Q1 2016 Earnings Call

Company Participants

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

Other Participants

- Charles Gregory Peters, Analyst
- Daniel D. Farrell, Analyst
- Jeff Schmitt, Analyst
- Meyer Shields, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning and welcome to the Argo Group 2016 First Quarter Earnings Conference Call. 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 over to Susan Spivak Bernstein, Senior Vice President, Investor Relations. Please go ahead.

Susan Spivak Bernstein {BIO 1514699 <GO>}

Thank you and good morning. Welcome to Argo Group's conference call for first quarter 2016 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; and Jay Bullock, Chief Financial Officer. Also with us for Q&A is Mark Rose, Argo's 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 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 intention, 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 filing with the SEC.

With that, I'll turn the call over to Mark Watson, Chief Executive Officer of Argo Group. Mark?

Mark E. Watson {BIO 20610831 <GO>}

Thank you, Susan, and good morning, everyone, and welcome to our first quarter conference call. After the market closed yesterday, we reported first quarter 2016 after-tax operating earnings of $29.9 million, or $1.06 per share. Gross written premium growth of 9%, and overall combined ratio of 94%, and an increase in book value per share of 3.3% to $61.71 from year end 2015.

Before discussing our underwriting results, I'd like to point out changes to how we report operating income for this quarter. As we've discussed for several years, our investment strategy is for total return. To that end, a portion of the portfolio is invested in strategies that are expected to produce recurring gains, and while we believe that growth in book value per share is the most important metric by which to evaluate financial performance for our company.

Beginning this quarter, we included an alternative investment income as part of net investment income, which we believe more accurately reflects operating earnings. For comparative purposes, alternative investment income has been reclassified in last year's results as well. Ironically, given the recent market volatility, the change actually had a slight negative impact in the current quarter's operating income relative to positive impact in the prior year's first quarter financial results.

That said, we believe that long-term reporting along these lines will allow you to more appropriately value the company relative to others. But, again, I still believe the best metric is the focus on growth and book value per share.

Moving on to our underwriting business, we had an encouraging start to the year with 9% growth in overall gross written premium. Perhaps more importantly, we achieved growth in all four of our operating segments and all four segments generated an underwriting profit. Our ability to produce growth, despite more competitive market conditions, is the result of the initiatives we've talked about throughout, both 2014 and 2015.

These include: identifying opportunities by business and by producers with the most significant opportunity for profitable growth and focusing our resources on these areas; capitalizing on the market dislocations stemming from recent M&A and restructuring activities to bring onboard talented people and in some cases underwrite business coming back into the marketplace; and simplifying the way we do business to improve efficiency and scalability, which is having a positive impact on our expense ratio and thus our underwriting margin.

Following two consecutive years of record underwriting results for our company, we continued the momentum in the first quarter with underwriting income of $20.7 million. Risk selection and underwriting discipline are the most important factors driving the improvement in our combined ratio. Our goal is to generate consistent year-over-year improvement in 2016.

Another favorable trend that's continued in the 2016 is the consistency in our reserving process. For the 20th consecutive quarter and the 11th consecutive year, we've seen positive prior year reserve development.

Now, let me briefly comment on first quarter 2016 results for each of our operating segments. With continued focus, our Commercial Specialty segment has now generated a significant improvement in the results. Overall, premium growth was up 8% in the quarter, driven by our program, surety, professional liability, and public entity businesses. Even more encouraging was the improvement in the combined ratio to 88% from 95.6% in the first quarter of last year.

We achieved this improvement despite more competitive rates and pressure in the energy sector on our mining and surety businesses. This quarter's results in Commercial Specialty also reflects, for the first time, our U.S. professional business, which we refer to as Argo Pro in this reporting segment. We thought it made more sense to move Argo Pro or professional liability from our E&S segment to Commercial Specialty, given that so much of our business is underwritten on a retail basis, which is primarily the way we address our policyholders in other parts of Commercial Specialty.

I should also add that we're working hard to strengthen and deepen the relationships with producers that will allow us to continue to grow in our niches within our Commercial Specialty segment.

Moving on to Excess and Surplus Lines, gross written premium was up 5.4% year-over-year. Our casualty unit, which is our largest business by volume within E&S achieved strong growth in excess of 16%, reflecting the benefits from our investments in technology, overall process improvement, and focus on profitable opportunities.

