S&P Global
Market Intelligence

Argo Group International Holdings, Ltd. NYSE:ARGO

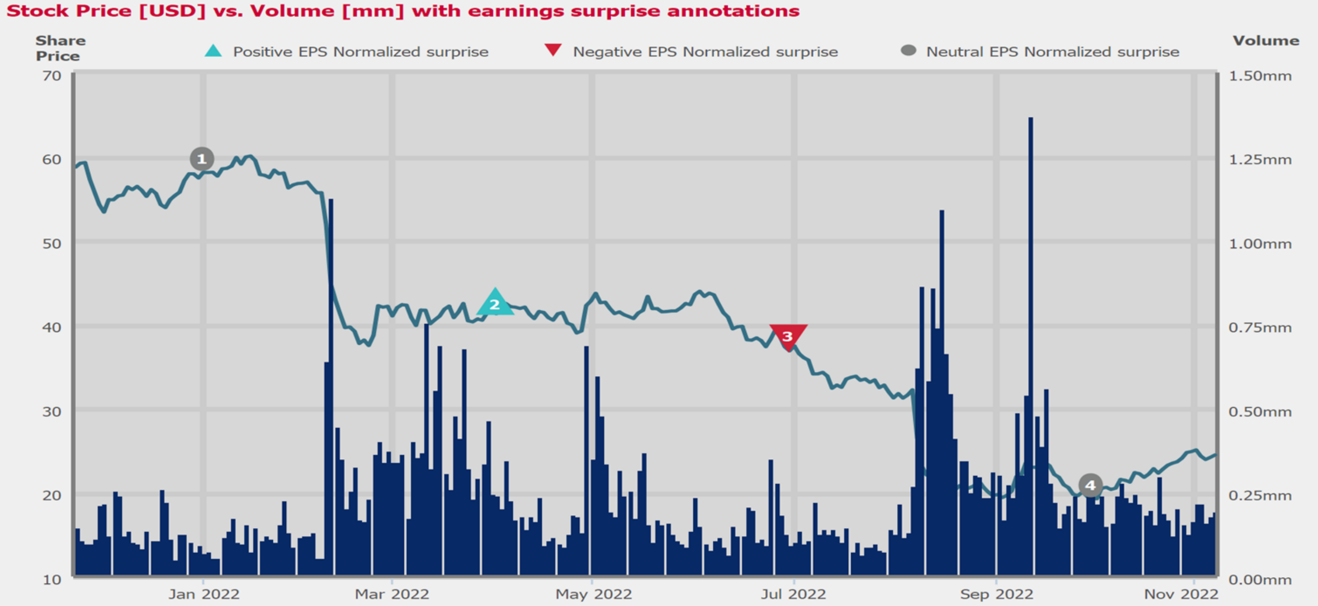
FQ3 2022 Earnings Call Transcripts

Tuesday, November 8, 2022 3:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2022-			-FQ4 2022-	-FY 2022-	-FY 2023-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	(2.02)	0.44	NM	1.07	1.18	NA
Revenue (mm)	425.30	444.30	4.47	491.80	1844.10	NA

Currency: USD
Consensus as of Oct-18-2022 7:02 AM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ4 2021	(2.02)	(1.77)	NM
FQ1 2022	1.10	1.24	12.73 %
FQ2 2022	1.19	0.89	(25.21 %)
FQ3 2022	(2.02)	0.44	NM

Table of Contents

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

Hello. Welcome to today's Argo Group Third Quarter 2022 Earnings Call. My name is Bailey, and I will be the moderator for today's call. [Operator Instructions]

I would now like to pass the conference over to our host, Andrew Hersom, Head of Investor Relations. Please go ahead.

Andrew Hersom
Head of Investor Relations

Thank you, and good morning. Welcome to Argo Group's conference call for the third quarter ended September 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 inherent risks and uncertainties surrounding future expectations generally and may materially differ from 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 the call.

For a more detailed discussion of such risks and uncertainties, please see Argo Group's filings with the SEC. Also note that we'll be referencing certain non-GAAP financial information. 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.

Over the past 2 years, we have transformed Argo, better positioning the company to advance our business strategies. In September, we announced the sale of our Lloyd's operation, which marks a significant milestone in Argo becoming a focused, pure-play U.S. specialty insurer. Importantly, this transaction further simplifies our corporate structure and enables greater focus on our diverse portfolio of profitable and scalable U.S. specialty businesses.

In addition, the announced U.S. loss portfolio transfer with Enstar will help provide protection against potential future reserve volatility. We believe these transactions will strengthen and derisk our balance sheet and better position the company to evaluate additional strategic opportunities. We are fully committed to maximizing shareholder value and remain focused on our strategic review process for the benefit of all Argo's shareholders.

