S&P Global
Market Intelligence

The Hanover Insurance Group, Inc. NYSE:THG

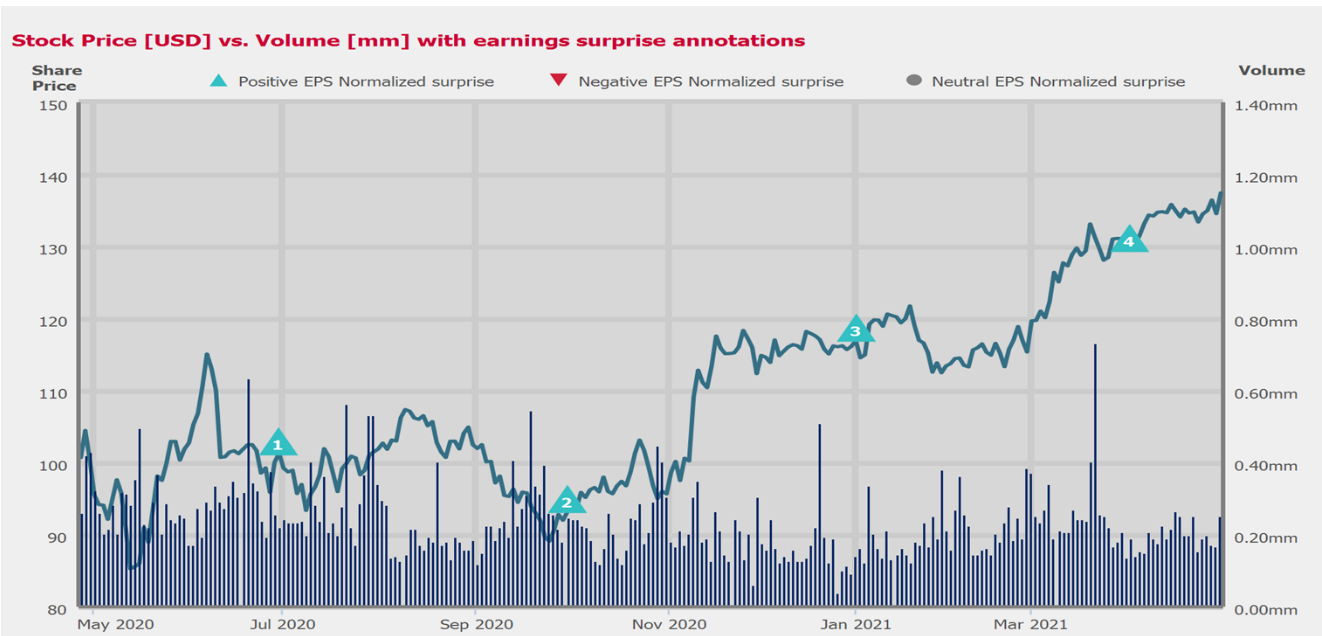
FQ1 2021 Earnings Call Transcripts

Friday, April 30, 2021 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ1 2021-			-FQ2 2021-	-FY 2021-	-FY 2022-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.74	1.66	▲124.32	2.28	9.05	NA
Revenue (mm)	1167.20	1196.10	▲2.48	1148.03	4822.57	NA

Currency: USD
Consensus as of Apr-30-2021 7:32 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2020	1.08	1.63	▲1 50.93 %
FQ3 2020	2.22	2.46	▲2 10.81 %
FQ4 2020	2.37	3.02	▲3 27.43 %
FQ1 2021	0.74	1.66	▲4 124.32 %

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Call Participants

EXECUTIVES

Jeffrey Mark Farber
Executive VP & CFO

John Conner Roche
President, CEO & Director

Oksana Lukasheva
Vice President of Investor Relations & Financial Planning

ANALYSTS

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Presentation

Operator

Good day and welcome to The Hanover Insurance First Quarter 2021 Earnings Conference Call. [Operator Instructions] Please note, this event is being recorded. I would now like to turn the conference over to Oksana Lukasheva. Please go ahead.

Oksana Lukasheva
Vice President of Investor Relations & Financial Planning

Thank you, operator. Good morning and thank you for joining us for our quarterly conference call. We will begin today's call with prepared remarks from Jack Roche, our President and Chief Executive Officer; and Jeff Farber, our Chief Financial Officer. Available to answer your questions after our prepared remarks are Bryan Salvatore, President of Specialty Lines; and Dick Lavey, President of Agency Markets.

