Q1 2017 Earnings Call

Company Participants

- Alain Lessard, Senior Vice President-Commercial Lines
- Charles Brindamour, President, Chief Executive Officer & Director
- Darren Godfrey, Senior Vice President-Personal Lines
- Don Fox, Executive Vice President
- Louis Marcotte, Chief Financial Officer & Senior Vice President, Finance
- Patrick Barbeau, Senior Vice President-Claims
- Samantha Cheung, Vice President-Investor Relations

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon. My name is Leandra and I will be your conference operator today. At this time, I would like to welcome everyone to the Intact Financial Corporation First Quarter 2017 Earnings and OneBeacon Acquisition Conference Call. All lines have been placed on mute to prevent any background noise. Thank you.

Ms. Samantha Cheung, VP of Investor Relations, you may begin your conference.

Samantha Cheung {BIO 19462616 <GO>}

Thank you, and good afternoon, everyone. Background information for the call is posted on our website at www.intactfc.com under the Investor Relations tab.

Before we start today's call, I'd like to advise you that this call and presentation do not constitute, reform and offer to sell or a solicitation of an offer to buy or subscribe to securities, nor shall it or any part of it, form the basis of or be relied on in connection with or if any inducement to enter into any contract or commitment whatsoever.

For purposes of inclusion and completeness, I'd also refer you to the detailed disclaimer legends contained in the front of our investor presentation with respect to additional matters, including the disclaimer with respect to non-IFRS measures, which is also reproduced in our press release.

In addition to the foregoing matters, I'd also like to reference the forward-looking statement contained in our press release of today's date and the forward-looking legend and disclaimer contained in our presentation material, which will apply to any forward-looking information we may discuss today, as part of this call.

Finally, I'd like to point out that we are currently in a period of distribution under applicable Canadian security laws and accordingly, we may be limited in what we can say on this call.

With respect to this call, we will be reviewing our first quarter earnings first, followed by a review of our proposed acquisition of OneBeacon Insurance Group. Given the concurrent securities offering, we will not hold a question-and-answer period on this call.

Joining this call from Intact are Charles Brindamour, CEO; Don Fox, Executive Vice President; Louis Marcotte, CFO; Darren Godfrey, SVP of Personal Lines; Alain Lessard, SVP of Commercial Lines; and Patrick Barbeau, SVP of Claims.

With that, I'll turn the call over to Charles to review our first quarter 2017 earnings.

Charles Brindamour {BIO 7012323 <GO>}

Well, good afternoon, everyone, and thank you for taking the time to join our call on what is clearly a short notice. Earlier today, we released our first quarter 2017 earnings and simultaneously announced the acquisition of OneBeacon, a pure play specialty insurer operating in the U.S. We'll discuss the acquisition in a few minutes but before we do so, I'd like to review our first quarter earnings.

So, we announced first quarter net operating income of CAD 0.90 per share driven by solid underlying – underwriting results and strong distribution income, offset by elevated cat losses and weather-driven frequency in personal auto. Our financial position at the end of the quarter was very strong with over CAD 1 billion of excess capital and our book value was up 8% from last year to CAD 43.14.

I'm pleased to see our top line growth 4% in the quarter on the back of growth initiatives, despite our pricing and risk selection actions across the country. Top line growth was muted in commercial lines due to the ongoing difficult economic conditions in the West and competitive pressure, but we're seeing positive momentum in specialty lines as our initiatives are paying off.

The combined ratio was 98.2% in the quarter after absorbing 4.5 points of cat losses well above historical levels for the first quarter. When looking at our underlying results, I see sound performances in all lines of business, particularly in personal and commercial property. Personal auto results were impacted by higher weather-related losses and lower prior year development. Overall, I see improvements in our underlying performances in all lines, a clear sign that our corrective measures are gaining traction.

Our operating return on equity was 10.6% at the end of the quarter, keeping in mind that three out of the last four quarters included unusually high levels of cat losses. In 2016, we also outperformed the industry by a margin of 580 basis points above our target of 500 basis points.

