Company Name: Fairfax Financial HD
Company Ticker: FFH CN
Date: 2014-05-02
Event Description: Q1 2014 Earnings Call

Market Cap: 10,955.79
Current PX: 488.80
YTD Change($): +64.69
YTD Change(%): +15.253

Bloomberg Estimates - EPS
Current Quarter: 6.047
Current Year: 44.588
Bloomberg Estimates - Sales
Current Quarter: 2013.000
Current Year: 8428.500

# Q1 2014 Earnings Call

## Company Participants

- V. Prem Watsa
- David Bonham

## Other Participants

- Paul Holden
- Tom MacKinnon
- Mikel Abasolo
- Daniel H. Baldini
- Arthur Charpentier

## MANAGEMENT DISCUSSION SECTION

### V. Prem Watsa

*Q1 Review*

*Q1 Highlights*

- Welcome to Fairfax's first quarter conference call
- I plan to give you some of the highlights and then pass it on to Dave Bonham, our CFO, for additional financial details
- In Q1 2014, book value per share increased 11.7%, adjusted for the $10 per share common dividend paid in Q1 2014
- Our insurance companies had an excellent first quarter with a combined ratio of 93% with excellent reserving and significant underwriting profits of $99mm
- OdysseyRe, again, had an excellent combined ratio of 85.6%, while Zenith had a combined ratio of 90.6%
- As shown on page 28 of our quarterly report, we realized gains on our investment portfolio of $380mm
- Excluding all hedging losses and before mark-to-market fluctuations in our investment portfolio, we earned $493mm in pre-tax income
  - Including all hedging losses and mark-to-market fluctuations in our investment portfolio, we reported after-tax income of $0.8B in Q1 2014 in excess of $0.6B loss for the full-year 2013
- As I mentioned to you in the past, prior to last year, we had two years, 1990 and 1999, that we had a negative total return on our investments
- In both cases, we rebounded significantly in the following year
  - With our losses in 2013, our first quarter in 2014 has rebounded significantly again

### *Investment Portfolios*

- You will note our investment portfolios went up by $1B in Q1 2014, in spite of being fully hedged 30% in cash and little exposure to corporate bonds
- How did it happen? U.S. treasury rates dropped by approximately 30BPS and our common stocks like the Bank of Ireland did much better than the Russell Index
- We have yet to financially benefit from our hedges and are approximately $100B in deflation swaps and, of course, our cash position gives us great optionality
- At our annual meeting, we made the point that while we were protecting our capital on the down side, our investment portfolios could also do very well
- Q1 2014 was a case in point

### *Common Stock Portfolios*

- Our common stock portfolios continue to be hedged at approximately 90%
- We did not add to our hedges
  - We continue to be soundly financed with year-end cash and marketable securities in the holding company of $1.1B

### *Insurance and Reinsurance Businesses*

- Insurance and reinsurance businesses, premium volume remained flat in Q1 2014 after a number of years of growth
- The combined ratio for our insurance and reinsurance operations, as I said before, was 93%
- At the subsidiary level, the increase in net premiums written in 2013 and 2014 and combined ratios were as follows:
  - So OdysseyRe had a 5%, approximately, decline in premium in Q1, combined ratio of 85.6%
  - Crum & Forster was up 16%, combined ratio of 99.8%
  - Northbridge in Canadian dollars was up about 1% with a 99.8% combined ratio
  - Zenith was up about 1.2% with a 90.6% combined ratio; and Fairfax Asia was up about 35.6% with a combined ratio of 93.8%
- As we have said before, very low interest rates and reduced reserve redundancies means there will be no place to hide for the industry
- Combined ratios will have to drop well below 100% for the industry to make a single-digit return on equity with these low interest rates
  - Although short-term, it’s always tough to predict, fundamentals will eventually play out

### *Net Investment Gains*

- Net investment gains of $1.006B in Q1 consisted of the following
- Please refer to page 2 of our press release

