![S&P Capital IQ]

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Markel Corporation NYSE:MKL

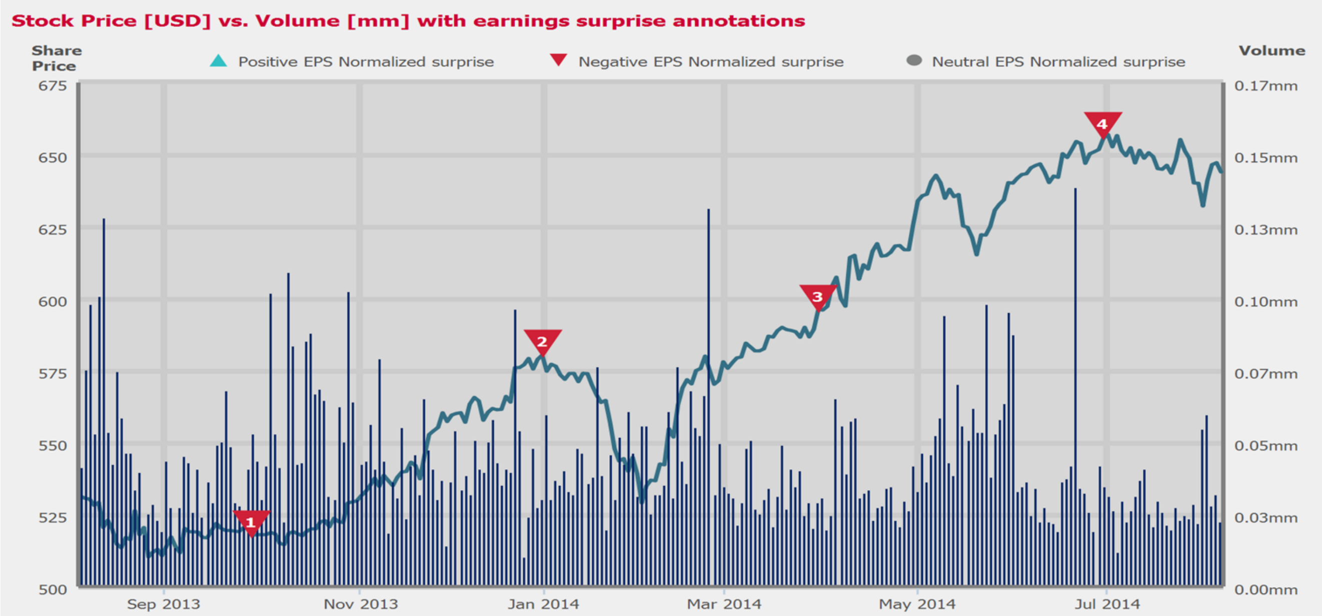
FQ3 2014 Earnings Call Transcripts

Thursday, November 06, 2014 3:30 PM GMT

S&P Capital IQ Estimates

	-FQ3 2014-			-FQ4 2014-	-FY 2014-	-FY 2015-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	5.44	5.30	(2.57 %)	5.62	17.80	22.92
Revenue (mm)	1291.90	1299.29	0.57	1324.36	5126.06	5433.55

Currency: USD
Consensus as of Nov-06-2014 2:25 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2013	6.14	4.67	(23.94 %)
FQ4 2013	5.77	5.54	(3.99 %)
FQ1 2014	5.74	5.32	(7.32 %)
FQ2 2014	5.75	2.47	(57.04 %)

Call Participants

EXECUTIVES

Anne G. Waleski
Chief Financial Officer and Executive Vice President

Francis Michael Crowley
Vice Chairman

Richard R. Whitt
Co-Chief Executive Officer and Director

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

ANALYSTS

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

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

Presentation

Operator

Greetings, and welcome to the Markel Corporation Third Quarter 2014 Earnings Conference Call. [Operator Instructions] As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Mr. Tom Gayner, President and Chief Investment Officer. Thank you, Tom. You may begin.

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

Good morning. Thank you, and welcome. We're glad that you're with us and we look forward to discussing our results from the first 9 months of 2014 as well as our thoughts on the business. Anne Waleski, our Chief Financial Officer, will review the overall financial results; and my co-Presidents, Mike Crowley and Richie Whitt will then cover our insurance operations. Then I'll return to discuss our investments and Markel Ventures activities.

