Q1 2015 Earnings Call

Company Participants

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

Other Participants

- Ben Cohen, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Greetings, and welcome to the Lancashire Holdings Limited First Quarter 2015 Results and Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. As a reminder, this conference is being recorded.

I would now like to turn the conference over to Mr. Alex Maloney, Chief Executive Officer. Thank you, Mr. Maloney. You may now begin.

Alexander Maloney {BIO 16314494 <GO>}

Okay, thank you. Good morning, good afternoon, ladies and gents. Today, we have myself presenting. We have Paul Gregory, easy for me to say, our CUO; Elaine Whelan, our CFO. We have Peter Scales, CEO of Cathedral; Darren Redhead, CEO of Kinesis; and Denise O'Donoghue, who's our Chief Investment Officer.

I'm delighted to report we grew fully converted book value per share by 3.3% (sic) [2.3%] (01:04) for the first quarter, with an excellent combined ratio of 72%. Excluding the dilutive effects of the warrant exercises, the growth in fully converted book value per share is 4.3%, which again demonstrates the quality of Lancashire's underwriting, weight of specialty insurance business, and our ability to trade through this stage of the cycle. So, I'm happy we continue to demonstrate the strength of the Lancashire Group in what are the most competitive trading conditions that we have seen in a decade.

I think that underwriters tend to forget that our business is cyclical, and in our opinion will always be, so we just have to deal with the current environment until things improve. There is no point spending all your efforts complaining about it.

Others in the market will amend their strategy to try either underwrite their way out of it or innovate into new products. We will not. All we focus on is being the very best underwriters we can be with relentless risk selection and adjusting the risk we are carrying versus the opportunity we see.

The change in the market is rapid, probably quicker than any of us have seen before, but the fundamentals remain the same. You have to add value to survive. Quality companies with established books of business with the best underwriters have the best chance to continue to provide acceptable return for their shareholders, and I'm confident we're still in the top tier of companies for our areas of expertise.

So, we will continue to be disciplined and stick to the areas where we feel we can add genuine value. We accept that we can't swim against the tide, but we can take advantage of it. And we have seen opportunities to bring our risk levels down; utilizing the best in reinsurance market we have seen in 10 years.

So, none of what I've said is earth-shattering, but we're not a company that tries to make big statements or tries to predict the future. All we really care about is trying to do the best job for our shareholders, clients, and brokers.

I'll now hand over to Paul Gregory.

Paul Gregory {BIO 16314515 <GO>}

Thanks, Alex. In today's rapidly changing and fiercely competitive market, our mantra of underwriting comes first has never been more important. With the specialty insurance lines now witnessing the same competitive pressures that the reinsurance lines have been experiencing for the past 18 months, now is the time to focus clearly on those areas that you understand and add value whilst not being afraid to make the correct underwriting decisions.

Through the first quarter, we've done exactly what we spoke of last quarter, which is to defend the high quality portfolio we're fortunate enough to have. With rates under pressure, walk away from non-core business where the margin is no longer sustainable. As you'd expect from us, if rates soften and we retract to our core portfolio, the availability of opportunistic business is less. It's this focus on profitable core business, backed up with a more comprehensive reinsurance program that we believe will carry us through the softer part of the cycle.

As Alex has already alluded to, it's those companies with the best underwriters and established books of business that are best set to weather this competitive storm whilst maintaining accessible returns to shareholders. We said before we cannot influence the market, or indeed the macroeconomic factors such as oil price, which only further heighten competition within it. What we can do is ensure we're in the top tier of markets within our specialism to continue to produce top tier underwriting results.

Once again, I'm extremely pleased with what our underwriting teams across the group had achieved. Other than a medium-sized energy loss, it was a relatively benign quarter. But nonetheless, a combined ratio of 72% is a very good result in this part of the cycle. All platforms are contributing to the underwriting profits of the group, highlighting the benefit of the diversified business we've built up over the past few years.

