S&P Global
Market Intelligence

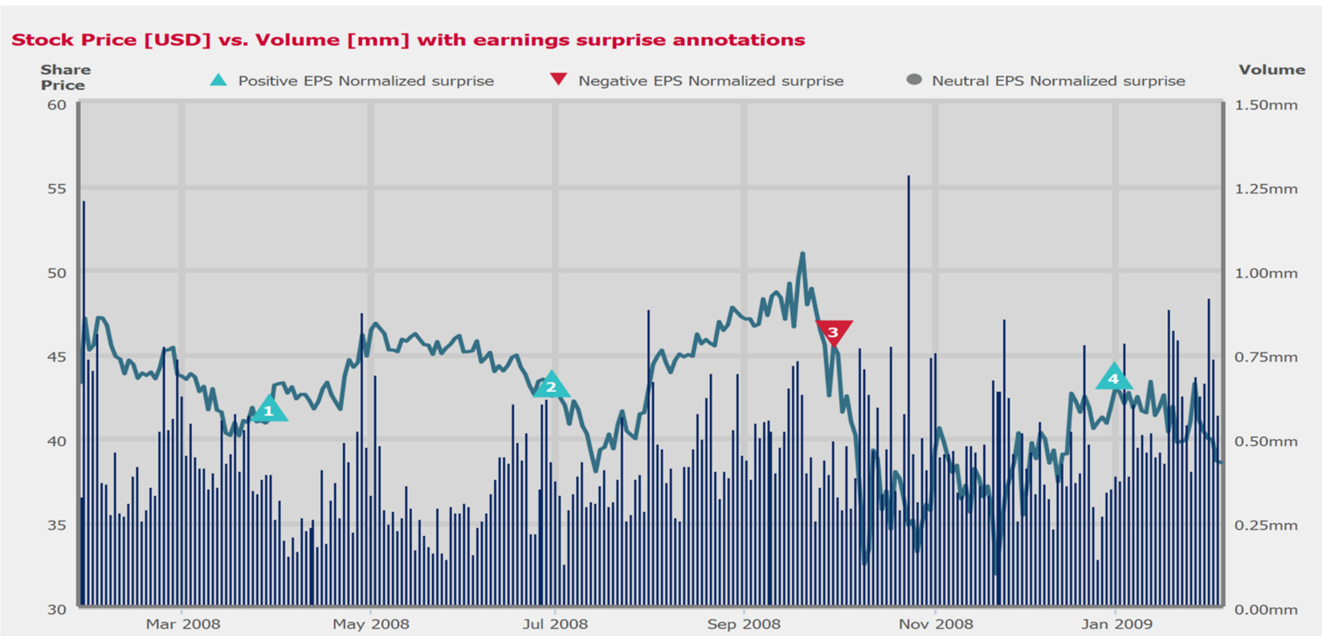
The Hanover Insurance Group, Inc.
NYSE:THG
FQ1 2009 Earnings Call Transcripts

Friday, May 08, 2009 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ1 2009-			-FQ2 2009-	-FY 2009-	-FY 2010-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.44	0.39	(11.36 %)	1.02	3.52	4.25
Revenue	-	-	(3.32 %)	-	-	-
Revenue (mm)	651.50	629.90	-	657.30	2586.47	2666.87

Currency: USD
Consensus as of May-08-2009 1:23 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ1 2008	1.05	1.10	1 4.76 %
FQ2 2008	0.96	1.07	2 11.46 %
FQ3 2008	0.01	0.07	3 (58.82 %)
FQ4 2008	1.13	1.16	4 2.65 %

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Call Participants

EXECUTIVES

Bob Myron

Frederick Henry Eppinger
Former President & CEO

Gene Bullis

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

ANALYSTS

Dan Farrell
Fox-Pitt Kelton

Jay Gelb
Barclays Capital

Michael Phillips
Stifel Nicolaus

Presentation

Operator

Good morning, ladies and gentlemen, my name is Michelle and I will be your conference operator today. At this time I would like to welcome everyone to The Hanover Insurance Group Quarter 1 2009 Earnings Conference Call. (Operator Instructions) As a reminder this conference is being recorded for replay purposes. I would now like to turn the presentation over to your host for today's call Mr. Bob Myron. Please proceed.

Bob Myron

Good morning and thank you for joining us for our first quarter conference call. Participating in today's call are Fred Eppinger our President and Chief Executive Officer; Gene Bullis our Executive Vice President and Chief Financial Officer; and Marita Zuraitis, President of Property & Casualty Companies.

Before I turn the call over to Fred for a discussion of our results, let me note that our earnings press release and a current report on Form 8-K were issued last night. Our press release, statistical supplement and a complete slide presentation for today's call are available in the Investor's section of our website at www.hanover.com. After the presentation we will answer questions in the Q&A session.

Our prepared remarks and responses to your questions today, other than statements of historical fact, include forward-looking statements. These include statements regarding expectations of earnings, pricing, accident year results, premiums, expenses, and other projections for 2009. There are certain factors that could cause actual results to differ materially from those anticipated by this press release, slide presentation, and conference call. We caution you with respect to reliance on forward-looking statements and in this respect refer you to the forward-looking statement section in our press release, Slide 2 of the presentation deck, and our filings with the SEC.

