S&P Global
Market Intelligence

Intact Financial Corporation TSX:IFC

FQ3 2018 Earnings Call Transcripts

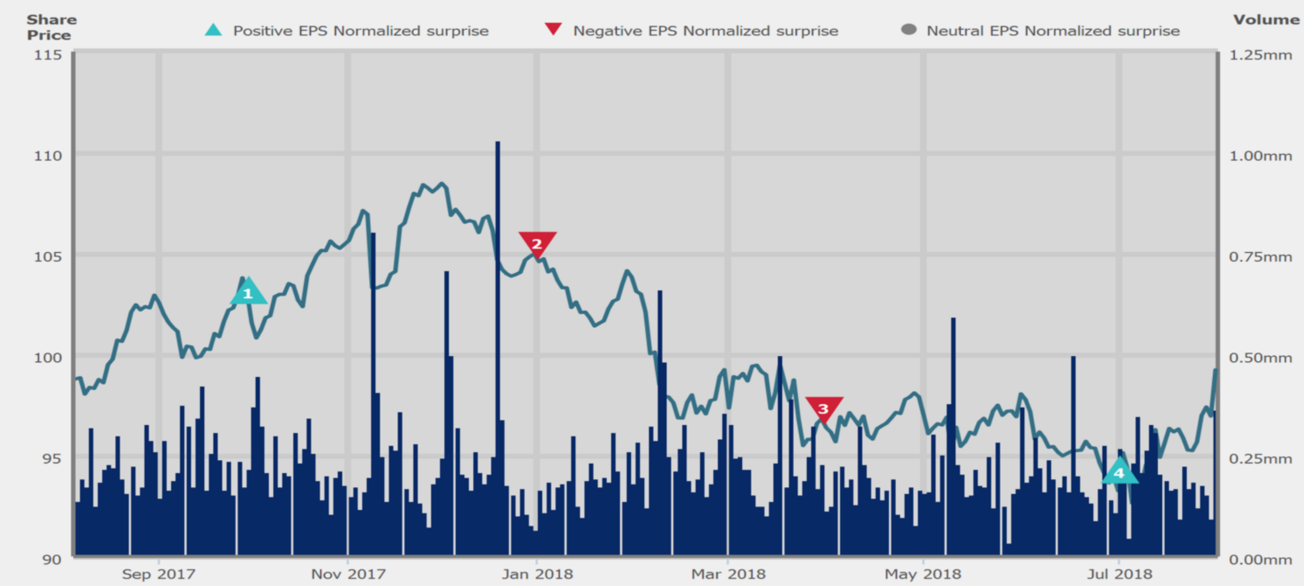
Wednesday, November 07, 2018 4:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2018-			-FQ4 2018-	-FY 2018-	-FY 2019-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.62	1.62	▲0.00	1.96	5.77	7.46
Revenue (mm)	2451.20	2471.00	▲0.81	2456.67	9657.52	9951.83

Currency: CAD
Consensus as of Nov-07-2018 12:03 PM GMT

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



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2017	1.59	1.61	▲1 1.26 %
FQ4 2017	1.73	1.63	▼2 (5.78 %)
FQ1 2018	0.87	0.81	▼3 (6.90 %)
FQ2 2018	1.22	1.38	▲4 13.11 %

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Call Participants

EXECUTIVES

Alain Lessard
Senior Vice President of Commercial Lines

Charles Brindamour
CEO & Director

Darren Christopher Godfrey
Senior Vice President of Personal Lines

Kenneth Anderson
VP of Investor Relations & Treasurer

Louis Marcotte
Senior VP & CFO

Patrick Barbeau
Senior Vice President of Claims

ANALYSTS

Brenna Phelan
Raymond James Ltd., Research Division

Brian Robert Meredith
UBS Investment Bank, Research Division

Doug Young
Desjardins Securities Inc., Research Division

Geoffrey Kwan
RBC Capital Markets, LLC, Research Division

Jaeme Gloyn
National Bank Financial, Inc., Research Division

John Aiken
Barclays Bank PLC, Research Division

Kai Pan
Morgan Stanley, Research Division

Meny Grauman
Cormark Securities Inc., Research Division

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Paul David Holden
CIBC Capital Markets, Research Division

Tom MacKinnon
BMO Capital Markets Equity Research

Presentation

Operator

Good morning. My name is Cheryl, and I will be your conference operator today. At this time I would like to welcome everyone to the Intact Financial Corporation third quarter results conference call. [Operator Instructions.] Ken Anderson, Vice President of Investor Relations and Treasurer, you may begin your conference.

Kenneth Anderson
VP of Investor Relations & Treasurer

Thank you, Cheryl. Good morning, everyone, and thank you for joining the call today. A link to our live webcast and published information for this call is posted on our website at intactfc.com under the Investors tab. As a reminder, the slide presentation contains the disclaimer on forward-looking statements, which also applies to our discussion on this conference call.

Joining me here in Toronto today are Charles Brindamour, CEO; Louis Marcotte, CFO; Darren Godfrey, SVP of Personal Lines; Alain Lessard, SVP of Commercial Lines; and Patrick Barbeau, SVP of Claims. We will begin with prepared remarks, followed by Q&A.

With that, I'll turn the call to our CEO, Charles Brindamour.

Charles Brindamour
CEO & Director

Thanks, Ken. Good morning, everyone, and thank you for joining us today. Yesterday evening we announced third quarter net operating income of CAD 1.62 per share, driven by solid underwriting performance in both Canada and the U.S. and strong net investment income. Robust top line growth of 23% was driven by the addition of OneBeacon and strong organic growth of close to 6% in commercial lines across North America. The overall IFC combined ratio was solid at 93.8%. The Canadian performance at 93.9% reflects significant improvements in personal auto and strong results in personal property. This was tempered by elevated CATs and large losses in Canadian commercial. In the U.S., the OneBeacon team delivered another solid quarter with a combined ratio of 93.5%.

When we compare ourselves to the industry at the end of the second quarter, our advantage widened further, as expected. We outperformed by 740 basis points on ROE, well above our target of 500 basis points. However, we remain unsatisfied with a 12% operating ROE. We're focused and committed to the actions necessary to return ROE to the mid-teens in the coming year.

Let's look at our results by line of business, starting with Canada. In auto, as anticipated, the portfolio shrunk, as our rate increases remained ahead of the market. However, our actions continued to drive bottom line benefits. The combined ratio at 99% was higher than expected, but improved over 6 points compared to last year, driven by stronger underlying performance. The main variation from expectations arose from 1.9 points of unfavorable prior year claims development, still largely isolated to pre-reform accident benefits in Ontario.

