S&P Global
Market Intelligence

The Hanover Insurance Group, Inc. NYSE:THG

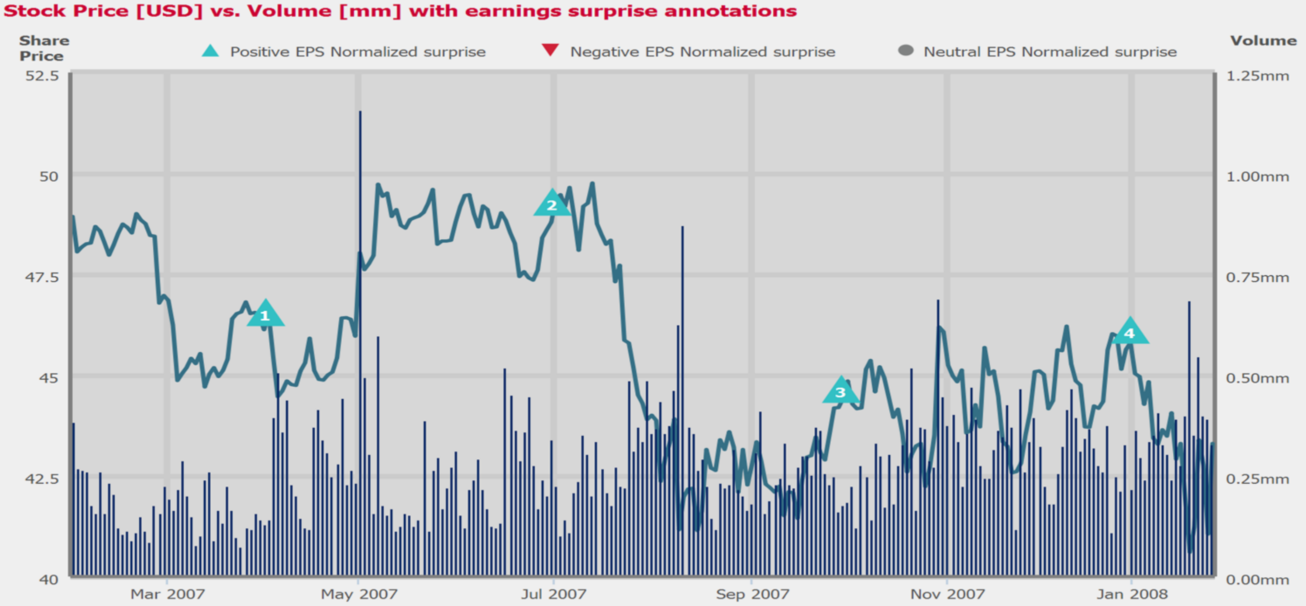
FQ1 2008 Earnings Call Transcripts

Tuesday, April 29, 2008 3:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ1 2008-			-FQ2 2008-	-FY 2008-	-FY 2009-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.05	1.10	▲4.76	1.08	4.34	4.38
Revenue	-	-	▲1.01	-	-	-
Revenue (mm)	622.23	628.50	-	641.40	2486.10	2518.05

Currency: USD
Consensus as of Apr-29-2008 3:31 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ1 2007	1.04	1.23	▲18.27 %
FQ2 2007	1.04	1.14	▲8.57 %
FQ3 2007	1.00	1.01	▲1.00 %
FQ4 2007	1.14	1.20	▲5.26 %

Table of Contents

Call Participants

EXECUTIVES

Eugene M. Bullis

Frederick Henry Eppinger
Former President & CEO

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

Sujata Mutalik

ANALYSTS

Jay Gelb
Lehman Brothers

Rohan Pai
Banc of America Securities

Unidentified Company Representative

Presentation

Operator

Good day ladies and gentlemen and welcome to the Q1 2008 The Hanover Insurance Group Earnings Call. My name Kobe and I will be your coordinator for today. At this time, all participants in listen-only mode. We will be facilitating a question-and-answer session towards the end of this conference. [Operator Instructions].

I would now like to turn the presentation over to your host for today's call, Sujata Mutalik, Vice President of Investor Relations. Please proceed.

Sujata Mutalik

Thank you Kobe. Good morning and thank you for joining our first quarter conference call. Participating in today's call are Fred Eppinger, our President and Chief Executive Officer; Eugene Bullis, Our Executive Vice President and CFO; and Marita Zuraitis President of Property and Casualty Companies.

Before I turn the call over to Fred for a discussion of our results, let me know that our earnings press release and our current report on Form 8-K were issued last night. Our press release, statistical supplement and a complete slide presentation for today's call are available in the Investors section of our website as www.hanover.com.

After the presentation, we will answer questions in the Q&A session. Our prepared remarks and response to your question today other than statements of historical fact may include forward-looking statements. There are certain factors that could cause actual results to differ materially from those anticipated by the press release or the slide presentation and the conference call, we caution you with respect to reliance on these forward-looking statements and in this respect refer you to the forward-looking statement section in our press release and slide 2 of the presentation deck.

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

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

Frederick Henry Eppinger
Former President & CEO

Good morning and thanks for joining our call. Today we will review the first quarter results and provide some insight in to the trends in our business. Let me start by saying, I am very pleased with the strength of our performance and quality of our earnings for the first quarter of 2008.

