S&P Capital IQ

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Mercury General Corporation NYSE:MCY

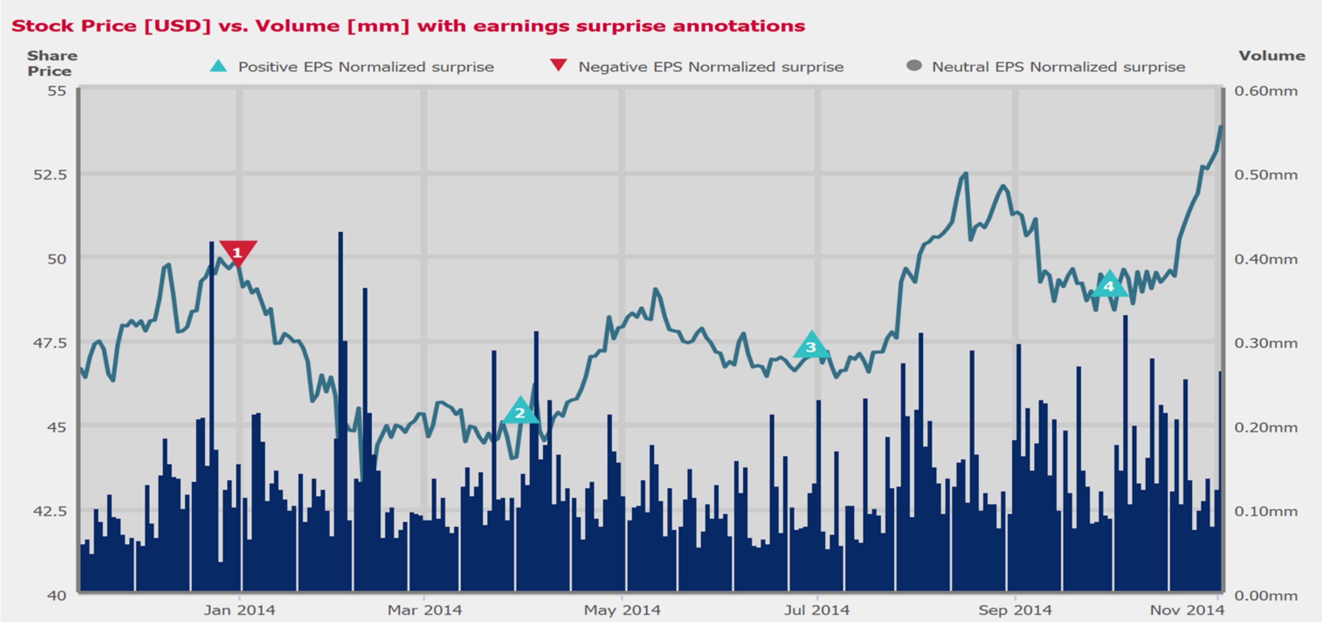
FQ4 2014 Earnings Call Transcripts

Monday, February 09, 2015 6:00 PM GMT

S&P Capital IQ Estimates

	-FQ4 2014-			-FQ1 2015-	-FY 2014-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	(0.01)	(0.13)	NM	0.72	2.51	2.28
Revenue (mm)	687.10	697.32	▲1.49	758.02	2830.50	2840.92

Currency: USD
Consensus as of Feb-09-2015 4:37 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2013	0.53	0.33	▼1 (37.74 %)
FQ1 2014	0.61	0.77	▲2 26.23 %
FQ2 2014	0.70	0.83	▲3 18.57 %
FQ3 2014	0.61	0.81	▲4 32.79 %

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Call Participants

EXECUTIVES

Gabriel Tirador
Chief Executive Officer, President and Director

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

ANALYSTS

Corey Wrenn

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

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Presentation

Operator

Good afternoon. My name is Sherrilyn, and I will be your conference operator today. At this time, I would like to welcome everyone to the Mercury General Corporation Fourth Quarter Conference Call. [Operator Instructions] This conference call my contain comments and forward-looking statements based on current plans, expectations, events and financial and 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. I would now like to turn the call over to Mr. Gabriel Tirador. Please go ahead, sir.

