S&P Global
Market Intelligence

The Hanover Insurance Group, Inc. NYSE:THG

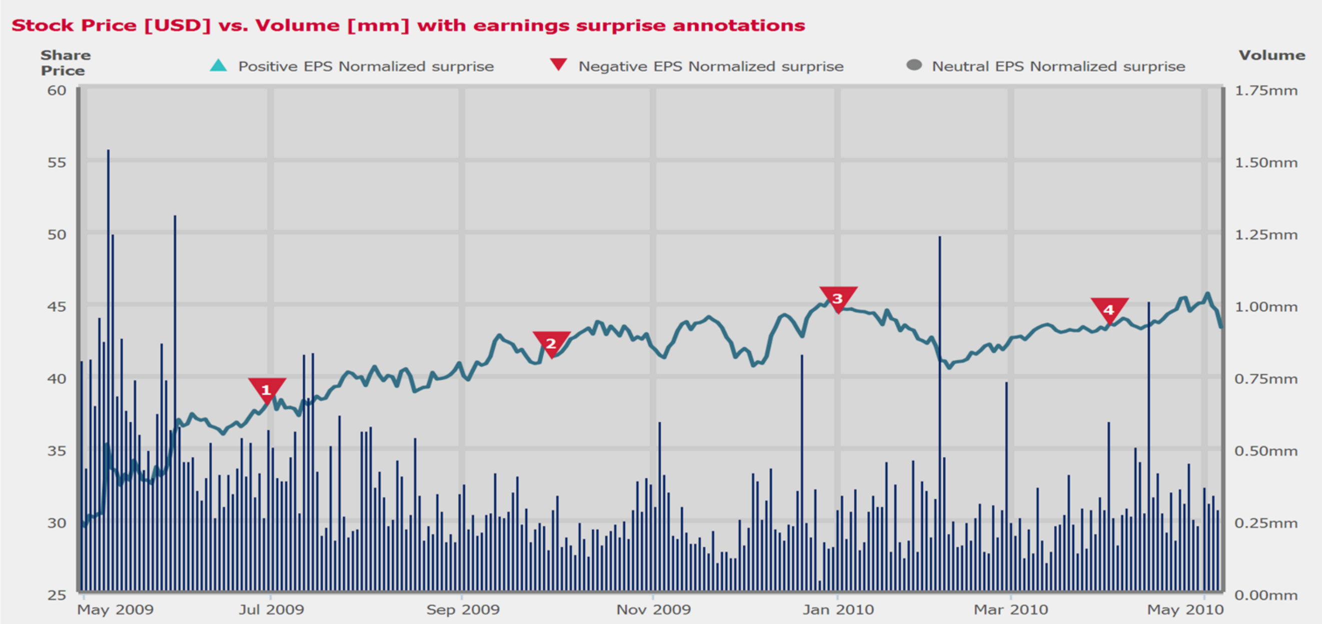
FQ2 2010 Earnings Call Transcripts

Thursday, August 05, 2010 3:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2010-			-FQ3 2010-	-FY 2010-	-FY 2011-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.20	0.04	▲(80.00 %)	0.88	2.81	4.30
Revenue (mm)	737.70	802.00	▲8.72	786.45	3070.65	3296.65

Currency: USD
Consensus as of Aug-05-2010 1:18 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2009	1.02	0.86	▼1 (15.69 %)
FQ3 2009	0.98	0.89	▼2 (9.18 %)
FQ4 2009	1.01	0.83	▼3 (17.82 %)
FQ1 2010	0.77	0.66	▼4 (14.29 %)

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Call Participants

EXECUTIVES

Frederick Henry Eppinger
Former President & CEO

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

Oksana Lukasheva
Vice President, Investor Relations

Steve Bensinger

ANALYSTS

Cliff Gallant
KBW

Sam Hoffman
Lincoln Square Capital

Vincent DeAugustino
Stifel Nicolaus

Presentation

Operator

Good morning and thank you for joining us for our second quarter conference call. Participating in today's call are Fred Eppinger, our President and Chief Executive Officer; Marita Zuraitis, President of Property and Casualty Companies; and Steve Bensinger, our Executive Vice President and CFO.

Before I turn the call over to Fred for a discussion of our results, let me note that our earnings press release, statistical 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 facts, include forward-looking statements. These include statements regarding expectations of after-tax operating earnings per share, segment earnings, pricing, accident year results, premiums, expenses, development of loss and LAE reserves, returns on equity and other projections for 2010 or beyond.

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, after-tax earnings per share, segment results excluding the impact of catastrophes and development, ex-CAT loss ratios 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, I will turn the call over to Fred.

Frederick Henry Eppinger
Former President & CEO

Good morning, everybody, and thanks for joining us this morning. As usual, I will begin our discussion by providing some context for our second quarter results and update you on our progress towards meeting our long-term financial objectives and marketplace positioning. Then I'll turn the call over to Marita and Steve who will provide additional insight into our performance and relevant trends.

A significant number of severe weather events during the second quarter were challenging for both our industry and our company. As we noted in our July 13 press release, we incurred $85 million of catastrophe losses, the highest second quarter level of catastrophe activity in our history.

Even with the high level of catastrophe losses, however, we generated positive earnings in the quarter and further increased book value per share. Our book value per share grew 20% from the prior year period and 6% from the year end 2009. On an ex-CAT basis, the underlying trends we see across most areas of our business are continuing to show good progress as evidenced by a 2.8 point improvement in our ex-CAT current tax end year loss ratio.

