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Atlas Financial Holdings, Inc. (AFH)

Q4 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Greetings, and welcome to Atlas Financial Holdings Fourth Quarter Conference Call. At this time, all participants are in listen-only mode. A question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Scott Wollney, Chief Executive Officer. Please go ahead, sir.

Scott D. Wollney

President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

Thank you very much, Victor, and good evening, everyone. With me today is Paul Romano, our Vice President and CFO. This afternoon we issued our unaudited financial results for the fourth quarter and the year-end December 31, 2018 along with the presentation accompanying this call. All these materials can be found in our website under the Investor Relations section.

I'll now turn it over to Paul to review our policy regarding forward-looking statements.

Paul Anthony Romano

Vice President & Chief Financial Officer, Atlas Financial Holdings, Inc.

Thank you, Scott, and good morning, everyone or afternoon. On this call, Atlas may make forward-looking statements regarding the company, its subsidiaries and businesses. Such statements are based on the current expectations of the management of each entity. The words anticipate, expect, believe, may, should, estimate, project, outlook, forecast or similar words are used to identify such forward-looking information. The forward-looking events and circumstances discussed on this call may not occur and could differ materially as a result of known and unknown risk factors and uncertainties affecting the companies, including risks regarding the insurance industry, economic factors and the equity markets generally; and the risk factors discussed in the Risk Factors section of its Form 10-K for the year ended December 31, 2017.

No forward-looking statement can be guaranteed. Except as required by applicable securities laws, forward-looking statements speak only as of the date on which they are made, and the company and its subsidiaries undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

When discussing our business operations, we may use certain terms of art which are not defined under U.S. GAAP. In the event of any unintentional difference between the presentation materials and our GAAP results, investors should rely on the financial information in our public filings. All amounts discussed on this call are in U.S. dollars, unless otherwise indicated.

With the objective of communicating our year-end results as soon as practical, we elected to issue today's press release prior to completion of our audit process. Final financial results will be filed in the company's Form 10-K.

As Scott mentioned, we will be utilizing a slideshow presentation in conjunction with this call. Though we may address a few slides specifically, in general, we will use this as an accompaniment. Feel free to follow along, as we will follow the basic structure of this document. The presentation is available on our website's Investor Relations section and then under the Earnings Release Info selection. It will also be shared with those of you on the live webcast version on this call.

For those of you following along with our presentation, we'll begin on slide 3.

With that, I'll turn the call back over to Scott.

Scott D. Wollney

President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

Thank you, Paul. Over the course of the past year, we focused on continuing to adapt to the changing conditions in our niche commercial auto market of customers using light vehicles primarily to transport people. This included the shifts in terms of our insured operators from what had been traditional taxi, livery, and para-transit businesses, the part of the new gig economy and the evolution of transportation network companies and the ride-sharing market. In addition, consistent with the things we outlined at our Investor Day in May, there are continuing challenges that both Atlas and all companies writing commercial auto are facing. These include distracted driving, greater prevalence of litigation, and higher claims severities.

To ensure that we're able to deliver the best outcome despite these trends, Atlas has implemented a number of process changes and other innovative tools and techniques. Our fourth quarter and year-end financial results were impacted by reserve strengthening based on year-end actuarial work despite the improvements that our operational activities demonstrated throughout the year in terms of actual claim closures. We are extremely displeased, and once again strengthened reserve estimates for prior accident years. This has been an ongoing challenge for Atlas and for the commercial automobile industry overall.

Actuarial estimation of ultimate claims severity has been the biggest driver of our reserve changes. The magnitude of this change in estimate was less than last year, but still had a meaningful impact on our results. During today's call, we will provide information about where and how these reserve changes impacted our business. We will also talk about why we expect the process changes implemented in the past to have a favorable impact on our results over time and the additional steps the company will be taking with the objective of maximizing shareholder value.

As shown on slide 4, the change in reserve estimates impacted each of our business segments. The bulk of strengthening impacted accident years 2015 and 2016. More recent accident years' loss ratios were affected much less, and we expect that we will be able to further improve on them going forward by continuing to leverage analytics and also taking advantage of the hard market condition in commercial auto insurance.

Actuarial estimation of ultimate claims severity has been the biggest driver of our reserve changes. Slide 5 breaks out the settlement year paid severities overall by loss band. While we are seeing a reduction in allocated loss adjustment expenses, or ALAE. which we attribute to the changes made in our claim process over the past few years, the average severity of claims over $100,000 has gone up.

As we've discussed before, in early 2016, we implemented a significant process change which utilize machine learning-based predictive analytics to triage and route claims with the objective of extinguishing legitimate claims earlier than before, preventing unnecessary leakage and reducing allocated loss adjustment expense. This acceleration also enables us to defend non-meritorious or fraudulent claims more vigorously. Both of these changes appear to be having a positive impact on actual calendar year results. Actuarial work in contrast with actual claim results attempt to estimate future outcomes based on data from the past.

We believe that our experience this year may be due in part to having settled meritorious claims more quickly following our process change in 2016 with the objective of reducing ultimate severity. The actuarial process is informed by past results and attempts to estimate the remaining liability related to open claims. Predicting future claims liabilities is inherently uncertain and we cannot ignore the possibility that underlying loss trend is higher than previously projected.

That said, slide 6 compares the average severity related to claims received before and after our process change at various settlement ages. As you can see, the slope of the post-process change line is flattening out at lower levels than was historically the case, and provided incremental closures continue to demonstrate this positive impact the ultimate claim cost will be reduced. This impact is seen for all three of our primary commercial [ph] auto – (00:07:45) liability lines of business.

Last year, we shared similar information on an aggregate basis, but post process change closures were limited to about a year of claim agent settlement. The incremental years' worth of data supports our belief that the process change is making a notable difference.

