Q1 2011 Earnings Call

Company Participants

- Brad Martin, VP, COO
- John Varnell, VP, CFO
- Prem Watsa, Chairman, CEO

Other Participants

- Jeff Fenwick, Analyst
- Mark Dwelle, Analyst
- Tom McKennon, Analyst

Presentation

Operator

Good morning. Welcome to Fairfax First Quarter results conference call. After the presentation, we will conduct a question and answer session. (Operator Instructions) Your host for this call is Prem Watsa, with opening remarks by Brad Martin. Mr. Martin, please begin.

Brad Martin {BIO 3466650 <GO>}

Good morning. Welcome to the conference call to discuss Fairfax First Quarter 2011 results.

The comments we make during this conference call may contain forward-looking statements, actual results may differ from those contained in such forward-looking statements as a result of a large variety of uncertainties and risk factors, the most foreseeable of which are listed in Fairfax's annual report. which is available on our website at Fairfax.ca, or set out under risk factors in Fairfax's base shell prospectus, filed with the regulatory authorities in Canada and United States. I will now turn the call over to our chairman and CEO, Prem Watsa.

Prem Watsa {BIO 1433188 <GO>}

Thank you, Brad. Good morning, ladies and gentlemen. Welcome to Fairfax's First Quarter conference call.

I plan to give you some of the highlights and then pass it on to John Varnell for additional details. In the First Quarter of 2011, book value went down to CAD3.55 approximately per share . This is our First Quarter reporting under International Financial Reporting Standards (IFRS).

Our investments are now shown at market value at the end of the quarter, and the fluctuations in market values rose through the income statement. Highlights during the quarter include, we had a net loss of CAD240.6 million in the First Quarter of 2011, CAD12.42 per share, mainly because of CAD217.7 million after tax losses, from the Japanese earthquake, and net investment losses of CAD101.5 million.

The company's estimation of its losses from the Tohoku, Japan earthquake event assumes an approximately CAD30 billion industry loss, and it is based on a combination of model information, underwriter analysis, client discussions and a profile of expos limited within the effected region. The nature and scale of the loss and its recent occurrence, introduces significant uncertainty to the loss estimation process. Therefore, we feel that ultimate losses could defer, perhaps materially, as further information becomes available.

The CAD217.7 million of after tax losses from the Japanese earthquake was under 3% of shareholders equity, well within our risk tolerance limits, and towards the lower end of industry experience. Fairfax had total cap losses from the Japanese earthquake, as well as from the New Zealand earthquake and the Australian floods, amounting to CAD404.4 million pretax, or 32.8% combined ratio points in the quarter.

Excluding these cat losses we had a combined ratio of 97.5%, while we suffered significant cat losses from Japan, New Zealand, and Australia, our thoughts and prayers, of course go to the families that have been effected by these massive natural disasters. We expect these cat losses to have an impact on catastrophe pricing worldwide. We have to wait and see the impact on pricing generally across all lines in the property casualty industry. We have a strong financial position to take advantage of our market, and we have continue to wait patiently for such an opportunity.

Net investment losses of CAD101.5 million in the First Quarter of 2011, consisted of the following. This will be on page two on our press release. And this will be on page two of our Press Release. In that table that we have, and we will disclose this table on a regular basis every quarter, you can see net gains on equity and equity related investments of CAD622 million, predominately unrealized, and with losses being neutralized by net unrealized losses of CAD428 million on our equity hedges.

Unrealized bond losses of CAD133 million, and CAD167 million in unrealized CPI linked derivatives, resulted in a net loss of CAD101.5 million,all unrealized. Net premiums written by the Company, then insurance and reinsurance operations of the First Quarter of 2011, increased 28% to approximately CAD1.4 million from CAD1.09 million in the First Quarter of 2010. Due primarily to the acquisition of Zenith National and First Mercury.

The Company hailed a little more than CAD1 million of cash, short term investments and marketable securities at the holding company level, at March 31st 2011, compared to

CAD1.5 million at December 31st 2010. The decrease in cash and marketable securities, is the result of the acquisitions of First Mercury, and Pacific Insurance Berhad of Malaysia.

