Q4 2014 Earnings Call

Company Participants

- Alexander Maloney, Group CEO, Executive Director & Chairman-Group Underwriting & Underwriting Risk Committee
- Darren Redhead, Chief Executive Officer
- Elaine Whelan, Group CFO, Executive Director & Chairman- Group Investment Committee
- Paul Gregory, Group Chief Underwriting Officer & CEO-Lancashire Insurance Co. UK Ltd.
- Peter David Scales, Chief Executive Officer & Director

Other Participants

- Ben Cohen, Analyst
- Jonny Peter Urwin, Analyst
- Kamran Hossain, Analyst
- Marcus P. Rivaldi, Analyst
- Nick H. Johnson, Analyst
- Olivia S. Brindle, Analyst
- Thomas Fossard, Analyst
- William F. Hardcastle, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Hello, and welcome to today's Lancashire Holdings Fourth Quarter 2014 Analyst and Investor Call. Throughout this call, all participants will be in listen-only mode and afterwards there will be a question-and-answer session. Just to remind you, this call is being recorded.

Today, I'm pleased to present Alex Maloney, Group CEO; Elaine Whelan, Group CFO; and Paul Gregory, Group Chief Underwriting Officer. Alex, please begin.

Alexander Maloney {BIO 16314494 <GO>}

Okay. Thank you. We also have Pete Scales, CEO of Cathedral in the call today; Darren Redhead, CEO of Kinesis Capital; and Denise O'Donoghue, who's actually Chief Investment Officer.

I'm delighted to report we grew fully converted book value per share by 5.4% for the fourth quarter, with an excellent combined ratio of 50.14%, (sic) [50.4%,] (00:51) our full-year combined ratio is 68.7%, which again demonstrates the quality of the Lancashire underwriting, [ph] writers' (01:04) specialty insurance business and efficient reinsurance purchasing. So, I'm happy that we've achieved what we said we would do in 2014, and we're in the right track as we enter 2015.

We are paid by our shareholders to take risk, which is commensurate to the return which we – that we can generate in the market. So, you have seen us take down risk levels in line with our view of the attractiveness of the opportunity. We have become more capital efficient without destroying our ROE. And we feel that we have the best risk-adjusted portfolio we have had in our history. You don't need to tell me that the market is competitive, I don't need to tell you that the market is competitive, but that is the nature of the beast.

Our industry is purely about supply and demand, and currently we have too much supply. But saying that, even in today's market, it's not impossible for us to grow, as we have demonstrated with the success we have achieved expanding Cathedral Syndicate 3010. This has gone from £30 million to £100 million stamp capacity in a little under 12 months. As we have previously stated, if we can find the right high-quality underwriter to employ, we will do that. And we actually believe that the current amounts of NII in our (02:20) industry, we only see the opportunity to bring new underwriters into the group as growing.

There are still lots of things we can do of our (02:28) business with the breadth of talent we have across the group. So, I'm comfortable we still have a business, which is relevant in the classes of business we underwrite, and we're still able to produce our stated returns of 13% above risk-free over the cycle.

I'll now hand over to Paul Gregory.

Paul Gregory {BIO 16314515 <GO>}

Thanks, Alex, quite a competitive market we faced in 2014, I'm delighted with what our underwriting team across the group has delivered. It's been a successful year on many fronts, positioning the group well for what looks to be a continuous competitive environment in 2015.

We've delivered the plan growth of Syndicate 3010, with the addition of new market-leading underwriters and the expansion of the Lancashire core specialty lines. In less than nine months, premiums of Syndicate has more than doubled and stamp capacity trebled year-on-year. Kinesis has delivered excellent returns to its investors, whilst demonstrating its claims' paying ability to its clients.

For the board or group, (03:24) the reinsurance protection we put in place with core reinsurance partners, optimizes our portfolio to match the market we will face. It allows to defend the high-quality underlying portfolio we've worked so hard to build since our inception, that manage our volatility, when returns are naturally lower given the writing environment.

It's also the most capital-efficient structure we've ever had, as evidenced by our ability to pay another special dividend today. And what was relatively benign last year, the combined ratio of 68.7%, it's been a fantastic performance. Especially, given our heavy weighting towards non-cash specialty insurance lines. It's in fact this weighting to specialty insurance lines that will help the group manage this competitive market environment.

Relevance for insurance clients does not correlate with balance sheet size. It correlates with relative line size, leadership, servicing and clients' (04:20) paying ability and good old-fashioned call-out (04:22) relationships. This is something we've been preaching for a number of years, and today this message is more apt than ever. Relevance and scale should not be confused.

The outlook for 2015 is one of continued competition and pricing pressure. One which is broadly in line with our expectations, and both Lancashire and Cathedral were able to defend the vast majority of their portfolios, while affecting (04:47) some business that no longer made underwriting sense and maximizing whatever new opportunities existed.

For Kinesis, we deployed broadly the same limit as last year, whilst increasing both the investor and client base. Just like in other parts of the group, we did decline search and renewals where the return metrics did not make sense, thereby, sticking to our mantra that underwriting comes first. As Elaine will speak to, it's worth remembering that we're being fortunate enough to tie up a number of risks on multi-year contracts, which would likely impact top line in 2015, but will eat (05:22) bottom line, as we take benefits with more favorable rating.

This is particularly important to Gulf of Mexico energy portfolio, where it's quite possible the margin will be affected by the lower oil price, by having a number of multi-year contracts that provides some level of protection from this, and any other further pricing pressure we may see.

Our underwriting structure remains the same. We're continuing to do what we've always done, and underwrite the market in front of us and adjust our portfolio with a combination of disciplined front-end underwriting matched with an appropriate reinsurance volume strategy. If market conditions change, then so will we.

I'll now pass over to Elaine.

