Q3 2011 Earnings Call

Company Participants

- Anne Waleski, VP, CFO and Treasurer
- Richie Whitt, President and Co
- Tom Gayner, President and Chief Investment Officer
- Wendy Houser, Managing Director

Other Participants

- Jack Sherck, Analyst
- Mark Dwelle, Analyst
- Vincent DeAugustino, Analyst

Presentation

Operator

Greetings. Welcome to the Markel Corporation Third Quarter 2011 earnings conference call.

At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. (Operator Instructions). As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Tom Gayner, President and Chief Investment Officer. Thank you, Mr. Gayner, you may begin.

Tom Gayner {BIO 1896932 <GO>}

Thank you, Devin.

Good morning. It's my pleasure to welcome you to the Markel Corporation Third Quarter conference call. Thank you for joining us.

On today's call, we will follow our normal line up, Anne Waleski leading off with the financial results, followed by Richie Whitt with operational comments. Mike Crowley is unable to join us today, so Richie will share and cover his comments. Then, I will discuss our investing and non-insurance activity. After everyone's comments, we'll be all available for your questions.

Before we begin, I'm duty-bound to remind you that during today's call, we may make forward-looking statements. Additional information about factors that could cause actual results to differ materially from those projected in the forward-looking statements is described under the caption Risk Factors and Safe Harbor and Cautionary Statements in our most recent annual report on Form 10-K and quarterly report on Form 10-Q. We may also discuss certain non-GAAP financial measures on the call today. You may find a reconciliation to GAAP of these measures on our website, at www.markelcorp.com in the Investor Information section under non-GAAP reconciliation, or in our quarterly report on Form 10-Q.

With that, Anne?

Anne Waleski {BIO 16735457 <GO>}

Thank you, Tom. Good morning, everyone.

I plan to follow the same format today as in prior quarters. I'll focus my comments primarily on year-to-date results. I will start by discussing our underwriting operations, followed by a brief discussion of our investment results, and bring the 2 together with a discussion of our total results for the nine months.

So, moving right into the underwriting results, gross premium volume was just under $1.8 billion for the first nine months of 2011, up 16% compared to 2010. This increase was due to higher gross premium volume in the Specialty Admitted and London Insurance Market segments. As of September 30, 2011, the Specialty Admitted Segment included $170 million of gross written premiums from our FirstComp workers compensation operations, which we acquired in late 2010.

The increase in gross written premiums in the London Insurance Market segment was due in part to an increase in premiums written by Elliott Special Risks, which has been converted from an MGA operation to a risk-bearing insurance division. We also saw significant increases in premium volumes within our Marine and Energy divisions, due in part to offering larger line sizes and an improved pricing environment.

Net written premiums were approximately $1.6 billion, up 15% to the prior year. Retentions were down slightly, at 89%, compared to 90% in 2010. Earned premiums increased 16%, primarily due to higher earned premiums in the Specialty Admitted and London Market segments, as a result of higher gross premium volume as compared to 2010. The Specialty Admitted segment included $147 million of earned premium from FirstComp.

Our combined ratio was 105% for the first nine months of 2011, compared to 99% in 2010. The increase is due to a higher current accident year loss ratio partially offset by more favorable development of prior year's loss reserve compared to 2010. The combined ratio for the first nine months of 2011 included $133 million, or 9 points of underwriting loss, related to natural catastrophes, including Hurricane Irene during the Third Quarter, the US storms in the Second Quarter, and the Australian floods, the New Zealand earthquakes and the Japanese catastrophe, all of which occurred in the First Quarter.

Our 2010 combined ratio included $17 million, or 1 point of underwriting loss, relating to the Chilean earthquake. The 2010 combined ratio also included $72 million, or 6 points of underwriting loss, on 2 programs now in runoff that were exposed to losses associated with the adverse conditions in the residential mortgage market. Favorable redundancies on prior year's loss reserves increased to $250 million, or 17 points of favorable development, compared to $181 million, or 14 points of favorable development in 2010. The increase was primarily due to more favorable development of prior year's losses in the Excess & Surplus lines segment. Our 2011 year-to-date expense ratio was flat to the same period in 2010.

Turning to our investment results next, investment income was $197 million for the first nine months of 2011, compared to $201 million in 2010. Net investment income included an adverse change in the fair market value of our credit defaults loss of $2.7 million. Net realized investment gains were $25 million, compared to $22 million in 2010. Unrealized gains decreased $31 million before taxes in 2011, due to a decrease in the fair market value of our equity security partially offset by an increase in the fair market value of our fixed maturities. Tom will go into further details in his comments.

