S&P Capital IQ

CONTENTS

Old Republic International Corporation

NYSE:ORI

FQ2 2014 Earnings Call Transcripts

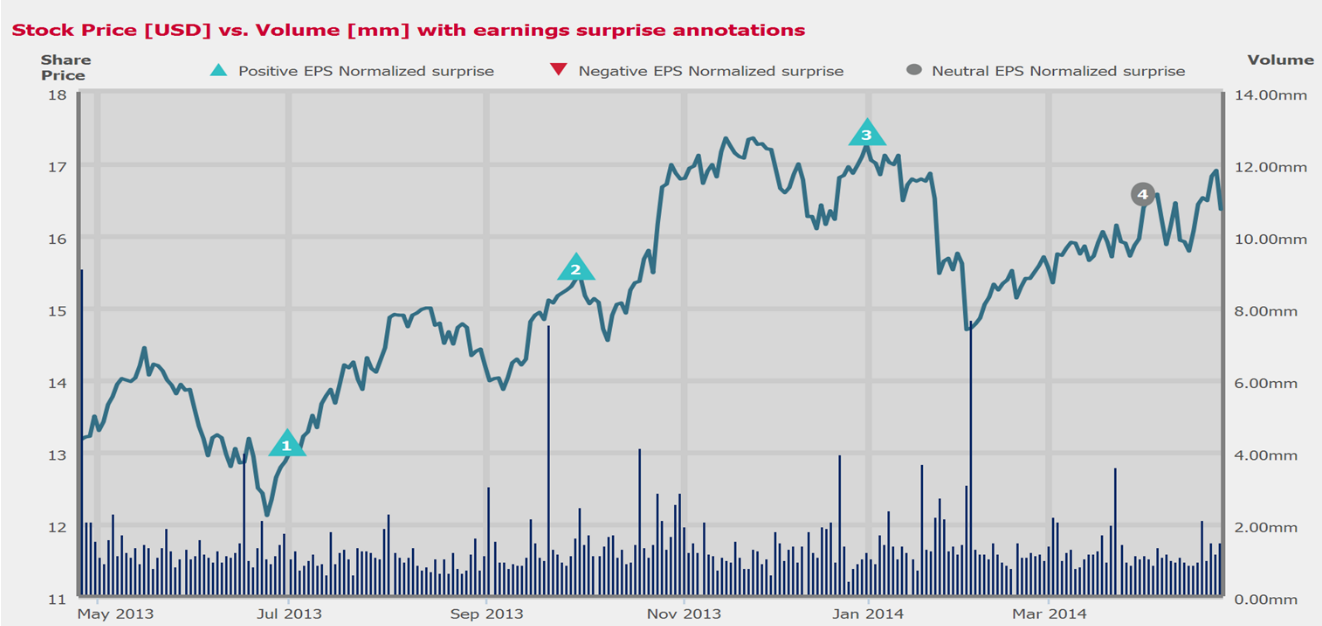
Thursday, July 24, 2014 7:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2014-			-FQ3 2014-	-FY 2014-	-FY 2015-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.26	0.13	(50.00 %)	0.26	0.96	1.12
Revenue (mm)	1294.45	1333.90	3.05	1337.90	5259.33	5268.60

Currency: USD

Consensus as of Jul-24-2014 3:42 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ2 2013	0.02	0.37	1750.00 %
FQ3 2013	0.11	0.35	218.18 %
FQ4 2013	0.20	0.33	57.14 %
FQ1 2014	0.24	0.25	0.00 %

Call Participants

EXECUTIVES

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Karl W. Mueller
Chief Financial Officer and Senior Vice President

R. Scott Rager
President and Chief Operating Officer

Rande K. Yeager
Chief Executive Officer and President

Scott Eckstein

ANALYSTS

Christine Amanda Worley
JMP Securities LLC, Research Division

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Presentation

Operator

Good day, and welcome to the Old Republic International Second Quarter 2013 -- 2014 Earnings Conference Call. Today's conference is being recorded. [Operator Instructions] I would like to remind everyone that this conference is being recorded.

I would now like to turn the conference over to Scott Eckstein with MWW group. Please go ahead.

Scott Eckstein

Thank you, operator. Good afternoon, and thank you for joining us today for Old Republic's conference call to discuss second quarter 2014 results. This morning, we distributed a copy of the press release. If there is anyone online who did not receive a copy, you can access it at Old Republic's website, which is www.oldrepublic.com. Please be advised that this call may involve forward-looking statements, as discussed in the press release dated July 24, 2014. Risks associated with these statements can be found in the company's latest SEC filings.

