S&P Capital IQ

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Liberty Mutual Holding Company Inc.

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Call Participants

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Edward Peña

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ANALYSTS

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Presentation

Operator

Good morning, ladies and gentlemen, and welcome to the Liberty Mutual Insurance Conference Call on its Second Quarter 2017 Financial Results. [Operator Instructions]

To begin Liberty Mutual's presentation is Ed Peña, Vice President and Director of Investor Relations. Mr. Peña?

Edward Peña

Thank you, and good morning, everyone. Let me first introduce myself. My name is Ed Peña, the new Vice President and Director of Investor Relations. I joined Liberty Mutual in July, succeeding Armando Petruzziello, who has moved on to a senior operations role within the firm. Hopefully, you've seen the second quarter earnings release and financial statements posted last night on our website, libertymutual.com.

David Long, Chairman and CEO of Liberty Mutual Insurance, will provide opening remarks; followed by Dennis Langwell, Chief Financial Officer, who will discuss the financial results. Also participating on today's call are Neeti Bhalla, Chief Investment Officer; Paul Condrin, President, Commercial Insurance; Jim Kelleher, General Counsel; and Jim MacPhee, President and COO, U.S. Consumer Markets.

As a reminder, today's discussions may contain forward-looking statements that represent the company's beliefs concerning future operations, strategies, financial results or other developments. Actual results may differ materially from those expressed or implied, so please refer to the Liberty Mutual website for a complete discussion of the risk factors related to this presentation and the company. The company does not intend and does not undertake any obligation to update these forward-looking statements, which speak only as of today's date.

With that said, it is my pleasure to turn the call over to David Long.

David H. Long
Chairman, Chief Executive Officer and President

Thanks, Ed. So at this call, we are excited to announce the completion of our acquisition of Ironshore, which closed on May 1. This transaction was partially funded with approximately $1.1 billion of short-term debt, which is set to be repaid in the third quarter through cash from operations. To be current with the acquisition, we combined the Ironshore U.S. Operating segment with the LIU U.S. segment, creating one U.S. specialty operation under the Ironshore brand. And the results of this combined segment will be reported within the Global Specialty strategic business unit.

Now let's jump into the quarterly results. Net income came in at $126 million, up $111 million from $15 million last year, but certainly below where we would like to be. The year-over-year uptick reflects improved investment results, partially offset by continued pressure from adverse underwriting trends in both personal and commercial auto, which I'll discuss in a few minutes.

Severe weather, particularly in Central U.S., added close to $700 million of catastrophe losses, lower than last year, but still sizable relative to normalized expectations.

Looking at underwriting results in the quarter. The combined ratio was 102.7, including the impact of catastrophes and prior year developments. That's an increase of 1.3 points compared to last year. The underlying loss and loss adjustment expense ratio had a number of moving parts. Current-year auto deterioration drove a point increase; higher noncatastrophe and weather related losses in homeowners, a point; and commercial property added 1 more point. Unfavorable prior year development also added a point. These negatives were partially offset by a 1.5 points decrease in catastrophes and continued improvements in our expense ratio, which dropped 1.5 points to 29.8.

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On the investment side, favorable valuations in the partnership, LLC and equity method investment portfolio drove an improvement of the $167 million over last year. And with respect to realized gains, we had a $30 million gain in the quarter compared to losses of $95 million, largely within the energy and natural resource portfolio a year ago. From a top line perspective, each of the SBUs delivered strong growth. Overall, net premiums grew almost 10% to $9.9 billion, with Ironshore premium contributing to 2.3 points of that growth.

At the business unit level, U.S. Consumer Markets grew 5.4% to $4.7 billion for the quarter, fueled by rate increases largely in auto, where we achieved a 5.6% increase in average premium. Auto policies in force grew by almost a point.

The homeowners premiums were up 2.8%, with average premium increases of a point and policy growth of 2%.

Pretax operating income for U.S. Consumer Markets was $11 million, down $49 million from a year ago, the main contributors being high catastrophe losses and the impact of auto loss trends, which remain elevated. Specifically for bodily injury, we're seeing 4% to 5% severity with flat frequency. Also in collision trends, roughly the same. And on the property side, we're experiencing a 5% severity uptick, with frequency up a point. In homeowners, frequency trends were high at 6% due to severe storm activity, but severity trends were benign. As a result, the U.S. CM combined ratio was 101.4% for the quarter, including 13 points of catastrophe losses. And this is up from 100.2% last year with 12.9 points of catastrophes.

Turning to Global Consumer Markets East and West. Net premium growth in the quarter was 10.5%. That's 9.6% in local currencies, coming in at slightly over $1 billion. The strongest organic growth came from Brazil, Portugal and China due to both auto rate increases and new business growth. The weakening U.S. dollar against the Brazilian reals drove close to a $20 million favorable impact on premiums in the quarter. Pretax operating income for the quarter was $21 million compared to 0 in the prior year quarter. The improvements in PTOI reflects the impact of a number of profit-focused strategies into bringing our international country operations closer to target returns.