So, let's look at our first quarter results in a bit more detail. Personal auto grew 3% on a combination of early rate actions taken across the country and customer-driven growth initiatives. The combined ratio deteriorated 6.2 points to 102.6% on higher weather losses and lower prior year development. When excluding the weather impact, our underlying performance improved by about 2 points, which is consistent with the actions we've taken so far, and there are more improvements in the pipeline.

Our written premiums reflect rate increases of nearly 5%, while our earned rates have only risen by 2% on average. This gap will continue rising for another quarter and be earned in over 12 to 18 months. Beyond that, we expect benefits from the 2016 Ontario reforms and our claims action plan.

We therefore remain confident in our ability to deliver mid single-digit improvement and personal auto's combined ratio. We continue to anticipate a rational, competitive environment in personal auto with low to mid single-digit growth in the coming 12 months, as cost inflation will be compensated by rate increases.

In personal property, premiums grew a healthy 8%, as new products and continued rate increases were deployed in favorable market conditions. This line of business continues to perform well, with a combined ratio of 92.8% after absorbing 12 points of cat losses, primarily from severe windstorms. With healthy top and bottom lines, personal property continues to be well-positioned going forward.

In terms of the industry outlook for personal prop, we see no change there. We expect firm market conditions continue as the industry adjusts the changing weather patterns with mid to upper-single digit growth over the next 12 months.

Our commercial P&C business is also performing well, with a combined ratio of 95.8% after absorbing 7 points of cat losses. Commercial auto premiums grew 9% in the quarter on the back of multiple initiatives in specialty lines, including products for the sharing economy. The combined ratio improved by 1.3 points to 96.2%, as higher weather-related claims frequency was upset by higher favorable prior year development.

We remain on the right path to reach our low-90s% target in this segment. We expect low-single digit growth in the coming year for commercial lines, as markets continue to be competitive across Canada and economic conditions remain difficult in Western Canada.

In summary, the 98.2% combined ratio for the quarter is disappointing, but it does include 4.5 points of cat losses, well above our expectations. All our lines of business are performing well or improving on an underlying basis and I'm confident the actions we're taking in personal auto will have a positive impact over the next few quarters.

With that, let me turn the call over to Louis, our CFO, to provide us a view on the quarter.

Louis Marcotte {BIO 18040440 <GO>}

Thanks, Charles. For the first quarter, net operating income was CAD 123 million, lower than last year as elevated catastrophe losses and higher non-cat weather claims frequency obscured a solid underlying performance, especially in the property lines of business. We saw a strong growth in our distribution income and stable investment income. Book value per share increased 8% from a year ago to CAD 43.14, thanks to our resilient operations and a significant appreciation in the value of our equity portfolio.

We experienced elevated catastrophe losses of CAD 88 million net of reinsurance due to windstorms in Central and Atlantic Canada and to two commercial fires. This is approximately 4 times higher than our historical averages for Q1, and thus, triggered our pre-announcement on April 5. In addition, there was challenging winter weather in the metropolitan areas of Western Canada where heavy snowfall led to spikes in auto collision frequency and water damage to properties.

Our expense ratio improved by 1.5 points on lower commissions and general expenses. The recent softer underwriting performance translated into lower profit-sharing commissions and lower variable compensation, while our cost saving initiatives also reduced general expenses. Our distribution activities delivered CAD 24 million to our pre-tax operating earnings in the quarter, CAD 10 million higher than last year, primarily due to the growth in our broken network and improved margins. We continue to expect distribution income to grow north of 15% in 2017, albeit with seasonal variations.

Our investment portfolio delivered consistent investment income at CAD 105 million, slightly above last year. Our Q1 non-operating results improved by CAD 89 million in the quarter, driven by realized gains on our equity portfolios. Our unrealized gain position increased CAD 44 million in the quarter to CAD 313 million, with all portfolios in a gain position.

In summary, we reported quarterly EPS of CAD 1.8, 3% lower than last year as our operating results declined on the back of cat and non-cat weather, while our non-operating results improved materially on higher investment gains. Our balance sheet remains very strong, with total excess capital exceeding CAD 1 billion and our MCT spending at 223% at quarter end, a good position to be in as we announced an acquisition.