On a seasonally adjusted basis, the run rate combined ratio is also improving to approximately 96% at the end of Q3. Our action plan, including rates, risk selection and claims, are delivering results. Both claims frequency and severity are lower again this quarter. Our work continues, and we're well on track towards our goal of a mid-90s run rate.

In personal property, premiums grew by 2%. While rates are up, our actions in auto are putting pressure on growth. The combined ratio was excellent at a mid-80s level, partly aided by a modest level of CATs in the quarter. Our strategies over time have proven to be quite successful, and this line of business is now running at a sustainable low 90s or better combined ratio.

Looking at commercial lines in Canada, top line momentum in both regular and specialty drove growth to 8% in the quarter. The combined ratio was higher than expected, both in the quarter and year-to-date due to elevated CAT and large losses. While we're monitoring closely, we remain confident that the underlying fundamentals of this business position it for a low 90s performance.

Turning to results for our U.S. commercial segment, premiums of CAD 469 million bolstered IFC's top line growth meaningfully. On an organic basis, growth increased to 5%, and this included low-double-digit growth in the segments we're focusing on for expansion. Segments with profitability plans declined as expected. The combined ratio of 93.5% represents a third sequential improvement since closing. While we can expect some lumpiness in quarterly results over time, we're pleased with this progress as we work towards a sustainable low-90s performance.

Let's now look at the outlook across our businesses. In auto, the marketplace continues to tighten with increasing rates, capacity constraints and ongoing growth in residual markets. This environment, in our view, supports our profitability improvement plan. Our competitive position is improving and we expect to return to growth in the coming year.

In personal property, the outlook remains favorable. The industry grew north of 6% in the first half of 2018, and we expect mid-single-digit growth over the next 12 months. As growth in auto improves, we expect property growth to accelerate.

In commercial in Canada, we expect mid-single-digit growth for the industry in the coming year, with our loss ratio outperformance running well above 10%. We're positioned to take advantage of the firming environment, and we expect our growth momentum to continue.

In U.S. specialty, market conditions are evolving better than anticipated, with modest upward pricing trends continuing. Overall, we expect low to mid-single-digit growth for the U.S. specialty industry over the next 12 months.

The OneBeacon team is only just beginning to capture the upside benefits from broadening product distribution. Fortunate fees and profitable segments position us well to outperform the U.S. industry growth in the coming year.

Turning to strategy, we're investing to lead in digital engagement and artificial intelligence, 2 key levers in our strategy. In August we added our newest telematics offer, UBI 2.0, to both Intact and belairdirect's industry-leading mobile platforms. UBI 2.0 has features and functionality to better engage with Canadians while promoting better driving. It's also significantly more predictive. On the data science front, we continued to roll out our latest auto-rating algorithms, which are grounded in machine learning.

In conclusion, our diversified platform produced solid results in Q3. In personal auto, our action plan is delivering and underlying performance is tracking towards a mid-90s run rate. In the U.S., we've improved the OneBeacon combined ratio in the 12 months following close and delivered close to 5% accretion to norms. We're well positioned to capture opportunities across our North American specialty business, where we target CAD 3 billion in premiums in the midterm and a sustainable low 90s combined ratio. Organic growth momentum is building across our platform as market dynamics continue to evolve in our favor.

And IFC's balance sheet is strong, too, and we're ready to take advantage should consolidation opportunities arise. Our strategies, initiatives and discipline position us to deliver on our financial objective of outperformance of the industry ROE by at least 500 basis points and to grow our net operating income per share by 10% per year over time.

And with that, I'll turn the call over to our CFO, Louis Marcotte.

Louis Marcotte
Senior VP & CFO

Thanks, Charles, and good morning, everyone. For the third quarter, net operating income of CAD 237 million was up 8% compared to last year. The improvement was driven by personal auto results, increased investment income and OneBeacon, which contributed CAD 22 million of underwriting income.

CAT losses in the quarter were lower than expected but remain elevated year-to-date. Our annual CAT expectations reflect a longer-term view of weather trends, premium growth and product changes. On that basis, we maintain our guidance for CATs at CAD 275 million per year for IFC. We continue to expect close to half to occur in the third quarter and approximately 75% to impact personal lines.

Now let me provide some additional color on underwriting results, beginning with Canada. In personal auto, the combined ratio improved 6.1 points compared to last year with close to 5 points of improvement in the underlying performance. This does not include a point of higher industry pool losses. At 72.5%, this loss ratio was the best Q3 underlying performance since 2014 and highlights the solid progress we are making.

Our action plan is delivering tangible results. Written rates are up 6% and earned rates up over 5% in the quarter. Rate momentum continues with rate approvals in place today guaranteeing mid-single-digit earned rate increases through the end of 2019. Beyond rates, our actions on claims and risk selection will also continue.

As Charles mentioned, we recorded 1.9 points of unfavorable prior year development, mostly on pre-reform accident benefits in Ontario. The uncertainty surrounding the ultimate cost of these files is diminishing fast and is expected to be negligible within a year.

The mid-90s auto combined ratio run rate objective is within our sights, and with our continuing actions, we're confident we'll be there by year end. Do note that we would expect approximately 3 points of unfavorable impact from seasonality in the fourth quarter.

In Canadian commercial, top line performance was excellent. Direct premium written growth in auto and P&C were up 12% and 6%, respectively. Rates, robust growth in specialty lines and the sharing economy were key drivers.

The combined ratio was higher than expected at 94.9%, driven by elevated CAT and non-CAT large losses. These events, which were mainly fire and water related, occur randomly and are not indicative of any unfavorable loss patterns.

Our Canadian expense ratio remains low relative to peers and stable at 28.5%. We remain focused on managing expenses thoughtfully while making ongoing strategic investments and prudently growing the business. We expect the overall expense ratio for the full year to remain at the Q3 year-to-date level.

Now turning to U.S. commercial, we reported a solid 93.5% combined ratio in the quarter, driven by a healthy underlying loss ratio of 57% and 2 points of favorable prior year development. Expenses ticked up slightly due to seasonal variations in the business mix. However, on a year-to-date basis, the expense ratio is in line with our expectations for the full year.

With a year behind us since closing, excellent progress has been made with the OneBeacon team to improve profitability. We have delivered 3 sequential quarters of combined ratio improvements. We've exited 2 lines, and our profitability improvement plans on underperforming lines have gained traction.

