Acquisition of The Navigators Group, Inc. by The Hartford Financial Services Group, Inc. Call

Company Participants

- Beth Ann Bombara, Chief Financial Officer & Executive Vice President
- Christopher J. Swift, Chairman & Chief Executive Officer
- Douglas G. Elliot, President
- Sabra Rose Purtill, Senior Vice President, Investor Relations & Treasurer

Other Participants

- Amit Kumar, Analyst
- Elyse B. Greenspan, Analyst
- Jay Gelb, Analyst
- Josh D. Shanker, Analyst
- Kai Pan, Analyst
- Mark A. Dwelle, Analyst
- Meyer Shields, Analyst
- Mike Zaremski, Analyst
- Robert Glasspiegel, Analyst
- Ryan J. Tunis, Analyst
- Scott Frost, Analyst
- Yaron Kinar, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. My name is Amy, and I will be your conference operator today. At this time, I would like to welcome everyone to The Hartford's call to announce its agreement to acquire The Navigators Group. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. Thank you.

Sabra Purtill, Head of Investor Relations, you may begin your conference.

Sabra Rose Purtill {BIO 1764408 <GO>}

Thank you. Good morning and thank you all for joining us today. Today's call and webcast covers our announcement to acquire Navigators Group, a leading specialty underwriter headquartered in Stamford, Connecticut. The news release and presentation addressing this future acquisition are available on our website. In addition, the 8-K which summarizes the major provisions of the agreement is also available on our website. Our speakers today include Chris Swift, Chairman and CEO of The Hartford; Doug Elliot, President and Beth Bombara, CFO. Following their prepared remarks, we will have time for Q&A. Just a few comments before Chris begins.

Today's call includes forward-looking statements as defined under the Private Securities Litigation Reform Act of 1995. These statements are not guarantees of future performance and actual results could be materially different. We do not assume any obligation to update information or forward-looking statements provided on this call. Investors should also consider the risks and uncertainties that could cause actual results to be different from these statements. A detailed description of those risks and uncertainties can be found in our SEC filings.

Our commentary today also includes non-GAAP financial measures. Explanations and reconciliations of these measures to the most comparable GAAP measure are included in our SEC filings as well as in the news release which is available on our website and also on our slides.

Finally, please note that no portion of this conference call may be reproduced or rebroadcast in any form without The Hartford's prior written consent. Replays of this webcast and an official transcript will be available on The Hartford's website for at least one year after this call.

Christopher J. Swift {BIO 3683719 <GO>}

Good morning and thank you for joining. Earlier today, we announced the agreement to acquire Navigators Group, a global specialty underwriter, for $70 a share or approximately $2.1 billion in cash. We have been attracted to Navigators' expertise and track record of underwriting profitability for quite some time and are very excited about the future potential this transaction provides. The combination of our two businesses will meaningfully advance several of The Hartford's key strategic initiatives. It enhances our commercial lines market presence with specialty and E&S capabilities. It broadens and deepens our product offerings with expanded industry verticals, and it expands our geographic underwriting reach with an international presence.

Importantly, we see compelling growth potential in cross selling the combined product offerings to our respective customer basis. This acquisition brings together two like-minded organizations with compatible cultures focused on disciplined underwriting, innovation, and financial performance. Finally, the transaction is expected to generate attractive financial returns in the low double-digit range over time. In a few minutes, Beth will cover some of the key financial impacts of the transaction. Earnings expectations will be refined between now and closing based on our go-to-market strategies and integration process.

Currently, we expect that within four to five years, the acquisition could contribute annual core earnings approaching $200 million excluding amortization of intangibles. An important driver of the financial returns on this acquisition is greater profitable growth. While there are some expense efficiencies, they are not the primary driver of future returns. Like us, Navigators primary focus has been on organic development with a strategy centered on adding products and talented people. Together, we anticipate additional momentum from several opportunities.

First, as Doug will discuss, Navigators brings underwriting expertise, industry and product key verticals in a global platform that can help us accelerate initiatives we recently launched. Second, with our expanded market presence and product offerings, we can offer more products and services through a shared distribution network, enhanced by The Hartford's brand and financial strength. Both Navigators and The Hartford have successful business relationships with the industry's top brokers and agents. The acquisition will further strengthen those partnerships and the coverage solutions that we can tailor for customers.

We also look forward to maximizing the potential of Navigators' Global Reinsurance business. It's a relatively small part of their business with about 13% of gross written premiums and is comprised of traditional P&C reinsurance, A&H and other product specialties. This business is an efficient way to participate in certain U.S. and international markets. Together, we are confident that we can accelerate profitable growth.

I look forward to welcoming Stan Galanski and his leadership team of 820 Navigators' employees worldwide to The Hartford. Our organization share a common culture and a commitment to attracting and retaining top talent, and we look forward to working together with our future colleagues.

Now, I'll turn the call over to Doug for his perspective on the benefits this acquisition brings to The Hartford.

Douglas G. Elliot {BIO 3700927 <GO>}

Thank you, Chris. We're very excited about joining forces with Navigators, as we continue our journey to become a deeper and broader commercial underwriter. As we've discussed with you many times, we believe that success in today's property and casualty market requires specialization that comes from highly skilled talent with extensive local market and industry knowledge. Agents, brokers and customers demand a partner that understands risk and is capable of solving their broad needs for protection, risk management and service.

