Markel Corporation NYSE:MKL

FQ3 2011 Earnings Call Transcripts

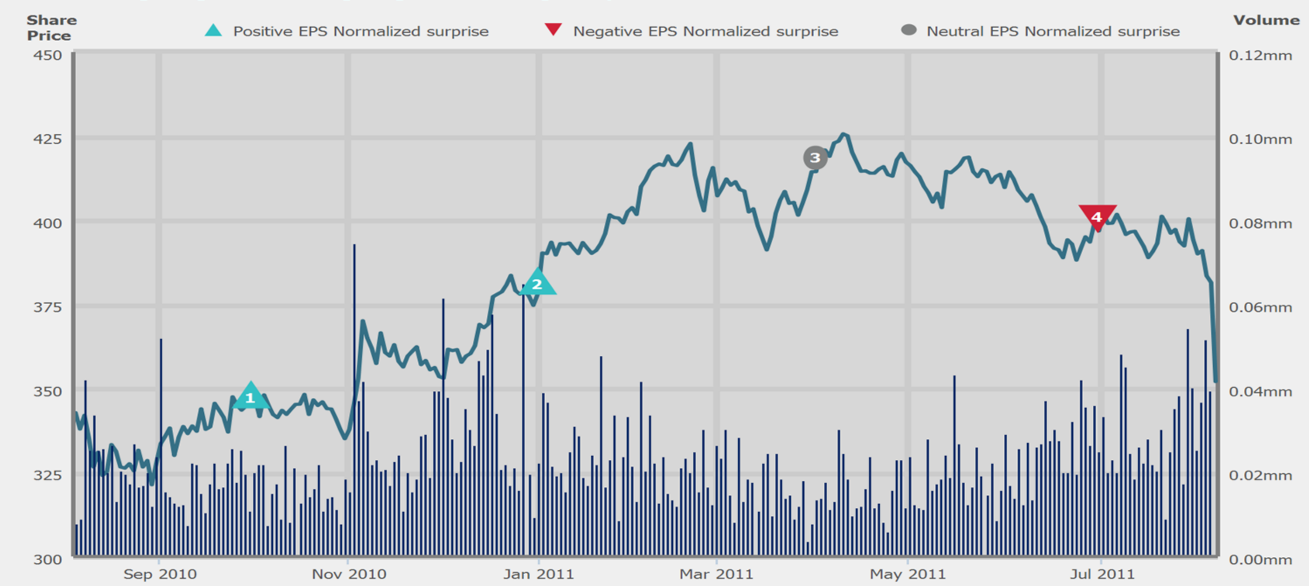
Tuesday, November 08, 2011 3:30 PM GMT

S&P Capital IQ Estimates

	-FQ3 2011-			-FQ4 2011-	-FY 2011-	-FY 2012-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	4.04	4.41	▲9.16	3.94	10.27	15.72
Revenue (mm)	636.16	676.09	▲6.28	650.92	2519.61	2673.07

Currency: USD
Consensus as of Nov-08-2011 1:11 AM GMT

Stock Price [USD] vs. Volume [mm] with earnings surprise annotations



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2010	3.58	5.86	▲1 63.69 %
FQ4 2010	4.38	12.91	▲2 194.75 %
FQ1 2011	3.40	(0.14)	NM
FQ2 2011	4.06	2.99	▼3 (26.35 %)

Call Participants

EXECUTIVES

Anne G. Waleski
Chief Financial Officer and Executive Vice President

Richard R. Whitt
Co-Chief Executive Officer and Director

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

ANALYSTS

Jack Schrek

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Vincent DeAugustino

Presentation

Operator

Greetings and welcome to the Markel Corporation third quarter 2011 earnings conference call. [Operator Instructions] As a reminder, this conference is being recorded. It is now my pleasure to introduce your host, Tom Gayner, Chief Investment Officer for Markel Corporation. Thank you. Mr. Gayner you may begin.