Segment earnings after tax were $57 million... $57.3 million or a $1.9 per share, compared to $60.2 million or a $1.16 per share from the prior year quarter. Earnings were slightly lower in the current quarter because of significantly more weather-related losses this year than last year.

Book value per share was up 2% in the quarter, at $45.23 per share, up from $44.37 per share at the end of 2007. Our fourth quarter trailing P&C levered return on equity was 13.7% at the end of the first quarter of 2008. These advantages resulted from strong earnings of our Property and Casualty segment which earned $98 million in the first quarter of 2008, compared to $100.9 million in the prior year quarter. Catastrophe losses in most so severe winter in the Midwest and Northeast really have a significant presence led to higher weather related losses in the first quarter of '08.

These losses were not outside our expectations for typical first quarter, but were much higher than our experience in the prior period quarter. Earnings in the current quarter would have been ahead of prior quarter by $2 million just adjusting for capital loans.

In addition non-cap weather related losses also were higher particularly in Personal Lines and are reflected in the higher current accident losses which would otherwise have reflected in improving accident-year trend in the aggregate, consistent with our ongoing expectations of maintaining or slightly improving accident-year margins.

Additionally, our business portfolio has continued to mature very favorably, particularly in Commercial Lines and consequently we experienced reserve releases related to prior accident-years across almost all our lines.

At the same time, our balance sheet continues to remain very strong as we maintain our carried reserve margin of actual indications of over 5% at the end of the first quarter. We continue to reserve our current accident-year prudently, giving careful thought to the pricing environment, introduction of new product enhancements and penetration of new states.

Clearly, our earnings power has remained strong and our underwriting practices have remained disciplined as we continue to write business that maintains our accident-year margins while we generate favorable prior accident-year reserve development. This is indicative of the quality of the business we are writing.

Turning to growth, our overall net premium growth in the first quarter was about 3% or 2.7%. This is within the range of our expectations to the first quarter given the tough comparison with the first quarter of '07. We continue to work at gaining shelf base with partner agents and it is our expectation that we should achieve somewhat higher growth rates as we go through the year resulting in mid single digit growth for the year in aggregate.

Personalized premium was flat, compared to the fourth quarter of '07, but was down about 4% when compared to the first quarter of last year. While this is partly a function of high first quarter base, we are also experiencing the impact of current economic and competitive factors in Michigan in Massachusetts.

As we've discussed previously Michigan continues to present a challenging business environment for the weak economy on a shrinking personalized market, but I am confident that we will continue to manage this market very well. In Massachusetts, we are transitioning to a new competitive market system. Our first quarter results still reflect last year's mandated 12% rate decrease. Open market conditions took effect on April 1, and at which time our average 8% filed rate decrease will come in to play.

We remain very positive about the new era of managed competition as we see a huge opportunity for us to offer our distinctive value proposition to Massachusetts agents. Something we haven't done before... couldn't do before. However, '08 will be somewhat of a transition year, and we will contribute to the top line pressure, primarily due to filed rate decreases, but we will see accounts increasing as we gain share.

Additionally, as you know, we have taken exposure management actions in Florida and Louisiana. The impact of these actions are reflected in our growth, but should continue to help our long term margins. Offsetting these trends we are seeing the validation of our strategy in our growth day [ph], where we are generating positive growth momentum even in today's more competitive environment.

We remain optimistic about our ability to generate solid growth in these states to balance out our position in Michigan and Massachusetts in the short term, as well as over company impact of exposure management actions. Marita will speak to these in more details in a couple of minute.

Our optimism in Personal Lines is based on regaining traction on our full value proposition. Unlike in prior years, our personalized product set is now more complete and has reached a level of distinctiveness. Our improved Connections Auto product is in place and ready to be sold across our entire footprint down, including Massachusetts. Our Connections Home product is well positioned and is now available in our big 16-state. Additionally, we have expanded our toy capabilities such as boats, and automobiles and our commitment to service has really taken hold.

Additionally, we are taking rate action in most states. We believe the market will support this and we are certainly seeing a similar pattern among our competitors. All in all we expect marginal Personal Lines growth for the year, and we should still deliver on our overall growth guidance of mid single digit growth in the aggregate by leveraging our more robust Commercial Lines business segment.

In Commercial Lines, we grew at 13% for the quarter. We mad some strategic changes as you know to our reinsurance program that Gene will provide more detail on. But our Commercial Lines written premium growth on a direct basis was 5% for the quarter, driven by our specialty business, which grew at 20% in the first quarter.

We closed on our acquisitions of Professional Direct in the third quarter of '07 and we closed on Verlan Holdings in March of this year. We should continue to see positive growth momentum through the year from these acquisitions as well as from our traditional growth and specialties which was at 9% for the quarter, and is expected to accelerate throughout the year.

Also contributing to our positive outlook for Commercial Lines growth is the position of our small commercial platform. We made significant upgrades to our small commercial models and platform during '07. We've many enhancements including more sophisticated pricing and an ease of doing business.

The performance in our small commercial business started to gain real traction at the end of '07 and we expect to gain further momentum in our small accounts as the adoption of our enhanced model continues to increase with our existing and new partners. Of course we will be affected by market conditions as we were in '07. Particularly, in middle market commercial segment where pricing competitiveness is still... is makes it a difficult market.

