Q4 2012 Earnings Call

Company Participants

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

Other Participants

- Ben Cohen, Analyst
- Chris Hitchings, Analyst
- Olivia Brindle, Analyst

Presentation

Operator

Welcome to the Lancashire Holdings Limited Q4 results conference call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Please note that this conference is being recorded.

I will now turn the call over to your host, Richard Brindle. Sir, you may begin.

Richard Brindle {BIO 1983776 <GO>}

Good afternoon, everybody. I'm joined by Alex Maloney, our Group Chief Underwriting Officer; Elaine Whelan, our Group Chief Financial Officer; and Denise O'Donoghue for the Q&A, who's our Group Head of Investments & Treasury. I'll just make a few brief remarks and then I'll hand over to Alex.

In my long years in this industry, I don't think I've ever seen such a disconnect between rhetoric and reality. Although more measured voices have started to be heard in recent days and weeks, the relentlessly positive commentary on the rating environment from companies is simply at odds with the facts of what is happening in the actual, as opposed to what one might call the virtual, market.

A minor, and short-term, uptick in SME commercial US property rating has been represented as betokening a broad-based rise in the property lines, which, sadly, is simply not the case.

This is not a bad market. I cannot speak for casualty with any authority, but the short-term lines are holding up reasonably well. But risk-adjusted rate increases are rare, and this year will be a struggle.

As far as our core portfolio is concerned, dull is good this year, although we will, as always, be on the lookout for anomalies and niches in the market.

We are also excited about the formation of Lancashire Capital Management. There is no doubt in my mind that ours is an industry in transition. We will expand this area of our business in a responsible and measured way, but this is a transition that we will be at the forefront of.

And I'll hand over to Alex at that point.

Alex Maloney {BIO 16314494 <GO>}

Okay. Thanks, Richard. 2012 was potentially a difficult year for Lancashire, with the biggest marine loss ever and a huge insured loss from the Northeast US storm. Both claims hit in our core lines of business.

To produce a net-loss ratio of 29.9% for the year was, therefore, a great result, and testament to the hard work we've done on the portfolio to get the right balance between risk and reward.

In an uneven market with strong rating in some lines, such as energy and property retro, but heavy competition in others, such as terrorism and AV52, I'm pleased that we were able to maintain a solid core portfolio, with an RPI of 104% across the whole book.

Looking at the individual lines, Energy has had a really solid year. There were no major losses, although there was the usual one of attritional events. Pricing was at good levels, and, although the increases that we've been obtaining over the last four years have petered out, RPIs of 103% on the worldwide and 100% on the Gulf of Mexico books represented a fair outcome.

We increased our gross written premium to just over $240 million; a 5.2% increase over 2011.

There is plenty of construction and new assets being deployed right around the world, and we're travelling to meet clients in Asia, Africa, Russia, the US and Europe.

We're continuing to work on the Energy liability products, as we understand the risks involved and we know the clients. Prices are at their highest level ever paid, so it merits further work, and we believe that we can build a decent portfolio.

For Marine, there was a brief flicker of optimism that the tragic Costa Concordia event might bring some backbone to the Marine market. But despite the fact that the client base, in this case Carnival, conducted themselves very well at the subsequent renewal and paid an appropriate increase, the excess capacity in the market meant the optimism was soon extinguished, and rates returned to flat.

The IGPIA renewal has attracted a lot of attention and opened up some possibilities for Lancashire, but, in general, the market is disappointing.

Even though Marine reinsurance saw significant rises at January 1, 2013, we still didn't believe that the cat exposure had been sufficiently addressed to warrant deploying additional capacity. The divergence between reinsurance and the direct pricing may force rate increases into the primary market eventually, but we are not holding our breath.

In Terrorism and political risk we had a good year finding new opportunities, and holding rates pretty steady, with an RPI of 97%.

We market our capabilities in this area constantly, and it pays off with an excellent submission flow. As such, especially in the Terrorism book, brokers will work with us to structure a program around our participation, and we can influence, not just the pricing but the loss level at which we attach as well.

Our sovereign book has grown substantially, and our overall political risk accounted for over $41 million of written premium in 2012.

