Q1 2015 Earnings Call

Company Participants

- Anne G. Waleski
- F. Michael Crowley
- Richard R. Whitt
- Thomas S. Gayner

Other Participants

- John D. Fox
- Mark A. Dwelle

MANAGEMENT DISCUSSION SECTION

Operator

Good morning and welcome to the Markel Corporation First Quarter 2015 Conference Call. All participants will be in listen-only mode. After today's presentation, there will be an opportunity to ask questions.

During the call today, we may make forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. They are based on current assumptions and opinions concerning a variety of known and unknown risks. Actual results may differ materially from those contained in or suggested by such forward-looking statements.

Additional information about factors that could cause actual results to differ materially from those projected in the forward-looking statements is included under the captions "Risk Factors" and "Safe Harbor and Cautionary Statement" in our most recent Annual Report on Form 10-K and Quarterly Report on Form 10-Q.

We may also discuss certain non-GAAP financial measures in the call today. You may find a reconciliation to GAAP of these measures in the press release, which can be found on our website, at www.markelcorp.com, in the Investor Information section. Please note this event is being recorded.

I would now like to turn the conference call over to Mr. Tom Gayner, President and Chief Investment Officer. Mr. Gayner, the floor is yours, sir.

Thomas S. Gayner {BIO 1896932 <GO>}

Thank you so much. Good morning and welcome to the 2015 first quarter conference call for the Markel Corporation. My name is Tom Gayner, and I'm joined as usual by Anne Waleski, Mike Crowley and Richie Whitt. Anne will brief you on the financial results, Mike and Richie will follow with some comments on our insurance operations, and then I'll finish with investment results and an update on Markel Ventures.

As always, we thank you for your interest and support of Markel and we look forward to your questions. With that, Anne?

Anne G. Waleski {BIO 16735457 <GO>}

Thank you, Tom, and good morning, everyone. I'm happy to report that we are off to a fantastic start in 2015 with our investing, underwriting, and Markel Ventures' operations all contributing to our success. While this is an exciting beginning, it's important to remember that there is a lot of year left to go.

So let's jump into our first quarter results. Our total operating revenues grew 5% to $1.3 billion in 2015 from $1.2 billion in 2014. The increase is driven by higher revenues from Markel Ventures. Other revenues, which included revenue from Markel Ventures, were up just under 40% to $260 million from $186 million last year, primarily due to our acquisition of Cottrell in July 2014.

Moving into our underwriting results, gross written premiums were $1.3 billion for the first quarter of 2015 compared to $1.4 billion in 2014, a decrease of 8%, driven by a decline within our Reinsurance segment. During 2014, we ceased writing auto reinsurance in the UK, and we also decreased our non-standard U.S. auto reinsurance business.

Foreign currency exchange rates had an unfavorable impact on the year-over-year change in gross written premiums. However, even at a constant rate of exchange, gross premium volume declined 5%. As Mike and Ritchie will discuss in more detail later, market conditions remain very competitive. Consistent with our historical practices, we will not write business when we believe prevailing market rates will not support our underwriting profit targets.

Net written premiums for the first quarter of 2015 were approximately $1 billion, down 9% from the prior year for the same reasons I just discussed. Net retention was down slightly in 2015 at 83% compared to 84% in 2014.

Earned premiums decreased 1% to $944 million for the first quarter of 2015. The decrease in 2015 was driven by the unfavorable impact of the U.S. dollar strengthening against foreign currencies. At a constant rate of exchange, earned premiums for the first quarter of 2015 increased 1% compared to the same period a year ago. During the period, we saw organic growth in several product lines within our U.S. Insurance segment.

Our consolidated combined ratio for the first quarter of 2015 was an 83% compared to a 95% a year ago. The decrease in the combined ratio was driven by a 7-point improvement in the prior accident year's loss ratio in 2015 compared to 2014. Also contributing to the decrease in the combined ratio was a 3-point improvement in the current accident year loss ratio and a 2-point improvement in the expense ratio in 2015. The improvement in the current year loss ratio was due to lower attritional losses in our U.S. Insurance and Reinsurance segments in 2015 compared to 2014. The improvement in the expense ratio is primarily due to lower general expenses in 2015 compared to 2014.

