S&P Global
Market Intelligence

The Hanover Insurance Group, Inc. NYSE:THG

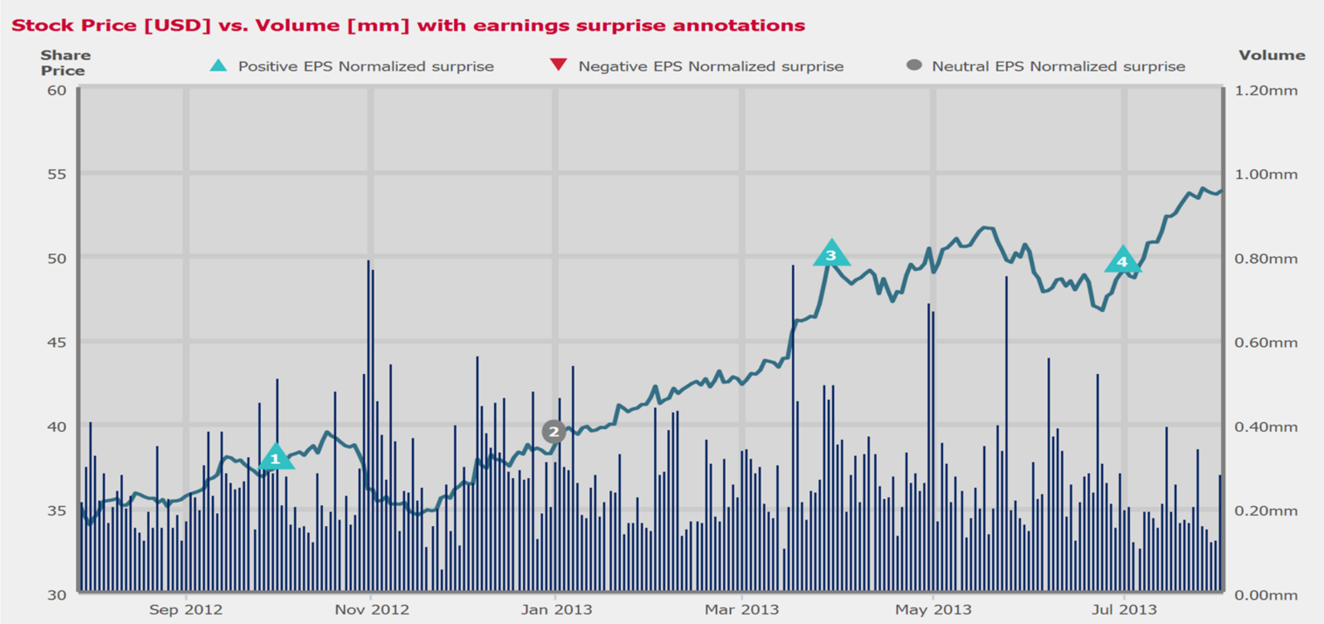
FQ3 2013 Earnings Call Transcripts

Thursday, October 31, 2013 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2013-			-FQ4 2013-	-FY 2013-	-FY 2014-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.04	1.36	▲30.77	1.06	4.67	4.65
Revenue (mm)	1181.63	1181.90	▲0.02	1084.35	4567.50	4709.70

Currency: USD
Consensus as of Oct-31-2013 12:52 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2012	0.68	0.72	▲5.88 %
FQ4 2012	(1.80)	(1.65)	NM
FQ1 2013	1.05	1.32	▲25.71 %
FQ2 2013	0.71	1.05	▲47.89 %

Table of Contents

Call Participants

EXECUTIVES

David B. Greenfield
Former Chief Financial Officer, Principal Accounting Officer and Executive Vice President

Frederick Henry Eppinger
Former President & CEO

John Conner Roche
President, CEO & Director

Mark R. Desrochers
Former Senior Vice President and President of Personal Lines

Oksana Lukasheva
Vice President, Investor Relations

Robert Arthur Stuchbery
Former Chief Executive Officer and Executive Director

ANALYSTS

Robert Paun
Sidoti & Company, LLC

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Third Quarter 2013 The Hanover Insurance Group, Inc. Earnings Conference Call. My name is Annette, and I will be your coordinator for today. [Operator Instructions] Please be advised this conference is being recorded for replay purposes.