We are also ahead of schedule on expense synergies. We realized CAD 7 million in Q3 and have exceeded our $25 million annual run rate target. Our focus continues on improving the underperforming lines and realizing the benefits from internalizing and improving the claims processes. We're making strong and steady progress towards the low 90s combined ratio objective, but we do expect some noise long the way. Already in October, we have seen elevated loss activity including hurricane Michael, which will likely impact the U.S. commercial combined ratio by some 3 to 5 points in Q4.

Net investment income of CAD 133 million was up 32% versus Q3 last year. This was driven not only by the addition of OneBeacon, but also by the portfolio optimization that took place earlier this year and higher reinvestment yields. We expect Q4 investment income to be close to the Q3 level, driving annual investment income growth north of 20% for 2018.

Distribution business contributed CAD 34 million to operating income this quarter, an increase of 13% over last year. With weaker industry results lowering estimates for contingent commissions, we expect distribution in Q4 to be similar to last year's Q4.

Now just a few words on our strong balance sheet. Book value per share at the end of Q3 increased 6% year-over-year, driven by earnings. We ended the quarter with a total capital margin of CAD 1.2 billion, a slight decline over last quarter, largely related to deleveraging. Our credit facility is now undrawn, and debt to total capital is just below 22%.

In conclusion, we delivered a solid quarter and made good progress on our near-term objectives. Improvements in personal auto and OneBeacon, together with rising investment income, are laying the foundation for near-terms earnings expansion and a return to a mid-teens ROE. With a strong balance sheet, we're making the right investments in our business to extend our competitive advantages, and we're ready to capture inorganic opportunities as they arise.

We've been very successful in our objectives of growing north of 10% annually over time and exceeding the industry's ROE by over 500 basis points every year. I am very confident that we have the right strategies in place to continue to meet our financial objectives over time.

With that, I'll return the call back to Ken.
Kenneth Anderson^ Thank you, Louis. In order to give everyone a chance to participate in the Q&A, we kindly ask that you limit yourselves to 2 questions per person. If there's time at the end, you can re-queue for a follow-up. So Cheryl, we're now ready to take questions.

Question and Answer

Operator

[Operator Instructions.] Your first question comes from the line of Kai Pan of Morgan Stanley.

Kai Pan
Morgan Stanley, Research Division

So my first question on personal auto, just want to clarify, Louis, about you have 3 points of unfavorable seasonality in fourth quarter, so which implies like 98% combined ratio in the fourth quarter would be -- you would consider achieving your target. So I just want to put it all together in 1 question. So if that's the case, I just wonder, are you getting to your profitability target that you were looking more for top line growth into 2019?

Louis Marcotte
Senior VP & CFO

So I guess on the run rate, your approach is right, Kai. So the 3 points is really saying we would deduct them from the reported combined ratio, assuming CATs are as expected and there would be no PUID in that 98%. But the 3 points I referred to as something that would be deducted from the reported combined ratio to arrive at the run rate for Q4. That's on the run rate on the next year, 2019.

Charles Brindamour
CEO & Director

Yes, I think on the top line, we're seeing the market is firming up. We're starting to see a bit more rate momentum. Now we're still taking rate. Just to put things in perspective, our work has not stopped. But incrementally, if we look across markets, we're seeing a deceleration in particular in the last few months, a deceleration of shrinkage.

I'll pass it to Darren, who will give you a better perspective on the state of the personal automobile insurance market.

Darren Christopher Godfrey
Senior Vice President of Personal Lines

No, absolutely. I think if you look at the industry results after the first 6 months of this year, the industry continues to be challenged with a combined ratio in excess of 100%, which clearly there's rate adequacy within the market that ultimately will drive further rate increases.

I think if you look within the capacity terms, in terms of the behavior of markets, the continuation of tightening is very evident. FA, so the Facility Association, the insurer of last resort, coast-to-coast is up 30% year-to-date, so it's another significant sign of tightening within the marketplace. So as Charles alluded to, I think we're seeing the curve of our growth has changed slightly. We do expect that the industry will catch up with rate adequacy as the conditions continue to firm. We'll continue to be prudent, but we're not chasing growth. We're not chasing growth by lowering rates as we move into 2019. We definitely will be looking more at assessing growth opportunities as they arise. Very segmented, very cautious, very prudent, but we do expect that there will continue to be some short-term pressure, but we think more in the 9 to 12 months phase, we could see growth opportunities arising for us.

Charles Brindamour
CEO & Director

Yes. I think, Kai, our experience with previous periods of that nature, given where we are in the cycle, some of the actions that we've taken, our view is that within 12 months we should be back in positive growth territory. The written rate momentum is very strong at Intact. And as other markets are catching up, I think the recent rate momentum and a deceleration of unit shrinkage should contribute favorably to the top line.

Kai Pan
Morgan Stanley, Research Division

That's very helpful. My follow-up question is that I'd be interested in your thoughts about potential implications from the legalization of cannabis.

Charles Brindamour
CEO & Director

Right. Darren, maybe you want to give a brief perspective on that -- very early, obviously.

Darren Christopher Godfrey
Senior Vice President of Personal Lines

Yes, no, absolutely, very early. So first of all, when you look at the introduction or the legalization of cannabis, first of all, there's no frequency impact studies available with respect to Canada. So we're very much using U.S. studies, and there are numerous studies coming out of the U.S. in terms of potential frequency impact. There is quite a range within those studies. Some are suggesting no impact, and others are obviously indicating otherwise. I think as we move forward, we'll be very prudent in terms of how we reflect the possible impact of cannabis, both in terms of our prospective view on automobile, but also in terms of subsequent rate increases that we'll be looking to gain pretty much coast-to-coast. So we'll be evaluating very closely our frequency trends and adjusting rates accordingly. I think what's important, as Charles alluded to, our rate momentum is very strong. In the month of September alone, written rates were up 6.5%. And with more momentum coming, that does not reflect the recent rate approvals that we just received in Ontario. So we have a lot of rate momentum -- written rate -- into the remainder of '18 and into '19. And then, obviously, a lot of earned rate momentum. And as Louis mentioned, mid single digits in the pipeline already on earned rates in 2019.

