Q2 2017 Earnings Call

Company Participants

- Albert A. Benchimol, Director, President & Chief Executive Officer
- Joseph C. Henry, Chief Financial Officer
- Linda Ventresca, Corporate Development Officer

Other Participants

- Elyse B. Greenspan, Analyst
- Meyer Shields, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day. And welcome to the AXIS Capital Second Quarter 2017 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 Linda Ventresca of Investor Relations. Please go ahead.

Linda Ventresca {BIO 5930519 <GO>}

Thank you, Alison, and good morning, ladies and gentlemen. I'm happy to welcome you to our conference call to discuss the financial results for AXIS Capital for the second quarter ended June 30, 2017. Our earnings press release and financial supplement were issued yesterday evening after the market close. If you would like copies, please visit the Investor Information section of our website, www.axiscapital.com.

We set aside an hour for today's call, which is also available as an audio webcast through the Investor Information section of our website. A replay of the teleconference will be available by dialing 877-344-7529 in the United States and the international number is 412-317-0088. The conference code for both replay dial-in numbers is 10109593.

With me on today's call are Albert Benchimol, our President and CEO; and Joe Henry, our CFO.

Before I turn the call over to Albert, I will remind everyone that the statements made during this call, including the question-and-answer session, which are not historical fact, may be forward-looking statements.

Forward-looking statements involve risks, uncertainties and assumptions. Actual events or results may differ materially from those projected in the forward-looking statements due to a variety of factors, including the risk factors set forth in AXIS's most recent report on Form 10-K filed with the SEC on February 17, 2017, as well as the additional risks identified in the cautionary note regarding forward-looking statements in our current report on Form 8-K filed with the SEC on July 6, 2017. We undertake no obligation to update or revise publicly any forward-looking statements.

In addition, this presentation may contain non-GAAP financial measures. Reconciliations are included in our earnings press release and financial supplement, which can be found on the Investor Information section of our website.

With that, I'd like to turn the call over to Albert.

Albert A. Benchimol {BIO 2023727 <GO>}

Thank you, Linda. Good morning, everyone, and thank you for joining us today. In the second quarter, we continued to take tangible actions and made strong progress in advancing our strategy to build long-term profitable growth for AXIS. We continue to enhance the AXIS franchise, invest in key areas like data and analytics and in recruiting top talent, and we further grew scale and relevance in important markets.

Last night, AXIS reported second quarter operating income of $1.31 per diluted share and operating ROE of 8.6%. We ended the quarter with diluted book value per share of $60.45. Growth in diluted book value per share adjusted for dividends, which we believe is the best measure of value creation, was up 3% in the quarter.

Joe will shortly review the financial results in more detail, but before that, I would like to touch on a few highlights. Operating results improved significantly over the 2016 quarter due largely to lower catastrophe and weather-related events, but we also saw improvements in other line items.

Adjusting for catastrophe and large weather losses, our ex-cat accident share loss ratio was up by less than 0.5 point. To put things in perspective, the ongoing impact of the Ogden rate adjustment in the UK contributed 0.5 point to the quarterly loss ratio. Thus, our ongoing portfolio enhancement activities allowed us to absorb both adverse rate and trend, and a higher frequency of property losses.

The Ogden rate impact should dissipate by next year. And assuming loss frequency and property normalizes, we should see corresponding improvements in underlying results. Therefore, I'm confident that further progress in underwriting results is achievable.

We're starting to see improvements in our G&A ratio year-over-year, reflecting the efforts we've discussed with you in prior quarters. And our partnerships with strategic capital providers, including Harrington Re, continued their positive momentum.

We reported $12 million of fee income in these – from these activities in the second quarter and $23 million for the first six months, and this compares to $1 million and $7 million, respectively, in 2016.

This strategy allows us to provide meaningful capacity to our clients, while sharing risk with our capital partners, all the while improving the balance of our portfolio and generating meaningful fee revenue.

While markets remained competitive, we've achieved good organic growth in targeted lines. We also expanded our franchise with the closing of the Aviabel acquisition in April. And on July 5, we announced our recommended offer to acquire Novae, a diversified specialty insurer that operates through Lloyd's of London.

We're very excited about this transaction, as it accelerates many of our stated strategic goals, including greater leadership in specialty lines and increase relevance in the important London market for international specialty risks.

The acquisition of Novae would establish us as a top 10 carrier at Lloyd's, which complements our position as a top 10 U.S. excess and surplus lines player, and our leading positions in the global professional lines in reinsurance markets.

