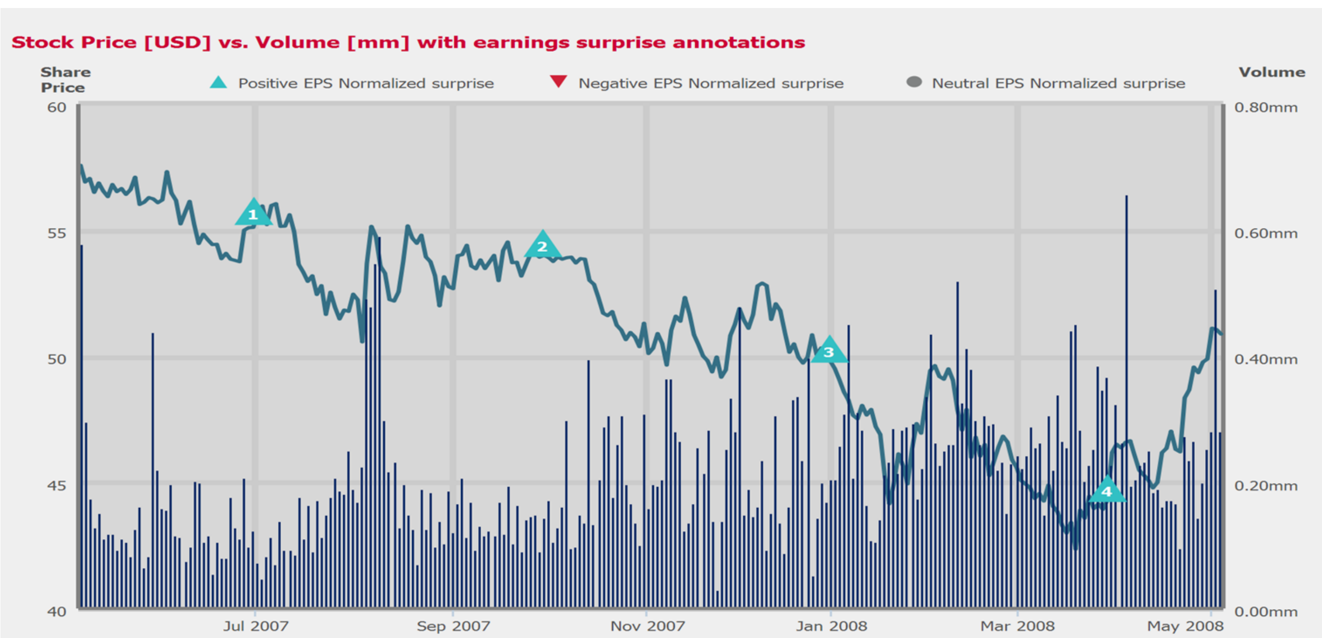
Mercury General Corporation NYSE:MCY
FQ2 2008 Earnings Call Transcripts
Monday, August 04, 2008 5:00 PM GMT
S&P Global Market Intelligence Estimates

	-FQ2 2008-			-FQ3 2008-	-FY 2008-	-FY 2009-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.98	0.86	(12.24 %)	1.06	3.83	3.69
Revenue	-	-	(2.16 %)	-	-	-
Revenue (mm)	699.30	684.18	-	708.90	2820.75	2778.05

Currency: USD
Consensus as of Aug-04-2008 5:49 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2007	1.09	1.15	5.50 %
FQ3 2007	1.12	1.13	0.89 %
FQ4 2007	0.82	0.96	17.07 %
FQ1 2008	1.00	1.02	0.99 %

Table of Contents

Call Participants

EXECUTIVES

Gabriel Tirador

Theodore R. Stalick

ANALYSTS

Alison Jacobowitz
Merrill Lynch

Dan Farrell
Fox-Pitt Kelton

Joshua Shanker
Citigroup

Meyer Shields
Stifel Nicolaus

Presentation

Operator

Good afternoon. My name is Brandy, and I will be your conference operator today. At this time, I would like to welcome everyone to the Mercury General Second Quarter 2008 Results Conference Call.

All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

This conference call may 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. Sir, please go ahead.

Gabriel Tirador

Thank you very much. I would like to welcome everyone to Mercury's second quarter conference call. I'm Gabe Tirador, President and CEO.

