S&P Capital IQ

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Mercury General Corporation NYSE:MCY

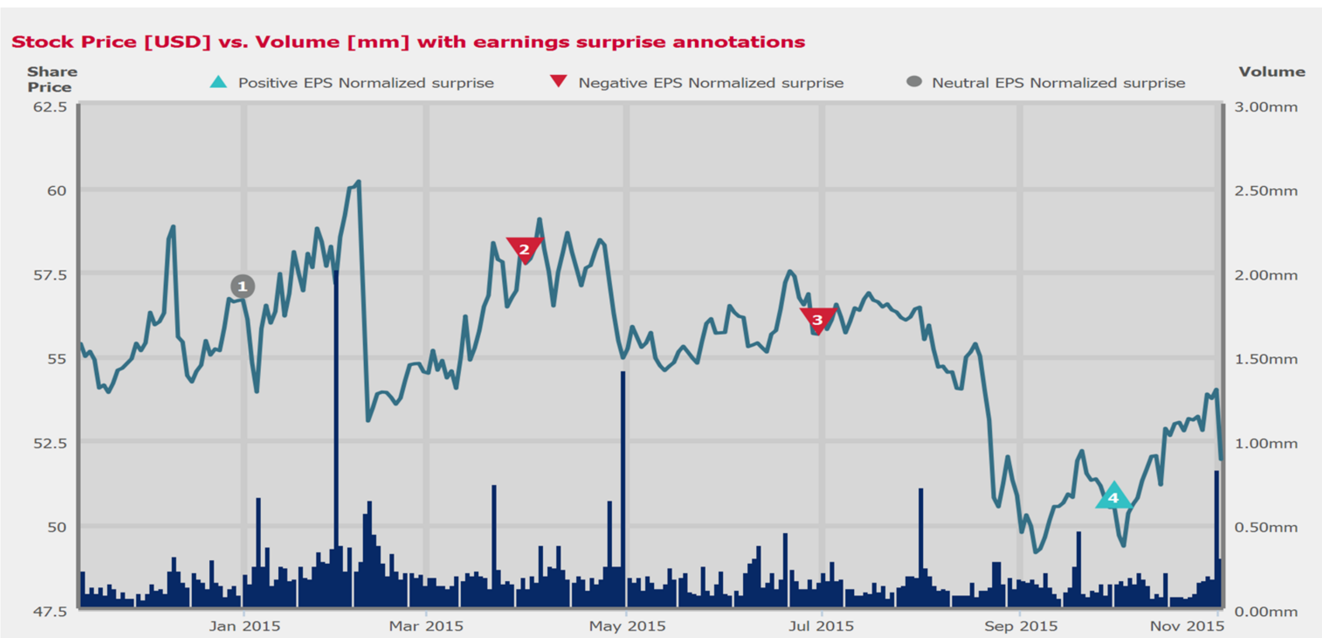
FQ4 2015 Earnings Call Transcripts

Monday, February 08, 2016 6:00 PM GMT

S&P Capital IQ Estimates

	-FQ4 2015-			-FQ1 2016-	-FY 2015-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.45	0.52	▲15.56	0.69	2.26	2.34
Revenue (mm)	736.10	746.43	▲1.40	777.50	2989.05	2999.39

Currency: USD
Consensus as of Jan-12-2016 7:25 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ4 2014	(0.01)	(0.13)	NM
FQ1 2015	0.73	0.59	▼1 (19.18 %)
FQ2 2015	0.67	0.64	▼2 (4.48 %)
FQ3 2015	0.58	0.59	▲3 1.72 %

Call Participants

EXECUTIVES

Christopher Graves
Chief Investment Officer and Vice President

Gabriel Tirador
Chief Executive Officer, President and Director

Robert Houlihan
Chief Product Officer and Vice President

Unknown Executive

ANALYSTS

Alison Marnie Jacobowitz
BofA Merrill Lynch, Research Division

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

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

Wesley Richard Guylay
Wesley Guylay Capital Management, L.P

Presentation

Operator

Good morning, good afternoon. My name is Stephanie, and I will be your conference operator today. At this time, I would like to welcome everyone to the Mercury General Fourth Quarter Conference Call. [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 certain 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. You may begin.

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 Ted Stalick, Senior Vice President and CFO; and Robert Houlihan, Vice President and Chief Product Officer. On the phone, we have Mr. George Joseph, Chairman; 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 2014 operating results and ratios were distorted by a $27.6 million fine imposed by the California Insurance Commissioner. Accordingly, all company-wide and California personal auto comparisons to 2014 are exclusive of the fine.

Our fourth quarter operating earnings were $0.52 per share compared to $0.37 per share in the fourth quarter of 2014. The improvement in operating earnings was primarily due to an improvement in the combined ratio from 101.7% in the fourth quarter of 2014 to 100.2% in the fourth quarter of 2015.