Today's discussion will also reference certain non-GAAP financial measures such as total segment income, segment results excluding the impact of catastrophes, loss ratios, book value excluding accumulated other comprehensive income, and accident year loss ratios among others. A reconciliation of these non-GAAP financial measures to the closest GAAP measure on a historical basis can be found in the press release or the statistical supplement, which are posted on our website as I mentioned earlier.

With those comments, let me now turn the call over to Fred.

Frederick Henry Eppinger
Former President & CEO

Good morning everybody and thank you for joining us today. Although severe weather and to a lesser extend the economic environment have affected our results I am pleased with our results for the quarter and feel very good about our prospects for the year. Gene and Marita will review the details around the quarter's results in their remarks and I will use my time this morning to talk briefly about our approach to the market in light of the accelerating disruption and to put our first quarter results in the context of our strategy.

Obviously the economy and the turmoil in the financial markets has put pressure on everybody in our industry, but for our company the dislocation and disruption creates tremendous opportunity if we stay focused on our strategy of writing high quality business with winning agents. I believe our momentum in the marketplace was confirmed and enhanced this morning by A.M. Best upgrade.

We continue to believe our investments and expanding our product and underwriting capabilities to achieve preferred shelf space with winning agents is not only prudent in this uncertain market, it will create tremendous shareholder value. In addition, our selectivity in the business we write as well as the price that we write it at will maintain the financial strength that is required to win through out the economic and underwriting cycle.

Our first quarter results show our commitment to building long-term shareholder value by demonstrating conviction and competence in our vision, our strategic priorities, and our ability to execute in a difficult market. In particular, our results once again reflect our commitment to disciplined underwriting, and profitable growth.

Property and Casualty pre-tax segment earnings of $49 million were solid, taking into the account the impact of unusually high catastrophe and other severe winter related weather. We are very pleased with this result, especially given where we are in the pricing cycle and in light of the current economic climate. At the same time, we continue to pursue growth in a thoughtful manner writing quality business at solid margins and not just any business available to us in order to meet short-term growth targets.

As I examine the first quarter results I remain confident that we will be one of the few companies that should see improvement in our accident year results for 2009. In personal lines, for example, where net premiums decreased slightly in the quarter, we significantly strengthened the quality of our book by writing more account and multi-car business and continue to sequentially increase policy counts in Michigan and Massachusetts, which are key legacy states that drive our profitability and also in several of our key growth states. Marita will provide more insight into our strategy on these markets.

In commercial lines we grew our net premium for the quarter at a level that significantly outpaced our regional and national peers. Growth in commercial lines was driven primarily by our specialty businesses. Notably, we continue to benefit from our recent acquisitions of AIX Holdings, Verlan Holdings, now Hanover Specialty Property and Professionals Direct, now Hanover Professionals. In addition our marine, bond, and our niche product offerings continue to do very well generating strong growth for the quarter.

Pricing in our core commercial markets, small and new markets continued to decrease marginally in January and February, however more recently in March and April pricing has turned slightly positive relative to a year ago. We believe this trend will continue in future periods. With that in mind, we made a conscious decision during the first quarter to sacrifice growth in these core commercial lines and we thought pricing was insufficient and margins were inadequate, reserving capacity for when pricing is more favorable. That was particularly true in January.

Overall, however, this has not impacted our outlook for growth in the full year. We fully expect to achieve our target of mid-single digit growth over the quarter 2009 as pricing improves, disruption increases movement of business and our partnership strategy continues to work.

In addition to maintaining our focus on disciplined underwriting and profitable growth our financial condition remains very strong providing us with a greater flexibility and competitive advantage in the marketplace. As you will see from our 10-Q disclosures to be filed later today or Monday, I believe that we continue to set reserves conservatively as reflected in our reserves margin.

We continue to feel good about our composition of our investment strategy and portfolio. Our portfolio performed in line with the expectations we outlined in our call in February. Investment income and increases in the market value of our portfolio drove book value growth as overall book value per share increased 4% in the quarter. As I said before, we have one of the most conservative investor portfolios in the industry and we believe very strongly that the vast majority of our AOCI is temporary and book value growth will be enhanced by narrowing spreads in our investment grade bond portfolio.

With the first quarter of the year behind us we are confident that our strategy is right and we will generate strong earnings and growth this year. In anticipation of improved pricing, continued disruption in marketplace and fully earning in the benefit of our recent acquisitions, we continue to believe that we will generate segment earnings for the year that are consistent with the guidance we provided in February. Of course the guidance we provided should be adjusted for catastrophe and weather related losses sustained in the first quarter, which have reduced our planned pre-tax segment income by approximately $25 million. Gene will provide more details around the components of our 2009 guidance in his remarks.

I would like to close with some comments about this mornings ratings upgrade by A.M. Best. Obviously we think that the significance of moving up to a full A cannot be over estimated given the current economic climate, the state of capital markets, and the impact that both of these are having on our industry. Obviously this is a very rare upgrade in today's world.

Further, the upgrade is a very important tool for us to optimize our partner strategy, as it will provide us with the ability to get more high quality business with those agents who are already partners and will help us to get other agents to full partnership status.

Lastly, I am just very proud of what this means to our company and our people. It is a reflection of how much we have strengthened our organization over the past several years and marks a very important milestone in the life of our company to have our rating with A.M. Best return to this level. In this regard we look forward to continuing our upward momentum and delivering value for our stakeholders in the coming years.