While this was a challenging quarter, we made excellent progress on the critical strategic initiatives that are positioning our company for strong long-term financial results. We continue to focus on a journey to create a world class property and casualty company, one that achieves attractive financial results with an 11% to 13% ROE through the cycle and deliver distinctive products to winning independent agents.

Since we began our journey, we have significantly improved all our core capabilities in the financial strength of the company. As you know, in most recent quarters, we have made significant investments to enhance our product portfolio and competitive position. Particularly since our latest AM Best upgrade in May of last year, we have accelerated the repositioning of the company.

In the last 15 months we have acquired and built a number of product capabilities and launched our geographic expansion, significantly improving our competitive position with some of the most important independent agents in the country.

Today I want to focus my comments on the levers we believe are the most important as we work to achieve our long-term financial goals and market position. First, we continue to establish strong momentum in growing our commercial lines and specialty businesses, leveraging the investments we have made in those areas.

During the second quarter we grew our commercial lines business by 46%. The growth in this business is an increase over the first quarter where we grew 33% continued to be driven by our renewal rates agreement with OneBeacon Insurance Group and the continued growth of our specialty and niche businesses.

We continue to be very pleased with the OneBeacon transaction. While it's still too early to tell just how much of this business we will ultimately renew and how much new business we will write with the new partners we appointed in connection with the transaction, we are certainly encouraged by the trends that have developed so far.

We also are very pleased with the excitement and enthusiasm the new partner agents have expressed about forming deeper partnerships with our company as evidenced by the amount of business we are writing with these partners.

In addition to generating strong growth, their enthusiasm is further confirmation that our value proposition delivering product innovation, franchise value, and responsiveness is resonating with winning agents. During the second quarter alone we renewed just over $80 million of high quality small and middle market business, bringing our total for the year-to-date to $150 million with the vast majority in segmented and niche business.

At the same time, we sustained strong growth momentum in our existing specialty and niche businesses. The specialty business has become a material part of our company and a competitive advantage for us. With our recent acquisitions of Campania and Benchmark, we are extending that advantage by opening up liability and other coverages to the Allied Health and Design industry.

With this growth of our commercial lines business, we are beginning to see the improvement we expected in our commercial lines expense ratio notwithstanding our continued investment in product capabilities and our ongoing western expansion.

We expect continued improvement during the third quarters and fourth quarters and into 2011 as we earn in growth related to the renewal rates transaction and our various specialty acquisitions at the same time are mixed toward a higher component of the commercial and specialty business will by definition drive a slightly higher overall expense ratio.

Second, our improving business mix will continue to help our margins and strengthen our position with winning agents. As I have mentioned before, the investments we've been making in our business are resulting in important geographic and business mix shifts which should drive fundamental margin improvement in our overall book of business and lead to more attractive margins and more stable earnings through the cycle.

We are pleased with a 21% overall premium growth we achieved in the quarter and we are even more pleased that the growth was generated in the right places, including casualty oriented commercial and specialty lines in the central, southeast and west regions.

In commercial lines, the overwhelming majority of our growth is coming from our target segment, niches and specialty business. In core lines, small or middle market, 70% of our total growth comes from the niche and segmented business.

In addition, specialty lines grew 44% in the quarter, led by the growth of our program business, AIX, with virtually all the growth coming in the form of mature profitable programs from our partner agent.

In personal lines, we continue to diversify away from our original six states and build a stronger, higher margin account-oriented book with partner agents. In total, our current product mix is making us a valuable partner with winning agents. As we become a much more important company to their success we achieve increasing and better shelf space.

I would like to comment briefly on the agreement we reached last month with IGW Group. The transaction is an excellent illustration of our efforts to optimize our geographic and business mix. It will enable us to enhance our surety capability while building out our portfolio in the west, adding more casualty business and further diversifying risk across the entire book.

As you know, we were able to hire 17 professionals and get access to about $15 million of surety business across the southwest and west, all places we were trying to grow our franchise. As I look forward to the rest of 2010 and into 2011, I see the momentum continuing due to our west expansion efforts and our product development action.

For example, given the acquired capabilities from OneBeacon and our other transactions, during the second quarter alone, we doubled our middle market coverages for industry segments and niches, strengthened our industrial risk solutions by expanding our appetite to include more than 30 new classes of business and expanded our management liability services.

In addition, we are making good progress on the integration, product development and rollouts for both our A&E product and our healthcare offering which we expect to be available to many of our partners this fall.

Third, we are making good progress enhancing our margin through pricing. Given the difficult market environment, I am extremely pleased with our progress. In personal lines, the pricing environment is obviously more favorable. Here we saw improvement in our ex-CAT accident year profitability for the second consecutive quarter demonstrating that we've been able to obtain price increases when and where we needed them.

We have continued to achieve 6% plus average increases on our overall book. We've also continued to emphasize discipline in our underwriting process, walking away from underpriced business and focusing on our account rounding strategy.

In commercial lines, the pricing environment continued to be very competitive in the quarter. On a positive note, exposures increased slightly but some of our competitors still saw the rates on renewal business trend down and others have continued to price new business irrationally.

In contrast, we seek to remain very disciplined in our approach, getting the rates we needed to support the risk we write, further supporting the strategic rationale of renewal rates transactions.

We continue to attain on average between 1% and 2% rate increases across our core commercial book with more success in the small commercial market. Our ability to get this rate reflects our emphasis on the smaller size accounts and industry segmentation as well as the benefit of our [part rate] strategy.

