FINAL

Bloomberg Transcript

Q1 2017 Earnings Call

Company Participants

- Axel Schmidt, Group Chief Underwriting Officer
- 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

- Arash Soleimani, Analyst
- Jeff Schmitt, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day and welcome to the Argo Group 2017 First Quarter Earnings Call and Webcast. All participants will be in listen-only mode. After today's presentation, there will be an opportunity to ask questions. Please note this event is being recorded.

I would now like to turn the conference call over to Ms. Susan Spivak Bernstein, Senior Vice President of Investor Relations. Please go ahead.

Susan Spivak Bernstein {BIO 1514699 <GO>}

Thank you and good morning. Welcome to Argo Group's conference call for the first quarter 2017 results. Last night, we issued a press release on earnings, which is available in the Investors section of our website at www.argolimited.com.

Presenting on the call today is Mark Watson, Chief Executive Officer, who will share his thoughts about the quarter after which Axel Schmidt, our Chief Underwriting Officer will discuss some of the trends in the business and Jay Bullock, Chief Financial Officer will add more commentary to our financial results. As the operator mentioned, this call is being recorded.

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 inherent risks and uncertainties surrounding future expectations generally and may materially differ from actual future results involving any one or more of such statements. 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'll turn the call over to Mark Watson, Chief Executive Officer. Mark?

Mark E. Watson {BIO 20610831 <GO>}

Thank you, Susan. Good morning, everyone and welcome to Argo Group's 2017 first quarter earnings conference call.

Beginning in 2017, we had two significant changes in our reported results. First, we closed the Ariel Re transaction and have two months of results included in our first quarter numbers. Second, we changed our reporting structure to better align reported results with the way we're managing our businesses and thinking about our operating structure. Going forward, we think that reporting our results in the way we run the company is more appropriate, which is by our U.S. Operations and our International Operations. Please note that International is defined as where we underwrite risk, not necessarily where the risk resides.

Now, getting to a few numbers. After the market closed yesterday, Argo reported net income of a $1.19 per share for the first quarter of 2017, up nearly 34% from the prior year and a return on average equity of 8.1%. For the past four years, our return on equity has averaged 9.7%. Adjusted operating earnings for the first quarter of 2017 of $21.9 million, or $0.71 per share was down from the same period in 2016, primarily due to some non-recurring items that Jay will go into further detail in his commentary.

Like others, this includes the charge for Ogden. These charges do not reflect our underlying business and we feel good to be continuing the momentum of 2016 and the current year. We ended the quarter with book value of $60.84 per share, an 8.5% increase from March 31, 2016, and a 10.1% increase when you take dividends paid into consideration.

As I have discussed on these calls and in our meetings, we consider the compounded annual growth rate of book value per share as the measure that most clearly demonstrates value creation for our shareholders. For the last 15 years including dividends paid the compounded annual growth and book value per share has been 10%.

These results demonstrate the continuous improvements we've made to the company. It's been quite a busy few months with the closing of the Ariel Re transaction, and once again I want to take the opportunity to welcome all of our new employees to the Argo team. We're making good progress on integration and I want to thank everyone for all their efforts to-date.

Having said that, I think we'll have a lot more to talk about at the end of the second quarter.

In our U.S. Operations over the last few years Kevin Rehnberg and his team have done an outstanding job of evaluating and building this business and bringing on new additions to our leadership team. Our U.S. Operations reported a 16.5% increase in gross written premiums in the quarter to $335 million.

While all core of our reported business lines within the unit grew versus the 2016 first quarter, the strongest growth was in our liability lines mainly programs, Rockwood and Trident followed by property. In terms of premium rates in most of our business lines they're headed in the right direction. Unfortunately, just not as fast as, we'd like to see.

On an overall basis in the quarter rates were up a little over 1% on our U.S. book. The first quarter of 2017 loss ratio excluding cat losses and reserve development was 57.6% versus 56.2% reported in the first quarter, mainly from higher attritional losses in our property lines from the few discrete claims including one fire claim that was for about $2 million.

We continue to implement and utilize new technologies that help us better analyze and select risk. As our digital and underwriting teams collaborate to improve the overall underwriting process, it reduces the cycle time to quote, so we can respond to more opportunities and underwriters have more time to focus on new business with the highest probability of success.

To give you one example where the improvement in technology is working really well for us is in our U.S. casualty business. By working with our clients, we've incorporated their feedback to improve our process of responding to the 90,000 or so submissions we receive annually, resulting in a reduction in cycle time of underwriting a policy from 10 days to 2 days. Ann an increase in monthly quotes from 700 to more than double at 1,600. With these types of initiatives, we'll demonstrate profitable growth rate at all phases (06:41) of the underwriting cycle we believe.

