S&P Capital IQ

CONTENTS

Markel Corporation NYSE:MKL

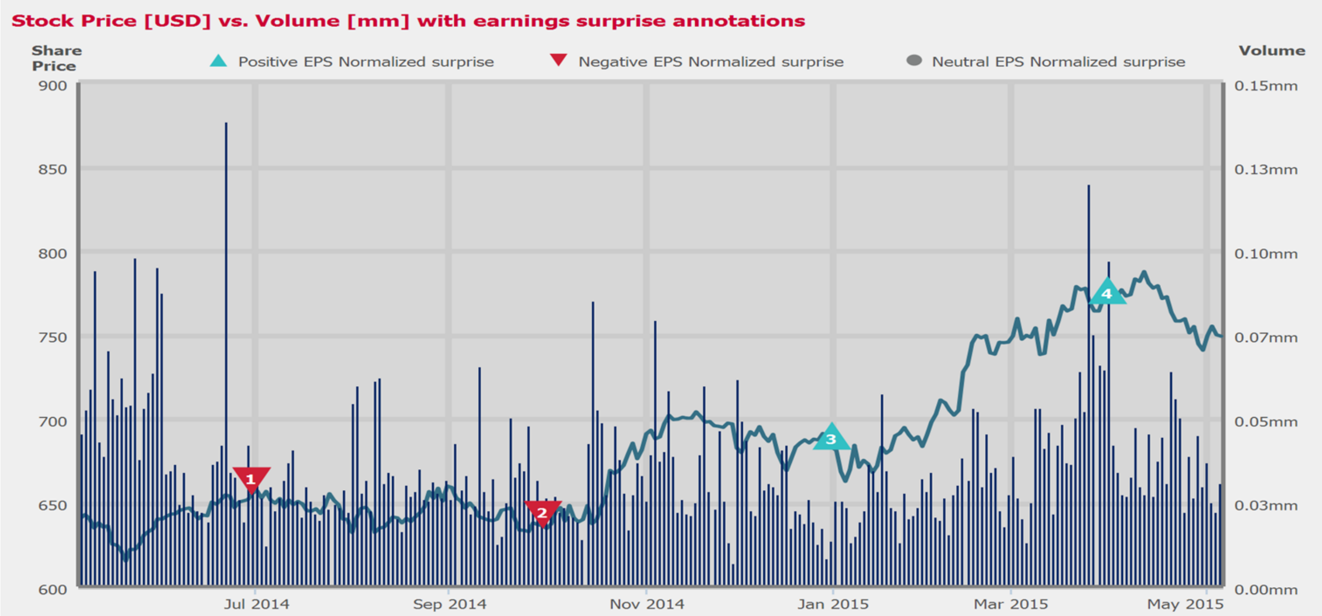
FQ2 2015 Earnings Call Transcripts

Thursday, August 06, 2015 2:30 PM GMT

S&P Capital IQ Estimates

	-FQ2 2015-			-FQ3 2015-	-FY 2015-	-FY 2016-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	6.04	6.10	▲0.99	6.44	30.21	25.69
Revenue (mm)	1284.98	1304.60	▲1.53	1318.74	5225.81	5353.36

Currency: USD
Consensus as of Jun-14-2015 10:26 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2014	5.75	2.47	▼(57.04 %)
FQ3 2014	5.44	5.30	▼(2.57 %)
FQ4 2014	5.52	8.18	▲48.19 %
FQ1 2015	5.85	13.17	▲125.13 %

Call Participants

EXECUTIVES

Alan I. Kirshner
Executive Chairman

Anne G. Waleski
Chief Financial Officer and Executive Vice President

Francis Michael Crowley
Vice Chairman

Richard R. Whitt
Co-Chief Executive Officer and Director

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

ANALYSTS

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Presentation

Operator

Greetings, and welcome to the Markel Corporation Second Quarter 2015 Earnings Conference Call. [Operator Instructions] As a reminder, this conference is being recorded.

During the call today, we may make forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. They are based on current assumptions and opinions concerning a variety of known and unknown risks.

Actual results may differ materially from those contained in or suggested by such forward-looking statements. Additional information about the factors that could cause actual results to differ materially from those projected in the forward-looking statements is included under the captions Risk Factors and Safe Harbor and Cautionary Statement in our most recent Annual Report on Form 10-K and quarterly report on Form 10-Q.