Turning to the third quarter. We reported operating earnings of $0.44 per common share and an ex-CAT current accident year combined ratio of 93.4%. Our performance continues to benefit from earned premium growth in attractive business lines, lower expenses and lower catastrophe losses despite Hurricane Ian. We also continue to be encouraged by the increasing investment income from our fixed income portfolio driven by higher reinvestment rates.

Our U.S. operations generated a strong current accident year performance with a 1.9 percentage point improvement in the segment's current accident year loss ratio compared to a year ago. This improvement was driven by disciplined underwriting, lower CAT losses and positive rate continuing to earn through.

While our thoughts are with those impacted by Hurricane Ian, we are pleased with the company's quarterly CAT losses decreased year-over-year for the sixth straight quarter despite elevated industry CAT losses. Our total CAT losses of $23.4 million in the quarter were down 14% from third quarter last year. Our U.S. operations accounted for just $4.2 million of these losses, which did not reach our U.S. CAT reinsurance retention levels. Our remaining CAT losses were in the International segment.

In contrast to broader industry trends, Argo's CAT losses for the 9 months of 2022 are nearly 60% lower than the same period last year while these losses in our CAT -- while these losses in our U.S. operations were down over 70%. The success of our volatility reduction efforts through exiting businesses with property CAT exposure is evident in these results.

We are also particularly pleased with the continued success of our ongoing cost reduction efforts. The expense ratio improved 0.9 percentage points from the prior year third quarter or 1.5 percentage points after adjusting for the reinstatement premiums.

Through 9 months, we have lowered total expenses by over $35 million and reduced the expense ratio 1.7 percentage points to 35.6%. Our expense reduction efforts have successfully helped streamline our operations. And we remain confident there are opportunities to further reduce costs and improve the expense ratio in the future.

We continue to feel good about the pricing gains we are seeing across our portfolio of businesses. We are achieving both rate and premium growth in many lines with particular strength in casualty, environmental and inland marine. While there are some pockets of rate softness in the portfolio, most notably public company D&O, we remain disciplined in our underwriting approach.

Consistent with the first half of the year, rates increased in the mid-single digits across the vast majority of our businesses. Importantly, the average rates we're achieving continue to trend above loss cost expectations.

We remain focused on executing our business strategies, building upon our performance through the first 9 months of 2022 and further enhancing the company's position for 2023. As I've said, we are fully committed to the strategic review process. And we continue as a Board, along with our financial and legal advisers, to actively consider a wide range of options for Argo.

I will now turn the call over to Scott to discuss third quarter results in more detail.

Scott Kirk
CFO & Principal Accounting Officer

Thank you, Tom, and good morning, everyone. Operating earnings for the third quarter were $15.5 million and $89.8 million for the 9 months in 2022. These results reflect our continued efforts to reduce CAT losses, maintain expense discipline and grow earned premiums in our ongoing businesses. These favorable trends were partially offset by the lower contribution from alternative investment portfolio compared to a year ago.

While we reported positive operating earnings of $15.5 million for the quarter, our net loss attributable to common shareholders was $51.4 million. The difference is primarily attributable to net realized investment losses of $44.7 million and a $28.5 million impairment of goodwill and intangible assets associated with the previously announced sale of our Lloyd's operation. Included in the net realized investment losses was $34.2 million of impairment losses related to the assets that will be transferred upon closing of the LPT.

Before I provide more detail on the results, I wanted to update you on the U.S. LPT transaction with Enstar. We received the final regulatory approval yesterday and expect the transaction to close imminently. The results for the quarter, therefore, do not include the circa $100 million net of tax charge in connection with the LPT as we'd originally anticipated per our Q2 earnings call. Now we expect to record this charge in the fourth quarter this year.

And with regards to the loss corridor in the LPT, as we previously mentioned, Argo will retain $75 million of losses above the $746 million of reserves transferred. By way of update, through the 9 months ended September 30, 2022, we have recognized $37.7 million of prior year development that falls within the retained loss corridor, leaving at $37.3 million of the corridor remaining until we reach the $275 million covered layer of the LPT. In addition, we expect to transfer just over $500 million of remaining reserves upon closing of the LPT transaction.

Looking at the consolidated results in more detail. Reported gross written premiums decreased 14.2% from the prior year third quarter primarily driven by businesses the company has exited. Gross written premiums in our ongoing business, however, were in line with the prior year third quarter. As Tom mentioned, we have seen positive rate trends across several areas in our portfolio.

Net earned premiums were $455 million compared to $487.5 million in the third quarter last year. This includes $12.5 million of reinstatement premiums primarily associated with CAT losses compared to $5.6 million of reinstatement premiums in the third quarter last year. In our ongoing business, however, net earned premiums grew over 13%. We are retaining more risk net on the businesses we feel are most attractive, resulting in net earned premiums outpacing gross written premiums on both a reported and ongoing basis.