Participating in today's call, we have Al Zucaro, Chairman and Chief Executive Officer; Scott Rager, President and Chief Operating Officer; Karl Mueller, Senior Vice President and Chief Financial Officer; and Rande Yeager, Chairman and Chief Executive Officer of Old Republic Title Insurance Companies.

At this time, I'd like to turn the call over to Al Zucaro for his opening remarks. Please go ahead, sir.

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Okay. Thank you, Scott. And this is Al Zucaro, and on behalf of all of us here, I bid you a good afternoon. We're going to follow the same approach we've taken in the past, and that means that we'll have several of our senior officers that Scott has just identified to participate in this discussion. Today, therefore, Scott Rager will address happenings in our General Insurance business. Rande Yeager will pick up the microphone for -- and discuss on our Title business. Karl Mueller will talk about the significant financial aspects of our consolidated operations. And I'll say a few words initially, and then at the end of the discussion, at which point we'll, as we've indicated, open it up to questions.

So let me begin by first addressing the RFIG runoff business, which has continued, obviously, to surprise, both positively and negatively in this particular quarter, as a matter of fact.

As we reported this morning, if you do the calculations, a little more than 80% of the approximate $110 million reduction in the latest quarter's consolidated earnings for Old Republic came from the RFIG runoff. And this overall RFIG operation obviously ended up in deep red territory on the heels and following, I should say, 4 consecutive quarters of positive performance, which began in the second quarter of 2013 and which was driven, principally, by the mortgage guaranty insurance operation, which was during those quarters and has remained in this latest quarter, favorably appreciative -- appreciating to the bottom line.

Now as we show in the release, this sudden turn into red obviously stemmed from the consumer credit indemnity, or the CCI portion, as we refer to it in the business, of the runoff book of business. And as we also said in the release, there are 2 basic reasons for this turn of events. First, we experienced in July a final settlement of a suit for an amount that exceeded the most recent expectations we had. And secondly, we made a management judgment to make some -- to effect some further increases in reserves for ongoing litigation that also relates to the separate CCI disputes and one in particular of some consequence.

This particular larger dispute is with one of the nation's largest banks, and it has been disclosed for a number of years in our regular reports and filings with the SEC. And this dispute stems from our findings of what we consider to be systemic misrepresentations and fraud committed by the institution to secure

CCI coverage from Old Republic in prior years, mostly, of course, the years which preceded the Great Recession.

Now, as in all litigation, there is never any certainty of outcome. But we believe that in this particular instance, there can be some great confidence that, litigation expenses aside, that our position should be sustained.

Turning to the mortgage guaranty portion of the RFIG runoff. The news here continues to be uniformly good. First and most importantly, we think, as we reported in -- on July 1, as I recall, we have stabilized the financial condition of our flagship Mortgage Insurance subsidiary, and we've done that by injecting a necessary amount, specifically $125 million of cash and securities that were available within our holding company system.

Concurrently, we also had applied and then received regulatory approval to, at once, discontinue the deferral of a portion, namely 40%, of all claims that have been finally settled in the past couple of years or so, and then to also liquidate all the accumulated and previously deferred payment balances. As I say, this was all accomplished during this month of July following the regulatory approval that came from the main insurance regulator for our mortgage guaranty company, which is the state of North Carolina.

So from this point forward, we expect some reasonably clear sailing as we work steadfastly to achieve an orderly and, we believe, very economical runoff of the mortgage guaranty book of business. As we said on many occasions, we count our blessings in having a very dedicated, highly qualified and resourceful group of associates in our Mortgage Guaranty business that are helping us to achieve all the worthwhile objectives we have.

As indicated in both the tables on Pages 3 and 4 of this morning's release, the MI business posted an operating profit for the fifth consecutive quarter. Again, as indicated, the key factors leading to this positive performance are the same as we've outlined in past releases, as well as this one, and as is further evidenced among the mortgage guaranty statistics and the trends that are shown in the financial supplement, which we've posted on our website, as we do each quarter.

As always, there is no guarantee that this MI runoff will continue to perform as positively as it has in the recent past. But housing trends are all favorable, as you know. They bounce up and down, but the longer-term trend does seem to be very forward-looking for anything having to do with housing for the foreseeable future. And all of this is a good omen for the mortgage guaranty runoff.

So look, before -- let me just add a couple of points before turning the call over to Scott Rager about the future effects that the mortgage guaranty runoff has on Old Republic's overall business franchise.

