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THG - Hanover Insurance Group Inc at Bank of America Merrill Lynch Insurance Conference

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PRESENTATION

Jay Adam Cohen - *BofA Merrill Lynch, Research Division - Research Analyst*

We have Hanover Insurance Group up next. Very pleased to have Jack Roche from Hanover as our next presenter. Jack was appointed as CEO, I guess, it was a little bit more than 15 months ago, although, he had been a senior leader at the company since 2006. So Jack really was part of the team that helped lead fairly dramatic change at Hanover over the past decade. And he played a number of different roles during that time. And as CEO, he has already begun to put his input on the company. So some changes are still occurring in this company. As always, it's a pleasure to have him here. Jack?

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

All right. Thank you very much, Jay. Good afternoon, everybody. I'm excited to update you on what we're up to at the Hanover Insurance Group. And some of you know us, others not as much. So I'll try to strike a nice balance between high level, what we are trying to accomplish, what our value proposition is, but also leave if there's something that I say that requires more drill down, we can certainly talk about it in the short Q&A session that we have or certainly with some follow-up with our team.

So with that, I would -- really, the key messages I want to deliver and have you take away from today's session is that we do, in fact, have what I think is a proven strategy that's now delivering the kind of financial returns commensurate with the company on the move. We've worked hard over the last decade, as Jay said, to take a regional generic insurance company and transform it into more of a national, more distinctive company that once we got through the build and some of the small acquisitions that we made to turn this company into something more worthy of investment into the future, we are proud of the fact that now we are delivering the types of returns that one would expect. And we're anxious to show you why we think that's sustainable and how we can build on all the progress that we've made. And we do have opportunities for profitable growth. Part of our investor proposition is that we not only think we can deliver sustainable top-quartile results, but we think we have plenty of opportunity to grow our portfolio. And in our business, you have to do that responsibly, but we think we've been able to prove in that we, in fact, have a great headroom with our distribution, and we have enough capabilities and profitability in those various sectors to fuel our growth. And as I'll show you at the end, we do have what anyone would consider ambitious goals, but we think they're achievable and we'll speak to how we do that in a responsible way, so that we can keep the journey going.

For those of you less familiar with us, we're roughly a $5 billion market cap company with $4.5 billion of revenue. At our peak, we were roughly $5.3 billion in net written premiums before we made the decision to sell our Lloyd's business, Chaucer, which I will speak to briefly. So one small step back to take 2 or 3 steps forward. And we generated last year roughly a 12.6% ROE after adjustment for the excess capital from the proceeds of Chaucer and maintained our strong A rating.

In terms of our competition, we think we have a well-diversified franchise that both provides for a good balanced business performance as well as, frankly, some distinctive offerings for some of the best agents in the country that we work with. As you'll see here, we have a substantially different geographic mix than we did a decade ago. When I came to the firm, 12 years ago, we were 2/3 Personal Lines and substantially in 5 major states. Since then, we've gone to a national footprint in Commercial Lines and to about 18 states in Personal Lines in the Midwest and the East Coast.

Equally as important, we have changed our mix over that time. You'll see now Personal Lines is just a hair under 40% of our business. Commercial Lines makes up 60%, 61%. Of that, we have 22% of our business in specialized Commercial Lines businesses that have fully dedicated models. But within the core Commercial Lines business, we have a substantial amount of that is specialized Commercial Lines offerings in niches and segments. They're just delivered through our small commercial and middle-market platforms. So I would like to suggest that in all of our businesses, we are a more specialized carrier, and we avoid playing in the commoditized sectors of the business.

Overall, the vision for the company and our value proposition to our distributors is to bring this new, more distinctive set of capabilities and bring them together in a coordinated, and sometimes, integrated way to some of the best agents in the country. And I'm going to talk a little bit about how our distribution strategy is different, and how it's helping us progress and build the company. Talk to you a little bit about how we think of specialization, not just in the Specialty Commercial area, but more broadly across our product set. And then last but not least, how hard we are working, in a cost-effective and capital-efficient way, to move some innovation into our business, both in terms of future growth opportunities and also in terms of modernizing our current business coming more efficient in what we do today.

On the green heptagons down below, I won't speak to these as much, but I will tell you they're equally as important as any lever we're pulling to drive our company forward. We believe we have a very unique collaborative culture. Our business is getting even more complex. And frankly, as you get into the specialized parts of the business, you can't leave yourself victim to one-dimensional leadership in those businesses. You have to set up a framework and an enterprise so that your company can understand the pursuits of each one of these specialized businesses, but a risk management and a capital allocation approach that allows you to make sure that none of those businesses get out ahead of you and cause you to take a wrong turn. That is one of the downsides of the more specialized worlds that the people that run those individual businesses usually are the ones that know the most about it. And so you really have to work hard building an enterprise that can manage across that network of specialized businesses.

