Q1 2012 Earnings Call

Company Participants

- Alex Maloney, Group Chief Underwriting Officer
- Elaine Whelan, Group CFO
- Richard Brindle, Group CEO

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Other Participants

- Ben Cohen, Analyst
- Christopher Hitchings, Analyst

Presentation

Operator

Welcome to the Lancashire Holdings Q1 results conference call. At this time all participants are in a listen-only mode. Later we will conduct a question-and-answer session. Please note that this conference is being recorded. I will now turn come the call over to your host, Richard Brindle. Sir, you may begin.

Richard Brindle {BIO 1983776 <GO>}

Thank you very much. Thanks, everybody, for joining. I am joined by Alex Maloney, our Chief Underwriting Officer; Elaine Whelan, our Chief Financial Officer; and Neil McConachie, our Group President. So just a few words from me and then I'll hand over to Alex.

This has been a solid if not spectacular quarter. We are pleased that we continue our strong story of sustained profitability and that we sustained two substantial marine losses in our sweet spot, so to say, as well as a reasonable sized tornado hit, but still produced a combined ratio in the 70s.

We also believe, with our strong focus on energy and property reinsurance, the power portfolio is as well-positioned as anyone to enjoy good trading conditions for the balance of the year. Having said all of that, it is still disappointing that after $110 billion of cat losses in 2011, we still do not have a hard market.

So once again, our message is one of risk selection and patience until better times return. And now I'll hand over to Alex.

Alex Maloney {BIO 16314494 <GO>}

Okay. Thank you, Richard. As Richard said, we produced a good set of results for the First Quarter. Our gross premiums of $234 million represent a 36% increase compared to the First Quarter of 2011. But then individual business lines showed quite a range of change, both up and down. We always speak about Lancashire being nimble and seeking opportunities, and our portfolio in the First Quarter of 2012 demonstrates this very well.

If you look at the different business lines, you will see that property retro and energy are growing strongly, but this is balanced by property cat, property insurance and marine decreasing. We continue to develop our BLAST tool to help us to allocate capacity and measure risk, and we feel our portfolio is well-balanced given the current market conditions.

We were able to expand our retro portfolio, including Accordion, to significantly attractive pricing and with some improvements to terms and conditions. We've written premium of $91 million at January 1, 2012, compared to $25 million on January 1, 2011. Demand for Accordion's worldwide product was strong, and we feel that the market is at least as good as 2006.

We saw clients from London, Bermuda, Europe and the US. We also saw strong demand for regional retro which is retained on Lancashire's own books, and we wrote $37 million of this premium.

For Accordion accounts we retained 15% of the business on our own capital, and then we own 20% of the joint venture. So we ended up with just under one-third of all premiums, as well as the overrider and profit commissions.

We can't say how long the demand for the retro product will remain strong enough to keep us in the market, but there's continued interest for April 1, and we will be looking to roll over Accordion for a second year.

In property cat the message was more mixed. European exposure, pricing, was often frankly disappointing and failed to show any movement in response to the new RMS swing model. As a result we reduced our exposures in several cases. In the US we came up lower layers (on one major segment's) program with inadequate renewal terms, on which the higher layers are locked in on a two-year deal.

Similarly, the Northeast accounts paid anemic rises and did not cover the increased cost of capital from the model change. And again, we model (inaudible) our positions. However, some regional US business, particularly the 2011 loss affected accounts, made considerable rises and new limits were purchased, which allowed us to write some new lines with some new clients. Overall, our cat XL written premium declined 6% year on year.

On the property insurance side, we feel that pricing in general has been weak both in absolute terms and certainly relative to reinsurance costs. Tornado and unmodeled perils such as CBI continue to be ignored from a pricing perspective despite losses. And as a result, we have reduced written premium by 37% in Q1. And we expect this to continue reducing through the rest of the year.

On the energy side, we're seeing a pleasing increase in activity, leaving some new orders both for risk and for (Gulf M) products. The 43% increase in offshore worldwide income is a result of new business and favorable timings on renewals. The doubling of Gulf of Mexico premium was all new business.

