S&P Capital IQ

CONTENTS

AXIS Capital Holdings Limited NYSE:AXS

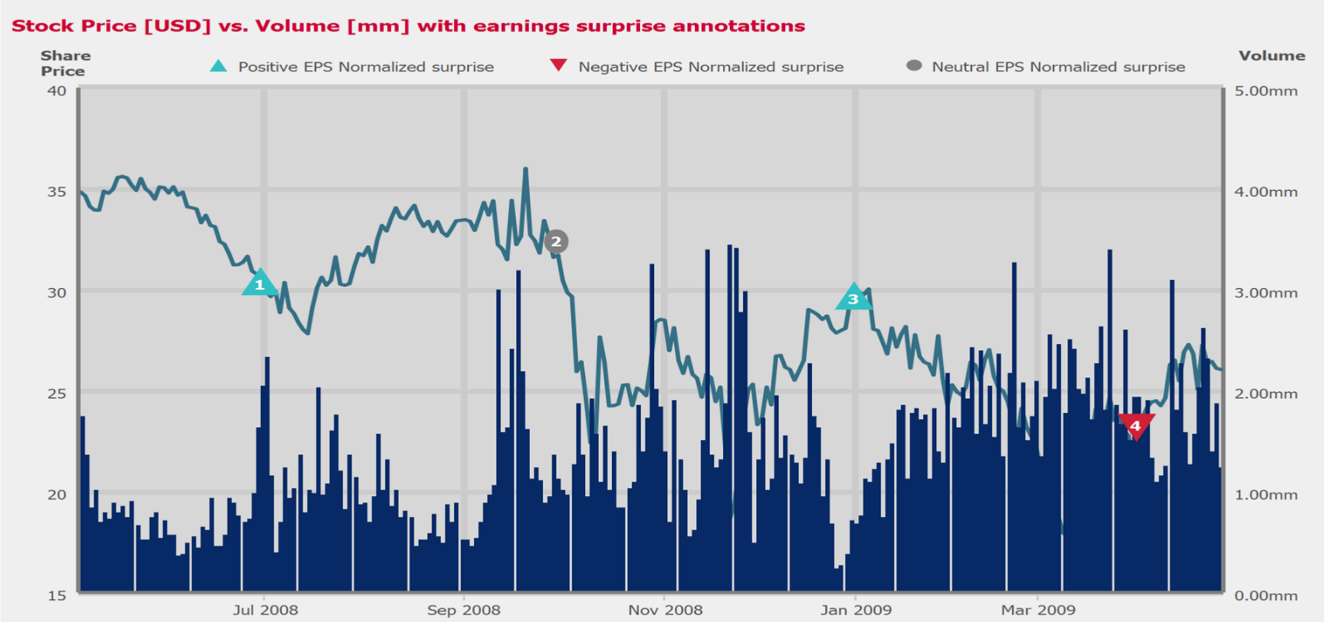
FQ2 2009 Earnings Call Transcripts

Tuesday, August 04, 2009 12:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2009-			-FQ3 2009-	-FY 2009-	-FY 2010-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.17	1.22	4.27	0.92	4.25	4.43
Revenue (mm)	672.44	701.01	4.25	561.42	2745.88	2871.28

Currency: USD
Consensus as of Aug-04-2009 12:02 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ2 2008	1.36	1.45	6.62 %
FQ3 2008	(0.97)	(1.22)	NM
FQ4 2008	0.99	1.09	10.10 %
FQ1 2009	1.11	1.05	(5.41 %)

Call Participants

EXECUTIVES

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Former Chief Financial Officer and Executive Vice President

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Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

Linda Ventresca

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Presentation

Operator

Hello, and welcome to the Axis Capital Holdings Ltd. Second Quarter 2009 Earnings Conference Call. [Operator Instructions] Now I would like to turn the conference over to Linda Ventresca. Ms. Ventresca?

Linda Ventresca

Thank you, Ryan. Good morning, ladies and gentlemen. I am happy to welcome you to our conference call to discuss the financial results for AXIS Capital for the quarter ended June 30, 2009.

Our earnings press release, financial supplement and quarterly investment supplement were issued yesterday evening after the market closed. If you would like copies, please visit the Investor Information section of our website www.axiscapital.com. We set aside an hour for today's call, which is also available as an audio webcast through the Investor Information section of our website. A replay of the teleconference will be available through Friday, August 14, 2009 by dialing 877-344-7529 in the U.S. The international number is 412-317-0088. The conference code for both replay dial-in numbers is 432235.

With me on today's call are John Charman, our CEO and President; and David Greenfield, our CFO. Before I turn the call over to John, I will remind everyone that statements made during this call, including the question-and-answer session, which are not historical facts may be forward-looking statements within the meaning of the U.S. Federal Securities Laws. Forward-looking statements contained in this presentation include but are not necessarily limited to information regarding our estimate of losses related to catastrophes and other loss events, general economic, capital and credit market conditions, future growth prospects and financial results, evaluation of losses and loss reserves, investment strategies, investment portfolio and market performance, impact to the marketplace with respect to changes in pricing models and our expectations regarding pricing and other market conditions. These statements involve risks, uncertainties and assumptions, which could cause actual results to differ materially from our expectations. For a discussion of these matters, please refer to the Risk Factor section in our most recent Form 10-K on file with the Securities and Exchange Commission. We undertake no obligation to update or revise publicly any forward-looking statements whether as a result of new information, future events or otherwise.

In addition, this presentation contains information regarding operating income, which is a non-GAAP financial measure within the meaning of the U.S. Federal Securities Laws. For a reconciliation of this item to the most directly comparable GAAP financial measure, please refer to our press release, which can be found on our website. With that, I'll now turn the call over to John.

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

Thank you, Linda, and by the way, happy birthday. Good morning, everyone and thank you for joining our call.

I'm pleased to report that we have delivered strong diluted book-value growth of $2.37 or 9% during the second quarter of 2009 and an annualized operating return on average common equity for the quarter of 17.4%. Book-value accretion was primarily driven by the significant improvement in asset valuations across much of our investment portfolio during the quarter. The total return for our investment portfolio was 3% for the quarter, up 3.1% for the year-to-date. Net investment income was up in the quarter over the first quarter of this year. Our combined ratio was 80.4% and included $97 million of favorable reserve development from prior accident years.

