S&P Capital IQ

CONTENTS



# Argo Group International Holdings, Ltd.

NasdaqGS:AGII

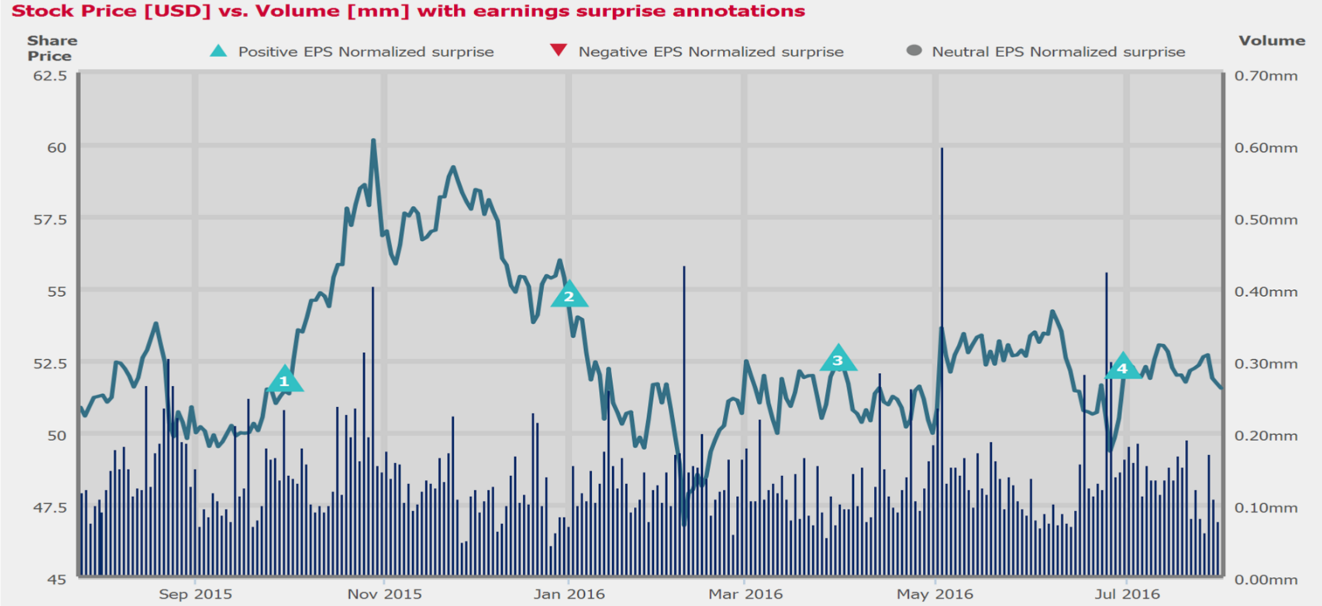
*FQ3 2016 Earnings Call Transcripts*

Wednesday, November 02, 2016 3:00 PM GMT

## S&P Capital IQ Estimates

| | -FQ3 2016- | | | -FQ4 2016- | -FY 2016- | -FY 2017- |
|---|---|---|---|---|---|---|
| | CONSENSUS | ACTUAL | SURPRISE | CONSENSUS | CONSENSUS | CONSENSUS |
| **EPS Normalized** | 0.85 | 1.12 | ▲31.76 | 0.89 | 3.86 | 4.07 |
| **Revenue (mm)** | 365.20 | 416.70 | ▲14.10 | 377.20 | 1511.90 | 1527.40 |

Currency: USD
Consensus as of Nov-01-2016 9:57 PM GMT




- EPS NORMALIZED -

| | CONSENSUS | ACTUAL | SURPRISE |
|---|---|---|---|
| **FQ3 2015** | 0.73 | 0.78 | ▲1 6.85 % |
| **FQ4 2015** | 0.80 | 0.82 | ▲2 2.50 % |
| **FQ1 2016** | 0.86 | 0.96 | ▲3 11.63 % |
| **FQ2 2016** | 0.51 | 1.20 | ▲4 135.29 % |

# Call Participants

## EXECUTIVES

**Jay S. Bullock**
*Executive Vice President and Chief Financial Officer*

**Mark E. Watson**
*Chief Executive Officer and Director*

**Susan Spivak Bernstein**
*Senior Vice President of Investor Relations*

## ANALYSTS

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

**Christopher Campbell**
*Keefe, Bruyette, & Woods, Inc., Research Division*

# Presentation

**Operator**

Good morning, and welcome to the Argo Group International Holdings Third Quarter 2016 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, SVP of Investor Relations. Please go ahead.