The trend is definitely continuing into quarter two with positive demand across all offshore sub-parties. The pricing environment is improving with price rises compounding on top of increases in the last two years, increased activity around the world as new resources are found in places such as Brazil, West Africa, and the Asia-Pacific region. We're also seeing a revival of Gulf of Mexico drilling.

However, we don't believe that pricing is yet at a level, compared to the risk levels associated, for us to dramatically change our portfolio. We are still highly selective about the way we deploy our capacity to the energy class.

On terrorism, both property and aviation, pricing has been flat to slightly down, and in both our incomes are relatively stable. On the marine side we've seen a decline of 30% in Q1 income, and this is reflected both in some structural changes as multi-year contracts in the First Quarter of 2011 were not due for renewal, but also our refusal to accept what we see as inadequate pricing and terms.

The Costa Concordia loss is exactly the kind of loss we would expect to pay, and the low attritional loss ratio on our marine book allows us to give significant support to large marine clients. However, we are disappointed at the weak reaction by many marine markets, specifically those outside of London, to consider the opportunity of rate adequacy on the marine portfolio.

Straight into quarter two, we can report a very successful start to the April 1 proxy reinsurance renewal season, with significant new premium written in Asia and elsewhere. Following our marketing efforts in the last two quarters, we found access to a wide range of Japanese business for which we are grateful to our brokers and our ceding company clients.

We think that pricing on excess products in particular is now adequate for the risk, and we expect these contracts to form part of our core portfolio. We found good opportunity from a loss affected JIA and regional retro products, whereby pricing and (certain) conditions were significantly improved.

We didn't just increase our Japanese exposure because of the improved pricing, but we felt we believed the actual losses are far more reliable to gauge damage ratios and exposure base than any model can. As a result of last year's Japanese earthquake, this has given us the increased confidence in deploying more capacity in Japan.

We were able to manage the PML increases with some attractive opportunistic reinsurance purchases, both in quarter one and quarter two. We also found more well-priced business for Accordion. Overall, our proxy reinsurance bound premium increased at April 1 to around $60 million from $10 million from the prior year, but we'll discuss more on our next earnings call.

Overall, our view of the proxy reinsurance sector is that pricing, absent a loss, is unlikely to increase significantly on a risk-adjusted basis from its current levels. So we are glad that we have deployed new capacity at favorable pricing now.

In general, there does seem to be a generally increased discipline in underwriting, driven in large part by the realization that the low interest rate environment looks to be with us for an extended period. As such, the combined ratio will be the engine of ROE, and underwriters around the world are having to face up to this.

With our historic six-year combined ratio of 60% and 74% in quarter one 2012, even with a very large marine cat loss, Lancashire can demonstrate that it's been exercising this discipline since its inception. And I'll now pass over to Elaine.

Elaine Whelan {BIO 17002364 <GO>}

Thanks, Alex. Hi, everyone. Our results are laid out on our website as usual. We've had a reasonably good quarter with a 3.4% return on equity. Nice to finally start a year without a major earthquake. We do have the impact of the Costa Concordia disaster reflected in our First Quarter numbers though, a net loss after reinsurance and reinstatement premiums of $34.1 million to the Group.

The main story for this quarter has, however, been on the premium side. So I'll spend a bit of time of that and then get to the multis later. As we flagged on our Q4 earnings call, we anticipated a significant increase in our property retro line at Jan 1. Alex has given some detail on that already, so suffice to say the opportunities were at least as good as we expected.

Gross premiums overall increased by $62.1 million year on year, and property retro premiums increased by $65.3 million. We wrote a total of $91.2 million for property retro alone, of which just under one-third which didn't qualify for the (inaudible) and sidecar which (retained) for our own balance sheet with the remainder qualifying. So $54 million of our CD premium for the quarter was entirely due to Accordion (session).

