Q2 2012 Earnings Call

Company Participants

- Dave Bonham, VP
- John Varnell, CFO
- Paul Rivett, IR
- Prem Watsa, Chairman, CEO

Other Participants

- Jeff Fenwick, Analyst
- Mark Dwelle, Analyst
- Paul Holden, Analyst
- Robert Roell, Analyst
- Tom MacKinnon, Analyst
- Wayne Cadwallader, Analyst

Presentation

Operator

Good morning. Welcome to Fairfax's 2012 Second Quarter results conference call. Your lines have been placed in a listen-only mode. After the presentation, we will conduct a question-and-answer session. (Operator Instructions) Today's conference is being recorded. If you have any objections, you may disconnect at this time. Your host for today's call is Prem Watsa with opening remarks from Paul Rivett. Mr. Rivett, you may begin.

Paul Rivett {BIO 15243791 <GO>}

Thank you, Carol. Good morning. Welcome to Fairfax's Second Quarter conference call. This call may include forward-looking statements. After results may differ perhaps materially from those contained in such forward-looking statements as a result of a variety of uncertainties and risk factors, the most foreseeable of which are listed in Fairfax's annual report which is available on our website and set out under Risk Factors and our Base Shelf Prospectus filed with Canadian Securities regulators. I know turn the call over to our Chairman and CEO, Prem Watsa.

Prem Watsa {BIO 1433188 <GO>}

Thank you, Paul. Good morning, ladies and gentlemen. Welcome to Fairfax's Second Quarter conference call. I plan to give you some of the highlights and then pass it on to John Varnell, our CFO, for additional financial details. As discussed in our press release, this will be John's last call as CFO as he passes the baton onto Dave Bonham will be our new CFO. John will become Vice President in Corporate Development while continuing to assist as Fairfax's liaison with the financial community. John has done a wonderful job for us over 25 years. Dave has been with us for eight years, most recently as Vice President Financial Reporting. A big thank you from all of you to John and a warm welcome to Dave in his new role.

In the Second Quarter of 2012, book value per share was up slightly from year end adjusted for the $10 per share common dividends paid out in the First Quarter of this year. We had a much improved underwriting result on increased premiums and we produced a small investment gain notwithstanding unrealized investment losses related to our defensive hedging strategy. We again finished the quarter with cash and marketable securities at the holding Company in excess of $1 billion.

Consolidated combined ratio for Fairfax in the Second Quarter and year to date was 97.5% and 98.1% respectively. Reserve redundancies were $48.8 million or 3.6 points on the combined ratio in the quarter. We continued to reserve conservatively. While some of our Companies have combined ratios about 100% recently, I will remind you of two points I made at our annual meeting. In the last 10 years, all our Companies that had an average combined ratio less than 100% on a fully developed accident year basis with only Crum & Forster being at about 100%. We have had redundancies on average of 6% to 8% each year over the past 10 years.

As I said in the First Quarter call, we are growing the gains. The large tax free losses in 2011, very low interest rates, and the reduced reserve redundancies means that there's no place to hide for the industry. Combined ratios have to drop well below 100% for the industry to make a single-digit return on equity with these low interest rates. Net premiums written by our insurance and reinsurance operations increased 14% to $1.57 billion from $1.37 billion in 2011. At the subsidiary level, net premiums written in the Second Quarter of 2012 where as follows. For Zenith, up 19%, Crum & Forster up 22%, OdysseyRe up 35%, Fairfax Asia up 5%, and Northbridge in Canadian dollars down 6%.

Net investment gains of $71.5 million in the Second Quarter of 2012 consisted of the following. Please note the table on page two of our press release. In the Second Quarter, net losses on equity and equity related investments of $584 million for all unrealized, as you can see from the table, and were largely neutralized by the next unrealized gains of $389 million on our equity hedges. After bond gains of $282 million, $7 million in unrealized CPI-linked derivative gains and other losses of $23.2 million, we had a net gain of $71.5 million.

We continue to be approximately 100% hedged in relationship to our equity and equity-related securities which includes convertible bonds and convertible preferred stock. We continue to be very concerned with the prospects for the financial markets and the economies of North America and Western Europe accentuated by the breaking of the real estate bubble in China in late 2011.