For the first quarter of 2015, prior year redundancies were $167 million compared to $107 million for the same period a year ago. The increase in prior year redundancies in 2015 was due in part to a decrease in the estimated volatility of our consolidated net loss reserves as a result of ceding a significant portion of our 1992 and prior asbestos and environmental loss reserves to a third party during the first quarter of 2015.

Due to the unique nature of asbestos and environmental exposures, the ultimate estimated value of these reserves is subject to greater uncertainty than other types of loss reserves that we hold. Once this transaction occurred, the resulting decrease in estimated volatility caused the confidence level on our consolidated net loss reserves to increase.

As you've heard us say over the years, our core principle of our reserving philosophy is to maintain a margin of safety in our loss reserves such that those reserves will prove to be more likely redundant than deficient. We apply this reserving philosophy period-over-period and monitor the actuarially determined confidence level in our reserves among other things to ensure that we apply our judgments in this area consistently.

Given these considerations, and in an attempt to maintain a level of confidence in our loss reserves within a range consistent with historic levels, we reduced prior year loss reserves during the period by $36 million, which had a 4-point favorable impact to the combined ratio. In addition to this one-time impact, we experienced more favorable prior year loss reserve development in our professional liability and workers' compensation product lines in the first quarter of 2015 than in the same period a year ago.

Now, I'll discuss the results of Markel Ventures. During the first quarter of 2015, revenues from Markel Ventures were $245 million compared to $171 million a year ago. That's a 43% increase.

Net income to shareholders from Markel Ventures for the period was just under $11 million in 2015 compared to approximately $1 million for the first quarter of 2014. EBITDA was $34 million in 2015, compared to $14 million in 2014. The increase in each of these measures during 2015 was primarily due to our acquisition of Cottrell in July 2014, and improved results within our other manufacturing operations, due in part to increased shipments in 2015 as compared to 2014.

Now, I will talk a little bit about our investment results. Investment income increased to $93 million for the first quarter of 2015 compared to $87 million last year. During 2014, we continued replace lower yielding fixed maturity corporate and mortgage-backed securities with higher yielding fixed maturity tax-exempt municipal securities as part of our effort to reposition the investment portfolio acquired through the Alterra transaction. We are seeing the benefit of that effort in the first quarter 2015.

Also, contributing to the increase is higher dividend income on our equity portfolio due to a larger equity portfolio in 2015 compared to 2014, due in part to the restructuring of the Alterra investment portfolio. Net realized investment gains for the first quarter of 2015 was $6 million compared to $17 million a year ago.

Looking at our total results for the year, our projected effective tax rate was 19% in the first quarter of 2015 compared to 25% a year ago. The decrease in the effective tax rate in 2015 was driven by foreign tax credits for foreign taxes paid. In previous periods taxes paid in foreign jurisdictions were not available for use as tax credits against our U.S. provision for income taxes. In 2015, we anticipate a sufficient amount of earnings from our foreign operations will be taxable in the U.S. This will allow us to recognize the benefit of significant foreign tax credits against our U.S. provision for income taxes. The recognition of these tax credits has a favorable impact of 8 points on our 2015 estimated annual effective tax rate. A similar benefit may not be available in future years.

We reported net income to shareholders of $191 million in the first quarter of 2015, compared to $88 million a year ago. Comprehensive income for the period was $282 million, compared to $230 million a year ago. And as a result, book value per share at the end of March 2015 was $564, an increase of 4% since the end of 2014.

I'll make a couple of final comments about cash flows and the balance sheet. Net cash provided by operating activities was $23 million for the first three months of 2015, compared to $22 million for the same period of 2014. Operating cash flow for the first quarter of 2015 included higher cash flows from our Markel Ventures operations and investing activities, offset by lower payments for income taxes and employee profit-sharing compared to the same period a year ago.

