Q3 2016 Earnings Call

Company Participants

- Alexander Maloney, Group Chief Executive Officer & Executive Director
- Elaine Whelan, Group Chief Financial Officer and Chief Executive Officer, Lancashire Insurance Company Limited
- Paul Gregory, Group Chief Underwriting Officer & CEO-Lancashire Insurance Company (UK) Limted

Other Participants

- Andreas Evert Cornelis van Embden, Analyst
- Anna Hui, Analyst
- Ben Cohen, Analyst
- Janet Demir, Analyst
- Jonny Urwin, Analyst
- Nick Johnson, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day and welcome to Lancashire Group Q3 2016 Results Conference Call. Today's conference is being recorded. At this time I'd like to turn the conference over to Alex Maloney, Group Chief Executive Officer. Please go ahead, sir.

Alexander Maloney {BIO 16314494 <GO>}

Okay. Thank you. Good morning, everyone. Thanks for calling in. I'm pleased to report a strong set of results for our third quarter, a return on equity of 3.1% and a combined ratio of 73.8% demonstrates our underwriting investment strategies continuing to fare well, considering different underwriting and investment conditions we continue to experience.

Our year-to-date return on equity of 10.5% and combined ratio of 75.6% are excellent indicators of our ability to manage this stage of the cycle. We said at the start of the year we believe we can maintain our premiums around the same level as 2015, which we had done within a reasonable margin.

We have continued our total focus on profitable underwriting across all of our platforms and managed our risk levels appropriately versus the underwriting opportunity. We have reduced risk levels year-on-year. We see this would change (01:16) in the overall outlook, so our strategy remains constant. We continue to see decline in pricing, with underwriting margins dim (01:23) in most, if not, all classes of business.

There does appear to be a realization that the pace of reductions will slow, and we expect the January 1 renewals to be in the region of single-digit reductions for quality accounts. Our view hasn't changed in that we do not believe the pricing environment will materially improve until capital was impaired and capacity decreases.

Hurricane Matthew was a timely reminder for our industry that when you're in the risk business, things can change quickly. This hurricane does not appear to have generated any real material losses for the industry, but easily (02:00) could have generated one of the largest cat losses we have seen for over a decade.

Again it demonstrates how easy it is to focus on premium, not risk at this stage of the cycle after such a benign period for such events and a very low insured cat loss activity for several years. The only thing which is guaranteed is that events such as this will eventually challenge our industry and we need to be able to respond accordingly and manage our customers' needs. We continue to make progress with the changed management we are bringing to our Lloyd's business, Cathedral.

We have hired many talented individuals to join our colleagues there, and believe that our Lloyd's business will only become more aligned to the overall group, allowing us to further leverage the benefits of our multi-platform business. Our underwriters at Cathedral continue to produce excellent underwriting results, while being totally focused on disciplined underwriting and risk selection.

We simply won't write risk for inadequate pricing. So our story doesn't change nor should it as we no immediate change in the underwriting or investment environment. Clearly, margins are high tight across most product lines, but we have demonstrated that Lancashire, Cathedral and Kinesis models continue to produce excellent results for our shareholders in challenging times.

I would like to thank everyone who works for our company for their huge effort in producing these results.

I'll now hand over to Paul.

Paul Gregory {BIO 16314515 <GO>}

Thanks, Alex. Once again, I'm able to report a solid set of underwriting results with a combined ratio of 73.8% for third quarter and 75.6% year-to-date. This has helped to deliver another strong quarter of ROE for the group. Most pleasingly, all platforms within the group continue to contribute to the group's underwriting results.

We've reiterated many times that these are the toughest trading conditions we've faced in the business, but in these difficult market leading underwriting results is very pleasing albeit we do know and we do appreciate the loss environment this year and in recent years has not been particularly testing. This is something we do not forget. That said, with the combined ratio in the mid 70%s we certainly have a little bit of margin for when these losses inevitably do arrive.

In fact, the fourth quarter has kicked off with Hurricane Matthew which turned out to be – which turned out not to be as destructive as first feared, but it's again a well-timed reminder we will not be in a benign loss environment indefinitely.