Elaine Whelan {BIO 17002364 <GO>}

Thanks, Paul. Hi, everyone. Our results are on our website, as usual. But before I could enter results for the quarter, I just wanted to highlight that we've included return on tangible equity in our press release and supplement this quarter. We've been getting more questions on return on tangible recently, so we thought we'd just include that for you. Our headline metrics remain the same.

So, on that basis, it's just (06:26) an ROE for the quarter of 5.4%, bringing us to 13.9% for the year. Cathedral contributed 1% to ROE for the quarter and a total of 1.6% into the year after acquisition adjustments. Warrant exercises this year registered (06:42) ROE by 0. 8%. Our ROE for 2014 is less than last year's 18.9%. Other operating performances are actually stronger this year. If you recall last year, included about 6.4% of ROE, the releases to equity issuance and economic foreign exchange hedging in relation to acquisition of Cathedral.

(07:05) course this year, and is often the case in our business, with no major reported losses this quarter and some favorable development on prior asset new losses, (07:13) we finished the year with the strong results. In a total prior year, we've had releases in the quarter of $25 million, with $11.5 million from Lancashire, and $13.5 million from Cathedral. With that, releases for the full year reflected $4.4 (07:30) million, and contributed about 2.2% to our ROE, that compares to $16.9 million and 1.1% of ROE for 2013.

On the premiums side, Lancashire's premiums are slightly behind the same quarter last year. Largely driven by timing on some multi-year contracts in lines, (07:49) with a lot of that reduction being offset by total Cathedral (07:52) and the new energy and terrorism lines of business, plus contributions from the new aviation team.

Paul has talked about the 1/1 renewals. As I said, last quarter, we don't provide (08:03) guidance, but bear in mind, the multi-year is throughout in (08:05) 2014 and they're forecasted 2015. While it's an obvious impact on the top line, we still get the benefits of the air (08:13) coming through (08:14)

Ignoring the lines of business that tends to be characterized by non-annual contract, we wrote about $120 million of multi-year deals across the property, power and energy lines. While pricing pressure continues across much of the rest of the group, we do expect to see some rule allowing (08:30) Syndicate 3010 in the new lines of business there.

Our net loss ratio was 12.2%, reflecting the last year's losses in the quarter and the releases I've already mentioned. Our accident year loss ratio was 25.2%. As we said previously, our business is lumpy and individual quarters are not representative of the group. (08:51) Last quarter, we had a high accident year loss ratio, this quarter we have a low accident year loss ratio. The accident year loss ratio for the through-year (08:59) is 35.9%, which reflects the fairly average year, nothing baked, a few bits and pieces here and there, nothing exceptional.

We've talked about our expectations of attritional loss ratio over the last few quarters, I think there's still some confusion when provisioning it (09:15) in the current market environment. Lancashire's news (09:18) in the low-20s percent to a high-20s percent attritional ratio, and Cathedral's ratio for a less volatile but lower attachment in the business, add some more in the mid-30s percent (09:24) As and when the market improves, I would expect attrition to stay volatile, but not if there was pressure via (09:31) Cathedral. For 2015, subject to pricing a single city and mid-attritional ratio (09:38) would be reasonable.

On investments, including our currency hedge, the portfolio returned 0.2% to the quarter, and then 4% (09:47) to the year. The fourth quarter, saw a return of volatile market and while most of our asset classes (09:54) our bank loans portfolio was impacted by the widening high-yield credit spreads.

As I said last quarter, our investment strategy is largely unchanged, and we continue to focus on managing our interest rate risk. Our hedge fund allocation is now at $152 million. (10:08) We may continue to add a little more stat growth for you, but we're broadly happy with the (10:12) positioning for now. Although, we will remain that, (10:17) as we navigate through the Fed (10:18) interest rate hike.

On KCM, we're in $6.2 million from underwriting fees for the year, with $1.9 million of that followed in the fourth quarter. Remember that the fees annualizing with (10:28) underlying exposure to each of this (10:31) portfolio, the majority there in Q3 and Q4. We expect to receive profit commission of $5.8 million for the first quarter of 2015, which covers most of the 2014 contract. KCM's expenses are reflected within Lancashire's other operating expenses.

Net expenses in its first year, which doesn't include the profit commission, KCM contributed 0.4% to group ROE. In terms of actual returns generated, Kinesis presented, made (10:58) a mid-teens return from initial draws. The remaining other income is managing agency fees and profit commissions to Cathedral, these tend to be higher in the fourth quarter as years goes out, obviously depending on underlying performance; $6.2 million was booked in the fourth quarter, mostly reflecting a good result on the 2014 (11:17) and $10.1 million for the year.

Our G&A includes $10.9 million of Cathedral cost, including $5.1 million of performance related (11:28) given strong performance in the quarter. There is no further amortization of the finite life intangible asset in the acquisition this quarter, that's fully amortized line, $8.4 million of amortization was included in other operating expenses this year.

Turning to cash flow, we got back a few more shares in the fourth quarter, have a stock comp (11:47) award, $15.6 million total in the quarter, so just a small amount. Otherwise, we're talking of last quarter's special dividend with the further $103 million.

I think, our assessment of the market last quarter was entirely accurate, have been (12:02) a very profitable fourth quarter and we're also able to take advantage of the declining (12:06) environment, by some exceptionally good reinsurance cover and further reduced our exposure level. Because of that, we've ended up with more cash (12:13) than we need, so we're actually giving that back (12:14) some more.

I anticipate our cash flow requirement for 2015 to be in the $1.4 billion to$1.45 billion range, if nothing else in the market changes.

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

Q&A

Operator

Thank you. And there'll be a brief pause while questions are being registered. The first question is from the line of Ben Cohen of Canaccord. Please go ahead. Your line is open.

Q - Ben Cohen {BIO 1541726 <GO>}

Hi, there, thanks very much. Good afternoon. I have two questions please. Firstly, on the sort of increased risk protection that you've bought. I just wonder, where we are going to see that in your numbers. When I look at the P&Ls, it doesn't look like they have reduced in the most recent disclosure or they haven't moved materially. And should we expect any sort of improvement in the attritional because of those better protection? So, that's one question.

