S&P Capital IQ

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Fairfax Financial Holdings Limited TSX:FFH

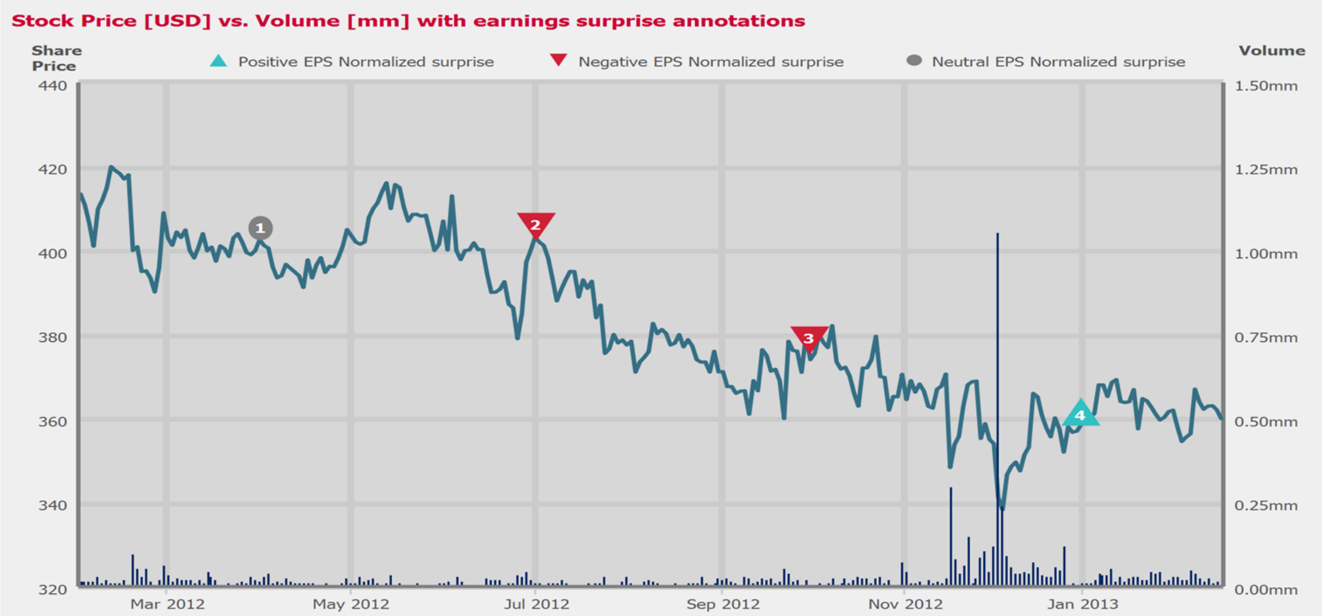
FQ1 2013 Earnings Call Transcripts

Friday, May 03, 2013 12:30 PM GMT

S&P Capital IQ Estimates

	-FQ1 2013-			-FQ2 2013-	-FY 2013-	-FY 2014-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	4.11	7.12	▲73.24	4.17	15.00	18.96
Revenue (mm)	1903.03	1891.80	▼(0.59 %)	1939.73	7906.92	8454.70

Currency: USD
Consensus as of May-03-2013 6:43 AM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ1 2012	4.35	(0.69)	NM
FQ2 2012	6.74	3.85	▼1 (42.88 %)
FQ3 2012	5.92	0.90	▼2 (84.80 %)
FQ4 2012	4.73	18.90	▲3 299.58 %

Call Participants

EXECUTIVES

David J. Bonham
Chief Financial Officer and Vice President

Paul C. Rivett
President

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

ANALYSTS

Howard Flinker

Jeffrey Michael Fenwick
Cormark Securities Inc., Research Division

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Paul David Holden
CIBC World Markets Inc., Research Division

Ryan Penton

Presentation

Operator

Good morning, and welcome to Fairfax's 2013 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 Paul Rivett. Mr. Rivett, please begin.

Paul C. Rivett
President

Thank you, Audra. Good morning, and welcome to the call to discuss Fairfax's 2013 first 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 filed with Canadian securities regulators.

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

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Thank you, Paul. 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 David Bonham, our CFO, for additional financial details.

