S&P Capital IQ

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The Hanover Insurance Group, Inc. NYSE:THG

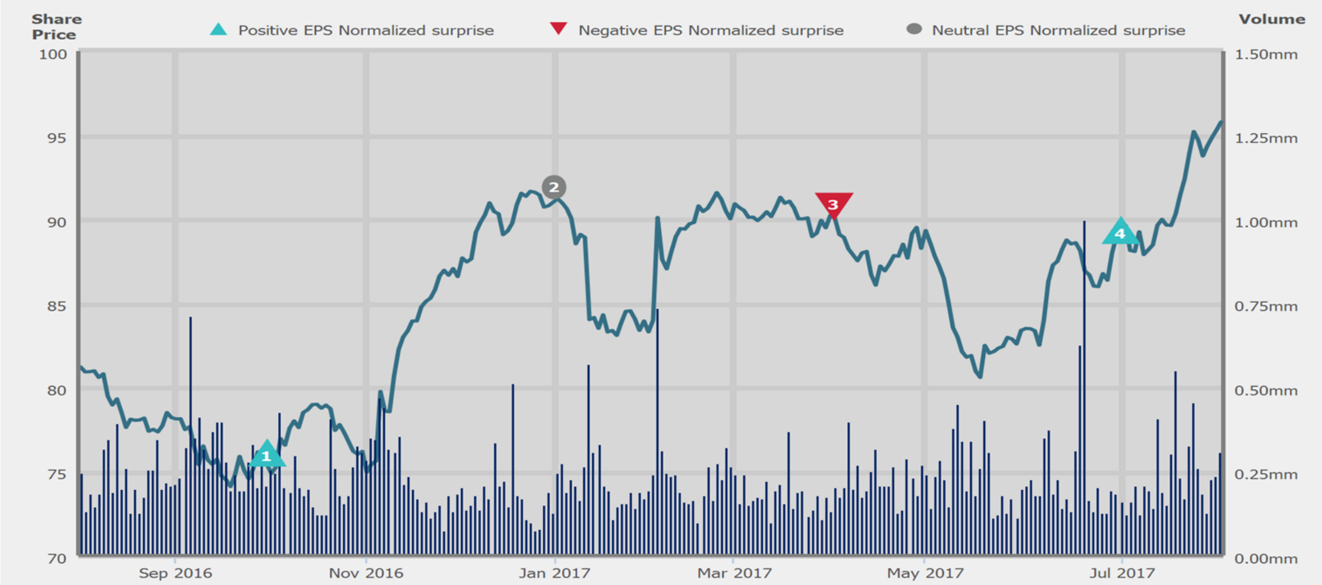
FQ3 2017 Earnings Call Transcripts

Thursday, November 02, 2017 2:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2017-			-FQ4 2017-	-FY 2017-	-FY 2018-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	(0.63)	0.11	NM	1.72	3.60	7.02
Revenue (mm)	1290.50	1322.50	▲2.48	1124.30	4877.30	5082.45

Currency: USD
Consensus as of Nov-02-2017 1:40 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2016	1.55	1.83	▲18.06 %
FQ4 2016	1.03	(0.46)	NM
FQ1 2017	1.72	0.95	▼(44.77 %)
FQ2 2017	1.55	1.69	▲9.03 %

Call Participants

EXECUTIVES

Jeffrey Mark Farber
Executive VP & CFO

John C. Roche
President of Hanover Agency Markets

John Fowle
Chief Executive Officer of Chaucer

Joseph M. Zubretsky
Former CEO, President & Director

Oksana Lukasheva
Vice President of Investor Relations

ANALYSTS

Matthew John Carletti
JMP Securities LLC, Research Division

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

Paul Newsome

Presentation

Operator

Welcome to the Hanover Insurance Group Third Quarter Earnings Conference Call. My name is Richard, and I will be your operator for today's call. [Operator Instructions] Please note that this conference is being recorded.

And I will now turn the call over to Oksana Lukasheva. You may begin.

Oksana Lukasheva
Vice President of Investor Relations

Thank you, operator. Good morning, and thank you for joining us for our third quarter conference call. We will begin today's call with prepared remarks from Joe Zubretsky, our President and Chief Executive Officer; Jeff Farber, our Chief Financial Officer; and Jack Roche, EVP and President of Agency Markets, who, as you know, will be succeeding Joe Zubretsky as the Hanover CEO on November 4. Available to answer your questions after our prepared remarks are John Fowle, Chief Executive Officer of Chaucer; and Bryan Salvatore, President of Specialty Lines.