First of all, we are achieving a run off by fully meeting all of our legitimate claim obligations and thus serving the direct interests of all MI policyholders, claimants and other stakeholders.

Secondly, and just as importantly, by stabilizing the MI insurance subsidiaries from a financial point of view, as we have, we are eliminating any perceptions or concerns that their operational difficulties of the past could have posed and served to expose the overall Old Republic business to certain dire happenings, such as liquidity or debt acceleration issues or even, I might say, possibly consequential risks to our reputation and good name. We think that all of these perceptions and related concerns can now be safely put to rest and that Old Republic can move forward on -- with the rest of its business and remain in very good shape for the future.

So on that note, I will turn the meeting now, as I said, to Scott Rager and my other associates, who will address the other important factors of our business. So Scott, do you want to take over?

R. Scott Rager
President and Chief Operating Officer

Thanks, Al. Okay, we'll now address the General Insurance group results, exclusive of the CCI product impact on those numbers. Net premiums earned were up nicely for the quarter and year to date at 9.4%, and we believe that trend will continue for the remainder of the year. As we're seeing new business opportunities in many segments of our operations, that, coupled with increasing payrolls associated with the slowly recovering economy, as well as moderate rate increases, would indicate that this increase is sustainable for at least the remainder of the year.

Premium growth is really taking place across all underwriting units, but it is particularly accentuated in our risk management, auto carry transportation and construction operations. Growth in the latter is much more driven by increased rate levels and organic growth of existing accounts.

On the claims side of the ledger, as our release indicates, we are still experiencing increased loss cost, particularly in workers' compensation and general liabilities. These trends are more pronounced in the middle-markets and construction segments of our business and much less pronounced in the loss-sensitive products.

In the latter, our insureds have skin in the game, so to speak, through higher retention levels or other experience-sharing mechanisms. And thus, that's our strategy to move our underwriting focus away from largely main street, rate-sensitive writings to more loss-sensitive products and programs.

As for the construction results, we believe the implications of the recession and the slower recovery in the commercial construction arena have definitely impacted claim costs to a greater degree than in other markets in which we participate. Pressures on opportunities for light-duty and return-to-work status continue to impact the long-term costs of claims. Loss costs thus mount, and more adequate rate levels are necessary to address this phenomenon.

We've implemented such strategies and are seeing gradual progress. All in all, workers' compensation and general liability aren't where we want them, and they won't remain there. Results can vary quarter-to-quarter, but our emphasis is on building quality books of business that deliver over time. That's our strategy, and we are actively managing to that end.

The loss ratio in workers' compensation year-to-date of 82.9% should moderate to 2013 year-end levels as the year progresses and as increased rate levels are realized through the earnings stream. General liability results should ultimately perform likewise, with the caveat, though, that general liability's a much more volatile line and can be more impacted by the severity of occurrences in that interim.

In a nutshell, as we've said before, the expected loss ratios in 2014 should track similar to year end 2013, with workers' compensation and general liability moderating thereafter to what we have demonstrated as more historic levels. Our expectations are not changed in these regards.

The expense ratio at 23% for the quarter and 23.2% year-to-date is the result of increased writings and of our deep-seated culture to efficiently manage the business.

So in summary, we expect good, steady growth for the remainder of the year, with operating ratios moderating toward those, as indicated, of 2013.

Those are my remarks. So now I'll turn the phone over to Rande Yeager. Rande?

Rande K. Yeager
Chief Executive Officer and President

Great, thanks, Scott. As we reported, the Title company experienced a nice profit rebound in the second quarter. As we reported this morning, the earnings were positive at $26 million. Industry-wide real estate activity remains sluggish. This year, refinancers are running about 65% below last year, and purchase money resale, new building money transactions are right about 10% below 2013 levels. But in this context, our commercial business has continued to grow, and our market share ticked up to 15.5% in the latest ALTA report. At this juncture, we don't see signs of a rapidly improving real estate market. Refinances are not going to improve to 2013 levels, and sales of new and existing homes are not going to improve quickly enough to compensate for the currently smaller refinance segment of the market.

We're going to see a gradually improving purchase money market, but it probably will take a 2- or 3-quarter look back at our business to say that things aren't as slow as they were, or at least what they seem they are.

Industry-wide, the first quarter was an aberration. Interest rates, regulatory influences, as well as the weather contributed to the falloff in the business. And I think in the second quarter, results represented some of the makeup for the difficulties we encountered in the first quarter. As you see in the release, premiums and fees were down about 18% for the quarter and 16.5% year-over-year.