In Aviation, the excess AV52 niche product, which is our cornerstone, continued to be competitive as the mainstream hull and liability markets increased their retentions and put pricing under pressure.

Absence of losses and abundant capacity means only one thing in insurance, but we battled hard to keep our 93%.

The marketing of our new satellite business got off to a good start with $23 million of premium bound in 2012. We have started 2013 with a loss of the Intelsat 27 explosion, but we expect losses in this class and this doesn't affect our view of the product.

In Property, our exit from D&F has taken a good deal of tail risk and parameter risk out of our exposures, which boils down to less uncertainty around the model.

We've been able to write reinsurance and retro with increased confidence. Retro pricing is at good levels at our higher attachments points and obviously Accordion has had a very successful year throughout 2012.

On the cat XL side, the Japanese market also had good pricing for both earthquake and wind products in April and we were able to increase our exposures there.

In the third and Fourth Quarter we were, as usual, quick to respond to opportunities after the Thai floods.

In the US our book was pretty stable, which reflected the market and the rating environment.

We launched our new Saltire product in November and, although we had a lot of interest to date, we have only sold one contract. It is a complex product, combining non-elemental and elemental protection on an aggregate and occurrence basis, with a feature being that the capital relief will fall to the buyers.

We will continue discussions with potential clients throughout the year and we are pleased to say that our third-party partners are very supportive of our measured approach.

Looking into the crystal ball for 2013 is the usual patchwork of expectations we would expect, absent our 2002 or 2006-type post-loss environment. For Energy pricing this will be fairly flat, but we think pricing is at good levels so that's okay.

On the Property reinsurance side we're already seeing predictions that Florida pricing could be down as much as 15% in June. This is a not a market we participate in, but we expect our portfolio to be flattish.

On the retro side, pricing in Germany stayed at good levels at January 1.

In Marine and Aviation we don't expect anything dramatic, but our portfolio is pretty much 100% core so we don't think there will be too much change.

We will continue to build out our satellite portfolio and we're optimistic that we will find new opportunities in the Energy liability line.

If all that sounds a little dull, it's worth remembering that dull is good in our business. We look after our brokers and our core business and we'll be ready for the opportunities when they come.

And on that note, I'll pass over to Elaine Whelan.

Elaine Whelan {BIO 17002364 <GO>}

Thanks, Alex. Hi, everyone. Our results are on our website as usual.

Despite the impact of Sandy we've had a strong quarter, producing an underwriting profit of $57.3 million and a combined ratio of 71.9%. Our return on equity was 3.1%, bringing us to 16.7% for the year. Our compound annual return from conception is now 19.2%.

You will also have seen in our release that we've declared our usual final dividend of $0.10 per share, but also a special dividend of $1.05.

Taking capital first then, as you know we declared a special dividend last quarter of $0.90 per share. Last quarter we had held back some capital following Sandy for two reasons.

Firstly was simply because it was pretty early days following the storm. While we expected our loss to be contained in our Fourth Quarter earnings, we wanted to take some time to fully assess the impact on our numbers.

Secondly, we had hoped we would see some effect in the market, some hardening of rates. Our Sandy loss is well within the range we published in December, at a net $44.5 million to the Company, and we still produced a decent profit for the Fourth Quarter.

While Sandy probably held pricing up, we didn't really see any dramatic change and certainly don't think there are any spectacular opportunities on the horizon. It's really just more of the same; pricing is decent but not exceptional.

We also issued debt in the Fourth Quarter and that gave us some extra headroom too. While we put some of it to work, we're back to the same place in terms of outlook; so we're returning around $200 million in capital over and above our standard final ordinary dividend.

That gets us back to around the $1.4 billion, $1.5 billion level of capital, which is a good level for us in today's markets. That puts our leverage at around 17% or 18%, which, again, is a good level for us.

Let me just flip back to Sandy for a moment. The majority of our reserve is Property D&F. Our Property cat and retro books were largely unaffected, with only a small reserve booked for Property cat accounts. There are a couple of Accordion accounts that we're monitoring, but no reserves have been posted as yet.

