S&P Capital IQ

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Fairfax Financial Holdings Limited TSX:FFH

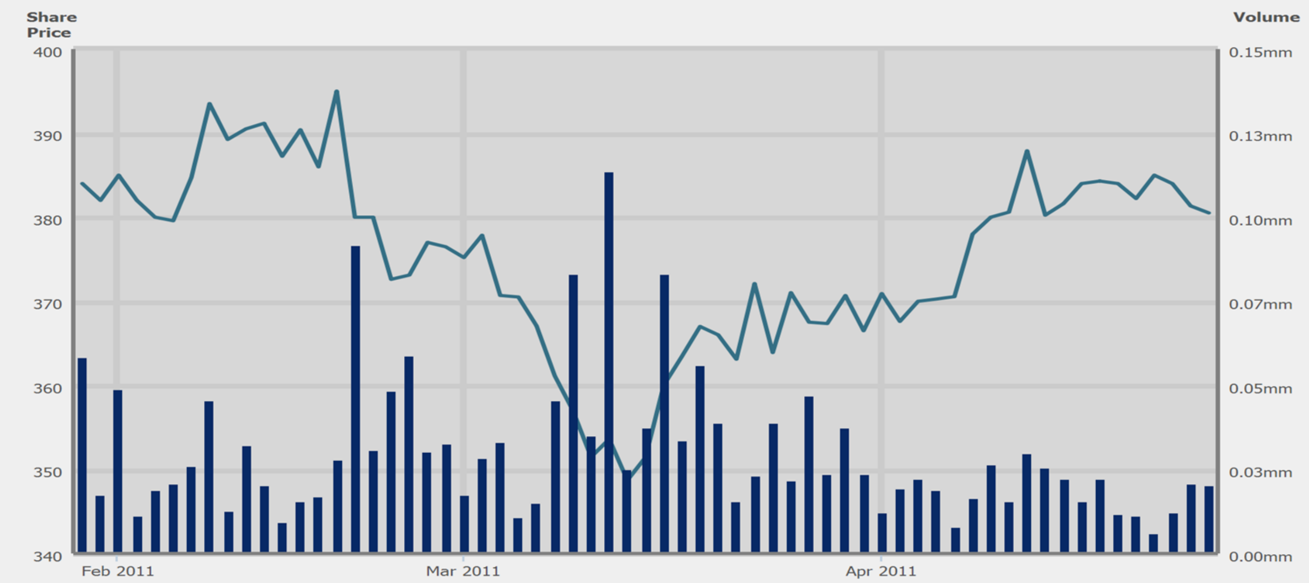
FQ2 2011 Earnings Call Transcripts

Friday, July 29, 2011 12:30 PM GMT

S&P Capital IQ Estimates

	-FQ2 2011-			-FQ3 2011-	-FY 2011-	-FY 2012-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	12.60	19.14	▲51.90	4.72	4.87	14.40
Revenue (mm)	1615.70	1755.00	▲8.62	1604.87	6352.80	6865.53

Currency: USD
Consensus as of Jul-29-2011 11:37 AM GMT



	- EPS NORMALIZED -		
	CONSENSUS	ACTUAL	SURPRISE
FQ1 2011	-	2.87	-

Call Participants

EXECUTIVES

Bradley Paul L. Martin
Vice President of Strategic Investments

John Charles Varnell
Vice President of Corporate Development

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

ANALYSTS

James Findlay

Jeffrey Michael Fenwick
Cormark Securities Inc., Research Division

Mark Alan Dwelle
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Paul David Holden
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Robert Alpert

Tom MacKinnon
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Unknown Analyst

Presentation

Operator

Good morning, and welcome to Fairfax's 2011 Second Quarter Results Conference Call. [Operator Instructions] Today's conference is being recorded. If you have any objections, you may disconnect at this time. Your host for today's conference call is Mr. Prem Watsa, with opening remarks from Brad Martin. Mr. Martin, please begin, sir.