Before we get started, I'll remind you of the Safe Harbor statement. As a reminder, comments made on today's call may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. They are based on current assumptions and opinions concerning a variety of known and unknown risks. Actual results may differ materially from those contained in our -- or suggested by such forward-looking statements. Please refer to the full disclosure regarding the risks that may affect Markel, which may be found in our most recent Annual Report on Form 10-K and quarterly reports on Form 10-Q.

With that, let me turn things over to Anne.

Anne G. Waleski
Chief Financial Officer and Executive Vice President

Thanks, Tom, and good morning, everyone. I'm pleased to report that the positive momentum that we experienced in the first half of 2014 has continued into the third quarter. Our financial results for the first 9 months of the year are very solid. We produced underlying profits in all 3 ongoing insurance segments and continue to align the legacy Alterra reserves with the Markel's preserving philosophy. Markel Ventures completed the acquisition of Cottrell, Inc. during the period and continue to look for profitable growth opportunities.

Our total operating revenues grew 25% to $3.8 billion in 2014 compared to $3 billion in the first 9 months of 2013. The most significant drivers of this increase continue to be the inclusion of 9 months of underwriting revenues from legacy Alterra product offerings in 2014, higher revenues from the Hagerty business, and higher investment income due to our larger investment portfolio. Also contributing to the increase, other revenues were up 25% to $630 million from $505 million last year, primarily due to revenue growth within Markel Ventures.

Moving into the underwriting results. Gross written premiums were $3.8 billion in 2014 compared to $2.9 billion in 2013, an increase of 30%. Net written premiums were $3.1 billion in the first 9 months of 2014, up 28% from the prior year. And earned premiums increased 26% to $2.9 billion. These increases were driven by the inclusion of 9 months of premiums from the legacy Alterra products in 2014 compared to 5 months of legacy Alterra premiums in 2013. Net retention was down slightly in 2014 at 82% compared to 83% in 2013. The slight decrease, which is in line with our expectations, is primarily due to higher use of reinsurance on certain insurance products previously underwritten by Alterra.

Our consolidated combined ratio for the first 9 months was 97 in both periods of in both periods, 2014 and 2013. As a reminder, the 2013 combined ratio included transaction and other acquisition-related cost of approximately $70 million or 3 points related to the acquisition of Alterra. The combined ratio in 2013 also included approximately $32 million or 1 point of catastrophe losses. Excluding the impact of catastrophe and transaction and acquisition-related costs from the 2013 combined ratio, the combined ratio for 2014 increased 4 points compared to the prior year. This increase was primarily due to the less-favorable development on prior year loss reserves in 2014 compared to 2013.

The consolidated combined ratio for the 9 months ended September 30, 2014, included approximately $260 million of favorable development on prior year loss reserves compared to $281 million of favorable development for the same period in 2013. The benefit of the favorable development on prior year loss reserves had less of an impact on combined ratio in 2014 than in 2013 due to higher earned premium volume in all 3 our ongoing underwriting segments in 2014. In addition, the U.S. insurance segment has less favorable development, due in part to adverse development on our architects and engineers product line in 2014, and less favorable development on Hurricane Sandy in 2014 compared to 2013.

Now I'll move to the results of Markel Ventures. During the first 9 months of 2014, revenues from Markel Ventures were $595 million compared to $486 million a year ago. Net income to shareholders from Markel Ventures was just over $16 million in 2014 compared to $18 million for the same period in 2013. EBITDA was $66 million in 2014 compared to $64 million in 2013. For the 9 months ended September 30, 2014, revenues were higher than the same period a year ago due to our acquisitions of Cottrell in 2014 and Eagle Construction in 2013. Likewise, EBITDA from our Markel Ventures operations increased in 2014 compared to 2013, primarily due to the acquisitions of Cottrell and Eagle, partially offset by less-favorable results in our existing manufacturing operations.

Moving to our investment results, investment income was $270 million for the first 9 months of 2014 compared to $229 million in the same period last year. The benefit of holding a larger portfolio was partially offset by this lower yield. Net realized investment gains for the period were $29 million compared to $41 million a year ago. Included in that, realized gains were $3.9 million of other than temporary impairments as compared to $4.6 million in 2013.