Other business units such as contract and allied medical posted modest declines, reflecting intense competition and pricing environment as well as a continuous effort to improve the underwriting result by calling (07:48) underperforming business. On average, rates were up modestly across this segment, property rates on the other hand has stopped growing – going down as rapidly as in the last few years.

Turning to Syndicate 1200, gross written premiums written were up 14.2% for the quarter year-over-year. You may recall in 2015, gross premiums written at the Syndicate were up approximately 4%. Having said that, the primary driver of the strong growth in this year's quarter was in part due to timing differences on business that would otherwise have incepted in the fourth quarter of last year.

Lloyd's remains a highly competitive market and we've reduced our participation in the Syndicate in each of the last three years notwithstanding the growth of the Syndicate. Within the Syndicate this quarter, we underwrote more business in property, direct and facultative and our new business lines in marine in Asia. As you can see from our expense ratio, which is hovering around 40%, Lloyd's is becoming an even more expensive place to do business, as brokers continue pushing additional compensation scheme.

Lastly, gross written premiums at our International Specialty segment were up 7.2% over the first quarter of 2015. This growth is primarily coming from our Bermuda operations, both insurance and reinsurance. Our Bermuda insurance business is experiencing strong renewal retention and high hit ratios, partially due to the recent M&A activity I was referring to a minute ago in the marketplace. Rates were down modestly, but the profitability of the book remains strong.

Argo Re's results were benefiting from low cat activity and the addition of new pro rata treaties. In Brazil, premium declined modestly due to the weakness in local currency, the slower economy, and select changes to our underwriting appetite as this business begins to mature. Having said that, our Brazilian operation made a profit for the second quarter in a row, and I'm very appreciative of their efforts and success.

Returning to investment. In the first quarter of – the first quarter of 2016 began with a complete selloff in risk assets triggered by concerns over China and a 30% decline in oil prices. In mid-February, it's like the opposite happened. Oil began to recover and risk assets responded to that. The S&P high-yield oil each finished the quarter up from where they began.

Argo Group's financial statement return was 1.2%, and our total return for the quarter was 1.7%. Energy stocks and bonds began down in the corner and rallied to finish with a positive contribution to the quarter, actively managed high-yield equities in emerging market debt were up solidly as well, hedge funds in private equity, which are accounted for a one month lag for our financial results detracted from our return, but beginning in March have been strong contributors.

Reported net investment income was $21.2 million for the quarter, down from $25.7 million in the first quarter of 2015. Included in these numbers is an alternative investment income loss of $1.6 million relative to a gain of $4.9 million in the comparative period a year ago.

Moving on to capital management, and I say this every quarter. We had a demonstrated track record of strong capital management for more than a decade. And in the last six years in particular, we've returned a total of more than $452 million to shareholders. This was accomplished through the retirement of 25% of our outstanding shares for $350 million through share purchases and $102 million paid in cash dividends.

Our priorities remain the same. Our first use of capital is to support the balance sheet; second is to grow our business organically; 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 quarter of 2016, we repurchased 343,652 shares of stock for $19 million at an average price of $55.32 per share, and we just reloaded our authorization to $150 million this morning. Last quarter, we increased the dividend - the cash dividend by 10%, and this quarter, we declared a stock dividend of 10%. We will continue to balance the return of capital to shareholders with our priority of building the Argo franchise and shareholder value in the long run.

In summary, I'd like to say that we're quite encouraged by our first quarter 2016 results, which demonstrate that our key initiatives are working. We've made many necessary competitive changes to our systems and processes, built a stronger and more focused team, invested in technology and innovation, and introduced new platforms and products. We will continue to improve the way our company operates.

Our investments in technology distribution and people are allowing us to serve our clients better and faster, and we can now better select risk and manage our own portfolio mix. I feel better about the people and our team that at any time in the past and most important of all, these are the efforts that are driving the more consistent results that generate more stable returns for our shareholders - we believe.

With that, I'd like to turn the call over to our CFO, Jay Bullock.

Jay Stanley Bullock {BIO 3644311 <GO>}

Thanks, Mark, and good morning, everyone. I'll quickly provide some additional detail, and then open it up for questions.

As Mark highlighted, we continue to have positive momentum and premium growth and underwriting income into 2016. There are a few moving parts that I'd like to highlight that might make the results a bit more comparable.

First, on a consolidated basis, the growth in gross written premium outpaced the growth in net written premium. This was the result of a higher rate of growth in business, where we've seen a much higher percentage of the risk and the effect of certain reinsurance agreements that incept in the first quarter, for which all the ceded premium is recognized in the quarter. The second impact will even out, as the year progresses.