I'm going to talk a little bit about the unique insights that we developed with our distribution strategy and our approach. And then last but not least, we have worked hard to really upgrade the performance of our business in a couple of different ways, not only the policyholder service from issuing policies to handling claims and risk control, but also the financial rigor and what we do to try to make sure that our businesses have optimal performance.

Our distribution strategy is unique. There are a number of companies that talk about how they have a thoughtful, limited distribution strategy. And many of those aren't authentic. But I don't think there are any carriers that have as much product breadth as we do and have such a selective number of agents that they work with. That's roughly 2,100 agents with nearly 3,000 locations. And in the Middle East, some of that is growing just from the acquisitions that many of these consolidators are making. But at the end of the day, we have a $4.5 billion, $5 billion company generated from a small subsector of the agents across the country. And I'll talk to you about why that's a good thing and not a limiting thing.

We also have deployed, all the way through many of our Specialty businesses, local resources, well-manage, well-coordinated. But in our business, the closer you are to the point of sale with that expertise, the better as long as you can deliver that cost effectively. And we do have a very local proposition.

And on the right-hand side, what I am going to show you is a little bit more of how we take our partnering approach with these agents and accelerate the way in which we can interact and exchange information with the purposes of creating these mutually beneficial partnerships. And so it's a little bit of a busy slide. But essentially, many companies will come out and they will go through the ritual of agents of exchanging, here's my products set, why don't you tell me a little bit about what businesses you have? A lot of that's very anecdotal, there's very little information exchange. And at the end of the day of this annual -- this kind of process and ritual of talking about how we're going to grow together, agents generally promise the same new business to 5 different carriers. And so frankly, many of us that gathered under this company really committed ourselves to delivering a much different experience that would actually help the agents grow and prosper but would inform our business strategies in a more meaningful way. So you can gather all the information you want around the market and around the agents. But we've been able to do, through a consultative process that we've built, is to get the vast majority of our agents to actually exchange in a fairly detailed way what their portfolio looks like. And we present back to them a consultative package that allows them to see how over time they can better serve those clients, and to do it in a way that's more cost-effective.

Many of the agents that are consolidating the business, obviously, are leveraging M&A and they're trying to buy some of the better agents, many of them moving downstream, which means they're taking on more small Commercial and Personal Lines portfolios than they historically did as a midsized or larger agent. But then they come to a point in their journey where they have to start becoming more operational. And they have to start understanding how they're going to transform what they bought into a much more operationally efficient and more effective organization that's client-centric. And many of them when the go through this consolidation effort, find themselves in a situation where they're serving their Personal Lines and small commercial and even some specialized smaller clients in a very ineffective way. Many of those customers, the service that they provide is a bill once a year and a phone call to follow up. So what we've been able to do is to take this planning process that we have and build a portal that allows us to gather the information from agents. Run data through a variety of different kind of consultative screens on how much account they're split versus monoline accounts? How much business do you have in certain sectors? How fragmented is your business? How much profit sharing are you likely deriving from your various businesses and there's opportunities to do that so you can improve your economics and ultimately, hire more people or better serve the customers.

In Personal Lines, we've been able to use some outside data to show them that the businesses -- that the customers that have the most lifetime value are the ones they tend to touch the least. And the more commodity-driven Personal Lines customers are the ones that are calling and looking for price savings or looking for regular service. So we're actually able to give them outputs that show them strategically how they can redirect their efforts, again, to improve their economics and improve their client base.

I would tell you, one of the reasons why I showcase this with people because there really is no insurance company in the U.S. that I'm aware of that exchanges data at the level that we do with some of the best agents in the land. So that's at least a proxy for the level of partnerships that we've built, that cause people to interact with our folks differently. But I think the combination of this trust and this information exchange and the fact that we focus on a small subset of the agents allows us to be operationally more effective in working with those agents and essentially be able to plot what that 3- to 5-year view of the partnership should look like. And when we do that, we know that we're not their only market, we're not their only favorite market. So we're open to the fact that there's places where we're going to have growth opportunities and there's other places where frankly, the business is already well served. By all in total, this agency insight tool and this approach that we've developed is industry-leading. And as many analysts and investors start to talk more and more the distribution system and individual agents, they get a sense for how different the Hanover is in terms of how we interact with those agents.