Operating cash flow for the period was net of approximately $70 million of cash paid in connection with the asbestos and environmental transaction that I previously mentioned. While we recognize that this transaction will have the short-term impact of reducing investment income, we will have eliminated the uncertainty around these exposures and increased our flexibility regarding capital allocation.

Historically, first quarter is our lowest cash generating quarter, based on the timing associated with incentive compensation payments to our associates and to our brokers. Invested assets at the holding company were $1.4 billion at the end of March 2015, as compared to $1.5 billion at the end of the year.

With that, I'll turn it over to Mike to talk about our U.S. Insurance segment.

F. Michael Crowley {BIO 6836605 <GO>}

Thanks, Anne. Good morning. As we've outlined before, the U.S. Insurance segment comprises all direct business written on our U.S. Insurance companies and includes all of the underwriting results of our Wholesale and Specialty divisions as well as certain products written by our Global Insurance team.

For the first quarter, gross written premium was up 2% over prior year. We've seen some growth in our Wholesale casualty lines and our Specialty workers' comp line. This growth has been offset by lower premium volume from architects and engineers where we have exited certain classes and our Wholesale property line where we've seen softening market conditions. The combined ratio for the quarter was 84%, compared to 96% for the same period a year ago.

In the quarter, we benefited from lower attritional losses in our binding and brokerage property lines and program business as well as more favorable prior-year takedowns due, in part, to the change in volatility which Anne just discussed.

In our core product lines, we also saw favorable development of prior-year losses in our professional liability and workers' compensation books. Additionally, the expense ratio was better due to lower general expenses in quarter one compared to last year.

Operationally, Britt Glisson is fully engaged in his new position as President of Markel Global, our large account business. We recently returned from the RIMS conference in New Orleans where our senior global underwriters had the opportunity to engage with a number of clients, brokers and prospects. And we continue to believe that under better market conditions, we have the talent and products to grow this business.

Matt Parker assumed the position of President of Markel Specialty April 1, taking over from Greg Thompson, who is focusing his efforts on finding new program opportunities for Markel. I'm very confident in Matt's ability to lead this division. Chad Bertucci replaced Matt in the leadership role at FirstComp, and is well prepared to continue that progress having served in a number of different capacities at FirstComp over the last few years.

Market conditions throughout the U.S. segment remain largely unchanged from the fourth quarter of 2014. We continue to generate modest rate increases on our smaller DNS and Specialty counts. The market is considerably tougher for the larger, more complex risks underwritten by our Global division.

Brian Sanders and his team in our Wholesale division are focused on three key issues: maintaining our relationships with our key wholesalers, continuing to communicate our underwriting appetite to these wholesalers, and improving efficiency in our backroom process. We held our binding and brokerage council meeting early in the quarter, and the feedback from our wholesale partners remains very positive.

Gerry Albanese and our product line leadership initiated several changes to their structure to better align with certain segments of our business. The public entity team transferred to the Global Reinsurance division and the senior living team transferred to the Global Insurance division. We also added talent to our environmental and binding teams.

All of the units in the U.S. segment are currently reviewing their profiles, objectives and priorities, making sure that their goals remain in line with our longer term objectives. Our North American platform is solid and we look forward to the rest of the year.

I'll now turn the call over to Richie.

Richard R. Whitt {BIO 7084125 <GO>}

Thanks, Mike, and good morning, everybody. Today, I'll focus my comments on the underwriting results for the first quarter of 2015 for both our International Insurance and Reinsurance segments.

As Anne said, 2015 is off to a fantastic start. However, we all need to keep in mind one quarter does not make a year and we all know there's a long way to go and a lot of hard work ahead of us.

The International Insurance segment, which includes business written by our Markel International division as well as that written by our Global Insurance division, had a great first quarter. Gross written premiums in the International Insurance segment did decrease slightly by 2% to $289 million. However, the combined ratio was 73% compared to 91% in the prior year.

The decrease in premium writings is primarily due to the impacts of the strengthening U.S. dollar. Excluding currency impacts, gross written premium volume actually increased 4% due to increased volume in our professional liability product lines, partially offset by decreases in our marine and energy product lines.