Bradley Paul L. Martin
Vice President of Strategic Investments

Good morning. Welcome to the conference call to discuss Fairfax's second quarter 2011 results. Comments we make during this conference call may contain forward-looking statements. Actual results may differ, perhaps, materially from those contained in such forward-looking statements as a result of a large variety of uncertainties and risks factors, the most foreseeable of which are listed in Fairfax's Annual Report, which is available on our website at fairfax.ca, or set out under Risk Factors in Fairfax's base shelf prospectus, filed with securities regulatory authorities in Canada, which is available on SEDAR.

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

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Thank you, Brad. Good morning, ladies and gentlemen. Welcome to Fairfax's Second Quarter Conference Call. I plan to give you some of the highlights, and then pass it on to John Varnell, our Chief Financial Officer for additional financial details. In the first half of 2011, book value per share decreased by 2%, adjusted for the $10 per share common dividend paid in the first quarter of 2011. The book value decreased to $359 per share. In the second quarter, book value increased by $4 per share, or 1.1%. This is our second quarter reporting under the International Financial Reporting Standards, IFRS. Our investments are now shown at market value at the end of the quarter, and the fluctuation in market values flows through the income statement.

Highlights during the quarter include, we had a net profit of $83.3 million in the second quarter of 2011, approximately $3.40 per share, mainly because of good operating results, 119.6, approximately $120 million in net gains and investments, offset by a $104 million loss on the premium paid for tendered bonds. The combined ratio of the company's insurance and reinsurance operations is 100.5% on a consolidated basis. Underwriting results in the second quarter were negatively impacted by the $88.1 million of pretax catastrophe losses, primarily related to U.S. tornado losses, which increased the combined ratio by 6.9 percentage points.

Net investment gains of $120 million in the second quarter of 2011 consisted of the following. Please note the table on Page 2 of our press release, which shows you the breakdown of these gains. In the table, you can see net gains on bonds of $260 million predominantly unrealized, and were largely offset by net unrealized losses of $118 million on our CPI, consumer price index derivatives. Losses on equity and equity-related investments of $119 million gain largely unrealized were offset by gains on our equity hedges. However, we had large realized gains on cost of $389 million, which includes International Coal. Net premiums written by the company's insurance and reinsurance operations in the second quarter of 2011 increased by 24.4% to $1.3708 million. Excluding acquisitions, our consolidated premium grew by 10% in the second quarter, which included some foreign exchange gains.

Also, during the quarter, we retired $694 million U.S. of outstanding Fairfax Crum & Forster and OdysseyRe notes, and refinanced this by issuing any of Fairfax bonds in the United States and Canada at record low interest rates for us. The company held $1.14 billion of cash, short-term investments and marketable securities at the holding company level, approximately $1.11 billion net of the short sale and derivative obligations. Now this is all at June 30, 2011. Finally, we continue to be approximately 86%

hedged in relationship to our equity and equity-related securities, which includes convertible bonds and convertible preferred stock.

Now I would like to turn it over to John so he can give you some more information on the underlying financials. John?

John Charles Varnell
Vice President of Corporate Development

Thanks, Prem. First, I'll talk about investment income, then operating company results and finally, our financial position. On investment income, interest in dividend income in the second quarter of 2011 increased by 4.6% to $195.1 million from the second quarter of 2010 of $186.6 million. On a pretax equivalent basis, we own about $4.6 billion of tax advantage municipal bonds and therefore, the interest in dividend income related to that should be grossed up for the tax advantage. The average portfolio size during the second quarter of 2011 for investments was almost $24.1 billion compared to $22.4 billion in the second quarter of 2010. Our annualized portfolio yield in the second quarter was 3.42% compared to a yield of 3.5% in the second quarter of 2010.

Turning to operating company results, starting with Odyssey. In the second quarter of 2011, Odyssey had a combined ratio of 93.1, and an underwriting profit of $32.2 million. In the second quarter of 2010, Odyssey had a combined ratio of 92.8, and an underwriting profit of about $33.7 million. The second quarter of 2011 combined ratio included about 10 combined ratio points or $47 million net of reinsurance and reinstatement premiums related to cat losses compared to about $17 million or about 3.6 combined ratio points last year. In the second quarter of 2010, just for comparison, Odyssey also had $30 million or 6.6 combined ratio points related to the Deepwater Horizon loss.