Gabriel Tirador
Chief Executive Officer, President and Director

Thank you very much. I would like to welcome everyone to Mercury's fourth quarter conference call. I'm Gabe Tirador, President and CEO. In the room with me is Mr. George Joseph, Chairman; Ted Stalick, Senior Vice President and CFO; Robert Houlihan, Vice President and Chief Product Officer; and Chris Graves, Vice President and Chief Investment Officer.

Before we take questions, we will make a few comments regarding the quarter. Our fourth quarter operating loss was $0.13 per share compared to operating income of $0.33 per share in the fourth quarter of 2013. Premiums written grew 4.4% in the quarter, primarily due to higher average premiums per policy as a result of rate increases.

Our fourth quarter operating results were negatively impacted by a $27.6 million fine imposed by the California Insurance Commissioner related to a 2004 Notice of Non-Compliance matter, $7 million of adverse loss reserve development and $4 million of catastrophe losses. Excluding the impact of the fine, operating earnings were $0.37 per share in the quarter compared to $0.33 per share in 2013, and the combined ratio was 101.7% compared to 102.5% in 2013.

We are very disappointed and strongly disagree with the Insurance Commissioner's determination that Mercury violated California's rate laws and with his decision to impose a penalty. This Notice of Non-Compliance matter is related to the Krumme vs. Mercury lawsuit that was decided in 2003. In the Krumme decision, the judge ruled that based on the mountain of evidence reviewed by the court that no financial restitution was warranted in light of the Department of Insurance's loose practices, including the lack of guidance provided as to what constitutes a broker or an agent, it is our strong belief that this decision is contrary to California's rate laws, due process and basic notions of fairness. We intend to vigorously litigate this matter of law, and we expect to ultimately prevail on the merits in the Court of Law.

As we mentioned on our third quarter conference call, our fourth quarter has historically been our highest frequency and severity quarter due to weather and increased driving. In California, our combined ratio, excluding the fine, was 100.2% in the quarter compared to 100.9% in the fourth quarter of 2013.

Personal auto loss frequency and severity increased in the low- to mid-single-digit range as compared to prior year. The year-over-year increase in frequency and severity is attributable to more bad weather in 2014 as compared to 2013 and possibly to increased driving as a result of lower gasoline prices.

In 2013, we had unusually good weather during the fourth quarter. Our results were good in our 2 largest states outside of California. In both Florida and Texas, we posted combined ratios under 100% and we are growing the top line. Our results in other states outside of California were mixed and overall profitability outside of California has been negatively impacted by our New York and New Jersey operations.

In New York and New Jersey, we instituted claims practices and procedures that sped up the setup of bodily injury case reserves and the payment of claims. These new practices have made it more difficult to estimate ultimate losses as historical or incurred, and paid loss patterns may no longer apply. As case reserves and payments were sped up, our expectation was to have less loss development as the claims

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matured. However, the expected lower development has not yet materialized in the data. So consequently, we use historical patterns to estimate our ultimate losses in these states.

As a result, we recorded $6 million of adverse development in New York and New Jersey in the quarter, which also had the effect of increasing our 2014 accident year loss estimates.

California continued to experience positive premium growth in the quarter as rate increases more than offset lower policy sales. Outside of California and excluding our mechanical breakdown product, our growth was flat in the quarter. This compares to negative growth of 3.9% and 7.6% for 2014 and 2013, respectively. The improvement in growth outside of California is attributable to increased policy sales as a result of rate reductions taken in many states early in 2014 and increased distribution.

For 2015, we expect to continue to improve our growth prospects outside of California from our improved competitive position, coupled with increased advertising spend and distribution.

