S&P Global
Market Intelligence

The Hanover Insurance Group, Inc. NYSE:THG

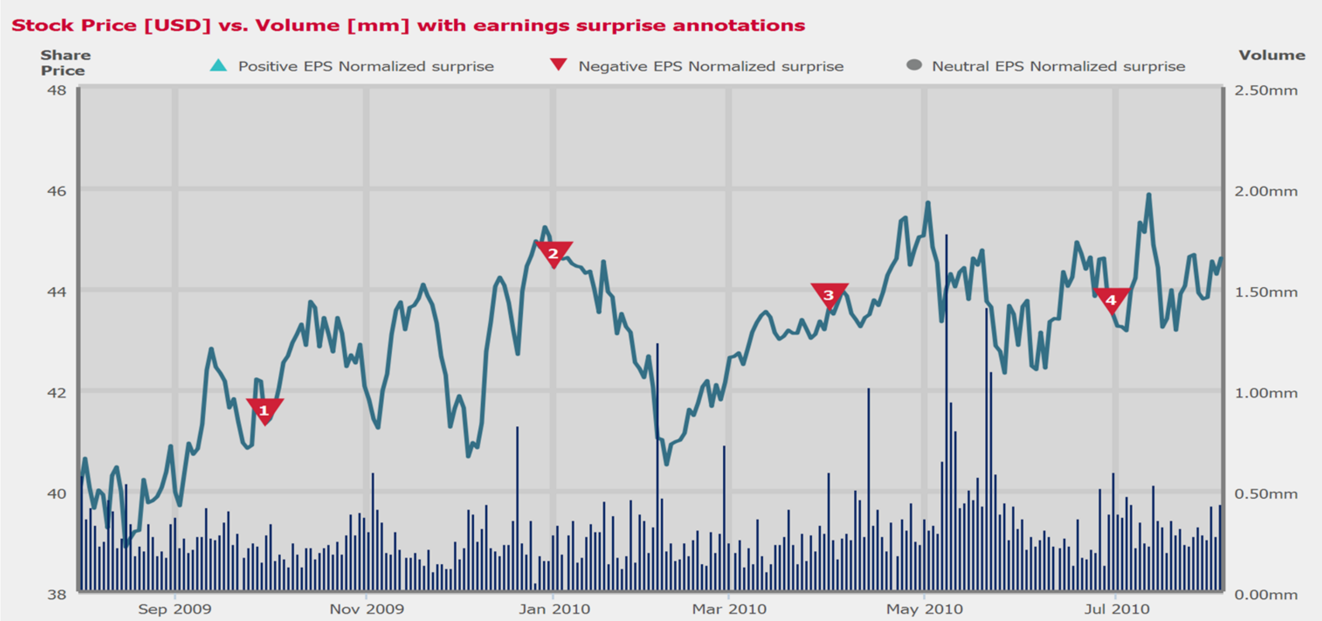
FQ3 2010 Earnings Call Transcripts

Thursday, November 04, 2010 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2010-			-FQ4 2010-	-FY 2010-	-FY 2011-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.93	0.98	▲5.38	1.15	2.83	4.16
Revenue (mm)	778.19	803.70	▲3.28	734.94	3035.16	3200.49

Currency: USD
Consensus as of Nov-04-2010 5:19 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2009	0.98	0.89	▼1 (9.18 %)
FQ4 2009	1.01	0.83	▼2 (17.82 %)
FQ1 2010	0.77	0.66	▼3 (14.29 %)
FQ2 2010	0.20	0.04	▼4 (80.00 %)

Table of Contents

Call Participants

EXECUTIVES

Frederick Henry Eppinger
Former President & CEO

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

Oksana Lukasheva
Vice President, Investor Relations

Steve Bensinger

ANALYSTS

Cliff Gallant
KBW

Presentation

Operator

Good morning and welcome to The Hanover Insurance Group third quarter earnings conference call. (Operator Instructions)

I would now like to turn the conference over to Oksana Lukasheva.

Oksana Lukasheva
Vice President, Investor Relations

Good morning and thank you for joining us for our third quarter conference call. Participating in today's call are Fred Eppinger, our President and Chief Executive Officer; Marita Zuraitis, President of Property and Casualty Companies; and Steve Bensinger, our Executive Vice President and CFO.

Before I turn the call over to Fred for a discussion of our results, let me note that our earnings press release, statistical supplement and a complete slide presentation for today's call are available in the Investors section of our website at www.hanover.com. After the presentation, we will answer questions in the Q&A session.

