S&P Global
Market Intelligence

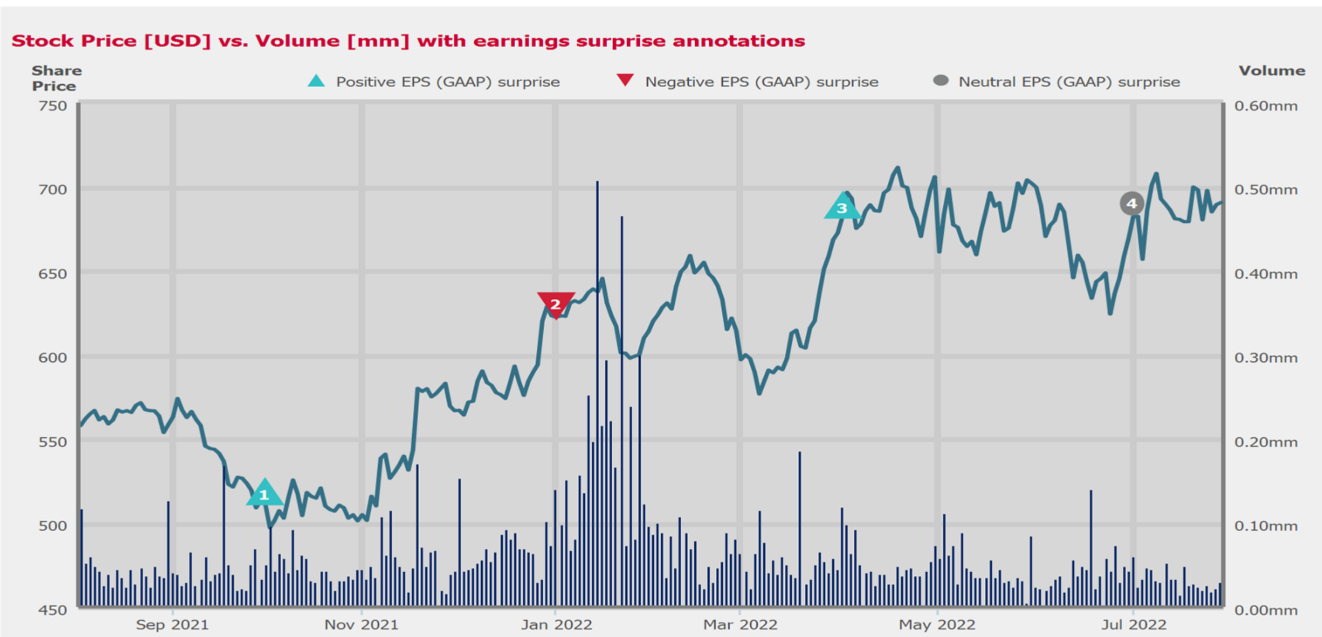
Fairfax Financial Holdings Limited TSX:FFH
FQ2 2022 Earnings Call Transcripts

Friday, July 29, 2022 12:30 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2022-			-FQ3 2022-	-FY 2022-	-FY 2023-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS (GAAP)	(16.01)	(37.59)	NM	38.88	48.95	NA
Revenue (mm)	6166.33	5502.30	(10.77 %)	6976.80	25721.75	NA

Currency: USD
Consensus as of Jul-29-2022 3:47 PM GMT



- EPS (GAAP) -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2021	9.60	16.44	71.25 %
FQ4 2021	34.19	33.64	(1.61 %)
FQ1 2022	1.16	4.49	287.07 %
FQ2 2022	(16.01)	(37.59)	NM

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Call Participants

EXECUTIVES

Derek Bulas
Associate Vice President of Legal

Jennifer J. S. Allen
VP & CFO

Peter S. Clarke
President & COO

V. Prem Watsa
Founder, Chairman & CEO

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BMO Capital Markets Equity Research

ATTENDEES

Unknown Attendee

Presentation

Operator

Good morning, and welcome to Fairfax's Second Quarter Results Conference Call. [Operator Instructions] Today's conference is being recorded. If you have any objections, you may disconnect at this time.

Your host for today's call is Prem Watsa, with opening remarks from Mr. Derek Bulas. Mr. Bulas, please begin.

Derek Bulas
Associate Vice President of Legal

Good morning, and welcome to our call to discuss Fairfax's 2022 Second Quarter Results. This call may include forward-looking statements. Actual results may differ perhaps materially from those contained in such forward-looking statements as a result of a variety of uncertainties and risk factors, the most foreseeable of which are set out under risk factors in our base-shelf prospectus, which has been filed with Canadian securities regulators and is available on SEDAR. Fairfax disclaims any intention or obligation to update or revise any forward-looking statements, except as required by applicable securities laws. I'll now turn the call over to our Chairman and CEO, Prem Watsa.

V. Prem Watsa
Founder, Chairman & CEO

Thank you, Derek. Good morning, ladies and gentlemen. Welcome to Fairfax's 2022 Second Quarter Conference Call. I plan to give you a couple of highlights. -- pass the call on to Peter Clarke, our President and Chief Operating Officer, to comment on the quarter; and Jen Allen, our Chief Financial Officer, to provide some additional financial details. Our company continued its excellent underwriting performance in the second quarter of 2022 with a combined ratio of 94.1% by growing gross written premiums by over 20%. Market conditions continue to be good, and our companies are taking advantage of that. Congratulations to all our presidents who have continued to grow profitably in a strong rating environment. As you know, we have a very decentralized approach and it works.

