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THG - Hanover Insurance Group Inc Chaucer Sale Closing to China Reinsurance (Group) Corp - M&A Call

EVENT DATE/TIME: DECEMBER 31, 2018 / 2:00PM GMT

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PRESENTATION

Operator

Good day, and welcome to the Hanover Insurance Group's conference call to discuss the completion of the sale of Chaucer Holdings Limited. My name is Anita, and I'll be your operator for today's call. (Operator Instructions) Please note, this event is being recorded. I would now like to turn the conference over to Oksana Lukasheva. Ms. Lukasheva, please go ahead.

Oksana Lukasheva - *The Hanover Insurance Group, Inc. - VP, IR*

Thank you, Anita. Good morning, and thank you for joining us. On today's conference call, we will discuss the close of the Chaucer sale, our Lloyd's International specialty division to Chaucer -- to China Re. We will begin today's call with prepared remarks from Jack Roche, our President and Chief Executive Officer and from our Chief Financial Officer, Jeff Farber. After our prepared remarks, we will answer questions during Q&A session.

Please note our news release has been posted on the Investors section of our website at www.hanover.com.

Our prepared remarks and responses to your questions today other than statements of historical facts, include forward looking statements regarding the sale of the remaining entities, the potential uses of proceeds from the sale and prospects for our domestic operations among others. There are certain factors that could cause the final sale of the ancillary entities, use of proceeds and financial targets to differ materially from those anticipated.

We caution you with respect to forward-looking statements and, in this respect, refer you to the Forward-Looking Statements section in the press release and our filings with the SEC.

Today's discussion will also reference certain non-GAAP financial measures, such as operating return on equity among others. Please see the section entitled Non-GAAP Financial Measures in yesterday's press release.

I will now turn the call over to Jack.

John Conner Roche - *The Hanover Insurance Group, Inc. - President, CEO & Director*

Thank you, Oksana. Good morning, everyone. Thank you for joining us, especially on such short notice. As announced last night, we have completed the sale of the major component of Chaucer to China Re. We are very excited about this milestone. This is truly a win-win that will benefit The Hanover and Chaucer as well as China Re, as each of us looks to expand our businesses.

For our part, the transaction strengthens our go-forward strategy and supports our goal to be the premier property and casualty franchise in the independent agency channel, one that delivers significant value to our partners, customers, employees and shareholders. We are pleased with the collaboration between all parties during the process. We want to recognize Chaucer's CEO, John Fowle, and the other members of the Chaucer team for their many contributions to the Hanover over the past 7 years and especially their efforts in the last year to make this transaction possible. We wish John, his team and China Re success in the future.

Our ownership of Chaucer was a great chapter for The Hanover and a very successful investment. Since the acquisition in 2011, Chaucer has consistently produced strong results with an internal rate of return of nearly 20%, including the gain on the sale. As we move forward, we are very excited about our prospects. This transaction enables us to focus exclusively on our successful domestic businesses. We plan to build on the strength of our domestic business, providing our agent partners with more relevant capabilities across personal, commercial and specialty lines, responsibly expanding our market presence and product offering. We are also reducing our exposure to significant weather events and gaining additional financial strength and flexibility.

As a result, we are better positioned than ever. We are continuing to build on our solid foundation, strengthening our position as one of the most highly regarded franchises in the independent agency space working three key levers.

First, we will continue to leverage the strength of our business, providing our partners with more capabilities, responsibly expanding our appetite and applying proprietary market analytics and insights to enable us to grow profitably together. We enjoy a strong market presence with excellent growth prospects in our existing segments, including personal lines, small commercial and our niche middle market business. Together, these businesses have generated very attractive returns and represent meaningful growth opportunities. We will continue to invest in these businesses and allocate capital to our highest -- higher return businesses.