Looking at our total results for the year, net cash provided by operating activities was $537 million for the first 9 months of 2014 compared to $543 million for the same period of 2013. The decrease is due to higher tax payments for our international operations, partially offset by higher cash flows from investment income and underwriting activities due to the inclusion of Alterra. Our projected effective tax rate was 25% in the first 9 months of 2014 compared to 28% a year ago. The decrease in the effective tax rate in 2014 is primarily due to anticipating a larger tax benefit related to tax-exempt investment income, and a decrease in the estimated foreign earnings subject to U.S. tax in 2014 as compared to 2013.

We reported net income to shareholders of $204 million in the first 9 months of 2014 compared to $182 million a year ago. Comprehensive income was $517 million for the first 9 months of 2014 compared to $253 million a year ago. Book value per share at the end of September 2014 was $514, an increase of 8% since the end of 2013.

With that, I'll turn it over to Mike to talk about the U.S. Insurance segment.

Francis Michael Crowley
Vice Chairman

Thanks Anne, good morning. The U.S. Insurance segment, as we pointed out before, comprises all direct business written on our U.S. in companies and included all the underwriting results of our Wholesale and Specialty divisions as well as certain products written by our Global Insurance team.

For the third quarter, gross written premium was up 3% over prior year. Year-to-date, gross written premiums have increased 13% over prior year. This increase was due in a large part to the Alterra lines of business that are now included in this segment. Excluding these lines, premium buy-in was up 5%. Keep in mind that we have been exiting or re-underwriting some lines in our Specialty and Wholesale divisions and this has impacted growth.

The combined ratio for the quarter was 95 for both 2014 and 2013. The combined ratio for the year was 97% as compared to 94% in 2013. As Anne pointed out, the higher insurance segment combined ratio was driven by less favorable development of prior year losses, due in part to adverse developments in the architects and engineers line of business. Partially offsetting this impact was a lower year-over-year expense ratio. The improvement in the expense ratio was due to higher contribution of earned premium from the legacy Alterra in 2014 and in 2013 and due to the nonrecurring transaction cost recorded in 2013 associated with the Alterra acquisition.

The rate environment in the U.S. segment remains competitive. However, we continue to achieve modest single-digit rate increases on small to medium-sized risk across the various divisions within the segment. Large accounts remain under competitive pressure and prices for property casualty lines on Fortune 1000 business remain soft. Operationally, during the quarter, we combined our Atlanta and Richmond specialty program units under one management team and we expect this reorganization to improve our results in 2015 from both an underwriting and expense perspective. Also in the Specialty division, year-to-date, data revealed benefits from our initiatives to cross-sell and round accounts between first comp and Markel Specialty programs. 566 accounts have added additional coverages through this rounding effort.

In our Wholesale division, we continue to see strong growth in our binding P&C, environmental and excess umbrella lines. Our E&S Executive team had a very busy outflow holding over 350 face-to-face meetings with our Wholesale partners. We continue to grow with our top wholesalers and this meeting provides the opportunity for an intense few days of one-on-ones. All 5 Wholesale regions' volume is up year-to-date.

Also, our Specialty and Global and Executive teams attended the annual CIEB conference, which, like [indiscernible], allows us to visit face-to-face with many of our key brokers and agents. The broad array of Markel products, both large and small accounts, has made us an attractive alternative for many agents. Gerry Albanese, our Executive Vice President and Chief Underwriting Officer, presided over a number of product line leadership meetings during the quarter. These meetings were attended by our most senior underwriters and they provide a platform for communication between the underwriting leaders and our regional operations as we finalize business plans and budgets for 2015.

In summary, we remain focused on those same key objectives that have driven us throughout 2014. Reassessment of some lines of business, expense reduction and control, attraction of talent and aggressive sales and marketing.

I'll now turn the call over to Richie.

Richard R. Whitt
Co-Chief Executive Officer and Director

Thanks, Mike and good morning, everyone. Following on from comments by Anne and Mike, I'd sum up the first 9 months of the year of Markel's underwriting operations as solid and business as usual. I think this is a really important statement when you consider that we are establishing, consistent with our historical practices, a loss reserve margin of safety on legacy Alterra business.

