Q1-2018 Results

Conference Call Transcription

Paris, 24 April 2018

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Moderator

Welcome to Coface’s conference call for the presentation of its quarterly results for the period ended 31 March. Your hosts for today’s conference call will be Mr Xavier Durand, CEO of Coface and Madame Carine Pichon, Group CFO and Risk Director.

Xavier DURAND, CEO, Coface

Good evening everyone and thank you for joining our call. Tonight, we are pleased to report on our numbers for the first quarter 2018.

Starting with our summary, the execution of our Fit to Win plan is driving returns within a sound economic environment. Our turnover for the quarter reached EUR 344 million, a rise of 2.1% at constant FX and perimeter. This quarter saw both mature and emerging markets growing, with strong inputs from client activity. Our client retention rate continued to climb further, despite a very competitive pricing environment. Our first quarter net loss ratio is down 18.3 points, to 39.8% and our net combined ratio stands at 72.5% for the quarter. We are continuing to see favourable trends in losses, particularly in Asia and North America, while mature markets remain stable. We are still seeing favourable past claims management and recoveries, within a supportive economic environment. Our net cost ratio stands at 32.7% versus 33.9% for the first quarter of 2017. This was driven by the continuation of strict cost controls and higher commission from reinsurance. We are making continued business investments that are fully funded by cost savings, as highlighted in previous conference calls. In total, our net income group share stands at EUR 35.5 million for the quarter, which drives our return on average tangible equity to 8.8% for the quarter.

As I mentioned at the end of last year, 2018 is a year where we are focussing on intensifying the execution of our Fit to Win plan. We are continuing to drive a deep cultural processes and systems transformation. So far this year, we have achieved 6 million euros of additional cost savings (compared to the first quarter of 2017) and we are confirming our total annualised target of EUR 30 million for 2018. We are making thoughtful, disciplined investments of an additional EUR 6 million into growth, risk management, compliance and process transformation.

As I mentioned, turnover growth for the quarter stands at 2.1%, driven by client activity and retention rates which stand at a very high level. We are clearly operating in an improved economic environment which is continuing to drive significant pressure on pricing. Other revenues (including factoring and services), are down by 4.9% versus last year. This is driven by lower factoring revenues in Germany, as we are continuing to focus on deal pricing and profitability. Our fees to earned premiums have increased by 0.5% on sales of information (which we have been driving) and I think that is good news for the business.

The geographical split of our turnover for the quarter shows that all the large mature markets are performing better. Western Europe grew by 3.6%, thanks to record client retention and growing client activity. Northern Europe remained negative, but within that number is a flat performance for credit insurance (which, as you know, has been declining for a while) and a decrease in our factoring business (as just explained). Central Europe and the Mediterranean and Africa are accelerating, at 5.2% and 7.1% respectively. North America is still negative but it is performing better, as the portfolio is now stabilised. As will be seen later, we have much improved losses, which are driving a premium refund for better performing contracts. Asia Pacific has started to grow again, now that the clean-up phase is over. The headline numbers in Latin America look disappointing at -10.8% (driven by the late booking of some large international contracts), but we expect this to normalise over the course of the coming quarters. There is also the fact that we have higher premium refunds, due to much better loss performance in this part of the world.

We are off to a relatively slow start in new business. We are being thoughtful about what to write and on which terms, recognising that this is a competitive market. At the same time, there are also delayed bookings and we expect this to improve over the next quarters. We are seeing a record level of client retention, at 93.9% - the highest it has been for the last four years. The price effect is -1.9%, so slightly below last year. This reflects the competitive pricing
environment at this point in the cycle. The volume effect is a positive 2%, which also highlights the positive economic environment and confirms what we started to see during the fourth quarter 2017.

We are now in the sixth consecutive quarter of loss ratio improvement. The loss ratio for this quarter stands at 39.7% - slightly below the ratio of the fourth quarter of 2017 which had also suffered from around EUR 10 million of losses that we had selectively reinsured to the market. I would say that it is at a record level in line with recent quarters and we are continuing to see strong momentum. This is supported by the positive economic environment, favourable prior period underwriting development, an improving cycle and the good work that the teams are doing on managing prior claims. I think we can say that we are seeing the full effect of the action plans we put in place in September 2016, in the context of our Fit to Win plan. There has been no change in our reserving policy and the bonus from previous years are well above the historical average (reflecting the point in the cycle we are in).