As mentioned, Excess and Surplus lines and Commercial Specialty were impacted by the movement of Argo Pro from one reporting segment to the other. It's worth noting that even without the contribution of Argo Pro to Commercial Specialty, the underwriting result for that segment doubled year-over-year. Of note, related to loss trends, our current action at year continues to perform well, with a non-cat loss ratio of 55.5%, that is improved from the 56.4% in the fourth quarter of 2015, and about the same as the 55.1% in the first quarter of 2015.

This year's first quarter accident year loss ratio includes the impact of a large energy-related loss at the Syndicate of approximately $4 million that impacted the overall loss ratio by about one point. In addition, the first quarter of 2016 continued our run of overall favorable reserve development from prior accident years.

For the quarter, we experienced net favorable development of $3.2 million, about the same as the $3.7 million in the first quarter of 2015. The largest component of this quarter's positive development was from our E&S segment, driven by accident years 2011 and prior. As always, all of 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 $3.3 million, again about the same as the $3 million from the first quarter of 2015. The quarter's cat losses were primarily due to U.S. storm activity, with the total impacted by one large claim along with a couple small international events in our International Specialty segment.

Of note, related to expenses in the quarter, the trend in our expense ratios continues to be positive. And as we mentioned last quarter, beginning in 2016, we made certain changes to our equity compensation program that should have the effect of lessening the volatility related to movements in the stock price in the future. We expect these changes to become more apparent in the quarters, where there is a significant appreciation in the price of our stock.

Two additional items to note. Again, as mentioned, we took action this quarter to reclassify the return on certain of our investments that are accounted for on the equity method, from realized gain and loss to net investment income, to better reflect the operating results of our business. And as noted, the early part of the first quarter presented a very challenging investment environment, and some of these investments are reported on a like basis the (16:52) results in this quarter reduced investment income by around $1.6 million.

This change in reporting, however, better reflects our long-term strategy, which will in most quarters reflect the positive return from these investments, and occasionally during periods of market dislocation reflect a negative result. The inclusion of this income and net investment income would have added $3 million of additional income in 2015, and $19.5 million of additional income in 2014.

For the first quarter of 2016, the effective tax rate for the group was 16.2%, lower than our standard assumption of 20%. In the quarter, the tax rate reflects earnings attributable to the Bermuda platform, offset by taxable income in the UK that was the result of the strengthening of sterling against the US dollar.

Finally to the balance sheet, there's a modest increase in receivables and payables that reflects a slight reduction in our participation on the Syndicate for 2016. We ended the quarter with a pre-tax unrealized embedded gain of $84 million, which is relatively flat from December 2015.

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

Q&A

Operator

We will now begin the question-and-answer session. The first question comes from Greg Peters of Raymond James. Please go ahead.

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

Good morning everyone, and thank you for hosting the call. I had just a couple of questions for you. And I appreciate in your prepared remarks the commentary on the difference in gross premium written versus net. But I'm curious how you think or assess the risk that new business that you're writing today might come at a cost in terms of a higher combined ratio relative to your renewal book?

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

Well, Greg, that's not a new concern. I mean, anytime that you write new business, it's not as well known to you as your renewal book, and you presume that it might run at a higher loss ratio. I'm not sure how to answer that other than to say that, that's an issue that we've been dealing with for decades.

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

Well, considering that the market is more competitive today, I'm wondering if you've altered your algorithm or perspective on how you're thinking about that?

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

No.

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

Okay. And Mark, I think you highlighted the mining and surety results. And I'm wondering if you could provide us some context on what's going in there? Reading the papers and hearing the news about all these coal companies going into bankruptcy leads me to be curious about how the insurance operations and surety operations behind those businesses might perform?

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

And so, we're not involved. We don't issue that many surety bonds to coal mining operators. In fact, I can't think of the last time, we issued one. That doesn't mean, we didn't; I just don't recall one. Most of our risk is workers' compensation risk. And the biggest challenge for us is, as coal mining businesses shrink and/or go out of business, there's less payroll and therefore less insurance premium.

Having said that, we have a team at Rockwood, our mining subsidiary. It does more than just insure coal mines. They insure a number of industries that have complex risk, again, mainly for workers' compensation. And actually if you look at the positive prior year development that comes out of that business segment that we talk about every quarter, about half of the positive prior year development comes from businesses other than coal mining operations.

