credits were well above expectations, the benefit from this was more than offset both by decreases in our assumptions for expected lapses as well as changes in our assumptions for future account value growth.

The revisions to our assumptions used to determine the liability for the lifetime income benefit rider under GAAP had no effect on our regulatory reserves as actuarial guidelines for regulatory reserves mandate that reserves for fixed index annuities with lifetime income benefit riders be computed assuming that policyholders act with 100% efficiency and elect payment streams that maximize the value of their policies on a net present value basis.

Investment spread for the third quarter was 270 basis points – down 2 basis point from the second quarter of 2017 as a result of a 2 basis point decrease in the average yield on invested assets.

Average yield on invested assets was 4.43% in the third quarter compared to 4.45% in the second quarter. The decrease in the average yield in the quarter reflected a lower benefit from non-trendable investment income items which added five basis points to the third quarter average yield on invested assets compared to eight basis points from such items in the second quarter of 2017. Non-trendable investment income in the third quarter of 2017 consisted entirely of fees from bond transactions and prepayment income; the contribution from an acceleration of the rate of paydowns on residential mortgage-backed securities was de minimus in the quarter.

The average yield on fixed income securities purchased and commercial mortgage loans funded in the third quarter was 4.39% compared to 3.96% in the second quarter of 2017 and 4.13% in the first quarter of 2017. The higher rate in third quarter reflects an increase in the amount of NAIC 2 rated structured assets purchased. In October, we invested new money at 4.40%.

The aggregate cost of money for annuity liabilities was 173 basis points – flat with the second quarter. The benefit from over hedging the obligations for index linked interest was six basis points in both the third and second quarters of 2017.

We continue to have flexibility to reduce our crediting rates if necessary and could decrease our cost of money by approximately 47 basis points if we reduce current rates to guaranteed minimums. This is up from 46 basis points at the end of the second quarter.

Interest expense on notes payable for the quarter was $7.6 million, down from $8.7 million in the second quarter. Interest expense decreased due to the refinancing of our 6.625% Notes due in 2021 with 5.000% Notes due in 2027. The 6.625% Notes were redeemed on July 17 and we recognized $1.2 million of interest expense for the sixteen days the 6.625% Notes were outstanding during the third quarter.

Other operating costs and expenses in the third quarter were $28.7 million which was a $2.8 million increase on a sequential basis. Half of this amount was related to the reduction in the liability for payments expected to be made pursuant to the retirement agreement with our former Executive Chairman that we recognized in the second quarter. The remainder of the increase primarily reflects higher salaries and increases in incentive compensation accruals.

Our estimated risk-based capital (RBC) ratio at September 30th is 375%, up from 366% at the end of this year's second quarter. The increase in the RBC ratio included four (4) 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 third quarter increase in our RBC ratio.

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

Ron Grensteiner

Thank you, Ted. Good morning, everyone.

As we reported yesterday, gross sales for the third quarter of 2017 were $915 million. This is down from sales of $1.5 billion in the third quarter of 2016 and $1.2 billion in this year's second quarter. Third quarter 2016 sales included $226 million of non-core multi-year guaranteed annuity sales of which 80% was coinsured. Third quarter 2017 had just $16 million of sales from multi-year products.

Net sales for the quarter were $834 million compared to $1.1 billion a year earlier and $1.1 billion in the second quarter of this year. As a reminder, beginning this year, we are retaining 50% of all Eagle Life fixed index annuity sales, up from 20%, previously.

Recent reports from several of our competitors suggest that industry fixed index annuity sales were down on a sequential basis. We believe low interest rates and the continuation of the equity bull market are the biggest headwinds for sales. We are not sure how much, if at all, implementation of the Department of Labor's fiduciary rule on June 9th affected the sequential decline in sales. Conversations surrounding the Rule have been muted, particularly since the announcement of a potential further delay of certain aspects of the rule beyond January 1, 2018.