Charles Brindamour
CEO & Director

So I think prudence embedded in our thought process in terms of frequency forecasting and relationship with the uncertainty associated with cannabis, Kai, is how I would sum it up, maybe. When I look at frequency today, though encouraged -- nothing to do with cannabis -- but encouraged by the fact that in the quarter, frequency was down 3.7%, and we've seen momentum building in terms of frequency dropping now for a few months, and that gives me comfort. When it comes to public policy issues around cannabis and the impact on frequency, early to tell.

Operator

Your next question comes from the line of Tom MacKinnon of BMO Capital Markets.

Tom MacKinnon
BMO Capital Markets Equity Research

I just want to -- a couple of questions with respect to the personal auto. I think one was with respect to the pre-reform accident benefits stuff you're seeing in Ontario. How long before you expect this to be negligible or essentially zero? We saw it in the second quarter, it ticked down a little bit in the third quarter, but when should we -- how should we be modeling prior year development associated with this going forward?

Charles Brindamour
CEO & Director

Tom, thanks for your question. Very topical. I'll ask Patrick to share his perspective, but I think the headline would be immaterial within 12 months, given the reporting pattern of those pre-reform claims.

Patrick Barbeau
Senior Vice President of Claims

Patrick speaking. So the activity in Q3, as was mentioned, really comes from, again, a few files in accident benefit dating back to pre-reforms. I will remind everyone that the new CAT definition started to apply on all accidents starting in June 1, 2016, so more than 27 months into it now. And what we see as a recent development is really psychological impairment, which is the area of the new CAT definition that will bring the most benefits in terms of cost reduction.

So we've been prudent in our reserving approach on those files. Lately we've seen some activity, and as we mentioned, when we look at the development patterns of those claims from the past, the remaining uncertainty around the total ultimate cost of pre-reform files is really diminishing rapidly and will reach a negligible level within 12 months. But it could also go the other way. I think that's an important thing to mention. Because of our prudent approach, when we look at the process for claims to become CATs, there is a first step, which is we receive a CAT application from clients. And as I was saying, since we're more than 27 months into the new reform, the number of new CAT applications that we expect to receive is really slowing down. And in fact, the ultimate number might be lower than what we project based on recent activity. Second, the number of those files where we receive CAT applications which will be considered or end up in the CAT zone, we assume and project that they would be in line with historical levels, but the recent files that are coming in are more stretch cases in the sense that they have a lower likelihood, in our view, of reaching the CAT definition threshold. And finally, from a severity perspective, we reserve those cases at face value, meaning we look at past average severity. But given they are more psychological in nature, we know that there's a likelihood that those remaining pending files could end up at the lower severity average.

Tom MacKinnon
BMO Capital Markets Equity Research

Okay, thanks. And a question with respect to your tax rate. The last couple of quarters you've been running on an operating basis in an 18% and a 19% tax rate. I think your guide was somewhere around 21%. How should we be thinking about the tax, operating tax rate going forward?

Louis Marcotte
Senior VP & CFO

So that -- you're right. We do expect it to be between 20% and 21%. It's always the same sort of story. The tax-free dividends, the portion of tax-free dividends is higher than what we would expect on a normal run rate basis. And we're seeing a bit of favorable impact from the U.S. operations, the OneBeacon operations added there, which takes the rate down a bit. When I gave you a 20% to 21%, it's combined. What's really driving now the fact that we're below that rate is the proportion of tax-free income to total operating income.

Tom MacKinnon
BMO Capital Markets Equity Research

So you want to stick with the 20% to 21%, or do you expect the trend that we've seen of late to temporarily help?

Louis Marcotte
Senior VP & CFO

No impact there. I will stick there, Tom, because I expect earnings to shift back into the underwriting side and that the proportion of tax-free dividends will be lower in future quarters.

Tom MacKinnon
BMO Capital Markets Equity Research

Okay, and if I could just squeeze a quick one here. If you talk about a mid-90s run rate by the end of 2018 for personal auto, if we had in 2019 no CATs and no prior year development and no impact from pools, then we should expect a reported rate of mid-90s?

Louis Marcotte
Senior VP & CFO

Yes, we'd be disappointed if that would not be the reported rate on the basis that you're describing, definitely, in particular given the rate momentum and some of the actions that we've taken. That would be disappointing to us if that would not be the case, Tom.

Operator

Your next question comes from the line of John Aiken of Barclays.

John Aiken
Barclays Bank PLC, Research Division

Louis, the capital MCT ratio is actually now below where we were at right after the OneBeacon acquisition, and I know we're still well above the company action level. But does a MCT ratio below 200% actually give you any limitations on what you may or may not want to do with capital?

Louis Marcotte
Senior VP & CFO

No, no, absolutely not. We actually monitor the total capital margin, which captures the excess capital in Canada and the U.S. and our other companies as well as the holding company. And that's really -- there's a bit of a shift between the Canadian operation and the holdco cash. And we use the cash to pay down the debt. But I would not read more into it, and I would be very comfortable running anywhere in the 195% to 200% range for Canada. This is minor noise on a quarterly basis and does not limit in any way our capacity to deploy capital.

John Aiken
Barclays Bank PLC, Research Division

Okay, and then if I can follow up with a question on distribution income. Your guidance for the fourth quarter does imply that we're going to be well below the 10% annualized growth rate. Completely understand with what's going on in the marketplace. Are you comfortable with looking at 10% growth for 2019, or do you expect the pressures that you're seeing this year to carry through into 2019?

Louis Marcotte
Senior VP & CFO

So I think it's a bit early to talk 2019, John, but I think we're seeing some pressure this year because of the market environment we're in. I think, given our outlook for next year, there's no reason why we should not be able to rebuild that distribution income to that growth level.

Charles Brindamour
CEO & Director

Acquisition activity in 2018 certainly goes to feed that up.

Operator

Your next question comes from the line of Brian Meredith of UBS.

Brian Robert Meredith
UBS Investment Bank, Research Division

Just a question here. You all talk about the large loss, kind of non-CAT weather, on a year-over-year basis with the impact that was in the underlying on the commercial and the homeowner's. But I assume you're always going to have some of this in your results. What was kind of the normalized kind of number you were thinking you would have this quarter, and where were we? What's the difference so we can kind of get a better run rate?

Charles Brindamour
CEO & Director

So Brian, we'll zoom in on commercial lines. I think this is where the issue resides, so I'll let Alain give you his perspective on that, both CATs and large losses. Alain?

