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Q1 2017 Earnings Call

Company Participants

- Alexander Maloney, Group Chief Executive Officer & Executive Director
- Elaine Whelan, Group Chief Financial Officer and Chief Executive Officer, Lancashire Insurance Company Limited
- Paul Gregory, Group Chief Underwriting Officer & Chief Executive Officer-Lancashire Insurance Company (UK) Limted

Other Participants

- Andreas Evert Cornelis van Embden, Analyst
- Anna Hui, Analyst
- Ben Cohen, Analyst
- Nick Johnson, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day, and welcome to the Lancashire Holdings Limited First Quarter 2017 Results Conference Call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Alex Maloney, Group CEO. Please go ahead, sir.

Alexander Maloney {BIO 16314494 <GO>}

Okay. Thank you, everyone. Thanks for dialing in. Today, we have Elaine Whelan, our group CFO; Paul Gregory, our group CUO; Denise O'Donoghue, who is our Head of Investments and Treasury; and Darren Redhead, the CEO of Kinesis. I'm pleased to report a strong set of results for the first quarter, where our underwriting investment strategies continued to add value for our shareholders. With return on equity of 2.7% and a combined ratio of 85.6%, we continue to maintain a healthy underwriting result in a quarter which has seen some attrition. The losses which we have suffered this quarter are all within management's expectations, so nothing out of the ordinary. But as we have said many times, a quarter can be bumpy dependent on the timing of claims.

We have written less premium than in the first quarter of 2016 as we have had a number of one-off premiums emulating from our (01:18) class, which is generally non-renewing, and some non-standard annual policies which skewed the numbers. But when they are just stripped out, comparable income is in line with our expectations. But Elaine will give more details later.

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Our investment portfolio has performed modestly better than we expected for the quarter, generating a 0.7% return. So overall, we're happy with our result for this quarter, and we are in line with where we still will be at the start of 2017.

The underwriting climate remains difficult, but we're finally starting to see things change. We have seen the slowing of rate reductions across a number of classes of business as the realization that there is little margin for further reductions finally (02:04). This is by no means a hardening of the market, but one of the early signs that the cracks are repairing. Within the broader insurance market, we have seen a number of people losing their jobs as tough decisions have been made on classes of business that make little economic sense. These actions are a sad reality, where we are in the cycle, but equally, a fair reflection of the lack of profitability across many classes of business after years of rate reductions driven by over capacity.

I expect this process to continue until underwriting margins become more favorable as our industry gets to grips with thin margins and issues of expense. Indeed, a lot of the recent M&A activity in my view has been expense synergy driven. We welcome our CEO of Cathedral, Andrew McKee, to our business in June. Andrew is one of the final senior recruits to join Cathedral after a period of considerable operational upgrade.

I'm delighted at how Cathedral continues to perform as one of the upper quartile syndicates in Lloyd's in very difficult trading conditions. Kinesis has grown modestly this year in assets under management and also in the number of investors we have. I take confident in the fact that Kinesis continues to underwrite only the deals which clear its hurdles.

Again, as we have said many times, we don't just deploy capital for fees, we are more interested in being good custodians of capital today to benefit from these opportunities, which may arise post inevitable cat loss in the future, whenever that occurs.

So to summarize, we are finally seeing the cracks repairing after years of rate reductions, over capacity of insurance capital, and little loss activity. This will not in itself materially change the outlook, but we still believe that once enough capital is impaired, things will change. Until that day, we will continue to stick to our path, and we will focus closely on producing sensible risk adjusted returns for our shareholders and capital providers across Lancashire, Cathedral and Kinesis. I'll now hand over to Paul.

Paul Gregory {BIO 16314515 <GO>}

Thanks, Alex. Despite a few mid-size losses in the quarter, I'm pleased to report that the group has produced a respectable combined ratio of 85.6%. We've been very happy with our start for the year across all the underwriting teams within the group. The renewals at 1/1 were broadly in line with expectation, both in terms of market conditions and retaining the business we want to do. Across most product lines, rating reductions are now in the single digits, showing that the market is slowing, but where the directions travel is yet to change in our favor.

