S&P Capital IQ

CONTENTS

Argo Group International Holdings, Ltd.

NasdaqGS:AGII

FQ1 2017 Earnings Call Transcripts

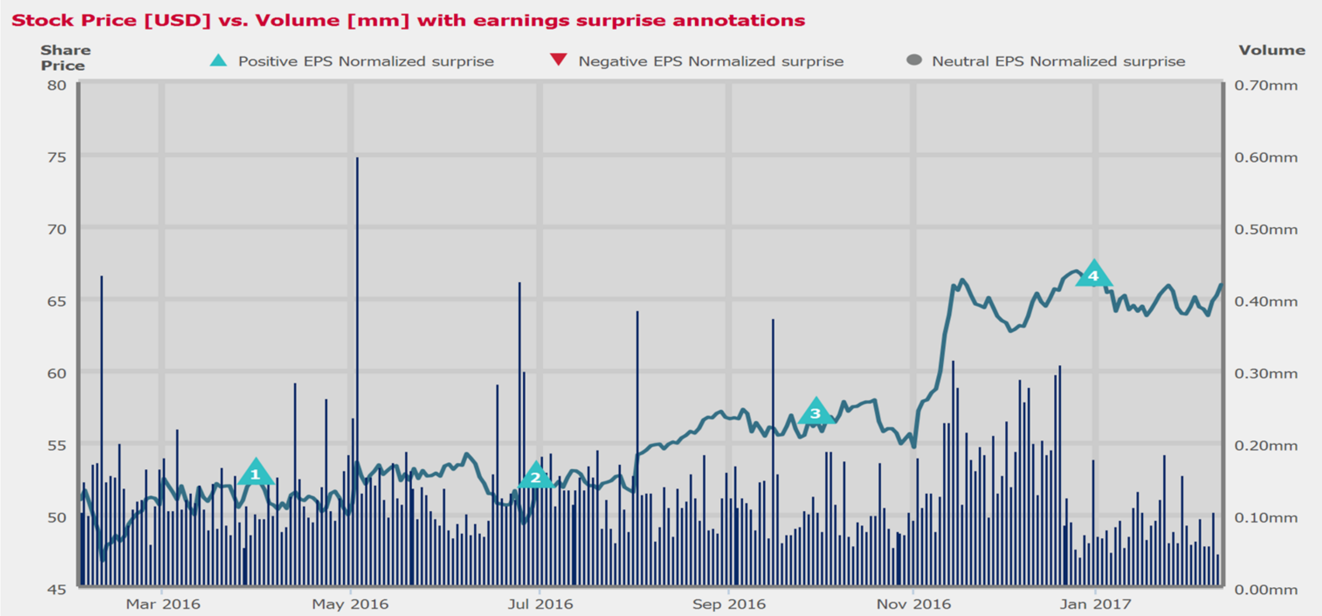
Thursday, May 04, 2017 2:00 PM GMT

S&P Capital IQ Estimates

	-FQ1 2017-			-FQ2 2017-	-FY 2017-	-FY 2018-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.61	0.71	▲16.39	1.16	3.92	4.04
Revenue (mm)	394.20	428.10	▲8.60	396.00	1587.80	1621.00

Currency: USD

Consensus as of May-04-2017 8:05 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ1 2016	0.86	0.96	▲11.63 %
FQ2 2016	0.51	1.20	▲135.29 %
FQ3 2016	0.85	1.12	▲31.76 %
FQ4 2016	0.64	0.65	▲1.56 %

Call Participants

EXECUTIVES

Axel Schmidt
Group Chief Underwriting Officer

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

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Jeff Schmitt

Presentation

Operator

Good day, and welcome to the Argo Group 2017 First Quarter Earnings Call and Webcast. [Operator Instructions] Please note this event is being recorded.

I would now like to turn the conference over to Ms. Susan Spivak Bernstein, Senior Vice President of 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 the first quarter 2017 results. Last night, we issued a press release on earnings, which is available on the Investors section of our website at www.argolimited.com.

Presenting on the call today is Mark Watson, Chief Executive Officer, who will share his thoughts about the quarter, after which, Axel Schmidt, our Chief Underwriting Officer, will discuss some of the trends in the business; and Jay Bullock, Chief Financial Officer, will add more commentary to our financial results. 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 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 filings with the SEC.