First quarter of 2013, book value per share increased by 1.3%, adjusted for the $10 per share common dividend paid in the first quarter of 2013. We had a strong underwriting result in the first quarter of 2013 on increased premiums, while maintaining disciplined underwriting. We are maintaining defensive equity hedges as we remain concerned about the financial markets and the economic outlook. We continue to be soundly financed with quarter end cash and marketable securities as a holding company in excess of $1.2 billion.

Net premiums written by the company's Insurance and Reinsurance Operations in the first quarter of 2013 increased by 5.5% to $1.606 billion, due primarily to increased property business at OdysseyRe, continued year-over-year rate increases at Zenith, modest growth and increased premium retention at Northbridge and modest growth at Fairfax Asia.

At the subsidiary level, net premiums written in quarter 1 2013 and combined ratios were as follows: OdysseyRe, up 13.6% with a combined ratio of 82.9%, Crum & Forster premiums were down 5.6% with a combined ratio a little below 100%, 99.7%. Northbridge, premiums were up 6.5% with a combined ratio of 100.5%. Zenith, premiums were up 11.9% with a combined ratio of 110.2%, and Fairfax Asia premiums were up 4.5% with a combined ratio of 91%.

Just a quick comment on Zenith. Its combined ratio it's still 110.2% over 30 years before our purchase. So prior to our purchase, 30 years of history, Zenith had a combined ratio, on average, of 95% and its last ratio over that 30 years was 15 to 20 points better than the industry. And so it's a terrific track record since our purchase because the business has been shrunk, has come down significantly. The combined ratios have been running at 125% to 130% come down to 110% and we think Zenith is well on its way.

So in the first quarter, we continue to grow very low interest rates and the reduced reserve redundancies means there's no place to hide for the industry, as I've said before. Combined ratios have to drop well below 100% for the industry to make a single-digit return on equity with these low interest rates. While the short term is always tough to predict, fundamentals will eventually play out.

Net investment gains of $9.4 million in the first quarter of 2013 consisted of the following. Please note the table on Page 2 of our press release. We will see in that table, net gains on equity and equity-related investments of $698 million were predominantly unrealized and were neutralized by net unrealized losses of $593 million on our equity hedges, after unrealized bond losses of $119 million and $32 million in unrealized CPI-linked derivative losses, resulting in a net gain of $9.4 million, all unrealized.

Realized gains from stocks and bonds during the quarter were $165.3 million. The company held in excess of $1.2 billion of cash, short-term investments and marketable securities at the holding company level at March 31, 2013.

Finally, we continue to be approximately 100% hedged in relation to equity and equity-related securities, which includes convertible bonds and convertible preferred stock. We continue to be very concerned about the prospects for the financial markets and the economies of North America and Western Europe, accentuated by potential weakness in China. There continues to be a big disconnect between the financial markets and the underlying economic fundamentals.

As of March 31, 2013, we have over 27% or $7 billion in cash and short-term investments in our portfolios to take advantage of opportunities that come our way. In the short term, our investment income will be reduced.

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

David J. Bonham
Chief Financial Officer and Vice President

Thank you, Prem. First, I'll focus on Fairfax's consolidated results for the first quarter of 2013, then I'll move on to the operating company results, and finally, I'll finish up with the consolidated financial position.

For the first quarter of 2013, Fairfax reported net earnings of $162 million or $7.12 per share on a fully diluted basis. That compares to the first quarter of 2012 when we reported a net loss of $3 million or a loss of $0.76 per share on a fully diluted basis.

Turning to the underwriting results of our Insurance and Reinsurance operations, in the first quarter of 2013, Fairfax reported a consolidated combined ratio of 94% and an underwriting profit of $86 million. That compares to the consolidated combined ratio of 98.8% and the underwriting profit of $16 million that we had in Q1 last year.

Current period catastrophe losses were comparable year-over-year and in the first quarter of 2013, we hedged just over $32 million of current period catastrophe losses, adding about 2.3 points to our combined ratio. That compares to the first quarter of 2012 at $26 million of catastrophe losses adding about 2 points to our combined ratio.

In terms of our reserve development, we experienced $36 million of net favorable development to prior year's reserves and that benefited our combined ratio in the first quarter of 2013 by 2.5 points compared to just $2 million of net favorable reserve development in the first quarter of 2012, which had a nominal effect on our combined ratio.

