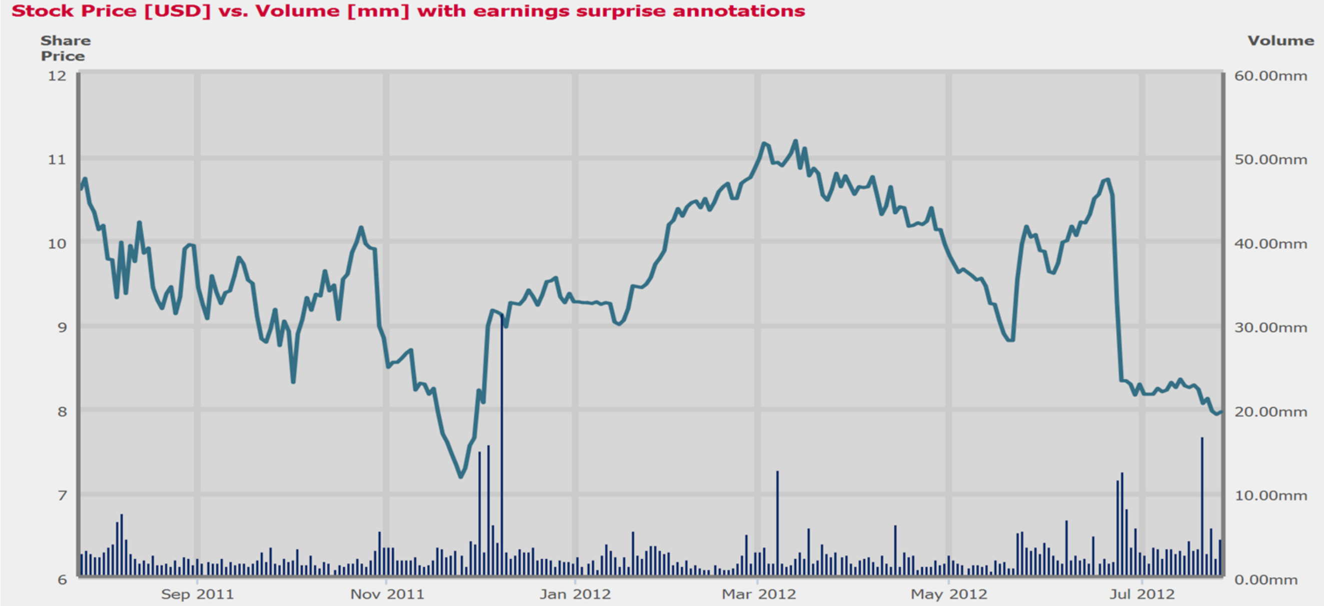
S&P Global
Market Intelligence

Old Republic International Corporation
NYSE:ORI
FQ3 2012 Earnings Call Transcripts
Thursday, October 25, 2012 7:00 PM GMT
S&P Global Market Intelligence Estimates

	-FQ3 2012-			-FQ4 2012-	-FY 2012-	-FY 2013-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	(0.03)	(0.11)	NM	0.25	0.44	0.60
Revenue (mm)	1137.99	1304.80	▲14.66	1196.08	4543.41	5611.67

Currency: USD
Consensus as of Oct-17-2012 8:07 AM GMT



	- EPS NORMALIZED -		
	CONSENSUS	ACTUAL	SURPRISE
FQ3 2011	(0.16)	(0.43)	NM
FQ4 2011	(0.16)	(0.11)	NM
FQ1 2012	0.21	(0.01)	NM
FQ2 2012	0.03	(0.19)	NM

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Call Participants

EXECUTIVES

Aldo Charles Zucaro
Chairman & CEO

Karl William Mueller
Senior VP & CFO

Scott Eckstein
Director of Account Services

ANALYSTS

Jim Ryan
Morningstar Inc., Research Division

Raymond O. Wicklander
Tradewinds Global Investors, LLC

Steven William Charest
Divine Capital Markets LLC, Research Division

Presentation

Operator

Good afternoon, ladies and gentlemen. Thank you for standing by. Welcome to the Old Republic International Third Quarter 2012 Earnings Conference Call. Today's call is being recorded. [Operator Instructions] And it is now my pleasure to turn the conference over to Mr. Scott Eckstein with MWW Group. Please go ahead.

Scott Eckstein
Director of Account Services

Thank you, operator. Good afternoon, and thank you for joining us today for Old Republics conference call to discuss third quarter 2012 results. This morning we distributed a copy of the press release. If there is anyone online who did not receive a copy, you can access it at Old Republics website which is www.oldrepublic.com.

