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Market Intelligence

Liberty Mutual Holding Company Inc.

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**Estimates Data not available.

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Call Participants

EXECUTIVES

Christopher Locke Peirce
Executive VP & CFO

David Henry Long
Chairman, President & CEO

Dennis James Langwell
Executive VP & President of Global Risk Solutions

Edward Peña

Neeti Bhalla Johnson
Executive VP, President & Chief Investment Officer of Investments

Timothy Michael Sweeney
Executive VP & President of Global Retail Markets

ANALYSTS

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

Presentation

Operator

Good morning, ladies and gentlemen, and welcome to the Liberty Mutual Insurance conference call on its second quarter and year-to-date 2018 financial results. [Operator Instructions]

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

Edward Peña

Good morning, and welcome to Liberty Mutual's Second Quarter 2018 Earnings Call. Hopefully, you have seen the earnings release and financial statements posted this morning on our website, libertymutualgroup.com. David Long, Chairman and Chief Executive Officer of Liberty Mutual Insurance, will provide updates on some of our recent announcements, followed by his opening remarks on the quarter. Following David, Chris Peirce, Liberty's Chief Financial Officer, will touch on our financial results. Also participating on today's call are Neeti Bhalla Johnson, Chief Investment Officer and President of Liberty Mutual Investments; Jim Kelleher, Chief Legal Officer; Tim Sweeney, President, Global Retail Markets; and Dennis Langwell, President of Global Risk Solutions.

Also, 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. 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.

I will now turn the call over to David for his opening remarks.

David Henry Long
Chairman, President & CEO

Thanks, Ed, and good morning, everybody.

Net income attributable to Liberty Mutual Holding Company was $981 million in the second quarter. Included in this number is a gain of $464 million, net of tax, resulting from the sale of Liberty Life Assurance Company of Boston, and that gain is reported in discontinued operations.

Excluding discontinued operations and noncontrolling interest, consolidated net income from continuing operations came in at $509 million, up $434 million from last year. This increase was primarily driven by lower catastrophe losses, higher net investment income and improved underwriting results, partially offset by realized losses attributable to some fixed maturity sales, impairments on corporate real estate and direct investments in oil working interests.

Net written premium in the quarter grew $685 million to $10.1 billion, a 7.3% increase, with Global Risk Solutions, GRS, being the largest growth driver, which I'll discuss in further detail shortly. Underwriting results improved 4.9 points from the prior year quarter, resulting in total combined ratio of 97.9% compared to 102.8% in Q2 2017. Just over half of the improvement was driven by lower catastrophe losses. About 1 point was driven by the absence of unfavorable developments and current accident year reserve reestimation that we saw in 2017. The core combined ratio decreased 1.3 points to 92.3%. Underlying loss ratio improvements contributed 0.8 points, and the expense ratio improved 0.5 point as we maintain cost discipline as we grow.

Switching over to by business results. Global Retail Markets, GRM, written premium was $7.2 billion, an increase of 4.6%. In private passenger auto, renewal rates increases were over 8%, but policies in-force declined 1.7%. That said, we do expect PIF growth to end the year roughly flat. In homeowners, renewal rates increased about 5%, along with modest policy growth. And in small commercial, rates were up 6%, while exposure growth was flat. Growth internationally was strong, most notably in Brazil.

GRM PTOI for the quarter was $326 million, up $290 million from the prior year quarter, primarily reflecting lower catastrophe losses and increased underwriting profitability as rate increases have outpaced loss trends. Let me just add a little color on loss trends. For bodily injury, severity is up 4% to 5% with slightly negative frequency; and for collision, roughly the same story, with severity in the 4% range. And within property, trends remained stable at around 5%, which is in line with long-term averages.

In small commercial, auto trends remained elevated in the mid-single digits, while all other lines, except workers' compensation, are in the low to mid-single-digit range.

The GRM core combined ratio was 90.3%, an improvement of 1.2 points from 2017. The underwriting expense ratio was down 0.9 points due to increased operating leverage and the decrease in the core loss and loss adjustment expense of 0.3 points.

