S&P Capital IQ

CONTENTS

Markel Corporation NYSE:MKL

FQ2 2010 Earnings Call Transcripts

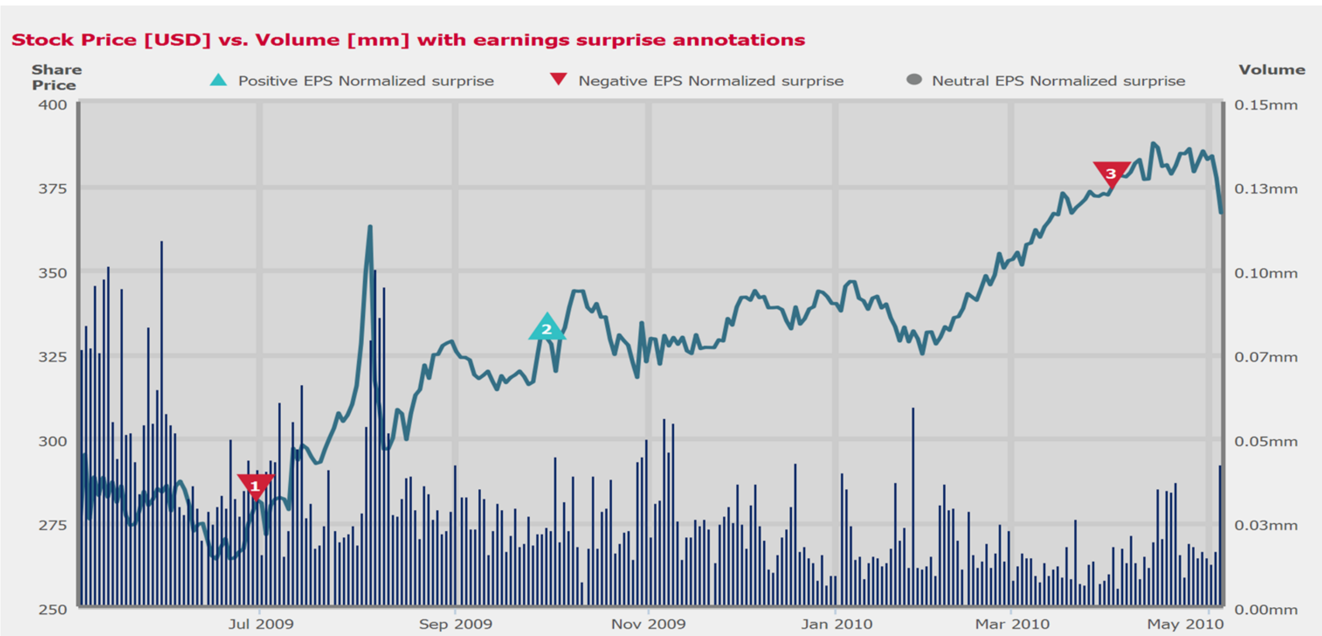
Monday, August 09, 2010 2:30 PM GMT

S&P Capital IQ Estimates

	-FQ2 2010-			-FQ3 2010-	-FY 2010-	-FY 2011-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	3.90	2.30	(41.03 %)	4.47	16.25	19.05
Revenue (mm)	537.83	515.41	(4.17 %)	535.97	2124.45	2196.05

Currency: USD

Consensus as of Aug-09-2010 12:41 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2009	5.03	4.36	(13.32 %)
FQ3 2009	4.44	7.78	75.23 %
FQ4 2009	4.65	-	-
FQ1 2010	4.73	3.23	(31.71 %)

Call Participants

EXECUTIVES

Anne G. Waleski
Chief Financial Officer and Executive Vice President

F. Crowley

Richard R. Whitt
Co-Chief Executive Officer and Director

Steven Andrew Markel
Vice Chairman

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

ANALYSTS

Amit Kumar
Macquarie Research

David McKinley West
Davenport & Company, LLC, Research Division

Elizabeth C. Malone
Wunderlich Securities Inc., Research Division

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Mark Hughes
SunTrust

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

Michael Steven Nannizzi
Oppenheimer & Co. Inc., Research Division

Presentation

Operator

Greetings, and welcome to the Markel Second Quarter 2010 Earnings Conference Call. [Operator Instructions] It is now my pleasure to introduce your host, Steve Markel, Vice Chairman for Markel. Thank you, Mr. Markel. You may begin.

Steven Andrew Markel
Vice Chairman

And thank you. I appreciate everybody joining the Markel Conference Call today. During our 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 statement and our most recent annual report on Form 10-K and on quarterly report, Form 10-Q. Our quarterly report, Form 10-Q, which is filed on our website at www.markelcorp.com, also provides a reconciliation to GAAP of certain non-GAAP financial measures, which we may be discussing in our call today.

The second quarter and six months of 2010 is off to a pretty good start. We're disappointed to report underwriting loss in the six-month period of time of 103%. Four points of this is related to the Chilean earthquake and the Deepwater Horizon oil rig loss. However, it's probably more important to note that pricing is still very, very weak in the property and casualty insurance sector. And we, as everybody else in the marketplace, is struggling to get appropriate levels of price increases.

The good news is that book value increased 3% at June 31 to $291.71 up from $282 at the end of the second quarter. Additionally, we have two other events that occurred in the quarter that I think are very important to note. First, we announced a couple of weeks ago, our agreement to purchase Aspen Holdings and FirstComp Insurance Group, which we hope will close in the fourth quarter of the year. Aspen and FirstComp write approximately $300 million of Specialty Workers' Compensation insurance through 9,000 retailers in 31 states. This transaction will significantly increase the size and scale and scope of our Specialty unit, where we market Specialty Insurance products to retail insurance partners. And we're hopeful, not only to expand our workers comp writings in more states and through other relationships within the Markel organization, but we're certainly hopeful to creating and delivering new and different Specialty Products to these 9,000 agents of Aspen. So we're very, very excited about that. I think it's going to be a very, very favorable move for Markel and creates a little bit of enthusiasm to do something new and exciting.