Slide 7 provides a similar comparison for ALAE expenses which historically accounted for more than 20% of our claim costs. While operating results during the past year demonstrate continuing improvement, it is taking longer than we would have hoped for these positive activities to be reflected in actuarial estimates. As was the case last year, we believe that the incremental reserve strengthening taken as of December 31, 2018 is an appropriate step based on the available information to account for future liabilities.

We've been providing data throughout the year to deliver transparency and believe claim closure data from our recent accident years demonstrates the fundamental efficacy of our processes. We will continue to provide quarterly updates sharing operational information about claim and reserve-related activities to ensure that Atlas is as transparent as possible with stakeholders. While we believe that aspects of our future indemnity and claim-related expenses may ultimately prove to be lower than actuarial estimates on which our reserve strengthening was based, we concluded that it was appropriate based on the available information to increase IBNR levels according to our independent actuaries range.

We believe that our process changes increasingly are resulting in liability being extinguished earlier in the lifecycle of our claim inventory and anticipate that this will result in less tail-risk than was historically the case. We will revisit the issue of claims and reserves later in the call, but will now focus on other aspects of our business.

Our team's strategy is to provide a specialty product to unique segment of the commercial auto space. We've been innovative in the use of analytics and technology, have a deep repository of data, strong and experienced team and a committed distribution channel. Operating as a hyper-focused niche player has been the investment thesis surrounding Atlas in conception. And despite recent challenges, we are confident that it remains sound.

We are also excited about the incremental opportunities, especially in the Transportation Network Company, or TNC, space coupled with our [ph] insured tech (00:10:10) related initiatives, including a new program launch with a leasing company in connection with a major TNC announced last quarter.

As highlighted on the slide 8, our business mix continues to shift most notably in the livery segment, which includes a growing number of commercial drivers under dispatch through TNCs. Current market conditions and the evolution of our target market are providing substantial growth opportunities for Atlas. That said, we remain focused on margin over top line growth as always.

As I've mentioned before, we think about growth in the context of return on deployed capital over the long-term and believe that a patient approach to expansion with a bias towards risk selection and price optimization will drive value creation. While market conditions remain hard, testing price elasticity and competitive response is critical to the execution of this strategy. Later in the call, I'll expand on our current observations and the related impact we expect to have in our results and strategic activities.

We have a nationwide platform. Distribution of premium in our larger states is highlighted in slide 9, shows the reach of our business. As we continue to evaluate underwriting results by segment, we expect that rate and other underwriting activities will cause certain segments and geographies to shrink while others have the opportunity to grow.

Demand for commercial auto insurance is very high as a result of the reduced capacity following the industry challenges in recent years. The size of our overall addressable market is also expanding with the evolution of the gig economy. As we've noted before, our competitive environment is currently populated primarily by smaller, local non-standard companies.

Atlas' comparative advantages, which I referenced earlier, are driven by niche expertise, customer-centric service and claims handling as well as other differentiators that compare favorably to these more generalist companies. These are the things that our customers prioritize when they decide where to purchase their insurance and evaluate how much of a premium they may be willing to pay.

We expect that while competitors in certain areas have been slower to follow rate increases than in the past, they will do so given the overall market condition in commercial auto. Our team are confident that the rate changes we've made will result and optimize underwriting margins and are comfortable with moderated growth or even reduced volume in areas that are more price sensitive in the current environment.

Based on feedback from our distribution channel, our products is still considered best-in-class from a service and claims perspective and the Atlas companies remain their premium choice to present to insurers. We are further distinguishing our offerings to the fintech initiatives cultivated in recent periods.

We outline our pricing changes on slide 10. We have continued to be very proactive in pushing rate into the marketplace well above the industry standard rate recommended by ISO. And quarter-to-quarter, this will shift based on underlying industry rate changes and our observations regarding price elasticity.

In addition to increasing base rates overall, Atlas is using predictive analytics in a way that distinguishes our business from our competitors, and we're committed to continue to innovate to sustain this competitive advantage. Our goal is to maximize hit ratios for favorable accounts and reduce the relative amount of less profitable accounts.

Post adjustment for loss ratio for more recent years continues to be better than broader commercial auto despite our reserve strengthening. We've recognized that underwriting profitability is the most important aspect of our business and believe that our business model will deliver above average results going forward.

Slide 11 shows our in-force business which remains at the highest level of just over $286 million. Generally speaking, we've maintained operating leverage of $2 in net written premium for every $1 of statutory surplus. Having strengthened reserves, our operating leverage is currently above those levels. In the short run, we'll be evaluating reinsurance options to bring operating leverage in line with our target levels. We do not need to do anything drastic to support our in-force business.

Growth opportunities will be balanced against capital constraints and alternatives. As one of our strategic priorities, we established managing general agency entity within our holding company system. This entity is now licensed across the U.S. and enables us to partner with alternative sources of capital in addition to retaining risk in our wholly-owned insurance subsidiaries. As always, being a good steward of capital is a high priority for our team.

One question we've been asked is the impact of A.M. Best on our book business. While we certainly will continue to work with A.M. Best to fully explain our position and capital adequacy plans, we don't believe that our business is particular rating sensitive. Last year, we did not see an appreciable shift in premium writings as a result of the ratings change.

I'll now turn it over to Paul to discuss our financial results in more detail.

Paul Anthony Romano

Vice President & Chief Financial Officer, Atlas Financial Holdings, Inc.

Thanks, Scott. As always, I encourage each of you to review our filings, our slide presentation and to reach out to Scott or myself with any questions.

Slide 13 provides some key financial highlights from our unaudited year-end financial statements. For the fourth quarter of 2018, gross premium written was $57.7 million, up 6.5% from $54.2 million in the prior-year period. As we have discussed in the past, while we do anticipate increased demand for our commercial auto insurance, based on current market conditions, we remain focused on underwriting profit and risk selection as our priorities.