Our accident year combined ratio in the first quarter of 2013 was 96.5%, and that compares to 98.9% in the first quarter of 2012. That improvement is primarily reflective of lower year-over-year noncatastrophe-related large losses and a decrease in the accident year loss ratio at Zenith National.

Now turning to our operating company results starting with OdysseyRe. In the first quarter of 2013, OdysseyRe reported an underwriting profit of $95 million and a combined ratio of 82.9%. That compares to an underwriting profit of $64 million and a combined ratio of 87% in the first quarter of 2012. Catastrophe losses were relatively light at $32 million, representing 5.8 combined ratio points, but slightly higher than the first quarter of 2012 where we saw catastrophe losses of $24 million, representing 4.8 combined ratio points.

In the first quarter of 2013, OdysseyRe's combined ratio included a benefit of 3.2 points or $18 million of net favorable and reserve development, and that principally related to favorable emergence on prior year's catastrophe losses. Odyssey wrote $604 million of net premiums in the first quarter of 2013 and that was up from $526 million in the first quarter of 2012. That increase reflected the impact of a Florida property quota share reinsurance contract that incepted on June 1, 2012, and also reflected increased retentions of U.S. crop insurance business.

Moving on to Crum & Forster. Crum & Forster reported an underwriting profit of $1 million and a combined ratio of 99.7% in the first quarter of 2013. That compared to an underwriting loss of $14 million and a combined ratio of 105.1% in the first quarter of 2012. The improvement in Crum & Forster's underwriting results was due to changes in the mix of business to focus on more profitable lines and the absence of net adverse development of prior year's reserves which added $5 million to the underwriting loss in the first quarter of 2012.

Net premiums written by Crum & Forster decreased from $308 million in the first quarter of 2012 to $291 million in the first quarter of 2013. The net premiums written at Crum & Forster were impacted by decisions to exit less profitable lines of business and that was partially offset by the continuation of the growth in specialty lines of business, which present greater opportunities for profitability.

Zenith National reported a combined ratio of 110.2% in the first quarter of 2013 and that compared to 117.7% in the same period last year. The year-over-year improvement primarily reflected earned premium price increases in the first quarter of 2013 that exceeded Zenith's estimates of loss trends and that also combined with a lower expense ratio, as a result of an 11.1% year-over-year increase in net premiums earned.

Net premiums written by Zenith of $286 million during the first quarter of 2013 increased year-over-year by 11.9% and that, primarily reflecting premium rate increases.

Northbridge's combined ratio in the first quarter of 2013 decreased from 104.3% in the first quarter of 2012 to 100.5% in the first quarter of 2013. The improvement in the first quarter of 2013 reflected increased net favorable development to prior year's reserves and fewer noncatastrophe-related large losses in the absence of any current period catastrophe losses.

Net premiums written by Northbridge of $248 million in the first quarter of 2013 and $202 million in the first quarter of 2012 require 2 adjustments to make them comparable. First, Group Re, an affiliated reinsurer, returned $39 million of premium to Northbridge effective January 1, 2013, following the cancellation of a 10% intercompany quota share reinsurance contract. Second, Northbridge's net premiums written in the first quarter of 2012 included $5 million related to its U.S. property business, which was renewed by an insurance subsidiary of OdysseyRe, effective May 1, 2012.

So excluding the $39 million of net premiums written from the first quarter of 2013 and adjusting for the impact of the nonrenewal of the U.S. property business, Northbridge's net premiums written increased by 6.5% in U.S. dollar terms in the first quarter of 2013.

Page 39 of our first quarter interim report describes these adjustments I just mentioned in more detail.

Fairfax Asia's combined ratio improved modestly from 92% in the first quarter of 2012 to 91% in the first quarter of 2013. Net premiums written by Fairfax Asia increased by 4.5% to $76 million in 2013 from $73 million in 2012. And this was principally as a result of increased writings of property, commercial automobile and engineering lines of business.

The combined ratio of the Insurance and Reinsurance - Other division improved from 101.7% in the first quarter of 2012 to 98.4% in 2013, primarily reflecting increased net favorable development of prior year's reserves in the first quarter of 2013.

