2013 Third Quarter Conference Call
November 5, 2013
8:30 AM ET

Operator: Greetings and welcome to the Atlas Financial Holdings, Inc. Third Quarter 2013 Earnings Call.

At this time all participants are in a listen-only mode.

A brief question-and-answer session will follow the formal presentation.

If anyone should require operator assistance during the conference, please press star-zero on your telephone keypad.

As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Scott Wollney, Chief Executive Officer for Atlas Financial.

Thank you, Mr. Wollney. You may begin.

Mr. Scott Wollney: Thank you very much, Kevin, and good morning, everyone.

With me today is Paul Romano, our Vice President and CFO.

On this morning's call, I'll provide an update of our operating results and market environment, Paul will then review our financials, and then I'll return with a few concluding remarks. We'll then open it up for Q&A.

Before I begin, I'll turn it over to Paul.

Mr. Paul Romano: Thank you, Scott, and good morning everyone.

Yesterday after market close Atlas issued its 2013 third quarter financial results. Copies of the press release are available at the Investor Relation section at the company's website at www.atlas-fin.com.

We will be utilizing a slide show presentation in conjunction with this call. This presentation is available on our website's Investor Relations section, and then under the Earnings Release Info selection. We welcome each of you to review this presentation and follow along.

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 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 the 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 10K for the year ended December 31st, 2012.

No forward-looking statement can be guaranteed. Except as required by applicable security 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 publically 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 in this call are in U.S. dollars unless otherwise indicated.

With that, I'd now like to turn the call back over to Scott.

Mr. Scott Wollney: Thanks, Paul.

Atlas reported strong third quarter operating and financial results. We achieved continued and accelerating gains in underwriting profit, lowered our combined ratio for the fourth straight quarter and we reported sizeable increases in gross premiums written and net premiums earned taking advantage of improving market conditions. We achieved all of this through well managed vertical expansion throughout our geographic base, which was established over the past two years and is presented on Slide 3 of the presentation Paul referenced.

Before we go any further, I'd like to begin by thanking each of Atlas' employees across the country. The ability and effort of each of these individuals is the basis for our success. We are hyper focused on the light commercial auto insurance market and feel confident that we have the right people and business partners in place to continue our momentum.

Let me touch on some of our basic financial and operating results from the quarter as summarized on Slide 4 of our presentation. Gross written premium increased 37.3 percent with 40.2 percent improvement in our core commercial auto lines. It's important to note that in the third quarter we renewed our New York excess taxi program. This is the business arrangement providing excess coverage above the levels of risk retained by the insurers. Due to the selective nature of accounts eligible to participate in this program, we do not expect large increases or decreases in premium year-over-year. When you remove excess taxi from our gross written premiums, Atlas' increase was 89.7 percent in the third quarter.

While we continue to increase our premiums written, our commitment remains to expand underwriting profit and maximize ROE. It's the principal focus of everyone in the organization. Our agent compensation and benefit plans are linked directly to ROE and our ability to achieve an underwriting profit.

On the next two slides of our presentation, we displayed consistent positive trends in these two areas. Atlas improved each of its operating ratios, reporting a combined ratio of 93.9 percent for the quarter. This marks the fourth consecutive quarter of positive year-over-year combined ratio trending, as illustrated on Slide 5, resulting in an $832,000 improvement in underwriting results over the prior quarter as seen on Slide 6. Steadily increasing our operating margins while simultaneously increasing net written premium to surplus, which creates operating leverage, will maximize ROE.

Moving to Slide 7, we continue to see positive trends from each of our core lines of business, which consist of specialty insurance products for users of light commercial vehicles, specifically taxi cab, limousine and paratransit operators. If you were to break out our core lines of business by premiums written, taxi insurance is the largest portion representing more than half of our business as of the end of the third quarter, with paratransit representing approximately 25 percent and limousine making up the remainder. At this point in the market cycle the taxi line supports the highest level of underwriting profit, while we've seen marginally greater price competition continuing in the limo line.

We're licensed to write in 49 states and have made strides since originally becoming a public company to further diversify our geographic book of business based on strategic parameters, which we've discussed previously.

In the third quarter, excluding our excess taxi business in New York, no state represented more than 9 percent of our total gross premiums written. Our distribution channel is key to this expansion effort. We work only with independent agents who are dedicated to our niche markets and public auto is their priority, as it is ours. Our job as an insurance carrier is to foster and strengthen these relationships over time, cultivating a best-in-class supply chain as it is important to our business as it is to other successful companies.

The longstanding relationships we have with our agents is one of our best barriers to entry over competitors. We work closely with our agents and respect their industry focus because we share the same commitment to our collective customers. We do not distribute through wholesalers, managing general agents or other intermediaries who are disconnected from the point of sale. This close contact with our agents and policy holders is critical to the effective underwriting as well as understanding exposures and loss reserving. Atlas' independent agents know their customers, understand our value proposition, know how to sell it and are as committed to our specialty niche as we are.

As I have noted many times in our conference calls and in meetings, our agents wrote nearly $150 million in commercial auto business through our three subsidiaries only a few years ago. This premium level was achieved predominantly in five states.

The agents transitioned business away during the years where our current subsidiary struggled prior to Atlas' ownership but retained their customer relationships. Our entire company has played a critical role in reenergizing these channels and have worked hard to bring that business back. We feel that with these relationships back on track and with a much larger geographic footprint there is significant room for further growth in our core lines.