Fourth, we will continue to be thoughtful about our capital management. For the last four quarters we have refinanced our debt, more than doubled our dividend and bought back $271 million of shares. While we believe we still have excess capital, we stepped away from further repurchases this quarter. We will continue to examine our options as the market pressures begin to generate new business opportunities for us.

Our thoughtful and prudent approach to capital risk management was highlighted by S&P when it upgraded our rating outlook to positive during this quarter and another affirmation of our momentum. As a result of the recent credit market crisis, independent agents have become even more sensitive to the company's financial strength rating and our ability to buck the trend gives us yet another reason for them to partner with us.

The first six months of 2010 and especially the second quarter have been characterized by very substantial weather related challenges. It wasn't too long ago that losses of this magnitude would have been much more difficult for us to absorb; however, with the progress we have made in diversifying our book of business in related earnings, we have the financial and organizational strength to make [technical difficulty] and to continue to execute the long-term strategic priorities that will establish our success over time.

I continue to be very enthused about the progress we are making. Before I conclude my remarks, I would like to comment briefly on another sign of the progress we are making. Just last week Business Insurance magazine named our company as one of the best places to work in insurance. In making its selection, Business Insurance considered a number of factors with the heaviest weighting placed on employee feedback on their workplace experience and on the company environment.

One important takeaway for us is more confirmation that our people, our biggest competitive advantage, are motivated and engaged in our journey and our effort to be the best partner for winning independent agents.

While we need to continue to improve, we believe this provides further validation that we are building a very strong company, one that can be regarded as one of the best in our business over the long term.

I will now turn the call over to Marita and look forward to taking your questions later on the call.

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

Thanks, Fred. Good morning, everyone, and thanks for joining us today. This morning I'll review our operating results and provide some insight into the progress we've made in executing our strategy.

Putting catastrophes aside, I feel very good about our overall performance in the quarter. In personal lines we're pleased with the continued improvement in our core underwriting margins, along with the growth that we've achieved in our target markets.

In commercial lines we saw a continuation of our industry leading growth driven by our specialty business, strengthening of our partner agent relationships, and of course the success of our OneBeacon renewal rates transaction.

As Fred noted, catastrophe losses had a significant effect on our results in the quarter and have been headline news in recent weeks, so I'll comment briefly on these losses before I move on to discuss the progress we've made in our underlying performance.

The majority of the $85 million of catastrophe losses in the quarter were associated with hail and wind events in Oklahoma and Michigan as well as wind, hail and flooding in Tennessee, Ohio and Illinois. As you'd expect, more than two-thirds of these losses occurred in our personal lines segment, mostly in our homeowner's line, with the balance driven by commercial property losses.

As you've heard from many of our competitors, the catastrophe activity this quarter was one of the most severe in recent history. For us it was a record high second quarter for catastrophe weather. Our focus on changing both our geographic mix and our business mix help us mitigate the impact from random catastrophic events.

At the outset of our journey, our footprint was principally east of the Mississippi River with high concentrations of business in Michigan, Massachusetts, New York and New Jersey. Florida and Louisiana rounded out the list of our top six largest states. At that time, The Hanover was predominantly a personal lines company. Two-thirds of our business was in personal lines and over 70% of that was in the Big Four states.

As you can see on Slide 7, we have significantly changed our mix of business and now have a much more balanced distribution of products and geography. Commercial lines, including our specialty businesses, now represent 52% of our total written premiums, compared to only 34% in 2004.

2010 year-to-date we wrote approximately 150 million of more casualty-oriented specialty business which is almost three times more than in the same period of 2008. We have actively expanded our geographic footprint in commercial lines and now have 11% of our commercial premium in the west.

Only 34% of our business is now coming from our former top six personal line states, compared to 55% six years ago, as we continue to diversify our exposures and actively manage coastal risk.

As we continue to make strides in our diversification efforts, we expect better balance and stability in our earnings going forward. Looking beyond the short-term impact of weather, our core underwriting trends continue to improve. Our overall ex-CAT combined ratio was slightly under 94% for the quarter.

Last quarter we talked about the notable improvement in our personal lines core profitability and we're pleased to see that this trend continued in the second quarter.

As shown on Slide 8, personalized produced $55 million of pre-tax segment income on an ex-CAT basis in the second quarter, this compared to $48 million in the prior year quarter.

The improvement was driven by better underlying loss ratios in both our auto and homeowner's lines. We improved our ex-CAT personal lines accident year loss ratio by four points in the quarter which we attribute mostly to the price increases we put through in recent years.

Also contributing to the improvement are the partnerships we're fostering with our agents to drive the desired whole account business mix profile and our diligent underwriting actions. The remainder is attributable to more normal non-CAT weather in the current quarter than experienced last year and somewhat improved overall auto loss trends.

As we've noted in the past, there is a natural time lag for the benefit of rate increases to work their way through to the bottom line. We have reached the inflection point where our past rate increases are now having a positive effect on our bottom line results. Our diligent management of rates and personal lines reflects our consistent underwriting discipline and our willingness to walk away from underpriced and unprofitable business.

We are now at a point where our mix profile is better aligned with our strategy to be an industry leading account writer with partner agents. We have a good line of sight towards achieving our return targets in personal lines through our rate and non-rate underwriting actions.

Turning to Slide 9 to discuss our personalized growth for the quarter; second quarter net written premiums increased 1.4% compared to the prior year quarter. This improvement was driven by rate increases in both our auto and homeowner's lines with auto up 6% on average and homeowner's up 7% on average.

