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Market Intelligence

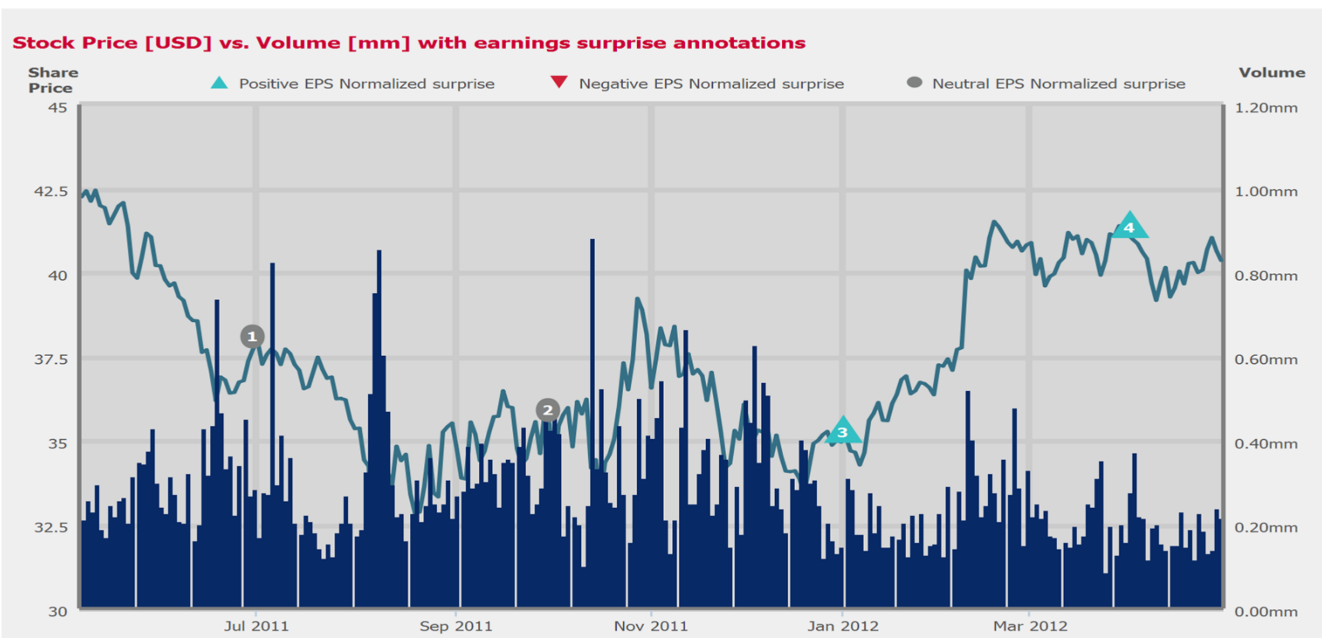
The Hanover Insurance Group, Inc.
NYSE:THG
FQ2 2012 Earnings Call Transcripts

Thursday, August 02, 2012 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2012-			-FQ3 2012-	-FY 2012-	-FY 2013-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.19	0.22	▲15.79	0.91	3.26	4.03
Revenue (mm)	1114.75	1197.60	▲7.43	1081.65	4345.71	4514.42

Currency: USD
Consensus as of Aug-02-2012 8:01 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2011	(0.56)	(0.84)	NM
FQ3 2011	(0.44)	(0.41)	NM
FQ4 2011	0.81	1.00	▲23.46 %
FQ1 2012	0.95	1.01	▲6.32 %

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Table of Contents

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Executive VP, Corporate Development & President, Surety

David B. Greenfield
Former Chief Financial Officer, Principal Accounting Officer and Executive Vice President

Frederick Henry Eppinger
Former President & CEO

Oksana Lukasheva
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Presentation

Operator

Welcome to the Hanover Insurance Group Second Quarter Conference Call. My name is Larissa and I'll be your operator for today's call. [Operator Instructions] Please note that this conference is being recorded.

I'll now like to turn the conference over to Oksana Lukasheva. Please go ahead.

Oksana Lukasheva
Vice President, Investor Relations

Thank you, Larissa. Good morning and thank you for joining us for our second quarter conference call. We will begin today's call with prepared remarks from Fred Eppinger, our President and Chief Executive Officer, and David Greenfield, our Executive Vice President and CFO. Also in the room and available to answer your questions after our prepared remarks are Marita Zuraitis, President, Property and Casualty Companies; Andrew Robinson, President of Specialty Lines; and Bob Stuchbery, President of International Operations and Chief Executive Officer of Chaucer.

Before I turn the call over to Fred, let me note that our earnings press release, statistical supplement and a complete slide presentation for today's call are available in the Investor 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 facts, include forward-looking statements such as our guidance for segment income per share for 2012 and commentary on 2013 and '14. There are certain factors that could cause actual results to differ materially from those anticipated by the 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 statements 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, after-tax earnings per share, segment results excluding the impact of catastrophes and development, 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 supplements, which are posted on our website, as I mentioned earlier.

With those comments, I will turn the call over to Fred.

Frederick Henry Eppinger
Former President & CEO

Thank you, Oksana, and good morning, everyone, and thank you for joining our call today. The results released late yesterday were in line with the early information we provided 2 weeks ago. Net income per share for the quarter was $0.46 and operating EPS was $0.22, which translates to an annualized operating RoE of 5% to the first 6 months of the year. Our book value per share, which is now 58.81 increased 8% over the last 12 months and 2% during the quarter.

Though our earnings for the quarter were disappointing due to some specific challenges we faced, we continue to seek favorable trends in our businesses and progress on our strategic priorities that positions us well for continued earnings improvement.

