Intact Financial Corporation TSX:IFC

FQ4 2018 Earnings Call Transcripts

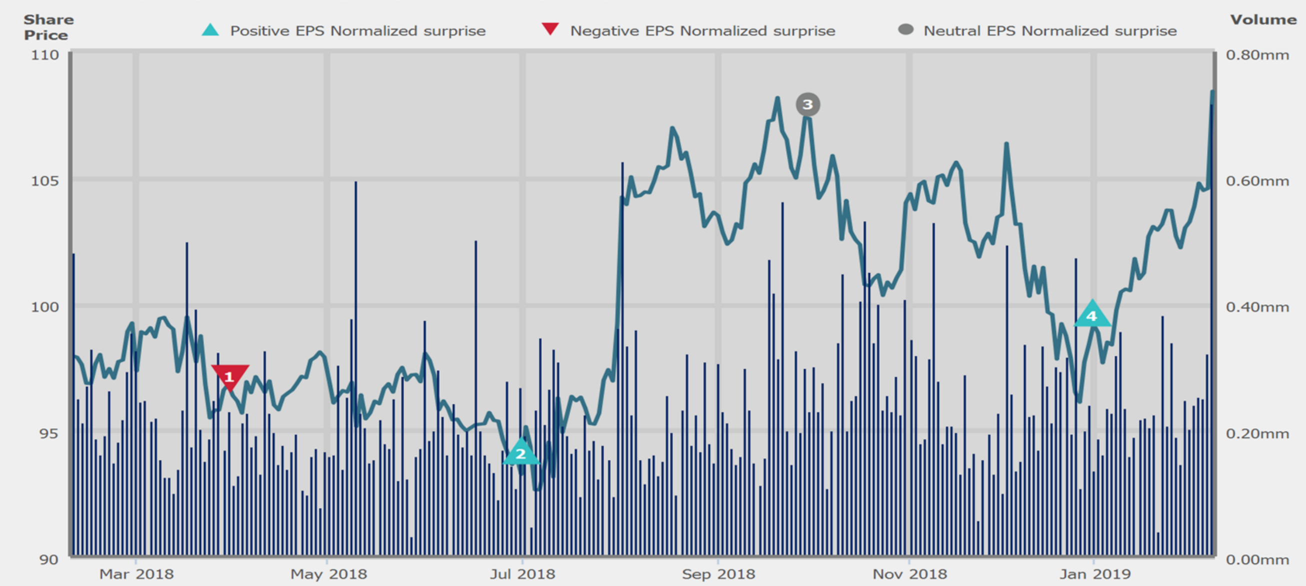
Wednesday, February 06, 2019 4:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ4 2018-			-FQ1 2019-	-FY 2018-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	1.74	1.93	▲10.92	1.45	5.57	5.74
Revenue (mm)	2443.43	2509.00	▲2.68	2394.00	9650.01	9715.00

Currency: CAD
Consensus as of Feb-06-2019 12:10 PM GMT

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



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ1 2018	0.87	0.81	▼1 (6.90 %)
FQ2 2018	1.22	1.38	▲2 13.11 %
FQ3 2018	1.62	1.62	●3 0.00 %
FQ4 2018	1.74	1.93	▲4 10.92 %

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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

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Raymond James Ltd., Research Division

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Doug Young
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RBC Capital Markets, LLC, Research Division

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Morgan Stanley, Research Division

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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 Fourth Quarter 2018 Earnings 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.

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. As a reminder, the slide presentation contains the disclaimer on forward-looking statements, which also applies to our discussion on this conference call. Charles' remarks will cover slides 5 to 11, and Louie will cover slides 13 to 18. With that, I'll turn the call to CEO, Charles Brindamour.

Charles Brindamour
CEO & Director

Thanks, Ken. Good morning, everyone, and thanks for joining us today. Last night, we announced strong fourth quarter results with net operating income increasing 19% to $1.93 per share, driven by broad-based improvements across the business.

For the full year, net operating income per share of $5.74 resulted in an operating ROE of 12.1%.

Our balance sheet remains very healthy with over CAD 1.3 billion of capital margin, despite the recent market volatility.

Top line growth was 4% in the quarter, fueled by strong growth in commercial and specialty lines across North America as well as improving market conditions.

Our combined ratio was strong at 91.7% with improvement both in Canada and the U.S. The Canadian performance at 90.8% reflects significant progress in personal auto and continued excellent performance in personal property.

In the U.S., our team delivered a combined ratio of 96.7% despite close to 6 points of cap losses.

After 9 months, we increased our outperformance versus the industry ROE to 750 basis points, well above our 500 points target.

And while we're outperforming by a wide margin, we're not satisfied. Our ongoing action plans and improving market conditions should soon return us to a mid-teens operating ROE in line with our historical track record.

Let's now look at our results by line of business, starting with Canada. So in personal auto, as anticipated, premiums declined slightly as our rate increases remained ahead of the market. However, industry rate increases are catching up, and we expect growth to return in the coming quarters. Our combined ratio improved nearly 4 points to 97.3% in the quarter, driven primarily by our profitability actions, which have helped to lower both claims frequency and severity for the third quarter in a row.

While we believe our run rate is in the mid-90s combined ratio as planned, we remain focused on creating sustainability in that performance. There is strong momentum still on many fronts including rates, underwriting and claims action.

In personal property, premiums grew 2% in the quarter, so while rates are up, our discipline in auto put some pressure on growth in property.

Results in this segment continued to be very strong with a 78.5% combined ratio in the fourth quarter and 88.3% for the full year.

Our actions over time have been very successful with an average full-year combined ratio below 90% for the past 5 years. That is in good and in bad times. So market conditions, in my view, in personal property position us very well to maintain that performance level.

In commercial lines here in Canada, rate increases in firm market conditions and strong momentum in specialty drove growth to 11% in the quarter.

The combined ratio was higher than expected for the full year 2018 due to elevated catastrophes and large losses. The quality of the portfolio remains high and this business is positioned for low 90s performance. If we turn to the outlook for Canada, we're seeing across all lines firm market conditions, and we expect mid-single-digit industry growth in the year ahead. In personal auto, the marketplace continues to tighten with capacity constraint and ongoing growth in residual markets.

Industry rate increases accelerated in the fourth quarter, and so we think this environment supports our profitability plan and our competitive position is improving. As we anticipated, we're now seeing clear, sequential monthly improvement in growth in this line.