I believe this underlining result is very respectable, given our belief that in 2009, we are at the bottom of the earnings cycle across all lines. Net investment income was up 13% relative to the first quarter of this year and down 18% over the prior-year quarter. Both our Insurance segment and our Reinsurance segment performed well and retained discipline against the backdrop of a very spotty market.

The result was an overall increase in gross premiums written and net premiums written of 5% and 2% respectively during the second quarter. With the exception of a few areas where we have continued to pull back, rate is stable to increasing in all lines and this has now been the case for the last two quarters.

Now I'd like to turn the call over to David, who will discuss the financial results for the quarter. Following David's review of our financial results, I will discuss some underwriting portfolio items and market conditions in a bit more detail. And just as another aside, happy birthday, David.

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

Thank you, John, and good morning, everyone. As John mentioned, we're pleased with our results for the quarter. Strong underwriting results enabled us to achieve an annualized operating return on average common equity for the quarter of 17.4%. This, combined with a significant improvement in asset valuations across our portfolio, contributed to the 9% increase in our diluted book value per share to $28.72 in the quarter. Diluted book value per share increased 11% for the year-to-date.

Net income for the quarter was $159 million or $1.06 per diluted share compared with $231 million or $1.47 per diluted share for the second quarter of 2008. After-tax operating income, which excludes the impact of realized gains and losses on investments, was $183 million or $1.22 per diluted share compared with $229 million or $1.45 per diluted share for the second quarter of 2008. For the first half of 2009, net income was $275 million or $1.84 per diluted share compared with $469 million or $2.95 per diluted share in the first six months of 2008. After-tax operating income was $338 million or $2.26 per diluted share, compared to $434 million or $2.73 per diluted share for the first half of last year.

Turning to our top line, our consolidated gross premiums written, were $915 million for the quarter, an increase of 5% from the second quarter of 2008. Consolidated gross premiums written for the first six months of 2009 increased 5% over the same period in 2008. Growth in gross premiums written for the quarter and the year-to-date were driven by our Reinsurance segment which increased 22% for the quarter and 17% for the year-to-date.

Gross premiums written for the quarter in our Reinsurance segment totaled $388 million. We were able to grow or catastrophe reinsurance lines, which benefited significantly from pricing improvement. Also, our property reinsurance line increased this quarter, relative to the same quarter last year, due to the renewal of a significant pro rata treaty, which was previously renewed in the first quarter of 2008.

Finally, we grew our professional lines reinsurance in the quarter, due to the new business and increased participations on attractive treaties. As a general comment, we've seen substantial increases in submissions to our Reinsurance segment, which continued into the major July 1 renewal date. John will discuss this renewal date in more detail, later in the call.

For the quarter, gross premiums written in our Insurance segment were $527 million, down 5% from the prior-year quarter. The decrease was driven by a continued reduction in our credit and political risk business. The impact of these reductions were partially offset by growth of our professional lines business, driven by new business opportunity, together with rate improvement, primarily in D&O and in financial institutions. As John will discuss later, we're also beginning to benefit from rate improvement in other parts of our insurance portfolio notably our energy and property lines.

Consolidated net premiums written increased 2% in the quarter and 5% for the year-to-date, reflecting the previously mentioned growth in gross premiums written. In line with these changes, net premiums earned increased 4% in the quarter and 2% for the six-month period.

Moving on to our underwriting results, total underwriting income for the quarter was $141 million compared with $138 million in the second quarter of 2008. Our combined ratio was 80.4% this quarter versus 81.2% in the prior-year quarter. Our current accident year loss ratio was 67.2%, which was essentially flat with the prior-year quarter. There are a few items to note here. Relative to the prior-year quarter, our Reinsurance segment's accident year loss ratio decreased seven points to 59%, reflecting a lower level of catastrophe and other large loss activity.

Our Insurance segment's accident year loss ratio increased 9.1 points to 78.3% for the quarter. Higher claims activity his year from our credit and political risk line resulted in upward movement in the accident year loss ratio of approximately 13 points relative to the same quarter last year. This was partially offset by a lower frequency of large property losses this quarter, relative to the prior-year quarter.

Our consolidated current year loss ratio for the year-to-date was 69% compared to 67.8% for the first six months of 2008. During the quarter, our estimate of net reserves from prior accident years continue to develop favorably with reserves reduced by $97 million this quarter. Of this amount, $47 million was from our Insurance segment, representing a positive impact of 15.7 points on the segment's loss ratio.

In our Reinsurance segment, we recorded $50 million in net favorable prior-period reserve development, representing a positive impact of 12.2 points on the segment's loss ratio.

Approximately 3/4 of the net favorable reserve development this quarter was generated from our short-tail lines. The balance of the net favorable development this quarter came from accident years 2004 and 2005 for our medium and long-tail lines, as our own experience continues to become more actuarially significant in the analysis of historical accident year, ultimate loss assumptions in certain lines. I do want to emphasize that we've not released reserves for longer-tail casualty lines in any meaningful way.

As we have in the last few quarters, I'll update you on the status of loss activity in reserving for our lines of business impacted by the financial crisis. Those lines are trade credit and bond reinsurance, professional lines insurance and reinsurance and credit and political risk insurance. Starting with the trade credit and bond reinsurance, as a general comment, loss experienced in this line remains purely frequency-driven at this point. Large insolvencies have not had any significant impact.

Our estimated accident year combined ratio for the trade credit and bond reinsurance line now stands at 99% for 2007, 138% for 2008 and 124% for 2009. As this is a line with primarily short-tail characteristics, we are comfortable that the 2007 and 2008 combined ratios are reasonably developed. For professional lines insurance, our estimated accident year combined ratio stands at 115% for 2007, 116% for 2008 and 102% for 2009. For professional lines reinsurance, our estimated combined ratios stand at 108% for 2007, 110% for 2008 and 110% for 2009. All of these years contain a substantial amount of IBNR.