- Net gains on equity and equity-related investments of $562mm, resulted from net gains of $63.7mm from common stocks and $71.5mm net loss on our equity hedge
  - Reflecting the outperformance of our common stock portfolio which is the Russell Index
- We realized gains of $393mm in our equity and equity-related holdings in Q1 2014
- Also, we had unrealized gains of $474mm, primarily on our municipal and Treasury bond portfolio because of the impact of dropping interest rates
- As we've mentioned many times in our annual meetings, annual reports, and quarterly calls, with IFRS accounting, where stocks and bonds are recorded at market and subject to mark-to-market gains or losses, quarterly and annual income will fluctuate wildly and investment results will only make sense over the long term

### *Core Inflation*

- Core inflation continues to be at or below 1% in the United States and Europe, levels not seen since the 1950s, in spite of QE1, QE2 and QE3
- Our CPI-linked derivatives with a nominal value of approximately $100B are down 72% from our cost and are carried on our balance sheet at $164mm at the end of Q1, even though they have 7.7 years, almost eight years to run
- Please remember that it took five years, as we mentioned in our annual meeting, took five years in Japan before deflation set in for the next 18 years
- When you review our statements, you will note that when we own more than 20% of a company, we equity account and when we own more than 50% we consolidate, so that mark-to-market gains in these companies are not reflected in our results

### *Investment in Associates*

- As you see on page 11 of our quarterly report, the fair values of our investment in associates is $2.5B, which is the carrying value of $2B and unrealized gain of approximately $0.5B that's not on our balance sheet
- We continue to be concerned about the prospects for the financial markets and the economies of North America and Western Europe, accentuated as we have said many times before, by the potential weakness in China and emerging markets
- As we have said now for some time, we believe there continues to be a big disconnect between the financial markets and the underlying economic fundamentals
- As of March 31, 2014, we have $7.7B in cash and short-term investments in our portfolios, which is approximately 30% of our total investment portfolio to take advantage of opportunities that may come our way
  - As a result, in the short term, our investment income will be reduced
- Now, I would like to turn it over to Dave Bonham, our CFO, so he can give you some more information on the underlying financials

## David Bonham

### *Financial Results*

### *Net Earnings*

- First, I'll focus on Fairfax's consolidated results for Q1 2014, then I'll move on to the operating company results, and we'll finish with the consolidated financial position
- For Q1 2014, Fairfax reported net earnings of $785mm, or $35.72 per share on a fully diluted basis
  - And that compares to Q1 2013 when we reported net earnings of $162mm, or $7.12 per share on a fully diluted basis
- Fairfax showed improved underwriting results in 2014, with our insurance and reinsurance operations reporting an underwriting profit of $99mm and a combined ratio of 93%
  - That compares to Q1 2013 when we reported an underwriting profit of $86mm and a combined ratio of 94%; that's a y-over-y increase of $13mm in our underwriting profit

### *Reserve Development*

- In terms of reserve development, we experienced $56mm of net favorable prior year reserve development and that benefited the combined ratio by four points in Q1 2014
- In the same quarter last year, we reported $36mm of favorable reserve development, representing 2.5 combined ratio points
- Current period catastrophe losses totaled $31mm, or 2.2 combined ratio points in Q1 2014, and that was essentially unchanged on a y-over-y basis
  - As Prem mentioned already, net premiums written by our insurance and reinsurance operations increased slightly in Q1 2014 by 0.4%

### *OdysseyRe*

- Now turning to our operating company results, starting with OdysseyRe; in Q1 2014, OdysseyRe reported an underwriting profit of $75mm and a combined ratio of 85.6%
- That compared with an underwriting profit of $95mm and a combined ratio of 83% in Q1 2013
- Catastrophe losses were $22mm and that translated into 4.3 combined ratio points and those were principally comprised of flooding in parts of the UK and other attrition losses
  - That compared with current period catastrophe losses, all primarily which were attritional of $32mm or 5.8 combined ratio points in Q1 2013
- OdysseyRe's combined ratio benefited from $22mm, or 4.2 combined ratio points of net favorable prior year reserve development, and that was principally favorable emergence on prior year's non-catastrophe loss reserves
- OdysseyRe wrote $573mm of net premiums in Q1, a decrease of approximately 5% from net premiums of $604mm in Q1 2013, and that principally reflected lower writings of property business and most notably a y-over-y decrease in participation on a Florida property quota share reinsurance contract, and that was partially offset by growth across most lines of the U.S. insurance division, and the growth there is inclusive of renewals related to the surety business of American Safety