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

Thank you, Devin, good morning. It is my pleasure to welcome you to the Markel Corporation's third quarter conference call. Thank you for joining us.

On today's call we will follow our normal line-up with Anne Waleski leading off with the financial results, followed by Richie Whitt with operational comments. Mike Crowley is unable to join us today, so Richie will share and cover his comments. Then I will discuss our investing and non-insurance activities.

After everyone’s comments, we’ll be all available for your questions. Before we begin, I am duty bound to remind you that during today's call, we may make forward-looking statements. Additional information about factors that could cause actual results to differ materially from those projected in the forward-looking statements is described under the captions Risk Factors and Safe Harbor and Cautionary Statements in our most recent annual report on Form 10-K and quarterly report Form on 10-Q.

We may also discuss certain non-GAAP financial measures in the call today. You may find a reconciliation to GAAP of these measures on our website at www.markelcorp.com in the Investor Information section under non-GAAP reconciliation or in our quarterly report on Form 10-Q.

With that, Anne.

Anne G. Waleski
Chief Financial Officer and Executive Vice President

Thank you, Tom, and good morning everyone. I plan to follow the same format today as in prior quarters. I will focus my comments primarily on year-to-date results. I will start by discussing our underwriting operations followed by a brief discussion of our investment results and bring the 2 together with a discussion of our total results for the 9 months.

So moving right into the underwriting results, gross premium volume was just under $1.8 billion for the first 9 months of 2011, up 16% compared to 2010. This increase was due to higher gross premium volume in the Specialty Admitted and London Insurance market segments.

As of September 30, 2011 the Specialty Admitted segment included $170 million of gross written premium from our FirstComp workers’ compensation operations, which we acquired in late 2010. The increase in gross written premiums in the London Insurance market segment was due in part to an increase in premiums written by Elliott Special Risks, which has been converted from an MGA operation to a risk bearing insurance division.

We also saw significant increases in premium volumes within our Marine and Energy division due in part to offering large loan sizes and an improved pricing environment.

Net written premiums were approximately $1.6 billion, up 15% to the prior year.

Retentions were down slightly at 89% compared to 90% in 2010. Earned premiums increased 16%, primarily due to higher earned premiums in the Specialty Admitted in London market segments as a result of higher gross premium volumes compared to 2010. This Specialty Admitted segment included $147 million of earned premium from FirstComp.

Our combined ratio was 105% for the first 9 months of 2011 compared to 99% in 2010. The increase was due to a higher current accident year loss ratio, partially offset by more favorable development of prior year's loss reserves compared to 2010.

The combined ratio for the first 9 months of 2011 included $133 million or 9 points of underwriting loss related to natural catastrophes including Hurricane Irene during the third quarter, the U.S. storms in the second quarter and the Australian floods, the New Zealand earthquake and the Japanese catastrophe, all of which occurred in the first quarter.

Our 2010 combined ratio included $17 million or 1 point of underwriting loss related to the Chilean earthquake. The 2010 combined ratio also included $72 million or 6 points of underwriting loss on 2 programs now in runoff that were exposed to losses associated with the adverse conditions in the residential mortgage market.

Favorable redundancies on prior year's loss reserves increased to $250 million or 17 points of favorable development compared to $181 million or 14 points of favorable development in 2010. The increase was primarily due to more favorable development of prior year's losses in the Excess and Surplus Lines segment.

Our 2011 year-to-date expense ratio was flat to the same period in 2010.

Turning to our investment results next. Investment income was $197 million for the first 9-months of 2011, compared to $201 million in 2010. Net investment income included an adverse change in the fair market value of our credit default swap of $2.7 million. Net realized investment gains were $25 million compared to $22 million in 2010.

Unrealized gains decreased $31 million before taxes in 2011 due to a decrease in the fair market value of our equity securities, partially offset by an increase in the fair market value of our fixed maturities. Tom will go into further details in his comments.

