W. R. Berkley Corporation (WRB) CEO Rob Berkley on Q3 2019 Results - Earnings Call Transcript

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Q3: 10-22-19 Earnings Summary

Press Release *10-Q*

EPS of $0.8472 beats by $0.17 | Revenue of $1.68B (4.57% Y/Y) beats by $7.36M

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W. R. Berkley Corporation (NYSE:WRB) Q3 2019 Results Conference Call October 22, 2019 5:00 PM ET

Company Participants

Rob Berkley - Chief Executive Officer

Rich Baio - Chief Financial Officer

Bill Berkley - Executive Chairman

Conference Call Participants

Mike Zaremski - Credit Suisse

Joshua Shanker - Deutsche Bank

Sean Reitenbach - KBW

Operator

Good day. And welcome to W. R. Berkley Corporation's Third Quarter 2019 Earnings Conference Call. Today's conference call is being recorded.

The speakers' remarks may contain forward-looking statements. Some of the forward-looking statements can be identified by the use of forward-looking words including, without limitation, beliefs, expects or estimates. We caution you that such forward-looking statements should not be regarded as a representation by us that the future plans, estimates, or expectations contemplated by us will, in fact, be achieved.

Please refer to our annual report on Form 10-K for the year ended December 31, 2018, and our other filings made with the SEC for a description of the business environment in which we operate, and the important factors that may materially affect our results. W. R. Berkley Corporation is not under any obligation and expressly disclaims any such obligation to update or alter its forward-looking statements, whether as a result of new information, future event or otherwise.

I would now like to turn the call over to Mr. Rob Berkley. Please go ahead, sir.

Rob Berkley

Thank you, Gigi, and good afternoon all. Thank you for joining us on our third quarter call this afternoon. So in addition to me also Bill Berkley, Executive Chairman and Rich Baio, Executive Vice President and CFO, are on the call.

We're going to follow a similar schedule through what we've done in over the past couple of calls. And I'm going to hand it over to Rich. He's walking through some of the highlights of the quarter. Once he's through his with his comments, I will be adding a few thoughts. But in relatively short order, we will be moving it over to Q&A, and you'll have the three of us at your disposal to answer any questions you may have.

So with that, Rich, if you would please.

Rich Baio

Great. Thanks Rob. Net income increased over the prior year to $165 million or $0.85 per share. Our results were favorably impacted by the accelerated growth in net premiums written of almost 8%, and improvement in our current accident either combined ratio excluding cat losses and higher foreign currency gains. Net investment income partially offset these favorable items due to investment funds reporting lower income, compared with a year ago quarter, but above our normalized range.

The growth in net premiums written was attributable to all lines of business with the exception of workers' compensation, which continues to experience favorable frequency trends and rate pressure by the rating bureaus. Overall, net premiums written was approximately $1.75 billion in the third quarter of 2019.

Premiums grew 5.1% to $1.5 billion in the insurance segment. The growth was led by an 11.9% increase in professional liability, followed by 11.2% in other liability and approximately 4% in commercial automobile and short tail lines. We also grew and that thing is written by almost 31% to approximately $220 million in our Reinsurance and Monoline Excess segment. The growth was in both property and casualty reinsurance.

Pretax underwriting profits increased more than 61% to $107 million compared with $66 million a year ago. The improvement was primarily attributable to an increase in net premiums earned of 4.6%, particularly in areas that we expect to be more profitable, and low underwriting expenses relative to the gross in net premiums earned. The current accident year loss ratio, excluding cats, improved by 1.1 loss ratio point to 60.4% in the current quarter compared with 61.5% a year ago.

In addition, cat losses in third quarter of 2019 declined 0.5 loss ratio point to 1.9%, or $31 million compared with $39 million or 2.4% last year. Finally, prior year loss reserves developed favorably by $4 million, representing approximately 0.2 loss ratio point. Accordingly, our reported loss ratio is 62.1% for the third quarter of 2019.

The expense ratio improved by 0.9% to 31.5% quarter-over-quarter, and was consistent with the preceding consecutive quarter. The benefit in the expense ratio is driven by higher net premiums earned, as well as scale from our new businesses added during the past few years and operational efficiencies as we continue to find ways to automate our processes.