Now with the work we did in '07 including the acquisitions we made and the opportunities that we will continue to evaluate in '08, we have given ourselves many options for profitable growth and position ourselves well for success with our partner agents. As I consider our progress, I remain convinced that our disciplined approach to identifying winning agent partners and our broad product approach is working and we are building momentum in market share with our winning agents.

At all times, we endeavor to carefully manage our growth at an agent level to ensure continued attractive margins and this will never change. To summarize I am pleased with the results in the first quarter of '08 and I believe we remain on track to deliver on our commitments that we made to you on Investor Day. We remain confident on our ability to grow profitably in Commercial Lines, while meeting our Personal Lines growth objective has become more challenging, we are still making sold progress in our growth rates and we will continue to manage Michigan and Massachusetts carefully.

Additionally, we will continue to demonstrate underwriting disciplines and you will see this in our ability to maintain or slightly improve our accident year performance. The favorable development in prior year's reserves continues in the first quarter and though we believe that our prior accident years are prudently reserves there may be additional favorable reserve development through the year, but likely at lower levels than we saw last year.

Finally, I remain convinced that we will lower our expense and LAE ratio by point of share outside our [indiscernible]. Clearly this is a competitive market and a difficult to come off [ph] the economy, but our company is in a strong position and we have the talent and the competitive position to be very successful.

With that I will now turn the call over to Gene for the financial review of the business.

Eugene M. Bullis

Thank you, Fred. Good morning every one, and thank you for joining our call. As usual a slide presentation accompanies my remarks and I trust all of you have this available,

Please turn the slide 5 which presents our consolidated results for the quarter. For the quarter, we reported net income of $59 million, a $1.12 per share, down from $64 million, or $1.22 per share in the first quarter of 2007. Net income for the first quarter of 2008 benefited by $5 million, or $0.09 per share from adjustments to after tax net gain on previously sold businesses.

Net income for the first quarter of 2008 also included pretax net realized investment losses of $5 million, or $0.09 a share, compared to a gain of $2 million, or $0.04 a share in the same period of 2007.

This quarter we recognized impairments of $7.5 million of certain fixed maturity securities, partially offset by pretax net investment gains of $2.5 million, primarily from sales of fixed maturities. The increase in impairments in the current quarter was attributable to credit market conditions not directly associated with financial institution losses.

Let's turn to slide 6 for a discussion of our segment earnings. Segment income after tax was $57 million for the quarter, down from $60 million in the first quarter of last year. Our Property and Casualty segment generated $98 million of pretax income, down from $101 million in the prior year quarter, primarily due to higher catastrophe and weather-related losses.

Our Life companies posted a $2.5 million loss from continuing operations, versus the loss of $1 million in the prior year quarter. The segment loss in the current quarter was $1 million higher than expected primarily due to unfavorable mortality experience in our run off traditional Life business.

Now let's turn to slide 7 for a review of our P&C results starting with the discussion of Personal Lines. The Personal Lines segment generated pretax earnings of $28 million in the current quarter, compared to $48 million in the prior year quarter. Catastrophe losses were $11 million for the first quarter of 2008, compared to $7 million in the first quarter of 2007.

Excluding catastrophes, segment income was $39 million in the quarter, down from $55 million in the prior year quarter. Ex-catastrophe earnings in the Personal Lines segment were lower in the current quarter for several reasons. The principle factor was lower favorable development of prior year reserves in the current quarter, compared to the prior year prior period quarter.

Prior year loss and LAE reserve adjustments with $12 million favorable in the first quarter of 2008 compared to $20 million in the first quarter of 2007. This reduction in favorable prior year loss in LAE development was driven primarily by personal loan [ph] and is consistent with expected 2008 loss trends.

Additionally, ex-catastrophe accident year losses in our homeowners' line were higher in the current quarter, compared to our prior year quarter. This is principally due to higher non-catastrophe weather related losses resulting from a more severe winter in the Midwest and the Northeast. Partially offsetting this increase in homeowners' accident year losses is a small improvement in the personal auto accident year loss ratio.

Finally, loss adjustment expenses were about $2 million higher in the current quarter due to higher technology expense related to our new claim system, which is not expected to recur. Expenses in this first quarter also reflect higher independent adjuster expenses that were needed to price at the higher number of weather related claims.

Now let's look at Commercial Lines results on slide 8. Commercial Lines pre tax segment income was $68 million in the quarter, compared to $49 million in the first quarter of 2007. Catastrophes were $8 million in the first quarter of 2008, which was consistent with $7 million in the first quarter of 2007. The increase in Commercial Lines earnings is primarily due to the favorable development prior year reserves as well as improved accident year margins. The favorable development at prior year reserves was $45 million in the first quarter 2008 compared to $31 million in the prior year quarter. Reserves develop favorably across all lines with improvement coming principally from our commercial multiple peril lines.

At the same time, the ex-catastrophe accident year loss ratio improved across most lines and was 49.2% in the current quarter, compared to 50.1% in the prior period quarter. Finally net investment income was up $3 million, this is primarily due to the transfer of employee benefit related assets and liabilities from FAFLIC our one of [ph] life insurance subsidiary to Hanover Insurance and to positive operating cash flows from the business.

