Q1 2013 Earnings Call

Company Participants

- Dave Bonham, CFO
- Paul Rivett, VP of Operations
- Prem Watsa, Chairman and CEO

Other Participants

- Howard Flinker, Analyst
- Jeff Fenwick, Analyst
- Mark Dwelle, Analyst
- Paul Holden, Analyst
- Ryan Penton, Analyst

Presentation

Operator

Good morning. Welcome to Fairfax's 2013 First Quarter results conference call. Your lines have been placed in a listen-only mode. After the presentation, we will conduct a question-and-answer session.

(Operator Instructions)

For time's sake, we ask that you limit your question to one.

Today's conference is being recorded. If you have any objections, you may disconnect at this time.

Your host for today's call is Prem Watsa, with opening remarks from Paul Rivett. Mr. Rivett, please begin.

Paul Rivett {BIO 15243791 <GO>}

Thank you, Audra. Good morning. Welcome to the call to discuss Fairfax's 2013 First Quarter results. This call may include forward-looking statements. Actual results may differ, perhaps materially, from those contained in such forward-looking statements as a result of a variety of uncertainties and risk factors, the most foreseeable of which are set out under Risk Factors in our base shelf prospectus filed with Canadian Securities Regulators.

I can now turn the call over to our Chairman and CEO, Prem Watsa.

Prem Watsa {BIO 1433188 <GO>}

Thank you, Paul. Good morning, ladies and gentlemen. Welcome to Fairfax's First Quarter conference call. I plan to give you some of the highlights, and then pass it on to Dave Bonham, our CFO, for additional financial details.

First quarter of 2013 book value per share increased by 1.3%, adjusted for the $10 per share common dividend paid in the First Quarter of 2013. We had a strong underwriting result in the First Quarter of 2013 on increased premiums, while maintaining disciplined underwriting. We are maintaining our defensive equity hedges, as we remain concerned about the financial markets and the economic outlook. We continue to be soundly financed, with quarter-end cash and marketable securities at the Holding Company in excess of $1.2 billion. Net premiums written by the Company's insurance and reinsurance operations in the First Quarter of 2013 increased by 5.5% to $1.606 billion, due primarily to increased property business at Odyssey Re, continued year-over-year rate increases at Zenith, modest growth and increased premium retention at Northbridge, and modest growth at Fairfax Asia.

At the subsidiary levels, net premiums written in quarter-one 2013 and combined ratios were as follows. Odyssey Re, up 13.6%, with a combined ratio of 82.9%; Crum & Forster, premiums were down 5.6%, with a combined ratio a little below 100%, 99.7%; Northbridge, premiums were up 6.5%, with a combined ratio of 100.5%; Zenith, premiums were up 11.9%, with a combined ratio of 110.2%; and Fairfax Asia, premiums were up 4.5%, with a combined ratio of 91%.

Just a quick comment on Zenith -- its combined ratio is still 110.2%. Over 30 years before our purchase -- so prior to our purchase, 30 years of history, Zenith had a combined ratio, on average, of 95%. And its loss ratio over that 30 years was 15 to 20 points better than the industry. And so it's a terrific track record since our purchase, because the business has been shrunk -- has come down significantly. The combined ratios have been running at 125% to 130%, come down to 110%, and we think Zenith is well on its way.

So in the First Quarter, we continued to grow. Very low interest rates and the reduced reserve redundancies means there is no place to hide for the industry, as I've said before. Combined ratios have to drop well below 100% for the industry to make a single-digit return on equity with these low interest rates. While the short term is always tough to predict, fundamentals will eventually play out.

Net investment gains of $9.4 million in the First Quarter of 2013 consisted of the following. Please note the table on page two of our press release. You'll see in that table, net gains on equity and equity-related investments of $698 million were predominately unrealized, and were neutralized by net unrealized losses of $593 million on our equity hedges. After unrealized bond losses of $119 million, and $32 million in unrealized CPI-linked derivative losses, resulting in a net gain of $9.4 million -- all unrealized. Realized gains from stocks and bonds during the quarter were $165.3 million. The Company held in excess of $1.2

billion of cash, short-term investments and marketable securities at the Holding-Company level at March 31, 2013. Finally, we continue to be approximately 100% hedged in relation to our equity and equity-related securities, which includes convertible bonds and convertible preferred stock.