Retention also improved which we attribute to our enhanced business mix. We are building a book of multi-car total account business that tends to be less price sensitive and, as a result, we are able to balance the need for additional rate without reducing retention.

Our homeowner's net written premiums grew substantially this quarter, mostly reflecting rate increases and, to a lesser extent, growth in policies in force as we pursue our account rounding strategy. Given our positive rate actions and improving core profitability of this book, we're pleased with the trend.

Overall, personal lines policy accounts decreased by 1%, due mostly to lower personal lines auto [tiff] in our core states, specifically, Massachusetts and Michigan which we attribute our efforts to maximize margins in those states. We have seen a reduction in new business in these and several other states, principally as a result of our pricing discipline in combination with some aggressive pricing behaviors from a number of our competitors.

Overall, our net written premium production in core states decreased by approximately 1%. Our growth states net written premium increased 9% in line with our strategy of diversifying our northeast and Michigan exposures. We have confidence that our pricing discipline, the changes in our business mix and our partner agent strategy will continue to drive future profitability improvement.

Moving on to commercial lines on Slide 10; pre-tax segment income for the quarter was $17 million compared to $51 million in the second quarter of 2009. Catastrophe losses in the quarter lowered our pre-tax earnings by $26 million.

Second quarter results were also impacted by a lower level of favorable development as well as higher expenses. Our ex-CAT accident year loss ratio, which we believe is a better indicator of the quality of our commercial lines book, was 46.6%, consistent with the second quarter of 2009.

Most lines compared favorably to the prior year quarter with the exception of CMP where more typical loss trends this quarter compared to unusually light losses in the second quarter of last year. In general, we are pleased with the loss ratios we've been able to sustain in commercial lines, especially given the persistent soft-market environment. These results validate our thoughtful approach to growth in difficult economic and market conditions.

Further, given the ongoing economic pressure and the strain it places on many of our insurers, we are watching carefully for any leading indicators of change in loss trends. We have enhanced our loss monitoring and our loss control capabilities so that we can identify and react to emerging issues early and respond to negative trends quickly.

Turning to expenses, as expected, our expense ratio this quarter, when compared to the second quarter of 2009, was higher and reflects the impact of our expansion initiatives. However, the ratio is one point lower than it was last quarter as we continued to earn in the premiums associated with these investments.

This was in line with our expectations for the quarter and we expect this trend to continue in the future as we gain scale from our newer businesses. I'll now move on to review of the commercial lines growth on Slide 11.

In line with our specialization and diversification focus, our 46% growth in commercial lines reflects the impact of the renewal rights transaction as well as growth in our specialty and niche businesses.

Approximately 31 points of the commercial line's growth this quarter is attributable to our renewal rights arrangement. The value of the renewal rights arrangement from the very beginning was to build deeper partnerships with winning agents, increase our segmentation focus and accelerate our geographic expansion and we believe our focus in these three areas now drives the successful execution of this transaction.

First, our tight agency selection process; in order to ensure that we maintain franchise value for our best partners, we focus on the premium available from Hanover agents as well as agents that have the potential to be strong Hanover agents.

Therefore, as we've said before, we walked away from $100 million of OneBeacon renewals spread among approximately 1200 agents we chose not to appoint. That action was certainly noticed by our partners and clearly demonstrated our commitment to create franchise value by continuing to limit the number of Hanover appointments.

The limited new appointments, only approximately 200, gave us better geographic spread and accelerated our credibility in new geographies. The transaction also made us stronger with existing Hanover agents.

Second, strong segmentation of this business; our strategy to increase the percentage of the premium in segmented business is enhanced by the transaction as about 75% of the premium acquired so far comes from niches and segments.

Approximately half of that was in existing programs and the balance came from a dozen of well-established OneBeacon niches and segments such as cultural institutions and craft brewers, which now complement out Hanover offering.

Third, geographic diversification; we are particularly excited about the level of agency support we're getting in the west. Approximately 30% of our OneBeacon renewals in the second quarter come from our western states. This validates our western expansion investments and diversifies our portfolio. As a result, we are pleased with both the quantity and quality of the business we are writing as well as the strong level of agency support we're receiving.

As we renewed this business, we obtained rate increases similar to those we've been getting on our legacy commercial lines renewals. Initial loss indications from the book are in line with our expectations and over time, as the scale drives expense improvement, the combined ratio of this book should come down making this business more accretive to our overall P&C earnings.

Outside of the renewal rights transaction, growth in small and middle market accounts was 2% driven by modest increase in rates including exposure of 1.5%. Our growing industry segmentation and a wide range of niche products allows us to gain business based on the strength of our offering and added service capabilities as opposed to competing with other carriers solely on price.

Given the overall insurance market environment we're very satisfied with our improved business mix, pricing discipline and the rates we're obtaining. However, we don't see a lot of help coming from improving pricing in the second half of the year, particularly in middle market. Middle market pricing leveled off this quarter and is essentially flat.

We continue to make very good progress in our specialty lines with 14 points of commercial premium growth coming from these businesses in the second quarter. I'm satisfied with the quality and the pace of our specialty growth as it is associated with deep agency partnerships, install books of business and strong underwriting expertise.

First, most of the premium growth comes from mature books of business that resided with the same agent for a long period of time. AIX is a good example of this as most of this growth is associated with converting books of business with our best partners.

As a result, since we acquired AIX less than two years ago, its net written premium base has more than doubled while the underlying loss trends of this business have improved. Our Marine business is another example where we continue to grow prudently, converting books of business with our best partners.