We also had around $(9.5) million in reinstatement premiums following the Costa Concordia loss, plus a few million dollars in opportunistic ILW purchases. Those three factors are the principal drivers of our increased reinsurance spend this quarter compared to 2011. So with increased gross written and increased ceded on a net and an earned basis, we're clearly in line with the prior year for First Quarter.

Accordion has obviously had a significant impact on the gross and ceded numbers, and we've been pretty pleased with the vehicle so far. It's given us good access to business and allowed us to optimize our own portfolio without overloading our risk profile. We've been able to access business we would have put on our own balance sheet anyway, just a larger share of it, with scale allowing us to drive best price and leveraging the sidecar, punching above our weight.

We also receive an overrider, an investment return, and hopefully, ultimately, a profit commission on this business. In the First Quarter, Accordion contributed a little under 0.5% to our ROE.

Just a quick word on acquisition costs. Our ratio probably looks a bit high this quarter. Although it may appear indicative of an underlying trend, that really isn't the case. Q4 2011 was impacted by profit commissions and year-end premium adjustments plus reinstatement premiums. Q1 2012 has been impacted by the Costa Concordia reinstatement premium. Ignoring reinstatement premiums, Q1 2012 would have been 19.8% versus Q1 2011 of 18.3%.

There are many subsidized premium adjustments that routinely happen on a risk attaching business. On losses, Q1 2011 reflected the Japanese and Gryphon losses, but otherwise low reported losses, offset somewhat by the releases from the independent reserve study we had conducted.

For Q1 2012, other than Costa Concordia, we've again had low attritional losses for the quarter, albeit not as low as 2011. There's been a handful of (headline) marine losses in the quarter. We do also have some marine and energy ILWs which would be triggered if the Costa Concordia loss is in excess of $1 billion. We don't believe it's there yet, but nothing is (booked), but we're keeping a watchful eye on that.

Lastly, we reserved about $12 million for the US tornado activity, and prior-year reserve releases were a little higher than we might have expected at $20.6 million. No real story there, simply better loss aversions than expected. There hasn't been any significant movement in any of our cat reserves, and we're still carrying some (precautionary) reserves on our ILWs in relation to Gryphon.

On investments we benefited through our credit and emerging market holdings from the spread tightening in the quarter. But as mentioned last year, we're really looking to minimize the impact of any market shocks to our portfolio and have positioned it accordingly.

We are pleased we've made the positive return of 1.1% in this quarter and realize that it's probably a good way behind a lot of our peers, but we're okay with that. It's about taking the volatility out of the portfolio as much as possible at the moment. So we're keeping duration short and not venturing into any new asset classes as yet, positioning ourselves to survive (inaudible) under (inaudible) trade.

We continue to have no exposure to European peripheral sovereign debt and our full portfolio listing is again published with our quarterly results on our website.

Our G&A expense and ratio look a bit odd this quarter. We had highlighted last year there would be a one-up adjustment for national insureds and employee compensation due to the change in our tax residency to the UK. This amounted to $6.9 million or 4.9% of the G&A ratio. Without that adjustment, our G&A would have been a much more normal $17.5 million for the quarter or 12.4%.

The reinstatement premium and Costa Concordia also skewed the ratio slightly. Without this, the ratio would have been 11.6%. Assessed on our tax bill, we expect our overall bill and the change in residency to be broadly unchanged. It will just show up more in G&A and less our corporation tax charge now.

Wrapping up as usual with capital, we've expanded our property retro book at one month, increased our Japanese writing to 1-4, and expect the energy renewal season to be a good one. We have ample capacity to write the business we want to, and believe there may be further opportunities if there are more industry losses.

So as in most years, we're unlikely to consider a special dividend until after wind season. And depending on what happens this year, we'd contemplate a capital raise, be that debt or equity. (inaudible) it's way too early to tell and, as ever, any capital actions will be driven by circumstances as they unfold.

And with that, I'll hand back to the operator for any questions.

Questions And Answers

Operator

(Operator Instructions) Ben Cohen.