I would now like to turn the conference over to Oksana Lukasheva, AVP, Investor Relations.

Oksana Lukasheva
Vice President, Investor Relations

Thank you, Annette. Good morning, and thank you for joining us for our third quarter conference call. We will begin today's call with prepared remarks from Fred Eppinger, our President and Chief Executive Officer and David Greenfield, our Executive Vice President and CFO.

Available to answer your questions after our prepared remarks are Jack Roche, President of Business Insurance; Andrew Robinson, President of Specialty Lines; Mark Desrochers, President of Personal Lines and Bob Stuchbery, President of International Operations and Chief Executive Officer of Chaucer.

Before I turn the call over to Fred, let me note that our earnings press release, financial supplement and a complete slide presentation for today's call are available in the Investor section of our website at www.hanover.com. After the presentation, we will answer questions in the Q&A session.

Our prepared remarks and responses to your questions today other than statements of historical fact include forward-looking statements, including our earnings guidance for 2013. There are certain factors that could cause actual results to differ materially from those anticipated by this press release, slide presentation and conference call. We caution you with respect to reliance on forward-looking statements. And in this respect, refer you to the forward-looking statement section in our press release, Slide 2 of the presentation deck and our filings with the SEC.

Today's discussion will also reference certain non-GAAP financial measures, such as operating income, operating income per share, operating results excluding the impact of catastrophes and development, ex-cat loss and combined ratio and accident share loss and combined ratios among others. A reconciliation of these non-GAAP financial measures to the closest GAAP measure on an historical basis can be found in the press release or the financial supplement which are posted on our website, as I mentioned earlier.

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

Frederick Henry Eppinger
Former President & CEO

Thank you, Oksana and good morning, everyone. Thank you for joining our third quarter earnings call. We reported strong results this quarter. I am pleased to say that each of our business segments performed well and contributed to the overall improvement in our returns.

Operating income for the quarter was $1.36 per diluted share, which translates to an annualized operating ROE of 10%. Our combined ratio for the period was 96%, compared to 100% in the third quarter of 2012. Certainly a lower level of catastrophe activity this quarter accounts for some of the earnings lift. More importantly, our results also improved on an ex-cat basis.

We made solid progress on all our strategic priorities, and we positioned ourselves well for continued improvement through the remainder of the year and into next. On an ex-cat basis we produced the highest 9-months operating earnings of our 10-year journey, demonstrating increasing earnings power and momentum for our franchise.

We are pleased to see that the work we have been doing to improve our business mix and achieve margin expansion is now flowing through our results. With that said, we remain focused on our financial return goals, and we have every expectation that our actions will continue to drive higher profitability in 2014 and beyond.

I will discuss progress on our priorities, our view of the prevailing market conditions and our updated outlook following David's remarks on our financial results.

David B. Greenfield
Former Chief Financial Officer, Principal Accounting Officer and Executive Vice President

Thank you, Fred and good morning, everyone. We had a very strong quarter with net income of $61 million or $1.37 per diluted share, compared to $40 million or $0.89 per diluted share in the prior year quarter. Operating income was $61 million or $1.36 per diluted share, almost twice the $33 million or $0.72 per diluted share we earned in the third quarter of last year.

Our combined ratio of 96% in the quarter compared to 100% in the prior year quarter. This 4-point improvement was driven by 3 main factors; most importantly our accident year underwriting operations excluding cat losses provided the real substance of our improvement.

In particular, with our domestic operations delivering a 61% ex-cat accident year loss ratio, we're moving closer to our long-term targets. Second, we benefited from lower catastrophe losses. Our actions have helped here, but the industry overall has seen a very favorable quarter.