Runoff reported a pre-tax loss of $14 million in the first quarter compared to a pre-tax profit of $54 million in the first quarter of 2012. And this was principally as a result of net investment losses of $13 million in 2013, which compared to net investment gains of $51 million in the first quarter of 2012.

Included in the runoff result was a $33 million gain recognized on the commutation of a reinsurance recoverable, and this was partially offset by reserve strengthening at U.S. runoff of about $31 million. The commutation allowed runoff to receive cash of approximately $119 million in satisfaction of a reinsurance recoverable which should be carried on our balance sheet at $86 million.

Our first quarter consolidated interest and dividend income decreased from $130 million in the first quarter of 2012 to $100 million in the first quarter of 2013. This decrease primarily reflected lower investment income earned as a result of sales during 2012 of higher yielding government bonds, those principally being Canadian government bonds and U.S. treasuries.

Rounding up with our review of the income statement, the company recorded a recovery of income taxes of $51 million despite $112 million of earnings before income taxes. The following are the principal reasons why our effective tax rate differed from our statutory tax rate. First, there was a regularly recurring adjustment, which was a benefit to our statutory tax rate related to nontaxable investment income, principally comprised of nontaxable interest income on municipal bonds, nontaxable dividend income that is received in the U.S. and Canada and certain capital gains, which are only 50% taxable in Canada.

Second, we had what we referred to in our press release as tax rate differences. This is also a regularly recurring adjustment. In this quarter, it benefited our statutory tax rate and it arises when we earn income or incur losses in jurisdictions where the tax rate is different from the Canadian statutory tax rate of 26.5%.

And finally, as has occurred in prior years, we earned income in jurisdictions where previously we had incurred operating losses. And we're able to use those operating losses in the current quarter, but those operating losses from prior years had never been set up as part of our deferred tax asset.

For further details of what I just mentioned, please refer to Page 19 of our first quarter interim report, which is posted on our website.

We ended the quarter with an investment portfolio, which included holding company cash and investments of 26 -- sorry, $25.6 billion compared to $26.1 billion at the end of 2012. A significant portion of the decrease related to the effect of foreign currency translation and net cash paid in connection with the reset provisions of the company's total return swaps.

Moving to our financial position. Our debt-to-total capital ratio increased to 26.8% from 25.5% at December 31, 2012, due primarily to the additional debt we issued in the first quarter of the year. We retired $48 million of debt in the first quarter and we have $183 million of OdysseyRe debt maturing in the fall of 2013. After repayment of the OdysseyRe debt in November, on a pro forma basis, our debt-to-capital ratio is expected to return to approximately 25.7% more or less consistent with December 31, 2012.

And now, I'll pass it back over to you, Prem.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer
Thank you, Dave. Now, we're happy to answer your questions. [Operator Instructions] Okay, Audra, we are ready for questions.

Question and Answer

Operator

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

Jeffrey Michael Fenwick
Cormark Securities Inc., Research Division

So Prem, you've mentioned that the insurance industry may have no place to hide going forward here. We're starting to see some data that commercial lines pricing is improving south of the border and I'm just wondering on a near-term basis here, what do you believe is the outlook for this year and into next year for a more definitive hardening in the commercial market south of the border?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Yes. So just to explain that comment, interest rates today, 5-year treasury rates up 0.65%, like less than 70 basis points, Jeff. And was this about 5%, 5 or 6 years ago? The hard market reserves, depending on how you define it, 2003 to 2006, or 2003 to 2008, is between 10% and 20% of total reserves that exist on property-casualty insurance company's balance sheet today. So there's the ability to have redundancies is reduced significantly. And so when you take those 2 into account and you look at the end of play of those 2 factors, even at a 95% combined ratio, you get a single digit return on equity. And so it just means that prices have to continue to go up. They're going depending on the line, 5%, maybe a little higher and worker's compensation, it's higher, 10% plus. California is a little higher than that. But we think the underlying fundamentals are attractive, but when you have a hard market, you have prices going up much more than that. We're not in that type of hard market, but we're certainly in a market that prices appear to be going up. Now some prices may come down, property-cat prices have gone up significantly up to 2011. The Japanese tsunami and the other catastrophes, the second largest cat year in 2011, well, they're tending to flatten out and come down. So you have these fluctuations, but broadly speaking, the property-casualty industry that we operate in, the pricing is improving and our business is improving. We've been growing now for a couple of years. In the first quarter, we grew about 5% in total, for all our companies.