Before I turn the call over to Joe, let me note that our earnings press release, financial supplement and a complete slide presentation for today's call are available on 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 fact, include forward-looking statements, including our guidance for the remainder of 2017. 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, to refer you to the forward-looking statements 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 operating income and accident year loss and combined ratios, excluding catastrophes, 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, the slide presentation or the financial supplement, which are posted on our website, as I mentioned earlier.

With those comments, I will turn the call over to Joe.

Joseph M. Zubretsky
Former CEO, President & Director

Thank you, Oksana. Welcome, everyone, and thank you for joining our call today. Overall, we are pleased with our results in the quarter. While catastrophe losses significantly reduced our earnings, our underlying performance was strong. And we continue to make strategic progress that will enable us to build on the positive momentum we have established across our businesses.

This morning, I will briefly comment on our overall financial condition and our results in the quarter. Jack will comment on our strategic focus going forward. Jeff will provide an overview of our business performance and progress in the quarter, and then we will open the line for questions.

First, however, I would like to take a minute to provide some perspective on my decision to leave The Hanover and to convey my strong confidence in the company, Jack and his talented and committed leadership team. I have very much enjoyed my time at The Hanover, and I continue to believe the company has tremendous potential. However, upon being presented with a personally compelling opportunity in the health care industry, I decided to leave but with the utmost respect for The Hanover and its people and confidence in its future.

Over the past 16 months, I have worked side-by-side with our executive leadership team and others across the organization. Together, we have developed and advanced a long-term strategy that will enable the company to achieve its full potential. At the same time, we have strengthened our balance sheet and improved our cost efficiency and culture of financial management. I have every confidence that the strategy we have embarked upon is the right one for this company and that the company has the team and the organizational commitment necessary to deliver. Jack played an integral role in developing our strategy. He is well prepared and fully capable of driving the strategy and this company to the next level.

Today, The Hanover is in excellent financial condition with a strong balance sheet, capital position and financial flexibility. The same disciplined financial and risk practices that have enabled us to establish our strong financial foundation also served us well during the quarter. Despite the significant catastrophe events in the quarter, we are pleased with our performance. Our losses from these events were less than our market share would indicate. We posted a profit in the quarter, and as disclosed previously, this was an earnings event rather than a capital event. Excluding catastrophes, the operating performance in the quarter was very strong. The company achieved an ex-catastrophe combined ratio of 89%, an increase in net written premium by nearly 6%. These metrics continue to support the strategic assertion that we can grow profitably as we execute to our clearly articulated Hanover 2021 strategic plan.

With that said, I would like to extend my most sincere thanks for the honest dialogue and your interest and support for our company. I wish you all the best going forward.

With that, I will turn it over to Jack.

John C. Roche
President of Hanover Agency Markets

Thank you, Joe. On behalf of our company and our entire team, I would like to thank you for your contributions to The Hanover. Our company is indeed stronger and better positioned today than ever before, and our vision for the future is well defined. In one of the most dynamic times for the industry, we have the right strategy to thrive and prosper in this changing world. All of us here at The Hanover wish you well.

I am honored and privileged and truly excited to serve as President and Chief Executive Officer of The Hanover. I have been proud to be part of our company for 11 years now and believe we have tremendous potential. Our team has what it takes to further distinguish our company in the marketplace and to position our organization for even greater success. As we move forward, we believe we have the right strategic focus, one that will benefit our partners, customers, shareholders and other stakeholders. Specifically, we are committed to several key tenets. First, further leveraging our distinctive agency business model and continuing to grow market share with the best agents in our business. Second, thoughtfully expanding our domestic and Chaucer specialty businesses. Both will be important contributors to our growth. While the catastrophes in the quarter may not lead to a hard market, it is likely that pricing conditions will improve. Third, continuing our focus on innovation as we closely work with our agency partners to pursue new business models and growth opportunities and to transform the way we do business together to better serve our customers. Fourth, maintaining our focus on disciplined financial and expense management.

With the pace of change rapidly increasing in our industry, I look forward with great confidence, supported by an experienced and dedicated team, intent on delivering on our promises to our shareholders and other stakeholders. I look forward to the opportunities ahead and to working with all of you.

I'll now turn the call over to Jeff for a review of our third quarter results.

