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Q2 2016 Earnings Call

Company Participants

- Jay Stanley Bullock, Chief Financial Officer & Executive Vice President
- Mark E. Watson, President, Chief Executive Officer & Director
- Susan Spivak Bernstein, Senior Vice President-Investor Relations

Other Participants

- Charles Gregory Peters, Analyst
- Jeff Schmitt, Analyst
- Matthew J. Carletti, Analyst
- Meyer Shields, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, everyone, and welcome to the Argo Group 2016 Second Quarter Earnings Conference Call. All participants will be in a listen-only mode. Please also note today's event is also being recorded. At this time I'd like to turn the conference call over to Susan Spivak Bernstein, Investor Relations. Ma'am, please go ahead.

Susan Spivak Bernstein {BIO 1514699 <GO>}

Thank you, and good morning. Welcome to Argo Group's conference call for the second quarter and six months 2016 results. Last night, we issued a press release on earnings, which is available in the investors section of our website at the www.argolimited.com.

Presenting on the call today is Mark Watson, Chief Executive Officer; and Jay Bullock, Chief Financial Officer. Also available during the Q&A portion is Mark Rose, our Chief Investment Officer. We're pleased to review the company's results for the quarter as well as provide you with management's perspective on the business. As the operator mentioned this conference call is being recorded. Following management's opening remarks, you will receive instructions on how to queue in to ask questions.

As a result of this conference call, Argo Group management may make comments that reflect their intentions, beliefs and expectations for the future. Such forward-looking statements are qualified by the inherent risks and uncertainties surrounding future expectations generally, and may materially differ from actual future results involving any one or more of such statements.

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Argo Group undertakes no obligation to publicly update forward-looking statements as a result of events or developments subsequent to this conference call. For a more detailed discussion of such risks and uncertainties, please see Argo Group's filings with the SEC. With that, I'm pleased to turn the call over now to Mark Watson, Chief Executive Officer of Argo Group. Mark?

Mark E. Watson {BIO 20610831 <GO>}

Thank you, Susan. Good morning, everyone, and welcome to our second quarter earnings call. After the market close yesterday, Argo reported growth in operating earnings per share of over 37 – excuse me 34% to $1.20 per share. This result reflects a lot of hard work finally paying off in the U.S. At a time where all markets are experiencing intense competition, our focus on risk selection and execution shows in the results.

Perhaps as important, we achieved these results in a quarter characterized by a high number of industry catastrophic-related loss events, both in the U.S. and outside the U.S., mainly the firestorm – excuse me – the fire in Fort McHenry as well as storms in Texas, both hail and flood.

Finally, this quarter results also benefited from strong results in our alternative investment portfolio. For the six months of 2016, our operating earnings per share of $2.16 per share grew 10.8% from the prior year. And book value per share of $57.93 at the end of the quarter is up nearly 7% from year-end 2015.

We continue to take encouragement from these results and remain thoughtful given the competitive landscape. Our underwriters are exercising discipline and passing on opportunities to underwrite business, where pricing objectives can't be met in our opinion. While this might lead to slower premium growth than we would like to see, it has also resulted in continuous improvement in the quality and we believe profitability of our portfolio. You can certainly see that in the – in our U.S. businesses this year.

Again, reflecting balance and execution, all four operating businesses generated an underwriting profit in both the quarter and the six month periods. Our combined ratio was 95.6% in the second quarter and 94.8% for the six month period and includes the impact of $23 million of catastrophic losses in the second quarter, and $26 million for the first half of the year. It also includes $12.7 million of positive reserve development from prior periods in the second quarter and $15.9 million for the first half of the year.

We continue to benefit from our prudent loss reserving strategy. Including this quarter, we benefited from favorable loss reserve development now for the last 21 consecutive quarters in each of the last 11 years or more than a decade.

Overall, our expense ratio is showing favorable year-over-year improvement as we have discussed in the past. Having said that, the Lloyd's market is becoming increasingly more expensive, as both commission expense and compliance expense increased. And we still aren't sure how to deal with Brexit. This is despite increasing pressure on the cost of acquiring business. This is an issue that is being felt industry wide and is approaching a

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point that in my opinion challenges the viability of our business model or the industry business model at Lloyds. We can talk more about that later.

Now let me briefly comment on each of our operating segments. It was a challenging quarter for premium production in our Excess and Surplus Lines of business. Gross written premium was up modestly in the second quarter and 2.6% for the first six months of 2016 compared to 2015.

