S&P Capital IQ

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Intact Financial Corporation TSX:IFC

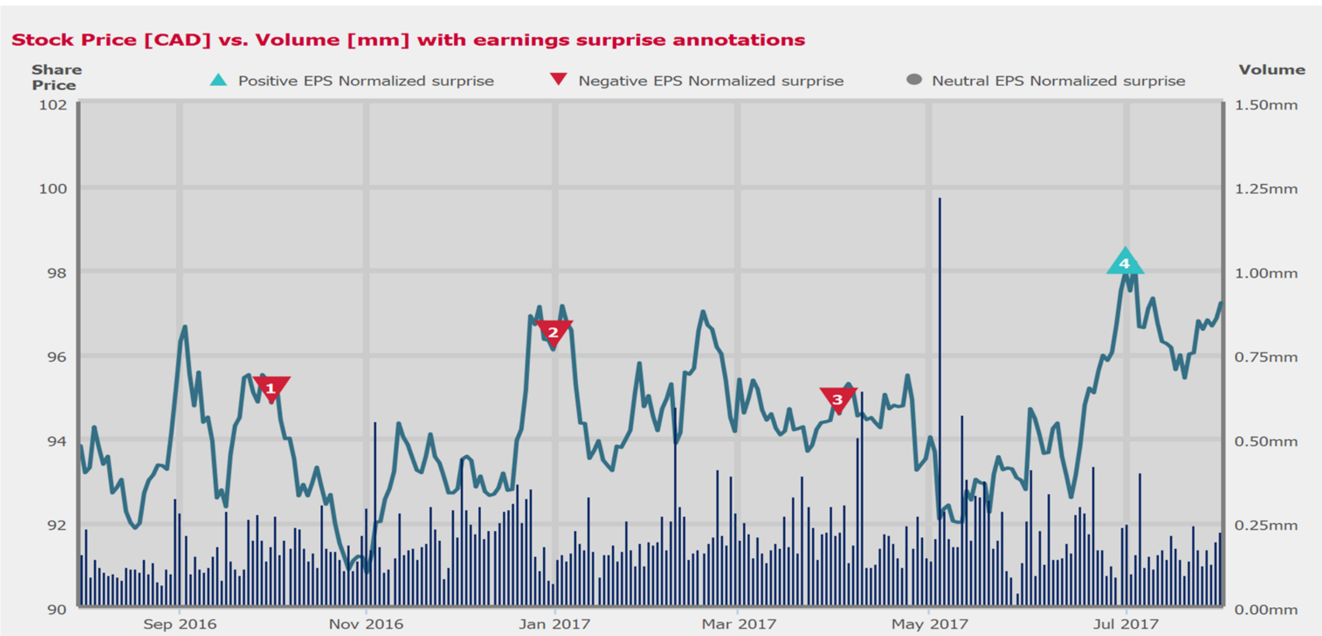
FQ3 2017 Earnings Call Transcripts

Wednesday, November 08, 2017 4:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2017-			-FQ4 2017-	-FY 2017-	-FY 2018-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.59	1.61	▲1.26	1.76	5.73	7.11
Revenue (mm)	2097.78	2082.00	▼(0.75 %)	2561.33	8688.36	9893.43

Currency: CAD
Consensus as of Nov-08-2017 11:40 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2016	1.04	1.01	▼1 (2.88 %)
FQ4 2016	1.75	1.58	▼2 (9.71 %)
FQ1 2017	1.03	0.90	▼3 (12.62 %)
FQ2 2017	1.32	1.44	▲4 9.09 %

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Call Participants

EXECUTIVES

Alain Lessard
Senior Vice President of Commercial Lines

Charles Brindamour
Chief Executive Officer and 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

ANALYSTS

Brian Robert Meredith
UBS Investment Bank, Research Division

Doug Young
Desjardins Securities Inc., Research Division

Geoffrey Kwan
RBC Capital Markets, LLC, Research Division

Jaeme Gloyn
National Bank Financial, Inc., Research Division

Kai Pan
Morgan Stanley, Research Division

Mario Mendonca
TD Securities Equity Research

Meny Grauman
Cormark Securities Inc., Research Division

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

Paul David Holden
CIBC Capital Markets, Research Division

Tom MacKinnon
BMO Capital Markets Equity Research

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Presentation

Operator

Good morning. My name is Kierstan, and I will be your conference operator today. At this time, I would like to welcome everyone to the Intact Financial Corporation third quarter results conference call. [Operator Instructions].

I would now like to turn the call over to Ken Anderson, Vice President of Investor Relations and Treasurer. Please go ahead, sir.

Kenneth Anderson
VP of Investor Relations & Treasurer

Thank you, Kiersten. 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. As a reminder, the slide presentation contains a disclaimer on forward-looking statements, which also applies to our discussion on this conference call. 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.

With that, I will turn the call over to our CEO, Charles Brindamour.

Charles Brindamour
Chief Executive Officer and Director

Good morning everyone and thank you for joining us today. Yesterday evening we announced third quarter net operating income of the $1.61 per share, an increase of 59% on the back of stronger underwriting results. Our top line was up 1%, driven by personal property and specialty lines. Growth in personal auto and commercial P&C was tempered by our rate action taken ahead of the market. On the combined ratio of 91.8% is a good overall results for the third quarter, while we benefited from lower catastrophes underlying performance in personal property and commercial P&C is very strong and improving. We also continue to see benefits from rigorous expense management. On the other hand, personal auto remains a drag on performance and I'll come to these results in a moment.

We also closed in the quarter the OneBeacon acquisition, putting in place a strong platform for long-term North American growth. And following the closing of OneBeacon, we ended the quarter in a strong financial position with MCT above 200%. Our operating ROE improved to 13.3% for the last 12 months and our book value per share is up 12%. When comparing ourselves to the industry at the end of the second quarter, we outperformed on ROE by 550 basis points. We expect to increase that advantage in the coming month.

So let's look in more detail at our results by line of business. So personal auto growth was muted in the quarter as our rate actions taken ahead of the market, resulting in some top line pressure as we expected. Despite our rate and other actions, the combined ratio was disappointing. Prior year claims development was unfavorable by 3.2 points reflecting a couple of actions this quarter. First, in response pre-reform trends observed earlier in the year on long tail claims, we performed a detailed file-by-file review in increased reserves. We followed this with an actuarial review of the auto portfolio and took a more cautious stance, leading to additional net reserves strengthening. With these reviews now complete, we're in a much better position going forward.

