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Fairfax Financial Holdings Limited TSX:FFH

Earnings Call

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Call Participants

EXECUTIVES

Derek Bulas
VP & Chief Legal Officer

Jennifer J. S. Allen
VP & CFO

Peter S. Clarke
President & COO

V. Prem Watsa
Founder, Chairman & CEO

ANALYSTS

Tom MacKinnon
BMO Capital Markets Equity Research

Presentation

Operator

Good morning, and welcome to Fairfax's 2023 Third Quarter Results Conference Call.

[Operator Instructions]

Today's conference is being recorded. If you have any objections, you may disconnect at this time. Your host for today's call is Prem Watsa with opening remarks from Mr. Derek Bulas. And Mr. Bulas, please begin.

Derek Bulas
VP & Chief Legal Officer

Good morning, and welcome to our call to discuss Fairfax's 2023 third quarter results. This call may include forward-looking statements. Actual results may differ, perhaps materially from those contained in such forward-looking statements as a result of a variety of uncertainties and risk factors, the most foreseeable of which are set out under Risk Factors in our base shelf prospectus, which has been filed with Canadian securities regulators and is available on SEDAR. Fairfax disclaims any intention or obligation to update or revise any forward-looking statements, except as required by applicable securities law.

I'll now turn the call over to our Chairman and CEO, Prem Watsa.

V. Prem Watsa
Founder, Chairman & CEO

Thank you, Derek. Good morning, ladies and gentlemen. Welcome to Fairfax's 2023 Third Quarter Conference Call. I plan to give you a couple of highlights and then pass the call on to Peter Clarke, our President and Chief Operating Officer, to comment on the quarter; and Jen Allen, our Chief Financial Officer, to provide some additional financial details.

As I've said for the last number of quarters, the most important point I can make for you is to repeat what I've said in the past. For the first time in our 37-year history, almost 38 years now, I can say to you, we expect, of course, no guarantees, our operating income to be more than $3 billion annually for the next 3 years.

Operating income consisting of $1.5 billion plus from interest and dividend income. We earned $1.4 billion year-to-date, $1 billion from underwriting profit. We made $943 million year-to-date and $0.5 billion from associates and noninsurance companies versus $1 billion year-to-date. This works out to be over $100 per share after interest expenses overhead and taxes.

We continue to exceed our expectations for the year with the year-to-date operating income already at $3.1 billion, excluding the effects of discounting and risk margin. Fluctuations in stock and bond prices will be on top of that. And this only really matters, as I've said many times over the long term.

Recently in October, during the spike in treasury yields, we have extended our duration to 3.1 years, with an average maturity of approximately 4 years at a yield of 4.9%.

In the next 4 years, we are likely to have a recession in the United States, resulting in corporate spreads widening, allowing us to extend our maturities further. Our fixed income portfolio remains conservatively positioned with approximately 70% in government securities and 19% primarily in short-dated, high-quality corporate bonds. Insurance and reinsurance operations continue to perform exceptionally well with gross premiums written for the 9 months of $22 billion, up 7.5%, a combined ratio of 94%, resulting in an underwriting profit of $943 million for the first 9 months.

I will now pass the call to Peter Clarke, our President and Chief Operating Officer for further updates. Peter?

Peter S. Clarke
President & COO

Thank you, Prem. We had an outstanding third quarter of 2023 with net earnings of almost $1.1 billion and our book value increased to $877 per share, an increase of 16.4% from year-end. That's adjusted for our $10 dividend.

And earnings per share in the quarter was $42. The strong performance in the quarter was driven by adjusted operating income of $967 million from our insurance and reinsurance operations generated through underwriting income of $292 million, interest and dividend income of $454 million and our share of profit of associates of $222 million. Our investment return for the quarter was 1.5%, driven by continuing increase interest and dividend income, strong share of profits of associates, while net gains in the quarter were relatively flat.