As we've mentioned in the past, please remember that, our expense ratio may experience some variability as we continue to make investments in the business. This brings our reported combined ratio for the third quarter of 2019 to 93.6% and our current accident year combined ratio excluding cat to 91.9%. Despite changes in the investment environment, our core investment portfolio remained relatively flat quarter-over-quarter.

As previously mentioned, our net investment income declined due to lower investment fund income. These investments generally reflect market value adjustments and can create a degree of variability from quarter-to-quarter as was evidenced by the $19 million reported in the current quarter compared with $41 million in the year ago quarter.

Our investment funds have performed as anticipated in the current quarter and overtime. We have maintained an average rating of AA minus and slightly increased the average duration to 2.8 years for fixed maturity securities including cash and cash equivalents. We recognized foreign currency gains of $23 million in the current quarter, the predominance of which is attributable to the strengthening U.S. dollar relative to the Argentine peso and UK sterling.

The effective tax rate was 18.6% for the quarter, which largely benefited from equity-based compensation. You may recall the accounting rules changed in 2017 that caused the increase in the value of equity-based compensation from planned date to be reflected as a benefit in income tax expense rather than stockholders' equity.

Since the predominance of our equity-based compensation passed in August, our effective tax rate was favorably impacted in the quarter. Otherwise, our effective tax defers from the U.S. federal income tax rate of 21%, primarily because of tax exempt investment income, offset by foreign operations with the higher tax.

Stockholders' equity increased to approximately $6.1 billion or $32.97 per share. Since the beginning of the year, book value per share increased 13.7% before dividends. Our return on equity for the quarter on an annualized basis was 12.2% on net income. Finally, we had strong cash flow from operations in the quarter of $392 million, as well as year-to-date with almost $800 million. Thank you.

Rob Berkley

Okay. Rich, thank you very much. Very clear, very helpful. So, my turn. Again, I will keep my comments relatively brief, because we certainly want to use this time in any manner that you all would like to. So I hear a few sound bites.

Clearly stating the obvious, the fear factor is on the rise. If low interest rate -- interest rate environment and consistent and global cat activity over the past several years wasn't enough, it would seem as though social inflation is finally coming into focus for the broader audience. People are beginning to realize that it is real and it is here.

Frequency of severity can no longer be ignored, both in the property space but even more so in the casualty space. In some ways when we look at the landscape, a few of us were chatting the other day and noting how, on a smaller scale there are some similarities to what we saw in the med-mal crisis back sort of around 2002, give or take. Where we saw a sudden a relatively sudden spike in claims activity, severity seem to spin out of control. And ultimately what eventually came into focus for society was that when you have these type of awards coming out of the legal system, it is society that pays the price one way or another.

Back in the days of the med-mal crisis, whether it was that people could not access doctors in certain cities, towns and counties, or just the price of healthcare faced further pressure and it's going up because of the cost of insurance. It is a small data point relative to what we may be seeing in the broader casualty or professional, i.e. liability market, possibly these days.

Should people be concerned? In our opinion, the answer is yes. Should people be surprised? In our opinion, the answer is no. We have for two and a half, three years, been beating the social inflation drum. We have been talking about what we have seen as much as four and five years ago in commercial auto. More recently, we have been talking about GL and much of the professional space as well. And we have been making our comments along the way that on the property front about how we felt there's much of the market was not appropriately pricing for the business.

We have been making comments about the reinsurance market, which led to as you may recall over the past several years until recently or the past couple of quarters, our reinsurance business exercise the appropriate discipline and it shrink and it shrink dramatically. It was not till the past couple of quarters we saw that trend reverse.

Social inflation is real, it is here and the industry is beginning to pay attention. It is something that we have been paying attention to for several years. We have not only been paying attention, we've been taking action. We've been addressing it, yes, in part through pricing. But the market will only let you do so much with pricing. We have been taking greater action through selection, terms and conditions, as well as attachment point.

So I do not mean to suggest that we are completely insulated from the challenges that the industry faces. But do I think for a whole host of reasons, we are more well positioned, without a doubt. I think in addition to that, the nature of our portfolio being the one that tends to focus on smaller business, tends to naturally steer us away from some of the headline losses that we read about in the papers. Again, does not completely insulate us but leaves us with a disproportionately modest amount of exposure.