In personal property, the outlook remains favorable. As our growth -- as our auto growth improves, we expect property growth to accelerate.

In commercial in Canada, our loss ratio outperformance after 9 months was north of 10 points. We're surprised by the speed at which this market is hardening and thrilled with our position to capitalize on this new dynamic.

In our U.S. commercial segment, premiums grew 2% in the quarter on a constant currency basis. Growth was 7% in segments that we're focusing on for expansion. The fourth quarter combined ratio of 96.7% was heavily impacted by CATs. The full year performance was solid at 94.8%. We're firmly on track to deliver a sustainable low 90s combined ratio within 18 to 24 months. Market positions are evolving favorably with modest upward pricing trends continuing in the U.S. We expect low to mid-single-digit growth for the U.S. specialty industry over the next 12 months.

While short-term performance matters, long-term strategic positioning is key. And on that front, our people have made giant steps in 2018.

Beyond building one of the best specialty lines business in North America, we made meaningful advances on our customer-driven transformation, leveraging both digital as well as artificial intelligence.

We launched our new mobile self-service app, which incorporates our latest telematics software. We also continue to roll out our latest rating algorithms, which are grounded in machine learning, and we see strong evidence that our investments in AI will drive growth and margin expansion in the years ahead.

Our focus on people and employee engagement was again recognized in '18. For the fourth year in a row, we are named as one of Aon's Best Employer. Glassdoor listed us as one of the 25 best places to work here in Canada, and we were again named as top employer in Canada for young people. This reflects our commitment to providing an environment that our people are proud of and where they can make a difference. This goes straight to our ability to attract the best people in the markets where we operate. I think we have a world-class team, and I'd like to thank our people across North America for their dedication to our customers, brokers as well as our communities.

And talking about long-term positioning, we'll be celebrating in the coming weeks the 10th anniversary of Intact Financial Corporation.

As I look back, I think we've had a decade of solid performance on many fronts but in particular against our financial objectives.

Since 2009, we've delivered over 630 basis points of ROE outperformance, beating our 500 basis points target. We've generated annual net operating income per share growth in excess of our 10% target over the same period and an operating ROE that averaged in the mid-teens.

These results and these objectives have translated into an annualized total return for shareholders of about 14% since the Intact Financial journey began, more than double that of the TSX.

On the back of our solid earnings growth track record and our positive outlook for the future, we're increasing our quarterly dividend by 9% to $0.76 per share. And by the way, we've increased our dividend every year since our IPO and have generated a CAGR of 9% in the last decade.

In conclusion, disciplined execution on our action plans and supportive market conditions provide us with momentum for the year ahead.

After 10 years of delivering on our financial objectives, I look forward with confidence that our people and strategies position us to continue to deliver into the future.

With that, I'll turn the call over to our CFO, Louie Marcotte.

Louis Marcotte
Senior VP & CFO

Thanks, Charles, and good morning, everyone. Net operating income was up 19% to CAD 281 million in the fourth quarter, fueled by significant improvements in underwriting, investment and distribution income. Our insurance businesses delivered a solid quarter with underwriting income of CAD 210 million, up 18% from Q4 last year.

In Canada, our combined ratio of 90.8% was the best performance in 3 years without any material impact from weather.

In the U.S., OneBeacon delivered a combined ratio of 96.7%, despite nearly 6 points of CAT losses, 2 of which related to hurricane Michael.

Our investment team drove fourth quarter net investment income to CAD 140 million, up 16% from Q4 last year, thanks to both our portfolio-optimization initiatives and reinvestment at higher yields that took place throughout 2018. We expect full year net investment income in 2019 to grow by approximately 5%.

And finally, our distribution businesses contributed CAD 36 million to operating income in the quarter, that's almost 30% better than last year as commission growth and margin improvements were better than anticipated.

On an annual basis, our distribution earnings have now reached CAD 146 million, nearly twice what they were 5 years ago. We believe more consolidation will take place in the distribution arena as evidenced by the 4 acquisitions announced by BrokerLink already this year. However, we expect mid-single-digit growth in distribution income in 2019, mainly because of the slower M&A activity last year.

Now let me provide some additional color on our underwriting results beginning with Canada. Progress on personal auto profitability continued in the fourth quarter with 7 points improvement in the current accident year loss ratio.

Q4 year-over-year weather was favorable by 2 points, while the remaining 5 points of improvement is attributable to our action plans.

We estimate the combined ratio run rate in auto at approximately 95% by adjusting for one point of favorable weather compared to long-term trends, removing prior year development and normalizing for pools, CATs and seasonality.

We are focusing -- we are focused on sustaining this performance level and our actions continue to carry positive momentum. For example, written rates were up 9%, and earned rates up 6% in the fourth quarter. Rate momentum will continue in 2019 with mid-single-digit earned rate increases secured through year-end.

Results in property continue to be excellent with a 78.5% combined ratio in the fourth quarter despite higher than average weather losses.

In commercial lines, the Canadian top line growth in the quarter was robust at 11% and the combined ratio was solid at 91.6% despite being 4 points above last year due to a higher CAT and non-CAT large losses. We are monitoring closely but do not see any unusual trends.

Before moving to U.S. commercial, I should note the slight increase in the Canadian quarterly expense ratio due to higher variable commissions. On an annual basis, the expense ratio in Canada remains stable as thoughtful expense management enabled us to increase our investments in digital and artificial intelligence in order to accelerate our customer-driven transformation.

Turning to U.S. commercial, we incurred 6 points of CATs in the quarter, bringing the combined ratio to 96.7%. This CAT level is clearly well above expectations for a quarter, and we view the full year level to be more indicative of future expectations albeit at the upper end.

Prior year development was slightly unfavorable representing mainly our share of losses from 2016 and prior accident years that were ceded to the adverse development cover.

The U.S. expense ratio improved 3.2 points to 33.7%, and included a few points of nonrecurring favorable adjustments, including one point of premium taxes.

With expense synergies realized ahead of schedule, we expect the expense ratio in 2019 to be similar to the full year 2018 expense ratio with some seasonal variations due to business mix.

We are now 15 months into the acquisition of OneBeacon, and I am pleased to see how much progress we've made. We delivered a full year combined ratio, in 2018, of 94.8% after executing on our plan, exiting unprofitable lines of business and realizing synergies in excess of CAD 25 million.