Navigators' team and product offering are an excellent complement to our strategy, capabilities and culture. Let me highlight a few areas where we believe this combination accelerates our business plan. Throughout their 44-year history, Navigators has been known for their expertise in marine liability, cargo, specie and whole insurance. In more recent years with innovation and entrepreneurial spirit, they have been adding capabilities in other specialty areas, including excess casualty, environmental liability and life sciences.

Navigators build out of their excess and surplus line strategy in the wholesale market is distinctive and respected. These capabilities are highly complementary with our own initiatives in industry verticals such as marine, construction, technology, life sciences and energy, as well as our expansion into surplus lines.

In addition, Navigators' Lloyd's platform and recent international expansion initiatives will extend our capabilities and geographic reach, adding a UK and European underwriting presence that we do not presently have. We have been impressed with the technical depth and market knowledge of the Navigators' leadership team. They clearly know their business well and have developed a well-earned reputation in the market as highly skilled underwriters and business professionals.

We are convinced that the combination of The Hartford and Navigators results in a stronger more diversified commercial lines company that is even better positioned to compete in the marketplace. Navigators' product and industry specialization will expand our risk taking skills and add to our growing industry verticals.

In areas such as management and professional liability, we will immediately increase our scale and market presence providing a better platform for profitable growth. Together, we bring a more comprehensive suite of product, underwriting and service capabilities including our market-leading workers' compensation offering to address the diverse needs of our agents, brokers and customers.

In the months ahead, we'd work on our plans to maximize the strategic and financial value of this acquisition. As we further evaluate our opportunities, we will make decisions about our operating model, assessing the most effective market strategies for various product lines and industries. From my vantage point, I see ample opportunities for us to accelerate our businesses and build value for our shareholders, customers, and distributors.

I'll now turn the call over to Beth.

Beth Ann Bombara

Thank you, Doug. I just wanted to touch on a few key financial and transaction items. The $2.1 billion purchase price can be paid in cash from existing corporate resources including those at the holding company and dividends from subsidiary. We will also evaluate financing alternatives between now and closing, which would reduce the utilization of our current resources. To be clear, we do not intend to issue common equity to fund this acquisition.

Our debt levels will increase slightly at closing due to Navigators' $265 million of debt, which will result in a modest increase to our total debt to capital ratio excluding AOCI, which was 25% at June 30, 2018. The actual impact of the acquisition on our income statement and balance sheet will depend on many factors including the timing of the closing, purchase accounting impacts such as intangible assets and goodwill, integration costs, and acquisition-related charges including transaction costs and any changes in loss reserve estimates that are deemed necessary.

We currently expect the total impact on 2019 shareholders' equity to be immaterial, but could be modestly negative primarily due to integration costs and acquisition-related charges. Excluding integration costs as well as acquisition-related charges, we expect the acquisition to be immediately accretive. For 2020, The Hartford expects the acquisition to be accretive to core earnings by $60 million to $95 million.

This is comprised of a contribution by Navigators of $110 million to $145 million in core earnings, offset by a reduction of approximately $50 million in The Hartford's net investment income after tax due to the cash used to fund the acquisition. I know that many analysts' models may already reflect a reduction in net investment income due to assumptions about share repurchase programs in 2018 and 2019, which we did not include in our outlook.

As we would further refine our go-to-market strategies and purchase accounting adjustments, we will update our earnings estimates including 2020 intangible asset amortization expense currently estimated at $15 million to $30 million after tax. As Chris mentioned, we expect the combination of revenue growth and expense synergies to generate higher earnings beyond 2020 as we will realize the full potential of the acquisition.

Finally, we expect to close the acquisition in the first half of 2019 subject to regulatory approval and The Navigators' shareholder vote. We expect the shareholder vote to occur by year-end 2018. Navigators' founder and certain other shareholders, who own together about 22% of outstanding shares, have agreed to vote in favor of the transaction.

There are various regulatory approvals necessary for us to acquire Navigators. In addition to approvals by regulators in the U.S., principally New York, which is Navigators state of domicile, we will need approval from a number of international regulatory bodies, including the UK Prudential Regulatory Authority, the UK Financial Conduct Authority, the National Bank of Belgium and the Luxembourg Financial Regulator. We also will need to obtain various consents from Lloyd's of London related to Navigators syndicate.

With that, I'll now turn it over to our operator, Amy, to repeat the instructions for asking a question as we begin the Q&A session.

Q&A

Operator

At this time, we will be conducting our question-and-answer session. Your first question comes from the line of Kai Pan with Morgan Stanley. Kai, your line is open.

Q - Kai Pan {BIO 18669701 <GO>}

Thank you, and good morning. So, my first question is about potential revenue growth opportunity as well as cost savings. Because you said that in four to five years, it will be – Navigators will contribute about $200 million ex amortization, which is about 60% more than sort of 2020 contribution, which is $110 million to $125 million, that imply about 12% to 15% annual growth over the four to five-year period. I just wonder like – could you elaborate more about where do you see the revenue opportunities as well as the potential like you said, modest expense saving opportunities?

A - Christopher J. Swift {BIO 3683719 <GO>}

Sure, Kai. It's Chris. I think the revenue assumptions going forward are – we can talk about it, but I would also say importantly, I think we've been realistic with the loss cost assumptions too, increasing really modestly as we take on some of these new product lines. But I think our models would really point to a more of a premium growth rate in the 5% to 6% range.

I think there are expense saves that Beth has mentioned. I would also say I think there's opportunities to increase the portfolio yield. So, you put it all together and that's why we're comfortable if you look out, as I said, that four to five-year range, we could see core earnings ex amortization of intangibles in that $200 million range. Beth, would you comment any more on expense synergies versus (14:54) investments?