Turning to slide 9, our accident year loss ratio for the first quarter of 2008 was 56.5%, which is up seven-tenths of a point to the prior period quarter. This increase is entirely due to the higher incidence of non-cat weather related losses in Personal Lines without which we would have improved our accident year margins. Despite these losses, impacting out first quarter accident year trends, we continue to believe that we will maintain or slightly improve our accident year margins for the year.

Our expense and LAE ratio improved by seven-tenths of a point primarily to favorable prior year development in LAE. Excluding development the ratio would have remained flat for the quarter, compared to last period's first quarter. We have some seasonality and expenses which causes the first quarter to carry a heavier expense loss [ph].

Our expense management initiatives are working and we continue to believe that should see more significant improvements to our expense and LAE ratio starting in the third and fourth quarters. Enabling us to meet our target for a point reduction overall subject to mix change.

Now let's turn to production which is on slide 10. Overall net written premium was $629 million for the current quarter, up 2.7% from the first quarter of last year. Written premium this quarter includes a benefit from changes we made to our reinsurance program. Effective January 1, 2008, we renewed our property, catastrophe and casualty reinsurance program with some changes to the reinsurance structure.

Changes to the reinsurance structure both at the top and the bottom together with more favorable reinsurance rates enable us to realize meaningful cost savings. In the first quarter, these reinsurance cost savings increased net written premium by $25 million... $25.3 million and net earned premium by $30.7 million. $10.7 million of the increase in that written premium in the first quarter will be non-recurring.

Our new structure optimizes our use of reinsurance with more robust earnings power we now have the capacity to retain more business in the lower layers that are typically placed at our higher rates and redeploy some of the savings to buy additional coverage at the top, improving our risk profile while retaining more of our profitable business.

Commercial Lines in net written premium increased about 13% for the quarter, compared to the same quarter last year, while Personal Lines decreased by 4%. Personal Lines production was somewhat lower than we expected, while Commercial Lines growth was on target. Marita will discuss production in more detail in her remarks.

Now let's turn to the investment section. As you can see on slide 12, our general account invested assets had a carrying value of $6.1 billion at the end of the first quarter of 2008. Fixed income securities, cash and cash equivalents, constituted 96% of our portfolio. Equities were less than 1% of our portfolio, 95% of our fixed income portfolio caries and investment grade rating and the average quality rating of our portfolio was A plus.

Turning to slide 13; you can see the sector breakdown of our fixed income portfolio. Here again we have a conservative risk profile with 49% of our fixed income portfolio in Corporates. MBS and CMBS were 28% of our portfolio and our Municipal Bond portfolio constitutes 15% of total investments.

On slide 14, you can see the break out of our Residential Mortgage-Backed Securities, which represents a total of $1.1 billion with less than 14% of this portfolio in non-agency securities. Our non-agency securities carry a AAA rating. None of our mortgage backed securities have sub prime exposure.

On slide 15, you can see the breakout of our commercial mortgage backed securities, which represent $468 million of our portfolio. 81% of our CMBS portfolio was rated AAA quality. Approximately 95% of our CMBS holdings were to pre-2005 vintages with 5% from 2006 vintage and none from 2005. The entire CMBS portfolio has a weighted average loan-to-value ratio of 67%.

Slide 16 breaks out our Municipal Bond portfolio. We have $825 million in municipal holdings of which $366 million carry an insurance enhancement by financial guarantors. However the average underlying ratings quality of these securities, even without regard to the insurance enhancement is A-.

Turning to slide 17, we have provided some additional information on our unrealized losses for the year. Gross unrealized losses on below investment grade fixed maturities and equity securities, a useful indicator of potential future impairments was only $17 million at March 31, 2008.

Finally, on slide 18 we have some key metrics that outline the strength of our balance sheet. Our book value per share was $45.23, up 2% for the quarter and up 10.5% compared to March 31, 2007 book value. Our operating leverage of 1.4:1 and our financial leverage of 18.1% continue to reflect our exceptionally strong capital position. Finally our holding company cash reflects our buy back activity offset by a $17 million dividend received from FAFLIC.

Through April we have repurchased a total of $38 million of value of shares of which $33 million or 765,000 share repurchases were completed in the first quarter. With $282 million in cash and investment at the holding company we have ample liquidity.

Finally, let me recap our outlook for this year which remains substantially unchanged. We expect to achieve net written premium in the mid-single digits in Commercial Lines and we expect our growth of Personal Lines to be relatively flat for overall net written premium growth of mid-single digits. We also expect to achieve low to mid-single digit growth in operating our earnings per share, excluding the impact of catastrophes.

Fred has already reiterated most of our outlook assumptions. In addition to the operating metrics our effective tax rate is expected to be in the range of 33% to 34% for the stand alone PC segment, but we also expect the continuing operations of the Life Company to operate at a loss of $4 million to $5 million, up from the $3 million to $4 million guidance we had provided earlier. We are continuing to explore alternatives for unlocking the capital supporting our Life business and will provide updates when we have something definitive to communicate.

In summary, even with difficult market conditions we believe our business platform will be capable of delivering above industry average results. With that, I will turn it over to Marita for a review of our Property Casualty business.