Our prepared remarks and responses to your questions today, other than statements of historical facts, include forward-looking statements. These include statements regarding expectations of after-tax operating earnings per share, segment earnings, pricing, accident year results, premiums, expenses, development of loss and LAE reserves, estimates of expense capital, returns on equity and other projections for 2010 and beyond.

There are certain factors that could cause actual results to differ materially from those anticipated by this press release, slide presentation and conference call. We caution you with respect to reliance on forward-looking statements and in this respect refer you to the forward-looking statement section in our press release, Slide 2 of the presentation deck and our filings with the SEC.

Today's discussion will also reference certain non-GAAP financial measures such as total segment income, after-tax earnings per share, segment results excluding the impact of catastrophes and development, ex-CAT loss ratios and accident year loss ratios among others. A reconciliation of these non-GAAP financial measures to the closest GAAP measure on a historical basis can be found in the press release or the statistical supplement which are posted on our website as I mentioned earlier.

With those comments, I will return the call over to Fred.

Frederick Henry Eppinger
Former President & CEO

Good morning, everyone, and thank you for joining the call. We're very pleased with our third quarter results, especially our continued progress on our strategic initiatives.

We posted after-tax operating income for the quarter of $45 million or $0.98 per share, a 10% increase over last year on a per share basis. We also continued to deliver very strong growth with net written premiums of 17% in the quarter, driven largely by gains in commercial lines, principally as a result of the OneBeacon renewal rates transaction and continued growth in our specialty and niche businesses.

Marita and Steve will review our quarterly results in detail with you shortly.

First, I'd like to take a few minutes to step back and review our progress and business outlook, given market conditions. Specifically, I would like to make three observations about our situation in the market.

First, we believe our company today is in a very strong and improving competitive position with winning agents. Second, given the financial leverage available to us, we believe we can continue to improve our financial performance over the next 12 months regardless of the general market conditions. Finally, we believe we will see growing market disruption over the next 12 to 18 months that will create increasing opportunity for the strongest competitors.

In 2003, we set out to build a company that combined the financial strength, talent and product capabilities of the best national companies with the local market knowledge and the responsiveness of the best regional. Since then, we've maintained an intense focus on that vision, making unprecedented investments across our organization and people, products, technology and service. We accelerated those investments, as you know, over the last couple of years, taking advantage of the market disruption to improve our product mix and expand our geographic position.

The return on these investments and the resulting progress we have made are becoming increasingly apparent, and the earnings power of this organization has increased as evidenced by recent quarterly trends.

Our ex-CAT combined ratio this quarter is at its lowest level in the last four quarters, despite the investments we continue to make in the business. At 51.5%, our ex-CAT next development loss ratio is consistent with the second quarter and is the lowest that it's been during the last 16 quarters. At 18% year-to-date, our topline growth is strong, constituting a key driver of our increasing book value going forward.

Our positive rate momentum is driven by growth in improved accident year profitability, demonstrating our strong underlying earnings power. And our quarterly operating ROE with budgeted caps continues to reflect improvement from quarter-to-quarter, increasing to 8% this quarter.

Since the very beginning of our journey, we've strived to provide distinctive value to our agency partners. Along the way, we've developed a compelling value proposition with focus on product innovation, commitment to partnership and franchise value and distinctive responsiveness and local expertise. Today, in the face of significant industry and economic pressures, our strengthening results continue to validate our strategic focus.

I would like to go over some aspects of how we believe our partner-focused strategy makes us more distinctive than many of our competitors to winning agents.

First, in a market often characterized by less and less product specialization and more commoditization, we've accelerated our investment in industry-oriented solutions for mainstream businesses, creating improved retention and growth opportunities for our agent partners.

Over the past 24 months, we've introduced more than 30 new products and product enhancements and have added over $300 billion in specialty premium. During the past 24 months, we've also made several acquisitions, giving our agent partners direct access to capabilities they value in small commercial and middle market in surety, professional liability and healthcare. And our product distinctiveness will continue in the coming months as we will discuss later.

Second, at a time when others are appointing more and more agents and using more wholesalers and aggregators to reach their market, we are appointing far fewer, limiting the availability of our products, selecting professional agents that can sell and deliver value. This is creating meaningful franchise value for our partners.