In California, a 6.9% personal auto rate increase went into effect in October 2014 for California Automobile Insurance Company, representing 15% of our total company-wide premiums. In addition, we have a 6.9% rate increase pending Department of Insurance approval and Mercury Insurance Company, representing about half of our company-wide premiums written. And an additional 6.9% rate increase was recently filed in California Automobile Insurance Company.

In January, we launched our first-ever national advertising campaign. We currently operate in 13 states, representing approximately 56% of the U.S. population. The economics made it more cost effective to advertise on a national basis rather than on a local basis. The national advertising campaign should bring more awareness to Mercury's ban outside of California.
Lastly, we closed on the Workmen's Auto Insurance Company acquisition in early January. This acquisition fills a strategic niche for Mercury, as Workmen's nonstandard auto product will complement Mercury's more preferred product offerings. We believe Workmen's auto product will allow Mercury to better penetrate the nonstandard market in California. With that brief background, we will now take questions.

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Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Vincent DeAugustino from KBW.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. So a couple of quick ones here. So we're starting to see some directional improvement in the first lines PIF growth. And so it seems like the growth outside of California is getting traction and -- so you guys had some comments this morning in the prepared remarks. And I so just wanted to double check and see from the growth outside of California, both in terms of the actual premium production and then margins, has all of that so far to date has kind of been coming in line with expectations.

Gabriel Tirador
Chief Executive Officer, President and Director

I would say with the exception of the 2 states that I mentioned earlier in my prepared remarks, New York and New Jersey, certainly not coming in from a margins perspective, in line with our expectations. It's mixed with the other states. But our 2 biggest states, Florida and Texas, certainly in line with our expectations, and we're growing the top line as well. And keep in mind that, as we have mentioned in prior calls, that we are pricing our product outside of California in many of these states to combine ratios that we don't expect, from a cost standpoint, we're pricing our expenses -- expense ratios that we're not there yet. So we anticipate to have higher combined ratios in some of these states outside of California because of that, probably closer to the 100% range as compared to a 95% target in some of these states. Now in Florida and Texas year-to-date, we're well below -- on a year-to-date basis, we are well below 100% combined ratio in those 2 states, our 2 biggest states.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. All right, perfect. And so on New Jersey and New York, maybe I just kind of was assuming here, but I guess with the reserve kind of movements, I would've figured that would have been on some of the older accident years -- maybe 2, 3 years older, not so much when you guys would have started growing that business. So is it more recent accident years where that growth is coming in and expectations kind of haven't played out or is it kind of the older stuff, where I was assuming that might be the case?

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

Vincent, it's Ted. It's really been on the last couple accident years and, as you know, as we bring up estimates on the most recent accident years and also causes us to reevaluate what we're doing for the most current 2014 period.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

And then, I guess, 2 quick ones, if I could squeeze them in. So on ad spend, do you guys have anything specifically budgeted for the 2015 ad spend?

Gabriel Tirador
Chief Executive Officer, President and Director

Yes. We're planning on spending about double the amount that we spent last year. And I think last year, we spent in the neighborhood of about $23 million. So in the neighborhood of $46 million, $47 million.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

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Perfect. And then, just last one. So thanks for all the comments on the NNC, just with the fines. So I guess looking forward, I guess, the way understand it is that California had previously bifurcated that issue into 2. And so we had just gotten kind of the state's ruling of that and understand that you guys are going to continue to defend that. But does open kind of the road forward on the second part of that, which I think was more around cause, not so much the rate side of it? Am I understanding that correctly?

Gabriel Tirador
Chief Executive Officer, President and Director

Yes. There were 2 sides of it. One of them was on rate side and second one was on the advertising -- or false advertising claim. Although both basically claimed that customers paid broker fees at the end of the day and the rate side was just adjudicated by the Administrative Law Judge, which, the Commissioner accepted his proposed decision. That went on Thursday, we just filed a rate of mandate challenging it in court. As far as of the other case, the other part of the bifurcated case, that's technically still out there. Haven't heard anything from the department on that, with respect to that case. Although from my perspective, I will say that at the end of the day, both cases led to the fact that someone paid -- at least from the department standpoint, alleging unapproved broker fees. So they both end up at the same result, but technically, that case is still out there. That is correct, Vincent.