NOIPS accretion was roughly 6% in 2018, and the IRR is north of 15%, but we have more to do and opportunities to capture.

Our work on profitability by line of business continues as well as our claims initiatives, leading to a low 90s combined ratio within 18 to 24 months.

Before going to the balance sheet, I want to comment on our expectation for prior year development going forward. In light of the recent increases in interest rates, we are adjusting our favorable prior year development expectations by 100 basis points for IFC as a whole, such that the expected future range is now between 1% and 3%.

This change does not impact the overall combined ratio as the reduction in prior year development related to the change is offset by improvement in the current accident year loss ratio.

Now a few words on our balance sheet. We ended the year in a strong capital position with total capital margin of over CAD 1.3 billion, Canadian MCT at 201% and U.S. RBC at 377%, and our debt-to-total capital was largely unchanged at 22%.

The volatility of capital markets in the fourth quarter impacted our book value per share by less than 3%, thanks to our well-diversified balance sheet. Losses on our equity portfolios were partly offset by gains from interest rate increases and the strengthening of the U.S. dollar. We are pleased with the resilience of our balance sheet in the face of adverse capital market conditions.

Since year-end, we have seen a significant rebound in common equities and a strengthening of the Canadian dollar. We estimate that the net impact to January 31 is a gain of $0.43 approximately or almost 1% of book value per share.

Our capital allocation priorities remain unchanged. We are deleveraging and remain on track to reach our 20% goal in 2019. With a strong balance sheet and confidence in our outlook for growth and profitability, we are pleased to raise our quarterly dividend by 9% to $0.76 per share, representing an average NOIPS payout ratio of 40% since the IPO, which leaves room to deploy capital on growth opportunities.

In closing, our action plans will continue on auto and OneBeacon. We're building on our momentum from last year to take advantage of growth potential we see across our underwriting, investment and distribution platforms. With that, I'll return the call back to Ken.

Kenneth Anderson
VP of Investor Relations & Treasurer
Thank you, Louie. [Operator Instructions] So, Cheryl, we're now ready to take questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Geoff Kwan from RBC Capital Markets.

Geoffrey Kwan
RBC Capital Markets, LLC, Research Division

Just had a question with the comments from the Ontario government looking at auto insurance pricing. It seems like the communications have generally focused on the price aspect of that. I was just wondering from discussions you have or your understanding of how much they recognized there needs to be efforts done on the cost side given where combined ratios are in the industry?

Charles Brindamour
CEO & Director

Darren, why don't you take this one?

Darren Christopher Godfrey
Senior Vice President of Personal Lines

Yes, thanks, Geoff. I mean I think that discussions that we've had to date both at the political level but also at the staff level have been very encouraging. They're very open to learning, understanding the issues that the industry is facing, but also the impact it has on Ontario drivers. So they have a clear willingness to reduce fraud, to reduce Red Tape and doing what's right for Ontario drivers. They recognize the cost pressures within the system and are looking for a balanced view as far as Ontario drivers. I think what is also maybe encouraging in those discussions is, it's supported by FSRA, which is the new regulator coming in Ontario to replace FSCO. They've recently published their priorities for 2019, 2020, and it's very much in sync around streamlining right regulations, supporting order reform strategy, developing fraud reduction strategies. So both from a government level and also from a regulator level, we firmly believe they've focused on the right areas, and we're encouraged by that. So we're very optimistic in terms of the process.

Charles Brindamour
CEO & Director

Yes, I think these guys are trying to get nonsense out of the system, and they're focused on the right thing.

Geoffrey Kwan
RBC Capital Markets, LLC, Research Division

And just the other question I had was, you talked about the OneBeacon and the integration seems to be going quite well. From an M&A standpoint, in the sense that Canada -- when something comes up, you guys probably have interest, but wanted to get a sense as to how you feel about doing something in the U.S. if there is a preference towards manufacturing over distribution, or how you're thinking about that?

Charles Brindamour
CEO & Director

Overall, when we look at priorities for capital deployment today, #1 is Canada and we're equally happy to deploy capital in manufacturing or in distribution in Canada, and I think that this is actually a good time with the outperformance at the level it is and the industry's performance being low, we feel like this is the right environment to deploy capital and hence priority #1.

When it comes to the U.S., I think we're gaining confidence in our ability to generate sustainable low 90s performance. We're not there yet, there is 18 to 24 months, but we've gained enough confidence to be opportunistic in that marketplace and strengthen the platform we have.

We have lots to learn. We're doing lot of work to understand the opportunities in distribution indeed in the U.S. and we'll be open to deploy capital. But in our mind, the priority is very clear. Our teams here and in the U.S. are keeping an eye on the opportunities in the marketplace, but there is a priority today.

Operator

Your next question comes from the line of Kai Pan of Morgan Stanley.

Kai Pan
Morgan Stanley, Research Division

So on the auto margin, you reached your target, mid-90s, and you said you're going to focus on sustaining that margin. Are you declaring like mission accomplished? I just wonder because is there more you can do that to improve any further. For example, your region price up 9% still above the earn price 6%. So is there more interim improvements below that 95% even if you don't do anything else?

Charles Brindamour
CEO & Director

Yes. So, Kai, I think we've found out over the past few years that declaring mission accomplished is a tricky thing to do, so we're certainly not there. I think that we think we're in the zone indeed of the mid-90s kind of performance. We'll take advantage of market conditions as they are firming up. And look, there is inflation in the system, Kai. This is a longer-term type or longer-tail type product. And so we remain and keep a degree of caution in terms of making statement, but we're in the zone, and we'll take advantage of the markets in which we're moving into, which will be quite favorable, we think, for the next 24 months. Darren, anything to add?

Darren Christopher Godfrey
Senior Vice President of Personal Lines

No, I think the other thing I would add there just in terms of the -- not just from a margin standpoint but the market definitely is moving now. So that's helping as far as our own action plan is concerned. We're seeing some momentum in Q4 in some provinces so that's encouraging. Industry, obviously, given the fact that we've been at this for a good 18 to 24 months, still has a couple of years ahead of it, in our view, from an adequacy achievement standpoint. So we're well placed but our focus remains on sustainability. As Charles alluded to before, we do see a pivot in our growth profile so that's encouraging as well too. So focus remains on sustainability but expectations around the pivot on the growth side as well, in 2019.

