Q3 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
- Christopher Campbell, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, and welcome to the Argo Group International Holdings' Third Quarter 2016 Earnings Conference Call. All participants will be in a listen-only mode. Please note this event is being recorded.

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

Susan Spivak Bernstein {BIO 1514699 <GO>}

Thank you, and good morning everyone. Welcome to Argo Group's conference call for the third quarter and nine months 2016 results. Last night, we issued a press release on earnings, which is available in the investors section of our Web site at www.argolimited.com. Presenting on the call today is Mark Watson, Chief Executive Officer; and Jay Bullock, Chief Financial 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 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 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. 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 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 Argo Group's third quarter earnings call. I'd like to share my thoughts about the quarter, after which Jay Bullock will add more commentary to the financial results. And then we look forward to responding to any questions you may have during the Q&A portion.

After the market closed yesterday, Argo reported 10% growth in book value per share since the end of 2015 to $59.65, that equaled an annualized return on average equity of 8.8%; growth in operating earnings per share of 58% to a $1.12 per share in the third quarter, and for the first nine months of the year we grew operating earnings 23% to $3.28 per share.

The themes we've been talking about all year carried through in the third quarter. Rigorous in our underwriting standards, simplifying how we work and leveraging technology, always a focus on improving our margin and creating a more customer centric environment. As you can see from our financial results I just discussed, the Company's performance continues to improve, and we're all positioned to continue the momentum. In short, in the quarter and frankly in a year where you've seen some not so favorable results in the market, we're executing and delivering strong results for our shareholders. Our long-term goal is to remain a leading global specialty underwriter with a reliable and increasingly visible brand.

In the first nine months of 2016, our gross written premium grew to $1.67 billion, up 6.4% over the same period last year. And while our combined ratio remained relatively flat at 95%, we achieved these results notwithstanding an increase in catastrophic loss and reduction in prior-year positive development in 2016 compared to 2015.

I'm happy to report that net investment income was $89.6 million, compared to $68.5 million last year, with our alternative investment income contributing strongly. An important point to note is that all four of our operating businesses generated an underwriting profit in both the quarter and the nine month periods. These results include the impact of $13 million of catastrophic losses in the third quarter, and $38.9 million in a nine-month period.

It also includes $2.9 million of positive reserve development from prior periods in the third quarter, and $18.8 million in the first nine months of the year. We continue to benefit from our prudent loss reserving strategies. Including this quarter, we have benefited from favorable loss reserve development now for the last 22 consecutive quarters, and each of the last 11 years – consecutive years.

Also as discussed in previous calls, our expense ratio is showing favorable year-over-year improvement. Before going through each segment, let me say again for the second quarter in a row that our U.S. business in total is doing very well. In fact, this quarter's U.S. underwriting income was one of the best in the history of the Company.

Now let me briefly comment on each of our operating segments. For the quarter, our Excess and Surplus Lines business grew by 6% and by 4% for the nine-month period. Growth is primarily being driven by our casualty and environmental units which have benefited in part by new technologies that help us better analyze and select risk, allowing us to drastically reduce cycle time and increase the value of business we process to ourselves and to our clients. As we continue making investments in these areas, we expect to see the benefit reflected across more of this segment over the coming quarters. On average, rates were up modestly across this segment, other than Property, which is down a fair bit due to the continued competition in this area.

Moving on, I'm happy to say that we're continuing to see significant improvement in our results from the Commercial Specialty segment. Gross written premium was up a little over 24% in the quarter and 20% for the first nine months. More importantly, earned premium was up 4%. More importantly for the quarter, both underwriting income and operating income were more than any other business segment, thanks in part to positive prior year development. Growth was driven by our program, surety and professional lines businesses. Overall rates in this segment were down modestly with the largest declines in our retail establishment and surety businesses. Having said that, we're still comfortable with our margins.