Looking at our total results for the first nine months of 2011, we reported net income to shareholders of $92 million, compared to $127 million in 2010. Book value per share increased 2%, to $333 per share at September 30, 2011, up from $326 per share at December 31, 2010. The effective tax rate was 17% in 2011, compared to an effective tax rate of 31% in 2010. The decrease from 2010 is primarily due to having lower estimated income before income taxes in 2011 as compared to 2010.

Next, I'll make a few comments on cash flow and the balance sheet. Operating cash flow was $261 million for the nine months ended September 30, 2011, compared to operating cash flow of $173 million for the same period of 2010. This increase was primarily due to higher cash flows from underwriting activities in the London Insurance Market and Specialty Admitted segments. Investments in cash held at the holding company were just over $1 billion at September 30, as compared to a little less than $900 million at year end. Finally, we have repurchased 85,000 shares of our common stock for $33 million in the first nine months of 2011.

Now I'll turn it over to Richie to further discuss operations.

Richie Whitt {BIO 7084125 <GO>}

Thanks, Anne. As Tom said, Mike Crowley is not going to be able to be with us today. Fortunately, we have redundancy built into the system here at Markel, and I will just discuss all of our insurance operations in his absence.

The Third Quarter for North America and International operations was relatively stable from a ratings standpoint. The various entities out there that gather rate change data reported that rate decreases have slowed. In particular, the CIAD recently released the commercial insurance market survey reporting that rates for most lines of business and account sizes declined less frequently and at a slower pace this quarter.

CIAD members place a large majority of US commercial premiums, which gives the survey a level of credibility. Markel's own results confirmed that in some lines rates have flattened, while in other lines, particularly the casualty lines, they continue to show some weakness. The competitive rate environment still exists and profitable business attracts many carriers vying for that business. The trends are amazingly consistent in both the domestic and international markets.

Now I'd like to make a few comments for each of our divisions. The Specialty division generated gross written premium of $154 million during the quarter. This was an increase of about $50 million over prior year. FirstComp premiums totaled $60 million in the quarter. The premium shrinkage in other areas was due to corrective actions in our Accident and Health division, and non-renewing underperforming books of business. Year-to-date, the divisions generated gross written premium of $432 million, which is an increase of about 65% from prior year's gross written premium of $261 million. The increase was due to the FirstComp acquisition.

Highlights for Markel Specialty include we launched a new Nurseries and Garden Center program in the quarter. We completed work to initiate our first venture into social media with our health and fitness product. Markel American, our personal lines division, went live with a Ringer's product with the largest provider of apartment community web sites and renter payment systems.

Cross selling efforts between FirstComp and Markel continue to gain traction. 20% of FirstComp's new business in the quarter came from agents that did business with both Markel and FirstComp prior to the merger, proving that now that FirstComp is part of Markel, agents are even more inclined to do business with FirstComp. Agents who were Markel agents and are now appointed by FirstComp have been twice as productive on new business as existing FirstComp agents. All these are really positive signs.

In addition, we announced the appointment of Luke Yeransian as President of Markel Specialty. Luke is the founder of FirstComp. His experience in developing strategy, analyzing distribution, implementing best practices and metrics management, and engaging technology are going to be invaluable as we continue to fine tune our strategy in Markel Specialty.

With regards to our Excess & Surplus lines segment, gross written premium for the quarter was $237 million, a decrease of 1% from the prior year. Year-to-date gross written premium totalled $664 million versus prior year $693 million. As we've previously discussed, this reduction in gross written premium is primarily due to the loss of 2 large programs. Our core regional premium in the Excess & Surplus lines segment was actually up 6% over prior year in the quarter and up 5% year to date. So, encouraging signs there.

Highlights for the Excess & Surplus lines segment include growth in our binding business, as well as our brokerage casualty, excess and umbrella, and property cat business. We completed and released the first phase of our broker portal, which is an update of our website for our wholesalers. This is providing much improved and faster experience for our agents, for 14 of our highest volume products. We are going to continue to frequently add functionality as we move forward.

We continue to focus on strategic initiatives with our national brokerage partners, led by our wholesale marketing department. This initiative has produced solid growth with our 12 largest wholesalers for the first nine months of the year. Submission counts continue to rise in all of our regions, a clear indication our marketing efforts are producing results.