We continue to be very concerned about the prospects for the financial markets and the economies of North America and Western Europe, accentuated by potential weakness in China. There continues to be a big disconnect between the financial markets and the underlying economic fundamentals. As at March 31, 2013, we have over 27%, or $7 billion, in cash and short-term investments in our portfolios to take advantage of opportunities that come our way. In the short term, our investment income will be reduced.

Now I would like to turn it over to Dave, so he can give you some more information on the underlying financials. Dave?

Dave Bonham {BIO 15243784 <GO>}

Thank you, Prem. First, I'll focus on Fairfax's consolidated results for the First Quarter of 2013. Then I'll move on to the operating company results; and finally, I'll finish up with the consolidated financial position.

For the First Quarter of 2013, Fairfax reported net earnings of $162 million, or $7.12 per share on a fully diluted basis. That compares to the First Quarter of 2012, when we reported a net loss of $3 million, or a loss of $0.76 per share on a fully diluted basis.

Turning to the underwriting results of our insurance and reinsurance operations, in the First Quarter of 2013, Fairfax reported a consolidated combined ratio of 94%, and an underwriting profit of $86 million. That compares to the consolidated combined ratio of 98.8%, and the underwriting profit of $16 million that we had in Q1 last year. Current-period catastrophe losses were comparable year over year; and in the First Quarter of 2013, we had just over $32 million of current-period catastrophe losses, adding about 2.3 points to our combined ratio. That compares to the First Quarter of 2012, where we had $26 million of catastrophe losses, adding about 2 points to our combined ratio.

In terms of our reserve development, we experienced $36 million of net favorable development to prior years' reserves, and that benefited our combined ratio in the First Quarter of 2013 by 2.5 points, compared to just $2 million of net favorable reserve development in the First Quarter of 2012, which had a nominal effect on our combined ratio. Our accident-year combined ratio in the First Quarter of 2013 was 96.5%, and that compares to 98.9% in the First Quarter of 2012. That improvement is primarily reflective of lower year-over-year non-catastrophe-related large losses, and a decrease in the accident-year loss ratio at Zenith National.

Now turning to our operating company results, starting with Odyssey Re. In the First Quarter of 2013, Odyssey Re reported an underwriting profit of $95 million and a combined ratio of 82.9%, and that compares to an underwriting profit of $64 million and a combined ratio of 87% in the First Quarter of 2012. Catastrophe losses were relatively light, at $32 million, representing 5.8 combined ratio points, but slightly higher than the First Quarter of 2012, where we saw catastrophe losses of $24 million, representing 4.8 combined ratio points.

In the First Quarter of 2013, Odyssey Re's combined ratio included the benefit of 3.2 points, or $18 million, of net favorable reserve development, and that principally related to favorable emergence on prior years' catastrophe losses. Odyssey wrote $604 million of net premiums in the First Quarter of 2013, and that was up from $526 million in the First Quarter of 2012. That increase reflected the impact of a Florida property quota share reinsurance contract that incepted on June 1, 2012, and also reflected increased retentions of US crop insurance business.

Moving on to Crum & Forster. Crum & Forster reported an underwriting profit of $1 million, and a combined ratio of 99.7% in the First Quarter of 2013. That compared to an underwriting loss of $14 million, and a combined ratio of 105.1% in the First Quarter of 2012. The improvement in Crum & Forster's underwriting results was due to changes in the mix of business to focus on more profitable lines, and the absence of net adverse development of prior years' reserves, which added $5 million to the underwriting loss in the First Quarter of 2012.

Net premiums written by Crum & Forster decreased from $308 million in the First Quarter of 2012 to $291 million in the First Quarter of 2013. The net premiums written at Crum & Forster were impacted by decisions to exit less profitable lines of business, and that was partially offset by the continuation of the growth in specialty lines of business, which present greater opportunities for profitability.