I will now turn the call over to Marita for additional comments on our operating performance.

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

Thanks, Fred. Good morning everyone and thanks for joining the call. As you heard Fred say this quarter is a reflection on how we have remained true to our vision and how we have executed our strategy that we articulated at the beginning of our journey. Once again we did exactly what we said we would do. Despite the weak commercial pricing environment and putting aside the adverse impact of weather, we produced core underwriting results that were consistent with our objective of growing profitably. We resisted the temptation to write lower quality business and maintained margins at desirable levels. This discipline has been key to our success over the past several years and it will be critical going forward as well.

With that as context, I would like to review our underwriting operations starting with a discussion of overall P&C results on Slide 5.

For the first quarter of the year our P&C business generated $49 million in pre-tax income. This is down from $96 million in the prior year quarter primarily due to higher catastrophe losses in the first quarter of 2009. The comparison was also impacted by non-catastrophe winter weather, predominantly in the Midwest and in New England and by lower favorable development in the current quarter when compared to the first quarter of 2008.

Excluding the impact of catastrophe and non-catastrophe weather our underlying accident year loss ratios remained relatively flat which we consider a very good result for this stage in the pricing cycle and in context of the current economic climate.

I would like to discuss the drivers underlying these results in more detail starting with personal lines.

Turning to Slide 6, our Personal Lines segment reported pre-tax earnings worth $3 million in the current quarter compared to $27 million in the prior year quarter. Excluding catastrophes, Personal Lines segment income was $29 million in the first quarter compared to $38 million in the prior year quarter.

Favorable development of prior year loss and LAE reserves was $8 million for the first three months of this year compared to $12 million in the same quarter of 2008. The underlying loss trends in our personal lines deteriorated slightly due to higher property losses. That being said, our connections auto loss trends are showing signs of improvement driven by successful initiatives implemented last year to move the book of business away from single car business to multi car account business.

Our stable underwriting margins provide proof of our disciplined underwriting practices and proactive pricing approach. They also are a manifestation of our prudent growth strategy in personal lines.

Slide 7 shows our personal lines growth results for the first quarter of this year. The net written premium decreased 1% compared to the prior year quarter. This quarters net written premium growth was impacted by some reinsurance related items and a decrease in assumed premium from voluntary pools. On a direct voluntary basis our growth was relatively flat. This is notable since, excluding rate changes, our average premium policy declined when compared to the prior year quarter.

Consistent with our strategy we have recently seen a shift in our connections new business policies to a much larger proportion of full account multi car business which is usually associated with better retention and more favorable loss trends. As the proportion of lower risk policies in our book of business has increased the average premium per policy has declined, so even though our premium is roughly flat, we are growing units in targeted classes.

We are seeing sequential improvement in the growth of policy counts, which is a better indicator of our growth trends considering the above mentioned mix shift.

We recorded flat PIF growth for the quarter when compared to the prior year quarter, but on a sequential basis we are seeing growth momentum with first quarter PIF growing at 1%. We believe we will be able to sustain this upward movement going forward as we anticipate better retention from this business due to profile improvements. Accordingly, if we hold new business constant PIF will continue to grow as our retention improves.

Also this current quarter was the first quarter since the beginning of 2006 in which we have increased policy counts in Michigan. Last year we experienced premium and policy declined in Michigan reacting to a very difficult economy. We have recently seen a much stronger disruption in the make up of the competitive landscape in Michigan relative to other states, stemming from surplus pressures among many of the smaller players in this market. We are a net beneficiary of this disruption, given our capital strength, depth of our agency relationships, and recent investments in our new multi various homeowners product.

While Michigan remains a challenging market, economic and regulatory issues in this state are not new and we have learned to navigate and continue to be profitable in this environment. We are extremely pro active in terms of monitoring loss trends and taking rate action where and when appropriate, while taking advantage of emerging opportunities.

In Massachusetts where initial managed competition rate filing of -0.6% was effective in April of 2008 and is depressing our growth numbers, the personalized net written premium decreased approximately 4% this quarter compared to the prior year quarter. At the same time policy counts grew 2% on a sequential quarter basis. We expect to maintain a moderate level of growth in PIF going forward as we continue to balance our strong agency partnerships in this state with careful management of risk concentration.

Prospectively, it is noteworthy that we have received approval for a 2% rate increase in auto effective in April of this year.

We continue to grow exactly where we said we would grow. We expected, as expected, we increased net written premium in key growth states of Oklahoma, New Hampshire, Ohio, Georgia, and Illinois, while we continued to reduce net written premium in our larger states of New York and New Jersey where our mix and geographic shift initiatives are still running through our book.

Also, we continued to diligently seek rate increases in excess of inflation. Our average rates in personal lines were 5% higher than in the comparable prior year quarter when excluding the previously mentioned 9.6% rate decrease in our Massachusetts auto line. We have additional increases planned for the rest of 2009.

So while premiums remained relatively flat for the quarter, we continue to grow our book of business in more desirable risks and more desirable geographies. As a result, this quarter we were able to see improvements in our connections auto loss trends which were unfortunately masked by elevated homeowner’s property losses. Going forward we expect favorable loss trends to become more apparent in our results, and net written premium growth to be helped by improved retention due to better mix, and strong partnerships with winning agents.