While the U.S. results have done better than our international business, let me say that notwithstanding the above average Cat losses, our international businesses are holding their own and gaining momentum. We're excited to have Jose Hernandez aboard as the new Head of our International Platform. Jose has a tremendous amount of experience building and running successful operations. His skill in leading and growing international business aligns fully with our ambitions, and we're delighted to have him on the team and here with us on the call today.

Turning to Syndicate 1200, competition remains robust in the Lloyd's market. We did achieve modest premium growth in gross written premiums of 1.5% in both the third quarter and first nine months of 2016, due in part to new product lines. But just as a reminder, this kind of overlooked how the Syndicate is doing in the whole, and what I mean by that is that in 2016, we reduced our ownership in the Syndicate by 5%, or I should our capacity in the Syndicate by 5% compared to a year ago. So actually, on a like-for-like basis the Syndicate's gross written premium is up approximately 7.7% for both the quarter and the nine-month period versus 2015. We continue to consider the Lloyd's market as one of the more challenging markets over the last couple of decades. In this environment, our advantage lies in our strategy moving forward around profitable relationships, deepened over time by solid underwriting, actuarial analytics, and outstanding service.

Similar to Lloyd's, our International Specialty segment continues to experience challenging market conditions. Having said that, in the third quarter of 2016 we grew gross written premiums by 2%. Despite the strong competitive environment, our Bermuda Casualty and Professional lines businesses grew compared to prior year as modest rate declines were more than offset by new business opportunities.

Our operations in Brazil were profitable again for the second quarter in a row as we gained scale and we saw record premium from our professional lines businesses. We also benefited from favorable currency exchange rates in Brazil in the third quarter. This growth was somewhat offset by lower premium in Argo Re due to increased competition. Having said that, we do see some signs that the market is bottoming.

Turning to investments. I want to remind everyone that we began to include the performance of our alternative investments in investment income in the first quarter of this year. All prior periods have been adjusted to reflect this change. For the quarter 2016, Argo's total return was 1.3%, bringing year-to-date returns to 4.3%.

We benefited during the quarter by allocation decisions made to certain less liquid investment grade and noninvestment credit instruments that showed particularly strong returns. Our reported net investment income was $32.8 million for the quarter, which while slightly lower than last quarter was up $14.3 million over the third quarter of 2015. In addition, you might note that our realized gain was larger than most past quarters. We took the opportunity in recent quarters to add modestly to positions post market dislocation, such as the Brexit in June, and as the markets have recovered, we've selectively reduced our exposures to some of these positions.

Moving on to capital management. Our philosophy has not changed. Our first use of capital is to support the balance sheet, the 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. In the first nine months of 2016, we repurchased 815,000 shares or thereabout for about $45 million. In total over the last six years, we've returned more than $492 million of capital to shareholders, with $376 million of that through share repurchases, and the remaining $116 million in cash dividends. We continue to view our stock as one of the best investments available and will balance the return of capital to shareholders with our priority of building the Argo franchise and shareholder value in the long run.

And with that, I'll turn it over to our CFO, Jay Bullock.

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 questions. As Mark highlighted, operating earnings, book value growth, and our return on equity showed continued progression during the quarter and first nine months of the year, and at nearly $50 million through September 30, underwriting income is roughly equivalent to the same period in 2015, despite the increase in catastrophe related losses.

Almost all trends were positive in the quarter, and each incremental positive movement however small, added to the overall result for the quarter and for the continued momentum through nine months. And when you look back over the last four years, you see the consistency of results and continuation of improvement in the underlying results.

Now to point out a few clarifying points on the financials. Gross written premiums were up 10% in the quarter and 6% through the first nine months of 2016. Net written premiums were up 8% in the quarter and 1% through the first nine months of 2016. The increase in gross written premiums is partially driven by growth in our state funds fronting business and the commercial specialty segment. As a fronting business where we see 100% of the rest of these state funds, it's more of a fee-based business and thus doesn't contribute to the net or earned results. The smaller increase in net written premium is also due in part to the reduced participation on the Syndicate of approximately 5% that Mark mentioned.