Our book value per share decreased by 5% adjusted for our dividend in the first 6 months as a result of unrealized losses on our investment portfolio of $1.5 billion in the second quarter. $874 million was from mark-to-market movements in our common stocks. Principally, Stelco, BlackBerry, Kennedy Wilson, reflecting the 16% drop in the S&P 500 in the quarter and $413 million of mark-to-market losses in the quarter on our bond portfolio due to continued rising interest rates. Our book value drop of 5% in the first 6 months of 2022 is among the lowest among our competitors. This does not include mark-to-market losses from associates and consolidated investments. Peter will discuss this further.

As in the past, we expect these mark-to-market unrealized losses to reverse over time and our long-term value investing approach to realize significant realized gains as time goes by. We benefited greatly by having such a low duration, 1.2 years on our fixed income portfolio. Our low duration on our $36 billion fixed income portfolio reduced the impact of rising interest rates on our bonds to a decrease of only 1.1% on the fixed income portfolio, significantly less than many of our peer companies. Notwithstanding our low duration, we had $965 million of unrealized bond losses that went through our income statement in the first 6 months of the year. We expect this will reverse over the next 12 to 18 months.

In the meantime, we've been able to invest at higher rates, increasing our current normalized annual run rate for interest and dividend income to $950 million, up from an approximate run rate of $530 million at December 31, 2021. Operating income in the quarter and the first half rose to a record amounts of $645 million in the quarter and $1.2 billion [and a half]. I should note that not recorded in our second quarter results is the previously announced sale of our pet insurance business to [JB] , the sale of Resolute, which happened just after the June 30, quarter end and the additional gain on digit insurance that will be taken upon regulatory approval for consolidation.

Upon closing of these transactions, we expect approximate pretax gains of $1.9 billion. We expect all 3 to close in the next 6 months. I must add, we continue to do all we can for our Ukrainian employees. Our whole company is behind all 3 outstanding Ukrainian presidents of our companies as they look after our employees under extremely difficult conditions. Our prayers are very much with our Ukrainian employees. I will now pass the call to Peter Clarke, our President and Chief Operating Officer for further updates. Peter?

Peter S. Clarke

President & COO

Thank you, Prem. We had a net loss of $881 million in the second quarter of 2022. As Prem highlighted, negatively affected by investment losses of $1.5 billion, partially offset by strong underwriting profit of $302 million, share of profit of associates of $257 million and interest and dividend income of $203 million. Excluding all unrealized mark-to-market fluctuations, our underlying numbers were very strong with $814 million of pretax income, including $269 million of net realized gains. Our combined ratio in the second quarter was excellent at 94.1%.

Gross premiums were up 22% in the quarter as we continue to see favorable market conditions in many of our major lines of business. A little more on that later. The operating income of our property and casualty insurance and reinsurance operations increased to $645 million in the second quarter of 2022, up from $398 million in the second quarter of 2021, driven by increased underwriting profit, higher interest and dividend income and an increase in our share of profit of associates. Our investment return in the second quarter was negative 2.1%, which resulted in a total investment loss of $1.1 billion, with net losses on investments of $1.5 billion, mostly unrealized driving the results.

Our net loss on our bond portfolio was $413 million in the second quarter and was generally the result of increasing interest rates. As Prem had mentioned, with the duration of 1.2 years on our fixed income portfolio, many of these unrealized losses will reverse over the next year. We continue to hold significant cash and short-term investments and short-dated U.S. treasuries and Canadian government bonds to protect against increasing interest rates. Our net losses on equity and equity-related holdings were $874 million in the quarter, driven by the significant overall drop in equity markets.

Unrealized losses on Stelco, BlackBerry, Kennedy Wilson and Commercial International Bank were the main contributors to the loss. As we have mentioned in previous quarters, our book value per share of $588 million does not include unrealized gains or losses in our equity accounted investments and our consolidated investments, which are not mark-to-market. With the volatility in the financial markets this quarter, the carrying value of these securities is in excess of fair value by $803 million, an unrealized loss position or $34 per share on a pretax basis.

At June 30, the company's insurance and reinsurance companies held portfolio investments of $49 billion, excluding Fairfax India's portfolio of $2 billion, of which approximately $22 billion was in cash and short-dated investments, representing approximately 45% of those portfolio investments. During the first 6 months of 2022, the company used net proceeds for maturities of short-term investments to purchase $10.3 billion of U.S. treasuries and Canadian government bonds, 1 to 2 years in term, benefiting our interest and dividend income in the second quarter.

We continue to have approximately $1.1 billion at the holding company, predominantly in cash and short-term securities and our $2 billion bank loan is totally undrawn. Please note, our cash in the holding company is to meet any and every contingency that Fairfax might face. We are not making any long-term investments with this cash other than to support our insurance and reinsurance operations.

As previously mentioned, our insurance and reinsurance business continues to grow rapidly all over the world. We wrote $7.3 billion of gross premium in the second quarter of 2022. The second quarter combined ratio was strong at 94.1% and produced a solid underwriting profit of $302 million, with all our major operating companies generated combined ratios below 95%. In aggregate, the quarter included catastrophe losses of $165 million or 3.2 combined ratio points with no material individual [cat] events in aggregate.