As of June 30, 2012, we have almost $8 billion in cash and short-term investments. Over 30% of the investment portfolio should take advantage of opportunities that may come our way. In the short term, our investment income will be reduced. This put the additional $190 million we invested in July in RIM in perspective relative to the $24 billion side of our investment portfolio.

On June 18, 2012, the Company announced an agreement to purchase the runoff business of Brit Group for about 94% of book value, which would require a cash payment by the Company's runoff operation of about $330 million. The transaction is expected to close in the Fourth Quarter of 2012.

On May 21, 2012, the Company announced an agreement to purchase 77% of Thomas Cook India Limited for about $150 million and the transaction is expected to close in the Third Quarter of 2012. Now I would like to turn it over to John and Dave so they can give you some information on the underlying financials. John?

John Varnell {BIO 5699703 <GO>}

Thank you, Prem. I'll talk about the operating Company results and then Dave will finish up with consolidated results and financial position. The Fairfax consolidated catastrophe losses for the Second Quarter 2012 were about $46.1 million pretax, or 3.4 combined ratio points from a number of smaller losses the largest be in the Italian earthquake. In terms of 2012 prior period reserve development, Fairfax had $48.8 million of favorable reserve development for the quarter, or 3.6 combined ratio points compared to $50 million favorable in 2011 which was 3.9 combined ratio points. So that works out a Second Quarter accident year combined ratio in 2012 of $101.1million including cat losses, and that compares to a 2011 accident year combined ratio $104.4 million.

So now we'll move to the operating Company starting with OdysseyRe. In the Second Quarter 2012, their combined ratio was $85.8 million -- or their combined ratio 85.8 and they generated an underwriting profit of $73.9 million. In 2011, Odyssey had a 93.1 combined ratio or an underwriting profit of $32.2 million. On an accident year basis, the combined ratio of Odyssey was 87.8 for 2012 compared to a 93.5 in 2011. Cat losses in 2012 for Odyssey amounted to $30.6 million, or 5.9 combined ratio points, compared to Odyssey cat losses in 2011 of $46.8 million, or 10.2 combined ratio points. Odyssey net payments written increased 35% in the Second Quarter of 2012 to $620.3 million from $459.7 million the year before, which reflected increased writings primarily in property quota share reinsurance.

Crum & Forster in the Second Quarter 2012 had a combined ratio of 102.4 and an underwriting loss of $7.3 million compared to 103.4 in 2011 and an underwriting loss of $8.4 million. On an accident year basis, the combined ratio was 102.4 in 2012 compared to 102.7 in 2011. Net premiums written at Crum & Forster were $329.2 million compared to $270.7 million in 2011, and that reflected increased writings of excess and surplus casualty lines of business, property lines in specialty business, and that resulted in a year-over-year increase of 21.6% in net premiums written in the Second Quarter of 2012.

Zenith had a combined ratio for the quarter of 116.4 and an accident year combined ratio of 116.4 compared to a combined ratio in 2011 of 129.3 and an accident year ratio of 123.8. The improvements reflected the 7.2% combined ratio decrease in Zenith expense ratio due to the rising net premiums. Net premiums written by Zenith were $105 million in Second Quarter compared to $105 million in 2011 an increased of about 19% and that reflects Zenith's ability to write new business and retain existing customers of higher prices as the competitive environment for the workers compensation business changes.

Northbridge's Second Quarter 2012 combined ratio was 105.6 compared to 104.3 in 2011. On an accident year basis, the combined ratio at Northbridge was 114.2 as Northbridge benefited from favorable development of 8.6 combined ratio points. Net premiums written by Northbridge were $289.3 million for the quarter compared to $336 million in 2011 measured in US dollars. The net premiums written at Northbridge decreased slightly when you restate them into Canadian dollars.

For the Second Quarter of 2012, the combined ratio at Fairfax Asia was 88.8 compared to 85 in 2011 and they generated an underwriting income of $6.3 million compared to $8.1 million in 2011. The Second Quarter 2012 accident year combined ratio was 94 compared to 97.9 in 2011. Net premiums written by Fairfax Asia were $54.8 million compared to $52.2 million in 2011. The net premiums written increased by 5% as a result of increased writings of commercial automobile, marine haul and property lines of business at Pacific Insurance.