Turning to loss trends, our current accident year non-cat loss ratio is 55.1% in the third quarter of 2016 and 54.9% in the first nine months of 2016. Both compare favorably to the same metrics for 2015, demonstrating continued improvement in our underlying business. By segment and for the group, the current accident year loss ratios are displayed in a new table in the press release reconciling the various loss ratios. In addition, through the first nine months of 2016, we continued the trend of overall favorable reserve development from prior accident years. For the third quarter, we experienced net favorable development of $2.9 million.

As you may recall, this is the quarter in which we do a more detailed review of runoff exposures. So the favorable result was despite the charge in the runoff segment related primarily to greater than expected defense costs on primary asbestos exposures, and to a lesser extent workers' compensation activity on very old accident years. As always, all the relevant figures on loss development are displayed in the table in the press release. Catastrophe losses that impacted our business for the quarter were $12.9 million. That's net of reinsurance and reinstatement premiums or 3.6 points on the combined ratio. For the nine-month period of 2016, the losses were $38.9 million or 3.7 points on the combined ratio.

In the quarter the losses were primarily related to the Louisiana floods, and to a lesser extent by late reported events from Texas hailstorms. For the nine-months, the losses related to these claims, along with other U.S. storms and the Canadian wildfires. As Mark mentioned, we continue to see a favorable trend in both our expense ratio and absolute expenses. We remain focused on organizing the business with a simplified approach in mind, that will allow us not only to scale our existing operations more effectively, but make it easier for our customers to do business with us.

A couple of comments on investment returns. We saw a meaningful contribution to investment income from alternative investments of $9.8 million in the quarter, and $20.8 million in the first nine months of 2016. As I noted in last quarter's call, these returns will be lumpy and the result through the first nine months of the year is more than we would expect in a normal annual period.

The foreign currency movement through the income statement was a gain for the quarter of $1.5 million and a loss year-to-date of $4.5 million. Recall that there are other offsetting effects that flow straight to the balance sheet as a result of movement in currencies. And despite the significant currency fluctuation experienced thus far in 2016, most notably the drop in the British pound relative to the dollar, the net impact to our book value per share has been fairly modest.

For the third quarter of 2016, the effective tax rate for the group was 11.2%, more than our run rate expectation of 20% as more than half our income was attributable to the Bermuda platform. Year-to-date, the effective tax rate is about 16%. Finally, on the balance sheet, we ended the quarter with an unrealized - with a pre-tax unrealized embedded gain of $151.3 million, compared to $84 million at December 31, demonstrating strong growth in asset values in the portfolio through the first nine months.

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

Q&A

Operator

The first question comes from Greg Peters with Raymond James. Please go ahead.

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

Good morning, and thank you for taking our questions. Just three areas I wanted to touch upon, the reserve development, the loss ratios and expense ratios. On the favorable reserve development, I noted in your table, the favorable development in the quarter was down year-over-year. Yet in the - for the year-to-date it's up. For most of the other companies that we follow, it seems like reserve development is trending downward or being less favorable going forward, and I'm wondering if that's an expectation that you guys are thinking about as well.

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

Good morning Greg. This is Mark. No, not at all. In fact and I'll let Jay be more precise in the second, but what we saw in the - what we reported in the quarter isn't terribly different from previous third quarters. We put a little bit more on our loss reserves for our A&E business as Jay mentioned again earlier. But for the most part, this is kind of what we would have expected based upon, the last few years and how we see the business going forward. Jay you want to add?

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

Well yes, I just think if you take a look at Page 11 in the press release and focus on the nine-month numbers and focus on commercial specialty, the issues that we were having in Argo - in our retail business over the last couple of years, have really settled down. And so you're starting to see real contribution from that. So I think I agree with Mark. This feels a lot more like a normal result, because we don't have that segment in particular with issues.