Zenith National reported a combined ratio of 110.2% in the First Quarter of 2013, and that compared to 117.7% in the same period last year. The year-over-year improvement primarily reflected earned premium price increases in the First Quarter of 2013 that exceeded Zenith's estimates of loss trends, and that also combined with a lower expense ratio, as a result of an 11.1% year-over-year increase in net premiums earned. Net premiums written by Zenith of $286 million during the First Quarter of 2013 increased year over year by 11.9%, and that primarily reflecting premium rate increases.

Northbridge's combined ratio in the First Quarter of 2013 decreased from 104.3% in the First Quarter of 2012 to 100.5% in the First Quarter of 2013. The improvement in the First Quarter of 2013 reflected increased net favorable development of prior years' reserves, and fewer non-catastrophe-related large losses and the absence of any current-period catastrophe losses.

Net premiums written by Northbridge of $248 million in the First Quarter of 2013, and $202 million in the First Quarter of 2012, require two adjustments to make them comparable. First, Group Re, an affiliated reinsurer, returned $39 million of premium to Northbridge, effective January 1, 2013, following the cancellation of a 10% intercompany quota share reinsurance contract. Second, Northbridge's net premiums written in the First Quarter of 2012 included $5 million related to its US property business, which was renewed by an insurance subsidiary of Odyssey Re, effective May 1, 2012. So excluding the $39 million of net premiums written from the First Quarter of 2013, and adjusting for the impact of the non-renewal of the US property business, Northbridge's net premiums written increased by 6.5% in US dollar terms in the First Quarter of 2013. Page 39 of our First Quarter interim report describes these adjustments I just mentioned in more detail.

Fairfax Asia's combined ratio improved modestly from 92% in the First Quarter of 2012 to 91% in the First Quarter of 2013. Net premiums written by Fairfax Asia increased by 4.5%, to $76 million in 2013 from $73 million in 2012, and this was principally as a result of increased writings of property, commercial automobile, and engineering lines of business. The combined ratio of the insurance and reinsurance Other division improved from 101.7% in the First Quarter of 2012 to 98.4% in 2013, primarily reflecting increased net favorable development of prior years' reserves in the First Quarter of 2013.

Run-off reported a pretax loss of $14 million in the First Quarter, compared to a pretax profit of $54 million in the First Quarter of 2012, and this was principally as a result of net investment losses of $13 million in 2013, which compared to net investment gains of $51 million in the First Quarter of 2012. Included in the Run-off result was a $33 million gain recognized on the commutation of a reinsurance recoverable, and this was partially offset by reserve strengthening at US Run-off of about $31 million. The commutation allowed Run-off to receive cash of approximately $119 million in satisfaction of a reinsurance recoverable, which they carried on their balance sheet at $86 million.

Our First Quarter consolidated interest and dividend income decreased from $130 million in the First Quarter of 2012 to $100 million in the First Quarter of 2013. This decrease primarily reflected lower investment income earned as a result of sales during 2012 of higher-yielding (government) bonds, those principally being Canadian government bonds and US Treasuries.

Rounding out our review of the income statement, the Company recorded a recovery of income taxes of $51 million, despite $112 million of earnings before income taxes. The following are the principal reasons why our effective tax rate differed from our statutory tax rate. First, there was our regularly recurring adjustment, which was a benefit to our statutory tax rate, related to non-taxable investment income, principally comprised of non-taxable interest income on municipal bonds, non-taxable dividend income that is received in the US and Canada, and certain capital gains which are only 50% taxable in Canada.

Second, we had what we referred to in our press release as tax rate differences. This is also a regularly recurring adjustment, and this quarter it benefited our statutory tax rate, and it arises when we earn income or incur losses in jurisdictions where the tax rate is different from the Canadian statutory tax rate of 26.5%.

And finally, as has occurred in prior years, we earned income in jurisdictions where previously we had incurred operating losses, and we were able to use those operating losses in the current quarter, but those operating losses from prior years had never been set up as part of our deferred tax asset. For further details of what I just mentioned, please refer to page 19 of our First Quarter interim report, which is posted on our website.

We ended the quarter with an investment portfolio which included Holding Company cash and investments of $25.6 billion, compared to $26.1 billion at the end of 2012. A significant portion of the decrease related to the effect of foreign currency translation and net cash paid in connection with the reset provisions of the Company's total return swaps.