If you're wondering why premium isn't growing faster, well with all of this ease of doing business for our customers, it's because the market is even more competitive today than it was a year ago, if you can imagine that.

Moving on to talk about our International Operations including London, Bermuda, Latin America and now Ariel Re. These are being run by Jose Hernandez. As I mentioned on our last call, Jose has considerable expertise in building and running successful operations in several countries around the globe. Under Jose's leadership, these businesses are collaborating to drive the growth globally. In the first quarter of 2017, gross written premiums were up 13.5% primarily driven by the acquisition of Ariel Re in both our property and specialty lines.

The loss ratio excluding catastrophe losses and prior year reserved development was 54.7% compared to 54.5% in 2016 or relatively flat. Market competition remains fierce in London market particularly Lloyd's, it's probably the toughest market in the last two decades.

In addition to price competition, the cost of acquiring business continues to rise. In my opinion, at some point, the market as a whole will have to ask itself, is enough, enough? In the meantime, our relationships inside the market deepened over time by collaboration, solid underwriting and outstanding service should see us through with our profitable partnerships.

Now turning to investments, Argo's first quarter return was 1.5% versus 1.2% in the first quarter of 2016. Our core bond portfolio was up 0.8% and our capital appreciation portfolio was up 3.6%, which continues the trend we experienced in 2016. Our reported net investment income was $30.5 million for the first quarter, $9million higher than the first quarter of 2016, and $5 million higher sequentially. Alternatives at $8.3 million in the quarter made up most of the increase both year-over-year and sequentially.

As a reminder, we expect the alternative contribution to be lumpy by quarter as can be seen in the table provided in our press release.

During the first quarter, the strongest asset class performers were global equities and emerging market debt. However, most of our asset classes held up reasonably well. Recently, we began rebalancing our portfolio by trimming some of our risk exposure in equities and high yield debt as the risk-reward becomes less compelling. And our risk portfolio return has grown at over four times the pace of our core bond portfolio, which I guess I would consider a high-class challenge.

We've talked a lot about in the past about capital management. This quarter, we did not repurchase any shares as one of our uses of capital is to have it available for opportunities as they arise, as we did with the closing of Ariel Re transaction.

Having said that, we did increase our quarterly dividend by 23% at our February 2017 board meeting. And I should point out that over the last six years, through share repurchases and dividends, we've returned over a $0.5 billion in capital and repurchased 32% of the shares outstanding of the company.

With that, I'll turn the call over to our Chief Underwriting Officer, Axel Schmidt. Axel?

Axel Schmidt {BIO 19499069 <GO>}

Thank you, Mark, and good morning, everyone. As Mark mentioned, it has been a busy few months. Through the first quarter of 2017, we have grown gross written premiums compared to first quarter 2016 in all of our major lines of business. About 44% of our first quarter GWP across group to generate some cash (10:44) products, we continue to benefit from having a diverse spread of products across our major lines of business. In fact, across the group, in Q1 2017, we were able to achieve a marginal increase in premium rates. We maintain our proactive approach to managing the portfolio across the cycle.

As key aspect of this is to ensure that we keep our underwriting discipline and we underwrite for profit and not for volume. I'm pleased to comment that our underwriters continue to demonstrate this philosophy across all geographies. In those areas of the portfolio that are more challenging, we seek to drive rate increases where appropriate or address the issues by other underwriting actions.

Where we see opportunities, we make investments in underwriting teams and underwriting systems.

In professional lines, our first globally managed line of business, we strengthened our offering. We added experienced leaders to our underwriting teams in Europe and U.S. The teams across all geographies collaborate effectively to generate new opportunities, such as our transactional liability risk program in the U.S.

Cyber is another area where we see significant market opportunities. In the first quarter of 2017, our syndicated loans to cyber product, our dedicated expertise in London complements our existing expertise both in the U.S. and Bermuda. And with our global approach to cyber, we further leverage our expertise across all platforms to deploy our capacity effectively. In the U.S., we have also built out our surety offering by introducing a broader contract surety product where the team has made a couple of key hires as well.

Finally, as Mark mentioned, we have made substantial strides to implement and utilize new technologies, to improve the efficiency and effectiveness of underwritings across the globe. Another area that this is significant is in our Brazilian (12:50) operation where nearly 40% of our business is now transacted digitally.

With that, I'll hand over to Jay Bullock to add some more commentary to our financial results.

Jay Stanley Bullock {BIO 3644311 <GO>}

Thanks Axel and good morning everyone. I'll provide some detail on the financials and then, open it up to questions.