**Susan Spivak Bernstein**
*Senior Vice President of Investor Relations*

Thank you, and good morning, everyone. Welcome to Argo Group's conference call for the third quarter and 9 months 2016 results. Last night, we issued a press release on earnings, which is available in the Investor 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. 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.

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 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 filings with the SEC.

With that, I'm pleased to 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. Good morning, everyone, and welcome to Argo Group's Third Quarter Earnings Call. I'd like to share my thoughts about the quarter, after which Jay Bullock will add more commentary to the financial results. And then we look forward to responding to any questions you may have during the Q&A portion.

After the market closed yesterday, Argo reported 10% growth in book value per share since the end of 2015 to $59.65. That equaled an annualized return on average equity of 8.8%. Growth in operating earnings per share at 58% to $1.12 per share in the third quarter. And for the first 9 months of the year, we grew operating earnings 23% to $3.28 per share. The themes we've been talking about all year carried through in the third quarter, rigorous in our underwriting standards, simplifying how we work and leveraging technology, all with a focus on improving our margin and creating a more customer-centric environment. As you can see from our financial results I just discussed, the company's performance continues to improve and we're all positioned to continue the momentum. In short, in the quarter and frankly in a year where you have seen some not-so-favorable results in the market, we are executing and delivering strong results for our shareholders. Our long-term goal is to remain a leading global specialty underwriter with a reliable and increasingly visible brand. In the first 9 months of 2016, our gross written premium grew to $1.67 billion, up 6.4% over the same period last year. And while our combined ratio remains relatively flat at 95%, we achieved these results notwithstanding an increase in catastrophic loss and reduction in prior year positive development in 2016 compared to 2015. I'm happy to report that net investment income was $89.6 million compared to $68.5 million last year with our alternative investment income contributing strongly.

An important point to note is that all 4 of our operating businesses generated an underwriting profit in both the quarter and the 9-month periods. These results include the impact of $13 million of catastrophic losses in the third quarter and $38.9 million in the 9-month period. It also includes $2.9 million of positive reserve development from prior period in the third quarter and $18.8 million in the first 9 months of the year.

We continue to benefit from our prudent loss reserving strategies. Including this quarter, we have benefited from favorable loss reserve development now for the last 22 consecutive quarters, and each of the last 11 year -- consecutive years. Also, as discussed in previous calls, our expense ratio is showing favorable year-over-year improvement.

Before going through each segment, let me say again for the second quarter in a row that our U.S. business in total is doing very well. In fact, this quarter's U.S. underwriting income was one of the best in the history of the company.

Now let me briefly comment on each of our operating segments.

For the quarter, our Excess and Surplus Lines business grew by 6% and by 4% for the 9-month period. Growth is primarily being driven by our Casualty and Environmental units, which had benefited in part by new technologies that help us better analyze and select risk, allowing us to drastically reduce cycle time and increase the value of business we process to ourselves and to our clients. As we continue making investments in these areas, we expect to see the benefit reflected across more of this segment over the coming quarters. On average, rates were up modestly across the segment, other than Property, which is down a fair bit due to continued competition in this area.

Moving on, I'm happy to say that we're continuing to see significant improvements in our results from the Commercial Specialty segment. Gross written premium was up a little over 24% in the quarter and 20% for the first 9 months. More importantly, earned premium was up 4%. More importantly, for the quarter, both underwriting income and operating income were more than any other business segments, thanks in part to positive prior year development. Growth was driven by our program, surety and professional lines businesses. Overall, rates in this segment were down modestly with the largest declines in our retail establishment and surety businesses. Having said that, we're still comfortable with our margins. While the U.S. results have done better than our International business, let me say that notwithstanding the above average cat [ph] losses, our international businesses are holding their own and gaining momentum. We're excited to have Jose Hernandez on board as the new Head of our international platform. Jose has a tremendous amount of experience building and running successful operations. His skill in leading and growing international business aligns fully with our ambitions, and we're delighted to have him on the team and here with us on the call today.