Alain Lessard
Senior Vice President of Commercial Lines

When we focused on the Q2 result of commercial lines in Canada, 94.9, that's clearly above expectation. And it was affected by 2 elements, CATs and large losses. When we look at CATs at close to 8 points in Q3, this is about 4.5 points above historical average. And let me remind you, a CAT for us is any large event in excess of CAD 7.5 million. So the major one that affected us, or the biggest one in Q3, was the tornado that went through the Ottawa Gatineau region. And unfortunately, that tornado went through a path where we had more commercial lines exposure, and that really drove the high level of CAT at 4.5 points above expectations, or above historical average.

On the large losses, when we look at the large losses we saw in Q3, we're about 1.5 points to 2 points above historical average. Those losses includes fire, a bit of liability bonds, but fire is basically the main contributor there. When we looked at that, we could not find any pattern in the type of loss that caused the region, the line of business. So, so far, we have no evidence that would suggest that the number and extent of large losses and catastrophes is increasing.

So when I take those into consideration, excess CAT and excess large losses, while the normalized combined ratio for Q3 would be more in the 88% to 89% zone, and this is in line with our view that the line of business operates close to low 90s.

Charles Brindamour
CEO & Director

I think if I can add color, Brian, we're getting a hard time with a mid-90s result in commercial lines. But if you take a broader perspective, I look at 5 years of combined ratio, all in, in commercial lines, you get to a 91-ish combined ratio. I look at the rate momentum where we're writing rate written in commercial P&C in Canada is close to 3 in Q3 and slightly above 4 in commercial auto. The outperformance from a loss ratio point of view with the industry is north of 10, so it's a massive outperformance, and the market is tightening up. So I'm pretty bullish about the value creation profile of commercial lines in the context of Canada, and I would say not overly bothered by CATs and large loss activity at this stage, even though we'll keep giving Alain a hard time with the bad luck here.

Brian Robert Meredith
UBS Investment Bank, Research Division

Great. So you're saying that you think that things are going to continue to firm up here in the commercial marketplace in Canada?

Charles Brindamour
CEO & Director

Yes. I mean, the momentum in the past 6 weeks -- 6 months -- has been quite surprising, and we started to realize that the firming up is greater than anticipated because the thing that came clear to us is our outperformance was actually much greater in commercial lines than we thought 18 months ago. And that all, I think the market tightening up makes more sense in that context. But I think the franchise itself is running low 90s.

Brian Robert Meredith
UBS Investment Bank, Research Division

What's driving the firming market? Are you seeing rising loss trends, or what's happening?

Alain Lessard
Senior Vice President of Commercial Lines

I don't think we're seeing a loss trend. I think there was really rate reduction for a long time in the commercial lines market, and now that's picking up. If you look, like Charles was alluding, if you look at our outperformance at the end of Q2, which is about north of 10 points and you look at our combined ratio, that puts the industry well above 100%. So this is for me really economics driving the needs for improvement in the pricing situation there.

Charles Brindamour
CEO & Director

I think, Brian, when I look at the work that Alain and team have done in the past 3 years, there were real bad classes of, or segments of the commercial lines marketplace that we tackled head on, starting about 3 years ago, where we really worked on about 5% to 10% of the portfolio, which touched a number of segments. And the market is really starting to focus on that because those segments where we de-emphasized in our portfolio have become quite unprofitable in the Canadian marketplace. Natural disasters as well has been a source of pressure in the past 7 to 8 years, and I think people focused on home insurance and not as much on commercial lines, and I think you're starting to see some movement there as well.

Brian Robert Meredith
UBS Investment Bank, Research Division

Great. Can I just squeeze just one more quick one in? Charles, just curious. On the improvement you're seeing in your personal auto book, you talked improvement in severity and frequency. Is there a way to dissect how much of that frequency improvement is your own underwriting actions and initiatives versus just general industry frequency perhaps trending downwards?

Charles Brindamour
CEO & Director

Too early to tell, Brian, because the drop in frequency started to appear earlier this year. And the level of granularity that we can get at the industry level will become available when, Darren?

Darren Christopher Godfrey
Senior Vice President of Personal Lines

Later this year.

Charles Brindamour
CEO & Director

Later this year. So it will be tough for us to differentiate between the two. That being said, when we measure the quality of the portfolio which results from the underwriting actions that we've taken, there is a clear improvement in the quality profile of the portfolio. And quality tends to be associated to a greater extent with frequency than severity because it is about underwriting. And in that regard, we've made good progress as part of the action plan. And Darren, maybe you want to share your perspective on that.

Darren Christopher Godfrey
Senior Vice President of Personal Lines

No, that's absolutely it. So when we look very much coast to coast, every province, both channels, when we're looking at what we call our rate adequacy index, meaningful reductions in terms of the improvement in quality, very much consistent in the last 12 to 18 months which is, as Charles said, we believe really flowing into the frequency impact. We also see it in terms of the mix change that we see within the portfolio as well, too. The quality of the new business that we're attracting, the quality of the retention, our existing customers that we're retaining, is driving a mix change towards better quality, which is ultimately driving those quality metrics, which we believe is flowing into the frequency that we're seeing today.

Operator

Your next question comes from the line of Meny Grauman of Cormark Securities.

Meny Grauman
Cormark Securities Inc., Research Division

A question on the legislative front. The private members' bill into our legislature, Bill 44 was defeated, but I think Bill 42 is still alive and kicking. So wondering your perspective, what you expect from the legislative process, how you expect the legislative process to play out. And then what would the impact of this bill be, based on your reading of it?

Charles Brindamour
CEO & Director

Let Darren give his perspective. He's closest to the legislative process in Ontario.

Darren Christopher Godfrey
Senior Vice President of Personal Lines

So you're right. There was 2 private members' bills, one sponsored by NDP, one sponsored by the conservatives. As you rightly mentioned, the NDP bill was defeated in the House on Friday. Now in terms of the conservative-sponsored private members' bill, we believe that, we understand that the first debate on that bill is expected to be in March of 2019, so there's still quite a bit of time in terms of when that particular bill will come before the House. I think overarching statement, we don't believe that restricting segmentation, whether it's location-based rating or other forms, is in the best interests of drivers and consumers. However, there's one element of the bill that we are quite favorable towards, which is around rescinding the current fiscal bulletin regarding the ability of governing territories and the way that we can use territories in ratings. So that's an important piece of the bill that we very much support. Longer term, we firmly believe that lessening the regulatory burden is important. It increases more price points in the market, drives further competition and ultimately drives lower premiums in Ontario and elsewhere in the country as we continue to push towards less regulation. We're obviously working very closely with the Ontario government in terms of the particular members' bill. But ultimately what we see is private members' bills sometimes don't proceed and can sometimes pivot towards government policy. So we're working -- as Intact, we're working as IBC to ensure that the government really understands in terms of what are the possible ramifications of restrictions of segmentation. And we're quite confident that we can illustrate the benefits to consumers of more options and more competition in the marketplace.