Additionally, in May, shortly after our shareholder's meeting, we announced some executive management changes. Richie Whitt, Tom Gayner and Mike Crowley became Co-Presidents of Markel. Additionally, Anne Waleski, was promoted to the Chief Financial Officer. So in today's call, our lineup will be slightly different. After -- well in that few seconds, I will introduce Anne Waleski, our Chief Financial Officer. She'll be followed by Richie Whitt, our new Co-President, to talk about operations, and Tom Gayner Co-President and Chief Investment Officer and President of Markel Ventures to talk about our investment activities. I'll follow it up to moderate the question-and-answer. Anne?

Anne G. Waleski
Chief Financial Officer and Executive Vice President

Thank you, Steve, and good morning, everyone. I will follow the same format that Richie has in past quarters. I will focus my comments primarily on year-to-date results. I'll start by discussing our underwriting operations, followed by a brief discussion of our investment results and bringing the two together with a discussion of our total results for the six months.

Moving right into the underwriting results, gross premium volume was up 1% at $1 billion for the first six months of 2010. Higher gross premium volume in the London Insurance Market segment, which was due in part to our acquisition of Elliott Special Risks in late 2009, which partially offset by continuing competition across many of our product lines, particularly within the Excess and Surplus Lines segment. Net written premium was also up slightly to the prior year at $900 million. Retentions were 89% compared to 90% on the prior year. Earned premiums decreased 9% compared to 2009 due to lower gross and net written premiums over the past several quarters. Our combined ratio was 102% for the first half of 2010 compared to 97% in 2009.

The 2010 current accident year loss ratio was 71% compared to 69% in 2009. The increase is due in part to losses from the Chilean earthquake and the Deepwater Horizon drilling rig explosion, which resulted in $33 million or four points of underwriting loss in the first six months of 2010. Favorable redundancies on prior year's loss reserve decreased to $75 million or nine points of favorable development compared to $94 million or 10 points of favorable development in 2009. The decrease was primarily due to less favorable development of prior year's losses in the London Insurance Market segment. Our 2010 expense ratio increased approximately two points to 40%. The increase in the expense ratio is primarily the result of lower earned premium and higher profiteering costs compared to the same period last year. Costs related to our One Markel systems project, also referred to as Atlas, represented approximately two points on a combined ratio in both period.

Turning to the investment results. Investment income was flat to 2009 at $133 million due to lower interest rates, which were offset by a larger portfolio. Realized gains were $13 million compared to $71 million of realized losses in 2009. The majority of the 2009 losses related to write-downs for other than temporary declines in the fair value of equity and fixed security. Unrealized gains increase $51 million before tax in 2010 due to increases in fixed income securities, partially offset by decreases in equity. Tom will go into further details in his comments. Looking at our total results in the first six months of 2010, we have reported net income to shareholders of $63 million compared to $49 million in 2009. As Steve mentioned, book value per share increased 3% to approximately $292 per share at June 30, 2010.

Turning to cash flows and balance sheet, I would like to make a few comments. Regarding cash flow, operating cash flow was $64 million in 2010 compared to operating cash flows of $115 million in 2009. In 2009, net cash provided by operating activities included the receipt of $34 million related to our 2008 federal income tax refund. Regarding the balance sheet, investments and cash held at the holding company were just under $940 million at June 30 as compared to a little more than $1 billion at the end of the year. The decrease from year end is primarily due to the holding company's fundings, stock repurchases and interest payments on debt.

At this point, I will turn it over to Richie to further discuss our operations.

Richard R. Whitt
Co-Chief Executive Officer and Director

Thanks, Anne, and good morning, everyone. I want to make a few comets this morning regarding our North American and international insurance operations. On future calls, Mike Crowley and I are going to share these duties. As Anne and Steve reported, we produced 132 combined ratio for the six months. While this does include four points of catastrophe losses even at a 98 combined, it really does not meet the return hurdles we desire. The markets in the U.S. and internationally remain extremely competitive. In addition, the weak economic recovery is adversely impacting demand for insurance products.

While the insurance market picture is a bit gloomy, we're extremely excited about the progress we're making in our businesses, and that's what really counts here. On the ENS side, One Markel continues make great progress, and we're closing the gap on premiums.

After being down 11% on gross written premium in the first quarter, Excess and Surplus Lines was down 5% in the second quarter. The combination of the One Markel platform increased marketing initiatives. New products and refresh products is having the desired impact. We're gaining momentum and believe that second half of the year is going to be strong for us.

Our Specialty Admitted segment continues to do well and they're holding their own against the competition. Market conditions are really no better here, but we're combating them with the relentless focus on sales and service. Just a quick example, our business development specialists have made almost

500 face-to-face agency calls in the first half of the year and that pace is going to continue for the rest of the year.

In addition, we're extremely excited, as Steve said, about our recently announced acquisition of Aspen Holdings, Inc. Aspen underwrites approximately $300 million of Workers' Compensation business in 31 states under the banner FirstComp. They focus on small accounts and low- to moderate-risk classes and service the heck out of this business with highly automated underwriting and policy issuance processes. We believe that the Markel brand and financial strength can help them to significantly grow the business, and we believe there are enormous cross-selling opportunities in both directions. Luke Yeransian has built a fantastic organization at Aspen, and we welcome them to the Markel family. As Steve said, we should have that transaction closed by the end of the year, hopefully, quite a bit earlier than just the end of the year.

Despite a six-month underwriting loss as a result of Chilean quake and the Deepwater Horizon loss, Markel International is having a solid year. Disasters like these are exactly why organizations purchase insurance, and neither of these losses were outside our risk management expectations. Risk premium volume was up about 8% in the first half of the year due to new product initiatives such as decline in trade credit and premiums from the 2009 acquisition of Elliott Special Risks coming online. Elliott is doing a fantastic job. We just completed taking on the majority, the great majority of the business that's written by Elliott. we're going to be putting reinsurance behind that business, and that's going to really help the premium volume in the second half of the year at Markel International.

We continue to look for international expansion opportunities, and we are going to be opening small offices in Hong Kong, Beijing and Barcelona before the end of the year. These represent long-term investments, and we don't really expect them to add meaningfully to volume in the near term. But as they say, over the long-term, they could be very significant for us.