On the split in loss performance by region, I will begin with the four most stable regions. Central Europe remains stable at around the 50% mark, at 52.3%. Western Europe, which had a spike in the fourth quarter of 2017 (due to one large file and some selectively reinsured contracts), is back to its pre-event level of 42%. Northern Europe continues to be stable at 54.8%, while the Med & Africa is around the 50% line. There is good news from the three regions that had been causing us some problems. North America is now at slightly below zero, on the back of better prior year recoveries, following a spike in the fourth quarter of 2017. Asia Pacific is coming back from its negative zone in Q4, and is now again just under zero. Latin America is normalising back to the 30% range, as we could have expected.

Our total costs are up 2.8% at constant FX and down by 0.8% in nominal terms. External costs are down by one million from the first quarter last year, at EUR 40 million, while internal costs are flat. We have had a positive benefit of EUR 4 million from FX. We have driven a further EUR 6 million in savings through our Fit to Win initiatives, continuous to those we have been talking about for the last six quarters. As I said, we are making deliberate reinvestments of some of these savings into initiatives geared around managing risk and driving further growth. We then have EUR 4 million of inflation, which brings us back to EUR 131 million (equivalent to the first quarter last year). As mentioned, we have driven an additional EUR 6 million in cost-savings compared to the first quarter of 2017 and we are confirming the annualised target of EUR 30 million that we highlighted during the launch of the Fit to Win plan. Our cost ratio for the quarter stands at 34.8%.

Carine PICHON, Group CFO and Risk Director

Thank you, Xavier and good evening everybody. Our reinsurance result was impacted by a record low loss ratio and higher accounting cession rates. As you may remember, we decided to increase our cession rates from 20% to 26% for 2017 and 2018 and we are seeing the full effect of that here. Premiums cession rate is at 28.7%, including quota share and all other treaties and we have the same cessions level for claims. Overall, we have a negative reinsurance result at EUR16.5 million, reflecting our very good loss ratio this quarter.

Our net combined ratio is 72.5%. Quarter by quarter, the combined loss ratio has been on a decreasing trend, thanks to improvements in the loss ratio (which is just under 40%), as well as improvements in the cost ratio - which at 32.7% is lower than previous quarters.

Our financial portfolio shows a slight increase in investment income. Income from the investment portfolio (excluding gain and sales) rose from EUR 9.8 million to EUR 10 million. We are still in a very low interest rate environment, but we are trying to keep the accounting yield stable. We also benefited from lower FX effects between Q1 2017 and Q1 2018, which explains why our net investment income grew from around EUR 6 million to just over EUR 8 million for Q1 2018.

Our net income stands at EUR 35.5 million. Operating income, which tripled compared to Q1 2017, reached EUR 58.4 million. This was boosted by the improvement in turnover and in the net combined ratio, in line with recent quarters. Our tax rate also continued to decrease. While in 2017 it stood at just over 50%, it is now down to 35% for this quarter.

Another way to express this improvement in profitability is the evolution on return on average tangible equity. Compared to last year, when we reported 5.3%, this figure has now risen to 8.8%. The main driver was our operating result which, as mentioned, has multiplied by three.
Just to wrap up this presentation, the takeaway for me is that this is clearly another strong quarter in terms of executing our Fit to Win plan, within an overall favourable economic environment. For the first quarter, our operating income is multiplied by three, to reach EUR 58.4 million. Our net combined ratio of 72.5% is driven by a record low loss ratio of 39.8%, while our return stands at a high of 8.8%. As we mentioned before, we are proposing to the General Assembly that we pay a dividend per share of EUR 0.34 for 2017. As you are aware, we have initiated a EUR 30 million share buyback programme and this is now approximately 20% complete.

In 2018 we are intensifying the implementation of our Fit to Win plan. We are driving an intense cultural transformation into every part of the company, underpinned by our key values of client focus, expertise, collaboration, courage and accountability. It is very important to me that this is driven deep into the company. We have just launched a new tagline for Coface, which is ‘Coface for trade’. This is an affirmative statement that expresses our belief that commerce is a driver of wealth, stability and development - and is, in general terms, good for the community. We are also working actively on the third pillar of our Fit to Win plan, which is capital management. We are closely monitoring a recent recommendation done by EIOPA, the European regulatory body, to the European Union to change the standard formula (and, if approved, could have an adverse impact on our business). At the same time, we are also progressing with the development of our partial internal model, with the goal of submitting it by the end of the first half of 2019. We are also confirming our guidance of EUR 30 million in cost savings for 2018 and a combined ratio target across the cycle of 83%, after the implementation of our plan.