Although Fairfax Brazil and Bright Insurance were affected locally from catastrophe losses. More on that later. And our combined ratio benefited marginally from favorable reserve development on prior years. Our gross premiums in the second quarter were up 22%, an increase of approximately $1.3 billion from the previous year. This growth is driven by the continued favorable market conditions and strong margins that prevail in many of [the fair] markets, particularly in North America.

Bright had the largest growth in the quarter, adding $315 million of gross premium and growing 40% in the second quarter of 2022 versus the second quarter of 2021. Approximately 40% of this amount was from P, for its innovative follow-on syndicate. He only started writing business in 2021 so the comparable quarter was naturally low. Excluding Key, Brit posted strong growth at 25% with growth across both its direct and reinsurance books of business.

Odyssey's gross premiums were up 28% or almost $380 million in the second quarter, with half coming from their North American Reinsurance segment, while its insurance segment had low double-digit expansion. Crum & Forster increased its gross written premium by 21%, led by its A&H division and the rebound of its travel and student health business.

Crum also continued to see strong growth in its E&S segment, it's cyber and tech E&O books of business and at Seneca Insurance. Allied World, Northbridge and Zenith all grew as well, increasing their premium by 13%, 12% and 10%, respectively. The premium of our international operations continues to increase. Although they are not seeing the rate increases experienced from the hard market conditions in North America, gross premiums were up $100 million in the second quarter of 2022 over the previous year.

Fairfax Asia premiums were up 86% at Singapore Re, which was only consolidated into our results in the second half of 2021 with [non-incomparable] number. Fairfax Asia was relatively flat excluding Singapore Re. Most of our companies in South America, Central and Eastern Europe registered strong growth in local currencies, although were somewhat muted in U.S. dollar terms by the strengthening of the U.S. dollar against most currencies in the second quarter. Over time, we believe our international operations will be a significant source of growth driven by underpenetrated insurance markets and strong local economies.

Our companies continue to grow into favorable market conditions, while absolute rate increases may reduce in some lines, overall rate level is expected to remain attractive throughout 2022. Our company had a great start to the year, and our management teams are focused on building that in the second half of the year. As previously mentioned, we posted a strong underwriting result in the second quarter with a combined ratio of 94.1%, producing underwriting profit of $302 million versus a combined ratio of 94.3% and underwriting profit of $228 million in the second quarter of 2021.

Northbridge had another outstanding quarter, posting an 87% combined ratio, benefiting from the compounding of year-over-year price increases and increased new business. Allied World produced the most underwriting profit in the group at $82 million with a solid combined ratio of 92.2%. Brit put up another sub 95 combined ratio and Crum & Forster continued its steady improvement with a combined ratio of 94.4%, while Odyssey Group and Zenith also produced strong underwriting results.

Our international operations had an elevated combined ratio in the quarter of 101.3%. The underwriting loss in the quarter was driven by crop losses at Fairfax Brazil. Brazil experienced a 1 in 100-year drought. While in South Africa, Brit was affected by severe flooding. Cat losses of $46 million in the quarter added 10 combined ratio points to our international operations combined ratio. Fairfax Asia, our Central and Eastern European and South American operations other than Brazil, all had great underwriting results. We have yet to see any significant impact on our operations from the conflict in Ukraine.

Our companies in Ukraine continue to operate while working remotely in a very difficult environment, business volume is down, but they continue to produce an underwriting profit. Our other insurance and reinsurance operations are not significantly exposed to the lines directly affected by the conflict, namely aviation, political violence, trade credit and marine. Our companies have up IBNR of approximately $70 million to cover potential losses. We are very hopeful this conflict will end soon, but it is still ongoing, so we continue to monitor the situation closely.

For the quarter, our insurance and reinsurance companies recorded favorable reserve development of $48 million or 0.9 points on our combined ratio. This is similar to the second quarter of 2021 of $32 million or 0.8 points. The overall favorable development was offset by unfavorable development at Allied World of $30 million that primarily related to development on 2021 catastrophy that occurred late in the fourth quarter. Prior year reserves are generally not significantly adjusted in the first half of the year given the thorough actuarial reviews conducted in the fourth quarter.

Our expense ratio continues to benefit with our earned premium volume outpacing expenses. Our overall underwriting expense ratio is 1.5 points lower year-over-year, with the underwriting expense ratio decreasing at essentially all our insurance and reinsurance operations. Our underwriting results were very strong in the first half, and we expect that to continue in the second half of the year with our companies very well positioned to capitalize on the opportunities within the market.

Finally, we are very happy to report that in the second quarter, Standard & Poor's upgraded Fairfax's issuer credit rating from Triple B minor to Triple B and the subsidiary financial strength ratings from E minor to A, reflecting Fairfax's very strong competitive position and the overall strength of our insurance and reinsurance operations. I will now pass the call to Jen Allen, our Chief Financial Officer, to comment on our investment results, our noninsurance company's performance and overall financial position.

Jennifer J. S. Allen
VP & CFO

Thank you, Peter. Fairfax reported a net loss attributed to shareholders of Fairfax of $881 million and $756 million in the second quarter and first 6 months of 2022. That compared to net earnings of just over $1.2 billion and $2 billion in the second quarter and first 6 months of 2021. The book value per basic share at June 30, 2022, was $588.36, which compared to $630.6 at December 31, 2021. Which represents a decrease in our book value per share of 5% adjusted for the $10 dividend that we paid in the first quarter of 2022.