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

Mark E. Watson
Chief Executive Officer and Director

Thank you, Susan. Good morning, everyone, and welcome to Argo Group's 2017 first quarter earnings conference call. Beginning in 2017, we had 2 significant changes in our reported results. First, we closed the Ariel Re transaction and have 2 months of results included in our first quarter numbers. Second, we changed our reporting structure to better align reported results with the way we're managing our businesses and thinking about our operating structure. Going forward, we think that reporting our results in the way we run the company is more appropriate, which is by our U.S. operations and our international operations.

Please note that international is defined as where we underwrite risk, not necessarily where the risk resides.

Now getting to a few numbers. After the market closed yesterday, Argo reported net income of $1.19 per share for the first quarter of 2017, up nearly 34% from the prior year and a return on average equity of 8.1%. For the past 4 years, our return on equity has averaged 9.7%. Adjusted operating earnings for the first quarter of 2017 of $21.9 million or $0.71 per share was down from the same period in 2016, primarily due to some nonrecurring items that Jay will go into further detail in his commentary.

Like others, this includes a charge for Ogden. These charges do not reflect our underlying business and we feel good to be continuing the momentum of 2016 in the current year.

We ended the quarter with book value of $60.84 per share, an 8.5% increase from March 31, 2016, and a 10.1% increase when you take dividends paid into consideration.

As I've discussed on these calls and in our meetings, we consider the compounded annual growth rate of book value per share as the measure that most clearly demonstrates value creation for our shareholders. For the last 15 years, including dividends paid, the compounded annual growth in book value per share has been 10%. These results demonstrate the continuous improvements we've made to the company. It's been quite a busy few months with the closing of the Ariel Re transaction, and once again, I want to take the opportunity to welcome all of our new employees to the Argo team. We're making good progress on integration, and I want to thank everyone for all their efforts to date. Having said that, I think we'll have a lot more to talk about at the end of the second quarter.

In our U.S. operations, over the last few years, Kevin Rehnberg and his team have done an outstanding job of evaluating and building this business and bringing on new additions to our leadership team. Our U.S. operations reported a 16.5% increase in gross written premiums in the quarter to $335 million. While all core of our reported business lines within the unit grew versus the 2016 first quarter, the strongest growth was in our liability lines, mainly programs, Rockwood and Trident, followed by Property.

In terms of premium rates, in most of our business lines, they're headed in the right direction. Unfortunately, just not as fast as we'd like to see. On an overall basis in the quarter, rates were up a little over 1% on our U.S. book. The first quarter 2017 loss ratio, excluding cat losses and reserve development, was 57.6 versus 56.2 reported in the first quarter, mainly from higher attritional losses in our property lines from the few discrete claims, including 1 fire claim that was for about $2 million.

We continue to implement and utilize new technologies that help us better analyze and select risk. As our digital and underwriting teams collaborate to improve the overall underwriting process, it reduces the cycle time to quote so we can response to more opportunities and underwriters have more time to focus on new business with the highest probability of success. To give you an example where the improvement in technology is working really well for us, is in our U.S. Casualty business.

By working with our clients, we've incorporated their feedback to improve our process of responding to the 90,000-or-so submissions we receive annually, resulting in a reduction in cycle time of underwriting a policy from 10 days to 2 days, and an increase in monthly quotes from 700 to more than double at 1,600. With these types of initiatives, we'll demonstrate profitable growth right all phases of the underwriting cycle, we believe. If you're wondering why premium isn't growing faster with all of this ease of doing business for our customers, it's because the market is even more competitive today than it was a year ago, if you can imagine that.

Moving on to talk about our International operations, including London, Bermuda, Latin America and now Ariel Re, these are being run by José Hernandez. As I mentioned on our last call, José has considerable expertise in building and running successful operations in several countries around the globe. Under Jose's leadership, these businesses are collaborating to drive growth globally.

In the first quarter of 2017, gross written premiums were up 13.5%, primarily driven by the acquisition of Ariel Re in both our Property and Specialty lines. The loss ratio, excluding catastrophe losses and prior year reserve development, was 54.7 compared to 54.5 in 2016 or relatively flat. Market competition remains fierce in the London market, particularly Lloyd's, it's probably the toughest market in the last 2 decades.