The positive effect of progress in the area of business development can be seen in the increasing volume of opportunities to core business and our approximate 85 percent renewal retention ratio, as graphed on Slide 8, as well as our target level hit ratio and growing volume of applications from both new and existing agents, as graphed on Slide 9. This data shows a strong indication of demand for our products. It's also critical to our properly evaluating whether we're pricing our policies effectively in the current marketplace.

With that, let me address a few of the trends we're seeing in the commercial auto pricing within our specific sector. As many have noticed over the past few quarters, commercial P&C has seen stable and steady increases throughout 2013. There are some lines of business where this appears to have flattened in Q3 as compared to Q2. But at this point we've not seen that through our agency network. Rates have been going up at increasingly marginal levels for the past two years and we don't see any deceleration.

Our clients are predominantly taxi cab, paratransit and limo operators with small to medium account sizes and relatively low limits, which tend to be less volatile than larger accounts, as noted in the next two slides.

What's most important for us is the strong rate at which our policies are renewing, coupled with the opportunity to buy new business with incremental rate. Our agents are faring well in the current marketplace and requests from potential new agents are the highest we've seen since the Atlas' inception.

We don't see any significant factors altering our pricing strategy for the remainder for 2013. It's also worth noting that Atlas is not materially exposed to catastrophic risk, which eliminates potential volatility in that regard.

Our customers can crash a lot but typically with relatively low severity. As a result of our history, Atlas has a significant amount of data from which to draw and we feel that we can effectively price our exposure with a high degree of confidence.

As we've noted before, in our particular industry a number of competitors, primarily those who are distributing products through managing general agents or wholesalers, have exited the market as we begin to transition towards hardening.

Others are having struggles in their larger market segments resulting in distraction from our specialty niche. While this may not directly affect Atlas in the short-term, we feel this should have a general positive impact both on pricing as well as our growth rate as the market continues to transition.

Slide 12 provides commercial auto rate change data going back to the middle of the last hard market cycle. As can be seen on this chart, market cycles tend to last three to five years. We're only beginning to enter a hard market and we'll see quarter-to-quarter fits and spurts as rate activity takes hold. Market cycles changes are fundamentally economic, but also have a psychological element. Increased price levels are generally tested and may pull back prior to continuing. The red arrow helps put into perspective the preponderance of very large rate increases seen in the last hard market, which are only just beginning to emerge in the current transitional market environment.

With that, I'll turn the call over to Paul for a review of our financial results.

Mr. Paul Romano: Thanks, Scott.

I'll briefly go through the quarterly highlights. I'll welcome each of you to review our press release and filings should you have any further questions.

As shown on Slide 14 of the presentation, Atlas' gross premium written increased 37.3 percent to $32.1 million in the third quarter of 2013 with a 40.2 percent increase from our core commercial auto lines.

Of the $8.7 million improvement in total gross premium written, approximately $2.8 million is attributable to the Gateway acquisition that occurred in January of this year. The remaining improvement is attributable to Atlas' vertical expansion of core lines of business in several key states.

Our net premium written increased 39.5 percent to $29.8 million during the third quarter, which is all related to Atlas' specialty commercial auto lines. Our net premium earned--our net premiums earned ratably over the term of their policies, which are generally 12 months in lengths. For the three month period ended September 30th, 2013, net premiums earned increased 64.4 percent to $18 million.

Let me take a moment now to summarize our operating results for the quarter. For the third quarter 2013, Atlas' loss ratio was 63.4 percent compared to 65.5 percent in the prior year period and 64.6 percent in the second quarter of 2013.

As Scott briefly mentioned, our insured's can crash a lot and our ability to handle this higher frequency of claims is one of the primary drivers of our value proposition.

For example, there is real economic value for an owner of a medallion taxi cab to get that vehicle back on the road more quickly. We believe that this focus on claims management coupled with pricing targets in our commercial lines will allow continued loss improvement during the remainder of 2013.

Acquisition costs were $2.9 million in the third quarter 2013 or 15.9 percent of net premiums earned as compared to 16.6 percent in the prior year period. Acquisition costs will vary quarter-to-quarter primarily due to state premium tax rates and business mix. Year-to-date our acquisition costs were 14.5 percent.

The ratio for other underwriting expense, or OUE, was 14.6 percent in the third--in three month period ended September 30th, 2013, an improvement over 17.3 percent reported in the second quarter, as well as an improvement over the 15.5 percent reported in the same quarter last year.

As previously communicated, we anticipate the OUE ratio to continue trending in the right direction. Some of the quarter-over-quarter improvement was expected--was the expected reduction in Gateway related integration costs, which contributed approximately 1.5 percentage points to the OUE ratio.

We also continue to see progress being made each quarter as we are beginning to reach our minimum efficient scale of an annualized 50 to $60 million in net premiums earned with our year-to-date net premiums earned at $50.8 million. As a result of these improvements, the Company’s combined ratio for the third quarter 2013 was 93.9 percent compared to 97.6 percent in the prior year quarter and 95 percent in the second quarter of 2013.

Net income for the quarter ended September 30th, 2013, was $1.69 million, a slight increase compared to the net income of $1.66 million in the prior year period. In the prior year quarter, the Company reported a realized gain of approximately $779,000 compared to the $33,000 in this quarter. The quarter-over-quarter income, excluding the impact of preferred share redemption, which I will explain in a moment, does appear relatively flat at $0.18 for the third quarter of 2013, as compared to $0.17 generated in the prior year quarter.