To put this in perspective, IBNR for these lines in the 2007 through 2009 accident years, is approaching $900 million. Our net average line size was in the low single digits in millions during the period.

Finally, in our credit and political risk lines, our estimated accident year combined ratio is 50% for 2007, 74% for 2008 and 118% for 2009. Loss activity has been in line with our expectations for 2009. Because the average length of policies is longer in this line of business, approximately five years on average, it's important to consider not only IBNR, but also on earned premium reserves. Together, these reserves are in excess of $0.5 billion at June 30, 2009.

Moving on to expenses, our acquisition cost ratio and general and administrative expense ratio for the quarter were 14.6% and 12.3%, respectively. These ratios were in line with the second quarter of 2008.

I want to comment on one additional item in our underwriting results. You may recall that we have longevity risk exposure in the form of a life settlement agreement in our Insurance segments. Based on the review of the valuation this quarter, we made a negative fair value adjustment of $15 million, which is recorded in the other insurance-related income or loss line in our income statement.

In our quarterly financial supplement, we've updated information about PMLs as of July 1 for the Axis Group at various return periods for peak industry cat zones. We have also provided estimates of industry losses at these return periods. The only change of note in the quarter relates to a modest increase in our PMLs reported for California earthquake. The increase was driven by attractive opportunities in our Reinsurance segment.

Moving on to investment results, in aggregate, the total return on our cash investments portfolio for the quarter was 3%. This comprise net investment income of $112 million, a decrease in net unrealized losses of $239 million and net realized losses of $24 million. The reduction in net unrealized losses this quarter was primarily due to tightening of credit spreads related to corporate debt and structured securities.

Net investment income for the quarter of $112 million represented an increase of $13 million or 13% relative to the first quarter of this year and a decrease of $25 million or 18% relative to the second quarter of 2008. Investment income from fixed maturities and cash and cash equivalents was a $103 million this quarter. This compared with $95 million in the first quarter of this year and $116 million in the second quarter of 2008. The decrease relative to the prior-year quarter, primarily reflects the impact of lower short-term and intermediate interest rates. The increase, relative to the first quarter of 2009, reflects the impact of higher average invested balances as well as redeployment of cash and cash equivalents into higher-yielding, high-grade fixed income investment. As a reminder, our alternative investments or other investments are accounted for at fair value with the change in fair value reported in net investment income.

Net investment income from other investments was $12 million in the quarter. This represented an increase of $5 million relative to the first quarter of this year and a decrease of $8 million relative to the same period last year. Strong performance in the quarter from our credit funds, which are largely focused on bank loan investments and our hedge funds, was partially offset by a $26 million reduction in the fair value of our CLO equity holdings.

We also adopted the new FASB guidance for the recognition of other than temporary impairments of fixed maturity securities in this quarter. The adoption of this guidance had no impact on our book value per share. During the quarter, we incurred net realized investment losses of $24 million compared to net realized investment gains of $2 million in the prior-year quarter. Net realized investment losses for the quarter included $15 million of impairment charges, uncertain mortgage backed and corporate debt securities and impairment charges of $6 million on certain equity securities.

At June 30, 2009, net unrealized losses within our available-for-sale portfolio were $529 million, a reduction of $239 million in the quarter. The improvement in asset valuation experienced during the quarter was primarily due to tightening of credit spreads on corporate debt and the structured securities.

During the quarter, we reduced U.S. agency residential mortgage-backed securities and invested primarily in U.S. agency debt securities and high-grade corporate debt. This shift has resulted in reduced extension risk while maintaining our investment portfolio yield levels. Looking ahead, we expect to continue redeploying cash into short duration, high-grade liquid investments with higher yields.

At June 30, 2009, we held cash and cash equivalent balances of $1.4 billion or 13% of total cash and investment. Our fixed maturity investment portfolio, which represents 81% of total cash and investments is well diversified, has a weighted average credit quality of AA+ and has an average duration of approximately 3.13 years. Our investments represent 5% of our cash investments portfolio at June 30, 2009.

With respect to foreign exchange, during the quarter, changes in exchange rates and changes in net currency exposure resulted in foreign exchange losses of $24 million compared to $7 million in the prior-year quarter. However, from a book-value perspective, these losses were offset by foreign exchange related appreciation of our available-for-sale investments. This is recorded in other comprehensive income.

During the quarter, we generated $207 million of positive operating cash flows. Total capitalization at June 30, 2009, was $5.4 billion, including a $500 million of long-term debt and $500 million of preferred equity. Common shareholders' equity increased $416 million to $4.4 billion during the quarter. Our financial flexibility is very strong with debt-to-total capital at 9%, debt and preferred to total capital at 18.5% and total capital, well in excess of rating agency requirements. We remained strongly capitalized for the risks we hold and the risks we are targeting and continue to deploy prioritized deployment of capital in underwriting opportunities. With that, I'd like to turn the call back to John.

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

Thank you, David. I have referred, for some time, to our belief that we are not experiencing a classic soft market, whereby the reinsurance market leads the insurance market in softening. Our price to the

P&C marketplace over the last couple of years, not only reflects the strength of the reinsurance market relative to the insurance market, but as importantly, it reflects our strong competitive positioning in the reinsurance marketplace.

For the Insurance segment, the story for the most part is also more positive this quarter than last, but remains unsatisfactory on the whole. Overall, rates in the reinsurance lines we target is, at the minimum, stable and in the best cases, increasing meaningfully.

As David noted earlier, business flow through our Reinsurance segment has been increasing steadily and we are binding good opportunities with quality savings. We continue to benefit through the concerns over the financial strength of distressed reinsurers, or dislocation in the wake of our weaker competitors de-risking activities.

The 1st of July renewal was very successful for our Reinsurance segment. At this renewal, we estimate our Axis re-underwriting year premiums were up approximately 19% over the expiring amounts. We non-renewed approximately 13% of expiring premium and 25% of the business found at this renewal was new business. We expect some other activity in the quarter that will impact top line for the segment for the 1st of July, generally gives a good indication of our competitive positioning. The most significant drivers of growth for us at this renewal were our property catastrophe reinsurance line and our U.S. casualty reinsurance line. We continue to evaluate other opportunities driven by capital needs of smaller regional specialty companies. The mails have represent new business for the Reinsurance segment in the third quarter.