In addition to price competition, the cost of acquiring business continues to rise. In my opinion, at some point, the market as a whole will have to ask itself, is enough, enough? In the meantime, our relationships inside the market deepened over time by collaboration, solid underwriting and outstanding service should see us through with our profitable partnerships.

Now turning to investments. Argo's first quarter return was 1.5% versus 1.2% in the first quarter of 2016. Our core bond portfolio was up 0.8% and our capital appreciation portfolio was up 3.6%, which continues the trend we experienced in 2016. Our reported net investment income was $30.5 million for the first quarter, $9 million higher than the first quarter of 2016, and $5 million higher sequentially. Alternatives at $8.3 million in the quarter made up most of the increase, both year-over-year and sequentially.

As a reminder, we expect the alternative contribution to be lumpy by quarter as can be seen in the table provided in our press release.

During the first quarter, the strongest asset class performers were global equities and emerging market debt. However, most of our asset classes held up reasonably well. Recently, we've begun rebalancing our portfolio by trimming some of our risk exposure in equities and high yield debt as the risk reward becomes less compelling, and our risk portfolio return has grown at over 4x the pace of our core bond portfolio, which I guess I would consider a high-class challenge.

We've talked a lot about in the past about capital management. This quarter, we did not repurchase any shares as one of our uses of capital is to have it available for opportunities as they arise as we did with the closing of the Ariel Re transaction. Having said that, we did increase our quarterly dividend by 23% at our February 2017 Board Meeting, and I should point out that over the last 6 years, through share repurchases and dividends, we've returned over $0.5 billion in capital and repurchased 32% of the shares outstanding of the company.

With that, I'll turn the call over to our Chief Underwriting Officer, Axel Schmidt. Axel?

Axel Schmidt
Group Chief Underwriting Officer

Thank you, Mark, and good morning, everyone. As Mark mentioned, it has been a busy few months. Through the first quarter of 2017, we have grown gross written premiums compared to the first quarter of 2016 in all 4 of our major lines of business. But 44% of our first quarter GWP across the group will generate [indiscernible] cash [indiscernible] products, we continue to benefit from having a diverse spread of products across our major lines of businesses. In fact, across the group, in Q1 '17, we were able to achieve a marked increase in premium rates. We maintain our active approach to managing the portfolio across the cycle. As key aspect of this is to ensure that we keep our underwriting discipline and to underwrite for profit and not for volume.

I'm pleased to comment that our underwriters continue to demonstrate this philosophy across all geographies. And those areas of the portfolio that are more challenging, we seek to drive rate increases where appropriate, or address the issues by other underwriting actions. Where we see opportunities, we make investments in underwriting teams and underwriting systems. In professional lines, our first globally managed line of business, we strengthened our offering. We added experienced leaders to our underwriting teams in Europe and U.S. The teams across all geographies collaborate effectively to generate new opportunities such as our transactional liabilities risk program in the U.S.

Cyber is another area where we see significant market opportunities.

In the first quarter of 2017, our Syndicate launched the cyber product. Our dedicated expertise in London complements our existing expertise both in the U.S. and Bermuda. And with our global approach to cyber, we further leverage our expertise across all platforms to deploy our capacity effectively. In the U.S., we have also built out our surety offering by introducing a broader contract surety product where the team has made a couple of key hires as well.

Finally, as Mark mentioned, we have made substantial strides to implement and utilize new technologies to improve the efficiency and effectiveness of underwritings across the globe. Another area that this is significant is in our Brazilian operation, where nearly 40% of our business is now transacted digitally.

With that, I will hand over to Jay Bullock to add some more commentary to our financial results.

Jay S. Bullock
Executive Vice President and Chief Financial Officer

Thanks, Axel, and good morning, everyone. I'll provide some detail on the financials and then open it up to questions.

As Mark highlighted and Axel discussed, we made changes to our segment reporting this quarter that reflect the simplification of our management structure, and we hope to give investors a clear understanding of our business fundamentals. In this and future releases, we'll discuss our business and few reportable operating segments with detail based on product lines relating to the underlying risk. As in the past, our consolidated results will include any impact from our runoff unit as well as expenses not otherwise allocated to the business units.

Additionally, as noted, our acquisition of Ariel closed in February, and as a result, the quarter reflects 2 months of operations for the business. As a significant portion of this business is written at January 1, the gross results do not reflect the business written by Ariel in the quarter.