Questions and Answers

Moderator

Ladies and gentlemen, the floor is now open for questions.

We have a first question from Guilhem Horvath, Exane BNP Paribas.

Guilhem HORVATH, Exane BNP Paribas

On the Solvency II model, can you elaborate a little on the recent change you mentioned concerning EIOPA and what the impact could be on Coface’s solvency ratio? Can you update us on the building progress, which you mentioned you had launched during the full-year 2017 conference call? You have now given a timeframe for submitting the model. Are you in the early stages, or is it already quite advanced? Is there any reason why you would end up with materially different capital consumption to your peers (as I think that Euler consumes quite a low level of capital compared to you on a net premium basis)? You are still saying that you expect continued improvements. Am I correct in thinking that you could report a better combined ratio in Q2 2018? Is this the way we should understand your target?

Xavier DURAND

Let me start with the Solvency II model. The development of a model like this is not a small undertaking and it is also an iterative process. We launched this process last year and announced that it was happening in the final quarter. I know that we have made enough progress at this stage to be able to foresee (or at least have a target of) submitting this programme by the end of the first half of 2019. That is still a while away. I think it is too early to give a detailed assessment of exactly where we stand – but we are making progress. In terms of the impact, it is difficult for us to say more until we have had discussions and feedback from the regulator. As I mentioned before, there are no other credit insurers in the French market that have developed this type of model. We are the first ones to do this - so it is a first for us and for the regulators. I think it would be unwise to forecast where it might end, but clearly we are making these efforts as we believe it could have a positive impact on our business.

As concerns the evolutions from EIOPA that we are monitoring, it is still early days. It is recent, but this is a process that involves them making recommendations and then the European Commission enacting some changes and legislation on
that basis - so there are several steps that still need to happen. We think there could be a negative impact on our business and that is why we are flagging it. We will be monitoring this closely going forward.

In terms of our targets for 2018 on the combined ratio, I think we should regard it in the same way we highlighted it at the end of Q4. In other words, we said we expect the momentum we saw in the fourth quarter 2017 to continue into 2018 (particularly in the first half of the year). I do not think we have changed our view on that.

Guilhem HORVATH

Just a quick follow up on the EIOPA thing. Can you explain a bit more about what they intend to do there? It may be very technical, but I do not understand why it could be negative for your business.

Carine PICHON

EIOPA is considering changing the calibration parameters concerning part of the capital requirements linked to underwriting risks. These changes could have a negative impact on capital requirements and increase our needs. This is the solvency capital requirements for premiums.

Guilhem HORVATH

Do you have any estimate on how hard this could be?

Carine PICHON

What we can say is that if the new calibration is implemented and if our interpretation is correct (although it is still early on and we need to confirm that), we will remain close to the middle of the range on our solvency comfort zone. This is before any mitigation or management actions that we might take. That is why we think it could be significant but our first, early, assessment is that we should remain in our solvency comfort scale.

Guilhem HORVATH

Perfect. Thank you very much.

Moderator

The next question comes from Michael HUTTNER, JP Morgan.

Michael HUTTNER, JP Morgan

You very kindly gave comments on the loss ratio by region, saying that Mediterranean Africa is normally at around 50% and Latin America normally around 30%. Could you give us some similar background for Asia-Pacific and North America? This is to understand better where the loss ratio will be and where the combined loss ratio could end up, once we have gone through the cycle of very large reserve releases. On the solvency side, I remember in Q4 that solvency improved massively, because you had a low combined ratio. I wondered if there might be another impact like that which we should expect, as the combined ratio has gone down one more notch? You said that with the new adverse changes in Europe, you would be at the middle of your target range. Could you remind me where that is?