Jeffrey Mark Farber
Executive VP & CFO

Thank you, Jack. As Joe mentioned, our financial results in the quarter were heavily impacted by several catastrophe events. However, we are pleased with the underlying performance of our business and feel very good about our prospects moving forward. We reported net income of $11.1 million or $0.26 per diluted share compared to $88.4 million or $2.06 per diluted share in the prior year quarter. After-tax operating income was $4.7 million or $0.11 per diluted share compared to $78.6 million or $1.83 per diluted share in the prior year quarter. Our combined ratio was 104.8% compared to 94.2% in the prior year quarter, driven by the exceptionally active catastrophe season.

Given the magnitude of weather events in the quarter, I will begin my review of the results with some comments on catastrophes. I will then discuss the other important quarterly highlights before reviewing our financials by segment.

The third quarter of 2017 will go down in history as one of the most active quarters for cat events. Hurricanes Harvey, Irma and Maria as well as 2 Mexico earthquakes resulted in devastating losses. The unprecedented frequency of these severe events served as a test of our organization and the industry as a whole, a challenge The Hanover successfully managed both operationally and financially. Our dedicated teams have been working around the clock to help our agents and customers recover as quickly as possible. Despite the catastrophe activity, we made a profit for the quarter and continue to have a strong balance sheet and capital base to execute on our strategy. Our current accident year cat losses were $202.4 million; net of reinsurance and before taxes were 16.5% of the combined ratio. We also had favorable development on prior year catastrophes of $7.9 million, including $7.5 million at Chaucer.

Domestic catastrophe losses were $77.5 million, stemming primarily from our commercial lines property exposures to Hurricane Harvey in Texas and, to a lesser extent, exposures related to Irma in Florida, mainly in commercial, multiple-peril and marine lines. The effect of exposure management initiatives over the last several years came through in our domestic results. As you know, we made a decision several years ago to exit the Florida personal lines business. We also have remained cautious in our coastal risk exposure and have a very thoughtful approach to flood risks. Though we did not utilize our domestic cat reinsurance treaty in the quarter, our per risk and facultative reinsurance programs helped limit our net losses. As a specialty insurer and reinsurer, Chaucer was more exposed to severe catastrophe events, sustaining $124.9 million of current accident year catastrophe losses net of reinsurance, which added 10.2 points to the consolidated quarterly combined ratio. Chaucer has a successful track record of underwriting the complex and sometimes volatile international risks such as those exposed to the third quarter catastrophe events, including treaty, direct property, marine and energy lines. Our reinsurance performed as expected, and our coverages remain in place.

Based on our market presence in the affected geographies and considering the unprecedented frequency of severe storms, we believe the losses sustained were less than our market share might indicate. The impact of these events is well within our risk appetite and modeled range of losses. While these catastrophe events had an adverse impact on our results in the quarter, over time, we anticipate a positive impact on pricing in the affected classes and geographies, particularly in international treaty as well as property and marine lines.

Catastrophes aside, our businesses performed extremely well. Several highlights are worth noting. First, our overall combined ratio, excluding catastrophes, was 88.9%, with both domestic and Chaucer businesses performing in line with our expectations. And our third quarter operating return on equity, normalized for catastrophe losses and related offsets, was 12.6%. Second, we delivered top line consolidated growth of 5.7%, driven largely by our domestic business, particularly personal lines and small commercial. Consistent with our strategy, we continue to thoughtfully grow in those lines where we can achieve adequate pricing and target profitability while maintaining appropriate rigor in our risk selection. Third, our overall expense ratio improved by about 1 point compared to the prior year quarter. We benefited from growth leverage as our top line continued to expand. We also continued to execute on the expense reduction initiatives we outlined in August, which yielded about $5 million in quarterly expense savings in the third quarter. Finally, our expense ratio also benefited from some onetime items, including a reduction in performance compensation. Overall, we have largely executed on and are on target to achieve the savings we shared with you last quarter.

I will now take a few minutes to discuss the underlying results and trends in each of our businesses.

In Personal Lines, we delivered a combined ratio of 89.2% and 85.5% excluding catastrophes compared to a combined ratio of 93.1% and 89.8% excluding catastrophes in the prior year quarter. Our current accident year loss ratio improved 3.1 points to 58% compared to the prior year quarter. The overall improvement benefited from ongoing pricing and continued focus on account business.