To sum it up, it's a slugfest out in the insurance markets right now. But we're gaining momentum on the premium side, while maintaining our long-standing underwriting discipline. The insurance markets have been softening for over four years now. We believe that some of the more aggressive competitors and competitors with sub-optimal platforms are going to start running out of options soon. I can't and won't try to predict when the market will turn. But while we wait, we will continue to strengthen and build our operations and we'll be prepared to take full advantage of the turn when it happens. Thank you. And now I'll turn it over to Tom.

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

Thank you, Richard. Good morning, everyone. Thank you for joining us. My comments today will be brief. I'll speak for a moment about our results for the first half of the year and then talk about our investment gain plan for the second half and beyond. Additionally, as always, I will answer any questions you might have during the Q&A period.

During the first half, we earned a total return of 2% on the Investment portfolio. Equities were mildly negative at 0.9% compared to a 6.5% decline in the S&P 500, and fixed income was a positive 4.1%. This produced the total return for the portfolio of 3.1% in local currency. The foreign currency effect in the quarter was a negative 1.1%, and the product of all these factors equaled a 2% positive return for the portfolio. Those are the results.

More importantly, I'll now attempt to describe what we are doing forward. First, in fixed income, we remain committed to owning the highest credit quality instruments that we can find and keeping our duration at the shorter end of the four- to five-year range in which we operate. We're pleased with the returns we've earned in fixed income over the last few years, but we can do simple math. The prospective returns from today's low level of interest rates will not be as good in the next two years, as what they had been the recent past. If you're tuned into the financial markets these days, it seems like deflation is the headline story of our times. As is almost always the case, the genesis for the headlines is true. True, especially if you are looking in the rearview mirror of a recent hard data, as opposed to the unclear, unknowable and imprecise future. All across the globe, we've had persistent unemployment issues, the ongoing deleveraging of the economy, the increased savings rates and new labor pools from the developing world, which we are creating more in the way of global supply than demand. All of these factors create pressure on prices and worries about deflation. These facts and worries can be seen clearly in the low levels of inflation expectations and interest rates. I don't hear bond holders talking about things like the fact that Disney just raised the admission price and that tuition and medical bills among others continue to rise. A one-year treasury now offers a yield investors of approximately 0.3%. We can almost get 10x that if you commit money for 10 years since the 10-year yield is almost 3%. Neither one of those rates is acceptable for us.

The popular idea of investing in bonds today strikes me as about the same as the chance of Dow, 36,000 a decade ago. The arguments were well reasoned and seemed plausible that time. The whole market can make you believe some incredible things. Today, the multi-decade bull market has been in bonds, not equity. And I think that similar incredible ideas are out and about in the financial markets. I don't think that committing our capital for returns of roughly 3% is a good idea that will stand the test of time.

In 1904, the New York City subway system opened with a fare of $0.05. The fare stayed the same 44 years until 1948. Over the next 62 years, prices increased regularity and now stands at $2.15. Investing in long-term fixed income instruments at today's interest rates makes sense, if you think the coming decades will see the subway fare remain at $2.15 or thereabouts. Personally, I'll take the over bet and invest your capital reflecting this view. We're not interested in locking up our capital for such low nominal returns. We maintain the fixed income holdings we must to match and protect our policyholders. Beyond that, we keep cash in fixed income in order to have this option of investing differently, as market conditions change and different opportunities present themselves.

During the first half of the year, we exercised some of that option as we continued our steady incremental purchases of minority interest and publicly traded equity, and we expanded the operations of our majority interest in the Markel Ventures group. Despite the negative 0.9% performance in the first half, the market value of our equity holdings actually increased from $1.3 billion at year end to $1.4 billion at June 30. This represents 49% of shareholders' equity and still leaves plenty of room for us to continue to increase our equity holdings.

Markel Ventures completed two transactions during the second quarter. First, we acquired Solbern Manufacturing, a manufacturer of equipments in the foods processing industry. Secondly, we formed Markel/Eagle partners in conjunction with the Eagle organization. Eagle is a successful, multi-generation real estate company in Richmond, Virginia, and Markel/Eagle will pursue opportunities to acquire intellectual and financial capital in the world of distressed real estate. There's a big inventory for us to work on.

While these transactions are individually small, they represent an ongoing build-out and application of our traditional equity investment approach to majority on holdings. We remain involved in several discussions, and I would expect that we would complete additional acquisitions of majority-owned businesses over the course of the coming year. Currently, in the romantically named section of income statement called Other, you can see total revenues of $77 million for the first half of 2010 and expenses of $68 million. These operations are adding profit to the bottom line of Markel.

Today, the Markel Ventures companies are contributing as expected, and we expect ongoing additions to the portfolio. Our capital commitment in this area is slightly north of $100 million, and then companies are producing double-digit percentage cash flow returns as we expected.

For the rest of 2010 and beyond, we will continue to add incremental into our Public Equity portfolio. We see attractive purchase opportunities. There's a solid lift of attractively priced global franchise company that tend to pay dividend near the level of what we could earn on bonds. We'll get the capital appreciation and growth for free. Results of a good set of firms with demonstrated skills of outstanding capital allocation that we own and continue to buy.

At the same time, as Richard mentioned, there's ongoing pressure on insurance premiere volume. As such, we will remain appropriately conservative in our equity allocation. We have our foot on the gas pedal, not the brakes, and yes, sudden accelerators, we know the difference. We are moving forward with positive allocations and higher-yielding investments in public and private equities. It's just that we're driving forward inside a crowded garage. Aspen is joining and adding to our insurance operations. Richie and Steve spoke earlier and enthusiastically about the cross-selling and expansion opportunities that Aspen represents.

Our global insurance operations continue to grow and develop. We are continuing our ongoing operational and marketing initiatives in the U.S. Additionally, we expect to ultimately see a better economy and higher insurance rates. As each of those developments take place, we can continue to move out of the parking garage and head towards the clear highway, if not the autobahn.

Thank you, as always, for your interest in Markel, and I look forward to answering any questions you may have during the question-and-answer period. With that, let me turn it over to Steve.

