S&P Global
Market Intelligence

Mercury General Corporation NYSE:MCY

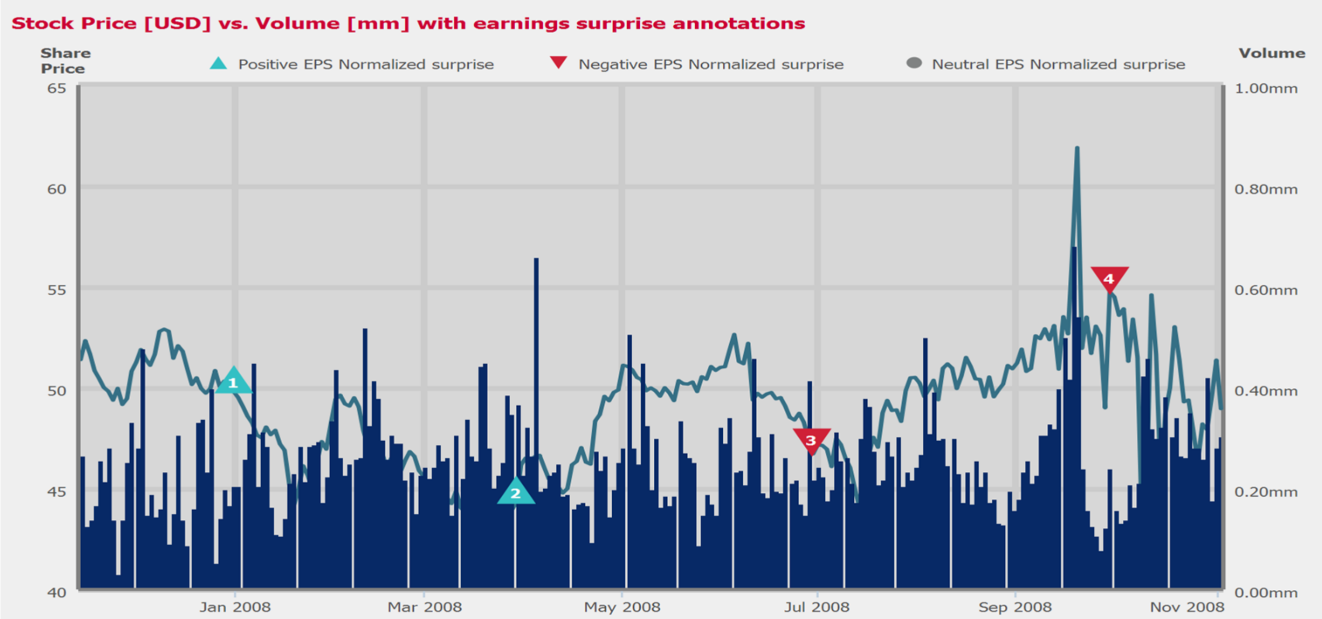
FQ4 2008 Earnings Call Transcripts

Monday, February 09, 2009 6:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ4 2008-			-FQ1 2009-	-FY 2008-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.78	(0.48)	NM	0.79	3.32	2.12
Revenue	-	-	(1.91 %)	-	-	-
Revenue (mm)	654.15	641.64	-	679.40	2762.45	2750.23

Currency: USD
Consensus as of Feb-09-2009 4:37 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2007	0.82	0.96	17.07 %
FQ1 2008	1.00	1.02	0.99 %
FQ2 2008	0.98	0.86	(12.24 %)
FQ3 2008	0.90	0.72	(20.00 %)

Table of Contents

Call Participants

EXECUTIVES

Christopher Graves

Gabriel Tirador

Robert Houlihan

Theodore R. Stalick

ANALYSTS

Alison Jacobowitz
Bank of America Merrill Lynch

D. Clifton Canfield
Private Investor

Joshua Shanker
Citigroup

Michael Phillips
Stifel Nicolaus

Presentation

Operator

My name is Dennis and I will be your conference operator today. At this time I would like to welcome everyone to the Mercury General Corporation 2008 results conference call. All lines have been placed on mute to prevent any background noise. This conference call may contain comments and forward-looking statements based on current plans, expectations, events and financial industry trends which may affect Mercury General's future operating results and financial position.

Such statements involve risks and uncertainties which cannot be predicted or quantified and which may cause future activities and results of operations to differ materially from those discussed here today. After the speakers' remarks there will be a question and answer session. (Operator Instructions) I will now turn the call over to Mr. Gab Tirador, President and CEO.

Gabriel Tirador

I would like to welcome everyone to Mercury's fourth quarter conference call. I'm Gab Tirador, President and CEO. In the room with me is Mr. George Joseph, Chairman; Ted Stalick, Vice President and CFO; Chris Graves, Chief Investment Officer; John Sutton, Senior Vice President Customer Service; and Robert Houlihan, Vice President and Chief Product Officer. On the phone we have Bruce Norman, Senior Vice President of Marketing and Ron Deep, Vice President of the Southeast Region.