The areas where we are achieving growth are in our casualty and environmental units, reflecting in part the benefit from our investments in technology. We are now able to more rapidly select and process submissions, allowing us to reduce turnaround time and improve results through better risk selection. As we continue making investments in these areas, we expect to see the benefit reflected in other areas of this segment over the coming quarters.

On average, rates were up modestly across this segment, other than Property, which is down a bit due to continued intense competition in this area. The first six months of 2016 continues the trend of improvement in most businesses within our Commercial Specialty segment. Gross written premium was up 27% in the quarter and 17% for the first six months. Growth was driven by our program and surety businesses with the contribution mainly from professional lines.

We've made incremental changes and improvements to our public entity business, which is once again performing well. Financial struggles in the energy sector have reduced new business opportunities in our mining and surety businesses. Despite these challenges, we achieved favorable underwriting income in each business.

As reported last quarter, we moved the reporting of Argo Pro, our U.S. branded professional liability business, into our Commercial Specialty segment to better reflect the largely retail distribution strategy of the business. Argo Pro is dedicated to serving groups, such as lawyers, accountants and architects with insurance against risks, such as errors and omissions as well as insuring the directors and officers of corporations and not-for-profit organizations.

Overall, rates in this segment were – overall rates in this segment were down modestly, with the largest declines in our retail establishment and surety businesses.

Turning to Syndicate 1200. Competition remained intense in the Lloyd's market, as I mentioned a minute ago. Gross written premium growth or I should say gross written premiums were down 9% in the second quarter, but still up 1.5% for the first six months of the year.

Variances in reported growth in any one quarter reflect changes to our (8:08) patterns and a shift to more business written in the market under Binder Authorities. The latter develops more slowly on both the written and earned basis than open market business. As to conditions in the market, it's not uncommon to hear that this is one of the most difficult markets in a long time at Lloyd's.

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Having said that we continue managing relationship by relationship, providing consistent business practices and outstanding servicing capabilities and renewed activity on partnering with our most profitable relationships. And despite the pressure on the margins from the distribution model in London, our platform has one of the lowest non-acquisition expense ratios in the market. As well, our overseas platforms in Singapore, Shanghai and Dubai are meeting our expectations, and joint efforts with our U.S. submitted business saw appreciable growth in a number of markets, mainly marine and livestock among them.

Our International Specialty segment continues to experience challenging market conditions, with gross written premium down 15% in the second quarter of 2016 and 6% for the first six months of the year. The decline in premium is somewhat exaggerated in Argo Re as a result of the timing of certain renewals, but was also impacted by the non-renewal business due to pressure on either pricing terms or terms and conditions. There are however in the market of touching bottom as a greater number of accounts are being rerated.

In the other business lines in this segment, excess casualty was negatively impacted by renewal timing, while production from our Bermuda professional lines and other global businesses was essentially flat. Partially offsetting this was higher premium in Brazil due in part to the appreciation of the real against the dollar. In Brazil, despite last year's climate of political and economic disruption, our balanced social response is seeing favorable reaction in the markets. And our long-term investment in Brazil – in the Brazil business is working well for us. And the platforms and products we developed there are now mature and replicable elsewhere, which you'll hear more about next quarter.

Turning to investments, as you may remember, last quarter, we began to include the performance of our alternate investments in investment income. All comparisons for this quarter are done under this reclassification.

For the second quarter of 2016, Argo's total return for the portfolio was 1.8%, bringing year-to-date returns of the investment for portfolio to 2.9%. Given the Brexit vote in our international businesses, we are pleased to report that the net impact was modest. During the second quarter, our return was positively impacted by our increased allocation to high yield, which we began in the third quarter of 2015. This has helped income and contributed to gains as well.

Speaking of income, our reported net investment income was $35.7 million for the quarter, which was $14 million higher than last quarter and $11 million higher than the second quarter of 2015. Alternatives contributed $12.5 million in the quarter versus a negative $1.6 million last quarter and a positive $2.6 million in the second quarter of 2015.

Moving on to capital management. Our philosophy has not changed and it's not likely to. Our first use of capital was to support the balance sheet, second is to grow the business, third is to have capital available for opportunities as they arise, and fourth is to actively return excess capital to our shareholders in an effective manner.

