Q2 2019 Sales and Revenue Call

Company Participants

- Aki Hussain, 'Chief Financial Officer'

Other Participants

- Andrew Ritchie
- Ben Cohen
- Jonny Urwin
- Nick Johnson

Presentation

Aki Hussain {BIO 19739719 <GO>}

Good morning, and thank you for making the call. You, no doubt, have read through our trading update issued earlier this morning. Now, we came to the conclusion in the last day or so that the market expectations of our half year performance have increased as a result of the pricing momentum we were seeing in Lloyd and the positive momentum on investment income. Whilst at the same time, the impact of reserve strengthening that we're doing was not sufficiently well understood.

So, we've been seeing expectations for the half year range from $150 million of profit to just under $300 million; and as a result, we're making this trading update to clarify our half year profit before tax expectations, which lie in the range of $150 million to $170 million. We are seeing positive pricing momentum in London market, which unlike last year is continuing to build. In reinsurance and ILS pricing improvements are more selective. We expect some of this positive impact to come through into our results in the second half of the year, but predominantly into 2020.

Our retail business continues to perform well and in line with expectations. We expect the combined ratio at the half year to be in the normal range of 90% to 95% and top line growth to be in line with the trend outset at Q1. Investment income at $150 million has benefited from positive mark to market movement on bond as interest rates have fallen. Of course, this does mean our reinvestment yield is reducing and the effect of this will come through into our results in 2020.

We've also benefited from higher asset values. Now turning to reserve strengthening, I would like to reconfirm that as we reported in our Q1 IMS, we have strengthened reserves set aside for Typhoon Jebi, Hurricane Michael and our excess book. We've increased reserves by $40 million. Also, please remember, in 2018 in the first half, we benefited from a significant release from the reserve set aside for Harvey, Irma and Maria and this amounted to $25 million.

So together, these account for a $65 million reduction to reserve releases from cat event. Reserve releases in aggregate will continue to be positive at the half year. Finally, we are making a provision of up to $60 million relating to tax matters, mostly following an internal reappraisal and reclassification of historic marketing activities related to planned building. This will not impact our 2019 financial results, but will come through the opening equity number.

With that, we'll turn to take questions. (Question And Answer)

Operator

Thank you. (Operator Instructions) Our first question today comes from Jonny Urwin of UBS Jonny, your line is open.

Jonny Urwin {BIO 17445508 <GO>}

HI, good morning, thank you.

Just a couple for me. So, on the -- I guess the new information in this release around the underwriting side of things, there is not pretty much in that. You'd already called out the sort of impacts of Jebi, Michael and the risk excess book in Q1, we knew that the -- releases weren't going to recur. The investment returns, actually a little better than we thought, but I guess the way we're thinking about this update today is that I think that the main delta on our numbers personally when we move numbers wasn't really around reserves, it wasn't really around investment return, I had to sort of creep the attritional loss ratio higher to get back down to your guidance.

So, any update on the underlying losses would be very useful. I know again in Q1, you called out slightly higher loss activity, more normal losses and retail and frequency and prophecy and then D&O, but has anything got worse since 2Q or is it still just in line with that Q1 commentary? That's the first question.

Aki Hussain {BIO 19739719 <GO>}

Sure. Good morning, Jonny.

So I -- I mean you're absolutely right in that on the reserve strengthening and the non-repeat of releases from last year. It's not new news, but what we certainly could see from our discussions with the market and some of the publications that we were seeing is that there were varying degrees of interpretation of how much that strengthening was and hence we saw the range for the half year of between $115 million and just under $300 million, in terms of profit expectations. Now, I guess turning to your point on attritional losses, I mean, the trends that we articulated in our Q1 IMS has continued into Q2, so in our retail book, we had a pretty benign first half in 2018. 2019 is well within expectation, but the loss environment is, I described as somewhat more normalized.

So, we are seeing slightly higher losses there. And in our London market business and particularly our property book, we are continuing to see a higher frequency of claims, which continues -- hasn't deteriorated, but continues the trend we saw in Q1 together with one or two large losses, so kind of reflect that in the half year number. Of course, we'll provide more color on the 29th of July.

Jonny Urwin {BIO 17445508 <GO>}

Thank you very much.