Before we take questions we will make a few comments regarding the quarter. Our results in the fourth quarter were very disappointing. Our operating results were negatively impacted from the Southern California wildfires, increasing severity of auto losses, adverse development of prior period reserves and the impact of lower average premium in our California personal auto line.

In California our combined ratio increased from 98.3% in the fourth quarter of 2007 to 109.2% in the fourth quarter of 2008. There were a few primary factors contributing to the increase in the combined ratio during the quarter including higher severity in our auto line that was partially offset by a reduction in frequency and the impact on earned premium from our California rate reduction in our personal auto line.

In the California personal auto line we experienced large increases in paid loss severity during the quarter particularly on the bodily injury coverage. In addition to what we believe was higher severity in the quarter due to weather and general inflation, we also settled a larger than normal number of high valued bodily injury claims that impacted our paid severities. As a result, we increased our paid bodily injury severity estimates for the entire year and recorded bodily injury inflation of just over 10% for 2008. We are monitoring the severity trend closely and will take the necessary rate action if the trend continues. We have filed for an approximately 2% rate increase in California for personal auto.

Our frequency in the fourth quarter was down in the low single digits as compared to the fourth quarter of 2007 but up from the third quarter 2008 as is typically the case due to weather and usage. In addition, the approximately 2% rate reduction in our California personal auto line that went in to affect in April 2008 had a negative impact on the combined ratio as the earned premium during the fourth quarter was earned at the lower rate level.

Our fourth quarter 2008 combined ratio of 128.8% in our non-California operations, produced an underwriting loss of $42 million compared to a combined ratio of 100.4% and an underwriting loss of $1 million in the fourth quarter of 2007. The deterioration in the results during the quarter was primarily due to our results in Florida and New Jersey which combined produced an underwriting loss of $31 million during the quarter compared to an underwriting gain of $1 million in the fourth quarter of 2007.

Included in the underwriting loss was approximately $17 million in adverse loss and loss adjustment expense development during the quarter in our non-California operations compared to $2 million of positive development in the fourth quarter of 2007. In Florida, our improved claims handling has reduced our bodily injury severity significantly.

In conjunction with the reduction in bodily injury severity, our expenses related to defending and containing bodily injury indemnity costs have increased. Accordingly, during the quarter we increased our loss adjustment expense reserves in Florida and recorded approximately $5 million in adverse development.

New Jersey continues to be the most difficult state to estimate our ultimate liabilities for the bodily injury and PIP coverages due to the lack of historical data and the long tail nature of these coverages. In New Jersey we recorded $9 million of adverse development in the quarter. We will continue to monitor the results closely. However, until we obtain more operating history in New Jersey estimating our ultimate losses will be challenging.

As we have discussed on previous calls, we are taking various steps to improve our results in New Jersey, our new territorial pricing changes went in to effect on August 1, 2008 and a new rating plan with improved segmentation and a rate increase of about 5% went in to effect on January 1st. In addition, we have tightened our underwriting, are working with agents to improve results and have made changes to our claims processes for PIP and BI.

We continue to believe that the claims process [inaudible] are having a positive impact on our PIP costs for the current accident year. However, because the data is very green, our selection for the 2008 accident year was based on the 2007 and prior accident years which have developed unfavorably.

Our companywide expense ratio increase from 27.4% in the fourth quarter in 2007 and 28.8% in the fourth quarter of 2008. The increase was primarily due to an increase in technology related expenditures, the establishment of our new product management function, approximately $2 million in expenses related to the AIS acquisition and the fact that fixed costs have not declined in proportion to the decline in premiums.

To address the increase in expense ratio, we have frozen salaries for all employees and have frozen hiring except for certain positions. We are also evaluating other cost reduction measures. We continue to aggressively make changes to our rating plans to improve our segmentation and overall pricing adequacy. We expect to implement five rating changes during the first quarter of 2009.

The competitive environment remains intense. The industry is experiencing a reduction in frequency but we believe the increase in severity more than offsets the reduction in frequency. We continue to observe more filings for rate increases than rate reduction however, we believe growth will be challenging over the next few quarters.

As we previously reported, we closed on the purchase of Auto Insurance Specialists on January 1, 2009. The transition with Mercury has been very smooth. We expect the purchase of AIS will be slightly accretive to earnings. Before we take your questions, Chris Graves, our Chief Investment Officer will provide information on our investments and Ted Stalick, our Chief Financial Officer will comment on our capital position.

Christopher Graves

Mercury's investment portfolio has suffered through another difficult period. At the start of 2008 Mercury adopted FASB 159 for the entire investment portfolio. Under FASB 159 Mercury recognizes market value changes not just sales as realized gains or losses on the income statement.