Moving to our financial position, our debt-to-total-capital ratio increased to 26.8% from 25.5% at December 31, 2012, due primarily to the additional debt we issued in the First Quarter of the year. We retired $48 million of debt in the First Quarter, and we have $183 million of Odyssey Re debt maturing in the Fall of 2013. After repayment of the Odyssey Re debt in November, on a pro forma basis, our debt-to-capital ratio is expected to return to approximately 25.7%, more or less consistent with December 31, 2012.

And now I'll pass it back over to you, Prem.

Prem Watsa {BIO 1433188 <GO>}

Thank you, Dave. Now we're happy to answer your questions. Please give us your name, your company name, and try to limit your questions to only one, so that it is fair to all of the call.

Okay, Audra, we're ready for questions.

Questions And Answers

Operator

Thank you.

(Operator Instructions)

Jeff Fenwick, Cormark Securities.

Q - Jeff Fenwick {BIO 15350794 <GO>}

Prem, you've mentioned that the insurance industry may have no place to hide going forward here. We're starting to see some data that commercial lines pricing is improving south of the border. And I'm just wondering, on a near-term basis here, what do you believe is the outlook for this year and then into next year for a more definitive hardening in the commercial market, south of the border?

A - Prem Watsa {BIO 1433188 <GO>}

Yes. So just to explain that comment. Interest rates today, five-year Treasury rates are 0.65%, like less than 70 basis points, Jeff, versus about 5%, five or six years ago. The hard market reserves, depending on how you define it, 2003 to 2006, or 2003 to 2008, is between 10% and 20% of total reserves that exist on property-casualty insurance companies' balance sheet today. So there's the ability to have the redundancies is reduced significantly. And so when you take those two into account and you look at the interplay of those two factors, even at a 95% combined ratio, you get a single digit return on equity. And so it just means that prices have to continue to go up. They're going, depending on the line, 5%, maybe a little higher. And workers compensation is higher, 10% plus. California's a little higher than that.

But we think the underlying fundamentals are attractive. But when you have a hard market, you have prices going up much more than that. We're not in that type of hard market. But we're certainly in a market that prices appear to be going up. Now, some prices may come down. Property cat prices have gone up significantly after 2011. The Japanese tsunami and the other catastrophes, the second largest cat year in 2011, well, they're tending to flatten out and come down. So you have these fluctuations. But broadly speaking the property-casualty industry that we operate in, the pricing is improving and our business is improving. We've been growing now for a couple of years. In the First Quarter, we grew about 5%, in total, for all our companies.

Q - Jeff Fenwick {BIO 15350794 <GO>}

Okay. And maybe, Prem, you just contrast that with Canada. It seems like Canada's taking longer to start to get any momentum behind it, and you've been doing a lot of work at Northbridge. How do you feel in the process of that effort in Northbridge, where it stands today, and how the Company there is positioned to move forward?

A - Prem Watsa {BIO 1433188 <GO>}

Northbridge for us -- we've been in Canada. We started in Canada. We've had 27 years. Our Company is in very good shape. All our companies, by the way, have really good reserving, which is very important. Because if you didn't, you're going to see companies show reserve development. So Northbridge came out with a combined ratio a little above 100%, and we're comfortable with where the Company is, focused on getting it, of course, below 100, under Silvy Wright's leadership. But Canada's always lagged, Jeff, the US. The US goes down a lot more than us and then comes back up, also significantly. We don't go down as much and we lag the United States.

I must also say -- and we said this at the annual meeting -- that our new structure, with Andy Barnard responsible for our insurance companies, property-casualty insurance companies worldwide, is also a big plus in terms of the focus on underwriting profitability. We've also always had a focus on underwriting profitability. It's accentuated by the fact that Andy's responsible for these companies all over the world. So yes, Jeff, we're very positive about what's happening at Northbridge.

Q - Jeff Fenwick {BIO 15350794 <GO>}

Okay. Thank you.

A - Prem Watsa {BIO 1433188 <GO>}

Thank you, Jeff. Next question, Audra.

Operator

(Operator Instructions)

Paul Holden, JIBC.

