S&P Capital IQ

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Mercury General Corporation NYSE:MCY

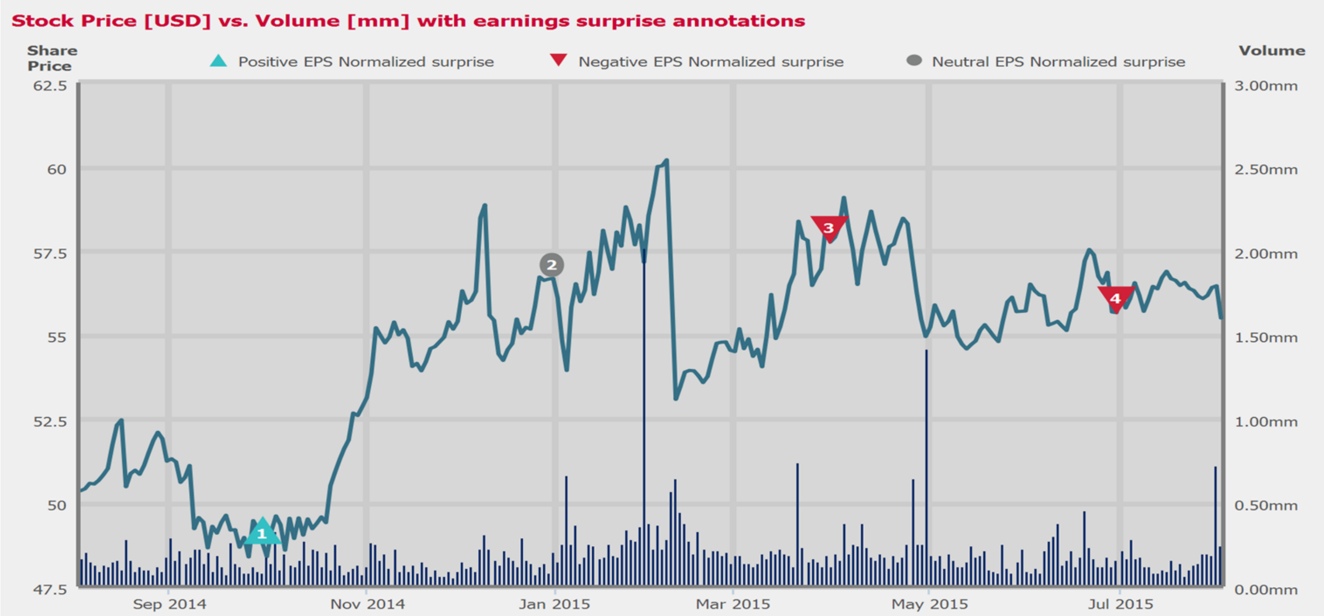
FQ3 2015 Earnings Call Transcripts

Monday, November 02, 2015 6:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2015-			-FQ4 2015-	-FY 2015-	-FY 2016-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.58	0.59	▲1.72	0.52	2.32	2.67
Revenue (mm)	745.00	778.92	▲4.55	732.20	2945.00	3048.00

Currency: USD
Consensus as of Nov-02-2015 2:56 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ3 2014	0.61	0.81	▲1 32.79 %
FQ4 2014	(0.01)	(0.13)	NM
FQ1 2015	0.73	0.59	▼2 (19.18 %)
FQ2 2015	0.67	0.64	▼3 (4.48 %)

Call Participants

EXECUTIVES

Gabriel Tirador
Chief Executive Officer, President and Director

Robert Houlihan
Chief Product Officer and Vice President

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

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

Presentation

Operator

Good afternoon. My name is Lori, and I will be your conference operator today.

At this time, I would like to welcome everyone to the Mercury General quarterly conference call. [Operator Instructions] Gabriel Tirador, you may begin your conference.

Gabriel Tirador
Chief Executive Officer, President and Director

Thank you very much. I would like to welcome everyone to Mercury's third 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.

Before we take questions, we will make a few comments regarding the quarter. Our third quarter operating earnings were $0.59 per share compared to $0.81 per share in the third quarter of 2014. The deterioration in operating earnings was primarily due to an increase in the loss ratio from 69.8% in the third quarter of 2014 to 73.2% in the third quarter of 2015. The primary contributors to the elevated loss ratio were from our California private passenger auto and homeowners lines of business.