As a result, our agents are able to differentiate themselves in their local markets, offering insurance solutions their competitors can't. In return, we are receiving more preferred shelf space in the agency and with the best accounts.

Third, because of our growing financial strength, we are able to thoughtfully diversify and deepen our geographic presence, adding local expertise and creating new relationships in a broader market.

During the past year, we've established a national footprint, creating a vast region with over 100 experienced insurance professionals. We also have hired additional professionals to our team across the country, adding towns and leadership in major markets and providing additional capabilities and responsiveness.

As I look forward, I am optimistic that we will continue to improve our financial performance regardless of when the market turns. We continue to focus on the four levers we have talked about in the past.

First, we will continue to effectively leverage our commercial business investments. We believe we will continue to see meaningful expense leverage in our commercial business through the end of 2011. The OneBeacon transaction, our strategic investments in specialty and our geographic expansion have all met our expectations to date. And I believe our improving expense position will be an important lever to reach our target returns over the next four quarters.

Second, the quality of our business continues to improve. In personal lines, we are approaching 70% of our business being accounts, and our growth continues to improve our geographic footprint.

In commercial lines we continue to grow specialty and niche businesses that bring us more high margin small and middle market business. The strategic geographic and business mix shifts will drive fundamental margin improvement in our overall book of business and create more stability.

Third, we will continue to have pricing discipline and leverage in our book.

Given the environment, I continue to be pleased with our progress. Obviously, we had driven significant rate in the Personal Lines book and we continue to see continued opportunities here due to the strong mix of account business and the struggles of our regional competitors.

And in commercial lines, unlike many of our competitors, our focus on smaller industry-oriented business has allowed us to maintain positive renewal rates. And the vast majority of our growth is coming in the form of renewal rights and book consolidations that are as attractive, if not more attractive than our existing book.

Four, we will continue to be thoughtful about capital management. We continue to hold excess capital, and while some of it is being deployed because of our current growth, the amount of excess capital remains at about $250.

My final observation is about the current competitive environment. And while the market continues to be difficult, it is becoming clear that there is an increasing financial stress in the industry. There will be increasing disruption in the industry over the next 12 to 18 months, particularly with some of our smaller regional competitors.

This disruption will clearly benefit the stronger companies. I believe we are well positioned to profitably capitalize on it.

Over the last few years, we have established a broad product capability and geographic reach that make us more relevant and important to the best agents in this country. And as we continue to deliver on our value proposition, we are confident that they will look to work with us even more in a time of disruption and opportunity.

We are confident that we have put the right building blocks in place, and that with continued solid execution we will achieve our goal of being regarded as one of the very best companies in our industry.

While clearly there is more work to be done, I believe our strategy and the profitability levers available to us puts us in control of our future success.

I'll now turn the call over to Marita and Steve to review our third quarter results.

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

Thanks, Fred. Good morning everyone. I'm glad you could join us today. This morning, I'll review our operating results for the quarter, and while doing so I'd like to build on the main themes that Fred mentioned in his remarks.

Our third quarter underlying results provide evidence that our focus on margin improvement is paying dividends. Starting with Slide 7, our third quarter combined ratio was 97% all-in, and 93.7% excluding catastrophes.

Our ex-cat, ex-development combined ratio, which is a better indication of our underlying quality of our earnings was 96.6% this quarter, representing a significant improvement from the 99.8% in the third quarter of 2009 and the 97.2% in the second quarter this year.

Our ex-cat, ex-development loss ratio has improved by 4 points on a year-over-year basis and is flat over last quarter. At 51.5%, it's the lowest it's been in several years. At the same time, we increased our net written premium by 17% in the quarter and 18% on a year-to-date basis.

Our results demonstrate progress in all of our key financial metrics. Last quarter, we talked about the notable improvement in our Personal Lines core profitability. We also discussed our strong loss performance in commercial lines despite the persistent soft market environment. And we're pleased to see that these trends continued this quarter.

With that in mind, I'd like to discuss the drivers of our performance in more detail, starting with Personal Lines on Slide 8.

Personal Lines Pre-tax segment income, excluding catastrophes was $59 million the quarter compared to $42 million in the third quarter of last year. This improvement was driven by better underlying loss ratios in auto and homeowners, as well as lower expenses.

Our ex-cat Personal Lines accident year loss ratio improved by 4 points in the quarter. We attribute this to our continued rate and mix of business improvement actions, as well as more normal non-catastrophe weather during the quarter.