Second, through the launch of our new product, including miscellaneous professional liability and employment practices liability, we are now able to sell new coverages to our established customers. By rounding out these accounts we expect to increase premium, improve retention, maintain pricing and strengthen our relationships.

Third, recent acquisitions of small niche underwriters with skilled professionals, like Verlan and PDI, and most recently Benchmark and Campania, become quickly accretive to our earnings and meaningful broaden our product offering to our existing franchise agents.

As we expand our product capabilities we become even more relevant to our agents, who, in turn, provide us with more and better quality business making our new product launches more successful and positioning us for continued profitable growth.

Overall, catastrophes aside, commercial lines produced results in the quarter in line with our expectations and in line with our long-term strategy. Going forward we expect to continue to improve the quality of our business mix while growing it at rates well above industry averages as we continue to capitalize on the tremendous business opportunities we have created over the last couple of years.

In my role, I have not only the opportunity but the responsibility to talk to agents every day. Simply put, our agents are excited about our strategy and acknowledge the strength of our value proposition. The greatest evidence of this support is both the size and quality of the pipeline of our opportunities. I've never felt better about our momentum and the profitable growth prospects that we have going forward.

With that, I'll turn the call over to Steve.

Steve Bensinger

Thanks, Marita, and good morning, everyone. Today I will be reviewing the company's financial results, referencing the Slide presentation starting with Slide 13. As Fred and Marita both noted, our solid underlying performance this quarter was overshadowed by a high level of catastrophes. On an ex-CAT accident year basis the combined ratio was 97.2% compared to 97.4% in the second quarter of 2009 and 98% in the first quarter of 2010.

Our pre-tax P&C segment earnings included $23 million or 3.3 points of favorable loss reserve development compared to $37 million or 5.8 points in the second quarter of 2009 in line with our expectations. We continue to experience lower favorable loss development than we've seen in the past.

Second quarter 2009 results also included approximately $8 million or one point of favorable LAE development related to a change in our reserving methodology. Turning to Slide 14 I'd like to briefly touch on our investment portfolio and yield.

As of June 30 we hold $5.3 billion in cash and invested assets. The composition of our portfolio remains largely unchanged from the first quarter of 2010. Cash and fixed maturities represent 98% of our total invested assets. Roughly 93% of our fixed income securities are investment grade. The average duration of the portfolio is 4.2 years.

In the second quarter net investment income was approximately $62 million compared to approximately $61 million in the prior year quarter. This increase is primarily due to the investment of cash into fixed maturities partially offset by the utilization of fixed maturities to fund certain corporate actions such as stocks and corporate debt repurchases and the January $100 million contribution to the company's pension plan.

The earned yield on our fixed income portfolio this quarter was relatively stable, 5.5%, compared to 5.4% in the prior year quarter. New money yields were about 5% in the second quarter of 2010 compared to 4.4% in the second quarter of 2009.

The lower new money yields in the second quarter of 2009 were driven primarily by relatively large investments in US treasury and other lower yielding, highly liquid securities as we waited for the market to regain liquidity and flow.

While we are pleased with the yields achieved through our investing activity this quarter, the current lower interest rate environment will put pressure on new money yields going forward. As we look to the remainder of the years, we expect our NII to remain relatively stable. Strong growth in our insurance operations should drive a moderate increase in invested assets.

Turning to Slide 18, our balance sheet remains very strong. Our GAAP equity increased $50 million or 2% during the quarter driven by the increase in net unrealized investment gains. On a per-share basis, book value increased to $52.61, an all-time high.

Our statutory surplus was $1.75 billion at the end of the second quarter and that 1.6 to one our premiums to surplus ratio remains more than acceptable for our current mix of business, which is heavily weighted toward shorter-tail lines.

We believe we have continuing capital flexibility at the operating company level based upon rating agencies' and regulators' risk-based capital models as well as our own economic capital assessment. We also have room to absorb growth from our western expansion initiatives, the OneBeacon renewal rights transaction and our other growth opportunities.

Holding company cash and investment securities were $350 million at June 30. We feel it's prudent to hold liquidity at the holding company for coverage of interest, dividends and potential operating contingencies. However, a portion of our holding company investments also represents excess capital.

After the two consecutive accelerated share repurchase transactions in December and March of approximately $100 million each, we did not repurchase additional stock in the second quarter. As of today we have about $61 million of capacity under the aggregate $400 million stock repurchase authorization.

We have historically scaled back our share repurchases pending the catastrophe season. We will continue to evaluate our capital management options and the pace of repurchases depending on overall market conditions, potential business expansion opportunities and weather in the second half of the year.

Moving on to a discussion of our financial strength ratings on Slide 19 recognizing our prudent approach to capital management as well as our strong operating results; S&P upgraded our ratings outlook to positive despite the fact that it continues to hold a negative outlook on the P&C industry in general.

This recent rating action continues the positive momentum established with the three rating agency upgrades we received in the midst of the financial crisis. We are proud that we were the only insurance company in the United States that was upgraded over the two-year period by S&P, Moody's and AM Best.

Our recent ability to buck the trend is further confirmation of the successful execution of our operating strategy. Of note, an important driver of the positive outlook was S&P's favorable assessment of our enterprise risk management program. S&P recognized our robust risk assessment process which encompasses all areas of our operations from catastrophe exposure management to capital and investment strategy.

To wrap up our remarks on risk management, I'd like to give you a quick update on our July 1 reinsurance treaty renewals. That's on Slide 20. In consideration of our continuing growth in commercial lines and the availability of reinsurance marketplace capacity, we felt it was prudent to further increase our Northeast catastrophe reinsurance coverage. As shown, we bought an additional $100 million in Northeast capacity, increasing our total catastrophe coverage to $1 billion in limit, inclusive of our net retention.

