Q3 2014 Earnings Call

Company Participants

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

Other Participants

- Jay A. Cohen
- Mark A. Dwelle
- Vincent M. DeAugustino

MANAGEMENT DISCUSSION SECTION

Operator

Greetings and welcome to the Markel Corporation Third Quarter 2014 Earnings 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 your host, Mr. Tom Gayner, President and Chief Investment Officer. Thank you, Tom. You may begin.

Thomas S. Gayner {BIO 1896932 <GO>}

Good morning. Thank you and welcome. We're glad that you're with us and we look forward to discussing our results from the first nine months of 2014 as well as our thoughts on the business.

Anne Waleski, our Chief Financial Officer, will review the overall financial results and my Co-President, Mike Crowley and Richie Whitt, will then cover our insurance operations. Then I'll return to discuss our investments and Markel Ventures' activities.

Before we get started, I'll remind you of the Safe Harbor statements. As a reminder, comments made on today's call may contain 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. Please refer to the full disclosure regarding the risks that may affect Markel,

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which may be found in our most recent Annual Report on Form 10-K and quarterly report on Form 10-Q.

With that, let me turn things over to Anne.

Anne G. Waleski {BIO 16735457 <GO>}

Thank you, Tom. And good morning, everyone. I'm pleased to report that the positive momentum that we experienced in the first half of 2014 has continued into the third quarter. Our financial results for the first nine months of the year are very solid. We produced underlying profits in all three ongoing insurance segments and continued to align the legacy Alterra reserves with the Markel's reserving philosophy. Markel Ventures completed the acquisition of Cottrell, Inc. during the period and continues to look for profitable growth opportunities.

Our total operating revenue grew 25% to $3.8 billion in 2014 compared to $3 billion in the first nine months of 2013. The most significant drivers of this increase continue to be the inclusion of nine months of underwriting revenues from legacy Alterra product offerings in 2014, higher revenue from the Hagerty business, and higher investment income due to our larger investment portfolio. Also contributing to the increase, other revenues were up 25% to $630 million from $505 million last year, primarily due to revenue growth within Markel Ventures.

Moving into the underwriting results, gross written premiums were $3.8 billion in 2014 compared to $2.9 billion in 2013, an increase of 30%. Net written premiums were $3.1 billion in the first nine months of 2014, up 28% from the prior year and earned premiums increased 26% to $2.9 billion. These increases were driven by the inclusion of nine months of premiums from the legacy Alterra product in 2014 compared to five months of legacy Alterra premium in 2013.

Net retention was down slightly in 2014 at 82% compared to 83% in 2013. The slight decrease, which is in line with our expectations, is primarily due to higher use of reinsurance on certain insurance product previously underwritten by Alterra.

Our consolidated combined ratio for the first nine months was a 97 in both periods 2014 and 2013. As a reminder, the 2013 combined ratio included transaction and other acquisition-related costs of approximately $70 million or three points related to the acquisition of Alterra. The combined ratio in 2013 also included approximately $32 million or one point of catastrophe losses.

Excluding the impact of catastrophe and transaction and acquisition-related costs from the 2013 combined ratio, the combined ratio for 2014 increased four points compared to the prior year. This increase was primarily due to less favorable development on prior year loss reserves in 2014 compared to 2013.

The consolidated combined ratio for the nine months ended September 30, 2014 included approximately $260 million of favorable development on prior year loss reserve

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compared to $281 million of favorable development for the same period in 2013. The benefit of the favorable development on prior year loss reserves had less of an impact on the combined ratio in 2014 than in 2013 due to higher earned premium volume in all three of our ongoing underwriting segments in 2014.

In addition, the U.S. Insurance segment had less favorable development due in part to adverse development on our architects and engineers product line in 2014 and less favorable development on Hurricane Sandy in 2014 compared to 2013.

Now, I'll move to the results of Markel Ventures. During the first nine months of 2014, revenues from Markel Ventures were $595 million compared to $486 million a year ago. Net income to shareholders from Markel Ventures was just over $16 million in 2014 compared to $18 million for the same period in 2013. EBITDA was $66 million in 2014 compared to $64 million in 2013.

For the nine months ended September 30, 2014, revenues were higher than the same period a year ago due to our acquisitions of Cottrell in 2014 and Eagle Construction in 2013. Likewise, EBITDA from our Markel Ventures operations increased in 2014 compared to 2013, primarily due to the acquisitions of Cottrell and Eagle, partially offset by less favorable results in our existing manufacturing operations.