Second, we will continue to expand our specialty capabilities and drive further specialization into our core lines of business. We will achieve this through selective appetite expansion as well as product build out, helping our partners address the broad spectrum of their clients' specialty needs. Our continued emphasis on building relevant products and coverages will remain at the forefront of our non-commoditized approach. We recently made strategic hires and are increasing our investments in the financial institutions and E&S markets as well as other specialty sectors relevant to our agent partners.

Finally, we will continue to drive innovation across the firm and deliver new solutions to enhance customer acquisition opportunities for us and our agents. We are investing in new data, analytics and technological capabilities to transform our risk control and claims operations. Our innovation efforts are targeted and have transparent financial parameters that are subject to a disciplined review process that enable us to be agile and focused on real value creation. I am very excited about the opportunities ahead.

Of course, an important priority is to manage our capital effectively. As we announced, several capital management actions are in place, including an ASR program and a special dividend. We expect to deploy the remaining proceeds in a reasonable period of time either in the form of investments in our business or by returning capital to our shareholders.

Jeff will provide a detailed account of the capital actions we have announced as well as our approach for the remainder of the capital generated from the transaction. We will provide additional insight into our strategic plans and our 2019 guidance on our earnings call on January 31.

With that, I will turn the call over to Jeff.

Jeffrey Mark Farber - *The Hanover Insurance Group, Inc. - Executive VP & CFO*

Thank you, Jack, and good morning, everyone. We are very pleased with the close process, the timeliness of the execution as well as the financial outcome. As we mentioned in the press release, yesterday's announcement represents a major component of the sale. The sale of the Irish and Australian Chaucer-related entities are pending final local regulatory approvals. We factored in the potential for a multi-stage close process as part of the purchase and sales agreement. All parties remain fully committed, and we expect the close of the final two entities to occur in the first quarter of 2019.

Total proceeds from the transaction are expected to be in the range of $930 million to $940 million and include $779 million in initial cash consideration received from China Re, $41 million in cash we expect to receive once the Irish and Australian entities close in the first quarter of 2019, a pre-signing dividend of $85 million from Chaucer received in the second quarter of 2018, and contingent consideration in the range of $25 million to $35 million, with $45 million placed in escrow by China Re. As we discussed in September, the $45 million contingent consideration is reduced dollar for dollar if Chaucer's 2018 accident year catastrophe losses are above 10% of net earned premium.

Based on preliminary estimates, Chaucer's 2018 accident year catastrophe losses are above the 10% threshold. We currently expect to receive between $25 million and $35 million of the contingent consideration, subject to final review in audit as of June 30, 2019. We expect to record a net after-tax GAAP gain in the range of $130 million to $150 million or $3 to $3.50 per share, which is dependent upon final transaction costs, the amount of the contingent consideration and other items. The net after-tax economic gain, which excludes the impact of historical unrealized investment and pension losses and other items, is expected to be in the range of $190 million to $210 million or $4.50 to $5 per share. This measure better reflects the impact of the sale on our stated book value.

This transaction frees up a substantial amount of equity capital. We believe $840 million to $860 million of equity could be deployed in our business or returned to shareholders in accordance with our longstanding capital management framework.

Concurrent with the close of the transaction, we announced a very robust initial equity deployment program. From this, you can see that we are seeking to deploy the funds relatively quickly in a way we think will be in the best interest of our shareholders.

Our Board of Directors has approved a new share repurchase authorization of $600 million. This replaces the prior authorization of which about $90 million remained. Within the framework of this authorization, we have entered into an accelerated share repurchase agreement for an aggregate purchase price of $250 million with J.P. Morgan. The structure of the agreement is such that we immediately bought back approximately 80% of the total shares to be repurchased under this agreement. The remaining portion will be retired at the end or over the execution period. This program will be completed in the second quarter, at which point the final purchase price for the shares will be set. The ultimate purchase price per share and, therefore, the number of shares repurchased will be based on the volume-weighted average price for each day during the bank's execution period.

Second, our Board of Directors also approved a special cash dividend of $4.75 per share for an aggregate amount of approximately $200 million. Accordingly, these two capital actions follow us -- allow us to immediately return approximately $450 million or more than half of the estimated deployable equity.