On top of that kind of base which we've built, we're very proud of the fact that we did not -- our strategy was not to try to dominate the weak. It was to try to actually attract the most effective agents, the most higher-quality agents. And that meant that not only that we have to have a good product set and the breadth of products that would be relevant to them, but we also had to convince them on the margin that we should be favored with that business. And that's why I think that partnership approach in combination with those relevant products has allowed us to have the growth and relevancy with these agents. And as you can see by this first bullet, as we're going into our new geographies and our new businesses and building on some of the foundation that we had, we're getting tremendous penetration. Last year alone, we had another 17% of our agents cross over that $5 million line. And that -- those businesses -- those agents that represent us for $5 million or more, across our various business sectors, now represent over half of our premium. Now admittedly, some of that's because the business is consolidating, and the bigger guys are getting bigger. But at the end of the day, I think it's also another example of how we're making tremendous strides in penetrating some of the best agents and getting to that relevancy. And our performance from a loss ratio prospective is better, frankly, with the larger agents than the small. I've been doing this for 30 years. That's hard to do. Right? When you're growing in our business, the bigger you are, the hard -- the bigger you get with an agent, the more likely that there is leverage that, that agency sees that they have power over that market. And we're very proud of the fact that we actually have higher profitability with the agents that we have the most penetration with.

As we're taking this to the next level, part of our playbook beyond just growing into the capabilities and the states that we have today, is to thoughtfully and at the right pace add to that product set. Some recent examples of that is we've hired some talent to help us get into the low to mid-sized financial services business, both in kind of community banks and asset managers and some of those related classes of business. A very large part of our business set. Our agents control over $2 billion of that business in total, and we only won a couple $100 million of it. So we're working through businesses. We've built on -- we're on our second version or a second edition of our technology platform build-out, including life sciences. That business we started from scratch 7 years ago. It's well over $100 million business for us today, one of our most profitable. And so we're taking the next step in expansion of risk appetite there.

And then in some of the select parts of our professional and management liability businesses, we're gradually moving up one octave in the risk appetite. We're not going into the public D&O or the large -- we're not going into med now. What we're doing is going from kind of small to midsize professional business up to the next tranche. And that's just another growth opportunity as we get some profitability that allows us to take more risk.

And then last but not least, we are appointing some new agents. Because part of our formula is that we're either moving towards a partnership or we're not. So every year, we call out a certain percentage of our agents that frankly just aren't on that path to partnership for whatever reason. We didn't either attract them to migrate more business to us or frankly, we thought it was a better fit and once we started working with each other, it wasn't quite as good. But we -- this last year alone, we appointed some 200 agents particularly, in Personal Lines and small commercial that's allowing us to spread our risk and grow our company.

Again, as I said, our leading -- our specialized capabilities are not just in our Specialty Commercial business. We are an account-centric Personal Lines market. We have real industry specialization and the unique approach in the middle market and Small Commercial world and obviously, a broad set of specialty capabilities.

So if you look at our Personal Lines business on a very crude basis, you have kind of the low end of Personal Lines that we're generally not interested in. We're not a high net-worth market. But we are inside this kind of $250,000 to $2,000,000 coverage A or $0.5 million to $2.5 million kind of Personal Lines customer. But what makes us even more unique is that now 84% of our business is in account. So we at least have the home and the auto, oftentimes, the umbrella or the toys. So this is an industry-leading staff. And that's why our profitability in Personal Lines is top quartile.

When you look at Commercial Lines, again, with a spectrum from a micro small commercial account all the way to the national accounts and the whole bunch of specialized categories, again, on a very crude basis, we focus on kind of the small-to-midsized business from the shoe store all the way to the life sciences account. And so we have a pretty good array of product. But we're not in the national accounts business. We're not really even in the upper middle-market business. And we're certainly not interested in trying to write $200 micro policies unless we can do it in a programmatic way. And then again, within them, we tend to have an account orientation, we're not really a monoline company.

So as you look into the future, we're going to be expanding some of our product capabilities, enhancing some of our excess and surplus lines businesses, primarily as a retail E&S player, building increasing relevance with our agents and leveraging our core commercial platform, which oftentimes creates the opportunity for some of our more specialized businesses.

And so you see the specialty business that we're in, in Marine, one of the largest Marine portfolios in the U.S. We have some program business, our professional liability business is now over $200 million. Management lability business over $100 million, specialty property, health care, mostly in the allied health and durable medical equipment sector. So we have a pretty broad array of specialized business in addition to what we have in our core commercial business.

As I said at the onset, we're not living in the present tense. We're trying to build for the future. And so we have a number of initiatives on the front end on trying to modernize the customer acquisition. We're working with insurtech firms and with agents to create a better model for particularly programmatic small commercial businesses. In the next few weeks, we're going to be announcing the extension of that so that we can be kind of the most digitally inclined kind of small commercial market for the independent agency channel. And so you'll see all that we think about is how we can help the agents modernize and take advantage of some of the technology that's coming to help us all.