And then my second question is just around the recursion on the tax. I mean just to confirm, this is you guys just doing an internal review is getting ahead of it just by seeing some potential, historic, legacy impacts of treatment that wasn't appropriate now, and it's nothing to do with external tax authorities.

Aki Hussain {BIO 19739719 <GO>}

Yes. That's right.

It is the result of an internal review. I mean frankly, marketing activity evolves and has evolved over time. We spent substantial amount of time, effort and money in building our global brand; and as new technologies have come about and marketing activity has changed, we've seen a gradual shift away from brand building to customer acquisition. And in our sort of historic record keeping that just hasn't kept up to pace, but the review was instigated internally.

We have notified HMRC, but we've not formally engaged with them yet on it.

Jonny Urwin {BIO 17445508 <GO>}

Great. Thank you.

Operator

Our next question today comes from Andrew Ritchie of Autonomous.

Andrew, your line is open.

Andrew Ritchie {BIO 18731996 <GO>}

Well, hi there. Could you just clarify, Aki, that the tax charge and how a capital implication and doesn't have any implication on the ongoing tax rate, because I'm guessing to classify some of your marketing expenses more or less tax deductibles than they were before;

let me just clarify that. And secondly, does the -- I'm just trying to say that this is loss creeping context as being problematic for the industry.

Hiscox has a historic track record of being much better than the industry. Is there anything -- what was it particularly about these events as unusual that has caught you out relative to the conservatism that you normally establish when you set up loss picks? And what is the expectation for ongoing medium term reserve release guidance? Is that changing the tool? I'm not talking for 2019, I'm talking, you know, beyond you talked about medium term expectations in the past as a percentage of strengthening reserves. Thanks.

Aki Hussain {BIO 19739719 <GO>}

Okay.

Morning -- morning, Andrew. So, I guess taking each of those questions in turn, the $60 million provision will reduce the surplus tax -- sorry, surplus capital that we're holding, but it will have no impact on our capital distribution policy. So, we continue to maintain a progressive dividend and we continue to remain strongly capitalized. You'll recall our strongest coverage ratio at the end of the year was in excess of 20%.

There'll be a modest adjustment to that, but nothing of significant concern. In terms of ongoing tax, we provided guidance at the end of the year that our effective tax rate would gradually rise to between 10% and 12%; now that was largely driven by the growth of our US business and growing profitability as well as some of the changes we made to our reinsurance arrangements following the implementation of beat in the US., plus the growth of our UK business; those are the major drivers of that. And we're not changing our guidance; we continue to expect the effective tax rate to be between 10% and 12% over time.

In terms of historic track record with respect to reserving, our reserve methodology and philosophy hasn't changed. We continue to adopt a prudent approach, and that held us in good stead for many, many years, but we won't get it right every time. And we typically write over 100 different lines of risk; and across those 100 lines, we tend to have favorable runoff and had that for a very long time. And we will continue to have positive reserve run-off at the half year.

Reserve releases will be significantly positive, just not as positive as last year, but there were some specific factors relating to Jebi, which caught the whole industry out somewhat. In the early period, the immediate aftermath after Jebi, the industry estimates range from around $2 billion to $4 billion as an overall loss. Current estimates now range somewhere between $14 billion and $16 billion. So, they've gone up by a factor of four.

Now we tend to be very cautious, but not ultra-cautious, because there's a balance to be achieved. The delta from the original 4 to 16 is a number of factors. Firstly, Japan hasn't experienced this type of event for, I think, around 25 years, and therefore, some of the data points were a little bit out of date as there's been a significant amount of high value construction in the meantime. There's also a degree of demand surge, given the Olympic Games and the Rugby World Cup and those resulted in claims inflation.

So, those are the kind of key factors, but we remain confident in our reserving philosophy and methodology. And then finally, in terms of ongoing guidance with respect to reserve releases, over the medium term, I expect the reserve releases to remain within the normal guidance that we provide, which is on the order of 9% to 15% of opening net reserves. That remains a suitable sort of modeling assumption.

Andrew Ritchie {BIO 18731996 <GO>}

And just a final clarification, should there be further deterioration on 2018 losses? Are they for your account or for your retro or reinsurance partners?