Weather once again affected our domestic results. Our catastrophe losses in the U.S. were 71 million or 9 points of the combined ratio. Additionally, in response to some emerging loss trends in auto lines, we increased our loss estimates, most notably for 2011. We also increased loss estimates on our contract surety book.

However, despite these challenges, we produced a profitable quarter given our diversified and improved portfolio, importantly we made progress on key strategic priorities. We continued to improve the quality

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of our business mix through targeted pricing and underwriting activities and increased share of the higher margin business in the mix. We further strengthened our position and alignment with winning agents while maintaining a disciplined focus on pricing. We have also gained expense leverage through operating model efficiency.

Finally, July 1 marked one full year since we completed the acquisition of Chaucer. Over the past year, Chaucer has delivered strong pre-tax segments of 88 million. Before I go into these areas in more detail and offer some thoughts on the market, the trends we are seeing in our business and the impact they should have on our 2012 and longer-term outlook, I would like to have David review our second quarter results and provide you a better context.

David B. Greenfield
Former Chief Financial Officer, Principal Accounting Officer and Executive Vice President

Thank you, Fred, and good morning, everyone. Net income for the second quarter was $20.8 million, or $0.46 per diluted share compared to a net loss of $32.2 million, or $0.71 per diluted share in the prior year quarter. Our segment income this quarter was $10 million, or $0.22 per diluted share, a substantial improvement over the loss of $38.4 million, or $0.85 per diluted share in the prior year quarter.

The difference between net income and segment income is due to a realized gain from CMI, a small workers compensation third-party administrator business we sold. This business was not a strategic part of our core operations and the sale allowed us to free up a modest amount of capital. This transaction resulted in an after tax gain of $11 million, or $0.24 per share, which is included in discontinued operations.

Catastrophe losses this quarter was $74 million, compared to $157 million in the second quarter last year. While losses in the quarter were much lower than the record high cats we experienced a year ago, they still represented 9 points of the domestic combined ratio, which is about 3 or 4 points higher than our longer-term expectations for this business.

The quarter was also impacted by unfavorable prior year reserve development. Overall for the company, we recorded net unfavorable prior year development of $17.2 million or 1.6 points of the combined ratio, compared to net favorable development of $15.3 million or 2 points in the second quarter of last year.

The unfavorable development was primarily attributable to a $13 million increase to the contract portion of our surety book, which is included in our other Commercial Lines business as well as $8.3 million related to auto lines. As you know, we significantly refocused and re-underwrote our surety business beginning in 2009.

Given the financial crisis and subsequent weaker economic conditions, certain issues in our book became apparent. As a result of our actions, premiums in the contract surety book was reduced from a high of $80 million in ‘08-’09 to only about $40 million this year.

Over the last 2 years, we’ve dramatically tightened our risk in financial metrics, upgraded our credit rating criteria, as well as brought in a new leadership team. As we mentioned in earlier calls, our contract surety book is currently divided into accounts we intent to support, which prevents the majority of the book and accounts that we’re putting runoff which includes accounts already in claims or otherwise closely monitored so that any potential loss can be managed to the best outcome.

During the quarter, we completed a comprehensive account by account and applied further stress testing for persisting economic pressures on our book. As a result, we identified some issues primarily in the runoff portion of the contract surety portfolio, which led us to record increased prior year losses of $13 million this quarter.

By way of background, we’ve been in this business for a very long time. Our contract surety book focuses on general construction with an average bond value of less than $2 million. The average duration of our project is less than 2 years although projects frequently begin subsequent to the date the bond is written so there is an extended exposure period that runs from the date the bond is written to the date the project is fully completed.

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To try to put this in perspective as to how this business impacts our financials our overall surety book of business performance over the past 2.5 years has averaged the combined ratio of 138%. Nonetheless, the attractive core of our contract surety business continues to perform well and we continue to realize good performance in the commercial portion of the surety book.

Finally, as it relates to our recent quarter loss experience, we've seen improvement in the underlying loss patterns, while we are still seeing claim activity the average size of losses has moderated as the average project completion ratio improved compared to only a year ago.

All in we are confident we've taken all the appropriate actions to improve the financial performance of this business and while we anticipate a moderation of loss activity from the runoff portion of the surety business we have incorporated in our financial outlook a higher expectation of losses for the second half of the year than we originally planned.

At the same time, we believe we'll continue to see positive earnings contributions from commercial surety and the go forward contract surety books. And we believe this issue will have little to no impact on our 2013 earnings. Besides the contract surety impact we also recorded unfavorable loss reserve development of $5.1 million and $3.2 million in our commercial and personal auto lines respectively.

The increase in net ultimate loss estimates was primarily in the 2011 accident year driven by higher severity trends in liability lines which began to materialize in the first quarter this year including the impact of a small number of large losses in commercial auto.

That covers the more significant loss development items this quarter. We had some pluses and minuses in other areas. In homeowners we recorded unfavorable development of $3.5 million. They are related to late reported heel claims on non-cat storm losses in the latter half of 2011.

And we continue to see favorable development in the multi parallel line and workers compensation line in the US as well as at Chaucer overall. While unfavorable development recorded this quarter is clearly a focus for us, it represents less than a half a percent of our total net carried reserves and we believe we have reacted relatively quickly through regular underwriting and pricing actions which have been underway and will continue.

Moving onto a discussion of our underwriting year results -- factoring the underwriting results, excluding catastrophe losses. In commercial lines, the accident year combined ratio was 98% for the current quarter compared to 97.9% last year. Underlying the stable margins our expense ratio continued to improve. The improvement comes from fixed cost leverage driven by earned premium growth, a more normal pace of business investments as well as the improving efficiencies in our operating model.