The underlying auto performance deteriorated 2.2 points year-over-year, mostly attributable to pools and the impact of the net reserve change we recorded. Overall, our view is that the auto combined ratio run rate is currently in the upper 90s. This is higher than we expected given the actions taken so far and certainly not an acceptable level of profitability. While we've largely eliminated inflation so far this year in this segment, we expect the reduction in severity. It has not materialized, that's physical damage costs have risen more than anticipated. To address this, we're increasing our actions. We plan to take further

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rate increases across the country and to add to our claims management and segmentation initiatives. With the plans already in place, the further actions to come and strengthened reserve levels, we're strongly committed to bring personal auto combined ratio back to the mid-90s in the coming years.

When it comes to the industry outlook, we've seen rate increases now in many markets this year. We also see expansion of the industry risk-sharing pool and our non-standard auto business is growing. These factors point to a firming market conditions across the country, so we expect mid-single digit growth for the industry in the coming 12 months. Personal property premiums grew 4% as rate increases were deployed in favorable market conditions. The combined ratio of 85% reflects excellent underlying performance, which positions this line very well going forward.

With a combined ratio of 92.4% year-to-date in personal property and an average sub 90% for the 3 years prior, we believe this line of business is price, take into account the ongoing levels of natural disasters. The industry outlook for personal property remains unchanged. Elevated catastrophe loss this year-to-date, support continued firm market conditions with mid-single digit growth expected over the next 12 months as the industry continues adjusting changing weather patterns.

Looking at commercial P&C, on top line we see rate increases flowing through in select segments, while conditions overall remain competitive. This line of business continues to produce excellent results. Excluding the unusually high favorable prior year development from diversification, this business delivered an impressive combined ratio just over 80%. Our pricing and segmentation actions are paying us nicely and this line too is well positioned moving forward. In commercial auto, premiums grew 5% on the back of multiple initiatives in specialty lines in particular. The combined ratio for the quarter was very strong at 86.8% and we continue to drive our profitability actions to deliver a sustainable 90% combined ratio in this line of business. In terms of outlook for commercial lines in Canada, we expect low-single digit growth in the coming year as markets remain fairly competitive across the country.

Turning to our recent strategic expansion, we closed the acquisition of OneBeacon on September 28, few months after announcing it, combining the strengths of our specialty teams in Canada as well as in the U.S. to create a leading North American specialty lines insurer. Under leadership of Mike Miller, actions are well underway to grow the business and leverage the stability of IFC's ownership and expertise that will be provided to both OneBeacon and its distribution partners. New growth pipelines are now open with underwriting desks on each side of the border supporting customers with the businesses in both countries. We're leveraging the OneBeacon industry leading expertise by introducing new specialty products in Canada as well. We recently launched an entertainment product and technology products will follow in the coming weeks.

Our OneBeacon profitability improvement plan is also in progress. The company has exited both programs as well as architects and engineers lines of business. We're also using Intact's analytics in segmentation to take underwriting actions in select other lines. Our proven claims practices are also gradually being deployed in the U.S. Then additional synergies are being realized and risk mitigation is in place, both of which we will describe in a moment. We are increasingly confident that our plans will bring U.S. combined ratio to a low-90s level within 24 to 36 months to deliver mid-single digit run rate accretion from net operating income per share by the end of 2019. This is before the growth upside we now see from being able to serve new customers across borders and export our products North and South.

Early observations on U.S. market conditions following closing are better-than-anticipated. We remain focused on Canada though, where we continue to accelerate our customer-driven strategy, leveraging our growing digital talent pool, belairdirect launched its mobile app, while Intact expanded its telematics offer via mobile. We completed the rollout of our online client center from coast-to-coast, simplifying our customers' lives, while gaining efficiencies. We also began the roll out of our next generation of advance pricing tools with the launch of our first machine learning [reading] algorithm for automobile.

In conclusion, I'm pleased with the underlying performance and continued momentum in personal property and commercial line. In personal auto, the reserving actions we've taken position us well, while profitability initiatives will improve our results in the coming year. We're already rolling with OneBeacon, which opens up significant growth pipeline for our business. Our financial position is strong and momentum is good as we execute with a customer-focused mindset. I'm confident we have the

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strategies in place to deliver on our financial objectives to outperform the industry ROE by at least 500 basis points, then grow our net operating income per share by 10% per year over time.

Before I finish, I want to take a moment to recognize our people, from coast-to-coast our folks are engaged and work tirelessly to improve our performance, widen our advantage and expand our leadership. And I want to thank them as they're really making a difference. And with that, I'll turn the call over to our CFO, Louis Marcotte.

Louis Marcotte
Senior VP & CFO

Thanks Charles and good morning everyone. Third quarter net operating income of $219 million was $82 million better than last year. Our results were driven by lower cat losses and strong underlying performances in personal property and commercial lines, but disappointing results in personal auto. Earnings per share grew 37% to $1.25 driving operating ROE of 13.3%. Our book value per share increased 12% year-over-year and 10% since Q2. Our financial position continues to be strong. We closed the quarter having completed the OneBeacon acquisition within MCT above 200% and approximately $1.2 billion in total capital margin, a new metric we use as a measure of our consolidated capital strength. Debt-to-capital was just below 25%, exactly where we were aiming at [announcements]. We still expect to bring our leverage back to 20% within 2 years.

There were 2 significant items that impacted our reserves this quarter. Firstly, the acquisition of OneBeacon required us to harmonize our actuarial practices, which were previously based on Canadian standards. Our revised approach is aligned with IFRS and the practices of global P&C peers. Now that we have operations in Canada and in the US, we recognize the benefit of risk diversfication between lines of business and between countries leading to a reduction of claim liabilities.

The second item is the strengthening of reserves Charles described earlier, which reflected a more cautious approach and impacted mostly personal auto. Although these 2 items are independent of one another, they can't be looked at in isolation as they both are essential in assessing the overall adequacy of claims liabilities. Together, they had a net positive impact on underwriting income of $39 million or 1.9 points of combined ratio. This benefit is unevenly distributed between lines of business and half of it is included in prior year development and the other half in current year.