And the second was, could you be a bit more specific about the impact of the increased Cathedral's 3010 Syndicate capacity. How much of that do you think you will use? Can you just remind us what you had in 2014, and how that's going to then affect gross written and net earned premium for 2015? Thank you.

A - Alexander Maloney {BIO 16314494 <GO>}

Okay. Yeah, good question. I think on the reinsurance question, and Paul may come in on this one as well. I think, yes, we bought more cover. You're in a great market when you're the buyer, so that's why we've done it (14:21). There are some impacts on our P&Ls, but equally, we've bought a lot more on our energy account and terror account. We've got energy Gulf of Mexico wind. So pretty much across the board. Our reinsurance purchasing on the Lancashire side's (14:40) much more comprehensive than what it used to be, which makes perfect sense for us, because it's the cheapest time to buy reinsurance in 10 years.

It won't necessarily affect the sort of attrition because our account's not built for attrition, but what it will do is if you get the losses, which we firmly believe you will at some point, we think that the recent period's been very benign. When you get the losses, we can kind of fully demonstrate what our net exposures are versus what they would have been before we bought the reinsurance.

We're not expecting to get any credit for that until we can prove it and that's fine, but I just think – we firmly believe it's absolutely the right thing to do. It's everything we said we would do. We've always said we're taking a maximum amount of risk when the returns are there and we're not afraid to cut back when the returns are not there. So that's, from where I'm sitting, this is just the Lancashire strategy, the way it's always been, nothing different.

A - Paul Gregory {BIO 16314515 <GO>}

I think as well – Ben, hi, it's Paul. If you look at the percentage of capital, the PMLs are similar but actually, as we brought our capital down, when you look at the dollar PMLs, they've actually come down quite dramatically. If you compared to 1/1/2014 versus 1/1/2015 in dollar terms, there's been some quite significant reductions in both the cat and the non-cat PMLs. And that's primarily driven by the new reinsurance structures we've put in place throughout this year and the additional reinsurance protections we were able to purchase at 1/1.

Q - Ben Cohen {BIO 1541726 <GO>}

So that's additional cover that we don't see in the latest disclosures, is that right? Just remind me so that – because that's a 31st, is it? 31st this wealth (16:35) basis?

A - Elaine Whelan {BIO 17002364 <GO>}

Yeah. And the numbers that we have in our supplement are the round one (16:40) numbers, so you should see it in there I believe (16:40).

Q - Ben Cohen {BIO 1541726 <GO>}

Okay, okay. All right.

A - Elaine Whelan {BIO 17002364 <GO>}

And just on the attritional ratio, I think – just mentioned in my narrative, I think financial reinsurance cover doesn't really make a huge difference to our expectations in labor and attrition, (16:58) I think given the pricing environment they're in, the gains you've had in the past is still (17:02) quite relevant.

Q - Ben Cohen {BIO 1541726 <GO>}

Okay. Thanks.

Operator

We now go to the line Nick Johnson of Numis Securities. Please go ahead. Your line is open.

Q - Nick H. Johnson {BIO 1774629 <GO>}

Hi, there. Afternoon all. It's just actually a follow-up from the reinsurance question. You say you bought more reinsurance. I was wondering if you could be a bit more specific about the dollar spend on reinsurance. Is that likely to go up or down versus 2014 or are you just getting more cover for the same dollar spend?

A - Alexander Maloney {BIO 16314494 <GO>}

So at the 1st of January, we – when we renew most of our cover, you kind of bear (17:37) the option don't you. So you can just go to the brokers and say, I want a competitive price. And in this market, you'll pretty much get a reduction on most things. Or you can do what we've done, which is (17:51) we went to the brokers pretty much across the board and said, what happens if we spend the same?

So all the reinsurers are struggling for revenue. So we think it's a buyout (18:01), if you provide the same revenue, what do you get for that. And our view is that by spending the same amount dollars in a falling (18:10) market, the value you get far outstrips the reduction that you would get in cash. So for us, it was very much a case of, we know (18:19) the market's declining, we would spend the same. That increases our relevance with our reinsurers' partners. It keeps our brokerage spend with the brokers the same, and all these are useful tools in the current market we're in. And as I said, more than anything, it's the cheapest time to buy reinsurance in 10 years. So why wouldn't you buy.

Q - Nick H. Johnson {BIO 1774629 <GO>}

Okay, so very clear. Thanks very much. Thank you.

Operator

We now move to the line of Kamran Hossain at RBC. Please go ahead. Your line is open.

Q - Kamran Hossain {BIO 17666412 <GO>}

Hi, afternoon. Two quick questions. The first one, just coming back to Paul's comments about kind of relevance in the current marketplace. Can you just give us an indication of the level of business or the percentage of business that you lead across the group, and how this might have moved year-on-year? And the second question, really helpful to have the guidance from the attritional loss ratio. Just thinking about the admin expense ratio, is this year's level or could you (19:19) kind of guide for 2015? Thanks.

A - Alexander Maloney {BIO 16314494 <GO>}

Okay. On the relevance point, I'll start. And then I think Paul's got some stuff to add. So I think - relevance is a word that comes up a lot at the moment and we've been waiting for the question. I think what people need to understand is that we - our customers, when they think about who's relevant, it's not always just how big's your market cap and doesn't (19:52) make you relevant.

There's a number of other factors that we always talk about and you can be relevant in many different ways and quite frankly from our point of view, if we weren't relevant in everything we do, we shouldn't be doing it. Because in this market, it'd be a waste of the time. You couldn't make any returns.