Before I turn the call over to Jack, let me note that our earnings press release, financial supplement and a complete slide presentation for today's call are available in the Investors 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 as defined under the Private Securities Litigation Reform Act of 1995 regarding, among other things, our outlook for 2021, the ongoing impact of the COVID-19 pandemic, economic conditions and other risks and uncertainties that could affect the company performance and/or cause actual results to differ materially from those anticipated.

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, the presentation deck and our filings with the SEC, which includes supplemental risk factors related to severe weather and catastrophes, among others.

Today's discussion will also reference certain non-GAAP financial measures such as operating income and accident year loss and combined ratios, excluding catastrophes, 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, the slide presentation or the financial supplement, which are posted on our website, as I mentioned earlier.

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

John Conner Roche
President, CEO & Director

Thank you, Oksana. Good morning, everyone, and thank you for joining us this morning. I will begin by discussing our first quarter financial highlights in the context of the current business and economic environment. I'll then provide a strategic review of each of our segments and our accomplishments during the quarter. Jeff will review our financial results in more detail and provide some thoughts on the quarters ahead, and then we'll be happy to take your questions.

Overall, we are very pleased with our strong financial performance in the quarter, especially in light of the unprecedented catastrophe and activity. We posted net written premium growth of 5.2% and a combined ratio excluding catastrophes that exceeded our original expectations, underscoring our ability to capitalize on market opportunities while prudently managing the complexities of an uncertain environment.

In particular, I want to call your attention to 3 highlights for the first quarter. First, we are very excited about the increasing growth momentum in our businesses. Premium production exceeded our original expectations for the quarter, elevating back to pre-COVID levels, reflecting our strong market position and the effectiveness of our strategy.

Our balanced approach to Personal Lines pricing has proven to be effective. And the overall business environment, including rate, remains strong in commercial lines, fueling our robust premium momentum. Importantly, we are well positioned to continue driving profitable growth in all major segments of our business, and we expect to achieve mid-single-digit growth or higher for the remainder of the year.

Second, consistent with our pre-announcement, we sustained elevated catastrophe losses of $133 million (sic) [$133.3 million] or 11.5% of net earned premiums, primarily as a result of Winter Storms Uri and Viola in mid-February. These losses were substantially concentrated in Texas across all industry classes due to damage from the record-low temperatures, power outages and paralyzing ice and snow, conditions not seen there for more than a century. Our thoughts are with those who have suffered from these unprecedented events, and we remain committed to providing our customers and agents with the responsive support they deserve.

With total industry-wide damage estimates projected to well exceed $10 billion, the week-long freeze in Texas and neighboring states is expected to be the costliest winter weather event in history. The extent of the damage highlights the need for further price increases across the U.S. property insurance market. In addition, we are already seeing momentum for sustained commercial insurance rate increases more broadly, particularly in light of the rising cost of building materials.

Third, from an underwriting perspective, our first quarter underlying results showed further evidence of our broad-based profitability that enables us to further penetrate our agent partners. This continued strong performance is a reflection of our differentiated strategy, favorable mix, robust rate increases and the benefit of temporarily lower-than-usual frequency in automobile.

At the same time, with the pace of the ongoing reopening of our economy and business activity continuing to pick up, we are keeping a close eye on the reemergence of social inflation, given the uncertainty created by court closings and related delays. Accordingly, we are maintaining prudence in our reserves and loss picks.

Moving on to the highlights by business, beginning with Commercial Lines. We are off to a great start in 2021. While we expected to gain some momentum in the first quarter, net written premium growth of 7% surpassed our expectations and was at or above pre-COVID levels.

From a macro perspective, we are quite encouraged by the ongoing rebound in leading economic indicators, driven by accelerating vaccine programs, a new infusion of fiscal stimulus and favorable job growth. In addition, 2020 marked a record year for the formation of small businesses, adding to our optimism for the year ahead given the nature of our commercial customer base.

Business production trends are also strong as we came out of 2020 with positive exposure changes in Small Commercial and in the first quarter, saw middle market exposures turned positive as the quarter progressed. Moreover, Small Commercial new business is off to an excellent start, with growth surpassed only by last year's record first quarter pace. It's worth noting that approximately 20% of our total Small Commercial new business came from new agents, those appointed over the past 3 years. We also saw a nice uptick in retention in the quarter, a result of our granular pricing segmentation and our strong agency position.

Specialty growth was even more robust, led by specialty property industrial, E&S, marine and management liability, which all delivered double-digit growth rates. All indicators point to continuing positive momentum in this segment, including increases in retention and new business.