And third, we saw modestly higher benefit of net favorable loss reserve development in the current quarter. Each of these deserves further comment starting with the ex-cat accident year loss ratios. As I mentioned, the underlying loss ratio in our domestic businesses was 61% in the current quarter, 4 points better than the 65% we reported in the third quarter of 2012.

As I've discussed on previous earnings calls, we did increase loss ratios in certain lines during the second half of last year, and so I continue to suggest that you also review our current quarter performance against full year 2012 loss ratios. Keeping this in mind, our Commercial Lines quarter accident year loss ratio excluding cat losses was 60%, compared to 64% in the third quarter of 2012, and 62% for the full year of 2012.

We are generating improved margins in commercial multi-peril and workers' compensation. In CMP increased pricing, disciplined risk selection and a lower incidence of large losses supported the underlying improvement this quarter. Stable workers' compensation results continued to benefit from our focus on smaller accounts, lower risk classes and rate increases.

In commercial auto our accident year loss ratio for the third quarter was consistent with the prior year quarter and although still higher than the full year 2012 ratio, this is within our expectations. We continue to price and manage profitability in this line aggressively to drive improvement over time.

As expected our accident year loss ratio in other Commercial Lines which includes surety and other program business has improved from the full year 2012, given our previous and ongoing underwriting and pricing actions. However, this improvement was somewhat offset by 2 large property losses in our special property line, which accounted for a couple of points increase in the loss ratio this quarter. Losses in this line can be lumpy, but overall this business has been historically profitable and despite these 2 losses still managed to deliver an underwriting profit this quarter.

In Personal Lines, we generated a 63% accident year loss ratio excluding cat losses, compared to 66% in both the third quarter and full year of 2012. We continue to earn in strong pricing increases and make meaningful improvements to the underlying quality of our Personal Lines book of business. The home owners' margin improved this quarter, compared to the full year 2012 despite a higher incidence of large fire losses that we experience occasionally in this line.

Chaucer's accident year loss ratio was 61% and also reflected some notable large loss events in the quarter. In particular the Nairobi mall loss in September and a large jewelry theft in July added about 6 points to the ratio. These types of losses are well within our risk appetite and while they drove a higher loss ratio this quarter, Chaucer continues to outperform our expectations for the year.

Overall, net favorable prior year reserve development in the period was $24 million or 2 points of the combined ratio. Chaucer's favorable development was $28 million. We had favorable experience in property and to a lesser extent in casualty lines. Additionally, Chaucer development also reflected positive foreign currency movements in the quarter.

In our domestic lines, prior year loss estimates overall proved to be solid. We had modest reserve additions related to auto bodily injury coverages. We also recorded modest unfavorable development in other commercial, primarily in surety as we continue to bring a handful of runoff claims to resolution. This was partially offset by favorable development in workers' compensation, where the benefit of the changing business mix towards smaller accounts is prevalent.

Catastrophe losses in the quarter were $31 million or about 3 points on the combined ratio, compared to the $52 million or 5 points in the prior year quarter. Chaucer's catastrophe losses were $12 million this quarter, modestly higher than a year ago. Losses were primarily driven by 2 September storms in Mexico and a more modest impact from floods in Colorado. Domestically, catastrophe losses of $19 million for the quarter were lower than the $45 million reported last year. Midwest hail and flood events in July and August and to a much lesser extent, Colorado floods in September were the main events this quarter.

Moving on to a discussion of expenses. Our current quarter and year-to-date overall expense ratio of 34% is in line with our target for the year. We continue to make meaningful progress in gaining operating efficiencies and growth leverage in particular in Commercial Lines, where the expense ratio is still somewhat higher than our longer-term targets. Although the overall expense ratio was in line with the prior year quarter, the current quarter included higher performance-based compensation expenses by nearly one point, as compared to last year, which reflects improved results so far this year.