So I think we're relevant in everything that we do. As I said, there is a number of factors. I think even down to (20:19), if you think about - and I'm sure I'm going to get one of these questions, you think about the M&A and what's happening now. If you think about it when you're a reinsurance customer, M&A means there's going to be less reinsurance customers. So every time a deal gets done, in my opinion, we become even more relevant for the brokers and our standard in bear list of (20:41) relevance goes up. So I think if anything, some of what's going on in the market actually really benefits us. And as I said, I had clients and brokers - I even had one underwriter come to me or come to Paul to say that we've lost a piece of business because we're not relevant and that just hasn't happened.

A - Paul Gregory {BIO 16314515 <GO>}

I think - and I'll come back Kamran on the leadership stats point, I think to that point as well, if you look at some of our insurance portfolios, got $100 million of terror and political risk premium, you don't have that unless you're relevant. We have, across the group now including 3010, $270 million of energy premium, it's combined in the 50%s (21:28) since inception (21:29), you don't have a portfolio like that unless you're relevant in that market.

To the leadership point, on the Lancashire portfolio, the stat is 73% of our business, we currently lead or have agreement party status on. Our historical range, if you look, is between 65% to 75%, but hopefully that gives you the guidance you need.

Q - Kamran Hossain {BIO 17666412 <GO>}

Yeah. No, that's a great kind of sign of your relevance. Thank you very much.

A - Elaine Whelan {BIO 17002364 <GO>}

And I think your second question was on G&A, I missed the start of your question, it kind of cut out a little bit, so if that's not great then let me know of it. And in the numbers for this year, so you see that we're reporting, we have included in our G&A the amortization of private (22:16) life intangible asset that was created in the acquisition, and that's $8.4 million for the year. So that was the way that that's done and that's to be (22:23) amortized. There's also a little bit of extra cost in 2014, just in terms of moving offices and (22:31) bits and pieces like that, so that's should trend, I know that (22:33) a little bit, you can adjust slightly for that too.

Q - Kamran Hossain {BIO 17666412 <GO>}

Thanks very much.

Operator

We now go to the line of Paris Hadjiantonis of KBW. Please go ahead with your question, Paris. Your line is open.

Yes, good afternoon. Thank you very much for taking my questions. I have two today. One, going back to your insurance program. I think that pretty much, you are guiding to a lower cat budget for the year. And if I take Alex's comments, then I assume that that cat budget which will be down 10% to 15%. Can you kind of guide us whether this is the kind of adjustments we should be making?

And then, can I ask a bit more about terms and conditions and what you have seen at 1/1. So have you been asked to relax terms and conditions or have you seen, as a buyer of reinsurance and retro, anyone offering more favorable T&C. And if so, what was that? Was it hours clauses, was it the reinstatement premiums, et cetera? Thank you.

A - Alexander Maloney {BIO 16314494 <GO>}

Well, okay, so I think I'll the leave numbers to Elaine and then Paul can your question about (23:46)

A - Elaine Whelan {BIO 17002364 <GO>}

Yeah. I think in terms of expectations on cat budget, we've been talking a lot about that attritional ratio, and I think you leave that really with the (23:53) reinsurance side of things and we hope to get some benefit of that. We have much more protection if it ever happens a tax with lower guidance (24:00), I think it's up to you as how you (24:02) set your numbers on that, if you want to move them very (24:04) slightly, then feel free. But it's been (24:10)

A - Paul Gregory {BIO 16314515 <GO>}

Paris, Hi. On the second point regards terms and conditions. I think you've got to split it into two parts, and which is what's happening in the reinsurance world and then what's happening in the reinsurance world.

On the reinsurance side, there's definitely some push from both clients and brokers to get some extended coverages, that may be in the form of extended hours clauses, some kind of terror phrase into (24:42) some treaties and progress to (24:45) reinstatements. It wasn't much beyond that, there were some other things that were tried but failed. We obviously see that through the front end, but on the backend, we get the benefit of that when we're buying retro. At the same time, we're also a very big buyer of marine treaty, whether it be energy, marine. And there was some broadening of coverages there and we obviously got the benefit of that.

On the insurance lines, to be honest, there hasn't yet been any push on terms and conditions. It's all been about rating. I'm not saying that, that won't come in time. But at the moment on the insurance lines, it's just rating pressure as opposed to terms of conditions pressure.

Q - Operator

That is very clear. Thank you.

We now go to the line of Marcus Rivaldi at Morgan Stanley. Please go ahead. Your line is open.

Q - Marcus P. Rivaldi {BIO 5739374 <GO>}

Thank you very much. Couple questions from me please. First of all, given what you have been doing on retro reinsurance buying, I'm just wondering why you wouldn't have thought you may need even less capital than you're guiding for to run the business than the $1.4 billion or $1.45 billion you're talking about.

Secondly, on the protections that you're buying, if you were to sell (26:01) second loss event on the 1/100 year, 1/250-year type of basis, would we see these numbers move up very materially? Thank you.

A - Alexander Maloney {BIO 16314494 <GO>}

That first question for Elaine in terms of (26:16)

A - Elaine Whelan {BIO 17002364 <GO>}

Yeah. I guess there's a balance between having too much and having too little capital, and we want to make sure that we've got enough capital to be able to absorb a reasonable sized loss and be able to access the market after that.

And also - but we don't have any great view (26:37) of opportunities at the moment, but they always start to come up, so we always have this kind of headroom (26:40) for that as well. So there is a bit of a buffer built into our capital and you can always adjust it (26:47) (26:48) we think that we'd rather have a little bit more cushion there, just so we can make sure that we can run our business properly.

Q - Marcus P. Rivaldi {BIO 5739374 <GO>}

So does that mean that - I mean obviously I think this extra special today was a bit of a surprise. Do you think you generally (27:02) have reset the capital base now to a sort of level - was that the big (27:06) buffer that you don't really want go below?