The market in each of our distribution channels remained competitive in the third quarter although we saw several rate reductions in September, and a significant competitor in the independent agent channel lowered participation rates on its accumulation products and pay out rates on its guaranteed income products in early October. Independent agents continued to shift their emphasis from guaranteed income to accumulation products focused on upside potential. We addressed this shift by placing more emphasis in our marketing efforts on our Choice Series at American Equity Life. The Choice Series accounted for 22% of American Equity Life's sales in the third quarter vs. 17% in the second quarter. In September it accounted for 25% of sales. We made changes to our lifetime income benefit riders in early July to recognize lower valuation interest rates used to compute statutory reserves for policies issued in 2017. We also discontinued our "no fee" version of the rider which was popular with our agents. Many of our competitors did not make similar adjustments which negatively affected our competitive position for guaranteed income which was less than our significant competitors through much of the quarter.

Due to the higher investment yields we have been capturing, we made several product changes in September and October. For accumulation products, we raised participation and cap rates on American Equity's Choice and Eagle Life's Select products. When coupled with the optional market value adjustment rider we introduced earlier this year, Choice 10 and Select 10 now offer some of the highest participation rates in the market among annual reset fixed index annuities. We believe these offerings compare very well with the proprietary index/multi-year term products which are quite popular in the market. Rather than a proprietary index, our products contract value growth is based on the S&P 500 – a transparent, public index with 60 years of history that a policyholder can easily track. We believe proprietary indices add another level of complexity to a safe money insurance product and do not offer a significant growth advantage.

Higher investment yields also led us to improvements in our guaranteed income products. In September, we raised roll up rates on our bonus products back to pre-July levels. In October, we introduced a new lifetime income benefit rider for our Foundation Gold fixed index annuity. Lifetime income on Foundation Gold is **VERY** attractive, particularly in many important age/deferral combinations where we expect it to offer higher guaranteed income than offered by our significant competitors. Also, since we charge rider fees based on contract values rather than income account values, our fees are the lowest in the market - making Foundation Gold even more attractive on a net of fees basis. We are emphasizing to our agents that fees matter and that this should be an important factor when comparing annuities with lifetime income guarantees for their clients.

In addition, we are again offering a no-fee lifetime income rider with Foundation Gold. We believe we are in the best competitive position – particularly at American Equity – that we have been in since last year. However, we will continue to work on new products and features to enhance our competitiveness even further.

Turning to current sales trends, pending business at American Equity Life averaged 2,196 applications during the third quarter and was 1,985 at the end of September compared to 2,206 applications when we reported second quarter 2017 earnings. Pending hit a low of 1,907 on September 7th but now stands at 2,178 applications.

Pending at Eagle Life stands at 213 applications today, up from 134 when we reported second quarter earnings. As we've noted in the past, sales momentum in the bank and broker-dealer channels tends to change much more quickly than in the independent channel.

Our distribution footprint at Eagle Life continues to grow. In the third quarter, we added 1 new wholesaler, 3 new selling agreements and 513 representatives. In total, we have 9 wholesaling distribution partners, 58 selling agreements and 5,829 representatives.

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

John Matovina

Thank you Ted and Ron.

We are pleased with our third quarter results as spread and non-GAAP operating earnings exclusive of the impact from revisions to actuarial assumptions and the loss on extinguishment of debt remained stable despite continued headwinds from low interest rates. Although sales were down sequentially in the third quarter, we are pleased with the momentum at Eagle Life which has carried over into the first part of the fourth quarter. Regaining momentum at American Equity Life may take longer, but our products are now more competitive, and we believe the value proposition we have always offered agents – transparent products, attractive renewal crediting history, and unparalleled service – remains as attractive as ever.

We are optimistic that the Department of Labor will finalize the delay of the implementation of its fiduciary rule to July 1, 2019 and hopeful that regulations unduly burdening distribution of annuities by independent agents will be substantially revised. While the eventual outcome of the 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 fiduciary rule won't change this.

While we look to continue to expand our investment horizon, the credit quality of our investment portfolio will remain high, and we will maintain our discipline of avoiding excessive credit risk. As we've stated many times in the past, we offer "sleep insurance" and that implies a promise to our agents and policyholders that they can trust us to be there when they need their money, whether that be tomorrow or decades from now.

On behalf of the entire American Equity team, thank you for your time and attention this morning. We'll now turn the call back to the operator for questions.