The build-out of 3010 has continued well, with new premium from energy, terrorism, and aviation adding to the group income. And with the swirling winds in M&A continuing, we look for any peaceful displacement (05:07) caused by this to add new talent to our bench. The decision to commit part of our portfolio on a multi-year basis in 2014 may be impacting year-on-year premium volumes, but does mean we're seeing the benefit of portions of our property cat and energy book still earning at 2014 rating.

Not only do we get the benefit of better rating, but on some parts of the book, in particular Gulf of Mexico energy, we have somewhat insulated ourselves from the impact of oil price on demand. The second quarter is a significant quarter for this sub-class, and last year a proportion of income was tied into multi-year deals, meaning the remaining plays through 2016. These contracts are usually with core partners, and as we've done every year, we'll always entertain commercial discussions, but these will only be cancels-and-replace should the terms be mutually agreeable.

Quite rightly, there's a lot of market commentary on the energy market at present. Increased capacity in the sector, combined with oil price lows, has created a perfect storm. The first time in years, capacity and values at risk are heading in different directions, creating a demand-and-supply imbalance in any market leads to inevitable competition. We cannot influence this, but as a market leader in the sector, we get to pick and choose how we mold our portfolio. This is important in a low oil price environment. Historically, losses tend to follow periods of depressed oil price, and we've already witnessed two reasonable-sized energy losses in the sector this year.

In energy, and across all our lines of business, we wholeheartedly believe that remaining focused on underwriting excellence is what will deliver superior returns. We've demonstrated it since our inception and remain committed to do so in the future.

I'll now pass over to Elaine.

Elaine Whelan {BIO 17002364 <GO>}

Thanks, Paul. Hi, everyone. Our results are on our website, as usual. We had a very good quarter, but our results are somewhat complicated by warrant exercises in the quarter, as our largest warrant holder chose to exercise his warrants on a cashless basis. In total, 17.2 million of the 18.7 million remaining warrant were exercised in the quarter. Given the cash dissolution, that has an (07:15) impact on our normal headline ROE.

ROE is 2.3%, but when we remove the impact of warrant exercised, ROE is actually 4.3%, which is a fair reflection of our actual underlying performance. The remaining 1.5 million warrants expire in December. If the holders of those also exercise on a cashless basis, there will be a further impact on our normal calculated ROE so with such a small amount remaining, that impact will be very small.

Going forward, our only dilutive instruments will be RSS awards. Our ROE of 4.3% breaks down as a 0.7% contribution from Cathedral, 0.4% from Kinesis, and the remainder from the original Lancashire platforms. With a fairly quiet quarter for losses, most of our performance comes from underwriting. Our investment portfolio also performed well, producing a return of 1% for the quarter.

Looking at our top line premiums written is a significant reduction compared to last year. If you recall, we talked last year about no-tier policies we wrote in our property cat and energy books. In the first quarter last year, we wrote $25 million of non-annual term contracts in the property cat and energy offshore books. They're not due to renew yet since the drop-off in the premiums written, but we still have the benefit of the earnings coming, too and offer stronger placing in the current market.

We also saw reductions in our terrorism and political risk books. Both of those typically have longer-term contracts and business can be lumpy. The reduction isn't indicative of any particular trend there.

Cathedral saw some reductions in some lines of business with pricing coming off and also the timing of some renewals, but that was partially offset by more (08:56) premiums in the new energy, terrorism, and the aviation lines added last year.

Our 1/4 property cat renewals held up reasonably well, but we did see further reductions in pricing, and our premiums are down compared to last year. I'd remind you that in the second quarter last year, we highlighted that over $70.5 million of energy Gulf of Mexico premiums written, about $64.5 million of that related to multi-year deals. That will obviously have a significant impact on our top line, but less than 20% of that earned last year.

We'll see about 35% of that coming through in earnings this year, and again with energy pricing under pressure, that's off a better priced business. Most of the rest we'll earn in 2016, with only a small amount deferred until 2017.

So, all in, we said last year that ignoring the lines of business that tend to be characterized but not under contracts, we wrote $120 million of multi-year deals across our property cat and energy lines. About 30% of that earned in 2014, 45% to 50% of that we'll earn this year, but the majority of the rest earning in 2016.