Steven Andrew Markel
Vice Chairman
Thank you, Tom. As you all know, Markel's financial model is drawing consistent underwriting process and superior investment returns to build shareholder's value. While our six month's result fall short on the underwriting side, we are optimistic that in the balance of 2010, we can still achieve that long-term goal. The investment outlook that is the short-term investment outlook, as always, is very uncertain. However, we continue to be optimistic about our ability to earn solid, long-term returns by investing in quality businesses, both public and private. With that, operator, I'd like to open the floor to questions.

Question and Answer

Operator

[Operator Instructions] Our first question is coming from the line of Amit Kumar with Macquarie bank.

Amit Kumar
Macquarie Research

Just starting with Aspen Holdings, I guess, three quick questions. First of all, you talked about a $300 million top line number. What sort of the number do you expect to renew or keep on your books going forward?

Steven Andrew Markel
Vice Chairman

Currently, Aspen's business is a mix of businesses they retained in their own insurance company and businesses they placed with other insurance companies. The transaction probably will not close until some time in the fourth quarter. So clearly, the impact in 2010 is virtually nothing, very, very small. We will, however, start participating in some of their business as soon as we can. We've achieved -- we had fillings in a number of the states that we will be able to start participating actually in the business probably before closing. But it will, obviously, in 2011, be something less than that $300 million. The workers' comp market is also very competitive. And Aspen, not unlike the rest of the market organization, has a clear mission of earning underwriting profits. So from our perspective, it's not about the volume, but it's about pricing the business in order to make and earn right profits. So that $300 million could be something less when we're looking to 2011 and certainly, will be as it relates what goes through Markel's books. In terms of earned premium, there's also a bit of a lag a when we provide the policy in January. We earn in around over the period. So even if we wrote the full $300 million, which we're not going to do, in 2011, the impact on earned premiums would be substantially less that. So it's really part of a longer-term strategy that we'll pay dividend hopefully in the long run. But in terms of the model for 2010, 2011, it's not going to move the needle in a huge manner.

F. Crowley

I think FirstComp, their carriers' keeping, I think, roughly $120 million of it today. We, obviously, will want to try to increase that. And so I think, probably at the top end, we could get the $200 million of it, assuming it stays at the $300 million in 2011.

Amit Kumar
Macquarie Research

Just a related question, $135 million is what you're paying upfront. Now there's a contingent value component, which would either depending on Aspen's loss reserve and profit commissions and there's an outstanding option to buy shares. What would that number add up to in terms of best case scenario?

Steven Andrew Markel
Vice Chairman

It's really unknowable at this point in time. I don't think it's -- Richard, it's really not the top side of it certainly not on the topside. Theoretically, if you results to zero, the number would be a very large number. But obviously, that's not going to happen.

Richard R. Whitt
Co-Chief Executive Officer and Director

I think the number that is sort of pegged on in terms of their 12/31 2009 balance sheet would be roughly $47 million. If that balance sheet were ultimately to prove out to be exactly the numbers they had booked, I think it would be roughly $47 million. To the extent that balance sheet improves, the number can go up. To the extent the balance sheet proves to have some deficiencies, and then the number would come down.

Steven Andrew Markel
Vice Chairman

When we close, we will be doing an actuarial evaluation of the loss reserves. And for Markel books at the date of closing, we will need to make an assessment of our view of those loss reserves. And when we do that, that number will have some more clarity. And I think that's probably the best way to think about it in...

Amit Kumar
Macquarie Research

Just one question on the reserve development and I will requeue. In the 10-Q, you talked about Italian med mal and construction professional in Australia, I presume this is the same Med Mal business, which some of the other companies in Specialty space, they also had adverse development. Is this the same book, which a lot of other companies are facing issues? Or is this a separate issue, which you might be facing?

Richard R. Whitt
Co-Chief Executive Officer and Director

No, this is actually a different book. This is Italian medical malpractice. It was business we wrote in 2007 and 2008. We went into that market and did a lot of work on the market. So we went in, feeling like we had a pretty good handle on what we were writing at Italian hospitals. And we canceled the program, ended the program fairly quickly but we're still seeing development from that program. So we've been out of that business since the beginning of 2009. But we're still seeing some development from it.

Amit Kumar
Macquarie Research

And does this relate to a GPA?

Richard R. Whitt
Co-Chief Executive Officer and Director

This is business we wrote through our Lloyd's syndicate. So it's Markel International business written through the Lloyd's syndicate medical malpractice business. So one thing, probably, let's just makes sure, our U.S. medical malpractice book, obviously that book is -- it was very profitable at the top of the hard market. A lot of people have realized that and driven the rates down considerably, certainly, from the peak in the U.S. But we're still doing very well on our U.S. medical malpractice book, and that book continues going forward. The book that we are talking about, the med mal that we're talking about in the 10-Q is that Italian program that we canceled at the end of 2008.

Amit Kumar
Macquarie Research

So this is the same book, which, I think, American Financial Group and Argo were also talking about?

Richard R. Whitt
Co-Chief Executive Officer and Director

That, I do not know. I haven't looked at their releases.

Amit Kumar
Macquarie Research

Just on the topic of adverse development, on the E&O book regarding the mortgage services, I think the number now is $34.1 million. You talk about one program. Do you think that this additional adverse development in Q2 like get closure to this issue or is it still developing?

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

I wish I could say it and put a closure to it. We felt like we had a reasonable handle on the mortgage E&O book last quarter, and we had our projection in terms of how many claims we would see as we went forward. And honestly, we've seen more claims than we would have expected at this point from the 2007 and 2008 accident year. We have looked at it pretty hard. We've put up our very best number. But I can't say at this point that we're absolutely certain. You're never certain on loss reserves. But we approached this just like we do everything else, which is to be more likely redundant than deficient. But it is the program that we no longer write. It is coming out of what was sort of, obviously, a mortgage bubble. And so it has proven more difficult to get our hands around it than maybe some of our more standard programs.

Operator

Our next question is from the line of Beth Malone with Wunderlich Securities.

Elizabeth C. Malone
Wunderlich Securities Inc., Research Division

The decision to acquire a workers' comp company is a little bit of a deviation from what you all historic position is then on workers comp. And I wonder, is this part of the strategy to increase your Admitted business and that part of Markel?