A - Beth Ann Bombara

Yeah. So, a couple of things. One, I just wanted to also be clear that in the contribution that we talk about from Navigators in 2020 that that would be inclusive of amortization of intangibles. So, when you're comparing it to the number that Chris gave, which was ex that, you need to make that adjustment. And then as it relates to expense synergies and things that we put in our model, we're currently modeling about $20 million after tax in expense synergies that we'd anticipate being able to achieve in the near-term. And then obviously, over a longer period of time, we will continue with applying The Hartford's continuous improvement procedures and so forth to continue to find ways to find efficiencies going forward.

Q - Kai Pan {BIO 18669701 <GO>}

It's great. My follow-up is on the sort of like, if you step back, consider alternatives for buybacks for example. So, the deal is probably 14 to 19 times earnings on The Navigators earnings 2020. But if you buy back the share, probably like 10 times earnings. So I just wonder can you give us a little bit (16:07) your thought process of considering alternatives, including buybacks before you do the deal and does the deal means that the buyback will be pushed back further like after 2019.

A - Christopher J. Swift {BIO 3683719 <GO>}

Yeah, Kai, what I would say is, again, we found this transaction financially attractive in addition to all the strategic benefits that Doug and I talked about. So, in relation to buybacks, we think it's attractive. I mean what it means for the future is, as Beth said, I mean there's quite a process here to get approvals, which we expect given our reputation and our capabilities, but it's going to take some time, probably early 2019 March/April-ish timeframe.

And then we look at our financials and we do generate capital, but we're still integrating and digesting the acquisition. We will begin to determine our go-to-market strategies here, build excess capital. So I'm not prepared to really talk specifically about capital management plans as we approach the end of 2019 and into 2020 now. But all I would tell you is I still believe we will generate significant excess capital over time, and as we approach the right time, we'll tell you what we're going to do with it.

Q - Kai Pan {BIO 18669701 <GO>}

Thank you so much.

Operator

Your next question comes from the line of Josh Shanker with Deutsche Bank. Josh, your line is open.

Q - Josh D. Shanker {BIO 5292022 <GO>}

Yes, thank you. I'd like to talk a little bit about the go-shop provision and given the 30 days if another suitor comes with a higher offer, are you going to chase it or is this $70 15:00 the best and final?

A - Christopher J. Swift {BIO 3683719 <GO>}

Yeah. Josh, yeah, the deal does contain a go-shop and a no-shop well where over the next 30 days Navigators does have the opportunity to solicit proposal. So we granted them that opportunity. We think $70 is a fair value for the shares, and I'm not going to speculate on what's going to happen. If any suitor emerges, we stand by. We negotiated, I think, a fair transaction for both parties, believe in it, that's why we're talking to you about it today, and we'll see what the future holds.

Q - Josh D. Shanker {BIO 5292022 <GO>}

And in terms of your own positioning in the areas that you're picking upon Navigators, when you look at the sort of synergies from a revenue perspective, how many of those lines do you have some sort of current market share in, and how much it's going to be brand new to you, and why do you expect to be the best operator in those areas?

A - Douglas G. Elliot {BIO 3700927 <GO>}

Josh, this is Doug. It's a multi-faceted question, so let me just take a few of the pieces, and then we can explore further if you'd like to. Clearly, they've got a terrific E&S wholesale operation that they have built out. Two years ago, we purchased Maxum. We've been growing the Maxum franchise, but they do add deep expertise there, and I think our wholesale strategies clearly are accelerated with the combination.

They also aside from Marine and their financial products have some excellent specialty offerings in the retail space, and I'm thinking specifically about their excess casualty program, their environmental strategies and some of their life science where those are all accelerants to early work that have been going on here as a company and pivotal to some of the success that we have ambition for a middle market over the next three to five years. So very excited that their complete array of products offer opportunities for us to do more.

There are places that we both compete. And I think immediately we develop a scale opportunity in the marketplace, but there are also products like life science that we are moving into. And they've had a presence for several years that day one, we hit the market with a much more aggressive approach.

Q - Josh D. Shanker {BIO 5292022 <GO>}

And in terms of places where you have duplicate capabilities?

A - Douglas G. Elliot {BIO 3700927 <GO>}

Well, I think that has to be worked on over the next 6, 9 and 12 months, and we will figure out how to lever the combination of both of those businesses to create a bigger competitor in the marketplace.

Q - Josh D. Shanker {BIO 5292022 <GO>}

Okay. Thank you very much.

A - Douglas G. Elliot {BIO 3700927 <GO>}

Josh, I didn't mention international. I certainly should have. Obviously, our footprint outside the U.S. is very, very small. And the fact that Navigators has been outside the U.S., they have our Lloyd's platform. They've got physical locations in nine cities around the world, and they have experienced a number of products and a number of rollouts. I think that gives us an acceleration there to think more globally, which is an important part of our strategy over the next three to five years as well.

Q - Josh D. Shanker {BIO 5292022 <GO>}

Well. Good luck with that, and we'll see. Thank you.

Operator

Your next question comes from the line of Amit Kumar with Buckingham Research. Amit, your line is open.

Q - Amit Kumar {BIO 15025799 <GO>}

Thanks and good morning. Two questions. First of all, can you spend some time and opine on how do you feel about Navigators reserves and do you foresee some adjustment to those?