Overall, Axis property cat reinsurance premium was up for the 1st of July. Broadly, we continue to attach higher in the number of programs. This renewal is dominated by large national U.S. Property cat placements. In general, these renewals were orderly and pricing was attractive. We estimate that overall, year-over-year percentage increase in pricing on a risk-adjusted basis, was in the mid-teens for the majority of the portfolio.

Despite our disappointment with respect to the non-renewal of the Texas Windstorm Insurance Association cat program, we were able to quickly re-allocate a material portion of that capacity to other well-paid transactions. While rates was modestly for property credit risk reinsurance renewals, in our opinion, this rate increases were not enough, particularly in lower layers with loss experienced. Therefore, we maintain our cautious posture in this line.

At the 1st of July renewal, we took a strategic position in bond Reinsurance business in Latin America. A significant gap has been introduced for the pullback of the former dominant market in this business. We had very little of this business getting into the renewal and in advance of this major renewal date, we recruited a market leader known to us for many years, which placed us in a particularly good position to address this dislocation.

In our U.S. Casualty Reinsurance business, quality capacity is limited and demand has been strong. Against this backdrop, our track record of consistency, service and performance, coupled with our strong balance sheet and ratings, have positioned us well. We are benefiting from the flight to quality and the continued trend towards counterparty diversification. Where we have written new business or treat [ph] (0:26:11) increased signings, we have done so on attractive terms. The general trend across the casualty reinsurance lines has been small but steady rate increases with no slippage in terms and conditions. There are, of course, exceptions such as reinsurance of financial institutions D&O, where rate is up dramatically. For the most part, we believe U.S. casualty reinsurance lines have bottomed. This bottoming is consistent with what we see in our cedents experience and confirmed by our own casualty insurance lines. Simultaneously, we were successful in pushing reinsurance terms. We expect this trend will continue.

Moving on to Insurance, based on recent experience, it is fair to say the we continue to see mixed conditions in commercial insurance lines. For the most part, where we have grown, rate was the primary driver. In a number of our U.S. wholesale lines, admitted markets continue to compete aggressively for the business. Distressed competitors remain an easy target for price-sensitive clients and brokers, who wish to turn a blind eye to counterpart its security, strength and expertise. In this environment, we believe our competitive advantage tends to compromise strong underwriting reputation and our global consistency of behavior and service.

Moving on to commentary by line, as expected, property insurance market pricing globally has responded positively. The most significant increase is seen in our London wholesale portfolio, where rate increases have been approaching up to 25%. This account is heavily influenced by North American catastrophe exposure, so this is to be expected.

Our U.S. based E&S property account, which is also influenced by its cat exposure, has seen positive rate movement up to 10%. Our retail property account began to see positive rate increases, but regrettably, this trend has recently moderated.

In offshore energy, clean international accounts renewed with rates up 10%. Gulf of Mexico accounts, excluding wind, renewed with rates up to 15%. Exposures are down, overall, and construction activity in the Gulf have substantially slowed. Fueled by four to five years of profitability, there was an increasing trend by clients towards higher retention of wind exposure. Despite this, we achieved a good balance in our portfolio, while maintaining overall premium volume and reducing our offshore energy related wind exposure by approximately 25%. The trend in our Insurance segment's professional lines is a continuation of that in the first half of the year. Financial Institutions' business is up at least 20% and non-financial institutions' commercial D&O and E&O is flat to down single digits, reflecting low loss activity. We continue to see many new and attractive opportunities in these lines. Casualty lines have, for the most part, stabilized, although reductions in the market are still common place. However, we continue to maintain a defensive posture in these lines.

Looking ahead in the aviation line, the fourth quarter accounts for most renewal activity, and we are pleased that the market has at long last, acknowledged the lack of profitability in this sector following severe underwriting losses this year. This latest year follows a string of unprofitable years for this line of business. We believe that there will be a major upward correction at this year end and if this correction exceeds our return requirements, we expect to selectively re-enter the market. As we have discussed on a number of occasions in the past, we materially reduced our participation in this line when in our view, rates reached inadequate levels at the end of 2005.

As a general comment, in the property and casualty insurance and reinsurance markets, top line continues to be under pressure as some insurers select to choose lower coverage or altogether forego insurance purchases. This maybe acting temporarily as a drag on the speed of hardening in insurance lines in particular. To keep some of our negative comments in perspective here, we are, in fact, experiencing rate increases across most lines at Axis. Once, there's a long way to go. These increases are in line with our expectations for this year and are decidedly positive.

Also, it is worth noting that for the most part, we do not believe the current underwriting environment is worse than the environment which preceded the last cycle term, when casualty was the last part of the market to harden in 2003. There were several factors contributing to poor results at that time, besides rate erosion. Specifically, there was a significant broadening of terms and conditions, which was not considered in either pricing or reserving. Also, loss trend was accelerating prior to that point in time and many companies were behind the curve in recognizing and reporting that trend. We do not believe that this is true today, although inflation represses appear to be lurking on the horizon.

Throughout Axis, we believe that we have been consistently conservative in our estimates of loss cost trend and our pricing and reserving activities. We are optimistic that the positive experience at the last two quarters will bode well for continued steady hardening across all lines. However, absent of major event, we remain more tentative about predicting the scale of that hardening. Regardless, we are well equipped to manage our diverse portfolio to produce good returns on capital, whatever the market conditions may offer. Our portfolio continues to perform well and within expectations. Our business model, which is predicated on diversification by product and geography, continues to allow us to comfortably absorb losses in some lines while continuing to generate good profitability in others.
Looking beyond this year, we are confident we have successfully positioned ourselves to be the benefactor of any market disruption that may arise. We remain focused and disciplined. We continue to re-deploy capital away from softer lines of business and into more profitable ones. Once, we have been very

defensive over the last couple of years. We have also been very diligent about building out our specialty presence geographically and in new lines of business. We have a strong balance sheet with plenty of capital available and we will take advantage of opportunities as they present themselves. And with that, thank you. Operator, and we are ready to open the line for questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from Dan Johnson of Citadel Investment Group.