The quarters expense ratio of 36.4% was impacted by the timing of certain performance based expenses. The 6 month 2012 expense ratio of approximately 38% is more in line with our expectation for the full year. The reported, commercial lines current accident year loss ratio, it indicates the deterioration in auto and other commercial lines, but on a fully developed 2011 basis, results are more consistent as we are seeing relatively stable loss trends as favorable frequency trends are offset by emerging severity trends.

In personal lines, the accident year combined ratio, excluding catastrophe losses, was 91% in the current quarter compared to 91.8% in the second quarter of 2011. The improvement is attributable to more favorable non-catastrophe weather losses in the current quarter notably in our homeowners line.

In auto through 6-months, the accident year loss ratio was flat. Like the industry, we watch this line closely and analyze the liability as we continue to react with appropriate rate actions.

Chaucer delivered its highest quarterly profit since the acquisition closed a year ago, generating $30 million of segment income before taxes. Chaucer's combined ratio of 91.9% included a low level of catastrophe losses of $3 million and favorable reserve development of $5 million, primarily within the 2010 and 2011 accident years.

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Chaucer's expense ratio was 37.2% this quarter, which is in line with our long-term expectations for this business. We continued to be pleased with Chaucer's business portfolio, disciplined underwriting practices as well as the more favorable market trends evident in its business segments.

Moving onto a discussion of our investment results, net investment income was $68.5 million for the quarter, up about 12% compared to the $61 million earned in the prior year quarter. The Chaucer invested assets acquired last year are the main driver of the increase, offset by lower yields on reinvested assets. For the second quarter, our overall earned yield on a fixed maturity portfolio was 4.3%. The Hanover's fixed maturities yielded 5.1% compared to 5.3% in the prior year quarter and Chaucer investments yielded 2.3%.

As you can see, on a sequential basis, we continued to generate a strong level of net investment income. Our yields are relatively unchanged as we continue to find favorable investment grade opportunities in the fixed income space. At June 30, 2012, we held $7.7 billion in cash in invested assets with fixed income securities representing 85% of the total, roughly 94% of our fixed income securities are investment grade and the average duration of the portfolio is 4 years.

Our balance sheet remains strong, we ended the quarter with $2.6 billion in shareholder equity. Our book value per share at June 30, 2012 reached an all-time high at $58.81m up 8% from the $54.44 at June 30, 2011 and 2% from $57.65 at March 31.

Our capital management approach balances rating agency and regulatory capital requirements with plans for reinvestment in our business, and opportunistic capital uses. And we will continue to be diligent about balancing all of our capital requirements and opportunities going forward.

During the quarter, we repurchased 259,000 shares of common stock for $10 million in open market transactions. We have $125 million remaining in our share repurchase program, which we can deploy opportunistically based on market conditions. We have good financial flexibility with a debt to capital ratio of 26% and total capital is in excess of rating agency requirements for our ratings.

Our holding company, cash and investments were $105 million at June 30, representing 2x our external interest in dividend requirements. And we also maintain a $200 million credit facility that provides additional flexibility.

As a confirmation of our overall financial strength and the health of our company, all rating agencies affirmed our current ratings in this year's review cycle, which for us typically runs April through June.

In their reports, they noted improvement in our market position and business diversification, lower integration risk associated with Chaucer and strong enterprise risk management culture and processes. Overall, despite the environment and some of the specific challenges we've discussed, we are pleased with the underlying trends in our business and our financial position.

With that, I will turn the call back to Fred.

Frederick Henry Eppinger
Former President & CEO

Thank you, David, as I mentioned earlier and as David just reiterated, we feel very good about the fundamentals of our business, our position in the market and our prospects for the future. When we evaluate the progress on our strategic priorities, we are pleased with the headway we made particularly giving the ongoing pressures in the economy in the current marketplace.

At this critical time for the industry, we remain fully committed to underwrite the best business. This means a heightened focus on pricing actions, continued exposure management practices, effective measures and the run-off portion of our surety book and continued efforts on realizing the value of our operating model efficiencies.

Through these glances, I would like to review the business initiatives we continue to implement this quarter as well discuss the market environment in each business segment beginning with commercial lines. We achieved growth of 9% in core commercial in the second quarter of 2012 primarily driven by

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pricing, continuing strong retention levels and increased new business with our partnering agents. Overall, price increases from the core businesses were just over 6%, demonstrating the continued success we were having and driving rate improvement. Our price increases in the middle market were 7% in the second quarter of 2011.

In commercial auto, where we experienced some increase in severity, our pricing increased 5% compared to 1% a year ago. And we are planning and expect to receive higher rate increases through the end of year. We approach price increases in a thoughtful targeted manner, so as to minimize disruption and improve the overall quality of our book.

We believe our results this quarter demonstrate that this strategy is working. Retention continues to be strong and we are confident our distribution strategy will enable us to achieve additional rate increases in the coming quarters.

We continue to increase new business production and further strengthen our position with wining agents who understand and are aligned with our focus on the importance of writing profitable business. New business is coming from our targeted industry classes with lower property component and we believe the quality of this business has never been better.

The growth momentum in all our business provides us the flexibility to be more aggressive in our profit improvement initiatives. Our exposure management actions are on course and while we curtail some growth primarily in the CMP line in certain states, we believe this is the right trade-off to make considering recent weather patterns and trends.

As a result of the price earnings through our book, mixed changes and given our current view of loss trends, we continue to be confident in improving results going forward. In our specialty lines, we grew 20% this quarter, driven by AIX healthcare management liability and specialty industrial segments. Rate increases across specialty businesses averaged over 8%.