A - Elaine Whelan {BIO 17002364 <GO>}

Well, probably a year, year and a half ago, we were seeing that we needed it at $1.6 billion in capital, but a year ago, we were seeing we needed $1.5 billion in capital. Now we're seeing we need $1.4 billion to $1.45 billion capital. So - and we've been bringing that down and some of that is a reflection of outlook and some of that is a reflection of the reinsurance program we saw (27:27) I think we're pretty comfortable at the level that we're at. But as always, we will adjust our capital as we need to.

Q - Marcus P. Rivaldi {BIO 5739374 <GO>}

Okay. Thank you.

A - Paul Gregory {BIO 16314515 <GO>}

Marcus, hi. On the second question, we changed the structure of our main retro program this year and the main way we changed that was turned a lot more of it into reinstatable limits. Last year, we had an aggregate product, which is very good. But what we were able to do this year and, as Alex said, there are no more spend at both reduce or (27:59) retention of that and get a vast majority of that limit reinstatable to give us that protection for the second loss obviously helps from a capital point of view as well.

It does remain an element of aggregate coverage there. But the vast majority of it is reinstatable. And on the marine coverages, we were able to secure additional - we already had sideway but we were able to secure additional sideways in some of the layers. And Pete, do you want to talk about Cathedral?

A - Peter David Scales {BIO 15393236 <GO>}

In terms of – as you know, we're more serial reinsurance buyers. Going back to Alex's previous answer and picking up the question, we have effectively made savings on our two property programs which are the larger 1/1s, the savings are larger than any rates degradation on the inward book. To the extent there's been any terms and conditions pushed, which in our world has largely been – small bit on the hours clauses which (29:01) again, if you bear in mind our U.S. cat book is entirely regional, tends to play tornado and therefore the hours clauses don't pick us up (29:09) too badly because it's through pretty quickly.

We have in both cases bought more cover. But the more cover is lower and slotted (29:19) underneath and we have more frequency cover down the bottom end of it. So again, it's just buttoning the thing up within the benefit of the savings we've been able to make and still leaves some residual savings.

Q - Marcus P. Rivaldi {BIO 5739374 <GO>}

So maybe just to sum up (29:33), and if I was looking at the Gulf of Mexico scenario, $235 million net first loss, where would that be on a second loss basis? Sounds like it would be very similar, is that you're saying?

A - Peter David Scales {BIO 15393236 <GO>}

Sorry. We lost you there.

Q - Marcus P. Rivaldi {BIO 5739374 <GO>}

Sorry. So just looking on the disclosure, so the 1/100 year Gulf of Mexico scenario, you say $235 million (29:58) on the first loss. The second loss, would it be very similar, is that what you're saying, ultimately something like that?

A - Alexander Maloney {BIO 16314494 <GO>}

Sorry, it won't be entirely similar, because some of that is on an aggregate basis but, as Paul said, the majority of that is reinstatable, and that's the big difference year-on-year.

Q - Marcus P. Rivaldi {BIO 5739374 <GO>}

Okay. And so I just wanted to follow up, and again, maybe this is the comments you've been saying about being able to buy more effective reinsurance. Obviously, there have been a lot of talk now (30:21) about offshore energy being very competitive and yet your your worldwide book, anyway (30:25) you were able to grow that. Well, certainly, it's more than what (30:29) we were thinking. Could you maybe give us some color on that please?

A - Alexander Maloney {BIO 16314494 <GO>}

Yeah. I think that's a pretty good (30:34) example of relevance. I mean, we are delighted with the way we could grow that book. And how we could grow that book in Lloyd's. We had massive support from clients and brokers. And in a number of cases, we had some against the tide. We have got bigger lines on the programs we won, when others there's not. And I think what you're going to see in the energy world increasingly is the sort of gap between the people that can add value and those who can't is going to get bigger and bigger.

So we still feel we can add value, we still think we can get sort of a better deal than some others in the market. And we will leverage everything that we can, including reinsurance spend, to get what we want. But that still doesn't exclude us from – the energy space will be competitive this year and obviously, you've got the oil price factor as well. So I think in terms of putting (31:34) example of us doing stuff in a very, very difficult market. And as I said, you can only do that if you are important, relevant, whatever you want to call it, reversing (31:45) clients and we've demonstrated that.

Q - Marcus P. Rivaldi {BIO 5739374 <GO>}

And just sort of follow-on there (31:49), would you say therefore if you look in that book, the fact you've been able to grow hasn't resulted in, I guess, expectations of net profitability changing – I mean growing, have you added in (32:01) top line (32:01) expense or bottom line?

A - Alexander Maloney {BIO 16314494 <GO>}

No. I mean look, we're not a top line underwriter, we never had been and there's no willingness here just to write business for the sake of it, that's just not what we do. So if the opportunity arrived now, we just wouldn't mind the business, that's the way we think.

Q - Marcus P. Rivaldi {BIO 5739374 <GO>}

Okay. Thanks very much.

Operator

We now go to Will Hardcastle at Bank of America Merrill Lynch. Please go ahead. Your line is open.

Q - William F. Hardcastle {BIO 16346311 <GO>}

Hi, guys, just two questions. The first one's on the Cathedral reserve release, can we just get an understating, is that just a usual sort of quarterly good news type of release, or is there any method changed within there that's fully aligned to Cathedral's reserving (32:46) process to the Lancashire process?

And the second question relates to, I'll try not to use the world relevant, but given the recent state of consolidation – the state of consolidation, could you give your thoughts on what you expect the net outcome to be for Lancashire, i.e., on certain lines of business. Is there any lines of business that you actually expect to see intensified competition within as a result, or like Alex you mentioned in terms of the reinsurance opportunities, any good benefits to arise?

A - Alexander Maloney {BIO 16314494 <GO>}

Sure, okay. So I'll take that one first and Peter will pick up more aligned with the next one (33:19). So I think on the M&A front. We do see that that as an opportunity, if you think about the guys that we bought into, Cathedral, from the H1 (33:32) Syndicate, an element of that was they had a new owner, and they were looking for new owner. So I think M&A is going to create opportunities for us.