Consolidated interest and dividend income of $513 million doubled from the third quarter of 2022, benefiting from a very low duration of our fixed income portfolio coming into 2022 and then reinvesting at higher rates primarily in government bonds. Net gains on investments of $56 million were driven by gains in our equity exposures of $273 million offset by losses on our bond portfolio of $197 million in the third quarter.

These losses consisted primarily of losses from U.S. treasuries due to increased interest rates in the quarter. Our fixed income duration at the end of the quarter continued to be relatively short at 2.3 years and as Prem mentioned earlier, in the fourth quarter, we have increased our duration to over 3 years.

Net gains on our equity and equity-related holdings were $273 million in the quarter, driven by unrealized mark-to-market gains on our Fairfax TRS, Commercial International Bank and John Keells, offset by unrealized losses on BlackBerry and Kennedy Wilson.

As mentioned in previous quarters, our book value per share of 877 does not include unrealized gains or losses in our equity accounted investments and our consolidated investments, which are not mark-to-market. At the end of the third quarter, the fair value of these securities is in excess of carrying value by $601 million, an unrealized gain position or approximately $26 per share on a pretax basis. Under IFRS 17, our net earnings are affected by the discounting of our insurance liabilities and the application of a risk adjustment.

In the third quarter of 2023, our net earnings benefited by $459 million pretax from the effects of discounting losses occurring in the current quarter, changes in the risk margin, the unwinding of the discount from previous years and changes in the discount rate on prior year insurance liabilities.

As interest rates move up and down, we will see positive or negative effects on earnings from discounting. Our insurance and reinsurance businesses continue to grow less than previous quarters, although we still see positive momentum as we wrote $7.2 billion of gross premium in the third quarter of 2023.

Our gross premiums were up 5% this quarter versus the third quarter of 2022, an increase of $350 million. The growth is driven by continued rate and strong margins that prevail in many of our markets, driven by increased pricing in our reinsurance business and international markets.

Our North American Insurance segment increased gross premiums by $196 million or 9.7%. Crum & Forster had double-digit growth at 13% driven by its surplus in specialty lines, Accident & Health business and Seneca Insurance. Northbridge was up almost 10% in Canadian dollars reflecting excellent customer retention and rate increases. And the premiums were offset by Zenith premiums that were down 5% year-over-year, driven by the competitive workers' compensation market.

Our global insurer and reinsurer segment was relatively flat with gross premiums increasing $65 million, up 1.6% in the third quarter versus the third quarter of 2022. Allied World was up 6.5% in the quarter, led by its reinsurance segment, which had double-digit growth, while its insurance segment was flat.

Odyssey Group was up approximately 0.5 point with reinsurance up over 10%, primarily in North American property, while its insurance business was down 12%, principally from Hudson Insurance in its financial and crop lines of business. Brit's premium was down 4%, largely due to reductions in its casualty and FinPro business, while key premium was down a similar amount.

The premium of our international operations again posted double-digit growth at 11.2% in the third quarter versus the third quarter of 2022, with gross premium of $848 million. Growth was exceptionally strong at Polish Re, Colonnade and Eurolife's non-life operations while Fairfax Asia was down on a gross basis due to timing differences, while maintaining strong growth in net premiums written.

On closing of our acquisition of an additional 46% of Gulf Insurance, which we expect to occur in the fourth quarter of 2023, we will begin consolidating the results adding an approximate $2.7 billion in gross premium annually to our international business. The long-term prospects of our international operations are excellent and will be a significant source of growth over time, driven by excellent management teams, underpenetrated insurance markets and strong local economies.

Our companies continue to grow into favorable market conditions, while we see rate increases moderating or rates reducing in some lines, public D&O, workers' compensation and cyber, for example. Overall margins remain attractive. The reinsurance market continues to harden, especially for Property business, and we expect that will continue into 2024. Our combined ratio was 95% in the third quarter of 2023, producing an underwriting profit of $292 million.