### *Crum & Forster*

- Moving on to Crum & Forster, Crum & Forster's underwriting results were relatively unchanged in Q1 2014 compared to last year with combined ratios of $99.8mm compared to $99.7mm, respectively

- Similarly underwriting profit of $0.6mm in Q1 2014 was comparable to the underwriting profit of $0.8mm in Q1 2013
- Current period catastrophe losses of $7.5mm had a 2.4 percentage point impact on Crum & Forster's combined ratio in 2014 and were the result of severe winter weather in the U.S. Northeast
- Q1 2013 was not impacted at all by catastrophe losses
- Net premiums written by Crum & Forster increased by 16.1% in Q1 2014 and that primarily reflected renewals of the American Safety business, the environmental casualty and the CoverXSpecialty lines of business, the positive impact of the acquisition of Hartville in pet insurance and the growth in the Fairmont accident and the health business

### *Zenith*

- Zenith reported significant improvements in its combined ratio, which decreased from 110% in Q1 2013 to 91% in Q1 2014
- That improvement reflected the following: a y-over-y decrease of 7.2 percentage points in the accident year loss ratio in Q1 2014, and that was related to earned price increases, exceeding estimates of loss trends
- Secondly, Zenith had increased net favorable development of prior year's reserves, representing 10.2 percentage points on Q1 2014 combined ratio, and that development was primarily related to the 2013 and 2012 accident years
    - And finally, decreases in the underwriting expense ratio of 2.2 percentage points, and that was the result of a 10% increase in net premiums earned on a y-over-y basis
- Net premiums written by Zenith of $290mm in Q1 2014 increased by 1% y-over-y and that reflected premium rate increases

### *Northbridge*

- Northbridge reported a combined ratio of 99.8% in Q1, an improvement relative to its combined ratio of 100.5% in Q1 2013
- Northbridge's combined ratio included the benefit of net favorable prior year reserve development across most accident years and lines of business of $15mm or 6.7 combined ratio points
    - And that compared to net favorable development of $9mm or 3.5 combined ratio points in Q1 2013
- There were no catastrophe events in Q1s of 2014 or 2013, but Northbridge's accident year combined ratio was adversely affected by severe Canadian winter weather and the impact it had on Northbridge's transportation logistics and direct personal lines business
- Adjusting for the one-time impact of the intercompany unearned premium portfolio transfer between Northbridge and Group Re in 2013 and excluding the unfavorable impact of translating Northbridge's premiums from Canadian dollars to U.S. dollars, net premiums written by Northbridge increased by 1.1% in Q1 2014 in Canadian dollar terms
    - And that reflected modest improvements in rate, retention in new business, partially offset by the strategic non-renewal of one portfolio of business

### *Fairfax Asia*

- Fairfax Asia's combined ratio increased from 91% in Q1 2013 to 94% in Q1 2014, and that was primarily the result of net adverse prior-period reserve development of 4.6 points, compared to net favorable prior-period reserve development of 6.5 points in the prior year
- Unfavorable emergence in 2014 was principally related to health and marine hull loss reserves at First Capital and the impact of the mandatory participation by Pacific Insurance in the Malaysian motor vehicle insurance pool
- On a y-over-y basis, net premiums written by Fairfax Asia increased by 36% in Q1 2014, principally reflecting increased writings in the accident and health, engineering, commercial auto and property lines of business
- The combined ratio of the Insurance and Reinsurance - Other division improved from 98.4% in Q1 2013 to 97.7% in Q1 2014