So, I feel pretty comfortable that Kurt Tipton and his team at Rockwood, are continuing to transition away from coal mining operators and looking at other heavy industries to ensure whether they can use their engineering expertise and the team that they've got to do that. So, it will just require us to continue transitioning away from a declining market. And of course, depending upon (22:04) White House administration we have come next year, that may change things even more quickly.

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

Indeed. So, the combined ratio was 94% versus 93.6%, as you highlighted in the press release. I think in the fourth quarter conference call or earnings call, you highlighted the target of getting a 100 basis point improvement in 2016 versus 2015. And I'm just curious if you've – what you're thinking about that target in the context of the first quarter results, if it's changed your view at all?

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

No. I think that we will continue to have the – I think that in the environment that we're in, given the changes that we've made in portfolio allocation, sorry to underwriting non-investment, and our ability to select risk, which I think just gets better as we have more data that we'll continue seeing improvement.

I think the challenge for us, since there are a lot of opportunities that are being presented to us right now, and balancing our ability to take advantage of those versus putting things on the bottom line this year, as I think both Jay and I have remarked, our expenses this quarter were actually down, sorry, our non-acquisition expenses were actually down this quarter year-over-year on more earned – on more premium written. So we're figuring out how to do a little bit more with less. We plan to continue looking for ways to save money in non-acquisition expense. But we also want to make sure that we can make proper investments in the future as well. So I'm still focused on reducing our combined ratio, or I should say, improving our underwriting margin and balancing that with investments in the future.

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

Perfect, thanks. Thank you for the answers.

Operator

The next question comes from Dan Farrell of Piper Jaffray. Please go ahead.

Q - Daniel D. Farrell {BIO 4935961 <GO>}

Hi, and good morning. Just on your other invested assets, you have about $500 million that are in sort of hedge funds, private equity and other investments. Can you say what percentage of those roughly are now contributing – returns are now contributing to net investment income that's flown through operating income? And then also, can you remind us, do you have a target return that you will do for those investments? Thank you.

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

I'll answer the first part of the question, Dan, and just to try to help broader understanding largely – in the round, it's private equity and some hedge funds and some private investments, you can't extrapolate directly from the $500 million to the whole thing, because in some categories, for various reasons, some are included and some aren't. A round number to kind of have available is around $350 million. So of that $500 million, would be generating the kind of returns that, sorry, would be classified as equity accounted for investments and the return on those investments would be the alternative income that we're including in net investment income.

A - Mark H. Rose {BIO 1557365 <GO>}

Within that segment, that supports our capital appreciation portfolio and the target return for the capital appreciation portfolio is 7%, and that's just one component of the diversified risk portfolio.

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

Yes, keeping in mind, so that was Mark Rose, our CIO. Keeping in mind that, that many of our hedge fund strategies are credit strategies.

Q - Daniel D. Farrell {BIO 4935961 <GO>}

Great. Okay, thank you very much. And then one other question, you've highlighted that one of the things that's helping growth rate now is maybe some of the market dislocation that that we're seeing. Do you think more of the benefit for you guys is coming from opportunities to incrementally hire talent, or is it ability to actually pick up business from other competitors that may not be writing it, or losing it for one reason or other? Thank you.

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

The answer is, yes.

A - Operator

Both (26:49).

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

I think it's both. I shouldn't say, I think, I know it's both. I mean, we hired - we've hired a number of talented people in senior roles over the last year, more than a dozen senior roles. And a fair amount of premium, particularly in some of the larger syndicated programs that we underwrite here in Bermuda, and to a lesser extent at the syndicate at Lloyd's are coming our way. Oh, and also our professional liability business; Argo Pro and our Commercial Specialty segments. So we're seeing it in three of the four segments.

Q - Daniel D. Farrell {BIO 4935961 <GO>}

Okay, great. And then can I - if I could just sneak in one more question as well. Some of the reinsurance buying that you're doing, is that going to have any impact on your acquisition ratio? And how do you think about your acquisition ratio trending with lines of business that you're writing, any mix changes taking place and obviously the context of reinsurance? Thanks.

A - Mark H. Rose {BIO 1557365 <GO>}

Well, we've mentioned on - over the last couple of years that we've been taking more risk net, as we get more diversification benefit in our underwriting portfolios. We felt that need to buy as much reinsurance. Having said that, with reinsurance pricing continuing to decline, we've been looking at whether or not we shouldn't turn the dial back the other way and buy a bit more and layoff a bit of risk. But on the margin, the last year, I would say that, it really hasn't changed too much. And so, therefore, it hasn't impacted our acquisition ratio.