We mentioned last quarter that we had some ILWs in place that trigger at a $20 billion industry loss level. PCS's latest number is $18.75 billion, although technically for us it's $18.4 billion due to certain state exclusions. It's not quite there yet, so we haven't taken any credit in our year-end numbers for recoveries from that.

We're obviously watching that meticulously and we're expecting PCS's next report to go out in late March. On our current reserve for Sandy, if the ILWs trigger, we'd expect a full recovery of $40 million.

Alex has talked about our (1/1) renewals and 2013 outlook, so let me just look back at the quarter we're reporting on.

Our premium level I shouldn't think would be a major surprise for anyone. We stopped writing D&F on July 1, so there's only a few million dollars of premium coming through there.

Property, cat and retro are a bit behind Fourth Quarter last year as there were some opportunistic deals written last year that didn't renew. Otherwise, we saw a boost in our Aviation premiums from our new satellite book.

Just a quick note on premiums for 2013. Again Alex has mentioned our renewals, and we wrote a bit less retro at 1/1 than last year; about $18 million less. There's more capacity coming into that market, so that will have an impact on pricing and how much we renew for the rest of the year.

We've ceased writing D&F, so there'll be a drop off in premiums there. Otherwise, I'd say our portfolio is broadly flat to last year, although there's some Energy and Marine multi-year deals that won't be up for renewal just yet.

That said, we're seeing some attractive new business flow in those classes. We'll also have the benefit of the prior-year multi-year deals in our earnings in 2013.

So all in, while we don't give top line guidance, we're likely to see some reduction in our gross written premium, although we expect to maintain our portfolio quality. In fact, this increased our session to the Accordion sidecar to 100% now and we also trimmed some (inaudible) accounts at 1/1. So on a risk-adjusted basis, we're sitting very nicely.

Back to the 2012 numbers, we saw some adverse development on prior-year reserves this quarter, although for the year we had net favorable development.

Of the $15 million adverse development we had this quarter, most of that relates to development on Thai flood losses driven by updated loss adjusters' reports received. Given where our reinsurance program attaches, we don't see that developing much from here.

The CD premium adjustment you see this quarter is reinstatement premium adjustments in relation to that Thai flood loss development.

As far as Japan, New Zealand and some of the other prior larger loss event reserves go, they've been pretty stable with no material movement.

Our accident year loss ratio for the quarter and year are 30.9% and 34.6% respectively; so pretty impressive results by any standard. Our attritional ratio for the 2012 accident year is running at around the 20% level.

Just a reminder, when you're comparing our reserve development to the prior year, we had a few things in 2012 that we highlighted were non-recurring.

Firstly, we had a reserve study conducted in order to adjust the industry factors we were using to our own history. That led to a decent sized release.

We also had sizeable releases on our (inaudible) reserves on our political risk book, plus a bunch of other medium-sized Property claims that closed in our favor during 2011.

Moving onto investments. With all that was going on in the world in the Fourth Quarter, we had a total return of 0.3%, which we're pretty pleased with. That gave us 3.1% for the year, which is a great result, given the volatility and uncertainty out there.

We continue to try to limit the downside risk in our portfolio. We have funded a small bank loan portfolio, and are looking at other measures to limit interest rate risk and volatility. No significant changes in the portfolio, though; we're just tinkering around the edges.

The last thing I'd like to mention is on the uptick in our financing cost. Our new debt issue is paying a coupon of 5.7%, with our existing debt 3.7% over LIBOR and EURIBOR. Our current blended rate is about 5.8%-ish.

There are also some costs in relate to the new debt issue, about $1.5 million, that won't be a recurring cost.

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

Questions And Answers

Operator

Thank you. We will now begin the question-and-answer session. (Operator Instructions) Ben Cohen, Canaccord.

Q - Ben Cohen {BIO 1541726 <GO>}

Could I ask two things? Firstly, could you say a little bit more about the opportunities in Energy liability, maybe something about the tail of the business that you would look to write there?

And the second thing was on Saltire. You've signed one contract so far. What's the outlook for that picking up? Where are you with discussions with other clients?

And maybe you could also just touch on its success, or not, in the context of this, the new venture that you've announced today. Thanks.