Across most of our commercial book, we continue to see rate meaningfully exceed loss trends. A range of factors is contributing to our ability to obtain substantial increases in rates. And these factors, which include social inflation, relatively low interest rates, property pressure and weather volatility, are expected to persist.

We believe that industry pricing will continue, given that some lines such as Commercial Auto remain in need of rate, while others such as Personal Lines are experiencing some loss pressure. The average rate increase across our core commercial book of business was 6.1% in the first quarter, generally in line with our fourth quarter increases. We are taking a slightly more competitive stance in certain more desirable geographies and business classes, on the strength of our granular pricing segmentation tools combined with our overall strong profitability.

Rate within workers' compensation appears to be leveling off, while Commercial Auto was still quite robust at nearly 10%. Rate increases in Specialty were 7.5%, slightly below fourth quarter levels. There is particular variability in our Specialty rate increases in any given quarter, which can be driven by specific renewals at the program or account level as well as profitability improvement actions.

Our assessment of the overall specialty rate environment in our markets is unchanged from the fourth quarter. Health care, specialty industrial and private company D&O are seeing the largest rate increases in our book. The robust flow of excess and surplus business supports the health of the overall market environment. And at the same time, it is enabling us to grow our E&S business above original expectations.

From a strategic standpoint, we rolled out our new TAP Sales platform for our Illinois and New Jersey business owners' policies accounts in the quarter, and it has received rave reviews from our agents, including the frontline account managers. Similar to Personal Lines, Our TAP Sales platform is poised to play an integral role in driving our success in Commercial Lines.

The new platform is significantly more efficient, reducing the time needed to generate a quote by nearly 50%. We've eliminated unnecessary steps, dramatically improved the navigation design and introduced pre-fill capabilities and third-party data to achieve this level of efficiency. The platform introduces significantly more pricing precision and flexibility, expands our small commercial industry class appetite and enables product flexibility as well, such as monoline casualty offerings in our cat-prone territories.

Our goal is to significantly improve the overall quoting and binding experience in this very competitive segment, which relies heavily on ease of doing business and CSR engagement. TAP Sales is part of a comprehensive set of investments in a broader innovation road map in Small Commercial, where we also have integrated other digital capabilities such as customer self-service and e-delivery of our policies.

In addition to Small Commercial, over the past few years, we have launched the TAP Sales platform for professional liability and management liability coverages and before that, in our Marine line of business. These professional and executive lines coverages can now easily be added to an account via our TAP Sales platform for small-sized risks. This provides us with the ability to seamlessly bring a full suite of coverages to our agents, which we believe to be unique and distinctive in the market.

We are very excited about expanding our Small Commercial capabilities. Our new BOP platform will be implemented across our national footprint throughout the year and will round out our complementary lines of business in 2022. As such, our Small Commercial business is poised to deliver considerable growth going forward.

At a high level, our goal is to make our independent agent partners more efficient in their transactional yet specialized Small Commercial segment, which generates very strong returns. Historically, the small commercial space has been largely defined by relatively simple risks easily addressed by relatively simple products. But the landscape is rapidly changing, with specialization now often required by industry class, size and geography.

A capability that allows for customization and flexibility in an efficient way is critical as the industry becomes increasingly customer centric and digitally enabled. And we believe TAP Sales is one of the components to enable this outcome and position us for even greater success.

Similarly, we are generating really strong growth from our Specialty initiatives, including the financial institutions focus in our professional and executive lines unit and cyber offerings. As we see our current specialty portfolio delivering strong growth and profitability, we are continuing to develop an additional pipeline of capabilities that allow us to maintain and build on this success, including expanded classes and capabilities in our Marine business.

We believe Specialty will continue to be an area of robust growth and opportunity for us. And these initiatives will further strengthen our ability to provide a distinctive set of products and capabilities that meet the evolving needs of our customers.

Turning to Personal Lines. Even in a very competitive market, we delivered strong earnings and net written premium growth of 2.2%. Our top line momentum accelerated meaningfully across the quarter as a result of renewal price adjustments that we signaled in our fourth quarter earnings call. With continuing price competition in Personal Auto, we have been selectively adjusting our rate increases in certain geographic regions to defend our renewals while remaining cautious on new business.

That being said, our rate increases were still healthy at 3.1% while we continued to increase our rate of growth in line with our expectations. Our disciplined approach to pricing allows us to retain our profitable renewal business and positions us well to capitalize on new business from some competitors' pricing adjustments as industry rates normalize with the increase in auto claim frequency throughout the year.