Looking at our total results for the first 9 months of 2011, we reported net income to shareholders of $92 million compared to $127 million in 2010. Book value per share increased 2% to $333 per share at September 30, 2011, up from $326 per share at December 31, 2010.

The effective tax rate was 17% in 2011 compared to an effective tax rate of 31% in 2010. The decrease from 2010 is primarily due to having lower estimated income before income taxes in 2011 as compared to 2010.

Next, I'll make a few comments on cash flow and the balance sheet. Operating cash flow was $261 million for the 9 months ended September 30, 2011, compared to operating cash flow of $173 million for the same period of 2010. This increase was primarily due to higher cash flows from underwriting activities in the London Insurance market and Specialty Admitted segment.

Investments in cash held as the holding company were just over $1 billion at September 30, as compared to slightly less than $900 million at year-end.

Finally, we have repurchased 85,000 shares of our common stock to $33 million in the first 9 months of 2011.

Now, I'll turn it over to Richie, to further discuss operations.

Richard R. Whitt
Co-Chief Executive Officer and Director

Thanks, Anne. As Tom said, Mike Crowley, is not going to be able to be with us today. Fortunately, we have redundancy built into the system here at Markel, and I'm going to discuss all of our insurance operations in his absence.

The third quarter for North America and international operations was relatively stable from a rating standpoint. The various entities out there that gather rate change data recorded that rate decreases have slowed. In particular, the CIAD recently released the commercial insurance market survey reporting that rates for most lines of business and account sizes declined less frequently and at a slower pace this quarter.

CIAD members placed a large majority of U.S. Commercial premium, which gives the survey a level of creditability. Markel's own results confirmed that in some lines, line rates have flattened, while in other lines, particularly the casualty lines, they continue to show some weakness. The competitive rate environment still exists, and profitable business attracts many carriers buying for that business.

The trends were amazingly consistent in both the domestic and international markets.

Now I’d like to make a few comments for each of our divisions. The Specialty division generated gross written premium of $154 million during the quarter, this was an increase of about $50 million over prior year. FirstComp premiums totaled $60 million in the quarter. The premium shrinkage in other areas was due to corrective actions in our accident and health divisions, and non-renewing underperforming books of business.

Year-to-date, the divisions generated gross written premium of $432 million, which is an increase of about 65% from prior year’s gross written premium of $261 million. The increase was due to the FirstComp acquisition.

Highlights for Markel Specialty include, we launched a new Nursery and Garden Center program in the quarter. We completed work to initiate our first venture into social media with our Health and Fitness product. Markel American, our personal lines division, went live with a wringers product, with the largest provider of apartment community websites and wringer payment systems.

Cross-selling efforts between FirstComp and Markel continue to gain traction. 20% of Markel’s - excuse me, of FirstComp’s new business in the quarter, came from agents that did business with both Markel and FirstComp prior to the merger, proving that now that FirstComp is part of Markel, agents are even more inclined to do business with FirstComp.

Agents who were Markel agents and are now appointed by FirstComp have been twice as productive on new business as existing FirstComp agents. All these are really positive signs.

In addition, we announced the appointment of Luke Yeransian, as President of Markel Specialty. Luke is the founder of FirstComp. His experience in developing strategy, analyzing distribution, implementing best practices in metrics management, and engaging technology, are going to be invaluable as we continue to fine tune our strategy in Markel Specialty.

With regards to our excess and surplus lines segment, gross written premium for the quarter was $237 million, a decrease of 1% in the prior year. Year-to-date gross written premium totaled $664 million versus prior year $693 million.

As we previously discussed, this reduction in gross written premium is primarily due to the loss of 2 large programs. Our core regional premium in the excess and surplus line segment was actually up 6% over prior year in the quarter, and up 5% year-to-date. So encouraging signs there.