Now I will turn to Slide 8 for a discussion of commercial lines.

Pre-tax segment income for the quarter was $47 million compared to $68 million for the first quarter of 2008. Excluding catastrophe losses Commercial Lines segment income was $58 million or $18 million lower when compared to the prior year quarter. This decrease was primarily driven by lower loss and

LAE development of prior year reserves, higher non-catastrophe weather losses, and as planned, higher expenses.

Ex-catastrophe accident year losses were higher in the current quarter reflecting higher non-catastrophe weather in commercial property lines. Excluding the impact of weather the underlying loss trends in all lines were flat to marginally improved. As we have stated many times before, we prefer to take expense risk over underwriting risk and our results in commercial lines reflect this strategy.

Our commercial lines underwriting expenses were higher in the current quarter compared to the prior year quarter. This was primarily due to the existence of higher expense run rates for our newly acquired specialty companies PDI, now Hanover Professionals, and AIX.

Also, as discussed on the call in February, expenses were impacted by increased pension expense.

Slide 9 shows our commercial lines net written premium growth which was 2% for the quarter compared to the prior year quarter, which reflects a 1x benefit of change in reinsurance in the first quarter of 2008. Adjusting for the 1x benefit of a change in reinsurance for the first quarter of 2008, our commercial lines net written premium growth would have been approximately 6%. This growth came primarily from our specialty businesses which grew 36% on a net written premium basis, which reflects the benefits of our recent acquisitions Verlan Holdings, now Hanover Specialty Property, and AIX. Excluding these acquisitions our specialty lines grew 6% for the quarter which we consider to be prudent at this point in the cycle.

The new business production of Hanover Professionals is coming from Hanover multi-line partner agents, as we continue to ramp up, and now constitutes nearly 50% of all new professional liability business written. We expect this trend to persist as we continue to install Hanover Professionals point of sales system in agencies offices in 2009.

The marine and bond businesses continue to grow moderately as we continue to turn down business that we deemed inadequately priced. Indeed our profitability in these lines remains very strong. Also, we have been careful to ensure that we have the right agency relationships in place to capitalize on the various government infrastructure initiatives that will drive premium growth in these lines in future periods.

Our traditional lines were off to a slow start in the first quarter of 2009 as market pricing in January and February continued to be soft; however, it turned marginally positive in more recent months. For us, while small and middle market pricing is taking longer to recover than we originally expected we continued to hold our pricing steady and actually had positive rates in small commercial accounts this quarter. At the same time, as in personal lines, we have continued to improve our underwriting discipline in these lines, thus shifting our new and renewal business profile to risks with higher margin expectations. This, not surprisingly, put additional pressure on our small and middle market business volumes, although this was a trade off that we were more than willing to make.

While we had somewhat slower growth in commercial lines in the first quarter relative to what we expected, we did not sacrifice margin for growth and we now have more capacity for an increased flow of better quality business as the pricing conditions improve and as the disruption in the market accelerates.

To summarize, in many respects the first quarter of this year was a good reflection of the company that we're building. We remain true to our vision doing what we said we would do. We retained our focus on profitability and on disciplined underwriting practices and despite difficult pricing conditions, weather related losses, and an exceedingly difficult economy, we produced solid, bottom line results for the quarter and made progress investing in our franchise. We kept our powder dry during the quarter and are better positioned to take advantage of the accelerating disruption in the marketplace and the price hardening that we expect over the rest of 2009.

With that I will turn the call over to Gene.

Gene Bullis

Thank you, Marita, and good morning everyone. Please turn to Slide 11 which presents our consolidated results for the quarter.

In the first quarter of 2009 we reported net income of $26 million or $0.50 per share compared to $59 million or $1.12 per share in the prior year. Net income in the current quarter reflects lower segment income and net realized losses on investments from our continuing and discontinuing operations of $9 million or $0.18 per share compared to negligible amounts of realized losses in the prior year quarter.

Net income in the quarter also includes income from discontinued operations principally arising from an after tax adjustment of $7.9 million to certain estimated indemnification obligations related to businesses previously sold.

Now turn to Slide 12 for a quick review of our segment results.

Segment income after tax was $26 million for the quarter compared to $57 million in the prior year quarter. Property and Casualty pre-tax segment earnings were $49 million in the first quarter of 2009 compared to $96 million in the prior year quarter. Our lower insurance operating results for the quarter were primarily driven by catastrophe and non-catastrophe weather related losses and lower favorable prior year reserve development. Given the number of moving pieces to this analysis, I would like to discuss them in more detail. I will use Slide 13 showing our underwriting ratios for the quarter as a context.

As you know, on March 20th we issued a press release stating that we expected higher catastrophe and non-catastrophe weather losses to impact our first quarter results by a range of $30 to $35 million. In aggregate this weather impact ended up being $36 million and was evenly split between catastrophe and non-catastrophe loss lines. As you can see on the slide, winter weather events impacted our personal lines catastrophe loss ratio by four points and commercial lines by one point of the combined ratio compared to the prior year quarter.

The non-catastrophe losses of $218 million included $12 million or two points of the overall combined ratio of adverse loss development from losses incurred in late December in the Midwest and in New England and are reflected as an offset of total favorable prior year loss development.

In the absence of this weather related adverse loss development our favorable loss development for the first quarter of 2009 would have been $12 million higher. The remaining $6 million increase in non-catastrophe weather came from commercial lines and related to January and February incurred losses.

