S&P Capital IQ

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Fairfax Financial Holdings Limited TSX:FFH

FQ1 2011 Earnings Call Transcripts

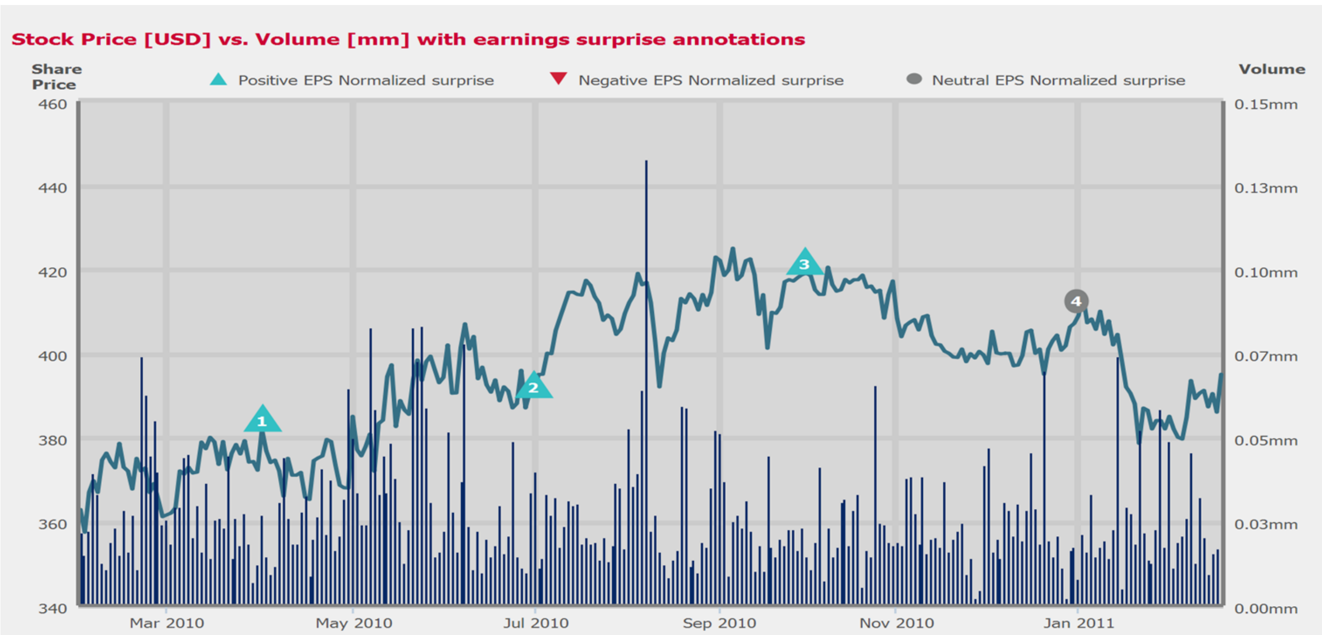
Friday, April 29, 2011 12:30 PM GMT

S&P Capital IQ Estimates

	-FQ1 2011-			-FQ2 2011-	-FY 2011-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS
EPS Normalized	(4.25)	2.87	NM	6.49	15.30
Revenue (mm)	1462.65	1564.20	▲6.94	-	-

Currency: USD

Consensus as of Apr-28-2011 10:02 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ1 2010	7.35	14.02	▲1 90.75 %
FQ2 2010	5.80	15.49	▲2 166.61 %
FQ3 2010	6.24	10.24	▲3 64.10 %
FQ4 2010	(5.68)	(18.43)	NM

Call Participants

EXECUTIVES

Bradley Paul L. Martin
Vice President of Strategic Investments

John Charles Varnell
Vice President of Corporate Development

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

ANALYSTS

Jeffrey Michael Fenwick
Cormark Securities Inc., Research Division

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Tom MacKinnon
BMO Capital Markets Equity Research

Presentation

Operator

Good morning, and welcome to Fairfax 2011 First 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 Brad Martin. Mr. Martin, please begin.

Bradley Paul L. Martin
Vice President of Strategic Investments

Good morning. Welcome to the conference call to discuss Fairfax's first quarter 2011 results.

The comments we make during this conference call may contain forward-looking statements. Actual results may differ, perhaps, materially from those contained in such forward-looking statements, as a result of a large variety of uncertainties and risks factors, the most foreseeable of which are listed in Fairfax's Annual Report, which is available on our website at fairfax.ca, or are set out under Risk Factors in Fairfax's base shelf prospectus, filed with the securities regulatory authorities in Canada and the United States, which is available on SEDAR and EDGAR.