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This trend continued at 1/4. The Japanese property cat renewals were very orderly, and we maintained our positions with all our core clients. In the Lancashire platforms, there were some non-annual multi-year impacted premiums this quarter that Elaine will explain in more detail. We're also likely to (05:02) more of this in the second quarter, which is non-annual contracts renewing later in the year. The energy market continues to be a tricky place to operate. Pace of change has certainly slowed even as the environment remains very competitive. It's certainly much too early to be optimistic about the energy market improving, but with a stable oil price and a (05:22) customer base, it's better positioned to contemplate future development plans, which could help future demands.

Thus far, we're very happy with how the energy team have weathered the storm over the past two years so that we're very well positioned to make the most of any future opportunities. Cathedral property treaty and D&F lines successfully renewed the business they wanted to during Q1, with premium year-on-year across the two lines only down by about 6.5%, which is broadly in line with rate reduction. Across the rest of the Cathedral business, premiums reduced in line with rates, and we also shared exposures in lines such as Aviation, Marine and Energy as we continue to employ underwriting discipline. There is also no premium in respect to the contingency following our decision to exit this class. As Alex had said, Kinesis had a successful renewal season at 1/1, with assets under management marginally increasing year-on-year, as well as further diversifying both the client and investor base. Our philosophy for Kinesis remains unchanged. If we can deploy funds that won't provide the required returns for our investors, then we'll do so. But if we cannot, we won't. It was pleasing to be able to grow Kinesis slightly, and diversifying both the investor and client base built upon the solid foundations already laid in order to expand Kinesis when the opportunity allows.

Across all the underwriting platforms, our underwriters have continued to execute the strategy set out to manage and navigate this soft market cycle. As I mentioned last quarter, we successfully renewed the vast majority of our reinsurance protections at 1/1, and we're able to purchase broader and deeper coverage, bringing risk levels down, which gives us more capital headroom than we would typically invest (07:02) to carry.

Hopefully, there will be some improvement in market conditions so we can put this capital to work via underwriting. But if the market's not improved, then post wind season, we can review our capital need and take the appropriate actions.

I'll now pass over to Elaine.

Elaine Whelan {BIO 17002364 <GO>}

Thanks, Paul. Hi, everyone. Our results are on our website as usual. Our ROE of 2.7% for the quarter reflects decent results in the current environment. We had a reduction in our net premiums earned this quarter, which is partly due to general market conditions, some exposure reductions in our Energy and Aviation books. There's also an impact from the timing of our reinsured renewals as we renewed some coverage earlier in the year. We had a few losses reported in the quarter, which have led to a slight uptick in our accident year loss ratio, although nothing was of any great significance.

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We continue to see, overall, a favorable development on our prior accident years. With a loss ratio of 37.7% and a combined ratio of 85.6% for the quarter, our underwriting performance continues to be steady. Our investment portfolio performed well through another rate hike, which is a return of 0.7%. At both Lancashire and Cathedral, as Paul has said, we maintained our core books through the 1/1 renewals. Our top line reduction, as mentioned, due to some exposure reductions in our Energy and Aviation books, some general pricing impacts from the Cathedral books, but mostly the impact of the timing of multi-year deal renewals. That impact is most notable in (08:30) that tends to be really lumpy.

We continued to see a good flow of new business on that book just less than in Q1 last year. As we previously said, we do expect pricing pressure to continue in 2017, and (08:48) top line to come off a bit. However, our 1/4 property cat renewals held out well with only a small reduction and exposure on our Japanese book. Our Energy offshore renewals were lower mainly due to the tightening of renewal of non-annual policies.