Finally, we continue to be approximately 83.1% hedged in relationship to our equity, and equity related securities. Equity related securities are predominately convertible bonds and convertible preferred stock. Now, I would like to turn it over to John, so he can give you some more information on the underlying financials. John.

John Varnell {BIO 5699703 <GO>}

Thank you, Prem. Today I will talk to you about our changed International Financial Reporting Standards,first, then a little bit on investment income. Then operating company results, in particular, and finally a little bit on our financial position.

The adoption of the International Financial Reporting Standards, or IFRS, did not have a significant impact on our book value per share. However, it will impact the manner on which we report unrealized net gains and losses going forward. The IFRS impact on our book value at December 31st, our consolidated book value was about CAD70 million lower than what had previously been reported under Canadian GAAP, and that equates to about a CAD3 before share decrease.

The principle adjustments related to the decrease were, the first one was the recognition of an unamortized actual gains and losses of pension and post retirement benefits, and the second item was certain adjustments to our deferred tax asset, or amounts previously deferred under Canadian GAAP, are not deferred under IFRS. As Prem said going forward, we will report all unrealized net gains and losses on investments, other than equity account investments and net earnings, previously under Canadian GAAP, unrealized gains and losses were recorded either net earnings or other comprehensive income, depending on their classification.

On investment income, interest and dividend income in the First Quarter of 2011, increased by 2.9% to CAD179 million, from the First Quarter of 2010 of CAD174 million. On a pretax basis we owned about CAD4.4 billion of tax advantage municipal bonds, and therefore, interest in dividend income if you grossed it up to the advantage would have equated to about CAD200 million.

The average portfolio size during the First Quarter of 2011, was almost CAD23.6 billion, compared to just under CAD22 billion in the First Quarter of 2010. Our annualized portfolio yield in the First Quarter, was 2.93%, compared to the First Quarter of 2010 where the yield was 3.32%. Turning to operating company results, starting with Odessey.

Odessey was obviously affected by the Japanese earthquake losses. In the First Quarter of 2011, Odessey had a combined ratio of 150, and an underwriting loss of CAD227 million. In the First Quarter of 2010, Odessey has a combined ratio of 112.8 and an underwriting loss of about CAD58 million. The First Quarter of 2011 combined ratio included 66 combined ratio points, or CAD297 million net of reinsurance and reinstatement premiums related to cat losses, compared to Odessey's cat losses pretax net to them in the First Quarter of 2010, of CAD118 million, or about 26 combined ratio points, mostly related to Chile.

The First Quarter, 2011 underwriting results for Odessey included one combined ratio point, or CAD4.7 million attributable to net development of prior years reserves. Without the Japanese, New Zealand, and Australia cats, Odessey would have had a combined ratio of about 89%. In terms of premium volumes, Odessey had a 7% increase in gross premiums written, primarily as a result of the reinstatement premiums related to the catastrophe losses.

Crum & Forster reported an underwriting loss of CAD10.8 million, and a combined ratio of 104.8 in the First Quarter of 2011, compared to an underwriting loss of CAD13.5 million a combined ratio of 107.4 in the First Quarter of 2010.

Crum's results included .9 of the combined ratio point, or CAD2 million of net favorable development of prior year's reserves, 2010 had insignificant development. On an accident year basis, Crumb and Forster's combined ratio was 105.7, and that compared to 107.7 in the year ago quarter.

Crum & Forster gross premiums written and net premiums written increased by 5.2%, and 4.1% respectively, as a result of growth in specialty lines. Zenith National reported an underwriting loss of CAD26.6 million,and a combined ratio of 123.4 for the First Quarter of 2011.

There was no development in prior year reserves, and gross premiums written during the First Quarter of 2011, reflected a 16% increase in business over the First Quarter of 2010. Zenith National had increases in new business written, stronger retention, and there was improved payroll trends.

First Mercury, which we acquired in February 2011, had an underwriting loss of CAD3.4 million, and a combined ratio of 109.8. However, that included CAD2.2 million of cat losses on a program that already exiting. Their combined ratio would have been 98.7, excluding the cat loss and a small restructuring charge.