Our underwriting profit actually increased to $832,000 or 315 percent over the prior year period. We redeemed and cancelled 18 million preferred shares at a $1.8 million discount in the quarter. The accounting guidance essentially calls for us to account for the $1.8 million discount as a dividend received from our shareholders. A dividend paid would ordinarily be recorded in retained earnings. However, since our retained earnings currently is in a deficit position, we have increased our paid in capital accounts for this discount. Furthermore, the accounting guidance calls for the discount to be added to the current period earnings to compute earnings per share. The impact of this discount increases our earnings per diluted share in the third quarter by $0.21. Including this amount in our earnings per diluted share was $0.39 in the third quarter of 2013.

On Slide 15, we highlight some of the particulars surrounding our current book value per share. We thought it might be helpful for investors to understand the impact of our IPO, the acquisition of Gateway, preferred share redemption, and what these and the other key elements had on our book value. As you can see, year-to-date these non-recurring events, which were beneficially to our business and capital structure, coupled with mark-to-market impacts, collectively reduced book value by $0.52 per share. During the same period net income increased book value by $0.47 per share.

It is also worth noting, as previously discussed via press release, Atlas' deferred tax assets were recast based on a triggering event as defined under IRS code, Section 382. As a result, Atlas' gross and net deferred tax assets were reduced by 1.7 million and 587,000 respectively. This triggering event did not affect book value based on the previous allowance held against these assets. Of the $1.86 per share in post triggering event DTA's an allowance of a $1.23 per share was held as of September 30th, 2013.

Now, let me touch quickly on investments. As shown on Slide 16 of our presentation, Atlas' cash and invested assets at September 30th, 2013, were $140.1 million as compared to $120.8 million at December 31st, 2012. Investment income including $33,000 of realized gains was 603,000 in the quarter, which represented an annualized yield of 1.7 percent.

Based on the size of our portfolio relative to common equity, investment leverage benefiting shareholders was 2.5 times. The duration of our investment portfolio matches the expected liquidity requirements for our client payment needs. Our current duration is 3.9 years and fixed income securities with an S&P rating of A or better represent 89 percent of our investment holdings. The average rating of our portfolio is AA.

Our investment philosophy is centered around preserving statutory capital to support our continuing above average growth rate. We feel investors should evaluate Atlas on our ability to achieve underwriting success and want to ensure that our capital can be fully deployed into the improving insurance market environment.

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

Mr. Scott Wollney: Thanks, Paul.

In summary, we're very pleased with the direction of Atlas and our subsidiaries, particularly the increase in operating profit from approximately $0.10 per share last quarter to $0.18 per share this quarter. We remain committed to continue winning back our agents trust and their business and appreciate the success and support we've enjoyed thus far. Further, we feel that given the history of our companies coupled with the $1.5 billion addressable market on which we focus there's considerable remaining upside.

As discussed on this call and illustrated in our slide deck, opportunities are increasing as the market transitions and we leverage our expanded geographic footprint. Our team will remain disciplined in terms of the Company's expense ratio, while ensuring that we staff to appropriate levels to maximize the benefit from this market cycle. Based on the extensive experience and expertise within our current staff, we're focusing hiring at the entry level and mandate a promote-from-within culture.

It's not easy to do what Atlas does well in a specialized market like ours. It requires strict underwriting, efficient and value creating claims handling and considerable expertise and focus from a dedicated network of agents.

As a niche insurer in a market where our value proposition results in a significant economic benefit to our customers, we feel that they are more inclined to insure their cabs, paratransit vehicles and limos with Atlas at above average rates rather than with a generalist competitor. Further, we believe that the quality of our team and their ability to utilize the large pool of accident and driver data we possess enables us to properly gauge loss trends in our business more effectively than others.

Commercial auto can be highly competitive. However, as a result of these advantages we feel Atlas is well-positioned to achieve a proportionate 20 percent market share in our $1.5 billion niche segment at above average levels of underwriting profit.

With that, let's open it up for questions.

Operator: Thank you.

We'll now be conducting a question-and-answer session.

If you'd like to ask a question, please press star-one on your telephone keypad.

A confirmation tone will indicate your line is in the question queue.

You may press star-two if you'd like to remove your question from the queue.

For participants using speaker equipment it may be necessary to pick up your handset before pressing those star keys.

Once again if you have a question today, please press star-one on your telephone keypad.

Our first question is coming from Paul Newsome from Sandler O'Neill.

Please proceed with your question.

Mr. Paul Newsome: Uh, good morning.

Um, maybe we could just start off, uh, with a little bit more on the competitive environment. Um, I'm particularly curious if there's been a fall out from the problems the Tower has had in New York.

Mr. Scott Wollney: Sure. I appreciate the question.

I mean, I'd like to stay away from talking about specific competitors, but what I can confirm, um, is that over the last 12 months we've seen a number of large generalists, primarily companies who are distributing through MGAs pulling out of the market.

While we know that they have terminated those programs, um, we have not yet seen the significant amount of non-renewals that are expected as a result of those terminations and that is typical because many MGA programs will have a 12 or even 18-month termination provision.

Um, in terms of other more recent competitive activities, um, we have definitely seen some of the companies that we've talked about being larger national competitors, um, either make strategic changes, you know, and/or face other distractions that are creating what I would best describe I think as tailwinds for us.

Um, so we definitely feel very good about the competitive environment, um, you know, again not just because of the issue, Paul, that you raised but a number of other issues as well. Um, but, you know, we are definitely anticipating acceleration in terms of opportunities to write business based on what we're seeing particularly in the last quarter or so.