Let me provide some additional color on personal auto, where we remain very focused on improving performance. Our action plans are delivering as expected with earned rates up [4.4%] in the quarter and written rates up 6.5%. Our segmentation actions are also translating into an improved mix of business in a higher quality portfolio, which ultimately will lead to a lower loss ratio. Despite this progress, the underlying loss ratio remains above our expectations, mainly due to the higher prices for parts and the time needed to replace them. The combined ratio is elevated at 105% for the quarter and 102% year-to-date. If we normalize for the net reserve change, prior year development and pool, we see the combined ratio running in the upper-90s. Between the existing action plan and further actions being taken to tame claims cost inflation, we expect our combined ratio to progressively improve towards a mid-90s target in the coming year.

Our cat losses in the quarter were well below last year and below our expectations. On a year-to-date basis, however, cat losses are still elevated. With the addition of OneBeacon, we are increasing our guidance for cat to $275 million. We still believe 75% of cat losses will impact personal lines and about 50% are likely to occur in the third quarter. Our rigorous expense management had a noticeable impact on our results, with a 1.6 point reduction in the Q3 expense ratio and 1.8 points year-to-date. This was driven by lower variable expenses and cost saving initiatives. At the same time, we continue to invest in our brand and customer experience, and in technology.

Turning to distribution income, we added $30 million of operating earnings in the quarter, bringing year-to-date growth to 19%. However, our full year forecast for 2017 growth is unchanged at 15% as indicated last quarter, given a reduction of variable commissions. Net investment income of $101 million was essentially unchanged from last year, as a benefit of higher invested assets was partly offset by the continued low rate environment.

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Now turning to OneBeacon, as the transaction closed at the very end of Q3, our U.S. operations had no impact on our underwriting and operating results for the quarter. However, there were a few items which did impact non-operating results. We had about $30 million in integration costs, including the net cost of the adverse development cover. There were $23 million in investment gains related to the U.S. book value hedge. Going forward, gains and losses on this hedge will flow through OCI.

OneBeacon's balance sheet is now fully consolidated with ours, after converting it to IFRS and into Canadian dollars. This reflected the fair value of the acquired assets and liabilities, including strengthening of reserves at closing. Between the adverse development cover, we purchased and the strengthened reserves, the risk of our results being impacted by adverse development from OneBeacon has been significantly mitigated.

With the acquisition behind us, we are totally focused on improving the combined ratio to low 90s. Our profitability improvement plan is based on 3 levers. Charles covered our progress in the lines of business as well as our claims initiatives. On the third lever, expense synergies, we expect to generate USD 25 million of savings within 24 to 36 months. After 9 months in 2017, we estimate OneBeacon's normalized combined ratio to be in the upper 90s, which is our starting point to measure progress. Our profitability improvement plan is expected to deliver 6 points to 8 points of enhancement and generate mid single-digit accretion to IFC's operating income within 24 months.

Let me provide some additional detail on the OneBeacon and its contribution to our results going forward. OneBeacon will be reported separately as a standalone line of business. Its result will therefore be readily available in our reports. OneBeacon's direct written premiums will increase IFC's top line starting in Q4 2017, and we expect the impact to be in the mid-teens. The addition of OneBeacon's investment portfolio to IFC's will provide [CAD 15 million] annually in incremental investment income.

And finally on the tax side, there is a minimal impact from the addition of OneBeacon to our operating effective tax rate in 2018, it should remain in the 20% range. After reflecting the acquisition on our balance sheet, our financial strength metrics remain strong. We introduced the metric capital margins to reflect our consolidated capital level. It is similar in concept to our previously disclosed excess capital and is well defined in our MD&A. With a capital margin of $1.2 billion and a debt-to-total capital ratio below 25%, we remain ready and well positioned to participate in Canadian consolidation opportunities as they arise, both in manufacturing and distribution.

In conclusion, our Canadian business is showing its resilience, thanks to the diversity of our businesses. Our property lines are performing very well, commercial auto is improving and we are near our targeted low-90s run rate combined ratio. Personal auto remains a drag on our performance, but we are not relenting on our goal of getting the combined ratios to the mid-90s. Our North American specialty business is on solid footing, giving us a strong presence in the U.S. and in Canada. Our transition plan with OneBeacon is well underway and we are beginning to deliver on our targeted combined ratio improvements. We remain focused on delivering on our financial objectives, growing operating earnings over time and outperforming the industry on ROE.

With that, I'll return the call back to Ken.

Kenneth Anderson
VP of Investor Relations & Treasurer
Thank you Louis. In order to give everyone a chance to participate in the Q&A, we would ask that you kindly limit yourselves to 2 questions per person. If there is time at the end, you can re-queue for a follow up. So Kierstan, we're now ready to take questions.

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Question and Answer

Operator

[Operator Instructions]. And our first question comes from Kai Pan with Morgan Stanley.

Kai Pan
Morgan Stanley, Research Division

Yes, I'm sorry, we were dealing with a new phones here. So my first question is on personal auto and on the higher fiscal damage. So can you give a little bit more detail about sort of like when did you find it out and what action you're taking and your ability to raise rates at what time -- like a timely fashion, and what give you confidence that you can improve the personal auto combined ratio to the 95%-ish in the next 12 months?

Charles Brindamour
Chief Executive Officer and Director

Thanks for your question. Kai, I think we've seen physical damage inflation for a few years. Our action plan anticipated to address those. And I think in the past say 9 months, we've seen that trend pick up a bit, therefore, the need to increase our action plan. If I look year-to-date in aggregate that the automobile performance, severity is up 0% in aggregate, frequency is up 1% in part because of winter conditions in Q1. So what we've done so far is largely in my mind broken the back of inflation in aggregate, but given the actions we've taken to improve the quality of the portfolio and the risk selection we would have expected, actually a reduction in severity. And so as we dig to find what is upsetting that expectation, we realize that there is more inflation in [PD] than we anticipated say 9 months ago, therefore, the need for greater action. Now, I will ask Patrick Barbeau to give you a bit of color as to what we're seeing in physical damage, and some of the actions we've taken so far in the past year or 2 and what's in the pipeline, and then we'll Darren to get into pricing and underwriting and why we feel good about our ability to take the combined ratio in the mid-90s. So Patrick, why don't you give it a try.