And importantly, as our newer businesses mature and as we gain efficiency in our core commercial segment, our expense ratio continues to move down from its high watermark of 43.5 in the first quarter of 2010 when we were making our most substantial investments in commercial lines.

And our normalized expense ratio run-rate this year has decreased by over a full point from last year. In line with our aspirations to be a top quartile insurer, we had to go through a period of very significant investments to build our competitive advantage in commercial lines.

We've always been attentive to our expense base and we remain focused on our goal and continue to execute on our promises as we build a strong and profitable insurance franchise. In personal line our focus on improving profitability translates into continued rate increases and managing pockets of exposure concentration in certain areas.

In terms of pricing, the momentum we saw in the first quarter improved during the second quarter as our applied rate increased to 2.5% in auto and 9% in homeowners compared to 4% and 7% respectively. And we expect continued pricing opportunities going forward.

It's important to note that the steps we are taking are not limited to rate. We are working on a number of levers as we target our improved underwriting margins. They include underwriting actions particularly changing underwriting standards with respect to actual cash value and groups -- as well as risk selection and location.

We continue to actively mitigate property exposure in the second quarter as we did in the first. While these efforts are ongoing, they affected growth during the second quarter more than in recent quarters and reflected in the premium declined of 1%.

During the quarter, we executed a renewal rights transaction with another party affecting approximately 30 million in annual net premium and eliminating roughly 80 legacy agents in New York, New Jersey and Connecticut. This transaction included 100% co-insurance agreement running from May until this agreement is expected to be fully executed, a period of approximately 18 months.

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As we discussed in Investor Day, we believe reducing micro-concentration in geographic areas enables us to improve long-term margin in our business and provide additional profitable capacity for our partner agents. Adjusting for this transaction, we would have reported a net written premium growth of 4% in personal line. This growth rate is more in line with the premium increases expected for the rest of the year.

We will continue our pricing and underwriting efforts to achieve further margin improvement. We believe that we will be successful given our strong relationships with our agent and the unique value propositions we bring to our customers.

Finally, we couldn’t be more pleased with the way Chaucer has performed in the year since we completed our acquisition, and we are very excited about the opportunities that lie ahead. With Chaucer, we now have a more diversified balanced company with greater scale, higher earnings resiliency, broader capabilities and greater earnings power. The financial benefits of Chaucer have exceeded our initial expectations. As part of the Hanover for 4 quarters, Chaucer has proven to be accretive to our organization. This said, we are only beginning to unlock the strategic value and distribution synergies that Chaucer brings to our company. While we intend to proceed methodically, we expect these synergies should further help build long-term shareholder value by improving the distinctiveness of our company for our best and largest agents and brokers and enhancing long-term returns in book value. In the meantime, the market environment always continues to improve.

Rates and terms and conditions strengthen in majority of the property line and especially those areas affected by last years cap, additionally as the market response to recent losses and energy marine sectors, we are seeing pricing in these accounts improved as well.

This said, in U.K. motor, rates have moderated on the back of substantial increases over the last 2 years. The current underlying loss trends in Chaucer’s business continue to be favorable. The quarter benefited from low frequency and severity of large losses and this was complemented by benign catastrophe activity. Top line growth also continues to track our expectations. We are confident Chaucer will continue to add to our earnings power and strengthen our market position with the best distributors going forward.

Based on the trends we just discussed and incorporating the first 6 months of operating results, we currently expect our segment earnings for the full year 2012 to be in the range of $2.70 to $2.90 per share. The major drivers for the change from our regional outlook are the following. We now expect catastrophe losses for the year to be 6 points of the combined ratio, reflecting the first 6 months of actual as well as the higher provision for July catastrophes in the U.S. which puts our third quarter catastrophe loss ratio expectation at around 7% of earned premium. Our updated outlook also incorporates a more conservative view of our auto margin. No material impact from prior year reserve development either favorable or unfavorable and a more conservative view on our contract surety book.

Overall, despite the challenges this quarter, we are excited about the capabilities we built at Hanover, the progress we have made and the momentum we have in the marketplace. We have a very strong and balance book of business, but as we’ve mentioned in the past, because of the recent weather patterns of economic trends, we believe it is important to remain focused on our underwriting, pricing and mix management to ensure we can continue to improve our financial position.

Given our strong position with agents and brokers our improved mix and maturing businesses as well as the additions we have made to our team including Chaucer, we are strongly positioned to fully capitalize on a changing market and achieve our financial goals. We are in a good position to significantly improve our financial position in 2013 and reach our financial goals in 2014.

Thank you.

Oksana Lukasheva
Vice President, Investor Relations
We are now ready for questions.

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Question and Answer

Operator

[Operator instructions] Your first question comes from Dan Farrell from Sterne Agee.

Daniel D. Farrell
Sterne Agee & Leach Inc., Research Division

A couple of questions. First on your new back guidance, you said the back half [indiscernible] of cat, how do we think about that for maybe next year -- is that should we think about that as the run rate, because you are engaged in ongoing cash per management then I'm also surprised that you bump the third quarter mor.e I realized we're in hurricane season, but you've also done a lot to address coastal exposure, because it's some of the events that have taken place thus far?

Operator

Dan, I am sorry, it was very hard to hear you, if you could talk a little bit louder.

Daniel D. Farrell
Sterne Agee & Leach Inc., Research Division

I am sorry, we try again there.

Frederick Henry Eppinger
Former President & CEO

I think we got some of it, Dan, but and maybe you can come back around, let me start with the second point on the CATS, we bumped the cats' in outlook, because of obviously what happened in the second quarter but also, you will recall there was a lot of activity around the end of June and into early July. So we already have an indication of some activity in July. Now I realize it's early in the quarter, but we are taking a view that we think the quarter will be a little higher than our original expectations as a result of what we have already seen for the first month of the quarter.