Mr. Paul Newsome: Perfect. Uh, and then more of a numbers question. Um, you know, my--if I recall correctly, um, as you increase your earnings for--over the course of the year, uh, eventually you'll kick to a level that, uh, you start paying taxes. Um, is that still the case, and, uh, are we getting to the point where we would expect some tax payments in fourth quarter?

Mr. Paul Romano: Yeah, our current philosophy, and it's been in place for the last couple--uh, for the last few years, has been to offset our tax expense on our statement of operations with an offset to our valuation allowance. Uh, we're going to continue that process. Um, we will be evaluating, as we have, quarter-to-quarter. We will be evaluating our allowance as we move forward. Um, but right now, we've not made any decision whether or not to actually take those allowance--uh, those NOL allowances down on the balance sheet.

Mr. Scott Wollney: All right, so from an income perspective, as long as we're carrying that large allowance, we shouldn't be booking tax on the income statement itself. We will pay cash tax--.

Mr. Paul Newsome: --Um-hmm--.

Mr. Scott Wollney: --Above the annual maximum amount we can use every year as defined by 382, um, which is around $2.6 million, um, but, uh, you know, until we write down the allowance and essential write up book value, we'll be able to continue to treat the net income the way that Paul is describing. Um, but in any a case we'll have that 2.6 million of tax free income going forward either on a cash basis or on a cash and income basis in the case where the DTAs are written up.

Mr. Paul Newsome: And from a reporting perspective are you going to--I mean does that essentially mean you will not have, uh, reported taxes in the fourth quarter?

Mr. Paul Romano: Um--.

Mr. Paul Newsome: --My understanding was there was a threshold by which you would start incurring at least on a reported basis.

Mr. Paul Romano: Well, to the to the extent that we have the allowance still up on the balance sheet against the NOLs, we will continue to take the process that we've been doing, um, offsetting tax expense with an offsetting, uh, decrease in the allowance.

Uh, we do have $1.23 still up on the balance sheet in terms of the allowance against those NOLs. So, to the extent that we have that allowance up on the books, um, we will continue this process of writing down the allowance to the extent that we have tax expense.

Mr. Paul Newsome: Okay, you just repeated what you said before and didn't answer my question. I'll just take it offline because before you told me that when you get one point--uh, I think it was 13 million of earnings you start incurring taxes under a particular tax rule at least on a reported basis, although that does affect your DTA. I understand the DTA wouldn't change, but apparently this is a change in how you're reporting. It's fine from a cash flow. I understand that. But, if this is a change in how you report it that's fine also. I just want to know if it is or not so that in the fourth quarter, which I fully expect you to reach a level of earnings and not putting an effective tax amount in there because of previous guidance.

Mr. Scott Wollney: Yeah. We'll go--.

Mr. Paul Newsome: --I'll take it offline if that's fine. But, it is important--.

Mr. Scott Wollney: --Absolutely--.

Mr. Paul Newsome: --Because you're going to miss fourth quarter earnings if you--for reasons that are just purely accounting, um, if that isn't made clear.

Mr. Scott Wollney: Yeah, we can talk to the details offline, Paul. The balance really is the allowance against the DTAs versus the impact on the actual reported earnings every quarter. And so, what happens with the allowance impacts what will happen in terms of the taxable earnings, um, but we can--let's walk through in detail offline because we can certainly make it clear.

Mr. Paul Newsome: Great. Thank you. A great quarter.

Mr. Scott Wollney: Thanks, Paul.

Mr. Paul Romano: Thank you.

Operator: Thank you.

Our next question today is coming from Matthew Berry from Lane Five Capital. Please proceed with your question.

Mr. Matthew Berry: Hello, gentlemen.

Mr. Scott Wollney: Hi, Matthew. How are you?

Mr. Paul Romano: Hi, Matthew.

Mr. Matthew Berry: Very well. Thanks.

Um, I actually have three questions if I can be that greedy. Um, the first is, uh, what is the timing in the quarter of the, uh, excess program and how much of that, uh, was earned in? I know you--the gross written premium is, um, 12.6 million, but, uh, how much of that is actually earned in in the quarter?

Mr. Paul Romano: So, the 12.6 was actually renewed on July 1st. So, we would actually earn in, you know, one fourth of that $12.8 million in the quarter.

Mr. Matthew Berry: Thank you.

Um, then the second question is, um, you spoke--uh, I noticed the quarter-over-quarter, um, tick up in the acquisition ratio, and you spoke about mix and state effects, um, and that some of this may be related to the excess program [unintelligible] such a big change of mix in the quarter. But, could you just, um, you know, to help us understand a little bit what's going on underneath could you talk about the mix and state affects in the quarter and how that impacted the acquisition ratio?

Mr. Paul Romano: Sure. It really comes down to the state premium tax. So, state premium taxes range from about half a percent of written premiums to as much as 2 percent, um, where New York is actually one of the highest, uh, levels of premium tax, um, uh, it's even higher than two. Um, and so because in the third quarter we have a significant amount of premium written in New York, um, that higher state premium tax has a bigger impact on the acquisition cost than it would in any other quarter.

Um, it's important to know too that the premium tax is based on the written premium, not the earned premium. And so, when you see a business makeshift from a written premium perspective that's where the acquisition costs are really going to be impacted. Um, so that really is the only thing that caused the acquisition costs to be higher, the actual commission rates that we pay the agents, um, including on the excess taxi program are all very similar.

Mr. Matthew Berry: Okay, that's good to know.

Um, and then my last question is just around, uh, the yields on the investment portfolio. Um, I understand that--uh, that you wish to be sort of evaluated on your underwriting--um, underwriting skill. And so, I don't want to press this too hard, but the yields on--um, on the portfolio certainly on an annualized basis look, um, low relative to, you know, market yields and relative to some other P&C, um, companies that I can name.