Taking advantage of favorable market pricing, we also concluded to fully place our expiring $200 million excess of $700 million layer. The increase in our catastrophe reinsurance coverage together with various underwriting actions we have taken over the past few years provides added confidence in our ability to protect our earnings and preserve capital as we enter this hurricane season which has been predicted by many experts to be quite active.

We also quite successfully renewed our sureties and property per risk treaties with the same structure as aspiring treaties.

Finally, a couple of thoughts on our full-year outlook; because pre-tax catastrophe loss is in the second quarter we're about $60 million higher than our previous assumptions. We're lowering both the upper and lower ranges of our guidance by a corresponding $0.85 per share. We're also reducing the upper end of the range by an additional $0.10 per share principally reflecting our updated view of the overall pricing environment in commercial lines.
Thus, our new guidance range for after-tax operating earnings is $2.85 to $3.10 per share. With that, let me turn the call back to the operator for Q&A.

Question and Answer

Operator

(Operator Instructions) Your first question comes from the line of Cliff Gallant - KBW.

Cliff Gallant
KBW

A couple of questions, one, it looked like there was a small reserve addition in the other commercial lines. I believe it might have been related to Surety. I was wondering if we get more color on that.

The second one was in terms of worker's comp. There was a California company that had some problems this quarter and they cited adverse loss trends. I was wondering if you're seeing anything in that area.

Frederick Henry Eppinger
Former President & CEO

First on the Surety, Cliff, it was -- we decided to put some more up on the Surety reserve. That is what happened in that other category. I feel very good about our Surety business. We've done very well over the last three or four years. Obviously, the economy continues to be somewhat of a concern and I think it was the appropriate thing to do given the outlook.

But I'm pretty positive about our overall book. We don't have a lot of big contractors or anything like that. It's a small amount but we thought it was prudent to do.

On the comp side, obviously we have very little comp in California and I'll let Marita comment. Obviously we're being very conservative about our comp. Probably the significant companies in the industry, we probably have less comp than anybody, I guess 5% of our overall book. But we do believe that comp can be attractive at the small end as we round out our small account business.

But in California, in particular, we're being quite conservative about where we use capacity and, to date obviously, it's a very small amount. But, Marita, I don't know if you want to give color.

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

Yes, I mean, as Fred said, with comp being less than 5% of our overall premium and certainly less than 10% of our commercial lines premium, we're not overconcentrated in the comp line. Previously we didn't have little or no worker's comp premium in California. With the OneBeacon renewal rights transaction we will write some worker's comp in California.

What's interesting about that, it will not be material. It will be very small. It's associated with total accounts in the commercial line space, almost 100% small commercial where, as of lately, we have grown a little bit in the low-risk, low-size worker's comp arena where the rates are there and the exposures are light.

We understand the worker's comp environment in California. Many of us have dealt with it in past lives. So we understand the risks associated with that marketplace and have no plans to expand beyond what writing is associated with our smaller accounts there.

Operator

Your next question comes from the line of Sam Hoffman - Lincoln Square Capital.

Sam Hoffman
Lincoln Square Capital

I just had two questions. Can you give some color on the programs, AIX including the lines of business, why season profitable business was set free by competitors and why they chose Hanover?

Frederick Henry Eppinger
Former President & CEO

Again, our program business, as we had said from the beginning when we made the acquisition, most of our core partner agents have mature programs in their book that they have controlled a long time.

What you typically get in our business often, though, is people that mostly deal with wholesalers or aggregators and the servicing of that business is quite weak.

So when we bought AIX we put a lot of money in the servicing and the claims handling as well as the underwriting (inaudible) and we went to our partner agents and have been working that channel pretty hard.

So if you look at the ski program we got from Wells -- I think Wells had it for 25 plus years and moved it to us. We've had Barney & Barney. We've moved some of their better programs to us. We've had a number of good programs with people like Leavitt and some of our other partners.

So in my view, from the beginning it's been a target strategy of the company. We knew our partners had it. Often time they'd have it with -- it's the only thing they have with the other company. So it's kind of an aside. A lot of these companies are ratings challenged, if you will, because they tend to be smallish companies that are in small specialty companies or they are kind of on their own, independent institutions.

So, to me, the quality -- what we bring is obviously a more significant balance sheet, better servicing, the whole franchise partnership and over time we will get a number of those programs to ship because of that. So I’m very encouraged by -- it's happening exactly the way we wanted it.

That's what lines of business do. Historically, people have done lots of comp and lots of what they call heterogeneous programs, which is fake programs. We have none of that. So when we have -- we took these programs.

These are account-oriented, industry-oriented programs, mostly casualty business for the most part and very, very nice margin business that the profit in most of these are shared with the agents. So it's controlled business that they also have a big piece of it themselves, so it's very well controlled as far as profitability.

Now, we're not aggressively growing that business. We're not trying to get it to any significant size. We're trying to do it as those programs become available to us from our partners. But I couldn't be happier with it. It's done exactly what we wanted it to do.

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

Yes, one of the beauties of AIX was they were such a disciplined, strong underwriter in the way they approached programs and we saw that in our due diligence, but they were somewhat growth constrained. We borught them access to the same types of programs that they always wrote in a disciplined way but now to a broader range of distributors because of the Hanover partners that we brought to the table.