Homeowners benefited from a favorable comparison to the third quarter of last year, which reflected higher-than-usual fire losses last year. Auto experienced lower frequency than in the same period last year, while severity was within our expectations. The comparison also benefited from the timing of 2016 accident year loss pick selection. Additionally, the loss ratio improvement for both auto and home included a small benefit from the expense initiative on loss adjustment costs.

Our strong momentum in Personal Lines continued in the quarter, with net premiums written up 7.7%. Retention increased 1.1 points to 84.2%, while rate increases averaged 4%, slightly above the loss trends in both auto and homeowners. New business grew 7% in the quarter due to both organic production and renewal rates activity.

We are pleased with our strong business mix, which is made up of 82% account business and 35% platinum accounts. Additionally, we are satisfied with the geographical composition of our growth as we continue to seek a larger portion of our agents' market share in states where we currently have lower penetration.

Overall, we are pleased with our Personal Lines performance and the strong trajectory we have established. Looking ahead, we will continue to monitor opportunities for rate increases given our price points in the marketplace. And we still have plenty of opportunities for market share gains within our existing agency plans.

In Commercial Lines, we reported a combined ratio of 102.1%, which included 10.3% of catastrophe losses. Excluding catastrophes, this business generated improved results, delivering a combined ratio of 91.8% compared to 96.2% in the prior year quarter as the 2016 ratio included 3.3 points of unfavorable prior year development. We do not record any prior year development in the current quarter. Our prior year loss trends are behaving as we expected, and overall, we believe our reserves remain appropriate.

The current accident year loss ratio, excluding catastrophes was, 56.8% in the quarter compared to 57.2% in the third quarter of last year, with improvement driven by workers' compensation and auto lines, partially offset by increases in commercial multi-peril.

Our underlying CMP results were in line with our expectations. The increase in our loss ratio quarter-over-quarter is primarily due to the fact that the 2016 quarterly ratio did not reflect the upward actuarial liability estimate adjustment that occurred during our year-end reserve review. We will continue to closely monitor the underlying trends in commercial multiple-peril and remain cautious in setting our reserves. The decrease in the commercial auto loss ratio reflects our efforts to actively manage our business mix while achieving mid-single-digit pricing increases.

We are also pleased with our performance in workers' compensation, where we have changed the mix significantly to smaller account size and lower risk profile over the past several years. With that said, we continue to watch loss trends in this line given the current pricing and potential inflationary trends.

Commercial Lines net premiums written grew 5.1%, driven by strong growth in small commercial. Middle market growth was intentionally more modest, albeit a meaningful pickup from the second quarter as we continued to execute profit improvement actions and achieved granular pricing segmentation. With overall growth of 4.1%, Specialty Lines also contributed to the Commercial Lines growth in the quarter. As we outlined previously, we are focused on agency penetration and expanding our specialty capabilities in the strongest, most profitable segments where we can effectively compete. We are allocating resources and capital appropriately to support this growth. Overall, despite the catastrophes, Commercial Lines business turned in a solid quarter as we continued to manage our product mix, risk and pricing segmentation.

Moving to Chaucer. We posted a combined ratio of 139.4% in the quarter, obviously impacted by catastrophe activity, as I previously outlined. Excluding catastrophes, the combined ratio was 86.6% compared to 82.8% in the prior year quarter. We experienced favorable development on noncatastrophe losses of $12.5 million and $20 million including catastrophes, which is in line with more recent performance and expectations but below the prior year quarter.

Our Chaucer ex-cat accident year loss ratio, adjusted for the small but favorable impact of reinstatement premiums, was slightly better than the third quarter 2016. We continue to prudently select risk in a challenging market and effectively use reinsurance.

Chaucer net premiums written increased by 3.8% or 1.6% excluding the favorable net impact from reinstatement premiums of $4.2 million on cat-affected business.

New businesses initiatives, including growth in treaty business, continue to help offset business loss because of inadequate pricing in certain market areas. Looking ahead, we are now actively seeking both improved pricing and terms and conditions in classes affected by catastrophes. We are also hopeful for a spillover effect into geographies and classes which were not directly affected by the recent weather events.

Overall, despite the weather, we are pleased with our consolidated performance. We demonstrated a commitment to superior customer service as we work with our insureds to help them recover following the catastrophe losses. Our results once again demonstrated the effectiveness of our disciplined underwriting, exposure management and approach to reinsurance.