Patrick Barbeau
Senior Vice President of Claims

Sure. As Charles you mentioned, the cost pressure on fiscal damage that has accelerated recently is only on the severity side. We've seen the cost of part and the complexity of repairing or replacing those parts go up, so also additional labor cost in the repairs. This clearly points to the general sophistication of newer car model and the general technology advances in car. Just to illustrate, I guess with simple example what we're saying could just mentioned the accelerated number of cameras and sensors of all sorts that we see, for example, in mirrors, bumpers and windshield. And when you think of those 3 parts in particular, they are often the first ones getting damaged in car collision, and we've seen the trend on those things accelerate in your car model. So clearly direct us that are coming from those parts, but also indirectly it increases other parts of the overall indemnities. When you think rental cars, when you takes more time to repair, those costs go up as well. Same for the percentage of total losses. So we discussed more to repair, more cars are deemed total loss and that adds to the cost pressure. And finally, it's also adds pressure towing and storage fees, because when it's more complex repairs, it's tougher to identify upfront, if they will be repairable or should be deemed total [loss] right away and we see more storage in towing around cars that we can't address.

Charles Brindamour
Chief Executive Officer and Director

And I'd think I -- overall, this is not a new observation. I would say that the breadth of the impact on stuff like storage, towing and rental days are certainly bigger than what we anticipated 6 months to 9 months ago. We've been on that trend for a while, but clearly more needs to be done. Why don't we talk about pricing underwriting, what it means in practice. Darren?

Darren Christopher Godfrey

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Senior Vice President of Personal Lines

Sure. Thanks, Charles. So from a starting point where do we see the current run rate today, so we've done a lot of -- obviously, as we always do a lot of bottom-up analysis from actuarial standpoint, looking at our current trends that we see from a claims cost standpoint, we're at from a rate standpoint today, normalizing for cat pools, et cetere, we see our current loss ratio run rate in the mid-70s today. [You throw on] top of expenses take us into the upper-90s. So when we look at our outlook around mid-90s anticipated within the 12 months, what are the actions we're going to look at from -- to bridge that particular gap there? So first comment I would make though is that much of the 2017 actions that we're undertaking today, whether that be rate increases, segmentation, risk selection and claims et cetera, we will continue to earn into 2018. We will be looking to make further improvements into our risk selection models and re-underwriting the worst segments of the portfolio as we continue into 2018, as we have done actually in 2017. But we will be filing further rate increases from coast-to-coast with a very strong bias from a segmentation standpoint to better refine our rating to reflect the trends that we're seeing from a physical damage standpoint. As Patrick alluded to augmenting our claims action plans to really address the residual inflationary pressures we see today. So when we look at from a rate standpoint, we are expecting roughly 4 combined ratio points of improvement through rate increases that we will earn into 2018. What I should say, though, is that all those 4 points, 3 points are already in the bank today from rate increases that were already taken in 2017. So 75% of that improvement from purely from a rate standpoint is already in the bank today.

Charles Brindamour
Chief Executive Officer and Director

So and by in the bank, we don't mean earned today, but rather rolling in the system to be earned next year. So the risk of getting those 4 points is small, given that 3 is already in the bank.

Darren Christopher Godfrey
Senior Vice President of Personal Lines

Thanks, Charles. And further to that when we look at our non-rate action, so in other words risk selection underwriting, claims, et cetera, together with our augmented claims action plan as Patrick has described, when we look at that net of expected claims inflation, we're expecting to see a further 1 point of improvement in combined ratio. So that gives us sort of essentially a 500 basis point improvement. So if we're starting from a upper-90s position, that positions the portfolio quite well to achieve the mid-90s within the coming 12 months.

Kai Pan
Morgan Stanley, Research Division

My follow up question is on the other 3 segments, which underlying results have been excellent. I just wonder how sustainable are those results going forward?

Charles Brindamour
Chief Executive Officer and Director

Well, I think that overall, if you look at personal prop, let's start there, you'll recall Kai, previous quarters people were saying, are you pricing this properly and can you make money in home insurance, combined ratio year-to-date is slightly above 92%, the average combined ratio in the past 3 years, including the Fort McMurray year was sub-90% and there's still momentum in terms of protecting those margins there. So a combined ratio sub-95% in bad times and in the upper-80s, low-90s in personal prop sustainable, I think that's what we've shown in the past 3.5 years. If you look at commercial lines, they have been running steady in the mid-80s. If you look at commercial auto, we said we would get in the 90s range. It's been there now for a number of quarter. There's actions to support that. So I think in commercial P&C, you want to strip the extra favorable development that's taking it in the 70s. We don't think this thing is running in the 70s. But it certainly has the strong momentum to stay in the 80s for awhile. I'll ask Darren to give a perspective of the marketplace in personal prop and some of the things we're doing there quickly, and then I'll ask Alain to give a perspective of our performance in commercial P&C and commercial auto, and it's perspective for those lines of business going forward. So Darren?

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Darren Christopher Godfrey
Senior Vice President of Personal Lines

Thanks, Charles. So from a personal prop standpoint, we continue to see firm conditions in the marketplace pretty much coast-to-coast, reflecting the new reality of natural disasters that we see. So we continue to -- as Intact but also from an industry standpoint, we continue to see low single-digit rate increases flowing, still through personal property. We don't see that abating and we expect sort of the growth to be in a sort of the mid-to-upper single digits moving forward from a personal prop standpoint. Obviously we've made a number of our product changes within the last few years and that's creating that sustainability as Charles alluded to from a product standpoint.

Charles Brindamour
Chief Executive Officer and Director

Thanks Darren. Alain?

Alain Lessard
Senior Vice President of Commercial Lines

When we mentioned in the commercial lines, as you can see we are in a competitive market. It remains competitive and in such a market for us, it's very important to protect our margin -- our underwriting margins. And currently we despite a competitive market, we are passing rate increase in commercial P&C to the tone of slightly less than 3%, and this rates will continue to earn over the next 12 to 18 months. On top of that, if you look at the growth and the mix of our portfolio, if I were to separate, if you want that portfolio into 2 pockets, we are at risk where we think these are very profitable risk, this part would currently be growing at about mid-single digit and the other part, which is risk where we think there are still some action needed, this part is shrinking at considerably double-digits. So the mix of our portfolio is changing towards more profitable risk and this again will be earned in the next 12 months to 18 months. So I think we're going to position to protecting the underwriting margin going forward. On the commercial auto side, a lot of our -- we've got rate increase still in the pipelines that will continue to earn in 2018 and a lot of our efforts on that portfolio was focused on trucking business, where we had double-digit rate increase in 2017. And again that has changed the mix of the portfolio and going to be continued to be earning in 2018. So, I think we're in a good path to operate that in the low-90s.

