S&P Global
Market Intelligence

Fairfax Financial Holdings Limited TSX:FFH

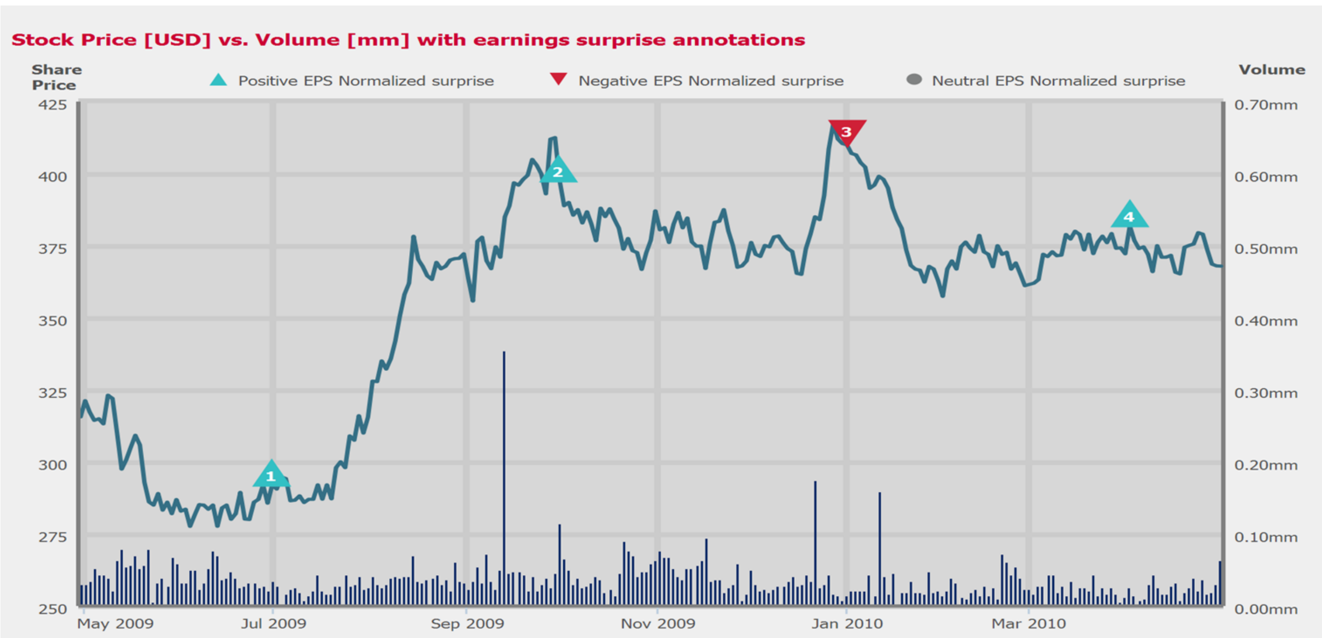
FQ2 2010 Earnings Call Transcripts

Friday, July 30, 2010 12:30 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2010-			-FQ3 2010-	-FY 2010-	-FY 2011-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	5.80	15.49	▲166.61	6.30	32.16	28.69
Revenue (mm)	1599.10	1811.70	▲13.30	1606.20	6637.40	6604.05

Currency: USD
Consensus as of Jul-30-2010 12:09 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2009	6.06	15.56	▲1 156.77 %
FQ3 2009	10.91	30.88	▲2 183.04 %
FQ4 2009	6.00	1.65	▼3 (72.50 %)
FQ1 2010	7.35	14.02	▲4 90.75 %

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Call Participants

EXECUTIVES

Bradley Martin

John Varnell

Prem Watsa

ANALYSTS

Jeff Fenwick
Cormark

Mark Dwelle
RBC Capital Markets

Presentation

Operator

Good morning and welcome to Fairfax's 2010 second quarter results conference call. Your lines have been placed on listen-only mode. After the presentation we will conduct a question-and-answer session. We would kindly ask that you limit yourself to one question each.