Peter has already provided detailed commentary on our insurance and reinsurance companies, so I'll begin my remarks on the results of our noninsurance consolidated companies. Looking to the second quarter of 2022 compared to the second quarter of 2021, excluding the impact of Fairfax India's performance [fees] to Fairfax, which was a reversal of $47 million of a performance [fee] payable to Fairfax in the second quarter of 2022 and an accrual of $43 million of performance fee expenses in the second quarter of 2021 as well as excluding the impact of a noncash goodwill impairment charge recorded in the second quarter in 2022 of $109 million relating to the company's investment in Farmers Edge.

The noninsurance companies produced operating income improvement of $71 million to $70 million in the second quarter of 2022, which compared to an operating loss of $1 million in the second quarter of 2021. The significant improvement of $71 million principally reflected higher operating income at Fairfax India of $34 million, primarily as a result of the higher share of profit of associates from its investments in Sanmar and CSD Bank, increased operating income from the restaurant and retail segment of $30 million, which principally reflected stronger business volumes across most companies in that segment, primarily related to the reduced COVID-19 related lockdown restrictions in 2022.

The improvement was despite the second quarter of 2021, benefiting from government subsidies that had not been received in the second quarter of 2022, and improved operating income at Thomas Cook India of $19 million, reflecting higher business volumes resulting from continued easing of COVID-19 related travel restrictions and increased domestic and international travel. That was partially offset by higher operating losses in the other segment. The other segment did reflect higher business volumes, [through] AGT and Dextera, which were primarily driven at Dextera by local acquisitions in the first quarter of 2022.

Looking at the first 6 months of 2022 compared to the first 6 months of 2021, again, excluding the impact of Fairfax India's performance fee, which in the period was a reversal of $50 million of a performance fee payable in 2022 and an accrual of $99 million performance fee expense in 2021 and excluding the impact of the noncash goodwill impairment charge noted previously related to the company's investments in Farmers Edge, the noninsurance companies produced operating income of increase of $124 million to $94 million in the first 6 months of 2022 compared to an operating loss of $30 million in the 6 months of 2021.

That improvement of $124 million reflected the same factors as previously discussed, for the second quarter of 2022, with the improvement in the operating income attributable to about $60 million from our restaurant and retail segment, $54 million from Fairfax India, $27 million from Thomas Cook, and that was partially offset by higher operating losses in the other reporting segment of $17 million. At June 30, 2022, we reported a pretax deficiency of the fair value over the adjusted carrying value of our noninsurance associates and certain consolidated noninsurance subsidiaries that the company considers to be portfolio investments of $803 million.

That compared to an excess at December 31, of $346 million, with the decrease reflecting the global financial market volatility experienced during the first 6 months of 2022. That pretax efficiency of $803 million is not reflected in the book value per share but is regularly reviewed by management. Our noninsurance associates accounted for the majority of that depreciation, and it was principally attributed to Atlas Corp. of $460 million, Eurobank of $197 million, [press] of $143 million and [resale] of $157 million. Please note that Resolute share price at June 30, 2022 of approximately $13 compared to the announced deal price of $2.50 that was announced on July 5, 2022. And it also excludes any of [tribe] value to any contingent value rates.

Looking at our investment performance in the quarter and the 6 months ended with our continued concerns around inflation at June 30, 2022, we continue to hold a significant portion of the investment portfolio in cash, short-term investments and other short-dated fixed income securities. During the first 6 months of 2022, the company used cash and proceeds from maturities of our short-term investments to make purchases of $10.3 billion in bonds, which was comprised of $9.1 billion in U.S. treasuries and $1.2 billion in Canadian government bonds with 1- to 2-year terms.

In addition, we also purchased short-dated, high-quality corporate bonds and first mortgage loans of approximately $1.2 billion and $385 million, respectively. At June 30, 2022, the company's low duration of only 1.2 years on the $36.3

billion invested in cash, short-term investments and short-dated U.S. treasuries and Canadian government bonds will limit the impact of the rising rates on the company's bond portfolio, while enabling the company to benefit significantly from increased interest income in the remainder of 2022 and future periods as the portfolio is deployed into 1- to 2-year treasury bond.

Our interest and dividend income reported increased to $203 million and $372 million in the second quarter and first 6 months of 2022, respectively. From $161 million and $329 million in the second quarter and first 6 months of 2021, with higher interest income earned, principally from the net purchases of our U.S. treasury bonds, the Canadian government bonds, first mortgages and other government bonds during 2021 and the first half of 2022. We also had increased dividend income earned on our common stock and preferred stock portfolio, which was partially offset by lower dividend income earned from our long equity total return swap and interest income earned from our U.S. corporate bonds.

As I noted, we had added $10.3 billion in U.S. treasuries and Canadian government bonds with low durations of 1- to 2-year terms, which will provide us with increased interest income for the remainder of 2022 and the future period. Turning to the consolidated share of profit of associates. We reported $257 million in the second quarter of 2022, which reflected strong results from the investments in associates and was principally comprised of share profit of $119 million from Eurobank, $72 million from Atlas Corp., $67 million from Resolute, which compared to share profit of associates of $75 million in the second quarter of 2021, which primarily comprised of share of profit of $27 million from Eurolife, which Eurolife has now consolidated in the results effective July 14, 2021, so no longer in our share of associate number and $23 million from Eurobank and $18 million from Atlas Corp.

Similarly, for the first 6 months of 2022, share profit of associates of $441 million continued to reflect the strong results with share profits of $149 million from Eurobank, $122 million from Atlas Corp., $78 million from Resolute. This was significantly higher compared to the $120 million of share of profit of associates reported in the first 6 months of 2021 that primarily comprised of share of profit of $99 million from our investment in Eurobank. Turning to a few comments on our net losses on investments.