Jeffrey Michael Fenwick
Cormark Securities Inc., Research Division

Okay. And maybe, Prem, you just contrast that with Canada. It seems like Canada is taking longer to start to get any momentum behind it and you've been doing a lot of work at Northbridge. How do you feel, in the process of that effort in Northbridge, where it stands today and how the company there is positioned to move forward?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

No, we -- I mean, Northbridge, for us, as you know, we've been in Canada -- we started in Canada, we were at 27 years, our company is in very good shape. All our companies, by the way, have really good reserving which is very important, because if you didn't, you're going to see companies show reserve development. So Northbridge came out with a combined ratio a little above 100% and we're comfortable where the company is, focused on getting it, of course, below 100% under Silvy Wright's leadership. But Canada has always lagged, Jeff, the U.S. The U.S. goes down a lot more than us and then comes back up also significantly. We don't go down as much and we lag the United States. I must also say, and we said this at the Annual Meeting, that our new structure with Andy Bernard, responsible for our insurance company's property-casualty insurance companies worldwide, is also a big plus in terms of the focus on underwriting profitability. We've always had a focus on underwriting profitability. It's accentuated by the fact that Andy is responsible for these companies all over the world. So yes, Jeff, we are very positive about what's happening at Northbridge.

Operator

[Operator Instructions] Our next question is from Paul Holden with JIBC (sic) [CIBC].

Paul David Holden
CIBC World Markets Inc., Research Division

Just one question for you, Prem. So you've talked about reserve releases for the industry and it looks like probably they're running out on redundancies. We're seeing pretty high favorable reserve development out of Fairfax for the last 4 consecutive quarters now. Is there much more room for Fairfax to be able to release reserves or is that pretty much played out as well?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Well, this is a good question, Jeff. So what we try to do is we always keep our accident loss ratios, accident combined ratios which we've shown you by company at a high level and with the idea that over time, we might have some redundancies. But it's fair to say that for the industry and to ourselves, that the surpluses of the hard market are much reduced. So it's fair to say. We just have a very strong reserving policy at Fairfax that over time, as I've showed you in our annual report, we need to see redundancies as opposed to efficiencies in hard markets and soft markets. So that is the policy we've got, but your point was taken that those will be more difficult for us to show as time goes by, but our policy is very much in place.

Operator

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

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

I think I have 2 questions. One is related to the reinsurance commutation in the runoff segment and the reserve addition for asbestos. Were those 2 things linked which is to say the reason you got the higher amount of commutation was because you recorded the additional amount, or were those 2 separate things that just happen to have a similar dollar amount?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

No, that's a good question, Mark. No, they are separate items and I've said to you in the past, we always look at commuting our reinsurance recoverables because when you commute those recoverables, you get cash in your hand, but you have to do it at appropriate prices. So we did it and we did what we think is a very good commutation. But we -- at the same time, we increased reserves separately on asbestos and pollution, environmental reserves. But they were separate, they were not linked.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

And then a second question I had, I just wanted to spend a little bit more time on the tax rate. I mean you itemized the 3 things that were largely in the footnote. I mean, I was really just -- I guess, the question I'm ultimately trying to get at is, we obviously had gains that were in areas where we hadn't usually had gains and we're able to utilize some deferred tax benefit. What would be the better way to think about maybe the full year tax run rate for the year or an effective rate that will be kind of normalized. Obviously, there's always timing differences with where gains and things occur but just trying to really get at the operating run rate of the business and what the appropriate tax rate on that should be.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Yes, Mark, that's a very good question. Let me pass it on to Dave. Let me just say that, while Dave answers, let's focus on the first quarter. And then remember that we have worldwide operations, right, Mark? So we have it in the United States, which has a higher tax rate than in Canada, and then you have operations in different parts of the world. And so the tax rates can be different. But Dave, in the first quarter, you've got a nice breakdown on why we had a recovery in the first quarter and then perhaps just a comment in -- for the whole year.