We've always concentrated on the long-term value of our business and we'll continue to do so. Our emphasis on the agency side of the industry helps us to keep our variable cost more in line with market downturns. Agency growth has certainly benefited our rapidly increasing national market share and does not appear to be stalling out. We're confident that this strategy will continue to benefit our bottom line. We remain highly committed to the success of our company and its long-term growth and profitability. We are continuing to search and have been succeeding in identifying additional sources of profitable revenue. We believe they are out there, and we really believe they will continue to enhance our performance and industry presence.

With that, I will turn it over to my associate, Karl Mueller.

Karl W. Mueller
Chief Financial Officer and Senior Vice President

Okay. As we've done with previous quarterly calls, I'll comment briefly on Old Republic's financial condition as of June 30 before we then open up this call for your questions.

This morning, we reported that Old Republic ended the quarter with consolidated assets growing to nearly $17.2 billion, and that's up about 4% from year-end 2013. The cash and invested asset balance of $11.4 billion is up slightly from the first quarter, as the portfolio continues to benefit from the investment of positive operating cash flows and higher market valuations on those securities. The fair value of the bond portfolio increased slightly from 103.6% of book value at the end of March to 104.6% at June 30. The credit quality of the portfolio remains at an overall A- rating, which is unchanged from the prior year end.

As noted in this morning's release, we continue to place greater emphasis on common equity investments, which now make up approximately 13% of the total portfolio, and that's up from around 9% at year end '13. Investment income increased 84 -- excuse me, $85.4 million in the second quarter, as new investments in fixed-income securities are benefiting from slightly higher market yields. In addition, investment income benefited from the shift to higher-yield income stocks and equity funds, which I just noted. On a year-to-date basis, these factors have resulted in net investment income increasing to $168 million, which is up from $158 million during the same period a year ago.

Claim costs on a year-to-date basis have developed essentially even with the prior year-end consolidated loss reserve balances, and that's in contrast to a modest favorable development for the same period in 2013. This year's reserve development was most significantly impacted by the CCI claims settlement that was noted earlier in this call and in this morning's release and the continued development of prior years' workers' compensation and general liability claims. The June 30 benefit in claim reserves balance also includes nearly $657 million of mortgage insurance deferred payment obligations, or DPOs, as we often refer to them. As discussed earlier, the North Carolina Department of Insurance recently approved the payment of these accumulated DPO balances, and we've now processed payment of these reserves and have used the short-term investment balances that had been accumulated over time in our Mortgage Insurance subsidiaries for this purpose.

So the impact of this payment will be to decrease reserves in the related balance sheet net reserve leverage by roughly 10%. In addition, it will reduce the size and financial significance of our flagship Republic Mortgage Insurance Company subsidiary in relationship to Old Republic's consolidated totals. We should also point out that investment income should not be negatively impacted in future periods, since the short-term investment balances used to fund the DPO payments have been earning a yield of basically next to nothing.

As of June 30, the debt-to-equity ratio stood at 14.3%, and the debt-to-total capitalization ratio was right at 12.5%, both ratios largely unchanged from the prior year end. While we have no imminent plans to raise debt capital for general corporate purposes, these leverage ratios clearly support our ability to do so.

Shareholders' equity at the end of June was $3.95 billion, or $15.29 per share, which was an increase of $0.32 per share from the end of the first quarter of this year.

Page 5 of this morning's release provides a reconciliation of the key elements affecting this change for both the quarter and the year-to-date periods.

And then finally, from a parent company liquidity perspective, as was mentioned earlier, we did complete the $125 million capital contribution to the mortgage segment during the second quarter, as we disclosed several weeks ago. And despite this contribution, we continue to remain sufficient -- maintain sufficient liquidity at the ORI parent company and our affiliated noninsurance underwriting subsidiaries to meet our foreseeable obligations.

So there you have the highlights of our current financial situation. And I'll turn the call back to Al for a few closing remarks.

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Okay, Karl. So looking ahead to the next few quarters, we think that the RFIG runoff, x any litigation surprises, should proceed on a fairly even keel. In General Insurance, as Scott intimated, we should experience a very gradual lessening of the upward pressure on workers' compensation and general liability claim costs, in particular, as the benefits of rate changes that have been instituted steadily in the past 30 months or so continue to kick into the premium income stream. And moreover, as Rande Yeager has indicated, our Title business is in good shape to also gradually provide upside potential, over time, to the Old Republic bottom line.
So now, having said all of this, as we promised and as was indicated, we'll now entertain the questions that any call participants may have. You can all direct your questions to me. And we'll, in turn, direct them to each of our associates here as necessary. So let's move on.