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

Thanks Gene. Good morning, everyone and thanks for joining the call. Like Fred I am very please with our companies performance through the first quarter of 2008. Our Commercial Lines segment delivered very strong results for the quarter, and our Personal Lines earnings were also very solid. Our overall combined ratio was 95% for the quarter. Written premium growth was also within the range of our expectations for the quarter and as we knew we would suffer from a tough comparison to the prior year quarter particularly in Personal Lines.

Net written premiums grew 2.7% for the first quarter, Commercial Lines growth of 13% was offset by a 4% decline in Personal Lines and as Gene pointed out our growth numbers include the benefit from changes to our reinsurance program.

I'll provide some inside into the result of each of the segment starting with Personal Lines. Personal Lines segment income of $28 million in the quarter includes $11 million in catastrophe losses and an additional $9 million in non-GAAP weather related losses. As a result the combined ratio in this segment was to $101.2 in the quarter. Our ex-GAAP accident year loss ratio was about two points higher than the prior year driven by our Home Owners Lines. This is due to higher non-GAAP weather related losses which we can see clearly in the data.

Our accident year loss ratios improved by nearly a point in Personal Auto which was less impacted by weather. These results reflect our commitment to disciplined underwriting even under more competitive conditions.

The quality of our business remains solid as we continued to see favorable development of reserves in prior accident years and our underwriting initiatives aimed at improving mix of business, particularly in personal auto, have also enabled us to sustain margins. Personal lines growth was down 4% in the quarter on a direct written premium basis. This outcome is not unexpected as we knew we suffered from a tough comparison this quarter, particularly in Personal Auto, however written premium is stable compared to the fourth quarter of 2007 with growth in Personal Auto offset by home owners, which was impacted by our cat [ph] management initiatives.

Our new business and renewal retention rates are stable on a sequential quarter comparison. Let me discuss the key factors affecting growth this quarter and what it means for our outlook. We have four states that need to be discussed separately and these are as you can imagine, Michigan, Massachusetts, Florida and Louisiana. The trends in the remainder of our states are more homogenous and can be addressed as a group.

So let me start with Michigan, as you have heard me say before our Michigan's remains a challenging state with its weak economy and competitive pressures. Given these pressures, our focus has been on maintaining on our profit margins. As a result of all of these factors our Personal Lines policy count have come down about 1% a quarter throughout last year and this trend continued in the first quarter of 2008. Net written premium in Michigan was down 3% in the quarter driven by Personal Auto. Our home owners' premium grew as we were able to taking inflations adjustments to rate and over come the lower policy accounts.

We continue to peruse several actions to stabilize and improve our Michigan position. We have already taken some great actions on our Auto group early this year and we have more plans for the subsequent quarters. We believe the market will support this. We also stepped up our agency management actions working closely with our partner agents to aggressively retain business while finding opportunities to consolidate shelf space to grow new business at profitable margins.

Again our focus remains on the bottom line and on maintaining margins while maximizing our opportunities for growth. We have a long standing and strong agency partnerships in Michigan and we know the market place very well, we believe barring any further deterioration of the economy we can maintain and overcome and over time improve our performance going forward.

Turning next to Massachusetts, net written premium was down about 10% in the quarter. This was primarily the result of the mandated 12% rate decrease in Massachusetts in Personal Auto that took a fact [ph] on April 1st 2007 and as Fred pointed out managed competition came into effect starting April 1st 2008 and at that time our average 8% filed rate decrease will come into play. Putting inside these rate decreases we are very optimistic about our potential opportunity in Massachusetts and our ability to use our multi-area product and our fore franchise value to drive profitable growth.

Our initial feedback is very positive as agents are responding enthusiastically to our value preposition. We expect we will compete effectively in the new environment and over time will grow our market share. Our Personal Auto policy counts were up 4% points compared to the prior year quarter.

As we continue to gain traction the outlook for the state will improve. Of course 2008 is a transition year for us and while we expect to grow in Massachusetts over the long half haul, we do not expect Massachusetts to contribute to growth during 2008 due to the current rate environment.

Finally, turning to Florida and Louisiana, here we have taken catastrophic management actions that have significantly improved our risk profile.

As we previously discussed, we have now started non renewing Florida home owners business effective December of 2007. This represents a total of about 12,000 [ph] policies and about 11.5 million in written premium for the year. We continue to reduce home owners' concentration in Louisiana. These types of strategic decisions have enabled us to reduce our P&Ls, each year, over the last three years. Improved our risk profile and attain more favorable rates from our reinsurers, which is one of the factors contributing to the reinsurance savings this year.

The impact of these intentional actions represent a 15% decrease in Personal Lines growth for the quarter in these two states. Balancing the desire for growth while optimizing risks and maintaining margins are the trade-off decisions we make everyday. Putting aside these four states with their unique considerations, the trends in our remaining state remain positive despite the challenging market. We are gaining traction in these other states and this will be evident once we get past this toughest quarter comparison. Let me spend a minute explaining this tough comparison.

As you may recall we began taking significant corrective actions last year to improve the profitability of our Connections Auto book. These actions which were aimed to improving pricing and mix of business had the impact of reducing our growth in less profitable Auto segment beginning in the second quarter 2007.