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

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Thank you, Brad. Good morning, ladies and gentlemen. Welcome to Fairfax's first quarter conference call. I plan to give you some of the highlights, and then pass it on to John Varnell, our CFO, for additional financial details. In the first quarter of 2011, book value per share decreased by 3.1%, adjusted for the $10 per share common dividend paid in the first quarter of 2011. And our book value went down to $355 approximately per share.

This is our first quarter reporting under International Financial Reporting Standards, IFRS. Our investments are now shown at market value at the end of the quarter, and the fluctuation in market values flows through the income statement.

Highlights during the quarter include: We had a net loss of $240.6 million in the first quarter of 2011, $12.42 per share, mainly because of $217.7 million after-tax losses from the Japanese earthquake and net investment losses of $101.5 million. The company's estimation of its losses from the Tohoku, Japan earthquake event assumes an approximately $30 billion industry loss, and is based on a combination of model information, underwriter analysis, blind discussions and a profile of exposed limits within the affected region.

The nature and scale of the loss and its recent occurrence introduces significant uncertainty to the loss estimation process. Therefore, we feel the ultimate losses could differ, perhaps materially, as further information becomes available. The $217.7 million of after-tax losses from the Japanese earthquake was under 3% of shareholders' equity, well within our risk tolerance limit and towards the lower end of industry experience.

Fairfax had total cat losses from the Japanese earthquake, as well as from the New Zealand earthquake and the Australian floods, amounting to $404.4 (sic) [$401.4] million pretax or 32.8 percentage combined ratio points in the quarter -- 32.8 combined ratio points in the quarter. Excluding these cat losses, we had a Combined Ratio of 97.5%.

While we suffered significant cat losses from Japan, New Zealand and Australia, our thoughts and prayers, of course, go to the families that have been affected by these massive natural disasters.

We expect these cat losses to have an impact on catastrophe pricing worldwide. We have to wait and see the impact on pricing generally across all lines in the property casualty industry. We have a strong financial position to take advantage of a hard market, and we continue to wait patiently for such an opportunity.

Net investment losses of $101.1 million -- or $101.5 million in the first quarter of 2011 consisted of the following, and this will be on Page 2 on our press release. And in that table that we have, and we will disclose this table on a regular basis every quarter, you can see net gains on equity and equity-related investments of $622 million, predominantly unrealized, and were largely neutralized by net unrealized losses of $428 million on our equity hedges. Unrealized bond losses of $133 million and $167 million in unrealized CPI-linked derivatives resulted in a net loss of $101.5 million, all unrealized.

Net premiums written by the company's insurance and reinsurance operations in the first quarter of 2011 increased 28% to approximately $1.4 billion from $1.09 billion in the first quarter of 2010, due primarily to the acquisition of Zenith National and First Mercury. The company held a little more than $1 billion of cash, short-term investments and marketable securities at the holding company level at March 31, 2011, compared to $1.5 billion at December 31, 2010. The decrease in cash and marketable securities is a result of the acquisitions of First Mercury and Pacific Insurance Berhad of Malaysia.

Finally, we continue to be approximately 83.1% hedged in relationship to our equity and equity-related securities. Equity-related securities are predominantly convertible bonds and convertible preferred stocks.

Now I would like to turn it over to John, so he can give you some more information on the underlying financials. John?

John Charles Varnell
Vice President of Corporate Development

Thanks, Prem. I'll talk to you about our changed International Financial Reporting Standards first, then a little bit on investment income, then operating company results in particular, and finally, a little bit on our financial position.

The adoption of the International Financial Reporting Standards, or IFRS, did not have a significant impact on our book value per share. However, it will impact the manner in which we report unrealized net gains and losses going forward. The IFRS impact on our book value at December 31, our consolidated book value was about $70 million lower than what had previously been reported under Canadian GAAP. And that equates to about a $3 per share decrease. The principal adjustments related to the decrease were, the first one was the recognition of unamortized actuarial gains and losses of pension and postretirement benefits, and the second item was certain adjustments to our deferred tax assets, where amounts previously deferred under Canadian GAAP are not deferred under IFRS.

As Prem said, going forward, we'll report all unrealized net gains and losses on investments other than equity accounted investments and net earnings, previously under Canadian GAAP, unrealized gains and losses were recorded in either net earnings or other comprehensive income depending on their classification.