The combined ratio included catastrophe losses of $389 million adding 6.7 combined ratio points, primarily from Hawaiian, the Hawaii fires, Hurricane Idalia and attritional catastrophe losses. This compares to a combined ratio of 100.3% and catastrophe losses of 15 points in the third quarter of 2022.

As our premium base has expanded significantly, and with the benefits of diversification, we expect to be able to absorb significant catastrophe losses within our underlying underwriting profit. Our global insurers and reinsurers posted a combined ratio of 92.7% led by Allied World, who had another great quarter with a combined ratio of 89.3%. With its global insurance segment producing an 88.3% combined ratio, while its reinsurance segment was at 91.4%.

Odyssey Group had a solid combined ratio of 94.7%, while Brit produced another strong quarter with a combined ratio of 94%. Our North American insurers had a combined ratio of 98.3% led by Northbridge who had another strong quarter with a combined ratio of 88.7%. Crum & Forster had a combined ratio of 105% for the quarter, which included catastrophe losses of 9.4 points principally from losses from the fires in Hawaii.

Crum & Forster has had a strong presence in Hawaii and have been in the market for many years. Zenith had a combined ratio of 92.8% producing an underwriting profit in the quarter while benefiting from favorable reserve development. Our international operations delivered a combined ratio for the quarter of 98.5% with all but 1 segment producing an underwriting profit.

Fairfax Asia had a combined ratio of 93.7% and our Latin American operations came in at 94.2%. Eurolife's non-life operations had a difficult quarter as they were hit hard by catastrophe losses, which amounted to $18 million from the wildfires in Greece and Storm Daniel.

Excluding catastrophe losses, our international operations posted a combined ratio of 93.7%. For the quarter, our insurance and reinsurance companies recorded favorable reserve development of $56 million or a benefit of 1 point on our combined ratio. This is compared to $48 million or the benefit of 0.9 points in 2022. Our companies are in the process of doing their extensive annual actuarial reviews, which will be reflected in the fourth quarter.

Our underwriting expense ratio was up approximately 1.2 combined ratio points in the third quarter of 2023 versus the third quarter of 2022, partially due to the effect of inflation on salaries and investments in people and technology and the timing differences at Brit, offset by increased earned premiums.

Through the first 9 months of the year, our underwriting income is approaching $1 billion while continuing to grow profitably. We are led by exceptional management teams and our companies are positioned very well to capitalize on their opportunities in their respective markets.

I will now pass the call to Jen Allen, our Chief Financial Officer, to comment on our noninsurance company's performance, overall financial position and recent transactions.

Jennifer J. S. Allen
VP & CFO

Thank you, Peter. As we disclosed in our first quarter 2023 interim report on January 1, '23, the company adopted the new accounting standard for insurance contracts, IFRS 17. Within our Q3 2023 interim report, please refer to Note 3 in sections within the MD&A under the heading Adoption of IFRS 17 Insurance Contracts on January 1, 2023, and the heading Accounting and Disclosure Matters for details on the adoption and the impact on our consolidated financial statements for this new standard.

Consistent with our Q1 and Q2 2023 interim reports, the comparative periods in the company's Q3 2023 interim report have all been restated and presented under the IFRS 17 measurement standard. So all the comparators now presented in our Q3 interim report are on the same measurement basis.

In our Q3 2023 press release, please refer to Page 2 and in the MD&A, Page 43 where we disclose tables that reconcile the insurance service result under IFRS 17 for our property and casualty insurance and reinsurance operations to underwriting profit. The key performance measures that the company uses and the property and casualty insurance industry uses in which we operate to evaluate and manage the business.

As a reminder, the primary reconciling adjustments presented in these tables are, first, we adjust to include other insurance operating expenses, which are presented in the consolidated statement of earnings outside of the insurance service results; and second, we adjust for the effects of discounting on net loss on claims and changes in the risk adjustment that are included within the insurance service results and the consolidated statement of earnings.