A - Richard Brindle {BIO 1983776 <GO>}

I'll take that, and then I'll ask Alex to talk about Energy liabilities.

I think one of the problems with third-party capital is that companies feel obliged to deploy it when they raise it. And that's just not the way we look at it. I think, in hindsight, we could have spent more time preparing the ground with potential clients for Saltire.

But the main factor in us not deploying was, of course, Hurricane Sandy, which just came along and, clearly, hogged the front page, if you will, for the latter period of last year.

We're in no hurry to deploy. When we returned the unused capital to the shareholders, they were actually very appreciative that we hadn't just felt, right, we've got your money, now we're going to use it willy-nilly. We could have done that, but it wouldn't have been at the return levels which we require, both for ourselves, in terms of our retention, and for our partners.

We've got the whole of 2013 now to talk to people. We think it's a great product, from a number of angles. On the cat side, it's sitting in a space which is largely unoccupied. On the risk side, it offers something pretty unusual. And yes, we're going to work closely with our brokers to widen the client base.

But just because we raised capital doesn't mean we have to deploy it. And we're not blinded by the fees. I think, with respect, some companies can be. And that's just not the way we look at it.

We look at it as a much more long-term thing. We think our credibility with investors is something which has to be built up over time. And we think ours was a responsible course of action to take.

Alex, do you want to talk about Energy (lines)?

A - Alex Maloney {BIO 16314494 <GO>}

I think, like anything, we see the Energy liability market as a possible opportunity. The reason I'm saying it's a possible opportunity is because, in general, when the market's flat, there's not many opportunities and you get a couple of opportunities here and there. But I wouldn't say it's a broad opportunity.

We are comfortable with Energy liabilities. Effectively, we're insuring the same people that we insure on the Property lines. We know the clients. There is a need for cover, particularly for offshore contractors and operators at a certain level.

And for us to write this business, we're pretty much going to see it at a level where the kind of event that's going to affect your liability budget is going to be a Macondo. And that, obviously, brings down any issues you've got about the tail of that business.

I think it will be complementary to our Energy lines. We do currently write some Energy cogency anyway within packages, and this is just something we're looking at at the moment.

So I can probably give you a bit more of an update on that in the next couple of quarters. Most of that business renews between now and July, anyway.

Q - Ben Cohen {BIO 1541726 <GO>}

And you mentioned that pricing there is at an all-time high. Can you give us any comparison, in terms of either against another line or pre-Macondo, where it stands now?

A - Alex Maloney {BIO 16314494 <GO>}

Yes, okay. This is not going to be exact, but I would say for offshore pricing for big clients, pre-Macondo, it's at least double. So on a historic basis, it's never paid any more than it's currently paying. That's not saying today's price is the exact price.

And if you look at some of the renewals, if you look at what's happened to a lot of the liability market, they've had to take much bigger retentions on their reinsurance programs, and pay a lot more for cover. And if you look at some of the rate rises charged in the direct market, that doesn't appear to be enough to make up the difference. But I think that's pretty much the story across the board.

If you look at the whole market, the reinsurance market is quite disciplined; and particularly for loss-affected business, clients have had to pay more for their reinsurance and, in some cases, take bigger retentions. But direct underwriters are not really passing that on, so you have to question the margin on some of this business.

Q - Ben Cohen {BIO 1541726 <GO>}

Right. Thank you very much.

Operator

Chris Hitchings, KBW.

Q - Chris Hitchings {BIO 2034501 <GO>}

I'm just -- a couple of things. One, just a detail. The impact of moving the ceiling rate on Accordion to 100%, and the other changes to the protections on your Property account, I think you've mentioned. I'm just trying to get what kind of relationship -- what kind of overall ceiling rate we're going to see, because, clearly, most of the retro business is written in the first half.

So does that mean we're going to see a markedly higher ceiling rate in the first half of 2013?

Secondly, I think -- I'm intrigued that your attritional loss ratio is, effectively, virtually zero. And I'm trying to work whether, in fact, the book of the business, ex D&F, is actually structured such that, really, the attritional loss ratio is zero. Or is this unusual?

