Q2 2018 Earnings Call

Company Participants

- Anne Waleski, Executive Vice President and Chief Financial Officer
- Richard Whitt III, Co-Chief Executive Officer
- Thomas Gayner, Co-Chief Executive Officer

Other Participants

- Bob Farnam
- Jeff Schmitt
- Mark Dwelle
- Mark Hughes

Presentation

Operator

Good morning and welcome to the Markel Corporation Second Quarter 2018 Conference Call. All participants will be in listen-only mode. (Operator Instructions) After today's presentation, there will be an opportunity to ask questions. (Operator Instructions)

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

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

We may also discuss certain non-GAAP financial measures in the call today. You may find a reconciliation to GAAP of these measures in the Form 10-Q which can be found on our website at www.markelcorp.com in the Investor Information section. Please note this event is being recorded.

I would now like to turn the conference over to Tom Gayner, Co-Chief Executive Officer. Please go ahead, sir.

Thomas Gayner {BIO 1896932 <GO>}

Good morning, and thank you, Denise. This is Tom Gayner. It's my pleasure to welcome you to the Markel's Second Quarter Conference Call. I'm joined this morning by my colleagues: Anne Waleski our CFO; and Richie Whitt, our Co-CEO. The purpose of these calls is to share our financial results with you to provide you with some commentary about the numbers and what they mean in terms of the economic progress of your company and to answer your questions.

The headlines for the first half of 2018 are that revenues grew 23% from $2.9 billion to $3.5 billion. Operating income grew 13% from $357 million to $416 million. Net income declined 2.7% from $219 million to $213 million and comprehensive income declined to $565 million to a negative $10.5 million a year ago.

When you look at that series of numbers, a reasonable first question might be, well, how is Markel doing? The answer is that we're doing well. It's complicated to take the steps necessary to understand that answer but we'll do our best to provide commentary as to why we have confidence in saying so.

In short, Markel grew revenues over 20% compared to a year ago. We deployed capital and made acquisitions to increase our revenue base and the size, scale and abilities of your company. At the same time, we competed, adapted, worked hard and learned more about how to grow throughout all our existing and new operations.

In our Insurance business, we increased our earned premiums 14% from $2 billion to $2.3 billion. We did so profitability for the combined ratio of 91 compared to 95 for the first six months of 2017. We also continue to increase the range of our insurance related capabilities. Richie will update you on our conditions and circumstances in our Insurance operations in a few minutes, but suffice to say that we are pleased with these results in an ongoing difficult and challenging insurance industry environment.

In our investment operations, the net investment income grew 6.9% from $199 million to $213 million. This part of the investment equation is the most consistent and stable component of our investment returns. It represents interest and dividend income from our portfolio of equity and fixed income securities.

By contrast the gains and losses from our portfolio are and will likely continue to be quite volatile in any given quarter or year. This is where year-over-year comparisons become somewhat arbitrary and not necessarily in keeping with underlying economic reality.

For example, in 2018, we reported net investment losses of $17.7 million compared to gains of $38.5 million in 2017. Additionally under the new industry accounting treatments in place for 2018, our unrealized gains and losses now flow through the income statement rather than just the balance sheet. While this new accounting makes no economic difference, our net income account during the first six months of 2018 displace unrealized losses of $220 million compared to unrealized gains of $340 million a year ago.

Over longer and more meaningful time periods, our investments earned positive and appropriate returns. We're confident that will continue to be the case. We don't worry too much about short-term volatility where we'd usually chart it out when things are going down. And we don't excessively celebrate short-term periods when the reported numbers are positive.

In our Ventures operations revenues grew 61% from $600 million to $970 million. EBITDA declined 15% from $97 million to $82 million. The primary driver of the increase in revenues comes from our ownership of Costa Farms, but Markel Ventures grew on an overall basis even without considering the impact of Costa.

Frankly, we faced unexpected challenges in one of our operations within Markel Ventures during the quarter. We took actions to deal with them and we posted charges totaling $48 million to deal with the issues. This charge is non-recurrent and should not mar our results going forward. Absent those charges, the EBITDA would've increased more proportionally to the revenue growth that will also be my expectation going forward.