The lower segment combined ratio was driven by more favorable prior accident year reserve takedowns and a lower current accident year loss ratio, partially offset by higher expense ratio. The decrease in the current accident year loss ratio was primarily driven by the non-claims development and lower attritional loss ratios across a number of lines within our Markel International division.

This segment included approximately 8 points of favorable prior accident years movement related to the change in estimated volatility on our loss reserves that Anne discussed earlier. We also experienced favorable prior years development across our Global Insurance division, which reported adverse development last year. The expense ratio for this segment increased slightly due to higher general expenses.

On the subject of volatility, it's worth pointing out that at least two types of volatility impact our underwriting results: business mix and reserve volatility. While they're closely related, they are different. We have discussed reserve volatility in great detail this quarter due to the movement in prior year reserves. Equally important, however, is the impact of business mix.

With the acquisition of Alterra, which just celebrated its two-year anniversary a week or so ago, we added Global Insurance and Reinsurance divisions. The addition of these divisions changed our business mix, adding larger excess limit Fortune 1000 business with Global Insurance and additional catastrophe exposure and larger limits with Global Reinsurance. This change in business mix contributes to additional volatility in our underwriting results as demonstrated this quarter.

Now I'd like to discuss the results of the Reinsurance segment, which includes treaty reinsurance programs written by our Global Reinsurance division, as well as that written by our Markel International division.

Gross premiums written during the quarter for this segment decreased to $378 million for 2015 from $490 million a year ago. Anne mentioned that the decrease in writings was driven by underwriting decisions to cease writing U.K. motor business and significantly reduced our writings of U.S. non-standard auto book business.

The combined ratio for the Reinsurance segment was 89% compared to 94% last year. Reduction in the combined ratio was driven by a lower current accident year loss ratio driven by lower property losses in the first quarter of this year compared to last year.

Finally, I'll touch on competition. As Mike and Anne both said, the market remains competitive. In the Reinsurance segment we saw pressure on terms and rates during the January 1 renewal process. As the years move forward, while still extremely competitive, it does appear that the decrease in rates and terms has slowed to some extent.

We certainly believe there is very little left to give in reinsurance terms or rates, and it would appear that at least a few of our competitors feel the same way and are pushing back against additional decreases.

In our International Insurance segment, we continue to experience rate pressure, with property and marine and energy being the most impacted. I don't see much in the way of change in the environment over the last quarter.

In summary, and we've stated it many times, we're not going to chase premium when we feel that rates are inadequate. We continue to reinforce this message with our underwriting teams as is reflected in our first quarter's gross written premium numbers.

Now, I'd like to turn it over to Tom. Thank you very much.

Thomas S. Gayner {BIO 1896932 <GO>}

Thank you, Richie. I'm going to try to set a record of brevity this morning in my investment and Markel Ventures comments. My colleagues in the room are placing bets as we speak. In short, we are earning positive and productive returns on our investment in Markel Ventures operations. I'm optimistic that we can continue to do so, even in the face of the tectonic force of low interest rates.

More importantly, our short duration fixed income portfolio, our percentage of equity capital invested in equities, and our range of possibilities that we can pursue in Markel Ventures and in our ongoing profitable insurance operations with the cash flow that they produce gives us great flexibility and many options as conditions and circumstances change.

I'm highly confident that we will see change and most of us will be surprised by the nature and speed of whatever comes our way. I also think it's fair to say that we are in a better position than many to take advantage of dynamic markets rather than just suffer blows.

As to the current numbers, so far in 2015, we're continuing to see the trends that have been in place for the last several years. We've earned reasonable returns from our equity investing activities with a return of 2.3% in the first quarter. In our fixed income operations we earned 1.6% in the ongoing low interest rate environment and that we kept the duration at just over four years.

The total portfolio have earned 1.7% in local currency terms, but only 0.5% after currency effects from the higher U.S. dollar. That currency drag on investment results is largely offset by the fact that we remain largely hedged in foreign currencies for our insurance reserves. As such, the dollar value of insurance liabilities diminishes by a similar amount. FX effects have been and remain largely neutral in our insurance operations. Those are the numbers and the facts.