Charles Brindamour
CEO & Director

Yes. And I think, Kai, if we can do better and grow, we will. Trust us on that. But at this stage, we want to make sure that we -- the inflation is indeed broken and that we can see that sort of mid-90s performance on a sustainable basis.

Kai Pan
Morgan Stanley, Research Division

That's great. Just follow-up on top line growth. And how do you pricing now comparing with the market pricing? I just wonder how big of a doubt is there? At what point do you think there will be a tipping point that the environment will be more favorable to you, and you could start to regain market share? At -- do you see that in the next, like by year-end or do you think it is probably more in 2020?

Charles Brindamour
CEO & Director

Kai, you're talking about personal auto, just to be clear?

Kai Pan
Morgan Stanley, Research Division

Yes.

Charles Brindamour
CEO & Director

Yes, we'll let Darren give his perspective on that.

Darren Christopher Godfrey
Senior Vice President of Personal Lines

I think in terms of gap relative to the industry, as I mentioned, quite a bit of activity in Q4 in Ontario in particular. Now one of those rate approvals are effective Q1, Q2. So we haven't seen yet the impact in terms of our competitive position on those rate approvals. If I look at over the last, sort of, 36 months, we still have a good one-rate increase ahead of the industry. We've got a 6-point gap. When I look at Alberta in particular, we've got 11-point gap between industry. So there still is a gap there relative to the competition. However, as I said, that is beginning to close, in particular, in Ontario. So when I look at growth, as you can see, in the premium side, we were down 2 points for the full year of '18, roughly down a point in Q4. And actually, if I look at the month of December, we were flat. So we are starting to see a little bit of that pivot. Now that is premium growth. So we continue to be remained focused on that. As far as the growth profile, I would say it's earlier than year-end. I would say towards the latter part of 2019, we would hope to see us changing that curve from a unit standpoint in the latter half of '19.

Charles Brindamour
CEO & Director

Yes, I think Darren's comment is bang on. In the past 3, 4 months, we have seen a clear change, not in all markets but in a number of markets, where either growth has picked up. I take Quebec, for instance, which is in the mid-single-digit growth range now. We've seen provinces that have been shrinking. We've seen deceleration in the negative growth, and I think that as Darren is saying in the second half of '19, we should be in a quite different place than we were in Q4.

Operator

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

Meny Grauman
Cormark Securities Inc., Research Division

Question on distribution and some bullish comments on distribution and you noted the recent deals. Just wondering if you could update us on valuations for brokers? What are they transacting? And how've multiples changed? Are they still climbing higher over time?

Charles Brindamour
CEO & Director

There is a lot of talk and anecdotes about multiple in distribution, and we are doing tens of deals every year. And we have not really, in the past 24 months, seen inflation in the multiple of smaller transactions, quite frankly. And so my own view, despite some anecdotes here and there, is that our opportunities to acquire distribution and still generate mid-teens IRR and plus on these transactions is very good because valuations have not changed dramatically in the past 12, 24 months. With has changed in the past 12, 24 months is our margin in distribution, which we've seen go up the sort of core distribution margin has gone up for profit sharing, which means that the opportunity for synergies in consolidation in my mind is up.

Meny Grauman
Cormark Securities Inc., Research Division

And just maybe a follow-up from the competitive standpoint. If you could talk about how much competition there is when you head into these negotiations? It would seem from your valuation comments that maybe there's not that much competition for these brokers.

Charles Brindamour

CEO & Director

I think there is competition for these brokers, for sure, and I think it varies across the land, it varies on the business therein, it varies based on the margins that they're operating at. Many of these transactions are often relationship driven though. And we're not big on auctions and processes in general, you know that, and it's certainly true in distribution. Now the fact that we have an unmatched local presence across the land with Intact Insurance, the fact that we have with BrokerLink a very deep regional footprint in over 100 communities, and the fact that we're there in good times and in bad times and it's many of the same people that have been around for the past decade or 2, our relationships for opportunities, in my mind, is very, very strong and these are the best conditions in which to transact, and that's what we'll keep doing in the next decade.

Operator

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

Brenna Phelan
Raymond James Ltd., Research Division

So I wanted to ask one more on personal auto and related to rate and unit growth. So is your view that the industry ultimately has to take more rate than you have or will generally have to given the other levers your scale affords you to pull?

Charles Brindamour
CEO & Director

That's a good question because we're -- we might be shooting for higher performance, right? And so it's hard to figure out exactly what the industry needs. But when we look at it high level, Brenna, it's about 10-ish points we think, Darren?

Darren Christopher Godfrey
Senior Vice President of Personal Lines

Yes, no. I think if you look at year-to-date 9 months industries running close to close at around about 75 loss ratio. Add on 30 points of expenses so we get to roughly 105. Now obviously, we know that there is inflation in the system. We have been fighting it for 18, 24 months. We continue to fight it. We have been successful at abating on inflation but we recognize that it's still there. So I think when you look at inflation in the system, you look at industries running at 105 now, I should point out that is supported by some strong, favorable prior year development in the industry as well. So that's sort of how we come up with the rough 10 points. But given the inflation environment, that's going to take a couple of years in our opinion. We've been going on it for close to 2 years. We started probably 2 years ahead of the industry, so it's fair to assume that the industry is at least 2 years. Now that timeline could look very different province to province, but generally, on an average across Canada, I would suggest that our view today is that we're at a 2-year window of the industry's still got a fair bit of work ahead of it.

Brenna Phelan
Raymond James Ltd., Research Division

Okay, so I guess what I'm trying to get at is, is it conceivable or in your outlooks that once your unit growth kind of bottoms out pivot spot to grow so that it could accelerate quite meaningfully because the industry is also moving very quickly?

Charles Brindamour
CEO & Director

It could, yes. I mean I wouldn't make it the central forecast, quite frankly, but it very well could. I think it's one thing to look at auto, you've got to look at the whole industry dynamic, and I think the industry's performance has been sub-mid-single digit, and we're seeing now across all markets. And I think there'll be meaningful potential for unit growth. But the speed at which you can turn the dial on in automobile insurance is not the same as in the other lines of businesses. We need to keep that in mind. And we've seen a shift in commercial lines that's pretty abrupt, I would say, in the past 6 months. In auto, that is not the case, so hard to tell but what is clear is we think it will be a favorable environment for us in the next 24 months. We're seeing sequential growth picking up, and I think we'll be in growth territory very high likelihood in the second half of '19.