Operator

[Operator Instructions] Once again, Vincent DeAugustino from KBW.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Just one quick one. Gabe, you'd mentioned the with the gas prices. And then you said this was a, I think the word was, possibly a factor. And so you guys, with the new company, will be kind of getting into nonstandard, so it's probably a little bit early to ask this question on the nonstandard side, but between, I guess, the preferred and standard books, we tend of think that frequency might react differently kind of based off of the affluence of the drivers. And so I'm wondering if between the 2 existing California tiers [ph], if you're seeing any difference in frequency that might help explain kind of the elasticity to gas prices, if you will.

Gabriel Tirador
Chief Executive Officer, President and Director

I'm trying to think, Robert, from a frequency standpoint between -- if I understood your question correctly, Vincent, between our Mercury Insurance Company and our Cal Auto company, the difference the frequency in those 2 companies, obviously, Cal Auto has a higher frequency rate and have higher absolute frequency rate. And I think the rate of change in Cal Auto was slightly higher than it was in Mercury Insurance Company. So call it the "standard/nonstandard at a higher frequency rate." And not only absolute, but also as far as an increase on the margin, year-over-year than it did in our preferred book.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. So that would seem to support the premise that lower affluent drivers would be reacting a little bit -- the reactions is a little bit larger on response to cheap gas?

Gabriel Tirador
Chief Executive Officer, President and Director

Yes, I mean, I think it's early to tell. It's 1 quarter. I mean, we have more employment. Also, more people on the roads with the employment better than it has been. But I -- at this point, we know that our fourth quarter frequency is always higher. Now it was higher than typical this quarter. But we're not ready to say that that's the trend at this point. I mean, that's 1 quarter. It's something that we'll continue to monitor closely. But until we have more data, I think it's early for us to call that.

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Operator

Our next question comes from the line of Ken Billingsley from Compass Point.

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

I wanted to just focus on one of the questions that was asked about the expense ratio. And your answer said that you're booking at below where you -- I believe you said you're booking at currently where it will actually run. And maybe I misinterpreted that. Does that mean that, essentially, you're booking the expense ratio lower than what you're actually seeing right now or do I have that reversed?

Gabriel Tirador
Chief Executive Officer, President and Director

No, no. We're pricing -- we're pricing our product so that we can be more competitive at expense ratios that we have not yet achieved. It's a pricing -- so, which basically means that -- let's say, we're targeting a 95%. If we hit our targeted expense ratio, but we're not there yet, that means that we're going to run a little hotter than that. We're going to run at 100 or so, until we hit those expense and LAE ratios. So it's a pricing status...

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

You're pricing it below where the combined ratio would imply where the expense ratio needs to be based on ultimate volume?

Gabriel Tirador
Chief Executive Officer, President and Director

Exactly.

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

And I may have missed if you gave this answer. About how much more growth do you need outside of California to get those expense ratios where they need to be. And I understand you're in multiple states now, so that may be harder to answer, but are we talking about 20%, 30% from current levels or...

Gabriel Tirador
Chief Executive Officer, President and Director

Well, it varies by state. It really does. In some states like Florida, where we have a lot of volume, our expense ratio's already there. Our LAE ratio isn't there in that state, but so it's going to vary pretty much by volume and by state, I should say, outside of California. Texas is another state that we're pretty much at. But yes, some other states where the volumes are low that we have a long way to go.

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

Okay. The underwriting leverage, just picking up, where is your comfort level? How high do you feel that you can take that, especially with the addition of the nonstandard business? And I know it may be a smaller piece right now, but where do you -- where are you comfortable taking statutory underwriting leverage to?

Gabriel Tirador
Chief Executive Officer, President and Director

Well, we've been -- 2.5x is something that we would be easily comfortable with, 2.5x. and I think we're at, what, well, 1.9x, 2x right now.

