S&P Capital IQ

CONTENTS

Argo Group International Holdings, Ltd.

NasdaqGS:AGII

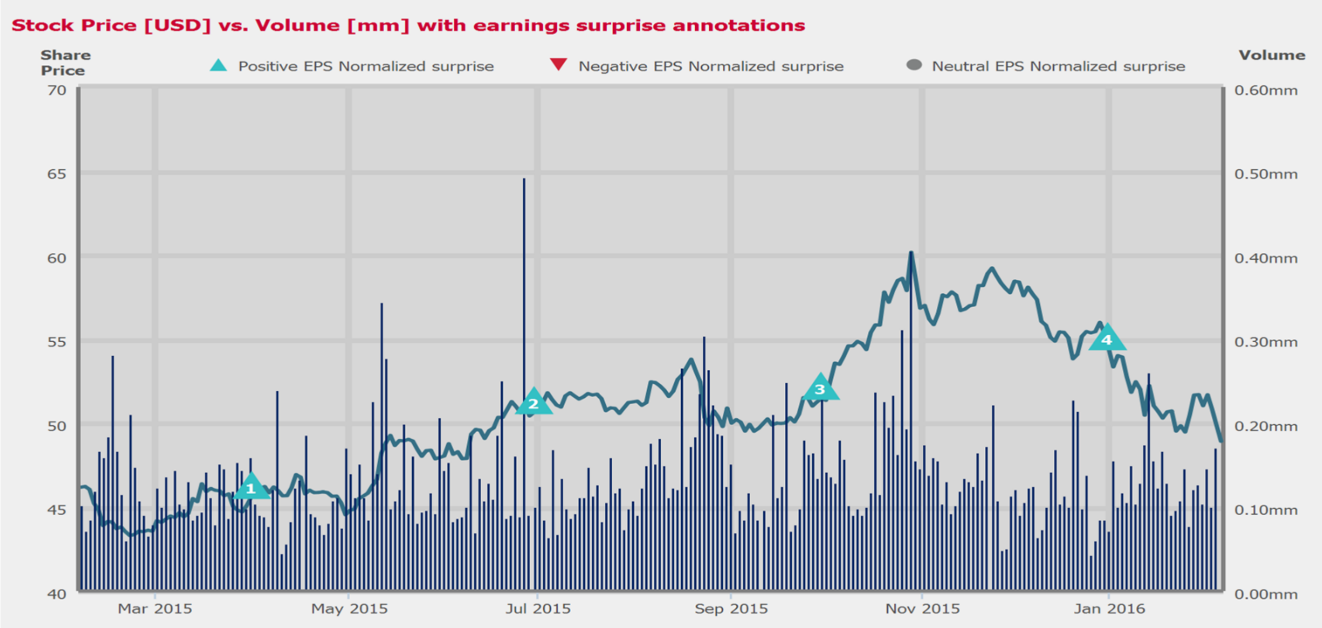
FQ1 2016 Earnings Call Transcripts

Tuesday, May 03, 2016 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ1 2016-			-FQ2 2016-	-FY 2016-	-FY 2017-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.86	0.96	▲11.63	0.88	3.45	3.70
Revenue (mm)	360.07	370.10	▲2.79	361.80	1450.53	1498.30

Currency: USD
Consensus as of May-03-2016 3:48 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ1 2015	0.76	0.93	▲22.37 %
FQ2 2015	0.68	0.83	▲22.06 %
FQ3 2015	0.73	0.78	▲6.85 %
FQ4 2015	0.80	0.82	▲2.50 %

Call Participants

EXECUTIVES

Jay S. Bullock
Executive Vice President and Chief Financial Officer

Mark E. Watson
Chief Executive Officer and Director

Mark H. Rose
Chief Investment Officer and Senior Vice President

Susan Spivak Bernstein
Senior Vice President of Investor Relations

ANALYSTS

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Daniel D. Farrell
Piper Jaffray Companies, Research Division

Jeff Schmitt

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Presentation

Operator

Good morning, and welcome to the Argo Group 2016 First Quarter Earnings Conference Call. [Operator Instructions] Please note, this event is being recorded.