The net written premium growth of 5% in the quarter reflected premium increases in Chaucer of 23%, a 6% growth in Commercial Lines and a 5% decline in Personal Lines as we continue to execute on our strategy of exposure management and profitability improvement actions in the domestic businesses.

Overall, each of our business segments performed well this quarter, and we're pleased with the improving underwriting trends. Our focus on a prudent pricing strategy, along with targeted underwriting initiatives is evident in our result thus far this year.

Moving on to investment results, we continue to maintain a high-quality well-lettered investment portfolio. At September 30, 2013, cash and invested assets were $8 billion with fixed income securities and cash representing 92% of the total.

Roughly 94% of our fixed income securities are investment grade, and the average duration of the portfolio is 4.1 years. Net investment income this quarter was $65.7 million, compared to $69.2 million in the prior year quarter and $67.9 million sequentially. The decline is the result of low new money yields. The earned yield on our fixed maturity portfolio was 3.99% in the quarter, compared to 4.23% in the prior year quarter and 3.98% sequentially.

I'll just finish up with a few comments on the balance sheet and capital. We ended the quarter with a strong total capital position of $3.5 billion. At September 30th, book value per share was $58.43, up 2% in the quarter and generally in line with the December 2012 level. We opportunistically repurchased approximately 115,000 common shares for $6 million. On a year-to-date basis, we repurchased 1.6 million shares at a cost of $78 million or $48.26 per share, which represents approximately 4% of our outstanding shares at year end 2012. Although we continue to favor capital deployment options that profitably grow our business, we will continue to be opportunistic as to stock repurchases.

With that I'll turn the call back to Fred.

Frederick Henry Eppinger
Former President & CEO

Thank you, David. I am pleased to report once again this quarter that we made considerable progress on achieving our goals for the year. And most importantly our efforts translate into higher underwriting margins. The measurable improvement in our loss trends that David just reviewed give me continued confidence in our ability to meet our goals for the remainder of the year and to generate even stronger results in 2014.

I would like to comment on 3 of the priorities we set at the beginning of the year to drive us toward top quartile financial. Those priorities are; continuing to improve our portfolio of mix and property concentrations; improving pricing in our domestic businesses and realizing the benefits of our Chaucer franchise.

As we discussed previously, we are assuming the increased frequency and severity of the weather that we and that the industry experienced over the last several years is here to stay. For that reason we continue to pursue targeted actions to reduce our property concentrations that will reduce our volatility and improve our profitability over time.

In addition, we targeted some small parts of our portfolio we believe could not reach targeted returns over the cycle. For example, some parts of our auto book. The impact of our ongoing actions on written premiums has peaked this quarter resulting in only a modest growth within domestic lines. In the quarter, our various exposure management initiatives resulted in approximately 30 million reduction in personalized premium or 8 points of quarterly growth. We continue to shrink the model line property book as well as reduce exposure in targeted areas in the North East and Midwest where we had significant concentration.

In Commercial Lines, our exposure management actions led to a reduction in written premiums of $11 million in core commercial and 20 million in specialty, impacting our growth for the quarter by 3 points and 10 points respectively. The implementation of our initiatives will continue for the rest of the year. We expect deduction of approximately 50 million in all domestic lines in the fourth quarter, which will put us at about 200 million of delivered premium reductions for the year.

Even with these targeted actions, we maintained significant momentum in the market. Given our improved portfolio and partner strategy, there is no shortage of growth opportunities for us in the current marketplace. Excluding our purposeful actions, our overall domestic growth rate was 8% in the third quarter and year-to-date. In core commercial, our new business production is the strongest it has been in several quarters, and our reported retention improved this quarter compared to last, despite these actions.

With our mix adjustment actions trailing off, we think we are well positioned for solid growth in Commercial Lines next year. The same is true with specialty where we continue to have a number of opportunities in our target segments that continue to profitably grow this business moving forward.