In addition to these strategic benefits, we expect the transaction to be financially attractive to AXIS, with targeted cost savings of $50 million, accretion to earnings per share in the first year and high-single-digit accretion in earnings per share by the second year.

We noted at the time of the announcement that we would spend our share repurchase program in anticipation of closing the transaction. But before that, we were very active in returning capital back to our shareholders, repurchasing $131 million of stock in the second quarter.

That activity brought our total capital returns to our shareholders in cash and share repurchases to $348 million for the year-to-date, representing over 200% of our six-month operating income. We expect to reinstate share repurchases in 2018.

So, overall, we've been working hard for the benefit of our clients, partners, and capital and distribution and shareholders. We're pleased with our progress and our focus on continuing the execution of our strategic initiatives to position AXIS as a leader in specialty risks, delivering superior value creation to its shareholders.

And with that, I'll turn the call over to Joe.

Joseph C. Henry {BIO 13390626 <GO>}

Thank you, Albert, and good morning, everyone. During the quarter, we generated good results featuring net income of $85 million and an annualized ROE of 6.7%. Our non-GAAP operating income for the quarter was $110 million and annualized non-GAAP operating ROE was 8.6%.

Our net income this quarter benefited from continued good underwriting performance, a lower level of catastrophe and weather-related losses, continued favorable prior year reserve development and strong investment income.

During the quarter, we closed on our acquisition of Aviabel, a premier insurer and reinsurer of aviation risk in the smaller general aviation arena and we recognized an associated bargain purchase gain. The bargain purchase gain is excluded from non-GAAP operating income. These positive factors were partially offset by a slight increase in our current accident year loss ratio, ex-cat and whether, and foreign exchange losses.

The growth in book value per share in the quarter – to $60.45 was driven by net income generated in the quarter, together with an increase in unrealized gains on our investment portfolio, which primarily reflected the tightening of credit spreads, strong equity market performance and the strengthening of the pound sterling and euro against the U.S. dollar, partially offset by common share dividends declared.

Moving into the details of the income statement, our second quarter gross premiums written increased by 3%, with an increase in both our reinsurance and insurance segments. Our reinsurance segment reported an increase of $30 million or 6% in gross premiums written in the second quarter of 2017, compared to the same period in 2016. The increase was primarily driven by our motor, catastrophe and property lines, partially offset by a decrease in our agriculture lines.

The increase in our motor lines was largely due to timing differences as the renewal of several treaties was delayed to assess the impact of the change in the Ogden discount rate. Positive premium adjustments also contributed to the increase in premiums written in our motor lines.

The increase in our catastrophe and property lines was primarily driven by new business spread across several cedants. The decrease in our agriculture lines was due to the non-renewal of a significant treaty, but year-to-date agriculture gross written premiums are up due to new business and increase line sizes on a few treaties.

Our insurance segment reported an increase in gross premiums written of $12 million or 2% in the second quarter, compared to the same period in 2016. The increase was largely driven by our liability and aviation lines, partially offset by a decrease in our property lines.

The increase in liability was principally due to the growth of U.S. primary casualty and select program business. The increase in aviation related to our recent purchase of Aviabel primarily in generally aviation.

The decrease in our property lines was driven by the impact of our exit from some retail insurance operations in the U.S. last year, partially offset by increases in E&S Property

(10:42) and program business.

Consolidated net premiums written decreased by 5% in the second quarter of 2017, compared to the same period last year. Insurance net premiums written were comparable to the same period in 2016. Reinsurance net premiums written were down 11%, reflecting the increase in premiums ceded to our strategic capital partners, partially offset by the increase in gross written premiums in the quarter.

As we have previously discussed with you, we have been ceding more of our reinsurance premiums to our strategic capital partners in recent periods, particularly in our liability and professional lines since the launch of Harrington Re. In addition, we have increased retrocessions of our agriculture business this year.

Our second quarter consolidated current accident year loss ratio decreased by 6.1 points to 68.9% compared to the same period in 2016. During the quarter, we incurred catastrophe and weather-related losses of $50 million or 5.1 points, primarily attributable to U.S. weather-related loss events. Comparatively, we incurred catastrophe and weather-related losses, net of reinstatement premiums, of $109 million or 11.7 points in 2016. Our second quarter current accident year loss ratio ex-cat and weather increased by 0.5 points to 63.8%.