### *Net Premiums*

- Net premiums written decreased by 17.3% in Q1 after excluding the initial one-time impact of that unearned premium portfolio transfer to Northbridge that we mentioned, which suppressed the net premiums written in the Insurance and Reinsurance - Other segment by $39mm in 2013
  - So after that adjustment, the decrease of 17.3% principally reflected the non-renewal of certain classes of business, where terms and conditions were considered to be inadequate at Polish Re and Advent
- Runoff reported an operating loss of $21mm in Q1 2014, compared to an operating loss of $34mm in the same period in 2013

### *Operating Profitability and Tax Rate*

- The y-over-y improvement in operating profitability primarily reflected lower net adverse development at [indiscernible] (17:53) Insurance
- Our consolidated interest and dividend income decreased from $100mm in Q1 2013 to $91mm in Q1 2014, the decrease reflected lower dividends earned on common stocks as a result of the sale of dividend paying equities in 2013
- The company recorded an income tax provision of $334mm in Q1 2014 at an effective tax rate of 29.9%
- The effective tax rate was higher than our Canadian statutory income tax rate of 26.5%, reflecting the significant income earned in the U.S., which is taxed at the U.S statutory income tax rate of 35%

### *Financial Position*

Turning to our financial position, our total debt to total capital ratio decreased to 25.1% at March 31, 2014 from 26.1% at December 31, 2013, and that was primarily as a result of the increase in our common shareholders' equity reflecting the net earnings in the quarter

# QUESTION AND ANSWER SECTION

**<Q - Paul Holden>**: Wanted to ask you a question about your appetite to underwrite more business. If I look at your underwriting leverage, it's still a little bit on the low side at about 0.8 times equity, didn't see much premium growth this quarter, but yet your underwriting margins are quite healthy, so, just kind of square off the healthy margins vs. lack of organic growth?

**<A - V. Prem Watsa>**: Yes, Paul, that's a good question. As you said, we're writing 0.8 times capital. We've got lots of capital and at the moment, the prices across the industry are coming down some, more on the cat-related business and less on other businesses. We've got a very well diversified worldwide business, and you see some of them are expanding. You've seen in Fairfax Asia for example, we've got significant growth in Crum & Forster because of the acquisition of Hartville and the environmental business, we've expanded. But broadly speaking, it's not a hard market by any stretch of the imagination and we've got the capital, we've got the management, we've got the ability to expand at the right time and at the moment we're holding steady.

**<Q - Tom MacKinnon>**: Prem, when I look at the Holdco cash position, it's just a little over $1B and it's actually a little bit lower than it was in Q3 last year. And then like about 45 days after Q3 last year, you raised equity and the primary purpose of it, you mentioned in the press release was to augment your cash position at the holding company. So you've got $1B at the holding company now and you had $1B at the holding company in Q3 and you wanted more then. So can you help us understand why you might have needed the money then and you don't need it now with the same kind of Holdco cash levels?

**<A - V. Prem Watsa>**: Yes, Tom. That's a good question. And at the end of Q3 when we looked at it, results in Q3 and for the nine months reflected significant unrealized losses. And we've just said before, we had just focused on having a rock solid balance sheet under any circumstances. So, our thinking was at that time that if those conditions continue for some time, then our financial position perhaps will be less strong. We took the opportunity to raise the equity and just keep it really, really strong. Well, today it's the opposite, Tom. You saw our first quarter's earnings, you saw the cash position. We realized, as you know, the Bank of Ireland went up more than three times and we sold one-third of our position. And we got our capital back. We're big fans of the Bank of Ireland and Richie Boucher who runs the company. And I said in our annual meeting, that that's the first company that we have $1B approximately depending on the stock price on a day-to-day basis of unrealized gains. So we are in a very sound financial position and we have no intention of raising any common equity. We're very, very careful, but financial position will always – if we have any doubts about financial strength, we'll raise some equity. And today, we think we're in a very strong position and getting stronger after Q1.

**<Q - Tom MacKinnon>**: But do you anticipate some to augment that $1B more or move it up higher or what would be the potential flows out of the subsidiaries as a result of the Bank of Ireland gains?