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In the first half of 2016, we repurchased 718,595 shares of stock for $40 million. Adjusted for the 10% stock dividend, the average price per share paid would have been approximately $51.05 per share. In total, over the last six years, we've returned more than $480 million of capital to shareholders, with $371 million of capital to shareholders through share repurchases, and we paid $109 million in cash dividends during that time.

We continue to view our stock as one of the best investments available. And we'll balance the return of capital to shareholders with our priority of building the Argo franchise and shareholder value in the long run.

With that, I'll turn the call over to our CFO, Jay Bullock. Jay?

Jay Stanley Bullock {BIO 3644311 <GO>}

Thanks, Mark, and good morning, everyone. I'll be brief in providing some detail on the financials and then open it up to Q&A.

As Mark highlighted, both operating earnings and book value showed continued progression during the quarter and the first six months of the year. And at $36 million through June 30, underwriting income is roughly equivalent to the same period in 2015 despite the significant increase in catastrophe-related losses, again, evidence of the hard work done by all our teams on improving the underwriting result.

To add some color to a few other items of note. The decline in the percentage of net written premium year-over-year was driven primarily by our reduced participation on the Syndicate of approximately 5% and by growth in our state funds funding business in our Commercial Specialty segment. As a funding business, the latter has the effect of increasing gross written, with no impact on net or earned.

Turning to loss trends, our current accident year non-cat loss ratio of 53.9% in the second quarter of 2016 and 54.7% in the first six months of 2016, both compare favorably to the same metrics for 2015. This was in part the result of a slightly lower incidence of large, attritional losses in the quarter.

In addition to the first 6 months of 2016, we continued the trend of overall favorable reserve development from prior accident years. For the second quarter, we experienced net favorable development of $12.7 million, which included positive development from all four of our operating segments and represented the fourth consecutive quarter, where all operating segments have shown favorable development.

This, despite modest adverse development in the Run-off segment, driven by the settlement of a large asbestos-related account, reducing that net exposure and future uncertainty. As always, all of the relevant figures on loss development are displayed in the table in the press release.

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Catastrophe losses that impacted our business for the quarter were $22.7 million, that's net of reinsurance and reinstatement premiums, or 6.8 points on the combined ratio. As we preannounced prior to our earnings release and as Mark noted, these losses stem from the Canadian wildfires and U.S. storms.

The favorable trend in our expense ratio in absolute expense is due to an organizational focus on realigning processes to a true shared search with true shared services platform where it make sense. This is an ongoing process, and we are seeing the results of our efforts both economically, but also on our ability to be more nimble on our approach to servicing our external customer base and for many of us, our internal customer base.

A couple of comments on investment returns. We saw a meaningful contribution to income from alternative investments. It's worth noting that the contribution came from a diverse group of more than 15 strategies, with no strategy accounting for more than 30% of the $12.5 million total.

As to realized losses of $2.1 million, while there were a number of offsetting gains and losses, the largest single contributor was from the – other than temporary impairment of certain equities that have yet to recover in value from the market dislocation in 2015. This was approximately $4.4 million.

Another item to note is FX. Despite the Brexit and the devaluation of sterling to the U.S. dollars, most other major currencies appreciated versus the U.S. dollar, resulting in a moderate FX impact for the quarter. For the second quarter of 2016 the effective tax rate for the group was 22.1%, modestly above our run rate expectation of 20%. In the quarter, the higher tax rate was mainly attributable to the approximate two-thirds of our earnings coming from the U.S. operating platforms. Year-to-date, the effective tax rate was approximately 19.4%.

Finally, on the balance sheet, we ended the quarter with a pre-tax unrealized embedded gain of $144 million compared to $84 million at December 31, 2016, reflecting the strong returns in the market. Operator, that concludes our prepared remarks, and we're now ready to take questions.

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Q&A

Operator

Ladies and gentlemen at this time, we'll begin the question-and-answer session. And our first question comes from Greg Peters from Raymond James. Please go ahead with your question.

Q - Charles Gregory Peters {BIO 4656608 <GO>}

I guess – good morning. And thank you for the call and taking my questions. Three questions for you, three areas; the expense ratio, reserve development and guidance on alternative investments. For the expense ratio, I think it's up – it's improved 100 bps in the

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first half of the year versus last year. And yet, Mark, you seem to suggest that there's some pressure coming at Lloyd's and other areas of the market that might lead to less improvement going forward. So perhaps, you can just provide us some additional color on that point.