Please be advised that this call may involve forward-looking statements as discussed in the press release dated October 25, 2012. Risks associated with these statements can be found in the company's latest SEC filings.

Participating in today's call, we have Aldo Zucaro, Chairman and Chief Executive Officer, Chris Nard, Chief Executive Officer of the run-off RFIG business, and Karl Mueller, Old Republic's Chief Financial Officer.

At this time, I'd like to turn the call over to Al Zucaro for his opening remarks. Please go ahead sir.

Aldo Charles Zucaro
Chairman & CEO

Okay, thank you, and good afternoon to everyone. So with this quarter's earnings report, we will continue with the refocused approach we adopted last quarter in discussing Old Republics business, specifically, we'll be focusing on our Old Republic holding company system sitting so to speak on a 3-legged stool, the 3 legs of course are represented by our 2 largest businesses of general insurance and title insurance and a much smaller life and accident operation.

The fourth leg which we recently reorganized as the Republic Financial Indemnity Group or RFIG, combines our mortgage guarantee and consumer credit indemnity coverages, both of which are in run-off operating mode and are not producing any new business currently or not going to be producing new business for the foreseeable future, and therefore their operations are limited to the collection of renewal premiums and the settlement of claims on the run-off business.

From an ERM enterprise risk management standpoint, we view the RFIG run-off business as being akin to a discontinued operation, and we say akin too because existing GAAP accounting rules do not allow financial reporting treatment as in fact a discontinued operation even though that is effectively what's happening with it, since it is being driven as I say, for an extended run-off period.

We firmly believe that the long term run-off in which these operations are currently, is absolutely needed to allow sufficient time for resolving both existing as well as future claim obligations in a very methodical and rational basis.

As we've reported in the past as well as in this morning's news release, a recapitalization of our mortgage guarantee line which is absolutely necessary since most, if not all of its capital has now been depleted, that such a recapitalization within Old Republic's holding company system is simply not in the cards.

We just do not have the kind of money to re-energize so to speak this business. Moreover, we have no assurance whatsoever that the necessary process we would need to have to not only raise the capital but also to seek and receive approvals from various entities would be anything but would be basically very time consuming and distracting to us.

That's another reason why a recapitalization within Old Republic's existing holding company system is not in the cards, as they say.

So our situation now is to do the very best job that we are clearly capable of doing. And that is to achieve 2 very important paramount objectives. One, is to manage the run-off in the most efficient and economical manner in order to maximize the benefits to all stakeholders who've relied on the terms of the mortgage guarantee policies that have been issued over the years by RMIC.

And two, to offer what we consider, and what I believe are highly regarded, good policy holder, and claim settlement services, as well as the capabilities of our back office infrastructure, to selected, unaffiliated companies who could benefit from those services in a very economical way.

So in the mean time, we will just plug along, and we'll include, we'll keep including the RFIG results in the Old Republic consolidated statements in the same manner as we've shown in this morning's report as well as in the second quarter report when we reconfigured the financial presentation of our business. As we've indicated in the past, we are very confident that RFIG will continue to register losses well into 2013 with still a good chance that the red ink should begin to disappear sometime in 2014.

So having said all of this, we'll turn now to a focus on, as I said, on our general and title insurance businesses, and this time around, Karl Mueller, our CFO and I will do, as I said before, we'll give some commentary and then we, the 3 of us Karl and Chris and I will respond to any questions you may have on these businesses as well as the mortgage guarantee business.

And beginning next quarter, I might say that we'll have the leaders of our general and title insurance businesses available to participate as well.

So beginning with general insurance, the good news so far this year is that the top line is reflecting quite a bit of momentum, as you can see in the report, as we reported last quarter, the uptick is coming mostly from a combination of rate increases for most of the coverages that we are offering in this segment, it's also coming from a higher product demand from existing as well as new customers, and from what we can tell, from a slight or moderate increase in the overall economic activity in most part of the nation's private sector which as you know, is the key generator of insurance demand for Old Republic.

The investment income line as you can see in the table on page 3 for the general insurance business, that line is treading water, and as we say there in the release, this is simply a function of a very low yield environment that's affecting both investments as well as reinvestments of available funds.

So even though we're experiencing a very good positive cash flow, and Karl will speak to that in a few minutes, and that cash flow is very additive to the invested asset base of our general insurance business, the adverse effect of the current, as well as foreseeable lower yields, is offsetting the positive impact of the growth in the invested asset base.

If you look at page 1 of the regular statistical exhibit that we post each quarter on the Old Republic website, you'll see that this year's claim ratio is being nudged up mostly in the worker's compensation line.