With underwriting margins so tight, it's not going to take much for the macro underwriting results for the industry to dip into the red. As we look forward to 2017, we do not anticipate Hurricane Matthew having any significant impact to the broader market conditions, only a retraction of capital will (04:49). However, it helps us edge (04:51) slightly closer to the bottom of the cycle.

Our business is notoriously lumpy due to line sizes in the Lancashire platforms and the impact of multi-year deals, but quarter-to-quarter there can be premium movements between subclasses, but in line with guidance our premiums in 2016 have broadly tracked with those of 2015 demonstrate that we continue to hold on to our core portfolio of risks.

Our expectations for 2017 is for rates to continue to reduce in most of our product lines, but the rate reduction should be less significant than in recent years. In particular the catastrophe reinsurance lines are likely to be less competitive than the specialty insurance lines as it feels like they are starting to bundle down the bottom.

For us this means same (05:34) as before which is to establish (05:36) defend the portfolio of businesses we have and purchase adequate reinsurance protection so our risk levels are managed appropriately. Our reinsurance strategy has been beneficial this year and absent any shift in market dynamics we will not be able to (05:51) strategy.

In any market, there'll always be new business opportunities and we will exploit these wherever possible, but at this stage of the cycle they are a far less than we would ideally like. So our underwriters maintain their discipline and won't underwrite top line. We do appreciate that this is a recurring message from us, but we strongly believe that this strategy is the correct one for this part of the cycle, enables the group to produce acceptable returns to our shareholders.

It's also one of the major reasons we've been successful in replenishing our underwriting teams with new talent throughout the year as good underwriters want to be allowed to underwrite sensibly. These new underwriters bring with them new broker and relationships that would also help us develop our existing books of business both in the short-term and longer term. I'll now pass over to Elaine.

Elaine Whelan {BIO 17002364 <GO>}

Thanks Paul. Hi, everyone. Our results are on our website as usual. We had a quite quarter in the loss fund with very little reported. While we had some adverse developments on some individual prior accident year claims, we still had net favorable development for the quarter. Underwriting performance was therefore very good again this quarter with a net loss ratio of 25.3%. Our investment portfolio also performed well despite uncertainty in the market and our overall ROE for the quarter was 3.1%, bringing us to 10.5% for the year-to-date.

With a bit of reduction in this quarter in Cathedral's reserves for the Canadian wildfires, Cathedral contributed 1.1% to the ROE for the quarter, bringing the contribution to ROE to 2.3% for the year-to-date. While it's too early to provide a solid estimate, we will undoubtedly have a loss in the fourth quarter from Hurricane Matthew although we expect that to be contained within earnings. Other loss activity in the fourth quarter so far has been light.

Back to the current quarter, there is a reduction in gross premiums written in this quarter compared to last year with most of that coming from Cathedral. While Cathedral maintained a core book to replace reductions across both lines of business as pressure on rates continues.

On the Lancashire book, we had reductions primarily in the political and sovereign risk books and offshore energy. We're still seeing good deal flow in the political and sovereign risk books, the timing is difficult to predict in that line of business due to the specific nature of the deals.

On the offshore energy book, reduction is mostly due to reduction in exposures driven by the oil price. The slight uptick in property cat is just the timing of the multi-year contract renewals.

While we don't give top-line guidance, as Paul has said, we expect the current pricing pressure to continue into the fourth quarter and next year. The fourth quarter is typically our lowest volume quarter, so there was a less of an impact there.

For 2017, I would imagine our top line will come off a little bit although there are all the certain pieces of new business opportunities around. Our premium ceded is higher than prior year due to some premium ceded to several high-risk (08:42) facilities, and also some reinstatement premiums.

As Paul said, the additional reinsurance purchased this year has been beneficial to the group, because of some substantial recoveries last quarter although there is a knock-on impact on the earned premium.

Our net earned premium is also impacted by some of the longer-tenured businesses we've written in the political and sovereign risk book. But, we will have the benefit of those premiums earning out over the years ahead.

Our acquisition cost ratio is trending back down in line with the expectations. I would anticipate the full year ratio of being around 26%.