So, I was wondering if you could talk about the impact of fees, um, you know, as a sort of percentage reduction in that yield and anything else that I need to be thinking about.

Mr. Paul Romano: Yeah, really--fees weren't really the driver there. It's really a function of the fact that, you know, we have elected not to take risk in the portfolio. And so, 99 percent of what we have, um, are all fixed income relatively short, which obviously in the current interest rates environment does not generate a significant annual yield, but the thought process is as we continue to grow and continue to lever up our surplus, um, you know, which we did illustrate the trend in net written premium to statutory surplus in the deck, um, what we want to make sure is that we are retaining that surplus to deploy into the business knowing that we're going into a hardening environment and wanting to really maximize the return on the underwriting on those dollars. Um, we wouldn't want to invest at this point in equities or other investments that could potentially in the short run cause us to lose surplus or even in the longer run, um, because that would then prevent us from writing more business at exactly the right time to write.

So, we are being intentionally conservative in terms of the portfolio [unintelligible] other P&C companies that may have a flatter growth rate. You know, companies in a more mature point in their lifecycle, um, might elect to put more of that surplus at risk in exchange for a higher yield or a higher return on their portfolio, um, but we feel like that would be a bad trade off essentially because we think the best investment for our capital is our own business going into this hard market cycle.

Mr. Matthew Berry: Okay, that makes sense.

And then, what is the impact of fees, um, maybe as a percentage impact on the yield? Are you able to kind of [unintelligible]--?

Mr. Scott Wollney: --The management of--um, the investment manager charges a very low amount. I can let you know offline. You know, our contract with them is confidential, but, um, it's a very small number of bips.

Um, so it really isn't a situation where fees went up and that caused the yield to come down. It really was what Paul pointed out in his part of the presentation, which was, you know, we just didn't have any capital gains in the third quarter. You know, our capital gains were $33,000 compared with, you know, more like $700,000 in the prior period.

Um, and so it was really just the absence of capital gains because, you know, in some of the prior periods we had liquidated assets to generate the cash to buy Gateway, or having bought Gateway we reallocated some assets across the statutory pool, which created some gains. Um, and so taking capital gains isn't a normal strategic part of our business plan. It's something we might do from time to time opportunistically if there's a specific reason, um, but it isn't the sort of thing that we look for opportunities to take gains every quarter. In fact, typically, what we intend to do is to hold everything we own to maturity, provided that, you know, the basis for the original investment in a particular security holds sound.

Mr. Matthew Berry: Okay, thanks, Scott, uh, and thanks, Paul. Thank you very much.

Mr. Paul Romano: Uh, sure--.

Mr. Scott Wollney: --You bet--.

Mr. Paul Romano: --Thanks [unintelligible].

Operator: Thank you.

Our next question today is coming from Brian Hollenden from Sidoti.

Please proceed with your question.

Mr. Brian Hollenden: Good morning, guys. Thanks for taking my call.

Mr. Scott Wollney: Of course, Brian.

Mr. Paul Romano: Hey, Brian.

Mr. Brian Hollenden: When you look out over the next 12 months based on what you see in the market, how low can your combined ratio go?

Mr. Scott Wollney: Well, I guess the--if you want to look at absolute opportunity or potential, and this is not intended to be guidance, um, when we saw the market transition from soft to hard last time around, looking at American country and American services results, the loss ratio went from about 70 percent fully developed down to the low 50s. Um, we're currently pricing to a 60, um, having again come down from the--you know, the sort of 70, 71 range in the most recent soft market.

Um, so while that swing from 70 down to 52, uh, which is 18 percentage points on the combined ratio, you know, is a big swing, and the last hard market was a very hard market, um, that probably gives you the sense for how much potential there is in terms of the elasticity of our niche to the overall hardening property casualty market. But, again, I want to be clear, you know, we right now are pricing to a 60. As the market, or presuming the market continues to harden, we will be opportunistic and improve our pricing targets, uh, even further.

Um, but, you know, hopefully that gives you a sense for potential. But, again, I want to be clear, I'm certainly not suggesting that that's where we are going to go, um, because to a great extent that will be a function of the market, you know, in terms of how much it hardens and, you know, how long it remains hard.

But, um, our focus is definitely to take advantage of the market cycle and what we--you know, we can be informed by prior market cycles, um, but each one is obviously different. But, you know, right now, we're carrying about a 64 percent loss ratio. We're pricing to a 60. And, you know, as we go forward, we'll continue to take advantage of the market opportunity to generate and increase the margin. So, that's on the loss ratio side.

On the expense ratio side, we're obviously approaching that 10 to 12 percent target range that we mentioned, um, you know, about a point and half of the third quarter OUE ratio related to integration costs, um, for Gateway. Um, as we've mentioned before at the end of this year we don't expect those to continue, um, as we fully integrate the operations, you know, in terms of consolidating expenses. You know, we are going to continue to maintain a Saint Louis operation, um, but we feel like we've created a platform that will be efficient going forward.

Um, so there's a couple of points left on the expense ratio in terms of opportunity from scale, um, but really it's going to be the loss ratio that drives, you know, increased improvement in the combined ratio going into the hard market cycle.

Mr. Brian Hollenden: Thanks. Appreciate the--uh, the color.

One final question, um, when do you expect to pay back the eight million in notes payable?