Steven Andrew Markel
Vice Chairman

I think the answer to that is simply, yes. We've been talking for the last -- for a long period of time, about the three different businesses and our recent reorganization that's been focused on the International business, Markel Specialty, which is the Retail business and the Markel One, which is really our Wholesale business. And we reorganized all of our Wholesale businesses into the five regions. That was really putting all of our Wholesale businesses together under one banner. And really, at the same time, we've talked about the desire to start putting an equal amount of focus and emphasis on the Markel Specialty businesses, which specialty products that we can market through the retail channel. And so absolutely, we want to build that business and think that the future opportunities for Markel in that space. We historically shied away from workers' comp because broadly speaking, workers' comp is, in fact, a commodity product and it's highly regulated by the states and those are attributes that has made us somewhat fearful of getting too involved in workers' comp. While we're so excited about Aspen and FirstComp, is that they've carved out of Specialty Workers Comp market by focusing on small accounts with small agents in small rural communities. And it's a platform that is web-based, excellent technology to enable the small agents in the small towns to get prices quickly and easily on the internet connections to the service at Aspen. It's a unique niche within the Workers' Comp business that, we believe, is going to be pretty powerful for Markel going forward.

Elizabeth C. Malone
Wunderlich Securities Inc., Research Division

Did you anticipate that there's going to be cross-selling opportunities with the ENS book that you have that often in the smaller businesses?

Steven Andrew Markel
Vice Chairman

ENS is the wrong label to use on that. But there's certainly a lot of Specialty Admitted products that can be marketed for those resources. We're writing children's summer camps today across the country through and have worker retail agents. There are 9,000 new agents that we could offer their product to. So the answer is yes. But not in -- the Excess and Surplus, by the nature of that term, that is primarily a wholesale product.

Elizabeth C. Malone

Wunderlich Securities Inc., Research Division

And then on the Deepwater Horizon loss, has this changed your strategy towards the energy market? Or what kind of risks are you going to take or change your reinsurance position?

Steven Andrew Markel
Vice Chairman

Absolutely not, in fact, the reverse. I think we're seeing more and more opportunities in that sector and that's one of the very, very few places that we were able to get appropriate prices for the risks.

Richard R. Whitt
Co-Chief Executive Officer and Director

That's actually a hard market right now. The only hard market I'm aware of is in marine, energy and liability. And the loss, as I've said, with inside of our, sort of, risk management expectations and so, we continue to write in that market and are very comfortable writing in that market.

Elizabeth C. Malone
Wunderlich Securities Inc., Research Division

And then finally on the financial, it looked like financial D&O-type risks. I guess this is international, there was some -- I was a little confused by the filing in that. There were some business that you saw favorable development and some business that you saw unfavorable. I don't know if I have that right, but can you talk about where you see the financial markets? I think it's in the international sector.

Steven Andrew Markel
Vice Chairman

Well, I think maybe -- I don't have it right in front of me, but the places we saw development in the first half of the year in international was, as we've talked about was a meet with the Italian medical malpractice, and I don't know if that was the same thing that was going on with some of the other companies out there, but it was medical malpractice, but a different market, the Italian market, where we saw some development. We also had Australian construction, where we saw a little bit of development and we're not writing Australian accounts now. So I think that will resolve some of those issues going forward. D&O, in some of the other areas in our Professional Liability business and International have performed very well for us. Just like everything else, pricing is tough in all of those lines, but we still see good results coming out of our professionals as D&O and miscellaneous E&O on the International side. So that helped offset some of the poor development or poor results we saw out of the construction in the med mal.

Operator

Our next question is from the line of Mark Hughes with SunTrust Robinson.

Mark Hughes
SunTrust

Does the Aspen transaction suggest a more optimistic view about workers' comp in, I guess, the macro sense?

Steven Andrew Markel
Vice Chairman

No, I mean I don't know that I think workers' comp, by itself, is a great place to be. But I do think there's a huge market and this is -- we've looked for Specialty areas within the comp market, a number of times, and I think there are several. This is one that we've been able to react to. But broadly speaking, if you're asking me, do I think I want to compete in the workers' comp market with the standard carriers and the standard business, the big risk and the like, I'd say, "No." But, yes, I think this is a unique, this is the first time we found one that was actionable that was able to put up in a Specialty area of that marketplace, and it's Specialty because it's small accounts through small agents in small towns and it's a fairly limited number of the business plans. We're not writing roofers and a lot of classes were people exposed to the more severe workers' comp losses. Now, everybody unfortunately is exposed to bad losses in workers' comp, but these are the more tamed classes in the field. But it does gives us now a base of knowledge, and hopefully, we'll find a number of other specialties in the comp arena. So it is a big market, I don't have the total U.S. premiums at the tip of my tongue, but I think it's a plus or minus, somewhere between $25 billion and $30 billion. It's been down a lot the last couple of years, because of course, the comp premiums are a function of payroll. And pricing has been depressed for the last couple of years. So it's not necessarily the best time to generically say, "Let's jump into the comp market." And we will be very, very cautious as we move into it, but there are some specialty niches in that area and we look to find them.

Mark Hughes
SunTrust

In terms of timing on any kind of turn in pricing, you don't have a particular view on that?

Steven Andrew Markel
Vice Chairman

No, I wish I did. The investment world, as Tom was talking about it, one of the historic problems of comp, it's a very long-tail business. And when interest rates were higher, there were hundreds and hundreds of companies willing to write comps at 120% combined ratio to capture the investment leverage. That investment leverage isn't worth a whole lot today. And it's a scenario that there is medical inflation, and it seems that, that's continuing, composite the forefront of medical costs still going up. There's a lot of things that one should be very, very cautious about, about workers' comp.

Mark Hughes
SunTrust

Is the Surplus business, new products, new marketing initiatives, I think you've suggested that the second half would be good for you. Is it possible that we see positive results in terms of gross premium in the second half?

Richard R. Whitt
Co-Chief Executive Officer and Director

That's certainly our goal. We would like to see -- we were down 11, down 5. We'd like that to turn positive before the end of the year and talking with all our folks out in the field, I said it's a brutal market out there, but our guys are really excited about the opportunities that they see, the new products that we've put out there, the enhancements and products we've given them. And they feel like the clients are taking notice are looking for ways to do business with us. SO we certainly would love to see it be up by the end of the year, and that's the goal.