Turning to Syndicate 1200, competition remains robust in the Lloyd's market. We did achieve modest premium growth in gross written premiums of 1.5% in both the third quarter and first 9 months of 2016, due in part to new product lines. But just as a reminder, this kind of overlooks how the syndicate is doing in the whole and what I mean by that is that in 2016, we reduced our ownership in the syndicate by 5%, or I should say, our capacity in the syndicate by 5% compared to a year ago. So actually on a like-for-like basis, the syndicate's gross written premium is up approximately 7.7% for both the quarter and the 9-month periods versus 2015.

We continue to consider the Lloyd's market as one of the more challenging markets over the last couple of decades. In this environment, our advantage lies in our strategy moving forward around profitable relationships deepened over time by solid underwriting, actuarial analytics and outstanding service. Similar to Lloyd's, our International Specialty segment continues to experience challenging market conditions. Having said that, in the third quarter of 2016, we grew gross written premiums by 2%. Despite the strong competitive environment, our Bermuda casualty and professional lines businesses grew compared to prior year, as modest rate declines were more than offset by new business opportunities.

Our operations in Brazil were profitable again for the second quarter in a row as we gained scale and we saw record premium from our professional lines businesses. We also benefited from favorable currency exchange rates in Brazil in the third quarter. This growth was somewhat offset by lower premium in Argo REIT due to increased competition. Having said that, we do see some signs that the market is bottoming.

Turning to investments. I want to remind everyone that we began to include the performance of our alternative investments and investment income in the first quarter of this year. All prior periods have been adjusted to reflect this change. For the quarter 2016, Argo's total return was 1.3%, bringing year-to-date returns to 4.3%. We benefited during the quarter by allocation decisions made to certain less liquid investment grade and non-investment credit instruments that showed particularly strong returns. Our reported net investment income was $32.8 million for the quarter, which while slightly lower than last quarter, was up $14.3 million over the third quarter of 2015. In addition, you might note that our realized gain was larger than most past quarters. We took the opportunity in recent quarters to add modestly to position post-market dislocation such as Brexit in June, and as the markets have recovered, we've selectively reduced our exposures to some of these positions.

Moving on to capital management. Our philosophy is not changed. Our first use of capital was to support the balance sheet; the second is to grow the business; third is to have capital available for opportunities as they arise; and fourth is to activity return excess capital to our shareholders in an effective manner. In the first 9 months of 2016, we repurchased 815,000 shares or thereabout for 400 -- excuse me, for 45 -- about $45 million. In total, over the last 6 years, we've returned more than $492 million of capital to shareholders with $376 million of that through share repurchases and the remaining $116 million in cash dividends. We continue to view our stock as one of the best investments available, and we'll balance the return of capital to shareholders with our priority of building the Argo franchise and shareholder value in the long run.

And with that, I will turn it over to our CFO, Jay Bullock.

**Jay S. Bullock**
*Executive Vice President and Chief Financial Officer*

Thanks, Mark, and good morning, everyone. I'll be brief in providing some detail on the financials and then open it up to questions.

As Mark highlighted, operating earnings, book value growth and our return on equity showed continued progression during the quarter and first 9 months of the year. At a nearly $50 million through September 30th, underwriting income is roughly equivalent to the same period in 2015, despite the increase in catastrophe-related losses. Almost all trends were positive in the quarter and each incremental positive movement, however small, added to the overall result for the quarter and for the continued momentum through 9 months. And when you look back over the last 4 years, you see the consistency of results and continuation of improvement in the underwriting.

Now to point out a few clarifying points on the financials. Gross written premiums were up 10% in the quarter and 6% through the first 9 months of 2016. Net written premiums were 8% in the quarter and 1% through the first 9 months of 2016. The increase in gross written premiums is partially driven by growth in our state funds fronting business in the Commercial Specialty segment. As a fronting business where we see 100% of the risk to these state funds, it's more of a fee-based business and thus doesn't contribute to the net or earned results. The smaller increase in net written premiums is also due in part to the reduced participation on the syndicate of approximately 5% that Mark mentioned.