In Personal Lines, we continue to aggressively promote our whole account strategy becoming the market of choice for home and auto owners with more complex insurance needs. Given the timing of our various exposure reduction initiatives, the resulting pressure on the top line was the highest this quarter. We expect this to subside over the next 3 quarters and believe our overall growth will resume in the second half of 2014.

To summarize, we are satisfied that the completion of the these target portfolio actions will improve our margins and create a strong foundation for future profitable growth, given an improved and distinctive portfolio as well as the strong position with our partners.

The second priority for us is to execute meaningful targeted rate actions to improve our underwriting margins. We are satisfied with the level of pricing increases we achieved this quarter. In the third quarter, we realized pricing gains of 10% in Personal Lines, 9% in core commercial and continued low-teen increases in specialty, essentially continuing the trends we achieved during the first half of the year.

In core commercial, middle market workers' comp showed the most strength where price increased by almost 12%. We bolstered the other lines hovering around 9%. We always approach our pricing strategy in a very targeted way with the objective of improving our overall quality of our book.

As importantly, we believe we will continue to see solid price increases going into 2014. We remain convinced that positive rate is needed broadly in the market, given the persistency of low investment yields and active weather. With that said, rate increases in our personal auto book will likely moderate from a current high water mark of 9%, as we are beginning to clearly see the cumulative benefit of past pricing actions on loss trends.

Now moving on to Chaucer, which delivered another quarter of strong performance. This segment produced $32 million of pretax operating earnings in the third quarter and a $110 million year-to-date, resulting in a combined ratio of 90% through the first 9 months of 2013. The 23% net written premium growth in the quarter reflected our nonrenewal of the Flagstone quota share this year and an increase in business opportunities with improved rates in a number of classes, particularly in our marine division.

We continue to tactically position Chaucer's business for softening market conditions, focusing on our efforts on areas of business where we have strong and distinctive underwriting capabilities including marine, political risk, casualty and energy. Given the team's strong expertise in risk selection, pricing and portfolio management, we are confident in our ability to continue delivering on our plan, and we are excited about our future opportunities. However, we remain cautious about growth in the near term.

In conclusion, we are pleased with the progress our team has made, and we are encouraged that initiates we put in place are translating into improved results this year and position us well for continued improvement in 2014.

With our broad and distinctive portfolio and preferred shelf space with our agent partners, we have great momentum in the marketplace. We are experiencing solid growth where we desire, effectively rebalancing our business towards a more profitable mix. We remain on target to deliver our financial goals for 2013.

We have only a few months remaining and a year-to-date ex-cat ratio of 93.4%, we remain confident in our original ex-cat ratio guidance of 93% to 94% for the full year. So given that our year-to-date EPS is $3.73, we are increasing our full year guidance range to $4.70 to $4.80 per share, assuming a cap ratio in the quarter of approximately 4%.
And with that, I would like to open the line for questions.

Question and Answer

Operator

[Operator Instructions] The first question comes from the line of Vincent DeAugustino of KBW.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Just - when I look at your auto results, we are starting to see the core loss ratio improvement come through in Personal Lines. And this quarter it seemed a flat core Commercial Lines loss ratio, and really if we look to what some of your competitors are doing this quarter, that looks really quite solid. And so what I'm curious about is if you are seeing perhaps different trends or if really what you're seeing here is just you taking a more conservative stance last year and when we think about the year-over-year comparisons there.

Frederick Henry Eppinger
Former President & CEO

Yes. I think that's right. I think we feel good about how we reacted very quickly. As you know, we talked about this a year ago. And we're little bit fortunate, right, because our commercial auto tends to be small fleets and similar to our Personal Line. So we have a pretty good insight into some of those severity trends, and so we reacted relatively quick. And our view is given the noise in the marketplace, that it's prudent for us to make the picks where they are this quarter, which is consistent with last quarter. But we believe we're right on where we expect it to be. I mean, there's no surprises. We feel good about what we did, and we feel good about the trend for us. So I think that's -- for us -- that we don't see any surprises or any change in our respect to volume.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Okay, good. And then just jumping to Chaucer real quick, when we see headlines for what people are calling as blind underwriting schemes impacting the Lloyd's market and Berkshire is the obvious one, those are taking out considerable slices of premium, and I was curious if there is any impact to Chaucer based off of the business mix there? And that longer term what you think the implications might be to the overall Lloyd's market if this type of activity continues?