Northbridge reported a combined ratio of 103.6, and a underwriting loss of CAD9.6 million in the quarter, and that compared to 104.6 combined ratio and CAD11.3 million underwriting loss in the year ago quarter. The First Quarter of 2011 underwriting result for Northbridge included three combined ratio points, or CAD8 million of net favorable development, there was .4 combined ratio points or almost CAD1 million of adverse prior period reserve development in the First Quarter of 2010.

The underlying accident-year combined ratio for the First Quarter was 106.6, compared to 104.2 the year before. Goss premiums written at Northbridge declined by 2.3% in Canadian dollar terms.

Fairfax Asia had another successful quarter, their combined ratio was 85.9 this quarter, compared to a combined ratio of 96.4 last year. Their gross premiums written were CAD111 million, up 35%, from CAD82 million last year, their net premiums earned were up about 18%.

And our segment that we call reinsurance and insurance other, the net earned premiums decreased to CAD126 million for the quarter, compared to CAD143 million last year, primarily because of less business written at advent. The First Quarter reinsurance and insurance other combined ratio was 166, compared to 127 last year, again, because of the Japanese cat losses. That (inaudible).

The result was combined ratios for the First Quarter for group three of 160, advent 194, Polish Re 101.5, and Brazil 216, which is our start up. Turning to our financial positions starting with book value per share, we ended the quarter at CAD354 a share, that's after Fairfax paid out the CAD10 a share dividend in the First Quarter. That is an IFRS book value that would be comparable to the IFRS book value at December 31st, of CAD376 per share.

Common shareholders equity decreased by about CAD460 million during the quarter to CAD7.24 billion, we paid dividends of just over CAD205 million during the First Quarter on our common shares, and we have the loss of CAD240 million which made up that decrease. Our debt at the holding company and debt at the subsidiaries increased slightly during the First Quarter, due to the First Mercury acquisition, which brought with it CAD66 million of debt. And combined with the First Quarter loss, it resulted in a slightly higher total debt to total capital ratio of 25.5%,

which is compared to 23.9%. And Prem, that's it.

Prem Watsa {BIO 1433188 <GO>}

Well thank you very much, John. Now we are happy to answer your questions, please give us your name, your company name, and try to limit your questions to only one, so it is fair to all that call. To MaryAnne, we are ready for questions

Questions And Answers

Operator

(Operator Instructions) Our first question comes from Jeff Fenwick of Cormark Securities.

Q - Jeff Fenwick {BIO 15350794 <GO>}

Hello. Good morning.

A - Prem Watsa {BIO 1433188 <GO>}

Good morning, Jeff.

Q - Jeff Fenwick {BIO 15350794 <GO>}

So I wanted to ask a question, a couple of questions around your premium volume numbers. We saw some impressive growth there out of Crum and Zenith, as well in the quarter. You mentioned some strength in specialty lines within Crum. A pretty material number after shrinking your volumes for sort of a prolonged period here, is this just being opportunistic in a specific area, or are you feeling like you are starting to see a little bit of firming in a larger number of markets.

A - Prem Watsa {BIO 1433188 <GO>}

A little of both, Jeff. We are been opportunistic at the Crumb level. John, on Zenith, mentioned higher retention, higher new business, for the first time in many, many years. Zenith is experiencing that. Of course the Workers Comp is being in Crum, too. But when you talk about the cycle, this cat event is very significant in Japan, but it's also significant in the sense that it's comes after New Zealand earthquakes, Australian flood losses, last year you had the Chilean earthquake, and a New Zealand earthquake, so the accumulated losses have been significant.

And so we see prices bottoming out and perhaps firming. No question they will firm in the cat area, in Japan, for example, in the renewals that are to come. It will firm, probably firm all across the cat markets worldwide, and we just have to wait and see in the next three months, six months, what happens in the property casualty industry across all lines.

But there is firming, and as I said, we have been very patient in waiting for the markets to firm. We don't make forecasts by the way, we actually wait until the prices go up, and then respond, and take advantage of the opportunity. But it is fair to say that prices have bottomed up and are moving up some.

Q - Jeff Fenwick {BIO 15350794 <GO>}

Okay. Just one follow on there, with respect to Odessey, you did mention that reinstatement premiums drove most of the growth and volumes there, but are you also seeing other areas within Odessey that are seeing organic growth?