While it was held early in the Fourth Quarter, I do want to mention that we had a very successful and intense NAPSLA [ph] conference. We conducted over 128 meetings with our wholesale partners out in San Diego last month.

At Markel International, we generated gross written premium of $194 million in the Third Quarter, and $677 million for the nine months. The increase for the nine months was approximately 14%, and this was adjusted for the impact of currency movements, and represented organic growth in our Marine and Energy division and the ramp-up of written premium from our Elliott Special Risk division. Highlights for International include our Marine and Energy team continue to produce solid premium growth, rates continue to modestly increase in the Energy sector, and rates appear to be flattening in other areas.

Out team in the new Rotterdam office have moved into their permanent space, and wrote their first policy in October. We are currently preparing for the January 1 renewals, when a significant portion of the professional liability business renews in Holland. Our Trade Credit division continues to progress nicely and has written it's first business from staff we added to our Singapore branch.

Finally, we recently appointed Paul Jenks to the Board of Markel international. Paul has done a tremendous job leading our Marine and Energy team over the past 10 years, and his input will be invaluable as we seek continued profitable growth at Markel International.

Our Product Line leaders have been working hard to improve on process for binders, submission acceptance standards, and application acceptance standards. We expect to see meaningful improvements in the Fourth Quarter, which will lead to more efficiencies. Other highlights for our Product Line group include adding contractors pollution coverage to our binding offerings in the Fourth Quarter. We believe this is going to be a compelling offering for our contractors and will attract new business.

We've also launched a companion auto product and are now able to write auto coverage to support existing accounts. We've had success in environmental contractors and railroads to date with this new product. This will be a differentiator for us, as many of our E&S competitors do not have this capability. With regards to pricing, our Product line leaders are currently working closely with our actuaries to our review our pricing strategies for all lines of business. While this is always an ongoing process, we are placing a strong emphasis on those lines we feel need attention moving into 2012.

In summary, the Third Quarter was a continuation of what we've been seeing in the market the last few quarters. We have modest optimism for a better rate environment for property lines; and casualty lines are clearly flattening, but certainly not hardening, at this point. We continue to revisit and refresh our product offerings, looking for efficiencies in our processes, and to be strategic in our marketing efforts. Our people continue to position Markel for success, despite what continues to be a competitive marketplace.

Now, I'd like to turn it over to Tom. Thank you, very much.

Tom Gayner {BIO 1896932 <GO>}

Thank you, Richie. I'll cover a few general topics this morning, and then of course, try to answer your questions.

The first topic is our public investment portfolio. Now, volatility technically means movement, and that would mean up as well as down. When people use the word these days, though, they mean down; and during the quarter, volatility, as it is used in the vernacular of our day, reared its ugly head and down it was. For the year to date through September, our equity portfolio declined 8.8%. By the way, volatility actually meant up in October, and marking the portfolio 30 days later would produce a very different result.

On the fixed income side, interest rates continue to perform their world class limbo dance and go lower and lower and lower. As a consequence, the coupon return was amplified by an increase in market values, and we earned a total return of 6.3% on the fixed income portfolio for the year to date. The combination of the 2, as well as a modest negative FX effect of negative 0.2% produced a total return of 2.8% so far in 2011.

As I stated last quarter, and probably several quarters before that, the strategic goals of the investment department are to, number one, protect and preserve the balance sheet through high quality fixed income investments; two, to allocate as much as possible to higher total return equity investments; and three, to increase the overall earning power and financial flexibility of the Markel Corporation through the ownership of a variety of profitable businesses. That will continue to be the case in the years to come.

On the last call, I emphasized that none of that had changed, despite the new headlines that the US government had just been downgraded from AAA. This call, I'll reiterate it in the face of the risk on, risk off volatility pattern that dominates daily financial markets.

Measured against our goals, I'm pleased with the progress we've made during 2011. First, we are protecting and preserving the balance sheet by maintaining a high quality and short duration bond portfolio. As is our goal, over 90% of the fixed income portfolio is rated A or better. And those are real A's, and supported with our own independent view of the underlying credits. We do not rely on the opinions of rating agencies to make credit judgements. We do our own work and refuse to buy a bond where we are concerned about whether they are money good or not. We don't always get it right, but we don't just take someone else's word for it.