Mr. Scott Wollney: So, those all relate to the buyback of the--or the, um--the, uh, convertible preferred shares from Kingsway. And so, the agreement there is that as the outstanding warrants that exist, which expire on December 31st of this year, are exercised, the money from those exercises will be used to pay down the note. Um, if fully exercised the cash that will come in as a result of the warrant exercises will allow us to fully pay down the note by the end of this year.

Um, those warrants are stricken in Canadian Dollars and we've hedged that FX exposure. And so, we feel very comfortable that, you know, we will be able to pay down the note by the end of the year based on the warrant exercises.

Mr. Brian Hollenden: All right, thank you. Great quarter, guys.

Mr. Scott Wollney: Great. Thanks very much, Brian--.

Mr. Paul Romano: --Thank you.

Operator: Thank you.

As a reminder, if you'd like to be placed in the question queue please press star-one on your telephone keypad.

If you are on a speakerphone it may be necessary to pick up your handset before pressing those star keys.

Our next question today is coming from Gregory Macosko from Montrose Advisors.

Please proceed with your question.

Mr. Gregory Macosko: Yes, uh, thank you.

Uh, two questions. Just--uh, just going back to the--you know, the goal with regard to the, uh, combined ratio does the--you know, your discussion of the 50 to 60 million net premium earned kind of is a goal, I guess. Does that affect, uh--will that have any affect on the combined ratio--um, you know, your combined ratio goal?

Mr. Scott Wollney: It will in the sense that we--when we first created Atlas and began acquiring the companies we own, we consolidated into an infrastructure and wanted to retain the expertise and really the people that had 15, 20 years of experience in this specialty niche, which is, you know, a lot of what allows us to create the value we talk about to our customers. And so, having done that, we had a bigger company in terms of headcount infrastructure, um, than you would need in a steady state to write less than 50 million or $60 million of earned premium. And so, um, that was a conscious decision. We were very clear and I think communicative about that, you know, early on, you know, with investors and other stakeholders. Um, but now we are approaching that minimum efficient scale.

So, as Paul mentioned, at this point year-to-date we've generated 50 million in earned premium. And so, we're just getting into that minimum efficient scale range of 50 million to 60 million that we've communicated consistently. So, as we get up into that range what will happen is we will see our other underwriting expense ratio come down. So, it's at about 14 now, 14.5 or so. Um, we'll see that come down by a couple of points, um, just because of the elimination of the Gateway integration costs, but then we'll also see it come down by another couple of points because of our reaching that efficient scale.

Now, we are at this point beginning to hire moderately, um, primarily on the business development and the underwriting side of the house, kind of the tip of the sword, because we are seeing application volumes pick up, opportunities to write business pick up as the market continues to improve and the impact of all the things that we've done over the last two years really take hold.

So, you know, there's going to be a little bit of a balance where scale will lever down operating expense. We will invest modestly to continue to make sure that we're well-positioned to take advantage of the market, um, but that should balance out probably at the top end of that 10 to 12 percent range we've talked about.

So, the short answer to your question is scale will impact the combined ratio by levering down the other underwriting expense ratio by, let's say, a percent to 2 percent from scale alone. Um, really where we're going to see continued increases in margin beyond that is going to be the impact of pricing action, um, and the improving the market environment where we can drive the loss ratio down.

Mr. Gregory Macosko: Okay, good.

And then, the second question, you mentioned, uh, agents and, you know, your agents are pleased. You're happy with that. And you said you had more agents applying. Uh, how are you going to manage that and what's kind of the goal there?

Mr. Scott Wollney: So, our goal has always been to have two to five, what we call, cornerstone agents in every major metropolitan area where we write. Um, we believe we have that. At this point, we've got about 280 agents across the country. Um, these are all small, uh, relative to, you know, a Marsh McLennan, for example. You know, these are all independently owned and operated agencies that focus on public automobile insurance, particularly taxi and paratransit. Um, that's who we're interested in working with.

So, we are not interested in further diversifying the type of agents we work with. Um, we want to make sure we have efficient distribution. That's the primary goal. Um, we don't want to over-saturate any given market where we're taking opportunities away from a given committed agent, um, but we will look at agents who approach us. Um, we're typically appointing about one out of 10 that go through the process, um, and we won't appoint an agent without doing background checks, reviewing their business plans, physically visiting their offices wherever they're located and really making sure that they are going to be additive to our channel as a long-term partner as opposed to just somebody who today lost their market and is looking for a place to park their business.

Um, and that's really what's driving I think a lot of these inbound inquires we're getting from agents is the fact that the market is hardening, a lot of generalists are pulling out, many agents are losing their markets for the type of business they write and they're scrambling to find a new home. So, you know, some of those agents may become good long-term partners. In more cases, our existing agents will have an opportunity to compete for that business.

Mr. Gregory Macosko: So, that means you have, shall we say, 10 or so cornerstone markets? You said, two to five for every cornerstone. You got 280. So, is that kind of what we're talking about? And do you intend--?

Mr. Scott Wollney: --No. No, I--we have 280 agents altogether. We'd like to have two to five cornerstone agents in--.

Mr. Gregory Macosko: --Right--.

Mr. Scott Wollney: --Major metropolitan areas.

Mr. Gregory Macosko: So, how many areas then you have?

Mr. Scott Wollney: Yeah. So, we're in 40 states plus Washington DC. And so, we have, you know, as I say, anywhere from two to five. So, in a city like Chicago we have more than we would have in a place like Springfield, Illinois, for example, you know, where the market size dictates how many cornerstone agents are really efficient distribution and obviously you need less in less densely populated areas.