Our traditional performance measures of underwriting profit and combined ratios were on an undiscounted basis, as discussed by Peter. So I'll begin my comments for the third quarter of '23 on the impact of IFRS 17 within our results. In the third quarter of 2023, net earnings of just under the $1.1 billion and for the 9 months, just under $3.1 billion, included a pretax net benefit of $459 million and $991 million, respectively, related to IFRS 17.

These pretax benefits are reported within 2 financial statement lines in our consolidated statement of earnings. First, included within our insurance service result line was the benefit of discounting losses and ceded loss on claims, net of changes in risk adjustment that were recorded in the third quarter of 2023 of $467 million and $1.6 billion in the first 9 months.

This was partially offset by the second component that we present on a separate line in our financial statements and the net finance expense from insurance and reinsurance contracts of $8 million in the quarter and $595 million in the first 9 months. This was comprised of interest accretion or an expense of $369 million in the quarter and approximately $1 billion in the first 9 months, resulting from the unwinding of the effects from discounting associated with net claim payments made during the period and that was partially offset by the effective increase in discount rates during the third quarter and first 9 months of '23, which was a benefit of $362 million and $452 million, respectively.

This compared to a pretax net benefit in the third quarter of 2022 of $772 million and approximately $2.5 billion in the first 9 months of 2022 which was comprised of the same components I just commented on for 2023, which was mainly the insurance service result, benefiting from discounting on loss and ceded loss on claims, net of our risk adjustment of $349 million for the quarter '22 and $916 million for the 9 months of 2022.

But unlike 2023, '22 also benefited from net finance income versus the expense in '23 of $423 million and just under $1.6 billion for the first 9 months. In '22, it reflected a benefit from the increase in the discount rates in the respective periods of $563 million and approximately $1.8 billion as a result of the interest rate environment being more pronounced in 2022 compared to '23.

And this was offset by the interest accretion or the expense of $140 million and $232 million in the first 9 months of 2022 related to the unwinding of those discounts associated with net claim payments made in the period. A final comment on the rising interest rate environment that continued in the first 9 months of 2023 and how it impacted our results. The company's asset and liability duration is not matched. And as a result, earnings before income taxes included a net benefit of $165 million in the third quarter and $169 million in the 9 months of 2023 that reflected the longer duration in our net insurance contract liabilities compared to the fixed income portfolio assets.

In this rising interest rate environment, as I noted previously, the company reported net finance income from insurance contracts held as a net benefit of $362 million in the third quarter and $452 million in the first 9 months of '23 that related to the effect of the increase in the discount rate on the net insurance contract liabilities that have an average duration of approximately 4 years. This exceeded the net loss on the bonds of $197 million in the third quarter of 2023 and $283 million in the first 9 months of 2023, recorded on our shorter duration fixed income portfolio.

Please refer to Note 4 in our Q3 2023 interim report for additional details on the discount rates applied on the losses and ceded loss on claims recorded within the period.

Moving on to a few comments on our noninsurance companies results in the quarter. The operating income of the noninsurance companies in the third quarter of 2023 were comparable to 2022 with strong results of $126 million.

Excluding the impact of Fairfax India's performance fees to Fairfax which was an accrual of $20 million and $5 million in the third quarter of 2023 and 2022, respectively, which are offset upon consolidation. The operating income for the noninsurance companies reporting segment increased to $146 million in the third quarter of '23 from $130 million in the prior period, principally reflecting higher business volumes and continued stable results produced by our Restaurant and Retail Operating segment.

The operating income of the noninsurance companies reporting segment marginally increased to $162 million in the 9 months of '23 from $160 million in the 9 months of '22. If you exclude the impact of Fairfax India's performance fees to Fairfax, which was an accrual of $42 million in the first 9 months of 2023 and a reversal of a performance fee payable of $45 million in the first 9 months of '22, the operating income increased to $204 million in the first 9 months of '23 from $115 million in the first 9 months of '22.