A - Christopher J. Swift {BIO 3683719 <GO>}

Yeah. Amit, I'll provide some comments and then Beth will follow up. I would say again during the process of coming to this point and we had the opportunity to do significant due diligence and meet the management teams, understand the strategy, typical stuff, but I would say we spent an exceptional amount of time on reserves. And you know the old adage, you get three actuaries in a room and you're going to have three different opinions.

And, I think that's – honestly, our views is there's a range of outcomes here that Beth will talk about, but the $70 a share that we confirmed with our offer here, I think, reflects a wide range of outcomes that make us comfortable with the negotiated purchase price. But Beth, what would you add?

A - Beth Ann Bombara

Yeah. Just to add to that, as Chris indicated, obviously, when you're evaluating reserves, there's always a range of estimates that depend upon underlying judgments and methodologies. And as we look overall through the diligence process at the reserves there, they're within a reasonable range. But as we look to harmonize kind of our judgments and our processes, there could be areas where we determine that our best estimate is slightly above where they are.

And we will take that into consideration between now and closing, and make any adjustments that we feel is appropriate. But as Chris indicated, as part of our process of just looking at the underlying valuation and where we came up from a price perspective, we took all that into consideration. So, if there are some reserve adjustments that we conclude, we should record, that doesn't change our view on the overall attractiveness of this franchise.

Q - Amit Kumar {BIO 15025799 <GO>}

Got it. That's helpful. The only other question, and I will get back in the queue. Chris, can you sort of just maybe even talk about the background of this deal, who approached whom? I'm sure there were other companies on the short list. And what happened at the end of it, why you ended up selecting Navigators versus – there was definitely some other companies too. Maybe just talk about how this came about? Thanks.

A - Christopher J. Swift {BIO 3683719 <GO>}

Yeah. What I would say and obviously, you'll read it in their proxy, but from our perspective, I'd first – to start with, it has been and is an attractive property to us. We've been very impressed with the underwriting talent, the claim talent, the support talent that Navigators has, the leadership, its entrepreneurial can-do open-up new markets approach. So it's been attractive to us for a while. How that management team and their board involved others, I really don't know.

But I would say that over to the last three years, we've made acquaintances with Stan Galanski, their CEO. We've stayed in contact informally. But I would say earlier this year, March-April-ish, as when there was informal outreach about seeing if there's anything we could do, thought about it. We engaged in a period of what we would say was exclusive and we came to this point. So I'd say, pretty quickly, over the last four or five months, we figured out that we could get something done and here we are today.

Operator

Your next question comes from the line of Elyse Greenspan with Wells Fargo. Elyse, your line is open.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Hi. Thanks. Good morning. So my first question is just thinking through the financing and paying for this transaction. On your last quarter's call, you guys said that you would end this year with about $2 billion as a holding company. I know you look to keep about 1 to 1.5 times of annual dividends in interest as a holdco. Would the financing of this deal maybe cause you to go to the low-end there?

And then can you talk through – obviously, dividends from the subs this year were lower due to the Aetna deal, just in terms of dividends we could expect next year. And I thought maybe some of that might have been second half weighted, whereas this deal is closing in the first half. Just correct me if I'm wrong. And then if you can just say how high you might let your leverage go to finance the deal?

A - Beth Ann Bombara

Sure. I'll cover off on that. So, yes, as we look at sort of pre this transaction and holding company resources at the end of the year, kind of in that $2 billion range and that was predicated on just other things that we might do as well relative to things like contribution to pension plan and so forth. So it's probably a little bit more than that.

You're right and that we typically target 1 to 1.5 times interest in dividends. And I think the combination between that excess capital we have as well as taking some dividends from the subsidiaries, I think we can put ourselves in a good position that we would still be within those thresholds. And we had talked about dividends in 2019, potentially being more in the second half, and so we might look to accelerate some of those as we think about paying for this transaction.

And then as far as our debt leverage, one of the things that we're also just evaluating is, as you know, we do have some debt that's maturing in January. Obviously, that's in our debt ratios today. And so when I think about just resources that we would use to fund this transaction where previously we were thinking of paying that maturity down and not issuing debt, we might consider issuing debt to sort of fund that.

So, again, I wouldn't anticipate that our leverage ratios would increase very significantly from sort of the pro forma that we're describing today, but there might be an opportunity for them just to go up a bit, and then we would look to manage them down as we continue to generate earnings, which obviously improves our equity position, and then we also have maturing debt in 2020 that we could look at as far as continuing to pay down and get back into levels that are a little bit lower than where we are today.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Okay. Thank you. That was helpful. And then my second question, if we look at Navigators' CAT exposure, they had about 7 points of CAT last year. Just how do we think about their CAT exposure going into wind season? And I'm assuming just given – I mean it's – there is smaller reinsurance exposure as part of their bigger portfolio that there is no color on this deal if (29:23) in fact we have a pretty strong hurricane season this year.

A - Christopher J. Swift {BIO 3683719 <GO>}

Yeah. Elyse, it's Chris. Between Doug and I, I'm going to see if we could paint a picture for you. So we do understand their exposure's using one in 100 return periods, one in 250. I would say that we believe they have a robust reinsurance program, so I'm not sure if that's changed over the years given their experiences, but what's in place today we think is very robust. So it nets down to, I'll call it, on a one in 100 basis or one in 250 basis on the information we have in that $35 million to $40 million range. So again within our tolerances and our balance sheet and our capital position, I think that's very manageable and tolerable. Doug, what would you add?