On losses, as I mentioned, there has been very little reported. A couple of individual claims from prior accident years deteriorated, but we still had net favorable development for the quarter. The 2014 and 2015 accident years in particular, had very few reported.

Investments, including currency hedging returned 0.6% for the quarter despite the increase in treasury yields. Our fixed maturity portfolio still generated a positive return due to credit spreads coming in and our risk assets performed well with strong returns from our bank loan, equity and hedge fund portfolios. With the expectation of Fed hikes in December, we maintain our current portfolio positioning, we continue to diversify our portfolio, stay fairly short durations and manage our interest rate risk.

In other income, profit commissions from Kinesis are down on prior year. This is largely timing as we have received $2.9 million in Q4 as collateral was released on the 1/1/15 and 1/7/15 underwriting cycles, with hopefully a little more still to come through. As there are no losses on the 1/1/16 underwriting cycle, profit commissions could be just under $6 million, but the earliest we will receive that would be Q1 2017.

Our G&A includes KCM's expenses. While our total G&A dollars spend is down on the prior year, the ratio has increased due to lower net earned premiums. We saw a bit more benefit in our cost base this quarter from declining sterling exchange rates. That benefit offset increases elsewhere due to increased head count and variability around incentive pay. With more than half of our cost base in sterling, there should be some further benefits from the falling (10:50) sterling in next year's expenses.

While our stock comp expense is impacted by vesting and performance assumptions, the significant reduction in the quarter's expense compared to the prior year is largely due to the departure of certain Cathedral employees earlier this year as awards granted in acquisition (11:07) lapse. We will see that trend continue for a few more quarters.

We had a positive benefit this quarter in the mark-to-market of our interest rate swaps as yields rose. Ignoring this swap mark-to-market and any one-off costs, our financing costs still tend to be around $4 million a quarter.

Lastly, on capital; as stated in the press release, we're declaring a special dividend of $0.75 per share. We said earlier this year, if there were no changes in the market, we would be likely to return earnings and maintain capital at the $1.35 billion to $1.40 billion level. The market is much the same and our outlook on 1/1 is for continued reductions albeit at a slower pace.

There is some benefit to us from own reinsurance buying and with some further enhancements in our program and the comprehensive income of $123.3 million for the year-to-date we're comfortably in returning $150 million of capital.

With that I'll now hand over to the operator for questions.

Q&A

Operator

We can now take our first question it comes from Ben Cohen of Canaccord. Your line is open, please go ahead.

Q - Ben Cohen {BIO 1541726 <GO>}

Good afternoon. Thanks very much. Hello. I wanted to ask two questions, please. Firstly, you made reference to the benefits of reinsurance in the quarter, I just wonder if you could say more about the lines and the size of the underlying (12:58) the gross loss where you made the substantial recoveries that you referred to.

And secondly, I was wondering if you could give us an outlook for the development of earned premium going into next year given that multiyear deals and where they fall does tend to make that lumpy. Would you expect that to be flat or could that even rise a little bit? Thank you.

A - Alexander Maloney {BIO 16314494 <GO>}

So, Ben, on question one there is a quite large energy loss in the market that you'd expect us to have. Our energy account is still substantial versus the market and we have one particular account there's a large loss there and we have - did a lot of reinsurance to protect us for that loss, so it's exactly what we'd expect to have (13:53) it's in their market share and the reinsurance program has worked accordingly. So it's pretty much similar. Elaine?

A - Elaine Whelan {BIO 17002364 <GO>}

Yes. In terms of the outlook for earned premium for next year, I think you should see that more broadly in line with this year. We do expect our top line to come down a little bit with pricing but in terms of the percentage of earned to net written it should be about the same.

Q - Ben Cohen {BIO 1541726 <GO>}

Okay. Thank you very much.

Operator

Thank you. We can now move along to our next question. It comes from Jonny Urwin of UBS. Your line is open, sir. Please go ahead.