With that increase of $89 million, reflecting lower losses from our other reporting segment of $60 million that reflected a noncash impairment charge related to the company's investment in Farmers Edge that was recorded in the first 9 months of 2022, which was partially offset by higher business volume at AGT.

We also saw higher operating income at Fairfax India of $25 million, primarily due to the increase in share profit of associates and higher operating income at Thomas Cook of $22 million, reflecting higher business volumes in all segments, resulting from increased domestic and international travel as the hospitality industry has continued to show significant recovery in 2023.

Turning to our share of profit from investment in associates. In our third quarter, investments in associates modestly decreased in the third quarter of '23, with share of profits of associates of $292 million compared to $318 million in '22 reflecting no share profit from Resolute, reduced share of profits from EXCO, partially offset by increased share of profit from Eurobank at $119 million, compared to $80 million in the prior year and Stelco at $21 million compared to no share profit in the prior year due to the commencement of equity method of accounting in Q2 -- sorry, Q3 2022.

Our share of profit from investments in associates increased in the 9 months of '23 to $895 million compared to $764 million in 2022 reflecting increased share of profit at Eurobank about $344 million compared to $230 million in the prior year.

EXCO Resources, $130 million compared to $43 million which was partially offset by no share of profit from Resolute as a result of our disposition of that investment and also reduced share of profits of Poseidon, formerly known as Atlas of $102 million compared to $180 million in the prior period reflecting higher interest rate expenses and transaction costs that related to the first quarter 2023 privatization of

Poseidon and the company expects Poseidon's earnings will start to normalize and continue to increase throughout the year.

As there were no significant acquisitions or divestitures that closed during the third quarter, I'll close with a few comments on our financial condition. The liquidity position of the company remains strong with our cash and investments at the holding company at $1.2 billion at September 30, 2023, which was principally held in cash and short-dated investments and access to our fully undrawn $2 billion unsecured revolving credit facility.

At September 30, 2023, the excess of fair value over carrying value of investments in noninsurance associates in market-traded consolidated noninsurance subsidiaries was $601 million compared to $310 million at December 31, 2022. That pretax excess of $601 million is not reflected in our book value per share, but is regularly reviewed by management as an indicator of investment performance.

Please refer to the MD&A on Page 67 for additional details. The holding company has no significant holding company debt maturities until August 2024 and our total debt to total cap ratio, excluding the noninsurance companies, improved to 21.6% at September 30, 2023, compared to 23.7% at December 31, 2022, principally as a result of very strong net earnings reported in the first 9 months of 2023 of just under the $3.1 billion that reflected the underwriting profit of $943 million, interest and dividends of just under $1.4 billion and the share of profit of associates of $895 million.

And lastly, our common shareholders' equity increased by $2.5 billion to $20.3 billion at September 30, 2023, up from the $17.8 billion at December 31, 2022, and that was principally as a result of our net earnings in the first 9 months of '23 of the $3.1 billion that was partially offset by payments on our common and preferred share dividends of $282 million, and we purchased approximately 258,000 voting shares for cancellation for cash consideration of $180 million, approximately $698 per share, with 78,000 purchased in the third quarter of 2023 for cash consideration of $55 million.

That concludes my remarks for the third quarter of 2023, and I'll pass the call back over to Prem. Thank you.

V. Prem Watsa
Founder, Chairman & CEO
Thank you, Jen. We now look forward to answering your questions. Please give us your name and your company name and try to limit your questions to only one, so that it's fair to all on the call. Okay, Fran, we are ready for the questions.

Question and Answer

Operator

So our first question now is from Mr. Tom MacKinnon with BMO Capital.

Tom MacKinnon
BMO Capital Markets Equity Research

Just a question here about the topline growth or the gross premium growth. And you talked about some pretty good growth in your North American insurance operations. But then when we get into reinsurance, while you're getting good topline growth in their reinsurance business per se in that category. The growth in their insurance business, i.e., Allied World and at Odyssey Re and at Brit for that matter, have been -- are declining.