A - Douglas G. Elliot {BIO 3700927 <GO>}

The only thing I would add, Chris, is that we spent a considerable amount of time with the reinsurance group, their leadership, Clay Bassett, and very comfortable with how they manage aggregates, they're disciplined by geography, et cetera. So looking forward to becoming partners and we think that we got a very disciplined group there on the CAT side.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Okay. Thank you very much.

Operator

Your next question comes from the line of Mike Zaremski with Credit Suisse. Mike, your line is open.

Q - Mike Zaremski {BIO 20606248 <GO>}

Hi. Good morning. First a follow-up to Kai's question. And I will say that I don't know Navigators that well and I think a number of people on this call don't appreciate Navigators as well and we'll get to know them over time. But if I look at their historical ROE, it's been about 7% and that you're paying close to 1.7 book. And so, I mean you feel you can earn a double-digit return over time. So, it implies that you think Navigators can meaningfully improve its ROE.

And so even if I take into account the modest expense saves and the 5% to 6% premium growth, I guess it implies that I shouldn't be thinking about the 7% ROE being reflective of what you – there might have been items in there that suppressed it. And so, maybe there's like structural items you feel we should better understand about Navigators which were suppressing its historical ROE.

A - Christopher J. Swift {BIO 3683719 <GO>}

Yeah. I understand the question, Kai. But as we tried to - or excuse me, Michael, as I responded to Kai, I mean it is about growing the premium base with, I'll call it, a slightly higher loss ratio and using our financial strength, our distribution networks, cross-selling in a more effective way. There are some modest expense saves. I do think there will be, I'll call it, a good lift in the investment portfolio with our asset allocation philosophy and methodology.

And ultimately, I think the view that I have along with Doug is that one on one is going to equal three here and we'll be able to contribute to their underwriting process, contribute maybe in risk taking in different ways to help drive a higher ROE because as you said, historically, it's been in that 7%, 8%, 9% range. And we're an ROE-focused company, and I think there is some tools, methodology approach, mindset that I think we'll be able to bring to the organization and as Doug said in a partner way. But Doug, what would you add?

A - Douglas G. Elliot {BIO 3700927 <GO>}

Mike, I would also add that we have, I think you know, invested mildly over the last decade in data science and data analytics. And I think we'll offer something in that regard as we work hard together on improving underwriting results across the board, both at The Hartford and also at Navigators. So, I'm excited about the tools we've built and I'm excited to share them at the appropriate time with Navigators.

Q - Mike Zaremski {BIO 20606248 <GO>}

Okay. That's helpful. And my last question, it's tougher for us to appreciate, but you talked about this strengthening your value proposition to agents and customers. And so maybe you can kind of update us on whether strategic goals post this deal, I know this deal will take some time to work through. But then does this kind of fulfill your desires in commercial lines, if we're thinking over the long run or are there still ambitions to maybe move up market or whatnot?

A - Christopher J. Swift {BIO 3683719 <GO>}

Yeah. What I would share with you, Mike, is that we are always pushing ourselves to be the best as we could be. As Doug said, the best underwriters with, we think, outstanding distribution with a broad array of products and underwriting skills and industry support as the world gets very, very specialized. So, I think this acquisition goes a long way to establishing - to contributing to our desires and vision and aspirations, but it'll never be completely satisfied and we're always going to push ourselves to do more.

I think what's particularly attractive to me is some of the international capabilities that we pick up through their Lloyd's presence, their larger London market presence and a beginning of a European strategy. So, The Hartford's vision and strategy is focused around small-to-middle market in select specialties and select activities and national accounts, but our bread-and-butter and I think our value added over the long term is going to be in that SME to specialty area to playing at the smaller end of national accounts in financial lines and things like that. So, we're very mindful of what we think we're good at.

We're very mindful of where I think the market allows you to make adequate returns and really going up market in a major, major way isn't part of our vision at this time.

A - Douglas G. Elliot {BIO 3700927 <GO>}

Mike, let me just add another thought too, as we think about our small commercial franchise which we're very proud of, over time, it'll have a bit more of a specialty edge to it, and I think Navigators helps that process, number one. Number two, we've talked over the last several years about our focus with our middle market franchise. Eight years ago, seven years ago when I arrived, heavily dominant with workers' compensation, we'd been working to increase our scale and our product offering in the property and casualty space.

Say we've made quite a bit of progress, but this acquisition also gives us the ability to have more product faster in that area, which we think is pivotal for us as we grow our franchise over the next three years. So, very excited about what we can do together, pleased with our progress, but I do see some accelerants here with Navigators with – they've been deep in the casualty side, and I think we'll learn a lot as we come together.

Q - Mike Zaremski {BIO 20606248 <GO>}

Thank you.

Operator

Your next question comes from the line of Ryan Tunis with Autonomous Research. Ryan, your line is open.

Q - Ryan J. Tunis {BIO 16502263 <GO>}

Hey. Thanks, good morning. I guess for Chris, it's been a pretty busy 12 months at Hartford M&A wise, a couple deals. I guess looking out to the close of this, presumably there's going to be some integration process, should we think about mid-2019 heading to (37:30) 2020? Are we kind of through the – try to grow through M&A aspect of, I guess, the lifecycle at Hartford, should we think about I guess kind of more of a balanced form of capital return at that point as you're integrating Navigators, or should the takeaway from this be that still indefinitely there is an appetite for M&A versus any other form of capital return that extends until told otherwise?