David B. Greenfield
Former Chief Financial Officer, Principal Accounting Officer and Executive Vice President

Yes. So we just -- now it is prudent and you can do the math that we gave you, but it's say $10 million to $12 million more in the second quarter, because of what we saw and it was that storm -- significant storm, that it was the last few days of June and then it was the first 3 or so days of July, that drove it. The other question you had is about our cat pics, as you know, last year, couple of things, we felt that there was a very important we said at Investor Day to assume that some of the weather patterns that we are seeing are real. So we took our non-cat estimates up 3 points this year. And that's why some of the rate activity in kind of transitioning to our through this year. We also took our cat percentages up. We haven't yet determined exactly what our cat percentage will be for next year, but as you know, we have sent out a lot of business. At the Investor Day, I talked about $200 million worth of business because it's not just, it's not really hurricanes, its notion of having some micro-concentrations with all these kitty cats that we are experiencing that are quite different. And so we've taken a lot of action to reduce -- we mentioned about $200 million of business, which were about 2/3 of the way down finished. And so I am not necessarily sure we will take up our cat estimates next year at all or -- that much, because again we believe that our mix, all our strategy towards a more balanced geography and more balanced casualty property, I think, offsets some other trends in the industry. So again, I think that we are likely to be close to where we are today at the end of next year, but we haven't really fully kind of assessed that.

Daniel D. Farrell
Sterne Agee & Leach Inc., Research Division

That's helpful. Then just on the insurance line, you said you put the provisions for higher losses through the rest of this year, will that through higher your development or higher accident year loss, because it's

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unfair to me that some of the contracts obviously started in 2008, things like [indiscernible] in the reserve development, but obviously you take higher pics as well, and then the 57.1 accident year loss ratio ex-cat within that other commercial line, is that a run rate or should we think about it as just having a little extra [indiscernible] catch up in the previous quarter?

Frederick Henry Eppinger
Former President & CEO

Let me try to first cover that first point, Dan. When you look at surety, it's a little bit different than the more traditional insurance lines in terms of current year versus prior year determination, because as you point out the projects span multiple years, the premium is written in the particular year, and then the point at which a project fails is sometimes debatable in the process. Obviously, the day we get a notice or the day we determine it is one thing but the actual day in which we might choose to determine a loss could be different. So I don't want to bog you down in all the details of that, if you will, I do think we'll see some prior year development and potentially some also current actions as we talked about in the outlook. I couldn't predict for you at this point without knowing exclusively what projects fail or what projects we're seeing loses come through whether it's going to show up in the prior year or current year. So it's one of the reasons why I made the comment about just looking -- trying to look at the ratios in this business more on a longer-term basis than on a period-to-period or quarter-to-quarter basis or year-over-year basis. And then in terms of the run rate, I don't have that in front of me. I think, in terms of the other commercial line, run rate where we are now is similar to where we will be in the second half of the year, maybe within a point or 2. I don't expect to be much different from a comparative standpoint. And I think, if you compare year-over-year, we were little higher last year in the third quarter in the other commercial lines. So we think that that will also sort of work its way out as we go into the second half of this year.

Daniel D. Farrell
Sterne Agee & Leach Inc., Research Division

[Indiscernible]

Frederick Henry Eppinger
Former President & CEO

Yes. That's a good point. This book, Dan, if we were in this business -- we were in this business, 100 years, so there was a portion of this book that we inherited that was small contractors and had certain characteristics. That portion of the book grew a little bit, but that's the book we really attacked in '09, it would have very specific credit characteristics. If you look at the losses we've experienced, that's where the vast majority of all the losses are coming from that and that is basically going away. So that book of business and those projects are finished, and so you can look at the result in all the different ways we look at losses and experiencing those in particular projects. That business is pretty much done, right. So, by the end of the year, that's gone away. So that's why we look going forward and the business we've actually kept in our core business is running very, very well. The credit characteristics are outstanding. It's got a more mixed towards a more sophisticated contractor and it's more commercial surety, it's more flow commercial surety and so the core of our book, both contract and commercial, that remains is quite attractive. And the rest of the business and the projects are essentially getting finished. And that's why it's pretty clear what's going to happen by the end of this year.

Operator

Cliff Gallant from KBW is on line with the question.

Clifford Henry Gallant
Keefe, Bruyette, & Woods, Inc., Research Division

When I look at the guidance now and I -- if I -- now sort of back the envelope now say, I figure 3 or 4 points of the bad weather in the second quarter and in the third quarter were to be pulled out. That would indicate that sort of underlying or normalized earnings powers in the $4 range, which is -- that means on average ROE -- I think it is a little less than 7%, is that the way we should be thinking about the profitability, the ROE potential of the company today, is that the right math?

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Frederick Henry Eppinger
Former President & CEO

I think if you look at the components, right, the 3 components we talked about, the weather you can do the 12 and see what that is -- that change. The other is probably a point in auto that comes from these trends. We thinks it's conservative and appropriate given what other people are saying in industry to take a different outlook a little bit more conservative outlook particularly on the severity side of the auto business going forward. And then to a much less extent some -- the surety adjustments. The upside obviously, the reason why we think there is going to be so much upside in 13, is our price almost across the board is above the lost cost pretty significantly now. So even in commercial auto and in personal auto where we are making adjustments, our current rate level is better than our lost contract. So what you're going to see is increasing earning power in the business in 13, that's why we are so confident and then obviously, the drag -- if point -- ends right. There is upside to that so that's why I think between -- through 13, the improvement of mix, the pricing earning its way in, we will also will have additional leverage on the expense side. We think that earnings power increases in '13 and as I said I think, by '14, we are at our target range.