The second quarter 2011 underwriting result for Odyssey included 1.5 combined ratio point, or about $1.8 million attributable to net favorable development of prior year's reserves. In terms of premium volumes, Odyssey had a 9.1% increase or $38 million net premiums written to $460 million in the second quarter from $421 million last year, primarily as a result of increased property business, some foreign exchange movements, offset by reduced casualty business.

Crum & Forster reported an underwriting loss of $8.4 million, and a combined ratio of 103.4 in the second quarter of 2011 compared to an underwriting loss of $10.7 million, and a combined ratio of 106 in the second quarter of 2010. Crum & Forster's results included 7/10 of a combined ratio point, or $1.8 million of unfavorable development of prior year's reserves. 2010 had $5.3 million, or 2.9 points of favorable development.

Crum & Forster's net premiums written increased by 40% in the quarter compared to the second quarter of 2010, principally due to the acquisition of First Mercury. If we excluded First Mercury, the premiums at Crum & Forster increased 6.4% as a result of growth in their specialty business. Zenith National reported an underwriting loss of $35 million and a combined ratio of 129 for the second quarter of 2011. There was development of prior-year reserves of $6.6 million or 5.5 combined ratio points. Net premiums earned during the second quarter and first 6 months of 2011 increased year-over-year by 14% for both periods, respectively, reflecting the combined impacts of new business and higher retention of their renewal business.

Northbridge reported a combined ratio of 104.3, an underwriting loss of $11.6 million in the second quarter. That compared to a 101.6 combined ratio, and a $16.4 million underwriting loss in the year-ago quarter. The second quarter of 2011 underwriting results for Northbridge included 6.7 combined ratio points, or $18 million of net favorable development. There was 3.7 combined ratio points, or almost $9 million of favorable prior-period reserve development in the second quarter of 2010. Net premiums written at Northbridge were $337 million in the quarter, an increase of 8% from $312 million in U.S. dollar terms last year, largely reflecting the stronger Canadian dollar.

Fairfax Asia had another successful quarter. The combined ratio was 85 this quarter compared to a combined ratio of 94.5 last year. Our net premiums written were $52 million, up 40% from $37 million last year. However, the second quarter of 2011 does include $10.3 million of specific insurance premium, which was the acquisition we closed in the first part of the year. In our segment that we call Reinsurance and Insurance Other, net premiums increased to $146 million for the second quarter compared to $113 million last year. The second quarter combined ratio was 92.7 compared to 91.8 last year for that segment, and the individual results in the second quarter were combined ratios for Group Re of 99, Advent of 73, and Polish Re of 110.

Turning to our financial position. As Prem said, we ended the quarter at $358.60 a share. That is an IFRS book value that would be comparable to the IFRS book value at December 31 of $376.33 per share. Common shareholders equity increased slightly from $7.24 billion at March 31, 2011 to $7.31 billion at June 30, 2011. As Prem said, we issued 10-year senior notes for U.S. $500 million at 5.8%, and Canadian $400 million at 6.4% in the quarter. And when we retired the debt, we recorded a one-time charge of $104 million in connection with the repurchase of the Fairfax-Crum -- Forster and Odyssey notes.

Our debt at the holding company increased slightly, and the debt at the subsidiaries decreased during the second quarter. The holding company had increased, but the subs decreased overall on a total consolidated basis, and increased somewhat due to the senior note repurchase. We finished the second quarter with a slightly higher total debt to total cap ratio of 27.1%, which is compared to 25.5% at March 31. That's it, Prem.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer
Thank you, John. Now, we are happy to answer your questions. [Operator Instructions] Okay, Julianne. We are ready for the questions.

Question and Answer

Operator

[Operator Instructions] First question comes from Jeff Fenwick from Cormark Securities.

Jeffrey Michael Fenwick
Cormark Securities Inc., Research Division

So Prem, in the quarter, we saw the news that Andy Bernard is moving into a role to oversee the global insurance operations, and then that was followed by some restructuring at Northbridge. Maybe you just speak a little bit about what the division is here for Andy. Is this the first step in several sort of enhancements to the business that we can expect going forward?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Yes, Jeff. So this is something that we've announced in the annual report and talked at our annual meeting, as you know. It's a very significant development for us. We have had very decentralized operations. With Andy Bernard being put in charge of our Insurance, Reinsurance operations, what we expect to do is to get a lot more coordination between our companies, in the U.S., particularly, but also elsewhere and in terms of opportunity. And of course, if there's competition among our companies, then that's the kind of areas where Andy will come in to reduce that. So it's a very positive move. Andy's been with us for the better part of 15 years, maybe 16 years now, and has built Odyssey, as you know from $150 million to $2.5 billion worldwide reinsurance company so he’s very excited about that. And we continue to be decentralized but Andy will coordinate our Insurance, Reinsurance operations.