Question and Answer

Operator

[Operator Instructions] And we'll take our first question from Vincent DeAugustino with KBW.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Just to start off, with Al or Scott, to the points that you made about expecting workers' comp and GL margins took moderate towards 2013 levels, I guess from one angle, it would seem that the market really isn't going to tolerate a rapid acceleration in rate increases. And so to your point on the loss cost side, I'm just curious what it is exactly about the loss cost environment that you expect to become more favorable, or if it's just really to clarify that you would expect some of the reserve pressure on workers' comp and GL to sort of taper off.

R. Scott Rager
President and Chief Operating Officer

Well, I think, to first answer your question, I think we've -- we're implementing, obviously, some loss cost mitigation factors in terms of the -- on the medical side. I think we're seeing a lesser degree of medical inflation than we've seen in the past -- particularly past 5 years. The other opportunity is I still think that, in the areas in which we seem to be having our issues with respect to workers' compensation, we are still able to achieve what we think are fair but adequate rate increases in those areas. Our business is spread over such a large spectrum of the industry -- different industries, actually, that some are, shall we say, low-risk, some are high-risk classifications. And where we're having the most issues, we are still capable at this point in time of getting moderate -- by moderate, I mean anywhere from mid-single-digit percentage to high single-digit percentage increases on those books of business. Also with respect to -- as I indicated earlier, it depends on where the book is and on the accounts and individual accounts and how -- whether we move those again to do more risk-sharing opportunities and programs versus middle-market guaranteed-cost-type products. And I think as we move the book -- and we've been successful on that endeavor over the last couple of years of gradually shifting that book more toward a loss-sharing book versus a rate-driven book, I think the results will be forthcoming. Does that answer your question?

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

It most certainly does. And then, Al, just completely understanding that your first priority is to responsibly run off the MI unit, if we go back to last quarter, I think one of the thoughts that was still kind of around was that at some point -- again, some point down the road, when the time was right, that there was maybe going to be an opportunity to for you part ways with RMIC. And I'm just curious if, with some of the new GSE capital rules coming out, if you would think that some of those capital requirements being a little bit more onerous would make it just a little bit more difficult to really recapitalize RMIC and turn the lights back on, if you will.

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Well, I think it's all going to be dependent on what appetite there is in the marketplace to have 1 or 2 or 3 additional players in the business. It remains to be seen what is done with the GSEs, specifically, the extent to which they are pulled back from the -- from the major activity that they had at a time. And if that happens, obviously, there's going to be greater room for the private sector to step in. And if it can be shown that the results can be there, the private sector usually fills the vacuum. As to your point about the greater capital requirements, I mean, those capital requirements are going to be uniformly greater for everyone. So whether you have an active company or a new company, it all comes down to, listen, can you make money at this business? Can you get a decent return? And if the answer to that is yes, the money will be there. That's our feeling right now. As to when this might be an active prospect for us, time will tell. We're just overcoming a bunch of activity, namely, the payment of the DPO, the recapitalization to stabilize the companies, et cetera. So now we're going to sit back and relax for a while before we attend to any other approach with respect to that business.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. And you may or may not want to comment on this. But if we look at AIG's favorable element with Bank of America over their MI claims, is that something we can maybe look at as a good indication of how your own litigation with Bank of America might turn out?

Aldo Charles Zucaro
Chairman and Chief Executive Officer

I think the issues tend to be similar, and I think that's why you had not just Bank of America, but other banks, Chase, Citi, you name them, all coming to the trough and settling. And I think our time is going to come, and I think our feeling is that the settlement with anybody that we are having difficulty with will be fine. It will work out fine. Because as I say, the issues are similar, and they all deal with misrepresentations of one sort or another and, sometimes, systemic fraud.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

If I can sneak one last one in, then I'll let someone else have a turn. On the Title side, just with the environment from a volume standpoint being a little bit more challenged, just has the pricing environment on the agency and indirect side, has that changed at all? Or is -- have things either been stable or more competitive? Just looking for some dynamics on what the environment might be like.

Rande K. Yeager
Chief Executive Officer and President

If you want help, Al, I can certainly address that.

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Yes, please. Sorry.

Rande K. Yeager
Chief Executive Officer and President

It's stable. We haven't seen any nods to higher or lower pricing. Agency splits have remained the same. And, as far as the different regulatory schemes that we have around the country, we're not seeing much difference at this particular point.