Commercial Insurance grew premiums 6.5% to $2.5 billion. P&C premiums were up 5.1%, reflecting a rate improvement of 3%. Rate increases were achieved across most casualty lines, with the biggest increase coming from commercial auto at 9%. 9%, but certainly not enough.

As for the loan property and casualty business, premiums were up 12.1%, driven by higher life contingent structured settlement sales and the impact of higher employee's new business sales. Pretax operating income for Commercial Insurance was $31 million, $100 million less than the prior year quarter, reflecting higher casualty loss ratios. The commercial auto line is the main driver as the current accident year loss ratio was increased to be in line with industry projections of 73%. Additionally, higher property losses can also be attributed to an increase in noncat property losses. The total Commercial Insurance combined ratio was 108.5% for the quarter, 5 points higher than the prior year, again reflecting unfavorable auto trends and higher property losses. And these losses were partially offset by a 2-point lower expense ratio.

Given the combined ratio in the quarter reflects higher current accident year loss picks within commercial auto, it's worth noting that in the second half, we'll also review prior accident year reserves within this line. Catastrophe losses of $130 million were $34 million less than the prior year, but still drove a 6 points impact to the combined ratio.

For Global Specialty, where the newly acquired Ironshore business resides, net premium grew 31% in the quarter to over $1.6 billion, and acquired Ironshore premium accounted for 17 points of the growth. The remaining growth is within targeted lines of business across multiple market segments. Global Specialty pretax operating income is $126 million, up 16%, despite some unfavorable prior year development within LSM, driven mostly by lower large loss activity across the business unit.

So while auto results and severe weather continue to weigh on our overall profitability, we are confident that our business has taken the appropriate actions, particularly within auto, to help us reach our target

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returns. Growth is encouraging, as is the addition of Ironshore, and we'll continue to make progress on the expense side to get the expense ratio in line with our long-term targets.

And with that, I'll turn the call over to Dennis.

Dennis J. Langwell
Chief Financial Officer and Executive Vice President

Thank you, David, and good morning, everyone. For the 6 months ending June 30, pretax operating income before partnerships, LLC and other equity method investments was down $533 million to $254 million. The year-to-date decline is consistent with the drivers for the quarter, with the exception that on a year-to-date basis, catastrophe losses increased 16% to $1.3 billion.

Net operating income before partnerships, LLC and other equity method investment results declined $337 million or 63% year-to-date. Pretax partnerships, LLC and other equity method investment income was $270 million, reflecting improved energy operations, pretax operating income and more favorable traditional private equity valuations in 2017. By contrast, in 2016, we had lower traditional private equity income and higher losses on energy working interests.

Net realized gains were $199 million versus a loss of $134 million in 2016. 2017 reflects fixed maturity and equity gains resulting from a repositioning of certain aspects of the investment portfolio. Additionally, the sale of a company-owned building generated a gain of $109 million. 2016 was impacted by higher impairments on direct investments in oil and gas wells.

Acquisition and integration costs relating to the Ironshore acquisition were $36 million year-to-date.
Net income attributable to LMHC increased 17% or $69 million to $477 million. Cash flow provided by operations was $1.1 billion, an increase of $469 million over the prior period. The increase reflects higher pension funding in 2016. During the quarter, we utilized $1.1 billion of short-term debt to help finance the Ironshore acquisition, all of which will be fully paid off by the end of the third quarter. We ended the quarter with financial leverage of 23.8%, excluding short-term borrowings. This level is well within the requirements for our ratings. We also exercised a call option on Ironshore's $250 million of senior debt.
GAAP equity at the end of the quarter was just under $21.5 billion, a 5% increase over the prior year-end.
This was primarily due to $478 million of consolidated net income and after-tax unrealized gains of $510 million.
This concludes our prepared remarks, and we'll now open it up for questions.

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Question and Answer

Operator

[Operator Instructions] We'll now take our first question from Rob Hauff with Wells Fargo Securities.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

I wanted to start with the -- if we could, with the personal auto business in the U.S. Could you talk about where the combined ratio ended the quarter? And how much more rate do you guys need to push for before we start to see margins improve in this business?

Timothy M. Sweeney
Executive Vice President and President of Global Consumer Markets

So this is Timothy from U.S. Consumer Markets. So the quarterly combined ratio was 101.4% this year, up a little bit from last year. If you dig into that, actually the result was higher, in large part due to weather. Catastrophes were about a tenth up from last year, but noncat weather losses actually impacted combined ratio this quarter compared to last year by 1.6 points, so actually, this year's been -- if you look at NOAA, there's been just a lot of weather activity, and you'd expect over the long term we'll go back to the average. In terms of loss trends, we've actually been increasing our rates in auto over the last many months, and we see that continuing in the future to combat the lost trends that we've seen, but with some minor reduction in auto damage severity in this quarter -- in the first quarter. But we think that you'll still see for the industry frequencies that are in the 0 to 1% increase range. And for auto damage claims, you'll see severity increases in like the 5% range attributable to just underlying increases in the cost to repair vehicles. For injury coverages, we do think that the increased rate of vehicle miles traveled, particularly on interstates, which is growing faster than overall, the increase in fatalities and in particular, pedestrian fatalities, will continue to exert pressure on severities there. So our rate activity is continuing to make sure we stay ahead of those trends.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

So I understand you guys are pushing for rate and taking the right actions to improve profitability. Do you think it's looking like a 2018 time frame before margins start to turn around? I'm asking because we're starting to see margins improve from some competitors' auto books, who have been taking the same action.