Brenna Phelan
Raymond James Ltd., Research Division

And then just quickly, could you give a breakdown of the premium growth in Canadian commercial? How much of that is coming from your specialty initiatives versus commercial auto and commercial property?

Charles Brindamour
CEO & Director

Yes, Alain?

Alain Lessard
Senior Vice President of Commercial Lines

Well, if I look to give you a bit of color on the growth when we look at the growth of 12% in the fourth quarter, I would split that 50-50 between regular, commercial and specialty lines. What I mean by that is, if you look at the dollar growth of direct written premium between 2017 and '18, 50% of the dollar growth is coming from regular lines and 50% from specialty lines. If I go a bit deeper on the regular lines, that's all driven by rates. Rates were up by 4% in P&C in the fourth quarter, 6.7% in regular auto in the quarter. So when you add to that a bit of inflation of insured value and car, basically that explains the full growth in regular commercial lines. There's really no unit growth overall, and the segmentation of that growth when we look at it, we're growing profitable segments and we are shrinking least profitable segments, so really well segmented. The specialty lines growth, which is the other 50%, considering the size of the portfolio, translate in a growth just north of 20% for our specialty lines portfolio in Q4. And I would say that growth is really driven by our action plan. Basically, we have a bed of rates in property, lots more rate in trucking. But overall, if I go back 2 years ago, we established our specialty lines division with the idea of growing and becoming a specialty line -- chief specialty line player in Canada. And basically, the idea was to expand our product suite, make it available across the provinces, makes our expertise available across Canada and become really considered by broker increasing the awareness. A year later, we acquired OneBeacon. That increased our credibility with the broker. We've brought new product from OneBeacon through technology and entertainment. And over that period of time, we've probably increased our staff by close to 80 people in Canada, and those staff are daily working on improving our product, building relationship with brokers and everything. And I would say, lot of the growth we see in specialty line is coming from those people. So I want to thank them for their daily hard work. This is really achieving our strategy. So overall, the growth is basically coming exactly where we want it to come.

Brenna Phelan
Raymond James Ltd., Research Division

And you think those trends can continue into 2019?

Alain Lessard
Senior Vice President of Commercial Lines

I would say yes, because when you look at the industry, why the market is firm when we look at the industry? We mentioned our outperformance of about 11 points in P&C and 6 points in commercial auto at the end of Q3. So when you throw that on the top of our combined ratio, that puts the industry north of 100% for both lines, and in fact, combined, you're probably close to 110%, which is unsustainable. So that will continue and our effort on specialty line will continue.

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 OneBeacon and the prior year reserve developments were negative. Just wanted to get a sense of -- in what areas were they negative? And as well, just wanted to get a sense of the coverage because I know this -- what you're showing is only your proportional stake of the prior reserve development but what's -- so I think you had USD 200 million was the max coverage for those adverse developments. Just wanted to know how much of that has been used? And then I have a follow-up.

Charles Brindamour
CEO & Director

So on the amount of coverage used, Doug, there's plenty of room left is what I will say, not a concern of mine. In terms of where the adverse development has been coming from, I'll let Alain give his perspective.

Alain Lessard
Senior Vice President of Commercial Lines

Okay. Well, when you look at the PYD for OneBeacon, you have to understand that this is -- can be very lumpy because of the nature of the business. We're looking at large losses in prior years, sometimes they take time to develop so it's relatively lumpy. And you can see that during the quarter, it was plus 1.5 but it's favorable 0.3 for the year. Overall, when we look at where it comes in this quarter, it came from a few losses and 80% of that PYD is coming from lines of business, which are under a profit improvement plan, okay? And basically, a lot of those are an area on those profit improvement plan where we're no longer writing that type of business within those business units.

Charles Brindamour
CEO & Director

And a big chunk of it, Alain, it's not just for profitability improvement plan, it's also the 2 lines we've shut down upon closing, which represent probably more than that of the PYD there, which gives us a very good sense that closing those lines were the right calls.

Doug Young
Desjardins Securities Inc., Research Division

I guess just on that, Charles, I thought with the PY -- or the prior year reserve developments for the accident business lines not go through your nonoperating results or does that -- so the exited lines would go through the prior year's reserve developments you show in the existing business or?

Louis Marcotte
Senior VP & CFO

Just to clarify that, you're absolutely right. So the prior year development on exited lines is affected to nonoperating. But it does consume some of the adverse development cover. So Alain was raising in the lines that are ongoing, where those have been used for the continuing lines. But you're right, a portion of them have been used for the exited lines.

Doug Young
Desjardins Securities Inc., Research Division

And that's the 2 lines that you shut down, I guess, that's mentioned.

Louis Marcotte
Senior VP & CFO

Yes, that's right.

Doug Young
Desjardins Securities Inc., Research Division

Yes, okay. Great. So you're not going to give me a dollar figure, but you're not like in terms of what's left in the coverage, I guess I'm trying to do the math, but you seem pretty confident, Charles, that this isn't going to be an issue?

Charles Brindamour
CEO & Director

Yes. There's plenty of room left in that cover.

Doug Young
Desjardins Securities Inc., Research Division

And I'm right, it's USD 200 million, that's correct?

Charles Brindamour
CEO & Director

Yes, yes.

Doug Young
Desjardins Securities Inc., Research Division

And then, Charles, just you mentioned something that piqued my interest, just in the U.S. Because in Canada you've been acquiring distribution, and I get why and what the strategy is there, and then if I heard you correctly, you are thinking potentially of doing acquisitions in the U.S. distribution but you're just trying to understand the marketplace is -- did I get that right?

Charles Brindamour
CEO & Director

Yes, I think that -- when you look at our footprint in the U.S., we have 14 business lines spread across the land. And there's a number of ways you can grow our presence. You can grow it organically, that is add products. You can add geographies to those segments and you can add brokerage relationships to those segments. And that's the sort of work we're doing at the organic level in the U.S. operations. Then when it comes to scaling it up through nonorganic measures, I mean you can look at companies or you can look at distribution. And in distribution in the U.S., I mean, if you slice it, it is a different ecosystem in specialty lines than it is in the context of Canada. You have what they call independent agents. You have MGAs who are specialized in certain segments. You have MGUs who are involved to an even greater degree. Some of these players sometimes retain a portion of the underwriting risk. You have wholesalers and the opportunities to expand our footprint, fortify our position, and build scale in those 14 products or 14 lines of business in my mind could very well go through distribution tuck-in acquisitions, which is different than our distribution strategy in Canada, which consists in building a massive, largely personal lines distribution operation. So it's 2 different strategies, but we do have distribution expertise as you can see from the numbers and from how long we've been active in it. And therefore, when we look at the U.S. marketplace, this is not, in our mind, for specialty lines just a manufacturing play. There might be distribution opportunities, and we're open to those and studying where they are and being proactive at this stage. So I don't know if it helps, Doug.