In-force premiums remain relatively flat at $286.1 million as of December 31, 2018 when compared to $286.7 million at September 30, 2018 and are up from $268.5 million at December 31, 2017. Net loss for the fourth quarter 2018 was $53.6 million or $4.47 loss per common share diluted. For the full year, we reported a net loss of $36.9 million or $3.08 loss per common share diluted. Book value per share was $4.08 at December 31, 2018 and is decreased 45% since year end 2017. Of this reduction, impairments related to intangible assets such as deferred tax assets represent approximately 19.1% of this change.

Our operating leverage as measured by net written premium to combine statutory surplus was roughly 3.2 to 1 at year end 2018 as indicated in the top chart on slide 14. Managing our leverage is important from both regulatory and rating agencies' perspectives. Again, we continue to view an approximate 2 to 1 relationship between the net written premium and statutory surplus.

During the fourth quarter of 2018, our quota share session rates were 30% and 25% of subject written premium for the ASI Pool companies and for Global Liberty respectively. In the near term, we will be working with reinsurance partners to evaluate the best approach to manage operating leverage and support underwriting opportunities.

Slide 15 provides both quarterly and annual combined ratio trend information including its components. As with our expense ratio, we encourage users to look at our combined ratio and its components on an annualized basis rather than focus on changes from quarter-to-quarter, as there are a number of factors that could impact a shorter term view.

The underwriting expense ratio for the three-month period ended December 31, 2018 was 33% compared to 30.8% for the prior-year period. As always, we encourage you to look at the full-year expense ratio as there are seasonality and timing impacts on this ratio in any given quarter. For the full year, our expense ratio was 28.6% versus the 2017 full-year expense ratio at 28.0%.

Slide 16 breaks out the key components of the combined ratio after accounting for the effects of reinsurance. Atlas' combined ratio was 175.5% for the three-month period end of December 31, 2018 as compared to 220.3% in the prior-year period. Full year combined ratio was 109.8%, of which 26.8% was the change in the reserve estimates in the quarter and the year-to-date.

Slide 17 and 18 provide a view of our overall balance sheet in our cash and invested assets. We have always maintained the view that a conservative investment philosophy is important. Our primary investment objective is to protect capital to support underwriting operations.

As shown on slide 17, cash and invested assets declined year-over-year as a result of funding, related increased quota share sessions initiated earlier this year and claim settlement activities. This was expected and consistent with the nature of this type of reinsurance arrangements and changes implemented in the claims processes.

As seen on slide 18, the majority of our $201 million of cash and invested assets are publicly traded high quality fixed income securities. During the year, we reduced our exposure to other than fixed income investments or OTFI. Our OTFI investments are audited annually and qualify as admitted assets from an insurance regulatory standpoint.

We do not have any concerns about the value of any of these investments. However, based on our current book value, we have made the decision to continue to reduce the level of OTFI investments going forward.

In the fourth quarter, OTFI investments were reduced by $4.7 million. These investments are generally less liquid than our publicly traded securities, and we are not forcing accelerated liquidation if it would negatively impact our returns. During the year, OTFI investments were reduced by a total of $8.9 million and actions were taken to liquidate another $11.8 million, which will be reflected in our 2019 results based on the timing and return of this capital.

Book value per common share was $4.08 as of December 31, 2018 as compared to $7.42 at December 31, 2017. The elements of the book value change per common share relative to December 31st are outlined on slide 19.

As indicated, we are working to finalize our yearend 2018 audit. In the meantime, we have put up a $20.6 million full valuation allowance placeholder against our deferred tax assets. However, they do remain viable and are available for use during the next 20 years with a portion of them having an indefinite life.

With that, let me turn the call back to Scott for his concluding remarks.

Scott D. Wollney

President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

Thank you, Paul. I'd like to conclude with next steps, analysis expectations for 2019 and beyond. Following the strengthening of our reserves for prior accident years, we will be in a position to continue to increase rate levels. Based on the fact that all of our business segments were impacted, we expect to take rate in virtually all areas. We will also be reevaluating sub-segments of our business on a post-reserve change basis to identify other underwriting actions that will help reduce potential loss ratio volatility. We will, of course, also continue to execute on the activities implemented to-date, which have resulted in better outcomes than would have otherwise been the case before implementing our current processes.

As a result of our use of data and these analytics, we believe the company is in a better position than our competitors to accurately predict and manage claim-related liabilities. We also believe that our repository of data and hyper focus on our light commercial auto niche will leave Atlas favorably positioned despite the unique and changing nature of our industry.

According to the latest report of the Council of Insurance Agents and Brokers, an exert of which is shown on slide 21, commercial auto quarterly rate changes are at the highest percentage growth level at any point in the past decade and we're seeing this in our specific niche as well. While our financial results continue to be impacted by the higher expected future severity that appears to be impacting our entire industry, we believe it would be proactive actions taken by the company along with the healthy rate environment will result in future underwriting profitability.

We've been adjusting price with a target loss ratio below 60% and most recent accident years are holding up. The market is hard and should continue to harden based on recent results and market data.

As seen on slide 22, commercial auto insurance is shown in the highest levels of overall rate increases of any large segment of property casualty insurance. We will provide more guidance regarding expectations for the balance of the year and beyond at our next call after evaluating sub-segments of our business.

Side 23 provides insured vehicle in-force information. While we are insuring more cars than last year, most of our premium change was the result of rate versus increased exposure. We also continued to reduce exposure to previously announced states like Michigan. Our risk selection process has effectively re-underwritten a significant portion of our book of business during the past few years as demonstrated by a renewal persistency and new business hit ratio data.

The fact that claim frequency trends compare favorably to in-force vehicle growth as shown on slide 24, supports our view that our underwriting process is identifying the better risks. Based on expected market conditions, we're optimistic that there will be an increasing overall demand for the type of business Atlas rights.

In addition, we've made significant inroads with Transportation Network companies and related businesses and have a strong pipeline of gig economy related opportunities. We have stated in the past that our belief is that a proportionate 20% market share within the light commercial auto niche, which we estimate to be approximately $2.25 billion was realistic.