Timothy M. Sweeney
Executive Vice President and President of Global Consumer Markets

Yes. I expect that our margins will continue to improve this year and into next year. We have great activity in excess of loss trends.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

Okay, great. And then if I could shift gears to the commercial side. Could you guys get a little more specific as to what drove the adverse development? I believe it was in general liability. Was it concentrated in a specific customer group, certain accident years? Or was it a little more widespread? If you could just talk about that.

J. Paul Condrin
Executive Vice President and President of Commercial Insurance

This is Paul Condrin. The adverse development really occurred in allocated loss adjustment expense related to a single claim. So we don't think it's systemic to the book overall.

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Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

Okay, okay. That's helpful. And then the current accident year reestimation in commercial auto, I believe you guys bumped this up in the fourth quarter of 2016. The magnitude looked like it was a little less this quarter. But I'm curious what's changed from the fourth quarter to drive this adjustment. If we could just start there.

J. Paul Condrin
Executive Vice President and President of Commercial Insurance

Yes. We actually have booked our combined ratio -- or our loss ratio up about 10 points from where we ended 2016. And we saw higher-than-expected case emergence in the prior accident years, which really caused us to raise our current accident year in line with the industry, which is about 73%. And as a result of that, we're also going to -- as David mentioned in his comments, we're undergoing a review of the prior accident years to make sure those are adequate. The overall combined ratio here is -- accident year basis is about 113%. In reported industry, it was about 111%, though we believe that's probably 3 to 4 points understated.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

And could you remind us again the size of your commercial auto reserves?

J. Paul Condrin
Executive Vice President and President of Commercial Insurance

Yes. The reserves are $1.5 billion, and the premium is about $1.6 billion.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

Okay. Great, that's helpful. Sorry, lastly on the commercial. The underlying loss ratio did pick up from 59.7% to 65.1%. You mentioned that there was some noncat property losses that helped drive that. Was that half the move? Could you guys quantify? I thought I heard David say in the beginning about a point of the overall combined ratio was driven by commercial property attritional losses. But I mean, was this a big piece of the move, within the commercial book just looking at the underlying loss ratio there?

J. Paul Condrin
Executive Vice President and President of Commercial Insurance

Well, I mean, the commercial book, the primary driver was the automobiles.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

Okay, all right. And then with Ironshore, certainly an exciting opportunity for you guys in the specialty business. It's not a surprise to see the integration costs coming through. But Dennis, could you talk about when you see this business being more of a contributor to the bottom line when the integration costs are complete and maybe some of the portfolio repositioning is done?

Dennis J. Langwell
Chief Financial Officer and Executive Vice President

Yes. It'll be a significant contributor. There's a lot of synergies that we're expecting to come out of the acquisition. Many of them are in reinsurance purchasing practices. But overall, Ironshore brings us a scale and capability in excess of surplus lines that we didn't have prior, and we think it's going to be a great opportunity for us here in the U.S.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

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So is it realistic to expect that sort of 2018 time frame when we'll start to see that impact?

Dennis J. Langwell
Chief Financial Officer and Executive Vice President

Yes. It'll ramp up through 2018. We think 2019 is we're expecting to get most of the run rate synergies out of the business and start to get revenue synergies as well, which we've been positively surprised by already.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

Good to hear. And then last one for me. We don't talk about this much, but the group life and disability books, they've been growing by a healthy clip. I saw in the statements you guys mentioned the disability loss ratio. It sounded like it was up a little bit, which is counter to what we've seen from some peers. So is there something unusual going on there? Was the year-ago quarter exceptionally low? I don't know if you can just talk about that.

Dennis J. Langwell
Chief Financial Officer and Executive Vice President

Yes. Yes, Rob, the first half of last year was much more favorable than the second half. We revised our assumptions on the disability book in the second half of last year, so the first half of this year is much more consistent with that outlook.

Operator

[Operator Instructions] There appear to be no further questions. I would now like to turn the floor back over to Mr. Peña for any closing remarks.

Edward Peña

Thank you, everyone, for joining us this morning. If you have any questions, contact details can be found on the Liberty Mutual website. Thank you, and have a nice day.

Operator
Thank you, and that does conclude today's conference. Thank you for your participation, and you may now disconnect.

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