We reported net losses on investments of approximately $1.5 billion during the second quarter of 2022, and they were principally comprised of net losses on our equity exposures of $871 million, reflecting the 16% drop in the S&P 500 in the quarter and net losses on bonds of $413 million as a result of the continued rising interest rate environment and net losses and other of $261 million. The net losses on the equity loss exposure of $874 million in the second quarter of 2022 were primarily comprised of net losses on common stock of $646 million.

The ABLN or asset value loan notes that we have with RiverStone Barbados of $135 million, our equity warrants and options of $97 million and convertible bonds of $94 million. That was partially offset by a net gain on long equity total return swaps of $77 million. The net loss on bonds of $413 million included net loss on U.S. treasuries and Canadian government bonds of $110 million, of which approximately $98 million related to the net purchases that we completed in the first 6 months of the $10.3 billion in U.S. treasuries and Canadian government bonds.

We also had unrealized losses of $62 million on the Greek government bonds that are primarily there to back the Eurolife reserves and net losses of $153 million on corporate and other bonds, primarily U.S. and other corporates. That was partially offset by net gains on U.S. treasury bond forward contracts of $32 million. The net losses reported on other of $261 million was primarily comprised of unrealized foreign exchange losses of $234 million that related to the strengthening of the U.S. dollar against the company's investments that are denominated in the Indian rupee, Sri Lankan rupee and the Egyptian pound.

Our net losses in the 6 months of 2022 of approximately $1.8 billion was comprised of the net losses on equity exposures of $611 million, net losses on bonds of $908 million and net losses and other of $244 million. With the net losses on the equity exposures of $611 million in the first 6 months of 2022, comprising of net losses on common stock of $407 million, the ABLNs with RiverStone Barbados of $205 million convertible bonds of $186 million, equity warrants and options of $16 million, and that was partially offset by the net gains on our long equity total return swap positions of $180 million. The net losses on our bonds of $908 million in the first 6 months of 2022, included net losses on our corporate bonds and others of $346 million, U.S. treasury bonds of $295 million and the Greek government bonds of $134 million.

That was partially offset by net gains that we held on our U.S. treasury bond forward contracts of $100 million. As noted previously, the low duration of only the 1.2 years on our $36.3 billion invested in cash and principally short-dated investments. If those investments are held to maturity, a significant portion of the $965 million that was reported in net unrealized losses in the bonds recorded in the first 6 months of 2022 will be reversed in the next 12 to 18 months. Net losses, as noted on $244 million was comprised also of unrealized foreign exchange losses as we noted earlier in the second quarter of 2022.

A few notes on our key transactions that we would like to highlight and provide some additional comments on. Firstly, in the prior quarter conference calls, we had mentioned the ability for the company to increase its ownership in digit above the 49% to a controlling interest upon receipt of regulatory approvals in India. At June 30, the regulatory approvals remain pending to permit the company to obtain control and digit. And as a result, we did not record any gains in the first 6 months of 2022 on the 49% equity accounted investment in Digit.

The second transaction was on June 18, 2022, we entered into a transaction with JAB Holding Company, which certain affiliates of JAB agreed to acquire the company's interest in Crum & Forster Pet Insurance Group and pet health, including all of their worldwide operations. As part of that transaction, we will receive $1.4 billion in the form of $1.15 billion in cash and $250 million in the seller or JAB's promissory notes, and we will also invest $200 million in one of the JAB Holding company's consumer funds. The transaction is subject to customary closing conditions, including various regulatory approvals, and is expected to close in the second half of 2022. We did not record any gains in the second quarter on the sale of the pet insurance operations. And on closing of that transaction, we expect to record an after-tax gain of approximately $975 million.

Lastly, on July 5, [Domital] Corporation entered into agreement with Resolute to acquire all of the outstanding common shares of Resolute for a combined cash consideration of $20.50 and a contingent value rate per share for Resolute common share of $6 per share. The contingent value right provides holders with the right to a share of any future software [lumber duty] refunds -- deposit refunds. Closing of the transaction is subject to shareholder and regulatory approvals and satisfaction of other customary closing conditions, which is expected to be received and closed in the first half of 2023.

At June 30, 2022, our estimated pretax gain that the company expects to record calculated as the excess of the cash consideration of $20.50 per Resolute common share and excluding any value given to the contingent value right over our carrying value of the investment in [associates] at June 30, and the fair value of those Resolute common shares that are held within our asset value loan note was approximately $180 million. In closing, a few comments on our financial condition position.

The liquidity and the position of the company remains very strong with our cash and investments at the holding company at approximately $1.1 billion at June 30th, 2022, and our $2 billion in the unsecured revolving credit facility fully undrawn. As noted in prior calls, our holding company cash and investment supports the company's decentralized structure and will enable us to deploy the capital efficiently to our insurance and reinsurance companies. On June 29, 2022, we amended and restated our $2 billion unsecured revolving credit facility with our syndicated lenders on substantially the same term, but have extended the expiry from June 29, 2026, by 1 year to June 29, 2027.