I would now like to turn the conference over to Susan Spivak Bernstein, Senior Vice President, Investor Relations. Please go ahead.

Susan Spivak Bernstein
Senior Vice President of Investor Relations

Thank you, and good morning. Welcome to Argo Group's Conference Call for First Quarter 2016 Results. Last night, we issued a press release on earnings, which is available in the Investors section of our website at www.argolimited.com. Presenting on the call today is Mark Watson, Chief Executive Officer; and Jay Bullock, Chief Financial Officer. Also, with us for Q&A is Mark Rose, Argo's Chief Investment Officer. We're pleased to review the company's results for the quarter as well as provide you with management's perspective on the business.

As the operator mentioned, this call is being recorded. Following management's opening remarks, you will receive instructions on how to queue in to ask questions. As a result of this conference call, Argo Group management may make comments that reflect their intentions, beliefs and expectations for the future. Such forward-looking statements are qualified by the 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 this conference call. For a more detailed discussion of such risks and uncertainties, please see Argo Group's filing with the SEC.

With that, I'll turn the call over to Mark Watson, Chief Executive Officer of Argo Group. Mark?

Mark E. Watson
Chief Executive Officer and Director

Thank you, Susan, and good morning, everyone, and welcome to our first quarter conference call. After the market closed yesterday, we reported first quarter 2016 after-tax operating earnings of $29.9 million or $1.06 per share, gross written premium growth of 9%, an overall combined ratio of 94% and an increase in book value per share of 3.3% to $61.71 from year-end 2015.

Before discussing our underwriting results, I'd like to point out changes to how we report operating income for this quarter. As we've discussed for several years, our investment strategy is for total return. To that end, a portion of the portfolio is invested in strategies that are expected to produce recurring gains. And while we believe that growth in book value per share is the most important metric by which to evaluate financial performance for our company, beginning this quarter, we included an alternative investment income as part of net investment income, which we believe more accurately reflects operating earnings. For comparative purposes, alternative investment income has been reclassified in last year's results as well. Ironically, given recent market volatility, the change actually had a slight negative impact in the current quarter's operating income relative to a positive impact in the prior year's first quarter financial results. That said, we believe that long-term reporting along these lines will allow you to more appropriately value the company relative to others. But again, I still believe the best metric is to focus on growth and book value per share.

Moving on to our underwriting business. We had an encouraging start to the year with 9% growth in overall gross written premiums. Perhaps more importantly, we achieved growth in all 4 of our operating segments, and all 4 segments generated an underwriting profit. Our ability to produce growth despite more competitive market conditions is the result of the initiatives we've talked about throughout both 2014 and 2015. These include identifying opportunities by business and by producers with the most significant opportunity for profitable growth and focusing our resources on these areas; capitalizing on the market dislocations stemming from recent M&A and restructuring activities to bring onboard talented people and, in some cases, underwrite business coming back into the marketplace; and simplifying the way we do business to improve efficiency and scalability, which is having a positive impact on our expense ratio and, thus, our underwriting margin. Following 2 consecutive years of record underwriting results for our company, we continued the momentum in the first quarter with underwriting income of $20.7 million. Risk selection and underwriting discipline are the most important factors driving the improvement in our combined ratio. Our goal is to generate consistent year-over-year improvement in 2016. Another favorable trend that's continued into 2016 is the consistency in our reserving process. For the 20th consecutive quarter and the 11th consecutive year, we've seen positive prior year reserve development.