Operator

And we'll take our next question from Christine Worley from JMP Securities.

Christine Amanda Worley
JMP Securities LLC, Research Division

I just wanted to dig in a little bit on the reserve development in the general liability and workers' comp lines. Would it be possible to quantify that?

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Well, as Karl indicated, and as we have indicated, I think, every quarter for many years, Christine, we always point out, first of all, that 1 quarter or half a year, in this case, does not make a whole year. That's point #1. And point #2, we have indicated for at least the last couple of years, I would say, that the level of reserve redundancy that we had been experiencing steadily at Old Republic for a good decade and more had been decreasing. And that is really reflective of the pricing issues that we have been dealing with, particularly in the last 4, 5 years before we started to, as Scott mentioned before, to rectify our pricing, both as a company, as well as an industry. So it bears repeating that the studies we make of publicly held companies' reserve developments, as those are set forth in the triangles, which appear in the forepart of the 10-K, still show Old Republic as one of the relatively few companies that produce reasonably steady development -- favorable developments of reserves. So what we're talking about and what, I believe, Karl indicated a few minutes ago, is that we are still in a positive manner. Overall, again, as Karl, I think, mentioned, the main issues relate to the RFIG business, specifically, the CCI as it's gone into the red for a longstanding claim which got settled, which therefore, by definition, ends up reflected as a negative or unfavorable development of prior year reserves. And you see those numbers there. That's been offset by the MI business, and we've indicated what the effect is there. And so what remains is the General Insurance business, and that's become much more of a touch-and-go. Typically, we've had 2% to 3% reserve -- favorable reserve developments in General Insurance over many years. And now, as I say, it's touch-and-go. It's pretty much on the button. That's the best we can say to you or tell you about the dynamics of this reserve development.

Christine Amanda Worley
JMP Securities LLC, Research Division

No, that is helpful. I'm just trying to, I guess, get to the core of sort of where the accident year is running for this year and if there were any movements in that in the quarter.

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Well, as we say in our footnote disclosures regularly, we do use loss pick technology for current year's long-tail business. And as you know, what that reflects is our best assessment of what's happened to pricing and the implications that has on prior year's actual developed claim costs. So for the last 3 years, in particular, we feel comfortable that the loss assumptions we're making should prove reasonable. So the lion's share of what we're experiencing, which is throwing a little bit of a monkey wrench into the thing, relates to years 2010 to -- what would you would say Karl, 2004, '05? That's where the lion's share of any adverse development is occurring. And it's occurring in these lingering cases. As you know, the easiest -- the easy cases are settled first, and the bad ones remain in the pipeline, and that's what we're trying to resolve right now. We're trying to get some of these old ones paid off and settled as quickly as we can. But whenever we do that, that's where we've been experiencing some case reserve deficiencies.

Christine Amanda Worley
JMP Securities LLC, Research Division

Okay. Did you experience, I guess, any of these hiccups in the first quarter? Or are those sort of better run rate numbers for our modeling for the -- for where the current accident year is running?

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Karl, help me on that. But I think the -- this has been developing steadily the last 2 years, right?

Karl W. Mueller
Chief Financial Officer and Senior Vice President

That's right. I would say the second quarter was perhaps a little more decimated [ph] than the first, but the conditions that Al described were present in the first quarter, as well.

Christine Amanda Worley
JMP Securities LLC, Research Division

Okay, thank you. That's helpful. And then in the general -- in these lines that you say you want to keep getting rate, is there a way to sort of quantify the gap between the rate that you're getting and where loss cost is currently trending?

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Well, as Scott mentioned, we're still experiencing, not across-the-board, some rate increases in GL, general liability and comp. But I think the biggest benefit for loss, again, as Scott has mentioned already, is going to come from the fact that we are moving -- keep moving a greater portion of our business to what's referred to as loss-sensitive approaches to underwriting, where the customer has got some skin in the game, as Scott reported before. And also, the utilization of alternative market mechanisms, such as retros and captives and what have you. That's where I think our biggest benefit is going to come from going forward, rather than straightforward rate increases.

Operator

It appears there are no further questions at this time. I'll turn it back over to our presenters for any closing remarks.

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Okay. As always, we appreciate your interest and look forward to our next visit. Hopefully, we will not have some of the adverse developments that we've had to report, rather unpleasantly, this quarter. So we look forward to visiting with you next time. You all have a good day.

Operator
And that concludes today's conference call. We appreciate your participation.