A - Mark E. Watson {BIO 20610831 <GO>}

Well, Greg, I wasn't trying to suggest that there'd be pressure going forward. I was trying to suggest that notwithstanding the pressure right now, that we're still making improvements. I don't see – I mean, I guess, there could be more pressure going forward, but there's so much right now, it's hard to imagine more. So the point I was trying to make is I think, notwithstanding us growing the top line at a slower rate than we had intended, that we're still making progress in simplifying our company's operations and having some of that flow to the bottom line and expense savings. And I think there's still more room to go. I do think we will begin growing again at a consolidated level. It's just a little lumpy from one quarter to the next.

Q - Charles Gregory Peters {BIO 4656608 <GO>}

And how do we square that or put the growth comment with your remarks about the challenging business model at Lloyd's?

A - Mark E. Watson {BIO 20610831 <GO>}

Well, I guess – I should've said the London market in general. I just – I think that as more and more business is being sucked up with line slips and more business is being placed locally and not getting to Lloyd's, there's more – there's not as much business to underwrite.

Having said that – and this is why I was making the remarks – why I made the comment in my remarks earlier, there are plenty of other places where we're picking business on our Lloyd's platform, Singapore and Dubai as examples of that. So the point I was trying to make is, I think, while things get challenging in one place we're flexible and we're picking up premium in other places.

Q - Charles Gregory Peters {BIO 4656608 <GO>}

Right. On the reserve development, I think most people would have expected or anticipated some gradual year-over-year shrinkage of favorable reserve development. And yet, you reported something – it was a positive surprise for us. Is there something underlying in your loss picks that led to this result? Or perhaps just some additional color on this positive variance would be helpful.

A - Mark E. Watson {BIO 20610831 <GO>}

Yes. So let me say two things. We would like to think that we have – that our loss picks are always a bit conservative, which is why I made the comment earlier that we've had, I think, 21 consecutive quarters of positive reserve development. And over the last 11 years, we've had positive reserve development. So I would like to think that our loss – our current loss picks are conservative, albeit, slightly, but I think conservative. And the second thing, if

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you remember that in this quarter a year ago, we had negative development in our Commercial Specialty segment of around $2 million. And so we had positive reserve development in that segment this time of about $5.5 million. So that's a $7.5 million swing and that's about the difference between this year and last year.

Q - Charles Gregory Peters {BIO 4656608 <GO>}

Okay. Thank you for the color there. Finally, on the alternative investment portfolio, it seems like there could be some volatility in that result, to say the least, going forward on a quarterly basis. What kind of guidance can you provide us so we don't get it too wrong?

Well, so let me start and then I'll let Jay finish. Yes, there will be more volatility in operating income, as the investment portfolio moves up and down. But I think that this isn't a new phenomenon. Let me rephrase that. Our allocation to investment isn't new, but a number of shareholders have asked us to be more inclusive in the returns of our alternative portfolio as a part of operating income, which is why we decided to make the switch last quarter.

So yes, it provides a little – it creates a little bit more volatility, but it probably more accurately reflects the earnings of the company. Jay, do you want to jump in?

A - Jay Stanley Bullock {BIO 3644311 <GO>}

Well, I guess the only thing additional I'd add, Greg, is if I'd refer you back, we haven't filed the Q yet, so I'd refer you back to the 10-K or the – I don't have the first quarter Q in front of me. But if you go back to year-end, we disclosed some of our – we disclosed the buckets of our alternatives. And two of them, they're going to be what I would call more recurring in nature or the hedge funds and loan only funds. That's about $350 million.

If I were to be conservative and say, what's my expected returns, in this environment if we can get 6%, 7%, 8%. Of course, any time we invest in one of these strategies, we see a potential to do better than that. But I think that that's a reasonable expected return over a long period of time out of those investment strategies.

Q - Charles Gregory Peters {BIO 4656608 <GO>}

Perfect. Thank you for the answers and congratulations on the quarter.

A - Jay Stanley Bullock {BIO 3644311 <GO>}

Thank you, Greg.

Operator

Our next question comes from Meyer Shields from KBW. Please go ahead with your question.

Q - Meyer Shields {BIO 4281064 <GO>}

Thanks. Mark, I was hoping that we could – sort of behind the curtain, and you talked a fair amount about the pressure that the markets are seeing. Is there any increased M&A potential because of that?