We may also discuss certain non-GAAP financial measures in the call today. You may find a reconciliation to GAAP of these measures in the Form 10-Q, which can be found on our website at www.markelcorp.com in the Investor Information section.

The presenters today from Markel Corporation will be in the following order: Mr. Tom Gayner, President and Chief Investment Officer; Ms. Anne Waleski, Executive Vice President and Chief Financial Officer; Mr. Mike Crowley, President and Co-Chief Operating Officer; and Mr. Richie Whitt, President and Co-Chief Operating Officer.

I would now like to turn the conference call over to your host, Mr. Tom Gayner. Sir, the floor is yours.

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

Thank you so much. Good morning, and welcome to the 2015 First Half Conference Call for Markel. My name is Tom Gayner, and as our host indicated, I'm joined, as usual, by Anne Waleski, Mike Crowley and Richie Whitt. Anne will brief you on the financial results, Mike and Richie will follow with some comments on our insurance operations and then I'll finish with comments on our investment results with Markel Ventures. As always, we thank you for your interest and support of Markel and we look forward to your questions.

With that, Anne?

Anne G. Waleski
Chief Financial Officer and Executive Vice President

Thank you, Tom, and good morning, everyone. Our financial results for the first half of 2015 are solid, and we produced underwriting profits in all 3 of our ongoing insurance segments, each of which have improved from a year ago. While our underwriting results were positive, our investing results and operating book value were impacted by an increase in interest rates during 2015.

Moving into the results for the first 6 months of 2015. Our total operating revenues grew 4% to $2.6 billion in 2015 from $2.5 billion in 2014. This increase was driven by higher revenues from Markel Ventures. Other revenues, which include Markel Ventures, were up 34% to $510 million from $380 million last year, primarily due to our acquisition of Cottrell in July 2014.

Taking a look at our underwriting results. Gross written premiums were $2.5 billion for the first half of 2015 compared to $2.7 billion in 2014, a decrease of 7%, driven by a decline within our Reinsurance segment.

During 2014, we ceased writing auto reinsurance in the U.K. and we also decreased our nonstandard U.S. auto reinsurance business.

Foreign currency exchange rates also had an unfavorable impact on the year-over-year change in gross written premiums. However, even on a constant rate of exchange, gross written premium volume declined 5%.

Market conditions continue to be very competitive, especially within the property and marine and energy product lines. Consistent with our historical practices, we will not write [ph] business when we believe prevailing market rates will not support our underwriting profit targets.

Net written premiums for the first half of 2015 were $2.1 billion, down 7% from the prior year, for the same reasons I just discussed. Our net retention rate was in line with the prior year at an 82%.

Earned premiums decreased 1% to $1.9 billion for the first 6 months of 2015. The decrease in 2015 was driven by the unfavorable impact of the U.S. dollar strengthening against foreign currencies. At a constant rate of exchange, earned premiums for 2015 would have increased 2% compared with the same period a year ago.

During the period, we saw organic growth in several specialty product lines within our U.S. insurance segment. Our consolidated combined ratio for the first 6 months of 2015 was a 90% compared to a 98% a year ago. The decrease in the combined ratio was driven by more favorable development on prior accident year's loss reserves in 2015 compared to 2014.

For the first half of 2015, prior year redundancies were $296 million compared to $167 million for the same period a year ago. As we discussed in the first quarter, the increase in prior year redundancies in 2015 was due in part to a decrease in the estimated volatility of our consolidated net loss reserves, as a result of ceding a significant portion of our 1992 and prior asbestos and environmental loss reserves to a third party during the first quarter of 2015.

In order to maintain a level of confidence in our loss reserves within a range consistent with historic levels, we reduced prior year loss reserves during the period by $36 million, which had a favorable impact to the combined ratio for the first 6 months of 2015.

Prior year loss -- prior year losses for the 6 months ended June 30, 2014, included $27 million of adverse development on asbestos and environmental exposures. In 2014, our annual review as -- of asbestos and environmental exposures was completed in the second quarter. In 2015, that review will occur in the third quarter.

Also contributing to the decrease in the consolidated combined ratio in the period was a lower current accident year loss ratio resulting from lower attritional losses in our U.S. insurance and our Reinsurance segments in 2015 compared to 2014.