Our loss ratio increased 1.7 percentage points to 65.7% in the third quarter driven mainly by net adverse prior year reserve development of $11.9 million or 2.6 percentage points on the loss ratio. The current accident year ex-CAT loss ratio of 58% increased

90 basis points from the prior year third quarter. However, when you adjust for the reinstatement premiums, the current accident year ex-CAT loss ratio for the third quarter of 2022 was 56.4%, which is in line with the prior year third quarter.

The loss ratio also benefited from lower year-over-year CAT losses, which totaled $23.4 million or 5.1 percentage points on the loss ratio in the third quarter of 2022. This result compares favorably to CAT losses of $27.3 million or 5.6 percentage points on the loss ratio in the prior year third quarter.

Turning to expenses. Our expense ratio was 35.4%, a 90 basis point improvement compared to the prior year third quarter. This reduction was primarily driven by an 80 basis point improvement in the G&A expense ratio and reflects $9.9 million decrease in G&A expenses when compared to the third quarter last year. And when adjusting for the reinstatement premiums, the expense ratio for the third quarter of 2022 was 34.4%, an improvement of 150 basis points from a year ago.

Moving on to the segment results. U.S. operations generated underwriting income of $9.3 million and a combined ratio of 97.2%. Gross written premiums in our ongoing business were in line with the third quarter of 2021 while earned premiums increased approximately 13% in our ongoing business.

The loss ratio increased 2.9 percentage points to 65.9% in the third quarter compared to the same period last year. The increase was primarily driven by the net adverse prior year reserve development of $16.2 million, which was primarily attributable to losses from businesses we have exited.

On a current accident year ex-CAT basis, the loss ratio of 59.7% was broadly in line with the prior year quarter. Catastrophe losses of $4.2 million or 1.3 percentage points on the loss ratio decreased nearly 60% from a year ago.

The expense ratio of 31.3% decreased 110 basis points from the prior year third quarter. This improvement was due to a 2.8 percentage point reduction in the G&A expense ratio partially offset by a higher acquisition expense ratio.

Turning to the international operations. The segment reported an underwriting loss of $3.5 million driven by the CAT losses and the reinstatement premiums from Hurricane Ian in the quarter. This compares to a $4.6 million loss in the third quarter last year. The loss ratio increased 2 percentage points to 65.3% in the third quarter of 2022.

CAT losses in our international operations were $19.2 million during the third quarter of 2022 or 15.3 percentage points on the loss ratio. These results compare to CAT losses of $17.3 million or 10.5 percentage points on the loss ratio in the prior year third quarter. The current quarter benefited from net favorable prior year reserve development of $4.4 million compared to $2 million of net adverse development a year ago.

The current accident year ex-CAT loss ratio of 53.5% increased 1.9 percentage points year-over-year. However, adjusting for the reinstatement premiums, the current accident year ex-CAT loss ratio was 48.9%, an improvement of 110 basis points.

The expense ratio of 37.5% decreased 2 percentage points from the third quarter of 2021. This improvement was due to a 4 percentage point reduction in the acquisition expense ratio partially offset by a 2 percentage point increase in the G&A expense ratio. Adjusting for the reinstatement premiums, the expense ratio for the third quarter of 2022 was 34.4%, an improvement of 3.9 percentage points year-over-year.

Moving on to investments. We generated net investment income of $34 million in the current year third quarter compared to $46.1 million a year ago with the decrease due to lower returns from our alternative investments. Now while down from the prior year third quarter, the alternative investment portfolio continued to generate positive net investment income. As we've said, alternative investment returns may continue to be challenged over the next few quarters given the continued volatility in the markets.

We are, however, encouraged by the increased investment income from our fixed income portfolio, which grew approximately 24% compared to the third quarter 2021 and approximately 10% from the second quarter this year. Our reinvestment yields were hovering around 1.75% at the end of 2021 for an average A bond compared to above 4.5% for short-term U.S. securities.

We continue to hold a relatively short duration portfolio at 2.7 years including cash. This shorter duration positions us well in a rising interest rate environment. Now as we expect duration to shorten further, we anticipate the future change in the level of unrealized investment losses from interest rate movements to be less volatile.

Now let me talk about capital. Book value per share was $33.72 at September 30, 2022, and decreased 10.4% from June 30 with the decrease driven largely by changes in accumulated other comprehensive income. The change in AOCI is mainly attributable to unrealized investment losses in our fixed income portfolio of $75.9 million net of tax for the quarter. For the 9-month period in 2022, we have approximately $340 million of unrealized losses net of tax from the investment portfolio included in AOCI.