When the ASR is completed in mid-2019, we will review how much of the approximately $400 million additional deployable equity freed up from this transaction has been redeployed and then assess our current position and next steps. We will follow our previously discussed equity capital deployment framework and revisit our options.

Additionally, to improve the efficiency of our debt capital structure, we will retire a $125 million FHLB note due 2029 with a coupon of 5.5% with the settlement to occur in a couple of days. This was a fully collateralized note that has limited use going forward. The funding for the retirement of this note will have no impact on Chaucer sale proceeds or deployable equity. The retirement will trigger a prepayment redemption provision of approximately $20 million after-tax or $0.47 per share. It is based on the net present value of the difference between FHLB's currently investment rates and the foregone future coupon payments to FHLB. We believe the steps we have taken demonstrate a thoughtful and deliberate capital management approach that allows us to balance the benefits of returning capital and maintaining flexibility for potential business investments in the near term. We fully anticipate deploying this capital with the best interest of our shareholders in mind and in relatively short order.

In the meantime, in order to provide clarity to the underlying earnings power of the company, we will continue to disclose an adjusted return on equity measure to our investors, which will remove both undeployed proceeds from the sale and the related net investment income in our quarterly results until the majority of the equity created by the sale is deployed or utilized.

Overall, as Jack outlined, we are optimistic about our strategic position in this dynamic market, and we are more confident than ever about our opportunities for future growth and the continued expansion of our domestic platform.

With that, we will now open the line for your questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question today comes from Amit Kumar with Buckingham Research Group.

Amit Kumar - *The Buckingham Research Group Incorporated - Analyst*

Just a few questions. The first question goes back to the discussion on the $400 million, which is remaining. I was wondering if you could maybe give us a bit more details. Should we think that there would be a likelihood of additional buybacks for the second half of 2018, maybe some modest money plowed back into investments, et cetera? Or how should we think about the sense of urgency in trying to utilize the remaining proceeds?

John Conner Roche - *The Hanover Insurance Group, Inc. - President, CEO & Director*

Amit, this is Jack. I'll just say a couple things and then Jeff can kind of get us back to the framework that we set forth. Obviously, with the transaction being completed here, we're now ready to move forward with the very deliberate capital management steps that we've been talking about for last several months. So we're excited to take the first step and show our investors that we were serious about returning the good portion of that capital upfront. And to follow up with that theme, we will, obviously, look for additional growth opportunities beyond what we're achieving in our organic plans, but we won't force anything, and so that feeds into the discussion of we plan on returning capital that we cannot use that meet our strict criteria in a timely manner and that part of our framework is not going to change. I think embedded in your question is some question about the deployable capital from the transaction versus maybe what we generate from earnings? And I'll let Jeff speak to that broader issue.

Jeffrey Mark Farber - *The Hanover Insurance Group, Inc. - Executive VP & CFO*

I think that was very well said. I don't have a whole heck of a lot to add to it candidly, but there is an urgency to redeploying and returning this capital. And I think as most know, it takes some time to deal with stock buybacks and we have an ASR, which is 4 to 6 months. And when that ASR is completed, we'll go through our capital framework and then if we've used some of it organically or otherwise; if not, then we'll continue to work through capital return options in the second half of the year.

Amit Kumar - *The Buckingham Research Group Incorporated - Analyst*

Just what I was trying to understand was, going back to the question, you have earnings coming in, you have this excess capital. Is there some sort of desire to -- when you said a timely manner, are you saying that you know what, obviously, this impacts our discussion on the ROE we generate and what we have talked about in the -- on the past calls. Hence we foresee this should be addressed in, let's say, by first quarter of 2019. Is there like some sort of an internal deadline or thought process? Or is it a bit more open-ended?