Inside the company, though, we leverage analytics increasingly within our claims department, underwriting risk control to try to drive not only loss ratio improvement but also efficiencies in how we do what we do. We have a number of examples of that. And then inside the operational side, we are -- we've got some 21 robotic products going on right now with some outside help. And we're using drones for not only some underwriting guideline work but also the claims side. And that will grow over time. So this is just to give you a sense is that we're not just living in the present tense. We're trying to figure out where the world is. We do -- everything we do in our innovation space is sponsored by a business unit. It is driven by use cases so that we know what it is, we're trying to pursue and we try to do it in a capital-efficient way, which usually means we get a partner to help us and we try not to build things from scratch on our own.

All this, kind of, translates into what we think is increasingly attractive financial returns and attractive returns for our shareholders. Over the last 5 years, we have, kind of, outpaced the S&P P&C sector. Last year, after you adjust for the excess capital associated with the sale of our Lloyd's business, we had a 12.6% return. And as we continue to deploy some of that capital or return it, our quest is to generate 13%-plus ROEs into the future.

How we got there is with a combination of improving our loss performance as we got into more attractive sectors of the business, as we built some scale. You'll see at the top. It's a little bit of a jagged line. But what we try to do is to normalize that, albeit, on a kind of a high-level basis. Adjustments for weather, both good and bad. But we have had some improvement in our loss ratio, which is already pretty attractive from an industry standpoint. But you've seen we've made meaningful improvements in our expense profile, not only through growing into our current set of capabilities but also taking some appropriate expense actions to try to get to our competitive expense profile quicker.

Overall, we've -- in addition to the improvement we've made in our fundamental from our business, we've had strong contributions from our investment portfolio. As you see, we had over $8 billion in our investment portfolio. And the percentages we're showing you in terms of how much is in fixed income versus equities versus cash on hand, this is a function of some of the proceeds from Chaucer, kind of, pre-Chaucer proceeds we had roughly 86% of our portfolio in fixed income. And that is kind of the target as we go forward. So we're taking and I'll talk about the -- where we are with deploying that excess capital. But from a performance standpoint, you've seen, we've had improvement across the portfolio. That's been substantially driven by the increased operational cash flow that we've been able to generate from that improving performance, but also from some of the limited partnership performance in addition to the fixed income portfolio that we've generated. So again, a well-balanced portfolio. We have a terrific in-house investment team that is industry -- has many industry awards. And our team continues to deliver steady but improving NII. And our view on investments is we take enough risk on the underwriting side, we don't need to take outside risk on the investment portfolio. So as we come potentially to the end of the credit cycle, we're taking the appropriate steps to derisk the portfolio a little bit and make sure that we have a flight to quality so that the investment portfolio can continue to make the strong contributions.

So all-in, as I said, we have some ambitious goals moving forward. Our target is 13% to 14% operating ROE. Again, we'll have to continue down the path of dealing with the excess proceeds from -- or the remaining proceeds from the Chaucer sale. But we believe we can generate top-quartile performance and grow above the industry average. There is no reason to believe that with the headroom we have and the momentum and the support we have from our distribution that we can to outperform the industry on the growth side while maintaining consistent top-quartile returns. And part of what you can see on the right-hand side is that we have, as you would expect, somebody that invested in new capabilities, invested in new geographies, we have a marginal expense ratio that's much lower than our actual. So growth comes through with better economics for us as long as we don't degrade the loss ratio just for the sake of growth. And that's always the balancing act in our business. But a more mature company, they're marginal expense ratio is remarkably similar to their actual expense ratio. For us, because the way we've rebuilt this company, we have clear growth leverage and we thoughtfully grow the business.

So at the end of the day, what we've been able to do is to kind of return over $1 billion of the capital through share repurchases as well as regular dividends. And that's putting aside the special dividend we did related to the Chaucer sale. So we have a strong balance sheet, and we continue to return the appropriate excess capital to our shareholders. When we sold Chaucer, we generated somewhere in the neighborhood of $850 million worth of excess deployable capital that we do not need for our business. We returned $450 million of it, almost Day 1 in the form of ASR, $250 million ASR and a $200 million special dividend. And we thought that was the right balance in terms of instruments. And the only reason really why we considered a special dividend was it was the most efficient way to get the capital back that we don't intend to use. That leaves us with $400 million to be deployed, and what we've told our investors is that we will continue to look for opportunities to use some of that capital to grow our business. But the reality is we generate a fair amount of excess capital from our operating earnings. So in order to tap into that well, we would have to find a small acquisition or something that would be helpful to our company.