Q - Ben Cohen {BIO 1541726 <GO>}

Could I ask two things? Firstly, on the share of profit of associate that I think relates to Accordion, can we sort of see this as essentially your share of the underwriting profit that you get from your equity investment in what presumably was a loss free quarter for Accordion? Or is there something else going on that means we can't extrapolate from that number?

And the second thing I wanted to ask was just on the outlook for the US renewals. I guess you were suggesting maybe some disappointment about some of the pricing in the US. Would you have fairly limited expectations for growth in June and July or is that a bit too bearish?

A - Richard Brindle {BIO 1983776 <GO>}

Okay. Thanks, Ben. Elaine, why don't you talk about the Accordion piece and then, Alex, maybe talk about the US renewals?

A - Elaine Whelan {BIO 17002364 <GO>}

Sure, hi, Ben. You're exactly right, that is our pick-up, over 20% equity share in the vehicle. So if you back that out, you get kind of the $14 million or $15 million of profit in the vehicle for the quarter. So just to kind of give a bit of background on that, we are getting some questions on Accordion. So let me take a little bit more of a detailed approach to that.

Alex and I both mentioned that we've had about $74 million of premium ceded this quarter, so that's still earning through. You've got about a quarter of that obviously earned in this year. We also had some business that we (inaudible) of 16, 17 last year. Not a whole lot but a little bit, so you get a little bit extra from that as well.

If you take all that and add on let's say average 10% commissions, we've got a 4% override on that, and we're not taking in a PC yet because that's contingent on future performance. So you can get there pretty quickly through those numbers to about kind of $14 million to $15 million profit in the vehicle, and then our extra pick-up.

That will give you kind of a framework for projecting forward. It's really just about earning out the premiums unless there's any loss, and profit commissions are a good bit farther down the line.

Q - Ben Cohen {BIO 1541726 <GO>}

Okay. Thanks.

A - Alex Maloney {BIO 16314494 <GO>}

I think your view of what I said is correct. We think that -- from what we've seen so far, we don't believe that the US renewal season is going to be spectacular. And I suppose a general comment is we believe the First Quarter, including Japan, gave us more opportunity to deploy capital than the Second Quarter will. So we're not that confident that the market is going to be fantastic for the US renewal season, but it is slightly early.

Q - Ben Cohen {BIO 1541726 <GO>}

Okay. Thanks very much.

Operator

Christopher Hitchings, KBW.

Q - Christopher Hitchings {BIO 2034501 <GO>}

A couple of things. I noticed that in a sense your guidance of what you think is going to happen to the top line this year is sort of evolving with the improvement in energy and what you've achieved in Japan. Is there any reason for you to amend the guidance that NEP for this year will be flat? I mean presumably the energy business you'll write more for your own account.

And I'm not entirely sure at what -- perhaps you can explain the -- to whose account the Japanese business has been written? Secondly -- yes, you've talked about how attritional losses were higher but probably still favorable. Are you stripping out of that your tornado losses? And you also referred to a couple of marine losses of which Concordia is one. Can you just give me some details of what the other is? That would be helpful, thanks.

A - Richard Brindle {BIO 1983776 <GO>}

Yes, no problem, Chris. I guess, Alex, you'll have to be very open with Christopher about the losses, and then Elaine -- and maybe also touch on Japan (inaudible), and then Elaine maybe comment on top line for the year, please.

A - Alex Maloney {BIO 16314494 <GO>}

Obviously, Elaine will handle the detailed premiums, but what I would say to you is, Chris, that we don't really have hard premium targets just because we just seek the opportunities wherever they are. So our premiums probably do jump around more than most.

On the losses, our marine portfolio historically has been very profitable. It's been slightly unusual, actually, this quarter that we picked up two relatively large marine claims. But they are clients where we would expect to pick up such claims. Concordia is a very large cruise ship. We've always said that's a target class for Lancashire. So Concordia is absolutely what we would do.

The other claim is another client that we've known for a long time. We've underwritten that account since the inception of Lancashire. It's a quality operator. They had a total loss just offshore Saudi Arabia. Again, it's the kind of business we write. It's just slightly unusual they're both there in the First Quarter.