You'll see there that the 2011 claim ratio for that line was at 72.3% for the whole year, and for the first 9 months of this year it stands at 77.9%, so we've had roughly almost a 6 point, percentage point increase in that loss ratio in general insurance or 8% higher.

The reasons for this, we think are a mixed bag, but generally speaking, they stem from some bleeding in prior years case reserves, meaning that some of the cases that we've settled this year so far have been settled at amounts that were higher than were provided in case reserves at year end 2011.

And also from a somewhat higher formula driven reserve increments that has been hitting both the current and prior years of worker's compensation claim cost in particular. In fact, what we do is to, as time goes on and as experience develops, we react accordingly and when we see, particularly in this case, where we see some reserve efficiencies coming up on individual case reserves, we take another look and boost the so-called IBNR or incurred but not reported reserves to hopefully accommodate and stem any further adverse development of the reserves going forward.

As we've said in the past, the main culprits particularly in the workers comp area, consists of a claim cost that are represented particularly in a high, relatively high unemployment situation as we're experiencing the past few years in our country, that those typically tend to be accompanied by lingering disabilities if you will.

As well as from the embedded inflationary pressures on healthcare generally, and on related pharmaceutical costs.

All of which of course impact workers comp, as they say. And as you can see in the same financial supplement, this year's claims ratios are pretty much in line with 2011 and 2010 with regard to the other lines of business.

Turning briefly to title insurance, there isn't much to report, it all is good news, the turnaround in this business continues unabated.

The underwriting and the service features of the business continues to trend very positively as you see, and it has now, the business has now produced increasingly favorable results for 5 quarters in a row. So the business starts to turn around in 2010, and has continued pretty much very steadily since then.

The underwriting ratios you see in title insurance on page 4 of the news release, attest to this turnaround with both claim as well as the expense ratios dropping concurrently when you do year-over year comparisons.

To a large extent, this positive underwriting and service performance is driven by what's happening to the top line in terms of both premium and fee revenues with fee revenues as you may know being generated primarily by our direct production facilities and the premiums being generated by the combination of our direct facilities as well as the very large agency plant, independent agency plant that we have in title insurance.

So the market share gains that we've had in the past 3 years or so, as well as the large investment we've made in people talent in this 3 year timeframe, those are the key elements that are enabling us to take full advantage of both a slowly improving purchase market and as importantly, particularly in the last year or so, from a surge in refinance activity.

That's obviously underpinned by historically low mortgage interest rates. So at this point in time, we think that this combination of favorable factors is going to continue as long, in particular as the Fed keeps its foot on the interest brake pedal, and as long as the housing sector improves as consumers become more positive about their future job and income security.

Let's see, having said that, about our operations, let's turn this call over to Karl Mueller who has prepared to make some additional and related points about our financial situation at standing.

Karl William Mueller
Senior VP & CFO

Okay, thanks, Al. As we reported in this morning's earnings release, we ended the quarter right at $3.7 billion in total shareholder's equity or $14.40 per share which by the way reflects little change from year-end 2011 as we show in the table, I think on page 8. On the asset side of the balance sheet. The investment portfolio mix has really not changed substantially since the prior year end. It continues to favor high quality liquid fixed income securities and continues to reflect solid market appreciation.

On the other side of our balance sheet, for the first 9 months of this year, the consolidated prior year end loss reserves are developing at essentially a breakeven point which is largely consistent with the same period of results for 2011.

However, I would note that the makeup of the current year development results from lower favorable development in the general insurance group for the reasons that Al just enumerated a little bit ago, and that is offset by lower deficiencies in the RFIG run-off segment. I do think it's reasonable, or we think it's reasonable to expect that these overall trends could continue for the next couple of quarters or so.

Our quarter end debt to equity ratio remains at 15.5% as of September 30th and the debt to total capital ratio is 13.4%, both of which are unchanged from June 30th. These percentages are much lower than the comparable percentages of 24.2 and 19.5 as of the prior year end, and again, that's due to the repayment of our 8% convertible debt securities that we discussed at length during our second quarter earnings call.

We believe that these debt leverage ratios provide us with more than sufficient flexibility to go to market and issue additional debt if the need arises, and to be able to do so without putting any undue pressure on our balance sheet leverage, our debt service requirements, or in our view our independent financial ratings.

In this morning's release we reported a year-over-year improvement in the consolidated operating cash flows to a positive $322 million from the first 9 months for this year. And as compared to a deficit of $127 million for the same period a year ago.

We did see improved operating cash flows in each of our operating segments, although the largest contributors to the total for this 9 month period originate from our general and title insurance operations.