John Charles Varnell
Vice President of Corporate Development

Okay. The Canadian operations restructuring, the fact that we are forming Northbridge Insurance Company, no, that was planned some time back, Jeff; no connection between the 2.

Jeffrey Michael Fenwick
Cormark Securities Inc., Research Division

Okay. And perhaps, if I just follow up with more question, after a period here of seeing premiums held back and shrinking through a soft market, we've seen a couple of quarters now with some nice organic growth out of your operations. Are we starting to see some hardening in some various corners of where Fairfax is active, and what's your feel there? I mean, that seems to be a fairly significant change here in the approach to underwriting.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Yes. So Jeff, you're exactly right, in a soft cycle, we shrink. We're seeing the market stabilize. We're seeing property cat prices strong. Workers' compensation is stabilizing and perhaps, increasing a little. The specialty lines are also firming up. So you're seeing Crum & Forster, excluding the acquisition of Mercury, up about 9.5% in that area. OdysseyRe is up. So we're seeing the markets react some but it's still early days. The redundancies of the past are disappearing, as you know, so that's helped the industry. That is slowly changing, and might well be pretty well gone this year and perhaps, next. And the investment income continues to come down as you have the bonds rolling over from higher rates to lower rates. So we think the markets will change. We can -- and perhaps, significantly. We can't say when, but our companies are well positioned to, as we've done in the past, to increase premiums very significantly, not on a forecast, but on prices actually going up significantly. We are focused on underwriting profits. When we get the opportunity, we'll react.

Operator

Paul Holden from CIBC.

Paul David Holden
CIBC World Markets Inc., Research Division

First question is related to cat losses from Japan. When you booked them in Q1, you said there might be some deviation or volatility in terms that estimate because it was hard to determine at that time. Do you have any more comfort now with your original estimate for cat losses?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Yes, our Japanese -- you know it's still -- you could still say it's early days because it's the second quarter. But it's stabilized. We haven't seen any movement of any significance. The pricing though has gone up on renewal quite significantly, right up to 50% for Japanese renewals, particularly with some cat exposure. And so we are seeing that, but our estimates for the Japanese earthquake are holding.

Paul David Holden
CIBC World Markets Inc., Research Division

Okay. And one more question, if I may, just regarding your position in U.S. treasuries and munis, given what's taking place in the U.S. and potential for a southern rating downgrade, any sort of change of opinion or stance or comment that you can make with respect to your holding in U.S. treasuries?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Well, we are long term, and we think that the debt limits will be worked out ultimately and even in the worst case where the United States takes a downgrade. If you compare the world, I think investors, worldwide, will still consider U.S. treasuries to be the best government bonds that you can buy, best country to invest in, in spite of all the problems that exist in the world. So we think this is a short term issue. It will be solved. It will resolved one way or the other, and we have cost focused on the long term.

Operator

Tom MacKinnon from BMO Capital.

Tom MacKinnon
BMO Capital Markets Equity Research

Question with respect to the -- I guess, the underwriting environment. It looks like we're seeing some improving results, really, at OdysseyRe to some extent, and then across the board with a lot of other reinsurers. And I'm wondering if you can comment on why that hasn't really necessarily transpired into improvements in Northbridge and Crum & Forster even if we look at combined ratios kind of x cats and x reserve development, we really haven't seen over the last couple of years any kind of improvement in Northbridge or Crum & Forster. But we have seen some improvement with OdysseyRe. Is it -- maybe you can dig down into -- so in Canada, was property cat prices related?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

[indiscernible] Tom, in terms of pricing, the U.S. tends to go down much faster, and then also come back much faster. Canada tends to lag. And on top of that, I think we had quite a – with the Pacific [ph] fires, and we had some cat losses, too in Canada. John, you want to add to that?