On investment income. Interest and dividend income in the first quarter of 2011 increased by 2.9% to $179 million from the first quarter of 2010 of $174 million. On a pretax equivalent basis, we own about $4.4 billion of tax advantage municipal bonds. And therefore, interest in dividend income, if you grossed it up to the tax advantage, it would've equated to about $200 million.

The average portfolio size during the first quarter of 2011 was almost $23.6 billion compared to just under $22 billion in the first quarter of 2010. Our annualized portfolio yield in the first quarter was 2.93% compared to the first quarter of '10, where the yield was 3.32%.

Turning to operating company results, starting with Odyssey. Odyssey was obviously affected by the Japanese earthquake losses. In the first quarter of 2011, Odyssey had a combined ratio of 150% and an underwriting loss of $227 million. In the first quarter of 2010, Odyssey had a combined ratio of 112.8% and an underwriting loss of about $58 million.

The first quarter 2011 combined ratio included 66 combined ratio points or $297 million net of reinsurance and reinstatement premiums related to cat losses. Compared to Odyssey's cat losses, pretax net to them in the first quarter of 2010, of about $118 million or about 26 combined ratio points, mostly related to Chile.

The first quarter of 2011 underwriting result for Odyssey included 1 combined ratio point or $4.7 million attributable to net favorable development of prior year's reserves. Without the Japanese, New Zealand and Australia cats, Odyssey would've had a combined ratio of about 89%.

In terms of premium volumes, Odyssey had a 7% increase in gross premiums written, primarily as a result of the reinstatement premiums related to catastrophe losses.

Crum & Forster reported an underwriting loss of $10.8 million and a combined ratio of 104.8% in the first quarter of 2011, compared to an underwriting loss of $13.5 million and a combined ratio of 107.4% in the first quarter of 2010. Crum's results included 0.9 of a combined ratio point or $2 million of net favorable development of prior year's reserves. 2010 had insignificant development.

On an accident year basis, Crum & Forster's combined ratio was 105.7% and that compared to 107.7% in the year-ago quarter. Crum & Forster's gross premiums written and net premiums written increased by 5.2% and 4.1%, respectively, as a result of growth in specialty lines.

Zenith National reported an underwriting loss of $26.6 million, and a combined ratio of 123.4% for the first quarter of 2011. There was no development in prior year reserves. And gross premiums written during the first quarter of 2011, reflected a 16% increase in business over the first quarter of 2010. Zenith National had increases in new business written, stronger retention, and there was improved payroll trends.

First Mercury, which we acquired in February 2011, had an underwriting loss of $3.4 million and a combined ratio of 109.8%. However, that included $2.2 million of cat losses on a program that they were already exiting. Their combined ratio would've been 98.7%, excluding the cat loss and a small restructuring charge.

Northbridge recorded a combined ratio of 103.6% and an underwriting loss of $90.6 million in the quarter. And that compared to 104.6% combined ratio and an $11.3 million underwriting loss in the year-ago quarter.

The first quarter of 2011 underwriting result for Northbridge included 3 combined ratio points or $8 million of net favorable development. There was a 0.4 combined ratio points or almost $1 million of adverse prior period reserve development in the first quarter of 2010. The underlying accident year combined ratio for the first quarter was 106.6% compared to 104.2% a year before. Gross premiums written at Northbridge declined by 2.3% in Canadian dollar terms.

Fairfax Asia had another successful quarter. Their combined ratio was 85.9% this quarter compared to a combined ratio of 96.4% last year. Their gross premiums written were $111 million, up 35% from $82 million last year. Their net premiums earned were up about 18%.

In our segment that we call our Reinsurance and Insurance Other, the net earned premiums decreased to $126 million for the quarter compared to $143 million last year, primarily because of less business written at Advent. The first quarter Reinsurance and Insurance Other combined ratio was 166% compared to 127% last year, again, because of the Japanese cat losses at the end of at the end of Group Re. The result was combined ratios for the first quarter for Group Re of 160%; Advent, 194%; Polish Re, 101.5%; and Brazil of 216%, which is our startup.

Turning to our financial position starting with book value per share. We ended the quarter at $354 a share. That's after Fairfax paid out the $10 share dividend in the first quarter. That is an IFRS book value that would be comparable to the IFRS book value at December 31 of $376 per share.

Common shareholders' equity decreased by about $460 million during the quarter to $7.24 billion. We paid dividends of just over $205 million during the first quarter in our common shares. And we had the loss of $240 million, which made up that decrease. Our debt at the holding company and debt at the subsidiaries increased slightly during the first quarter due to the First Mercury acquisition, which brought with it $66 million of debt. And combined with the first quarter loss, it resulted in a slightly higher total debt to total capital ratio of 25.5%, which is compared to 23.9%.