Jeffrey Mark Farber - *The Hanover Insurance Group, Inc. - Executive VP & CFO*

I wouldn't call it open ended, but I wouldn't want to pin ourselves down to completing it before the end of '19, but it is certainly possible that it's completed before the end of '19. But I don't think we want to make that commitment because we're not sure of all of the options and we're not sure of what the choices that one might want to make.

Amit Kumar - *The Buckingham Research Group Incorporated - Analyst*

The one other question, and I will requeue is, is there any early read on catastrophe losses for 4Q?

Jeffrey Mark Farber - *The Hanover Insurance Group, Inc. - Executive VP & CFO*

So are you talking about domestically or are you talking about for Chaucer impacting the contingent consideration -- I mean...

Amit Kumar - *The Buckingham Research Group Incorporated - Analyst*

Domestic.

Jeffrey Mark Farber - *The Hanover Insurance Group, Inc. - Executive VP & CFO*

So I think this call was really -- the sole purpose of it was to talk about the Chaucer deal, equity capital management, how good we feel about the domestic business. So we will share that, obviously, on the earnings call, which is scheduled for February 1 and maybe even sooner, as you know, when we have cats that are greater than 50 basis points higher than our cat load. In mid-January, we've agreed to release those. So it's -- we haven't gone through that process yet, but it's entirely possible that you could hear from us sooner.

Oksana Lukasheva - *The Hanover Insurance Group, Inc. - VP, IR*

Excuse me, so just one quick technicality, so the call is scheduled for January 31.

Operator

(Operator Instructions) The next question comes from Christopher Campbell with KBW.

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

My first question is on the special dividend and then the ASR mix. How did you arrive at the $200 million, $250 million mix versus possibly doing a bigger ASR?

Jeffrey Mark Farber - *The Hanover Insurance Group, Inc. - Executive VP & CFO*

Given the liquidity of our stock and how many shares trade, we felt that was the right amount of an ASR that we could comfortably get done in the first 6 months of the year without substantially moving the market beyond a comfortable level. So based on a lot of advice from bankers and analysis we've done ourselves, we thought that was the right level for an ASR for 6-month period.

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

Got it. And so does that ASR assume that as you buy back shares, the book value per share increases and then it gets to some limit where it wouldn't make sense to purchase above that?

Jeffrey Mark Farber - *The Hanover Insurance Group, Inc. - Executive VP & CFO*

Well, separate issue, Chris. So we're thinking about what is the amount of stock you could buy without putting too much pressure on upside on the market, given how much trades in a given day, and people have different views whether that's 5%, 10%, 15% on a given day. The other issue is at what price does one want to buy stock and how much dilution of book value is appropriate? And so we look at a lot of measures there. We consider payback period on the dilution to book value. We look at intrinsic value, and we feel very comfortable with stock buyback at this point and with the ASR in general.

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

Okay, got it. And then just how would the dividend policy be impacted going forward? I mean, should we expect periodic special dividends, regular quarterly increases, like you've been doing throughout time? I guess, just is it really just a one-off special? Or is there a potential for this to be a recurring type of event?

Jeffrey Mark Farber - *The Hanover Insurance Group, Inc. - Executive VP & CFO*

So overall, we increased our ordinary dividend in December, as we have done for many, many years, based on the earnings opportunity of the firm and how we feel about it. We had a slightly outsized increase in the dividend, and that had nothing to do with the expected deployable capital but more to do with the earnings of the firm and particularly because of a reduced tax rate. With respect to your question specifically around special dividends, I guess, what makes them special is, they're not ordinary and predictable and recurring. So I wouldn't expect lots of them. It's entirely possible that there is one or more, but we haven't made that commitment and certainly our board hasn't approved. And again, we're going to go through our framework. After we get through the first 6 months, we'll consider what opportunities we have, what we've deployed and then we'll revisit.

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

Got it. And is there like a certain like excess capital level that you want to keep at the holdco, like at all times, I guess, just for contingency, interest expenses, other holding company things that you would manage to that above that we would consider that excess after the 6 months?