We are pleased that our progress in our insurance segment continues with the current accident year loss ratio ex-cat and whether decreasing by 1.7 points to 61.5% from 63.2%, principally driven by a decrease in midsize loss experience in our marine lines and changes in business mix, partially offset by higher than expected attritional loss experience in our property lines and the ongoing adverse impact of rate and trend.

Our reinsurance segment current accident year loss ratio, ex-cat and whether, increased by 2.7 points to 66.1% from 63.4%, principally due to a large risk loss in our property lines, the continued impact of the Ogden rate change on our motor lines and the ongoing adverse impact of rate and trend. Year-to-date, our current accident year loss ratio decreased by 1.1 points to 68.1%, driven by 2.4 point decrease in the cat loss ratio.

During the year, we incurred $85 million of pre-tax catastrophe and weather-related losses, net of reinstatement premiums, compared to $124 million in the same period in 2016. After adjusting for these events, our current accident year loss ratio increased by 1.3 points to 63.7%, primarily due to the ongoing adverse impact of rate and trend, and the continued impact of the Ogden rate change on our motor lines.

Turning to loss reserves established in prior years, our results benefited from net favorable loss development of $71 million during the quarter. Our insurance segment reported $20 million of favorable loss reserve development, including $11 million of favorable development on professional lines relating to multiple accident years, $9 million of favorable development on marine lines attributable to accident years 2013 and 2016.

Our reinsurance segment reported $51 million of net favorable loss reserve development, including $20 million of favorable development on property related to almost all accident years, $16 million of favorable development on liability lines, primarily related to the 2008 through 2014 accident years and $11 million of net favorable development on professional lines, primarily related to earlier accident years.

During the second quarter, our acquisition cost ratio increased by 0.8 points compared to the same period in 2016, primarily attributable to higher profit commission cost, driven by good loss experience in our accident and health operation.

As we have discussed with you in previous quarters, the benefit of fees from strategic capital partners are now included in other income or offset against general and administrative expenses. In the second quarter, fee income from strategic capital partners consisted of $5 million included in other insurance-related income and $7 million included as an offset to general and administrative expenses.

Year-to-date, fee income from strategic capital partners consisted of $9 million included in other related – other insurance-related income and $14 million included as an offset to general and administrative expenses.

Commencing this quarter, we have provided additional disclosure in our Investor Financial Supplement with respect to fee income generated from relationships with our strategic capital partners, so we hope you'll find this useful.

Our general and administrative expense ratio in the second quarter was comparable to the same period in 2016, down in both our insurance and reinsurance segments, partially offset by a slight increase in corporate expenses.

Net investment income was $106 million for the quarter, an increase of $14 million from the second quarter of 2016. This increase was attributable to our alternative investments portfolio, in particular hedge funds and credit funds, which have benefited from the strong performance of the equity markets.

In aggregate, the total return on our cash and investment portfolio for the quarter was 1.2%, including the impact of foreign exchange movements or 1% excluding foreign exchange and was comparable to Q2 2016.

The total return in the quarter was primarily driven by unrealized gains on fixed income and equity securities. Year-to-date, the total return on investments was 2.4% including foreign exchange movements or 2.1% excluding foreign exchange.

On April 17, 2017, the company redeemed the remaining $351 million of its 6.875% Series C preferred shares. Therefore, we expect preferred dividends to be $11 million per quarter for the rest of the year.

In conclusion, I'd like to emphasize our good underwriting results, continued progress in our targeted growth initiatives and continued momentum in our strategic capital partnership activities.

And with that, I'll turn the call back over to Albert.

Albert A. Benchimol {BIO 2023727 <GO>}

Thank you, Joe. Turning to industry conditions, the state of competition in most of our market remains challenging. We do observe that rate reductions are less than what we've seen in the past few years, but they remain reductions nonetheless.

In our insurance business, renewal rates were down 1% on average. This compares to minus 3.3% last year at this time. Encouragingly, about 53% of our insurance premium renewed flat to up in the quarter and this compares to 41% last year. But, of course, this is still not enough.

In our international division, which had been the most competitive in recent quarters, the pace of average reductions has cut in half and we're seeing a growing number of renewals coming in flat or with modest increases.

Within the U.S. property and casualty marketplace, rates are up 1% on average, reflecting reductions in property and increases in casualty. We would note, however, that in many cases, the increases we see in casualty are not sufficient in some of the toughest classes. Some carriers are still reducing rates on difficult classes that have experienced increased loss severity.

Trends in U.S. professional lines are similar to prior quarters, with flat or modestly declining rates in primary layers, with increasing reductions as you go up coverage towers (18:55). E&O lines are generally better priced than D&O.