And Prem, that's it.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer
Well, thank you very much, John. Now, we are happy to answer your questions. [Operator Instructions] So Mary Anne, we are ready for your questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from Jeff Fenwick of Cormark Securities.

Jeffrey Michael Fenwick
Cormark Securities Inc., Research Division

So I wanted to ask a question, a couple questions around your premium volume numbers. And when we saw some impressive growth there out of Crum and Zenith as well, in the quarter, you mentioned some strength in specialty lines within Crum. But a pretty material number after shrinking your volumes for sort of a prolonged period here, is this just being opportunistic in a specific area, or are you feeling like you're starting to see a little bit of firming in a larger number of markets?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

A little of both, Jeff. We are being opportunistic at the Crum level. John, on the Zenith, mentioned higher retentions, higher new business. For the first time in many, many years, Zenith is experiencing that. Of course, the workers comp has been experienced in Crum too. But when you talk about the cycle, this cat event is very significant in Japan, but it's also significant in the sense that it comes after New Zealand earthquakes, Australian flood losses. Last year, you had the Chilean earthquake, you had the New Zealand earthquakes. So the accumulated losses have been significant. And so we see prices bottoming out and perhaps firming. No question, they'll firm in the cat area. In Japan, for example, in the renewals that are to come, it will firm. Probably firm to all across the cat markets worldwide, and we'll just have to wait and see in the next 3 months, 6 months what happens in the property casualty industry across all lines. But there is firming. And as I said, we've been very patient in waiting for the markets to firm. We don't make forecast by the way. We actually wait till the prices go up and then respond and take advantage of the opportunity. But it is fair to say that prices have bottomed out and are moving up some.

Jeffrey Michael Fenwick
Cormark Securities Inc., Research Division

Okay, and just one follow-on there, with respect to Odyssey, you did mention that reinstatement premium drove most of the growth in volumes there. But are you also seeing other areas within Odyssey that are seeing organic growth?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

A little -- it's still early days on that, Jeff, still early days on that. We're watching the impact of that earthquake and all these cat losses on the industry. But it will be fair to say that the financial flexibility of the industry has been reduced significantly. And so, you have these reserve redundancies coming in. You have less investment income because of interest rates being low. And as you're rolling over 3, 4, 5-year bonds into current interest rates, investment income comes down. So we are thinking that this had previously -- some time, these markets will change. And you just have to be ready to take advantage of it. John, you want to add to that?

John Charles Varnell
Vice President of Corporate Development

Yes, and just to be careful, First Mercury, there were some premium in there for the first quarter because we bought it around February 9. So you would have picked up some premium just because it was a new acquisition. And then Zenith wasn't in there till the second quarter last year. So we picked up premium as well just because Zenith wasn't there. So just to be careful on that.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Right. You understand that when we say 28% increase of premium, like we have, First Mercury, as John said, for maybe 1.5 months, 2 months. And Zenith, which we never had last year. But I think, even if you exclude that, we had an increase in premium, and I don't know, I forget, 7%, something like that. So we are certainly seeing some premium increase, but we're not thinking a lot yet that it's a hot market that we could expand significantly.

Operator

Our next question is from Tom MacKinnon of BMO Capital.

Tom MacKinnon
BMO Capital Markets Equity Research

I'm wondering if you might be able to shed a little light on the announcement of Mark Ram's departure. It seems to be that people at Fairfax kind of stay there forever. I don't think Mark's quite 50. So he will stay on it, seems like in a consulting role, but if you can shed any light as to his departure, that would be appreciated.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Yes, for sure. Mark, of course, has done an outstanding job for us over the past 20 years. And as he had said, he's retiring from our company for family reasons. And a big thank you to Mark. As I said, he's done a wonderful job for us. Silvy Wright, who was #2 to Mark, will take over our Northbridge. And Silvy had worked with him, with Mark, I think for the better part of 16 years, perhaps even longer, and at Markel and now in Northbridge. So there'll be a seamless transition. But you're exactly right, we will miss Mark.