A - Mark E. Watson {BIO 20610831 <GO>}

Well, you saw one M&A transaction earlier this year. I think there are a couple of others that are underway at the moment. You got at least one listed company there that's hit the wall. So yes, I think that you might see another couple of deals this year. I don't think there will be a wave of M&A activity, but I think that you'll see one-off deals between now and the end of the year.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. Is it reasonable to infer from the consistent share repurchase that you're not building a war chest for that? I understand the priorities that you laid out. That make sense. I'm just wondering how you think about the timing of that, having that capital available?

A - Mark E. Watson {BIO 20610831 <GO>}

Well, I would say right now, we have the high-class problem of generating capital faster than we can deploy it. And given our share prices it's been a pretty easy decision to buy back our stock. Having said that, we've got plenty of capital to look at pretty good-sized deals, either between cash in the balance sheet or the investment portfolio or access to the capital markets.

So it isn't that we haven't been looking. It's just that things that we've looked at seem to get bid up and get away from us. And I'll give you a great example. There was a company that we looked at a few years ago that we were allegedly the coveted bidder, and I'll use that word allegedly. And we just couldn't figure out how to get to the price that we got to, because we thought there was a hole in the balance sheet, and it would appear that, that company reported about a $200 million hole in their balance sheet last week.

So sometimes, I think we know too much when we do due diligence, and it's just these things keep getting away from us on price. And so that's okay, we'll wait for the next one.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. Fantastic. Thank you so much.

Operator

Our next question comes from Jeff Schmitt from William Blair. Please go ahead with your question.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Hi, good morning, everyone. I missed the beginning of the call, so I apologize if you covered this. But the jump in premiums in the Commercial Specialty segment looks to be

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close to 30%. What drove that?

A - Mark E. Watson {BIO 20610831 <GO>}

A fair amount of that was in our program business segment, followed by growth in professional liability, surety and to lesser extent, public entity.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Okay. And then on the E&S side, I mean, we're hearing from some people that some of the standard writers are - may start to include what had traditionally been the E&S risk into a packaged policy as opposed to sending it elsewhere. Are you seeing any further encroachment there beyond historical levels?

A - Mark E. Watson {BIO 20610831 <GO>}

I wouldn't say we are seeing encroachment beyond historical levels, but you are correct that the admitted market is increasing its appetite at the moment. This isn't the first time, and it won't be the last.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Okay. Thank you.

Operator

Our next question comes from Matt Carletti from JMP. Please go ahead with your question.

Q - Matthew J. Carletti {BIO 5249827 <GO>}

Thanks. Good morning. Just had a numbers question on the Lloyd's Syndicate, the ex-cat accident year loss ratio was - I think I got to go back several years to find that one low. And I know, Jay, you mentioned in your comments briefly that there was a slightly lower, I think, frequency of large attritional losses. You have been running kind of mid-50s for several quarters, if we average it out, and it was good five, six points below that. Is that the full impact there? Or is there - is that just a small piece of it and there's other things going on?

A - Jay Stanley Bullock {BIO 3644311 <GO>}

That's by far, the biggest impact. And again, as you know, we did have some cat losses there. That business has been, has avoided most of the catastrophe events for the last couple of years. And as we've reported in quarter after quarter, large bad things have happened, and Lloyd's were insuring most of those things.

So I would say that the majority of the impact is related to that. There's also a few other things that we've done where we're - well, we're moving out of some businesses that are going to have an impact on that as well. Really small numbers, but small numbers that have bad results can have larger impacts than they deserve.

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Q - Matthew J. Carletti {BIO 5249827 <GO>}

Yes. (29:22). Okay. That's very helpful. Thank you and congrats on a nice quarter.

A - Mark E. Watson {BIO 20610831 <GO>}

Thank you.

Operator

And ladies and gentlemen, at this time, I'm showing no additional questions. I'd like to turn the conference call back over to management for any closing remarks.

A - Mark E. Watson {BIO 20610831 <GO>}

Thank you. I'd like to thank everyone for joining us today. It's a choppy market, but I think our company sits in the best position it has in a long time. We absolutely did very well in the U.S. this quarter, as I mentioned on our – in my opening remarks. In fact, I think we made more money on both an underwriting basis and operating income in the first half of this year than we ever have.

And I'd like to thank everyone in the U.S. for all their hard work. And I look forward to talking to you all again at the end of the third quarter. And operator, that concludes my remarks.

Operator

And with that, ladies and gentlemen, today's conference is now concluded. We thank you for attending. You may now disconnect your lines.

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