The game plan going forward on the investment side is as follows. And most of you will recognize these comments from previous quarters and years. A: We will continue to steadily and methodically increase our equity portfolio as we find suitable ideas. We will continue to come to work every day and sort and sift through our universe of opportunities to deploy capital in insurance, investing and Markel Ventures opportunities.

B: We will continue to let the duration of our fixed income portfolio be less than our estimate of the duration of our insurance liabilities, given the low level of interest rates. We simply don't think we're being paid appropriately to take the risk of higher rates. Also, the opportunity costs of holding the shorter duration portfolio remain minor since it's more of a yield line than a yield curve out there.

C: We will continue to focus our fixed income holdings at the high end of the credit quality universe. Again, we just don't think we're getting paid to take on more risk. So we will not do so.

Finally, I'm sure that if we were really smart and clever, we could find some alternative investment approach that would increase the yield on our short-term portfolio from essentially nothing to something more than that. We're not that clever or smart, so we won't try to perform that sort of alchemy. We've seen enough of those experiments end badly to dissuade us from going down that path.

As to Markel Ventures, we've got some unabashed good news. Our business has enjoyed a record quarter of profitability. Revenues grew 43% from $171 million to $245 million and

EBITDA grew 136% from $14.2 million to $33.6 million. Our manufacturing operations, in particular, performed quite well.

While several of our companies are cyclical and will have volatile results during an economic cycle, I can report to you that business is good right now and order books look encouraging as well.

Given the overall pricing environment for new acquisitions, we're finding it tough to find new businesses to add to Markel Ventures at the moment. We are pleased with our organic growth, though, and we're focused on running what we already have. We act in the same disciplined fashion all around Markel, whether you're talking about insurance underwriting, equity or fixed income investing, or within any corner of Markel Ventures.

The good news for all of us as shareholders is that that approach continues to serve us well and I expect it will continue to do so in the future. I think that we are in a relatively unique position where we can continue to earn positive returns in the current environment and we have a wide range of flexibility and options as the environment inevitably changes. That is the long-term story of Markel and it continues to be the case.

With that, we look forward to answering your questions.

Q&A

Operator

Thank you, sir. The first question we have comes from John Fox of Fenimore Asset Management. Please go ahead.

Q - John D. Fox {BIO 1796608 <GO>}

Yeah, hi. Good morning, everyone. I have two questions. First one is on the reserve releases, which over the last two quarters have been over $300 million. And I imagine you could have started that process, instead of the fourth quarter last year, the second quarter last year or maybe the second quarter of this year. And I understand there's always a margin of safety in the reserves. But other than the expense of this transaction, what's been the catalyst or the reason why you feel comfortable taking the size of reserve releases that you have taken in the last two quarters? Did something change? Did you just feel you got to your margin of safety level or is there some other catalyst? And then I have another question. Thank you.

A - Anne G. Waleski {BIO 16735457 <GO>}

Good morning, John. I don't think anything has changed. I think, overall, the experience that we have seen in the loss reserves has been positive. I do think we have a tendency to wait until the second half of the year to look real hard, as we have historically, at A&E or different things.

But I don't think anything in the process or our approach has changed at all recently or over the long term, nor do I think it will. I think we have seen the Alterra portfolio experience be maybe better than we expected on day one, but we are still being cautious in that space. So I understand that the reserve takedowns have been significant, but I don't think there's anything different happening here.

A - Richard R. Whitt {BIO 7084125 <GO>}

John, Richie. I'll just add to that. I talked about volatility. And as an example, in our Global Insurance division, last year we had prior year development. This year, we had prior year redundancies. And it sort of gets back to that business is – it's excess limit, large limit business and it's just simply more volatile. So that was just a complete turnaround year-to-year and one of the drivers.

Q - John D. Fox {BIO 1796608 <GO>}

Okay. And Richie, my second question is on Reinsurance. Should we expect to see the magnitude of decline in gross written that we saw this quarter, which I applaud if you're not getting the adequate rate? So should we think about that line being down 20% year-over-year or something of that nature?