Dan Johnson
Citadel Investment Group

You went through, on the Insurance segment and talked about how the political credit book had added, I think about 13 points year-over-year. But sequentially, the accident year ex cap loss ratio came up a fair bit, likewise on the combined ratio. Was there a sequential increase driven by that line? Or did we have large losses? Or anything else you could add some color and then I've got a follow up.

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

As far as -- my take on it, Dan, is the fact that the underlying activity within the primary lines has been very good, the claims activity. I talked about the political risk increase in reserves and I, no doubt, will be answering more questions on that as we go through this Q&A, which I'm happy to do. But actually, the primary portfolio, when you consider that we're at the bottom end of a very soft cycle, I think, has performed extremely well and I'm not, in any way, uncomfortable about either the totality of it or the individual components within it. David, I don't know if you...

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

Just to elaborate on the components, I mean much of the increase in the ratio, sequentially, is driven by the credit political risk business. There is some attritional losses that have come through but it's primarily, from that credit political risk.

Dan Johnson
Citadel Investment Group

And is that driven because there's a different earned premium pattern? Or is it because their loss picks were higher in 2Q versus 1Q?

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

The loss picks are somewhat different but by and large, similar, so it's not largely different loss ratio in the second quarter to the first quarter. I think you hit on the point. That's very important in this book of business, which is -- this is a long tale of book of business in the sense that the policy, as I said in my remarks, are on average, five years and that premium is spread out over multiple years as opposed to single years, as in much of the other parts of our business. So, that drives the loss ratios and the ratio's off a little bit when you're comparing to other lines of business.

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

And if you think about the fact that there are three lines that have been affected by the global credit crisis, of which two of those lines sit within the primary side, that's political and credit risk as well as professional lines business, the professional lines' numbers have been remarkably consistent and static.

Dan Johnson
Citadel Investment Group

And then a follow-up, in terms of any larger losses in the quarter. Can you talk a little bit about anything in particular, Air France comes to mind and if there's anything else worth highlighting, and whether or not, frankly, that will be on the insurance or reinsurance side?

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

At the Air France thing, I think it's a terrible tragedy, and it will be interesting to find out whether they will eventually be able to discover what actually happened to the airplane. But you know and I've said time and time again that we withdrew from the vast majority of our Airline business in October, November 2005 because we saw huge price reductions being passed on to airlines, which we felt at that time, we've made the account unprofitable because all the published numbers that you see are at leader's terms and they don't necessarily -- premium terms tend to be averaged at. As well as that if you were to actually, put on the expense costs associated with that portfolio of business whether it's reinsurance costs, G&A and acquisition costs. You'll find actually that in '06, it was pretty well, maybe a breakeven. '07, '08 and '09 are definitely loss years, so I think that the Air France loss was the straw that broke the camel's back. And the market has no option but significantly move in a different direction, and we've been sitting patiently for nearly four years now waiting for it.

Dan Johnson
Citadel Investment Group

And so you're maybe -- add on to that, were there actual losses of any size to note from that event and you've cut back, I think, almost 2/3 or maybe 75%?

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

We were involved but it's not material because we have very long-standing relationships with a number of the world's airlines which go back 25 years, and so once we disagree with their pricing from time to time during market cycles. If we don't withdraw from those coverages, we substantially reduce our exposures. So it's really not material to us and that allows us to quickly ramp up when the market hardens, and we will be able to move back in reasonably freely.

Operator

Our next question comes from Jay Cohen of Bank of America-Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

I got several questions I guess first is, you made a comment earlier on your prepared remarks, John, about 2009 being the bottom of the earnings cycle and although we're seeing pricing stabilizing, you also suggested in another time in the call that we still have a long way to go. And so given how the premiums are earned, I'm wondering how you're confident that '09 is the bottom of the earnings cycle versus say 2010?

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

I think, Jay, I think it's a very important point. you've raised. I think you've really have to look at the diversity that we have within our portfolio and that helps us in almost -- we're one of the most diversified specialty businesses out there, not only by product but by geography, and as well as that we can play between insurance and reinsurance, and I often think that people don't give us as much credit as they should do for our ability to move capital between those businesses quickly and speedily and in a very focused way to find real earnings value, even at the lowest point in the cycle, and I think we continue to demonstrate that. So yes, we're not predicting a substantial one-off resetting of the industry. We think it's going to be much more steady, and much more deliberate but I think our portfolio allows us to continue to get through that transitional stage if you want to call it that. And I'm pretty comfortable about being able to do that.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

So I guess you're comment wouldn't necessarily apply to the industry being at the bottom of an earnings cycle?

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

Absolutely.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

And then two other quick follow-ups. First is bond reinsurance in Latin America, I'm just not familiar with that business. Can you just give us a 30-second summary of what that businesses is and who is pulled back there?

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

Yes. I think that it was one of the largest reinsurance companies of the world is pulled back, and not pulled back because of any adverse experience in that part of the world, but because of greater problems they might have had within their balance sheet. As I've said in my prepared remarks, this is a line of business that is highly specialized. That company has been doing business in that part of the world forever. The individual concerned is extremely well respected in the industry, is a very capable person. We have a lot of respect for him, and we were delighted when he agreed to join us at Axis. And so it's a combination of the opportunity which is reasonably unique. It's very steady business. It has very, very good profit characteristics, very stable as I said, and we actually have the reputation on this gentleman's reputation to be able to build our portfolio down there.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

What's the underlying risk likely you're taking? What kind of credits are you ensuring?

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

Could be commercial construction. This has been -- this is a portfolio that has been in existence for decades. And if you look at countries like Brazil and there is a long history of buying this type of insurance, so this is not something that and actually has been largely unaffected by the credit crisis as well.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

And one last quick one. David, I think you had mentioned the losses in the CLO equity portfolio, and I guess that was somewhat surprising. What drove those losses?