Our diligent management of rate and mix in Personal Lines reflects our consistent underwriting discipline and our whole account strategy. In addition, we are seeing the benefit of our book consolidation efforts. And barring any unusual weather, we expect continuing improvement in our Personal Lines loss ratios going forward.

Moving on to expenses. Our underwriting expenses were lower this quarter, mostly driven by more normalized technology investments and lower employee-related expenses, as well as the benefit of non-reoccurring items.

Overall, we have a good line of sight towards achieving our return targets in Personalized through our rate and non-rate underwriting actions.

Now, turning to Slide 9 to discuss our Personal Lines growth for the quarter, our Personal Lines net written premium decreased 2% compared to the third quarter of last year. As we noted in the second quarter 10-Q, we entered into an agreement to reduce our homeowners exposures in Louisiana while maintaining our partner agency focus in that State.

While this enables us to better serve our key partner agents in the state and mitigate our wind exposure, it also reduced our third quarter overall Personal Lines growth by 1.6 points. Excluding this action, Personal Lines net written premium in the quarter would have declined by about 0.5%, which is essentially in line with the flattish growth trends we saw during the prior quarter.

As we have said before, given our significant market position in our core states, along with the shrinking Michigan economy, we managed these states with a focus on margin management, not growth. Because of our robust account product offering and preferred shelf space, our retention is holding, and we continue to grow with our best partners.

In our growth states, our strategy and account-focused offering have been well received. We increased premiums in these states by 6% during the quarter, while policies in force grew 5%. At the same time, we continue to remain diligent with our rate actions. Country wide, we increased our rates this quarter by 7% in auto, as well as 7% in the homeowners line.

Retention improved on a year-over-year basis, and has remained stable compared to the second quarter. Our account and multi-car business now represents 75% of our Personal Lines book. We have confidence that our pricing discipline, the positive changes in our business mix, and our partner agent strategy will continue to drive future profitability improvement in Personal Lines.

Moving on to commercial lines on Slide 10, Pre-tax Segment income for the quarter was $35 million compared to $39 million in the third quarter of 2009. Our ex-cat accident year loss ratios improved compared to last year, driven by improved loss ratios in commercial multi-peril and other commercial lines.

The calendar year earnings comparison is affected by lower favorable development as well as higher expenses. As expected, our expense ratio was higher this quarter when compared to last year and reflects the impact of our continued investments in our business.

The expense ratio is however, half a point lower than it was last quarter, as we continue to earn in the premiums associated with these investments. Long term, we expect this trend to continue as we gain scale from our newer businesses and the renewal rights transaction, although there may be variations on a quarter-over-quarter basis.

Our ex-cat accident year loss ratio, which we believe is the best indicator of the underlying quality of our commercial lines book was 48% compared to 49.5% in the third quarter of 2009.

As Fred indicated, our strategy allows us to increase the earnings power of our organization despite difficult current market conditions. Our ability to consistently maintain strong accident year margins in combination with industry-leading growth provides the best supporting evidence that our strategy is working.

The primary reasons we have been able to achieve these results is that we have remained disciplined, consistent and resourceful in our search for growth opportunities, whether it is in specialty capabilities or in our core commercial lines, the common themes of our growth strategy is converting business in blocks through book consolidation efforts or through other non-traditional means. This allows us to access controlled profitable business, rather than engaging in the aggressive competitive environment for undifferentiated new business.

Our partner agent strategy is gaining momentum. Our pipeline of book consolidation opportunities continues to expand. Our partners understand how we can better serve their customers and also improve their own economics.

The sources of our growth in commercial lines fall into three categories: first, the OneBeacon renewal rights transaction; second, growth in our specialty businesses; and third, our niche and segmented commercial lines offering. Approximately 30 points of our commercial lines growth this quarter is attributable to our renewable rights agreement with OneBeacon.

The strategic value of this transaction from the very beginning was to build deeper partnerships with winning agents, increase our segmentation focus, accelerate our geographic expansion and build operating efficiencies. And we have delivered on all of those levers.

With $77 million of net written premium renewed in the third quarter and $226 million on a year-to date basis, we are certainly gaining scale and expense leverage through this transaction. From a distribution standpoint, we did this by appointing less than 300 new agents, choosing not to partner with many more, while also increasing our book with many of our existing agents.