**<A - V. Prem Watsa>**: Yeah. So Tom, like we've said that our dividend capability normalizes between $0.5B to $1B from our insurance companies like OdysseyRe and Crum and Zenith. And we don't need to take those dividends, they are in the companies. As Paul in the previous question said, we got 0.8 times of operating leverage. So we have excess capital in our companies. We can take that up at anytime if we need to, in terms of augmenting that $1B that we have in the holding company. So we like the fact that our insurance companies are well capitalized and not significant operating leverage there. We can, literally as I've said this before, we can double our premium when the opportunity comes. And of course we can take dividends if we wanted.

**<Q - Mikel Abasolo>**: Thank you for taking my question and this question comes from someone who fully shares your concerns about the economies, developed economies and the markets in general. But my question to you is, under which circumstances or under which scenario do you conceive changing substantially your investment stance, one that you have maintained, if I'm correct since mid-2010? Thank you.

**<A - V. Prem Watsa>**: Repeat that last part again, if you don't mind, Mikel.

**<Q - Mikel Abasolo>**: Yes. The questions is, you've had your equity investment portfolio hedged essentially since 2010 based on your diagnosis of the dreadful economic situation, underlying the apparently better numbers that economists throw out. And I guess that also, in terms of your concerns about valuations. Now my question is, what would change your mind about those equity hedges, what would make you feel more constructed about investing in equities or about hedging your equity portfolio? What would be the scenario, what would be those circumstances?

**<A - V. Prem Watsa>**: Yeah. Now, that's a very good question. And it's one that we of course review all the time. I answered that at our annual meeting. And we might, as time goes by, just muddle through so that the United States grows 2% or 1.5%, 2.5% something like that. Europe muddled through and China also, all the problems in China, we talked about it at our annual meeting, may well muddle through. So, in that case, we won't have any problems, any unintended consequences, and our hedge will slowly come off. Right now we haven't increased our hedge. We haven't reduced it either. Our stock positions went up, our hedges were the same amount, so it's down to 90% right now. So, that's certainly one possibility. On the other side, you saw Q1 G&P growth in the United States very minimal. You saw inflation in Europe about 0.5% and in the United States in the 1% area. China, there's lots of things happening in China, you can monitor them. In terms of the capital markets, [ph] much default (27:59) in the trust area and the wealth management products and corporate bonds, a lot of changes. And in the midst of all this, as the Fed tapers, meaning they're no longer buying government bonds, the long Treasuries went down as you know in the last few days to 3.42%, below 3.5%. So we look at all of this and wonder if we're going to muddle through and we might well desire, but there is a possibility of course of unintended consequences. They might originate from China. They might originate in the United States. We've got a very low economic growth or almost no growth in Q1. Many people say it's because of the winter. Well, if Q2 comes in a similar way, I'm not saying it will, I'm just saying it might, and we might all wonder what the effects of QE1, QE2, and QE3 are. So we take all of this into account and all of us has – we've got our investment committee and we watch it very carefully. But today, we're very happy with the position that we've got. So thank you for your question.

**<Q - Daniel H. Baldini>**: Thanks for taking my question, and it's a little bit long, so please bear with me. Over the past couple of years, you've committed a fair amount of capital to the Runoff business. And I was wondering if you could explain a little bit what your operating philosophy is there. And maybe by way of comparison, if I look at the results in 2013 and 2012, there was a small underwriting profit in 2013, and a small underwriting loss in 2012. And when there has been pre-tax income, it's come really from the gains on investments and that happened again in Q1 this year. The only company that I am familiar with, which is the same business is Instar. And my sense is that they are roughly the same scale as your Runoff business. And they seem to have operating income of $100mm plus every year or the past couple of years, but really not so much in terms of investment income or realized gains. Now, I'm assuming both companies are capably managed, and I'm wondering if you could sort of outline your philosophy and how it leads to these different results.