In the room with me is Mr. George Joseph, Chairman; Ted Stalick, Vice President and CFO; and 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 South East Region. Before we take questions, I'll make a few comments regarding the quarter.

In California, our combined ratio increased from 90.2% in the second quarter of 2007 to 91.8% in the second quarter of 2008. The primary reasons for the increase were an increase in auto severity in the mid-single digits and an increase in our expense ratio, partially offset by a reduction in auto frequency in the low single digits.

In addition, in the second quarter of 2008, we recorded positive development in California of about $1 million, compared to adverse development of $5 million in the second quarter of 2007.

The second quarter of 2008 continued the trend of increasing severity in medical, labor and parts costs. Our California auto frequency was positively impacted in the quarter, from what we believe was reduced sliding as a result of higher fuel costs. It is difficult to predict, whether the reduction in frequency during the quarter will continue for the next several quarters or if driving levels will revert to previous levels as fuel costs stabilize or decline.

In California, we recently filed new rates to comply with the new territorial rate regulations. Based on our initial review of very few competitors' filings, it appears the impact of the new territorial regulations is mixed. Some competitors appear to have little, if any, dislocation while others are having moderate dislocation. However, this initial assessment is based on a limited number of filings. And as more filings become public over the next month, we will have a better idea of the impact the new regulations will have in the California market.

In addition, we recently obtained approval for a 10% rate reduction in our California homeowners line, the new rates going to effect on August 15, 2008. We believe our new homeowners' rates will make us more competitive on package policies.

Our second quarter 2008 combined ratio of 116.3% in our non-California operations were significantly worse than 106.5% combined ratio, posted in the second quarter of 2007. The deterioration in the combined ratio was primarily due to adverse development in New Jersey and increased losses in Oklahoma and Texas, related to severe weather during the quarter.

The adverse development in our non-California operations was $10 million which was comprised of $13 million of adverse development for New Jersey, partially offset by $3 million of net positive development from other states. The development in New Jersey was primarily related to re-estimation prior year's loss and loss adjustment expense reserves for the PIP coverage.

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. 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.

We are taking steps to improve our results in New Jersey, including new territorial pricing changes that went into effect on August 1, 2008 and a new rating plan to be filed shortly with much improved segmentation and a rate increase of about 5%.

In addition, we obtained our underwriting on working with agents to improve results and have made changes to our claims processes for PIP and BI. The early indication is that claim process changes are having a positive impact on our PIP costs for the current accident year. However, the data is too grim to make any changes to our selections for the current accident year.

Our company wide expense ratio increased from 27.1% in the second quarter of 2007 to 28.2% in the second quarter of 2008. The increase was primarily due to an increase in technology-related expenditures, the establishment of our new product management function, slightly higher advertising expenditures, and the fact that fixed costs have not declined, and in proportion to declines in premiums. So to address the increase in expense ratio during this soft market, we are freezing new hiring except for certain positions.

As I mentioned in the first quarter conference call, we are aggressively making changes to our rating plans to improve our segmentation and overall pricing adequacy. During the second quarter, we implemented four rate changes, and we expect to implement four additional rate changes in the third quarter of 2008.

Although the competitive environment remains intense, we continue to observe more filings for rate increases than rate reductions. The industry is experiencing a reduction in frequency, but we believe the increase in severity more than offsets the reduction in frequency. We believe we will continue to see an increased level of rate action taken by some of our competitors. However, we expect our growth rate over the next several quarters to be negative in the mid-to-high single digits.

We continue to focus on various strategic initiatives that will allow us to take full advantage when the market begins to harden. The various strategic initiatives, include continuing to standardize our claims and underwriting processes, improving our pricing to improve segmentation, improving our technology, and enhancing our customer service levels.

In June, we deployed our Mercury First auto front-end sales systems to the state of New York. We expect to deploy two additional states this year with the remaining states to be completed by the first quarter of 2009.

With that brief background, we will now take questions.
Question And Answer

Question and Answer

Operator

[Operator Instructions]. Your first comes from the line of Josh Shanker with Citigroup.

Joshua Shanker
Citigroup

Good morning.

Gabriel Tirador

Good morning, Josh.