From a parent company liquidity perspective, we ended the quarter with cash and short-term investments at the holding company and its non-regulated subsidiaries of right at $146 million. This amount can vary from period to period as you might suspect due to the timing of cash flows in and out of parent company. And this year's parent company cash flow was in fact impacted by the settlement of certain intercompany tax balances during the third quarter of 2012.

As we look forward and as a result of paying off the 8% convertible notes during the second quarter, as I mentioned, our interest payment requirements will decline by a little over $25 million annually on a go-forward basis. So that should be additive to our cash resources. We continue to believe that our general title and life insurance segments, the companies operating in each of those segments are adequately capitalized to not only support our current level of operations, but as well to support a reasonable amount of future growth.

We manage capital adequacy by monitoring a wide variety of metrics and our long-term trends at all times throughout the year. Given the long term nature of our business, a key metric that we focus on relates to the ratio of claim and claim expense reserves to our capital base. And with respect to the general insurance group, we think that we can easily operate with reserves on an overall basis of up to 1.75 times its corresponding capital base.

And if you were to look back over the past 5 years, you'd see that we've been operating within a range of 1.39 to 1.55 times capital. And as of September 30th, we're right at about 1.4 times. So we're at the lower end of our 5-year range. We think that these are very acceptable and conservative ratios that should allow us to grow the business at a reasonable pace if the opportunities in the market place present themselves.

We think this is particularly -- so given that we have experienced basic reserve adequacy over a long period of time, this reserve structure serves to protect the capital base and that enables us to safely add reserves to the balance sheet as the book of business grows over time. This same methodology and outlook to capital adequacy also applies to our title and life segments of the 3-legged stool that Al referred to earlier.

Finally, I might just note that the amount of dividends being paid to our holding company from our 3 active segments are and continue to be at a sustainable level, and at a level that can easily meet the ongoing cash flow requirements of the Old Republic parent company.

So that concludes my remarks. And why don't I just turn it back to Al for any final thoughts.

Aldo Charles Zucaro
Chairman & CEO
Okay. I think between Karl and I, we've given you some additional color on this morning's release. So I think we should go ahead and open up this meeting to any questions you have.

Question and Answer

Operator

[Operator Instructions] And our first question will come from Jim Ryan with Morningstar.

Jim Ryan
Morningstar Inc., Research Division

Okay. When I'm looking at your title insurance operating statistics, I see the open and closed orders. Could I assume that those are your direct operations?

Aldo Charles Zucaro
Chairman & CEO

That's the...

Karl William Mueller
Senior VP & CFO

Yes, it is.

Jim Ryan
Morningstar Inc., Research Division

Okay.

Aldo Charles Zucaro
Chairman & CEO

It says direct orders and direct orders close, right? Because as you know, those are the orders that we can track. The orders that come in from the agents, particularly from an opening standpoint, we can see closings, but we cannot see the openings that are in the system.

Jim Ryan
Morningstar Inc., Research Division

And could you remind me what percentage of the reported premium on title is agent versus direct?

Aldo Charles Zucaro
Chairman & CEO

Roughly our business now is at around almost 65% agency and 35% direct. Most of the growth that we've had substantially, a substantial portion of the growth we've had in the size of our title business has come from the agency side. We've had -- yes, go ahead.

Jim Ryan
Morningstar Inc., Research Division

Then could we assume then since like most title companies, you're reporting on a one quarter lag basis, that most of the revenue we're seeing on title is really coming from the second quarter.

Aldo Charles Zucaro
Chairman & CEO

Correct.

Jim Ryan
Morningstar Inc., Research Division

Which means fourth quarter will have the third?

Aldo Charles Zucaro
Chairman & CEO

Correct, that's absolutely right.

Jim Ryan
Morningstar Inc., Research Division

Okay, all right. So then, you might assume judging from the competitor of yours that reported today that the fourth quarter would be even far better?

Aldo Charles Zucaro
Chairman & CEO

It should be.

Jim Ryan
Morningstar Inc., Research Division

Okay. I just wanted to clarify that.

Aldo Charles Zucaro
Chairman & CEO

Yes, sir.

Operator

Our next question will come from Steven Charest with Divine Capital Markets.

Steven William Charest
Divine Capital Markets LLC, Research Division

Just looking at one of the items here on a post-classified basis, I guess, we could call it, net premiums are growing about 15% and benefits and claims cost, up 22%. Aside from the workmens comp narrative, is there any sense from your perspective historically on seasonality in that?