At this point, I'll turn the call over to Anne to provide you with more details on the array of numbers in our report. Richie, will then discuss our insurance operations. And I'll return with comments about our investment in Ventures operations. Anne?

Anne Waleski {BIO 16735457 <GO>}

That you, Tom, and good morning everyone. I'm happy to report the performance for the first half of 2018 was strong. Our underwriting Markel Ventures operations have made substantial contributions to our results during 2018, largely attributable to profitable growth from acquisitions made in 2017.

Our investment returns reflects unfavorable market movements on our fixed maturity portfolio due to rising interest rates. However, we continue to maintain a long-term focus with our investment strategy.

Total operating revenues grew 23% to approximately $3.6 billion in 2018; the increase was primarily attributable to a 14% increase in earned premium and a 62% increase in revenues for Markel Ventures. The increase in earned premiums and other revenues was partially offset by net investment losses for the first six months of 2018 compared to net investment gains last year.

Starting with our underwriting results. Gross written premiums were $3 billion for the first half of 2018 compared to $2.8 billion in 2017, an increase of 7%. The increase in gross premium volumes was attributable to the contribution of premium from our new surety business, which we acquired in May, 2017 and our collateral protection business, which we acquired in November of last year.

We also saw organic growth across most lines within our insurance segment. Retention of gross written premiums decreased from 85% in 2017 to 83% in 2018. This decrease was driven by lower retention on our classic car business within the insurance segment and on our Property product line within the Reinsurance segment. Earned premiums increased 14% to $2.3 billion for the first half of 2018 due to higher written premiums in our insurance segment and higher earnings in our Reinsurance segment related to increased premiums volume in 2017.

Our consolidated combined ratio for the first six months of 2018 was 91% compared to 95% last year. As I mentioned previously the 2017 combined -- consolidated combined ratio included $85 million or four points of adverse development on prior year loss reserves in our Reinsurance segment resulting from the decrease in the Ogden Rate which is used to calculate some awards on U.K. bottling injury cases.

Now let's talk about the results of our Markel Ventures segment. Revenues from Markel Ventures for the first six months of 2018 increased to $971 million compared to $601 million a year ago. The increased revenues are primarily attributable to the third quarter 2017 acquisition of Costa Farms as well as higher revenues in both our products and services businesses. Operating income for Markel Ventures were $37 million for the first half of 2018 compared to $64 million last year. EBITDA was $82 million for the first half of 2018 compared to $97 million last year.

The decrease in both operating income and EBITDA was primarily due to expenses related to an investigation and remediation associated with the manufacture of products at one of our businesses and to an impairment charge related to intangible assets of this reporting unit. These expenses were partially offset by the contribution of operating income and EBITDA attributable to Costa Farms in 2018.

Now taking a look at our investment results. Investment income increased from $200 million for the first half of 2017 to $213 million this year. The increase was driven by short term investment income primarily due to higher short term interest rates and higher dividend income due to increased equity holding and dividend rate compared to the same period of 2017. Net investment losses included in net income were $18 million for the first half of 2018 compared to net investment gains of $38 million in 2017.

Net investment losses for 2018 include $9 million of pretax losses attributable to the decline in the fair value of our equity portfolio. As we discussed last quarter effective January 1 2018 all changes in fair value of the equity portfolio are included in net income rather than other comprehensive income. Net unrealized investment gains decreased $282 million during the first half of 2018 reflecting a decrease in the fair value of our fixed maturity portfolio.

Given our long term focus variability in the timing of investment gains and losses is to be expected. Taking a look at our total results for the year. Our effective tax rate was 47% in 2018 compared to 27% a year ago. As I mentioned last quarter the impact of management's decision to elect the two U.K. subsidiaries as U.S. taxpayers beginning in 2018 added $102 million or 25% to the effective tax rate. Our estimated annual effective tax rate which excludes this impact as well as certain other items that are infrequent or unusual in nature were 20% in 2018 compared to 27% in 2017. The decrease in the estimated annual effective tax rate was primarily attributable to the decrease in the U.S. corporate tax rate from 35% to 21% as a result of Tax Reform Legislation enacted in the fourth quarter of 2017. We reported net income to shareholders of $214 million for the first half of 2018, compared to $220 million a year ago.