Tom MacKinnon
BMO Capital Markets Equity Research

And if I could just squeeze one more in here, Prem, you used to talk about the runoff segment, and with an objective of trying to break even with a reasonable level of investment gains. I looked at this runoff segment in the quarter, and it actually broke even without any investment gains. And I'm wondering, how should we look at that segment kind of going forward. Should we still think of it as being a break-even segment, or is there opportunity for it to even do better than that? And was there anything unusual in the quarter that kind of bumped that number up higher?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

I'll take the first crack ahead, and then maybe John can add to it. But no, and the GFIC acquisition that we talked at the annual meeting, Tom, was very significant. And significant in the sense that there was very significant downside protection with that contingent note, that is without development goes against the contingent note. There were no expenses of any significance that we had to take over. And we had a big investment portfolio that provides the interest and dividend income. So the characteristics of runoff have improved, and that's why we like the runoff when it's purchased properly with very well due diligence. But yes, so in runoff, you always can have, in the insurance business, surprises, not significant ones, but you could have surprises. But we're very comfortable with the runoff that we have today, and that with Nick Bentley’s leadership, we'll be comfortable with it going forward. John, would you add to that?

John Charles Varnell
Vice President of Corporate Development

Nothing unusual in the quarter and runoff that was there. And just that we'd like to try to make money with our gains and runoffs. And so we'll just try to keep improving, and that's what we're doing.

Operator

Our next question is from Mark Dwelle of RBC Capital Markets.

Mark Alan Dwelle

RBC Capital Markets, LLC, Research Division

A couple of numbers questions to start off with. You had mentioned that a lot of the premium growth in OdysseyRe, which related to reinstatement, could you provide the number that relates to that? It would just help in going forward, in terms I'm modeling, what portion of that is sort of earned and how that premium earns out?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Yes, for your models, Tom, maybe we can -- I'll ask John to provide it to you after the call. But unless you are -- are you comfortable with it, John? We'll provide it after the call on the reinstatement premiums, Mark. Well, what's the next question that you have?

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

The second question, just in general terms, what is the duration on the municipal bond portfolio?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

The municipal bonds have a call feature, not a redemption feature, but a call feature, which the municipality can call. Frankly speaking, these are Berkshire Hathaway guaranteed bonds, which is 65%. Between 5 to 10 years from now, we expect them to call it because the rates are quite high compared to -- and perhaps not compared to these last 3 months, but compared to over time. So that's what the deal rate is -- what the term is, Tom. On the rest of the muni bonds, it's not too different in terms of term to maturity.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay, the last question I had kind of relates to the CPI-linked derivatives. I guess I had understood when you initially took the position of kind of $34 billion notional that it was a reasonably matched hedge against the overall asset portfolio of the company. But now, the notional portion of that derivative contract or that group of derivative contracts is now about $49 billion, and which to my mind, makes it a fairly significant, call it naked bet on the direction of CPI. And I'm just wondering if you could kind of explain the thinking behind that, that increase in the notional value or notional exposure.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

And basically, what it is, Tom, is averaging down in terms of opposition. We're pretty well. That's the type of position we've been looking to achieve, somewhere in that -- we look at two things. One is the $49 billion that you pointed out. The second is the amount of money that we had invested, so it's about $400 million, a little more than $400 million. And it's over 10 years. Now on that, Mark, I should make the point that it fluctuates. I've said that at annual the meeting. I've said it in conference call. These things fluctuate up and down. We saw a very significant fluctuation in this quarter. And basically, we use dealer codes, which are based on supply and demand and some modeling. And like the credit default swaps in the past, these fluctuate, and our thinking is, really, until you sell them, you won't know what the values are. But it is protection for us, Mark, in our assets. It's protection from the unintended consequences in the property casualty business. We haven't really gone through deflation for a long time. Basically, in North America, we haven't seen it since the '30s. And so we are always looking at the unexpected, the one that's not the -- possibilities that are not forecasted. And we keep worrying about the possibility of deflation on our business, on our assets, on our business. And so, we think it helps us in terms of the unintended consequences on our business. But this is amount that we feel comfortable. It's 10 years. It fluctuates very significantly based on supply and demand. And we've taken a very significant $167 million hit in the first quarter. It's of course unrealized. But we think you to keep monitoring it over time. Thank you, Mark, and John did you want...

John Charles Varnell
Vice President of Corporate Development

Yes, for the answer on the reinstatement premium. If you look on the bottom of the Page 76 about 8 lines up, you'll see it's disclosed there, $17.8 million of reinstatement premium related to the company.

Operator

[Operator Instructions]

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Mary Anne, if there are no more questions...

Operator

At this time, there are no questions.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Okay. Terrific. Thank you very much. Well, if there are no more questions, thank you all for joining us on this call. We look forward to presenting to you again after the next quarter. Thank you, again.

Operator
This does conclude today's conference call. You may disconnect your phones at this time.