Xavier DURAND

On the loss ratio, I think we have always said that we are targeting a combined ratio of around 83% through the cycle. As you have seen, our combined ratio is much lower than that at this stage, reflecting the fact that we are actually at a high point in the cycle. No insurance business can be run with very, very low loss ratios in the long term, so we do expect these loss ratios to normalise over time in each of the regions and oscillate around the mean. I do not think we are expecting anything different when it comes to North America or Asia, as market forces will revert the whole market to the mean in any case.

Michael HUTTNER

Where is that mean? You gave the mean for MEDAF and colour statements for the others. Where would the mean be?
Xavier DURAND

There is not a mean per market. The mean is what we have always said - around the 50% mark. That is more or less what we are seeing in other markets.

Carine PICHON

Your question was whether we could anticipate any further improvement on the solvency ratio, as the loss ratio is slightly better in this quarter than the previous one. We should have emphasised that on the solvency ratio, the way we estimate loss ratio is on a best estimate view. To make it simple, we have already anticipated most of the positive effects on the Q4 ratio.

Michael HUTTNER

Solvency is based on Q4?

Carine PICHON

Yes. The solvency ratio you had at the end of 2017 is based on estimates of the year to come - so it has already anticipated improvements in the loss ratio.

Michael HUTTNER

You said that you thought you would be in the middle of the target range. Could you remind me what the target range is?

Carine PICHON

The comfort scale for the target solvency ratio range is between 140% and 160%.

Michael HUTTNER

With the buyback and dividend, you thought you would be at 164% or 166%?

Carine PICHON

The 166% we disclosed in December 2017 already included the share buyback programme, as we were anticipating what will happen in the year to come.

Michael HUTTNER

This adverse thing could cost about 14 points. Is that similar to Euler, which had a kind of haircut of I think 20 points when it introduced an internal model? Is that a similar reaction to the regulator?

Carine PICHON

I think it is different. I do not know exactly about Euler, but it is related to the discussions with their regulator. Their discussions concern raising a standard formula, not an internal model.

Xavier DURAND

This is something that is industry-wide and not something that is specific to Coface.

Michael HUTTNER

If it is industry-wide, does it mean that the end-buyer of credit insurance would face the same capital costs from all their providers?

Xavier DURAND

It depends on whether they are operating under the standard formula, or if they have an internal model. This makes the internal model question even more important. To be clear, it is still early days and I think there are more discussions to be had on this topic with the regulators.

Moderator
The next question comes from Benoit PETRARQUE, Kepler Cheuvreux.

Benoit PETRARQUE, Kepler Cheuvreux

On the loss ratio for the current year, you are reporting 72.4% - which is pretty stable compared to the past four years. I know you have been investing a lot in risk management and improving underwriting. I was trying to understand why the loss ratio for this year is still relatively high in the current context and considering all the investments? I am trying to understand why it is still at the 72.4%? I also have a question on the costs. You have achieved EUR 9 million to date this year and EUR 19 million last year. That means you have achieved a total of EUR 28 million, which is close to the EUR 30 million you mentioned. I am wondering how we should think about the rest of the year. Are we going to see a bit more cost inflation, or do you remain confident that you can still cut costs more aggressively than the EUR 30 million?

Xavier DURAND

Let me start with the last question, as I want to make sure we avoid any confusion here. When we made our plan Fit to Win in the third quarter of 2016, we started counting cost savings on the basis of 2016 costs. When we say we have achieved EUR 9 million for the quarter, it means that we have made EUR 6 million in addition to the EUR 3 million that we already saved in the first quarter of 2017 versus 2016. Therefore, we had EUR 3 million in savings in the first quarter of last year and this year we have driven another EUR 6 million in savings to pool at EUR 9 million (as part of the EUR 30 million).

Benoit PETRARQUE

You have saved EUR 22 million out of the forecast EUR 30 million?

Xavier DURAND

Yes – and a little more in fact. We just had to find the least confusing way to calculate this. It shows that we are driving savings hard and moving resources from areas of the business that are less interesting, to other areas where we believe they could be better used (such as risk management and growth initiatives).

Carine PICHON

On your question on the current year loss ratio of 72.4%, as you know, we have not changed any reserving policy and at the beginning of the year we prefer to be prudent as we have less information. We will see any further benefits during the quarters to come.

Benoit PETRARQUE

Is it right to assume that the Q1 2018 result I have seen is much more conservative than in past years?