Comprehensive loss to shareholders for the period was $11 million compared to comprehensive income to shareholders of $566 million a year ago. The comprehensive loss for the period was driven by the decline in the fair value of fixed maturities since the end of 2017, which was largely offset by net income for the period. Book value per share was $683 at the end of June 2018 compared to $684 at the end of 2017. I think we can call that flattish.

Finally, I'll make a couple of comments on cash flow and the balance sheet. Net cash provided by operating activities was $308 million for the first half of 2018 compared to $238 million for the same period of 2017. Operating cash flows for 2018 reflected higher premium collections, higher cash flows from Markel Ventures and lower payments for employee profit sharing compared to the same period of 2017.

2018 also included higher claim payment, largely driven by the 2017 capacity losses. As of June 30, 2018 we have paid 61% of our total estimated losses on the 2017 catastrophe. Invested assets at the holding company were $2.4 billion at June 30, 2018 and $2.7 billion at the end of the year 2017. The decrease in invested assets is primarily due to an increase in loans and capital contributions to our subsidiaries and interest payments associated with our unsecured senior notes.

With that, I'll turn it over to Richie to talk more about our underwriting results.

Richard Whitt III {BIO 1836438 <GO>}

Thanks, Anne. Good morning, everyone. Today I'll focus my comments on our underwriting operations and also provide a brief updates on State National and Markel CATCo. So first I'll start with the insurance segment. As a reminder starting in the first quarter of this year, we have consolidated the operating results of our previously reported U.S. insurance and International Insurance segment into a new single insurance segment. All results from prior periods for the two separate segments have been combined, so you can compare those.

Gross written premiums for the quarter were up $125 million, or 11% compared to the second quarter of 2017. On a year-to-date basis, writings were up $305 million or 15%. The acquisitions of Markel surety and the State National collateral protection line added $51 million in premiums in the quarter and $118 million in premiums on a year-to-date basis.

Premium growth for both the quarter and on a year-to-date basis excluding the newly acquired product lines was driven by organic growth in our general liability professional liability and personal lines product lines. Earned premiums for this segment are up 14% for the quarter and 17% on a year-to-date basis due to similar reasons as the gross written premium increases.

The combined ratio for the insurance segment was 92 for the second quarter of 2018 compared to 91% for the same period a year ago. The 1 point increase in the combined ratio was driven by the impact of higher earned premiums which reduced the impact of the prior year's loss reserves releases on the combined ratio.

The benefit of higher earned premiums on the expense ratio was offset by an increase in G&A expenses from the newly acquired surety and lender services businesses. Those two businesses have a lower loss ratio but higher expense ratio associated with them.

The year-to-date combined ratio for the insurance segment was 90 versus 91 for the same period last year. The one point decrease in the combined ratio was driven by a lower current accident year loss ratio, due to large attritional losses on Property lines in 2017 and the impact of a lower attritional loss ratios from acquired businesses.

Next, I'll talk about the Reinsurance segment. Gross written premiums for the quarter are down $39 million or 16% compared to the second quarter of 2017. On a year-to-date basis, writings were down $95 million or 12%. The decrease in gross written premiums in the quarter was driven by lower premium volumes in the general liability and Property product lines, due to timing of renewals of multi-year contracts and non-renewals in the Property book.

The decrease in gross written premium on year-to-date basis was primarily driven by a large specialty quota share treaty entered into the first quarter of 2017 that was not renewed along with the decrease in our Property lines, due primarily to two contracts that were not renewed.

During the first half of the year, we have not renewed marginal Property business, where rates and returns did not improve sufficiently to meet our profitability targets. As mentioned in previous quarters, significant volatility in gross premium volume can be expected in our Reinsurance segment, due to individually large deals and timing of renewals on multi-year contracts.

Earned premiums for this segment are flat for the quarter, and up 5% on a year-to-date basis, due to gross written premium growth from 2017 contracts earning into this year. The combined ratio of the Reinsurance segment was 90% for the second quarter of 2018 compared to 85% for that same period a year ago. The five point increase in the combined ratio was due to less favorable development on the prior year's loss reserves.