Charles Brindamour
CEO & Director

I think that my view of the current government, there's 2 things they're focused on, in my mind. And it is reducing fraud and then unleashing competition so that Ontarians get a better deal. And with that sort of mindset, in my view, you get a better outcome in the market, and I have confidence that those principles will guide their decision-making pattern. If you zoom in on Ontario, Ontario historically limited the number of territories that you could use to 55. When you look at other jurisdictions, you're in the hundreds of territories. But Ontario, for some reason, had this artificial constraint on the number of territories. The private bill on the table today is killing that constraint, which is a good thing. Then, of course, you want to make sure that there are no unfair pricing or underwriting practices. That's totally reasonable. And how that will be enforced or implemented, I think it will be done in a way to increase competition and make the Ontario marketplace one that is more vibrant than a marketplace that had all sorts of constraints on pricing and segmentation. So we'll see where that goes. I think that will materialize later in '19. But I think we're well equipped from a segmentation point of view, with all the tools we have in the toolbox, to do well in that environment.

Meny Grauman
Cormark Securities Inc., Research Division

And then just a numbers question just on personal auto. The combined ratio on a run rate basis -- I'm not sure if you mentioned that -- but you talked about 97% in Q2. What would the equivalent number be for Q3?

Charles Brindamour
CEO & Director

There's a range around those things. We think it's around 96%.

Operator

Your next question comes from the line of Geoff Kwan of RBC Capital Markets.

Geoffrey Kwan
RBC Capital Markets, LLC, Research Division

Just on personal auto, trying to think about, I guess, the levers on what you might be able to do over the medium term of reducing the combined ratio from the kind of the mid-90s that you've talked about, if you're able to do it, given rates probably something you need to be a little bit careful about, given what we've seen so far in the industry. Is there an ability to grind that kind of mid-90s down a little bit over time, whether or not it comes from telematics or some of your investments in technology that may help in terms of risk selection and other factors?

Charles Brindamour
CEO & Director

Well, I think if you go back in time, Geoff, you will see that we have run the portfolio for a number of years below mid-90s, okay? You go back to 2013, combined was 93.2%; go back to 2014, 94.5%; 2015, 95%. And if you go back in time, those who have followed the stock since the IPO, there were years where the combined ratio was actually sub-90%. I wouldn't want people to think this thing will run sub-95%, quite frankly, because it's been a difficult process to break the trends we've been observing. There is a lot of momentum building in rates, but I think when the industry tightens up, I want us to be cautious about the future rate increases you think you can get. And I think for me, once we'll run that business clean at 95%, I will say this is success. If the market conditions allows us to go below that, you can be sure that we'll be focused on going there. But I wouldn't want people to think along these lines because it's been a rough 18 months to 24 months. We'll get it to mid-90s. We have good momentums of actions, and that's what we're focused on at this stage.

Geoffrey Kwan
RBC Capital Markets, LLC, Research Division

Okay. And just the second question I had was there was that thing in the news around the HST lawsuit. Wondering if you have any comments on that front. And also, given it was just, I believe, pertaining to Ontario, is there any potential for that to pop up in any of the other provinces?

Charles Brindamour
CEO & Director

I think what you're seeing in the Ontario marketplace, and this relates to the PYD as well as this class action lawsuit, is the fact that the reforms of June '16 have really brought back sanity in terms of how much is available for recovery, and it really diminishes the opportunities of people who are in the car accident business to take advantage of this marketplace. And by that, I mean entrepreneurs who find a business out of injuries. And I think what you're seeing now is people agitating, trying to drum up CATs that really shouldn't be CATs, claim for CATs and put in place all sorts of lawsuits of that nature. And so I think it is a sign to me that the reforms that have been put in place are actually focused on the right things.

I'll let Patrick give perspective on the lawsuit itself and hopefully, this will answer your question.

Patrick Barbeau
Senior Vice President of Claims

Yes, so briefly on the class action that was announced last week, each of Intact and Belair were named in that lawsuit that's related to the treatment of HST following its introduction in 2010. We have been reviewing in details the allegations made. But I can confirm that at Intact, we are paying the agency and we're counting it -- we're not counting it, sorry -- towards the limit of the EAB as per current fiscal guidelines. So it's really not an issue from our perspective. In terms of how this could eventually get outside of Ontario, I think it's more the environment that Charles was mentioning, and we don't see any materiality to what this means.

Operator

Your next question comes from the line of Brenna Phelan of Raymond James.

Brenna Phelan
Raymond James Ltd., Research Division

So going back to the question on the legislative front, is there any particular state in the U.S. that you can point to where you think they've done a good job of regulating rate increases to allow for the necessary profitability improvements to be made that you're using when you're advising the IBC?

Charles Brindamour
CEO & Director

Yes. The U.S. marketplace is interesting in that it is a mosaic of rate regulatory environments, ranging from what is called use-and-file, which is basically what we have here in Quebec, where you put in place your rate change increase or decrease as quickly as you can, and then you file it with the regulator right up to what is called prior approval, which is what exists, for instance, in Ontario, where you need to get your rates approved before they can actually be used. And that process, in the case of Ontario, can last 6 months. So I would say, Brenna, that all the states that use a use-and-file system in the U.S., Midwest states in particular, would be a very good example that we have used in the past. And the market here in Quebec, which has a use-and-file system, is the market that has the best outcome for consumers because this is the market where companies are most aggressive because they know that if they're too aggressive, they can self-correct, which is not the case in other markets. So every use-and-file state in the U.S. we tend to use as a group as an example for a well performing market.

Brenna Phelan
Raymond James Ltd., Research Division

Okay, that's really helpful. And then if we're thinking about a return to unit growth over the next 12 months, how should we be thinking about that geographically? Are there any particular regions that you think you're better positioned to return to growth?

Charles Brindamour
CEO & Director

So when we look at the market across the land, in the last 6 months there is a dichotomy in terms of growth performance. Markets like the Province of Quebec, both channels are growing mid single digits. The pressure is really in Ontario first and in Alberta second because the regulatory regimes are heavier, and we move much faster than our peers with increases that were more meaningful, and therefore the pressure is very much in these markets. These are the markets where there is capacity tightening at the moment, these are markets where companies are pushing to get rate increases and this is where I see the biggest delta in terms of growth in the coming 9 to 12 months.

