Q1 2018 Earnings Call

Company Participants

- Jay S. Bullock, Chief Financial Officer & Executive Vice President
- Mark E. Watson III, Chief Executive Officer, President and Director
- Mark H. Rose, Chief Investment Officer & Senior Vice President
- Susan Spivak Bernstein, Senior Vice President-Investor Relations

Other Participants

- Jeff Schmitt, Analyst
- Meyer Shields, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, and welcome to the Argo Group First Quarter 2018 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 Susan Spivak Bernstein. Please go ahead.

Susan Spivak Bernstein {BIO 1514699 <GO>}

Thank you and good morning. Welcome to Argo Group's conference call for the first quarter of 2018. Last night, we issued a press release on earnings, which is available on the Investors section of our website at www.argolimited.com.

With me on the call today is Mark Watson, Chief Executive Officer; Jay Bullock, Chief Financial Officer; and Mark Rose, Chief Investment Officer. We're pleased to review the company's results for the quarter, as well as provide you with management's perspective on the business. As the operator mentioned, this conference call is being recorded. And following management's opening remarks you will receive instructions on how to queue to ask questions.

As a result of this conference call, Argo Group management may make comments that reflect their intentions, beliefs, and expectations for the future. Such forward-looking statements are qualified by the inherent risks and uncertainties surrounding future expectations generally and may materially differ from actual future results involving any one or more of such statements. Argo Group undertakes no obligation to publicly update forward-looking statements as a result of events or developments subsequent to this call.

For a more detailed discussion of such risks and uncertainties, please see Argo Group's filings with the SEC.

With that, I'll turn the call over to Mark Watson, Chief Executive Officer of Argo Group. Mark?

Mark E. Watson III {BIO 1463509 <GO>}

Good morning and welcome to our call today. This year is off to a good start demonstrating the balanced approach to growth and profit from both our international and U.S. operations, continued strong contribution from net investment income and our investments in digital.

Last night, we reported adjusted operating earnings of a $1.05 per share, a 67% increase from the $0.62 per share we reported in the first quarter of 2017.

Both underwriting income and investment income were up in the quarter as we benefited from the disciplined growth in our underwriting business and the resulting increased level of invested assets. Net income and EPS were down year-over-year due to the adoption of new accounting standards requiring us to reflect changes in the value of our investment portfolio through the income statement. Historically, we only reported that change directly to shareholders, equity on the balance sheet. When you exclude the impact of this accounting change to compare with last year's ROE, the result is an 11.2% return on equity and against an 8.1% result for the first quarter of 2017.

Underwriting results are benefiting from our investments in talent as we continue hiring very good people into our company, risk management using thoughtful capital allocation and an enhanced capital structure to improve our capital efficiency, better working with our partners and third-party capital providers to augment our underwriting business to ultimately maximize our return on capital, and our digital platform, which I'll discuss in more depth shortly.

First a few words about our operations. In the U.S., gross premiums were up 11.3% in the first quarter of 2018 driven by growth in liability, professional and specialty lines, partially offset by lower property premium. We continue in some cases to reduce our property exposures as we seek the optimum distribution of exposures across our businesses and platform. A small decline in underwriting income in the first quarter reflected this year's higher catastrophe activity than a year ago related to winter storms in the Northeast and a smaller contribution from favorable prior year development than last year.

That said, in several of our core growth business units such as professional lines and surety, we saw strong increases in underwriting income compared to 2017. From a core margin perspective, the ex-cat accident year loss ratio was 58.3%, up slightly from the first quarter of 2017, which was 57.6%. U.S. business continues to perform well and the modest increase in the loss ratio was a function of the few non-catastrophe related property losses beyond what we would typically expect in a quarter and small shifts in the business mix, mainly in increase in our casualty business.

Moving on to our international operations, results in our international business improved substantially this quarter compared to 2017, as initiatives to grow the business, while at the same time improving the underwriting results become more apparent. The results also reflect the full quarter's results for Ariel Re compared with only two months in 2017, keeping in mind that January is the biggest month of the quarter for our reinsurance business.

Gross premiums written were up 28.1% in the first quarter of 2018, compared to the same period in 2017, again with January being the largest month for Ariel Re. The timing of the close as mentioned above is reflected in this year's numbers. Across the broader international business segment, Property, Liability, and Professional lines all grew compared to the prior year's first quarter.

From a profitability standpoint, the ex-CAT accident year loss ratio improved to 53.8%, compared to 54.7% in the prior quarter. The year-over-year improvement again is a reflection of the full quarter's inclusion of the results for Ariel Re. The calendar year loss ratio for the international segment showed substantial improvement and benefited from a return to reporting positive reserve development as well as from the absence of catastrophe losses in the first quarter.