Contributing to the increase in the prior year's loss ratio was less favorable development on prior year's loss reserves on the whole account product line and adverse development from the 2017 cat events of $5 million, partially offset by more favorable developments in Surety and Marine and Energy product lines.

The year-to-date combined ratio for the Reinsurance segment was 94 versus 108 for the same period a year ago. The 14 point decrease in the combined ratio was driven by more favorable development on prior year's loss reserve and the lower current accident year loss ratio and expense ratio.

As Anne, previously discussed many times, the first quarter of 2017 results for the Reinsurance segment included $85 million or 19 points on the segment combined ratio of adverse development related to the decrease in the Ogden Rate.

Excluding the impact of Ogden, the segment had less favorable development in 2018 compared to 2017 due to adverse development in our Property reinsurance lines compared to favorable development in Property to previous year.

The adverse development experienced in 2017 -- 2018 is driven by $17 million related to the 2017 cat events. On a year-to-date basis, in total, our insurance and reinsurance segments increased reserves for the 2017 cat events by approximately $5 million. The decrease in the current accident year loss ratios for the first six months in 2018 was due to higher earned premium as a result of net favorable premium adjustments this year compared to net unfavorable premium adjustments last year. The decrease in the expense ratio was due to lower profit sharing expenses in 2018 compared to 2017.

Next I'll make a few comments about our State National acquisition. As a reminder, State National business is comprised of two primary products a collateral protection insurance coverage results for which are included in our insurance segment and farming platform which provides insurance licenses, waited paper and services for fee. We refer to this business as our program services business. This business is non-risk bearing to Markel and is reported separately from our underwriting operations.

The collateral protection insurance line contributed $42 million of gross written premium in the quarter and $88 million on a year-to-date basis to the insurance segment operating results. It also produced a solid underwriting profit. The program services business added $555 million in gross written premium in the quarter and $1 billion for the first six months. The business also contributed $23 million in the quarter and $45 million during the first half of 2018 and speeding commission fee revenue from the gross written premium funded during the period.

This was reported in other revenues within our operating results. We're very pleased with the State National's year-to-date results. Moving to Markel CATCo. Assets under management including funds held that would be used to settle claims for incurred losses increased to $6.6 billion at June 30, 2018 up from $6.1 billion at the end of 2017. As of June 2018, Markel's investment in the Markel CATCo funds was approximately $132 million. We recognized investment losses of $28 million in the quarter and $51 million on a year-to-date basis due to decreases in the net asset value of the funds due to adverse developments on the 2017 cat events.

The adverse development was primarily related to Hurricane Irma as a result of significant increases in loss adjustment expense, late claim reporting and increased Caribbean loss estimates. Finally, I'll end with some market commentary. Honestly, there's not much new to report from last quarter. The market remains competitive but we are achieving modest digit rate increases in many of our lines of business. The highest rate increases are in Property. However despite continued increases in losses from the 2017 cat events inexplicably property price momentum has slowed through the first half of the year.

Interesting -- interestingly you can see underwriting pain getting to pick up in the market. Whether it'd be the Lloyd's franchise drive to remediate under-performing lines of business or companies having earnings misses due underwriting business -- underwriting payment is increasing. I've also personally noted that many more of today's insurance headlines are about insurance pulling out of lines of business. While a year ago all the news seem to be about insurance entering new lines of business or adding underwriting teams.

They're also clear signs of inflation pressure are building in the real economy. I define the real economy is the one where you and I buy stuff versus the fantasy economy the government reports on that seems to exclude the stuff that people buy. Full employment leading to wage inflation, tariff leading to increases in commodity cost and replacement cost and the gradual erosion of tort reform are all leading towards rising claim cost inflation.

Every day at Markel, we're stretching to our underwriters the absolute necessity of price increases and underwriting discipline. Unfortunately it's been proved over and over again severe underwriting pain is required before the insurance industry will collectively get its act together and price risk appropriately. At Markel, we see the pain coming and we're working hard to ensure that we are not impacted when it gets here.