Total gross written premiums for the quarter for Ariel Re were approximately $125 million, with approximately $30 million of gross written premiums included in the 2-month results. As we noted in our press release a few weeks ago, we did have some nonrecurring items in the quarter that impacted both our reported loss and expense ratio. While these numbers are included in operating earnings, they do not reflect the underlying profitability of the business.

First, the impact of prior year results on the loss ratio. We continue to benefit from positive reserve development in our U.S. operations. The $5.2 million of positive reserve development was driven primarily by releases in our casualty and workers' comp lines. And while the reported development on our International segment was negative, the result was impacted by $4.5 million related to the Ogden rate change in the U.K., and by additional claims of approximately $5 million from Hurricane Matthew.

Excluding these 2 items, the development in the International business was slightly positive, and for the group overall, very much in line with last year's first quarter results. Catastrophe losses in the quarter were $1.8 million compared to $3.3 million in the first quarter of 2016. Losses in this year's quarter are primarily from U.S. storms and Cyclone Debbie.

On the expense ratio, there are really 3 items that impacted results. The first is one-time costs related to the Ariel Re transaction of $2.5 million, primarily related to professional fees. The second is $4 million of costs for restructuring and transitioning certain infrastructure and technology services to outside third-party managers. We expect this work to enhance our platform stability and lay the groundwork for further operating efficiencies.

Finally, during the quarter, we saw a meaningful increase in the stock price and recorded approximately $1.5 million of expense related to equity compensation, above what we would have expected. Excluding these items, the expense ratio was 38.4% compared to 38.5% in the 2016 quarter.

For the first quarter of 2017, the effective tax rate for the group was 14% versus our base assumption of 20%. The lower-than-expected rate was mainly due to a higher portion of earnings -- proportion of earnings from our Bermuda operations.

Finally, on the balance sheet, as we mentioned, we recently closed the acquisition of Ariel Re. The acquisition was funded with cash on hand and a $125 million term loan. This is reflected on the balance sheet under Other Indebtedness. In addition, we assumed $84 million of junior subordinated debt with the Ariel acquisition. This debt is structurally very similar to the trust prefers we have on our balance sheet and offers some useful capital advantages.

We ended the quarter with a pretax unrealized embedded gain of $131 million, compared to $116 million at December 31. Majority of gains relate to our equity holdings. Our fixed-income holdings remain very short in duration and the carrying value currently approximates market value.
Operator, that concludes our prepared remarks. We're now ready to take any questions.

Question and Answer

Operator

[Operator Instructions]

The first question comes from Arash Soleimani of KBW.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

How -- just going forward, how should we think about your net-to-gross ratio? I mean, to what extent are you increasing or decreasing your use of retro?

Mark E. Watson
Chief Executive Officer and Director

So right now, I don't -- we've been pretty consistent. Well, let me rephrase that, within a couple of percentage points. I don't see that changing for the next few quarters. As we think about our capital structure for 2018, we may make some changes. We'll probably highlight those in the November call. I say that, Arash, because our cat loans were issued on a multiyear basis and they expire at the end of this year, so we'll be rethinking how we want to use the capital markets to support our property cat underwriting program in 2018. But other than that, I think the difference between gross and that will remain fairly consistent depending upon reinsurance pricing and insurance pricing. But I don't expect too much of a change between gross and that other than supporting our cat program.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. And the other question I had. I don't know if this was mentioned in the prepared remarks, but did you say what specifically drove the strong performance in alternatives?

Mark E. Watson
Chief Executive Officer and Director

I think it was just -- it was across the board in all of our hedged strategies. Most of them are credit, you may recall. And we also did, I think, pretty well in some of our high yield portfolio, which I also mentioned we'd sold off a part of it.

Operator

And the next question comes from Jeff Schmitt of William Blair.

Jeff Schmitt

Question on the expense ratio in the U.S. operations. It looks to be up a fair amount, the 35%. Were the transition -- I guess, $4 million for transition of IT functions, did that fall in there?

Jay S. Bullock
Executive Vice President and Chief Financial Officer

That was -- those costs were retained at the holding company. What you see in the U.S. operation, in the first quarter of 2016, we divested off a portion of our nonrisk-bearing business. So there's a gain on sale of about $1.5 million related to that. As Axel mentioned, we've made a few key strategic hires in areas like professional liability and surety. That also was reflected in the first quarter. So I actually expect that number to come down. But of course, that gain in the first quarter of 2016 was a one-time item. But I do expect to see that number start to trend down as earned premium starts to pick up, reflecting those new hires.