As Mark highlighted and Axel discussed, we've made changes to our segment reporting this quarter that reflect a simplification of our management structure, and we hope to give investors a clear understanding of our business fundamentals. In this and future releases, we will discuss our business in two reportable operating segments with detail based on product lines relating to the underlying events.

As in the past, our consolidated results will include any impact from our run-off unit, as well as expenses, now otherwise allocated to the business units. Additionally, as noted our acquisition of Ariel closed in February and as a result the quarter reflects two months of operations for the business.

As a significant portion of this business is written at January 1, the gross results do not reflect the business written by Ariel in the quarter. Total gross written premiums for the quarter for Ariel Re were approximately $125 million with approximately $30 million of gross written premiums included in the two-month results.

As we noted in a press release a few weeks ago, we did have some non-recurring items in the quarter that impacted both our reported loss and expense ratio, while these numbers are included in operating earnings, they do not reflect the underlying profitability of the business.

Firstly, impact of prior year results on the loss ratio. We continue to benefit from positive reserve development in our U.S. Operations. The $5.2 million of positive reserve development was driven primarily by releases in our casualty and workers' comp lines. And while reported development in our international segment was negative, the result was impacted by $4.5 million related to the Ogden rate change in the UK and by additional claims of approximately $5 million from Hurricane Matthew.

Excluding these two items the development in the International business was slightly positive and for the group overall very much in line with last year's first quarter result. Catastrophe losses in the quarter were $1.8 million, compared to $3.3 million in the first quarter of 2016. Losses in this year's quarter are primarily from U.S. storms and Cyclone Debbie.

On the expense ratio, there are really three items that impacted results. The first is one-time cost related to the Ariel Re transaction of $2.5 million, primarily related to professional fees. The second is $4 million of cost for restructuring and transitioning certain infrastructure and technology services to outside third-party managers. We expect this work to enhance our platform stability and lay the groundwork for further operating efficiencies.

Finally, during the quarter we saw a meaningful increase in the stock price and recorded approximately $1.5 million of expense related to equity compensation above what we would have expected. Excluding these items, the expense ratio was 38.4%, compared to 38.5% in the 2016 quarter.

For the first quarter of 2017, the effective tax rate for the group was 14% versus our base assumption of 20%. The lower than expected rate was mainly due to a higher proportion of earnings from our Bermuda operations.

Finally on the balance sheet, as we mentioned, we've recently closed the acquisition of Ariel Re, the acquisition was funded with cash on hand and a $125 million term loan. This is reflected on the balance sheet under other indebtedness. In addition, we assumed $84 million of junior subordinated debt with Ariel Re acquisition. This debt is structurally very similar to the trust preferreds we have on our balance sheet and offer some useful capital advantages.

We ended the quarter with a pre-tax unrealized embedded gain of $131 million, compared to a $116 million at December 31. Majority of gains relate to our equity holdings, our fixed income holdings remain very short in duration and the carrying value currently approximates market value.

Operator, that concludes our prepared remarks, we're now ready to take any questions. Operator?

Q&A

Operator

Okay. We will now begin the question-and-answer session. The first question comes from Arash Soleimani of KBW. Please go ahead.

Q - Arash Soleimani {BIO 18869554 <GO>}

Thanks. Good morning. How – just going forward, how should we think about your net to gross ratio. I mean, to what extent are you increasing or decreasing your use of retro?

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

So, right now, I don't – we've been pretty consistent, well let me rephrase that, within a couple of percentage points. I don't see that changing for the next few quarters as we think about our capital structure for 2018, we may make some changes, we'll probably highlight those in the November call. I say that Arash because our cat months were issued on a multi-yeared basis and they expire at the end of this year. So, we'll be rethinking how we want to use the capital markets to support our property cat underwriting program in 2018.

But other than that, I think the difference between gross and net will remain fairly consistent depending upon reinsurance pricing and insurance pricing, but I don't expect too much of a change between gross and net other than supporting our cat program.

Q - Arash Soleimani {BIO 18869554 <GO>}

Okay. Thanks. And the other question I had, I don't know if this was mentioned in the prepared remarks. But did you say, what specifically drove the strong performance in alternatives?

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

I think, it was just – it was across the board in all of our hedged strategies. Most of them are credit you may recall. And we also did, I think, pretty well in some of our high-yield portfolio which I also mentioned, we had sold off a part of it.

Q - Arash Soleimani {BIO 18869554 <GO>}

Okay. Perfect. Thank you very much for the answers.