Thanks for your time today. And now I'll turn things over to Tom.

Thomas Gayner {BIO 1896932 <GO>}

Thank you, Richie. Investments result during the first half reflected a normal pattern short-term volatility. In our equity portfolio, we were up a modest 1.5% during the first half. Over the last 5.5 years we're up 222% cumulatively. Over that timeframe, we've been up as much as 33% in a single year, and down as much as 2.5% in a year.

I would happily sign up for those results for the next 5.5 years and we continue to invest each day with the same discipline that has produced such outstanding long-term results.

Publically traded equity stood at 64% of shareholders equity at June 30, compared to 62% at year-end. We continue to modestly and steadily add to our equity portfolio and we think the recent volatility allows us the chance to purchase wonderful long-term businesses at attractive prices. That is exactly what we are doing.

In our fixed income operation, we were down 0.3% during the first half. In the last 5.5 years we're up 14.2% cumulatively. The best year in those five was up 6.5% and the worst was flat. I think this longer term comparison highlights why we allocate so much of our investment portfolio to equities.

I would also sign up right now for these types of fixed income returns over the next 5.5 years, since they reflect the underlying actions of buying the highest credit quality securities that we can find, roughly matching the duration of our bonds to that of our insurance liabilities, and minimizing frictional cost along the way.

Also point out that net investment income from an interest income and dividends totaled $213 million during the first half, compared to $199 million a year ago, an increase of roughly 7%. This higher return portion of our total return stems from rising interest rates and increase in dividends from our high quality equity securities. This line is much less volatile than the unrealized gains and losses. And I'm pleased with this progress and expect more to come.

At Markel Ventures, we reported revenues of $971 million versus $600 million, an increase of 61%, while EBITDA declined 15% to $82 million versus $97 million. I'm highly optimistic that we will enjoy proportional increases in profitability going forward to go along with the increased size and scale of Markel Ventures. All of our businesses faced challenges such as competitive market conditions, labor market price and availability pressures, steel price volatility, trucking and transportation bottlenecks and numerous other factors. Despite these forces, the group continues to make economic progress and produce good returns for Markel.

Overtime EBITDA should highly correlate to total revenues. One of our unique competitive advantages at Markel is our focus on long-term results and long-term commonsense behavior in all aspects. If you're trying to figure out a normalized earnings power sort of number for Markel Ventures, I would take a normalized revenue number and a normalized EBITDA percentage number to get normal economic earnings. I look forward to reporting on the group's results in coming period and demonstrating that very outcome.

During the quarter, we also announced formation of Rosemont Investment Group as part of Markel Ventures. Chas Burkhart joins us with 18 years of successful history in running Rosemont. In this business, we'll be investing in the ownership of asset management firms. We're excited to announce this addition to Markel Ventures and we're optimistic about the multiple opportunities we are already seeing in light of this announcement. With that, I hope you we've given you some sense for why we are confident that Markel is indeed doing well.

And I'd like to open the floor for your questions. Denise, if you would open-up for questions?

Operator

Thank you. We will begin the question-and-answer session. (Operator Instructions) And your first question this morning will come from Mark Hughes of SunTrust. Please go ahead.

Mark Hughes {BIO 1506147 <GO>}

Thank you. Good morning.

Thomas Gayner {BIO 1896932 <GO>}

Good morning.

Anne Waleski {BIO 16735457 <GO>}

Good morning.

Mark Hughes {BIO 1506147 <GO>}

The step-up sequentially in the Markel Ventures revenue I think you we're 439 in terms of other revenue in the first quarter of the 628. How much of that was seasonality versus underlying growth?

Thomas Gayner {BIO 1896932 <GO>}

Yeah. It's a mix of both and cost of which we referred to you several times. Second quarter would be one of the biggest seasons of the year third quarter will be not quite that and fourth and first quarter are the lowest. So, yeah, there is seasonality factor involved.

Mark Hughes {BIO 1506147 <GO>}

And when we look at the -- I think your organic growth in the insurance segment you had mentioned general liability and professional liability as a stand out there. Can you talk about the maybe the price or rate that you're seeing there in any particular updates on medical professional liability?