Moving to our investment results, investment income was $270 million for the first nine months of 2014 compared to $229 million in the same period last year. The benefit of holding a larger portfolio was partially offset by lower yields. Net realized investment gains for the period were $29 million compared to $41 million a year ago. Included in net realized gains were $3.9 million of other than temporary impairments as compared to $4.6 million in 2013.

Looking at our total results for the year, net cash provided by operating activities was $537 million for the first nine months of 2014 compared to $543 million for the same period of 2013. The decrease is due to higher tax payments for our international operations, partially offset by higher tax pledge from investment income and underwriting activities due to the inclusion of Alterra.

Our projected effective tax rate was 25% in the first nine months of 2014 compared to 28% a year ago. The decrease in the effective tax rate in 2014 is primarily due to anticipating a larger tax benefit related to tax exempt investment income and a decrease in the estimated foreign earnings subject to U.S. tax in 2014 as compared to 2013.

We reported net income to shareholders of $204 million in the first nine months of 2014 compared to $182 million a year ago. Comprehensive income was $517 million for the first nine months of 2014 compared to $253 million a year ago. Book value per share at the end of September 2014 was $514, an increase of 8% since the end of 2013.

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

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F. Michael Crowley {BIO 6836605 <GO>}

Thanks, Anne. Good morning. The U.S. Insurance segment, as we pointed out before, 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 third quarter, gross written premium was up 3% over prior year. Year-to-date, gross written premiums have increased 13% over prior year. This increase was due in a large part to the Alterra lines of business that are now included in this segment. Excluding these lines, premium volume is up 5%.

Keep in mind that we have been exiting or reunderwriting some lines in our specialty and wholesale divisions and this has impacted growth. The combined ratio for the quarter was 95% for both 2014 and 2013. The combined ratio for the year was 97% as compared to 94% in 2013.

As Anne pointed out, the higher insurance segment combined ratio was driven by less favorable development of prior year losses due in part to adverse development in the architects and engineers line of business. Partially offsetting this impact was a lower year-over-year expense ratio. The improvement in the expense ratio was due to higher contribution of earned premium from the legacy Alterra in 2014 than in 2013 and due to non-reoccurring transaction cost recorded in 2013 associated with the Alterra acquisition.

The rate environment in the U.S. segment remains competitive. However, we continue to achieve modest single-digit rate increases on small to medium size risk across the various divisions within the segment. Large accounts remained under competitive pressure and prices for property and casualty lineson Fortune 1000 business remained soft.

Operationally during the quarter, we combined our Atlanta and Richmond specialty program units under one management team and we expect this reorganization to improve our results in 2015 from both an underwriting and expense perspective.

Also in the specialty division, year-to-date data revealed benefits from our initiatives to cross-sell and round accounts between FirstComp and Markel Specialty programs, 566 accounts have added additional coverages through this rounding effort.

In our wholesales division, we continue to see strong growth in our binding P&C, environmental and excess umbrella lines. Our E&S executive team had a very busy NAPSLO, holding over 350 face-to-face meetings with our wholesales partners. We continue to grow with our top wholesalers and this meeting provides the opportunity for an intense few days of one-on-ones. All five wholesale regions volume is up year-to-date.

Also our specialty and global and executive teams attended the annual CIAB conference, just like NAPSLO allows us to visit face-to-face with many of our key brokers and agents. The broad array of Markel products both large and small accounts has made us an attractive alternative for many agents.

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Gerry Albanese, our Executive Vice President and Chief Underwriting Officer, presided over a number of product line leadership meetings during the quarter. These meetings were attended by our most senior underwriters and they provide a platform for communication between our underwriting leaders and our regional operations as we finalize business plans and budgets for 2015.

In summary, we remained focused on those same key objectives that have driven us throughout 2014, reassessment of some lines of business, expense reduction and control, attraction of talent and aggressive sales and marketing.

I'll now turn the call over to Richie.

Richard R. Whitt {BIO 7084125 <GO>}

Thanks, Mike, and good morning, everyone. Following on from comments by Anne and Mike, I'd sum up the first nine months of the year in Markel's underwriting operations as solid or business as usual. I think this is a really important statement, when you consider that we are establishing consistent with our historical practices, a loss reserve margin of safety on legacy Alterra business.

Turning specifically to the results of the International Insurance and Reinsurance segments, the International Insurance segment which includes business written by our Markel International division as well as that written by our Global Insurance division has performed well so far this year.