Our California private passenger auto loss ratio increased to 71.2% in the quarter from 68.5% in the third quarter of 2014 and was up slightly from the second quarter 2015 loss ratio of 70.1%.

Our California homeowners loss ratio increased to 85.4% in the quarter from 76.7% in the third quarter of 2014.

In the third quarter of 2015, California private passenger auto frequency was relatively flat and severity increased in the low single digits as compared to prior year. Higher average premiums from rate increases taken in 2014 and 2015 offset the year-over-year increase in severity in the quarter. However, the California private passenger auto loss ratio increased as there was less favorable development in the quarter from prior and current accident year reserves as compared to prior year.

To address the higher-than-targeted loss ratio, a 6.4% rate increase was implemented in late May for Mercury Insurance Company, representing about half of our company-wide premiums written; and a 6.9% rate increase for California Automobile Insurance Company, representing about 15% of our company-wide premiums was implemented on August 2. In addition, a 5% and 6.9% rate increase is pending approval for Mercury Insurance Company and California Automobile Insurance Company, respectively.

Our California homeowners loss ratio was negatively affected by an increase in frequency and severity in the quarter. We believe the hotter-than-typical summer in California this year may have been a contributing factor to the increase in frequency and severity in the quarter. During the quarter, we experienced more than our historical number of large water and fire claims, which negatively impacted our severity.

Partially offsetting the increase in loss ratio during the quarter was a reduction in our expense ratio. Our expense ratio was 26% in the quarter compared to 26.9% in the third quarter of 2014. The reduction in the expense ratio was primarily due to lower average commissions and profitability-related accruals, partially offset by increased advertising expenses. Net advertising expense in the quarter was $10.9 million compared to $5.3 million in the third quarter of 2014.

Outside of California, the combined ratio was about 101% in the quarter compared to about 103% in the third quarter of 2014.

Premiums written grew 8.2% 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 at $5.2 million added 0.7 point to the quarter's premium growth.

Company-wide private passenger auto new business applications submitted to the company increased 15% in the third quarter of 2015 and homeowners new business submissions were up 9%.

In California, we posted premiums written growth of 7.5%.

Outside of California and excluding our mechanical breakdown product, premiums written increased 9.1% in the quarter.

We generally expect our fourth quarter combined ratio to be higher than the rest of the year by several points due to increased loss frequency and higher severities caused by seasonal driving and weather.

This year, we expect the California personal auto rate increases implemented earlier in the year and earning into our results in the fourth quarter will offset some or all of the seasonal loss effect.

That said, it is hard to predict with certainty as there are many factors currently unknown or beyond our control including the severity of elevated precipitation levels predicted from this year's El Niño event. With that brief background, we will now take questions.

Question and Answer

Operator

[Operator Instructions] Your first question is from Ken Billingsley of Compass Point.

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

One of the questions I want to have is, specifically, I know you gave some detail on the loss ratios in and outside of California and in the state. From a bucket standpoint, how much of it is primary business versus maybe what you would consider nonstandard auto business? And where is that growth coming at -- from as a percentage of overall book of business?

Gabriel Tirador
Chief Executive Officer, President and Director

Well, let's talk about California first. In California Mercury Insurance Company, which is our largest subsidiary here in California, and you have Cal Auto, which is our mid-market company, we're primarily seeing more new business growth here in Mercury Insurance Company. And as far as the loss ratio, loss ratio is much better in Mercury Insurance than it is in Cal Auto. So there is a discrepancy between the preferred and the nonstandard market. Outside of California, we try to have a product that basically covers a broad range of risks. And we usually have one company outside of California, and we're able to write, like I said, a broad range of risks. With respect to the loss ratio, there are certain states outside of California where the loss ratio of nonstandard has been hotter. But I can tell you in general, outside of California, we've been able to price that pretty well, and in many of our states outside of California, the nonstandard piece is actually behaving very well.

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

So outside of California, nonstandard's performing better than expected?

Gabriel Tirador
Chief Executive Officer, President and Director

I wouldn't say better than expected, but in general, it's performing like we're expecting.

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

Okay. And is this kind of business -- some of it is a mix of business. It's interesting, I saw your lower expense ratio; some of that, I believe, you said was driven by lower average commissions. Is that driven in California? Or are you seeing improvements outside of California? If I recall correctly, you guys were paying higher commissions initially as you were growing that business.