Richard Whitt III {BIO 1836438 <GO>}

You know, I would say both of those areas we're seeing sort of a low single digit increases in pricing. I clearly would love to see more but that's what the market provides at the moment. And with the growth in the economy I think most of the growth we're seeing is not price I think that's a good economy out there. There's a lot of construction going on and as a result we're seeing more business.

In terms of medical I would say that's still one of the lines that were struggling to gain price direction to start going up. I think results have been for the most part poor for people in medical in the recent years. But for whatever reason pricing hasn't responded yet. So that would be one of the I'd say most lines we're seeing sort of the single digit increases. Medical is probably one of those areas where we're still waiting to see some increases.

Mark Hughes {BIO 1506147 <GO>}

And then finally you mentioned Lloyd that they are doing I think a comprehensive review. Have you seen any behavioral changes in your relevant markets?

Richard Whitt III {BIO 1836438 <GO>}

I think so. I mean the news as I sort of pointed out a year ago it seems like everybody was reporting on adding lines of business or adding teams. In the last several months particularly since Lloyds announced their drive to work on sort of the lines of business that were hurting the market, you're seeing people move out of lines of business or teams leaving. And so I think reality is starting to set in.

Mark Hughes {BIO 1506147 <GO>}

Thank you.

Questions And Answers

Operator

The next question will be from Jeff Schmitt of William Blair. Please go ahead.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Hi, good morning, everyone. Question on Costa Farms just about the -- how's the business doing after the inventory loss last year? I mean did that have any effect on the quarter or was that sort of properly grown and had no impact?

A - Richard Whitt III {BIO 1836438 <GO>}

Yes, in addition to the seasonality question that Mark asked before that is magnified and stood out a little bit more by the fact that we are still recovery from the hurricane to a certain amount. So just with growing cycles what they are some plans taking couple of weeks some things take a couple of months. It takes a while to refill the entire pipeline. So the main take away I would say is a, the business doing well that's how we're as delighted as we possibly could be with the affiliation and the cost of family and the nature that business. It would be a mistake to annualize the current year results or last year results if it both have a lot of distortion to it. But remember we have a long term focus at Markel and when you start looking at the thing over years as a fellow Markel shareholder I feel very happy that that's part of the family.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Okay. And then did I -- I may misheard a minute or two ago when you talked about the seasonality of Costa Farms. Did you say the fourth and first quarters were lower? I would think the fourth would be higher from with Christmas but is that not the case?

A - Richard Whitt III {BIO 1836438 <GO>}

Well I invite you to see how much of it is in the cost up [ph] -- versus some of the other stuff we buy in different parts for the year. (inaudible) but that tends to be something that you leave it open there's price promotions by the retailers and what not. (inaudible) but the second and third quarters are our highest parts of the business.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Okay. Is there anything more you can say on the investigation charge and the goodwill impairment? I mean, is there a potential for that to for there to be more charges?

A - Richard Whitt III {BIO 1836438 <GO>}

Well, we've put up our best estimates, what we think the total expenses involved are. And that's the same process and philosophy in the way we put up insurances reserve and deal with uncertainty in life and we have a history of conservative accounting of doing our very best to recognize things quickly. And at the instant, we know what, you know it soon after is possible [ph].

Q - Jeff Schmitt {BIO 19747235 <GO>}

Okay. And then last one, you had mentioned some pressure on losses from tort activity. Is that -- are you seeing that anecdotally? Or can you quantify that in anyway?

A - Richard Whitt III {BIO 1836438 <GO>}

It's hard to quantify, but things in the world tend to work in cycles. And few years back there was a lot of effort in tort reform and ever since then planet bar [ph] has been sort of chipping away at that. And you continue to see that I mean in states like Florida, Texas California there's been significant erosion in tort reform in those areas. And you're starting to show up in lost cost. I couldn't quantify it for you, but it's just kind of what happens as markets change.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Are there any lines in particular that you're seeing the most aggressiveness?