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

I think the -- that's an investment category we have where there isn't clear market trading information, so we used various assumptions and models to price that portfolio and you can see all of that in our 10-K and 10-Qs. What really drove the movement in the pricing there was recovery rates, adjustments to recovery rates and default rates in the quarter. There was a number of things that caused us to want to change those assumptions, be at the rating agency reports on default rate movements and also underlying performance within those investments. We were seeing a higher trend of defaults in some of the investments in the class. So we've made adjustments to those assumptions, and that triggered the price movement in that portfolio.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

That's like a bit of a catch up maybe?

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

No, I mean I think, not in so much a catch up because we look at it very, very closely, and we had very good performance in those in the past, but there was some downturn in the past quarter that triggered us to change those assumptions.

Operator

Our next question comes from Josh Shanker of Citi.

Joshua Shanker
Citigroup

I was reading over your press release and although I often miss your comments, the press release also have some pretty strong words in it. The words blindingly obvious is the markets needs to change. And following up on that, looking at your results and your peers, accident year results, for almost everyone still look good. Well, I might agree with you that the market needs to change. When are we going to see those accident year combined ratio's come up for the industry that's going to shock out of its somnambulance.

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

I think that financial results are one thing. When you're actually underwriting a portfolio, you really have to look at what's happening to the underlying exposures, and really see whether you're getting aide for the underlying exposures, especially when you overlay climate change and the changes that have occurred there over the last five to 10 years. So whilst you could argue that the accident year numbers look pretty reasonable, as an old fashioned underwriter, I believe that the market is giving away its capital far too cheaply relative to the exposures that it's assuming. And I'm not only talking about the short-tail stuff. I'm talking about the long-tail stuff because I still believe that tail risk is not being properly priced by the market. So we put it in a relatively benign loss position so far this year, if you strip out what's been happening from the global credit crisis. But it's been pretty benign, so don't get fooled by accident year loss ratios. I look at the quality of the earnings and the quality of the premium that the market is harvesting for the risk it is accepting. In my old fashioned sort of way, I think it's still very inappropriate and I think it's naive.

Joshua Shanker
Citigroup

Do you think it was on, I mean, notable change in the market access will be shrinking in the coming year 2010?

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

The market has moved, Josh, on the primary side. So it stabilizes and it's moving upwards across-the-board and the reinsurance market, you and I have been banging on that for three years, it's a much better place to be than the primary market. And I think that that's -- our view has been justified by our results. I'm not too fast. The movement is in the right direction. It's just the speed of it. I don't understand why companies are not looking more closely at the reasonable characteristics of the business they're writing.

Operator

Our next question comes from Terry Shu of Pioneer Investments.

Terry Shu
Pioneer Investments

Extending on to Josh's question, is it not true, John, in the past though that the players in the market have to be really shocked into action that very few of the underwriters, the good underwriters do as you say, which is to think about returns and risk rewards? So therefore, the firming so far has been slow, frustrating as you said, and it may not continue. Is that one way to look at it because I don't remember any time in the past where the industry turns just because it's the right thing to do, to price properly?

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

No, absolutely. I'm afraid our industry has never been terribly good in understanding price to exposure. It's a bit like dangling a carrot in front of a donkey. Unless you dangle it there, the donkey is not going to move.

Terry Shu
Pioneer Investments

Therefore, is it not then fair to say that one may have to wait, and if maybe there's some directional move but it doesn't have the impetus to go ahead or not right?

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

I think that as I've said before that I've been concerned, really, for the last couple of years because the primary market has not been able to give margin away because its come from the reinsurance market, and so the net erosion of our primary balance sheet should have been showing through more than it appears to have done. But I know my own balance sheet very well. What I don't know is what other industry players' balance sheets. How they work their loss picks. But I would have expected to have seen greater deterioration on that net margin that has been shown so far. It may be a combination of things.

Terry Shu
Pioneer Investments

So the driver therefore, probably has to come more from like a push from the primary side with that deteriorating providing impetus for the overall market to turn more, right?

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

Yes, I think it depends on what happens on the asset side of the balance sheet for the rest of this year as well. But if you're looking at a low interest rate environment going forward, your default might have been even greater and put pressure on primary companies to expand their underwriting margins.

Terry Shu
Pioneer Investments

And then a separate question, you gave us quite a bit of data on the trade credit and for bond insurance multiple years 2007 to 2008 the combined ratio. And when we look at those results, clearly when we look back, those lines have not been yielding sufficient profits. So is it more because pricing was not right, or just this credit crisis was much worse than we saw?

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

I think we're in the business of providing insurance or reinsurance policies to people, we expect losses. As I said earlier, these three lines, the political and credit risk insurance portfolio, the reinsurance credit and bond risk portfolio and the professional lines, D&O, Financial Institution business and insurance and reinsurance. Those are lines that you would naturally expect to have increased loss activity during a serious global financial meltdown. And so otherwise, they'd be looked by these policies. And so when you consider the severity of the financial crisis we've had to deal with, I think that those three portfolios have performed very well considering, and actually have stabilized significantly. The characteristics are exactly as what we expected and the loss trends are exactly where we thought they would be. And I've talked myself blue in the face trying to explain these different accounts. They're part of a fully diversified portfolio, where we're producing significant profitability in other parts of the portfolio. Not everything moves in the same profitable periods, and that's why we have a diversified portfolio. But if you take local and credit insurance risk, Axis is nearly nine years old, eight years old. For the first five years, we didn't have a claim. We started to see a few claims emerge in 2007. It's still profitable and the nature of this sort of business is the fact, you have one year going into it which is 2008 and we have one year coming out of it. I've said that I expect the 2009 accident year ultimately to be there or thereabouts. It'll be break even or thereabouts. And I'm still as comfortable today as I was at the beginning of the year when I expressed my opinions. So don't get hung up on the fact that those three lines are loss making. Of course, we don't like to have anything that's in negative territory. But nobody will buy the policies unless they actually have value from them in such extraordinary times such as we live in.

Terry Shu
Pioneer Investments

When you say you believe '09 will in the end be break even, so when we will look back at '09...

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

There or thereabouts, Terry. I don't have a crystal ball but I have my 38 years of experience in this business. It tells me that I would be there or thereabouts.