If you were modeling this business going forward, as I have to and, presumably, you do, then what kind of attritional and cat loss ratios should we be thinking? And is it much different? Thanks.

A - Richard Brindle {BIO 1983776 <GO>}

Both of those are for Elaine, please.

A - Elaine Whelan {BIO 17002364 <GO>}

I guess, in terms of how to think about Accordion, we ceded 85% last year, and we're now ceding 100%. We wrote a little less, in terms of the dollar value of the Accordion contracts as 1/1, but, in terms of the net impact on our book, it's about the same as we would have ceded last year.

So last year, in the First Quarter, we ceded about -- we wrote about $64 million of Accordion-related retro contracts; 85% of that, which is about $54 million. And this year, we wrote about $55 million, $56 million of Accordion contracts, and we're ceding all of that.

Q - Chris Hitchings {BIO 2034501 <GO>}

Yes, okay. So in terms -- yes, okay, fine. That's very helpful. And almost all the Accordion business is written in the First Quarter, isn't it? Or --?

A - Elaine Whelan {BIO 17002364 <GO>}

Mostly, yes. Most of our retro business is written in the First Quarter. We do do a little bit throughout the rest of the year, but not so much, and --

Q - Chris Hitchings {BIO 2034501 <GO>}

Okay, fine. That's very helpful. Thank you. And the attritional loss ratio?

A - Elaine Whelan {BIO 17002364 <GO>}

On the attritional loss ratio, there is a couple of things impacting that this quarter. Obviously, when you strip Sandy out, it looks like our accident year ratio is about zero.

We did have some reserves that we put up earlier in the year, on US hail and tornado in Q1 and Q2. So if you go back to Q1 and Q2, you'll see that our accident year ratio was a little bit higher. We actually had a favorable development on the current accident year prior quarter losses, this quarter.

So that brought that down, plus some other cat related. So if you back them out, we're probably actually looking at an attritional ratio for this quarter of about 10%; which is still low. And that's just reflective of just very low reported losses this quarter.

If you go back to last year, you're probably looking at an average run rate of about 22%. This year, we're closer to 19%, 20%.

Q - Chris Hitchings {BIO 2034501 <GO>}

And so if I looked at -- yes, because, clearly, it's come down, partly because the D&F book's gone. And presumably, the D&F book was a source of quite a lot of your attritional loss experience. I wonder -- I realize attritional loss ratios would come down, post the D&F, but I didn't realize they'd come down -- it's very hard to gage how much.

A - Elaine Whelan {BIO 17002364 <GO>}

Yes. Our attritional ratios have come down more, because we're using our own experience as opposed to industry loss factors. And that was something that we did last year, pretty early on, which is why last year's reserves were a bit chunkier.

So I think we had vindicated last year, if were running with about 25% attritional loss ratio to knock off a couple of points on that. This year has just been low. It's not really driven by D&F. So the attritional losses are more in the Energy and Marine books.

Q - Chris Hitchings {BIO 2034501 <GO>}

So you would very much keep to the original guidance, that somewhere around 20%, 22% attritional loss ratio is reasonable.

A - Elaine Whelan {BIO 17002364 <GO>}

Yes. Absolutely.

Q - Chris Hitchings {BIO 2034501 <GO>}

Thank you very much indeed.

Operator

Olivia Brindle, Barclays.

Q - Olivia Brindle {BIO 17273762 <GO>}

I've got two questions. So the first one is on your cat risk exposure, and I see you've taken that down both for the 1-in-100 year and 1-in-250 year events. I gather that's related to buying a bit more reinsurance cover and I just wondered if you could comment a bit on the rationale for that.

Then the second one is around the new capital management business. If you could give a bit more color on the structure of that and, in particular, two things. Are you investing any of your own capital at all to back that? And also, are you targeting any minimum size for what that business might be?

A - Richard Brindle {BIO 1983776 <GO>}

Let me deal with the first part of the second question and, as to structural investments, I'll hand over to Elaine.

I think there is a structural change on the way in our industry. There are vast amounts of money in the world looking for a return. A lot of the sources of money don't really currently have a strategy for the ILS space. There is a clear logic in some of that money coming to be deployed by people with good track records, like ourselves.