During the nine months of 2014, gross written premiums in the International Insurance segment increased 13% to $653 million. The combined ratio was 95% compared to 92% in the prior year. The increase in premium writings is primarily due to the Global Insurance division, which was created after the acquisition of Alterra and contributed nine months of business in 2014, compared to only five months of business in 2013.

The higher segment combined ratio was driven by a higher current accident year loss ratio, partially offset by a favorable expense ratio. The improvement in the expense ratio was due to transaction cost of the Alterra merger back in 2013 and higher earned premiums from the Global Insurance division which carry a lower expense ratio.

Now I'll turn to the Reinsurance segment, which includes reinsurance programs written by our Global Reinsurance division, as well as that written by our Markel International division. Gross written premiums for this segment were $999 million for the first nine months of 2014 and that was up from $443 million a year ago.

The increase in premium writings was primarily due to including nine months of writing from product previously written by Alterra in 2014, compared to five months of writings in 2013.

The combined ratio for the Reinsurance segment was a 97 as compared to 108 last year. Last year's combined ratio included seven points of catastrophe losses, really very minor catastrophe losses this year, really of the attritional nature, I would say, and approximately 10 points of non-recurring costs associated with the acquisition of Alterra.

Operationally, during the quarter and the first nine months of the year, we recently announced that Dave Kalainoff will be retiring from Markel Re in June of next year and that Jed Rhoads will be taking over responsibility for all of Markel Re.

I can't thank Dave enough for all that he has done to ensure the smooth transition of Alterra Reinsurance operations into our Markel Re division. Also I know Jed will do a fantastic job leading our reinsurance team into the future.

Markel International's integration of its Abbey acquisition continues to go well. We've added marketing and sales resources as well as some new product capabilities to the Abbey team. Abbey is a wonderful franchise and with the additional resources that Markel can bring to the table, we believe that solid growth is possible.

As Mike said, all areas of the P&C market remain competitive. The only difference really is the degree to which they are competitive. The International Insurance and Reinsurance segments are probably among the most competitive in the market today. We're in the process of completing budgets and plans for 2015 and barring any significant market changes, organic growth is going to be difficult to come by in 2015.

As a result, as Mike alluded to, we are focused on controlling our expenses, finding efficiencies and emphasizing risk selection and portfolio management. In soft markets, we will always choose underwriting discipline over growth. Despite these difficult market conditions, we still believe there are great opportunity available to us and believe we have built the platforms to pursue those opportunities.

With that, like to turn it over to Tom.

Thomas S. Gayner {BIO 1896932 <GO>}

Thank you, Richie. My comments this morning will be brief, since our news is good and straightforward. I am happy to answer any questions or cover any details when we get to the Q&A. On the investment side of the house, we earned 7.3% on our equity investments and 4.5% on our fixed income portfolio during the first nine months, which produced a gross total return of 5.2%. In the equity portfolio, we continue to methodically add to our holdings steadily throughout the year.

Between purchases of roughly $300 million so far as well as depreciation of the portfolio, we've now got roughly 52% of our shareholders' capital invested in equities, compared to 48% at year-end 2013. We continue to have an unusual combination of investment ideas that we're confident about, positive cash flows from our insurance and ventures business and some sense of overall caution and wariness about investment markets overall.

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The net effect of these cross-currents is that we continue to steadily dollar cost average our way into building positions. We think that approach prudently protects our balance sheet and leaves us with the ability to be able to invest more money in equities as opportunities present themselves, expect us to continue our steady, consistent approach in building the equity portfolio.

In our fixed income operations, we earned a total return of 4.5% as low interest rates that prevailed at the end of 2013 went under an even lower limbo stick by the time we got to the end of September. Net-net we got some capital appreciation in the portfolio, in addition to recurring interest income. We remain cautious as we have been for multiple years about the balance between risk and reward in bonds.

Long-term rates just don't have that much room between where they are (18:16). They have a lot of room between where they are and where I've seen them in my career. Consequently, we keep the duration of our bond portfolio a bit shorter than the duration of our insurance liabilities. Including cash, the duration stood at roughly 4.25 years at September 30, and we do not plan to go longer than that in the current interest rate environment.

We also remain committed to safety first. In addition to not stretching for yield by extending the duration, we don't stretch for it by reducing credit quality either. 97% of the portfolio is rated A or better, but we don't stop there and rely solely on the rating agencies. We do our own credit analysis on top of that to make sure that we are comfortable with the credit risk we take, as always, safety first.