These kinds of winter events, specifically extreme cold, and ice storms tend to have a longer claim tail. Often there is a time lag between the weather event and the discovery of the loss, like water damage from an ice dam.

LAE expenses reflect the benefit of $7 million or one point on the LAE ratio compared to last years first quarter associated with favorable development of loss adjustment expense reserves due to a change in reserving methodology. Absent this adjustment, our LAE for the first quarter of 2009 would have been moderately higher than the comparable period last year.

Marita has already reviewed the drivers of our profitability in detail, so I will move on to a discussion of our investment portfolio.

We hold $4.9 billion in cash and invested assets at March 31, 2009 including assets of our discontinued accident and health business. The cash in fixed maturities represents 97% of our investment portfolio with a carrying value of $4.8 billion. 94% of our fixed income portfolio was rated investment grade. Our below investment grade securities are principally actively managed high-yield corporates with very few fallen angels.

Our earned yield on total invested assets was $532 for the quarter compared to $547 for the prior year quarter. Net investment income from continuing operations in the current quarter was $64.9 million compared to $64.6 million in the prior year quarter. This stable income stemming from our bond and government paper focused portfolio provides good visibility into a stream of future stable earnings even in this disrupted financial market environment.

We continue to have no direct exposure to investments in subprime mortgages or subprime mortgage backed securities.

On Slide 16 we provide a breakdown of our corporate holdings, which represent 48$% of our overall fixed income portfolio. Industrials constitute about 26% of the overall fixed income and about 13% or $552 million is invested in financial sector holdings.

Skipping to Slide 18, which depicts the strength of our CMBS portfolio, we discussed the superior quality of our commercial mortgage backed securities in prior calls. We are pleased to see this quarter that the market has begun to modestly recognize the quality of our portfolio visa vee the broad CMBS market.

Moving onto a discussion of our unrealized losses for the quarter on Slide19, the majority of unrealized losses, $168 million, relates to our fixed income corporate holdings due to widened spreads and credit market liquidity contraction in 2008. The unrealized losses in this portfolio were improved by $20 million during the quarter.

As our disclosures indicate, our holdings are diversified and high quality. Again, we believe that the loss of market value is temporary. With our substantial liquidity position and a later duration structure in our fixed income portfolio we have the ability and intent to hold these securities until recovery or maturity which will allow us to realize their anticipated long-term economic value.

Additionally, we have done numerous sensitivity tests to determine default probability of all of our fixed income corporate holdings. Even the most conservative assumptions return default percentages well below the default assumption implied by current marks.

Our municipals and RMBS market values increased along with broader market indices. As I mentioned earlier, our CMBS holdings exhibited a positive trend versus the market due to the exceptional quality of our portfolio.

Although we have not adopted FASP staff position FAS 157-4 this quarter, we do not anticipate a significant change in our unrealized loss position when we adopt it next quarter. Our level 3 invested assets are only $72 million with a net unrealized loss position of under $1 million as of March 31. While we believe the level of defaults implied by current market values vastly exceeds the level of defaults we will ultimately experience, our portfolio does not include the types of securities we would expect to fall under the purview of the new accounting standards.

On Slide 20, we have displayed changes in our book value which improved by 4% in the first quarter of 2009. The improvement was primarily driven by a decrease in net unrealized losses in our investment portfolio of $47 million or $0.93 per share for the quarter together with operating earnings. Additionally, we think it is noteworthy that the net unrealized loss position of our investment portfolio narrowed by an additional $40 million in April, representing approximately $0.80 of book value per share.

On Slide 21, we have some key metrics that outline the strength of our balance sheet. Our GAAP equity grew 4% in the quarter to $1.97 billion. Our debt to total capital including AOCI came down slightly during the quarter, resulting from a higher capital base. At 21% our financial leverage, giving no credit to our hybrid securities, remains conservative.

Holding Company liquidity of cash and investment securities was approximately $400 million at March 31, which reflects receipt of the proceeds from the FAFLIC sale transaction on January 2, 2009 of about $220 million. We are contributing $25 million of the $400 million to AIX to meet certain individual entity licensing requirements so that we can expand into new markets.

In the first quarter we did not repurchase any additional stock with respect to our outstanding $100 million stock repurchase program of which $40 million remains unused. As always, our goal is to use our capital as effectively as possible to strengthen our organization, take advantage of growth opportunities, to ensure that we are positioned to win in the long term.

Lastly, I would like to summarize our expectations for 2009.

Our original earnings expectation provided at the February earnings call was $360 million of pre-tax, pre-corporate interest expense P&C segment income. Included in this number was an expectation of first quarter earnings which we missed by approximately $25 million, principally due to winter weather related events. Since we do not have a basis for projecting the weather related loss assumptions will vary from our original expectations for the remainder of the year, we are adjusting our pre-tax, pre-interest full year segment earnings expectations from $360 million to $335 million. The assumptions leading to this earnings estimate are essentially unchanged.

Combining personal lines and commercial lines we expect to achieve mid-single digit net written premium growth.

We expect to improve our accident year loss ratio relative to actual 2008 results, recognizing that with the first quarter non-cad weather effects the degree of difficulty in achieving this expectation has gone up.

We have increased our catastrophe estimate from 3.5% to 4.1% of net earned premium reflective of higher than expected Q1 catastrophe losses.