Today's conference is being recorded, if you have any objectives, you may disconnect at this time. Your host for today's call is Prem Watsa and Brad Martin will make a brief statement first. Please go ahead Mr. Martin.

Bradley Martin

Thank you, Shirley. Good morning, welcome to the conference call to discuss Fairfax's 2010 second quarter results. The comments we make during this conference call may contain forward-looking statements. Actual results may differ perhaps materially from those contained in such forward-looking statements.

As a result of a large variety of uncertainties and risk factors and most foreseeable which are vested in Fairfax's Annual Report, which is available on our Website at fairfax.ca or are set out under Risk Factors in Fairfax's Base Shelf Prospectus filed with the securities and regulatory authorities in Canada and United States which is available on SEDAR and EDGAR.

I will now turn the call over to our Chairman, CEO Prem Watsa.

Prem Watsa

Thank you, Brad and good morning, ladies and gentleman. Welcome to Fairfax's second quarter conference call. I plan to give you some of the highlights and then passing on to John Varnell, our CFO for additional financial details.

Before I do I wanted to take this opportunity to thank Greg Taylor for doing an outstanding job for us as CFO for the last five years.

In the first half of 2010, book value per share increased by 6% adjusted for $10 per share common dividend paid in the first quarter of 2010. Book value in the first half increased to $383 a share. In quarter two book value decreased by 0.3%.

As of June 30, 2010, common shareholders' equity increased to $7.9 billion from $7.4 billion as of December 31, 2009, an increase of almost $472 million after repay $200 million in dividends and issued $200 million of common stocks.

Highlights during the quarter include our consolidated combined ratio for the second quarter was 101.2% with good reserving and our company has continued to be well capitalized. OdysseyRe had a combined ratio of 97.1%, Crum & Forster had a combined ratio of 106% and Northbridge had a combined ratio of 107.3%.

Crum & Forster and Northbridge are operating in continued weak commercial lines markets. As with all of our companies that disciplined approach to walking away from unprofitable business, caused our net premium down to decline in the second quarter, and as a result the expense ratio to increase. More on the combined ratios from John Varnell.

In the second quarter of 2010 interest and dividend income increased by 6.1% over the second quarter of 2009 to $196 million. On a pre-tax equivalent basis interest and dividend income was $222 million.

The acquisition of Zenith was completed on May 20, 2010, so our second quarter statements show the impact of Zenith for 41 days. We are very excited about the long-term prospects of this acquisition under Stanley Zax's leadership.

Our holding company cash after the $1.4 billion acquisitions of Zenith for cash was $1.4 billion as of June 30, 2010. Since the end of the quarter we raised 230 million Canadian in a 5% five year resalable preferred.

We continue to maintain a very strong financial position and have effectively refinanced 136 million bonds due in 2012 and $218 million OdysseyRe bond due in 2013.

Our first runoff acquisition in over five years is now subject to regulatory approval which is expected in August 2010. We are buying General Fidelity Insurance Company, a Bank of America subsidiary for approximately 350 million, which approximates book value, payable 100 million in cash from TIG, and approximately 250 million remainder by a non-interest bearing contingent note due in six years.

As of March 31, 2010, the investment portfolio of the acquired company was 616 million gross reserves were $334 million and reinsurance recoverable to a $19 million.

The acquisition is being made and paid for by our TIG runoff subsidiary. Our runoff group lead by Nick Bentley and his management team did almost six months of due diligence therefore we agreed to the purchase of General Fidelity.

Dennis Gibbs who led our runoff group before Nick reviewed this deal and blessed it. You will notice that we have very significant downside discussion on this runoff purchase and with some good fortune we will make a good return on the investment portfolios. We have looked at dozens of runoff opportunities in the past five years, and this is the first one that met our stringent criteria.

We have received the consent from the bondholders of the Crum & Forster and OdysseyRe to amend their indentures to provide certain financial estimation and financial statements in lieu of the reports they currently filed with the SEC. In both cases, we had to pay $10 for $1000 of principal to the bondholders' consent. We continued to be focused on simplifying our operations.