A - Richard Whitt III {BIO 1836438 <GO>}

Probably every one of the areas in this business been talked about in a lot on calls over probably the last years in auto. You're seeing some really eye watering verdicts in some of the auto claims particularly like trucking things of that sort, commercial auto in particular. Where it really looks like judgments are more to punish than to make people hold.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Okay, thank you.

Operator

And next question will be from Bob Farnam of Boenning and Scattergood, please go ahead.

Q - Bob Farnam {BIO 15005467 <GO>}

Yeah. Hi, and good morning. I have a question on the expense ratio in the insurance operations. So consolidated expense ratio is about 39% in the first -- in the second quarter. And they may gradually trending down over the last five years or so from low 40s to the high 30s. I understand, the surety in the collateral protection this is just going to put some of upward pressure on that. But I'm just curious where do you see that the expense ratio going overtime. Can we expect that to come down?

A - Richard Whitt III {BIO 1836438 <GO>}

I'll take this and you guys are welcome to jump-in. I mean, that is absolutely our goal for that to continue to trend down, Bob. We -- by adding surety and the -- the vendor services business -- collateral protections, sorry -- we kind of gone the other direction in terms of mix that probably adds a point just in terms of mix of business. But in our underlying sort of G&A cost everything we've done a nice job of reducing those. So, we'll -- as long as businesses generate sufficient underwriting profits we'll be indifferent as to the loss ratio component and the expense ratio component. But sort of a headline number gets pushed up as a result of adding those businesses. The other thing that tends to happen throughout the year is our bonus accruals and the balance around and add some volatility. And I think you're seeing a little bit of that in the second quarter as well. So we still believe the underlying trend is reduction to the expense ratio, it just doesn't show up as well with the no ways [ph] right now.

Q - Bob Farnam {BIO 15005467 <GO>}

Great. And then as you say, it's probably more important the combined ratio basis than looking expense ratio versus loss ratio. So actually another question for you. So there was a substantial growth in the program services business gross written premium in the second quarter relative to the first quarter, is there any seasonality to the State National book?

A - Thomas Gayner {BIO 1896932 <GO>}

No, there is no seasonality but much like we talked about there could be big transactions in our reinsurance segment. In the State National fronting programs those can be big programs and when they come on, they move the numbers rather quickly. So I think it's more a factor of when new programs come online. And then how big those programs are. So there's probably going to be a little more volatility in that than some of the other lines of business.

Q - Bob Farnam {BIO 15005467 <GO>}

So should we look at maybe the first six months and use that more of a trend going forward -- is that.

A - Thomas Gayner {BIO 1896932 <GO>}

Yes, I mean we're certainly experiencing growth in the vendor services business. It can be bumpy from quarter-to-quarter but the underlying trend is growth.

Q - Bob Farnam {BIO 15005467 <GO>}

Okay. And the last question for me is it looks like you received your license to reinsure business in India. I don't know much about the market in India. What kind -- what's the opportunity there in your mind?

A - Thomas Gayner {BIO 1896932 <GO>}

Well, I think the opportunity is one of the most populated countries in the world with a rapidly growing middle class rapidly growing GDP it's been a very closed market to insurance companies outside of the country. That is -- that's been changing gradually over the last few years. And has changed to the point where we are willing to invest in the company in a -- in the country in a small way. I wouldn't expect to be talking about huge writings in India on the next several calls. We want to get there we want to learn about the culture and how the business works and hopefully grow as that economy grows.

Q - Bob Farnam {BIO 15005467 <GO>}

And likely reinsuring domestic writers, is that likely.

A - Thomas Gayner {BIO 1896932 <GO>}

Correct, correct. Which we have done historically. We've just done it from Singapore or we have done it from London.

Q - Bob Farnam {BIO 15005467 <GO>}

Okay.

A - Thomas Gayner {BIO 1896932 <GO>}

So it's something best to have feet on the ground people there that know have relationships and know the culture and that's the steps we've taken now.

Q - Bob Farnam {BIO 15005467 <GO>}

Okay, very good. Thanks for that.

Operator

And the next question will be from Mark Dwelle of RBC Capital Markets. Please go ahead.