Operator

Meyer Shields is in queue with question from Stifel, Nicolaus.

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

A couple of quick ones. And then maybe a bigger picture question, with the real rates transactions, should the offset to written premium growth, I guess, is that pretty evenly spread over the next 3 quarters?

Frederick Henry Eppinger
Former President & CEO

No -- actually a lot of it affected us this quarter because of the way the transaction came through. We do -- we expect we will be back on a growth pattern to the comments that Fred made when we get in to next 2 quarters and really overall the amounts involved here are not that significant that I think it would affect your spreading, if you will.

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

Okay. So the fact that it -- actually negative growth you are saying is an anomaly?

Frederick Henry Eppinger
Former President & CEO

Yes, a lot of it is really kind of more or less coming through now.

David B. Greenfield
Former Chief Financial Officer, Principal Accounting Officer and Executive Vice President

That's right.

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

Okay. That's very helpful. What were the CMI results reported up until now, anything commercial?

Frederick Henry Eppinger
Former President & CEO

Yes, it was. It's pretty small on a performance basis, so -- I won't go through the actual numbers but it really will have a very tiny affect on our -- really almost no effect on our earnings going forward. It was a pure servicing business that -- so there was no underwriting aspect to it.

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Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

Right. I understand that. And the bigger picture.

[Technical Difficulty]

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

Okay. Sorry, I am having problems with my headset. Fred, you talked about how rate increases are exceeding current trend and I think that's consistent with what we are hearing across the board. What leading indicators do you look to sort of fee where trend will be when these rate increases are being earned?

Frederick Henry Eppinger
Former President & CEO

Is what are -- indicators for trends you are saying?

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

Right. In other words, trend get worse now and then ultimately keep up with or even exceed the earned premium increases stemming from higher rate levels?

Frederick Henry Eppinger
Former President & CEO

Yes. I guess we look hard at the trends and what the timing of the trends are. And as I said, we haven't seen anything in the trends. If you look at frequency because our mix of business is getting better and most of our businesses we are seeing a continued decrease in frequency and as we said in the couple of the auto lines we seeing severity pick up a little bit, but the lost cost trends in total have not changed that much, for us across the board, so far. So we don't see that changing right now and we see the pricing trends maintaining and going up a little bit in our businesses.

Operator

Matt Carletti from JMP Securities, online.

Matthew John Carletti
JMP Securities LLC, Research Division

Fred, I just had a question on, I wanted to talk about U.K. motor for a second and in recent conversations I have noted some people are little more concerned about line, I would not say alarmed anyway, but it comes up in conversation a lot more these days. Yes, you mentioned the rate environment easing a bit, is that your only concern right now or are you seeing kind of underlying car trends deteriorating as well and as an add-on to that, is that a line that longer-term is core to Hanover or might at some point you look for options if it were to deteriorate?

Frederick Henry Eppinger
Former President & CEO

Bob is here, so I'm going to let Bob answer the question and I can follow-up obviously if there anything else.

Robert Arthur Stuchbery
Former Chief Executive Officer and Executive Director

First, we will go into the right expectations we've got. Obviously you had a situation where there needed to be some quite severe adjustment over the last couple of years, which we managed to get through in the market as well. So we are seeing a moderation of those rate increases in 2012 as we got that book

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back on track. The book is hasn't changed at all, the core portfolio we've got as we remained pretty static and we are very selective about what we do right and some have a very low market share in the U.K. So some of the industry dynamics being talked about probably aren't so apparent to us and aren't significant to us and so I'd really say from our point of view we are comfortable with the rating levels we're seeing at the moment, performance of that book and really there is no indications that there's anything other than we expected from market conditions.

Frederick Henry Eppinger
Former President & CEO

Yes. And if you recall from our earlier conversation, to Bob's point, I don't want to describe it as a non-standard but we have a very interesting -- program business and some specialty auto business and it is not that big and we got good rate increases over the last very significant rate increases last couple of years and we have had very stable earnings right now. So I think we're going to -- we feel that we're in a pretty good place right now. And we don't see a big change in our ability to earn the margins we expect this year.

Matthew John Carletti
JMP Securities LLC, Research Division

Okay. That is helpful. And then just kind of a follow-up on the ROE and kind of accenting your improvement discussion, kind of refresh my memory, is that a 12% ROE, or 11 to 13 range of the target and so going on the map, that was gone over before, pointed to kind of normalizing things, I think is called rough numbers, if you were to normalize this year, let's say, 7% ROE. So I guess you feel confident that given the rate increases you're seeing in the lost cost environment you're seeing that over 2 years '13 and '14 there is 500 basis points of ROE improvement to be had?