We've obviously already done Accordion and Saltire and it's something that we're taking very seriously. Whenever industries undergo fundamental change, you have the option of either -- some of them you think the change is sensible and inevitable, which I think it is for both of the above. You have the choice of sitting on the sidelines or getting involved and trying to help shape the way that this convergence takes place.

There have been some perfectly sensible comments by others about hot money. I agree with that. Some of the money is hot, but this is not our operatives. We're looking for longer term partners.

Obviously you have certain types of investors who are in and out and who could get spooked by a loss, but there's also a lot of other money out there which is hard earned, slower to get on board, but, once you do get it on board, likely to be stickier, and that's really where we're looking.

We're not putting ourselves under any pressure to grow this thing at a certain rate. Obviously, as always, we will use our underwriting judgment first and foremost, but this is coming soon to a cinema near you. This is definitely a structural change that is underway in our industry.

There will be those who sit it out, and I think they run the risk of looking rather one-paced in a few years' time. There will be others who get too over excited and think that every single deal they see can be transformed with third-party capital, and that will probably come unstuck.

But we think the right approach is to acknowledge that this transition is underway, to embrace it, to take the lead in fashioning it, but not to be blinded by the fees into underwriting business we shouldn't be underwriting.

As to structure and investment, I'll hand over to Elaine and then, Alex, maybe you can cover the point about cat exposures after that.

A - Elaine Whelan {BIO 17002364 <GO>}

As Richard says, it's really just recognizing and formalizing what we've already been doing in terms of this space. So it's just putting a new business division in place.

These things are driven either by a market opportunity, like Accordion, with a retro product, or by designing a product like Saltire was. So it will be some kind of combination of the two of those, no doubt, that we end up with going forward. And nice to have some of this on the go, but not too much that we end up losing focus on Lancashire itself.

So we would like to grow it a little bit. As Richard says, we'll take our time with that and do that slowly. And in terms of capital for it, we have plenty of capital headroom for this business and for our business divisions.

A - Alex Maloney {BIO 16314494 <GO>}

To answer your question, Olivia, at January 1 there was quite a lot of changes to our cat towers. We had a very large treaty renewal that wasn't renewed, which we knew about. You can probably work out who that is.

Then it's very much a case of us looking at the towers. So if we're looking at US Wind, we're looking at Japan, we're looking at our Energy towers, and, in an ideal world, we would have the towers all level and that would probably be the most optimal use of capital.

I think we are very close to that now. What we've done on Accordion, we can't have too much retro on our books because it would just make our exposures too spiky. So that's why we increased the quota share from 85% to 100%.

We did buy some opportunistic reinsurance, which, increasingly, is an area that we're happy to look at. I think that our Bermuda underwriting team is now fully integrated with our actuaries and modelers.

We're just getting much better at looking at risk and return and trying to get the most optimum use of capital, but without forgetting the (saws); the more traditional underwriting factors like continuity for clients.

So I'm quite happy with where we are on a risk-adjusted basis year on year.

Q - Olivia Brindle {BIO 17273762 <GO>}

Okay. Thanks very much. And just, sorry, to follow up on the capital management point. So there's no target for now and you're not actually putting a penny of your own capital again for now, although you could do in the future. Is that right?

A - Richard Brindle {BIO 1983776 <GO>}

Yes. That's right, Olivia. We've obviously had an investment in Accordion and Saltire and we will make investments in future iterations of third-party capital deployment. But there's no target.

We're not really into targets. We don't have targets for our premium, we've never had that. We have forecasts, but we don't have targets.

How can you really have targets in a cyclical market? You've just got to roll with the punches and see what the market conditions are like. If you set yourself targets for growth in a cyclical market that seems, to me, completely daft.

Q - Olivia Brindle {BIO 17273762 <GO>}

Sure, that make sense. Okay. Thanks very much.

Operator

(Operator Instructions) We have no further questions at this time. I will now turn the call back to your host.

A - Richard Brindle {BIO 1983776 <GO>}

Okay. Thanks very much, guys. Bye-bye.

Operator

Thank you, ladies and gentlemen. This concludes today's conference. Thank you for participating. You may now disconnect.