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

And also, we had a bit more large loss activity at the Syndicate than we would've expected and so that drove a slight deterioration in loss reserves for the quarter.

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

Thanks for that color. On the loss ratios, I was looking at reconciliation of loss ratios, the table that you put in your press release and where it's showing some improvement, both on the quarter and year-to-date – on a year-over-year basis. And I'm wondering if we shouldn't expect some upward pressure going forward on some of those numbers, as we think about your comments about growth and the competitive pressures in the marketplace?

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

Well, I think if you go back and read our transcripts for the last 10 quarters, we've been saying the same thing. Having said that, perhaps not every single quarter, but certainly year-over-year, our loss ratios continue to improve and that's been our ability to select risk better than we did before, in part driven by better data analytics, which I talked about earlier today, and I've referred to in the last few calls.

And equally important, our mix in business has changed. We haven't grown the top line as fast as we would have liked, or as fast as some of our competitors over the last couple of years, because we've spent most of our time realigning our portfolio and focusing on those lines of business where we think we have the best opportunity to generate an acceptable margin. And that's still the case today.

I mentioned that our E&S business was growing mid-single digits, but if you look at – if you look inside of that, our Casualty portfolio, and our environmental portfolio which I made reference to in my remarks, they're growing double-digits. So as we continue to grow the parts of our portfolio that have better margin and deemphasize the parts that don't – I actually think that there's still some room for loss ratio improvement as opposed to deterioration.

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

Perfect, that's great color. Thanks Mark. And just finally on the expense ratio. I think this quarter is more flat or less year-over-year improvement, and I'm just wondering thinking ahead, if we've sort of plateaued in terms of expense ratio improvement or is there other low hanging fruit that you think you might be able to harvest over the course of the next 18 months.

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

Well it's true that that it only improved modestly. What's driving that though is change in mix of business. If you look at our non-acquisition cost, that's been pretty flat year-over-year. And so what's happened is as we change the mix of business, it runs at a higher expense ratio. So think Surety as an example. That's one of the fastest-growing parts of the business on a percentage basis. And the average expense ratio all in for the Surety business is 50% or thereabouts, depending upon which part of the portfolio you're talking about. Of course, the corresponding loss ratio is in the 20s or 30s. The same is true of some of our risk managed business within commercial specialty. It runs at a higher expense ratio, but a lower loss ratio.

Having said that, I think the biggest challenge that we all have in the marketplace today with expense ratio is commission expense. I think I mentioned on our on our call last quarter that at the Syndicate in particular, we're paying in some cases five points more commission. When I say we, I mean the market, not just Argo. We're paying substantially more commission for the same business. And that at some point becomes unsustainable. And while I was criticized by a few for my remarks about the London market last quarter, it's still a real issue that we as a market are dealing with. So you'll note that other parts of the group may be growing a bit faster right now, and who would've thought that Commercial Specialty wood have generated the most amount of underwriting income in a quarter.

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

Right. Excellent color. Congratulations on your quarter.

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

Thank you.

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

Thanks, Greg.

Operator

Our next question is from Christopher Campbell with KBW. Please go ahead.

Q - Christopher Campbell {BIO 20262752 <GO>}

Good morning.

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

Good morning.

Q - Christopher Campbell {BIO 20262752 <GO>}

Quick question on the alternative net investment income. Can we get any additional color on what was driving that and how we would want to think about that on a run rate basis annually going forward?

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

Yes, I'll – Chris, this is Jay Bullock. I'll try to give the same color that I gave last time. So if you look in the -- there's a disclosure table in the 10-Q, we haven't published this quarter's yet obviously, but from last quarter, that talks about hedge funds and then certain alternative - sorry, certain private equity investments. Let's use a round number. Let's say that's around $300 million.