So data points that we have shared with some of you in the past. Our average, excuse me, approximately 90% of our policies domestically have a policy limit of $2 million or less when we are legally allowed to have a policy limit, workers' comp by example being an exception. The average premium for one of our policies is approximately $11,000. So as you can see from these data points, we are not an insurer of the type of exposures that tend to grab the headlines.

Turning to our quarter. Rich did a nice job walking you all through it. A couple of comments I will offer. In addition to his thoughts, the top-line, again, as he touched on, obviously, up considerably. Rate increases, as he referenced in the release, were meaningful, coming at actually at 7.4% for the quarter, excluding workers' compensation. We have heard a question about why do we exclude workers' compensation and our rate monitoring. I would have thought that we have addressed this in the past, but let me address it again for a good measure.

For those that are not aware, workers' compensation and how the product is priced is heavily dependent on payroll. To the extent that payrolls are keeping up with inflation, that is a meaningful difference from other lines of business. So from our perspective, workers' comp, because and how it is priced off of payroll is a different animal to a great extent than many other lines that we track. So we felt as though it is more helpful to the audience to understand what the number is ex comp, because comp can be misleading or distort the texture.

So, again 7.4 on the renewal retention ratio, that continues to sit around 80%. Again, as we've mentioned in the past, that gives us a sense that the portfolio is not shifting a great deal. We do not think we are particularly susceptible to adverse selection when we look at the 7.4 in context with the 80%. New business relativity, which again is not a perfect measure as we have talked about in the past for the quarter, came in at 1.037%.

In other words, our best estimate is our new business, on average, is being charged 3.7% more than our renewal business. Again, as we have commented into the past, we think that makes sense. Given that we know more about our renewal book than we do about our new book, i.e. there is more unknown, more risk, which means we should be getting more rate.

Accident year loss ratio, as Rich touched on, improved considerably. From our perspective, really the driver behind that is again mix of business in the underlying portfolio. We understand that the math from the outside looking in may not work perfectly, because you're looking at our loss ratio, you're trying to throw in some trend and then you're trying to throw in what type of rate we achieve.

But one should not underestimate the impact that mix amongst other things has on that loss ratio. And again, when we look at it that is the big driver. Rich touched on the expense front. Congratulations and a heartfelt thanks to many people that continued to work tirelessly to make our business as efficient as possible, which presumably inner to the benefit of all stakeholders.

A couple of comment just on the investment front, Rich covered that in some detail. I would just add the funds and the returns they generated in the quarter are really more normalized as he mentioned this time last year, or third quarter '18 was a bit of an exception, a happy one, but it was still an exception. And the last comment you may have noticed in Rich's comments or in the release perhaps, the duration move back out from 26 to 28. That was primarily a result of us using some cash to pay down a significant amount of debt during the quarter, which I think was about $440 million.

So a couple of parting comments, I usually do this at the end of the call. But I've noticed that many of you drop-off before I get a chance to do it, because you've got your questions off your chest, so I'm going to tuck-in it now, so you can't escape. It is without a doubt a challenging moment for the industry. It is going to be particularly challenging for those that have not been both paying attention and taking action. The combination of low interest rates along with Mother Nature that doesn't seem to want to leave us alone on the cat front and then really the big nut out there being social inflation, this is a pressurized situation. We think that we will be disproportionately less impacted relative to many of our peers, because of the type of business that we operate and our approach to running the business.

In addition to that, we think we are disproportionately well-positioned, because of the nature of business that we ride again. We think this shift in the marketplace is not going to be attempt to what we saw in 2011. And while no cycle is a mirror image of other cycles, there certainly are some of the fundamentals that are lining up that would suggest that, while it may not be like '86 it certainly could be, in some ways, attempt to 2002, 2003. This will undoubtedly create opportunity and benefit for the specialty space and in particular meaningful opportunity for the EMS space, which as you all know, is a significant and important part of our business.

So Gigi, I am going to pause there and I will leave it to you to please open it up for questions, if you would.

Question-and-Answer Session

Operator

[Operator Instructions] And our first question is from Mike Zaremski from Credit Suisse. Your line is now open.