The reinsurance and insurance other division in the Second Quarter had a combined ratio of 100.9 compared to 92.7 last year, there was favorable development of 12.4 points in 2012 compared to 26 points in 2011. The net premiums written increased to $148.3 million from $146.4 million. And finally, our runoff group had another good quarter and earned $78.9 million pretax in the Second Quarter of 2012 compared to $144.9 million earned in 2011 as a result of lower net investment gains. Now I would like to turn it over to our incoming CFO, Dave Bonham.

Dave Bonham {BIO 15243784 <GO>}

Thanks, John. I'll give you a quick overview of the consolidated results and the financial position. For the Second Quarter of 2012, Fairfax had a net profit of $95 million, that compares to net profit of $83 million in the 2011 Second Quarter. Fully diluted earnings per share was $3.85 per share compared to $3.40 per share in the same period last year. For the Second Quarter of 2012, Fairfax had a combined ratio of 97.5% reflecting an underwriting profit of $35 million, that compares to a combined ratio of 100.5% in 2011 that reflected an underwriting loss of $6 million. The Second Quarter 2012 catastrophe losses were $46 million, or about 3.4 combined ratio points, which was lower than the Second Quarter of 2011 catastrophe losses of $72 million, or about 2.7 combined ratio points.

Consolidated interest and dividend income decreased by 46% from $195 million in the Second Quarter of 2011 to $105 million in the Second Quarter of 2012, primarily as a result of sales during 2011 of higher yielding bonds, the proceeds of which were reinvested into lower yielding cash and short-term securities and also reflected higher total return swap expenses partially as a result of the timing of dividends related to those TRS positions.

The average portfolio size at fair value was comparable on a year-over-year basis and $24.6 billion at June 30, 2012 compared to $24.1 million at the end of last year. We ended the quarter with an investment portfolio, which included holding Company cash and investments of $24.1 billion. In terms of financial leverage, our quarter end total debt to total capital ratio decreased to 25.8% compared to 26.4% at December 31. In April 2012, the Company had repurchased its $86 million maturing debt at par. That concludes my section and back to you, Prem.

Prem Watsa {BIO 1433188 <GO>}

Thank you very much, Dave. Now we are happy to answer your questions, please give us your name, your Company name and try to limit your questions to only one so that it is fair to all on the call. So Carol, we are ready for questions.

Questions And Answers

Operator

Okay, one moment, sir. Our first question.

Q - Paul Holden {BIO 6328596 <GO>}

Paul Holden, CIBC. Two questions, because the first one is pretty quick, and that is any kind of color you can provide us on crop insurance that you may have in the US given the drought conditions down there? Then second question is, as you derisk the investment portfolio and move more money into cash, understand you said you want to keep that cash around and take advantage of opportunities that might arise, but does it make sense in the intermediate term to decrease financial leverage given your getting sort of a negative spread there on your cost of debt versus what you can earn on your cash investments?

A - Prem Watsa {BIO 1433188 <GO>}

Yes, so Paul, your first question was on crop insurance, right?

Q - Paul Holden {BIO 6328596 <GO>}

Yes.

A - Prem Watsa {BIO 1433188 <GO>}

Yes, so you all know that the crops are being affected in the United States. Our results have not been affected by crop losses in the Second Quarter, but we anticipate that due to the drought conditions in the United States, the third and Fourth Quarter crop losses will increase. But we don't expect that the losses will be significant for us as our crop business is very small relative to our overall premium base. But $190 million, $200 million in terms of total crop premium. The majority of our crop premiums are outside the states that had been significantly affected by the drought conditions. We continue to monitor the situation closely, but this is really not a major concern for us right now.

Secondly on your -- we have a significant cash position, and what we would do with it of course -- over 27 years, Paul, we've never been able to anticipate what can happen in the future. But if I take you back to 2008, 2009, the fact that we had 75% of our investment portfolios in cash and government bonds gave us the ability to take advantage of the crisis that took place in late 2008 and early 2009.

And so we-- it's not so much a forecast, we just think that spreads are low in the bond markets and we think it doesn't make sense to reach for yields. And stock prices have basically doubled from 2009 lows, so we think this is a good time to be very conservative. Lots of concerns as you know in Europe and in the United States as the US economy slows, and of course in China. And so our worry is that the world over we have very little ammunition left, and so we continue to be concerned and have hedged our equity portfolios.