John Charles Varnell
Vice President of Corporate Development

Well, Northbridge and Crum both have more commercial business as well. So the Commercial business has been quite competitive in both Canada and the United States so that's where there's more pricing pressure. Odyssey has more of a mixture where they can move around so they can do more property cat. They can decrease their casualty lines. So they have more flexibility in what they can do, whereas Northbridge and Crum have to work at that Commercial business. They'll move more and more to specialty lines but they still have the commercial business that they have to compete in.

Tom MacKinnon
BMO Capital Markets Equity Research

Okay, that helps explain it. What percentage, John, of what's being written at Odyssey would be property cat?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Some property cat exposure would be if you had to take a business that had some exposure, it would be about 20%, 25%, some type of cat exposure. And so -- and we're writing more of that, well within our limits, well within our limits, of course, Tom, but we see opportunity in the property cat area. And so we're taking OdysseyRe to Brian Young and Andy Bernard, of course, are taking advantage of that.

Tom MacKinnon
BMO Capital Markets Equity Research

Well, going forward, I guess the million-dollar question is when is all this going to trickle down in some sort of a firmness in commercial lines. And I guess the question is there's nothing that you can see that's going to indicate that. I mean, you're still in the release stage...

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

No. It's like everything else associated with markets. You have to be ready. You have to be patient. You can't write when the markets are not appropriate in soft markets, and then you got to wait. And we are patient. We've been in business for 25 years. We've seen the cycles. And so obviously you just wait. And when the opportunity comes, we'll react. We won't until the opportunity is in front of us. And it's the same in the financial markets, Tom. You remember in 2006, in 2007, we were very patient. We had government bonds. We had our stock positions hedged in 2008, completely hedged. But when the markets went down 50% -- hedges up, we bought a lot of common stock. And when the spreads widened dramatically at the end of 2008 and early 2009, we reacted, but you had to be patient. You have to have government bonds. You have to have hedged your stock positions to take advantage of that opportunity. And the Insurance business are very similar. So we are, all of our presidents are being very careful and focused on underwriting, and waiting for that right time when the markets have changed and the opportunity’s in front of us.

Operator

Mark Dwelle from RBC Capital Markets.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

My question’s related to -- a couple of question on the investment side. It looks like you liquidated a fairly large portion of the equity warrants position. Was that the main driver of the capital gains in the quarter?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

No. We had quite a few situations that gave us the gains, Mark, but the one that we've talked about in the past, which has been in the press is International Coal. That was significant but we had other realized and unrealized. We have quite a few unrealized positions that went up. But the one that we have been able to talk about is International Coal. We, once a year at the end of the year, of course, we tell you where the big gains were on costs unrealized figures. But our common stock position, if you look at the press release that we have for you on Page 2, you can see for the -- in the second quarter, equity and equity-related investments, we lost $119 million. And on the hedges, we made $119 million so it was flat. And if you go into the 6-month mark, you'll see we made $500 million, and equity hedges were $309 million. So we had made about -- after the hedges, about $200 million, $194 million, to be exact. But these are fluctuations with IFRS. All the fluctuations go through our balance sheet and our income statement but we like acquisition. We like the fact that we're hedged 86%. We like the fact that we've got government bonds, a significant amount of them. The spreads have narrowed significantly. Stock prices are up 100% from the bottom. We think you have to be cautious. You have to be careful, and so that's where we are. We are very cautious and careful today. That doesn't mean we don't take advantage of opportunities we see, but we're cautious in this environment.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. One other real quick question. The recently reported position in Bank of Ireland, is that going to be a holding company investment, or is that going to be purchased by using the cash at the subsidiary levels?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