Joshua Shanker
Citigroup

In terms of thinking about your positioning for your national program, we talked many years ago about the 50/50 plan. What do we have is this 3 to 5 year plan for Mercury right now as a national carrier?

Gabriel Tirador

Well right now, our focus is in turning profitability, underwriting profit outside of California in all of our states, Josh, that's a number one priority right now. Our product management team that I mentioned earlier in my prepared remarks, is working very hard in getting that done. Having said that, subsequent to accomplishing that, we're going to be looking at adding additional states, once we feel that we have the infrastructure in place, that we have the proper segmentation, the proper underwriting and claim processes throughout the entire country, and we not there yet. So, that's basically the answer.

Joshua Shanker
Citigroup

Are you fully migrated to one technology platform?

Gabriel Tirador

No.

Joshua Shanker
Citigroup

Where do you stand in terms of that process?

Gabriel Tirador

Well on the front-end system, as I mentioned earlier, we just deployed to our first state, New York. And we expect to be completed through the remaining 12 states by the end of the first quarter of '09.

Joshua Shanker
Citigroup

And in back office?

Gabriel Tirador

Back office is going to be later than that, Josh.

Joshua Shanker
Citigroup

Okay. And in terms of... Just so I understand the process about adopting these things, what's the difficulty of the quick transition? Why does it take so long?

Gabriel Tirador

With respect to systems? With respect to what, Josh?

Joshua Shanker
Citigroup

Developing a back-office system. Why isn't there a platform that you guys can believe and have a 12 months objective of getting it installed throughout the network?

Gabriel Tirador

Well on the back end... we, a few years back, as you recall, Josh, decided to build a platform, a proprietary platform ourselves. It has taken longer than we anticipated and originally forecasted. And our real focus right now... we're focusing on back end is to focus on the front-end systems where we believe we're going to get a lot more value on the front end system, by providing a system that our agents and customers can use, that is very easy to use, regardless of what the back-end system is hooked up to.

So our current strategy is to have a larger focus on the front-end system as opposed to the back-end system. And we've been putting more resources on that currently, that's not to say, that we want to get to a consolidated platform longer term.

Joshua Shanker
Citigroup

And is it the willingness of the agents to adopt the platform that's the big roadblock in getting it deployed?

Gabriel Tirador

Wellyou're mixing up the front end and back end.

Joshua Shanker
Citigroup

No, yes now front-end.

Gabriel Tirador

At the front-end, we expect to deploy... like I said that's a going to be a rapid deployment, because we think there's more value there. And that's going to be in the first... by the first quarter of '09. And we just finished the development of that. And we just deployed it to the State of New York in the second quarter.

Joshua Shanker
Citigroup

And was it easy seamless deployment?

Gabriel Tirador

It was... like with most deployments, initially there is always some issues. And that's one reason why, Josh, we always pick up smaller state. I'm not... not all agents have it right now in New York. So we're in the process of continuing to deploy at New York, getting their feedback with respect to the system and making appropriate changes before we begin the remaining deployment to the additional states.

Joshua Shanker
Citigroup

And would New Jersey be the last state to receive such a thing, because everything seems very precarious in New Jersey?

Gabriel Tirador

Actually New Jersey is not the last state to receive it. I am not sure what the last state is off the top of my head, but New Jersey is not the last state.

Joshua Shanker
Citigroup

Okay. Very good. Well, I wish you guys the best of luck.

Gabriel Tirador

Thank you, Josh.

Operator

Your next question comes from the line of Dan Farrell with Fox-Pitt Kelton.

Dan Farrell
Fox-Pitt Kelton

Hi, just a question on New Jersey reserve addition. Can you just give a little more color on the years that apply to the accident years? And then also, can you just tell us where New Jersey premium currently stands right now and also, what the total reserves are on the New Jersey book of business?

Gabriel Tirador

Go ahead...

Theodore R. Stalick

Yes Dan, it's Ted. As far as your question on the accident years, it's primarily in the last two accident years of '06 and '07 although I think there is a little bit from '05 as well. As far as the... what was your other question... on the premium volumes in New Jersey?

Dan Farrell
Fox-Pitt Kelton

New Jersey premium where that's running right now as a percentage of total claims and also just what's the total amount of reserves in further New Jersey book of business?