A - Richard R. Whitt {BIO 7084125 <GO>}

You know, it's a little hard to say. I mean we're going to have to see how the rest of the year goes, John. We made two pretty fundamental decisions over the last number of months in terms of exiting U.K. motor and significantly reducing U.S. non-standard, simply because we couldn't make – we didn't think we could make money in either of them the way we needed to. We're going to look at every contract that comes up on its own merits. Those were, obviously, two pretty big items, and we'll just have to see how the rest of the year goes.

Q - John D. Fox {BIO 1796608 <GO>}

Okay. Thank you for the terrific results.

A - Richard R. Whitt {BIO 7084125 <GO>}

Thank you.

Operator

Next we have Mark Dwelle of RBC Capital Markets.

Q - Mark A. Dwelle {BIO 4211726 <GO>}

Yeah. Good morning. A couple of questions. Dwelling on that last one, the U.K. motor book that you had exited at the end of last year, is that a quota share book or an excess book, which is to say, is it something that's going to affect all of the forward quarters of this year or is it something that's kind of won and done?

A - Richard R. Whitt {BIO 7084125 <GO>}

Mark, it's mostly renewed January 1. There are some renewals throughout the year, but a big renewal date on that business is January 1. It is excess loss business, it's not a quota share business.

Q - Mark A. Dwelle {BIO 4211726 <GO>}

Okay. Thank you. The second question relates to the tax rate. Anne, I think you kind of described how it works. Is it right or at least reasonable to assume that 19% is going to be the run rate for this year, unless something changes otherwise? I know you true it up later in the year, but as a starting point is that where we should begin thinking?

A - Anne G. Waleski {BIO 16735457 <GO>}

That's what our expectation is and we'll true it up each quarter, but you're right.

Q - Mark A. Dwelle {BIO 4211726 <GO>}

Okay. And then finally on the asbestos retrocession transaction, what portion of overall asbestos reserves were transferred? And I guess, if it's not 100%, why not 100%?

A - Anne G. Waleski {BIO 16735457 <GO>}

Well, it was about 35%.

A - Richard R. Whitt {BIO 7084125 <GO>}

Yeah. It was Mark, as Anne said, 35%. The reason for the third is this would be all of the asbestos in environmental reserves that resided in our U.K. insurance company, Markel International Insurance Company. And what it really does is it cleans up and removes all of that asbestos in environmental, and in fact all 1992 and prior exposures from that balance sheet. It was just an opportunity to – we've been working for 15 years to sort of clean up the legacy that we purchased with Terra Nova, and this is the culmination, if you will, of those efforts. And the guys over there did an absolutely fantastic job cleaning that up.

Q - Mark A. Dwelle {BIO 4211726 <GO>}

Okay. But you didn't really – this was just opportunistic with respect to that book. Did you consider getting rid of the U.S. portion as well, or that just wasn't really what was on the table?

A - Richard R. Whitt {BIO 7084125 <GO>}

That wasn't what was on the table at the time. I mean we've been running that book, that legacy position down for a long time over there and it was an opportunity to complete it, if you will. In the U.S., I mean we've certainly – I mean obviously, we look at it all the time to decide whether you're better off running it off or you're better off letting someone else run it off. But we're perfectly comfortable keeping the rest of it.

Q - Mark A. Dwelle {BIO 4211726 <GO>}

Okay. Thanks. That's all my questions.

Operator

At this time, we're showing no further questions. We'll go ahead and conclude today's question-and-answer session. I would now like to turn the conference back over to Mr. Tom Gayner, President and Chief Investment Officer, for any closing remarks. Sir?

A - Thomas S. Gayner {BIO 1896932 <GO>}

Thank you very much for joining us and we look forward to catching up next quarter. Take care.

Operator

And we thank you, sir, and to the rest of the management team for your time also today. Again, the conference call has concluded. At this time, you may disconnect your lines. Thank you and have a great day, everyone.