Now let me briefly comment on first quarter 2016 results for each of our operating segments. With continued focus, our Commercial Specialty segment has now generated a significant improvement in results. Overall premium growth was up 8% in the quarter, driven by our program, surety, professional liability and public entity businesses. Even more encouraging was the improvement in the combined ratio to 88% from 95.6% in the first quarter of last year. We achieved this improvement despite more competitive rates and pressure in the energy sector on our mining and surety businesses. This quarter's results in Commercial Specialty also reflects, for the first time, our U.S. professional business, which we refer to as Argo Pro in this reporting segment. We thought it made more sense to move Argo Pro or professional liability from our E&S segment to Commercial Specialty, given that so much of our business is underwritten on a retail basis, which is primarily the way we address our policyholders in other parts of Commercial Specialty. I should also add that we're working hard to strengthen and deepen relationships with producers that will allow us to continue to grow in our niches within our Commercial Specialty segment.

Moving on to Excess and Surplus Lines, gross written premium was up 5.4% year-over-year. Our casualty unit, which is our largest business by volume within E&S, achieved strong growth in excess of 16%, reflecting the benefits from our investments in technology, overall process improvement and focus on profitable opportunities. Other business units such as contract and Allied Medical posted modest declines, reflecting intense competition and the pricing environment as well as a continuous effort to improve the underwriting result by culling underperforming business. On average, rates were up modestly across the segment. Property rates, on the other hand, have stopped going down as rapidly as in the last few years.

Turning to Syndicate 1200, gross written premiums written were up 4 point -- 14.2% for the quarter year-over-year. You may recall, in 2015, gross premiums written at the Syndicate were up approximately 4%. Having said that, the primary driver of the strong growth in this year's quarter was, in part, due to timing differences on business that would otherwise have been incepted in the fourth quarter of last year. Lloyd's remained a highly competitive market, and we've reduced our participation in the Syndicate in each of the last 3 years, notwithstanding the growth in the Syndicate. Within the Syndicate this quarter, we underwrote more business in Property, Direct and Facultative and our new business lines in Marine and in Asia. As you can see from our expense ratio, which is hovering around 40%, Lloyd's is becoming an even more expensive place to do business, as brokers continue pushing additional compensation schemes.

Lastly, gross written premiums in our International Specialty segment were up 7.2% over the first quarter of 2015. This growth is primarily coming from our Bermuda operations, both insurance and reinsurance. Our Bermuda insurance business is experiencing strong renewal retention and high hit ratios, partially due to the recent M&A activity I was referring to a minute ago in the marketplace. Rates are down modestly but the profitability of the book remains strong. Argo Re's results are benefiting from low CAT activity and the addition of new pro rata treaties. In Brazil, premium declined modestly due to the weakness in local currency, the slower economy and select changes to our underwriting appetite as this business begins to mature. Having said that, our Brazilian operation made a profit for the second quarter in a row and I'm very appreciative of their efforts and success.

Returning to investments. In the first quarter of -- the first quarter of 2016 began with the complete sell-off in risk assets triggered by concerns over China and a 30% decline in oil prices. In mid-February, it's like the opposite happened. Oil began to recover and risk assets responded to that. The S&P, high yield and oil each finished the year up from where they began. Argo Group's financial statement return was 1.2% and our total return for the quarter was 1.7%. Energy stocks and bonds began down in the corner and rallied to finish with a positive contribution to the quarter. Actively managed high-yield equities and emerging market debt were up solidly as well. Hedge funds and private equity, which are accounted for on a 1-month lag for our financial results detracted from our return, but beginning in March, have been strong contributors. Reported net investment income was $21.2 million for the quarter, down from $25.7 million in the first quarter of 2015. Included in these numbers is an alternative investment income loss of $1.6 million relative to a gain of $4.9 million in the comparative period a year ago.