Mike Zaremski

First Question, so as you and other insurers talk about higher loss trend, and actually you or the question, I guess would be, are you guys seeing higher lost trend. But I guess some people had sort of point out the fact that like many others, W. R. Berkley has seen decelerating levels of reserve releases. And so I guess just curious, does it make any sense for a company like Berkeley, which has a good underwriting track record, to become more cautious on its loss reserving practices in order to say like build a cushion for say, should loss trends accelerate further?

Rob Berkley

Mike, as you well know and others are acutely aware, one of the challenges of this industry is you don't know your cost of goods sold until after you have made the sale. And that leads to many consequences, including not always the level of precision that one would like.

So to your point, we are conscious and have been conscious for some number of years, which is why we've been sharing the observations, making the points, waving the flag that the environment is changing that loss costs are on the move. That is why we have been measured. You can -- we can see that in the last text that we are using, we can see that and how quickly we are prepared to recognize development, we are trying to be measured.

During a period of time that is stable, one does not need to exercise the same level of caution. But we have some time ago and as you look back at our commentary as well as our results. We have decided to be measured, because we are conscious of the environment shifting. And while we will not be able to quantify it perfectly other than through hindsight, we are paying close attention and want to make sure that we are being responsible.

Mike Zaremski

And so are you seeing loss trends move higher as one other insurer said they saw today and another an insurer earlier this week?

Rob Berkley

So we've been seeing, if I'm understanding correctly, we've been seeing what you're talking about for several years, depending on the product line you wish to drill down into. Commercial auto, we've been seeing it for five years. Some of the other lines, we've been seeing it for more than two, less than four.

And I think one of the points that's worth noting and we learned this quite frankly the hard way with commercial auto is that the trend move and it moves quickly. So in an environment where things are not changing quickly, you realize you're behind, you raise your rates by what you think you need to raise it to and you feel like you hit the bulls eye.

The problem is over the past few years, and it continues to be the case, the bulls eye is moving quickly. So you can address that through rate. In some cases, I don't think rate is the optimal way to address it. Sometimes, you really need to be doing it to terms, conditions, attachment points and selection.

Mike Zaremski

Okay. One follow-up on Commercial Auto. Would you be willing to share whether your commercial auto has a big element of Monoline or is it mostly package?

Rob Berkley

We have both.

Mike Zaremski

Okay, and…

Rob Berkley

And we have a meaningful amount of both. So we will write everything from Monoline long haul trucking. We write a fair amount of excess transportation, or vehicular and a lot of it is truck. Then of course, we're writing some commercial auto that's part of a package as well. Some of the challenges that the industry is facing, I think came into focus earlier for the long haul Monoline stuff. I think some of the package stuff came into focus a little more slowly, or more recently. But that would just be experience. I can't speak for the industry.

Operator

Our next question is from Joshua Shanker from Deutsche Bank. Your line is now open.

Joshua Shanker

So you have obviously made a centerpiece of your discussion, the way that social inflation's impacting the industry's numbers. Can you talk about, given that we had a number of years of benign inflation, I think over the last decade. When the inflection point is that social inflation had become an issue and how you have been reserving for that in your numbers, timing wise?

Rob Berkley

So we started, depending on the product line, we started noticing something was percolating, give or take three years ago, some lines it was a little bit more, sometimes at some lines it was a little more recent. And we certainly -- it didn't just wear its head all at once and you started to see incremental signs of it and we dug in. And as a result of that, we started to take what we viewed as appropriate action both on the reserving side but even more so prospectively on how we were selecting and offering covers and pricing.

As far as the details around specifically how we reserve for different product lines, that's typically not something that we would be getting into as far as that type of detail on this call. If you're looking for a lot more granularity, you're welcome to give Karen a call and of course she will share with you whatever she can without obviously being mindful of the regulations and the law.

Joshua Shanker

Yes, of course. I guess, if we think about -- it's hard to talk about a phenomenon as like IBNR, but those reserves that you put up three years ago than anticipated. Have they been met with claims in line with expectation? Or is there still a material amount of adding between what you expect the social inflation to be and where you set the reserve for?

Rob Berkley

Josh, when we look at our reserves, we obviously -- we have 53 operating units. We have a variety of different products. And ultimately, there're some places where we've gotten a little bit long there, some places we get it a little bit cold. But in the aggregate, we're pretty comfortable with where things stand. So again, I'm reluctant because it's just I don't think really in the best interest of our shareholders to start talking about chapter and verse how we reserve by product line. But from our perspective, we are very comfortable with our reserves. And what seems to be coming into focus for the industry is something that we started to contemplate some number of years ago. And yes, in part that is included in the last text that we have used in the more recent years, and we are -- I'm comfortable with it.