Aldo Charles Zucaro
Chairman & CEO

Not really. I mean, as we've said before, Steve, we look at our reserve developments every quarter. And they're fundamentally driven in most of our lines of insurance. They're driven by paid claim trends. And in the general insurance business, in particular, their relationship of paid claims on individual case reserves. So when you see what's happening to us in the last couple of quarters, that's really reflective of that quarterly review of paid claim trends. Now obviously, depending on what happens to prior years reserves, that gives us the ability to determine what the effective cost have been for prior year's earned premiums. And therefore, we apply prospectively based on our views of what's happening to premium rates and so forth. We apply that prospectively to the current year. And that's why I believe I said that these adjustments impacted both some of the -- reflected both some of the prior year's cases being settled currently, as well as this prospective application of past experience to the current year's book of business. So particularly in general insurance, a lot more so than title or mortgage guarantee for that matter, there is very little seasonality to our business, especially when you consider that the premiums are earned on the so-called rule of 24th. So the premiums we write in a particular quarter get in fact amortized or earned over the next 12 months. So that stems or that reduces the seasonality on the revenue side of business. And then when you look to the claim side, as I say, we are very proactive in assigning a claim cost to the proper period. I think that's an overly long explanation and answer to your question but [indiscernible].

Steven William Charest
Divine Capital Markets LLC, Research Division

Yes. No, I appreciate it. I think I'll squeeze one more in there on the mortgage side of the business. Let's call it a chain of event from decreased delinquencies through the clearance process. We've been seeing improvement on the delinquency side the last few quarters as you guys reported and not yet seen evidence of improvement on that clearance cycle yet. Do you have any color that we could help fill in some of the story there or that's still too unclear yet?

Karl William Mueller
Senior VP & CFO

When you say that clearance cycle, I'm not sure I follow you on your term.

Steven William Charest
Divine Capital Markets LLC, Research Division

Yes. Right. So we're looking at claims or delinquencies coming down, not claims, delinquencies coming down and the expectations would be if that continues at some point, we would start to see the claims start to come down and the loss ratio start to bottom out maybe at 2014 or so as we discussed. And is there any more evidence of anything that we can look towards on a speculative basis?

Karl William Mueller
Senior VP & CFO

I think what we mentioned in the press release was as delinquencies have continued to come down as the economy recovers, we continue to make some adjustments in our provisions for rescissions. So we're taking down the estimated impact of rescissions in this quarter. That had a big impact and, in essence, swamped some of the benefits from the reduction of delinquencies. So what I would tell you is as those reserve adjustments begin to level off, then it'll be a clear view to seeing the impact of the reduction in delinquencies in the future.

Operator

[Operator Instructions] Our next question will come from Ray Wicklander with Tradewinds Global Investors.

Raymond O. Wicklander
Tradewinds Global Investors, LLC

The adverse development in workers' comp, how much of that was attributable to the PMA-acquired portfolio?

Aldo Charles Zucaro
Chairman & CEO

Well, that portfolio is melded with the rest of our business. We're looking at lost developments in their totality. We don't have the numbers right now, fully separated at least, and separated as we'd like them to be. So I can't answer the question. But we have a couple of books of business that as you might suspect in the construction area, which has had its difficulties in this economic climate, which are showing, have shown weakness on case reserve development. And then we've got a mixed bag elsewhere. We've got a couple of big claims that hit where we -- jury verdicts went against us. It is nothing that really stands out. But no question about it that the construction and some of the PMA represented a big chunk of what we had.

Raymond O. Wicklander
Tradewinds Global Investors, LLC

Okay. And then one more if I could, could you just enumerate some of the pricing gains you've seen in comp just to whet our appetites a little bit?

Aldo Charles Zucaro
Chairman & CEO

Well, I think you're looking at about a 5% or 6%, which is what we've said before. And also, as we've said before, we don't think that that's got by itself the makings of an improvement in profit margins, because we are still going to be incurring upward changes, lost cost driven by health care, pharmaceuticals, et cetera, as I said. Those are moving at a faster clip than 6%. So we think it's pretty much of a breakeven thing. So we're not going to -- we for one are not going to whet your appetite, to use your word, about what lies ahead because of these rate increases. They're good and we welcome them, but they're still not sufficiently high as to drive up the underwriting account profitability.

Raymond O. Wicklander
Tradewinds Global Investors, LLC

Okay. So pricing is still aways away from genuine adequacy, in your opinion?

Aldo Charles Zucaro
Chairman & CEO

Correct.

Operator

And with no further questions in the queue. I'd like to turn the conference back over to management for any additional or closing remark.

Aldo Charles Zucaro
Chairman & CEO

Well, we don't have any more comments. We appreciate the interest and look forward to our next visit to cover year-end results that will be public. So again, thank you, and you all have a good afternoon.

Operator
Once again, ladies and gentlemen, that does conclude today's call. Thank you for your participation and have a great day.