As reported, Mercury's realized losses for the quarter were $218 million. Under FASB 159 the total 12 months realized losses were $551 million. A little more than half of the $551 million in losses came from fixed income assets that are still be held by the company. As our bonds and stocks recover their values, depreciation will be booked under GAAP as realized gains.

The company ended the year with about 8% of the portfolio allocated to common stocks. Cash and short term investments make up 7% of the portfolio or about $204 million. The remaining 85% of the portfolio is invested in bonds. Mercury ended the year with $2.2 billion in municipal bonds with an average rating of [AA3AA], the average rating of all $2.7 billion in fixed income assets including cash and short term investments is [AAAA].

I'll now turn it over to Ted Stalick for some comments.

Theodore R. Stalick

Our capitalization is very strong, even after taking some hits due to investment losses resulting from the turbulent capital markets. We ended the year with $1.5 billion in GAAP equity and $1.4 billion in statutory surplus. Our premiums to surplus ratio is 2 to 1 and our debt to total capital is 9.6%. After accounting for the $120 million borrowed on January 1, 2009 that is not yet in our yearend numbers, the debt to total capital ratio will be about 16%.

While we are not pleased with the declines in shareholder equity in 2008, the balance sheet is still very strong. Our total loss reserves are $30 million greater than they were at yearend 2007. Our position in equity securities is now only 8% of the portfolio compared to 12% at yearend 2007 and our fixed maturity portfolio consists primarily of highly rated municipal bonds that we believe will ultimately recover most of the approximately $200 million in unrealized losses that existed at yearend.
We are fortunate to have a strong balance sheet during a time like this. Our current capitalization is strong enough to allow us to absorb more shocks and to begin to grow when the insurance markets start to harden. With those comments, now we'll open it up for questions.

Question and Answer

Operator

(Operator Instructions) Your first question comes from Michael Phillips - Stifel Nicolaus

Michael Phillips
Stifel Nicolaus

One of the things you guys have mentioned pretty consistently in the past couple quarters for probably I guess the past year is putting off the geographic expansion plan to get the focus on profitability outside of California and also related to that is your pricing segmentation getting that a little more updated and you mentioned that in your comments to start off. I guess, where are you today with that second piece, that pricing segmentation with where you think you need to be.

Gabriel Tirador

I'll go ahead and let Robert Houlihan our Vice President and Chief Product Officer to answer that question.

Robert Houlihan

Well, we recently updated our auto product in New York and New Jersey and part of our plan is to roll out a line tiering and more advanced tiering in our auto product in all of our states. We also plan to introduce some complimentary homeowners products throughout this year as well.

Michael Phillips
Stifel Nicolaus

So it sounds like a lot of that stuff is still in the works then, correct?

Gabriel Tirador

Yes. We've developed what we're referring to - or we're in the process of finalizing what we're referring to as an aligned product which is what we believe is much improved segmentation. We've deployed as Robert mentioned, in a few of our states but we have in plan for 2009 to really deploy it throughout the rest of our 13 states. We're really primarily talking outside of California here.

Michael Phillips
Stifel Nicolaus

Your opening comments Gab also alluded to the expense ratio because of technology and I think you've mentioned in the past the front end versus the backend systems and I believe you've talked about a new policy administration system, I guess the front end system, coming out this quarter. I guess I'm wondering how much more on the expense ratio side do we expect to see an uptick because of the technology there?

Gabriel Tirador

I really don't expect an uptick because of the technology there. A lot of it has to do right now with the fact that at least in '09, will have to do with the fact that fixed costs versus declining premium volume if that were to occur. We don't expect to spend more money on technology in '09 than we did in '08.

Michael Phillips
Stifel Nicolaus

I'll jump off after this one more, did you have any adverse development from Hurricane Ike losses?

Theodore R. Stalick

No. Hurricane Ike I believe was right around $6 million in the third quarter.

Operator

Your next question comes from Joshua Shanker - Citigroup.

Joshua Shanker
Citigroup

Curious, what was the last time that Mercury General bought back stock and what do you think about that as a way of returning capital to shareholders?

Gabriel Tirador

I believe the last time we purchased stock was in about the year 2000. Our preference has been as you know Josh I think, is to return capital to our shareholders via dividend. That's not to say that the board doesn't discuss buying back stock but obviously it would depend on the level of the stock. But, our preference has historically been to pay dividends to return capital and I don't really see that changing.

Joshua Shanker
Citigroup

In terms of the integration of the acquisition from AON, how's that going?

Gabriel Tirador

That has gone extremely smooth, very, very smooth. In fact, better than I anticipated. It has gone very well.

Joshua Shanker
Citigroup

Finally, in terms of talking about trend of auto accidents, can you talk about where California might be differing from the rest of the US market on frequency, severity and what not?