In Markel Ventures, we purchased Cottrell industries during the third quarter. Only five weeks of their results are included in our third quarter numbers and you'll see more from them as well as the rest of the Markel Ventures companies in the fourth quarter. Cottrell is the leading manufacturer of car hauling trailers and equipment and we welcome them to the Markel family.

As we stayed in the Markel Style, we seek to be a market leader in each of our pursuits. I can assure you that Cottrell fits that description as well as other elements of the Markel Style. For the nine months to-date, you could see imaginatively named other revenues on our income statement of $630 million versus $459 million a year ago. Anne gave you the portion for Markel Ventures and you can see the vast majority of those revenues indeed relate to the Markel Ventures operations.

Our EBITDA from the group was $66 million versus $64 million in 2013, which is a much smaller percentage increase than the increase in revenues. We got off to a slow start in the first quarter of this year and have been making up ground ever since. I assure you that I look forward to reporting the full year results.

When you add all of our activities together from insurance, investing in Markel Ventures, you get to the bottom line of comprehensive income. Comprehensive income through the first nine months at Markel exceeded $0.5 billion. As it shows in the Q in round numbers the drivers of comprehensive income came from pre-tax underwriting profits of over $70 million, pre-tax investment income and gains of about $300 million, increased pre-tax unrealized gains in the portfolio of almost $350 million, and pre-tax cash flows of over $70 million from Markel Ventures in non-cash intangible amortization. We then paid gobs of taxes and provided for the rest of what we have. Some of those items comes to the $0.5 billion of comprehensive income we earned. We are pleased with that result and we hope you are as well.

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Looking forward, every insurance, investment, industrial and service business that we own or operate in faces challenging and competitive markets. They always have and they always will. Despite those facts, we continue to produce solid returns for you as our shareholders and we expect to continue that to be the case over time. We're grateful for the opportunity to do so and we now look forward to answering your questions.

With that, John, if you'd be so kind to open the Q&A period.

Q&A

Operator

Thank you. Our first question comes from the line of Vincent DeAugustino from KBW. You may state your question.

Q - Vincent M. DeAugustino {BIO 17976273 <GO>}

Hi. Good morning, everyone.

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

Good morning.

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

Good morning.

Q - Vincent M. DeAugustino {BIO 17976273 <GO>}

Just to start off. So last quarter you guys had talked about the reinsurance environment kind of theoretically being at bottom if everybody was being disciplined. And I am just wondering if at this point there is any change in kind of that assessment or if it's one of these things where we have to really wait for 1/1 to play out before we can get a true test, if that's going to kind of – if we are going to be at bottom and potentially rebound or go lower?

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

This is Richie, Vincent. I think it's a little early to say. Like you say, I think we got to see what happens with the 1/1 renewals, but a lot of people are talking about it being the bottom. I wouldn't look for a bounce at this point. I think there is too much capital out there for it to be any sort of bounce. If I had to guess, you might just see a little more reduction, but I

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just can't imagine the kinds of reductions we've seen the last two years. And certainly, if people are looking for those kinds of reductions at 1/1, we'll probably be coming off of some business. So it feels like we're getting close to a bottom, but I'd like to see those 1/1 renewals before I commit to that.

Q - Vincent M. DeAugustino {BIO 17976273 <GO>}

Okay. Good deal. And then just to switch over, two questions on the Markel Ventures side. And Tom, sorry if I missed this. I know you said you look forward to kind of giving us the full year numbers. But with Cottrell and Eagle, just where roughly with those two businesses should that put us on an annualized EBITDA and net income basis?

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

Annualized run rate of the revenues should be a round number of $1 billion plus or minus; there's cyclicality to that and that's looking into 2015, and we would expect double-digit EBITDA earnings from that mix collection of business.

Q - Vincent M. DeAugustino {BIO 17976273 <GO>}

Okay. Cool. Thank you. And then just...

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

Round numbers with a lot of zeroes involved there.

Q - Vincent M. DeAugustino {BIO 17976273 <GO>}

Good deal. Just a theoretical question between the split in terms of when you're speaking with investors between Markel Ventures and the equity portfolio, do you feel that you get more credit for the Ventures' income stream versus the public equity since on the Ventures you don't have to do the whole equity look through your earnings add back?

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

No.

Q - Vincent M. DeAugustino {BIO 17976273 <GO>}

All right. Take care, guys. Thank you.