Back to you, Charles.

Charles Brindamour {BIO 7012323 <GO>}

All right. Thanks, Louis. It's probably worthwhile to ask Darren to give us his perspective on the personal automobile performance but more importantly, the actions we're taking and his expectations for the remainder of the year.

Darren Godfrey {BIO 19791482 <GO>}

Thanks, Charles. I was disappointed with the results in personal auto, with a 102.6% combined ratio, particularly when we have a 6.5-point deterioration in PYD and a 0.9%

increase in current accident year compared to Q1 of 2016. With respect to prior year development, a meaningful proportion of this deterioration was driven by short tailed physical damage claims. We do not expect any further impact from this in the remainder of the year.

Looking at the current accident year results, we see 3 points of combined ratio explained by a tough weather – tough winter, namely, in Alberta, impacting frequency in the quarter. This suggested our underlying performance improved in the quarter once you look through the noise from weather.

We can see that our action plans are starting to show traction. Our right momentum continues to build, as Charles said, with a gap in written to earn rate increases in Q1 of 3%. The gap will continue to grow for another quarter. All rights are now implemented or about to be implemented across the country, giving us confidence that we will generate 3 points of loss ratio improvement due to rate activity in our segmentation strategy alone.

Our additional actions, namely, improvement in our risk-selection models, claims action plans, as well as ongoing Ontario reform impact are gaining traction and are expected to contribute a further 1 to 3 points of loss ratio improvement. Although our Q1 personal auto results were disappointing, we remain confident that our actions will deliver 4 to 6 points of improvement with majority of the benefits to materialize in the latter half of the year.

Charles Brindamour {BIO 7012323 <GO>}

Great. Thanks, Darren. We've talked about whether. We've talked about reforms in Ontario. Patrick, it would be good to get your perspective in those – and provide some color on these two areas.

Patrick Barbeau {BIO 18476397 <GO>}

Sure. Weather certainly affected our results in Q1, the elevated amount of catastrophes, totaling CAD 88 million in Q1, was almost entirely in property loans primarily caused by severe winds. But winter storms and variations in temperature have also significantly affected driving conditions in automobile results. The volume and size of claims in automobile has been higher than expected for the major part of the winter, starting in early December until mid-March.

With regards to the auto Ontario environment, the reforms are, so far, producing the benefits that we were expecting, and we'll start to have full impact in Q3 this year. The Ontario government continues to be proactive in trying to reduce costs in the automotive system and the provincial budget released last week refer to specific recommendations coming from the recently introduced Marshal report, aiming at making the Ontario auto system more cost-efficient. There are positive recommendations in this report and consultations should start in the coming month.

In the meantime, we remain focused on executing our own plan to improve our auto results, including rate increases, segmentation, risk selection and claims cost containment.

Charles Brindamour {BIO 7012323 <GO>}

Great. Thanks, Patrick. Alain, we've been working on the commercial auto for some time. It would be great to get your perspective on our performance.

Alain Lessard {BIO 17592535 <GO>}

Yes, Charles. So, the strong growth we saw of 9.2% in the quarter was affected positively by the sharing economy product. As we mentioned a few times in the past, the premium for this product is closely related to usage and the popularity of right sharing and car sharing is still very strong. This was partially offset by the profitability action we are taking on our trucking portfolio where we are still taking double-digit rate increase on the least profitable business. We also saw some impact from the weak economic condition in Alberta, but overall, the growth was strong in the quarter.

On the profitability side, we are pleased with the improvement in the combined ratio, considering the seasonality of the first quarter and the fact that we still have 2 to 3 points of rates to be earned. We're in a good position to operate this line around 90%.

Most of the increase we saw in the underlying current year loss ratio was due to increased frequency from weather-related event, mostly in Western Canada, the level of large losses remained the same as last year. This increase was partially offset by an improvement in PYD where we saw a 4.6-point improvement despite 1.7-point more large losses. The 2017 level of PYD is more in line with what we would normally expect for our first quarter. So overall, I'm quite confident that this line is trending in the right direction to operate around 90%.