Also, we continue to painfully allow the duration of the portfolio to shorten with the passage of time. Trying to maintain or improve current investment income by buying longer term bonds or by buying riskier credits looks like an incredibly dangerous game of hot potato to me. I think that people with too short a time horizon are worried that they might lose their jobs if they under perform for 1 quarter or 2, along with people who are convinced that deflation will occur and drive interest rates lower, are taking huge risks.

The space between the current level of interest rates and 0% requires an electron microscope to see it. The space between the current level of interest rates and any that we've observed in 30 years is huge. The risk/reward ratio for long-term investors seems clearly unbalanced to me, and as such, we will continue to forego current investment income to preserve and protect Markel's balance sheet by keeping the bond maturity short.

Secondly, we continue to allocate capital to higher return equity securities. While the drop in market values during the Third Quarter, the positive returns on fixed income, and our own share repurchases combined to reduce the percentage of equities as a percentage of shareholders' equity to slightly below 50%, we continued to actively purchase equities during the Third Quarter. We continue to do so now, and fully expect to increase the percentage of our capital in equities in future quarters.

As always, we will be measured and systematic in doing so. I remain of the opinion that high quality, global franchise firms represent the best place to put the bulk of our capital these days. By the way, as we do so, we are often not giving up any current investment income, as dividend yields equal or even exceed the fixed income alternatives.

Additionally, as I've indicated since 2005, when we acquired majority interest in AMF Baking Equipment, increasing the earnings power and financial flexibility of the Markel Corporation means acquiring controlling interest in non-publicly traded firms. Markel Ventures is the group that conducts this activity. Through the first nine months, other revenues at Markel, which are largely those of the Markel Ventures company, were $260 million, versus $125 million in the prior year, an increase of more than 100%. Markel's share of the associated EBITDA totalled $34.2 million versus $16.2 million, or more than double the level of 2010. As always, a reconciliation of EBITDA to net income is available on the website.

The net of all this is that even with the catastrophic events of the first nine months, we are reporting comprehensive positive income at Markel. During the Third Quarter, we announced the purchase of Weldship, which closed in the Fourth Quarter and will be included in our results going forward. Weldship makes tube trailers and other storage containers for industrial gas applications, and is a market-leading company in its sphere of operations.

Our permanent capital alternative continues to be attractive to owners and entrepreneurs, and I am excited about the addition of this profitable and durable business to Markel. Additionally, AMF acquired BAKETECH at the end of the quarter. BAKETECH was well known to AMF, and adds product lines and customer relationships depth as well as profitable to AMF. We continue to work on other transactions, and we expect ongoing organic and acquisition opportunities within the growing framework of Markel Ventures.

Our portfolio and our acquisitions remain conservative. We believe in a fortress balance sheet, which enabled us to withstand the sort of catastrophic weather and natural events we experienced during the first nine months, and that withstood the sort of financial catastrophes that occurred in 2008, as well as the current volatility.

By having the balance sheet and the business experiences we've enjoyed over the decades, we've been able to respond to opportunities through insurance, investment and industrial world to build the value of your company. We continue to see opportunities on all fronts, and I'm pleased to report to you that we have increasing levels of financial and human capital, as well as the courage and creativity needed to make the most of it.

With that, I'd like to open the floor for your questions. Devin, if you'd be so kind as to poll for questions.

Questions And Answers

Operator

Thank you. We will now be conducting a question-and-answer session. (Operator Instructions). Our first question comes from the line of Vincent DeAugustino with Stifel Nicolaus. Please proceed with your question.

Q - Vincent DeAugustino {BIO 17976273 <GO>}

Hello. Good morning.

A - Tom Gayner {BIO 1896932 <GO>}

Good morning.

Q - Vincent DeAugustino {BIO 17976273 <GO>}

I guess I'd first like to first start off and focus on the runoff errors and omissions program for mortgage servicer, since it's leaving a sizeable dent in the otherwise very favorable reserve development. I think, looking back to earlier this year, a large portion of liabilities relating to those problematic claims was resulting in some favorable development and we're now seeing some adverse development flow through again from these mortgage programs. And I'm just curious if there's any historical precedent pointing to what the tail looks like, or at least how much longer until you think you'd be out of the woods on these things? Thank you.

A - Anne Waleski {BIO 16735457 <GO>}

Vincent, I think you maybe have misunderstood what was in the Q. That reference to those programs was for the 2010 comparison. There is no development in this quarter for that. And the programs have performed as we had expected thus far.