As I mentioned, the returns on that can be lumpy, but if you think somewhere between 4%, 5% or 6%, those are obviously conservative numbers. When we make those investments, we expect greater returns than that. But that's the amount of gain that we would expect to see out of that portfolio go from what would have historically been an increase in value through realized gains, but it's more of a recurring return and so that's why we've included it in investment income. So I think that's consistent with what I said last quarter and should give you some direction as to what you might want to expect.

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

And we'll be filing that - I believe we're going to file the Q with the table in it on Friday.

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

That's the plan.

Q - Christopher Campbell {BIO 20262752 <GO>}

Okay. And then just switching to your fee income, that was up about $700,000 this year-over-year. Is that being driven by the increased funding business or is there anything else that's driving that increase?

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

It's coming from two different places. We've got a business that we call Alteris, that's on the margin doing better than it had been in the past, still not where we'd like for it to be from a scale standpoint. And then we're seeing - we've had good results in the Syndicate, and so what you see coming through there is as we manage third-party capital, we had paid fees for doing that, and so you're starting to see some of that flow through the numbers as well.

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

Yet let me just jump in. So I mentioned in my remarks earlier, that we have 5% less of the capacity at the Syndicate this year. So we're getting slightly more fee income from the 5% that we gave up to third-party capital. And as for Alteris, which Jay referred to first, that's a managing general agency that we own 100% of.

Q - Christopher Campbell {BIO 20262752 <GO>}

Okay. And then just to circle back on the expense - on the expense ratios. Is there - with your retentions coming down, how should we think about the expense ratio going forward? Could you get the seeding commission off of that and that would help offset the acquisition cost increases?

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

I'm not sure we understand the question. Do you mind just saying it one more time?

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

With regard to retention specifically, I'm not sure what you're referring to.

Q - Christopher Campbell {BIO 20262752 <GO>}

Yes, so I was just thinking about how your net-to-gross overall has been decreasing, right, and so that you would be getting the seeding commissions back on that business, which would offset the acquisition costs. And so I just want to think about how that would feed into your run rate expense ratio?

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

Okay. So let me start that, and then I'll let Jay jump in. For some of the quota share contracts, that's true. Most of the changes that we've made to our quota share structures were done a couple of years ago. So some of the changes that you see on net retention today are a function of us taking slightly more net from some of our excess loss covers, but of course that puts more premium on the books, which actually improves expense ratio. And also it's a function of a change in product mix. For some of our smaller account businesses, like I mentioned our casualty business within E&S earlier, we've always retained more of that net. So as we change our mix of business, that changes the difference between gross and net as well.

Q - Christopher Campbell {BIO 20262752 <GO>}

Okay. Great. And just one final one on, can we get an update on your recruitment efforts? And are there any additional lines that Argo is looking to add or areas to grow?

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

The answer is yes. I think it was this call a couple of years ago – sorry it was last year, the end of the third quarter that I suggested that I thought the best strategic thing we could do at the time and over the next year was to focus our attention on recruiting some very talented people to our organization, which is kind of what we've done.

I mentioned earlier on the call that we have Jose Hernandez, the Head of our International Business with us here today, but over the last year, we've hired more than a dozen senior people from the industry into our Group. There are couple of roles that we're still looking to fill that our product line focused, and a couple of geographic roles that we're looking to fill. And I think we'll have that done by midyear 2017. The number of talented candidates continues to grow and it's a really nice place to be.

Q - Christopher Campbell {BIO 20262752 <GO>}

Great. Well, thanks a lot for all the answers, and good luck in the fourth quarter.

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

Thank you.

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

Thank you.

Operator

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

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

Thank you. I'd like to just thank everyone for their time today. I know today is a busy day for everyone. We're not the only one that reported last night. And I'd also like to thank my colleagues at Argo. You'll are doing a great job and I appreciate all the hard work and I appreciate everyone staying focused on our Company, and I look forward to talking to you all at the end of the fourth quarter. Operator that concludes my remarks.

Operator

Thank you, sir. And thank you everyone for attending today's presentation. You may now disconnect. Take care.