Terry Shu
Pioneer Investments

And therefore, '09 is probably going to be, or '08 the worst year and things are -- claims are receding, so that's the way we should look at it, more on a multiple-year basis.

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

You have to look at these lines individually. '09 in my view will be the worst year for the Political and Credit Risk business. I think the credit and bond and professional lines have stabilized, and I'm very comfortable about the fulfillments now, those product lines.

Operator

Our next question comes from Vinay Misquith of Credit Suisse.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

Just to follow up to Dan's question on the Credit and Political Risk Insurance business, just looking at it quarter-over-quarter, first quarter versus second quarter. The accident year loss ratio x cat was up about 10 points. So if could help me understand, was that an earnings pattern for the Political Risk business where you earn more premiums this quarter versus last quarter that's why the loss ratio went up, or why your loss picks for the second quarter higher than the first quarter? And if you could give me a sense of the claims you received. Are they picking up this second quarter versus the first quarter?

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

As I said a little earlier and maybe to give a little more color to it, you've hit on an important point, and I don't think you've seen this information yet but it will be released when our financial statements are finalized where we have earned premium information by line. But the earned premium for this line of business was higher in the second quarter of '09, and actually substantially higher than it was in the first quarter. And that's a function of the comment I made a bit earlier about the length of the policies, the earning patterns and the like, and in situations where losses do come in, we are going to match up the premium for the policy at the same time we record the losses. So that has to do with some of the movements you'll see in earned premium within the quarter because as you know for the last several quarters, we've not written much business in this line. So you will see an increase in the earned premium. The loss ratio this quarter relative to the first quarter is around the same vicinity. It's not substantially different but overall, when you look at the quarter-over-quarter and the earnings within the lines of business, you'll see that increase in this line of business driving that loss ratio up or combined ratio up.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

Do you expect to own more of these premiums in the next few quarters just because it's now a larger portion of your earned premiums?

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

No, I wouldn't answer the question that way. I wouldn't necessarily comment on future quarters, but we have a static portfolio at the moment in a sense we're not writing very much new business. So the earning pattern will continue in connection with the length of the contracts, but in the case where we received claims on a contract, we are going to match up the premium recognition with the claim recognition.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

Are you seeing more claims in the second quarter versus the first quarter?

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

The issue, Vinay is -- these claims activity tends to sort of lag about three months to what's happening in the global economy. And so as I've said to you before and I think I certainly said it publicly, for the last 18 months as the world went into this global recession, we have had a list of -- we've reviewed our portfolio fairly, we do that very, very regularly. And so we've had a hit list of potential issues that may arise. So whether we have two claims in a quarter or four claims in a quarter, it's in that sort of region. And the average claims, when they come through on a net basis, tend to be the very low double digits in millions, as well as that our recovery assumptions we're still very comfortable with. And then a very important point which I'm sure you haven't missed is the fact that over the last two or three months, commodity prices have recovered quite substantially, and that helps enormously in terms of liquidity and underlying collateral values. So again, I can only say to you that bearing in mind the scale of the global recession we're having to deal with, I'm very comfortable with where we are with this portfolio at this time.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

On the investment portfolio, I believe David mentioned that you will be putting more money to work in higher yielding securities. So would that be the fresh cash flows or would you move money out of some other securities you have and move them into higher yielding securities? And should we expect a high yield on the investment portfolio going forward?

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

Well, a couple of things, I guess. The answer to the first two parts of your question is yes. We are going to deploy and have been deploying more cash into the investments I mentioned. We're also reallocating in the portfolio from one class of assets to another. So we're doing both of those things in concert with the market conditions and what seems appropriate for our balance sheet and for our expectations. On the last point about yield, we're fighting against reductions in rates, so wherever we're moving money, we're looking for good opportunities that meet our risk return characteristics but we're also being challenged by a low rate environment.

Operator

Our next question comes from Ian Gutterman of Adage Capital.

Ian Gutterman
Adage Capital

I guess I wanted to follow up on what Josh and Terry had to say. I guess and I share all your thoughts, and I'm probably disappointed as you are but given we are staring into the teeth of another Great Depression and not knowing where companies' balance sheets were and whether they can raise capitals as they need them and so forth. The companies told [ph] (1:02:44) were cutting prices and the government seems to have no regard for what its entity does. Now the storm has mostly passed, what's going to put the fee to the fire? Is just seems there's no -- actually returns are going to deteriorate slowly, right? It's not like we're going to have some shock that's going to wake people up, and that kind of feels a little bit like boiling the frog, right? You do a little bit at a time and they don't know that they're dead. Isn't that just was going to happen. People who are going to disregard what we were seeing last six months ago, and what's going to make them wake up now?

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

I think absent a major event. I really believe that a number of companies have been very optimistic in the way that they've not only put their premium numbers, but also the way that they've established their loss picks. And some companies and I don't know which ones they are, will pick a loss pick at the beginning of the year, and they probably won't look at it for 12 months to 15 months. And my view is that because the margins on the primary side are just not there in the way that they're being reported. That has to come up, that has to catch up sooner or later. And so being the eternal optimist I am, because as I said I've been in this business for 38 years, I'm hoping that those financial numbers will come under greater strain over the next six to nine months. And I think that when CEOs and you will hear me criticize some of my colleagues in the industry, they're being far too detached from the actual reality of what is taking place in their business. And some of the pretense about risk monitoring and the reality of what is taking place from what is being reported, I hope some of that actually washes through. Without a shadow of a doubt, the risk reward factors for the primary industries for this year have been under a great deal of strain and that's why I said at the beginning of this year, this is a year to get through. We're getting through our balance sheet on the asset side, rebuilding that and I want to make sure that on the underwriting side, we are a strong and as well-prepared as we possibly can be. We've got great reserves, we've got great underwriters, we've got great product lines and just give us a business we can trade in.

Ian Gutterman
Adage Capital

I share that same criticism with some of your colleagues and how you differentiated yourself. I guess my concern is, isn't that sort of how '97, '98 out of the '97 to '01 period started, right? As we are a little bit behind on accident results and enough company's sort of did a wink and a nod, and by the time they got serious about it we're into a wall [ph] (1:05:49) where things are really bad. And it was sort of too late to stop it.