Q - Jonny Urwin {BIO 17445508 <GO>}

Hi, there. Thanks for taking the questions. Just two from me. So firstly on reserve releases, $5 million in the quarter was a bit lower than I was thinking, and that's weighed by - weighed down by the marine (14:45). I just wondered if you could quantify that because I also saw a comment in the release that said, clearly, case reserves are coming down a bit because we haven't had any losses in the recent years. But I'm just trying to think about what reserve releases might do in the coming years? But I guess, these will trend towards the $40 million guidance.

Secondly, just thinking about the attritional loss ratio for next year, so you're looking to hold the premium base broadly steady, down a little bit. You're talking about single-digit rate reductions on high quality business, I mean, will that just drop straight through to the attritional loss ratio because presumably you won't be managing the cycle as actively (15:26)? Thanks.

A - Elaine Whelan {BIO 17002364 <GO>}

Okay. I think we've talked in previous quarters about the lumpiness of our book and reserve releases (15:36). It's very timing dependent with the specialty lines we write; energy losses can happen at any time depending on when that happens it can either be a prior accident year development or a current year. This quarter overall was just quite on both fronts, but take any day, we do have some old claims sitting around there and given the nature of the business that we've got it, it can go against us. We've talked about that in the past as well in terms of forecasting reserve releases which is something that we don't want to give any guidance on.

Our approach to reserving hasn't changed, so the reserve for attrition and if nothing comes through then we release those to our – kind of – our IBNR reporting pattern releases are pretty much in line, and then it comes down to individual larger losses or events, and I'm sure you know that they can either go for us or against us.

In terms of the attritional loss ratio for next year, I don't really see any reason to change our guidance on that as that's kind of like mid-30s kind of range and we are lower this quarter, but one quarter doesn't drive a change in that. If you wanted to price adjust that for next year then you could but we are seeing the price decline slowing and being lower than they have been up until now.

Q - Jonny Urwin {BIO 17445508 <GO>}

Thanks. Can I just follow-up on the reserve releases point, because I guess, I mean obviously you'll have your attrition which is an ongoing level, but given we haven't really had the big loss for two years or three years, you're not reserving those for those specific (17:08) large losses. So I mean, I guess structurally we should just think about reserve releases coming down because, I mean, one, the premium shrunk quite a lot and, two, we haven't had those large losses coming through. Is that a fair assumption?

A - Elaine Whelan {BIO 17002364 <GO>}

No, I don't think so. We're looking at larger losses, we're looking at those in best estimate basis, and we're hoping that we'll get them right. We do get some development off and some of those that works in our favor, but it also goes the other way. I think we saw an entire flood loss developed adversely in early years and then it ended up being favorable in later years, and if you look at (17:41) cost (17:42) then that obviously went against us as well. So as I said things do move around and it's not but sand-bagging old larger losses to get the releases going forward.

Q - Jonny Urwin {BIO 17445508 <GO>}

All right. Thank you.

Operator

Thank you. We can now move along to our next question, it comes from Janet Demir, of Morgan Stanley. Your line is open. Please go ahead.

Q - Janet Demir {BIO 19462264 <GO>}

Thank you. One of mine has been answered already. So, just one from me. You mentioned that you expect to operate at a similar capital level to 2016, of $1.35 billion to $1.4 billion in 2017. Given this, does this mean that you expect market condition to remain broadly the same in next year, and should we then expect a similar level of capital returns? Also are you able to say at what end of the $1.35 billion to $1.4 billion you're most comfortable operating at? Thanks.

A - Elaine Whelan {BIO 17002364 <GO>}

I think we've talked a little bit about outlook. We do expect pricing to come off a little bit, but we're very much defending our core book of business line, so there is a degree of stability around that. I wouldn't want to begin to try and forecast what our capital return would be this time next year, lot of it is dependent on loss performance throughout the year. And in terms of capital level, the $1.35 billion to $1.4 billion, we're probably more comfortable settling at the lower end of that range of $1.35 billion.

Q - Janet Demir {BIO 19462264 <GO>}

Okay. Thank you.

Operator

Thank you. We can now take our next question, it comes from Andreas Van Embden of Peel Hunt. Your line is open. Please go ahead.