Q - Vincent DeAugustino {BIO 17976273 <GO>}

Okay. Great. Thank you. And then, can you give any sense of where the FirstComp accident year combined ratio is running?

A - Richie Whitt {BIO 7084125 <GO>}

You know, I think we talked about this, shoot, last Fourth Quarter, that we obviously are going to be in a transition year this year and we're working to sort of bring their reserves to the same reserving standards that we have here at Markel.

So the accident year is probably running in to the tune of 108, 110. And we expect that to be about a $30 million underwriting loss for the year. And we're actually running a bit better than that. So you know, bottom line is, we're exactly where we would have expected to be at this point in terms of FirstComp, and you know, we're well on our way in terms of getting to our overall more likely redundant than deficient stance on reserves.

Q - Vincent DeAugustino {BIO 17976273 <GO>}

Okay. Great. Thank you.

Operator

Thank you. Our next question comes from the line of Mark Dwelle with RBC Capital Markets. Please proceed with your question.

Q - Mark Dwelle {BIO 4211726 <GO>}

Yes. Good morning. Couple of questions. First, with respect to the -- you had -- in the other income line, you had around $90 million, $82 million of that or so appeared to be related to Markel Ventures. Is there something unusual or infrequent related to the remaining $9 million? That's more than the amount that we usually see run through that line.

A - Anne Waleski {BIO 16735457 <GO>}

That amount is related to the MGA operations still associated with Aspen FirstComp.

Q - Mark Dwelle {BIO 4211726 <GO>}

Okay.

A - Richie Whitt {BIO 7084125 <GO>}

And Mark, it's probably worth pointing out that we took all of that business onto our paper as of July 1, so that will be running down as we move forward.

Q - Mark Dwelle {BIO 4211726 <GO>}

Okay. That's helpful. With respect to Markel Ventures, as I recall, when we -- when that was originally established, you had sort of a $250 million acquisition budget. By my math, it looks like we've pretty much used that up. Has that been further authorized beyond that level or is my math a little bit off?

A - Tom Gayner {BIO 1896932 <GO>}

Yes. There was never a budget attached to that. That was a description of how much capital we had committed to it so far. So, rough order of magnitude what we have done so far, but we would expect to do more going forward.

Q - Mark Dwelle {BIO 4211726 <GO>}

That's fine. I misconstrued that, that was the budget, then. The next question I had, you have the credit default swaps, I guess those were a little bit of a drag on the results in the quarter, how much longer do we continue to have those?

A - Richie Whitt {BIO 7084125 <GO>}

2014.

Q - Mark Dwelle {BIO 4211726 <GO>}

2014. Okay. I think that's all my questions. Thank you.

A - Tom Gayner {BIO 1896932 <GO>}

Thank you.

Operator

(Operator Instructions). Your next question comes from the line of Jack Sherck with SunTrust. Please proceed with your question.

Q - Jack Sherck

Thank you, very much. On the workers' comp market, with the firming we've seen there in terms of rates, have you seen any recent changes in the competitive landscape there?

A - Tom Gayner {BIO 1896932 <GO>}

You know, things are starting to happen in workers' comp. I wouldn't call it a dramatic change. But certainly in some of the more distressed markets, particularly California, rates seem to be going the other way. In some of the other states, maybe it's more of a flattening of rates, but certainly things appear to be a little bit ahead of the rest of the market in workers' comp. There certainly appears to be a movement afoot.

Q - Jack Sherck

How about just in terms of any real competitive changes in regional versus national carriers, any flavor or color there?

A - Tom Gayner {BIO 1896932 <GO>}

I don't know of anything particular to point out there. You know, it's been an incredibly, almost a suicidally competitive market for a long time. I think particularly again, in California, things seem to be moving the other direction. I don't know that you'd see a big difference between regionals or mono lines or nationals in particular.

Q - Jack Sherck

Okay. Great. Thanks very much.

Operator

Thank you. Our next question comes from the line of Wendy Houser with Markel Corporation. Please proceed with your question.

A - Wendy Houser {BIO 21578528 <GO>}

My item has already been addressed. Thank you.

Operator

(Operator Instructions). There appear to be no further questions at this time. I'd like to turn the floor back over to management for closing comments.

A - Tom Gayner {BIO 1896932 <GO>}

There appear to be no further questions, so we thank you for your participation. We're around here today. We'll be happy to hear from you. Thank you, as always, for your support of Markel and we look forward to speaking with you soon. Good-bye.

Operator

This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.