Charles Brindamour {BIO 7012323 <GO>}

Well, good. Thank you, Alain. This concludes the earnings part of our call, and hopefully, while brief, we try to hit the points which we felt were important and where you'd like to have color. And it probably makes sense now to move to the other news of the day, our acquisition of OneBeacon.

So, we really have taken an important step today to building a world-class P&C insurer, and I'm thrilled to announce that we've entered into an agreement to purchase OneBeacon, a leading U.S. specialty insurer for a total consideration of $1.7 billion. Combined with our own specialty lines division here in Canada, we're creating a leading North American specialty insurer focused on small to mid-sized businesses, with over CAD 2 billion in specialty lines premium.

As you know, we've been looking to grow our business outside Canada and identify the U.S. small to mid-sized commercial and specialty market as an attractive entry point. And the key was finding the right company, not only from a strategic, operational and financial perspective but also for overall fit, and I'm very pleased to see that OneBeacon checks all those boxes.

These guys had built a really high quality organization, thanks to their commercial and specialty lines expertise, strong broker relationships and the depth of their team, led by their CEO, Mike Miller. Mike and I firmly believe that combining OneBeacon's deep commercial and specialty lines expertise with Intact's track record in commercial lines and strengths in data, claims and digital will create a formidable platform to serve brokers and customers and to capture growth opportunities. There's no doubt in my mind that we're a great fit. Together, we have the scale, the people, the technology and the expertise to build a leading North American specialty insurer.

And while we continue to be well-positioned to participate in the consolidation of our industry here in Canada, the acquisition of OneBeacon also opens up new and significant growth opportunities for Intact. It bolsters Intact's Canadian business with new products and cross border capabilities. It allows us to deliver broker and customer experiences that are second to none and better positions us to compete with international insurers in Canada and in the U.S.

Our business profile improves as well once you add the two businesses together, with commercial and specialty lines representing nearly half of our total premiums. Our business mix is more balanced and we've increased our geographic diversification.

The financials, I think, are compelling. The transaction is neutral to net operating income per share in the first year and generates mid single-digit accretion within 24 months. The IRR is attractive in excess of 15% due to multiple top and bottom line opportunities and a strong financial position to start with.

It is also conservatively structured. Our financial leverage will be below 20% within two years. And at closing, we'll have purchased CAD 200 million (19:52) of downside protection against adverse reserve development. Our balance sheet remains strong and well protected, allowing Intact to capture future opportunities.

We built a strong track record of successful M&A transactions to become the largest P&C insurer in Canada, ensuring one out of four small to mid-sized businesses. And working alongside our new colleagues at OneBeacon, I'm confident that we can leverage our track record to grow our organization further by consolidating a fragmented market. This is an exciting time for both our companies. And I'll ask Don to provide a bit more color on the transaction.

Don Fox {BIO 19993241 <GO>}

Thanks, Charles. Appreciate that. So, OneBeacon is a unique pure play specialty insurance company operating in the United States and writing approximately $1.2 billion in annual premiums. It's publicly listed on the New York Stock Exchange, domiciled in Bermuda and headquartered in Minnesota. It offers a wide range of specialty insurance products and is focused on small to mid-sized customers as we are.

OneBeacon is a company with a strong focus on underwriting. It's licensed in 50 states, has differentiated distribution channels and strong values, very similar to ours. I've been particularly impressed by their very experienced management team as well as their flexible and scalable technology platform.

This acquisition is consistent with Intact's strategy. We have, for some time now, communicated our interest in growing outside of Canada, particularly in the U.S. and particularly in the small to mid-sized commercial and specialty lines businesses. This market is attractive because it's still quite fragmented. It's more profitable in personal lines and we can leverage our strengths as the largest writer of insurance for small to mid-sized businesses in Canada.

The combination of our businesses will bolster our Canadian operations and drive cross market synergies. We expect to use the expertise of OneBeacon's management team, combined with our own capabilities in Canada, to serve our customers and brokers better. This will certainly help get our Canadian specialty lines premiums to our targeted CAD 1 billion level within a few years.