Next let's take a look at the results of Markel Ventures. During the first 6 months of 2015, revenues from Markel Ventures were $485 million compared to $355 million for the same period a year ago.

Net income to shareholders from Markel Ventures for the period was $8 million in 2015 compared to $5 million for the same period in 2014.

EBITDA was $47 million in the first 6 months of 2015 compared to $35 million in the same period of 2014. The increase in revenues from our Markel Ventures operations during 2015 was primarily due to our acquisition of Cottrell in July of 2014 and higher revenues within our manufacturing operations due in part to higher sales volume in 2015 compared to 2014.

Likewise, net income and EBITDA from our Markel Ventures operations increased in 2015, primarily due to our acquisition of Cottrell and more favorable results within our manufacturing operations. However, these increases were partially offset by an increase during the second quarter of 2015 in our estimate of the contingent consideration obligation associated with the acquisition of Cottrell.

Next, we'll turn to our investment results. Net investment income increased to $183 million for the first 6 months of 2015 compared to $179 million for the same period a year ago. The increase in net investment income in 2015 was primarily due to increased dividend income on our equity portfolio due to higher equity holdings in 2015 compared to 2014. Net unrealized investment gains for 2015 were $12 million compared to $25 million a year ago.

Net unrealized investment gains decreased $187 million for the first half of 2015 compared to an increase of $515 million for the same period last year. The decline in net unrealized investment gains this year was attributable to an increase in interest rates during 2015.

Looking at our total results for the year. Our effective tax rate was 16% for the 6 months ended June 30, 2015, compared to 24% for the same period a year ago. The decrease in the tax rate for the first 6 months of 2015 was driven by the recognition of U.S. tax credit for taxes paid in foreign jurisdictions.

As we discussed in the first quarter, we have paid taxes in foreign jurisdictions in previous periods, which have now been available for use as tax credits against our U.S. provision for income taxes. In 2015, we anticipated sufficient amount of earnings from our foreign operations will be taxable in the U.S., allowing us to now recognize these tax credits. A similar benefit may not be available in future years.

We reported net income to shareholders of $282 million in the first 6 months of 2015 compared to $128 million a year ago. Comprehensive income for the first half of 2015 was $149 million compared to $481 million a year ago. And as a result, book value per share at the end of June 2015 was $555 a share, an increase of 2% since the end of 2014.

Finally, I'll make a couple of comments on our cash flows and our balance sheet. Net cash provided by operating activities was $238 million for the first 6 months of 2015, flat to the same period a year ago. Operating cash flow for the first half of 2015 included higher cash flows from our Markel Ventures operations and lower payments for income taxes compared to the same period in 2014.

Operating cash flow for the period was net of approximately $100 million of cash paid for 2 ceded reinsurance transactions, which we completed in the period. Invested assets at the holding company were $1.4 billion at June 30, 2015, as compared to $1.5 billion at December 31, 2014.

With that, I'll turn it over to Mike to talk about our U.S. Insurance segment.

Francis Michael Crowley
Vice Chairman

Thanks, Anne. Good morning. U.S. insurance segment, as we said before, comprised of all direct business written on our U.S. insurance companies and includes all of the underwriting results of our Wholesale Specialty division as well as certain products written by our global insurance team.

The rate environment in the U.S. remains very competitive and relatively unchanged from the first quarter of 2015. We're hitting our rate targets for U.S. business in the Specialty and E&S divisions, achieving modest single-digit rate increases.

A large account in property and casualty business remains under significant rate pressure, and we're maintaining our underwriting discipline and walking away from business that we deem to be underpriced.

Britt Glisson and the global insurance team are continuing to look for opportunities on large accounts, but growth will be difficult to come by until the rate pressure subsides.

For the second quarter, the U.S. segment gross written premiums declined nearly 2% over the prior year, while year-to-date gross written premiums were flat to the comparative period. Decline in the quarter has been driven by lower premium from our Wholesale property line, where we continue to see soft market conditions as well as declines in our wholesale access and umbrella and environmental lines. In addition, we've exited several programs and changed our underwriting appetite for the architects and engineers line of business.

Offsetting these reductions, we've seeing continued growth in our Wholesale casualty lines as well as in the workers' comp and Hagerty Classic Car programs, both in our specialty division.