Frederick Henry Eppinger
Former President & CEO

And again one of the things that's unique about us, you guys know this but in '09 when we got the rate increases, we had made the company better but my view was that our portfolio wasn't distinctive enough and wasn't diversified enough to have sustainable ROEs in the range that we believe we would need to be one of the better companies. And so, a lot of our investment from '09 forward was to change that portfolio, whether it was the charter acquisition of the OneBeacon renewal rights deal, the investments we made in some of the specialty lines. Our portfolio now is dramatically different, right, both it has a nice geographic spread, it's 50-50 casualty property, it is much more distinctive in its mix as far as industry solutions. And so when we look at it, it's not -- we are little bit different than others. We get really 3 things that are helping us. One is, -- what I would call, the traditional pricing that people are getting. That we are getting as well that is really quite helpful and I would add to that pricing is that we are doing really good work right now on portfolio improvement particularly around properties. So we've gotten off as I said we focused on about $200 million worth of business that were property centric and places we didn't think, we can get excess returns or adequate returns. So we have gotten rid of those and we've gotten rid of a lot of those micro concentration about 2/3 of this is behind us. We have been creative with renewal rates and other ways but we -- some transition cost to that obviously but the combination of just core pricing and that has been very helpful. The second point though is the maturity of our businesses. So, what we have now is probably $1 billion worth of business that either, because of the geography or because it's a relatively new business, where we build the operating model and specialty where we invested in it, that those businesses are maturing so not only do I have an operating leverage point, we have a lost ratio points because there is no question we minimize do business penalty when we did that and we did renewal rights and all these other created reasons to avoid new business penalty. But obviously when your business matures and you get the kind of rate increases we are getting, 8.5%, 9% in specialty and rate increase in margin improvement and mix improvement across the board and some of these new businesses, all of those maturing businesses have huge leverages for us. And if you have the operating expense leverage, it is very material and you're seeing it right, it's over 5 points, it's our peak when we started investing. And then the final point that I would tell you is that, our retentions given the market dynamics and because we focus on smaller average quality size and because of the disruption and the percentage of our business with partner agents, what we are seeing is, we're getting better retention

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and better stability and a lot of the high margin pockets which again helps the overall performance of the business. So when you look at our leverage, you get the pricing that we have a lot more other leverage because of where we are and what we have done that gives us a lot of confidence in how we are kind of getting it. And yesterday I talked about the big components right, the rate, the mix, and the maturing of these new businesses and if you look at the portfolio, we have so much more higher margin, more stable business. Now I had another one today, after today's conversation. We obviously are also putting behind some of the last legacy issues that we had and one is this obviously surety business that was not as good as it should have been and we probably made some mistakes on not getting rid of that business quicker, but that's going to be behind us too. So that's why we're pretty -- we're confident in increasing earnings power. We probably, we got to prove it. We got to keep delivering it. But if you look at the underlying mix and the momentum we have with agents, it's tremendous right now. We're getting best books and best business and we're allow to kind of take the mix changes because of our partnership position with the agents we have. So it feels pretty good. But it's a little bit different than the traditional guys that are saying, this is exactly the same and I am just getting rate, right. I mean, we have other leverage because of the investments we've made that we control, if you will, right. So, that's why I feel quite good about it.

Matthew John Carletti
JMP Securities LLC, Research Division

That's very helpful. And my last question is a numbers question. Kind of following on the rate increases which clearly have been very nice, can you give any sort of guidance on where you at least think your loss cost inflation numbers are now and so we can kind of get an idea of what -- if you think yours only different than kind of the numbers that are thrown out of the industry whether on personal lines or commercial lines or otherwise?

Frederick Henry Eppinger
Former President & CEO

Yes. We don't normally talk about the numbers, per se, but I would say we are not dissimilar to the industry is. We're definitely a few points below where we're getting on rate. And so, we were very comfortable about the trend if you will that Fred was talking about in terms of pricing about our loss cost trends. I would say, the other point to be made here is we still have very strong retention which also gives us the opportunity to drive more rates. So, we're not worried at all about the loss cost point at this moment in the juncture. And again, I won't go into the actual numbers there, but we are not dissimilar to what we're seeing in...

David B. Greenfield
Former Chief Financial Officer, Principal Accounting Officer and Executive Vice President

One of the things about us is that we have -- if you look at our -- we have probably the lowest percentage of middle-market workers comp in the top 20 companies too. So that is the one line obviously where the lost costs have continue to be pretty significant trend. We just don't experience it, we are mostly a small comp writer and we have a small percentage of comp? So, most of ours, if you look at it what we -- it's more contained, right, and -- because even if severity that we are talking about in commercial auto is a very contained thing, right. It's pretty obvious to see and you can address it pretty quickly with rates. We haven't -- we don't have a lot of long tail. We don't have public company D&O, which I think is another place where I think people look at that and say, they were been harder, either much more short tail, more manageable, more clear and with a gap to us is pretty stable.

Frederick Henry Eppinger
Former President & CEO

But to your point in commercial auto, Fred, when you think about the second quarter of last year where we were only getting one point of auto price and a very profitable book, in this quarter, getting 5 point of price on that auto book as you mentioned in your script. And only a slight increase in the severity trend plus with what the industry is seeing, it bodes well to what we'll be able to build enterprise in the auto line going forward. So I think that's a very good example of that.

Operator

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Ray Iardella from Macquarie is on line.

Raymond Iardella
Macquarie Research

Couple of quick questions, I guess, first, maybe David on the stress test that you outlined on the surely reserves, Just curious sort of can give us a high level sort of what are the parameters you are assuming and sort of worst case scenario, I mean that is drastic downturn in the economy, give us some thoughts if possible?

Frederick Henry Eppinger
Former President & CEO

Yes. I'm going to ask Andrew Robinson who leads our specialty business. I am going to ask him to comment on that for you Rick.

Andrew Scott Robinson
Executive VP, Corporate Development & President, Surety

Obviously we went through coming out of 2008 a pretty severe downturn in the economy and the construction economy was largely maintained by big infrastructure projects which really isn't where most of our contract book is, so we are able to do very -- against sort of a prolonged period that looks like 2008. And so what we were able to do is just get, when Fred talked about sort of a go forward book or David talked about it, what we were able to do is just get to the segment of the market that we feel has credit quality well in excess of where the market is today that we would feel comfortable in allowing us certainly some comfort if there was a further downturn in the construction economy. I would say that also we are thinking very seriously about is, is where our business is placed. So for example, looking at the upper Midwest is very different than looking at Texas or even looking down in parts of the Gulf where there is a good deal of land reformation work. And so some of that is very geographic centric about how we look at our portfolio. And so it was those combination of things and through the course of the process, I wouldn't say that we were surprised by what we concluded and what accounts we are going to support and what accounts we are not -- we are just more comfortable that what we have is the view that, that does look at the sort of stress test of the economy that looks like sort of a period of 2008 prolonged into the future.