Steven Andrew Markel
Vice Chairman

We do also have the, sort of, the wind is starting to get to our back with regard to our, sort of, internal reorganization. We're continually improving on our service levels as we've conquered e various problems of our One MarkelRe organization. So that probably caused some headwinds over the last year for Markel. But the other factor, the pricing and our price discipline, as well as the soft economy, are certainly headwinds and whether our service and our new products can overcome that is a bit of a speculation.

Richard R. Whitt
Co-Chief Executive Officer and Director

I will say our people are optimistic, and they know that it's underwriting profits versus Markel, but I'd love to see the optimism that they're showing and the enthusiasm they're showing with everything that we've done. I think they feel it. I think our producers are starting to see the power of the model we've put in place. And as Steve said, we've fixed a lot of the service issues we had initially. I think our service levels are, at least, back to where we were before. And hopefully, we're charting new ground in terms of service levels from where we were. So we're pretty optimistic for the second half of the year, but we're not kidding anybody, it's the same market we've been dealing with.

Steven Andrew Markel
Vice Chairman

More importantly, Mark, we will be a survivor. We'll be one of the company that's successful over the next five and 10 and 15 years. The insurance industry is, historically, had a reasonably high fall-out ratio and the number of companies have disappeared over the last five, 10, 15, 20 years is not immaterial. And we will be one of the survivors and one of the successful ones for the long term, but we can't tell what will happen in the next months.

Operator

[Operator Instructions] Our next question is from the line of Michael Nannizzi with Oppenheimer.

Michael Steven Nannizzi
Oppenheimer & Co. Inc., Research Division

First off, for Tom. In the second quarter, it looks like book value or AOCIs had about a $5 reduction. Can you, kind of, just talk about what happened during the second quarter and what drove that change?

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

First, you'll have to remind me what AOCI is...

Michael Steven Nannizzi
Oppenheimer & Co. Inc., Research Division

I'm sorry. Accumulated...

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

Other comprehensive income. Obviously, the equity markets were soft during the quarter. So during the year, I talked about that we were down 0.9%, but we were up about 9% in the first quarter from a down about, in the shade more than 9% in the second quarter. And I think that accounts for the bulk of the AOCI, which you described.

Michael Steven Nannizzi
Oppenheimer & Co. Inc., Research Division

And so was any of that related to -- I imagine most fixed income security is marked up because of the yield environments?

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

Interest rates were down. We didn't have any credit problems.

Michael Steven Nannizzi
Oppenheimer & Co. Inc., Research Division

Just one question about the acquisition, if I could. I think, maybe, Steve, you might have said it before if I missed it was, what is the notional book value of Aspen? And can we just get an understanding of what the balance sheet looks like a little bit?

Steven Andrew Markel
Vice Chairman

I think the best way to respond to that is just to ask you to wait until we close because at closing, we will have a comprehensive review of the loss reserves and the contingent commissions that I'll refer to in that contingent value right agreement, and it will enable us to put out some numbers that makes some sense. Aspen has previously been a privately owned business. They do have a number of shareholders, but basically not in a publicly traded business. And the financial statements that were audited were back in December 31. And to some extent, the numbers are moving targeted as the year progresses. I think we believe though that, fundamentally, the book of business is going to earn an underwriting profit for Markel. And it sounded like the loss reserves and the balance sheet that we put on our books when we closed will be conservatively stated.

Michael Steven Nannizzi
Oppenheimer & Co. Inc., Research Division

And just on the strategy, the purchase, within Specialty, did you extract to be writing then more bundled policies, like Small business, bundled [ph] policies and filling out the product assortment that way? Or just, kind of, step one, just the initial cross-sell maybe, a general liability program or something of that nature? Or is the first step more the other way, where you start with your legacy policy holders and look to sell them comp through Aspen?

Richard R. Whitt
Co-Chief Executive Officer and Director

I think step one is continue to grow Aspen and the business that they write today. They are only in 31 states. There's still some states out there that are on their wish list, and so, we certainly want to make sure we support them and help them grow the existing book. And then we believe we can take some of our Specialty Admitted products to those 9,000 agents that Steve talked about. So that's probably step two, after we make sure we're helping them grow their book. Finally, we, on the Specialty Admitted side, we write package policies. The only piece we don't have today is the workers' comp piece. So bringing that comp piece over to our day cares and our child, our summer camps, all those sorts of things makes a lot of sense. And that's probably step three. That's the order we'll approach it in. And it'll take a little while to get to step two and three because we want to make sure we're supporting the Aspen folks in growing their business organically.

Michael Steven Nannizzi
Oppenheimer & Co. Inc., Research Division

Just on expenses, it looked like just from our first here look that, expenses, the expense ratio is a little bit higher. I guess part of that is due to the top line, maybe, and also within the ENS segments, the One Markel initiative. Can you talk about how you think about that run rate expense within the ENS segment? And also, within Lloyd's, for example, where it's a little bit higher? And then also, within Specialty and how Aspen might impact them?

Richard R. Whitt
Co-Chief Executive Officer and Director

In terms of the expense ratio in Markel International this quarter, you have to be a little careful with that. We had over $10 million of reinsurance reinstatement premiums that are fully earned in the quarter as a result of the Deepwater Horizon loss, and so that pumps up the expense ratio. And if you bring it down to a more normalized level, I'm going to say 37%, 38%, does that sound about right, guys? So that's throwing things off on the International side. In terms of the U.S. side of the business, we've got pretty full bonus accruals up at the moment. However, obviously, we haven't had a stellar first half of the year, but we don't really dig in to bonus accruals until we get to the third quarter because that's really when we're going to have a good idea of how the year's going to, within reason, where the year's going to land. So if we don't start making progress towards the sub-100 territory, some of those bonus accruals are going to come down, obviously. If we have a strong second half of the year, then they'll stay in there. But I think this year compared to last year, we're a little heavier on bonus accruals, but that could easily turn around if we don't start seeing a solid second half.

Michael Steven Nannizzi
Oppenheimer & Co. Inc., Research Division

And then the One Markel, each within E&S, I think you said two points. I mean, is that expectation that will likely continue?