Moving to GRS. Top line growth was robust at 13.5%, reaching $2.9 billion. The Ironshore acquisition, which closed on May 1, 2017, contributed 5 points to growth, with new business and favorable rate changes adding the remainder.

Rate gains were 4.7% in the quarter across GRS, with specialty and reinsurance continuing the positive trend we have seen since Q4 2017 of 5.6% and 4.5%, respectively. Rates were positive in almost all lines of business, up double digits in commercial auto and property lines and up mid-single digits in all other lines except for workers' compensation where the low negative single-digit rate is generally consistent with what we're observing across the market.

Pretax operating income in the quarter increased $190 million to $302 million and was driven by profit margin on growth and in premium, decreased current year loss activity and favorable catastrophe losses.

The GRS combined ratio for the second quarter, excluding the impact of catastrophes, prior year developments and current year reestimation, came in at 95%, a 3.5 point decrease from the prior year period. Contributing to the positive results was a 3 point decrease in the loss and LAE ratio, primarily driven by favorable current accident year loss activity from both reinsurance in North American Specialty, partially offset by higher casualty losses in National Insurance.

The 2018 casualty loss ratio picks were higher than we booked in the first half of 2017 but consistent with our results in the second half of last year. The GRS expense ratio decreased by 50 basis points.

Including the impact of catastrophes, prior year developments and current year reestimation, the total combined ratio was 96.7%, a 6.7 point decrease from the same period in 2017. The decrease reflects the previously mentioned changes in the combined ratio; as well as 1.6 points of favorable catastrophe losses; 1.2 points of lower prior year developments related to a large GL loss in 2017; and finally, 0.4 points of current year reestimation booked in Q2 2017.

As a side note, within GRS, we also recently announced another collateralized reinsurance transaction with Limestone Re Ltd. This latest transaction brings the total Limestone reinsurance collateralized capacity placed with insurance-linked security investments to nearly $700 million.

On the investment side, income from our partnership, LLC and other equity method investment portfolio was $291 million, $185 million increase over the prior year period due to favorable valuations in our natural resource portfolio. This drove net investment income of $724 million, which was $187 million increase over Q2 2017.

Net realized losses for the quarter were $59 million due to some losses on fixed maturity sales, impairments in corporate real estate and direct investments in oil working interests. This compared to $18 million of realized gains in 2017, but overall, investment results were positive year-over-year.

In conclusion, we like the positive momentum indicated in the results for both the quarter and the year-to-date. The tangible benefits of the realignment into 2 businesses of broad capabilities and scale, GRS and GRM, are indicated by the improvements in both core underwriting results. Rates, excluding workers' compensation, are positive, and we expect these increases to drive continued top line growth and improved profitability.

Furthermore, as we focus on growing our core business, we will make further investments to improve customer experience and ease of access for our distribution partners while actively managing expenses.

I will now turn the call over to Chris.

Christopher Locke Peirce
Executive VP & CFO

Thanks, David, and good morning, everyone.

For the 6 months ended June 30, pretax operating income before partnership, LLC and other equity method investment income was $864 million, up $744 million from 2017. The drivers for the year-to-date results are largely consistent with the quarter, with lower catastrophe losses providing a substantial boost to our results, consistent with the prior quarter, as David discussed. Through Q2 2018, we've incurred $865 million in catastrophe losses versus nearly $1.4 billion year-to-date in 2017.

Our underwriting results have also improved on a year-to-date basis. The combined ratio before catastrophes and net incurred losses attributable to prior years was down 0.4 points to 93.7%, reflecting improved scale, favorable auto results and lower current accident year loss activity in GRS. The combined ratio further benefited from a 3.3 point improvement in the catastrophe ratio and 0.2 point improvement in prior year incurred losses, bringing the total combined ratio to 98.5%, down from 102.4% year-to-date in 2017.

Pretax partnership, LLC and other equity method investment income nearly doubled to $507 million year-to-date, largely reflecting more favorable valuations in our natural resources portfolio.