From a strategic standpoint, our customer-centric focus and the geographic diversification of our Personal Lines business represent significant competitive advantages. Hanover Prestige, our popular full account offering for customers with higher-value homes and autos, continues to gain momentum with strong growth in the quarter.

In addition, we continue to expand the reach of our TAP Sales online quote and issuance platform, making it easier for our agents and customers to do business with us. We also introduced coverages for motorcycles and personal cyber across multiple states while making further technology enhancements to our platform.

With the strong first quarter behind us and the light at the end of the tunnel shining brighter, we are off to a terrific start to the year. Our performance in the quarter and through the last year reflect the effectiveness of our strategy, the viability of our analytic capabilities as well as our underwriting experience and discipline. Our highly collaborative actuarial, underwriting, marketing and claims teams have helped us to successfully navigate through the challenges and the dynamic conditions of the past year.

We believe 2021 will continue to bring both challenges and opportunities as we manage through the economic volatility and settle into a new normal as a country. And we are positioned better than ever to react quickly, pursuing attractive business opportunities while watching for areas of pressure.

With broad-based profitability, strong agency support, differentiated products and advanced analytics, we are committed to driving profitable growth across our portfolio, growth that will enable us to continue to invest in our company and deliver increasing value for our shareholders, agents, customers and other stakeholders.

With that, I will turn the call over to Jeff.

Jeffrey Mark Farber
Executive VP & CFO

Thank you, Jack. Good morning, everyone. For the first quarter, we reported net income of $92.7 million or $2.51 per diluted share compared with a net loss of $40 million or $1.04 per basic share in the prior year first quarter. After-tax operating income was $61.4 million or $1.66 per diluted share compared with $86.8 million or $2.23 per diluted share in the first quarter of 2020. The difference between net and operating income in the first quarter of each year primarily reflects the increase in the fair value of equity securities in 2021 and the decline in the first quarter of 2020.

Our combined ratio was 98.8% compared with 95.2% in the prior year quarter, reflecting the impact of elevated catastrophe losses. In the quarter, we incurred catastrophe losses of 11.5% of net earned premium, driven by large losses from the severe winter freeze events in the South. Texas was impacted particularly hard by the freezing temperatures, power outages and winter conditions, accounting for about 2/3 of the total cat losses in the quarter, mostly in the commercial multi-peril line, of which we hold about 2.9% market share in the state.

We have worked tirelessly over the last decade on our property aggregation. And for most events over the last 4 to 5 years, we have been pleased with our losses relative to the specific industry concentration and position, and first quarter's events were not an exception.

Prior year reserve development was favorable in the quarter by $8.2 million, primarily reflecting lower-than-expected losses in Personal Auto and continued favorability in workers' comp. These results and our prudent reserving actions reinforced our focus on building a strong balance sheet and highlight our successful efforts over the years.

This being said, we continue to exercise prudence and thoughtfulness in making our loss picks, taking into consideration 2020 loss pattern changes, which were disrupted by the pandemic. We are also keeping an eye on reserving uncertainties as a result of court closures, potential delays in reporting medical procedures and other issues that may delay claims. Many of these factors are historical outliers and as such are less indicative of future trends. This presents reserving challenges, resulting in the need for appropriate conservatism.

Claims activity related to the COVID-19 exposures continues to be in line with our expectations and is fully manageable. We did not change our COVID reserves in the quarter, which continue to have ample IBNR. Our position remains very solid given our use of ISO-based policy language. Our mix of business, which excludes travel, trade credit and event cancellation coverages as well as our use of ISO-based forms has served us well during the pandemic.

Our expense ratio for the first quarter of 2021 was 31.6%, which was a bit lower than our expectation for the first quarter, but up slightly from the prior year quarter, primarily driven by higher agency compensation expenses. We have a clear line of sight to delivering at least a 30 basis point expense ratio improvement for the full year. Fixed cost leverage is expected to yield higher improvement in future quarters as our earned premium growth continues to accelerate throughout the year.

I am very pleased with our underwriting performance, excluding catastrophes, as demonstrated by an ex cat combined ratio of 87.3%, which is a function of mix improvement, earning and of rate increases and the continuing benefit of lower loss frequency in auto.

Looking at our underlying underwriting results by segment. Our Commercial Lines combined ratio, excluding catastrophes, was 89.8%, down from 94.7% in the first quarter of last year. This improvement is primarily a reflection of loss ratio decreases in our CMP and auto lines as compared to the first quarter of 2020.