Just a couple of words about the rating environment, everyone has heard a bit already on the environment, and I would say that our company is showing good signs of rate improvement. Having said that, while it's across the board it's limited to single digits. We're still seeing more rate increase and loss affected business. But as we talked about on last quarter's call, it isn't quite as exaggerated as people were expecting in the fall of last year. Having said that, given our financial results for the quarter, I'm pleased with how our portfolio looks right now.

Let me go on to capital management. Our number one priority remains deploying our capital into the businesses where we see attractive returns and we've been doing that as evidenced by the growth in certain core businesses, such as casualty, professional lines and surety. We also continued to return capital as we deem appropriate.

During the first quarter we repurchased $18.6 million of our stock or just over 300,000 shares. In February 2018, our board declared a 15% stock dividend and paid a cash dividend of $0.27 per share. Just as a reminder, in the past seven years our cash dividend has more than doubled. Between stock buyback and dividends paid, we have repatriated over $600 million of capital since the program began in 2010.

I would like to now turn the call over to Mark Rose for a minute, our Chief Investment Officer to talk about our investment portfolio and outlook for 2018. Following his commentary, I'll provide an update on the changes we've made in technology and the progress in our digital platform. Mark?

Mark H. Rose {BIO 1557365 <GO>}

Thanks Mark and good morning everyone. The first quarter portfolio total return was a negative 0.35% or down versus first quarter 2017 which was up 1.5%. In the first quarter, the global financial markets, including both bonds and stocks, became reacquainted with volatility. Leading the disruption was the two-year treasury and similarly LIBOR which rose in yield from 1.88% to 2.27% or an increase of 20% in the quarter. The U.S. 10 year, which people are more familiar with, was up nearly 50 bps during the quarter, or 50 basis points during the quarter to nearly 3%, but by the end of the quarter settled around 2.75%.

If you step back and observe what's been going on in the markets for the past two years, three-month LIBOR has gone from approximately 0.6%, or 60 basis points to nearly 2.4% that's a 4 times increase. Borrowing costs have risen for all companies. During the quarter, treasury volatility had its impact on all major credit markets, which were down in the first quarter except for bank loans and floating rate bonds in general.

For Argo, our core bond portfolio was down only 0.2% due to our short duration, which is around 2.3 years when we included cash and our exposure to non-dollar assets. Our risk portfolio, which has driven total return for the past two years was down 0.6% in Q1. Our equity portfolio was the biggest detractor this quarter, but it was offset by bank loans, special situations credit, private equity and hedge funds.

Our reported net investment income was $36 million for the first quarter of 2018, up $5.5 million versus a year ago and $1 million versus the fourth quarter of 2017. Net investment income largely benefited from a larger asset base and higher yields in comparison to prior periods. For example, one benefit from the jump in LIBOR is that we're able to source over 3% yields in AAA floating rate asset back in CLO debt securities. This is up over 1% from the prior year.

As mentioned earlier for this quarter, we began the accounting for the change in market value of our equities through realized gains and losses. For Q1 2018, we experienced negative $15.7 million in total realized losses, of which we had negative $31 million that was due to market value changes and equities.

With that, I'll turn the call back over Mark.

Mark E. Watson III {BIO 1463509 <GO>}

Thanks Mark. Two years ago, Argo made the strategic decision to outsource application and infrastructure support. In making this decision we realized that managing servers and IT infrastructure did not offer a strategic advantage to the company. By using strategic partners that were experts in these services, we would get a higher quality results for a lower cost. As of today, all of our business application is supported by an offshore partner and we've migrated all of our U.S. infrastructure on to a private cloud with state-of-the-art technology. One could say that we have drastically moved away from the flinstonian approach that many larger companies have taken with their back office. By the end of the year, we will have our international applications transitioned into this new model as well.

Many of our competitors have leveraged and outsourced model for insurance company and are doing more with application support. We've gone a step beyond that trend by utilizing an outsource partner to host and manage the infrastructure services. Using this strategy, we can further invest in business growth in 2018. In fact this year we will nearly double the number of projects that we're working on, adding new business capability, while improving the level of service available to the organization. I should also add that an added benefit to this model is the ability to quickly scale. By using our partner network we can easily add infrastructure and resource capacity without large upfront costs as we grow our business.

On to digital, if you remember on last quarter's call I talked in depth about our digital initiatives. In the first quarter of 2018, we continued to make progress towards our goal of using technology to reshape our business. Our efforts to digitize the business are starting to bear fruit for our distribution partners, policyholders and employees, and here are just a few highlights for the quarter.