Our city (09:03) premium is higher than Q1 last year due to renewing our group umbrella cover in January this year versus June last year. (09:11) anticipate our full year spend to be in line with last year, otherwise, we've again been able to see the advantage of further price savings replacing our main program and expanding some of our cover. Our acquisition cost ratio is in line with where we expect to be for the current business mix and reinsurance program we have. Our losses, as I mentioned, we've had a few losses reported this quarter, which elevated our loss ratio. None of these claims are significant individually, and in total, they're less than 10% of our loss ratio. That has our pure attritional loss ratio running a little higher than the mid-30s, but that's the nature of the book we write and is not indicative of an underlying trend. I would still view our attritional loss ratio in the mid-30s. We also had a 2016 accident year energy claim drifting to this quarter. It has a favorable development on other claims, most of all, general IBNR releases due to lack of reported claims coming due. Overall, we had net favorable development on prior accident years of $10.6 million for the quarter.

Investments returned 0.7% for the quarter. Although all of our asset classes had a positive contribution to the return, most of the return comes from our fixed maturity portfolio. The market was really prepared for the Fed rate increase, and the increase in yields in the quarter was offset by narrowing credits spreads. We're continuing to reposition our hedge fund portfolio, but otherwise, we're happy with the diversification we have in our portfolio under current duration positioning. The increase in other income this quarter is due to the tightening of profit commission recognition for Kinesis.

In Q1 last year, some collateral for the 1/1/15 underwriting cycle has been released, which pushed the recognition of PC out to later in the year. In Q1 2017, most of the profit from the 1/1/16 underwriting cycle has been released, and therefore, we've been able to recognize most of the PC. The earnings contribution from the underwriting fees is broadly in line with last year, and we see most of that coming through in the next couple of quarters. As there are no losses on the 1/1/17 underwriting cycle, profit commissions could be about $6.5 million, but the earliest we will receive that would be Q1 2018.

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And the reduction in our G&A this quarter are primarily due to additional (11:27) recorded in Q1 2016 due to Cathedral exec departures. Continued benefits deduction is down and was offset by (11:35) as an additional expenses in relation to the Kinesis renewals. And reduction in the stock compensation charge are reflected from adjustments to (11:46) and performance assumptions, they're also entirely due to awards lapsing due to the departures of Cathedral employees.

We had a small gain this quarter on the mark-to-market of purchase rates (11:57), both yields grew slightly. Ignoring the soft mark-to-market and any one-off costs, our financing cost will tend to be around $4 million (12:05). Lastly, on capital, we said last quarter that the target here of $1.3 billion to $1.5 billion of capital (12:10) is well within the expected rate.

We are clearly carrying a bit more than that at the moment, and we'll keep that through the coming wind season. Once we see what wind season brings us this year, we'll adjust that capital balance in November. With that, I'll now hand over to the operator for questions.

Q&A

Operator

Thank you. And we can now take our first question from Nick Johnson from Numis Securities. Please go ahead, sir.

Q - Nick Johnson {BIO 1774629 <GO>}

Good afternoon. Just one question. Also another quarter of price decreases. Just wondered whether there are any segments where the economics are becoming really marginal and might be unsustainable. Obviously, you've exited some segments in the past. I just wondered whether any others might be on the watch list. Thanks.

A - Alexander Maloney {BIO 16314494 <GO>}

I think it's a good question, Nick. I mean, clearly, margins are tight across all classes, it's something we clearly look at all the time. I think that we would believe that our loss ratios are better than the market average, and that's why we can still convince ourselves that the lines of business we have make sense. I think the only exception to that, and, PG, correct me if I'm wrong, is the – when we pulled out of the contingency class last year, I mean, that wasn't a huge book for us, that was in our Cathedral business, but we just couldn't satisfy ourselves that there was an opportunity to make money in the future. So we look at those things closely, and I think as a broader comment, you are seeing that across the piece (14:04) now. People are looking at classes of business that they haven't looked at for a number of years. I think people are finally getting to grips with the realization that some of these product lines do not make money, and they can't continue to lose money. So that's something we see every day now, which is a big change we've seen. But I think from where we are today, with the classes of business we have, we still believe that we can make sufficient return across the cycle for the product lines that we currently underwrite.