Joshua Shanker

And then on submission flow, obviously, you guys are aware that 2019, Lloyd's as a distribution center or as a, at point of sale, pull back from the market to some extent, giving a lot of your businesses, and look at the business they may not have seen before. Looking at 2020 and what you're seeing in the market right now, do you expect Lloyd's to be more aggressive? Do expect to see as much submission next year as you saw this year? How do you think that's going to shake up compared to, '18, to '19 to '20?

Rob Berkley

So as far as Lloyd's goes, while they do have a presence in the casualty and the professional market, they are certainly much more short-tail marketplace than they are a long-tail, or liability market. That being said, we certainly have benefited from a change in appetite by many market participants. I'm not singling out Lloyd's. How they will choose to behave and what their appetite will be for the 2020 year and beyond, I think that's a better question for Mr. Neal and Mr. Hancock than me.

Having said that, it is our expectation that much of what we're seeing gone in the marketplace where capacity is being constrained, not just by Lloyd's but by many other household names where most situations where there were once willing to put out $50 million, $25 million chunks of capacity, now they are looking to put out $5 million and $10 million of capacity. That is something that is innerving to the benefit of all market participants. So we are clearly seeing a growing number of lines where I wouldn't say there is an absence of capacity, but capacity is clearly tighter.

Operator

Thank you [Operator Instructions]. And our next question is from Sean Reitenbach from KBW. Your line is now open.

Sean Reitenbach

So in terms of pricing, do you guys still see pricing accelerate throughout the quarter, and which lines are you -- are still need the most rates in your view?

Rob Berkley

So clearly, we saw the momentum continued to build as far as rate goes in the third quarter, when you compare to any data point earlier this year or for that matter of data points last year on the rate front. Again, ex-workers' compensation, workers' comp continue to move in the other direction. As far as lines of business that need the most rate from our perspective, there is a broad rate need for the industry. And we are looking forward to rates continuing to move up from where they are. And once they reach a certain level, I think you'll see us start to grow the business more aggressively.

But we have to pull our horns in some lines of business over the past couple years, because of market condition. And whether that was the terms and conditions or pricing that wouldn't sell that was the reality as the market is moving more towards what we think is a responsible place, you'll see us expand. But as far as where the rates going to go, I would suggest to you to look -- getting the earliest, that's where probably you will have the most rate increase and just the overall most firming in the market.

Sean Reitenbach

And then on the tort in social inflation environment, to what extent you guys still expect this to continue to get worse over the next 12 months or longer? And how much do you think is a -- is it a political [indiscernible] of court justices or in broader societal movement that might be a little tougher to ultimately reverse or even stabilize?

Rob Berkley

You want to comment on it?

Bill Berkley

I think you're really looking at several things going on at the same time. Society wise, as we can clearly see in the political process, we're really seeing a group of people who are fermenting resentment of those who have. We're seeing in court decisions that make no economic sense that court is trying to punish people. And as we start to see that, that's going to continue until people realize that the people who really get punished and people who ultimately have to buy insurance as Rob talked about the malpractice situation.

The reality of the system is the decisions are worse the trends are not going to change. We have a while before you're going to see a change. A while meaning you probably have, on the short end, it would be 18 months, on the longer end three years. But there's a while. People are unhappy and angry and that resentment is coming from court decision. And you're seeing more and more of those Obama judges in courts supporting those decisions. So I think that things will get more difficult for a while on all fronts.

Operator

Thank you. At this time, I'm showing no further questions. I would like to turn the call back over to Mr. Rob Berkley for closing remarks.

Rob Berkley

Okay. Well, we certainly thank everyone for their time. And from our perspective, it was a solid quarter. When we look at on the horizon, as suggested earlier, we think it's not without its challenges, but our organization is particularly well positioned to take advantage of it. Given our product offerings, given how we participate in the marketplace and given that we think we are on a strong foundation, it will allow us to capitalize on what it will undoubtedly be a more challenging market, which will also undoubtedly provide opportunity.

Thank you all very much. Have a good night.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.