Theodore R. Stalick

New Jersey premiums are... for the quarter were about little over $22 million, $21 million-$22 million the quarter. And I don't have a total reserve number for New Jersey right now. It's well over $100 million I know, but I don't have the number handy.

Dan Farrell
Fox-Pitt Kelton

Okay. And then just a question on California growth. This is now, I think, the third... fourth consecutive quarter where you had negative PIP growth. Do you feel you are starting to see an inflection point in the PIP ex- any movements that we're seeing in the rates or how do you see that turning going forward?

Gabriel Tirador

Well it's hard to forecast that trend, because there are going to be some changes ongoing here in California with the new territory regulations. We have seen some competitors file for rate increases on that, some of them not yet implemented. We're planning on making some changes on our own. What we've seen here in California is basically that our new business has slowed to a point that it's just not offsetting the loss in our renewals.

Our retention is down very slightly, but our new business growth is down quite a bit. And I think it's a function of the current market conditions in California, the increased competition levels, the advertising, all of which we have discussed in the past, which we do believe will change. And we are also hopeful that this new change in our homeowner rates will make us much more competitive on our package policy. That's basically where we are at.

Dan Farrell
Fox-Pitt Kelton

Okay. And I apologize I missed it in your initial comments. But what were the most recent California rate changes that you put through?

Gabriel Tirador

Well, we just filed... I said in my prepared remarks, that we had just filed for the new territorial rate regulations.

Dan Farrell
Fox-Pitt Kelton

Okay.

Gabriel Tirador

As was required by our competitors, for the new territorial rate regulations in July... mid-July we filed, note implemented, just filed.

Dan Farrell
Fox-Pitt Kelton

Okay. All right. Thank you very much.

Gabriel Tirador

Okay.

Operator

Your next question comes from the line of Meyer Shields with Stifel Nicolaus.

Meyer Shields
Stifel Nicolaus

Thanks. If I can start with New Jersey, was the rate increase that you filed there, did that take into account the fact that you had a reserve change in the quarter and therefore underlying loss experience was little higher than you'd previously thought?

Gabriel Tirador

No, the rate change that we just filed for, that went into effect on August 1st, was purely a territorial rate change. And keep in mind, Meyer, that as I mentioned in my prepared remarks, we are actually seeing improvement on the current accident year with respect to some of the claim process changes that we made, year-over-year on an accident year basis.

We have not changed the selections for the current accident year but are seeing some improvement in our losses in the current accident year. But if I understood your question correctly, this latest change that we made were purely on territorial rate changes. A subsequent rate change that we plan on making here this week, I believe, is going to be about plus 5%.

Meyer Shields
Stifel Nicolaus

Okay. That is helpful, I appreciate it. In California, I guess, when I look at either sequential year-over-year policy in-force changes, it seems like you are having more trouble with auto than with home. And I guess, I am trying to understand the thinking of taking further rate decreases in homeowners would address that.

Gabriel Tirador

Well, the further rate decreases in homeowners, a lot of it is a function of the profitability that we've had in that line. The margins have been favorable in that line, a lot of that is at function. In addition to that, we felt that we weren't properly segmenting certain homes in the state and that finally takes care of that as well.

And thirdly, we believe that with a more competitive homeowner product that we're going to be able to package, not only the homeowner, but also get the auto. In cases where we weren't competitively priced in homeowners, we were losing the whole package, both the home and the auto.

Meyer Shields
Stifel Nicolaus

Okay. Is there any common thread? It's a difficult question to ask probably, worse to answer, in terms of the new business that you're not seeing. Is that disproportionately non-standard or in certain geographic regions?

Gabriel Tirador

Pretty much, the new business that reduction, if I understood your question, is pretty much across the board. And one other comment, I would like to make that, that homeowner rate reduction in addition... one additional comment is that it was also a fine that was required for us to make from the insurance commissioner.

Meyer Shields
Stifel Nicolaus

Okay. No, that's very helpful. Thank so much.

Gabriel Tirador

Thanks.

Operator

Your next question comes from the line of Alison Jacobowitz with Merrill Lynch.

