S&P Global
Market Intelligence

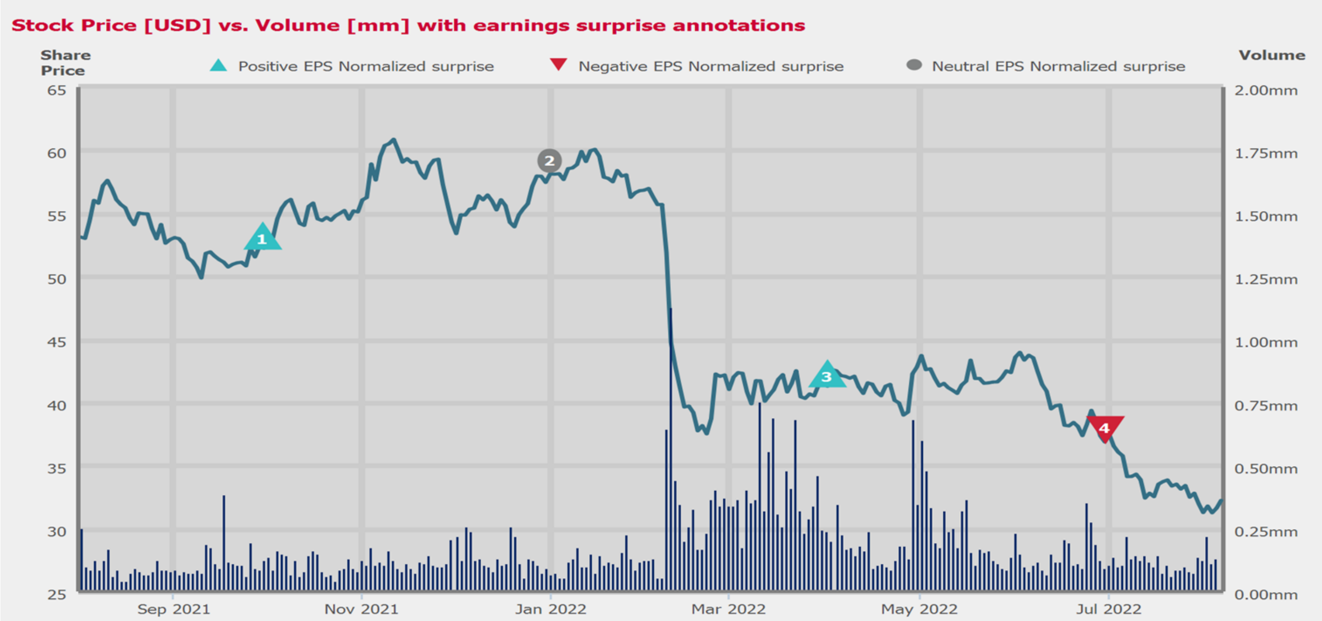
Argo Group International Holdings, Ltd.
NYSE:ARGO
FQ2 2022 Earnings Call Transcripts

Tuesday, August 09, 2022 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2022-			-FQ3 2022-	-FY 2022-	-FY 2023-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.19	0.89	▼(25.21 %)	0.81	4.37	NA
Revenue (mm)	519.30	443.20	▼(14.65 %)	490.00	1912.00	NA

Currency: USD
Consensus as of Aug-09-2022 10:05 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2021	0.11	0.91	▲1 727.27 %
FQ4 2021	(2.02)	(1.77)	NM
FQ1 2022	1.10	1.24	▲2 12.73 %
FQ2 2022	1.19	0.89	▼3 (25.21 %)

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Call Participants

EXECUTIVES

Andrew Hersom
Head of Investor Relations

Scott Kirk
CFO & Principal Accounting Officer

Thomas A. Bradley
CEO & Executive Chairman

ANALYSTS

John Thomas Heagney
Dowling & Partners Securities, LLC

Presentation

Operator

Good morning, everybody, and welcome to today's Argo Group Second Quarter 2022 Earnings Call. My name is Drew, and I'll be coordinating your call today. [Operator Instructions] I'm now going to hand over to Andrew Hersom, Investor Relations, to begin. Please go ahead.

Andrew Hersom
Head of Investor Relations

Thank you, and good morning. Welcome to Argo Group's conference call for the second quarter ended June 30, 2022. After the market closed last night, we issued a press release on our earnings, which is available in the Investors section of our website, argogroup.com, and was filed with the SEC.

Presenting on today's call is Tom Bradley, Argo Group Executive Chairman and Chief Executive Officer; and Scott Kirk, Chief Financial Officer.