Doug Young
Desjardins Securities Inc., Research Division

Yes, no, that helps. I'm just trying what makes you -- what gets you to the point where you're comfortable? That's I guess where I'm just curious like...

Charles Brindamour
CEO & Director

Gets me to the point where I'm comfortable meaning?

Doug Young
Desjardins Securities Inc., Research Division

In terms of transacting and purchasing distribution because it sounded like you're not there yet but you're almost there.

Charles Brindamour
CEO & Director

Yes. I think we look at opportunities. These are much smaller capital deployment steps as well. And as I'm saying, we're gaining confidence. We're not yet at the low 90s performance level in the U.S. We're therefore not at the level of big capital deployments in the U.S. Hence, our priority for capital deployment is Canada. But we're certainly starting to explore smaller mid-tier capital deployment opportunities in the U.S. and that very much includes distribution.

Operator

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

Tom MacKinnon
BMO Capital Markets Equity Research

It's question really with respect to your outlook in the U.S. and in Canada. In the U.S., in commercial lines, you mentioned pricing remains stable. And this is from a combination of what you viewed as a current favorable economic environment in the United States. And I guess so my first question here, what's so favorable about the economic environment in the United States, especially in light of talk about of a -- of perhaps a coming recession? And then as a follow-on, when you compare the 2 markets, you talk about the U.S. being stable but Canada is firm. And am I reading then that Canada is better than the U.S. in terms of a -- an insurance market right now? Why is that? Maybe you can compare. And is -- does Canada generally follow the U.S. market?

Charles Brindamour
CEO & Director

So in aggregate -- I'll let Alain talk about the U.S., and I'd be cautious about drawing too many direct relationships with the economy. But when you look at the U.S. market, different parts of the markets are behaving very differently. If you look at commercial automobile, for instance, in the U.S., there is meaningful firming going up -- going on. There are segments of property as well but overall the momentum we're seeing there is nowhere near what we're seeing in the context of Canada. I'll let Alain maybe say a thing or 2 about the U.S., and then we'll get into Canada.

Alain Lessard
Senior Vice President of Commercial Lines

Okay. So thank you, Tom. So if I give you a bit of perspective on the U.S. market, when we say stable, it's rate increase are stable, and we're seeing modest rate increase to the tone of 2%, okay? Basically if that we compare our OneBeacon environment it's operating, it is slightly different market than the overall market. There's way less Workers' Compensation and our rate increase in the fourth quarter for OneBeacon were 4.4%. So quite -- this situation is one point that makes us positive on the U.S. market. The second point is the judicial system, okay, where there is a bit more conservatism that is happening in our judicial system. There's a few court case, as an example, that had increased the burden of proof if you want for people claiming excessive force from law enforcement body, and this is really positive in our worker -- in our government risk business unit. And overall, what we see is a judicial system that is slightly more favorable to business. And the third one was more economic. You were talking about the downturn but basically, when we look at the outlook, we're talking about a slightly less GDP growth but still within 2% to 3% growth, inflation below 2%, unemployment rate still going downwards, and again from business point of view, this is a favorable environment. So for an organization like OneBeacon that focus on mid-to-small specialty lines of business, the overall judicial system rate environment and economic environment puts us in a nice position right now.

Charles Brindamour
CEO & Director

Yes, so Canada is far more cost driven at the moment. You've seen inflation in auto, the industry needs to react. You've seen changes in weather patterns, the industry needs to react. Then in commercial lines, as Alain was saying, the industry is operating above 100%. That is a combination of it being soft in the past decade and a bit of inflation including changes in weather patterns. So what you're seeing -- because all these lines at the industry level are not performing very well, the reaction is stronger than what we're seeing in the U.S. So, Tom, hopefully, this was -- this is helpful.

Tom MacKinnon
BMO Capital Markets Equity Research

I mean, just as a follow-on, I know the weather patterns has been an issue both north and south of the border. Are we just slower to react to them here? And, presumably, inflation driven in terms of auto repairs is -- I assume is a problem both north and south of the border. Are we just slower to react here?

Charles Brindamour
CEO & Director

I'm not sure I would draw that conclusion. I think that the industry's performance in Canada over time as compared with the industry's performance in the U.S. over time, if anything, it's been about a point above. So it -- I wouldn't draw that conclusion, Tom. I'd say the inflation in auto is not just physical damage as you know. And I think it's a convergence of these factors, which is leading Canada to be firmer at the moment.

Operator

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

Brian Robert Meredith
UBS Investment Bank, Research Division

A couple of quick questions for you. First, I am sort of just curious, down in the U.S., commercial auto continues to be a challenging line for a couple of companies that take charges for it. It sounds like it's performing pretty well now in Canada. Is there a difference that we should think of as to why it's still performing well over there? Is something you guys are keeping your eyes on?

Charles Brindamour
CEO & Director

Well, commercial auto in the context of Canada has had pockets of pressure, trucking being a good example. Half of commercial auto is unregulated in the context of Canada. So your ability to put in place corrective measures quickly is greater, and I would say this makes a difference. Alain, do you want to add anything?

Alain Lessard
Senior Vice President of Commercial Lines

Yes, and I would say it's quicker in Canada because a lot of it is unregulated. It's bit slower in the U.S. because it's a bit more regulated. And when it comes to commercial auto, this is a very regulated product. So coverage, accident benefit, liability can vary a lot by states, can vary a lot by province. So I would be cautious in comparing the state of the commercial auto in the U.S. and the commercial auto in Canada.

Brian Robert Meredith
UBS Investment Bank, Research Division

One of the things you've also talked about is an increase in legal representation on claims. I'm wondering if that's maybe different in Canada and U.S.?

Charles Brindamour
CEO & Director

Not here to us.

Brian Robert Meredith
UBS Investment Bank, Research Division

Not there, okay. Another question, I'm just curious, Charles, if I look back on the last kind of major acquisition you guys did, Jevco, came kind of on the heels of a period where the industry was having some challenging profitability as well. I'm wondering, one, do you think that we could potentially see some larger transactions here in the next year or 2 as the industry continues to struggle from a profit perspective? And then what is your kind of capacity for an acquisition ex-issuing equity at this point?