No, this is a -- it's just a regular insurance investment, Mark. Because it was in the Bank of Ireland, and in Ireland, it was significant with a lot of publicity. So we explained why we acquired that position. We did that -- there were, I guess, 3 others that acquired it together with us, separately, I may add, but did their own work. But we liked Ireland; we've been there for 20 years. And so we like Ireland. We like the Bank of Ireland as the best bank in Ireland, the only private one, and full-service bank with 250 branches. And so and -- as a financial services analyst, Mark, you’ll recognize their capital position is very strong. Tier 1 capital is at 15%, core equity capital is, meaning equity capital, is 10%. And they have, the central Bank of Ireland, has very significant, very tough stress tests, and they hired Blackrock to put these stress tests in. And the 2 stress -- 2 tests that they have is one, house prices up, dropped 60% from the top, and commercial property prices dropped 70% from the top, and you still have to have your minimum capital level. So the 15 Tier 1 and 10 from core can handle these 2 stress events, and so we liked it. We like the management team. We like Richie Boucher, who's CEO; he's very disciplined, focus, very commercial. So we liked him, and we made our investment. We'll own less than 10%, but it will be an investment for us, part of our $24 billion portfolio.

Operator

Robert Albert from Atlas.

Robert Alpert

My question was on the Bank of Ireland. You just answered it.

Operator

The next question comes from Serge Catrin [ph] from KIP [ph].

Unknown Analyst

Could you please comment on your insurance runoff business? And the second question is, could you please comment on your CPI-linked derivatives, please?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Okay. So the runoff business is a business that we have and have had for a long time, 1998 so for 12 years. We like the business. We have a very good team run by Nick Bentley, and we've made a couple of acquisitions, which we described in the -- in our annual report. We like the business. We like the management that we have. And over time, it's been a very good business. You can see the results in our second quarter statements. On the CPI, the Consumer Price Index, so we had a cost of $428 million that we invested in the Consumer Price Index derivatives that benefit from deflation but that suffer from inflation. Again, explained in our annual report. What's this cost, well this is what we paid for it. We've already taken a $246 million loss unrealized, it would be the 10-year contracts. So in our books, it's at $182 million. When you look at the 6 months, you'll see a $285 million loss in the 6 months. That's because we had some unrealized profits in 2010. But if you look at cost, we paid $428 million; we've taken $246 million loss so it's in our books at $182 million. This is what fluctuations do. They go up and down. These are 10-year contracts. We think of this as insurance in terms of the unexpected. And if we have deflation, these contracts can be very, very valuable. And we have not sold any. We have the better part of $50 billion in terms of nominal exposure. But it fluctuates and so our statements in the first 6 months so $285 million loss, that's gone through our statements. But in terms of our costs, it's original cost, $246 million. We like it, and we like it over the long term.

Operator

James Findlay from Park.

James Findlay

Could you just remind me what your cost is in some of your international operations, and how you think about the value of those. You seem to be, every quarter, you make more investments.

John Charles Varnell
Vice President of Corporate Development

Okay. Cost in the international operations. Wait until I get my sheet here.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Yes. We've given a little in the annual report for you. But John, approximately, how much have you got in our international operations?

John Charles Varnell
Vice President of Corporate Development

Our share of book value would be the -- just under $1.3 billion. We would have premiums that would be greater, somewhat greater than that $1.3 billion. In some of those cases, we have 100% ownerships. In other cases, we have 26% ownership in India. So we have a good mix there. The reason we like those markets is that there's not a lot of insurance written there so you can grow your insurance business quite a bit. And also, you have low penetration in terms of how -- the number of people buying, so you have good growth opportunities there. And the example, best example would be India, where we went in about 10 years ago, put in $10 million, $20 million, and now we have the largest private insurer in India, which would write in excess of $800 million, $900 million. And so that's the reason we like it is the growth opportunity as well as the investment opportunity for looking at local investments with local management who know the market, so it gives him and Watsa an advantage there as well.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

We've built these over the last 10 years, and they're getting to be quite significant and as John said, growing, but with little money in.

James Findlay

Out of the $1.3 billion book cost, how much of that would be India?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

How much is India?

John Charles Varnell
Vice President of Corporate Development

Seriously; $100 million, just over $100 million in terms of book.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Our equity interest in our India operation, that's 26%. That's a maximum that the Indian government allows foreign companies to own. It's approximately $100 million.

Operator

I have no further questions in the queue at this time.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

No more questions, Julianne? Well, if there are no more questions, thank you all for joining us on this call. We look forward to presenting to you again after the next quarter. So thank you.

Operator
This concludes today's conference call. Thank you for joining. All parties may disconnect at this time.