A - Prem Watsa {BIO 1433188 <GO>}

A little, it's still early days on that, Jeff. Still early days on that. We are watching the impact of that earthquake, and all these cat losses on the industry. But it will be fair to say that the financial flexibility of the industry has been reduced significantly.

And so you have these result redundancies coming in, you have less and less of an income because of interest rates being low, and as you are rolling over 3, 4 or 5 year bonds into current interest rates, unless income comes down, and so we are thinking that as you said, previously, sometimes these markets will change. And you just have to be ready to take advantage of it. John, you want to add to that?

A - John Varnell {BIO 5699703 <GO>}

Yes, just to be careful, First Mercury, there was some premium in there for the First Quarter, because we bought it around February 9th, so you would have picked up some premium just because it was a new acquisition, and then Zenith wasn't in there until the Second Quarter last year, so just to be careful on that.

A - Prem Watsa {BIO 1433188 <GO>}

You understand when we say 28% increase in premium, like we have First Mercury, as John said, for maybe a month, month and a half, two months, and Zenith, which we never had last year. But I think even if you exclude that, we had an increase in premium, and I forget 7%, something like that. And so we are certainly seeing some premium increase, but we are not thinking yet that it's a hard market that we can expand significantly.

Q - Jeff Fenwick {BIO 15350794 <GO>}

Okay. Thank you, I will reque.

A - Prem Watsa {BIO 1433188 <GO>}

Thanks, Jeff, next question please.

Operator

Our next question is from Tom McKinnon of EMO Capital.

A - Prem Watsa {BIO 1433188 <GO>}

Good morning, Tom.

Q - Tom McKennon

Good morning, everyone. I wonder if you might be able to shed a little light on the announcement of Mark Ram's departure. It seems that people at Fairfax stay there forever. I don't think Mark is quite 50, so he will stay on it seems like in a consulting role, can you shed any light as to his departure, that would be appreciated?

A - Prem Watsa {BIO 1433188 <GO>}

For sure, Tom. Mark, of course, has done a outstanding job for us over the past 20 years, and as he has said, he is retiring from our company for family reasons. And you know, a big thank you to Mark, who as I said, has done a wonderful job for us. Sylvia Wright, who was number two to Mark, will take over Northbridge, and Sylvia's worked with Mark for the better part of 16 years, perhaps even longer, and now in Northbridge, so there will be a seamless transition. But you are exactly right, we will miss Mark.

Q - Tom McKennon

And if I can just squeeze one more in here, Prem, you used to talk about the run off segment within an objective of trying to break even within a reasonable level of investment gains. I look at the run off segment in the quarter and it actually broke even without any investment gains. And I'm wondering, how should we look at that segment kind of going forward? Should we still think of it as being a break even segment, or is there opportunity for it to even do better than that? And was there anything unusual in the quarter that kind of bumped that number up higher?

A - Prem Watsa {BIO 1433188 <GO>}

I'll take the first crack at it, and then maybe John can add to it. But no, you know that (inaudible) that we talked about at the annual meeting Tom, was very significant, and a significant in the sense that there was very significant down side protection, with that contingent note. The result development goes against the contingent note. There were no expenses of any significance that we have to take over. And we had a national portfolio that provides the interest and dividend income.

So the characteristics of run off have improved. And that's why we like the run off, when it's purchased properly, very well due diligence, but yes. So in run off you always can have in the insurance business, surprises. You know, not significant ones, but you can have surprises. But we are very comfortable with the run off that we have today, and under Nick Bentley's leadership, we are very comfortable with it going forward. John, would you add to that.

A - John Varnell {BIO 5699703 <GO>}

Nothing unusual in the quarter in run off. That was there. And just that we would like to try to make money without gains and run off, and so we will just try to keep improving it, and that's what we are doing.

Q - Tom McKennon

Okay. Thanks very much.

A - Prem Watsa {BIO 1433188 <GO>}

Thank you, Tom. Next question Mary Ann.

Operator

Our next question is from Mark Dwelle, of RBC Capital Market.