Q - Paul Holden {BIO 6328596 <GO>}

Just one question for you, Prem. You've talked about reserve releases for the industry, and it looks like probably that they're running out on redundancies. And we've seen a pretty high favorable reserve development out of Fairfax for the last four consecutive quarters now. Is there much more room for Fairfax to be able to release reserves, or is that pretty much played out, as well?

A - Prem Watsa {BIO 1433188 <GO>}

Well this is a good question, Jeff. What we try to do is we always keep our accident loss ratios, accident combined ratios, which we've shown you by our company, at a high level, and with the idea that over time, we might have some redundancies. But it's fair to say that for the industry and ourselves, that the surpluses of the hard market are much reduced. So it's fair to say. We just have a very strong reserving policy at Fairfax that, over time, as I've showed you in our annual report, we need to see redundancies as opposed to efficiencies, in hard markets and soft markets. So that's just the policy we've got. But your point's well taken. Those will be more difficult for us to show, as time goes by. But our policy's very much in place.

Q - Paul Holden {BIO 6328596 <GO>}

Great. Thank you.

A - Prem Watsa {BIO 1433188 <GO>}

Thank you, Paul. Next question, Audra.

Operator

Mark Dwelle, RBC Capital Markets.

Q - Mark Dwelle {BIO 4211726 <GO>}

I think I have two questions. One is related to the reinsurance commutation in the Run-off segment and the reserve addition for asbestos. Were those two things linked, which is to say the reason you got the higher amount of commutation was because you recorded the additional amount, or were those two separate things that just happened to have a similar dollar amount?

A - Prem Watsa {BIO 1433188 <GO>}

No. That's a good question, Mark. No. They're separate items. And I've said to you in the past, we always look at commuting our reinsurance recoverables, because when you commute those recoverables, you get cash in your hand. But you have to do it at appropriate prices. So we did what we think is a very good commutation. But at the same time, we increased reserves separately on asbestos and pollution, environmental reserves. But they were separate. They were not linked.

Q - Mark Dwelle {BIO 4211726 <GO>}

Okay. Thanks for that. And the second question I had, I wanted to spend a little bit more time on the tax rate. You itemize the three things that were largely in the footnote. The question I'm ultimately trying to get at is, we obviously had gains that were in areas where we hadn't usually had gains and were able to utilize some deferred tax benefit. What would be the better way to think about the full-year tax run rate for the year, or an effective rate that would be kind of normalized? Obviously, there's always timing differences with where gains and things occur, but trying to really get at the operating run rate of the business and what the appropriate tax rate on that should be.

A - Prem Watsa {BIO 1433188 <GO>}

Yes, Mark, that's a very good question. Let me pass it on to Dave. Let me say that, while Dave answers, let's focus on the First Quarter. Then remember that we have worldwide operations, Mark. So we have it in the United States, which has a higher tax rate than in Canada; and then you have operations in different parts of the world, and so the tax rates can be different. But Dave, in the First Quarter, you've got a nice breakdown on why we had recovery in the First Quarter. Then perhaps just a comment for the whole year?

A - Dave Bonham {BIO 15243784 <GO>}

Sure. Mark, in addition to what I mentioned, what I might add is what you're seeing are adjustments that we have every quarter. They're regularly recurring. And this quarter they just happened to be magnified a little bit by the fact that we have lower pretax earnings, and that's combined with just the mix of where our earnings were earned in the current quarter. And that mix, if you looked at it, is in low tax jurisdictions, we had earnings; and that was offset by some losses in higher tax jurisdictions. So what I would say there is it's just what you're seeing in the quarter is just a difference in the mix of where we had earnings and losses. And for your full-year outlook, I think if you looked at our earnings and it was more of a normalized level of earnings, then you'd probably start to see an effective tax rate return to where it's been in the past seven or eight quarters. And I think that's in the neighborhood of about 25% to 30%. But that's going to vary, once again, depending on where we have earnings and losses around the world.

A - Prem Watsa {BIO 1433188 <GO>}

So Dave, if you look at BRIC. We made a very significant gain in BRIC. And so as far as our taxes on BRIC were concerned, you mentioned there the 50% -- only 50% get into capital gains, and also where the BRIC position might have been held in our worldwide operations.