Our total debt to total cap ratio, excluding the investments in our consolidated noninsurance companies was 25% at June 30, 2022, which was an increase compared to the 24.1% at December 31, 2021, primarily reflecting the decrease in common shareholders' equity as a result of the primarily unrealized losses on investments. And finally, a few comments on our common shareholders' equity, which decreased to $13.9 billion at June 30, 2022, from just over $15 billion at December 31, 2021, reflects the net loss that attributed to Fairfax of the $756 million, which was comprised of the noted net losses on investments, which were principally all unrealized.

That was offset by the increased underwriting profitability, increased interest and dividends, increased share in profit of associates and improved operating income from the noninsurance companies. The common shareholders' equity decrease also included other comprehensive income loss of $281 million, primarily related to unrealized foreign currency losses, net of hedges, and payments on our common preferred share dividends of $272 million, which was partially offset by net gains on our defined benefit plans of $109 million. That concludes our remarks on the quarter. I'll now turn the call back over to Prem. Thank you.

V. Prem Watsa
Founder, Chairman & CEO
Thank you, Jan. We now look forward to answering your questions. Please give us your name and your company name and try to limit your questions only to one so that it's fair to all on the call. Okay, Catherine, we're ready for your questions.

Question and Answer

Operator

And the first question is coming from Nik Priebe, CIBC Capital Markets.

Nikolaus Priebe
CIBC Capital Markets, Research Division

[indiscernible] allocation on the investment portfolio was relatively unchanged sequentially. Just with everything that's enfolded in the macro environment since the last time we hosted a conference call here, can you just update us on your real-time views towards inflation, interest rates and what level you might look to reallocate more aggressively back into short creation categories?

V. Prem Watsa
Founder, Chairman & CEO

Yes. Nik, so inflation is running at about 9% in the United States, and they're running a little less than that in Canada and about 9% just came out in Europe. And so there are very high inflation rates with the Federal Reserve increasing its rate by 75 basis points, you've got about 2.5% in the Fed funds rate. And in Europe, we got another 50 basis points for the first time in 11 years, they've increased it by 50 basis points, but it's 50 basis points was 90%. So we just don't think these increases will have much of an impact on inflation. And so we are keeping our powder dry by limiting the term on our bonds that we purchase.

First of all, the best credit that you could get. We don't think you're getting paid for taking credit risk and you're not getting paid for [turn rate]. So 2 years, 3% in that area is what we're getting today. So investment income, as I've said before, has gone up very significantly, running at about $1 billion. If we get about 3.2%, and you include profit from our associates, easily, our investment income can be $1.5 billion plus the underwriting profit of $1 billion. So you get about $2.5 billion. In the first 6 months, it was $1.2 billion. So operating income for our company is very significant, reflecting the higher interest rates.

But the immediate answer to your question is that yes we are very careful, Nik, with the potential rate in interest rates. If you look at our book value, including stocks, is now 5%. If you look at the industry in the United States, most companies book value is down about twice, 10%. Very few are down in the 5% area. I think we are among the lowest. But if you go in and the numbers are coming out in Europe, interest rates in the book value of some of the European companies are down 30% plus because of these rising interest rates. So interest rates that go up further will have a significant impact on the capital of insurance companies. So we're very careful about that. And we think vigilance is needed.

Operator

The next question is coming from Tom MacKinnon, BMO Capital.

Tom MacKinnon
BMO Capital Markets Equity Research

Thanks very much. Good morning. Just a question with respect to the proceeds that are probably going to be coming and associated with the pet insurance deal. It looks to be about $1.2 billion in cash. Now your buy-backs, I mean, you did the SIB, but since then they've been still relatively modest. What are your thoughts as to what to do with this $1.2 billion in cash from that pet insurance deal?

V. Prem Watsa
Founder, Chairman & CEO

So Tom we're always flexible, of course, and we look at all the possibilities. In terms of acquisitions in the Property Casualty business, we are not focused on that because business now is running at about $28 billion, that's US dollars, of course. In 2015, it was $8 billion. In 2018, it was $15 billion, and now it's running at 2022, at $28 billion. And that's not including the GIG, the Middle Eastern company that we've got, which is another $3 billion and digit close to $4 billion.

So we've got a significant amount of operations, decentralized all over the world and running at an underwriting profit. And very good reserving, I may add. So no acquisitions. I mean small acquisitions here in Asia, Latin America, but nothing significant. And so we look at, obviously, buying back our stock. That will be the #1 thing that we'd look at, but not at the expense of our financial position. I've said that many times for you, not at the expense of our financial position, but we would look at buying back our stock.

Tom MacKinnon
BMO Capital Markets Equity Research

Okay. Just following up on that, you mentioned you're not interested in buying any more insurance operations yet these are really good markets right now for P&C insurance. Why are you hesitant about buying into what it seems a business that has some really good fundamentals.

V. Prem Watsa
Founder, Chairman & CEO

Yes, now that's a good question, Tom. It's basically that they're all over the world. I mean, they're global companies, they're all over the world. The United States, we're about 70% -- 65%, 70% of our businesses. And we've got big companies and we keep them separate, like our Odyssey running at $6 billion. Our Allied World is running about $6 billion. Crum & Forster, as Peter said, it's running about $4 billion plus significant size and significant growth potential. And we don't like to put companies together. We think our big advantage is that we are decentralized. We have the same management team that's been with us for decades. And so we like that. And that's a very big strength, Tom. Tough to replicate.

Operator

The next question is coming from Mark Dwelle, RBC Capital Markets.