As we continue to see pricing pressure over the rest of the year, I'd expect Q3 and Q4 premiums to come off a bit. But with about 65% to 70% of our business written in the first half of the year, that was the smaller impact and we expect some growth in the new lines of business added to Syndicate 3010.

On the CD (10:21) side, spend this quarter is broadly in line with Q1 last year. But behind that, the original Lancashire platform spent more and bought more cover, which generally touches lower. Cathedral was able to reduce (10:33) further price reductions while still buying more cover. Overall for the year, you should see a little less spend than last year. We have again been able to improve the terms of our cover.

Our acquisition cost ratio looks high this quarter. Q1 2014 acquisition costs were impacted significantly by the support in legal (10:50) as we received $6.7 million of profit commission on the commutation of our quota share. We see $5.1 million of profit commissions from Kinesis this quarter, but they're included in other income and did not impact our acquisition cost ratio.

Excluding profit commission and reinstatement premiums, the Q1 2014 ratio would have been a more normal 20.3%. Q1 this year is higher than that due to the additional reinsurance we purchased, plus general changes in business mix that can impact the ratio. That will normalize a bit over the rest of the year, and expect it to be around 23%-ish for the year.

On losses, as I mentioned, it's been a relatively quiet quarter. We did see one mid-size energy loss so accident year ratio is elevated due to that at 45.4%. We've talked before about assuming a (11:39) loss ratio, and I see no reason to change that. Otherwise, we had some favorable developments which included additional recoveries in our 2011 Thai flood losses with one large claim fully settled in the quarter.

On investments, including our currency hedging, the portfolio returned 1% for the quarter. While volatility remains, our hedge funds and bank loans performed well. They contributed just under 40 basis points to the overall return. Our hedge fund allocation now stands at $156.6 million and we added a bit more to that on April 1 to bring that to just under $175 million.

We don't intend to add any more to that portfolio now. We have more risk assets in our portfolio now than we've had in recent years, but no real change in our investment strategy. The risk assets we've added are generally lower volatility and are there to address our interest rate risk. We'll stay pretty at short duration this year and start increasing that due to expected salary hikes. (12:34)

We also had fairly high cash balances at the end of the quarter. That's in part due to funding our dividend payment and in part due to the closeout of the 2012 year account (12:43) at Cathedral. You should see that cash balance come back then again next quarter.

On KCM, I mentioned we received our first profit commission this quarter due to close-out of the first underwriting cycle. We expect about another $0.7 million to come through from that in the second quarter.

The 2015 underwriting fees are earned in line with the underlying risk profile, so you'll see most of that come in over the U.S. hurricane season again. If there are no losses on the 1/1/15 underwriting cycle, profit commissions could be just under $7 million, but the earliest we'll receive that would be Q1 2016. We've added a new page to our supplement, basically what's included in other income. So you can see the contributions from KCM and Cathedral there.

Our G&A includes KCM's expenses. Our G&A ratio looks a little higher this quarter, and that's largely due to bonus accrual adjustments. Cathedral's bonus accruals are linked to their profit, so you'll likely see that move around a bit over the year. Our G&A ratio should normalize over the rest of the year and we should trend around the same level as last year, possibly slightly lower.

Finishing off on capital, we're pretty comfortable at the level we're at. And if nothing happens to change the market this year, we'll likely return earnings at the end of the year. If the market does change, we'd anticipate using some or all of our extra capital for underwriting.

With that, I'll now hand over to the operator for questions.

Q&A

Operator

Thank you. We will now be conducting a question-and-answer session. Our first question is from Ben Cohen of Canaccord. Please go ahead.

Q - Ben Cohen {BIO 1541726 <GO>}

Thanks very much. Good afternoon. I had a couple of questions. Firstly, on the Gulf of Mexico renewal, you mentioned that you wrote a lot of multi-year premium last year. Could you just be more specific as to what you actually wrote in this period? How that renewal (14:53)?