Our California private passenger auto combined ratio improved in the fourth quarter of 2015 as compared to the fourth quarter of 2014. California private passenger auto frequency declined slightly and severity increased in the mid-single digits as compared to the fourth quarter of 2014. Higher average premiums from rate increases taken in the latter part of 2014 and in 2015 offset the year-over-year increase in severity in the quarter. New rate increases pending Department of Insurance approval include a 5% rate increase filed in June 2015 from Mercury Insurance Company, which represents about half of our company-wide premiums written and a 6.9% rate increase filed in July 2015 for California Automobile Insurance Company, which represents 15% of our company-wide premiums written.

Our California homeowners combined ratio was 104.5% in the quarter compared to 97.5% in the fourth quarter of 2014. Adverse development and an increase in severity negatively impacted our results.

Outside of California, our results were negatively impacted by adverse development, catastrophe losses and higher than expected loss frequency and severity in several states. The combined ratio was about 113% in the quarter compared to 108.1% in the fourth quarter of 2014.

Our expense ratio was 25.9% in the quarter compared to 26.5% in the fourth quarter of 2014. The reduction in the expense ratio was primarily due to lower average commissions and advertising expenses. Net advertising expense in the quarter was $4.8 million compared to $6 million in the fourth quarter of 2014. We expect our advertising spend in the first quarter of 2016 to be similar to our first quarter 2015 spend of approximately $15 million.

Premiums written grew 7% in the quarter primarily due to higher average premiums per policy, the acquisition of Workmen's Auto and an increase in new business policy sales. Workmen's Auto premiums written of $4.1 million added 6/10 of 1 point to the quarter's premiums growth. Company-wide private passenger auto new business applications submitted to the company increased 13% in the fourth quarter of 2015 and homeowners new business submissions declined 2%. In California, we posted premiums written growth of 6.8%. Outside of California and excluding our mechanical breakdown product, premiums written increased 12.3% in the quarter.

With that brief background, we will now take questions.

Question and Answer

Operator

[Operator Instructions] You do have a question from the line of Ken Billingsley with Compass Point.

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

This is Ken Billingsley with Compass Point. I wanted to just follow up on the expense ratio. You said that average commissions were down and advertising expenses. I just want to verify 1 number. You said it's $15 million to the spend in the first quarter of '16?

Gabriel Tirador
Chief Executive Officer, President and Director

Yes. That's what we expect, about the same level as in 2014, Ken.

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

Okay. And I'm on the East Coast and I've seen a lot more advertising for Mercury, I knew you had done a global campaign on the advertising side. Have you scaled that back? That's the first question, have you scaled it back? And if so or not, what is the plan for that advertising spend?

Gabriel Tirador
Chief Executive Officer, President and Director

Well, we spent about $44 million in 2015, and we expect to spend about $42 million in 2016. And we think that the advertising is working. We're recovering the majority of our advertising cost. We did in 2015. So our cost per sale is really close to where it needs to be in '15 and we expect to get to where it needs to be in 2016.

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

And on the lower average commissions, can you talk about that? I know at one point, it's, at least -- I believe, you were paying slightly higher commissions in some new territories and at some point, you were expecting that the expenses were going to catch up with the premiums that you plan to write in those states. So is that a case of the premiums catching up? Or is this actual less commission percentage being paid out?

Gabriel Tirador
Chief Executive Officer, President and Director

It's really a combination of both. We are growing in some states outside of California quite well, in some of the states outside of California, but our average commissions are down. We are actually paying less as a percentage of premium as we were before. We've cut our commissions.

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

And is it in line with competitive rates? Or are you below your competitors now?

Gabriel Tirador
Chief Executive Officer, President and Director

No, it's in line with our competition. In California, we're quite a bit above our competitors. I think in California, we average about 17% or so commission rate, 16% to 17% and the competition is probably around 13%. Outside of California, we're probably hovering around 13%, 13% and change, which is where the competition is at.

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

Okay. And the last question I just want to ask was, again, on the dividend and the payout ratio, it looks like you still have a lot of capital capacity. I believe you said in the past you would write -- could write up to 2.5X your surplus level. So it looks like you still have room to maintain this dividend. What do you need to -- is there anything that you guys are looking to see change in 2016 to create a footing to maintain the high dividend payout ratio?