Operator

The next question comes from Jeff Schmitt of William Blair. Please go ahead.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Hi. Good morning, everyone. Question on the expense ratio in the U.S. Operations, it look to be up a fair amount the 35%, or the transition – I guess $4 million for transition of IT functions did that fall in there?

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

That was – those costs were retained at the holding company. What you see in the U.S. Operation in the first quarter of 2016, we've divested off a portion of our non-risk bearing business, so there is a gain on sale of about $1.5 million related to that. As Axel mentioned we've made some few key strategic hires in areas like professional liability and surety that also was reflected in the first quarter. So, I actually expect that number to come down a bit, of course, that gain in the first quarter of 2016 was a one-time item. But I do expect to see that number start to trend down as our premium starts to pick up reflecting those new hires.

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

Yeah. In addition to that, some of the IT did flow through there, it's a little over a $1 million and earlier Jay mentioned that – that with our share price moving up in the quarter that we had more equity compensation expense than we intended and that was over $1 million for the syndicate as well. When you add them all up that get you to a couple of points on the expense ratio.

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

Sorry, that was a more than a $1 million for the U.S.

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

Yeah.

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

For syndicate, yeah.

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

Sorry, for the U.S.

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

Yeah.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Yeah, yeah. And then looking at the consolidated underwriting acquisition cost, it look to be about $19 million higher than if you just add the two segments, $6.5 million one-time cost which you showed one cost, which you showed, but that remaining $12 million, how much of that was incentive comp versus I guess what else was in there?

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

Well, there is $3 million related to the incentive comp. There is a $1 million of IT that Mark mentioned. You have to take into account the $1.5 million gain from last year, I'm not sure what that gets us to now, fairly, fairly close. So, those are sort of the big identifiable items. As I mentioned, there is a small impact from of the new people coming on board. But as I said, we expect to see the earned premium pickup related to that.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Okay. And then, one quick question on losses in the U.S. segment. We're seeing accident year loss ratio has moved up, 100 basis points to 150 basis points for a lot of competitors, but it looks like yours was mainly driven by a property loss. Could you maybe talk about loss trends, are you seeing any uptick in loss cost?

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

Yeah. Well let me start, and then I'll let Axel jump in. If you look at the trends of our portfolio over the last four years now, I think you've seen a pretty steady improvement in loss ratio, as we've rebalanced our portfolio, Axel, mentioned to that earlier actually. Loss cost trends haven't really changed too much. I think that for our portfolio to move around 100 basis points here or there from one quarter to another doesn't worry me too much, as we continue moving around the balance of our portfolio. Axel, do you want to add anything to that?

A - Axel Schmidt {BIO 19499069 <GO>}

Yeah. Kind of few things. Thank you, Mark. I think the really critical is that particularly with regards to attritional losses that as we both Mark and I and Jay mentioned earlier, our rate level has not gone further down. So, that's slightly up it's one good thing in terms of operational loss ratio exposure.

Secondly, we have that same, I think very effective reinsurance program in place across the board for the larger losses. And then if I compare our loss ratio Q1 to plan, we are doing about 1.5 points better than planned. So, I'm pretty much and I see that, that's going to continue over next quarter that we're in line, better this plan based on all the actions and initiatives and mitigating actions we put in place. So, I'm comfortable that, we will not be negatively surprised by loss trends.

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

Yeah, let me say one – let me just say one last thing, notwithstanding the growth in our P&L over the last few years, it's still, I find it's surprising to be honest that, that when we have a $2 million or $3 million loss, it still impacts the quarter in terms of attritional losses. So, it's – there is still a little bit of lumpiness to that sometimes.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Okay. Thank you.

Operator

We have a follow-up question from Arash Soleimani of KBW. Please go ahead.

Q - Arash Soleimani {BIO 18869554 <GO>}

Thanks. Just wanted to follow-up on the loss cost trends. I was going to ask, I know on a couple of previous calls, there were comments about, I guess, the plaintiff's attorneys being more aggressive, and higher jury awards coming through, are you seeing any of that in your book?

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

No, not really.

Q - Arash Soleimani {BIO 18869554 <GO>}

Okay. All right. Thank you.

Operator

This concludes the question-and-answer session. I would now like to turn the conference back over to Mr. Watson for closing remarks.

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

All right. I'd like to thank everyone for joining us today. I know, it's a busy day, a busy week and a busy couple of weeks actually with everyone reporting. I think, we'll have a lot more to talk about at the end of the second quarter, particularly what things look like for 2018 and also I think, we'll have made a little more progress in the integration of Ariel into our organization.

So, thank you again for everyone being on the call today. And I look forward to talking to you again at the end of the second quarter. Operator, that concludes our remarks.

Operator

The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.