Christopher Graves

I think on the frequency side we're generally seeing continued downward trends in California in the low single digit range which is fairly consistent with what we're seeing outside of California. On the severity side, as Gab Mentioned earlier, we are seeing higher severities than we have had in the past.

Joshua Shanker
Citigroup

Although it's not weather related so much I guess is that coming from medical costs or is that coming from body work? Where do you see that coming from?

Gabriel Tirador

Really, primarily it's medical costs. I will say that the fourth quarter for us tends to have historically at least higher frequency and severity for us. But, whether or not it's more severe accidents because of the weather or not, we do notice that the severity for us is generally higher in the fourth quarter but, most of it has to do with medical bodily injury not parts costs or repairing cars.

Operator

Your next question comes from Alison Jacobowitz - Bank of America Merrill Lynch.

Alison Jacobowitz
Bank of America Merrill Lynch

I just wanted to check one thing, I wanted to make sure the 2% rate increase you said you're going to file in California, I wanted to see what percent of that book that was? Then also, I'm not sure I got it from the comments, was there a true up in the fourth quarter reserves for the first three quarters? And if so, can you quantify it?

Gabriel Tirador

I'll go ahead and answer the first question and I'll let Ted answer the second question. The 2% probably represents - it's our California book, it probably represents 75% to 80% of our total business.

Alison Jacobowitz
Bank of America Merrill Lynch

But it is the whole California book, you can do it on the whole book?

Gabriel Tirador

There's slightly different percent changes by company, now one of them I believe is 1.5% and the other I think are 2.2% or something like that but they're approximately combined approximately 2%.

Alison Jacobowitz
Bank of America Merrill Lynch

Actually while we're on that, given what's happened with the margins, why not file for a larger rate increase?

Gabriel Tirador

Well, one quarter Alison isn't necessarily indicative of the whole year or a continuing trend. That's something we monitor very closely. We do continue to see benefits from our frequency and we're going to monitory the severity closely. This is a decision we made probably three or four months ago.

Alison Jacobowitz
Bank of America Merrill Lynch

Then the true up in the quarter?

Theodore R. Stalick

There is in the $33 million of development that we reported, a very small amount of that is true up from the prior quarters in 2008.

Alison Jacobowitz
Bank of America Merrill Lynch

So most of the adverse affect then was prior years.

Theodore R. Stalick

Prior years, yes.

Alison Jacobowitz
Bank of America Merrill Lynch

Then I'm wondering on the large - you said there was a higher number of large severity claims filed in the quarter. You can't quantify that can you? Or, is some of it unusual?

Gabriel Tirador

No. I believe we generally get, and this is just ballpark figures Alison, in any given quarter we tend to see seven or so very large claims and I think in this quarter we closed something in the neighborhood of 20.

Operator

Your next question comes from [D. Clifton Canfield - Private Investor].

D. Clifton Canfield
Private Investor

I wanted to compliment you on your paying out on dividends rather than buying back stock. I wanted to know if you think you'll be able to continue on the present amount or perhaps have to lower the annual dividend?

Theodore R. Stalick

Each quarter we evaluate our dividends in relation to our capital and operating results and we're happy that because we have such strong capitalization even in light of our results from '08, that we're able to continue the same dividend that we did in 2008. We'll continue to evaluate that every quarter going forward.

D. Clifton Canfield
Private Investor

In other words, at this time you don't anticipate increasing it do you?

Theodore R. Stalick

I think we can say that we evaluate it each quarter and we make the decision at that point in time.

D. Clifton Canfield
Private Investor

One other one, in the state of Michigan how do you find your loss ratio overall, 100% or less? The loss in expense from the state of Michigan?

Theodore R. Stalick

We're running combined ratios over 100%. That is somewhat of a startup operations in which we tend to run at a higher combined ratio.

Gabriel Tirador

There's a very high expense ratio there, we've only for the whole year have written a couple of million in premiums so it's not a significant percentage for us right now.

D. Clifton Canfield
Private Investor

What's the biggest town that you have your premiums in, in the state of Michigan?

Gabriel Tirador

I don't know that off hand, Robert do you?

Robert Houlihan

We're only at $2.2 million for the year and it's sort of spread out through many counties so I don't think there's a large concentration through one particular geographic area.

Operator

Your next question comes from Michael Phillips - Stifel Nicolaus.

Michael Phillips
Stifel Nicolaus

Just one more, on your California homeowners, the rate cut that you took earlier, how much of your current earned premium is still at the old rate level versus the newer level?

Gabriel Tirador

I would say most of it is probably still - these are annual policies remember so most of it is still under probably the old rate level.

Operator

At this time there are no further questions.

Gabriel Tirador

I’d like to thank everybody for joining us for the call and we hope to provide you with some better results in the first quarter of ’09. Thank you very much.

Operator

Ladies and gentlemen this does conclude today’s conference. You may now disconnect.