Within this market, we've taken what we believe to be the right actions, reducing writings in less promising lines, what targeting growth in those lines still offering appropriate returns. We're pleased with our growth in attractive lines, such as accident and health, cyber, E&S property and casualty and renewable energy.

Moving on to reinsurance, competition abounds across most of our major lines of business. We were encouraged early in the quarter by indications of the cat market softening seemed to be bottoming out. However, as the quarter came to a close, we saw the appetite of collateralized reinsurers and sidecars impacting the June Florida renewals, with some deals up 10% or more. Some of this may have been model driven. In our book, recent cat renewals were done at average rate reductions below 5%.

In U.S. professional and liability lines, we observed ongoing requests for more ceding commissions, but the market generally push back and most renewals were completed flat. However, we recognized that quota share reinsurers are still absorbing the pressures faced in the primary markets. Our response to these developments has been to reduce participations or exit treaties (20:16) entirely, where we felt terms were no longer acceptable.

European reinsurance market trends are generally unchanged from previous quarters. We continue to manage the market prudently, declining new business where profitability is not adequate and reducing lines where needed.

Approximately, 13% of AXIS Re's annual total premium was renewable in July. Our renewal volume was essentially flat with expiring and we mitigated pricing trends through tactical portfolio changes, maintaining technical profitability essentially flat with expiring terms. Through these renewals, we continue to support key accounts, providing superior product expertise, service and cooperative (21:02) claims management.

We also continue to explore opportunities for profitable new premium, partnering with strategic capital partners in lines that make sense. As Joe noted, while gross premiums were up modestly, net premiums written were down in the quarter consistent with this strategy that we've discussed with you previously.

Going forward, we will continue to engage proactively with our clients and brokers, expanding our brand and improving our leadership in the areas we find attractive. Our risk funding flexibility is key as we match risk with the best source and form of capital. This will enable us to keep providing attractive risk to capital partners, while enhancing our ROE and benefiting our own shareholders.

The market has – the market churn has not occurred yet and we won't hazard a prediction on when it will, but our focus is on continual improvements and superior profitability regardless of the market.

We remain steadfast in our conviction and our strategy continues to yield strong progress, positioning us to serve clients and brokers, capital partners and employees, while providing sustainable superior returns to our shareholders. While there is more work that must be done, AXIS is on a strong and exciting path forward.

Thank you for your attention. And with that, let's open the call for questions.

Q&A

Operator

Thank you. We will now begin the question-and-answer session. And our first question will come from Elyse Greenspan of Wells Fargo. Please go ahead.

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

Hi. Good morning. My first question, so in some of your commentary on, Albert, it seems like you guys were existing in some liability reinsurance business. I thought last year, you guys have written some multiyear covers, which assumes (23:15) the business wasn't down as much as I would have thought. Are there still multiyear covers that you're writing on or is it just not the appropriate comparison?

A - Albert A. Benchimol {BIO 2023727 <GO>}

There is no doubt that in the past we have written more multiyear covers. And frankly, as you know, that strategy has helped us, because we were able to maintain pricing for multiple years and sustained pricing in second and third years of treaties, while the market was actually going down. So, it was the right strategy for us and it actually protect the profitability. There are a handful of multiyear treaties occurring this year, but significantly less than we wrote in prior years.

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

Okay. And then, based off of your market commentary, it seemed like things are maybe getting very modestly better on the margin, I'm talking about the primary insurance market. I think some folks are saying maybe we're getting towards the bottoming. I mean, how would you kind of put it altogether? Do you think we're getting closer to kind of seeing an inflections point on the primary insurance side or just on the margin, maybe just a little better than last quarter?

A - Albert A. Benchimol {BIO 2023727 <GO>}

I think, it's wonderful to take comfort that price reductions are 1% instead of 3%, but that's still not good enough, Elyse. We – and there's real reason, frankly, for the markets to be more disciplined in its pricing – increased (24:33) pricing. So, we certainly observe the trends, but put us front of the line and saying that's absolutely not enough.

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

Okay. And then, a couple of numbers questions. The acquisition cost seem to have picked up in the quarter really in the insurance segment and the ratio obviously as a result. Is that something that we should be modeling going forward?