So why is it that you're able to get some growth in your North American insurance business? But then if we look at your reinsurance companies, what's categorized as insurance in those is not growing. So maybe a little -- if you can help us understand that and what you see as growth going forward.

V. Prem Watsa
Founder, Chairman & CEO

Tom, that's a good question. The reinsurance markets continue to be hard. But Peter, why would you give us [two cents] for what's happening in the market?

Peter S. Clarke
President & COO

And yes, so in the quarter, our premium was up about 5%, Tom, and about 7.5% through the first 9 months. And just to remind everyone that, that's on the back of 3 very strong years where we averaged about 16% growth per year. But as you mentioned, for Odyssey, Allied and Brit, on the insurance side, their premium relatively flat for the year and in the quarter. And -- but those are the lines of business where they grew significantly the last number of years, specifically cyber, D&O, et cetera. And so in the insurance segment, we have a Crum & Forster and Northbridge. So Northbridge is Canadian. So that's a little different than what Allied and Odyssey is writing on the direct book. And Crum & Forster is really more specialty business.

And they're, again, seeing a lot of growth in A&H, which isn't -- which Odyssey and Allied don't write a lot of.

For Brit, I should mention we talked about this a little bit in the past that Brit has really done -- taken some underwriting actions over the last 12 months. And you see that in their premium. Their premium was down about 3% or 4% in the quarter. But maybe more importantly, was their combined ratio was also down. So we're seeing those actions come through on the bottom line. And obviously, that's what's most important for us.

Tom MacKinnon
BMO Capital Markets Equity Research

Okay. And if I could just squeeze one more in here. Just with respect to more of a stable interest rate environment, now that you are kind of more matched with respect to your liabilities and your assets, the $459 million kind of net benefit that we saw, at least as if we take out the changes in the risk adjustment impact, that was still in the area of $380 million or $370 million. Wouldn't we find that overall that the combination of the finance expense, this discounting and changes in market value of the bonds? Now that you're more matched, would there be kind of less noise in this net benefit item going forward?

V. Prem Watsa
Founder, Chairman & CEO

Yes. So Tom, first of all, what we're going to do in our annual report is made of -- I'm going to make sure that everyone understands all the ins and outs, okay? So it will take some time to disclose in enough detail, but so that you can understand the ins and outs of discounting. But having said that, Peter, you want to add to -- you want to reply to Tom's question?

Peter S. Clarke
President & COO

Yes, sure. I'll make a couple of comments and then maybe Jen can add if she wants. But I think, generally speaking, Tom, you're right that if interest rates are flat, premium is flat, more or less, the discount you put on the current year is more or less offset on the unwinding of the discount from the previous years. And then as if by chance, the bond maturity is very similar to the duration on our liabilities, that matches as well. When those relationships change, you're going to see movements. But generally speaking, I think as things remain stable, you'll see less noise around the discount. Jen, anything?

Jennifer J. S. Allen
VP & CFO

Yes. No, I think that's a fair statement. Tom, the way we think about it is how I commented in the -- my comments in the earlier part of the call, which is if you kind of look at that net financing, look at the change in rates compared to your bond portfolio, you saw a benefit of net 165 in the quarter. That would go away as the interest rate environment was static. So the last 2 pieces you're looking at is the new change in discount rates and the unwind. And as Peter said, it's still a net benefit because we are unwinding at a longer rate than the new claims are coming on. But over time, it's not a huge impact. And over time, you should start to see that kind of net to almost a nominal impact.

Operator

At this time, I have no further questions in queue.

V. Prem Watsa
Founder, Chairman & CEO

Okay. That's terrific. Tom, you're the only guy to ask the question. We thank you all for joining our conference call and we look forward to our year-end call in February. Thank you. Thanks again. Thank you, Fran.

Operator
You're most welcome. Thank you, everyone, for your participation. As we are concluded, please disconnect at this time. Thank you very much.