Turning to loss trends. Our current accident year non-cat loss ratio is 55.1% in the third quarter of 2016 and 54.9% in the first 9 months of 2016. Both compare favorably to the same metrics for 2015, demonstrating continued improvement in our underlying business. By segment and for the group, the current accident year loss ratios are displayed in a new table in the press release, reconciling the various loss ratios.

In addition through the first 9 months of 2016, we continued the trend of overall favorable reserve development from prior accident years. For the third quarter, we experienced net favorable development of $2.9 million. As you may recall, this is the quarter in which we do more a detailed review of Run-off exposures. So the favorable result was despite the charge in the Run-off segment, related primarily to greater-than-expected defense cost on primary asbestos exposures and, to a lesser extent, Workers' Compensation on -- activity on very old accident years. As always, all of the relevant years on loss development are displayed in the table in the press release.

Catastrophe losses that impacted our business for the quarter were $12.9 million. That's net of reinsurance and reinstatement premiums, or 3.6 points on the combined ratio. For the 9-month period of 2016, the losses were $38.9 million or 3.7 points on the combined ratio. In the quarter, the losses were primarily related to the Louisiana floods and, to a lesser extent, by late reported events from Texas hailstorms. For the 9 months, the losses related to these claims along with other U.S. storms and the Canadian wildfires.

As Mark mentioned, we continue to see a favorable trend in both our expense and -- expense ratio and absolute expenses. We remain focused on organizing the business for this simplified approach in mind that will allow us not only to scale our existing operations more effectively, but make it easier for our customers to do business with us.

A couple of comments on investment returns. We saw a meaningful contribution to investment income from alternative investments of $9.8 million in the quarter and $20.8 million in the first 9 months of 2016. As I noted in last quarter's call, these returns will be lumpy and the results through the first 9 months of the year is more than we would expect in a normal annual period. The foreign currency movement through the income statement was a gain for the quarter of $1.5 million and a loss year-to-date of $4.5 million. Recall that there are other offsetting effects that flow straight to the balance sheet as a result of movement in currencies. And despite the significant currency fluctuation experienced thus far in 2016, most notably the drop in the British pound relative to the dollar, the net impact to our book value per share has been fairly modest.

For the third quarter of 2016, the effective tax rate for the Group was 11.2%, lower than our run rate expectation of 20%, as more than half of our income was attributable to the Bermuda platform. Year-to-date, the effective tax rate is about 16%.

Finally, on the balance sheet, we ended the quarter with an unrealized -- with a pretax unrealized embedded gain of $151.3 million compared to $84 million at December 31, demonstrating strong growth in asset values in the portfolio through the first 9 months.
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 with Raymond James.

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

Just 3 areas I wanted to touch upon, the reserve development, the loss ratios and expense ratios. On the favorable reserve development, I noted in your table, the favorable development in the quarter was down year-over-year, yet in the -- for the year-to-date, it's up. For most of the other companies that we follow, it seems like reserve development is trending downward or being less favorable going forward, and I'm wondering if that's an expectation that you guys are thinking about as well?

**Mark E. Watson**
*Chief Executive Officer and Director*

Good morning, Greg. This is Mark. No, not at all. In fact, I will let Jay be more precise in a second. But what we saw in the -- what we reported in the quarter isn't terribly different from previous third quarters. We put a little bit more on our loss reserves for our A&E business, as Jay mentioned again earlier. But for the most part, this is kind of what we would have expected based upon kind of the last few years and how we see the business going forward. Jay, you want to add?

**Jay S. Bullock**
*Executive Vice President and Chief Financial Officer*

Well, yes. I just think if you take a look at Page 11 in the press release and focus on the 9-month numbers and focus on Commercial Specialty, the issues that we were having in Argo -- in our retail business over the last couple of years have really settled down, and so you're starting to see real contribution from that. So, I think I agree with Mark. This feels a lot more like a normal result, because we don't have that segment in particular with issues.

**Mark E. Watson**
*Chief Executive Officer and Director*

And also we had a bit more large loss activity at the syndicate than we would have expected. And so that drove a slight deterioration in the loss reserves for the quarter.