A - Dave Bonham {BIO 15243784 <GO>}

Yes. The BRIC gain was about 80% taxable under Canadian tax rules, so it was taxed at 50%. And if you looked at what the effective rate on that gain alone was, it was about 17%. So that would be a typical example of an item that would be a benefit, or would reduce our effective tax rate.

A - Prem Watsa {BIO 1433188 <GO>}

Good, Dave. Mark, any follow-up on that?

Q - Mark Dwelle {BIO 4211726 <GO>}

No. We'll go with that for now, and let me do a little bit of math and I may come back to you off-line. Thanks.

A - Prem Watsa {BIO 1433188 <GO>}

Terrific. Thanks, Mark. Next question, Audra.

Operator

Howard Flinker, Flinker and Company.

Q - Howard Flinker

This is a question of clarification. If we guess that workers comp rates rose 12% or 14%, is that pure rate or is that 90% rate and 10% is higher payrolls?

A - Prem Watsa {BIO 1433188 <GO>}

No. That would be pure rate, right? I'm just looking at our -- yes, that would be pure rate, Howard. And yes, that would be pure rate. And these are rate on rate increases. We had rate increases last year, and we've got further rate increases this year.

Q - Howard Flinker

There's a long way to go. Thanks.

A - Prem Watsa {BIO 1433188 <GO>}

Terrific. Thank you, Howard. Next question, Audra.

Operator

(Operator Instructions)

Ryan Penton, BMO Capital Markets.

Q - Ryan Penton {BIO 20170097 <GO>}

Can you provide some commentary on your cash position? I believe this quarter it was about 27% of your full investment portfolio. And you mentioned on the call that you'd probably hold onto the cash until some opportunities arose. And what would those opportunities look like for you to deploy that cash?

A - Prem Watsa {BIO 1433188 <GO>}

Well you never can say, these opportunities develop. You never can say when they will develop and what they will be. But this I can tell you, you won't be able to take advantage of them unless you have cash or cash-like investments. So if I go back to 2008, 2009, the stock markets dropped significantly, you had spreads widen dramatically. Well because we had cash, we could take advantage of that opportunity. For example, in the last two months of, in the last quarter of 2008, we bought approximately $4 billion of muni bonds at about 5.75% after-tax yield, in two months. $300 million a day, $500 million a day. Where today, you can't buy $10 million of those bonds.

So it's that ability to take advantage of the opportunity. But on the other hand, the cost is you don't make any investment income today on the 27% cash, the $7 billion-plus of cash that we have. That's why we've always focused on the long-term, and we've always said that our earnings are going to be lumpy and we're focused on increasing our book value over time. Our earnings and our book value on a quarter-by-quarter, perhaps even on a yearly basis, are very tough to predict. But as you know, over 27 years, our record is quite good.

Q - Ryan Penton {BIO 20170097 <GO>}

Thanks. And I have one follow-up. Can you remind us of how much capacity you have to write in a hardening market. I think a couple of quarters ago, you used to say you could probably bump up your premiums by 50%, or around there, in a hardening market. Is that --

A - Prem Watsa {BIO 1433188 <GO>}

In a hardening market, we've got -- we write about $6 billion in premium. We have about $8 billion in equity capital, $2 billion, say, of net debt. So that's $10 billion. So if you look at our premium, this is our worldwide premium, $6 billion on $10 billion, that's 0.6 times. And that ratio can be 1.5 times. The last hard market, we took it to 1.5 times. So what that means is that each of our companies separately would be able to double our premium, approximately, which would result in the $6 billion going to $12 billion. We don't know when that will take place, or even if that will take place. But if the conditions are right, rest assured, we'll take advantage of the opportunity.

Q - Ryan Penton {BIO 20170097 <GO>}

Great. Thank you.

A - Prem Watsa {BIO 1433188 <GO>}

Thank you, Ryan. Next question, Audra.

Operator

Currently, there are no further questions.

A - Prem Watsa {BIO 1433188 <GO>}

Well if there are no more questions, thank you all for joining us on this call. We look forward to presenting to you again after the next quarter. Thank you, Audra.

Operator

Thank you. Today's call has concluded. Thank you for participating. Please disconnect your phone line at this time.