We have an application that provides quick quotes and that handles 100% of all quoting for one key line of business within our casualty portfolio. We grew that towards as of the first quarter 18% of the quotes coming in are submitted were done so directly by brokers. Of those submissions, nearly 80% had automated quotes that our underwriters never had to touch and these aren't tiny policies either. On average, the quota is around $25,000 and we've seen quotes in the hundreds of thousands of dollars as well.

Our broker partners are now repeatedly using the system as they realized that better customer experience they can provide by getting a quote in minutes. We are achieving this through artificial intelligence coupled with a simpler digital user experience, which reduces the questions that that was previously required by 70% from a traditional form.

We're now leveraging this quick portability into another application for a portion of our management liability business. In this case, we expect a 100% of the quoting to be automated and you'll be hearing more about our quick quote platform later this year as we deploy more lines of business with our partners. Our ability to quickly bring simple automated insurance products to market using a test and learning philosophy is a differentiator in the marketplace we believe.

Our broker portal continues to show growth in partnering customer engagement, roughly 35% of all new business for one of our business units which is Argo Insurance uses this next generation of self-service tool. Brokers and insurers appreciated simple user interface and they tell us it's unique in the marketplace, but we're not stopping there, we will expand this portal to other lines of business and continue adding new features based on customer and partner needs going forward.

Finally, we continue to be active investing in technology startups to both fill the need in the market and can strategically help our core businesses. We've been an active player in the cyber arena for many years and in the first quarter of 2018, we made an investment in a startup that provides cyber prevention, mitigation and insurance for small businesses, which is a high growth segment due to the continued increase of phishing and Ransomware attacks.

We are active and we'll continue to broaden our portfolio of cyber partners and investments in other segments of the market as well. So in summary, the progress we're making on our digital initiative is changing how we transfer risk as we utilize powerful technology and tools. I've also talked earlier and in the last quarter about how we transferred risk to our changing capital structure as well. Our strategy focuses on automation of both existing and new lines of business as well as leveraging advanced data and algorithms to provide insights for the underwriting process. I'm happy to discuss this more during our Q&A.

And with that, I'll turn the call over to our Chief Financial Officer, Jay to discuss the financial results in greater detail. Jay?

Jay S. Bullock {BIO 3644311 <GO>}

Thanks, Mark and good morning, everyone. I'll make a few comments and then open it up to questions. Following reporting of the last two quarters of 2017 that required a lot of explanation to get the true underlying trends of the business, 2018 has not only started off on a positive note, it's a lot simpler to explain, which will allow me to be brief.

There was the one accounting change that has been mentioned related to the change in the value of our equity portfolio, but that's more about where the result shows up than anything else. The change had no effect on book value.

While Mark commented on the positive growth trends in both the U.S. and the International segments, it's worth pointing out that a large portion of the growth in gross written premium for the International segment was driven by the inclusion of the month of January for the (00:18:10). That said, without the impact of that in the numbers, growth in the segment was still over 15% as we saw growth in parts of our Bermuda-based business as well as some of our growth initiatives in Europe.

Starting with the International segment, the slight reduction in net written and earned reflects the accounting for certain outwards reinsurance contracts in the first quarter as well as a planned reduction in the participation on certain of our voice-based businesses.

Moving to loss trends in the quarter, the underlying core loss ratio for the group was essentially flat quarter-over-quarter. Catastrophe losses while modest, increased slightly over last year and this quarter's prior accident year movement was a relatively small, but positive result following last year's result, which included the impact of the Oregon rate change along with activity on one prior catastrophe of that. All in pretty straightforward, pretty consistent and pretty good.

Moving on to the expense ratio, we showed year-to-year improvement in the first quarter of 2018 with the expense ratio to 38.6% versus 40.5% in 2017. Even excluding one-time items from the 2017 first quarter, the expense ratio showed improvement and we expect that trend to continue as our investments in people and technology continue to enable growth. The only thing I noticed back for making more improvement was a slight increase in acquisition expense related to small shifts in the business mix.

For the first quarter the income tax expense was $200,000 and that translated into effective tax rate of nil. That was largely the result of a tax impact on the negative mark to the equity portfolio, which resulted in a tax benefit that largely offset the tax on earnings in taxable jurisdictions.

Post the tax reform in the U.S. and certain changes we've made to our tax structure we continue to believe that our effective tax rate will be approximately 20%. We continue to monitor this closely and if results suggest otherwise, we'll communicate that changed assumption in the future.

Finally, of note on the balance sheet, while Mark Rose covered the investment performance and we discussed the mark on the equity portfolio, we saw a similar decline in value, $38 million with regard to the fixed income portfolio. That decline was significantly mitigated by the short duration we've kept in the portfolio for some time in anticipation of a rising rate environment.

Operator, that concludes our prepared remarks and we're now ready to take questions.

Q&A

Operator

We will now begin the question-and-answer session. The first question will come from Jeff Schmitt of William Blair. Please go ahead.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Hi. Good morning, everyone.