Highlights for the excess and surplus line segment includes growth in our binding business as well as our growth in casualty, excess in umbrella, and property CAT business. We completed and released the first phase of our broker portal, which is an update of our website for our wholesalers. This is providing much improved and faster experience for our agents, for 14 of our highest volume products. We are going to continue to frequently add functionality as we move forward.

We continue to focus on strategic initiatives with our national brokerage partners, led by our wholesale marketing department. This initiative has produced solid growth with our 12 largest wholesalers for the first 9 months of the year.

Submission counts continue to rise in all of our regions, a clear indication our marketing efforts are producing results.

While it was held early in the fourth quarter, I do want to mention that we had a very successful and intense national conference. We conducted over 128 meetings with our wholesale partners out in San Diego last month.

At Markel International, we generated gross written premium of $194 million in the third quarter, and $677 million for the 9 months. The increase for the 9 months was approximately 14%, this was adjusted for the impact of currency movement, and represented organic growth in our Marine and Energy's division, and the ramp-up of written premium from our Elliott Special Risk division.

Highlights for International include, our Marine and Energy team continued to produce solid premium growth, rates continue to modestly increase in the energy sector, and rates appear to be flattening in other areas.

Our team in the new Rotterdam office have moved into their permanent space, and wrote their first policy in October. We are currently preparing for the January 1 renewals, when the significant portion of professional liability business renews in Holland.

Our trade credit division continues to progress nicely, and has written its first business from staff we added to our Singapore branch.

Finally, we recently appointed Paul Jinx to the board of Markel International. Paul has done a tremendous job leading our Marine and Energy team over the past ten years, and his input will be invaluable as we seek continued profitable growth at Markel International.

Our product line leaders have been working hard to improve on process for binders, submission acceptance standards, and application acceptance standards. We expect to see meaningful improvements in the fourth quarter, which will lead to more efficiency.

Other highlights for our product line group includes adding contractor pollution coverage to our binding offerings in the fourth quarter. We believe this is going to be a compelling offering for our contractors and will attract new business.

We've also launched a companion auto product, and we're now able to write auto coverage to support existing accounts. We've had success in the environmental contractors and railroads to date with this new product. This will be a differentiator for us as many of our ENS competitors do not have this capability.

With regards to pricing, our product line leaders are currently working closely with our actuary to review our pricing strategies for all lines of business. While this is always an on-going process, we are placing a strong emphasis on those lines we feel need attention moving into 2012.

In summary, the third quarter was a continuation of what we've been seeing in the market the last few quarters. We have modest optimism for a better rate environment for property lines, and casualty lines are clearly flattening, but certainly not hardening at this point.

We continue to revisit and refresh our product offering looking for efficiencies in our processes, and to be strategic in our marketing efforts. Our people continue to position Markel for success despite what continues to be a competitive marketplace.

Now I'd like to turn it over to Tom. Thank you very much.

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

Thank you, Richie. I'll cover 2 general topics this morning, and then of course, try to answer your questions.

The first topic is our public investment portfolio. Now volatility technically means movement, and that would mean up, as well as down. When people use the word these days though, they mean down. And during the quarter, volatility as it is used in the vernacular of our day, reared its ugly head and down it was.

For the year-to-date through September, our equity portfolio declined 8.8%. By the way, volatility actually meant up in October, and marketing the portfolio 30 days later would produce a very different result.

On the fixed income side, interest rates continue to perform their world-class limbo dance and go lower, and lower, and lower. As a consequence, the coupon return was amplified by an increase in market values, and we earned a total return of 6.3% on the fixed income portfolio for the year-to-date. The combination of the 2, as well as the modest negative FX effect of negative 0.2% produced a total return of 2.8% so far, in 2011.

As I stated last quarter, and probably several quarters before that, the strategic goals of the investment department are to number one, protect and preserve the balance sheet through high-quality fixed income investment. Two, to allocate as much as possible the higher total return equity investment. And three, to increase the overall earning power and financial flexibility of the Markel Corporation through the ownership of a variety of profitable businesses. That will continue to be the case in the years to come.