In response to the significant appreciation in equity market through 2009 and early 2010, and the economic uncertainty in the United States and Europe, we have increased our equity hedge ratio to approximately 93% of our equity (technical difficulty).

John Varnell

Hello, Prem, are you there?

Operator

Sir, we lost Prem. Reconnecting him right now. One moment.

John Varnell

Okay, thank you.

Operator

Sir, you're reconnected to the conference.

Prem Watsa

Yes, I'm sorry. So, in response to the (technical difficulty) in equity markets in 2009, and early 2010, the economic uncertainty in the U.S. (technical difficulty) our equity hedge ratio to approximately 93% of our equity exposure. The effect of this increase by entering into Russell 2000 and (technical difficulty) total return swap contracts, average index level of 646.5. This was in addition to the S&P 500. Russell's total return swap contracts we had done in September 2009 at an S&P 500 (technical difficulty). Now, I'll (technical difficulty) give you some information on the line financials, (technical difficulty). Thank you.

John Varnell

Thank you, Prem. Just as a reminder, our full second quarter result is available on our Website, www.fairfax.ca. Information is also available on SEDAR and on EDGAR. First, we'll talk about our Fairfax consolidated financial results for the second quarter, then we'll talk about operating company results, and finally we'll discuss our financial position.

So, starting with our second quarter financial results consolidated, the net earnings for Fairfax shareholders were $325 million in the second quarter. That compares to earnings of $275 million last year. Six month earnings were $615 million this year compared to $215 million last year

The second quarter fully diluted EPS was $15.49 compares to diluted EPS of $15.56 in the quarter last year. As Prem said, our book value per share ended the quarter at $382.70, which is down slightly from $383.83 at March 31, 2010.

The $382.70 book value is up from the $369.80 at year end that's up about 6.1% for the first six months. If you take into consideration the $10 a share of common dividend that we paid out in the first quarter.

The second quarter earnings were largely driven by two factors and the first is the underwriting result. We had a $13 million underwriting loss in the quarter compared to a $17 million underwriting profit last year.

Contributing to that underwriting loss where catastrophe losses on a pre-tax consolidated basis, net of reinstatement premiums of $37 million or about 3.4 combined ratio points which included the impact of Eastern European floods, U.S. Midwest storms and the Ontario tornado. We also had losses of $36 million from the Deepwater horizon loss and those are classified as non-catastrophe losses.

Our second quarter calendar year results, we had a combined ratio of 101.2 on a consolidated basis compared to 98.4 last year. Cat losses again $37 million of net losses on a pre-tax basis. The cat losses accounted for about 3.4 points of that combined ratio, and as a result our second quarter combined ratio, if you didn't excluded cat losses was about 97.9%.

And the Deepwater Horizon loss again $36 million or a similar combined ratio impact. Also note that for six months this year, the combined ratio was 106.3%, including 10.1 points related to catastrophe losses and last year the combined ratio was 98.5% impacted by 3.4 points related to cat.

On an accident year basis, looking at the impact on the results of prior period reserve development, we had about $25 million in reserve redundancies in the second quarter. That resulted in a benefit of about 2.3 combined ratio points in terms of favorable reserve development.

The result would be a second quarter accident year combined ratio this year of about 103.4% versus 98.9% last year. Now the 2010 accident year combined ratio excluding the cat losses would be about 100% and that would compare to 96.3% in the second quarter of '09.

For comparison purposes in the second quarter of 2009, we had about $28 million in cat losses or about 2.6% combined ratio points. The second major component of second quarter earnings was investment income. We had about $389 million of net investment gains pre-tax during the quarter, and we had strong quarterly interest and dividend income.

Two reasons for that. First, being the average portfolio size. Our average portfolio during the second quarter was about $22.5 billion compared to about $19 billion in the second quarter of 2009.