So, in terms of agency count, I think our state count is really where we'd expect it to be. You know, it may increase a little bit, but really it's a focus of making sure we're getting a proportionate amount of business from each and every one of those agents because we aren't their only insurance market and we don't expect them to be exclusive distributors of our product either.

And so, you know, we are underwriting part of each agent's book of business and our goal is to, you know, through the value proposition and the commitment to the industry any other things that we do to continue to get an increasing proportion of the business they have. And by supporting them, we'll give them an opportunity in this transitional market to increase their overall book of business as well because many of their competitors at the agency level are losing their markets, you know, and these are the guys to a great extent that we are not signing up. And so, that should give them the ability not only to maintain the business they have and rotate more of it to us but also to increase their overall volume of business.

Mr. Gregory Macosko: Thank you very much.

Mr. Scott Wollney: Sure. Thanks for the questions, Greg.

Mr. Paul Romano: Thanks, Greg.

Operator: Thank you.

Our next question today is coming from Fang Li from Baleen Capital.

Please proceed with your question.

Mr. Fang Li: Morning, Scott. Morning, Paul.

Mr. Scott Wollney: Morning, Fang.

Mr. Paul Romano: Hi, Fang.

Mr. Fang Li: Thanks for, uh, doing a wonderful job executing so far and, um, for taking the question.

Mr. Scott Wollney: Of course--.

Mr. Fang Li: --So, my question is actually a little bit accounting related. It's on the conversion of written to earned premiums. And, um, so I guess in the quarter you guys wrote 30 million of net premiums earned, you know, 18 million, and if you add up kind of year-to-date, um, kind of written to earned premiums there's similar trend of you've written a lot more than you've earned. And I just wanted to, um, ask for a little bit more color around that.

Mr. Paul Romano: Certainly. So, um, our policies are earned ratably over the term of the policy and typically we have 12 month policies. So, for example, if we write a 12--a $12,000 policy in January, we'll have writings of $12,000 and then earnings of one month's worth of that premium in January, one month in February, and so on. So, if we didn't write any more business, we would actually earn off that extra amount every month until it was fully earned throughout the balance of the year.

So what happens on the balance sheet is as we write this business it goes into an account called unearned premium reserve. And as we earn off those premiums dollars within that premium reserve, the premium reserve will begin to shrink. However, as we continue to write more and more business, if there's more business written than earned our premium reserve will continue to increase.

So, for example, um, our unearned premium reserve balance at the end of Q3 was $44.8 million. When we compare that premium reserve to the reserve that we had at the end of Q3 2012 of $28.3 million, we actually have grown the unearned premium reserve by 58 percent. So, this is kind of like money in the bank. As we continue to grow the business, uh, the unearned premium reserves should continue to grow and will be earning opportunity for those premiums over the course of the next 12 months.

Mr. Fang Li: Gotcha. So, the fact that your Q3 '13 unearned premium reserves grew at faster rate than your--um, your written premiums--sorry, your earned premiums implies that, um, maybe it's just a timing thing where there may be--.

Mr. Scott Wollney: --Yeah. So--.

Mr. Fang Li: --It's kind of a little bit more stuff like towards the end of the quarter.

Mr. Scott Wollney: Yeah. So, we're going to have some seasonality in our book, um, when you look at Q1, uh, versus Q2 and Q3 versus Q4. There will be some increases in our unearned premium reserve in Q1 and in Q3 as a result of we write more business in those quarters. But, as we continue to grow the seasonality will become less and less evident in those two quarters.

Um--.

Mr. Fang Li: --Gotcha--.

Mr. Scott Wollney: --So, for example, like in Q3 of 2012, uh, if we compared Q3 2012 unearned premium balance to Q3 of 2011, we had actually grown that, um, unearned premium reserve by 62.4 percent from the prior year quarter as compared to 58.1 percent for this year. So, it is decreasing a little bit but you will see some seasonality particularly in Q1 and Q3.

Mr. Fang Li: Gotcha. So, if the unearned premium balance is kind of like money in the bank that you haven't--you've written, you just haven't earned it yet, um, on a--as you exited the quarter, say like, you know, the last monthly quarter when there was less of, um, a timing issue, uh, what was the run rate level of earned premiums that you would have earned as you're exiting the quarter?

Mr. Scott Wollney: Um, can you restate the question a little bit?

Mr. Fang Li: Well, I guess, you know, as--I guess based on--I guess the question is based on the amount of premiums you've written to date, um--.

Mr. Scott Wollney: --Um-hmm--.

Mr. Fang Li: --Especially in Q3--.

Mr. Scott Wollney: --Um-hmm--.

Mr. Fang Li: --Uh, which is a lot higher than what you've earned. Um, as you exited the quarter, which let's say in September as opposed to be it, you know, July, August and September, um, you know, you're earning a greater proportion of that unearned, um, premium bank. And--?

Mr. Scott Wollney: --Right--.

Mr. Fang Li: --I was just wondering so as you exit the quarter, um, what was the kind of run rate, you know, level of earned premiums that you're exiting the quarter with? It was--?

Mr. Scott Wollney: --Well--.

Mr. Fang Li: --It'd be higher than 18 million, right, I guess?

Mr. Paul Romano: Yeah. You know, as we continue to move forward and as we continue to grow the book, um, the earned premiums will continue to grow. You know, as you've seen, um, quarter-over-quarter we've increased our earnings, um, you know, by a million and a half or almost two million dollars every quarter this year. You know, as we continue to grow the top line in the written premium, you'll continue to see the earned premium increase, but may be not as rapidly as you'll see the changes in written premium quarter-to-quarter. It's more of a gradual because, you know, you're dividing that written premium in any month by 12 and actually gradually earning that in overtime.