Moving on to capital management, and I say this every quarter, we have a demonstrated track record of strong capital management for more than a decade. And in the last 6 years, in particular, we've returned a total of more than $452 million to shareholders. This was accomplished through the retirement of 25% of our outstanding shares for $350 million through share repurchases and $102 million paid in cash dividends. Our priorities remain the same. Our first use of capital is to support the balance sheet; second is to grow our business organically; third is to have capital available for opportunities as they arise; and fourth is to actively return excess capital to our shareholders in an effective manner.

In the first quarter of 2016, we repurchased 343,652 shares of stock for $19 million at an average price of $55.32 per share. And we just reloaded our authorization to $150 million this morning. Last quarter, we increased the dividend -- the cash dividend by 10%. And this quarter, we declared a stock dividend of 10%. We will continue to balance the return of capital to shareholders with our priority in building the Argo franchise and shareholder value in the long run.

In summary, I'd like to say that we're quite encouraged by our first quarter 2016 results, which demonstrate that our key initiatives are working. We've made many necessary competitive changes to our systems and processes; built a stronger, more focused team; invested in technology and innovation; and introduced new platforms and products. We will continue to improve the way our company operates. Our investments in technology, distribution and people are allowing us to serve our clients better and faster, and we can now better select risk and manage our own portfolio mix. I feel better about the people on our team than at any time in the past and, most important of all, these are the efforts that are driving the more consistent results that generate more stable returns for our shareholders, we believe.

With that, I'd like to turn the call over to our CFO, Jay Bullock.

Jay S. Bullock
Executive Vice President and Chief Financial Officer

Thanks, Mark, and good morning, everyone. I'll quickly provide some additional detail and then open it up for questions. As Mark highlighted, we continue to have positive momentum and premium growth in underwriting income into 2016. There are a few moving parts that I'd like to highlight that might make the results a bit more comparable.

First, on a consolidated basis, the growth in gross written premium outpaced the growth in net written premium. This was the result of a higher rate of growth in business where we see a much higher percentage of the risk and the effect of certain reinsurance agreements that incepted in the first quarter, for which all the ceded premium is recognized in the quarter. This second impact will even out as the year progresses. As mentioned, Excess and Surplus Lines and Commercial Specialty were impacted by the movement of Argo Pro from one reporting segment to the other. It's worth noting that even without the contribution of Argo Pro to Commercial Specialty, the underwriting result for that segment doubled year-over-year. Of note, related to loss trends, our current accident year continues to perform well, with a non-CAT loss ratio of 55.5%. It is improved from the 56.4% in the fourth quarter of 2015, and about the same as the 55.1% in the first quarter of 2015. This year's first quarter accident year loss ratio includes the impact of a large energy-related loss at the Syndicate of approximately $4 million that impacted the overall loss ratio by about 1 point. In addition, the first quarter of 2016 continued our run of overall favorable reserve development from prior accident years. For the quarter, we experienced net favorable development of $3.2 million, about the same as the $3.7 million in the first quarter of 2015. The largest component of this quarter's positive development was from our E&S segment, driven by accident years 2011 and prior. As always, all of the relevant figures on loss development are displayed in the table in the press release. Catastrophe losses that impacted our business for the quarter were $3.3 million, again, about the same as the $3 million from the first quarter of 2015. The quarter's CAT losses were primarily due to U.S. storm activity, with the total impacted by 1 large claim along with a couple of small international events in our International Specialty segment.

Of note, related to expenses in the quarter, the trend in our expense ratios continues to be positive. And as we mentioned last quarter, beginning in 2016, we made certain changes to our equity compensation program that should have the effect of lessening the volatility related to movements in the stock price in the future. We expect these changes to become more apparent in quarters where there is a significant appreciation in the price of our stock. Two additional items to note. Again, as mentioned, we took action this quarter to reclassify the return on certain of our investments that are accounted for on the equity method from realized gain or loss to net investment income to better reflect the operating results of our business. And as noted, the early part of the first quarter presented a very challenging investment environment. And as some of these investments are reported on a lag basis, the result in this quarter reduced investment income by around $1.6 million. This change in reporting, however, better reflects our long-term strategy which will, in most quarters, reflect a positive return from these investments; and occasionally, during periods of market dislocation, reflect a negative result. The inclusion of this income in net investment income would have added $3 million of additional income in 2015 and $19.5 million of additional income in 2014.