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

On the loss ratios, I was looking at the reconciliation of loss ratios, the table that you put in your press release. And where it's showing some improvement both on the quarter and year-to-date on a year-over-year basis, and I'm wondering if we shouldn't expect some upward pressure going forward on some of those numbers, as we think about your comments about growth and the competitive pressures in the marketplace.

**Mark E. Watson**
*Chief Executive Officer and Director*

Well, I think if you go back and read our transcripts for the last 10 quarters, we've been saying the same thing. Having said that, perhaps not every single quarter, but certainly year-over-year, our loss ratio has continued to improve and that's been our ability to select risks better than we did before, in part driven by better data analytics, which I talked about earlier today, and I referred to in the last few calls. And equally important, our change of -- our mix in business has changed. We haven't grown the top line as fast as we would have liked or as fast as some of our competitors over the last couple of years, because we've spent most of our time realigning our portfolio and focusing on those lines of business where we think we have the best opportunity to generate an acceptable margin. And that's still the case today. I mentioned that our E&S business was growing mid-single digits, but if we look at -- if you look inside of that, our casualty portfolio and our environmental portfolio, which I made reference to in my remarks, they are growing double digits. So as we continue to grow the parts of our portfolio that have better margin and deemphasize the parts that don't, I actually think that there is still some room for loss ratio improvement as opposed to deterioration.

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

Perfect. That's great color. And just finally on the expense ratio. I think this quarter is more flat or less year-over-year improvement, and I'm just wondering thinking ahead if we sort of plateaued in terms of expense ratio improvement? Or Is there other low-hanging fruit that you think you might be able to harvest over the next course of 18 months?

**Mark E. Watson**
*Chief Executive Officer and Director*

Well, it's true that it only improved modestly. What's driving that though is change in mix of business. If you look at our non-acquisition cost, that's been pretty flat year-over-year. And so, what's happened is as we've changed the mix of business, it runs at a higher expense ratio. So think surety as an example. That's one of the fastest growing parts of the business on a percentage basis. And the average expense ratio all-in for our surety business is 50% or thereabouts, depending upon which part of the portfolio you're talking about. Of course, the corresponding loss ratio is in the 20s or 30s. The same is true of some of our risk-managed business within Commercial Specialty. It runs at a higher expense ratio, but a lower loss ratio. Having said that, I think the biggest challenge that we all have in the marketplace today with the expense ratio is commission expense. I think I mentioned on our call last quarter that at the Syndicate in particular, we're paying in some cases 5 points more commission. When I say we, I mean the market, not just Argo. We are paying substantially more commission for the same business. And that at some point becomes unsustainable, and while I was criticized by a few for my remarks about the London market last quarter, it's still a real issue that we as a market are dealing with. So you will note that other parts of the Group maybe growing a bit faster right now. And who would have thought the Commercial Specialty would have generated the most amount of underwriting income in a quarter?

**Operator**

[Operator Instructions] Our next question is from Christopher Campbell with KBW.

**Christopher Campbell**
*Keefe, Bruyette, & Woods, Inc., Research Division*

Quick question on the alternative net investment income. Can we get any additional color on what was driving that? And how we would want to think about that on a run-rate basis annually going forward?

**Jay S. Bullock**
*Executive Vice President and Chief Financial Officer*

Yes. I will -- Chris, this is Jay Bullock. I'll give you the -- I'll try to give the same color that I gave last time. So if you look in the -- there is a disclosure table in the 10-Q. We haven't published this quarter's yet, obviously, but from last quarter, that talks about hedge funds and then certain alternative -- sorry, certain private equity investments. If I choose a round number, let's say, that's around $300 million. As I mentioned, the returns on that can be kind of lumpy, but if you think somewhere between 4%, 5% or 6%, those are obviously conservative numbers. When we make those investments, we expect greater returns than that. But that's the amount of gain that we would expect to see out of that portfolio go from what would have historically been an increase in value through realized gains. But it's more of a recurring return, and so that's why we've included it in investment income. So I think that's consistent with what I said last quarter and should give you some direction as to what you might want to expect.

**Mark E. Watson**
*Chief Executive Officer and Director*

And we'll be filing that. I believe we're going to file the Q with the table in it on Friday.