There's going to be people available that maybe, we kind of got in the past and we're definitely having some of those conversations as we speak. I think what's interesting, if you look at some of these big deals, and if you look at cat in XLs a good (33:57) example. There's kind of lots off lines of business, where they are quite big already. So let's just pick energy as an example. In my view and I'm not the client, but it's unlikely the client is going to give XL and cat then – (34:11) be combined amount of dollars that they currently get.

So one plus one doesn't always make two. So I don't believe that the stakes have been raised massively in something like energy is a good example, because I just don't think the clients are going to give one counterparty that amount of aggregate dollars. So I don't think it changes a lot for us on our ability to trade. Every line of business we have at Lancashire, we have capacity that sort of puts us in the top five, if you like, and I can't really see that changing.

But as I said from M&A, we actually see opportunity. And as you said, if we can get quality underwriters in, the sort of checkbook is always open as long as it's business that we can understand, and we've demonstrated we can grow. So if we can do more of that, we will. And if we can't get the people, we won't.

A - Elaine Whelan {BIO 17002364 <GO>}

On the reserve release question, there's been no change in methodology, we still use the (35:14) best estimate and there is going to be a lot of adjustment involved in that. (35:15) There's enormous legal exercise that's (35:18) carried out in the fourth quarter, but with the more sort of (35:21) Cathedral events (35:22) than at Lancashire just in terms of is it a client (35:25) closing out. Well, if you're competing against the prior year, thinking that it looks a bit chunky compared to prior year, just remember that you really picked up a (35:32) couple months worth of Cathedral's performance in the prior year?

Q - William F. Hardcastle {BIO 16346311 <GO>}

Okay. That's already clear. Thanks, guys.

Operator

Next question's from the line of Tom Fossard at HSBC. Please go ahead. Your line is open.

Q - Thomas Fossard {BIO 1941215 <GO>}

Good afternoon. I've got three questions. Two for Alex, one for Peter. The two question for Alex will be more I would say helicopter and strategical questions. The first one, Alex, do you feel any pressure to adapt further the Lancashire business model to the environment. We see you've been undertaking some changings over the past quarters. I mean is there anything you would like to adapt further. And connected to that, having in mind the evolution of the cycle, I mean, do you feel any pressure to restate at some stage the targets of producing a certain percent return on equity over – risk-free?

And the question for Peter is that, could you comment a bit more on the ongoing pressure on the Cathedral book as Air PI provided in the press patches (36:39) mainly related to the Lancashire book? Thank you.

A - Peter David Scales {BIO 15393236 <GO>}

(36:49)

A - Alexander Maloney {BIO 16314494 <GO>}

On your first question, I think you just – you always have to adapt and evolve, and I think that if you don't, you will be left behind. So I think we've demonstrated that. I think one of the sort of funny things actually about M&A is that we've done M&A sometime ago, and that was after that into (37:10) the market. I think us buying more reinsurance is adapting to the market. So, yeah, I think you would have to adapt and evolve.

We see ourselves as a purely specialty underwriting company. We would like to evolve and have more specialty underwriting things. So we definitely like to do that. And as I said again, getting back to Cathedral, the second you got Lloyd's platform, it opens you up to more opportunity and it even opens you up to a bigger talent pool in underwriters that maybe you can attract (37:44) to a structure outside of Lloyd's.

So if you look at that, if you look at sort of our capital page (37:51), we're pretty much covered across what we want to be to attract the right talent. And as I said, you just have to adapt to the market, and everything that we do every day is adapting to the market that's changing really quickly.

And again, I think that's quite interesting. We – I personally don't believe there's anything new this time, I still believe in the cycle. What is different is how quick things have changed, but that might not necessarily be a bad thing. But then when it comes to returns, we're comfortable with our stated return over the cycle. We sure think we can achieve that and we're still outstripping that. If that changes, we'll, obviously come and tell everyone where we are at the moment, and we're comfortable with that.

A - Peter David Scales {BIO 15393236 <GO>}

On our part of the world, there's lots of similarities across Cathedral and Lancashire, pretty much every line of business, there is rating pressure per se. So far as our renewals that are heavily 1/1, the property treaty book, you probably take 10% off (39:02) as a rough example if you blended the international book and the U.S. regional cat book. In terms of T&C, some, given the hours clause, there's not much on the international. In terms of aggregates, flat or down. In terms of savings on both sides of the book, the reinsurance would outstrip the fall on the RPI people (39:30) coming in was outstripped to the outwards much the same as last year. So from a net trading respective, manageable.

The deal flow is great, no issues at all in signings. And that's because, again, we have very long standing relationships with clients and fundamentally, we're underwriters. We understand that we have good years and so do they, win-win (39:54) fundamentally a high margin business. We -it's not like writing motor or something where it's small base your very RPI functional (40:02). And so therefore, if there's a run of claim returns into the market, then your clients – we fully expect to give them some money (40:13) and equally, if we pay their client's losses, we fully expect them to pay us over a period of time.

So that just ebbs and flows the market on a consistent basis. And we think the biggest value of being a leader in somewhere, where the clients would come to see you time and time again, and you retain your business, is because you have that consistency. You're not playing around a metric of you write it, you don't write it (40:35).

On the direct property side, again you – funny enough I was (40:44) going through 1/1, the prices on the binder delegation authority book are actually holding, if not creeping up a little. So we've adjusted the portfolio, to see a little (40:53) more of that. The open market is not much, goes through 1/1, and that will be very competitive. Again, we tend to bounce out of the way from the big Fortune 500 stuff, which tends to be the more commoditized stuff, where there will be bigger rate pressures built through the year. Again, we bought lower – again, the savings we made on the outwards far outstripped anything on the inwards. So again the story of net's pretty sensible.