Brenna Phelan
Raymond James Ltd., Research Division

Okay, that's helpful. And then last one for me -- just in terms of the claims side, companies reporting most recently in the quarter in the auto space, referring to labor shortages with auto, auto body shops. Is there anything that you're seeing here that could potentially derail some of the profitability improvement components on the claims side?

Charles Brindamour
CEO & Director

I think when I review what is being reported in the U.S. now in terms of physical damage, inflation, labor shortage, integration of technology, that's what we've been talking about and acting upon for the last 12 to 18 months. And therefore, I think what you're hearing in the U.S. more and more is what we've been on now for over a year. Patrick, anything you want to add?

Brenna Phelan
Raymond James Ltd., Research Division

I think it's right. And on the labor shortage per se, I think with the relationship we have with our Rely Network is one of the places where I think we might have some advantage compared to our peers. And from all those actions we've been working around that Charles, you're referring to, we're really seeing traction, and it's contributed to the fact that we've been a few months now seeing severity going down.

Charles Brindamour
CEO & Director

And labor shortage, broadly in the context of Canada as a direct impact on cost of repairs, it has a direct impact on the cost of leasing vehicles for our customers. When we started to see towards the end of '16 and into '17 some bumps in relationship with that, we've put a number of claims actions in place to help on that front. And I think, Patrick, you might just give a brief comment on that. But also talk about customer satisfaction in automobile insurance in the last year, which talks to how we've dealt with those shortages and delays.

Brenna Phelan
Raymond James Ltd., Research Division

Yes, and one of the key indicators that we are getting traction on our action plan is the fact that cycle time on total loss and also the average time that we pay for rental has gone down compared to last year after some of our actions were taken. From a customer satisfaction, this is also good for customers. It's good for our costs and it's good for our customers when we close those files fast and we've seen our net promoter score gain 3 to 4 points overall Canada-wide in auto despite all the actions we're taking on that front. So a good outcome so far, and we're keeping the focus on continuing through the next months.

Operator

Your next question comes from the line of Doug Young of Desjardins Capital Markets.

Doug Young
Desjardins Securities Inc., Research Division

Just wanted to go back to just the performance in Ontario, and hopefully, this is a quick question. But Charles, the 2016 reforms, are they holding? I mean besides the pre-reform claims moving into the CAT bucket, are you seeing any other leakage from that reform? Or frankly, are you seeing any other leakage outside of just the reforms that were being put through that you have any concerns with in Ontario?

Patrick Barbeau
Senior Vice President of Claims

No, really, the last development or activities on prior years was seen in Ontario was really all coming from reforms. And what makes us confident with the new reform, and that's not been fully tested, is that when we look at the definition that was introduced in June, it's really tackling the exact same source of activities that is causing some of the noise we see right now. And we're starting to see the first few files. Like the psychological impairment CAT application, we usually will take 2 years to develop. So you go from June 1, 2016, we're just past now or starting to pass the first few claims post-reform that are testing that limit, and the few that we've seen are holding. And we'll see more of that in the coming quarters, but it looks good so far.

Charles Brindamour
CEO & Director

And Doug, the other thing that matters here, we talked a lot about CAT because it's been a source of PYD. But minor injury are an important part of the equation, and you know there have been reforms over the past few years. There's been a reform in the spring of '16 around the mediation and arbitration process, you will recall, in Ontario. And the outcomes of the new system that are known as the LAT, are actually holding very steady at this stage. We're spending, both Patrick and myself, a lot of time with adjusters on that very question. What are we seeing? How has the environment changed? And we've held discussions with 10s of adjusters a couple of weeks back on that very topic. And it really boils down to pre-reform psychological damage attempts by the legal community to get CATs which, as we've said, we're reserving as is, but our view is these things won't really -- will not turn not CATs at the same rate as CATs have turned into CATs historically.

Doug Young
Desjardins Securities Inc., Research Division

So my view always has been it takes about 2 to 3 years for these individuals to find a way to kind of find a hole or kind of put a wedge in somewhere. But you're not seeing any of that? These reforms are actually kind of holding firm at this point in time. Is that a fair characterization?

Charles Brindamour
CEO & Director

It is a very fair characterization, and I think, Doug, the fact that people are going back in old claims to attempt to claim CATs on the basis of psychological damage, to me, is a sign that the door with the reform has shut.

Doug Young
Desjardins Securities Inc., Research Division

And can you put a finer point on that? Like how many claims are eligible that are sitting there, pre-2016, that could actually move into that bucket? I mean I would imagine it's a lot less than it was, call it a year ago. But can you put a finer, like how many of these claims are still out there that could attempt to move into that area?

Charles Brindamour
CEO & Director

I think when you see, I imagine that it is a lot less than a year ago. I would say that is a true statement. And the other thing I would say is that the uncertainty that comes from that, that has translated in a point or 2 of PYD for quarters in the past 2 years, we expect that uncertainty to shut down by half within the next 12 months, at which case it becomes really immaterial. Patrick?

Doug Young
Desjardins Securities Inc., Research Division

No, that's it. And in terms of number of cases, I couldn't quote the number, but obviously, it's a small number. It's just that each of them have a high severity. We reserve them at face value. Like we said, could go up to CAD 1 million each. So it's only a few cases left. And when we talk about the uncertainty that remains until this is fully behind us, this is why there's uncertainty. It's just a handful of cases of difference compared to our projection costs of CAD 1 million.

Charles Brindamour
CEO & Director

I would say probably more than a handful, but there's a finite shelf to this, and we expect that this will drop in the coming year.

Operator

Your next question comes from the line of Paul Holden of CIBC.

Paul David Holden

CIBC Capital Markets, Research Division

I'll try to keep this quick. First question regarding OneBeacon. Just want to understand the nature of the hurricane exposure a little bit better. Because if I recall correctly, there wasn't any material hurricane impact in 2017 despite the fact that those were bigger industry events. So I just want to understand the change here.

Charles Brindamour
CEO & Director

Yes, I think the nature of the exposure -- first of all, we talked about large losses or large events in addition to the hurricane that we have referred to. But we could think about the exposure there. Ocean-marine, marine, marinas and then special property exposure, where we would have a commercial building or tranche of a commercial building, which tends to be less exposed to the natural disaster. But in the case of Michael, it's been a bit of a hit there.