Raymond Iardella
Macquarie Research

All right. That's helpful. And I guess my question was kind of more focused on the accounts where you guys have reserves right now. I mean is there any sort stress test you are doing around that and kind of put some parameters around what sort of the worst case scenario, maybe what are the reserves currently held on that discontinued book and then perhaps sort of -- give us an idea of maybe worst-case scenario in your mind as it stands right now?

Frederick Henry Eppinger
Former President & CEO

I think that's exactly what we did and what you saw us do. I mean that's why we put the money up, so the vast majority of that was about this which says, what could happen, what's the worst outlook. And to David's point, most of it we adjusted in the reserves, but we also were saying on a go forward, we did some also adjustment on our outlook to really capture in a pretty bad scenario what it would be because we thought it was the right thing to do to be conservative, just kind of really do this and put it behind us this year, but that's what you are seeing is that kind of assessment and the impact of it on this quarter.

David B. Greenfield
Former Chief Financial Officer, Principal Accounting Officer and Executive Vice President

And I'll add one other item which is, whenever we see a claim situation or a prospective claim situation, we are looking at the principal across all bonded exposure and non-bonded exposure. So if you think about our point of view is really looking at the entire financial characteristics of the principal, so that

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we can understand how activities, as it relates to some contract that we have or multiple contracts that we have, might be affected by some other non-bonded exposure, etcetera. And so for us, we are pretty comprehensive in understanding how some of these things relate and what really could be sort of the ultimate loss so to say with maybe just a single claim that we're getting.

Raymond Iardella
Macquarie Research

Okay. That's helpful, and I appreciate the color. So just putting it in a sort of big picture, I guess, the majority of the change was IBNR as opposed to any specific cases or is that the right way to think about it?

Frederick Henry Eppinger
Former President & CEO

No.

David B. Greenfield
Former Chief Financial Officer, Principal Accounting Officer and Executive Vice President

No. If you get -- it was both, because these would be -- again, because they are run-off business. If we could specifically identify it to the account, it would put it into the case, right. So we literally did every single account left in our book, and did this and assessed it. And again, to Andrew's point, just a -- this is a business we were in for a very long time, and it was geographically centered to where we used to be big. It had characteristics, it was mostly small contractors. And as you know, when the credit crisis came, they were the most affected by this. And so, we believe we have a good handle on it. And as I said, with a stress test on our go forward book, I want to echo how good we feel about our go forward book, because even with all these stress tests and assessment our go forward book in all scenarios performs very, very well, so we feel very good about where we are right now in the go forward.

Raymond Iardella
Macquarie Research

Okay. Now that's helpful. And then maybe moving on sort of ex-surety and maybe some of the auto lines; was there any movement in the loss picks for the current year?

Frederick Henry Eppinger
Former President & CEO

Yes. So again, in our outlook obviously we've tried to adjust looking at the past and then looking at our book what I was saying about our outlook, a big portion of our outlook change is, just taking a more conservative point of view on the current accident year pick in auto, particularly personal auto is where -- we are not as big in commercial auto, we don't write heavy trucks or anything. So, most of our activity is really personal auto. And I would tell you also that we're not just looking at our book, we're also listening to the industry dialog about what the industry is saying and what's unfolding in the industry, which makes us want to take the conservative point of view on this, because of the -- we're not the only person talking about what's happening with severity in the auto book. So we thought it was appropriate for us to, on a go forward basis, affect our picks. And again, most of this is '11 and forward, right. I mean, that's -- really that's what it is, and that's how we address this.

David B. Greenfield
Former Chief Financial Officer, Principal Accounting Officer and Executive Vice President

Yes. But besides those points I think there's very little movement in our other picks for the year.

Raymond Iardella
Macquarie Research

Okay. So second quarter no movement really up or down, year-to-date?

Frederick Henry Eppinger

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Former President & CEO

I'm sorry. You have to expand on that.

Raymond Iardella
Macquarie Research

During the second quarter, did you adjust any of your loss picks for the current accident year?

Frederick Henry Eppinger
Former President & CEO

Just in the lines we've talked about we have -- across the other lines very -- we might have tweaked something but really marginally.

David B. Greenfield
Former Chief Financial Officer, Principal Accounting Officer and Executive Vice President

Not materially.

Raymond Iardella
Macquarie Research

Okay, okay. That's what I was looking for. And then lastly, and then I'll re-queue. Sorry to take up so much time. Buybacks, what is your thought on that going forward? I know there was marginally some buybacks in the second quarter, but just any color would be helpful.

Frederick Henry Eppinger
Former President & CEO

Yes, sure. And I made some references in my remarks, but we saw the opportunity to deploy some capital in buybacks. There was a lot of volatility in the market. We saw -- there was some good value in putting some money to work here, and we did do some buyback. And as I said in my remarks, we're open to potentially doing some more, but I would tell you it'd be very modest amounts through the rest of the year. So we have a lot of authorization left and there is no way we're going to spending that entire authorization, and I think as we see where our share price is today, and as we look at the volatility in the marketplace, we are going to opportunistically look at putting some money against more buybacks.

Oksana Lukasheva
Vice President, Investor Relations

Thank you for your participation today. And we're looking forward to talk to you next quarter.

Frederick Henry Eppinger
Former President & CEO

Thank you.

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

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