So that's where we are, Paul. We have a very conservative -- we have a very strong financial position with our $1 billion plus of cash in marketable securities at the holding Company. Whatever we do, we want to continue to maintain that cash and marketable position. And in terms of financial leverage, we paid some, John, about $80 million of debt in the Second Quarter, Fairfax bonds we retired, and we will continue to retire some bonds as we go forward.

Q - Paul Holden {BIO 6328596 <GO>}

Okay. Great. Thanks.

Operator

Next question.

Q - Mark Dwelle {BIO 4211726 <GO>}

Mark Dwelle, RBC Capital Markets. First on the new quota share agreements at OdysseyRe, those were pretty substantial couple pieces of business win. It looked like that was around $150 million of premiums in the quarter. Is that a reasonable run rate to think about, or was there some type of front loading or catch up related to the amount seen in the Second Quarter?

A - Prem Watsa {BIO 1433188 <GO>}

So that was a significant piece of business that OdysseyRe acquired, Mark. On these businesses, when you get them the incumbent has had losses that they paid in the past and so normally they would require significant rate increases and the person who has the Company that hasn't taken a part in these losses can perhaps get it at a lower rate. The terms have changed dramatically, and the pricing has improved, and so our OdysseyRe underwriters feel very comfortable that this will work out over time. But John, in terms of the run rate?

A - John Varnell {BIO 5699703 <GO>}

Yes. The run rate you said use probably ($250 million) is about the right range, maybe ($250 million) to ($300 million).

Q - Mark Dwelle {BIO 4211726 <GO>}

That's quarterly or annually?

A - John Varnell {BIO 5699703 <GO>}

Annually. Annual run rate.

A - Prem Watsa {BIO 1433188 <GO>}

That's an annual run rate, Mark.

Q - Mark Dwelle {BIO 4211726 <GO>}

Thank you. Okay, second question, just kind of parsing through some of the comments in the interim report related to Northbridge. It seems like a fairly substantial change in direction going on there exiting the US property business, some refocusing. Could you just talk a little bit about what's going on there, and why these changes are viewed as necessary at this point?

A - Prem Watsa {BIO 1433188 <GO>}

Yes, so the one major change that took place, of course, is the fact that the three companies have come together, right? That began early in the year, Northbridge Insurance. But specifically in commonwealth, the old commonwealth, we used to write US property business and it didn't make any sense to do that, so we moved that to Hudson. So the Property business we described in our quarterly report has been moved to Hudson. So a premium decrease, Mark, is less if of course if you take that into account apples to apples.

But in Northbridge, we have excellent reserving so we're very focused on having very conservative are reserving. The price increases, the rate increases that we are seeing in the United States in some areas pretty significant, workers comp in California, Florida. In Canada, Canada always lags in terms of rate increases. And of course just the transition to one Company we figure will take 18 months or so. Â¶ And so all of these things are going through.

We feel very comfortable with what's happening under Silvy Wright's leadership, and we expect the combined ratios to come down significantly over time. But we've got a very good Company, very good reserving into our combined ratios, I mentioned those -- that. At this time, and just coming out of a soft market, not in any significant way I may add, but just coming out of a soft market it is always important to have good reserving, and that's what we have at Northbridge and Crum & Forster and Odyssey.

Q - Mark Dwelle {BIO 4211726 <GO>}

Okay and one last real quick question, if I may, related to the CPI hedge, the indices that those relate to, are those sort of headline numbers CPI or are those X food and energy type indices?

A - Prem Watsa {BIO 1433188 <GO>}

No they're pretty well CPI numbers that you see, they're headline numbers, Mark. And yes, no they're very much the headline numbers here and in Europe they're the two big ones. We have a small amount in the UK.

Q - Mark Dwelle {BIO 4211726 <GO>}

Okay, that's all my questions, thank you.

A - Prem Watsa {BIO 1433188 <GO>}

Yes. Thank you, Mark. Next question, Carol.

Q - Tom MacKinnon {BIO 2430137 <GO>}

I've got a question with respect to the IL acquisition, if I may. It's the second acquisition of runoff business you've made over the last two years here now. And it looks like the runoff share of assets is obviously going to be increasing, and it's share of your total capital is going to be increasing may be closer to 15% or 20%. From a strategic perspective, why would you want to continue to invest in runoff business if you think that the industry would see some sort of firming going forward?