Now we have some pretty strict criteria about how we would approach anything inorganic. It has to be accretive in a relatively short period of time, relative at least from an ROE perspective. It have to meet -- it has some relevancy to our distribution approach. And last but not least, the people that would come in from any type of M&A would have to be able to meld into our culture. Because it's something that we've worked really, really hard at. And we don't -- we're not a place for rogue specialists. We try to bring in people that actually want to be part of an enterprise that like what we're trying to accomplish with our distribution approach. And so that -- those criteria, frankly, limit some of the inorganic opportunities. But they assure our investors that we're not going to do something kind of -- that's not accretive or not strategic as we go forward. So we work closely with our investment community to articulate that in relatively short order. We will either interpret thoughtfully some of that capital or return that in the form of an additional ASR and/or special dividend. And we won't to be sitting here a 1 year, 1.5 year talking about. We know that -- we don't intend to allow excess capital to be dilutive to ROE.

So at the end of the day, I hope I've given you at least a taste of what we've accomplished and where we stand today as we go into a very exciting time in our business. We do think we have a proven strategy. We think we have tremendous upside. I think we have really solid followership from the investment community as well as from some of the best agents in the country. And so we see the future as very bright for our company. Our team has never been more excited to take on the challenges that come with all the change that's coming upon us. And I think of ourselves as a midsize, agile company that over the last decade proved that we know how to embrace change and we know how to transform a company.

And that sounds to me like the flavor of a company that should be well suited to take on the challenges of at least the next 5 to 10 years.

So with that, I'd love to just open it up and entertain any questions.

QUESTIONS AND ANSWERS

Unidentified Analyst

Just out of curiosity, I mean, you touched on technology and expenses a little bit in the conversation. We heard over the course of the day, particularly, from some of the larger companies about how important technological advancement is going to be. At your size, is that something that you're going to be able to continue to develop to keep pace? Or is this going to be the sort of thing where in size that you are in and your creditors are that you will need to see some M&A?

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

It's in an appropriate question. And I don't think I have a concurrent view. But I think I have a different view than some of the folks that are 6x, 7x, 10x our size. I look out and see how much the world is going to change. How we settle claims. How we market our product? How we underwrite the product? And I, frankly, think most of the change that's going to happen is going to be from really smart people understanding how to leverage data and analytics and technology to help you improve what you do today and then eventually, pave new path towards new operating models. Frankly, that's hard to do. It takes a lot of collaboration, it takes a lot of integrated thinking. It's takes a lot of use case type analysis. I don't think the best way to do is kind of buy some technology company and hope that they're going to somehow transform the insurance company or create a venture capital fund and hope that somehow somebody's going to stumble across something. I think what we see with the insurtech firms around us is that the reason why they call themselves more enablers than disruptors now is that our business is a complicated one. So what I would suggest to you is I don't feel this advantage. I think that it takes money, but it takes, I think, a thought process of what is going to transform, what's the pace of change going to be. And do you set yourself up in the right sectors of the business where you won't be disadvantaged by scale and size. Right? If we were in the private passenger auto monoline business, I would say we're full of baloney. The fact that we're one of the best account writers in the mid space and Personal Lines, and we're digitizing our product and creating new ways of doing business, I actually think that's harder to do when you're 6x our size. And so time will tell, and we're not naive. We have, obviously, a thoughtful board and others that are challenging our thinking. But I think the use cases that we've built start to show in a small commercial world how programmatic niche small business can transform into a very unique different business model. And we have those use cases underway, and we got some really clever insurtech firms helping us advance that. So I don't have to build it inside my company. We just have to have the right kind of thought process about where the business might go and frankly, leverage some really bright people to help us get there. So time will tell.

Unidentified Analyst

So to ask very quickly is that basically the excess capital. You never -- you didn't mention buybacks. Is that just a function of your current price-to-book? Or is that something you consider at a different share price?

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

No, $250 million of the $450 million that we announced was a share repurchase, ASR.

Unidentified Analyst

The additional repurchase -- the additional $450 million.

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

That ASR will kind of run its course over the next few months, no later than June. Once we get word from our bank, heard that they have bought up all the stock, we will reevaluate whether we entertain a new ASR, whether we engage in some buyback. But that's very much a part of our playbook.

Jay Adam Cohen - *BofA Merrill Lynch, Research Division - Research Analyst*

Great. We should probably end it there. Thanks a lot, Jack. Thank you so much.

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

All right. Thank you. Appreciate it.