The timing of these actions has created a difficult year-over-year comparison to the first quarter 2007 when our growth in Connections Auto had not yet been materially impacted by these actions. Again our Personal Auto premium in the first quarter of 2008 is up compared to the fourth quarter numbers. Looking forward the remaining quarters of 2008 should see a much less unfavorable comparison to prior period quarters.

On a positive note, the mix improvements that these actions were aimed at such as an increased proportion of multi-car and more whole account business that are consistent with our strategy have taken hold and we're starting to improve retention indicators and margins.

Once we get passed this first quarter hurdle we see positive momentum in these states which gives us confidence that our strategy is working effectively. We are focused on partner and our partner agent's strategy and on winning new business through the consolidation of shelf based rather than one policy at a time. We can see traction on these funds giving us confidence that we can grow profitably through the cycle.

In summary, given our outlook in Michigan, the transition phase we are in and Massachusetts is coupled with the catastrophe management actions flowing through, it would be more prudent to anticipate relatively flat growth in Personal Lines this year, while we remain confident in our strategy based on our growth trajectory. Importantly, earnings in Personal Lines should remain solid, as we expect to maintain our ex-catastrophe accident year margins.

Our loss trends remain stable and we plan to maintain and improve our accident year margins by taking right actions that are consistent with expected loss trends, we believe the market will support us and we are currently earning in about 2% of rate increases in the first quarter.

Turning next to Commercial Lines; we had another strong quarter with segment earnings of $68 million. Reserves related to prior accident years continue to develop favorably across all lines, reflective of our disciplined underwriting, and our current ex-cat, ex-[indiscernible] losses improved a point to 49.2%. Our combined ratio was 85.3% for the quarter.

Net written premium growth was 13% in the quarter, this includes a four point benefit due to the consolidation and cancellation of our umbrella treaty that will not re-occur in subsequent quarters of 2008. Besides from this, the strategic changes of our re-insurance program will continue to benefit growth in subsequent quarters.

Direct written premium growth in Commercial Lines was 5% in the quarter, this growth came primarily from our Specialty Business which grew a robust pace of 20%, as expected PDI and Berland provided a good lift in the quarter. Our other specialties also grew by 9% on a direct basis. In a more competitive market with price pressures, Specialty Lines continue to provide us with better breadth and diversification of our earnings base.

With over $300 million in annual written premium, Specialty Lines now represent a mature book of business, supported by strong agency distribution and constitute about a third of our Commercial Lines book. Our traditional business also continues to show positive momentum in the quarter with growth in exposures and in written premium. Pricing remains competitive, particularly in the middle and larger market segments. However we continue to compete effectively in the small market and get pricing. Additionally the completion of our small commercial operating model provides yet another stimulus to growth in our traditional business.

During the past year we have done a tremendous amount of work in enhancing the product and the operational effectiveness supporting our small commercial platform that allows for easy coding, issuance and renewal of policies to our agency portal. The agents can now see all the components of their small business accounts, including Commercial Auto and workers compensation and we believe we are now well positioned to write more of this balanced floor [ph] business that has very attractive economics, as more of our partner agents adopt this enhanced model.

To sum up the growth story in Commercial Lines, our first quarter growth gives us confidence that we will meet the mid-single digit growth objective we laid out at investor day. I also feel good about making our overall commitment of mid-single digit growth knowing that there are enough positive catalysts to prudent growth in Commercial Lines that can be used to balance the challenges we may face in Personal Lines. Even more importantly while we expect to make our growth goals in Commercial Lines, we expect to do so by maintaining or improving our accident year margins as we did in the first quarter. I think we have demonstrated our commitment to underwriting discipline putting margins and prudent risk management before growth and gaining market share and in a manner that is true to our strategy. And with that all I will turn the call back to Sujata.

Sujata Mutalik

Thanks, Marita. Operator, with that we will open up for questions.
Question And Answer

Question and Answer

Operator

[Operator Instructions]. Your first question comes from the line of Jay Gelb with Lehman Brothers. Please proceed.

Jay Gelb
Lehman Brothers

Thanks, Good morning. I was hoping

Unidentified Company Representative

Hi, Jay.

Jay Gelb
Lehman Brothers

How are you? I was hoping you could update us with your conversations on the rating agencies and I know you don't have an update today on the potential side of Life business but maybe you can walk us through how you see that playing out?

Frederick Henry Eppinger
Former President & CEO

Sure. On the rating agencies obviously we are right in the middle of those conversations we got Moody's upgrade last quarter. We had a terrific conversation with S&P that just concluded and Iwe are in the middle kind of a quarterly best March [ph] we go with them as well. I am very optimistic about the last two pieces of this occurring sometime over the next twelve months and I can't decide when they are going to do things, but I would tell the conversations we've been have were very positive, we are meeting all their expectations and I actually feel very, very good. We've said the way the calendar works and when people make decisions my guess is at S&P the decision will come before our best [ph] decision, but I feel very, very good about those conversations. Do you have any add on that?

Eugene M. Bullis

No, I think that's exactly where we are and we expect to see... I think out we are out there with a positive outlook from S&P... and they have to do something with respect to that sometime in the next two months

Frederick Henry Eppinger
Former President & CEO

And we're also positive allocation very best in the guidance they've given is kind 18- to 24 months and so when they gave to us, so again so I think this year is a big year for us in both cases and I... nothing in the conversation that make me anything but optimistic about it. [Indiscernible] is very happy with the Moody's move which proceeded the other two.