Mark Alan Dwelle
RBC Capital Markets, Research Division

A couple of questions. First, a couple of numbers questions. You commented in the opening remarks about Allied World having some development associated with prior year accounts. Could you share the amount of that? I'm really just trying to understand like what the run rate was ex that. I know that's not an entirely normal occurrence.

V. Prem Watsa
Founder, Chairman & CEO

Yes. Mark, I'll pass that to Peter. I'll just preface it by saying that our reserves are very strong because all this expansion that you've seen and I talked about, Mark, had been in a very hard market. And our experience is that when you go through those expansion like we have done, our results are going to be good for a long, long time. But Peter?

Peter S. Clarke
President & COO

On a net basis, the strengthened reserve is $30 million. And it really related to catastrophes that occurred late in 2021 and in the reinsurance book. So it was late reported claims. Typically, while we do any property type losses that come through. We book it up immediately. On the casualty side, we'll hold off on any redundancies until it plays out. So it was just a one-off strengthening of catastrophes.

V. Prem Watsa
Founder, Chairman & CEO

Peter just a comment for Mark and others [in top] the reserving already looked at the end of the year.

Peter S. Clarke
President & COO

Yes. Our reserving process occurs really in the fourth quarter. All our companies do a thorough actuarial review at the end of the fourth quarter and any major reserving actions and sort of adjusting for actual versus expected, et cetera, [tours] in the fourth quarter. During the first 9 months of the year, we'll really just react to any immediate development on property type business and then wait for the full review analysis.

Mark Alan Dwelle
RBC Capital Markets, Research Division

That's very helpful. And another quick numbers question, if I may. The sale of the pet insurance business, can you give a sense of kind of a range of about how much revenue you'll be, I guess, selling when that happens? And again, it's just -- I'm trying to understand, as we get into next year, revenue that will go away from Crum & Forster to be able to keep track of the run rate there.

V. Prem Watsa
Founder, Chairman & CEO

Sure. [indiscernible] approximately $350 million, and it's a pet insurance, and it's in the United States, mainly but Canada and in the U.K., some. And obviously, we like the price. But JAB they get a lot of good things from Crum & Forster, including data on 30 million pets and ASPCA support for 16 years. And so we think it's a win-win. We think JAB is going to do extremely well. They're focused on this segment, not only pet insurance, but supplies and pet care hospitals. And we just think this company has done very well. We've seen what they've done in coffee, and we think, over time, they're going to do very well.

Mark Alan Dwelle
RBC Capital Markets, Research Division

That's very helpful. It's definitely a good deal. It's a great example of how there's -- a lot of times, there's value hidden in plain sight on the balance sheet. The last question I wanted to ask was just related to -- you commented that your -- with respect to associate and affiliate holdings that your fair value calculation was in excess of your carrying value on table that in the supplement. Can you just talk through what the process is on evaluating that? And when -- if they are -- if a goodwill impairment or other value impairment is required, how that process works and when it would be undertaken?

V. Prem Watsa
Founder, Chairman & CEO

So the 2 big ones there are Atlas, and it's fluctuations mainly and Eurobank, both of them fluctuate significantly up and down. And in this quarter, they fluctuated and the only impairment we took was on [indiscernible] for approximately $100 million. But the fluctuations, Mark, go up and down, as you know, you've followed us for some time. And you might ask the question, why do we accept this volatility? Some of you might think why are we accepting the volatility? It's from inception, and this is on Page 182 of the 2021 annual report.

Page 182, 2021 Annual Report. $18 billion in cumulative investment income is $14 billion. Our investment gains are $16 billion. And that's coming from a very small company. Now we're a much larger company, and we expect to have a ton of investment gains over the next 5 years and 10 years. And so our company accepts the volatility because I think you can do in stock prices dropped 16%. But over time, we've done really well for our shareholders. We expect that to continue.

Operator

[Operator Instructions] The next question comes from Jaeme Gloyn, National Bank Financial.

Jaeme Gloyn
National Bank Financial, Inc., Research Division

My question is focused on the top line growth. Gross premiums written, obviously, really rapid growth in the last 3 quarters. I guess, a modest deceleration but still at north of 20% in Q2 2022 year-over-year gross premiums written growth. Just want to get your views on where you expect to see that top line number trending over the next couple of quarters? Should we continue to see north of 20% premiums growth? Or is there some dynamics in the market, whether it's a deceleration of hard markets in some lines that might keep or push that growth rate down below 20s but still in [between]

V. Prem Watsa
Founder, Chairman & CEO

So Jimmy, the next quarter, 2 quarters or 3 quarters, we never -- you never can tell what the growth is going to be, but there's a lot of momentum for these growth rates that you've seen to continue. We don't believe in forecasting these things because look at what has happened. But there is a lot of momentum for it to continue. I admit it's not going to continue forever. It will stop some time. But the big thing that you should focus on as an analyst, all of you analysts, look at the impact of interest rates going up, like shareholders' equity for a whole ton of companies reporting record earnings, operating income like us, book value down 5%.

Now our book value, at least on the fixed income side, it doesn't last long, between 6 months and 18 months, as Jen was saying, it disappears, meaning it's redeemed, then we put the money back into higher-yielding income, and that's why treasury bonds and other bonds, and that's why our rates going up. But if many of the US companies have got 10 and maybe 15% decrease in book value, shareholders' equity per share.