A - Christopher J. Swift {BIO 3683719 <GO>}

Yeah. Thank you, Ryan. I'd say you framed it fairly well, right? So, very pleased with the Aetna integration as we've reported periodically to you. As we get into early 2019, there are some major hurdles, milestones that we feel very comfortable in achieving, so I believe that integration is on track, and it's going to achieve or slightly exceed some of the goals that we've put out there.

This one is a little different, right, where – and it was like a full integration into our tools and technology, and we were using some of the things we acquired there, so little different. They have their own process and systems and legal entities. So, the integration here from a back office side probably is going to be a little lighter. And as Doug alluded to, it's more one of the best go-to-market strategies that we need to have to capture and win additional business.

So, that's probably going to take, I would say, most of 2019 to sort of sort through and being in a good position and rebuild the balance sheet. I think from there philosophically, I think you know me pretty well. I mean we still want to invest in our businesses to make them distinctive, to make them competitive to differentiate ourselves and offer value to our customer agents, our customer customers and have our people feel proud.

So, we always are going to have a mindset of how do we get better. And we've always had a mindset of, can we build as Doug just said over the years. I'm really proud of what we've built and created and we'll bring that organic mindset. But there's also a part of us that is also going to be aware of opportunities that can accelerate things that we want to achieve. But these two acquisitions go a long way and, again, reserve the right to sort of say that maybe beginning in 2020 we could think about capital differently.

But as we sit here today, we still want to invest, we still want to be the best we can be and grow and offer more products and services through our agents and to ultimate customers, and we'll see what develops. It's hard to forecast what's the world going to look like in 2020 and beyond. So, we'd like to keep our options open and really see what develops.

Q - Ryan J. Tunis {BIO 16502263 <GO>}

That's helpful. And then actually – and really one for Doug, but I guess with earnings, looking back in earnings, there was a much more cautious stance at Hartford on workers' comps than pretty much any competitor. And I guess, would that in retrospect, I'm curious if Doug has any updated thoughts. I know it's actually been a month, but I guess just kind of trying to square that triangle on why did it sound like there was somewhat of a pickup in inflation at Hartford that we haven't necessarily seen as an industry phenomenon?

A - Douglas G. Elliot {BIO 3700927 <GO>}

Ryan, yeah, I don't have much of an update. I can tell you we're spending a lot of time looking at our books of business, evaluating all of our lines including workers' comp. I can't speak to the other carriers that we compete with, but I stand by my remarks on the second quarter that this is an important line for us. We pay attention to trends and we'll react to what we see in our book of business in the ensuing months ahead.

Q - Ryan J. Tunis {BIO 16502263 <GO>}

Thanks.

A - Douglas G. Elliot {BIO 3700927 <GO>}

Thank you.

Operator

Your next question comes from the line of Bob Glasspiegel with Janney Montgomery. Bob, your line is open.

Q - Robert Glasspiegel {BIO 1764160 <GO>}

Good morning, everyone. You did a very good job on the strategic basis for the deal. I need a little bit more help on the financial side. The numbers you used on accretion sort of used a 2.3% cost of financing. I'm sure you used a more rigorous analysis than that as a hurdle rate. But what hurdle rate do you use in paying 70% over book from a financial point of view for a payback to be in line with what you want to get?

A - Christopher J. Swift {BIO 3683719 <GO>}

Thanks for the question, Bob. Sorry, we can't square your triangles as they say. But I would say we use our cost of equity capital as a hurdle. I would say we estimate that in 8.5%, 9% range today. So this deal – and when you get two, three years out, exceeds that. And we don't view exceeding that as anything, but we want to try to be as wide as we can to the spread of our equity cost of capital. So we understand we mix in debt and maybe other securities from time to time that gets our overall cost of capital down, but we measure hurdle rates as our cost of equity capital over a reasonable period of time.

Q - Robert Glasspiegel {BIO 1764160 <GO>}

So 9% and 2.1% would be – you need $180 million of earnings power from the deal in two to three years, is that a fair statement?

A - Christopher J. Swift {BIO 3683719 <GO>}

Yeah. And that's why I made the statement I did is that when you get out a little further, 4% to 5% in this particular case, given that there is growth aspirations that we have, we approached that $200 million range, ex-amortization of intangibles with – I would say we capitalized that cost. So we don't penalize ourselves. So that's why we backed that out philosophically. We know it's an expense, we don't ignore. We included in core earnings. But when Beth and I look at our capital allocation, our models, we do back that up.

Q - Robert Glasspiegel {BIO 1764160 <GO>}

One last question. What's the breakup fee?

A - Christopher J. Swift {BIO 3683719 <GO>}

There's two. One is during the go-shop period. It's basically 2%. And then there is a, what the deal lawyers call, a no-shop period and it jumps up to 3.25%. So view it as a 2%, and if after 30 days someone emerges, it goes up to 3.25%.

Q - Robert Glasspiegel {BIO 1764160 <GO>}

Thank you.

Operator

Your next question comes from the line of Yaron Kinar with Goldman Sachs. Yaron, your line is open.

Q - Yaron Kinar {BIO 17146197 <GO>}

Good morning, everybody. My first question is around the reinsurance portion of the operations. I realize it's pretty small on pro forma base, but I saw that this was maybe an area that you were less interested in being involved. And, so I was just curious, is that a core business for you, or would you view it as a core business, and if so is it a business that you'd also be looking to maybe explore some alternative capital growth opportunities in?