I suspect you wouldn't be able to get-- take advantage of that opportunity if you were to increase your holdings in runoff. So maybe you can think, is there a little bit of a change in strategy here with respect to beefing up runoff, or is it just some opportunistic things that you see?

A - Prem Watsa {BIO 1433188 <GO>}

Yes. That's a good question. You'll remember we're decentralized. You'll remember that our runoff is separately capitalized, so this purchase is coming in through our runoff Company, so it doesn't affect the capital in any of our ongoing operations.

We expect to finance it at the runoff level. And these acquisitions, not strategic at all with opportunistic. Tom, what happens is when we bought GFIG, as you'll remember, about 18 months ago it was one of the best investments we've made. Here we are buying a company at we think at good reserving 94% of book value, and it's got very significant investment portfolio. At the end of March it was $1.9 billion, it'll come down some with all of the closing conditions that take place.

But these-- and we've got a group, Tom, who examines claim by claim, go through all the details and it's making sure that our downside is protected, and so we found them to be very good investment. They come-- you can't predict when they come, this happened to have come in recently. So when we see them opportunistically, when we can finance them at the runoff level, not using cash from our holding Company, and when our companies are all well-capitalized then we'll take advantage of them. But that's how we look at it, Tom. As you follow our GFIG acquisition and some of the others we've made, you'll see these are very significant -- significantly profitable investments for us.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Okay. Thank you.

Operator

Jeff Fenwick.

Q - Jeff Fenwick {BIO 15350794 <GO>}

Jeff, I'm with Cormark Securitites. I think most of my questions have been answered, but I wanted to ask one on the workers compensation area in the US. That's clearly shown some good volume growth there, I'm just wondering what you think the prospects are, do you see that trend continuing, things are obviously still challenging south of the border. The prospects of growing volume there and starting to get Zenith working its way down towards that 100% combined ratio level, what was sort of your feeling around how that business is going now?

A - Prem Watsa {BIO 1433188 <GO>}

Yes, just to put it in perspective, Zenith used to write $1.1 billion and in the soft cycle under Stanley's leadership they took it right down to $450 million, Stanley and Jack Miller, who is that the current CEO. And so the people who wrote business at that time Jeff, have been pulling back, of course, because the pricing wasn't appropriate.

And while they pull back, we get the opportunity to write more business. The prices have gone up as we've said 9%, 10% for the 2012, and we expect them to continue to go up and I think we are running at around $600 million right now annualized, Jeff. And overtime, as long as these trends continue, we have the ability to write business, write the amounts of business that we wrote in the past.

And Zenith is highly disciplined. I have mentioned to you that over the 32, 33 years the combined ratio has been on average 95%. So when you go through periods like this the last few years where the combined ratios have been 125%, 130%, 135%, well rest assured we'll-- they'll have to have combined ratios much less than 100% to get the average down to 95%. And that's what's happened to them in the past. We expect that to happen again in the future.

Q - Jeff Fenwick {BIO 15350794 <GO>}

And perhaps one question on M&A. We started to see a little bit of more movement in the Canadian marketplace and that certainly hasn't been a factor for Northbridge for quite some time. And you think there might be some opportunities in the Canadian market place or maybe your priorities still lie elsewhere in emerging markets for the US?

A - Prem Watsa {BIO 1433188 <GO>}

No. We are very much aware of opportunities taking place in Canada and elsewhere. We're focused on the commercial side, as you know, not on the personal side. Our expertise is on the commercial end and we're pretty sizable in the commercial end. And so we'll continue to look for opportunities. We like companies that have demonstrated underwriting profitability on the commercial side and so that continues to be our focus, Jeff, and we're very much interested in Canada, that's where we began and so no we haven't deemphasized it at all.

Q - Jeff Fenwick {BIO 15350794 <GO>}

Okay. Thank you.

A - Prem Watsa {BIO 1433188 <GO>}

Thank you, Jeff.

Operator

Next question.

Q - Wayne Cadwallader {BIO 17207426 <GO>}

Wayne Cadwallader, Elkhorn Partners. Just a quick one back on the Brit Insurance. It's a company I remember from some years ago, and they had questionable approach to their underwriting and also on the investment sides. And I guess two things, as I'm sure there's lots of opportunities in combining the book with your current runoff, and therefore some good synergies. And plus, on the investments, what did you do to clean up the investment side quickly to make sure that's all solid? If you could respond to that would be great. Thank you.