And in Europe, where interest rates went to zero and negative, and they're now moving up and they're still very marginal at best at 10-year rates at 1% and a 30-year rates at 1.5%, 2%, increase in those rates will have a significant impact. And like I said, 30% drop in shareholders' equity for some early reporting companies. And so you have to watch that. And a lot of the European companies report only in the second half. Meaning there were only, not on a quarter-by-quarter basis. And so what we might be seeing is the [hot market] continuing. You can tell, but you have to watch this and the [hot] market might continue. Peter, you want to add on that to that?

Peter S. Clarke
President & COO

I think the only thing I'd add is we're still getting rate and we're still getting fairly good rates, like 7.5%. So that's going to drive growth alone. And then different lines of business are increasing still. D&O, [V & O] for example, in the U.S. has stabilized. But property cat, a lot of rate, a lot of capacity there and a lot of opportunities. So we're seeing a little bit more on the reinsurance side, less on the insurance side, but I think we'll see -- we'll still see strong growth in the next 6 months.

Jaeme Gloyn
National Bank Financial, Inc., Research Division

Yes. And I guess I take it that your more resilient equity base, balance sheet book value allows you to be more competitive in this hard market than some of your global peers?

V. Prem Watsa
Founder, Chairman & CEO

That's exactly right, Jaeme.

Jaeme Gloyn
National Bank Financial, Inc., Research Division

Just a quick numbers clarification. Just thinking about -- maybe this is for John, just the share count. It seems to me that there was no dilution impact in this quarter. Could you just [curve] or confirm that? And then how should we think about dilution impact in the upcoming quarters? Is there some level that I should be thinking about?

V. Prem Watsa
Founder, Chairman & CEO

How are you thinking of the dilution impact, Jen?

Jennifer J. S. Allen
VP & CFO

Specifically, you're talking about the ECS business?

Jaeme Gloyn
National Bank Financial, Inc., Research Division

Correct.

Jennifer J. S. Allen
VP & CFO

Yes. So when you're in a loss position in your basic EPS, you can't be anti-dilutive, so you cannot take it lower. So normally, when you look at your anti-diluted position, if you're in a net earnings position, you would take -- it's like an average of any of our treasury shares that are outstanding. I would look at it compared to probably a historic 2021 run rate that's provided in the EPS note.

V. Prem Watsa
Founder, Chairman & CEO

So Jaeme, our shares outstanding approximately 24 million, and that's after that 2 million shares that we bought back at the end of last year. And we're hoping that over time, we'll continue to reduce the [shares] standing.

Operator

The next question is coming from Howard Flinker of Flinker & Company.

Howard Flinker
Flinker & Co

First, I ask that you abide by your own rule of one question per person. Some people like to run on. Taking ahead 12 months or so, property cash for the companies are getting very large margins. And in the past months, part of their losses in equity have been recovered. So if we think of next summer, not this summer or next item, not this summer, -- do you think there's a possibility that rates will start to soften?

V. Prem Watsa
Founder, Chairman & CEO

You're talking about insurance rates, right?

Howard Flinker
Flinker & Co

The P&C rates, yes.

V. Prem Watsa
Founder, Chairman & CEO

I remember, Howard, what I mentioned this earlier that could well happen. The other side of it is capital depreciation, capital being destroyed because interest rates are going up. Now most people think it say they're going to come down longer are going to come down next year. If that happens, then the capital is not going to come down. But if by chance, inpatient stays at these levels -- Howard, you've been in the business for a long time. You remember that in the 1970s and early 1980s, interface in way up to 21% and most people don't think inflation will never come down. Today, that's the other side of that story, -- inflation and most people don't think inflation's going up. And so they don't think interest rates are going up. And we've got almost record low interest rates. Obviously, in 2020, they were lower. Go right ahead Allen.

Howard Flinker
Flinker & Co

That's why I added a partial recovery in equities this month. But inflation is 6% or 5% next year, never mind 9 interest rates are going up anyhow.

V. Prem Watsa
Founder, Chairman & CEO

You got it. And the effect on insurance companies, property and [tragedy] insurance companies on that portfolio, given durations of 5, 6 years on average for most of them will be quite significant.

Operator

The next question is coming from [Junior Rosa], he is a private investor.

Unknown Attendee

A question about Fairfax India. How do you think the market will eventually realize the true intrinsic value of Fairfax because there's a big gap between what the true value is versus what the market is willing to pay for it.

V. Prem Watsa
Founder, Chairman & CEO

Well, that's a good question, [Julio]. And no one knows the answer to that. But Fairfax India has got extremely good value and it's obvious. But there's a lot of good values in the stock market today with the market coming down about 20% in the first 6 months. And my experience is you never know when the market changes. There is -- high-tech is coming down. It's come down quite a bit. Backing up in the last month maybe. And that's not too different from what happened in 2000. In 2000, the first leg down in the year 2000, [for rig down] was about 35%.

It backed up, the NASDAQ went back up 30%, then it dropped 40% for a 50% drop in 1 year, 2.5 years later, the NASDAQ was down 75% from the high, while value-oriented stocks did extremely well. I mentioned that before. And so we continue to watch what's happening. We think Fairfax India's outstanding value, and we buy the shares of the FC Fairfax India's press release, they continue to buy shares back and retire the shares. So [Julio], thank you very much for your question, and Catherine I think we are just about finished at 9/30. And we thank you very much, Kathy, for hosting the call, and thank you for joining us on this call. All of you who are on the call, and thank you, Catherine.

Operator

This will conclude today's conference. All parties may disconnect at this time.

V. Prem Watsa
Founder, Chairman & CEO
Thank you.