Charles Brindamour
CEO & Director

So I think, Brian, I'd go back 20 years here since I've been involved in the transactions we've done as a team and the best ones came on the heels of tough low-single-digit ROE environment. I can think of the Zurich acquisition, which we've done in '01, '02. The Allianz acquisition, which we've done in '04, '05. So my view is, this sort of environment is a good one for consolidation and for assets to change hands. I think people changed their view on their property in those kind of markets, and I think that's good for us, especially given our outperformance. So I'm positive about the environment that we're entering into on that front. With regards to capacity to issue before -- or to finance before issuing equity, Louie, do you want to take perspective on that?

Louis Marcotte
Senior VP & CFO

Sure, that would be a combination of net excess capital and perhaps it would be about CAD 1 billion of capacity without issuing common equity.

Operator

Your next question comes from the line of Mario Mendonca of TD Securities.

Mario Mendonca
TD Securities Equity Research

Just a quick question on investment income. So, obviously, a good job of increasing the market-based yield, just looking at your MD&A, I see that, that's up -- the market-based yield is up 47 basis points year-over-year. This is Q4 versus Q4 '17. Where I'm going with this is, could you help us think through that 47 basis point increase? How much of that would have been just extending duration? How much going out on the risk curve? Is there any way you can break that out with some precision?

Louis Marcotte
Senior VP & CFO

Sure. So I'm careful with using the market-based yield because it's also affected by the denominator, which has varied a bit, but if I look at year-over-year, Mario, where we were last year. This year it's CAD 97 million of additional income. We allocate about 1/3 of that to simply the addition of OneBeacon's assets to our portfolio. Then 1/3 to a higher yield. And so about CAD 30 million related to higher interest rates. Then we have higher dividend yields for about CAD 16 million. The exchange rate has had a positive impact for about CAD 6 million. And then tweaking the OneBeacon portfolio and part of this is interest rates and part of it is the asset mix. But tweaking the -- their assets, their portfolio towards our asset mix. So we took it over last year and the investment team took it on January 1, and then they migrated to our asset mix and that has contributed to the gap. So I would say it's not very much a yield -- a risk play here, very much just adopting our own asset mix and leveraging the fact that rates were rising this year and because we have to move assets between geographies, for example, that gave us an opportunity to trade and capture higher yields on the way. So a -- favorable market conditions as the rates were going up and the fact that we transitioned.

Charles Brindamour
CEO & Director

And I think to your point, Mario, when we've done the optimization exercise, the risk envelope itself didn't change. And the optimization exercise is one where all of a sudden you have 2 capital regime, 2 tax regime and you want to make sure that you take that into account in establishing the asset mix of your sub in the U.S. and your sub in Canada. And that in itself without playing with the risk envelope has been, as Louie is saying, an important contributor to the performance you've seen.

Mario Mendonca
TD Securities Equity Research

Okay. So this sort of leads me to the follow-up question then. If you're not taking additional risk and you are essentially just optimizing for the higher yield, I would have expected a little bit more pressure than in terms of realized losses in the bond portfolio, for example. Because when you're buying higher-yielding assets, you're also selling something else and presumably there will be a loss there because rates have moved higher. So why is it that don't we see that on Page 21 of the MD&A?

Charles Brindamour
CEO & Director

So I think you would have seen it perhaps earlier in the year when we traded, and it was offset with gains on the equity portfolio, but that happened earlier -- in the earlier part of the year.

Mario Mendonca
TD Securities Equity Research

Okay. So when I look at Page 21 again and I look at 2018, there's about CAD 26 million of losses there in the bond portfolio. Is that essentially -- that would be what you would point me to in terms of losses associated with the optimization and other factors, I guess?

Charles Brindamour
CEO & Director

Yes.

Operator

You're next question comes from the line of Meyer Shields of KBW.

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

Two quick questions back on personal auto. First, obviously, tremendous improvement, but I'm wondering beneath the surface, is marijuana legalization having any impact?

Charles Brindamour
CEO & Director

We're -- I don't think seeing it because we've had 3 quarters of sequential drop in frequency. So it's hard to break it into what might have been an upward pressure point. I don't know, Patrick or Darren, if you have a perspective on that.

Patrick Barbeau
Senior Vice President of Claims

No, Charles, I agree with you on that in the sense that from the file by file claims and we haven't seen cases where there's clear incidence of that, but it's tough to get that information as you say frequency has been going down overall for the year. We have no increase in frequency also and three quarters where it was going down. So maybe it's -- there is a bit of influence in there, but it would be fairly small given overall frequency is going down, and we have no clear signs there.

Charles Brindamour
CEO & Director

And we were on high alert in November following the change I think to identify signs of that, and there's no clear evidence at this stage. Darren, anything to add?

Darren Christopher Godfrey
Senior Vice President of Personal Lines

No, the only thing I -- it's still very early in terms of the process. I think what's -- what I am encouraged about is the awareness campaigns that have been running from all levels of government as far as the dangers of driving and cannabis consumption. So I think that's encouraging from an educational standpoint as well too, but it's still very early.

Charles Brindamour
CEO & Director

Yes.

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

Okay. That's very helpful and very thorough. Second question I guess, with regard to Louie's guidance on distribution, does that assume that as competitors catch up on rate increases, again predominantly personal auto, that there will be more contingent commission income or is that upside to the guidance?

Louis Marcotte
Senior VP & CFO

I would say upside at this point. I think right now we're guiding mid-single digit for next year based on the current portfolio. But I would say if there was better outcome on the underwriting side, it would be upside.

Charles Brindamour
CEO & Director

Yes, for the distribution income per se, yes, certainly, and I think just from a market dynamic point of view, what is interesting from a distribution point of view is that when you get into harder market like the one we're in, the issue for brokers -- this is tough for them because it's not just rates. The reality is that there are capacity issues, where brokers' ability to find an insurance company for all their customers is actually constrained. And from our perspective, this is also a pretty good environment for further consolidation in distribution and that in my mind is where the true upside lies.

Operator

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

Paul David Holden
CIBC Capital Markets, Research Division

So question on personal auto. Given you hit your margin target now, you have a hard market across the industry. Do you have enough comfort around where cost inflation is that you can start turning up the dial on market share? Or do you continue to focus at this point on solidifying that profit margin?