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

Thank you.

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

Thank you.

Operator

Our next question comes from the line of Mark Dwelle of RBC Capital Markets. Please state your question.

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

Yeah. Good morning. Just a few sort of numbers questions, because as you said, it was a pretty straightforward quarter. In the discontinued line segment, there was a $6.8 million of adverse development. Was that just a true-up of the asbestos study from the second quarter or was it something different?

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

That's actually some development that we saw on the discontinued businesses from the Alterra acquisition that occurred during the quarter.

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

Okay. The figure for the remaining amortization of the premiums in the investment – or the premium in the investment portfolio, is that number somewhere in the 10-Q I haven't found it, if it is.

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

It's not. But given the – and I don't have the number with me Mark. But given the amount of the portfolio that we have turned over, the number that's left has gotten smaller, but I don't have the specific number with me and it's not in the Q.

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

Okay. And then finally, was there any meaningful amount of catastrophe loss across any of the businesses? I know Rich you mentioned in the reinsurance there was not. Just asking on the other units?

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

Nothing to speak of.

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

No. We always have a bit of an attritional amount of catastrophes built into our assumptions and I would say it was even probably a light attritional quarter from that standpoint.

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

Okay. Those are all my questions. Thank you.

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

Thank you.

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Operator

Our next question comes from the line of Jay Cohen of Bank of America Merrill Lynch. Please state your question.

Q - Jay A. Cohen {BIO 1498813 <GO>}

Yes. Thank you. In the reinsurance segment, the expense ratio in the third quarter dropped, I guess, about four points from the first half. In the Q, you suggest there was an increase in experience-related funds or something, I forget exactly the phrase. But I am wondering how much of an impact that had on the expense ratio in the quarter in the reinsurance segment?

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

Yeah. I would say the impact for the quarter was probably not significant.

Q - Jay A. Cohen {BIO 1498813 <GO>}

So do you see the third quarter number as a reasonable run rate going forward because it's about 30% versus nearly 34% in the first half?

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

No. I do not think that this is reasonable run rate. I think you can take the earlier quarters and use those. This would be a non-recurring one-time adjustment that we make and then we'll trend it going forward, but I think you can use the earlier quarter's indication.

Q - Jay A. Cohen {BIO 1498813 <GO>}

That's helpful. And, I guess, for the overall company, when you think about the expense ratio. Given the market conditions in internationally and in reinsurance, should we expect any improvement at all in the expense ratio going forward or should we just kind of assume it stays reasonably flat?

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

Well, this is Richie, Jay. Obviously, we continue to work to reduce the expense ratio. But it's fair to say we don't expect to have a whole lot of help in that effort from growth next year as of growing the top line. If the market stay like this, that's going to be difficult, so we're going to have do it the old fashion way, which is spending less. So immediately it's going to be difficult – what did we have? Like 37%...

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

37%.

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

...a little over 37% this quarter. I think that's probably fair for next year and we're going to work hard to see if we can reduce it.

Q - Jay A. Cohen {BIO 1498813 <GO>}

That's great. If I could squeeze one more in. Markel Ventures, Tom as you had mentioned, the improvement was pretty noticeable versus the first half and specifically in the manufacturing segment where the net income or GAAP income went from a little above $4.5 million in the first quarter up to $21 million this quarter, so pretty impressive. Does seasonality play a role there? And should we think about the third quarter again as a reasonable run rate going forward?

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

Seasonality plays a small role, but I would say it's much more economically cyclical than what I would describe as seasonal. And frankly, the first quarter was low. We were in the midst of integrating some acquisitions and there's always a little bit of ingestion and process that's connected with that and as we've gone through the year, those issues are starting to resolve themselves and we're getting to a more normal basis.

I really would steer you towards EBITDA because, given the amortization, purchase accounting and that sort of stuff, the true cash that's being produced by the business is best represented by the EBITDA and that's what we hold the managers accountable for, because they can't control the tax rate, they are very lightly levered, we're not borrowing a bunch of money, so that really does describe the cash flows in the business.

Q - Jay A. Cohen {BIO 1498813 <GO>}

Fair enough. Thanks Tom.

Operator

Management, at this time, there seems to be no more further questions. Would you like to make any closing remarks?

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

Thank you very much and we look forward to chatting with you next quarter. Take care.

Operator

This concludes today's conference. Thank you for your participation. You may disconnect your lines at this time.

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