Our renewal retention rate is in the high 70s, which is much higher than a typical renewal rates transaction. We have also written approximately $40 million of new business as a direct result of this transaction. Both renewal retention and the quality of the new business generated demonstrates the strong relationships we are building.

A large portion of the OneBeacon renewal business is written in segments and niches, which is consistent with our small and middle market strategic focus. Over 70% of the premium we have renewed so far falls within these targeted segments and niche programs. As a result, we are pleased with both the quantity and quality of the business we are writing as well as with the strong leverage of agency support we are receiving.

As we renewed this business, we obtained rate increases similar to those we have been getting on our legacy commercial lines renewals. Initial loss indications from this book are also in line with our expectations. Growth in small and middle market accounts outside of the renewal rights transaction contributed approximately 2% to the overall commercial lines growth this quarter.

In order to better meet the more specialized needs of our best agents, over the last couple of years we have expanded our core product offerings which now include a growing suite of industry niches and segmented products.

As a result, the growth we are seeing now is driven by the strength of our offering, account solutions and added services and not principally on price. In fact, we continue to achieve marginally positive renewal pricing in our core commercial segment despite the persistence of market environment.

Moving on, our specialty lines contributed 10% to our overall commercial line's growth in the quarter. The specialty business is a key component in the value proposition we are for our agents. It demonstrates our commitment to product innovations and franchise value. These businesses distributed through a limited number of our best agents are on track to become a robust source of our earning's growth.

Many of these products like miscellaneous professional liability and healthcare are still in the early stages of development. And we still need to earn in our investments. But these new capabilities are in high demand among our best partners.

Through our miscellaneous professional liability offering that we introduced in January of this year, we wrote professional liability in conjunction with our existing segmented and niche businesses like document destruction and real estate property managers, educators' legal liability and curators professionals. This gives our partner agents more to sell, and should ultimately improve our future profitability through better account retention and better overall customer service.

Additionally, during the fourth quarter, we are expanding our technology capability building on our strong and small commercial technology foundation and introducing middle market and E&O capabilities.

Our product capabilities will continue to expand. For example, leveraging the expertise of Campania, a company we acquired earlier this year. We plan to launch our durable medical equipment and home healthcare products. Our more mature specialty businesses continued to perform very well this quarter.

For example, we continue to gain momentum on our Lawyers Professional Liability front. Our partner agents allow us to be selective in the business that we write. And because of that, we were able to grow and obtain an excess of 5% of pure rate in what is otherwise an intensely competitive market.

We also remain very positive about the performance in future of our program business since we are getting good rates and winning very distinctive programs. We remain disciplined in our strategy of writing mature programs with skilled partner agents. We continue to be satisfied with the quality and pace of the growth of our specialty business overall as it is associated with solid agency partners, controlled books of business, and strong underwriting expertise.

Our commitment to invest in product capabilities, our agent partner's need and to partner with them in ways that will help both of us win is resonating with our best partners and is generating an increase in flow of quality business opportunities. The strong support from our partners, whether it's through mix management in personal lines or controlled business conversion opportunities in product innovation in commercial lines, we continue to produce strong topline and bottomline results.

And with that, I'll now turn the call over to Steve, and I look forward to answering any questions that you may have later in the call.

Steve Bensinger

Today, I'll review the company's financial results representing the slide presentation starting with Slide 13. Fred and Marita noted our solid core underwriting trends. Our strong underwriting performance coupled with our stable net investment income in the strong balance sheet allows us to drive improving operating earnings.

First, I'd like to comment briefly on the reserve development. Our pretax P&C segment earnings for the quarter included $21.4 million or 2.9 points of favorable loss reserve developments compared to $38.6 million or 6.1 points in the prior year quarter.

The third quarter of 2009 included a benefit of $10.5 million relating to favorable reserve development from our run-off voluntary pools business primarily as a result of a third party actuarial study that's conducted every four years on a reinsurance pool in which we participated. In our ongoing P&C operations, we experienced slightly lower favorable prior reserve releases as compared to the prior year to the prior quarter. In the third quarter of 2010, we also benefited from realized investment gains of almost $6 million resulting from some portfolio repositioning.

Turning to Slide 14, I'd like to briefly touch on our investment portfolio and yield. As of September 30, we held $5.5 billion in cash and invested assets, an increase of approximately $300 million from year end 2009. This was mostly driven by market appreciation and to a lesser extent, an increase in assets under management due to the company's overall growth.