If you want to go through the smaller classes, we can do and you can perhaps take this up at the analyst presentation, but one question over time (41:30) . But that's basically (41:32) the flavor of it. In terms of net trading position where we were, less of the same exposure, better cover for it and again, we're not top line underwriters either. But net book's in pretty good condition because we have a good solid consistent client base.

Q - Thomas Fossard {BIO 1941215 <GO>}

Okay. Thank you.

Operator

We now go to the line of Olivia Brindle at Deutsche Bank. Please go ahead. Your line is open.

Q - Olivia S. Brindle {BIO 17273762 <GO>}

Hi, guys. I had two areas that I wanted to probe a bit further, I guess, expanding on things you guys already mentioned. So, the first one is on the ROE and the second is on the capital, so that's business-related. (42:08) On the ROE, you said you're comfortable with the target across the cycle. But Alex, last quarter you also said that 15% is probably the top end of what you'd expect in this current market, and I was wondering whether you consider to expand on how you're thinking about that now bearing in mind that you have reduced the capital base little bit? So, actually if you're still sort of in the same ROE range, does that mean actually you're up to do earnings probably should trend down from what you previously expected? And I know 1 percentage point of ROE seems cool, (42:43) but it could be 10% of your earnings, so it's quite material. So, I guess, help (42:47) me understand, how you're thinking about that?

And then on the capital itself, I appreciate that you're buying more reinsurance, et cetera, but you did tell us at the third quarter, that you think the requirement would be $1.5 billion. So, I mean, what really has changed that much between November and now, that would reduce that by as much as a $100 million? And it seems like most of the market conditions are actually fairly similar to what they were then. And sort of a final point, sort of related to the capital requirement, again, at the third quarter you sort of said that you probably can't go much below the $1.5 billion even if you bought more protection, because that's sort of absolute sales requirement. So, I just wanted to understand how that makes sense with what you're saying now about, if this is $1.4 billion or even less possibly?

A - Alexander Maloney {BIO 16314494 <GO>}

Fine. Okay. Obviously, all of that comments were a moment in time and things changed. I think, we don't give out guidance. But for us to achieve 15% in this market is probably the absolute top-end is probably 14%. But as I said, that would mean we'll have a very good year, and that I think that'd be exceptional in this market. I think on the capital side, that's – I'd love to leave that to Elaine. But I think, comps have emphasized enough, when you buy a lot more capital efficient reinsurance what that does to your book. And remember that our capital needs are just effectively about how much risk, how much net retained risk we have on our books. So, if that changes dramatically as it has done at 1/1, that's why you're seeing the capital needs change.

A - Elaine Whelan {BIO 17002364 <GO>}

Yeah. (44:33) and we were able to decide the more capital efficient reinsurance, so we're changing guidance from Q3 from $1.5 billion to $1.4 billion to $1.45 billion, so it's not a huge drop. And it's nice to be able to buy something that was capital efficient, that allows to just manage that data a little bit and reduce our exposure level.

Q - Olivia S. Brindle {BIO 17273762 <GO>}

And to your comments that you made previously that there is some kind of absolute size requirement you can't just keep going down and down and down, does that still hold, or can you conceivably get much below even $1.4 billion?

A - Elaine Whelan {BIO 17002364 <GO>}

You could possibly get lower than $1.4 billion. I think, we target into the $1 billion to $1.2 billion size range, then it's probably running (45:15) into issues with the rating agencies, and again, it depends very much on market outlook.

A - Alexander Maloney {BIO 16314494 <GO>}

Yeah, but on that, though, Olivia, so obviously, you've got the rating agency requirement, but that's one requirement, that even if you didn't have to worry about that. We live in a very gray world, where lot of issues can be strange and things can happen, and running with too little cuts though would be a disaster. So, for us, there's always going to be a buffer, there's always going to be a head room, obviously, that does create a slight drag on your ROE. But at Lancashire, we do numbers on the kind of drag you get, so some pretty substantial – sort of, once the capital, it's not really massive. It's not like we could not cost $200 million and it really boosts our ROE. So, it's just wide enough that, how much capital do you want to keep, how much you want to have in the bank. If something does happen and if there's right opportunity, and like what we've always said, particularly in this kind of environment, if opportunities come along you've got to move really quickly, because that probably won't be here for long. So, there's no point sitting there with no capital supply, when you really need it. And then it's just a debate about, how much additional capital you want to hold versus the drag on your ROE.

Q - Olivia S. Brindle {BIO 17273762 <GO>}

Okay. Thanks very much, guys. That's it.

Operator

Okay. We go over to the line – back to the line of Ben Cohen of Canaccord. Please go ahead. Your line is open.

Q - Ben Cohen {BIO 1541726 <GO>}

Hi, there. Two things, firstly, could you just answer the question that I posed to begin with, in terms of the impact of the increased line size for Cathedral's 3010 on gross written on premium in 2015? Sorry, If I missed that. And secondly, also on Cathedral, in terms of the profit commission that it earns, it looks like 2013 was a better combined ratio year than 2012, would that mean that mechanically, that number should go up when we go to the end of 2015? Thank you.

A - Elaine Whelan {BIO 17002364 <GO>}

In terms of the impact on premium, we obviously did quite a lot in terms of the energy and the terror book this year, so you'll see some incremental growth in those lines of businesses with the (47:50) market growth there. And the aviation team joined us in the later part of the year, so I think we'll be able to see (47:55) a much more significant increase in there. And that new team can earn about $7 million, $7.5 million worth of premiums in the fourth quarter. So, (48:06) and a fair bit that we can do with that. And in terms of the PC, a lot of PC you see coming through that is off of the 2012 year, but also add some recognition of 2013 in there, and we'll need to wait and see how the rest of that year plays out. And (48:23) commissions you can recognize there, but 2012 was a pretty good year.