On the last call, I emphasized that none of that had changed despite the new headline that the U.S. government had just been downgraded from AAA. This call, I'll reiterate in the face of the risk-on, risk-off volatility pattern that dominates daily financial markets.

Measured against our goals, I'm pleased with the progress we've made during 2011. First, we are protecting and preserving the balance sheet by maintaining the high quality and short duration bond portfolio. As is our goal, over 90% of the fixed income portfolio is rated A or better. And there's a relay as supported with our own independent view of the underlying credits. We do not rely on the opinions of rating agencies to make credit judgements. We do our own work, and refuse to buy a bond where we are concerned about whether they are money good or not.

We don't always get it right, but we don't just take someone else's word for it. Also, we continue to painfully allow the duration of the portfolio to shorten with the passage of time, trying to maintain for improved current investment income by buying longer term bonds or by buying riskier credits, looks like an incredibly dangerous game of hot potato to me.

I think that people with too short a time horizon or worry that they might lose their job if they under perform for a quarter or 2, along with people who are convinced that deflation will occur and drive interest rates lower, are taking huge risks. The space between the current level of interest rate and zero, require an electron microscope to see it. The space between the current level of interest rates and any that we've observed in 30 years is huge. The risk reward ratio for long-term investors seems clearly unbalanced to me. And as such, we will continue to forego current investment income to preserve and protect Markel's balance sheet by keeping the bond maturities short.

Secondly, we continue to allocate capital to higher return equity securities. While the drop in market value during the third quarter, the positive returns on fixed income and our own share repurchases combined to reduce the percentage of equity as a percentage of shareholders equity to slightly below 50%, we continue to actively purchase equities during the third quarter. We continue to do so now, and fully expect to increase the percentage of our capital and equities in future quarters.

As always, we will be measured and systematic in doing so. I remain of the opinion that high quality, global franchise firms represent the best place to put the bulk of our capital these days.

By the way, as we do so, we are often not giving up any current investment income as dividend yields equal or even exceed the fixed income on part of this. Additionally, as indicated since 2005 when we acquired majority interest in AMF Bakery equipment, increase in the earnings power and financial flexibility at the Markel Corporation, means acquiring control interest in non-publically traded firms.

Markel Ventures is a group that conducts this activity. Through the first 9 months, other revenues at Markel, which are largely those of the Markel ventures company, were $260 million versus $125 million in the prior year, an increase of more than 100%. Markel's share of the associated EBITDA totaled $34.2 million versus $16.2 million, or more than double the level of 2010. As always, a reconciliation of EBITDA to net income is available on the website.

The net of all this, is that even with the catastrophic events of the first 9 months, we are reporting comprehensive positive income at Markel. During the third quarter, we announced the purchase of Weldship, which closed in the fourth quarter, and will be included in our results going forward. Weldship makes 2 trailers and other storage containers for industrial gas applications, and is a market leading company in this sphere of operations.

Our permanent capital alternative continues to be attractive to owners and entrepreneurs, and I am excited about the addition of this profitable and durable business to Markel. Additionally, AMF acquired BAKETECH at the end of the quarter. BAKETECH was well known to AMF and adds product line and customer relationship depth as well as profitability to AMF.

We continue to work on other transactions and we expect on-going organic and acquisition opportunities within the growing framework of Markel Ventures. Our portfolio and our acquisitions remain conservative. We believe in a fortress balance sheet, which enabled us to withstand the sort of catastrophic weather and national events we experienced during the first 9 months, and withstood the sort of financial catastrophes that occurred in 2008 as well as the current volatility.

By having the balance sheet and the business experiences we've enjoyed over the decades, we've been able to respond to opportunities through insurance, investments, and industrial world to build the value of your company. We continue to see opportunity on all fronts, and I'm pleased to report to you that we have increasing levels of financial and human capital as well as the courage and creativity needed to make the most of it.
With that, I'd like to open the floor for your questions.