Turning specifically to the results of the International Insurance and Reinsurance segments. In the international Insurance segment, which includes business written by our Markel International Division, as well as written by our Global Insurance division has performed well so far this year. During the 9 months of 2014, gross written premiums in the International insurance segment increased 13% to $653 million. The combined ratio was 95% compared to 92% the prior year. The increase in premium writings was primarily due to the Global Insurance division, which was created after the acquisition of Alterra, and contributed 9 months of business in 2014 compared to only 5 months of business in 2013.

The higher segment combined ratio was driven by a higher current accident year loss ratio, partially offset by favorable expense ratio. The improvement in the expense ratio was due to transaction cost of the Alterra merger back in 2013. And higher earned premiums from the Global Insurance division, which carry a lower expense ratio.

Now I'll turn it to the reinsurance segments, which includes reinsurance programs written by our Global Reinsurance division, as well as that written by our Markel International division.

Gross written premiums for this segment were $999 million for the first 9 months of 2014, and that was up from $443 million a year ago. The increase in premium writings was primarily due to, including 9 months of writing from product previously written by Alterra in 2014 compared to 5 months of writings in 2013. The combined ratio for the reinsurance segment was a 97, this compares to 108 last year. Last year's combined ratio included 7 points of catastrophe losses. Really very minor catastrophe losses this year really of the attritional nature, I would say. And approximately 10 points of nonrecurring cost associated with the acquisition of Alterra.

Operationally, during the quarter and first 9 months of the year, we recently announced that Dave Kalainoff will be retiring from Markel Re in June of next year and that Jed Rhoads will be taking over responsibility for all of Markel Re. It can't thank Dave enough for all that he's done to ensure the smooth transition of Alterra reinsurance operations into our Markel Re division. Also, I know Jed will do a fantastic job leading our reinsurance team into the future.

Markel International's integration of its Abbey acquisition continues to go well. We've added marketing and sales resources as well as some new product capabilities to the Abbey team. Abbey is a wonderful franchise and with the additional resources that Markel can bring to the table, we believe that solid growth as possible.

As Mike said, all areas of the P&C market remain competitive. The only difference really is the degree to which they're competitive. The international insurance and reinsurance segments are probably among the most competitive in the market today. We're in the process of completing budgets and plans for 2015 and barring any significant market changes, organic growth is going to be difficult to come by in 2015.

As a result, as Mike alluded to, we're focused on controlling our expenses, finding efficiencies and emphasizing root selection and portfolio management. In soft markets, we will always choose underwriting discipline over growth. Despite these difficult market conditions, we still believe there are great opportunities available to us and believe we built the platforms to pursue those opportunities.

With that, I'd like to turn it over to Tom.

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

Thank you, Richie. My comments this morning will be brief since our news is good and straightforward. I'm happy to answer any questions or cover any details when we get to the Q&A.

On the investment side of the house, we earned 7.3% under equity investments and 4.5% on our fixed income portfolio during the first 9 months, which produced a gross total return of 5.2%. In the equity portfolio, we continue to methodically add to our holdings steadily throughout the year. Between purchases of roughly $300 million so far, as well as appreciation of the portfolio, we've now got roughly 52% of our shareholder's capital invested in equities compared to 48% at year-end 2013.

We continue to have an unusual combination of investment ideas that we're confident about, positive cash flows from our Insurance and Ventures businesses and some sense of overall caution and weariness about the investment markets overall. The net effect of these cross currents is that we continue to steadily [indiscernible] cost average our way into building positions. We think that approach prudently protects our balance sheet and leaves us with the ability to be able to invest more money in equities as opportunities present themselves. Expect us to continue our steady, consistent approach in building the equity portfolio.

In our fixed income operations, we earned a total return of 4.5% as low interest rates that prevailed at the end of 2013 went under an even lower limbo stick by the time we got to that end of September. That meant we got the capital appreciation in the portfolio in addition to recurring interest income. We remain cautious, as we have been for multiple years, about the balance between risk and reward in bonds. Long-term rates just don't have that much room between where they are and 0. They have a lot of room between where they are and where I've seen them in my career. Consequently, we keep the duration of our bond portfolio a bit shorter than the duration of our insurance liability. Including cash, the durations stood at roughly 4.25 years in September 30 and we do not plan to go longer than that in the current interest rate environment.