The market continues to evolve, and we believe that we can benefit from being hyper-focused on the change within this specific line. We're intent on increasing the amount of business we write in the sub-segments of our niche that are expected to generate the greatest underwriting margin. We are also equally committed to reduce exposure to any geographies or sub-segments that appear to be more challenging. Our goal continues to be to generate the best return possible on capital deployed into underwriting.

To conclude, we believe the long-term foundation for our underwriting profitability that has been our thesis remains valid. If we believe the unique attributes of our niche market create opportunities that are more positive than the overall commercial auto insurance segment. We will be reevaluating our traditional business with the objectives of reducing potential loss ratio volatility and at the same time exploring the best ways to maximize new opportunities we've cultivated.

Our commitment to analytics, technology and insured tech initiatives remain as strong as ever. In addition, as noted in our press release earlier today, to further strengthen its processes and review its capital allocation and opportunities, the company is engaging industry experts with a broad knowledge of insurance, finance, analytics, claims handling, reserve estimation, financial risk management and capital efficiency. Management and the company's board of directors will examine conclusions and recommendations of this work and report the results to shareholders and other stakeholders by mid-year.

Now let's open it up for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] One moment please, while we pool for questions. Our first question comes from the line of Bill Dezellem with Tieton Capital Management. Please proceed with your question.

William Joseph Dezellem
Chief Investment Officer & President, Tieton Capital Management LLC

Q

Thank you. I have a group of questions. First of all, what geographies are the culprits to this reserve addition?

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

So, it was pretty widespread, Bill. It was not focused in any one state. As we highlighted in the slides early in the deck 4 and 5, it was really across all the segments. And we really saw it across most geographies as well. So, we are going to drill down further as we referenced in terms of identifying what I'm referring to as sub-segments within geographies and lines of business to figure out which lines are or which indicators suggest more volatility. And the approach we're going to take is to assume that the reserve estimate adjustments are necessary even if we have a more optimistic view about what the actual outcomes might be and shrink those aspects of our business nonetheless.

Because in the end, obviously, we want to reduce exposure real or expected given the fact that our business does rely on these estimates and we have to assume that there's the possibility that the future is going to be worse than the past, irrespective of the things that we've tried to do to create the best outcome. So, at this point, if there are no specific geographies I can highlight as the problem, but we are looking at everything and we are going to be very proactive as we were a few years ago with Michigan to reduce exposure to those things.

William Joseph Dezellem
Chief Investment Officer & President, Tieton Capital Management LLC

Q

And you referenced a work by outside parties that'll deliver a midyear report. Is that including the sale of the company? Is that part of the thought process there?

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

It's not an explicit decision in that regard at all. But I think company and the board want to make sure that we aren't ruling anything out either. So, the scope is broad as we referenced in the press release and I reiterated on the call, we want to bring in a number of experts, some that we've worked with before, others that we haven't with the objective of really evaluating all of the assets within the business, the opportunities that we have in front of us given the market conditions but also take an external and objective view at some of the challenges we've been facing also, whether they're specific to Atlas or if affected everyone in commercial auto, the reality of it is, commercial auto is all we do.

And so, unlike bigger diversified insurance carriers, who may have maybe having similar challenges, we can't simply stop writing commercial auto because of course that's the thing that we focus on. But what we can do is figure out how we can best take advantage of what is a very favorable market condition and at the same time, eliminate exposure to these challenges that have been essentially plaguing us from the past. So, it will be a broad analysis. I don't think we will rule anything out, but the intent isn't a foregone conclusion. Again, we want to get the input and advice. And the company is supportive of it and as we've referenced it of course so is the board.

William Joseph Dezellem
Chief Investment Officer & President, Tieton Capital Management LLC

Q

And current accident year loss ratio in the fourth quarter was, what, 33.6%. Normally it's been running closer to 60%. Would you please discuss that particularly in light of the extra reserve strengthening?

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

So, the most recent accident years were actually determined to have been more favorable actually. And so, the full-year loss ratio for 2018 was identified or projected by our actuaries to be better than what we've been carrying it at. And so, the adjustment to that impacts, it's the full years' worth of dollar adjustment but it impacts just the quarter which is why it has a bigger effect on the loss ratio percentage for the quarter itself. On a full-year basis, it came down but more modestly.

I think the view though that we are going to take for 2019 is that while that's encouraging that we're seeing not only a better than expected loss ratio early on for 2018, but that we've seen the sequential improvements over the last three or four years. We are going to continue to carry a higher loss ratio than we've been targeting for 2019 until we see more development really prove that out. And unfortunately, well, that it's been a frustrating constraint that we've been having to work with. We don't want to be too optimistic until we see the more recent years continue to come in as expected.

William Joseph Dezellem
Chief Investment Officer & President, Tieton Capital Management LLC

Q

And so, to make sure I understand that correctly that this year you have been over reserving in the Q1, Q2 and Q3 for 2018 Q4 when that became obvious, there was a reversal that took place and that's why we see the low number for the current year, but then we still have the problems with the prior year.

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

Correct. And that is based on the selections and range provided by our outside actuaries. So, the current year wasn't – we didn't apply different judgment than was applied to the older years just to be clear. But yes, what you articulate is correct.

William Joseph Dezellem
Chief Investment Officer & President, Tieton Capital Management LLC

Q

And are you using the same actuary that you were last year?

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

No, we've retained a different actuarial group also based in Chicago. They have done a fair bit of work with us in the past to evaluate the impacts of our predictive analytics and claims in particular. This was the first year that we've hired them to do our reserving work.

William Joseph Dezellem
Chief Investment Officer & President, Tieton Capital Management LLC

Q

And then looking at the prior years, it seems as though 2015 continues to be a bit of a corporate year. Would you please talk about that year in terms of industry phenomenon and what you all maybe didn't do as well as you could have in that year?