**<A - V. Prem Watsa>**: Yeah. So in the business of runoff, first of all, you've got to have an exceptional runoff team, and we do have an exceptional runoff team located in the United States and in the UK, and they've been doing this for the better part of 20 years. They're among the best in the United States and in the world. There's only a few runoff companies. So in the last five or six years, we might have made, Daniel, about seven acquisitions, something like that, and our rates of return, we watch this very carefully, and our rates of return are in excess of 30% for the whole book of business. We look at each one of them, and we see what the rates of return are, and the rates of return are exceptional, and there are two components as you well know; one is on the underwriting or making sure that the claims are well reserved and are paying off with their expenses below what we've set them up. And the second is the investment side. So the advantage of the runoff is, we have noticed over the years, as you know the claims, you can see every claim. If you like, before you buy something, you can check every claim and make sure they're appropriately reserved, you can add a margin on top of that which we do. While in the ongoing business, you take risks in the ongoing business and you never know what can happen and whenever you underwrite. So the runoff business has a lot of attributes to it that provide downside protection as long as you know what you're doing, and we have a separate runoff company. It's not mixed with our ongoing operations. It's separate, they're focused on it, and we think it will continue to be a great opportunity for us. But there's no pressure to buy a company just like there's no pressure to Fairfax to buy a company, an insurance company. There's no pressure to add to our runoff. It has to meet our requirements which is to make a 15% return on our capital. And if it does that, then we make the acquisition. In the past, as I said five years, six years, the runoff book has done really well.

**<Q - Arthur Charpentier>**: You showed a very nice unrealized gain in your bond portfolio in Q1 and in your opening remarks you seemed to attribute that to, I think, 30 basis point rally in the U.S. Treasurys. And I guess my question is, and I understand it's not necessarily your position that rates would be rising. My question is, should we see a reversal of that and the next several months or quarters or whatever show rates moving 30BPS, 40BPS, 50BPS in the other direction, would we see the mirror image of this or do you in fact have, I don't know, mechanisms, protections, whatever to mitigate the harm that that could cause?

**<A - V. Prem Watsa>**: Yes, Art. That’s a good question. Of course, if interest rates go up, you’d see some reversal of our position as long as we haven’t sold the bonds. If stock prices come down for Bank of Ireland or other stock positions that we have, you’ll see some reversal. Yes, so, that’s the reason, Art, I make the point that the only way to measure results with mark-to-market fluctuations is to take the long-term view and wait until they’re realized, and so that’s been our view for a long time. But your point is well taken, things can change, can reverse, and that can certainly happen. Next question…

**<Q - Arthur Charpentier>**: And may I ask if you do have any appetite to realize some of these gains?

**<A - V. Prem Watsa>**: Just repeat that again, Art, sorry.

**<Q - Arthur Charpentier>**: I said, may I ask if you have any appetite at this time to realize some of those bond gains?

**<A - V. Prem Watsa>**: Yes, I mean obviously I’m not going to tell you when we’re going to realize it or not. But yes, you know Bank of Ireland, it went up three times, we sold a third of our position. So we realized it you might say. That position was like $1.2B, $1.3B in our books, and you might say, how are they going to realize as they own almost 10% of the company. Well, the environment changed and there was a ton of demand, and Wilbur Ross and ourselves sold a third of our position. So yes, we are in the marketplace. We look at opportunities. We look at prices fluctuating every day. We don’t react to them, but when we want to, we can, we have and we will and we can.

**<Q - Tom MacKinnon>**: Prem, just looking on the Bloomberg on the Bank of Ireland Holdings, some is listed under Fairfax and some is listed under Prem Watsa. Now, are those amalgamated or are those supposed to be the Fairfax Holdings? Is that the way you should be looking at that?

**<A - V. Prem Watsa>**: Yes. That’s a good question, Tom. Because I am the controlling shareholder of Fairfax, so any position that Fairfax owns comes to me. I wish that whole position was mine, but it's not. So it’s – I think I might have, Tom, and I think it’s something like 100,000 shares of Bank of Ireland, and the rest is all Fairfax. But any time we disclose a position that Fairfax has, from a reporting standpoint, it comes up to me because of a control position. And then, of course, if I’m a Director that you have reporting obligations because of being a Director also. But I think I have to – I’m sure I'll report separately my own position and Fairfax’s position.