Frederick Henry Eppinger
Former President & CEO

Let me -- I'll comment and have Bob comment, too. Obviously when we acquired Chaucer, we thought about Chaucer. Chaucer is not -- a lot of the folks in Lloyd's or some of the people in Lloyd's are more focused kind of -- I would say in kind of reinsurance portfolio. Chaucer is a very specialty oriented business. It leads a lot of its business. We have very good distinctive underwriting, and real leadership position in things like energy, marine, et cetera. And for us we don't believe that it's going to have a material impact on us. But I do think the smaller syndicates, some of those that aren't distinctive that just tag along could see some meaningful impact, but for us we feel very good about it. As matter of fact, we have been -- since the transaction, we have acquired and attracted additional teams in some of our areas of focus and feel that we will be leading more the business going forward. So I feel pretty good about where we're positioned. Bob, is there anything you want to comment on? I want to make sure.

Robert Arthur Stuchbery
Former Chief Executive Officer and Executive Director

No. You really touched on those points. I think you're right. You might see over a period of time some of the smaller players in the Lloyd's market consolidating. But from our position, we are quite strong in leadership and we haven't really seen any effect to date.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Okay, great. And then just keeping on Chaucer, David, you've mentioned that there was FX impact on the reserve development. Would you be able to quantity that?

David B. Greenfield
Former Chief Financial Officer, Principal Accounting Officer and Executive Vice President

Yes. It's in the low millions of dollars. It wasn't any particular currency, just a number of currencies move that when we revalue our reserves, obviously that has an impact on some of the foreign claim reserves that we have. But it was pretty modest this quarter compared to previous quarters when I have talked about it. I will tell you sort of in the $5 million to $6 million range.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

And if I could sneak one more in before I re-queue, would it be safe to say with the year-to-date results so far coming through this quarter that you would be incrementally more confident in your ability to reach the 10% or better ROE kind of in the near- to medium-term horizon?

Frederick Henry Eppinger
Former President & CEO

Yes. That's a great point. As you know, we worked really hard [indiscernible] on the last few years to really get our portfolio and our position in a place where we believe that we can sustain our target returns through the cycle, that '11 to '13 that we talk about. And we believe we are right on track for doing that and we think '14 is going to be meaningful step in that direction, another improvement from this year. Obviously, the yields coming down put a little bit of stretch on that as far as making it difficult to get all the way there, but we feel very good about where we are and frankly, a lot of the actions in the marketplace that we're seeing confirms that our strategy of what we focus on, the breadth of our portfolio, the balance of our portfolio, and this notion of a balanced and kind of preferred agent strategy that allows us that preferred shelf space. It's really working out very nicely. So we're pretty confident that we're moving in the right direction. Clearly, we've got to continue to improve, but we're set up nicely to have a material step of improvement in '14 and frankly, even more after that. So I think we're in a pretty good spot right now as far as momentum.

Operator

[Operator Instructions] Next round of question comes from Robert Paun from Sidoti & Company.

Robert Paun
Sidoti & Company, LLC

Can you talk more broadly about the Personal Lines segment and what drove the improvement on the accident year combined ratio? Is it mostly rate and some non-renewals or has there been any changes to the terms and conditions of policies?