The strategic merits of this transaction are very clear. The financial merits are also quite clear, which is particularly important as we complete our first major acquisition outside of Canada. This deal is the right fit and it's a manageable size while making a meaningful impact.

The price offered for the shares of OneBeacon is $18.10 for a total purchase price of $1.7 billion. This represents a price to book value ratio of 1.6 times based on OneBeacon's latest balance sheet, and about 15.8 times 2016 earnings. The IRR is in excess of 15% and we expect the transaction to be immediately accretive to book value per share by approximately 5%.

Charles already mentioned that the acquisition is neutral to net operating income per share in the first year and mid single-digit accretive within two years, as the combined ratio improved and the synergies materialized. These numbers are especially compelling for a company entering a new market. We look forward to working with Mike and his team to operate our specialty lines businesses with combined ratios in the low-90s%.

I'll now let Louis provide some insights on the synergies and the financing structure.

Louis Marcotte {BIO 18040440 <GO>}

Thanks, Don. We believe this acquisition creates significant value for shareholders as evidenced by the expected returns and accretion levels Don highlighted earlier. Our plan to create value is very clear and it's built on the following six levers: growing OneBeacon's industry leading lines of business is the first; improving underperforming lines, the second; leveraging impacts, risk selection, analytics and claims expertise across OneBeacon's platform; capturing expense synergies in all our businesses; bolstering our Canadian business by adding OneBeacon's products to our shelves and expanding our cross border capabilities; and finally, pursuing consolidation opportunities in both markets.

With regards to synergies, we see opportunities in three main areas. Supply chain management, where we will leverage our Canadian experience and combine the purchasing power to drive savings. Secondly, we expect efficiencies from leveraging best practices in claims, in IT, operations and shared services, as well as for managing our investment portfolio internally and delisting the company. Lastly, we see benefits from reinsurance through combining the OneBeacon programs with our own. This brings me to the financing of the transaction.

We are paying approximately CAD 2.4 billion for the acquisition, including costs. OneBeacon's existing debt remains outstanding. Our proposed financing structure is consistent with what we've been telling investors for some time now. It also takes into consideration the needs of regulators and rating agencies. This is a great opportunity to deploy the excess capital we've been accumulating.

We plan to use approximately CAD 700 million of our excess capital and still remain well capitalized with MCT estimated above CAD 200 million at close. We plan to use a combination of debt and preferred share instruments up to CAD 1 billion with a goal of maintaining debt to capital below 25% at closing. We will use the significant cash flows generated by the combined businesses to bring that leverage ratio below our target level of 20% before the end of 2019. Accordingly, we are temporarily halting purchases under our normal course issuer bid.

The remainder, being CAD 700 million, will be financed by the issuance of subscription receipts, CAD 340 million of which have already been sold on a private placement basis, a strong testament to the merits of the transaction. The rest is being issued as we speak. The subscription receipts are convertible into common shares at close of the transaction, which is expected to take place during Q4 2017 subject to regulatory approvals. We hedged the U.S. dollar purchase price to avoid any material change to its Canadian dollar equivalent between now and closing.

A quick word on the assets of OneBeacon. Their investment portfolio is conservatively managed with over 80% of total invested assets and fixed income securities, and their overall portfolio has a similar risk profile to ours. We plan to manage these assets internally along with our existing investment portfolio.

In summary, our financing plan is conservative and our balance sheet strength is maintained. This is important to us as we believe the consolidation of the Canadian P&C market will continue and we want to be in a strong position to capture those opportunities as they arise. The acquisition is not a pivotal (27:19) way from the Canadian markets but one step on the path to building a world-class insurer. Charles?

Charles Brindamour {BIO 7012323 <GO>}

Well, thanks, Louis. Alain, you've been quite involved in this transaction. You're the commercial lines guy really here. So, it would be great if you could share with the investors your view on the opportunities that this transaction brings, but also the fit between our company.