We also had the Zenith National investment portfolio, our latest acquisition added to our results for 41 days. For comparison in the first quarter of 2010, the average portfolio was just under $22 billion. So that significant year-over-year portfolio size increase accounted for most of the result. The interest and dividend income was a $196 million in the second quarter of 2010. It was the first quarter of 2010 interest and a $185 million was the comparable number in the second quarter of 2009.

The second factor impacting our results was our annualized portfolio yield. In the second quarter that yield on an annualized basis was 3.5% and in the second quarter of '09, the yield was 3.89%. The portfolio yield was a little change from the 3.55% in the first quarter. So, those changes basically reflect the interest rate trends that we've been seeing; short-term rates have dropped and we carried significant liquid short-term balances especially at the holding company level.

In terms of investment gains, we had a good quarter. We had $389 million in net investment gains in the second quarter. Last year we had gains of $330 million. The largest component of those $389 million in gains were net gains on equity and equity index total return swaps for $324 million and bond gains of a $109 million reduced by our losses on foreign currency. There was one other than temporary impairment charge of $8 million in the results for the second quarter of 2010.

I'll just note for you that we had net appreciation of available for sale bonds during the quarter of $137 million pre-tax or about $94 million after-tax and net depreciation of available for sale common stocks of $556 million pre-tax or $397 million after-tax during the second quarter. Again that didn't go through earnings, but it does work its way into book value through OCI.

Turning to operating company results starting with Odyssey whose underwriting results were quite solid for the quarter. In the second quarter of 2010, Odyssey had a combined ratio of 97.1% and an underwriting profit of $14 million. In the second quarter of 2009, Odyssey had a combined ratio of 96.5% and an underwriting profit of about $17 million.

The catastrophe losses for Odyssey just by comparison, Odyssey's cat losses pre-tax net to them second quarter 2010 were $17 million or just about 3.6 combined ratio points.

By comparison for the second quarter of '09, they had $14 million in cat losses and about 2.9 combined ratio points accounted for by those losses. There were no significant changes related to the Chile earthquake losses in this quarter and if you all remember, Chile was the big impact in the first quarter.

Odyssey's accident year for the second quarter 2010 combined was 95.5%. If you set aside the cat losses that Odyssey had, they were at a 91.9 combined ratio. In terms of premium volumes, Odyssey's net premium written decreased 8.3% this quarter compared to last year and that occurred as the net premium written in the Americas declined in the competitive casualty lines.

At Crum & Forster, the combined ratio was 106 in the second quarter. That compares to 102.4 a year ago. Crum had insignificant cat losses in both quarters and a favorable reserve development in the second quarter of 2010 that resulted in 2.9 combined ratio point improvement versus the 3.6 benefit from favorable development in the second quarter of 2009.

Our premium volumes are affecting Crum's combined ratio as we explained you in recent quarters. We did have lower earned premiums in the second quarter of 2010, and that translates into a higher expense ratio. On an accident year basis Crum's combined ratio was 108.9 and that compared to 105.9 in the year ago quarter.

In terms of premium volumes industry conditions in the U.S. commercial line markets are still tough, the weak economy continues to have a large impact and casualty pricing remains soft. At Crum we saw modest decrease in net premiums written of 2.3% in the quarter and they are starting to see some signs of stability in their premium volumes.

At Northbridge, Northbridge had a combined ratio of 107.3 in the quarter and that compared to 105 in the year ago quarter. The main difference was the impact of catastrophe losses in the quarter of six combined ratio points, principally from the Leamington, Ontario tornado and Midwest storms in the U.S. offset by favorable claim development in the second quarter of 2010 of 3.7 combined ratio points.

This compares to insignificant catastrophe losses in the second quarter of 2010 and half of a combined ratio of point of favorable claim development. As result the underlying accident year combined ratios are quite comparable for Northbridge; Q2 of 2010 is a 105.1 combined ratio, accident year basis, and the year ago is 105.7. Market conditions in Canada in commercial lines continue to be very challenging.

Premium volumes in Canadian dollars terms at Northbridge in terms of net premiums written declined about 1.2%. However in U.S. dollar terms you'll see that Northbridge's net premiums written showing in our quarterly report will show an increased by 12.8% and that is due entirely to foreign currency translation impact.