Sam Hoffman
Lincoln Square Capital

My other question is on the expense ratio. Based on the trends in the quarter, I think it's now evident that the expense ratio can easily get to 34% just by running in the premiums from OneBeacon over the next year or so.

But at least the way we estimate it, this only gets the company to kind of a 10% to 11% ROE range once it turns in, assuming the cat assumptions that you make in various other kind of basic assumptions, which is still well below the 12% objective that you've laid out.

So the question is, we think you really need to get back to the 33% expense ratio that you had in '07 and '08 in order to reach your objectives. So the question is, is that possible? It looks like you're benefiting from having $3 billion or so premiums versus $2.5 billion before.

But on the other side of it, you have more commercial business, which has a higher expense ratio. Then if you reach your objectives you probably have higher comp. So you really almost need to keep your G&A expenses flat in order to get to that objective. So the question is, is that possible or desirable?

Frederick Henry Eppinger
Former President & CEO

Yes, and I don't really actually think about it completely like that. Obviously it's about combined ratio not expense ratio and it has everything to do with the mix of business and the margin within the business.

But to your point, why we're so different and why it's easy for us to talk about -- hard to do but easy to talk about -- how by the end of '11 we're have a run rate in the 11% to 13% range is because if you look at where we are you can see all the leverage pretty clearly.

One, our mix of business is getting better every day. So what we have is much higher margin business that we're bringing on than what we had originally in small commercial and unsegmented middle market, whether it's Fidelity or Surety or -- if you look at the stuff we do on the segmented business or the AIX business, all of that stuff brings with it better margin.

Two, expenses and it's not just OneBeacon. We bought five companies in the last six quarters and brought in 550 people that came with them, as well as this ICW renewal rights deal. So we have not just an earned issue. We had a lot of startup costs that had to do with the filings and some were temporary, which we've used our outsourcing partners to help us with.

But we had a lot of upfront costs in all those transactions to file. We entered eight states. We did 1200 plus filings in the last 12 months. So what you see is there is obviously a lot of upfront costs in many of these businesses and of many we're subscale, if you will, because we took an expense risk like we did in EPL and HPL, etcetera.

So what we see is in each of those you're going to see -- both in the earned end you'll see an improvement but you'll also see less absolute expense. So we won't have the startup costs you're going to have.

So we look at the second lever as this expense leverage and, again, I don't know exactly what that percentage -- it has everything to do with what's the mix of business that comes in because obviously some of these businesses, like our specialty property business, which has a combined ratio below 80, has a very high expense ratio.

So depending on how that mix actually shakes out, I don't know exactly whether it'll win but it clearly is going to improve significantly.

The third lever is we do have $250 million to $300 million of excess capital obviously that you return nowhere close to the 11% to 13%. Whether we see more renewal rights opportunities or business transactions or growth opportunities or we give it back like we've given it back in the last four quarters, you can imagine that has a lot of leverage on our ROE. You can see the math. You can see how it does.

Then finally, 50% of our business is Personal Lines and we're getting 6% plus rate. So if you just do the math on that -- and, again, well, we don't like bad weather. Bad weather helps us. I mean, the most underpriced part of the country has been in the Midwest over the last decade. You've got to believe the ability to continue to get rate in the Midwest on all lines of business is going to be enhanced by what just happened because the regional companies are in deep trouble.

They are under a lot of pressure. They've had a real pressure from the weather and from the financial crisis. So you're seeing -- what we're seeing for the first time in places like Indiana and Ohio, the regional companies we compete against, Michigan too, are being more aggressive on rate which allows our rates to come with better retention because we've always been taking a rate but we had a retention threat.

Now I think that's left. So on all those levers -- better mix; expense leverage that's going to increase dramatically; the pricing we're getting on both businesses; and the fact that we now have capital leverage as well -- gives me confidence that you're going to see continued improvement in our margins.

Again, do we wish that the middle market pricing was a little better? Sure. But if you look at our mix improvement and the fact that most of our new business is renewals business, the renewal rights deals, we have a lot of transparency to get more than inflation. So what we see is regardless of the market, our ability to move in that direction over this -- between now and the end of '11 is there.

Do I hope that middle market pricing gets a little bit more rational? Sure. I think that would help everybody. But we don’t need it to get to where we need to get because of our mix and size and the type of business we're running.

Sam Hoffman
Lincoln Square Capital

Did you say 6% increase in homeowner's pricing or is it -- ?

Frederick Henry Eppinger
Former President & CEO

It's everything

Sam Hoffman
Lincoln Square Capital

Oh, everything.

Steve Bensinger

Homeowner's is better than that.

<TAG>Fred Eppinger

So, again, you'll hear people talk rating cases. They say where we file we have an average ex. When we talk about it, that's our average increase on our entire book is 6% plus. So that's strong. I mean, I don't know if there's anybody else that's out there that's doing that. It has everything to do with our ability to do account-based business and keep our attention with partner agents.

The other thing -- most of our Personal Lines growth comes from book sense and book rolls. So it is very, very powerful.

Operator

Your next question comes from the line of Vincent DeAugustino - Stifel Nicolaus.

Vincent DeAugustino
Stifel Nicolaus

Just two questions for Fred; the first one, I’m just curious if you're seeing any increase in the number of weak carriers on the brink out there? I know you said before that you'd like to have a good measure of dry powder in terms of capital on hand to kind of capitalize on those weaknesses.

I was wondering if more specifically, does that mean that you'd like to have capital on hand to compete in the market for those premiums as they get shed via rate increases of those carriers or is it something similar to doing renewal rate deals with those companies that are in a little bit of trouble?