We continue to expect lower prior year development as compared to actual amounts in 2008.

We expect an increase in the total expense ratio of between ½ point to a full point.

We expect an effective tax rate of 33% and we are assuming average shares outstanding of $51.4 million.

With that I will turn the call back over to Bob.

Bob Myron
Thank you, Gene. Operator, that concludes our prepared remarks. Could you please open the line to questions.

Question and Answer

Operator

(Operator Instructions) Your first question comes from Michael Phillips of Stifel Nicolaus.

Michael Phillips
Stifel Nicolaus

Part of your strategy that you talk about is we are going to approach agents with something like the following pitch, give us your niche business, the stuff that you are kind of growing now obviously the schools, the public institutions and the churches and social services. Give us that and obviously we will get around the wholesale and therefore can pay you more. In return can you give us a chunk of the flow business? That is the basic deal, the way I understand it. I don't see who would say no to that and so I am missing something. What kind of bumps on the road do you have with agents when you go through those talks and why would somebody say no to that?

Frederick Henry Eppinger
Former President & CEO

I think it is something that for people that know us and have decided to commit to us, I think it is a very compelling story and particularly with the disruption. Because, what we are seeing today with these companies that are troubled, they have to be very careful that they don't give too much of their business to the two or three significant companies you can think of that are taking advantage of this disruption. So they are looking for more markets to build a deeper relationship with that have a strong financial position. They are very receptive to it.

With the upgrade today, as you can imagine, one of the biggest issues you've got is when they think about giving us an "unfair advantage" that they want to make sure that we are here for the long haul. So this upgrade is going to be an enormous help for a lot of the agents that were maybe giving us preferred treatment, but hadn't really committed to a full partnership. So, I am very confident this is going to work.

Now, why do you see the numbers, why personal and the small commercial doesn't grow regardless of the cycle at significant levels: remember we still have a bunch of that business and traditional agent relationships and in states that are not completely in the partnership realm. So they are legacy positions that we have with folks. They are good agents, but they are small agents with less upside and particularly in our core states.

So, what you are seeing is a mix change in our company from non-partner and partner business to more and more and more partner business and that is why we are so confident that you are going to see greater momentum as we get through the year, as those kind of partnership relationships take off. Again, I am very confident in those.

One thing you are seeing us do, as I mentioned in the February call, one of the things we needed to invest more in is continuing to make it easier to do the book thinning and book shifting to us and so we are spending quite a bit of money in what we call doing business, but download capability etc… to make that easier for people to do. So, I feel very good that that book will work and that we'll see greater momentum in the growth of the partner strategy.

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

We are seeing solid signs of that shift and not only is it and will it help the growth momentum, but it also has some nice margin ramifications as well as these winning agents have very good books of business and we have solid partnerships with them as well. So it is not only a growth strategy, but clearly articulates to the bottom line and good margin lift as well.

Michael Phillips

Stifel Nicolaus

If we go back a couple of years, Fred, you talked a lot about the expense ratio and getting some points out of that and clearly those times have changed. There have been some opportunities to make some investments which you have done. How do you think about that now? You are sitting on probably some excess capital, you are not using share repurchase, so what do we do with and maybe more PDIs of the world or where is that [interposing].

Frederick Henry Eppinger
Former President & CEO

That is a great question because as you know we took about 1 ½ point last year and I felt that we could continue to take, since the beginning I was saying, almost a point again out this year. What changed obviously is the dramatic disruption that we saw that has made us focus pretty aggressively at expansion particularly in some of the casualty lines. You have seen it with social services and this liability, EPL, our ability to acquire teens and get up and running in those businesses quickly. I also have more transparency to my confidence in the rating upgrades that we got from Moody's and S&P and Best over the last 15 months which have come in rapid fire. Which make us a much more competitive market in some of those, so we clearly have invested additionally on the expense side.

Now, as I said, what is nice about the disruption is I think the payback will be right very quick. This is in the three-year paybacks, I mean I think we will see some shifting of business that will make this much safer than maybe a large acquisition.

Now your question on capital which is also a good one there continues to be a lot of activity, a lot of discussions we are having with lots of smaller companies and specialty companies to enhance our capability. We talked to probably over 50 in the last couple of quarters. We are being very prudent about that. Because what I want is I want something that can be very quickly, if not instantly accretive. I want something that adds to our value proposition quickly that fits our strategy of small, kind of average policy sizes and I want to make sure it is done at a price that is appropriate with very little risk. So, we may get one or two or three of those kind of opportunities in the next year and we may not.

What I am more confident of than I have ever been is our ability to, if we don't fill in our portfolio, to be able to acquire teens and talent to do that organically because the disruption has caused tremendous amount of uncertainty with people and you are seining people move around the industry fluently. As you can imagine we are one of the very few people that are hiring people, have excess capital or growing and so we are getting a lot of attention and I feel very confident that we can continue to prudently move in that direction.

The question in your question is what do you do with the excess capital, right. What I would tell you is we have an Investor Day coming that we are going to spend a lot more time talking about it. Obviously this rating upgrade just happened, but it is obvious to all of you that we have both a very strong balance sheet and some excess capital. Because the transaction of the life company in January freed up some additional surplus, it is our obligation to be thoughtful about how we get shareholder returns to that excess capital.