On the Life Company, again we are in process there, I don't see any reason why this can't be achieved, it is as we said it's not anything like the first year that we did, this is a more straight forward book of business. And we kept it so because we wanted to retain the tax attributes that were in it. I think it was the right decision but now it's the right decision to move forward to monetize it, and I think we will do that. Now the way we are thinking about it Jay is very straight forward, but what I like about the situation for us is that obviously we've had some amount of jet capital types in our like business because we've held it to really get those tax attributes.

So we couldwe could see ourselves this year as we come to closing on that transaction being able to free up capital fees to give back to our shareholders, or to take and put it in a much more productive 12% plus return type of business. So I see that's going to be a tremendous boost to people's transparency of our company. I think it was the right decision to keep it because the MPD was good on the tax attributes, but I would tell you that you can just do the math, right that the ROE bond for doing... taking dead capital and either applying it to our business at a 12% return or giving it back shareholders should be very positive action and the right action that we should be able to achieve this year. Again Gene is there anything else that...

Eugene M. Bullis

Yes, it's a process that we don't want to get out ahead of ourselves in terms specific disclosures, but we set out to achieve an outcome that we set at Investor day today and I think we are on track to do that.

Jay Gelb
Lehman Brothers

Okay, and then my... my last question is, given the significant transaction we the\saw last week, I was wondering if that makes you re-look at in bound or outbound M&A with all the cash there.

Frederick Henry Eppinger
Former President & CEO

No, I mean again, I think I have been pretty clear on this last four years, I believe very strongly that we are going to see a consolidation in the industry I think that there are 500 little companies that are represented by 45% of the $450 billion market that are sub scale, there are about 18 to 20 that are big and what you are going to see is the big guys potentially buy each other and you are going to see the consolidation of some of these small opportunities, and what we are seeing is lot of opportunities to talk to a number of company's that I have done through the last couple of years and pricing expectations are more in line now and the people are more thoughtful about what they have and they don't have.

So I continue to see opportunities for us, I don't need them per se, but we would continue to look at them and if we think it helps our value proposition and we can make a significant shareholder value creation we will do it and the other thing I would say is that we had built this company to take advantage of disruption and so one of the best days in my life is when [indiscernible] was merged and we are able to acquire a lot of great talent and this takeover opportunity presented an enormous opportunity for us and both the disruption at the agency level and places like small commercial across our network when they just lost the market in the talent that is under and we are uneasy about the consolidation challenges that company now has present real share holder value operation opportunity for us if we continue down the path to accelerate some of our partnerships because of the deals.

So we have always been very activist and part what I do, I talk to everybody always and because I do think that this is the part of the cycle where these opportunities represent and I think what we're going to try to do is what we've done last four years is trying to do the right thing to create shareholder value and capitalizing opportunities as presented.

So I am pretty again, I've said all along, I've talked about how casualty I'd thought it was going to happen, this one is not, to me a surprise at all. I do think there will be something among the big guys, given the pressure that they face and I think there will be a lot of small guys that will also feel the pressure from subscale. So we are still optimistic about the opportunity presented to us [ph].

Jay Gelb
Lehman Brothers

Right, thanks for the answers.

Frederick Henry Eppinger
Former President & CEO

Thank you.

Operator

Your next question comes from the line of Rohan Pai with Banc of America Securities. Please proceed.

Rohan Pai
Banc of America Securities

Hi good morning.

Frederick Henry Eppinger
Former President & CEO

Good morning.

Eugene M. Bullis

Good morning.

Rohan Pai
Banc of America Securities

Fred, I guess the first question I had, had to do with the personal auto, just looking at the calendar year combined ratios have been rising sequentially in each of last four quarters it was 102 in the first quarter. And based on Gene's comments, may be reserve releases decline going forward, is what kind of a combined ratio are you willing to tolerate in personal auto on a calendar year basis?

Frederick Henry Eppinger
Former President & CEO

I think what we target is 95, 96, I feel like we can hit that, where accident years will improve this year. We are I think people know, I think this weather thing was a little bit... its what we don't really have big cats for a kitty cat kind of company, and the first quarter tends to be the most volatile for us given dry stock, dry kind [ph] storms and freezes that we had this year.

Buy I'm actually quite bullish, Personal Lines, if you look at where we are with our core accident years excess whether they continue to improve, and I think that they're going to be very stable. Now, we are very conservative, if you look at what we do because if you'll recall last two years we totally revamped our Personal Lines home and auto in every state, Connections is now $500 million business.

And we were very conservative about our accident years because we were going returning over an entire book of both home and auto as we watch those new products and we're going into new states. So our conservatism we were out first last year with somebody's accident year's increases and that's why we think there is an opportunity to continue to decrease it.

So our goals by the way is at the 12% ROE through the cycle. We don't mess around that's what we focus on, I'm very clear that we're going to do that. I have no qualms about us doing that in the P&C business and as we get rid of the Life business and we get these upgrades our capital will be better managed and more appropriate and that'll be very easy to do for the overall business.