Moving on to balance sheet and investments. Net investment income increased by 13% in the quarter to $76.6 million compared to $67.8 million in the prior year quarter as we continue to reinvest higher operating cash flows from underwriting activity. Results in the quarter also benefited from higher partnership income by about $4 million as well as other onetime items. Cash and invested assets were $9.3 billion at the end of the quarter, with fixed income securities and cash representing 87% of the total.

Our fixed maturity investment portfolio has a duration of approximately 4 years and is 95% investment-grade. The portfolio remains high quality and is well laddered.

Our book value was $70.10 in the third quarter compared to $70.18 in the second quarter. Book value per share, excluding net unrealized gains on investments, was also essentially flat on a sequential basis.

From a capital management perspective, we returned $9.2 million to shareholders through stock buybacks in the beginning of the quarter. We had suspended stock repurchases temporarily in response to the significant catastrophe activity. There is $146 million available for repurchase under our current share buyback authorization, which we will continue to use opportunistically.

Before we open the line for questions, I would like to discuss our view for the rest of the year. Clearly, catastrophe activity for the year through September 30 was higher than our original expectations. Excluding catastrophes, our results remain on track to our overall full year guidance, with fourth quarter combined ratio, excluding catastrophes, expected to be 90% to 91%. Our fourth quarter catastrophe loss assumption is approximately 4.3%.
Operator, let's open the call for questions.

Question and Answer

Operator

[Operator Instructions] Our first question on line comes from Mr. Paul Newsome from Sandler O'Neill.

Paul Newsome

I'd like to ask a big picture question. Every hard market I've experienced or really read about is -- has some big lesson to it, something that is fundamentally different in how things should have been underwritten before and then later underwritten afterwards. Is there something in your book now that you see the lessons of the third quarter that you say we're just going to do it differently here, whether it be correlation risk between tax losses like crash risk after 9/11, severity issues and liability after the '80s hard market? What's your view as to what -- what's the lesson here that will broaden -- that will change underwriting fundamentally?

John C. Roche
President of Hanover Agency Markets

Thanks, Paul. This is Jack, and appreciate your question. Obviously, after any material event, we do look and reflect upon how we performed but also what's going on more broadly in the environment and look for those lessons to be learned. And I think as we look at these somewhat unprecedented frequency of severe storms, I would say, our biggest takeaway is it gives us additional motivation to continue down the path we've been going down over the last several years to appropriately diversify the firm. And in the U.S., we've obviously been spreading our risk into more geographies from a property perspective. We've been diversifying into more casualty lines of business, including some of the specialized businesses that we bought and built. Obviously, we purchased Chaucer a number of years ago to help with that diversification. And so it really just motivates us to pursue that diversification even more thoughtfully. We do not look back at these events and have major changes that we would make in our underwriting execution or, for that matter, even underwriting direction. We actually feel quite good about the performance. And when we get down even to the granular level with our underwriters, we were quite pleased with the day-to-day execution on terms and conditions and how we spread our risk in the affected geographies. So I think, overall, we're motivated to keep moving down the path we've been after for the last half a dozen years.

Operator

[Operator Instructions] Our next question on line comes from Meyer Shields from KBW.

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

I just want to start by congratulating both Joe and Jack on your new roles. Jeff, in your comments, you talked -- I think it was your comments, I apologize for getting this wrong. You talked about pursuing tighter terms and conditions along with rates in Specialty and Chaucer lines. What are the terms and conditions that you think need tweaking?

John C. Roche
President of Hanover Agency Markets

Well, this is Jack. I think John Fowle is on the line, so we can let him respond more specifically to that question. I think, in general, though, what I would offer to you is that we continue, both in Chaucer and the U.S. domestic businesses, to get further refined in where our profit pools are building and where they're moving and where our pricing is adequate and where there is room for improvement. So I think as we get ready to deal with a market shift here, both in London and in the U.S., we're getting ready to use that segmentation and to start pushing harder on both price and terms and conditions where the individual sectors require that. So with that, John, do you want to follow up from a Chaucer perspective?

John Fowle
Chief Executive Officer of Chaucer

Sure, Jack. Thanks. Certainly, from our perspective over last several years, we've seen an erosion of terms and conditions generally in that -- and price. But it's also being deductible levels, discretionary language getting weaker, limits being broader. That's being the pressure we've been under and managing through the down cycle. We expect to all of those facets there'll be timing up over the next year as well as we reclaim some of that ground we've lost. And that's across most classes but also most particularly, in those either cat-affected or cat-exposed classes.