A - Mark E. Watson III {BIO 1463509 <GO>}

Good morning.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Could you discuss the London property book? Are losses still elevated there and where do you stand on that repositioning?

A - Mark E. Watson III {BIO 1463509 <GO>}

We started repositioning the portfolio a year ago. So we're pretty close to being through the end of that. I'm not sure what you mean by elevated, but as both Jay and I talked about earlier this morning, and as we released in our financial results, the property – the expected losses for the quarter were, well, they were in line with our expectations. We did not have negative development as we did a year ago, in fact actually we had slight positive development in our loss reserves.

I think the bigger issue is not our portfolio going forward, it's just market pricing. There is still plenty of capacity in the marketplace, and I think that perhaps there is a better use for our capital and our property exposure that's just sitting in the London market.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Okay. And then on the digital investment front, obviously you provided a lot of detail there which was interesting, something that jumped out at me, did you say the questions that was down 70% in some cases, was that to write a quote?

A - Mark E. Watson III {BIO 1463509 <GO>}

Yeah. So to just say it simplistically, if we add – if we – if on a policy form we asked 10 questions before, now we're only asking three.

Q - Jeff Schmitt {BIO 19747235 <GO>}

All right.

A - Mark E. Watson III {BIO 1463509 <GO>}

Maybe that's a little too simple because we do ask more than three questions, but actually we have another policy form for a small professional liability cover where we actually only ask five questions, and one of them is what's your name? So we are figuring out how to use third-party data, and on some of the smaller account business where we're underwriting on a portfolio basis, we're finding that actually we don't need quite as much information as the market dictates.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Okay. Okay. And then, what are you seeing in terms of submission growth and the time that it takes to write a policy? I mean, how much does that improve? I know you've talked about in the past, but...

A - Mark E. Watson III {BIO 1463509 <GO>}

Yeah. So it depends on line – it depends on line of business. But we're seeing submission activity grow anywhere from 30% to 50%. But as I've said before, we're not trying to generate more submission activity, although that's nice. What we're really trying to do is be more effective with the submissions that come in the door, so that we can be more responsive to the brokers and agents that we're already transacting with. And so that I would say that it's hard to measure responsiveness, but if I had to, I would say that we're probably 30% to 50% more responsive today than we were a year ago.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Okay. Okay, great. Thank you.

Operator

The next question is from Meyer Shields of KBW. Please go ahead.

Q - Meyer Shields {BIO 4281064 <GO>}

Thanks. Good morning. Two brief questions. First, I was hoping you could dig in a little bit more into the gross written premium decline in property year-over-year. I guess I would have expected more of an uptick given the increases that we saw?

A - Mark H. Rose {BIO 1557365 <GO>}

Well actually, no. I mean look, is property an important part of our portfolio? Yes, it is. But with market pricing where it is and I'm talking in general, I think we're happy with the amount of risk that we've got on the books. The decline is – the decline in top line is intentional. I mean, it's not a substantial number. And if you look at how much the company grew in total, we've just had – we've seen better opportunities in other lines of business. Again property is an important part of the company, including in London. That won't change. But right now we're seeing more growth opportunities in other places. Having said that, our property business, outside the U.S. did grow in the quarter year-over-year.

Q - Meyer Shields {BIO 4281064 <GO>}

It's okay. No. That's helpful. Thank you. Second question and I don't know if it's too early at this point in time, but is the profile of the business that you're getting or that you're quoting on quick quote, is that materially different from your current imports book?

A - Mark H. Rose {BIO 1557365 <GO>}

No. It's not. And I forgot what the – I didn't mean to call it quick quote, it's just my point was to say, you can get a quick quote. I don't actually remember what we call it. It's another name. But it's the same business that we already have on the books which is why I was making the point in the remarks earlier this morning that the digital teams focus has primarily been on digitizing the business that we already have. We have plenty of opportunities for new business to come in the door. But we make a strategic decision, a year and a half ago that we should really focus on digitizing what we already have first and then leverage that. And so that's the plan we have been executing against.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. Understood. Thanks so much.

Operator

There are no additional questions at this time. This concludes our question-and-answer session. I would like to turn the conference back over to Mark Watson for closing remarks.

A - Mark E. Watson III {BIO 1463509 <GO>}

Thank you operator. I'd like to thank everyone for being on the call today. As Jay said, things were going well for the quarter and there's not a lot of movement for us to talk about. We look forward to talking to you again at the end of the second quarter, and I think that'll give us a chance to have good visibility not only on the end of – on the remainder of 2018, but we look forward to talking about 2019 a bit as well, and give you an update on the progress and the evolution of our company.

Thank you again for being with us and we'll talk to you in August.

Operator

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