Gabriel Tirador
Chief Executive Officer, President and Director

Yes, improve our combined ratio. We -- really if we ran even at a 98.5, 98, you're talking about more than paying the dividend. And our target is a 95. Now in California, we have some rate increases in MIC that are pending approval that we feel that once we get that rate increase in MIC, we're going to be pretty much where we need to be for the time being in MIC. In Cal Auto, we have a 6.9% that's pending approval that hopefully will get that approved well pretty soon I should say. So those 2 rate increases are going to go a long way to improve our profitability. Outside of California, we were -- this quarter was a disappointment. But when you take a look at our accident year results for private passenger auto, I think in 2013, we ran a combined of about 101% outside of California for PPA, private passenger auto and in '14, we ran at about 100%. This year, we got surprised by the increase in frequency and severity and our rates really were not -- did not keep pace with that. So we anticipate increasing rates outside of California. We're also going to be driving down our LAE and expense ratios outside of California. They're not where they need to be. And the 101% and the 100% that I quoted earlier, that's with the higher expense and LAE ratios that we have. So we're going to be very focused going forward in driving that down, our LAE and expense ratio, especially outside of California. We're going to be increasing rates where we need to to offset some of this frequency and severity that we saw outside of California. And in California, as I said, MIC and Cal Auto, we have some pending. So to answer your question, we don't expect our combined ratio to be at this level. And if we drive that combined ratio down to closer to our target, our dividend paying capacity will be fine.

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

And your California expense ratio or your commission ratio you said it was 17%. I mean it's 400 basis points higher than the comp. Is there a reason that needs -- does it need to be that elevated? And is it just historical and it's driving better business, at least, in your opinion?

Gabriel Tirador
Chief Executive Officer, President and Director

Well, it's historical. I also do think it can drive better business, but it is -- that's actually come down as well. We've actually reduced some commissions here in California. But we do think that in California, it's a different market and we've been here a long time and we have very strong agent relationships. So even though we've driven that down a little bit, it's not going to be driven down as much as you're seeing outside of California.

Operator

Your next question comes from the line of Greg Peters of Raymond James.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

I just wanted to circle back on the pending rate increases. I think you went through and identified a couple pieces in California that were pending for approval. What is -- what's going on outside of California? Are there rate increases that are on the board that will begin to flow through immediately? Or is there a waiting for approval process that you're following?

Gabriel Tirador
Chief Executive Officer, President and Director

It's much easier to get a rate outside of California, but I'm going to go ahead and Robert talk about that.

Robert Houlihan
Chief Product Officer and Vice President

Yes, I think in our largest states we actually already have had recent rate increases that are starting to earn in in most of our big states outside of California, so Texas, Florida, Georgia. We do have 1 pending for New York. But by and large, we've already taken rate increases to react to the trend that we've seen in those states.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

And -- I mean -- you went through and identified those states. I imagine those are the states where you're running a combined ratio temperature. What's been the magnitude on average of the rate increase that you've filed for or are implementing?

Robert Houlihan
Chief Product Officer and Vice President

In general, high single digits. New York, the pending increase is a little bit higher, but on average, high single digits.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Okay. And I think you cited what your ultimate target of a combined ratio is in the mid-90s, but I think you also, in answer to the previous question, used the 98% to 98.5% sort of benchmark. Is -- should we view that as an intermediate term sort of objective for management? And do you have a time stamp on when you think you might get there?

Gabriel Tirador
Chief Executive Officer, President and Director

Well, I mean our target is a 95% and the reason I stated a 98%, 98.5%, it was related to the dividend question and the fact that our earnings are below our -- the dividend of $2.60 or so. Reaching a 98% and change in combined ratio gets us to about that level, but our objective is still to get to a 95%. I think in California, absent any trend, I think we're going to be starting to get close to that number. Outside of California, it's going to take time for these rate increases to earn in and it will take us a little time to reduce our expense and LAE outside of California. So I would say that in '16 outside of California, no, we don't expect to be near that combined ratio target. But in California, I think we're going to be much closer to it. So if you want to call it an interim step of 98%, an interim step, that's -- I wouldn't argue too much about that.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Okay, that's fair. And of course, this is going to be a gradual improvement. It's not going to come all up in the first quarter. It's going to bleed in through the course of the year, frankly, in the next couple of years. I imagine.

Gabriel Tirador
Chief Executive Officer, President and Director

Yes, it's not -- yes, it's not an overnight -- it doesn't happen overnight, yes.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Thank you, for that clarification. And I'd like to spend just a minute talking or asking you about 2 other components of your business that you don't spend a lot of time talking about. And I thought it'd be a good opportunity for you to remind us, first and foremost, on the property side. Can you tell us a little bit about your business mix of where your exposures are on the property side? And then, the second question is going to segue into the investment portfolio, and I know you've had periods where you've been very successful. And I'm just curious what your portfolio exposure looks like to limited partnerships or high yield or energy investments. It certainly seems to be topical these days to be asking about that.