Charles Brindamour
Chief Executive Officer and Director

Thank you very much Alain. Just an aggregate, Kai, when the inflation picked up in auto little more than a year ago, it was very clear to us that not only did we need to put in place a robust action plan in automobile insurance, no matter what, but it was also equally important to protect or expand the margins in the other lines of business, given how at that time important automobile is, now it is less. So, they're following OneBeacon and it was also important for us to take expenses out of the system to absorb the uncertainty of automobile insurance. This is very much what we've done and I think to your question, are these performance in other lines of business sustainable, I mean we've managed those lines to make sure that it is sustainable at this point in time.

In aggregate, we're trying to outperform the industry's ROE by more than 500 basis points. We're certainly there and I expect this to increase in the coming year. We want to grow our net operating income per share, and so it's an earnings growth strategy that we're pursuing. There is growth pressure [while in] the business, which we're comfortable with because there's plenty of growth for us to come. If you look at personal prop, you look at all the upsides there is in Canada in specialty lines plus what we think is a good market environment coming into the acquisition of OneBeacon, I think that on both fronts, when I look at our 2 big financial objectives over the next 24 months, we're in pretty good shape there.

Last point I'll make is 13.3% operating ROE is not good in our minds and therefore we are working hard to make sure that a, we improve auto but we protect the margins in the other lines of business, even if we're hitting the 2 big financial objectives that we've laid out.

Operator

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Next question comes from Tom MacKinnon from BMO Capital.

Tom MacKinnon
BMO Capital Markets Equity Research

Question on the prior-year development, I think the guidance now is 2% to 4% of opening claims reserves. I think historically Charles, you may have been talking this to be more of like a 3% to 4%, and it actually has been trending higher than that. I am wondering if you can describe what drove this guidance and if you can explain that in the context of bringing in OneBeacon, whether that had anything to do with it? And how should we be looking at this in terms of lines of business, e specially given the fact that your comments about, we should strip out the extra favorable development we are seeing in the commercial lines. Are you insinuating then that the main reason for this decline has to do -- we shouldn't expect high levels of favorable development, we're getting in commercial lines going forward?

Charles Brindamour
Chief Executive Officer and Director

No, I think that your question is pretty astute actually and you partly answered the question in asking it. I've been pretty consistent talking about 3% to 4%. We have outperformed that for many of the past few years. We could highlight the number of reasons why we were above 4%. Our view is that this range is certainly not out of whack with where the future is going. I think, why it's 2%, it's because OneBeacon is new to us and therefore, we'll need to learn a little more about OneBeacon in the coming period before we can develop a perspective that the long-term range is 3% to 4%. As you know, new country, new liability profile, the duration of OneBeacon's liability is actually pretty short, it's 2.3 duration liability as you also know, we have cut the adverse development potential of that business for [excellent] year 2016 and before by increasing reserves and buying PYD cover, but it's new to us. We're taking a cautious stance, so we see 3% to 4% for the Canadian business and we're adjusting our guidance downward because of the addition of OneBeacon essentially at this stage.

With regards to commercial lines, I think my point Tom is that, you shouldn't see commercial P&C running in the 70s and commercial P&C is the line that was most favorably impacted by the diversification benefit that we have been talking about. Therefore I'm cautiously saying, hey Tom, just think about that line of business in the 80s as opposed to the 70s because of this one-time benefit in that segment.

Tom MacKinnon
BMO Capital Markets Equity Research

Maybe one follow up, do you know what the pool impact was on your combined ratio in the third quarter and was it higher than normal and how should we be thinking about the impact of pools going forward?

Charles Brindamour
Chief Executive Officer and Director

Yes. Darren can you take this one.

Darren Christopher Godfrey
Senior Vice President of Personal Lines

Yes, so in the quarter itself, Q3 of 2017, there was an unfavorable pools impact of 0.4. When we look at Q3 of 2016, it was 1.3 favorable, so there is a [delta] of 1.7. But as I said before, we do tend to see that noise and bounce around from quarter-to-quarter. And as I said before that Tom, year-to-date it's 0.4 favorable.

Tom MacKinnon
BMO Capital Markets Equity Research

Is that for the entire business -- is that the impact on the entire business or just personal auto business?

Darren Christopher Godfrey
Senior Vice President of Personal Lines

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My numbers there Tom were on personal auto. So the 0.4 favorable as we said is consistent with the longer-term average.

Operator

Next question comes from Paul Holden from CIBC.

Paul David Holden
CIBC Capital Markets, Research Division

I appreciate all the detailed answers on personal auto. Given the trend towards more complex components in cars, the proportion of the cars with those complex components will only increase over time. So I guess what I'm interested in is, how you view pricing and segmentation going forward versus just necessarily catching up with historical trend?

Charles Brindamour
Chief Executive Officer and Director

Yes, I think that's right and when we look at the profile of the car pools by province, we actually see differences in trends by province. So it is here a question of pricing and risk selecting properly to address this trend going forward, having address the claims issues, so Darren maybe you want to share your thought process on that?

Darren Christopher Godfrey
Senior Vice President of Personal Lines

Yes. So you're right Paul. I mean obviously from a rate increase standpoint, we'll tackle from an absolute standpoint. But what we also were doing is a lot of detailed analysis from the segmentation standpoint. So we have identified a number of variables that we have within our rating structure that we could probably dial-up from a segmentation standpoint. We've identified a number of new variables that we can reflect within our rating, which is really targeted on PD. The [remainder] outcome of all of that is to really drive a mix change to drive a change in the new business profile, to drive a change in the renewal profile as well, to really target from a right standpoint, from a segmentation standpoint, those particular vehicles that are driving the excessive trend and mostly related to technology and sharpening the pencil on maybe on those and are not so much driving that particular trend. So really is around driving segmentation. Obviously absolute right level, yes, driving segmentation to issue a better quality of new business profile moving forward.