Frederick Henry Eppinger
Former President & CEO

I think -- I know, it's a great question. I think both things are true. If you go back -- we've been talking about this for two years. What we try to say is that if you look at the last four years in our business, share shift in the last couple of years of a soft market and the first year of the turn -- because what people do is they hit the wall as far as capital.

They stretch, they stretch, some maybe they even play with their reserves a little bit but then they run out of gas and then during the real -- when the market turns they have to really shrink and re-underwrite their books because of their capital constraint.

What you're seeing -- and, again, this market is unique because the soft market got almost a power boost from the AIG struggles because what you had was a lot of people that went to Bermuda and to new companies that are getting into new businesses. So it was almost like we extended the soft market, particularly at the high end and in the broker world where everybody tried to build these businesses.

So what you've got is a little bit of a blood bath at the top. So a lot of these small specialty companies, and even the little regional guys, that tried to grow in a lot of these specialty businesses by going to the brokers or going to the high end are getting killed. I mean, the pricing there cannot be attractive. If you listen to the calls in some of these smaller companies you can feel the stress.

Now, what we see is a lot more talk among a number of companies that are smallish and it's for a number of reasons. I think what we see is because of tax changes -- so if you're a private company or a family-owned company and you look at capital gains and actually think it's going to be greater -- you look at the economy. It’s not going to be great for the next couple of years. Pricing is tough. You see your margins on casualty being really, really threatened. You start thinking about alternatives.

I will tell you that the number of people talking has gone way up. Even for some smallish public companies I see the same thing, lots of actions and -- not purposeful kind of deciding things but thinking about things, reaching out, having conversations. What that tells me is people are thinking about either shrinking their position and saving some capital and getting out of some non-core lines or trying to figure out what their strategic alternatives are.

Again, I don't think it's going to just happen in a wholesale way but what we see is just -- I think the opportunity both in renewal rights and pieces and in acquisitions you're going to see -- somebody asked about worker's comp. You've seen a couple of worker's comp transactions occur and that's because those are businesses that are under a little bit of stress. So I think you're going to continue to see that.

For us, I don't know what's going to unfold. What I do know is that what we're seeing is agents are starting to think about quality of the underlying companies a lot more. They're starting to think about who could have a problem and they look at the ratings of the businesses a little bit more. So I think there's going to be both organic opportunity and inorganic opportunity and that's why, by the way, we're being a little cautious about holding our capital right now as we look over the next 12 months.

By the way, this is -- I'm not saying anything you haven't heard from some of the other very big, strong companies that are basically holding capital. But I think we all kind of see that this could occur.

Now, again, some people believe you need an outside event. I'm not one of those people. I think at some point people get so stressed they have to pull back and I think you're going to start to see that in the next 12 months for sure.

So we're excited -- I mean, again, would I love pricing? Sure. But this kind of disruption is just what we expected. We tried to position ourselves for it. We tried to be very conservative, the way we do rates and pricing so that our capital is available. There's nothing that tells me that this isn't going to happen over the next three, four quarters.

Vincent DeAugustino
Stifel Nicolaus

Then in terms of communicating the 11% to 13% ROE goal in the long run -- so, I mean, one of the ways that -- I think I've heard you say numerous times of getting there is the net room premium growth with still respectful underwriting margins. I'm just curious, with getting to that ROE goal, what your thoughts are in terms of net written premium to a statutory surplus ratio.

Frederick Henry Eppinger
Former President & CEO

Again, the science of that is quite detailed because it has everything to do with the mix of business and concentration because a lot of the [BACA] ratios is about your geographic concentration. So when I talk about diversification, my marginal cost of capital in New England property is higher than my incremental cost of capital in some of these other businesses.

So that translates into that ratio. So if you look at it from very simply -- we said we think that 1/6 is really strong but it's a very superficial way to look at it. You've got to look at the lines of business and that's why we do a lot of work on this and we talk about our marginal cost of capital by geography, by line of business, so that we don't fool ourselves into what the real cost of capital of this stuff is.

Again, what I get excited about is that every time we have better business with better margins that diversify us away from a Personal Lines only company in four states, your cost of capital keeps going down.

So you're going to see us -- that ratio will probably be similar but you've got to remember Personal Lines companies typically hold less capital than Commercial Lines companies. What makes us a little less complicated is because of our concentration, which created a need for additional capital and the fact that we weren't very good. So our margins were lower.

As our margins get better and our performance gets better, both those things help our capital leverage in a significant way. So not only are we -- that's another lever that we're getting. Our cost of capital is getting better every day as we get better. So the ratio will stay the same but the complexity of our business -- if you just landed from Mars and you said what should happen, you should say, well, they must have to carry a different ratio because they're more commercial.

Because of the diversification, because of the quality of the business it probably won't change that much at all. It might even improve some. So, again, I'm quite excited about it. By the way, we carry capital that are really a couple notches higher -- if you look at the criteria of the rating agencies, we're not carrying A-level capital. For the most part we're carrying two notches above that capital.

So when I talk about excess I'm not trying to strip it down because I believe we're going to continue to get upgrades over time. It's part of our main objective, to be one of the most financially strong companies in the industry. So there's excess even on top of that is the way we think about it. I hope that's helpful.

Operator

This concludes our question-and-answer session today. I would like to turn the conference back over to Oksana Lukasheva for any closing remarks.

Oksana Lukasheva
Vice President, Investor Relations
Thanks to all of you for your participation today and we look forward to speaking to you next quarter.