So I feel very good about what we're going in again I think we have some transparency to the improving accident years that I feel is going to be fine. What you've seen in some of our competitors because of the appointment of many agents in the commoditization of auto is that you will see greater turn from them, than from us. Because what we're doing is focusing on fewer agents in account-based business with partner agents. And so we won't have the volatility that you see from doing a lot of business say with aggregators and on the Internet where you're essentially haven't called the impact of kind of the new business of course when you compare auto to auto. Our gain is more of an account based place, so you can deck into what a 12% returns based on our capital and therefore we think that's what we need to do and that's what we will do over the cycle.

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

You know with the frequency in severity trends in this line being relatively benign and our ability to drive some rates in personal auto and the markets acceptance to that rate is really giving us hope looking forward and add to the long term profitability of that line.

Eugene M. Bullis

But those are two separate subjects though again on reserve releases

Frederick Henry Eppinger
Former President & CEO

And our action here is are not two separate subjects, when you turn over its much focused you do, we are very thoughtful and very conservative that in total we get, we create shareholder value, we think about it that way, because we did enter a lot of new states with new products. It is not two separate conversations.

Rohan Pai
Banc of America Securities

Thanks for the detailed answer. Marita what kind of rate increases were you referring to, what prices are you putting through and what are you seeing in the marketplace for personal auto?

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

Yeah, we mentioned specifically what we did in Michigan and obviously it differs by state and location, but the answer to that question will be as much as the market will possibly bear. And the hope is that we can continue to push that bar higher and higher. I can tell you that all of our rate activity at this point is on the positive side of the house, not the negative side of the house. But those numbers obviously differ dramatically by individual states, what the rate need is, where our indications are, what the market will bear, but we're clearly seeing a trend on towards positive numbers and the markets ability to bear that.

Frederick Henry Eppinger
Former President & CEO

We track in every one of our states every one of the major competitors, say the top ten and we have a map, and what you've seen as a turn going to the first quarter last year it was kind of split and near the tail end it became more 50-50. Now you are seeing most people are taking rate and so the opportunity here is dramatic. Now we are pretty aggressive about taking rate every year in almost every market, Massachusetts being the exception. But what we see is people starting to take rate and we believe that you will see that to be very common practice by the second half of the year. Everybody is seeing the same results and so we are relatively bullish on seeing rates in the second half of the year.

Rohan Pai
Banc of America Securities

I guess on a different note, in Michigan there seems to be a bill for

Frederick Henry Eppinger
Former President & CEO

Taken out credit.

Rohan Pai
Banc of America Securities

Exactly.

Frederick Henry Eppinger
Former President & CEO

Its on the house side, the republican side is of senate, but we do not believe that has any legs at all because the... on a house side it just barely passed and what we said... what we're hearing is not going to taken up by the Senate. The other thing that's been introduced which is the more important thing for portability in Michigan is there's been a bill filed in the Senate about the PIP coverage its the only state union that has mandatory PIP coverage and what we're looking for is a different type of optional environment that would save money for consumers, and frankly avoid the potential cost shifting and risk that could occur in the PIP area in Michigan. So we're pretty bullish that something will happen like that much more likely been the credit thing I can't imagine the credit thing pass much legs given what I've seen in the political environment in Michigan.

Rohan Pai
Banc of America Securities

Okay, that's good news. And just it is finally Massachusetts you seem pretty bullish on growing policy account [ph] despite the price decrease. What is the combined ratio there in that state for personal auto?

Frederick Henry Eppinger
Former President & CEO

We do very well... we do very well in Massachusetts and we believe we can maintain what we have in Massachusetts going forward. Its one of the few states where you are actually still seeing frequency declines. If you recall, we were late to the game in Massachusetts both for broad [ph] and then the other thing that we didn't have an assigned risk plan. So people didn't take responsibility, one of the big reforms that you now see are facing end of the resign risk plans. So you are going to see underlying cost trends in Massachusetts is actually be... continue to be a little bit better if they probably flatten out this year, but what we will see is maintaining our margins.

The one place we've spent a little bit is we did... I think I talked about the last call. We spent a little bit more expenses than others because we put in a full multi-variant [ph] product while others held back. One of the optimistic feelings we have is that this is the time when these other folks have done a lot of segmentation for us to really improve our position in the agencies shelf space because we have so much better segmentation. And particularly the market leaders here and the ability to increase margins is real for us because now it's based on your own experience not just the overall state [ph] experience.

So we believe that we can continue improve margin but we are very solid and we are happy with that margins and I don't see it deferred [ph] a deterioration of those margins except we did spend probably $2 million or $3 million more kind of in a one time expense play around the new product and services, that's a little pressure on our expense margin this year.

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

And knowing the state as well is we do clearly gets us some market advantage no doubt about that.

Rohan Pai
Banc of America Securities

Thank you. Thanks Marita for the answers and congrats on the results.

Frederick Henry Eppinger
Former President & CEO

Thank you.

Operator

[Operator Instructions]. At this time, there are no more questions appearing in queue.

Sujata Mutalik

All right then I think... I thank you all for joining the call and we will look forward to talking to you again.

Operator
Thank you for your participation in today's conference, this concludes the presentation, you may now disconnect. Good day.