The combined ratio for the second quarter was 93% compared to 100% for the same period a year ago. Combined ratio year-to-date was 89% compared to 98% for the 6 months ended June 30, 2014.

Our loss ratio continued to benefit from lower attritional losses across multiple product lines in all 3 divisions. For the quarter, this benefit was most noticeable in the marine and professional liability product lines within our Global Insurance division. In our core product lines, we also saw more favorable development from prior year's loss reserves. Favorable development was most significant in our casualty, professional liability, workers' comp and brokerage property books. Our positive underwriting results reflect the number of initiatives put into place in 2014 by Jerry Albanese, our Chief Underwriting Officer, and his team. We believe that the steps we've taken to improve results are taking hold in having the desirable effects.

The third quarter is a busy time with the beginning of our 2016 budget process, and with both the NAPSLO and CIB annual conferences. We look forward each year to NAPSLO and CIB where we engage with our wholesalers, producers and reinsurers. These meetings provide a background for our 2016 planning process and gives us insight into what our producers are thinking about the new year.

With that, I'll turn it over to Richie.

Richard R. Whitt
Co-Chief Executive Officer and Director

Thanks, Mike, and good morning everybody. My comments are going to be extremely brief today. I'm going to focus on our underwriting results for the first half of 2015 for both the International Insurance and Reinsurance segments.

While not as strong as their excellent first quarter results, both segments continue to produce solid underwriting results for the first half of 2015. First, I'll start with the International Insurance segment, which includes business written by our Markel International division as well as that written by our Global Insurance division.

For the first half of the year, gross written premiums declined 4% to $627 million. The year-to-date combined ratio was 86% compared to 94% in the prior year. The decrease in premium writings is primarily due to the continued impact of the strong U.S. dollar. Excluding currency impact -- impacts, gross written premium volume actually increased to 1% due to continued growth in our professional liability product lines as well as growth across our retail product lines in the Markel International division.

This growth was partially offset by the continued decline in our marine and energy book due to the extremely competitive market conditions in that area.

The lower segment combined ratio was driven by more favorable prior year takedowns, partially offset by a higher current year expense ratio. The segment included approximately 4 points of favorable prior accident years movement related to the changes in estimated volatility of our loss reserves that Anne referred to in her comments.

We also experienced favorable development across our Global Insurance division, which had slight adverse development through 6 months of last year. The expense ratio has increased nearly 4 points due to higher profit-sharing costs and higher general expenses.

In the Reinsurance segment, which includes treaty reinsurance programs written by our global insurance division as well as that written by our Markel International division, gross written premium for this segment decreased 20% for the first 6 months to $637 million, down from $793 million a year ago.

As we disclosed at the end of last year, and Anne referred to it as well, we made the decision to stop writing U.K. motor business and to take smaller line sizes in our U.S. nonstandard auto books of business. This is now starting to show up in the gross written premium volume comparisons.

The year-to-date combined ratio for the Reinsurance segment was 94% compared to 97% last year. The reduction in the combined ratio was primarily, driven by a lower current accident year loss ratio, driven by lower property losses in the first half of the year compared to last year.

As Mike said, market conditions remain extremely competitive, but I would say there's not a whole lot of change from what we reported to you in the first quarter, quite honestly.

As always, we remain focused on underwriting discipline and generating underwriting profits. With that, I'd like to turn it over to Tom to discuss investments in Markel Ventures.

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

Thank you, Richie. I'd like to make a few comments about our investing in Markel Ventures operations this morning, that I hope will accurately describe our results and give you some insight about what we and you should expect going forward.

The investing message is short and straightforward, we made modest returns of 1.5% in our equity portfolio for the first 6 months and we were flat on our fixed income portfolio, as the slight rise in interest rates offset the modest coupon income from the portfolio. After the effects of foreign currency exchange rates are taken into account, we show a small loss of 0.5% for the entire portfolio due to our holdings of foreign currency bonds.

As a reminder, foreign holdings exist largely to match against our foreign currency insurance liabilities. The net effect to Markel from swings in the value of the dollar is as close to 0 as we can possibly make it. Our long-standing policy of matching our foreign liabilities to foreign assets remains in place and it has functioned well over many years. That we will continue to be our approach. But given the large moves in the dollar recently and the low level of interest rates, the relative contribution of that line item is bigger than normal. As such, I thought it was worthwhile to call it to your attention.