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

So, that's a difficult question to answer in a way that will probably be very satisfying. I want to be careful that it doesn't sound like we're trying to hide behind what happened to the industry as being an excuse. But 2015 and 2016 were years that the industry, commercial auto industry saw the biggest development. And I think the thing that is probably true for the industry, but I know it's true in our case. We start to see the largest claims generally get paid later in the process. As we talked about, we've done things to proactively accelerate that.

But historically, claims that would have come in would get settled at those higher levels after a second or third year of being open. And so, if you look back to where the industry result was and where our result was in 2015, it looked very good. It had been good. The market was starting to harden. We were taking rate exceeding what had been lost trend. And so, all of those things suggested that the loss ratios we initially carried for [audio gap] (00:35:53) were appropriate. And as those 2015 accident year claims started to age, we started to see them be paid for higher amounts. And so, I think that 2015, half of that year the claims would have come in before our claim process change, half would have come in after. And so, it is a difficult year to kind of get right because we see half the claims sort of having been triaged and routed one way and half the other way. And it also happens to be the year that seems to have tripped up virtually everybody else. And again, I think, it had to do with that was when the market was turning, it looked as if the rate environment was getting better, coming off of some pretty good years in commercial auto, and that turned out not to be the case. So, we were getting the rate, but it wasn't actually exceeding what turned out to be the actual loss trend now that we've closed more and more of those claims.

William Joseph Dezellem
Chief Investment Officer & President, Tieton Capital Management LLC

Q

And apologies for continuing on with the questions here. But as you look at 2015 and the claims that were estimated under the old system versus under the new system since roughly half was done with each, what are you seeing different if anything between those two approaches for that year which granted had its issues?

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

Yeah. We filed reviewed claims that were too old to be modeled when we implemented the model. And we did that review at the end of last year. We have been tracking and reporting how those settlements have come in. These are the claims that had come in prior to the process change, but we're evaluated with more than a year's worth of information at the end of 2017, into the beginning of 2018. And so, we've now closed approximately 65% of those claims. There's about 400 to 420 left open. Those aren't all for 2015, but the majority are.

And so, those closures are coming in consistent with the midpoint of the range that our adjusters estimated when that file review was conducted. When we look at the claims from 2015 that were received later and therefore we're able to be modeled. With the exception of claims received in the second quarter of 2016 which was the transition quarter when we implemented the process change, we are seeing that in aggregate the predictive model based case reserves are holding up.

And so, the exception I cited for the second quarter, some of those claims are actually exceeding the total which I think is reasonable to attribute to the fact that it was a new process that was implemented in a single quarter and it took some time for it to have an effect. Every quarter after that consistently looks to be the case that the model is holding up. So, we have not done a side-by-side analysis to see if 2015 average severities for pre-model claims how they compare with the post-model claims. We have worked with Guidewire Predictive Analytics or the third-party we work with for – the machine-learning tools we use. And they do believe that the impact of the process change does appear to be at or even above the 3% to 5% overall impact on severity that we hope to have, but again that's all claims received prior to in-post, it's not specific to 2015.

William Joseph Dezellem
Chief Investment Officer & President, Tieton Capital Management LLC

Q

And changing topics, the TNC on-demand, would you please give us an update what you're seeing there from your trends and then just in general, how interested are the drivers in this product?

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

Sure. So, we did launch the pilot sort of a proof-of-concept in the fourth quarter. We saw a lot of download activity. We are testing a variety of different sort of marketing methods and turning them on and off to see what seems to be triggering demand and isolating it. From a conversion standpoint, we're seeing fewer drivers by policies than I would have expected, but we also are seeing more drivers actually download the app than I would have expected. So, I think it's premature to have enough information to confidently say this is what the market size could be. But I think the fact that the downloads are there demonstrates there's an interest. The challenge, of course, with our business is you have to have interest at a price. And so, that's the thing that we're trying to best understand.

It's important though to keep in mind that we are currently operating independent of any of the TNC companies. And from conversations we've had, we know that there would be an interest in figuring out an appropriate way to work together, if we are able to demonstrate that drivers are interested or recognize a need for primary insurance, which there is a real need and are willing to pay something, because today, the TNC companies are absorbing a significant amount of that expense. These amounts are now being highlighted in the various filings that the company's going public or making for example. And so, there is a real interest in figuring out a way to reduce that expense to the TNC companies. And if we can do it in a way that also benefits the drivers, whether it's from a marketing perspective or a subsidy perspective, we know that there is an opportunity to cultivate that business. So, we're very happy with how the technology is working.

I don't yet have a clear view as to exactly where price sort of price elasticity is or where supply meets demand, but that's what we're testing for. It's why we're running an isolated process in a relatively limited geography. And at the same time, we're having a lot of dialogue with Transportation Network companies and their other partners, leasing companies in particular and where we are seeing a very significant increase in demand for full-time commercial auto insurance because these vehicles are being leased predominantly to full-time drivers or at least more than 30-hour a week drivers.

And so, I think in the near-term, we're going to see more real opportunity in terms of dollars through programs like the one we wrote a couple of years ago in New York and the one we wrote late last year in conjunction with lift. So, again, we'll provide more guidance once we have a clearer view as to what our plans are going to be for 2019 and how much of that we intend to try to convert. But we do have a lot of activities going on in that space and, there is definitely an increasing awareness for the need for insurance.

William Joseph Dezellem
Chief Investment Officer & President, Tieton Capital Management LLC

Q

Thank you for taking all the questions.

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

Sure. No, I appreciate it, Bill. Thank you.

Operator: [Operator Instructions] Our next question comes from the line of Sam Hoffman with Lincoln Square Capital. Please proceed with your question.

Samuel Adam Hoffman
Portfolio Manager, Lincoln Square Capital Management LLC

Q

Scott, thanks for taking my question. I actually have a couple. The first one is, what is going to be the impact to the cost of reinsurance as a result of what's happened in the last couple years. And do you feel that the reinsurers agree with you 100% in terms of the impact of the changes that you've made with the predictive analytics or are they can only partially buy-in or be completely skeptical?