Q - Mark Dwelle {BIO 4211726 <GO>}

Yeah, good morning. A lot of my questions have already been covered but a couple for Tom. Within Markel Ventures a lot of those businesses use steel for lack of better description. Are you seeing any cost pressures yet, and any anticipation of cost pressures, or your ability to pass that cost along should it occur to customers as a result of tariffs and whatnot?

A - Thomas Gayner {BIO 1896932 <GO>}

It'll work, yes. And it's not just cost it's availability. So just getting our hands on steel to run the business is more of a challenge today than it was a year ago. Now everybody works hard and figures that out but yes that's a topic (inaudible) these days.

Q - Mark Dwelle {BIO 4211726 <GO>}

Okay. Secondly I mean you made some comments already about the charge in the quarter and the goodwill impairment there. Was that item or that issue a subject to litigation? It appeared in the contingency second section, I wasn't clear from that placement, whether that was a litigation item or just something that you guys were investigating?

A - Thomas Gayner {BIO 1896932 <GO>}

That was internal and we have to put contingencies like what we did in a standard business practice.

Q - Mark Dwelle {BIO 4211726 <GO>}

Excellent. Thanks. And I guess the last question that I had. Again, it relates to the tax rate. I'm still been struggling to get my arms around this, this quarter seems to be little bit higher than the first quarter. I didn't know. And if you had any kind of guidance, or way of thinking about that tax rate to try to help us kind of pin that down a little bit more exactly?

A - Anne Waleski {BIO 16735457 <GO>}

No, I mean, I think it was slightly higher than the first quarter 20% versus 19%. So I mean, I think something in the low 20s% high-teens is probably a fair guess. As we talked about whether it's the U.K. tax election that we made earlier or it's the movement in the equity portfolios that tax rate is going to move around some. But I would think that that effective annual tax rate of 20%-ish is probably a fair enough estimate for your purposes.

Q - Mark Dwelle {BIO 4211726 <GO>}

All right. Okay. That's kind of what I thought as well. I think those are all my questions. Most of guys ahead of me already covered the other ones. Thanks.

A - Thomas Gayner {BIO 1896932 <GO>}

Terrific.

A - Anne Waleski {BIO 16735457 <GO>}

Thank you.

Operator

And the next question will be a follow-up from Mark Hughes of SunTrust. Please go ahead.

Q - Mark Hughes {BIO 1506147 <GO>}

I just had a general question your view on the strength of the economy the sustainability of the kind of this GDP we've seen lately? And, if there is inflation on the way? How are you thinking about the equity portfolio?

A - Thomas Gayner {BIO 1896932 <GO>}

Yeah, I'll take that and there's two different parts to answer that, strength and sustainability. In terms of strength, I mean, it's boom times out there. So anywhere you want, look out to construction cranes try to hire somebody, look at labor markets, try to get a hold, anyone of those measures that you wanted to look at. The conditions are about running as hot as I could remember in a long, long time. Sustainability, your guess is as good as mine, that's crystal ball stuff and we don't know.

So I don't really have anything to add on that. In terms of the equity portfolio itself and the insurance pricing risk that Richie referred to. This is the kind of stuff that he and I talked about on a regular basis to keep one another informed on both sides as to what we're seeing and thinking about and trying to make show we're communicating throughout the organization to do the best we can.

We've always been very cognizant of sort of real pricing power in the business as we invest in now and we've also always had a pretty high proportion of equity securities where those are dynamic businesses that we even live and move and change and adapt to whatever circumstances they find themselves in. So part of the answer to your question and protecting Markel is to increase the allocation to equities in a prudent and reasonable way. Because those are inflation protected in a better way than a bond would be by definition.

Q - Mark Hughes {BIO 1506147 <GO>}

Thanks for that.

Operator

And ladies and gentlemen, this will conclude our question-and-answer session. I would like to turn the conference back over to Tom Gayner for his closing remarks.

A - Thomas Gayner {BIO 1896932 <GO>}

Thank you very much. We'll talk to you next quarter.

Operator

Thank you, sir. Ladies and gentlemen, the conference has concluded. Thank you for attending today's presentation. You may now disconnect your lines.