A - Christopher J. Swift {BIO 3683719 <GO>}

Yeah. We tried to frame it in our comments is that it's about 13% of reinsurance is defined as 13% of their gross written premiums, but if you really subdivide that, Yaron, is that 7-ish percent of that reinsurance premiums is traditional P&C reinsurance. And again, we put some slides together to sort of give you that. So half would be traditional, the other half, we would say, is A&H and other specialty lines that are ways of getting into markets in essence of a synthetic direct basis.

So we're intrigued. Yeah, obviously, it's part of the acquisition, we want to try to maximize it. So, yeah, we'll look to continue to allocate capital to, that division, but measure it against risk-adjusted returns that we think are appropriate over a longer period of time and surpasses that hurdle rate, great. But yeah, I'm optimistic given that how they used reinsurance in certain territories to enter and try to grow profitably. So, I think their strategy is – I'm looking forward to learning more about it because I'm intrigued by it.

Q - Yaron Kinar {BIO 17146197 <GO>}

Okay. That's helpful. And then, my second quarter is just about the broader kind of premium growth assumption for the Navigators business. So, I think you talked about 5% to 6% growth that you're building in, which is I think roughly in line with the Navigators' multi-year growth average, but certainly lower than what they've been posting the last couple of years. And between that kind of the deceleration from recent years and your cross-selling opportunities, I'm just curious as to why it would be 5% to 6% and not continuing this improving trajectory that you're thinking of.

A - Christopher J. Swift {BIO 3683719 <GO>}

Look, I mean, we debate all the time what is an appropriate growth mentality, because I mean you could grow a lot faster, but you're going to have poor underwriting results and probably not the profitability you want. So, we're trying to strike what we think is the right balance with their product sets, our products sets and creating a growth environment that makes prudent sense to grow and maximize ROEs at the same times and that's what we believe is accurate. As Doug just alluded to, I mean workers' comp is under a little pressure right now, still a profitable line. But you've got to be really select in how you want to target growth balanced against ROE. Doug, but what would you add?

A - Douglas G. Elliot {BIO 3700927 <GO>}

I guess the only other thought is that their markets really do extend outside of the U.S. and around the world and there are certain product niches in parts of the world where I would say pricing is rather soft, and they've commented on their prior quarterly call. So, they're managing all of their niches and verticals aggressively and I think being very thoughtful about that. But all their markets don't exist the same way today. I think there are spots where they're competing differently based on what they think are financial return opportunities in the market as they exist.

Q - Yaron Kinar {BIO 17146197 <GO>}

Got it. Thank you very much.

Operator

Your next question comes from the line of Meyer Shields of KBW. Meyer, your line is open.

Q - Meyer Shields {BIO 4281064 <GO>}

Great. Thanks. So, quick modeling question. Can you talk about the, I guess, premium leakage and P gaps adjustments that are included in the 2020 core EPS outlook?

A - Christopher J. Swift {BIO 3683719 <GO>}

Premium leakage and P gaps, I'll look to Beth on P gaps, I think on premium leakage – Doug – it's modest. I mean, again, there is good complementary nature of these two franchises. We share a lot of the same distribution relationships, so we don't see any shock losses coming or dis-synergies in the premium leakage, so I think it's managing retention in a price environment that makes sense is our basic going in assumption, Doug, but...

A - Douglas G. Elliot {BIO 3700927 <GO>}

And also included in our modified expectations of top line, I think it's all rolled out and because of transaction is legal and it'd be different than certainly the Aetna transaction. I look at that renewal dynamic a little bit different in this combination with Navigators.

A - Beth Ann Bombara

Yeah. And Meyer, as it relates to purchase accounting adjustments, I'm assuming you're referring to sort of amortization of intangible expenses, and as I said in my remarks, the numbers that we gave for 2020 include a range of about $15 million to $30 million after tax, so obviously, we'll be chewing those off as we go through the process of doing all of the purchase accounting adjustments that come with the balance sheet, but that's what's embedded in those numbers right now.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. Perfect. Thank you. Second question if I can, Beth you talked about possibly truing up Navigators' reserves to the best estimate. The Hartford obviously has been sort of increasing the excess of recorded reserves to the best estimate. Would you expect to have to the same standard on the legacy Navigators reserves?

A - Beth Ann Bombara

Yeah. So again, we'll look at the overall reserves and, as I said, harmonize them with our methods and judgments. We don't necessarily target a specific number as you're referring to it, but we'll take that into consideration. And as I said, I think that there then may very well likely be some adjustments that we'd make to kind of true it up to our best estimate.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. Perfect. Thanks so much.

Operator

Your next question comes from the line of Jay Gelb with Barclays. Jay, your line is open.

Q - Jay Gelb {BIO 21247396 <GO>}

Thanks and good morning. I was looking at the slide number 24, with The Navigators financial highlights. So, I can see that in the first half, the company generated a core return on equity of right around 10%, and in prior years, it had been lower. And just trying to get your view on where you see Navigators' ROE kind of coming in on a normalized basis as it stands currently and then as part of The Hartford?

A - Christopher J. Swift {BIO 3683719 <GO>}

Yeah. I can't comment, Jay, on Navigators and their history. All I can comment upon is what we think we could do with it going forward and that's what I said, is I think we could get it to a low double-digit range. Over time as we integrate, as we cross-sell, as we sort of lift our combined premium base and maximize our distribution power that I think that the two organization has, I'm confident, highly confident, we can get that into the double-digit range.