Carine PICHON

No. It is the same, but we do not yet have much information.

Benoit PETRARQUE

I am trying to understand why, given all your investments in risk management, we do not see a lower starting point, as you can anticipate risks much better than in the past. Why is this level relatively stable despite the investments?

Carine PICHON

It is relatively stable, but this is not abnormal when you start the year. However, we strongly believe that all the efforts we have made regarding risk and infrastructure will have positive effects and reach a level with a bit more risk margin, as there is more volatility at the start of the year.

Moderator

The next question comes from Roland Pfaender, Oddo BHF.
Coming back to the previous years underwriting profits, could you provide us with an outlook for the next quarter? Will this number be on the same level? What would be the normalised level you would expect in the two or three quarters to come? You improved your tax ratio to 35%. What would be the final tax ratio in one or two years, following the possible improvements you are planning?

Roland PFAENDER, ODDO BHF

Xavier DURAND

We do not provide quarterly guidance on loss ratios going forward. This is something we are not going to do this year.

Carine PICHON

As you mentioned, the tax ratio is 35%. We may have some improvement in the future, but it will entirely depend on the breakdown of our results by geography. If we have made most of the improvements (which came down from a very high 52% and are now 35%), there may still be some positives to come. This will depend on the timeline and the breakdown of profitability per geography.

Moderator

The next question comes from Thomas Fossard, HSBC

Thomas FOSSARD, HSBC

On your reinsurance strategy (obviously with the potential negative impact you foresee on your solvency ratio on a standard formula basis), how will this potentially impact your reinsurance programme and buying process? Xavier, in your previous statement I think you mentioned that we are at the top of the cycle. Can you clarify whether you meant the top of the credit cycle or the reserving release cycle?

Xavier DURAND

I think it is the economic cycle - as our loss experience tends to follow the economic cycle. As we said last quarter, in 2017 we saw synchronous growth in all regions of the world and I do not think this has happened for 30 years or so. We have seen Europe pull back from the economic crisis after eight or nine years of sluggish growth. We have seen recoveries in the emerging markets. We have seen the US continue on an unprecedented nine-year expansion cycle. I think what we are saying is that these conditions are as good as we can foresee. If you look at some of the risks out there, whether political, geopolitical, the talk of trade wars, or the amount of debt in the market, it is hard to see how things would get significantly better from where they are. Our view is that this is probably the peak of the economic cycle and, while we could never predict what is going to happen, it is reasonable to consider that this is a particularly good part of the cycle. I have been asked this question in the past and clearly I think everything is going pretty well.

On the reinsurance strategy, I want to point out that it is still very early days for regulatory discussions. It is quite new, and I think there needs to be further discussions with the regulatory bodies in terms of their intentions, what they want and when (and if) it will happen. The only thing I can tell you is that if our cost of capital increases as a result of something like this, then obviously the difference in cost of capital with the reinsurers would also increase. There are a lot of ifs and precautions here, but that could potentially make the recourse to reinsurance more attractive if that was the case. I am going to take a few language precautions here. We have not changed our reinsurance policy. I think we highlighted the changes we made at the end of the last quarter and we have no other plans at this stage. I think we will have to see down the road if these things continue to materialise.

Thomas FOSSARD

Coming back to your comments on the peak of the economic cycle, everything is going fine but the growth from your clients is still only 2%. Does that not seem likely to translate into the top line growth of your own clients?

Xavier DURAND

I think there is a mixture of effects, so I would be hard-pressed to give you the details. If you look at how it has evolved over the last four years, it is clearly much higher than it has been in the past. It involves a number of things, such as our clients in different sectors. As we know, commodity prices are a particularly important factor.
Carine PICHON
The volume effect is around 2%, as it only concerns one quarter. This means that it is more or less double than that of last year and even compared to 2015 and 2016. Therefore, it does impact the activity. I think it is positive, as it is a quarterly effect.

Xavier DURAND
A quarterly effect is cumulative, so it is pretty strong.

Moderator
The next question comes from Guilhem HORVATH, Exane BNP Paribas.

Guilhem HORVATH
You mentioned geopolitical risks and trade wars. What is your exposure to Russia today and do you see, or expect, any deterioration there? I think the accounting yield is starting to flatten compared to the past. Should we expect it to remain flat year on year in the future?