More importantly, the credit quality for the bond portfolio remains as close to pristine as we know how to make it. We have no credit losses to report to you. Over time, our credit losses round to 0 and we work assiduously to make sure that remains the case. It's been a long time since we've seen credit risk that we think is worth taking.

On the equity side, our positive return of 1.5% is modest at best and roughly in line with the overall market. From that return and the similar return of the S&P 500, you may think that we're looking at what a sailor would call becalm, not much wind or action.

I would beg to differ. In truth an interesting fact that I think begins to describe the somewhat tumultuous and fractured nature of the equity market so far in 2015. Specifically, the New York Times publishes a graphic everyday that shows the S&P 100 stocks by name. It shows each of these largest companies, the closing price and the 52-week range of the stock price. Also, it breaks that 52-week price range into a visual graph of 4 quartiles to indicate in which quartile the stock is trading.

In yesterday's graph of the top 100 stocks, 30 of them were in the bottom quartile and 48 were in the top quartile, leaving only 22 in the middle 2 quartiles combined. This strikes me as a relatively unusual distribution. If we were in rip-roaring bull market, you'd expect to see a bunch of the companies in the top quartile and very few at the bottom. In a tough bear market, you'd expect to see a bunch of companies in the bottom quartile and a very few of the top.

This market is bizarre to me. They've got a disproportionate number of names at the top and a disproportionate number of names at the bottom at the same time, with very few companies in the middle of the range. To me, this illustrates the volatility and somewhat topsy-turvy nature of things right now.

I apologize for my use of such technical terms. More importantly, my point, and I do have one, is that I believe this represents a real opportunity for us.

During the first 6 months of the year, we've increased our equity holdings, as a percentage of our shareholders' equity, from 54% to 56%, with our steady and unrelenting program of regular additions to the equity portfolio. With the price volatility present in the markets, I believe we've been able to purchase shares in high-quality companies at very reasonable prices as they go on sale and that we're stocking the pipeline for attractive future returns.

Specifically, we continue to acquire holdings in energy, finance and consumer products businesses that meet all of our 4-point test, and I'm optimistic about the future returns we'll see from doing so. Expect us to continue this approach.

As to Markel Ventures, we enjoyed a much better first half than what the recorded EBITDA numbers would suggest at first glance. For the first half, reported EBITDA was $46.8 million compared to $35.1 million a year ago. This was a 33% increase and not bad. The EBITDA of this year of $46.8 million though comes after a charge of $17.6 million, stemming from a recent acquisition that's actually doing better than what we expected when we purchased it. We have an earn-out agreement associated with the purchase and we will pay additional consideration for the company due to the fact that they are doing well, that's a good thing. And as such, I would view the apples-to-apples comparison of Markel Ventures EBITDA at $64.2 million versus $35.1 million, an increase of 83.4%. It strikes me as former accountant that what we pay for a company is a capital transaction and belongs in the balance sheet accounts rather than the income statement. But current accounting rules treat this differently. As such, the good economic fact that the business we bought is doing better than we expected shows up as a cost in our income statement. Warren Buffett discussed this sort of accounting issue and its implication in the 2012 Berkshire Annual Report, it's on Page 13, if you'd like to study the matter further. The very good news is that the aggregate economic performance of our Markel Ventures companies is very positive in 2015, and we continue to expect a good year overall.

They are now causing this particular accounting [indiscernible] end in 2015, again, my apologies for using such technical terms. Starting next year, the good news should just be good news and bad news will just be bad news, at least as far as our existing operations are concerned. As we acquire new companies within Markel Ventures, we will continue to face accounting decisions and we'll continue to try to translate for you into how we think about the underlying economics of our businesses are doing.

In the current marketplace, we seek more opportunities to buy attractively priced publicly traded securities than private businesses so we are allocating our capital more towards public markets. We'll continue to actively hunt for opportunities in both arenas, and I'm optimistic we'll find treasures in both markets, that's one of the true beauties of Markel and that we are able to pursue the highest and best returns no matter where they might be.
We have a full 360-degree view of insurance, industrial and public and private debt and equity markets, and we're comfortable in deploying capital into any and all of them, as circumstances arise. We're delighted with the long-term results from doing so, and we look forward for continuing these activities in the future. With that, we look forward to your questions. If you'd be so kind as to open, we'll take any questions.