Q - Andreas Evert Cornelis van Embden {BIO 1795530 <GO>}

Hello, good afternoon. I just had one question about risk appetite, given the fact that you're keeping your capital levels sort of stable, does that also mean that there is going to be no change in your risk appetite for 2017, i.e., just confirming whether there going to be no changes in your gross risk appetite, and no changes in your reinsurance program. Thanks.

A - Alexander Maloney {BIO 16314494 <GO>}

So, Andreas, I mean, clearly, we are just coming up to our 1st of our January renewals and we will see how they go and then also more importantly, we're just in the process of meeting with our reinsurers and working out what reinsurance that have for 2017. And our general view is that if we can buy more cover for around about the same price that we will look to do, but we've done a lot of surgery on our risk levels in the last couple of years, and we have managed our retentions down pretty low, and we've bought a lot of cover as well at the towns (20:37) as well.

So there is a limit to what we can do. We're pretty comfortable where we're at. We think we've got the approach of (20:43) amount of risk versus the opportunity, but that's not say if our renewal discussions where our reinsurers guide (20:52) better than we think maybe there is a bit more we can do, but as I did say earlier, the market is slowing out, you know, we are seeing pricing slowing out, and we are seeing reinsurers hardening up. That's not to say the market's hardening in reinsurance, but the...

Q - Andreas Evert Cornelis van Embden {BIO 1795530 <GO>}

Yes.

A - Alexander Maloney {BIO 16314494 <GO>}

...pricing is slowing down and Il think that you're just seeing – there is a very little margin left in all product lines and it's going to be incredibly hard for anyone sensible to give lots of pricing for 2017. So, we think we're going to be pretty similar to this year and hoping that we can tweak a bit here and there. But as I said, overall, we've done a lot of surgery on risk levels, we're very comfortable where we are versus the opportunity and as we've always said million times we would love to assure more risk, but we refuse to do that until we get paid for it.

Q - Andreas Evert Cornelis van Embden {BIO 1795530 <GO>}

Okay. Thank you very much.

Operator

Thank you. We can now move on to our next question, it comes from Joanne Pearson of Dovetail Securities (21:58). Please go ahead your line is open.

Thank you. I've two questions. Firstly on the energy markets, you commented in your Investor Day how challenging that is and see that in the comments today, but with the losses that are knocking around the market, could you give us a feel for how you think the energy market may respond in 2017? Are we getting to the point where we may see some small positive movements or more capacity come out?

And then secondly, as I'm sure you're well aware, Blenheim (22:34) have now got the go ahead and will be underwriting and some of your old colleagues are joining during 2017, could you update us on where you feel you're in terms of Cathedral book and what business may or may not get locked? Thank you.

A - Alexander Maloney {BIO 16314494 <GO>}

Sure. Okay. I'll take the Blenheim (22:55) question and then I'll hand over to Paul for the energy one. So, yes, those got approved which wasn't a surprise to any of us here, but clearly, yes, they were not the competitor like everyone else and we have said this lots of times. You're in a difficult market already where everyone is competing, so that's just another competitor, but clearly with those guys, those elements of our book which they have very good client relationships with as do we.

What we have done, we have – we're pretty much fully staffed at the January 1, a number of those guys are still in the garden, so they're unable to underwrite 1st of January anyway. So we're fully staffed. Everyone we've employed, we've employed to have the same kind of client relationships. I honestly don't believe we will lose a material amount of business to Blenheim (23:49), that's not the say they won't get business, because clearly they will.

Brokers are very good at shuffling the pack, but we are completely aware of those guys' ability to look at the business that we have. And, we've done a huge amount of work already. So, yes, we're up for that one, they will get business. I don't believe they'll get as much business as they think they will because I think a startup whoever you are in this market, quite honestly, it's close to impossible. But as I said, one thing I want to be really clear on is that we will not get into a pricing war with anyone.

And I think if we see – we see various things happen in the last quarter, we saw an energy account there was a 50% reduction, which is insane, particularly once Paul gives you a description of the current energy market. We walked away from that piece of business. We saw a marine risk that was 40% off. We walked away from that piece of business.