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A - Paul Gregory {BIO 16314515 <GO>}

Yeah. I mean, it's certainly something, particularly at this stage of the cycle, that we look at all the time. We look at every line of business quite regularly, and take a view on the sustainability of those lines is something we do all the time. And as you said and as Alex mentioned there, we have a history of if we don't think line's going to be profitable, then we will take decisions, and that with contingency, as Alex mentioned, and not that long ago in satellite in the Lancashire platform.

So we're broadly prepared to make those decisions, but as Alex said, at the moment, we continue to outperform in most of our major classes of business, so we're happy with the lines we've got at the moment.

Q - Nick Johnson {BIO 1774629 <GO>}

Okay. Thanks very much.

A - Paul Gregory {BIO 16314515 <GO>}

Thanks, Nick.

Operator

And we can now take our next question from Ben Cohen from Canaccord. Please go ahead.

Q - Ben Cohen {BIO 1541726 <GO>}

Oh, hi, guys. Thanks very much. I just wanted to ask on the net earned premium, if you could be a bit more explicit – excuse me – about the outlook for the rest of the year. I think you mentioned that you've pulled out of some areas, but the decline in the first quarter, I guess, is about 15%. So that seems maybe quite steep.

But if you could tell a bit more about that. And then secondly, how should we think about the decline in earned premium or in the top line with regards to what your capital requirements might be going forward once we get through the hurricane season? Would it be reasonable to assume that it – that they would come down in line with the retained premium? Thanks.

A - Alexander Maloney {BIO 16314494 <GO>}

Elaine?

A - Elaine Whelan {BIO 17002364 <GO>}

Yeah. Hi, Ben. It's Elaine. We don't typically give very much guidance in terms of premium, which you know, but we do expect there to be a bit of an impact in terms of top line and from multi-years this year. It's not as big as it would have been back in kind of 2014, 2015, we're talking kind of $30 million, $35 million, maybe $40 million now, and that won't (16:42) sort of completely to net earned.

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But there will be a little bit of an impact as some of the higher volume of multi-years in the past runs off. And we are also expecting our non-multi-year, if you like, premium to come down a bit this year, just a reflection of pricing. So that (17:01) to come through and have an impact on earnings as well.

And the impact that we're getting in terms of our reinsurance is tightening really. We've renewed some stuff early in the year that we had in place at June last year. So that really (17:15) a bit more. So we are expecting top line to be lower, we are expecting the earned premium to be lower, but that's as much guidance that we're able to give at the moment.

And in terms of capital requirements, we've been saying $1.3 billion to $1.35 billion. We're probably at the lower end of that in terms of our capital expectations. We've been focusing on core book for a while now. I don't see anything changing there in terms of the focus on core book. So any capital impact would just be a function of pricing and exposure.

Q - Ben Cohen {BIO 1541726 <GO>}

Okay. Thank you very much.

Operator

And we can now take our next question from Andreas van Embden from Peel Hunt. Please go ahead.

Q - Andreas Evert Cornelis van Embden {BIO 1795530 <GO>}

Hello. Good afternoon. Just three questions from me, please. First of all, on your prior year, I think there's been some settlement in the first quarter, which were above your initial expectations. Just wondering whether there are any other large losses that came through in 2016 or 2015 that haven't settled yet and would – could lead to some reserve additions.

In terms of your reinsurance spend, I appreciate you bought forward material to do spending to Q1 from Q3 last year, and I understand that this is sort of an umbrella cover for the full year. Does this mean that at the 1/6/17 renewals, you won't be purchasing any further cover ahead of the wind season? Or do you expect to change your risk profile at 1/6/17 ahead of Q3? And my final question is on the energy market. Yeah, what are your expectations for renewals in Q2? Is there any sort of light at the end of the tunnel? Thanks.