Question and Answer

Operator

[Operator Instructions] And the first question we have from Mark Dwelle of RBC.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

A couple of numbers questions to start off with. The expense ratio in the quarter was a little bit higher than where it had been running for the last several quarters. And I was wondering if there was anything unique or unusual in the quarter or any other factor that might explain it?

Anne G. Waleski
Chief Financial Officer and Executive Vice President

Hi, Mark, it's Anne. Sort of to Tom's point about good news, in fact, we did make an adjustment to the profit-sharing accrual during the quarter based on the results year-to-date, so that's what you're seeing pushed through in the expense ratio. It's about 2 points in the quarter, I think.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay, very good. The second question relates to amortization expense, which is normally pretty stable but it kind of popped up relative to the last several quarters' runway. Was there some revisitation of prior acquisitions or something in that?

Anne G. Waleski
Chief Financial Officer and Executive Vice President

We did a -- we've been working on a -- for lack of a better term, simplification within the legal entity structure. And we closed off the legacy Europe operations of Alterra, then we finalized that at the beginning of the year. So there was a write-off for some licenses that they held. And you saw that in the quarter. That's what I think you're seeing there.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

I see. So sort of one-off there on that.

Anne G. Waleski
Chief Financial Officer and Executive Vice President

Correct.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. The third question, Tom mentioned the earn-out related to Cottrell. Was that all in the second quarter results or was there any in the first quarter?

Anne G. Waleski
Chief Financial Officer and Executive Vice President

There was nothing in the first quarter. You're seeing the change come through in the second quarter to the extent that the forecast for Cottrell moves around, you could see some movement up or down in the third and fourth quarter. So we're not expecting it to be a material move.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. And then the last question I had related to the tax rate, and I think I understand from last quarter how that was meant to be calculated and estimated. And I guess what confused me is that the tax rate that came down in the quarter, relative to the first quarter, yet the earnings related to the related international entities were actually worse in the second quarter than the first quarter. So that seems counterintuitive, and I was hoping you could help me reconcile it.

Anne G. Waleski
Chief Financial Officer and Executive Vice President

Yes, I think the thing to remember there is that it's all about what portion of the foreign operations get taxed in the U.S. And during the quarter, when we did the provision work, the amount of foreign income that we expect to be taxed in the U.S. declined.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. Maybe I'm not sure I understand that last point.

Anne G. Waleski
Chief Financial Officer and Executive Vice President

I'm not exactly sure how to articulate it differently. But not all of our foreign operations get taxed in the U.S. So when we do the provision work, we have to do an allocation to determine how much of it we expect will be taxed in the U.S. and...

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

I see. It's not just what you earned, it's very specifically exactly where you earned it which is in something you...

Anne G. Waleski
Chief Financial Officer and Executive Vice President

That's correct.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Which isn't something that anybody with my level of financial statements is ever going to see, it will be something that your internal level that you'd be able to track.

Anne G. Waleski
Chief Financial Officer and Executive Vice President

That's right. And if it makes you feel any better, it's as challenging for us as it probably seems to you.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

I guess the last question to that point is, shall I think about the 16% year-to-date run rate as being the best estimate to think about for the balance of the year? Or should it be more. . .

Anne G. Waleski
Chief Financial Officer and Executive Vice President

Okay. That's right. Although just to so -- to make sure we're all sort of talking about the same thing is that would be our estimates for the year that we would expect for future years our best estimate is what the historical run rate has been, so low to mid-20s.

Operator

[Operator Instructions] Well, at this time, we're showing no further questions, and we'll go ahead and conclude the question-and-answer session. I will now like to turn the conference back over to management for any closing remarks. Ms. Waleski? Gentlemen?

Alan I. Kirshner
Executive Chairman

Over to management for any closing remarks. Ms. Anne Waleski, gentleman?

Thomas Sinnickson Gayner
Co-Chief Executive Officer and Director

Thank you very much. It's glad to be with you. Talk to you soon. Bye-bye.

Operator
And we thank you, sir, and to the rest of the management team for your time also today. The conference call has now concluded. At this time, you may disconnect your lines. Thank you. Have a great day, everyone.