As the operator mentioned, this call is being recorded. During this conference call, Argo management may make comments that reflect Argo's intentions, beliefs and expectations for the future. Such forward-looking statements are qualified by the inherent risks and certainties surrounding future expectations generally and may materially differ from the actual future results involving any one or more of such statements. Argo Group undertakes no obligation to publicly update forward-looking statements as a result of events or developments subsequent to this call. For a more detailed discussion of such risks and uncertainties, please see Argo Group's filings with the SEC.

Also note that we will be referencing certain non-GAAP financial information, including reconciliations thereof. More information regarding these non-GAAP financial measures is provided in our earnings release.

I will now turn the call over to Tom.

Thomas A. Bradley
CEO & Executive Chairman

Thank you, Andrew, and thank you to everyone for joining us today. Before getting into the results, I wanted to say it is a privilege to be appointed CEO and lead Argo and its dedicated employees forward into the company's next chapter. Together, we have transformed many aspects of the franchise over the past couple of years, positioning it well to deliver growth and profitability. As a result, I'm excited about the opportunities ahead to further enhance the company to better serve customers, expand our leadership role in the specialty insurance market and maximize value for shareholders.

Now turning to the quarter. The company's performance for the second quarter and for the first 6 months of the year reflects our continued execution on our strategic priorities and our focused approach to profitable growth as we successfully target business lines we view the most attractive. For the second quarter, operating earnings were $0.89 per diluted common share, benefited from positive underwriting income as we continue to achieve double-digit net earned premium growth in our ongoing business, primarily driven by increased retentions and positive rates continuing to earn through.

For the first 6 months of the year, the combined ratio of 95.6% drove an operating return on average common shareholders' equity of 10.2%. These results reflect significant year-over-year improvement in underwriting income, which more than offset the decline in net investment income from the alternative investment portfolio.

In our ongoing businesses, top line growth was strong through 6 months with earned premiums increasing approximately 16% from a year ago. I'm particularly pleased with our efforts to reduce CAT volatility and manage expenses as demonstrated in our underwriting results. Catastrophe losses of $2.5 million in the second quarter marked the fifth consecutive quarter of year-over-year improvement and is Argo's lowest level since 2019. The reduction in our CAT losses is in contrast to the level of these losses the industry is continuing to experience.

Year-to-date, catastrophe losses were $11.2 million compared to CAT losses in the first half of 2020 and 2021 of $57 million and $59 million, respectively. The success of our strategy of reducing volatility through exiting noncore business is evident in these results.

The expense ratio improved by over 2 percentage points for both the second quarter of 2022 and on a year-to-date basis, reflecting the effectiveness of our ongoing cost reduction efforts. We are steadfast in our commitment to further reduce costs and remain very confident in our ability to continue improving the expense ratio. We feel good about the rates we are seeing and the direction of our markets. We continue to see strong levels of both rate and premium growth in many business lines, with particular strength in casualty, environmental and inland marine.

Overall, consistent with the first quarter, rates increased in the mid-single digits across the vast majority of our businesses. Importantly, the average rate we're achieving continues to trend at or above loss cost inflation expectations.

We continue to explore a wide range of potential options to maximize shareholder value and take advantage of opportunities in the market. Consistent with that objective, we are entering into a loss portfolio transfer with Enstar, which covers the majority of our U.S. casualty insurance reserves, including construction, relating to accident years 2011 to 2019.

While Scott will give more details on the transaction shortly, I would like to note that this gives us protection against reserve volatility and provides us with additional capital flexibility. We remain focused on pursuing profitable growth as a U.S. specialty insurer with leading positions in very attractive specialty markets.

I'll now turn it over to Scott to discuss the results in more detail.

Scott Kirk
CFO & Principal Accounting Officer

Thank you, Tom, and good morning, everybody. The current quarter's performance reflected positive underwriting income and increased fixed income returns. While perhaps as expected, there was a lower contribution from alternative investments.

Operating earnings of $31 million decreased from $56.1 million in the prior year second quarter. However, through the first 6 months of 2022, operating earnings increased nearly 4% from a year ago. We reported a net loss attributable to common shareholders of $18.9 million for the second quarter of 2022. The difference between our net loss and our operating income is primarily attributable to pretax, net realized investment and other losses of $40.4 million, which included a net loss of $21.3 million associated with the sale of the company's Malta operations, ArgoGlobal Holdings. It's worth noting that our Malta operations were owned by Argo Re in Bermuda, and the realized loss on the sale of the business was not subject to corporate tax, and this resulted in a higher effective tax rate for the current quarter.

Turning now to our consolidated operating results. Reported gross written and net earned premiums decreased 10.2% and 3.4%, respectively, from the prior year second quarter. This was driven by a business the company has exited. Gross written and net earned premiums in our ongoing business grew 3.5% and 12%, respectively.