Richard R. Whitt
Co-Chief Executive Officer and Director

Yes, that's probably a pretty good run rate for the rest of the year.

Operator

Our next question is coming from the line of Jay Cohen of Bank of America.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

In the Q, you talked about going into, I guess, some sort of mediation with guaranteed bank. I was wondering, as you look at this relationship, what the chances are this will result in some, sort of, charge to resolve this?

Richard R. Whitt
Co-Chief Executive Officer and Director

All I can say on that, Jay, is obviously, we've had the contingency disclosure for several quarters now. We have started discussions with Guaranty, which of course, is positive that we're talking. And we have reserved -- just like everything else we do at Markel, we try to be more likely redundant than deficient. I don't think I can really say much more about that at this point, given, kind of, where we are with that.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Second question, with Aspen, in the past, when you've made acquisitions, you didn't pay up for them and you bought companies that had some underwriting issues and you were able to fix them, partly through shrinking the business. Would you characterize Aspen that way? In fact, if you could just talk about what the combined ratio has been for that business?

Steven Andrew Markel
Vice Chairman

No, Aspen is very, very definitely not a picker-upper and not in this file of companies that's been distressed than any form or fashion. Aspen has been growing, up until the last couple of years, it was growing very, very rapidly. In the last couple of years, the underwriting discipline has caused the premium volume to actually decline a bit. But in terms of their desire, their increase in retaining the business that they're writing has continued to be growing. And to some extent, because it was privately owned and a head, I think, a couple of rounds of some private equity financing, but didn't have as much capital as it could use to build and grow the workers' comp. It was both the underwriting manager and an underwriter and an underwriting manager has to live and die on commission. And I think they haven't had some choices. One that they could continue to raise money in the private markets and could continue slowly and gradually evolve from an underwriting manager to an underwriter, or another more important with Markel and get the benefits of leveraging our resources as well as some of the cross marketing opportunities. But they had been recording on very, very significant underwriting profits for pretty much their whole history. I mean, it has the occasional state that it was ill-advised or something went wrong in and there was not a perfect record by any stretch of the imagination, but it's very, very strong.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

And with Aspen, what's the exposure to California?

Steven Andrew Markel
Vice Chairman

About half of that business is California. And as they've been recording in the past, a respectable results in California, and they've been achieving significant rate increases as well in the last couple of years. One of the difficulties in why there is a contingent value aspect of this transaction is that the book is not your

20-year season. In some states, it's only three or four years old, in other states, it might be 10 years old. But the book of business, as you know, workers' comp is a fairly long-tail business and there's some uncertainty about what the ultimate reserves would be. Both of us, both Aspen and Markel believe that the business is possible. I think it's fair to say Aspen believes it's more profitable than we do. Therefore, the difference of opinion that will be resolved through this contingent value agreement. But part of that is not knowing with precision that the small and rural and class of business they write necessarily, is much better than the average comp. And so if you look at loss development triangles for comp, in general, it's not at all that easy to pick it out for a book of business that's exactly near as Aspen's underwriting style, which is smaller campus, small towns. And so, we'll, over time, learn that and ultimately, the shareholders of Aspen will receive the appropriate compensation for their shares.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Was there any spillover in the second quarter from the Chilean quake?

Richard R. Whitt
Co-Chief Executive Officer and Director

No, those numbers have been held pretty solid.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

When you talk about the quarterly results, you obviously tend to focus on, in this case, the first half. As a user of your financial statements, for me, and I assume it's with others, I would prefer to hear more comments on the quarter itself, which for us is the, kind of, the new information, just again a commentary, do with what you'd like.

Operator

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

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

I think, Rich, you commented that, I think I heard you to say that more of the Elliott Special Risks premiums were going to be coming over on to Markel International's books over the second half of the year. Is that correct?

Richard R. Whitt
Co-Chief Executive Officer and Director

We, obviously, purchased Elliott in order to underwrite almost all of the business that they were producing. And the various agreements they had with previous markets, the last of those, came up in July. So as of the 1st of July, we are retaining virtually all of that business, and then we bought reinsurance where necessary behind that business. So in the second half of the year, the Elliott business should pick up substantially.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

And then by way of just thinking about that, I mean I know, historically, you usually retain a pretty high proportion of your risks. As far as where you're reinsuring that, is it significantly below your overall average, or maybe say it the other way, you're retaining less than your overall average?

Richard R. Whitt
Co-Chief Executive Officer and Director

Retention should look pretty similar to our overall book on that business.

Mark Alan Dwelle

RBC Capital Markets, LLC, Research Division

What, sort of, lines will be picked up as a result?

Richard R. Whitt
Co-Chief Executive Officer and Director

Policy limits you mean or...

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

No, I just mean, in terms of lines of business?

Richard R. Whitt
Co-Chief Executive Officer and Director

It's Professional Liability business. So it's a lot of Airs and Emission business. Some products Liability and Umbrella business, so it's the kind of stock we really liked.

Operator

Our next question is from the line of Meyer Shields with Stifel, Nicolaus.

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

Is there any reinsurance projection against adverse development on Aspen's reserves or is it just in terms of the hoping they're paying [ph] average price?

Steven Andrew Markel
Vice Chairman

Aspen has a meaningful amount of its own reinsurance and it's been a participant in somewhat of a pool. And so they've had other companies writing the business in certain states and they act as a reinsurer and the same company participates in the reinsurance behind them. And so over the years, Aspen has had a number of reinsurance treaties to protect them. And going forward, after the acquisition, between now and the acquisition, Markel will start participating in some of those pools. And then after the acquisition, and as we evolve, and more and more of the business obviously, will become written on Markel paper, and we'll own the first comp paper that's been used and we'll structure the reinsurance over time, as it makes sense for Markel.

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

But no policy particularly focused on the...

Steven Andrew Markel
Vice Chairman

We didn't buy a special coverage for that. However, the shareholders of Aspen are receiving a contingent value. Note, that will reflect the ultimate development as it relates to the reserves.

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

On a related note, NCCI has a theory that during recessions, Workers' Compensation business is more profitable because the people are most likely to get injured, tend to lose their jobs early in the recession? Can you talk about that with regard to high-hazard classes? I know you described Aspen is basically being low hazard, I was wondering whether that sort of trend shows up at all?