For the first quarter of 2016, the effective tax rate for the group was 16.2%, lower than our standard assumption of 20%. In the quarter, the tax rate reflects earnings attributable to the Bermuda platform, offset by taxable income in the U.K. that was the result of the strengthening of sterling against the U.S. dollar.

Finally, to the balance sheet, there's a modest increase in receivables and payables that reflects a slight reduction in our participation on the Syndicate for 2016. We ended the quarter with a pretax unrealized embedded gain of $84 million, which is relatively flat from December 2015.
Operator, that concludes our prepared remarks, and we're now ready to take questions.

Question and Answer

Operator

[Operator Instructions] The first question comes from Greg Peters of Raymond James.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

I had just a couple of questions for you, and I appreciate in your prepared remarks the commentary on the difference in growth in gross premium written versus net. But I'm curious how you think or assess the risk that new business that you're writing today might come at a cost in terms of a higher combined ratio relative to your renewal book.

Mark E. Watson
Chief Executive Officer and Director

Well, Greg, that's not a new concern, I mean, any time that you're writing new business, it's not as well known to you as your renewal book and you presume that it might run at a higher loss ratio. I'm not sure how to answer that other than to say that that's an issue that we've been dealing with for decades.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Well, considering that the market is more competitive today, I'm wondering if you've altered your algorithm or perspective on how you're thinking about that.

Mark E. Watson
Chief Executive Officer and Director

No.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Okay. Mark, I think you highlighted the mining and surety results, and I'm wondering if you could provide us some context on what's going in there. Reading the papers and hearing the news about all these coal companies going into bankruptcy leads me to be curious about how the insurance operations and surety operations behind those businesses might perform.

Mark E. Watson
Chief Executive Officer and Director

So we're not -- we don't issue that many surety bonds to coal mining operators. In fact, I can't think of the last time we issued one. That doesn't mean we didn't, I just don't recall one. Most of our risk is workers' compensation risk, and the biggest challenge for us is, as coal mining businesses shrink and/or go out of business, there's less payroll and, therefore, less insurance premium. Having said that, we have a team at Rockwood, our mining subsidiary, that does more than just insure coal minds, they insure a number of industries that have complex risk, again, mainly for workers' compensation. And actually, if you look at the positive prior year development that comes out of that business segment that we talk about every quarter, about half of the positive prior year development comes from businesses other than coal mining operations. So I feel pretty comfortable that Kurt Tipton and his team at Rockwood are continuing to transition away from coal mining operators and looking at other heavy industries to ensure where they can use their engineering expertise and the team that they've got to do that. So it will just require us to continue transitioning away from a declining market. And of course, depending upon who -- what White House administration we have come next year, that may change things even more quickly.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Indeed. So the combined ratio was 94% versus 93.6%, as you highlight in the press release. I think in the fourth quarter conference call or earnings call, you highlighted the target of getting 100 basis improvement in '16 versus '15, and I'm just curious if you've -- what you're thinking about that target in the context of the first quarter results, if it's changed your view at all.

Mark E. Watson
Chief Executive Officer and Director

No, I think that we will continue to have the -- I think in an environment that we're in, given the changes that we've made in portfolio allocation -- sorry, to underwriting non-investment and our ability to select risk, which I think just gets better as we have more data, that we'll continue seeing improvement. I think the challenge for us is that there are a lot of opportunities that are being presented to us right now, and balancing our ability to take advantage of those versus putting things on the bottom line this year. So I think both Jay and I have remarked, our expenses this quarter were actually down -- sorry, our non-acquisition expenses were actually down this quarter year-over-year on more premium written. So we're figuring out how to do a little bit more with less. We plan to continue looking for ways to save money in non-acquisition expense, but we also want to make sure that we can make proper investments in the future as well. So I'm still focused on reducing our combined ratio or, I should say, improving our underwriting margin and balancing that with investments in the future.