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

The difference of the reinsurance market was soft then. It's not. The reinsurance market has been pretty professional, pretty focused and maintained its margins. Others have been trying to grow them. That's very differentiated.

Ian Gutterman
Adage Capital

I agree, that's definitely the positive. I guess my concern would be that some of these sort of government-sponsored entities if you will. On the insurance side maybe start to weaken in terms of conditions and we see the T&C [transfer and convertibility] side go down the way it is last time.

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

I really don't see that on the cards. I think it's a recognition from some of these CEOs that the returns that they're looking at, in the near term are maybe not going to be there for them.

Operator

Our next question comes from David Small of JP Morgan.

David Small
Bear Stearns

On the Political Risk, you've mentioned, I just want to clarify, are there new claims that are coming in this quarter just because the waiting period is off, and essentially the banks have been able to come to a resolution? Or these new notices where they still on the waiting period but you're putting up reserves for them?

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

No, David, these are claims that have come in the door this quarter. What this -- we haven't really talked about the specifics of the claims this morning, but we did have new claims in the quarter as we had in the last several quarters. As John commented on, none of them individually were that significant. But as I mentioned again, it's a long duration in some of these policies between the time the contract's written and the time all of the premium were associated with that contract is earned. And so as we look at the book and we're looking at the reserving for the book, we are looking at the claim values, we're going to adjust the premium that is sitting on our books unrecognized in cases where we're recognizing claims amounts. I would maybe be pretty clear on this or very clear on this point, which is we don't record claims unless the waiting period is past. We need to have a default and the waiting period has to expire before it becomes a claim on our books, an actual claim. We do reserve for the book as well on an overall basis.

David Small
Bear Stearns

And then just in terms of your extended duration of the portfolio in the quarter. Is that all reflected to Vinay's question in the run rate net investment income we saw this quarter?

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

The duration extension comes just from the rate environment. We have seen a tick up in rates on the mortgage-backed portfolios or on the mortgage rates out there, so the amount of refinancings and prepayments if you will have slowed, and that's really the result which is an extended duration on the portfolio. As I mentioned in my remarks, we did reduce some of the mortgage-backed portfolios which also helps reduce the duration but nevertheless, it's a big portion of our overall asset. So the tick up really is related to what's going on in the prepayment market.

David Small
Bear Stearns

And then just could you remind us what drives the negative fair value adjustment on the life settlements?

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

One most important factor is the underlying experience of the portfolio and just as a reminder, it's a limited portfolio or a small portfolio of lives in that overall contract, something about 180 or so lives. We have assumptions about the number of expirations that will occur in that portfolio over time, and certainly it's not going to be every quarter where our assumptions are going to bear out exactly but as we see experiences different than our underlying assumptions, we make adjustments. So we had less experience this quarter than was anticipated and that triggered that adjustment.

Operator

Our next question comes from Brian Meredith of UBS.

Brian Robert Meredith
UBS Investment Bank, Research Division

First one, was there any adverse development in the quarter and in line to this is kind of like we had in trade and credit reinsurance in the first quarter?

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

Sorry, I didn't catch that, Brian.

Brian Robert Meredith
UBS Investment Bank, Research Division

Was there any meaningful adverse development on any lines of business in the first quarter? Kind of like we had trade and credit reinsurance in the first quarter of '09?

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

There wasn't really any meaningful in that sense, Brian, and that's why I didn't comment on it in the prepared remarks. There was some adverse development in the professional lines 2008 year, but it was small enough that it wasn't worth mentioning, frankly.

Brian Robert Meredith
UBS Investment Bank, Research Division

I want to get in the duration of investment portfolio. Where do you stand right now relative to the duration on your liabilities since you have more room to extend duration on the asset side?

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

We definitely can extend duration. We're purposely staying short because the issue here I think is going to be that rates begin to rise and we don't want to be caught out in that issue. So we definitely have a much shorter duration than we otherwise could have.

Brian Robert Meredith
UBS Investment Bank, Research Division

John, wondering if you could remind us on the Political Risk business. What are the kind of average limit exposed on that business, and what protections do you have in place to kind of net down your potential losses on this exposure?

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

The average limits that we put out are around $30 million, $35 million. And we actually do not buy reinsurance on that portfolio. The way I look at it is it's got an in-built reinsurance which is actually the recovery rate of the underlying assets, which has been proven to be very strong at a very long period of time.

Brian Robert Meredith
UBS Investment Bank, Research Division

Just on an average limit, there is one particular political risk out there that I guess is probably disclosed. It looks like your limits are fairly large on that one. Is that kind of a one-off type of item?

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

Yes, it is.

Operator

Our next question comes from John Hall of Wells Fargo.

John Arthur Hall
Wachovia Securities, LLC, Research Division

In your comments, you we're talking about smaller regional and specialty carriers. I was just wondering if you could categorize or give a little bit more detail on the demand that you're seeing there, what they're looking for exactly?

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

I think that there's some signs emerging of some capital relief issues that need to be addressed which may present us with some opportunities over the next couple of quarters which we will look forward to.

John Arthur Hall
Wachovia Securities, LLC, Research Division

So that hasn't fully played out as of yet?

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

No, it's just emerging. I think it will be good.

John Arthur Hall
Wachovia Securities, LLC, Research Division

And David, in your response to David Small's question about life settlements. I was just wondering if you could offer what's the size of that life settlements portfolio is?

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

In terms of lives, I mentioned it's 188 million. In terms of the size of portfolio. I have to go back and look on whether we've disclosed on it, I just don't remember. If it is, it would be in our 10-K. I'm sorry, I don't have it in front of me.

Operator

That does conclude our time allotted for the question-and-answer session. I would now like to turn the call back over to management for any closing remarks.

John R. Charman
Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe

Well thank you again, ladies and gentlemen for listening to us this morning. I was interested to hear the Stairway of Heaven music just before we started our commentary. I hope that you can think of us as sort of moving strongly up that stairway, and we'll get there as quickly as we possibly can do. Thank you again. Bye.

Operator
The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.