Question and Answer

Operator

[Operator Instructions] Your first question comes from the line of Vincent DeAugustino with Stifel, Nicolaus.

Vincent DeAugustino

I guess I'd like to first start off and focus on the runoff errors in admissions program for mortgage servicers. Since it's leaving a sizable dent in the otherwise very favorable reserved development. I think looking back to earlier this year, a large portion of liabilities relating to those problematic claims was resolved, resulting in some favorable development. And we're now seeing some adverse development flow through again from these mortgage programs, and I am just curious if there is any historical precedent pointing to what the sale looks like, or at least how much longer until you think you would be out of the woods on this things.

Anne G. Waleski
Chief Financial Officer and Executive Vice President

Hey, Vincent. I think you maybe have misunderstood what was in the Q; that reference to those programs was for the 2010 comparison. There is no development in this quarter for that, and the programs have performed as we had expected thus far.

Vincent DeAugustino

And then can you give any sense of where the FirstComp's accident year combined ratio is running?

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

I think we have talked about this, shoot, last fourth quarter that we obviously are going to be in a transition year this year and we're working to sort of bring their reserves to the same reserving standards that we have here at Markel. So the accident year is probably running into the tune of about 108-110 and we expect that to be about a $30 million underwriting loss for the year. And we are actually running a bit better than that. So the bottom line is, we're exactly where we would have expected to be at this point in terms of FirstComp, and we are well on our way in terms of getting to our overall, more likely redundant than deficient stance on reserves.

Operator

Our next question comes from the line of Mark Dwelle of RBC Capital Markets.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

A couple of questions. First with respect to - in the other income line, you had around $90 million, $82 million or so of that appeared to be related to Markel Ventures. Is there something unusual or infrequent relating to the remaining 9 million? That's more than the amount we usually see run through that line?

Anne G. Waleski
Chief Financial Officer and Executive Vice President

That amount is related to the MGA operations still associated with Aspen FirstComp.

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

Mark, it's probably worth pointing out that we took all of that business on to our paper as of July 1, so that will be running down as we move forward.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

That's helpful. With respect to Markel Ventures, as I recall, when that was originally established, you had sort of a $250 million acquisition budget, and by my math, it looks like we've pretty much used that up. Has that been further authorized beyond that level or is my math a little bit off?

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

There was never a budget attached to that; that was a description of how much capital we had committed to it so far. So that's a rough over a magnitude of what we have done so far, but we would expect to do more going forward.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Yes, that's fine. I misconstrued that, that was a budget then. The next question I had, you had the credit default swaps, I guess there was a little bit of a drag as a result on the quarter. How much longer do we continue to have those?

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

2014.

Operator

[Operator instructions] Your next question comes from the line of Jack Schreck [ph] with Suntrust.

Jack Schrek

On the workers' comp market, with the firming we have seen there in terms of rates, have you seen any recent change in the competitive landscape there?

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

Yes. Things are starting to happen in workers' comp. I wouldn't call it a dramatic change, but certainly, in some of the more distressed markets, particularly California, rates seem to be going the other way. In some of the other states, maybe it's more of a flattening of rates. But certainly things appear to be a little bit ahead of the rest of the market in workers' comp. There certainly appears to be a movement afoot.

Jack Schrek

How about just in terms of any real competitive changes in regional versus national carriers. Any flavor or color there?

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

I don't know of anything particular to point out there. It's been an incredibly, almost a suicidally competitive market for a long time. I think, particularly, again, in California, things seem to be moving the other direction. I don't know that you'd see a big difference between regionals, or monolines or nationals in particular.

Operator

[Operator instructions] There appear to be no further questions at this time. I'd like to turn the floor back over to management for closing comments.

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

There appear to be no further questions, so we thank you for your participation. We're around here today and would be happy to hear from you. Thank you, as always, for your support of Markel, and we look forward to speaking with you soon. Bye-bye.

Operator

This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.