A - Alexander Maloney {BIO 16314494 <GO>}

Okay. We'll go to PG for questions two and three, and then we'll come back to Elaine.

A - Paul Gregory {BIO 16314515 <GO>}

Yeah. Hi, Andreas. Yeah, on the reinsurance spend, you're right, we did – we purchased something mid-year last year. I think it actually just went into Q2. And we renewed that for

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the full-year at the beginning of January. This year, as we sit here today, I wouldn't expect to buy anything additional on the reinsurance side. Our appetite in terms of inwards business at 1/6/17, assuming the market remains as it is, remains pretty static, as Elaine just referred to, we're looking to renew our core book. But what I would also say is that we always look, as we walk into wind season, if there are any opportunities in terms of reinsurance buying that makes sense. So, we'll always review it, but at the moment, our plan would be stick with what we've got. In terms of the energy market, I don't think we're at the point where we can say there's light at end of the tunnel. But I would say as the prices changed, it certainly flowed up quite a lot through 2017 versus 2016. So, you are still seeing rate reductions, but they are a lot smaller than they were last year. But obviously, there is a lot less premium in the market, which we've talked about a number of times.

The one thing I would say that's a slight light at the end of the tunnel is I think our clients have found their feet, they've adjusted to the oil price change, and they're now set up to be stable. And we've just started to see a few clients look at mothballing a few - a few projects that were mothballed coming back online. It's very early days, but obviously, that would be good for demand. But in terms of market dynamics, until there's some capacity that comes out of the energy market (21:00) then it's still going to be a competitive marketplace. It's certainly a lot steadier than it was. It's just not moving in the right direction just yet, but steady is better than the carnage that we witnessed over the past two years.

Q - Andreas Evert Cornelis van Embden {BIO 1795530 <GO>}

All right. Thanks.

A - Elaine Whelan {BIO 17002364 <GO>}

And on the claims side of things, it was not just settlement, it was a claim that got reported in this quarter. So it's an energy claim that happened late last year. It's nothing really particularly unusual. And for something like that to take several months to come through, that's quite common. It's just a little bit above our attritional levels, so that's (21:40). In terms of whether there's anything else that can come through, we do have some balances on our over years (21:46), you can see those in our supplement. We've got some old political risk claims, energy claims and cat claims on there. There's always a chance that something can develop adversely, and we do talk about that every quarter. Our hope is that we've got a good reserve on there. And we'll see some favorable developments, but sometimes things go the other way. We do take a long, hard look at those every quarter in our reserve committee and decide what we think we need to reserve on those books. And hopefully, it's all good there, but things can go against us.

Q - Andreas Evert Cornelis van Embden {BIO 1795530 <GO>}

All right. Thank you.

Operator

We can now take our next question from Anna Hui from RBC. Please go ahead.

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Q - Anna Hui {BIO 19762795 <GO>}

Hello. Just one question on Kinesis. Can you give an indication of what level of property commission we can expect through the rest of the year or have you taken it all now? Thank you.

A - Elaine Whelan {BIO 17002364 <GO>}

We've taken most of that. There might be a little bit more that comes through over the rest of this year. If you look at the property commission that we have for last year, I think that should give you a kind of fairly good idea of the indication of the overall level. But – and the vast majority of the collateral is released on this – the 1/1/16 underwriting year. So, that's kind of done, and there will hopefully be something coming due on the 1/7/16 underwriting cycle, but it's a much smaller capital raise. There's much less than (23:10) so it won't be very much.

Q - Anna Hui {BIO 19762795 <GO>}

Okay. Thank you.

Operator

We have no further question from the line at this time. So, I'd now like to turn the call back to our host for any additional remarks.

A - Alexander Maloney {BIO 16314494 <GO>}

Okay. Thank you for your questions and we'll talk to you next quarter.

Operator

Thank you. That concludes today's conference call. Thank you for your participation. Ladies and gentlemen, you may now disconnect.

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