The composition of our portfolio remains largely unchanged from the second quarter of 2010. Cash and fixed maturities represent 97% of our total invested assets at the end of the quarter. Roughly 93% of our fixed income securities are investment grade. The average duration of the portfolio is 4.2 years.

This quarter, net investment income was approximately $61 million compared to $62 million in the prior year quarter. This small decrease is primarily due to the utilization of fix maturities to fund certain corporate actions such as stock repurchases and a contribution to the company's pension plan. Partially offset by hire income from opportunistic investments in fixed maturities and from the investment of proceeds from our February debt offering.

The earned yield on our fixed income portfolio of 5.5% this quarter was in line with the third quarter of last year. Fixed income, new money yields, however, were about 3.7% in the third quarter of 2010 compared to 4.9% last year. We expect that the persistence of the current low interest rate environment will continue to put pressure on new money yields. As a mitigant, however, we believe growth in our invested assets coupled with our well laddered portfolio should help alleviate the effect of lower yields on net investment income in future periods.

We expect about 11% of our portfolio to mature in each of the next two years. That will take a relatively long time for our installed book yield to decrease materially. And, given the relatively small amount of liquidity, we have to reinvest at any given time. We've been finding pockets of opportunities with attractive risk reward characteristics in the fixed income area.

We also invested approximately $75 million in stable large cap equities with attractive dividend yields during the quarter. Considering current fixed income yields, the yield characteristics of these securities were very attractive. Additionally, with only 2% of our total portfolio currently allocated to equity securities. We believe our portfolio can absorb incremental equity risk, while benefiting from additional diversifications.

As you can see on Slide 18, our balance sheet remains very strong. Our GAAP equity increased $127 million or 5% during the quarter, driven by the increase in net unrealized investment gains and earning. On a per share basis, book value increased to $55.25, an all time high. Our statutory surplus was $1.8 billion at the end of the third quarter. And at 1.6521, our premium to surplus ratio remains more than acceptable for our current mix of business, which is heavily weighted towards shorter-tail lines.

We believe we have continuing capital flexibility at the operating company level based upon rating agencies, and regulators, risk-based capital models as well as our own economic capital assessment. We also have room to observe growth from our western expansion initiative. The OneBeacon renewal rights transaction, and our growth opportunities in commercial lines.

Holding company cash and investment securities were approximately $350 million at September 30. We feel it's prudent to hold liquidity at the holding company for coverage of interest, dividends and potential operating contingencies. However, a portion of our holding company investments also represents excess capital.

We'll continue to be thoughtful about capital management. We've taken a number of significant steps over the past several quarters to effectively manage our capital. These include the two consecutive accelerated share repurchase transactions in December and March of approximately $100 million each. The $100 million increase in the stock repurchase authorization we announced last night, provides us with additional flexibility and reflects confidence in our overall financial condition and long-term growth potential.

As of today we have about $161 million of remaining capacity under the aggregate $500 million stock repurchase authorization. As always we will continually assess market opportunities and look for the best use of our capital for the ultimate benefit of our shareholders. Finally, we're affirming our guidance range for the full year of 2010, which now stands at $2.85 to $3.10 per share of after tax operating earnings. With that, let me turn the call back to the operator for Q&A.

Question and Answer

Operator

(Operator Instructions) Our first question comes from Cliff Gallant of KBW.

Cliff Gallant
KBW

I just had a quick question for Steve. And it just came down to the investment income number. It seems like there's a lot of moving pieces there, you outlined that new money yields are weak. You've got the buyback, which if you execute early will put some pressure on investment income. But it seems like you're actually not too much of the portfolio is turning over. And you should have some cash flow benefit of all the growth. So when I look out to next year, should I be modeling for a little bit of investment income growth?

Steve Bensinger

Cliff, thanks for the question. I think as we look forward, I think what we're sort of seeing in our own model is that the pressure from lower and new money yields. Although as I said only about 11% of our portfolio will mature next year is going to be more or less offset by what we're expecting in terms of new money to invest. So I would look at it right now, probably as consistent with this year.

Operator

(Operator Instructions) We are showing no further questions at this time. I would like to turn the conference back over to our speakers for any closing remarks they may have.

Frederick Henry Eppinger
Former President & CEO

Well, I want to just thank everybody for joining the call today. We obviously are excited about this quarter and we expect continued improvement on financial returns, as we continue on our strategic direction. So thank you very much for participating today.

Operator
This concludes today's conference. Thank you for joining. You may now disconnect.