That continues to be reflective of the underwriting actions undertaken by Northbridge in these markets and the pricing discipline that they've been exercising in recent years.

In terms of investment income at Northbridge, we had a slight decrease in interest and dividend income to $32 million. We had strong investment gains of $100 million in a quarter and that resulted I increased pre-tax income of $114 million compared to $72 million last year.

Fairfax Asia, we've been reporting to you for a number of quarters profitable growth and Fairfax Asia continued this profitable growth in the second quarter of 2010. Their combined ratio was 94.5%. The growth in gross premium written was 23%, net premium written were flat, and the earns were up.

In our segment that we now call Other Reinsurance and Insurance, we renamed it to add the insurance because now it includes Fairfax Brazil, which began business in the first quarter when it was fully licensed, and it's writing commercial lines business in Brazil.

The segment's second quarter combined ratio was 91.8%. We also had combined ratios for Group Re of 100.1%, for Advent of 67%, and for Polish Re which was affected by the European floods had a combined ratio of 109%.

Now turning to our financial position starting with book value per share, Prem laid it out for you that it's $382.70 a share; that's after Fairfax paid a $10 a share dividend in the first quarter of 2009. Common shareholders' equity ended the quarter at $7.9 billion, preferred stock ended the quarter at $410 million.

In terms of financial leverage on June 22, we completed a public debt offering of Canadian $275 million of 10-year 7.25% unsecured senior notes, which increased our holding company debt to $1.45 billion at June 30.

As you can see on page #52 under capital structure and liquidity, the debt at the subsidiaries was essentially unchanged during the second quarter. The Zenith acquisition hardly affected our leverage ratios and capitalization. Our total debt to total capital ratio was 23.3% and that's compared to 23% at the year end.

We funded the May 20 acquisition of Zenith National Insurance primarily through a 200 million common share offering and from subsidiary dividends. The cash purchase consideration at closing was $1.3 billion. There is also a $100 million already owned of Zenith in the investment portfolios and so if you add those two together, the $1.3 billion plus the $100 million you'll get the $1.4 billion. You'll note that at quarter end Fairfax had holding company cash and securities of $1.4 billion.

And then during the month of July we received additional net proceeds from our 5-year 5% preferred Series G issue of CAD$242 million to leave us with significant liquidity at the holding company. Prem, that's it from my section of the report.

Prem Watsa
Thank you, John. Now, we are happy to answer your questions. Please give us your name, your company name, and try to limit your questions to only one, so that it's fair to all on the call. Shirley, we are ready for the questions.

Question and Answer

Operator

Thank you. (Operator instructions). Our first question comes from Jeff Fenwick. You may ask your question. Please state your company name.

Jeff Fenwick
Cormark

Hi, good morning. I'm Jeff Fenwick with Cormark. I guess my question is reading through your quarter here and the hedges that you've taken particularly the CPI derivatives, it's pretty clear that your view here is that we're likely facing a multiyear period of flat or even declining growth or negative growth?

When you look at the insurance business, I guess this is a sign maybe that you are anticipating multiple years of soft markets for the P&C business. I guess and that highlights seeing how much the volumes have tapered off here. Is there room in your insurance groups to further reduce the cost base there if you think that the volumes are going to remain depressed for multiple years?

Prem Watsa

That's a good question, Jeff. We continue look at cost savings, of course. As far as the cycle is concerned, Jeff, you never can tell when it will change. The insurance cycle is very tough to predict. We do know that most companies have an accident year combined ratio of 100% plus. We also know that interest rates are very low. So we think it's only a question of time before results will force companies to increase prices.

As far as the deflation protection or Consumer Price Index protection that's just a safety strategy from us. (inaudible) protect our portfolios and protect our company, but on the insurance cycle, it's a tough cycle as you say. You never can say when it'll change, but we are focused on keeping the underwriting profitability going and only writing good business.