Q - Mark Dwelle {BIO 4211726 <GO>}

Good morning.

A - Prem Watsa {BIO 1433188 <GO>}

Good morning, Mark.

Q - Mark Dwelle {BIO 4211726 <GO>}

A couple of numbers questions. You had mentioned a lot of the premium growth in Odessey Re, was related to reinstatement,could you provide the number that relates to that? Just help in going forward in terms of modeling what portion of that is sort of earned, or how that premium earns out?

A - Prem Watsa {BIO 1433188 <GO>}

Yes, for your models, Tom, I'll ask John to provide it to you after the call. Are you comfortable with it, John? We will provide it after the call on the reinstatement premiums, Mark. What is the next question that you have.

Q - Mark Dwelle {BIO 4211726 <GO>}

The same question, just in general terms, what is the duration on the municipal bond portfolio?

A - Prem Watsa {BIO 1433188 <GO>}

The municipal bonds have a call feature, not a redemption feature, but a call feature which the municipality can call. (inaudible) Berkshire Hathaway guaranteed bonds, which is 65%, between five to ten years from now, and we expect them to call because the rates are quite high compared to perhaps not compared to these last three months, but compared to over time. And so that's what the term is, Tom. And on the rest of the Muni bonds, it is not too different, in terms of terms of maturity.

Q - Mark Dwelle {BIO 4211726 <GO>}

Okay, the last question I had kind of relates to the CPI link derivatives. I guess I had understood when you initially took the position of a CAD34 billion notional, that it was reasonably matched hedge against the overall asset portfolio of the company. But now the notional portion of that derivative contract, or that group of derivative contracts, is now about CAD49 billion, which to my mind makes it a fairly significant, call it naked bet, on the direction of CPI. And I was just wondering if you could explain the thinking behind that increase in the notional value and the notional exposure.

A - Prem Watsa {BIO 1433188 <GO>}

And basically, what it is, Tom, is averaging down in terms of opposition. That's the type of position we were looking to achieve. we look at two things, one is the CAD49 billion, as you pointed out, the second is the amount of money that we had invested, so it is about CAD400 million, a little more than CAD400 million. And it's over ten years, now, on that mark, I should make the point that it fluctuates. I have said that at the annual meeting, I have said it on conference calls, these things fluctuate up and down. We saw a very significant fluctuation in this quarter.

Basically, we use a dealer quote, which are based on supply and demand and some modeling, and like the creditable swaps in the past, these fluctuate and our thinking is really until you sell them, you won't know what the values are. But it is protection for us, Mark, in our assets, it's protection from the unintended consequences of the property casualty business. You know we haven't really gone through the inflation for a long time. You know, basically, in the North America we haven't seen it.

Since the 30's, and so we are always looking at the unexpected, the one that's not the possibilities that are not forecasted, and we keep worrying about the possibility of deflation on our business, on our assets, on our business, and so we think that it helps us in terms of the unintended consequences on our business. But this is about the amount that we feel comfortable. It's ten years, it fluctuates very significantly based on supply and demand, and we have taken a very significant CAD167 million hit in the First Quarter, it's of course, unrealized, but we think you have to keep monitoring it over time.

Q - Mark Dwelle {BIO 4211726 <GO>}

Okay. Thank you, that's a helpful update.

A - Prem Watsa {BIO 1433188 <GO>}

Thank you, Mark. John, did you want to --

A - John Varnell {BIO 5699703 <GO>}

For the answer on the reinstatement premium, if you look on the bottom of page 76, about eight lines up, you will see it's disclosed there CAD17.8 million of reinstatement premium, related to the company.

A - Prem Watsa {BIO 1433188 <GO>}

Thank you, John, Mary Ann next question.

Operator

Once again, if you would like to ask a question please press star one on your telephone keypad.

A - Prem Watsa {BIO 1433188 <GO>}

Mary Ann, if there are no more questions --

Operator

At this time there are no more questions.

A - Prem Watsa {BIO 1433188 <GO>}

Okay, terrific, thank you very much. Well if there are no more questions, thank you for joining us on this call. We look forward to presenting to you again after the next quarter, thank you, again.

Operator

This concludes today's conference call, you may disconnect your phones at this time.