Operator

The next question comes from Dan Farrell with Piper Jaffray.

Daniel D. Farrell
Piper Jaffray Companies, Research Division

Just on your other invested assets, you have about $500 million that are in sort of hedge funds, private equity and other investments. Can you say what percentage of those, roughly, are now contributing -- returns are now contributing to net investment income that's flowing through operating income? And then also, can you remind us, do you have a target return that you look to for those investments?

Jay S. Bullock
Executive Vice President and Chief Financial Officer

I'll answer the first part of the question, Dan. And just to try to help broader understanding. Largely -- in the round, it's private equity and some hedge funds and some private investments. You can't extrapolate directly from the $500 million to the whole thing because in some categories, for various reasons, some are included and some aren't. A round number to kind of have available is around $350 million. So of that $500 million would be, generating the kind of returns that -- sorry, would be classified as equity accounted for investments and the return on those investments would be the alternative income that we're including in the net investment income.

Mark H. Rose
Chief Investment Officer and Senior Vice President

Within that segment, that supports our capital appreciation portfolio. And the target return for the capital appreciation portfolio is 7%. And that's just one component, it's a diversified risk portfolio.

Mark E. Watson
Chief Executive Officer and Director

Yes. Keeping in mind -- sorry, that was Mark Rose, our CIO. Keeping in mind that many of our hedge fund strategies are credit strategies.

Daniel D. Farrell
Piper Jaffray Companies, Research Division

Great. Okay. And then one other question, you highlighted that one of the things that's helping growth right now is maybe some of the market dislocation that we're seeing. Do you think more of the benefit for you guys is coming from opportunities to incrementally hire talent or is it ability to actually pick up business from other competitors that may not be writing it or are losing it for one reason or another?

Mark E. Watson
Chief Executive Officer and Director

The answer is yes. I think it's both. I mean, I shouldn't say I think. I know it's both. I mean, we've hired a number of talented people in senior roles over the last year, I mean, more than a dozen senior roles. And a fair amount of premium, particularly in some of the larger syndicated programs that we underwrite here in Bermuda and, to a lesser extent, at the Syndicate at Lloyd's, are coming our way. Oh, and also our professional liability business, Argo Pro, and our Commercial Specialty segment. So we're seeing it in 3 of the 4 segments.

Daniel D. Farrell
Piper Jaffray Companies, Research Division

Okay, great. And then, can I -- if I can just sneak in one more question as well. Some of the reinsurance buying that you're doing, is that going to have any impact on your acquisition ratio? And how do you think about your acquisition ratio trending with lines of business that you're writing, any mix changes taking place in, obviously, the context of reinsurance?

Mark E. Watson
Chief Executive Officer and Director

Well, we've mentioned over the last couple of years that we've been taking more risk, net, as we get more diversification benefit in our underwriting portfolio. We felt less need to buy as much reinsurance. Having said that, with reinsurance pricing continuing to decline, we've been looking at whether or not we shouldn't turn the dial back the other way and buy a bit more and lay off a bit of risk. But on the margin in the last year, I would say that it really hasn't changed too much. And so therefore, it hasn't impacted our acquisition ratio.

Operator

The next question comes from Jeff Schmitt of William Blair.

Jeff Schmitt

The -- I believe you said the Casualty book within the E&S segment was up 16%. Is that right?

Mark E. Watson
Chief Executive Officer and Director

That's correct.

Jeff Schmitt

Could you maybe provide a little bit more color on what's driving that? Was there anything kind of unique in the quarter? Where are the pockets looking forward?