Charles Brindamour
Chief Executive Officer and Director

And really refining how we classify those vehicles to a greater degree of granularity that what's been done in the past. I think claims can be an important lever as well and that thing claims practice, so let Patrick give you a bit of perspective on what can be done in claims to break that trend going forward.

Patrick Barbeau
Senior Vice President of Claims

Yes, thank you. I mentioned earlier, what's causing this trend. But in terms of how we can help reducing it in claims, there are a few things we can do, and it's somewhat linked to what Darren was mentioning on the risk selection and segmentation parts, because this trend is not happening at the same pace on all types of vehicles on the model. And when we look at our rely and our network with repairing the cars, there is quite a bit of difference between those who are specializing in certain types of repairs than others. In terms of action plan of what we can do in claims to support all the efforts are few things. We can -- we are improving our [appraisal] controls and guidelines, so that we more quickly identify the types of repairs we're facing, sending cars to the best performing shops for the particularities of the claims we see. We can better estimate the total amount of the repairs early on, so we send -- we determine quickly if it would be a total loss, if it would be repairable and save on all those other costs I was referring to rental service and towing. Overall, by working closely with our networks, we see opportunities to reduce the

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cycle times on both repairs and total loss, which have savings as well on the rental. So those are few of the examples we are implementing at the moment in claims.

Operator

Our next question comes from the line of Geoff Kwan from RBC Capital Markets.

Geoffrey Kwan
RBC Capital Markets, LLC, Research Division

Just back on the personal auto and I just want to make sure kind of summarizing, I guess everything you've been saying is -- you've been pricing in for what you've seen from PD issues in the past, but maybe because over time, more people are getting vehicles that have more technology and it's maybe a bit of a learning experience here is -- that's really what's been driving the claims issue, now you're just kind of reacting to it and adjusting accordingly for that, is that appropriate, or --

Charles Brindamour
Chief Executive Officer and Director

Well, I don't think it's just the fact that that the profile of the car pool is changing. I think that when you start to observe a trend, there is a period where you wonder if you're seeing a trend. Then there is a period where you actually thinking you have a trend and you want to granularize your understanding of it. And there is a period where you know you have a hard trend and I think that we've identified the fact that we have a hard trend in the last 18 months maybe and I think what we're seeing now is that this trend was stronger than what we anticipated. And this is combined with the fact that over the past 2 years while this happen, the car pool has changed as well. Therefore, the importance of segmentation in adapting the claims work that we've been doing.

Geoffrey Kwan
RBC Capital Markets, LLC, Research Division

Okay. And just other question I had was, it's different types of vehicles generally speaking, but is there any spillover that we should be thinking about on the commercial auto side, particularly as you get more into the ride sharing in that part of the business?

Charles Brindamour
Chief Executive Officer and Director

Well, we're not seeing the same kind of level of trend on the car because the mix of our portfolio is a mix of trucks, heavy vehicle and personal car. And the personal car part is relatively small compared to the rest of the other vehicles. So we're applying the same kind of review and things like this. It's going through the same claim settlement aspects, but we're certainly not picking up the same kind of trends to the level we are seeing in personal auto.

Operator

And our next question comes from the line of Brian Meredith from UBS.

Brian Robert Meredith
UBS Investment Bank, Research Division

A couple questions here for you. The first one, back in the personal auto, what are you seeing from the competition right now? Are they having similar actions in trying to push rate at this point or are they still kind of lagging behind you and maybe some lost market share going forward, if you guys as you address these severity issues?

Charles Brindamour
Chief Executive Officer and Director

So, I would say, Brian, the picture for me has changed meaningfully in the past quarter in that regard. We are though a full year ahead of our peers which moves depending on the jurisdiction that are quite

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significant and in some jurisdictions we've been at it for 2 years. So I think that you will see top line pressure for another 6 months would be my guess. But I will let Darren talk about some of what we're seeing both in rates as well as what we call residual or substandard markets.

Darren Christopher Godfrey
Senior Vice President of Personal Lines

Yes. So if you look at the market, there's probably 20 to 25 players that we're competing against every single day. If we look at recent activity, I would say even within the last 3 months or so, and what we're hearing about what is potentially coming into Q4, I would say probably a third of the market has started to move from a rate standpoint. So as Charles alluded to, yes, we still continue to be ahead. We still continue to be a little bit kind of cyclical. However, we are starting to see some of that momentum coming from a rate activity from the competition. As we talked about Charles' comments before around the risk-sharing pools, we're seeing meaningful growth in the risk-sharing pools, which is a little bit of a sign of markets starting to use those pools to manage their overall exposure, which talks to a little bit in terms of adequacy as well. And obviously in Ontario with our own non-standard ride [indiscernible] we're seeing meaningful double digit increase in unit growth right now at least in Q3. So again that is a sign for us of hardening within the regular market that's the traditional we've seen in past cycles, where as market tend to get harder, it starts to flow through the non-standard, flow through the residuals and then ultimately drive into rate increases as well too. So we are seeing momentum Brian, but we are looking to see moving forward what the rest of the market is doing. But it's looking a better position today than maybe where we were on our last earnings call.

Brian Robert Meredith
UBS Investment Bank, Research Division

And then the second question has to do more with OneBeacon. Charles, I'm just curious, one, what are they seeing right now with respect to price in U.S. and what their outlook is? And then on top of that, from your perspective, you're right now in a position right now -- period right now OneBeacon where you're trying to improve your combined ratios. Do you have the ability or are you comfortable at this point if there is an opportunity in the U.S. to grow some market share at this point to take advantage of [permanent] pricing environment? Are you in a position you can do that at this point?

Charles Brindamour
Chief Executive Officer and Director

Yes, totally. So your first question is what our team is seeing in the U.S. As you know, the tone has changed meaningfully in the U.S. commercial lines market and in particular in property at this stage, we're seeing a change and our folks in the field will attempt to take advantage of the changes taking place and certainly test the market as much as possible and I view this as an opportunity.