Q - Daniel D. Farrell {BIO 4935961 <GO>}

Okay, great. Thank you very much.

Operator

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

Q - Jeff Schmitt {BIO 19747235 <GO>}

Hi, good morning, everyone. The - I believe you said the casualty book within the E&S segment was up 16%, is that right?

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

That's correct.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Could you maybe provide a little bit more color on what's driving that? Was there anything kind of unique in the quarter or where are the pockets looking forward?

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

Well, I mean, that's been with - we've been growing at a similar rate for several quarters now. And as I said in my remarks, it's primarily a function of changes that we've made in our business process that we think make it much easier for our clients to do business with us, and to a lesser extent, but also important our use of technology. So we haven't changed our risk appetite. We're just better at processing the business that's coming in the door, or to say it in another way, we haven't widened the funnel of business opportunities coming in and we're just doing a better job at addressing the business that's in the funnel.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Okay. And then reserve development in the E&S segment looked to be down about half of what it's been running at, a little bit below. Is there anything that drove that that's unique or...?

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

No. The only thing I can tell you is, it's never the same amount in any one quarter for any one year.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Right. I just didn't know if it was – okay. Thank you.

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

Yes. No, it's just – there was no aberration. It's – there were just never the same number.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Yes, okay. Okay, thank you.

Operator

The next question comes from Meyer Shields of KBW. Please go ahead.

Q - Meyer Shields {BIO 4281064 <GO>}

Great, thanks. Good morning, everyone. Two, I guess, related questions. The underwriting expense at a dollar amount ratio in the Syndicate and International Specialty have been bouncing around a little bit, and the first quarter 2016 looked pretty good. Was there anything unusual, or is this a reasonable run rate going forward?

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

Well, I don't think a 40% expense ratio at the Syndicate is a reasonable run rate, which is why I made a comment earlier about it. We are – most of that is commission expense. Our non-acquisition expense ratio was actually pretty low. I believe, that's around 12%, but don't hold me to that, because I don't have the numbers in front of me. But we continue to pay – the market as a whole is continuing to pay more and more to produce business into the Syndicate. So we need to continue looking for ways to change our mix of business there at the Syndicate. As you can see the loss ratio is just fine. Jay did point out in his remarks that it was a bit higher this quarter than a year ago because of – bit of loss activity beyond what we would have expected. But I think that's more of a timing issue than a change in the market, or in our portfolio.

As for International Specialty, there are lot of different businesses within International Specialty and I would say that our expense ratio there perhaps maybe a little unusually low for the quarter. But I do think it's trending in the right direction as we continue to get scale in our business in Brazil and we continue growing our business here in Bermuda.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay, that's helpful. With the casualty business rate going, are you – I'm not sure how to ask this, are you either seeing or you're booking any different loss cost trends than you had over the past few years?

A - Mark H. Rose {BIO 1557365 <GO>}

No, and that's why I was trying to make the point a minute ago in the last question that the business that we're looking at today is the same as it was a year ago or two years ago. We're just doing a much better job of raising our hit ratio and our close ratio on the business that's coming in the door.

Q - Meyer Shields {BIO 4281064 <GO>}

No, no, no, I understood that. I think that was clear. I'm just trying to get a handle on whether the trends that you're seeing externally are evolving at all?

A - Mark H. Rose {BIO 1557365 <GO>}

Yes. No, there are sitting pretty constant. Remember that we tend to focus on smaller account business where – that we're talking about limits of a million – we're talking $1 million of limits, in some cases it's more than that, but a whole lot of what we underwrite in that portfolio. Our policy limits of a $1 million and the premium that we're charging for that is usually thousands of dollars perhaps $10,000 or $15,000, but not $50,000 or $100,000. And so that portfolio has been pretty stable for several years. So rates may go up or down, low-single digits, but we're not seeing huge changes in rates.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay, perfect. Thanks so much.

A - Mark H. Rose {BIO 1557365 <GO>}

Thanks.

Operator

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

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

I'd like to thank everyone for joining our call today. I know that this was a busy morning with a lot going on. But I think that as I said in my remarks earlier that a lot of hard work that we've been doing over the last couple of years is starting to pay off. We still have plenty of work to do. But I think that our financial results this quarter accurately reflect some of the progress that we've made. And we look forward to talking to you again at the end of the second quarter. And operator that concludes our remarks for today. Thank you.

Operator

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