We also remain committed to safety first. In addition to not stretching for yields by extending the durations, we don't stretch forth by reducing credit quality either. 97% of the portfolio was rated A or better, but we don't stop there and rely solely on rating agencies. We do our own credit analysis on top of that to make sure that we are comfortable with the credit risk we take. As always, safety first.

In Markel Ventures, we purchased Cottrell Industries during the third quarter. Only 5 weeks of their results are included in our third quarter numbers. And you'll see more from them as well as the rest of the Markel Ventures coming in the fourth quarter. Cottrell is the leading manufacturer of car hauling trailers and equipment and we welcome them to the Markel family. As we stated in the Markel Style, we seek to be a market leader in each of our pursuits. I can assure you that Cottrell fits that description as well as other elements of the Markel stock.

For the 9 months to date, you could see the imaginatively named Other revenues on our income statement of $630 million versus $459 million a year ago. Anne gave you the portion from Markel Ventures, and you can see the vast majority of those revenues indeed relates to Markel Ventures operations. Our EBITDA from the group was $66 million versus $64 million in 2013, which is a much smaller percentage increase than the increase in revenues. We got off to a slow start at the first quarter of this year and have been making up ground ever since. I assure you that I look forward to reporting the full year results.

If we add all our activities together from insurance, investing and Markel Ventures, we get to the bottom line of comprehensive income. Comprehensive income, through the first 9 months of Markel exceeded $0.5 billion. As it shows in the Q in round numbers, the drivers of comprehensive income came from pretax underwriting process of over $70 million, pretax investment income and gains of about $300 million, increased pretax unrealized gain from the portfolio of almost $350 million and pretax cash flows of over $70 million from Markel Ventures noncash intangible amortization. We then paid gobs[ph] of taxes and provided for the rest of what we have. Some of those items comes with $0.5 billion of comprehensive income we earned. We're pleased with our results and we hope you are as well.

Looking forward, every insurance, investment, industrial and service business that we own or operate in faces challenging and competitive markets. They always have and they always will. Despite those facts, we continue to produce solid returns for you as our shareholders and we expect to continue that to be the case over time. We're grateful for the opportunity to do so. And we now look forward to answering your questions.
With that, John, if you'd be so kind as to open the Q&A period.

Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of the Vincent DeAugustino from KBW.

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

I'll just start off. So last quarter, you guys have talked about the reinsurance environment kind of, theoretically, being at bottom as everybody was being disciplined. And I'm just wondering if, at this point, there's any change in kind of that assessment of it's one of these things where we have to really wait for 1:1 to play out before we get a true test of -- if that's going to kind of -- we're going to be at bottom and potentially rebound or go lower?

Richard R. Whitt
Co-Chief Executive Officer and Director

This is Richie. I think it's a little early to say. Like you say, I think we got to see what happens with the 1:1 renewals. But a lot of people are talking about this being the bottom. I wouldn't look for a bounce at this point. I think there's too much capital out there for there to be any sort of bounce. If I had to guess, you might just see a little more reduction, but I just can't imagine the kinds of reductions we've seen in the last few years. And certainly, if people are looking for those kinds of reductions at 1:1, we'll probably be coming off of the business. So it feels like we're getting close to a bottom but I'd like to see those 1:1 renewals before I commit to that.

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

Okay, good deal. And then just to switch over, 2 questions on the commercial ventures side. I'm sorry if I missed this, I know you said you look forward to kind of giving us the full year numbers. But with Cottrell and Eagle, just very roughly, with those 2 businesses, should that put us on an annualized EBITDA and net income basis?

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

Annualized EBITDA -- annualized run rate of the revenues should be a round number of $1 billion, plus or minus. There's cyclicality to that and that's looking into 2015. And we would expect double-digit EBITDA earnings from that mix collection of business.

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

Okay, cool. And then just...

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

I know that there's a lot of zeros involved there.

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

Good deal. Just a theoretical question between the split in terms of when you're speaking with investors between Markel Ventures and the equity portfolio. Do you feel that you get more credit for the venture's income stream versus the public equities since on the ventures you don't have to do the whole equity, look for earnings add back?