You're just at that final stages of the soft market, where incumbents are doing crazy things. If you're a startup, you're pretty much going to have to do whatever the brokers tell you that's just the market you're in.

So, we won't compete on price because the margins are so skinny already. We would rather walk away. Hopefully, that doesn't happen. But as I said, it's tougher than we're competing with everyone, every day anyway. So, I don't think it massively changes anything for us really and one will be difficult for everyone.

Q - Operator

Okay. Thank you.

A - Paul Gregory {BIO 16314515 <GO>}

Hi, Joanne (25:30). Yes. Everything you said about the energy market in terms of the fundamental we're going through the market, doing something in 2017, doing something post 2017, unfortunately as always our market isn't particularly logical.

I mean we've had a run of losses in 2015 and 2016 overlaying that the premium into the upstream energy market is pretty much halved in that time, margins were incredibly tight. But the one thing we haven't seen is capacity exit the sector. And unfortunately until that point that happens, my view, and I hope I'm wrong by the way, my view is that that market won't change, I think the rate reductions will soften slightly in 2017 as people realize that there's very, very little margin in that business. But I still do think it will go down.

What will be interesting is I don't think the reinsurance market is going to get any cheaper at 1/1 because they themselves have been hit with a number of losses, which is further going to squeeze the direct market. And it's things like that where you start to see some change, but my general view is 2017 is too early. I think we're looking at 2018. As I say, I hope I'm wrong, but just the fundamentals are just that nobody is leaving the sector and if capacity doesn't come out, and there is a far less premium people will take that premium, which will just make sure that there's still competition there. So that's our view of the energy market in 2017.

Q - Operator

Okay. Thank you.

A - Paul Gregory {BIO 16314515 <GO>}

Sadly. Yes.

Operator

Thank you. We can now move along to our next question, it comes from Anna Hui of RBC. Your line is open. Please go ahead.

Q - Anna Hui {BIO 19762795 <GO>}

Hello, just one question from me, please. So given that you've about $1.6 billion in capital and your capital guidance is $1.35 billion to $1.4 billion, how should we think about specials in Q4 this year?

A - Elaine Whelan {BIO 17002364 <GO>}

Hi, Anna. I think, when you look at the capital, you look at on a tangible basis. So you need to knock off the $154 million of tangible which takes us to the $1.49 billion.

Q - Anna Hui {BIO 19762795 <GO>}

Okay.

A - Elaine Whelan {BIO 17002364 <GO>}

And then we have a dividend coming out of $150 million.

Q - Anna Hui {BIO 19762795 <GO>}

Okay, thank you.

Operator

Thank you. We can now move on to Nick Johnson from Numis. Your line is open sir. Please go ahead.

Q - Nick Johnson {BIO 1774629 <GO>}

Hi, (28:18) There's another question on capital. So the capital base sort of stabilizing at these levels, very much positioned for a soft market. Just wondering how much headroom there is in capital for growth if we saw significant opportunities there. How much could you grow volumes with the existing capital base? Thanks.

A - Elaine Whelan {BIO 17002364 <GO>}

Hi, Nick, when we look at capital, we always put in a buffer for headroom there for loss absorption and for rating agency reasons, so that we can't take a loss and still be able to continue to move forward and access the market afterwards and that's a decent buffer. At the moment we're carrying a little bit above that and just so we can see how the market shapes out next year, call it a little bit of our insurance policy if you will but I think we're pretty comfortable that we've got plenty of headroom to be able to respond if something does happen.

Q - Nick Johnson {BIO 1774629 <GO>}

Okay.

A - Alexander Maloney {BIO 16314494 <GO>}

I think on that, Nick, as well it just depends where the opportunity is. If the opportunity presented in the specialty line or outside of cat, obviously we don't need as much capital (29:19) for cat business.

Q - Nick Johnson {BIO 1774629 <GO>}

Okay, great. Thank you very much.

Operator

We have no further questions at this point. So I would now like to hand the call back to the speakers for any additional or concluding remarks. Thank you.

A - Alexander Maloney {BIO 16314494 <GO>}

Okay, thanks for your time today and we'll see you at the next one.