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

Well, I think it's going to be a blend between buy-in or middle of the ground. We, obviously, have had a lot of conversations with our existing reinsurers about the process and the process changes. They're seeing firsthand the data behind the graphs that we shared that are actually showing a change in trajectory post-process versus pre, but they also have the same observations I shared on the call, which is that while it's encouraging to see that the second year of data shows what we hoped, we still need to see years three and four before everybody is going to be 100% confident that it's working out the way we expect. And so, I think that we are going to get support from our current reinsurers. We will, of course, want them to have a first opportunity, as we're going to be increasing our use of reinsurance, which we most likely will. But we may also bring in other reinsurers both test to market and because it's not uncommon these insurance programs especially quota share programs get bigger to see multiple participants.

So, we are going to be expanding the scope of the dialogue. And so, it's harder – I can't predict what someone we haven't already talked to is going to think, but I think the information there is compelling. And post adjustment, the loss ratios that we are carrying are still within the acceptable ranges of our current reinsurance agreements. So, pushing us beyond what was anticipated when as far as range goes when those were written. So, I do think we'll get good support. And I think it's going to be harder to characterize exactly what someone we haven't worked with yet is going to think about the process change, but I do feel confident that we'll be able to show them what it's been doing already, and that those things are moving in the right direction.

So that said, the cost of commercial auto related reinsurance is going up generally because that's tracking with the overall industry result. And so, I don't know what the cost is going to be for incremental coverage. It'll depend how we structure it and how much we end up using. So that's all going to be part of the analysis that we referred to. And so, we'll provide that information as soon as we have it, but we have not gone through the discussions of the negotiations yet. So, generally speaking, there is still is a lot of capacity in the reinsurance space. And so, I would expect that writing business with the use of more reinsurance would still be accretive as opposed to not writing it, especially if there're areas that we identify is being most profitable, but other than kind of that general perspective I can't give you specifics on the cost, but will as soon as we have that information.

Samuel Adam Hoffman
Portfolio Manager, Lincoln Square Capital Management LLC

Q

Okay. Did you renew your reinsurance at the same terms and pricing on December 31st, and then the incremental reinsurance is what you're talking about may come on different terms on pricing?

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

So, we did renew our quota share arrangement with similar terms. It was a little bit more expensive by a few hundred basis points, a couple percentage points and we committed to a flat 30% use of quota share which at the time seemed to be what we would need. So, it's on that basis that we have the higher operating leverage that Paul referenced. So, again, we'll need to go back and revisit that in terms of either increasing [ph] 8% (00:48:15) with our existing partners or potentially bringing others in or some combination of both.

Samuel Adam Hoffman
Portfolio Manager, Lincoln Square Capital Management LLC

Q

Okay. Next question is, can you talk about to the extent possible, what could happen in terms of your discussions with the rating agencies?

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

Well, we will give them the same kind of information that we always have. They are considered insiders, and so we are able to give them a significant amount of detail about our plans and underlying data, even forecasts. And so, we want to maintain good rapport with them, we want them to be comfortable that what we're doing going forward makes sense and there's appropriate capital and reinsurance, et cetera in place. In terms of what would happen if they were to further downgrade the companies. We're currently at levels that aren't hitting any sort of thresholds that would enable us to write incremental business. We did not see a meaningful impact last year when the companies were downgraded in the amount or type of business that we were writing. So, I wouldn't anticipate a rating change if there was one would have any real impact on the go-forward business. But that said, we still want to maintain a good trajectory and believe that we have a positive story to tell in terms of making sure they understand that we think things have turned the corner and despite these broader challenges and the challenges we specifically been dealing with. The future underwriting result is going to be much better and more consistent with what's being seen in the more recent years, both internally and also from partners. So, don't think it will have a significant impact, still want to maintain a good dialogue. And we'll go from there.

Samuel Adam Hoffman
Portfolio Manager, Lincoln Square Capital Management LLC

Q

Okay. Next question is with regulators. As a result of this year's results, do you need to have additional discussions with the insurance departments of any state and what are the potential implications there?

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

So, we have confidentially advised the insurance regulators of the decision to strengthen reserves. And obviously, we filed our statutory statements so they're aware of what the financial result was. We've had a lot of dialogue with our domestic regulators to make sure they understand what we've been doing with analytics both in terms of our overall discussions with them and also in connection with some rate filings that we've made that's specifically tied to the use of analytics on the underwriting side. So, we think they're very up to speed in terms of what we're doing. And so, we'll continue that dialogue, but I don't see any significant impact on our business or business plans because of discussions with regulators.

Samuel Adam Hoffman

Portfolio Manager, Lincoln Square Capital Management LLC

Q

Okay. Next question is, you mentioned that the data that have been coming out and recent accident years have been favorable, [ph] every (00:51:41) three years one and two of the development, why was there adverse development in accident year 2017?

Scott D. Wollney

President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

So, there was a small amount but when you look at the actual post adjustment loss ratio, it's still very consistent with what we've been targeting. So, from that perspective, it's much better than what the industry result has been. And it would generate a return on capital that we would find attractive. And so, although there was a little bit of strengthening there, it wasn't meaningful in terms of the adjustment to the loss ratio which is kind of that comparison chart that we shared in the deck as well.

Samuel Adam Hoffman

Portfolio Manager, Lincoln Square Capital Management LLC

Q

Okay. And what gives you the confidence that years three and four and so on will produce the results that you need because aren't the case as to last the longest amount of time the ones that they're subject to much more variability in size?

Scott D. Wollney

President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

Sure. I mean, I think that's at the heart of what the challenge has been in terms of estimate as opposed to closure data, right, where the closure data that we are seeing are demonstrating the favorable trends that we're expecting. But it's the estimate on the [ph] unpaid (00:53:04) that's being most informed by the past. So, I mean, I think the best sort of visual representation of that is what we showed on slide 6 and 7 of the deck where the blue trajectory which shows the average severity of claims paid at those incremental claim ages. And so, those are the number of months the claims were opened before they closed.