Mike, as you know, from the beginning our goal is 12% through the cycle and we will get it and whether it is through attractive organic opportunities or inorganic opportunities, or if not, give it back to the shareholders, our commitment is to over a very timely period, to ensure that we are not holding onto capital that we are not appropriately using for the long-term value of the company. I would tell you that we will have that conservation at some length at our Investor Day, but again, I feel pretty confident in our organic investments that will get the kind of returns and I am constantly paying attention to the transactions that appear to be out there.

I will tell you one other thing though, I do believe we still are maybe a quarter or two away to the expectations of value from some of this, is still a little high in my view. But, I think over the next couple of quarters what you are going to see, particularly with some of the smaller companies, as these statutory pressure, pressure on statutory surplus rips through, you are going to see more renewal rights deals, you are going to see some people act in that way, because they are doing a lot of things to try to hold onto their ratings right now and over time what they will have to do restraint, in my view. So, I would say that there should be some significant opportunities.

I apologize for the long answer, but I wanted to make sure that I got it all.

Michael Phillips
Stifel Nicolaus

Yes, no, that was everything. I have a numbers question. Gene, you mentioned $12 million. Your prior period reserves would have only been $12 million, so was that personalized that $12 million?

Gene Bullis

Yes, that is substantially all personalized.

Michael Phillips
Stifel Nicolaus

Okay, thank you guys.

Operator

Your next question comes from Jay Gelb of Barclays Capital.

Jay Gelb
Barclays Capital

On the ROE goal for 12%, is that just on P&C segment income or is that all in? [Interposing]

Frederick Henry Eppinger
Former President & CEO

Jay, obviously we have thought about it up to this point separately, because I had this life company that we did the NPV and we talked about the valuation of life company as dividends of cash flow out of that and taking advantage of tax attributes. We are now one company, right. So, the way I think about it is through the cycle I have to return that for all of our capital, so we don't have what I call captive capital anymore. Now you can't turn a switch and do that over night and you have to be prudent on how you do it, but make no mistake about it, that is where we are going. We have to go there. That is adequate.

You can assume 11 to 13 two points a cycle, but it is again, what I believe is that the best companies can earn that 12. Now our goal is to be a little bit more of a boring company. You won't see us grow property cad of the other volatile stuff that jumps around and I think we are very capable of getting to that kind of range for the whole company, but as you know, historically I did divide it, but simply I divided it because I had to because I had that captive capital in the life company that we were evaluating based on tax attributes and the NTD of the cash flow of dividends. But that now is gone, right, so again, we are just one company so that we have to think about our overall capital position the way you just articulated.

Jay Gelb
Barclays Capital

I see and should I include the corporate?

Frederick Henry Eppinger
Former President & CEO

Absolutely and again, you know obviously in today's world you should hold some liquidity at the corporate. But, what I believe is, is that that should be incorporated in the way you think about your cost of capital, so we should be looking for a portfolio that enables us to earn enough to cover that tax, if you will, and I think that is what we should be focused on. That is why, by the way, you are seeing our portfolio, I continually look for a mix that gives us better margins in our business overall.

Again, I would tell you it is going to take a little bit of time. You can't take $300 million or $400 million and bang, redeploy it. So, we are going to be very thoughtful about it and, as I said, we will talk about it more at Investor Day, but my goal is to start talking about our returns and improving. You know we are probably at around nine in total and I have to get that where it belongs right? So, now that we have freed up this excess capital.

Jay Gelb
Barclays Capital

That is helpful. Can you talk a little bit about what type of opportunities you are seeing, as there are some larger stressed competitors out there? What the agents are saying?

Frederick Henry Eppinger
Former President & CEO

Yes, again it comes in two flavors and obviously there are some people, the bigger companies that are more suited to the long tail casualty lines. You are seeing their share shift happening quicker. I mean, DNO world and the biggie in estimate world is moving quicker for obvious reasons, because of a couple of the large companies that are stressed. I would also say that some of the specialty businesses, because they are so rating sensitive, you are seeing that movement occur faster, say bond, some of the real estate businesses, etc…

So, we are and to a lesser extent capitalizing on that. We are not in the large business, but there are some of our specialty businesses that clearly are seeing things more now than they were six months ago because of all that stress. So that is one category. I would say after today's announcement we are going to see a lot more of that in some of our businesses, although again, we are not in the large accounts, but in our casualty lines and in some of our specialty businesses we will see that.

The second part of the opportunity though, to me is even more profound. Which is, people are worried about the number of companies that can grow. If you look at the number of companies that have been downgraded by one of the three or four rating agencies in the last 12 months it is overwhelming. If you look at the mutuals, the percentage of mutuals that have lost over 15% of their surplus, it is also daunting.

So, what they see is they see a market turning, and market pricing firming, but a lot of their companies have to shrink to retain their ratings, so we're getting a lot of conversations with our partner agents about moving portions of their book to us, because they see us as more able to help them as they try to grow; that is why I see our niche business being so powerful, because some of the niche business is in these mutuals and small companies that do not have the ability to grow, frankly they have to shrink. We see that opportunity as quite significant.

The third category that I want to touch on is the disruption just from pure pricing. We compete against regional companies that tend to be under priced. They have excess surplus by definition, most of them, and they hold their price because all they care about is keeping their surplus flat. Well they had the worst year in history last year as far as weather and financial results, because the mutuals much more than the stock companies hold more of their investment portfolio in equities, because they consider it excess capital.