Aki Hussain {BIO 19739719 <GO>}

On these specific items that we've identified, the risk excess is the limit loss we've done, and on Jebi and Michael were into our -- program, so there is now a significant cover to our net addition.

Andrew Ritchie {BIO 18731996 <GO>}

I'm sorry, and just to be clear that wasn't the case at the end of Q1, so the further deterioration in 2Q was for your account?

Aki Hussain {BIO 19739719 <GO>}

Some of it was Jebi deterioration. Yes.

Andrew Ritchie {BIO 18731996 <GO>}

Some of it was. Right.

Okay, great. Thanks.

Operator

Our next question today comes from Nick Johnson of Numis. Nick, your line is open.

Aki Hussain {BIO 19739719 <GO>}

Hi, Nick.

Nick Johnson {BIO 1774629 <GO>}

Good morning, hi. Just a factual question really please. Just wondering what the market yield currently is on the bond portfolio, the yield to maturity currently? Thanks.

Aki Hussain {BIO 19739719 <GO>}

The yield to maturity at the start of this year was 2.4% and we're now just above 2% given the significant fall in particular in the US rate.

Nick Johnson {BIO 1774629 <GO>}

Great. Thanks very much.

Operator

(Operator Instructions) Our next question today comes from Ben Cohen of Investec.

Ben, your line is open.

Ben Cohen {BIO 1541726 <GO>}

Thanks very much. I just wondered if you could comment as to with the price rises that you're getting in the first half of the year, what impact you would see that having on the attritional loss ratio going forward? And also I guess a sort of an information request, if you could, as I suppose this warning sort of highlights, if you could help us better sort of set out really what your attritional loss ratio is over time. I think that would be very helpful.

So we can see what is reserved movement? And what's really happening to the book underlying? Thanks.

Aki Hussain {BIO 19739719 <GO>}

Sure. Good morning, Ben. So, if I heard that point specifically with respect to London market, I think, while we are seeing -- while we have seen an increase in attritional losses on the property book, the pricing momentum in the first half has been quite positive, and has been building through the month and that does allow us to then make changes to terms and conditions such as increasing deductibles, and so on and so forth.

So, my expectation is as that business begins to turn out that attritional losses surely start to reduce. And I expect that to kind of start to come through probably into the second half of this year, but as I mentioned earlier predominantly into 2020. As far as disclosure is concerned, I hear you and we continue to review the disclosures that we provide. We'll be looking at the information that we're providing; we do that all the time and I'm sure it will evolve over the coming months and years.

Ben Cohen {BIO 1541726 <GO>}

Okay and thanks. Could I ask just as a follow-up; have you, I guess your growth rates in some of the lines in the first quarter maybe were slightly low particularly in reinsurance. Are you made -- have you made any sort of material changes to the shaping of the book, i.e. above and beyond, I suppose, what you talked about in D&O in the first half, maybe in response to these losses or whatever else you're seeing in the market?

Aki Hussain {BIO 19739719 <GO>}

So with respect to our reinsurance in ILS book, we have reduced our appetite for the risk aggregate product. This is something that we started, I think four or five years ago.

It's not gone quite in accordance with our expectations, so we've pulled back, and we've re-priced and significantly come back on the premium in that area. That together with the slightly lower available -- deployable ILS capital accounted for the revenue reduction at the end of Q1. I expect during the course of quarter two, that revenue comparator to improve a little bit relative to last year, we've had a good one four where loss affected lines we saw the rates increase significantly for Japanese renewals. And we've also had on improved one sixth with the Floridians, where again we've achieved some price increases.

And we haven't increased our positions, our exposure, but we have received more premium. So that's kind of generally the sort of like changing the shape of the book over and above the D&O action that we're taking in our retail book.

Ben Cohen {BIO 1541726 <GO>}

Okay. Thank you very much.

Operator

We've no further questions. I will hand back to you, Aki, for any remarks.

Aki Hussain {BIO 19739719 <GO>}

Thank you very much, but once again, thank you for taking the time to join the call and thank you for the questions. If there are any further questions that occur, that arise during the course of the day, please feel free to contact Ryan Thompson.

Other than that, I wish you a great day and a great weekend. Bye, bye.