Really shows you the trajectory that the business appears to be on and so provided that we do see years three and four for the orange line stay on the flatter curve that you see that is going to support our belief. And so, I think the confidence comes from the fact that that's what the process change was intended to do. And it's not that it was just one sort of magic bullet issue. We refer a lot to the predictive analytics and how we're using it and that is a critical tool to identifying these potentially large claims, but we also have a number of other things that our claims team are doing in terms of their own expertise and also working with other outside tools and vendors to make sure we can get appropriate but better outcomes, and especially in our business which does have a lot of sort of "tough claims" have the ability to manage leakage or fight fraud when necessary.

And so, the confidence really comes from the fact that we know we have a claims process that can produce better outcomes when it's deployed effectively. We believed that using analytics will help us do that. And I think this information confirms that that seems to be happening. And that's the piece that is still uncertain from an actuarial perspective. And really that's the biggest difference between what I believe the potential is and what's been kind of driving some of the challenges. But that said, and we try to be clear about this on the call, I mean there has been increased severity trend in commercial auto. And so, I don't think we've escaped it, I do think we're delivering better outcomes over the last couple of years than would have otherwise been the case if we hadn't done all of these other things or didn't have the focus we have. So that's really what gives me the confidence, but again we obviously strengthen reserves because that was what the actuarial estimate was, and that's the appropriate thing for us to do kind of given the constraints and the uncertainties in our business.

Samuel Adam Hoffman
Portfolio Manager, Lincoln Square Capital Management LLC

Q

Can you disclose the same that you've been disclosing each quarter on the closed claims that happened post whatever year you feel is appropriate and the reserve for that claim and how it differ? Can you do that for the fourth quarter whenever you issue your 10-K and then do it across the following quarters?

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

So, I don't know if we'd be putting out a specific disclosure about that in the K. We never have. I mean, obviously, the data that's always been in the K will be there on our next quarterly call. I'm certainly open to providing as much transparency as we can. I think one of the things we want to do is make sure that we can not only share the kind of information we had been sharing, but also think about other things we can do to help provide even more clarity, especially now that we are starting to see more incremental data for older settlements on those post-predictive model claims that a year ago these same charts that I just referenced on slides 6 and 7, the first years' worth of data just showed that we were paying more early. It didn't show that we were paying less down the road. And so, I think, are being able to share more of that kind of information also is going to be helpful.

Samuel Adam Hoffman
Portfolio Manager, Lincoln Square Capital Management LLC

Q

Okay. And I guess the last question is what is the cost to the company and to you guys of conducting the actuarial type of review at the end of the year in terms of time and in terms of money? And would it make sense to do something like that each quarter, because I mean from an industry standpoint it's kind of difficult to sort of obviously listen to the reports each quarter and all we have is the closed claims and how they compare with reserves versus a more detailed analysis? And as many people said, people you're going to say that each quarter where that was reported as subject to the year-end actuarial review. So, is there anything that you could do, is it worth it in terms of time and money to spend on doing something each quarter not only for investors but also so you could keep better track of how the business is developing?

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

Sure. Well, first and foremost, we always want to get it right, right. That is always the objectives, whether a quarterly review is going to help do that especially given the size of our business versus the cost and time is obviously something that will be exploring as part of this broader analysis, right. But, I think our perspective has always been having enough incremental data, so that you would feel confident that any difference that might be seen actuarially was credible is the only interval that makes sense because spending time to run incremental regressions on a relatively small amount of data were a few big claims or the absence of a few big claims to distort the outcome would probably not lead to any sort of credible reaction.

And so, it's important to make sure that there is enough additional information that whatever the news is good or bad that you'd be confident enough to something about it rather than dismiss it as it's distorted because it didn't have much incremental data in it. So, I mean that's why we've always had a year in process, which is common and it's why you see even really large companies generally do their deepest actuarial dive and generally have the most reserve adjustment up or down at year end. Because even for bigger companies, I think you have the same issue with the amount of incremental data and its credibility.

So, I'm certainly not dismissive of the idea that we should always look for more ways to test what we think against what is ultimately inform our results especially at year end. And I don't know that the answer is necessarily a quarterly review, but we want to make sure that we are doing everything we can do to get the most accurate results all the time. And so, obviously it's evaluating the process is going to be important not because I think it's wrong, but because we obviously want to make sure that we're on the phase of incremental volatility and the result we should revisit what we should be doing to make sure that we're identifying that and dealing with it as soon as possible, but also as soon as it's credible.

Samuel Adam Hoffman
Portfolio Manager, Lincoln Square Capital Management LLC

Q

So, I mean, you're saying that basically the way we should take the result of this year's review is that there really isn't that much incremental data except for the fact that commercial auto has deteriorated more and the actuarial firm decided to apply the regression analysis to interpret it in a way that they kind of assume years three and four are more consistent with the old years and the industry then they are with your newer years and so applying a quarterly would add even less incremental data so just want to be worth doing?

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

Well, no. I don't think it's that black and white. I think – what I'm trying to say is that doing a quarterly review would have less credibility than doing an annual review. And especially for the size of our business, having those incremental reviews may not actually inform different decision making because any result, good or bad, might not be considered very credible. And so, you might end up waiting for multiple cycles anyway. And again, I'm not ruling it in or out. I'm just saying that's one of the important considerations when you're thinking about this kind of work and it's why most companies do it once a year other than focusing in areas that really are highlight areas that seem to be jumping out as problematic or much better than expected.

So, as far as the work that they did at the end of this year, they had a year's worth of incremental data. And so, that was I think a sufficient amount of information that we felt was necessary important to react to. So, I was really focusing more on your question about whether a quarterly review made sense and it's less about time and money and more about is it going to inform different decision making, because if it's not then because of a potential concern about credibility then it's not worth it. If it is, then it could be.