Frederick Henry Eppinger
Former President & CEO

Obviously for Personal Lines for us, that started a couple of years ago when we recognized this non-cat weather phenomenon, where we wanted to get more rate into the system. We also have been moving for multiple years into this full account approach to the business, which helps create stability and a more attractive portfolio, and what you're seeing is that just playing out. So that is really playing into the results. What's interesting is lot of the reduction that we're taking, while it helps us in our concentration of volatility of the future, frankly a lot of the Personal Lines business we're getting out of marginally contributes today. It's not bad business. But it does in the future take off the volatility. So most of our improvement, frankly -- comparison improvement is really this rate that's going into the book and has moved into an account approach which gives us a lot of stability in the book. Mark, is there anything you want to add?

Mark R. Desrochers
Former Senior Vice President and President of Personal Lines

Yes. The only thing I would add to that and you alluded to non-renewal, but I would describe it more as non-rate actions that we are taking around either agency management actions because of profitability or some rate pursuit type of activities that are not pure rate but that also drive some improvement to the bottom line as well.

John Conner Roche
President, CEO & Director

And just add one last point on that Robert, When you're looking at our quarters, you obviously were more cautious about the fourth quarter, given where we have a weather impact in that book of business.

Frederick Henry Eppinger
Former President & CEO

Yes. That's true. What we thought about our -- we've had nice improvement. We will have nice improvement and comparisons in the fourth quarter for the previous year. But David is right. Sequentially we have a little bit of winter storm kind of thing that's going to happen in the fourth quarter which is normal, which we have every year.

Robert Paun
Sidoti & Company, LLC

Okay. And as far as the Commercial Lines pricing environment, can you just talk about what you are seeing and experiencing in that business? Contrary to some recent industry discussions, it seems like your renewal rates continue to show sizable increases. I just wanted to get your thoughts on that.

Frederick Henry Eppinger
Former President & CEO

Yes. And I'll have -- I'll make sure Jack comments on this too. Remember, our portfolio -- I think our middle-market average policy size is 75,000 and we -- most of our small, we are a small commercial writer. And so what you see is -- I think a lot of the comments are about -- in my view are about large, large accounts, if there's anything softening, but we don't see it. And we see good stable rate increases across our book, and again small doesn't tend to go up as much, or go down as much, but we feel like we are in a really good position to have some stability. We would also say that in casualty lines, there are some people that have had some issues, right, recently here. And so for our kind of business that also helps a little bit. I think that you will continue to see some causality rate in our business. But so far, we feel pretty good about what we see and what our outlook is for the fourth quarter. So Jack, is there an...

John Conner Roche
President, CEO & Director

Yes. I guess the only thing I would add is that like all good companies, we have gotten better and better at segmenting our business and making sure that while we pursue market available rate, that we also improve our portfolio along the way. And so we continue to drive a good portion of our increases through the segment of the business that needs it the most. And as Fred said, because we concentrate on the small and the first and second tier middle-market business, I think we get a better average price on good business. We are not playing up in the upper-middle market where it tends to be a little bit more volatile.

Robert Paun
Sidoti & Company, LLC

Okay. And just one more question. I wanted to get your overall view on the reinsurance market. It confuses though, pricing is becoming more attractive from a buyer's standpoint. Does this rate environment change your thinking on purchasing reinsurance?

Frederick Henry Eppinger
Former President & CEO

It's clear that on -- clearly in the property cat market, I do think there is some softness. We've seen the actions and frankly, the lack of losses that are also going to contribute to that and the new capital from outside the industry. From our perspective, that's helpful, obviously at some level to us. But our cat purchase in particular, where most of the sensitivity is in that market is really about the Northeast, which is kind of an infrequent event really, and so therefore we retain up to that $200 million. So it has some impact. I would say, it's not tremendous. There is a lot of flexibility in the reinsurance market now and an ability to partner more effectively on multiple years and things like that. So we will be very thoughtful about that and think about that to enhance our position, and it's clearly available but it's not huge for us. It's something, and it's important and we should manage it, but I don't see it is overwhelming of any way.

Oksana Lukasheva
Vice President, Investor Relations

Thank you for your questions. I think we don't have any more questions. So thank you, everyone for your participation today, and we look forward to speaking to you next quarter.

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