I think that the beauty of the improvement plan at OneBeacon, Brian is that there are 2 lines of business that we're shutting down. Most of the lines of business are doing really well and are in full capacity to go and take advantage of a changing marketplace. There are 3 lines, where we have a profitability action plan with very strong teams and I think that a changing environment will help us do what we want to do in these lines and potentially grow as well. So I have mentioned to investors before that one of the things that I was impressed with OneBeacon beyond the team and the strategy is the the fact that the platform is scalable. And we certainly intend to test that organically in the coming year as I hope market conditions will improvement in the U.S. So I would say, I spent a fair bit of time with the teams in the U.S. in the past month or 6 weeks since closing and I'm quite encouraged not only by the profitability improvement plan that is rolling already, but equally with our appetite to test, what I think is a changing market conditions.

Operator

Our next question comes from the line of Meyer Shields from KBW. Your line is open.

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

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If I can continue on the OneBeacon team. You talked about the rating the reserves on OneBeacon as part of the harmonization process. Do that also imply that before the impact of rate changes and the discontinued program that we should anticipate a higher sort of underlying loss ratio for this business compared to what OneBeacon have reported?

Charles Brindamour
Chief Executive Officer and Director

No, because the strengthening we've done to these reserves is done on the lines of business, primarily that we're exiting. A big chunk of the strengthening is on the lines that we are exiting. So when I look at the business in the past, excluding those 2 lines and the business going forward, it's pretty consistent and the results in most of these segments this year, I've pointed in that direction.

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

And second also on OneBeacon, should we expect more retention of it's direct return premium because the overall base is bigger and more diverse?

Charles Brindamour
Chief Executive Officer and Director

Not clear to me, I think that in the lines of business which we're committed to, we'll do everything we can to protect our portfolio, hopefully the market conditions will allow that.

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

What you mean by retention, just [indiscernible], you mean the customer retention on the reinsurance retention?

Charles Brindamour
Chief Executive Officer and Director

Maybe you're on mute --

Operator

The caller's line is no longer with us.

Charles Brindamour
Chief Executive Officer and Director

So I think that the lines of business that we're committed to will go on growing in the marketplace and taking advantage of the market conditions in which they operate, probably consistently with what they would have done anyways. I think where the growth upside certainly comes in the near-term is the fact that we have put in place cross border desks both in the U.S. and Canada. This has been an impediment to our growth in Canada in the past, which I'm hoping we're unlocking now in the early signs are positive. We brought a technology product in Canada from OneBeacon and entertainment products from Canada on OneBeacon. I think that the growth potential of the cross border and these 2 products, when you put that in relationship with the size of OneBeacon, when you leverage the impact distribution in Canada, I think there will be a meaningful needle mover for sure. So hopefully I've answered your question and hopefully you'll come back on the line. When it comes to reinsurance retention, if that was your question, their retention is $20 million right now and we will integrate the OneBeacon program within our program throughout 2018.

Operator

And our next question comes from Jaeme Gloyn from National Bank Financial. Your line is open.

Jaeme Gloyn
National Bank Financial, Inc., Research Division

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My first question is related to the impacts of Harvey and Irma and maybe even potentially the wildfires in California. Is there any long-tail impacts from exposure in those states to those events in OneBeacon?

Charles Brindamour
Chief Executive Officer and Director

I would say it is really limited, and the place where they had the most exposure would be Texas and the type of damages business interruption, but the expectation is not very long-tail and it's been picked up and properly reserved up until closing, so the expectation is not any [longer].

Darren Christopher Godfrey
Senior Vice President of Personal Lines

It is small as we anticipated and we feel very well reserved at this stage and still subject to the reinsurance threshold of $20 million that OneBeacon had originally. So I don't expect bad news from those elements at this stage. And I think in aggregate diversifying our natural cat exposure by being more exposed to commercial lines and broadening our geography was part of an upside of the transaction we've done, and I think in an absolutely extreme context like the one we've seen in the U.S., we were really pleased to see how OneBeacon fared very well in that context.

Jaeme Gloyn
National Bank Financial, Inc., Research Division

And my next question is related to the capital structure in the debt-to-capital ratio currently at 24.7%. I understand the target is 20%. Can you refresh me on why 20%, and is there something about the [AMI-A] rating that is absolutely critical in the longer term rather than maybe even a [BBB-plus] or something along those lines?

Charles Brindamour
Chief Executive Officer and Director

So we established that level some while back as the optimal level because it was the lowest cost of capital to maintain an A-minus, BBB-plus rating level and that's how it was established. So we sit there and we're comfortable where we are in terms of the rating structure and that comes would the 20% leverage ratio.

Patrick Barbeau
Senior Vice President of Claims

We said that in case of acquisition we would be very comfortable getting in the mid-20s, but eventually we'll take it back to the 20s. I mean, we have those big financial objectives and then we have a certain risk appetite. And our thought process initially when we established a 20% was that within what we think is a cautious risk appetite, a 20% debt to total cap structure allows us to outperform the industry by more than 500 basis point, run the business in the mid-teens ROE and give us ample room to grow those earnings by at least 10% over time. It is at the least these slightly cautiou end of the financial services landscape in Canada, but certainly not out of [whack] would it and there is no intention at this stage to modify that structure. The other thing to keep in mind as we're using preferred shares, which one has to take into account when you look at the overall capital structure of an organization and our usage of preferred share also leads us at the lower-end of the debt -- pure debt to total cap ratio.

Operator

And our next question comes from the line of Meny Grauman from Cormark Securities. Your line is open.

Meny Grauman
Cormark Securities Inc., Research Division

I just had question, clarification about the diversification benefits that you talked about. Just in terms of how those benefits or whether those benefits can continue. How much discretion do you have there and is there still an impact going forward?

Louis Marcotte

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Senior VP & CFO

Well, we've set up the model calculation, so these will be applied going forward in a -- the same methodology, which you want. So I wouldn't expect a material impact like we've had this quarter, but that number is maintained, as we had in the past, with our risk margin. So it evolves over time, but it's not one where we completely change it. We have to apply the same approach on a going concern or going forward basis.

Charles Brindamour
Chief Executive Officer and Director

Yes. I would say this comes with a range, this was the first time really that we reflected diversification in establishing our provision for adverse deviation or bias was to take a cautious road to determine where that point was, and very much in our historical reserving philosophy.