Samuel Adam Hoffman
Portfolio Manager, Lincoln Square Capital Management LLC

Q

Well, it's just something to think about. And that was the end of my questions because I mean obviously if you end up taking the same type of loss next year then there won't be any book value left. And so, it's just a question of order of magnitude, other companies may not need to do it, but you're in a difficult industry and maybe something is worth doing. But I mean, I'll sort of leave it at that. And thanks again for taking my questions.

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

Sure. Of course. Appreciate it. Thank you.

Operator: [Operator Instructions] Our next question comes from the line of [ph] John Levin with Untamed Capital (01:03:43). Please proceed with your question. [ph] John Levin (01:03:53), your line is now live. Please ask your question.

Q

Yes. I'm just wondering if there is enough capital for the company to stay in business.

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

Well, so, I mean the short answer is yes. We do have sufficient capital from an operating ratio standpoint and from a regulatory perspective. As I mentioned, we are going to look at alternatives to use more reinsurance so that we could support growth if ultimately we conclude that the current environment and the historic results justify that, which I think offhand they do. An alternative in our business obviously is to also be even more selective and potentially shrink the size of your business so that the risk relative to capital is less volatile that way too. And so, really the way that we want to approach it is to say, let's focused on the things that have been most profitable we followed and do more of it in this favorable rate environment. Let's restrict the things that had been more volatile and more challenging, which we've historically done also and again I'd cite Michigan is an example of that.

Leverage the things that we have learned and have developed in term of analytics and other tools that we've been referencing, and do that with a partner whose balance sheet is bigger, who has more diversification, the way that reinsurers do, expect a lower return in exchange for that support than we think our margin is. And that's a very accretive way to grow despite the fact that we have a smaller balance sheet than we did before. And so, and I don't want to dismiss the amount of reduction in book value, because it obviously was significant, half of it, more than half was [ph] a lot went (01:05:52) up against intangibles which haven't disappeared, and that was a full allowance as Paul mentioned. So, we think that's appropriately conservative approach to take in terms of that aspect of the balance sheet, but clearly we need to look at how to appropriately utilize the capital we have and hopefully take advantage of what is a very attractive reinsurance market and also what we believe is an increasingly and attractive primary market from a competitive standpoint.

Q

So, I'm hearing you describe efforts to improve operating performance and underwriting outcomes. And I'm hearing you describe an effort to increase the, I guess, distribution side of the business. I'm wondering if the loss of so much permanent capital really doesn't prevent the company from continuing as an underwriter, as an effective underwriter without an extreme number of select properties. And are you going to be forced into a role purely a distributor in this business?

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

I'm sorry, I think we had a little trouble with the line. Could you repeat the...

Q

Sure. I...

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

Are you sure interacting, right, sorry about that.

Q

No, it would just seem that with the loss of so much permanent capital that the business is going to face a significant ratings action or is going to be facing a recognition that it is not a strongly rated underwriter. And therefore, might be subject to some amount of adverse selection so that the business that you are able to write is not the business that anyone else will want to write. So I'm really asking if, if you're not being forced into a situation where you can really at this point operate only as a distributor.

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

Yes. I don't think [Technical Difficulty] (01:08:22-01:08:35) constructive dialogue with A.M. Best and A rating makes sense, but it's not because having a higher ratings somehow qualifies us for categories of our niche that are more or less attractive. Most of our customers, 75% are owner operators [Technical Difficulty] (01:08:57) competing with small [Technical Difficulty] (01:09:00) standard companies that don't have ratings at all. So, I don't think it's a reasonable conclusion to assume that a further ratings downgrade would impair the quality of business we have access to. But I think it is reasonable to ask the question about how do we take advantage of the value of our distribution and of the current rate environment when we do have a more limited capital base. And that was really the question I was trying to answer the first time around.

And I do think there are a variety of ways to do that and that's what we're going to be exploring. And candidly, I think, well, two things, it's very important to know, we've always maintained the view that we're never going to put top line growth ahead of margin. You've seen that in all of our rate activity. We've always increased rate ahead of ISO every single quarter going all the way back to 2011 when we started the company. And we've done that even in scenarios where it's caused us to shrink before the market continue to harden and allowed us to grow again.

So, I think we've demonstrated that we have a discipline to be bottom line focused versus top line underwriters. And so, we would never pursue a strategy that puts growth ahead of margin but to the extent that we can grow with current or expanding margins in terms of the more recent accident years, but do so with a partnership with somebody who's cost of capital is lower than we are or is willing to charge less than our cost of capital would be. That's a smart thing to do in the current competitive market environment.

And the reality of it is, distribution has value in and of itself. Distribution with underwriting and claims capability is value generally well above what most primary insurance carriers are getting valued at today. So that isn't the reason why that's interesting, but I think it is important to recognize that there is value in all of the things we're doing including our ability to distribute underwrite, maintain systems, manage the better claims outside, et cetera. So, what we want to make sure is that we are creating shareholder value over time leveraging all of those things not just focusing on the traditional view of owning a statutory underwriting company even though we obviously own four.

Q

Okay. And then finally, would you consider a rights offering at this point?

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

So, I think it would be premature for me to make any comment on that, because one it would be a board decision and I think the board is going to want to be informed by the analysis that we've already talked about. But like I said before, our view is, we wouldn't rule anything out if it made sense from a shareholder value perspective and enables us to leverage all of the things that I just talked about.

Q

Okay. Thank you.

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

A

Richard, questions?

Operator: [Operator Instructions] Ladies and gentlemen, we have reached the end of the question-and-answer session, and I would like to turn the call back to management for closing remarks.

Scott D. Wollney
President, Chief Executive Officer & Director, Atlas Financial Holdings, Inc.

Well, thank you very much, everyone. Again, if there are any additional questions, feel free to reach out to Paul and myself. I look forward to seeing those of you who are attending AIFA Conference this week and we'll also be participating at the upcoming CFA Insurance Conference in New York as well. So, thanks again for your time, and we appreciate your support.

Operator: This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.