If you look at our marine combined ratios since inception of Lancashire, we're currently at 75% excluding G&A. We still think that's miles better than the rest of the market. So we don't think there's anything wrong with the portfolio. Equally, we don't believe that the rating levels are such that we should go out and write more marine business, but we're kind of happy with the losses, if that makes sense.

And the tornado loss, which we picked up in the First Quarter, in my script I mentioned that we did write some post-loss opportunities in the US. We did -- this claim is coming from one of those clients. It is early days; I would say it's early days on this claim, and there's quite a big number of IBNR which is making out that loss. But it is a post-loss opportunity, good pricing. That's the kind of thing Lancashire is interested in. So yes, there's nothing more to say than that really.

A - Richard Brindle {BIO 1983776 <GO>}

I decided, Chris that -- I think we said this to you before -- one thing we never do is give our underwriters, our individual underwriters, budgets. As you know, everything is written through the daily conference call. We make forecasts, of course we make forecasts, but they're just that. And frankly, if the business isn't good enough to support us writing it, then we don't write it. And there's no pressure put on our different teams of underwriters to produce a certain number for the year.

But having said that, Elaine, why don't you talk about top-line guidance for the year?

A - Elaine Whelan {BIO 17002364 <GO>}

Sure. I don't really think anything has changed, Chris, in terms of what we were talking about before. I think all that's happening is that everything is kind of shaping up the way that we thought it was going to. If you look at where we ended up last year, we did talk about some multi-year deals that we had in there last year. So we've got about $60-million-odd in there for that.

And we've had a significant increase this year in retro already. Then you wrap some energy increases into that as well. So there are some other lines we've been reducing, and you're now seeing an example there if business hasn't been quite as favorable.

So all of that wraps up to be pretty much the same as we said before. We think that we'll have a little bit of a higher top line, but we're obviously going to have less written with connections to Accordion, but on a net earned basis probably broadly in line with the prior year.

Q - Christopher Hitchings {BIO 2034501 <GO>}

Okay, fine. That's helpful because clearly I wonder will there be opportunities in energy. I mean just in the Japanese business that you've added to has been largely written for Accordion, has it?

A - Richard Brindle {BIO 1983776 <GO>}

No, not really. As you know, we've always regarded Japan as a key long-term market for us, Chris, and we like the way they do business. The relationships can take a little while to get going, but once you get relationships in place they endure for long periods of time.

The first thing we did after the earthquake was send a donation to the Japanese Red Cross and extend most of the major contracts for three months at pro rata. A lot of other markets did too, in fairness, but some refused to, which was I think crass. The Japanese massively respected that.

Don't forget at that time the 1-4 renewal, the earthquake was in March. So at the time of the renewal they were still pulling bodies out of the wreckage. It was not the time to be arguing about premium rates.

And being the very honorable sort of cedents they are, they came back at 1-7 and not only paid the rises but backdated them to 1-4. So they behaved as you would expect Japanese clients to behave. We were then invited out to Japan in November, which is a great compliment, away from the usual cattle round which is in sort of January/February, to sit down with our clients and talk about what their needs were for 1-4.

We then went back in February to have a more transactional trip, actually talking turkey, if you like. And they (read) the products that we wrote, ranged from just good old-fashioned excess and loss opportunities of earthquake and winds to some Japanese interests abroad, where there really was a (inaudible) for capacity following the Thai losses and other losses.

Then there were some pro rata opportunities in Japan, so we wrote a whole slate of business; very good renewal terms, very positive RPIs, and at the same time building strong relationships for the future. So I think that's a really strong segment of our business which you can expect to see and deal for years to come there.

Q - Christopher Hitchings {BIO 2034501 <GO>}

Excellent, thanks.

Operator

(Operator Instructions) We have no further questions at this time.

A - Richard Brindle {BIO 1983776 <GO>}

Okay, well, that's great. Thank you very much, everybody. It's half past one. Thanks for dialing in.