Meny Grauman
Cormark Securities Inc., Research Division

And then if I could just ask another question on OneBeacon, just also a clarification, as you go from the high 90s to the low 90s in terms of the combined ratio, you talk about synergies as one area of improvement. And I'm wondering -- I'm not sure if you've mentioned it before, but how much of that reduction specifically is tied to synergies, if you can quantify that?

Louis Marcotte
Senior VP & CFO

Sure. So I shared earlier the dollar amount of synergies we're aiming for at USD 25 million. Now what our improvement plan calls for is to, which is equivalent [to about] 2 points of combined ratio. But recall, our entire plan with the 3 levers is aiming for 6 to 8 points, which will go from the upper 90s to the low 90s.

Charles Brindamour
Chief Executive Officer and Director

Two of which would be expense synergy roughly, pure expense, not claims just expense.

Operator

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

Mario Mendonca
TD Securities Equity Research

Just -- Charles, I'll try to be quick here. I'm looking at the growth in written insured risks in personal auto over a very, very long stretch. I think, I have information [riding aback about] 14 years and there are very, very few occasions when the written insured risks in personal auto actually decline year-over-year. It happens very, very rarely. Given the trend we're seeing from the sort of high single digit growth in written insured risks that we saw. And you can see that in '15 and '16, particularly around that time, you became a lot more confident with telematics. It sort of trended down to almost 0 now. Could this be one of those occasions short lived that is but one of those occasions where the written insured risks in personal auto sinks below 0?

Charles Brindamour
Chief Executive Officer and Director

Could be, yes. I think Mario, it's not just about rates, there is marketing, there is various digital experiences. We have a broad distribution strategy, but it could be below 0 for a short period of time and would be comfortable doing that if it helps us get to where we want to be from a combined ratio point of view.

Mario Mendonca
TD Securities Equity Research

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And then just on telematics specifically, and I am certainly no expert in this. But is it fair to say that telematics really hasn't lived up to all the hype, specifically couldn't telematics have been somewhat helpful in giving you an earlier signal of what was happening?

Charles Brindamour
Chief Executive Officer and Director

I think telematics -- I'll tell you, telematics has lived up to our expectations quite frankly. First, the appetite for consumers to embrace telematics is higher than what we thought. Second, the loss ratio of customers who choose telematics after the discount is better than the average loss ratio. And then the field of segmentation that we have gathered in the past 3 years with 3.7 billion, 3.8 billion kilometers driven, and the machine learning we were able to do on that is very significant. The upside of that in my mind will be for the coming years and then the opportunity to interact with customers has changed meaningfully. So it has lived up to what we were set to do with telematics per se. Could we have used telematics to a greater extent to better understand these trends in physical damage? Not clear to me, Mario, because it is primarily severity driven. We've used telematics to try to understand frequency changes, we've tried to understand if people drove more what impact would it have on frequency and so on, harder to leverage on severity per se.

Mario Mendonca
TD Securities Equity Research

That's clear. And then just finally, is there the political will to take another look at Ontario auto from a regulatory perspective? Or do you believe that, that ball has been fired and [that's tele pricing] from here?

Charles Brindamour
Chief Executive Officer and Director

I think that the government has demonstrated, Mario, a lot of appetite since 2010 to improve the product per se. And so if I look backwards, it's hard for me to question the will of the government in Ontario. I wouldn't say the same thing in all jurisdictions, but we're talking about Ontario. They have hired last year and did work most of this year, gentlemen called David Marshall, who used to run WSIB, who's identified a number of what I think are common sense recommendations. The main one being let's get cash out of the system and let's focus on care, which would take a lot of incentives for all sorts of people to claim that system. And I think the government is thinking about his recommendations very seriously as they look at the next months. And therefore, I think there is will. There will be an election in the spring. And what it does to will, I'm not sure, but they're -- certainly they have shown their willingness and they're actively engaged thinking about that, would be my read on the situation.

Operator

And our next question comes from the line of Doug Young from Desjardins Capital Market.

Doug Young
Desjardins Securities Inc., Research Division

On personal auto, there was 31 million negative prior year reserve developments. And curious how much of that related to the physical damage, how much related to the older file, more older files, so pre-2016 moving into that cat loss bucket? And it's the latter component that I'm more curious a bit, because that's a bump I think you had in Q2. I'm just tring to get a sense of where you stand with that issue?

Louis Marcotte
Senior VP & CFO

Yes. So the bulk of the PYD, Doug, is long tail natured claims and a non-negligible portion of that within the cats. Cats, which have been trimmed as far as I'm concerned in the June 2016 reform, which we think are pretty good at least based on what we observed so far. And I think you have a couple of things there. You -- if I just talk about cats and it's not just cats, it's long tail natured bodily injury type claims, cats being an important portion of that in the Ontario marketplace. I think we've seen -- in the legal system,

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you have 2 years to report a claim and then 1 year to serve it actually. And we have seen 4 excellent years like '13, '14, '15, a bit of late reporting on big cats and then we went back to many of the cats that were open, where there was a risk of psychological damage to actually strengthen our position. The -- if you look at PYD, the number you've quoted is small, but if you look at the actual increase in reserves in the quarter in long tail lines automobile insurance between IBNR and case reserves, this is a number that is much bigger than that, which helps us with our confidence of adequacy in that segment for these lines of business sitting here today.

Doug Young
Desjardins Securities Inc., Research Division

And for Charles, just you talked about this? I mean, we've seen some progressive deterioration in the personal auto prior year reserve development over the last few quarters. I mean, as we go into 2018, 2019, do you think -- I mean should we move back into positive developments in personal auto? I mean, has this -- have these issues been dealt within your view?

Charles Brindamour
Chief Executive Officer and Director

Well the reserves have gone up meaningfully. I think these issues have been dealt with. And when I look progressively or prospectively, the reforms in particular in Ontario are meant to limit that sort of outcome to a greater extent, yes.

Operator

And we now have reached the end of our Q&A. Time is over. I would like to turn the call back over to our presenters.

Charles Brindamour
Chief Executive Officer and Director

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. The transcript will also be available on our website in the financial reports and filings archive. Our fourth quarter 2017 results are scheduled to be released after market close on Tuesday, February 6, 2018. Thank you again and this concludes our call for today.

Operator
Once again this does conclude today's conference call. Thank you for your participation. You may now disconnect.

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