Richard R. Whitt

Co-Chief Executive Officer and Director

No.

Operator

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

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Just a few sort of numbers questions because, as you said, it was a pretty straightforward quarter. In the discontinued lines segment, there was a $6.8 million of adverse development. Was there -- was that just a true up of the asbestos study from the second quarter? Or was it something different?

Anne G. Waleski
Chief Financial Officer and Executive Vice President

That's actually some development that we saw on the discontinued businesses from the Alterra acquisition that occurred during the quarter.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. The figure for the remaining amortization of the premiums in the investment, or the premium in the investment portfolio, is that number somewhere in the 10-Q, I haven't found it, if it is.

Anne G. Waleski
Chief Financial Officer and Executive Vice President

It's not, but given the -- and I don't have the number with me, Mark. But given the amount of the portfolio that we have turned over, the number that's left has gotten smaller, but I don't have a specific number with me. It's not in the Q.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. And then finally, was there any meaningful amount of catastrophe loss across any of the businesses? I know Rich, you mentioned in the reinsurance, there was not. Just asking about the other units.

Anne G. Waleski
Chief Financial Officer and Executive Vice President

Nothing to speak of.

Richard R. Whitt
Co-Chief Executive Officer and Director

No, we always have a bit of an attritional amount of catastrophes built into our assumptions. And I would say it was an -- even probably a light attritional quarter from that standpoint.

Operator

Our next question comes from the line of Jay Cohen of Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

In the Reinsurance segment, the expense ratio in the third quarter dropped, I guess, about 4 points from the first half. In the Q, you suggest there was an increase in experience-related funds or something? I forget exactly the phrase. But I'm wondering how much of an impact that had on the expense ratio in the quarter, in the Reinsurance segment?

Anne G. Waleski
Chief Financial Officer and Executive Vice President

Yes, I would say the impact to the quarter was probably not significant.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

So do you see the third quarter number as a reasonable run rate going forward? Because it's about 30 versus nearly 34 in the first half.

Anne G. Waleski
Chief Financial Officer and Executive Vice President

Yes -- no, I do not think this it is a reasonable run rate. I think you can take the earlier quarters and use those. This would be a nonrecurring, onetime adjustment that we make and then we'll trend it going forward. But I think you can use the earlier quarter's indication.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

That's helpful. And I guess for the overall company, when you think about the expense ratio, given the market conditions in International and in Reinsurance, should we expect any improvement at all in the expense ratio going forward? Or should we just kind of assume it's stays reasonably flat?

Richard R. Whitt
Co-Chief Executive Officer and Director

This is Richie, Jay. Obviously, we continue to work to reduce the expense ratio, but it's fair to say, we don't expect to have a whole lot of help in that effort from growth next year. And as for growing the top line, if the markets stay like this, that's going to be difficult, so we're going to have to do it the old-fashioned way, which is spending less. So admittedly, it's going to difficult. What did we have? Like 37, little over 37 this quarter? I think that's probably fair for next year. We're going to work hard to see if we can reduce it.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

That's great. If I can squeeze one more in. Markel Ventures, Tom, as you have mentioned, the improvement was fairly noticeable versus the first half. And specifically in the manufacturing segment where the net income, the gap income went from about over $4.5 million in the first quarter up to $21 million this quarter, so pretty impressive. Does seasonality play a role there? And should we think about the third quarter again as a reasonable run rate going forward?

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

Seasonality plays a small role, but I would say it's much more economically cyclical than what I would describe this season. And frankly, the first quarter was love. We were in the midst of integrating some acquisitions and there's always a little bit of indigestion in process that's connected with that. And as we've gone through the year, those issues are starting to resolve themselves and we're getting to a more normal basis. I really would steer you towards EBITDA because given amortization, purchase accounting and that sort of stuff, the true cash that's being produced by the business is best represented by the EBITDA. And that's why we hold the managers accountable for, because they can't control the tax rate. They're very lightly levered when I'm borrowing a bunch of money, so that definitely does describe the cash flows in the business.

Operator

[Operator Instructions] Management, at this time, there seems to be no more further questions. Would you like to make any closing remarks?

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

Thank you very much, and we look forward to chatting with you next quarter. Take care.

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