Q - Ben Cohen {BIO 1541726 <GO>}

Okay. Thank you very much.

Operator

We go to the line of Jonny Urwin at UBS. Please go ahead, your line is open.

Q - Jonny Peter Urwin {BIO 17445508 <GO>}

Hi, there. Thanks for taking my question. Just a very quick one on – out with reinsurance spend. I mean, it's been a feature of the last few renewal periods, where a lot of the inward pressure can be offset by further reinsurance buying at little cost or buying the same, spending the same and getting more. I was just wondering, I mean, given current rating trajectory, how much longer can that go on for? And I guess, linked to that is how deep, how much deeper can the reinsurance get?

A - Alexander Maloney {BIO 16314494 <GO>}

Yeah. I think, if I knew the answer to that question, I probably won't be sitting here, quite frankly. I don't know. I mean, people have a view that there's a floor in the market, I'm not really sure if I also have (49:21) that view. ,So it will be interesting to see, how much further reinsurance can go. I think, it sort of depends on the class of business as well. You have, I mean, even on the long-range (49:33) side, you have seen some funds in particular, not right capital and kind of do the right thing, we would think. So, I don't really know the answer to that question. I think, it very much depends on the carrier. But as I said earlier, if you think about the M&A that's going on, the M&A means, probably less reinsurance spend, for the reinsurance companies. So, I don't know, I mean, I think it's going to be competitive, and usually in our market, nothing changes until people have big losses.

A - Paul Gregory {BIO 16314515 <GO>}

I think, the one thing I'll just add to that, Jonny, is, and I agree with Alex, is it's almost how long with a piece of string, (50:15) we don't really know. But while sit here relatively comfortably, is we've got a book of business that's come as a combined ratio, 68%. So, that does put in a far nicer position than a lot of others. It does continue to go down for a period of time. And I think, if it does continue to go down, it will be those markets, with those good underlying books of business with good combined ratios, obviously, going to be better-positioned to ride it out.

Q - Jonny Peter Urwin {BIO 17445508 <GO>}

Okay. Thanks.

Operator

We now go to line of Frank Haywood of Frank Haywood Associates. (50:50) Please go ahead. Your line is open.

Hello. Well, congratulations, all, on an another really excellent quarter. Having gotten some of the amortization and other expenses associated with the Cathedral acquisition and some drag on some claims from the big (51:11) for you. It's good to see Lancashire kind of back in the saddle there. But I would like to ask a couple of things, it seems like there's a lot of latent value that may not be obvious, potentially, just there's (51:27) some major catastrophe loss, a big super cat of some sort. Could you explain a little bit more about how Kinesis might be able to access alternative sources of capital, and perhaps, write an enormously greater amount of that coverage, compared to what's written now?

And then, the other question has to do with this dormant syndicate at Cathedral that has grown it's stamp capacity quite substantially over the period after the acquisition. It seems that, that might not show up on the book value, but might in fact, if we were to have a market value, you can see much more valuable than when it was acquired?

A - Alexander Maloney {BIO 16314494 <GO>}

Okay. Frank, (52:20) thanks for those questions. I think, Darren will start with the Kinesis one. Can you join and talk about the stage one over the line? (52:24)

A - Darren Redhead {BIO 17995744 <GO>}

Yup. Good morning, Frank. (52:28) Thanks very much for the question. Just got a link to that, yes, if there was a, if you like, a sizeable dislocation within the market, we'd have three patterns within the group of the Kinesis, Cathedral and mother ship, to grow and take the advantage of, but we feel we could, with our existing partners, grow Kinesis dramatically, say to $1 billion that would then, if you like, treble the existing fees. And more so, Lancashire will be an investor in that, so the whole point of Kinesis is to build up a stable portfolio track record. But then, have the ability to grow as and when the market it takes, so, yes, though. (53:05) But in no time soon do we see that happening, but we'll still continue the organic growth at Kinesis in the difficult market.

A - Peter David Scales {BIO 15393236 <GO>}

Hi, Frank, (53:16) Peter. On the 3010 part of the world is the only difference between 3010 and 2010 is that Lancashire Group owned 58% of the capacity in the business of 2010 and 100% of 3010. All of the underwriters and all the business lines are managed in exactly the same way. And all of the traders' need to (53:40) the lines basically play what they see in front of them, that's always been the business, all (53:45) in terms of calling where we go in the market. The Syndicate 2010, to the extent it has 42% out, does have a trading price that people wishing to participate within the lowest market and 3010 doesn't trade. So, arguably, if one day it did or third-parties will access it, I'm sure some of them will pay (54:06) the premiums to be on it, or if one day you end up putting the two together. Again, it would have some sort of market trading price, there's no doubt about that. But it is what it is, and fundamentally, we as a group, don't see whether you work for 2010 or 3010, any difference between it, it's another line of business managed in the same way and the exposures are all brought together in the same way. So, it's just a maths exercise between it, Frank.

A - Alexander Maloney {BIO 16314494 <GO>}

I think, as well, Frank, while we're delighted with Cathedral, the purchase of Cathedral is that, it backs up our view that the price we pay for Cathedral was worth paying. Because when you got a quality franchise in Lloyd's, you can grow and you can do what we've done. If we had bought a syndicate in Lloyd's that didn't have the track record that Cathedral has, it'd be very hard to grow, because Lloyd's would put a lot of restrictions on you. So, I think, it just reinforces the price we paid for Cathedral, and the kind of things we can do with that business, and obviously, if we can grow it even more organically, we will, and that would just add to the value even more.

Q - Operator

Well, thank you very much. I think that's a very good explanation.

Okay. At this stage, there are currently no further questions in the queue. So, can I please pass the call back to you?

A - Alexander Maloney {BIO 16314494 <GO>}

Okay. Thanks for all your questions, and we'll talk to you next quarter.

Operator

This now concludes the call. Thank you very much for attending, you may now disconnect your lines.