As we've said on previous calls, we are retaining more risk net on the business we feel is most attractive, resulting in net earned premiums outpacing gross written premiums on both a reported and ongoing basis. Now this is evident in our retention ratio calculated as net written premiums divided by gross written premiums, and this increased 3.6 percentage points to 64.1%.

It's worth noting that after adjusting for the funding business that we write in the U.S., our retention ratio increased 5.3 percentage points to 68.3% in the quarter. Our loss ratio increased 3.1 percentage points to 60.8%, driven primarily by net adverse prior year reserve development of $16.3 million or 3.6 percentage points on the loss ratio. The net adverse prior year reserve development of $6.7 million in the U.S. Operations was primarily attributable to losses from business we have exited.

In our International Operations, net adverse prior year reserve development was driven by a reassessment of potential losses associated with large excess claims in our professional lines business in our Bermuda operation. The adverse development in our Bermuda business was partially offset by favorable development from Syndicate 1200.

The loss ratio benefited from year-over-year lower CAT losses, which totaled $2.5 million or 60 basis points on the loss ratio in the second quarter of 2022. This result compares favorably to CAT losses of $11.1 million in the prior year second quarter.

As Tom mentioned, the successful implementation of our strategy to reduce property-related exposures has resulted in a meaningful reduction in our CAT losses.

The current accident year ex-CAT loss ratio of 56.6% increased 1 percentage point from the prior year second quarter. It's worth noting that this quarter's current accident year ex-CAT loss ratio is in line with Q1 of this year and the full year of 2021, and I'll provide some more color on the segment loss ratios shortly.

Turning to expenses. Our expense ratio was 35.4%, a 2.3 percentage point improvement compared to the prior year second quarter. Our G&A expense ratio improved 2 percentage points versus the second quarter of 2021, while our acquisition ratio also improved slightly. The year-over-year improvement reflects our ongoing cost reduction efforts that we began implementing at the back end of 2020. Now this is evident in our expense dollars, which continue to decrease as general and administrative expenses were down from $95.6 million in the second quarter of 2021 to $83.2 million this quarter.

Now moving on to our segment results. Our U.S. Operations generated underwriting income of $28.2 million, an increase of 13.3% from the prior year second quarter. The combined ratio of 91.5% improved 50 basis points from a year ago. Gross written premiums in our ongoing business increased approximately 5% in the second quarter of 2022. Net written premiums and net earned premiums in U.S. ongoing business increased 9.9% and 14.5%, respectively, versus the prior year second quarter.

The loss ratio increased 2.5 percentage points to 60.8% in the current year second quarter. The increase was primarily driven by the net adverse prior year reserve development. The current accident year ex-CAT loss ratio increased marginally but was offset by lower CAT losses. The current accident year ex-CAT loss ratio of 58.5% increased 60 basis points from the prior year second quarter. And this variance is primarily attributable to the prior year second quarter, including frequency benefits from the economic slowdown during COVID-19. In addition, the loss ratio in the current quarter reflects our response to anticipated inflationary loss cost trends.

The current accident year ex-CAT loss ratio was in line with the current year first quarter and full year of 2021. The expense ratio of 30.7% decreased 3 percentage points from the prior year. This improvement was due to a 2.4 percentage point reduction in the G&A expense ratio and modestly lower acquisition expense ratio. The reduction in the G&A expense ratio was driven by a 9% decrease in general and administrative expenses, coupled with a 5.8% increase in net earned premiums in the second quarter of 2022.

Turning now to our International segment. We reported an underwriting loss of $4.2 million compared to underwriting income of $7.5 million in the prior year quarter. The underwriting loss in our International segment was attributable to our Bermuda business.

Syndicate 1200, however, generated another strong quarter of underwriting income as indicated by a combined ratio of 89.5%. Notably, this result marks the fifth consecutive quarter of year-over-year improvement in the combined ratio for the Syndicate. While gross written premiums in the International ongoing business were broadly in line with the prior year second quarter, earned premiums increased 5.3%, primarily due to Syndicate 1200.

The loss ratio increased 3.7 points to 59.4% in the second quarter of 2022. This was driven by net adverse reserve development in our Bermuda business that I mentioned previously, partially offset by lower CAT losses. The current accident year ex-CAT loss ratio of 51.4% was generally in line with the prior year's second quarter.