Xavier DURAND
Let me talk a bit about Russia. It has been a tough spot for the company, particularly when I think back to 2014, which was driven by a series of things. One was the fact that oil prices came down, seriously impacting the Russian economy. Then there were sanctions from the US, which aggravated the issue, followed by reciprocal sanctions from Russia on European products, which further stressed the situation. I think what we have seen over the course of the last 12 months is the Russian economy’s return to positive growth, helped by the relative recovery in oil prices. I think our outlook on Russia is probably better than it was a couple of years ago. Clearly, every time there is a sanction from the US it impacts their economy (as we have seen recently). It particularly impacts individual sectors and we have seen the price of aluminium jump after the announcement of sanctions on sRusal. There has also been posturing and there may be a delay, or dampening, of these sanctions. There are risks, but I do not think it is going to change the overall economic outlook for Russia compared to what we saw a couple of years ago.

As concerns the accounting yield on the portfolio, I think you are referring to bonds and interest rates. Most of our book is in Europe, while the second largest share is in the US. As you know, our maturities are relatively short, but we do not expect a significant increase in interest rates in Europe before the end of this year and potentially into next year. It will take time for any increase in interest rates, if it happens, to materialise in our book in any meaningful way. This is very consistent with what we are saying.

Moderator
The next question comes from Thomas Fossard, HSBC

Thomas FOSSARD
It is going to remain flat and you do not expect any deterioration going forward?

Xavier DURAND
I think flattish. I think we are in an environment where rates have been low for quite some time. I think up to last year and today, we were still investing at lower rates than what we had in the book. What proportion of the book and how long that lasts will determine the precise answer to that question.

Moderator
The next question comes from Michael Huttner, JPMorgan.

Michael HUTTNER
On the UK and UK exposure, I wondered if you could say what your exposure is (assuming that it could be the exception to this positive economic scenario). Concerning the large reserve you had in Q4 in 2017, is the write-back of that reserve included in the Q1 prior year[] development, or is that yet to come?
Xavier DURAND

Let me say a word about the UK, because clearly what we are seeing is that Brexit has bitten the UK economy. The reality is that it has had a pretty significant impact on the currency. Exports are pretty good, but imports have suffered. A lot of companies have postponed investment decisions. This has driven some inflation in the UK market and the level of indebtedness of UK consumers has risen. We can see that all these numbers are impacting the UK economy and there have been some well-publicised insolvencies with companies such as Bargain Booze, Conviviality, and Carillion the construction company and a few others. While still positive, we think that UK growth has actually been driven by the economic cycle we are seeing in the rest of Europe and the US. The UK is not proportionally doing as well as the rest of the European market.

Carine PICHON

The large claim we mentioned in Q4 is still in the book, so we have not changed our assessment at this stage.

Michael HUTTNER

That was 10 million?

Carine PICHON

It represents 9.7 points of loss ratio, but a significant part of it is reinsured. I would say that whatever relief we may have on this claim, it will not have an impact on the net result in the end. The remainder will have an effect if we reassess, but we do not have any information on that.

Michael HUTTNER

What was the figure for UK exposure?

Xavier DURAND

I do not have that number in front of me. I will have to get back to you on that.

Michael HUTTNER

It would be really nice if you could, because it is not published anywhere else. That is why I asked for it today.

Xavier DURAND

I think we provide some details on our exposures on an annual basis, so you will see these numbers in Q4 statements in the reference document. I do not believe they have changed materially since the end of the last quarter.

I just want to wrap this up and thank you everybody for logging in to our call. We are driving the execution hard here and there is a lot to do. As I said, we are deepening our efforts to change the culture and performance of the business at all levels. I think some of the things we have launched are clearly working and this creates a very positive feeling for the company. I look forward to updating you more about how we are doing on our next call, for the second quarter. Thank you for joining everybody.

(End of transcript)
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FINANCIAL CALENDAR 2018 (subject to change)
Annual Shareholder’s General Meeting 2017: May 16th 2018
H1-2018 results: July 26th 2018, before market opening
9M-2018 results: October 24th 2018, after market close

FINANCIAL INFORMATION

This press release, as well as COFACE SA’s integral regulatory information, can be found on the Group’s website:
http://www.coface.com/Investors

For regulated information on Alternative Performance Measures (APM),