Realized gains year-to-date were $96 million, a decrease of $73 million from year-to-date 2017. The current year gains reflect $162 million gain resulting from the consolidation of our previously held equity method investment, partially offset by net losses and fixed maturity sales. The gains in the prior year period included a $109 million gain on the sale of a company-owned building, in addition to gains on fixed maturity sales.

Ironshore acquisition and integration costs were $24 million in the first half of the year, down from $36 million in the prior year period. 2018 year-to-date also includes restructuring costs of $31 million versus 0 in the first half of 2017.

Consolidated net income from continuing operations was $1.1 billion, up from $369 million last year. We recognized a $464 million after-tax gain on the sale of Liberty Life Assurance that David noted was reflected in the $530 million of income from discontinued operations. This brings us to net income attributable to LMHC of $1.6 billion year-to-date. Net income for the year also benefited from lower income tax rate as a result of the 2017 Tax Cuts and Jobs Act.

Cash flow provided by continuing operations was just shy of $1.2 billion, an increase of $425 million over the prior year period, reflecting higher premium collections, lower catastrophe payments in GRM and pension funding in 2017 that did not recur.

We ended the second quarter with financial leverage of 22.8%. This level is well within the requirement for our ratings. GAAP equity at the end of the quarter was just under $20.9 billion, an increase of roughly $200 million over the prior year-end. Despite our strong net income year-to-date, equity growth was impacted by after-tax unrealized losses of $1.7 billion due to rising interest rates and the aforementioned sale of Liberty Life Assurance.

While GAAP equity was flat, statutory surplus increased $2.3 billion or 13.4% through June. The increase was driven largely by the gain on sale of the life business and strong net income, which was $3.6 billion on a statutory basis.
This concludes our prepared remarks, and we'll now open it up for questions.

Question and Answer

Operator

[Operator Instructions]

And we'll take our first question from Rob Hauff with Wells Fargo Securities.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

Wanted to start with the auto books, if we could. Looks like you guys had a nice quarter. I'm just trying to understand how much the improvement in the auto books were a contributor year-over-year. So if you could give us a sense how personal auto's combined ratio's coming in compared to where it was a year ago. And then on the commercial auto side, if you could do the same thing, that would be great.

Timothy Michael Sweeney
Executive VP & President of Global Retail Markets

Yes. This is Tim Sweeney on the personal -- the U.S. personal lines. This is Tim Sweeney. I'll talk about the U.S. personal lines combined ratio year-over-year. I think in the last call that we had a quarter ago, we talked about a 101% combined ratio on our target needing to be 97% on the U.S. personal auto. Our combined ratio on U.S. personal auto through the first 6 months is running at 96%. So we're actually quite pleased with where we're at on personal auto profitability and really poising to accelerate growth, as David said during his opening remarks.

Christopher Locke Peirce
Executive VP & CFO

And Rob, this is Chris. I'll touch sort of at a high level on the commercial auto. So the commercial auto is -- I think the personal auto is driving much more of the improvement in the core underwriting results you're seeing. On the commercial side, we're achieving -- we achieved double-digit rate increases in 2017. We're in that range again in 2018, depending on the small end to the large end of the book between sort of 10% and 16% of written rate increase. We think the commercial auto loss trend is probably in the 7 to 8 point range. So I think we're making pretty good progress, but that's going to take a while to earn in. And I think as we said at the end of last year, it's going to be 18 to 24 months to get the commercial auto piece back towards more close to target profitability. And I think the other -- beyond rate, there's a lot of underwriting actions going on and focused on -- a lot on the monoline book because I think that's where we can be most aggressive. A lot of the nonmonolines stuff, be it in the large accounts space or in the small end of it, are part of packages or multi-coverages for clients where the overall relationship is pretty profitable. So I think we need to be a little more careful on those accounts.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

Okay. So is it a fair assessment then that the commercial auto underwriting improvement will probably be more visible towards the end of 2018, maybe more into 2019 given the actions you've taken?