Steven Andrew Markel
Vice Chairman

I'm not an expert on that. Any comment I make is purely an opinion and not seeped in a lot of fact. But Aspen's business, as you point out, is not a high-hazard classes. I think there is some validity that in recession, and if people are worried about their jobs and they have an injury and they can keep their jobs, they're less likely to report a claim so that they can keep the job. Likewise, if someone has an injury and gets laid off and can't get another job, I think that claim is more likely than not to get worse. And what the balance of power between those two forces is, at any point in time, I don't know the answer to that. I think the biggest impact on the comp market over the last several years has been the fact that payrolls are down a whole lot. And therefore, the number of employees at work is down, and the frequency is down because the number of employees are down.

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

On a related note, I know AON's been talking about retaining all the wholesale risks and running it through AON offices in London, rather than sending it to third-party wholesalers. Is that affecting new business submissions for Markel at all?

Richard R. Whitt
Co-Chief Executive Officer and Director

We clearly heard about all that. I don't think it has a particularly huge impact on us and we'll see if they're able to accomplish it. But I sensed there was more revenue sharing between the U.S. and London and all those sorts of things. You get into some interesting politics around those sorts of things sometimes. But I think in terms of the markets, in terms of the carriers, I haven't seen how it's going to affect us.

Operator

Our next question is from David West with Davenport & Company.

David McKinley West
Davenport & Company, LLC, Research Division

Following up on the expense ratio question, I think Anne and her comments on the 10-Q, you mentioned profit-sharing accruals, could you put some dollar figure around that?

Anne G. Waleski
Chief Financial Officer and Executive Vice President

I'm not sure I have the dollar figure, David. We did make some reductions to the profit sharing provisions in the second quarter of '09. So that's where some of the variance in the current period is coming from.

Richard R. Whitt
Co-Chief Executive Officer and Director

Dave, we might catch you offline and help you out with that.

David McKinley West
Davenport & Company, LLC, Research Division

One other question, you got the new credit facility in place this quarter, $270 million. You mentioned that under certain terms and conditions, you can't increase that $350 million. Could you outline what those terms and conditions are?

Richard R. Whitt
Co-Chief Executive Officer and Director

I think it just has a typical accordion feature in it that we can increase -- we can bring additional banks to increase the $350 million. I don't think there's anything particularly onerous in terms of terms and conditions to do that. It just gave us a little flexibility.

David McKinley West
Davenport & Company, LLC, Research Division

To correlate to that, when you do the Aspen deal, do you probably intend to tap that line of credit? Or you look like you have pretty ample balance sheet liquidity. Would you tend to use cash on hand?

Anne G. Waleski
Chief Financial Officer and Executive Vice President

The current plan is to use cash on hand at the company.

Operator

Our next question is a follow-up from the line of Amit Kumar from Macquarie.

Amit Kumar
Macquarie Research

On Aspen, first of all, this deal was announced on July 12. I'm wondering, did your actuaries look at the '09 schedule piece or did they look at the six months 2010 loss triangles?

Steven Andrew Markel
Vice Chairman

All of the above.

Amit Kumar
Macquarie Research

What was their view? Did they feel that they were -- like there was a good cushion, were they at a midpoint? Can you just give us some more comfort? I guess what I'm trying to ask is if you look at some of the other comp companies, recently, that have added to reserves in Q2, they talk about this phenomenon of medical costs, which is being stretched because people are unemployed and they're not going back. I'm just trying to get some comfort that the same issues won't show up at first comp. That would be very helpful.

Steven Andrew Markel
Vice Chairman

I think the answer is that the issues could very well show up at first comp. We do not believe they will, but it's Workers' Comp business. And what we have done is taken what we think is a measure of look at the classes of business of state they're writing in, the historical development, the way they handle the claims. We've looked at them to do the claims styles. We've done all of the normal due-diligence thing. And as we know very well, in doing due diligence on another company, there is no way to do it perfectly and what we don't know, unfortunately, we won't know until we do know it. And that's just the fact of life. In doing the purchase, we've structured the purchase price at a contingent value agreement so that there's a very significant bridge between conservative and optimistic view of loss reserves and some other balance sheet items, related to Aspen's balance sheet. From our perspective, the much, much more important issue is our assessment about our ability to make underwriting profits on a going-forward basis. And we believe very strongly that in this small business market with small agents and small towns, that we will with Aspen's platform, be able to write workers' compensation as an underwriting profit.

Amit Kumar
Macquarie Research

Aspen has roughly 550 employees. Do you expect to retain all of those or there could be some changes on the expense side from them?

Steven Andrew Markel
Vice Chairman

I don't think there'll be any changes because of our acquisition of Aspen. In fact, if we're successful in building out new states and expanding Aspen's business, that number, possibly, can and should increase. We, currently, do know workers' compensation. And so, in terms of skill sets and underwriting, in terms of the claims handling, in terms of the processing of this business, there are very, very few opportunities for integration of operations. Clearly, when it comes to capital allocation and investments and some other core functions, cash management, we'll certainly seek to find some efficiencies and operations, but it's certainly not going to impact a meaningful number of people. And to the extent that there are overlaps, my guess is that we'll find, very, very good uses for those people. So in terms of the employment account, the transaction, by itself, will not generate any headcount reductions.

Operator

Our final question today is a follow-up from the line of Jay Cohen of Bank of America.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

On the Markel International business, can you give us a sense if currency impacted the premium growth in the quarter?

Richard R. Whitt
Co-Chief Executive Officer and Director

I think it's actually -- the headline number, I think we were up 10%. And if you took out currency, we were up 8%, and that was for the six months. Jay, we can give it to you for the quarter, but I think it benefited us two points for the six months, 10 versus eight.

Operator

There are no further questions at this time. I would now like to turn the floor back over to management for closing comments.

Steven Andrew Markel
Vice Chairman

Thanks very much. I'd like to thank all of you for your participation in today's call. And as always, if you have any further questions or comments, don't hesitate to give us a call and thank you very, very much for your loyal support of Markel. Have a great day.

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