Mark E. Watson
Chief Executive Officer and Director

So I mean, that's been this -- we've been growing at a similar rate for several quarters now. And as I said in my remarks, it's primarily a function of changes that we've made in our business process that we think make it much easier for our clients to do business with us and, to a lesser extent but also important, our use of technology. So we haven't changed our risk appetite. We're just better at processing the business that's coming in the door. Or to say it another way, we haven't widened the funnel of business opportunities coming in, we're just doing a better job at addressing the business that's in the funnel.

Jeff Schmitt

Okay. And then reserve development in the E&S segment looked to be down about half of what it's been running at or a little bit below. Is there anything that drove that, that's unique or...

Mark E. Watson
Chief Executive Officer and Director

No, the only thing I can tell you is it's never the same amount in any one quarter, for any one year.

Jeff Schmitt

Right, I just didn't know if it was... okay.

Mark E. Watson
Chief Executive Officer and Director

Yes -- no, it's just -- there's no aberration. It's -- they're just never the same number.

Operator

[Operator Instructions] The next question comes from Meyer Shields with KBW.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Two, I guess, related questions. The underwriting expense, either dollar amount or ratio, in the Syndicate and International Specialty have been bouncing around a little bit. And the first quarter of '16 looked pretty good. Was there anything unusual or is this a reasonable run rate going forward?

Mark E. Watson
Chief Executive Officer and Director

Well, I don't think a 40% expense ratio at the Syndicate is a reasonable run rate, which is why I made a comment earlier about it. Most of that is commission expense. Our non-acquisition expense ratio was actually pretty low. I believe that's around 12% but don't hold me to that because I don't have the numbers in front of me. But we continue to pay. The market, as a whole, is continuing to pay more and more to produce business under the Syndicate. So we need to continue looking for ways to change our mix of business there at the Syndicate. As you can see, the loss ratio is just fine. Jay did point out in his remarks that it was a bit higher this quarter than a year ago because of a bit of a loss activity beyond what we would have expected. But I think that's more of a timing issue than a change in the market or in our portfolio. As for International Specialty, there are a lot of different businesses within International Specialty, and I would say that our expense ratio there, perhaps, may be a little unusually low for the quarter. But I do think it's trending in the right direction as we continue to get scale in our business in Brazil and we continue growing our business here in Bermuda.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Okay, that's helpful. With the Casualty business, where you are growing, are you -- I'm going trying to ask this -- are you either seeing or are you booking any different loss cost trends than you had over the past few years?

Mark E. Watson
Chief Executive Officer and Director

No, and that's why I was trying to make the point a minute ago in the last question that the business that we're looking at today is the same as it was a year ago or 2 years ago. We're just doing a much better job of raising our hit ratio and our close ratio on the business that's coming in the door.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

No, I understood that, I think that was clear. I'm just trying to get a handle on whether the trends that you're seeing externally are evolving at all.

Mark E. Watson
Chief Executive Officer and Director

Yes -- no, they're staying pretty constant. Remember that we tend to be focus on smaller account business where -- we're talking about limits of $1 million -- we're talking $1 million limits. In some cases, it's more than that. But a whole lot of what we underwrite in that portfolio, our policy limit is at $1 million and the premium that we're charging for that is usually thousands of dollars, perhaps, $10,000 or $15,000 but not $50,000 or $100,000. And so that portfolio has been pretty stable for several years. So rates may go up or down low single digits, but we're not seeing huge changes in rate.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Mark Watson, President and Chief Executive Officer, for any closing remarks.

Mark E. Watson
Chief Executive Officer and Director

I'd like to thank everyone for joining our call today. I know that this was a busy morning with a lot going on. But I think that as I said in my remarks earlier, that a lot of the hard work that we've been doing over the last couple of years is starting to pay off. We still have plenty of work to do, but I think that our financial results this quarter accurately reflect some of the progress that we've made. And we look forward to talking to you again at the end of the second quarter. And operator, that concludes our remarks for today. Thank you.

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