Q - Jay Gelb {BIO 21247396 <GO>}

I appreciate that. And then I'm just trying to square your comment, where I believe you said within four to five years, Navigators could add $200 million to after-tax core earnings, excluding amortization of intangibles. If I take their first half results, which were around $120 million of core earnings after tax, is there that much expense synergies or other synergies that could get that $120 million to $200 million?

A - Christopher J. Swift {BIO 3683719 <GO>}

No. That's comment (53:06) upon what we're thinking in terms of expense, so that's $20 million. But the components of how the math's going to work is ultimately growth. Modest expense saves, NII. We think we can add NII, net investment income to their portfolio and overall margin improvement with our ROE mentality, our data and analytics, our tool sets. That's the equation.

Q - Jay Gelb {BIO 21247396 <GO>}

Okay. Thank you.

Operator

Your next question comes from the line of Scott Frost with State Street Global. Scott, your line is open.

Q - Scott Frost {BIO 16894956 <GO>}

Thank you. Thanks for taking my question. You touched on this a little bit with Elyse's question and the change I heard from a credit perspective was that you may issue debt in January versus previous plans to paying that maturing debt down. That sounds like a modification of previous leverage guidance, but not a change. Is that the right way to look at it? Are you still planning to target low 20% leverage by 2020?

A - Beth Ann Bombara

Yeah, Scott. So, yes. So, I was talking about the fact that as we look at the resources that we'll utilize for this transaction, the fact that we do have maturing debt in January, as we said we would explore other financing options and that's what we're taking into consideration. So, might take us a bit longer than we originally said relative to kind of getting down to lower leverage ratios, but I still think overall when we look through 2019 going into 2020 that we're still on that path, but we want to just keep our options open as we just sort of think about the best way to finance this transaction.

Q - Scott Frost {BIO 16894956 <GO>}

Okay. But just to clarify, you're still planning to target a low 20s percentage by the end of 2020, is that my understanding or (55:07)?

A - Beth Ann Bombara

Yeah. Mid to low 20s is – yeah, what we've said before is mid to low 20s, is what we're targeting.

Q - Scott Frost {BIO 16894956 <GO>}

And just to follow up, I think for (55:15) for agencies, I think had you in a leverage band of sub-30%, I mean do you expect any negative reaction from rating agencies or how would you characterize your conversations with them regarding this transaction?

A - Beth Ann Bombara

Yeah. I think they were very constructive and kind of understand how we're thinking about this.

Q - Scott Frost {BIO 16894956 <GO>}

Okay. Thank you very much.

A - Sabra Rose Purtill {BIO 1764408 <GO>}

Thank you. Amy, I think we have time for one more question.

Operator

Okay. Your last question comes from the line of Mark Dwelle with RBC Capital Markets. Mark, your line is open.

Q - Mark A. Dwelle {BIO 4211726 <GO>}

Yeah. Good morning. Just a couple of quick questions, are you contemplating retaining The Navigators' brand or is this a vehicle to really push The Hartford brand out into international markets?

A - Douglas G. Elliot {BIO 3700927 <GO>}

Mark, those discussions I've just initially kicked off and we'll spend time over the next six, nine months deciding how we do market ourselves. Obviously, there's enormous strength in The Hartford brand. There's also a great recognition of Navigators' brand, particularly in some of their deep rooted products. So we're open on that and I think Stan and his team will add a lot of thought and we'll come up with what we think is the best decision for the overall franchise.

Q - Mark A. Dwelle {BIO 4211726 <GO>}

And I guess related to that, considering that there's not a lot of synergies particularly planned over the near-term, can you elaborate a little bit more on some of the integration costs? I mean it wouldn't sound as though a lot would be expended on relocations and head count adjustments and things of that sort. So, I'm just trying to get an idea what goes into the kind of $70 million to $110 million.

A - Beth Ann Bombara

Yeah. I'll take that. So again, as we think about the synergies here, there is obviously some expenses, we said it's modest, but it's also on just our go-to-market strategies. And in order to really set ourselves up best to do that from an integration perspective, we do need to make sure our systems are able to talk to each other. So, if you're comparing that cost to just expense synergies, it might look high, but we're really looking at it more broadly as we bring sort of the Navigators operations into our environment that really allows us to maximize our ability to use our tools and so forth. So, we really think about it from both sides, revenue and expense.

Q - Mark A. Dwelle {BIO 4211726 <GO>}

And a last real quick question if I may, do you intend to kind of show this as a separate operating division or will this be embedded within the commercial lines segment?

A - Christopher J. Swift {BIO 3683719 <GO>}

Yeah, Mark. I think again preliminarily, right, we haven't really started to plan activities in integration, but I do envision sort of our global specialty segment. I think we'll have to work together to define what that is Doug, but I think in addition to our standard commercial lines, our national account presence, having a global specialty segment that makes sense to us. But those are some of the things that we'll work on. And obviously, once we close the deal, we'll announce what we're going to do.

Q - Mark A. Dwelle {BIO 4211726 <GO>}

Thanks very much, appreciate the answers.

Operator

This concludes our question-and-answer session. I would now turn the call back over to Sabra Purtill for closing remarks.

A - Sabra Rose Purtill {BIO 1764408 <GO>}

Thank you, Amy. We just wanted to appreciate your availability today to join us at short notice to discuss our agreement to acquire the Navigators. Obviously, we have lots of materials on the website including, as I mentioned, the 8-K. So if you have any additional follow-up questions, please do not hesitate to contact the Investor Relations team today. Thank you very much and have a good day.

Operator

This concludes today's conference call. You may now disconnect.