Jeffrey Mark Farber - *The Hanover Insurance Group, Inc. - Executive VP & CFO*

I think there's 2 concepts implicit in your question, Chris. One is liquidity that we want to keep at the holdco. So we do keep meaningful liquidity at our holding company and gives us the flexibility to deal with various insurance companies, pay bills, service dividends, interest, all those sorts of things. And so we're very comfortable with our liquidity, et cetera. The second, really, is around excess capital. And we've never really -- we've always been comfortable with our capital level. The disclosure was intentionally about the incremental capital that was created for the Chaucer sale that was created by the sale in and of itself. So that's the $840 million to $860 million is the incremental capital. And any other capital that gets created or utilized would separately go into that mix unrelated to the sale.

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

Okay, got it. But you guys were at an excess capital position before the Chaucer sale?

Jeffrey Mark Farber - *The Hanover Insurance Group, Inc. - Executive VP & CFO*

We haven't shared that, but we were comfortable with our capital position.

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

Okay, got it. And then just next question on the debt retirement. I guess, can you walk us through why it made sense to do the home loan bank debt versus taking out one of the higher coupon issues?

Jeffrey Mark Farber - *The Hanover Insurance Group, Inc. - Executive VP & CFO*

Sure, Chris. This particular piece of debt at one time had gotten S&P rating agency capital treatment and in the last year no longer received that. The coupon was 5.5%. It was invested and largely in agency securities. Those agency securities were earning meaningfully less than 5% -- 5.5%. Those were posted as collateral. So not getting capital treatment from a rating agency perspective really made it an inefficient piece of debt versus the other pieces of debt you're referring to do get capital treatment. So there's effectively leverage on your equity, and it's a more efficient piece of debt to hold even though the coupon's a little higher.

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

Okay, that makes sense. And just one final one on the two book value gains in the press release, I guess, which one should we be thinking about for modeling?

Jeffrey Mark Farber - *The Hanover Insurance Group, Inc. - Executive VP & CFO*

So if you're thinking about the increase in book value, it should be the economic gain because the difference between the two meaning the unrealized losses on equity securities or some of the pension adjustments, those had already gone through our book value. So the gain -- so those items had to roll through the income statement upon sale. But if you're modeling the increase in book value, it would be the larger item or the economic gain. If you're trying to figure out what's the one-time adjustment to your earnings, it would be the smaller or the GAAP gain.

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

Okay, got it, got it. So the difference is like the AOCI impact basically.

Jeffrey Mark Farber - *The Hanover Insurance Group, Inc. - Executive VP & CFO*

You got it. Things that had already gone through as a negative item in equity, in book value, but need to work their way through the income statement but no longer have an impact on equity. So the bigger number is your book value increase per share.

Operator

(Operator Instructions) The next question comes from John Helfst with Voya.

John Helfst - *Voya Investment Management LLC - Equity Analyst*

Just to really keep it simple. So your $450 million GAAP pop in book value then less the special and then less the $0.47 in FHLB to get to the new book value ignoring all the buyback which will be, here or there, those three are the big movers, right?

Jeffrey Mark Farber - *The Hanover Insurance Group, Inc. - Executive VP & CFO*

I think that's right other than the quarterly earnings.

John Helfst - *Voya Investment Management LLC - Equity Analyst*

Right, no, of course. And then FHLB will be accretive, it sounds like in go-forward earnings because it was a negative spread.

Jeffrey Mark Farber - *The Hanover Insurance Group, Inc. - Executive VP & CFO*

Yes, so that's correct. That will come back over time. That's correct. It is accretive.

Operator

(Operator Instructions) As there appears to be no further questions, I would like to turn the conference back over to Oksana Lukasheva for any closing remarks.

Oksana Lukasheva - *The Hanover Insurance Group, Inc. - VP, IR*

Thank you, everyone, for your participation this morning. Happy New Year. And we are looking forward to speaking to you on our fourth quarter earnings call on January 31. Bye.

Operator

This conference is now concluded. Thank you for attending today's presentation. You may now disconnect.