And could you also say a bit more about where you've been reserving releases from specifically on the 2011 and 2014 years? And could you just remind us what you would expect as a kind of normal level of release in a year? Thanks.

A - Alexander Maloney {BIO 16314494 <GO>}

Well, again, I think that both of those ones are for Elaine. The only comment that I would have on Gulf of Mexico multi-year is that we started turning multi-year a number of years ago. So post-Hurricane Ike, we started turning multi-year to some of our core clients. But I'll let Elaine talk to you about the numbers.

A - Elaine Whelan {BIO 17002364 <GO>}

Yeah. Not really sure what to add to your question, so if you can get a bit more specific with me, then I'd be happy to answer it. We wrote $70.5 million and mostly two- and three-year deals. So, as I said, $64.5 million that was multi-year, so 20% of that earned last year and 35% we'll earn this year, with the rest of that coming through mostly in the following year. Was there something more specific...

Q - Ben Cohen {BIO 1541726 <GO>}

Yeah. It was just – so do we take it that on that renewal this year or the lack of multi-year, that essentially goes to zero, that part? I mean, what did you write that was new this year on the rate for renewal? That's my question in terms of the gross written premium.

A - Elaine Whelan {BIO 17002364 <GO>}

All right. Those renewals are still ongoing. We were kind of working through the Gulf of Mexico renewals, and Pete can give you a bit more information on that.

A - Paul Gregory {BIO 16314515 <GO>}

Yeah. Hi, Ben, it's Paul.

Q - Ben Cohen {BIO 1541726 <GO>}

Hi.

A - Paul Gregory {BIO 16314515 <GO>}

Yeah, most of the – as Elaine mentioned, most of those fall into Q2, and most of them fall into kind of mid-May to June.

Q - Ben Cohen {BIO 1541726 <GO>}

All right.

A - Paul Gregory {BIO 16314515 <GO>}

So, there are a couple of annual renewals ongoing, so there will be then those coming through. Obviously, the vast majority is in multi-year, as we have done, as I mentioned in my script, in previous years.

We only offer a certain amount of clients multi-year. They tend to be core clients. Sometimes we do re-negotiate those if we can extend them out for a further year if there's a mutually agreeable deal to be done. So, that could happen, but we're literally just at the stage of talking to clients and brokers at the moment. So, it's a little bit too early to say, I'm afraid, but obviously next quarter, we'll be able to give you the full color on that.

A - Elaine Whelan {BIO 17002364 <GO>}

Yeah. And then, on reserve lease space of it, we settled some of our Thai flood loss claims this quarter. And as a result of settling those claims, reported our reinsurance recovery, so that's where the recovery there is coming from and that's what's driving most of the 2011 development.

Q - Ben Cohen {BIO 1541726 <GO>}

Right.

A - Elaine Whelan {BIO 17002364 <GO>}

2014, there's nothing very specific in there. It's really just a standard reporting pattern being released in the lack of claims coming through.

Q - Ben Cohen {BIO 1541726 <GO>}

Okay. And there's sort of a normal progression because I guess Q1 was quite high.

A - Elaine Whelan {BIO 17002364 <GO>}

Q1 is quite high in the same part, that was because of debt recovery and just generally being quite quiet, nothing coming through. I mean, if you look at where we've been over the last few years, the average has probably been in the kind of $15 million to $25 million (18:00) range, not that we plan for reserve but this is obviously we're reserving to what we actually think is the best estimate on it. But always nice to see some paper work coming through.

Q - Ben Cohen {BIO 1541726 <GO>}

Okay, thank you very much.

Operator

Thank you. Okay, everyone, it doesn't appear that we have any further questions at this time. I'd like to turn it back over to management for any additional or closing remarks.

A - Elaine Whelan {BIO 17002364 <GO>}

Thanks, Ben, for asking the question.

A - Alexander Maloney {BIO 16314494 <GO>}

Yeah. Thanks for that. We'll approach you next quarter.

Operator

Thank you. Ladies and gentlemen, this does conclude today's teleconference. You may disconnect your lines at this time and thank you for your participation.