Mr. Scott Wollney: Right. And the actual earnings calculation is done daily in terms of the way that we calculate the earn. So, you know, we're actually taking the written premium and earning it daily over 365 days in the policy period, um, and so it is smoothed out, but over the course of 12 months the full premium will be earned ratably.

Mr. Fang Li: Okay, gotcha.

Um, and then on the--on an incremental basis, like, if you--so we have--uh, we have premiums--we have earned premiums that haven't kind of flowed through on an accounting basis yet, and we also I guess--the implication on an operating profit basis is, um--would it be correct to say that the level of operating expenses that you ran in the quarter, um, was related also to the premiums written not the premiums earned, so that as that flows through the only expenses that will be related to that would be the loss ratio on the acquisition, um, costs but not fee--?

Mr. Paul Romano: --There is--um, there is a bit of a smoothing under GAAP as well for OUE, as well as the acquisition costs, particularly the commissions. So, when we earn in the premium dollars, we're also earning in the percentage of commission associated with that earned premium. So, we're actually deferring some of the commission expense to the extent that we have unearned premium reserves.

Similar, there are certain expenses within the structure of the other underwriting expenses that we have the ability to defer as well based on the unearned premium reserves that we have at any point in time. So, there is a little bit of a matching but, you know, most of the expenses--a big preponderance of our expenses are actually based on maybe more of a cash basis. However, there are expenses that we do continue to earn in as--or expense out as we earn in the premium dollars that we wrote.

Mr. Scott Wollney: Right. But, I think it is important to note along the lines of the question, Fang, is, you know, writing new business is more expensive than supporting renewal business. And so, in our current growth mode, um, where we're recapturing a lot of business written in the past, the cost of writing that business is higher in terms of the time it takes for the people in the organization. Um, and so as our renewal book gets bigger and bigger, and our renewal retention is about 85 percent, which is where we're targeting, um, going forward the cost related to supporting that renewal component of the book will be marginally less than the cost to write that business in the first place. And so, that coupled with us, you know, simply getting to that minimum efficient scale, um, that we talked about where we're just now getting into that range, um, should have a real compound benefit in terms of what it really costs the organization to support the premium dollars that we're generating.

Mr. Fang Li: Oh, that's wonderful. Awesome. Thank you, guys.

Mr. Scott Wollney: Great. Thanks for the question--.

Mr. Paul Romano: --Thank you--.

Mr. Scott Wollney: --Fang.

Operator: Thank you.

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Our next question is coming from Dan Farrell from Sterne Agee.

Please proceed with your question.

Mr. Dan Farrell: Hi. Good morning.

Mr. Scott Wollney: Hey, good morning, Dan.

Mr. Paul Romano: Hi, Dan.

Mr. Dan Farrell: Hi. Um, just a quick question. Um, you had mentioned, um, that you thought there was an ability to start picking up some more business, potentially some roles from other carriers, um, through--uh, through MGAs. And I was wondering if you could just, um, talk about the potential, um, size of that market opportunity and maybe if you could relate it to how big a percentage that is of the overall, like, commercial auto marketplace?

Mr. Scott Wollney: Sure, happy to. Uh, and to be clear, you know, when we talk about picking up business from MGAs it would be by competing with them as opposed to supporting them. Um, you know, obviously we are only writing through independent agents, but our independent agents are generally competing with other agents who may source their business through these MGAs.

So, there have been number of generalists, uh, who are in the market. They got in in the soft markets through managing general agents. Um, we estimate that the generalists who are either in the process of exiting or have confirmed that they're exiting to their agency base, um, represent around 300 to potentially as much as 400 million of the total $1.5 billion addressable market in our niche. And so, it is a big percentage of the total addressable market.

In terms of timing, you know, we'd expect that the exit of those programs will occur over the next 12 to 24 months, and to put some color around that, you know, if a carrier terminates a managing general agent and that contract has an 18th month termination provision, which is pretty typical, what that means is that the managing general agent can continue to offer renewals for that full 18 months post termination and only after that will they be forced to non-renew those individual policies as the policies come up for renewal.

So, what that means is the rotation of business out can actually take as much as, you know, two or three years. Um, now as those programs kind of wither away, the support tends to disappear as well. And so, what we generally would expect to see is an acceleration of rotation away from, you know, those businesses. Uh, but in the first year, you know, many policyholders will often go ahead and renew even though they may be aware that the program's going away because often times those MGA distributed programs were also the cheapest ones in the marketplace. And coming out of the last soft market, you know, customers, as I mentioned, are just kind of psychologically getting used to the idea that rates are going up.

Um, and so, um, you know, again, I wouldn't expect a sudden influx as a result of what we're talking about, but we do think it'll be meaningful and we do expect it over the next, you know, year to two.

Mr. Dan Farrell: That's--uh, that's a helpful detail. Thank you very much.

Mr. Scott Wollney: Thanks for the question.

Mr. Paul Romano: Thanks, Dan.

Operator: Thank you.

We have reached the end of our question-and-answer session.

I'd like to turn the floor back over to management for any further closing comment.

Mr. Scott Wollney: Great. Thanks, Ken, and thanks, everyone, for joining us. We're available to answer any additional follow-up questions you might have and look forward to speaking with you again after year-end.

Operator: Thank you.

That does conclude today's teleconference.

You may disconnect your lines at this time and have a wonderful day.

We thank you for your participation today.