Gabriel Tirador
Chief Executive Officer, President and Director

Okay. On the property side, we write homeowners in a variety of states or in many states, California being the biggest state that we write homeowners in, probably over $300 million in homeowners in California, but we also write in Arizona, a little bit in Georgia, Illinois, New Jersey, Nevada, New York, Oklahoma, Pennsylvania, Texas and Virginia. Many of those states are very, very small though. To give you an example, we wrote $329 million in homeowners in California and I think our next biggest state is probably about $14 million, $15 million and that would be like Texas. We also write some commercial property business primarily in California and that's about $75 million or so of business in the property side. We do have CAT cover. We have a retention of about $100 million. And you can read about that in the 10-K for more specifics but -- so -- that's on the property side as far as our exposure. Most of our exposure as you can see is in California. And on the investment side, Chris, are you on the line?

Christopher Graves
Chief Investment Officer and Vice President

Yes, I'm right here. Greg, thanks for the question. The -- it's interesting. I'm actually -- I forget. I really am getting more and more bearish as time has been moving along here. Last year, we took down our equity investments by 25% to 30% and pushed a lot more capital towards municipal bonds, which turned out to be a pretty decent move for the 2015 cycle. In terms of high yield, we don't have a much of an axe there. We do have investments in senior secured bank loans through 2 special investment vehicles in that area. But on a $2 billion or excuse me, $3 billion portfolio, 70% of it is in municipal bonds, AA rating. The overall portfolio rating is pretty much AA as well.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

And you don't have any energy -- meaningful energy components in that either, correct?

Christopher Graves
Chief Investment Officer and Vice President

In the equities, no. We have taken down -- actually, we've got a couple of MLPs, maybe still in there that we may be kicking ourselves over. But for the most part, the energy exposures are significantly down from where they were many, many years ago. And in fact the portfolio is much more broadly diversified at this point. There is still a fairly good concentration in utility stocks as you can understand for the income. And thankfully, those have had a nice -- they've firmed in here anyway for this year so far. So we're definitely watching the risks, but the concentration in risk is much, much lower than where it was just from a few years ago and actually, went through this whole walk-through last week with investment committee and the board that I continue to really watch our risk exposures and have a de-risk bias in the portfolio.

Operator

[Operator Instructions] Your next question comes from the line of Jay Cohen with Bank of America.

Alison Marnie Jacobowitz
BofA Merrill Lynch, Research Division

It's Alison Jacobowitz. Just wondering, the policies outside of California, are they -- what's the balance between 6 months and annual policies? Or are they all 6 months? I don't remember.

Gabriel Tirador
Chief Executive Officer, President and Director

Robert?

Robert Houlihan
Chief Product Officer and Vice President

There's a couple of states where we write annual policies but the vast majority are 6-month policies.

Alison Marnie Jacobowitz
BofA Merrill Lynch, Research Division

Thanks. And also, I didn't hear it, so forgive me if you said it already, but on the frequency and severity in California, or particularly frequency, it seems like it's a little bit different than some of your competitors. Can you add a little bit more color, if you didn't already, on frequency trends?

Unknown Executive

Well, hi, Alison. In California, in general, we had frequency for the year up slightly in the low single digits, but we had a fairly favorable fourth quarter where it dropped down to a favorable trend slightly. And we're not sure why. Sometimes it's frequency. For example, in the first quarter of '15, we had a big spike up in frequency. So sometimes there's just some variability from quarter-to-quarter.

Operator

[Operator Instructions] Your next question comes from the line of Wesley Guylay with Wesley Guylay Capital.

Wesley Richard Guylay
Wesley Guylay Capital Management, L.P

What is the combined ratio running in California Auto?

Gabriel Tirador
Chief Executive Officer, President and Director

We don't disclose that, but it's not at our target right now, Wesley. It's above our 95% target. It's between 95% and 100%.

Wesley Richard Guylay
Wesley Guylay Capital Management, L.P

So you think these rate increases that are coming, I think you said shortly, will get you down to your target?

Gabriel Tirador
Chief Executive Officer, President and Director

I think it gets us to our target in our largest company on a go-forward basis depending on what the trends are, but yes, we think that in MIC, our largest company in California, gets us to target. Cal Auto, I think that there may still be more rate need, which is the nonstandard company, the standard mid-market company. But in MIC, our largest company, I think it gets us where we need to be absent any kind of adverse loss trends that we're not anticipating.

Wesley Richard Guylay
Wesley Guylay Capital Management, L.P

That would be very good. There's a lot of leverage just to getting that towards your target.

Gabriel Tirador
Chief Executive Officer, President and Director

Yes. I agree.

Operator

I currently show that there are no further questions at this time. I turn the call back over to the presenters.

Gabriel Tirador
Chief Executive Officer, President and Director

Well, thank you for joining us this quarter and we look forward to speaking with you first quarter of '16. Thank you very much.

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