Alison Jacobowitz
Merrill Lynch

A few questions. I was wondering if you could quantify the weather loss in the Midwest. Then also what was your accident year combined ratio outside of California excluding New Jersey if you have it? And then also if you could just... I just want to make sure I have it right, the filing in July. Can you remind us, if you tell us... I don't think you said in the intro. Did you? And can you repeat yourself so at that?

Gabriel Tirador

Go ahead. You start on the weather related.

Theodore R. Stalick

On the weather, it accounted for about $3 million of additional losses this year that we didn't have last year in Oklahoma and Texas. I don't have the --

Gabriel Tirador

Well the underwriting... yes the underwriting loss was approximately $20 million for New Jersey.

Alison Jacobowitz
Merrill Lynch

Okay

Gabriel Tirador

So you backed that out.

Alison Jacobowitz
Merrill Lynch

All right.

Gabriel Tirador

And what was your question regarding July, was that?

Alison Jacobowitz
Merrill Lynch

If you could just repeat the details of the July rate filing. I just want to make sure I still have it right.

Gabriel Tirador

In California?

Alison Jacobowitz
Merrill Lynch

Yes, yes. The file with the territory.

Gabriel Tirador

Yes, the new regulations here in California required all companies to become fully compliant with the new territorial regulations that were promulgated about two years ago. All companies were required to file with the new regs and be 100% compliant by the mid of July and all companies should have filed at that time and we did it so as well.

Alison Jacobowitz
Merrill Lynch

And how much have you filed? Did you take the full amount?

Gabriel Tirador

Well yes, all companies have had to become fully compliant with the new weighting scheme with respect to how much weight territories have in the overall pricing structure.

Alison Jacobowitz
Merrill Lynch

And have you given, like net... what you think the net effect will be on your top line of your margin? Some companies have given, we think it will be x point or whatever, have you done that?

Gabriel Tirador

Well, our overall... first of all, we believe that what we filed... we were already pretty much fully compliant. So, the dislocation with respect to any changes in premiums for us, as a result of the new territorial regulations based on what we filed is very minimal. However, we do have a slight increase that we filed for maybe in the neighborhood of, maybe 2% overall with respect to this filing as well, with the future implementation date of some time in '09.

Alison Jacobowitz

Merrill Lynch

Okay, great, thank you very much.

Operator

[Operator Instructions] Your next question is a follow-up question from the line of Dan Farrell with Fox-Pitt Kelton.

Dan Farrell
Fox-Pitt Kelton

Hi thanks for taking the follow up. Just actually quick numbers question. The adverse development this quarter was $9 million. I think the six month you have there is $70 million of adverse. But I thought first quarter was positive. So I'm just not sure I am understanding that if there is... maybe there is the new off in the accounting for that development, I'm not following?

Theodore R. Stalick

Yes, Dan, this is the first quarter that we've started showing development on prior quarters within the current accident year. What you have going there is you have all the development on prior accident years, plus the effective development on first quarter that it flowed through in the second quarter, for the current accident year.

So for example, in California, we actually had some redundancies on Q1 reserves that flowed through in the second quarter that offset the deficiencies on the accident year reserve.

Dan Farrell
Fox-Pitt Kelton

Okay. So, in the second quarter they were all redundancies that offset the first quarter? It looks like they'd be first quarter deficiencies, that's what I am just trying to understand on apple-to-apples?

Theodore R. Stalick

No it's a pure accident period, loss ratio.

Dan Farrell
Fox-Pitt Kelton

Okay, all right. Fair enough, thank you.

Theodore R. Stalick

Okay.

Operator

Your next question is a follow-up question from the line of Meyer Shields with Stifel Nicolaus.

Meyer Shields
Stifel Nicolaus

Thanks. I guess just briefly following up on Josh's question earlier on the call. Is it safe to assume that you're not looking at acquisitions in states outside of California?

Theodore R. Stalick

Yes, it's pretty safe to assume at this point.

Meyer Shields
Stifel Nicolaus

Okay, thanks.

Operator

There are no further questions at this time. Are there any closing remarks?

Gabriel Tirador

No, I would just like to thank everyone for joining us on the call and we look forward to speaking with all of you next quarter. Thank you.

Operator

This concludes today's Mercury General's second quarter 2008 results conference call. You may now disconnect.