David J. Bonham
Chief Financial Officer and Vice President

Sure. Mark, in addition to what I mentioned, what I might add is, what you're seeing are adjustments that we have every quarter. They're regularly recurring and this quarter, they just happened to be magnified a little bit by the fact that we have, say lower pre-tax earnings and that's combined with just a mix of where our earnings were earned in the current quarter. And that mix, if you looked at it, is in low tax jurisdictions, we had earnings and that was offset by some losses in higher tax jurisdictions. So what I would say there is it's just the -- what you're seeing in the quarter is just a difference in the mix of where we had earnings and losses, and for your full year outlook, I think if you looked at our earnings and it was more of a normalized level of earnings, then you'd probably start to see an effective tax rate return to where it's been in the past 7 or 8 quarters. And I think that's in the neighborhood of about 25% to 30%. But that's going to vary, once again, depending on where we have earnings and losses around the world.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

So Dave, and if you look at BRIC, we made a very significant gain in BRIC. And so as far as our taxes on BRIC were concerned, you mentioned that the 50% -- there are only 50% get into capital gains and also where the BRIC position might have been held in our worldwide operations.

David J. Bonham
Chief Financial Officer and Vice President

Yes, the BRIC gain was about 80% taxable under Canadian tax rules so it was taxed at 50%. And if you kind of looked at what the effective rate on that gain alone was, it was about 17%. So that would be a typical example of an item that would be a benefit or would reduce our effective tax rate.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Good, Dave. Mark, any follow-up on that?

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

No, we'll go with that for now and let me do a little bit of math and I may come back to you offline.

Operator

Our next question is from Howard Flinker with Flinker & Company.

Howard Flinker

This is a question or a clarification. And if we guessed that worker's comp rates rose, say 12% or 14%, is that pure rate or is it, say 90% rate and 1/10 higher payrolls?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

No, that's -- that would be pure rate, right? I'm just looking at our -- to first half of the year -- yes, that will be pure rate, Howard. And, yes we -- that will be pure rate. And these are rate-on-rate increases. We had rate increases last year and we've got further rate increases this year.

Operator

[Operator Instructions] There's a question from Ryan Penton with BMO Capital Markets.

Ryan Penton

Can you provide some commentary on your cash position? I believe this quarter, it was about 27% of your full investment portfolio. And you mentioned on the call that you probably held on to the cash until some opportunities arose and what would those opportunities look like for you to deploy that cash?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Well, you never can say. These opportunities develop, you never can say when they will develop and what they will be. But this I can tell you, you won't be able to take advantage of them unless you have cash or cash-like investments. So if I go back to 2008, 2009, the stock markets dropped significantly. You had spreads widen dramatically. Well, because we had cash, we could take advantage of that opportunity. For example in the last 2 months of -- in the last quarter of 2008, we bought approximately $4 billion of muni bonds at about 5.75%. The after-tax yield in 2 months, $300 million a day, $500 million a day. Well today, you can't buy $10 million of those bonds. So it's always that ability to take advantage of the opportunity, but on the other hand, the cost is you don't make any investment income today on the 27% cash, the $7 billion plus of cash that we have. And that's why we've always focused on the long term and we've always said that our earnings are going to be lumpy and we're focused on increasing our book value over time. Our earnings and our book value on a quarter by quarter, perhaps even on a yearly basis are very tough to predict. But as you know, with 27 years, our record is quite good.

Ryan Penton

I have one follow-up. Can you remind us of how much capacity you have to write in a hardening market? I think a couple of quarters ago, you used to say you could probably bump up your premiums by 50% or around there in a hardening market. Was that...

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Yes, no, in a hardening market, we've got a -- we write about $6 billion in premium. We have about $8 billion in equity capital, $2 billion sales and net debt, so that's $10 billion. So if you look at our premium, this is a worldwide premium, $6 billion on $10 billion, that's 0.6x. And that ratio can be 1.5x. The last hard market, we took it to 1.5x. So what that means is that each of our companies, separately, would be able to double our premium approximately, which would result in the $6 billion going to $12 billion. We don't know when that will take place or even if that will take place, but if the conditions are right, rest assured, we'll take advantage of the opportunity.

Operator

Currently there are no further questions.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

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, Audra.

Operator
Thank you. Today's call has concluded. Thank you for participating. Please disconnect your phone line at this time.