Paul David Holden
CIBC Capital Markets, Research Division

Okay, and the difference between this year and last year is just geographic exposure?

Charles Brindamour
CEO & Director

Yes.

Paul David Holden
CIBC Capital Markets, Research Division

Okay, fair. Second question, then. Maybe you can give us an update on how your investment portfolio performed in October, given the market correction at the time?

Louis Marcotte
Senior VP & CFO

Sure. So of course, we were hit on the common shares, essentially. We estimate that the overall impact of the October volatility was about CAD 1.00 of book value per share.

Paul David Holden
CIBC Capital Markets, Research Division

Great. And then one last quick one. Last year in Alberta there was a rate cap introduced, or a maximum rate increase of 5%. Wondering if there's any update to that for 2019?

Charles Brindamour
CEO & Director

So just the point of reference, Paul, you're absolutely right. When you start seeing inflation, it's very important to move quickly because when everybody wants to increase their rates, regulators get a little more nervous. We started to move rates in Alberta over 2 years ago and feel like we're in a good shape. But I'll let Darren share his perspective on the cap itself and our position in Alberta.

Darren Christopher Godfrey
Senior Vice President of Personal Lines

Thanks, Charles. So indeed, Paul, so the rate increase cap in November was just recently extended -- in other words, a further 5% cap has now been granted by government. So like 2017 cap, we took the 5%, both companies. We intend to do the same. But to Charles's point in terms of getting ahead of the marketplace, if I look since, say, early 2016, we're a good 11 to 12 points ahead of the marketplace in that period of time. And if I extend even further back than that, I could probably add another 5 to 8 points on top of that again. So even before the rate cap came in place at the end of 2017, we were well ahead of the marketplace. The 5% rate cap was pretty much in line with what our plans were for '18. And now that there is another increase or another 5% available, we'll take that. The market itself is well exceeding 100%. There's tremendous inadequacy in the marketplace. We're obviously a whole lot better positioned. When we look at our outperformance gap, meaningful double-digit outperformance in Alberta versus the industry. So we're very, very well placed in terms of rate action. And what we also see from an inflationary standpoint, significant progress, Patrick and team, on the bodily injury side, containing costs, but also on the physical damage side as well, too. So very much favorable view from a severity standpoint and also a favorable view from a frequency standpoint in the Province of Alberta as well, too.

Operator

Your next question comes from the line of Meyer Shields of KPW.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Just 2 really quick questions. One, was there any reserve development for prior years in auto besides the pre-reform Ontario AB charges?

Charles Brindamour
CEO & Director

Not much, no. No.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. And you talked a little bit about seasonality impacting the OneBeacon expense ratio. Is there any trend besides that as the business mix shifts, or should we just look at, let's say, the last 4 quarters as a good guide to seasonality?

Louis Marcotte
Senior VP & CFO

So that's a good question. On the expenses, there is a bit of seasonality in Q3, particularly because of some of the growth in the U.S. Surety, for example, has driven some of the recent expense ratio. But looking back 12 months, I think, is a good way to analyze the seasonality. That's really the main factor, and I wouldn't read much more into it.

Charles Brindamour
CEO & Director

To Meyer's question, the segments that are under profitability are shrinking. The remaining 10 segments are growing double-digit. Any shift in the mix as a result of that driving a difference in expectation for expenses, you think.

Louis Marcotte
Senior VP & CFO

Well, long-term, we're still seeing a downward shift in the expense ratio because of the synergies and the expense saving we're driving and seeing. In this quarter particularly, we had the mix impacted a bit higher than we had anticipated. But what we're referring to is the year-to-date around 37.5 is what we would have expected for the full year, just a blip in Q3 for that mix part. There's a bit of the tuition reimbursement business as well that drives a bit of seasonality [indiscernible] is a bit more elevated. But I would go for a 37.5 annual run rate as the expected level.

Charles Brindamour
CEO & Director

And based on synergies?

Louis Marcotte
Senior VP & CFO

Yes, CAD 7 million realized in the quarter. That takes our run rate higher than the CAD 25 million target we had established, so that's going well, and we keep on counting on expenses and trying to improve the expense ratio in the U.S.

Operator

Your last question comes from the line of Jaeme Gloyn of National Bank Financial.

Jaeme Gloyn
National Bank Financial, Inc., Research Division

The first question, on the Hurricane Michael guidance, 3 to 5 points of impact, is it best to think about that as an increase from the Q4 '17 levels of 60.5% for the claims ratio?

Louis Marcotte
Senior VP & CFO

No. So just to be clear, Hurricane Michael I mentioned just because it's part of the activity we've seen. It is not the only activity. So it's not like we have a huge hit from Michael. It was just one big event that impacted the U.S., and it's part of the activity we've seen in October so far. Then we think this activity will drive roughly 3 to 5 points of additional combined ratio points in the quarter, but we would --

Jaeme Gloyn
National Bank Financial, Inc., Research Division

For U.S. commercial lines.

Charles Brindamour
CEO & Director

For U.S. commercial lines, thank you. And I would use the most recent sort of run rate combined ratio as your starting point and add these 3 to 5 points to be our expectation for the Q4 U.S. commercial.

Jaeme Gloyn
National Bank Financial, Inc., Research Division

Got it, thank you. And the last one for me -- I don't think this has been touched on yet -- is around distribution and some commentary around how that's tracking and any outlook for '19.

Louis Marcotte
Senior VP & CFO

Yes, so we shaved a bit the expectation for Q4, suggesting that it would be equal to what we reported last year's Q4. So that's a bit lower than what we had anticipated at the beginning of the year. We had given 10% expected in 2018. What we're suggesting is there's no reason why we should not go back to this kind of growth in 2019. It's still early in our minds, but that's what we're thinking for next year because we expect activities to come back, the results to improve, and that will improve distribution results.

Operator

There are no further questions at this time. I will turn the call back over to the presenters.

Kenneth Anderson
VP of Investor Relations & Treasurer

Thank you all for joining us today. Following this call, a telephone replay will be available for 1 week, and the webcast will be archived on our website for 1 year. A transcript will also be available on our website in the Financial Reports and Filings archives. Our fourth quarter and full year 2018 results are scheduled to be released after market close on Tuesday, February, 5, 2019. Thank you again, and this concludes our call for today.

Operator

This concludes today's conference call. You may now disconnect.