Our CMP current accident year loss ratio, excluding catastrophes, improved by 8.3 points to 57.5% due to the favorable comparison with the prior year quarter, which was affected by one large fire loss and the impact of an annual aggregate reinsurance deductible. We continue to watch property trends carefully but also remain appropriately conservative on the liability component of CMP.

Our Commercial Auto current accident year loss ratio, excluding catastrophes, improved 6.9 points to 59.6% as we continued to experience frequency benefits throughout the quarter. Additionally, our current year first quarter loss ratio was impacted by favorable involuntary pools results versus the first quarter of 2020.

We remain appropriately cautious and prudent as we set picks for Commercial Auto bodily injury liability in light of potential claims delays and social inflation concerns. We also continue to achieve strong rate increases to address the multiyear liability pressure in this line.

Turning to workers' comp. The ex cat current accident year loss ratio improved 3.1 points to 60.3% compared to the prior year quarter. Frequency is starting to pick up in this line compared to mid-2020 lows, but underlying trends overall remained largely favorable. We are keeping an eye on the current rate environment and the potential new risks that can emerge as businesses begin to reopen their offices and facilities on a larger scale.

In other commercial lines, the current accident year loss ratio, excluding catastrophes, improved 2.4 points to 52.9%, underscoring the benefits of the profit improvement actions we took in prior years, along with robust rate increases that are now earning in.

Overall, Commercial Lines net written premiums grew 7% in the first quarter, with contributions from both our core and specialty businesses. Our core commercial retention at 87.3% increased 2 points sequentially from 85.3% while new business gained momentum. Specialty growth accelerated in the quarter as the business continues to gain traction in several attractive profitable lines.

Turning now to Personal Lines. Our combined ratio, excluding catastrophes, was 83.9% for the first quarter, down from 87% in the same period last year. The continuing temporary frequency declines in auto and favorable underlying activity resulted in a 7-point improvement in the auto loss ratio to 60% compared to the first quarter of last year, which was only impacted by the COVID-related economic shutdown in the second half of March.

As the first quarter progressed, we saw signs of driving patterns picking up in off-peak hours. However, auto accidents during peak commute times, which typically make up a large portion of losses, remain suppressed. With the reopening of the economy, we expect frequency to trend towards more normalized levels by the end of this year. Thus, managing the balance between growth, rate and profitability in the shorter term is critically important.

The loss ratio in our homeowners line increased 5 points to 53.4%, primarily due to a higher incidence of large fire losses and an unfavorable comparison to low non-cat weather in the first quarter of 2020. Our homeowners book remains very profitable. However, elevated weather losses and increases in the prices of materials, particularly lumber, highlight the need for rate increases in this line in the marketplace. Fortunately, the short-tail nature of this line allows us to react quickly to adjust pricing on our book of business if needed.

Personal Lines net written premiums increased 2.2% in the quarter, driven by new and renewal business. We are particularly pleased with the sequential improvement in retention, which was up 1.3 points from the fourth quarter of 2020, reflecting the effectiveness of our recent pricing actions and the strength of our Personal Lines offering.

Moving to investment performance. Our net investment income was $76.8 million for the quarter, up 10.3% from the prior year period, on the strength of better-than-expected investment partnership performance. This performance was primarily driven by positive valuation changes in the fund's equity holdings and certain successful but nonrecurring transactions in underlying partnership investments. First quarter partnership results do not change our outlook for investment partnerships or overall net investment income for the rest of the year.

We were pleased to see new money yields pick up during the first quarter. If this trend continues, it should be marginally helpful for our net investment income over the balance of the year. However, overall new money yields are still below earned yield levels and will continue to put pressure on our net investment income for future years.

Cash generation from our underwriting operations remained strong, which should mitigate this impact. Cash and invested assets at the end of the quarter were $8.9 billion with fixed income securities and cash representing 84% of the total. Our fixed maturity investment portfolio has a duration of 5 years and is 96% investment grade. We have a high-quality portfolio with a weighted average of A+.

Net unrealized gains on the fixed maturity portfolio at the end of the first quarter 2021 were $281 million before taxes, representing a decrease in fair value of $228 million since December 31, 2020, due to an increase in prevailing interest rates. Our portfolio is well laddered and diversified by industry and asset class, and we are certainly not cash constrained. We typically hold fixed income securities to maturity and are not concerned about the temporary movements in the market value of our portfolio.