Given our shorter duration investment portfolio, we would anticipate the unrealized investment losses arising from interest rate movements to unwind over approximately 3 years as securities reach maturity. At the same time, we will also see higher interest rates continue to benefit investment income. Excluding AOCI, book value per share was $43.23 at the end of the third quarter 2022, a decrease of 3.9% from June 30.

And in closing, we continue to engage in regular communication and maintain strong relationships with our rating agencies and regulators. Most recently, S&P reaffirmed our A- strong financial strength rating.

And with that, I would now like to hand the call back to Tom.

Thomas A. Bradley
CEO & Executive Chairman

Thank you, Scott. And before we open the call for questions, I'd like to briefly address matters related to our upcoming annual meeting and one of our shareholders, Capital Returns Management.

Last week, we filed a definitive proxy statement, an accompanying blue proxy card and other relevant materials with the SEC in connection with the solicitation of proxies for the annual meeting. As I hope we have made very clear to you today and over the past several months, Argo's Board is actively overseeing a robust strategic review process to maximize value for our shareholders, which includes exploring a potential sale, merger or a strategic transaction.

At the same time, Argo has made significant progress in repositioning the company for growth and increased profitability. Today, Argo is a focused, pure-play U.S. specialty insurer with over $2 billion in premium and renewed momentum, better positioned to drive our business strategies and evaluate further strategic opportunities to drive value.

Argo consistently engages with its shareholders and appreciates their ideas and input towards maximizing shareholder value. In keeping with this, for more than a year the Argo Board and management team have engaged with Capital Returns in an attempt to foster constructive dialogue and hear their views.

Despite this outreach and the significant progress we have made, Capital Returns has nominated 2 director candidates to stand for election at our 2022 annual meeting. Pursuant to our established policies, the Board's Nominating and Corporate Governance Committee formally interviewed both of Capital Returns' nominees and concluded that neither candidate offers any incremental skills or experience that would be additive to the current Board or to its ongoing strategic review process. In fact, we believe they would diminish the Board's overall capabilities and expertise.

As such, the Board presented its recommended slate of director nominees in our definitive proxy materials, encouraging shareholders to use the blue proxy card and vote for all of the Argo nominees. Any and all details related to our annual meeting can be found in our public filings on our IR web page.
With that, I'd like to hand the call back over to the operator for any questions.

Question and Answer

Operator

[Operator Instructions] There are no questions registered at this time -- we have a question registered, apologies. Our first question today comes from the line of John Heagney from Dowling & Partners.

John Thomas Heagney
Dowling & Partners Securities, LLC

I did want to touch on one thing, maybe get your thoughts. You're talking a lot about changing the portfolio, business development. I guess could you take a deeper dive into what has actually changed in the U.S. operations?

I mean I get it holistically. You sold Lloyd's. You're focused on the U.S. But what specifically in the U.S. is now changing or improving versus, let's call it, 2 years ago, 1.5 years ago, when you had -- when the company had its first sort of strategic review of its underwriting business?

Thomas A. Bradley
CEO & Executive Chairman

Yes. Thank you, John, for that. The biggest single change that we've kind of referred to is property, not only deemphasizing it but specifically reducing our exposure there as not only as a capital management exercise but as a profitability exercise. We had poor results and not the right capabilities to do that. So we sold off some of those businesses and just dropped out of others.

I think the other significant change would be rationalization of some of the programs in our program segment. Again, to actively manage programs and where we see we don't have a future visibility into profitability, we've taken action to, a, either remediate or exit those programs.

Scott, anything you want to add?

Scott Kirk
CFO & Principal Accounting Officer

No. John, I'd just also add that, obviously, we've been actively looking at the level of expenses we've incurred in the business. And over the last 18 months or so, you've seen a significant reduction there. It's a great profitability lever for us. And look, we continue to be active and execute on those opportunities.

Operator

[Operator Instructions] There are no additional questions waiting at this time. So I'd like to pass the conference over to Tom Bradley for any closing remarks.

Thomas A. Bradley
CEO & Executive Chairman

Thank you, operator. In closing, our third quarter performance continued to benefit from the execution on our strategic priorities, including growth in our most attractive lines of business, reduced underwriting volatility and lower expenses. Catastrophe losses declined year-over-year despite elevated industry losses, highlighting the success of our strategy of reducing volatility through exiting businesses with property CAT exposure.

Our LPT and Lloyd's transactions will strengthen and derisk our balance sheet as we have delivered on our core strategy of becoming a focused, pure-play U.S. specialty insurer. And finally, we are unwavering in our commitment to evaluate additional strategic alternatives, including the potential sale or merger of the company that will deliver on our goal of maximizing value for all shareholders. We are pleased by the progress of our strategic review and the level of interest in Argo to date.

Thank you, everyone, for your time and for your interest in Argo. Good day.

Operator
This concludes today's conference call. Thank you all for your participation. You may now disconnect your lines.