Kenneth G. Billingsley

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Compass Point Research & Trading, LLC, Research Division

Right around there, yes.

Gabriel Tirador
Chief Executive Officer, President and Director

I mean, in our history, we've been -- I can recall years in our history where we've been way above 3x, right? But anyway, 2.5x is probably a decent target.

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

One of the benefits we have is we have some additional capital up in the holding company. So if the margins -- the underwriting leverage gets too high, we'll always have the ability to contribute the capital down in the insurance subs.

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

And if you needed to do that, it looks like you still have some room. Does that impact maybe the future dividend payout ratio assumptions going forward? I mean, is that holding company cash allowing you to maintain that high dividend currently?

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

Well, not really. I mean, obviously, that's some additional cash that you can use to pay out dividends. But most of the dividends are upstream and out of current income from the insurance subs. So to the extent that your insurance subs are writing profitably, higher underwriting leverage actually gives you a higher capacity to pay out upstream dividends to the holding company, which then can be paid out to the shareholders.

Gabriel Tirador
Chief Executive Officer, President and Director

I want to say from a dividend standpoint, our strong capital position does allow us to pay a dividend in years, where maybe a dividend payout ratio is above 100 in years, maybe like this year, where we had a tough fourth quarter. So we obviously recognize that we cannot, on a long-term basis, have a payout ratio above 100. But I think our very strong capital position that we have today allows us to continue to pay the dividend in years such as this one. So...

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

Well -- so, in talking about the kind of tough fourth quarter, can you talk about any of the cat exposure in the Northeast so far? I realize you said that it wasn't all East Coast storms. Some of it was rainstorms in California. Can you maybe separate that and tell us, I mean, how you -- the storms that were seen in the Northeast maybe impacting results going forward?

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

Are you talking about the storms in January or the storms from the fourth quarter?

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

More about how maybe the January storms may be shaping up versus what you saw in the fourth quarter. Are they going to be just as big?

Theodore R. Stalick

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Chief Financial Officer and Senior Vice President

I don't think we really have a read on that yet.

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

Okay. And last question is, the old case, the adverse review coming from California for the $27 million, if I read correctly, I believe you had said that -- or at least there was no -- or maybe it was from California, that there were no penalties or interest added to that $27 million. If you take this to court and you lose, do you run the risk of the penalties and interest being added back in?

Gabriel Tirador
Chief Executive Officer, President and Director

Well, first of all, this is a fine, this is a penalty. So really the question has to do with interest, if interest is due. We're going to be filing for a stay with the court as well, to stay the decision. And so the underlying question is interest that's due. This is not -- in our opinion, this is not like a regular judgment, where in a regular judgment interest would be due. So that's our view. I suppose that the other side may take an opposing view. But our reading of the code of the law suggests that a penalty is different than a judgment.

Operator

[Operator Instructions] Our next question comes from the line of Corey Wrenn from Pecaut.

Corey Wrenn

My question is concerning more of the future, I guess. I was wondering, we have losses in New Jersey and New York. And I was wondering what the aggregate results have been there. And at what point would you say enough is enough from an operating standpoint if it's just not working for you?

Gabriel Tirador
Chief Executive Officer, President and Director

I don't have the aggregate numbers. But if we felt that we could not get an adequate -- we've heard in those states -- at that point, if we felt that we just cannot make it work and get an adequate return, that's the point that we would do it. I will say that New York -- I mean, New Jersey, for the whole year actually, posted combined ratio, let me see here...

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

Around 100%.

Gabriel Tirador
Chief Executive Officer, President and Director

Around 100% for the whole year. So the quarter was bad, but -- so it's a good question. Obviously, it's a very good question that at some point, if we didn't feel that we could get an adequate return and make the operations allow for that return, make the changes necessary either from a pricing operational standpoint, then at that point, we would have to take a look at that.