A - Prem Watsa {BIO 1433188 <GO>}

Sure, two things, just on Brit. When Nick Bentley and our runoff group did their due diligence, of course there was some liability, some reserve that they weren't as comfortable. And so they have a reinsurance, they reinsured it back to Brit so that over the next 18 months they do more due diligence than perhaps commute it, so that's one level of protection, Wayne, in terms of-- and not only a 94% of book value, but that reinsurance transaction that we've got.

And the second, on the investment side, of course it's a significant portfolio. Right now we're very conservative. But these things change, Wayne. The investment markets still are not static. They change and they can change dramatically, so we have the flexibility of using these monies as and when changes take place.

We've got lots of cash right now in our own portfolio, $8 billion. But 2000-- I'm just going back to 2008, in our 27-year history, we've never been able to say when things change, but when they change the companies that have cash, have government bonds, are in a very strong position. People who have other assets might have some problems.

In our investment portfolios, we still have a long treasury bond. We sold, as I have said to you quite a bit in the past, we still have about on our cost base-- book value basis about $1.3 billion of long treasury bonds. And as of end of June their value was about $1.6 billion. And the long treasuries I think were about 2.75%, they're about 2.5% here. And we still hold them. But of course, we can send them -- we can sell them at anytime. So that's where we stand.

The Brit investment of course will be -- at $1.9 billion I mentioned to you in terms of that portfolio at the end of March, there will be adjustments to it. And finally, we'll disclose the final investment portfolio as and when it closes. But those are the reasons Wayne and thank you for your question. Can we go onto the next one, Carol?

Operator

Okay I'm showing no other questions at this time. (Operator Instructions)

A - Prem Watsa {BIO 1433188 <GO>}

Any further questions, Carol?

Operator

I'm showing no other questions at this time.

A - Prem Watsa {BIO 1433188 <GO>}

Terrific. Carol, thank you very much and if there are no more questions, thank you all for joining us on this call. We look forward to presenting to you again after the next quarter. Thank you.

Operator

Excuse me, we did have a question pop up, would you like to take them at this time?

A - Prem Watsa {BIO 1433188 <GO>}

Sure, is there one?

Operator

One, yes one just populated. One moment.

A - Prem Watsa {BIO 1433188 <GO>}

Yes, no problem. Yes. Is there a question there?

Operator

Robert, your line is open, please state your company name.

Q - Robert Roell {BIO 4918524 <GO>}

Sure, it's Robert Roell with Surveyor Capital. Prem, you've been positioned very defensively for some time, rightly so. I'm just wondering what would make you more positive, what would cause you to be concerned about inflation as opposed to deflation, what would cause you to be more positive? What are you looking at, what are you looking for?

A - Prem Watsa {BIO 1433188 <GO>}

Robert, it's difficult to say. We continue to monitor it on a daily basis, but if we see in 2008, 2009 just the fact that spreads widened significantly, and the stock markets dropped from the high maybe 50%, well that's a change in conditions and we became very positive. If there was some things happening that suggested that the economic recovery would be more sustainable, well, we'd feel a lot more positive.

Right now we don't see that and we see a lack of ammunition among governments, among monetary authorities. Interest rates are very low, negative interest rates in many countries for two years and three years. So in that environment we just think we should be conservative.

I'll remind you that we said that this, and this is an opinion and not a fact, but we think that what we're going through is not like what we've gone through in the last 50 years, not a recession like we've experienced, this is our view. And we think it's more comparable to the 1930s and to what Japan has experienced in the last 20 years. So that's our framework for analyzing what's happening right now, and we think-- I think-- we think you have to be cautious and worry about what can happen the next few years.

Q - Robert Roell {BIO 4918524 <GO>}

Thanks very much.

A - Prem Watsa {BIO 1433188 <GO>}

Thank you, Robert. Any more questions, Carol?

Operator

I'm showing no other questions at this time, sir.

A - Prem Watsa {BIO 1433188 <GO>}

Well thank you, Carol.

Operator

This does conclude our conference for today, all participants may disconnect at this time. Thank you.