A - Joseph C. Henry {BIO 13390626 <GO>}

So, Elyse, it's Joe. Just a couple of comments on insurance. The acquisition costs are up 2.4 points, as I said in my commentary. Some of that was driven by profit commissions and unusually high level of profit commissions in the quarter on our accident and health business. But, on the insurance side, I will admit, there is pressure with respect to base rates or as we call variable rates. So, there is some pressure. I'd just say our acquisition costs are a little bit higher than normal because of the profit commissions I referred to.

Secondly, I want to point on the reinsurance side, gross acquisition costs are actually down in the quarter. There is a little bit of an offset because of the mix of business that reflects a slight increase 0.20 point of an increase, but that's really due to mix, not necessarily acquisition costs. So, our reinsurance teams are experiencing actually acquisition costs which have stabilized or in some cases have gone down.

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

Okay. And then, in terms G&A, the total kind of G&A costs were about just under $150 million in the quarter. I think, Albert, that was kind of the level you had pointed to last quarter as more or less the go forward expense level. Anything out of the ordinary in that number in the quarter?

A - Albert A. Benchimol {BIO 2023727 <GO>}

No. Only comment that I would make is that expense, management is a very important part of what we do going forward and we discussed the $150 million being the right level for the rest of this year. But, we continue to be looking further opportunities. Joe, do you want to add to that?

A - Joseph C. Henry {BIO 13390626 <GO>}

Yeah. The only thing I will add there, Elyse is, remember, we are consolidating Aviabel for the first time, so we have $3 million worth of expenses booked in Aviabel, which we wouldn't have had in the prior year. We also – if we also have the revenue. So, from a ratio standpoint, it's not there, but in terms of pure costs, our costs are up because of the fact we consolidated Aviabel.

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

Okay. Great. Thank you very much for the color.

A - Joseph C. Henry {BIO 13390626 <GO>}

Yeah.

A - Albert A. Benchimol {BIO 2023727 <GO>}

Thanks, Elyse.

Operator

Our next question will come from Meyer Shields with KBW. Please go ahead.

Q - Meyer Shields {BIO 4281064 <GO>}

Great. Thanks. Albert, clearly seeing (27:18) really good performance from the various underwriting actions intended to offset the impacts of rate and trend. Philosophically, do you look at those as sort of like a finite group of actions or is that something that you'll always be able to do?

A - Albert A. Benchimol {BIO 2023727 <GO>}

I think improving portfolio, quality portfolio results and reducing volatility is a full-time job from now until God knows when. There is always an opportunity to analyze the portfolio, scrub it, get more granular with the data. So, no, I don't believe that this is a job that we ever stopped.

As I mentioned to you earlier, I continue to have a fair amount of confidence that there is more progress to be achieved. We absorbed a couple of issues this quarter, the ongoing impact of the Ogden rate, which obviously as we run-off, the UPR will disappear. There's obviously some volatility in quarterly loss activity. This quarter, we had some higher property losses.

But not only that, I'm really encouraged by the way our team works together engaging analytics actuary claims personnel, the underwriters through the whole thing and looking for ways to continue to improve the portfolio. So, improving the portfolio quality and profitability is job one here and we'll continue doing it.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. Thanks. That's helpful. Second, I guess, related question. We're hearing some commentary about may be a return to normal levels of social inflation compared to the depressed levels or the benign levels we've seen in the last few years. You're seeing that in your book?

A - Albert A. Benchimol {BIO 2023727 <GO>}

To be fair, we haven't seen much of that. We're not seeing any real changes in loss trends. Now, as you know, just to be clear, we continue to be reserving on the basis of long-term trends, which of course, is one of the issues that's driving reserve releases, because whereas we've consistently been reserving on the basis of long-term trends, those have not come through.

Are there a couple of lines where you had some increases? Of course, auto liability is one that is well known in that area. But with regard to our book, for the moment, we have not seen any significant trend with regards to social inflation or any particularly deterioration in our loss trends. So, for the moment, it's within what I would call the normal realm of normal quarterly volatility, nothing special.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. Great. Thanks so much.

A - Albert A. Benchimol {BIO 2023727 <GO>}

You're welcome.

Operator

And having no further questions, this will conclude our question-and-answer session. I would like to turn the conference back over to Mr. Albert Benchimol for any closing remarks.

A - Albert A. Benchimol {BIO 2023727 <GO>}

Okay. Well, thank you all for your questions and interest in AXIS. Again, just to summarize, we discussed that, I think, this quarter, we continue to make strong progress in advancing our strategy to build long-term profitable growth and we remain committed to our steady execution of the strategy. And so, we look forward to reporting further progress in our upcoming conversations. Thank you, everybody.

Operator

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