Corey Wrenn

Okay. And my next question, I see enormous amount of advertising from the direct writers. Actually, I found an advertiser from Mercury Insurance in Iowa on TBS, or something like that, I thought it was a nice commercial. I was wondering what kind of impact can you make given the huge budgets that these guys have. It's almost like you're Daniel in the lion's den or something. I think they've got these huge ad budgets and you're running your ads, and have you had any sort of feedback yet around the effectiveness of these?

Gabriel Tirador

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Chief Executive Officer, President and Director

It's early. It just started in January. Our leads in the 13 states that we're in are up significantly, I would say. And when we made these investments, which $46-million-odd investment, we made certain assumptions on how many leads we're going to get based on the advertising that we were going to be doing and the lifetime value of the business we would sell, made assumptions over close ratios. So we put together an investment analysis for this $46 million that we are investing. I will say that's new to us, though, so it's -- we had to make assumptions based on that ever advertising in some of these states. California, the assumptions we made, we've been here a long time. We understand what the ads do here. So we did go in with the advertising with a plan and an expected return. And we're going to have to see if that pans out or not. It is, as you point out, we have competitors that spent a lot more money than we do and that is an accurate statement.

Corey Wrenn

What were you -- where to you -- my last question is, where do you see the business in 5 years? I mean, obviously, there's been this big swing. I think back in the early '90s, I once asked George about Progressive doing both the direct model and the agency model, and he said, "Well, we'll see how that works out." And I was just wondering where do you see personalized insurers? I see your Policies-in-Force have declined on the personal lines side, and when does that rate of decline start to bother you? And that will be my last one.

Gabriel Tirador
Chief Executive Officer, President and Director

Well, it starts -- it's bothering me now. But there's no question that this business has changed, and it's become more commoditized than it has an, in the past, there's a lot more lot more quoting, a lot more aggregators out there. The agency's comparative raters, it's just become a lot more transparent and commoditized. So our goal is to try to adapt to that environment. We do allow now online sales. We have the buy button and it's a small percentage of our overall sales, but it's still a strategy of ours to be able to offer that to consumers. We have national aggregators that we've partnered with, national accounts, a recent release with respect to Google that we're going to be coming out with -- or Google is coming out with. So we're trying to do everything we can to try to reach the customer and to try to get quoted. But there's no question in my mind that the last 10 years have brought a lot of change. And there's going to be more change in the future and we just have to be able to adapt. You've got autonomous cars that may be on the road 10 years from now. One of our strategies is obviously to continue to grow our homeowners market. We want to try to wrap more commercial business, so to diversify in that area as well, but the business has changed the past 5, 10 years.

Operator

Our next question comes from the line of Vincent DeAugustino from KBW.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

But, Gabe, you mentioned the Google aspect? And so I just wanted to make sure I understood how that is all going to play out with any involvement of Mercury and kind of the Google platform, if you could.

Gabriel Tirador
Chief Executive Officer, President and Director

Well, Google's going to -- they're launching a new insurance marketplace called Google Compare. And consumers will answer rating questions and be able to view rates from a number of carriers. Very similar to a comparative rater. If the consumer likes the particular rate, the consumers can then link to that carrier and complete the purchase. So we believe that's going to provide access to many customers that might not otherwise be exposed to the Mercury product. But I'm not sure when that's launching. As of yet, Google has not announced when that's going out officially. There have been some articles out there and some blogs that talk about it, but we don't have kind of any dates or anything like that.

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Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. And so just to make sure I understand that. There will be -- the end consumer will be able to go -- and we've come kind of in tune with the Google side of it, but from a Mercury's standpoint, the customer will be able to buy a Mercury policy through that see through that Google platform?

Gabriel Tirador
Chief Executive Officer, President and Director

That is correct.

Operator

There are no further questions in queue at this time. I'd turn the call back over to our presenters.

Gabriel Tirador
Chief Executive Officer, President and Director

Okay. I'd like to thank everyone for joining us this quarter, and I look forward to talking to you in the first quarter of '15.

Operator
That concludes today's conference call. You may now disconnect.

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