Moving on to our equity and capital position. Our book value per share of $84.21 reflects a decline of 4.3%, driven by the declines in net unrealized gains of our fixed income portfolio. Excluding these unrealized gains, our book value per share was $77.50, representing an approximate 2% improvement in the quarter.

We remain strong stewards of our shareholders' capital. During the quarter, we repurchased approximately 358,000 shares of our stock, and we also paid a regular cash dividend of $26 million. Through April 27, 2021, we repurchased an additional $40 million of stock under our 10b5-1 repurchase plan, leaving $40 million under our existing stock repurchase authorization. We are planning to discuss a potential increase to the current authorization at the upcoming Board meeting in mid-May.

Our capital priorities remain unchanged. First, we strive to maintain our strong capitalization and adequate liquidity. Second, we continue to prioritize improving organic growth for which we generate plenty of capital. And third, we continue to maintain our policy of returning excess capital to shareholders through cash dividends and share repurchases. We will continue to remain nimble and actively manage our capital with the best interest of shareholders in mind.

Given the magnitude of catastrophe losses in the quarter, we are very pleased with the operating ROE of 8.8% that we delivered in the first quarter. Normalizing for catastrophe losses, our ROE would have been above our long-term target, underscoring the strength of our underlying earnings power.

Looking ahead, we continue to expect overall net written premium growth in the mid-single digits or higher for 2021, with top line momentum accelerating throughout the year. The growth in the first quarter and the continuing momentum in April give us confidence in our growth trajectory for 2021. As noted earlier, we remain on track to reduce our expense ratio by at least 30 basis points in 2021 to 31.3%. And we expect our second quarter cat load, which is typically our highest, to be 6.1%.

In closing, we are very pleased with our underlying performance and our ability to build on our positive momentum in the quarter. We are confident that we are well positioned to sustain our profitable growth momentum and top quartile profitability, delivering value for our customers, agents, shareholders and other stakeholders.
With that, we will now open the line for questions. Operator?

Question and Answer

Operator

[Operator Instructions] And ladies and gentlemen, our first question today comes from Meyer Shields with KBW.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Great. So I want to start with a question for Jack, if I can. You talked about taking, I think, a very rational, more competitive posture in Small Commercial. Can you talk about what you're seeing from your competitors? In other words, does this improve your competitive position or hold it steady?

John Conner Roche
President, CEO & Director

I think -- Meyer, first of all, thanks for the question. I think there are a number of factors that are allowing us to build on the momentum that we've worked so hard on in Small Commercial. Not only is the profitability of our current portfolio and all the hard work we do with our agents to position our products to be broad-based and to be a little bit more comprehensive than many of the competitors that we compete against.

But I think probably one of the biggest factors that's causing us to feel even better than ever about our Small Commercial opportunity is that more and more agents are getting strategic around their flow businesses and in particular, are starting to work on their operating models and how they can concentrate their business with fewer and more strategic carriers, which we believe plays right into our business strategy and our capability set.

So if you add all of that up, being profitably positioned, investing in our capabilities, including our new platform, that couldn't be coming at a better time. Frankly, it gives us a lot of reason to be optimistic about how we can further build on our Small Commercial momentum.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. Understood. Maybe a related question, And I think the growth opportunity seems fantastic. But I'm curious as to -- when you have new business coming from new agents, is that booked more conservatively than, I don't know, new business from existing agents?

John Conner Roche
President, CEO & Director

Well, I think one of the things we've shared in the past is that, even with new appointments, we have a real transparent approach to envisioning what our future partnership would look like, what our underwriting appetite is and how that matches their current book of business, leveraging our Agent Insight tool.

And then as we start the process of building momentum, we hold them to the same high standard that we hold all of our agents in terms of the quality of the mix, the pricing that we look at vis-à-vis our own renewal book and some of the statistics that we gather from our Agency Insight tool. So we're quite confident that new business from high-quality new agents is at least as disciplined, if you will, as the new business that we write with our existing agency plan.

Operator

[Operator Instructions] Ladies and gentlemen, this concludes the question-and-answer session. I'd like to turn the conference back over to the management team for any final remarks.

Oksana Lukasheva
Vice President of Investor Relations & Financial Planning

Thank you, everybody, for your participation today, and we're looking forward to talking to you next quarter.

John Conner Roche
President, CEO & Director

Thank you.

Jeffrey Mark Farber
Executive VP & CFO

Thanks, everybody.

Operator
Thank you. This concludes today's conference call. We thank you all for attending today's presentation. You may now disconnect your lines, and have a wonderful day.