Christopher Locke Peirce
Executive VP & CFO

Yes. I think you'll see bigger impacts in '19 and then into '20 as those rate increases sort of more fully earn in. And I think, also, to point out, the commercial auto is a much, much smaller percentage of our overall book. I mean, personal auto is the lion here. So in terms of the overall company results, the commercial auto is not going to drive nearly as much.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

Okay, fair enough. And then looking at the -- more on the commercial side. There was reference in the MD&A and in the opening remarks, David, you made about national accounts. I was wondering if you could give us a little more color on what you're seeing here. Is this general liability lines that are experiencing a little bit of loss pressure? Or if you could just kind of expand on what you're seeing there.

Dennis James Langwell
Executive VP & President of Global Risk Solutions

Yes. Rob, this is Dennis Langwell. It's pretty much across the casualty lines. Commercial auto, we just talked about. General liability and CMP liability, we're under pressure in terms of loss trends that were identified last year. So pretty aggressively going after rate across the board. So we're booking to a higher loss ratio this year for several of those lines. Workers' comp continues to be very favorable. But for that line, there's storm clouds on the horizon as the NCCI and the bureaus continue to look to lower rates there. So we'll have improving casualty lines, partially offset by workers' comp, to a lesser extent. Again, we'll start to see more of that come through in the second half of the year as rate increases are improved.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

And are the rate increases that you're starting to push through, are they starting to match where loss trends are at this stage? Or are they still playing catch-up a little bit?

Dennis James Langwell
Executive VP & President of Global Risk Solutions

No. I think that the rates are exceeding loss trends, but they're not fully earning through. And so it's going to take a while, as Chris said, a couple of years for it to fully earn through and return to the target profitability.

David Henry Long
Chairman, President & CEO

And Rob, this is Dave. So in the first half of last year, we were booking losses a little lower. We booked them up in the second half. So what you'll see is the loss ratios we're booking to now are both in line with the second half of last year.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

Okay, got it. That's clear. And then I wanted to ask about Pembroke. There's been some news in the press that you guys could be looking to sell that business. I'm not sure how much you guys can opine on the situation. But is part of the rationale that there was just overlap with this business and the existing Lloyd operations that you guys have when Ironshore came onboard? Or is there another motivation for looking to sell this?

Dennis James Langwell
Executive VP & President of Global Risk Solutions

Well, we can't comment on speculation that's in the Insurance Insider. But we're continually looking at segments and lines of business on an ongoing basis for whether or not they fit strategically.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

Okay. And then one quick one. You mentioned some favorable cat losses. Was that from the 2017 hurricanes or something else?

Christopher Locke Peirce
Executive VP & CFO

Those references were strictly to 2018 activity. So through Q2, we've not made any adjustments to our 2017 reserves. And that -- we'll do that in the second half of the year, I mean, as we sort of finalize our overall reserve reviews across the business. But no, we think we're in good shape on the 2017 cat reserves, and our overall reserves will likely have some pluses and minuses across different lines of business. But we think, in total, we wouldn't expect anything meaningful.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

Okay. And then one on the investment portfolio. The cash balance is going up, looks like due in part to some of the sale of your private equity holdings. Is the plan to reinvest that cash or hold on to that for other strategic purposes?

Neeti Bhalla Johnson
Executive VP, President & Chief Investment Officer of Investments

Rob, it's Neeti. In fact, most of that cash has been put to work. We've essentially gone back to neutral risk overall. As we discussed, I think, at the last call, the private equity secondary sale was really to align the portfolio to our go-forward strategy as well as to capitalize on some of the valuations in the market. And since then, we've deployed the cash across the rest of the portfolio.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

Okay, excellent. And then last one for me, I see the -- thanks for the clarification on the stat net income. With the gain on the life business in the quarter, I'm curious, does that have any impact on your RBC ratios?

Christopher Locke Peirce
Executive VP & CFO

Yes, Rob. It definitely will. I mean, I think we said at year-end, on a pro forma basis, the life transaction's probably approximately 50 RBC points. And then, obviously, we've had very favorable sort of core operating income in the first half of the year. So we won't formally calculate RBC until the end of the year. But the life transaction is probably about 50 points. And then, obviously, the favorable earnings will be on top of that.

Operator

[Operator Instructions]
And with no further questions, that does conclude today's call. Thank you for your participation. You may now disconnect.