Jeff Fenwick
Cormark

Just a comment maybe on those CPI derivatives, any color perhaps yourself or John can add around, just how liquid are those types of contracts and they're certainly very long-term. So any color on the counterparties there and then your ability to add or reduce those positions overtime?

Prem Watsa

Yes. So we've put a little more than a $180 million to the CPI linked derivative contracts. So obviously the maximum we can lose, we bought them for $180 million, and the maximum we can lose over 10 years is $180 million. The notional amount that we disclosed is about $23 billion and they fluctuate, Jeff. They fluctuate up and down and on a daily basis, it's difficult to determine, but it does give us significant amount of protection.

Jeff Fenwick
Cormark

And you're confident the counterparties you have there are able to stick around for the 10 years I guess through the life of those contracts and -

Prem Watsa

They are similar to the credit default swaps. The counterparties are very, very strong, and we already have been concerned about our counterparties. If there is money that's owed to us, it will have to be collateralized with government securities.

Jeff Fenwick
Cormark

Okay. Thank you very much.

Operator

(Operator instructions). Our next question comes from Mark Dwelle. You may ask your question. Please state your company name.

Mark Dwelle
RBC Capital Markets

Yes, good morning. Mark Dwelle with RBC Capital Markets. The main questions I had related to the acquisition that was done in TIG. I just wanted to get a little bit more detail in terms of what types of lines of business that I gathered it's acquired for purposes of runoff. Just sort of what lines or types of lines of business the company had been writing to try to get a sense of what the tail looks like on how long that might take to do a significant runoff?

Likewise, whether that business unit is writing any premiums or had been writing any premiums in, either this year or recently that there would be any follow through on unwritten premiums or premium revenue from here forward?

Prem Watsa

Yes. Mark, they're basically doing runoff now. They might have very small amount of earned premium. I think it's about $330 million, something in that area. Yes, five year perhaps, John, five years maybe half to three quarters of the investment portfolio was paid off and reserves will be paid off in that time period. That's why we assume that at the end of six years, the contingent note, the reserve development goes against the note. And then six years, we'll be able to find out the condition of reserves. John, would you like to add to that?

John Varnell

Yes, the duration will be a little shorter than that Prem, more in the three to five-year range. The books of business that were written were submarine, some transportation and some homebuilder.

Prem Watsa

So the book value, Mark is about $350 million. We have put a $100 million down, $250 million contingent note, and any reserve developments as John was saying in the next three or five years goes against the $230 million. We pay no interest unless the consumer prices go up very significantly.

We think as I said in our conference call, we have very significant downside protection and in terms of losing the $100 million, but at the same time we have the investment portfolio of $600 million that we expect overtime to do well for us. The fact is, we looked at many, many potential runoff acquisitions in the past. This one we think fits our criteria.

Mark Dwelle
RBC Capital Markets

Looks like a potentially pretty good deal. One last question, it looks that based on the estimated purchase price that that's going to be a bargain purchase. Will that be either a gain or a favorable amortization pick up in the numbers in third quarter or balance of the year?

Prem Watsa

No, I think the way we would do it is the contingent note of $230 million and you would know about reserve development until some time, and so we will just wait till the reserves to follow. We have to fair value it. When it closes, we'll have to look at the reserves and value them appropriately. So, perhaps some of the contingent notes will be used in the process, and we haven't got the numbers for the end of June yet, Mark, and so all of that will be based on June 30th figures.

Mark Dwelle

RBC Capital Markets

Fair enough. Thank you.

Prem Watsa

Thank you, Mark. Next question, Shirley.

Operator

At this time, I'm showing no further questions. (Operator instructions). One moment for our next question.

Prem Watsa

Any questions, Shirley?

Operator

At this time I'm showing no further questions.

Prem Watsa

Well, thanks, Shirley. There are no more questions. Thank you all for joining us on this call. We look forward to presenting to you again after the next quarter. Thank you.

Operator

Thank you. And this does conclude today's conference. We thank you for your participation. At this time, you may disconnect your lines.