**Jay S. Bullock**
*Executive Vice President and Chief Financial Officer*

That's the plan.

**Christopher Campbell**
*Keefe, Bruyette, & Woods, Inc., Research Division*

Okay. And then just switching to your fee income. That was up about $700,000 this year-over-year. Is that being driven by the increased fronting business? Or is there anything else that's driving that increase?

**Jay S. Bullock**
*Executive Vice President and Chief Financial Officer*

It's coming from 2 different places. We've got a business that we call Alteris that's on the margin doing better than it had been in the past, still not where we'd like for it to be from a scale standpoint. And then we are seeing -- we have had good results in the Syndicate. And so what you see coming through there is as we manage third party capital, we had paid fees for doing that and so you are starting to see some of that flow through the numbers as well.

**Mark E. Watson**
*Chief Executive Officer and Director*

Yes, let me just jump in. So I mentioned not in my remarks earlier that we have 5% less of the capacity at the Syndicate this year. So we're getting slightly more fee income from the 5% that we gave up to third party capital. And as per Alteris, which Jay referred to first, that's a managing general agency that we own 100% of.

**Christopher Campbell**
*Keefe, Bruyette, & Woods, Inc., Research Division*

Okay. And then just to circle back on the expense ratios, is there -- with your retentions coming down, how should we think about the expense ratio going forward? I mean, could you -- would get the seating commission off of that, and that would help offset the acquisition cost increases?

**Mark E. Watson**
*Chief Executive Officer and Director*

Can you -- I'm not sure we understand the question. Do you mind just saying it one more time?

**Jay S. Bullock**
*Executive Vice President and Chief Financial Officer*

With regard to retentions specifically, I'm not sure what you're referring to.

**Christopher Campbell**
*Keefe, Bruyette, & Woods, Inc., Research Division*

So I was just thinking about how your net to gross overall have been decreasing, right? And so that you would be getting the feeding [ph] commissions back on that business, which would offset the acquisition costs. And I just want to think about how that would feed into your run rate expense ratio?

**Mark E. Watson**
*Chief Executive Officer and Director*

Okay. So let me start that, and then I'll let Jay jump in. For some of the quoto-shared contracts, that's true. Most of the changes that we've made to our quoto-share structures were done a couple of years ago. So some of the changes that you see on net retention today are a function of us taking slightly more net from some of our excess to loss covers, but of course, that puts more premium on the books, which actually improves expense ratio. And also, it's a function of a change in product mix for some of our smaller account businesses like, I mentioned our Casualty business within E&S earlier. We've always retained more of that net. So as we change our mix of business, that changes the difference between gross and net as well.

**Christopher Campbell**
*Keefe, Bruyette, & Woods, Inc., Research Division*

Okay. Great. And then just one final one on -- can we get an update on your recruitment efforts? And are there any additional lines that Argo is looking to add or areas to grow?

**Mark E. Watson**
*Chief Executive Officer and Director*

The answer is yes. I think it was this call a couple of years ago -- sorry, it was last year, at the end of the third quarter that I suggested that I thought the best strategic thing we could do at the time and over the next year was to focus our attention on recruiting some very talented people to our organization, which is kind of what we've done. I mentioned earlier on the call that we have Jose Hernandez, the Head of our International Business, with us here today. But over the last year, we've hired more than a dozen senior people from the industry into our group. There are a couple of roles that we're still looking to fill that are product line focused and a couple of geographic roles that we're looking to fill. And I think we will have that done by kind of mid-year 2017. The number of talented candidates continues to grow, and it's a really nice place to be.

**Operator**

[Operator Instructions] This concludes our question-and-answer session. I would like to turn the conference back over to Mark Watson for any closing remarks.

**Mark E. Watson**
*Chief Executive Officer and Director*

Thank you. I'd like to just thank everyone for their time today. I know today is a busy day for everyone. We're not the only that reported last night. And I'd also like to thank my colleagues at Argo. You all are doing a great job, and I appreciate all the hard work, and I appreciate everyone staying focused on our company. And I look forward to talking to you all at the end of the fourth quarter. Operator, that concludes my remarks.

**Operator**
Thank you, sir. And thank you, everyone, for attending today's presentation. You may now disconnect. Take care.