Alain Lessard {BIO 17592535 <GO>}

Happy to do so, Charles. First, I'd like to say I've had the pleasure of meeting with the senior management team of OneBeacon and I was impressed, impressed by their expertise in specialty lines. They've build from ground up a very strong specialty insurer with leading position in the niche area where they operate.

I would like to say Intact has its own strength in specialty lines. Over the past two years, we've had developed a portfolio which has a volume just north of CAD 600 million and operates at a high profitability margin. We also have leading position in lines that are complementary to OneBeacon's lines of business.

In my mind talking about the fit, both companies share the same philosophy. We believe that our employees are the competitive advantage. In specialty insurance, profitability is attained by risk selection and segmentation and growth is generated by the quality of product and broker relationship. Both of these elements require a strong underwriting team. Over the years, OneBeacon has attracted top talent with expertise and deep technical knowledge. I'm very excited to be joining forces and leveraging the talent in both organization.

Going forward, we've established a plan on our best to leverage the acquisition of OneBeacon to maximize growth both in Canada and in the United States. Don, Charles and Louis have already mentioned the opportunity for cross border business but there are also other avenue by which we intend to accelerate our plan to achieve CAD 1 billion of premium in specialty lines within Canada.

We will utilize OneBeacon expertise and bring some of their product into the Canadian market. Products such as technology, entertainment and environmental insurance would be some examples of the many possibilities. The same opportunity also exists in reverse. We believe that our leading position in certain lines such as contract, surety, farm could be used to expand their own offering in the U.S.

In addition, we will also leverage Intact's capability in data, claims and digital to support the operation of OneBeacon in the United States. As an example, we believe that the digitalization trends we are seeing in personal lines and small commercial lines will also spread to specialty lines. We intend to use those to infuse Intact's web capability to stay ahead of this trend.

It's clear for me that between OneBeacon's strong team, Intact's proven track record, we have all the ingredients necessary to build a leading North American specialty insurer that will operate with high profit margin.

Charles Brindamour {BIO 7012323 <GO>}

Well, thanks, Alain. So in summary, the OneBeacon acquisition is, we think, an important step on our path to be a world-class P&C insurer. The deal provides a scalable platform to grow organically both in the U.S. and in Canada in specialty lines. It also provides an opportunity for us to leverage our M&A track record to consolidate another fragmented market. These avenues of growth are substantial and we have the team to pursue them.

On the operational side, we're clearly bolstering our capabilities in specialty and commercial line. Between the deep expertise of both teams and Intact's strengths in data, claims and digital, we're building a powerful engine to serve small to mid-sized businesses on both sides of the border.

From a risk point of view, we've been very careful. Our financing is conservative and consistent with past acquisitions. We've maintained the strength of our balance sheet and protected ourselves against significant adverse development potential by partnering with a reinsurer. And I believe the diversification of our business mix, with better balance between commercial and personal lines and our extended geographic footprint, reduces our overall risk profile.

On the financial side, the numbers speak for themselves. We're entering the largest commercial P&C market in one of its most attractive segments while driving near-term accretion and creating value for shareholders.

So on behalf of my colleagues and all the employees at Intact, I'd like to take this opportunity to welcome the entire crew at OneBeacon. They've build an outstanding organization based on their expertise and strong values, and we're quite proud to join forces with them as we continue building a world-class P&C insurer.

On that, I'll return the call to Samantha.

Samantha Cheung {BIO 19462616 <GO>}

Thank you, Charles. Please note that a telephone replay will be available for a period of one week, while the webcast will be archived on our website for one year, and a transcript will also be available on our website shortly after this call.

We also invite you to listen to our Annual General Meeting of Shareholders which will take place tomorrow at 10:30 AM Eastern Time or 11:30 AM Atlantic Time at the Lord Nelson in Halifax, Nova Scotia. Our Second Quarter 2017 Earnings Call is scheduled for August. Thanks again for your time today.

Operator

This concludes today's conference.

Samantha Cheung {BIO 19462616 <GO>}

We're done.

Operator

This concludes today's conference call. You may now disconnect.