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

Okay. That's very helpful. Second question, I guess. So you've had a lot of success in the, I'm thinking, workers' compensation business mix shift towards smaller accounts. Is that a permanent strategy? Or are there markets where it would make more sense to not start moving back up?

John C. Roche
President of Hanover Agency Markets

Yes, this is Jack. Obviously, it's kind of The Tale of Two Cities in that there are sectors of the business that are very profitable and we feel better positioned than ever to focus on some of those as we've been a relatively conservative worker's comp market in the industry. That said, there is also pricing pressure in the line. And so you've got kind of conflicting motivations there. We have areas like the technology sector where we have made a lot of progress and small and midsize firms where a disproportionate amount of our profit comes from the worker's comp line. And so we've continued to refine our strategy both in small commercial and middle market to target kind of subsectors of the business that have outsized profit opportunities and then just cautiously watch the pricing environment to make sure that we're getting our timing right. But I think I would finish that with saying that, yes, the ultimate answer is that we believe there's an opportunity to mature over time, be a little bit more fulsome in our worker's comp capabilities, to be a full account writer in the right sectors and generate profitable returns on accounts within the desired industry sectors.

Operator

[Operator Instructions] Our next question on line comes from Mr. Matt Carletti from JMP.

Matthew John Carletti
JMP Securities LLC, Research Division

Actually, I just want to dig a little deeper on both of Meyer's topics he hit on. Jack, maybe just sticking with worker's comp, what have you seen real recently kind of since the events? I mean, this had been a line that, like you said, there'd been rate pressures. I think it's attracted some new competition as other lines of business have been under even more pressure. Will that maybe changing going forward given what's going on in property and maybe I'll trickle in elsewhere? Have you seen any change in appetite or change in competitive landscape in the comp business? Or so far, has it really not changed?

John C. Roche
President of Hanover Agency Markets

I haven't seen anything dramatic other than the fact that most states do have rate decreases in place based on some favorable experience, but that will turn around relatively quickly. And so the industry trends have been relatively benign and stable, and there's some indication that will kind of now turn the corner here and there'll be some pressure going back the other way. But I would go back to kind of what I was alluding to earlier that the business is getting very segmented and proprietary in terms of its pricing. People -- the better carriers, the more sophisticated carriers understand where the profit pools are and where the challenges are. And I think we've made tremendous progress as a company to get better at understanding by sub-geography, by industry sector, certainly, by state, where are the best opportunities for profit. So you can't -- I think it's a microcosm of the overall business where you can't make general statements anymore. And that's why I think as we look forward and we see the market cycle trying to make some kind of turn here, it's not going to be very uniform. It's going to be somewhat specific about where are the opportunities for strategic offense and where do you, quite frankly, have to start pricing up some profit pools that are starting to deteriorate.

Matthew John Carletti
JMP Securities LLC, Research Division

That makes sense. And maybe just a follow-up for John on Lloyd's. Basically, a similar question. What are you seeing so far? I mean, I appreciate the comments on kind of where you expect to kind of see the greatest pressures. I know there aren't a lot of business renewing right now, but based on what you've seen, I mean, are we getting in kind of exposed property areas? Or are you seeing some of the double-digit changes that some others have quoted? Or are you seeing something different?

John Fowle
Chief Executive Officer of Chaucer

No, I think when we're looking at impacted Caribbean business, I mean, the change in rate environment there is seriously not. And as you said, there's no huge amounts of business renewing now. What we're really doing is trying to turn the tide, and I think that's common across a lot of the lead underwriters who are trying to change the dialogue with the brokers and the clients. And we're having a very different discussion with people than we were having a quarter ago about the rate that's needed for a sustainable underwriting and how dialogue has changed. At it stands at the moment in terms of having stats, we're at a stage really in November of testing the client and brokers' ability to accept the rate demands we have. But I do think that shift in dialogue in the market is quite key, and as one of the leaders in our sectors, that's really the job over the next month or so.

Operator

We have no further questions at this time. I would like to turn the call over to Oksana for closing remarks.

Oksana Lukasheva
Vice President of Investor Relations

Thank you, everybody, for your participation today. We are looking forward to talk to you next quarter.

Operator
Thank you, ladies and gentlemen. This concludes today's conference. Thank you for participating. You may now disconnect.