CAT losses were $1.5 million during the second quarter of 2022 or 1.2 percentage points on the loss ratio. These results compare favorably to CAT losses of $9.1 million or 5.9 percentage points on the loss ratio in the prior year second quarter. We did not see any change in our COVID-related losses during the current quarter. And while we reduced expenses by $8 million in our International business, the expense ratio increased 4.7 points to 44.1%, driven by lower net earned premiums.

Turning now to investments. We generated net investment income of $29.3 million in the current quarter. Now as expected, the decrease is due to a reduction of income from alternative investments. While down from the prior year second quarter, the alternative portfolio continued to generate positive net investment income. And as we previously stated, alternative investment returns may continue to be more challenged over the next few quarters given the recent volatility in the markets.

Now we are, however, encouraged by the increased income from our fixed income portfolio, which grew approximately 20% compared to the second quarter of 2021 and approximately 10% compared to the first quarter this year. Now for context, our reinvestment yields were hovering around 1.75% at the end of 2021 and are now above 4% today. And we continue to hold a relatively short duration portfolio at 2.9 years.

Before moving on to capital, let me remind you that at the beginning of the first quarter this year, we increased our assumed tax rate used to calculate operating earnings to 19% from 15%. This reflects our view of the distribution of profits across the company and the jurisdictions we believe these profits will be generated from.

And finally, let me talk about capital. The reduction in shareholders' equity during the second quarter of 2022 reflects a continuation of the trends we observed during the first quarter and is largely attributable to an increase in unrealized investment losses of $121.1 million net of tax in our fixed income portfolio. The unrealized position improved in July, resulting in approximately $40 million improvement net of tax in our unrealized loss position at month end.

Book value per share was $37.65 as of June 30, 2022, down from $45.62 at the end of 2021. Book value per share, excluding accumulated other comprehensive income, was $44.97 as of June 30, 2022, a decrease of just under 3% from $46.27 at year-end. As Tom mentioned, we entered into a loss portfolio transfer for majority of our U.S. casualty insurance reserves, including construction relating to accident years 2011 through 2019. Under the terms of the agreement, Enstar will provide a ground-up cover for $746 million of reserves. Now we will retain a loss corridor of $75 million above the $746 million of reserves. Enstar will then provide an additional $275 million of cover in excess of the $821 million of reserves.

We anticipate recognizing an after-tax charge for approximately $100 million in connection with this transaction in the third quarter of 2022. Now completion of this transaction is subject to regulatory approvals and other customary closing conditions, and we expect the transaction to close in the second half of 2022. The loss portfolio transfer transaction provides increased certainty in our reserve position in addition to providing us with further capital flexibility.

And with that, I will now turn the call back over to Tom for some concluding remarks.

Thomas A. Bradley
CEO & Executive Chairman

Thank you, Scott. Before turning to Q&A, I'd like to cover 2 things. First, our Board of Directors has continued to undertake a strategic alternatives review process. We are evaluating a range of options, and as we previously noted, the company has not set a timetable for the completion of this process. The process has progressed as expected, and we have been pleased with the opportunities available for us to consider. We were able to execute on one of these opportunities with the announcement of the loss portfolio transfer. Again, the objective is simple, to maximize the company's value and its considerable long-term prospects for the benefit of all shareholders.

Secondly, as announced yesterday, we are pleased to welcome Dan Plants as a member of the Argo Board of Directors. The company will benefit from his valuable skills and perspectives in the areas of capital markets, strategy, corporate governance and his understanding and insights about Argo.
Operator, that concludes our prepared remarks. We're now ready to take questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes today from John Heagney from Dowling & Partners.

John Thomas Heagney
Dowling & Partners Securities, LLC

Could you just help me a little bit with the math on the $100 million after-tax charge? Does that assume then that you're booking the $75 million loss corridor up to the attachment point of the ADC with Enstar?

Scott Kirk
CFO & Principal Accounting Officer

John, it's Scott here. No, that does not assume we're booking the $75 million.

John Thomas Heagney
Dowling & Partners Securities, LLC

Okay. And then the other quick question I had, Boy Scouts of America, there's -- would appear to be a handful of policies that Argo has or had to enforce. Is there any exposure there? And I assume it would be in the runoff book, though I'm not 100% positive of that. Or do you have any sort of mass tort reserves that would cover it?

Scott Kirk
CFO & Principal Accounting Officer

John, it's Scott here again. Look, we wouldn't comment on anything specific to an individual case.

Operator

We have no further questions. So on that note, that concludes today's Q&A session, and I'll now refer you back to Tom Bradley for closing remarks.

Thomas A. Bradley
CEO & Executive Chairman

Great. Thank you. Thanks, everybody, for your time and attention this morning and your interest in Argo. Good day.

Operator
That concludes today's call. You may now disconnect your lines.