Mark E. Watson

Chief Executive Officer and Director

Yes, in addition to that, some of the IT did flow through there, it was a little over $1 million. And earlier, Jay mentioned that with our share price moving up in the quarter, that we had more equity compensation expense than we intended and that was over $1 million for the Syndicate as well. When you add them all up, that gets you to a couple of points on the expense ratio.

Jay S. Bullock
Executive Vice President and Chief Financial Officer

Sorry, that was more than $1 million for the U.S. [indiscernible] Syndicate, yes.

Mark E. Watson
Chief Executive Officer and Director

Yes. Sorry, for the U.S.

Jeff Schmitt

Yes. And then looking at the consolidated underwriting acquisition costs look to be about $19 million higher than if you just add the 2 segments. $6.5 million one-time costs which you showed. But that remaining $12 million, how much of that was incentive comp versus, I guess, what else was in there?

Jay S. Bullock
Executive Vice President and Chief Financial Officer

Well, there's $3 million related to the incentive comp. There's $1 million of IT that Mark mentioned. You have to take into account the $1.5 million gain from last year. Not sure what that gets us to now. Fairly close. So those are sort of the big identifiable items. As I mentioned, there's a small impact from some new people coming onboard. But as I said, we expect to see the earned premium pick up related to that.

Jeff Schmitt

Okay. And then one quick question on losses in the U.S. segment. We're seeing, [indiscernible] loss ratios move up 100, 150 basis points for a lot of competitors. But it looks like yours was mainly driven by a property loss. Could you maybe talk about loss trends? Are you seeing any uptick in loss costs?

Mark E. Watson
Chief Executive Officer and Director

Yes. Well, let me start, and then I'll let Axel jump in. If you look at the trends of our portfolio over the last 4 years now, I think you've seen a pretty steady improvement in loss ratio as we've rebalanced our portfolio. Axel mentioned that earlier, actually. Loss cost trends haven't really changed too much. I think that for our portfolio to move around 100 basis points here or there from one quarter to another doesn't worry me too much as we continue moving around the balance of our portfolio. Axel, do you want to add anything to that?

Axel Schmidt
Group Chief Underwriting Officer

Yes. Kind of a few things. Thank you, Mark. I think really critical is that particularly with regards to attritional losses, that as we both Mark and I and Jay mentioned earlier, our rate level has not gone further down. So it's actually slightly up. It's one good thing in terms of situational loss ratio exposure. Secondly, we have that same, I think, very effective reinsurance program in place across the board for the larger losses. And then if I compare our loss ratio Q1 to plan, we are doing about 2 -- 1.5 points better than plan. So I am pretty much -- and I see that going to continue over the next quarter that we're in line the [indiscernible] plan based on all the actions and initiatives and mitigating actions we've put in place. So I am comfortable that people not be negatively surprised by loss trend.

Mark E. Watson
Chief Executive Officer and Director

Yes, let me just say one last thing. Notwithstanding the growth in our P&L over the last few years, it's still -- I find it surprising to be honest, that when we have a $2 million or $3 million loss, it still impacts the quarter in terms of attritional losses. So there is still a little bit of lumpiness to that sometimes.

Operator

[Operator Instructions] We've a follow-up question from Arash Soleimani of KBW.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

I just wanted to follow up on the loss costs trends. I was going to ask, I know on a couple of previous calls, there were comments about, I guess, the plaintiffs -- attorneys being more aggressive and higher jury awards coming through. Are you seeing any of that in your book?

Mark E. Watson
Chief Executive Officer and Director

No, not really.

Operator

This concludes the question-and-answer session. I would now like to turn the conference back over to Mr. Watson for closing remarks.

Mark E. Watson
Chief Executive Officer and Director

All right. I'd like to thank everyone for joining us today. I know it's a busy day, a busy week and a busy couple of weeks, actually, with everyone reporting. I think we'll have a lot more to talk about at the end of the second quarter, particularly what things look like for 2018. And also, I think we'll have made a little more progress in the integration of Ariel into our organization. So thank you again for everyone being on the call today and I look forward to talking to you again at the end of the second quarter. Operator, that concludes our remarks.

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