Charles Brindamour
CEO & Director

So as I said, we're in the zone. When you look at frequency in severity trends, it's looked good in the past few quarters. We want to make sure though that there's sustainability there. There is lot of momentums in terms of action, and, Paul, my hope here is that we don't need to turn the dial. The markets make it up and naturally for us, meaning we keep doing what we're doing, and our relative position improves and growth picks up as a result. We're not in the zone of saying, should we trade a point of ROE for a point of growth? That's not how we're thinking, not in that zone. This business is not generating upper teens ROE certainly. And that's the zone where you start to ask yourself the question, am I better off staying closer to mid-teen for an additional point of growth? You know how it kind of makes value works. Past that point, it makes sense to have the discussion. I don't feel that's the space we're in yet in automobile. I do feel that the market dynamic itself will bring growth to the Intact personal automobile platform without us having to make any sacrifices to get that growth. And that's the sort of environment where we have done extremely well in the past.

Paul David Holden
CIBC Capital Markets, Research Division

Got it, that's helpful. And then second question is related to U.S. commercial lines. So you've given an indication over what you expect for industry growth of low to mid-single digits. Assuming you're targeting something higher than that, maybe you can give a little bit more color on context around sort of the range or idea of what type of growth you are targeting?

Alain Lessard
Senior Vice President of Commercial Lines

I think we're -- at this point, what I would say globally we're basically focused still on making sure we achieve our low-90 objective. That is the #1 priority of the team. And -- but we're seeing opportunity in some of the business units, especially a few ones -- 75% of them are doing very, very well. So I would say right now probably a little better than the industry. So that would be let's say mid-to-upper single digit.

Operator

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

Jaeme Gloyn
National Bank Financial, Inc., Research Division

Quick question on the personal auto side. With the return to the 95% combined ratio level and more normalized profitability levels of say, is there any risk that expenses tick back up to where they were historically as well, sort of in that 25% range as a percentage of earned premiums? Or is there enough -- or have enough initiatives been put in place to keep this down in the 22%, 23% range that it operated at the last 2 years?

Charles Brindamour
CEO & Director

Louie, do you want to give your perspective on that?

Louis Marcotte
Senior VP & CFO

Yes, so I would say I think it's a bit deflated here in auto because due to profitability challenges, the variable items were a bit more limited. As I would expect a part of it to come back to past years, probably lose a point, just slightly north of a point of expense when the profitability comes back. So it's going to be good news because we'll have better profitability and there's going to be -- some of that's going to be -- some of that will be shared. But it won't stay at the level it's staying at. If you look in the aggregate expenses, which is really what we manage, that's been -- there is -- there was a structural decline and I would say 0.5 point -- a bit more than 0.5 point of expenses have been completely shaved. But there's another part that's variable. And will come back when the profitability returns to where we want it to be.

Charles Brindamour
CEO & Director

But that's baked in our view that this business is performing in the mid-90s and should continue to do so in the coming years. I think that's the sort of tactical view on expenses. I think strategically, our business units are focused though on reducing their cost operating base. In particular, our direct operation has seen its expense ratio drop by close to 4 points over the past 5 years. And we'll be shooting for something in that zone over the next 5. So yes.

Jaeme Gloyn

National Bank Financial, Inc., Research Division

No, that's good. And last one just quickly, obviously, a little bit of storm activity and cold weather in January. Do you have any comments related to the impacts of weather in January to start the first quarter of '19?

Charles Brindamour
CEO & Director

I think that's the business we're in, just to be clear. But I think seasonality, obviously, is relevant. I'll ask Patrick, who mans the phone with this team, so share his perspective.

Patrick Barbeau
Senior Vice President of Claims

Yes, winter is always -- our most year, have busy time for claims. We expect that and the operations are preparing for it. Q1 2018, as you might recall, was a proof point of that, and if you look at the average of the last 3 years or 5 years, all lines combined, the combined ratio in Q1 is about 4 points higher than the yearly average. So this is somewhat expected, I would say, January so far is in line with...

Charles Brindamour
CEO & Director

It's winter.

Patrick Barbeau
Senior Vice President of Claims

It's winter, but it's only a small portion of the quarter.

Charles Brindamour
CEO & Director

And to be clear, Patrick, the 4 points you're talking about ballpark is for all lines and in automobile?

Patrick Barbeau
Senior Vice President of Claims

It's similar at 4 points for auto too.

Operator

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

Tom MacKinnon
BMO Capital Markets Equity Research

Just a follow-up with respect to the growth in commercial auto. Year-over-year DPW up 18%. I'm wondering if you can share with us what's happened with respect to some of the products you've been able to offer in terms of sharing economy. And in particular, I think you have some -- a contract with Uber. So has that helped with respect to that growth that we're seeing?

Charles Brindamour
CEO & Director

Yes. So I'm not going to get into specific deals that we have, Tom. But I would say when I think about commercial automobile, there's sort of 3 buckets. One is rates per se, there's a lot of rate momentum in commercial automobile and the business seems to be sticking. Trucking, in particular, a ton of rates in trucking and that market is very firm if not very hard. And then the specialty lines operation also the growth Alain was talking about earlier is filtering into commercial auto and clearly, our sharing economy practice is very healthy in the context of Canada, very healthy in the U.S. as well. So we're building, in my mind, a beautiful franchise on the sharing front. And it goes beyond one specific contract. Alain, I don't know if there's anything you want to add.

Alain Lessard
Senior Vice President of Commercial Lines

Well, I think we've mentioned that a couple of times over the last few calls, but our sharing economy approach is to, basically, base premium on usage. The more kilometers driven, the more rental there is, the more usage there is of the sharing economy, the more premium you collect. So clearly, there's been a healthy and popularity increase in the sharing economy contacts and that is fueling our growth in commercial auto overall.

Operator

There are no further questions at this time. I would like to turn the call over to Ken Anderson for closing remarks.

Kenneth Anderson
VP of Investor Relations & Treasurer

Thank you all for joining us today. Following this call, a telephone replay will be available for one week and the webcast will be archived on our website for one year. A transcript will also be available on our website in the Financial Reports & Filings section. Lastly, our first quarter 2019 results are scheduled to be released after market close on Tuesday, May 7, and our AGM is scheduled for Wednesday, May 8. Thank you again, and this concludes the call for today.

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