What we have seen is the depletion of their capital in their investment portfolio and in the fact that the weather has kicked them a little bit. You are seeing much more aggressive pricing by those guys, which has shocked a lot of agents and it makes them think about moving more of that business to us, and again, we are seeing this in Michigan. So, in Michigan where so many of our competitors are in the one fifteens, one twenties and they held rate, they are all trying to run and get rates so quickly that is making agent go wow, I should shift share to somebody like, us. Because, what our philosophy, as you know, has been is always get inflation every year. Never get nothing. Always get inflation so you don't have the big up ticks like they are having to experience from their regionals.

In all three categories, I am very optimistic, at least in the third and fourth quarter, we are going to see lots of this. We are starting to have lots of conversations, but obviously renewals come out 70, 90 days ahead, so we will see some of it in the next quarter, but I would argue you are going to see more in the third and fourth particularly if capital availability remains as it is today.

Jay Gelb
Barclays Capital

That is helpful, thanks Fred.

Operator

Your next question comes from Dan Farrell of Fox-Pitt Kelton.

Dan Farrell
Fox-Pitt Kelton

Can you talk about how getting the A benefits you as an acquirer both of the small companies and also teams? Does that help you look at stuff that you might not have looked at, other lines of business that you can get into now that you may have not been able to before?

Frederick Henry Eppinger
Former President & CEO

That is a great question. It is three levels and I think it is more profound than people understand. The notion of being an A today is so much more important than it was 12 months ago for a couple of reasons. One, even consumers who would have never asked about the rating of their personal line carriers are starting to ask. So, I would argue that in almost all lines some portion of the customer base is thinking about it. Because traditionally it was mostly the long tail casualty driven by the ENL exposures of agents and frankly the debt holders. So, I would argue that rating in general is more important.

The other thing that you have seen is the compression of rate. So, before there was a huge difference in very credible companies between the guys with AAA or AA and A-. A is it now right, so you are seeing a lot of the higher rated companies down to the A and so A has become, in my view, kind of the threshold for the high quality institutions. That compression means that A is kind of what you need to be, in my view, you don't need to be above it, but being below it is going to be harder. So just in general it is important.

But, the specific question you asked, I would say it is profound in like three ways. One, in bond business, in casualty business, in a lot of the interesting long tail businesses that we have pieces in, it opens up so many areas of opportunity with agents we already have great relationships with. They love us, but they had alternatives, that were higher rated, which makes all the sense in the world, for them, to place it with. While we will all of a sudden see all of that business that we didn't see because they have more comfort in our rating and we'll be able to sell the same rate or a little higher rate because we have equal rating as our competitors.

The second category is we will be able to go into businesses in the bond area in particular that we really can't. I some of the miscellaneous professional liability and some of the professional liability areas, I believe that it would have been very difficult for us to make the investments we're making without the A.

But, the other category that, again, I think is quite important. Remember our strategy. We are asking for an unfair advantage of the best agents in this country. They have all the companies and they love our strategy. They want to give us a preferred position, but when you are an A- you are one-step away, one hurricane away from a B++ company that for security reasons they can't place this. Where we are now, that goes away. So any hidden constraint for them to do more with us is really gone. I would take it a step further. Because we are the only financial services company, I think the only significant company in America, that has been upgraded I the last 15 months by Moody's, S&P and Best, that momentum is so shocking, or so differentiates us that a lot of these new partner relationships are going to make them feel much more comfortable to move that partnership forward.

I would argue that it is both quality of access of business with our counter partners of stuff we already do. It is new businesses that you will see us accelerate in the liability and casualty areas, and it is the conversion of partners in just the flow business, because they are more confident in our financial strength.

We just became an alternative and I will add one other thing, because you referred to hiring. Our ability to hire, we have been pretty good at it for the last 36 m months, 2,800 people. It is hard to imagine us not being able to recruit anybody we want now. I mean, this was the last piece that people asked about. It not only gives you confidence in the strength of the balance sheet, it is another confirmation that we do what we say we are going to do. A lot of people might disagree with me. They will say in P&C, A- , A it is all the same. I don't think that is true anymore.

I think the last 12 months that is not true and that is why some of these guys that are A with negative outlooks are shrinking so aggressively and doing quota shares, because they know that a downgrade right now is reacted to in a more severe way than it would have before. You are seeing it with a lot of major players. I mean just the movement affects agents because they get nervous about being stuck with a concentration of business with somebody that is financially unstable, but also shrinking, which is a damn hard thing for an agency to manage. Again, it is a big deal.

Dan Farrell
Fox-Pitt Kelton

That is all very helpful, thank you.

Operator

That concludes the question and answer session. I will now turn it back to Bob for closing remarks.

Bob Myron

Thanks everyone. As a final point, I want to remind you that our Investor Day is scheduled for May 28 at the Roosevelt Hotel in New York City. If you would like more information about our Investor Day please feel free to call me on our Investor Relations line at 508-855-3457 or look at the Investor Relations section of our website at www.hanover.com. Otherwise thanks for your participation today and we look forward to speaking to you again next quarter.

Operator
Ladies and gentlemen thank you for your participation in today's conference. This concludes the presentation (Operator Instructions) Have a great day.