Gabriel Tirador
Chief Executive Officer, President and Director

Well, outside of California, we made some changes to our commission structure. You may recall, Ken, back, I think it was, in January of '14, where we reduced rates, but we also reduced commissions back in '14. And in California, we've also made some changes to our commission structure as well, where we reduced our base commissions as well as profitability-related commissions.

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

Is this potentially creating any adverse selection?

Gabriel Tirador

Chief Executive Officer, President and Director

No, we don't believe so. Our commission levels are still well above industry average in California. For example, our commission -- average commission rate in California hovers about 17% or so when you include contingent commissions. And I'd say the competition probably is in the neighborhood of 13%.

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

Okay. Moving on just on the equity side, on the balance sheet side. It seems like we've had 5 quarters now that you've been selling equities and taking a realized loss. Can you talk about what the strategy and what's going on there? Is there a -- I mean, is there a need from a cash standpoint? Or what is the strategy, what you're using that cash for?

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

Ken, first of fall, I just wanted to clarify that our entire portfolio is classified as trading. So the realized gains, the losses are primarily mark-to-market adjustments and not securities that we have actually sold. So you can't really look at our P&L realized gains and losses and tease out the portion that was sold. But if you look at our 10-Q, it will be disclosed separately there. With that said, we have been shifting a portion of the portfolio out of equity securities and more toward fixed-maturity securities. We started doing that earlier in the year and that was primarily because Chris Graves, our Chief Investment Officer, became less and less comfortable with the equities in the markets and felt like there was more opportunities in the fixed income space.

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

All right. Last question I have is just on the dividend and the payout ratio. How -- where do you think you can take the leverage of the business on a statutory basis given your mix of auto and home? And I'm assuming the home's going to continue to grow. Where can you take the leverage ratio? And how long can you support a dividend payout ratio that exceeds 100% before you feel that you need to adjust somewhere?

Gabriel Tirador
Chief Executive Officer, President and Director

Well, I think we've answered this in previous quarters, Ken. I think we feel comfortable at about 2.5x, and we're close to about 1.92x now. We feel comfortable at about 2.5x. And as far as the 100% payout, we anticipate -- one of the things you got to keep in mind is we don't anticipate running at a 99% combined ratio long term. Our target ratio historically has been a 95% combined ratio. I think with the rate increases that we've taken here in California, that's going to help us get closer to that in California. Outside of California, we're willing to write a little bit higher than the 95% at this time to try to build the business. But that said, we don't expect a 99% combined ratio and a dividend payout ratio above 100% long term. But I will say this, we do have the luxury that we have enough capital that we feel very comfortable with paying at 100% or slightly above 100% payout because we have a pretty darn strong balance sheet.

Operator

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

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

I wanted to talk about 2 areas or have -- ask about 2 areas. First of all, marketing relationships you have both in California, outside of California, outside of the traditional independent agency channel. Can you talk about relationships you might have with CoverHound or your use of comparative raters outside of California?

Gabriel Tirador
Chief Executive Officer, President and Director

Sure, I'll let Robert Houlihan talk a little bit about that.

Robert Houlihan
Chief Product Officer and Vice President

Sure. Outside of California, aside from our traditional core independent agents, we've been growing our business through national accounts: so Answer Financial, Goji, CoverHound. We also have been growing our business direct-to-consumer, and we get that business generated from our advertising. We get some business by leads -- through lead generators. And then, we get a fair amount of business from comparison sites like Google Compare and Compare.com.

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

Can you possibly -- are you having different type of loss experience with these sources of business versus your traditional channel?

Robert Houlihan
Chief Product Officer and Vice President

So on Buy Button, on the direct consumer business, our loss ratio has actually been favorable -- not by much, but slightly favorable to our core business. On some of the national accounts, it's been running a little bit hotter, and we've been evaluating different underwriting approaches to bring that back into line.

Gabriel Tirador
Chief Executive Officer, President and Director

And it does vary by state. I'll say it varies by state. The national accounts do vary a little bit by state as far as the profitability by state. It does vary.

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

And you're segmenting Google -- your relationship with Google and to the direct channels, is that correct?

Robert Houlihan
Chief Product Officer and Vice President

Correct.

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

And can you just talk about just the growth of those different channels? Maybe -- I'm obviously focused on Google, just seeing how successful -- there's been a lot of noise in the marketplace, and I think CoverHound just recently completed another capital raise. So any perspective on that emerging market would be interesting.

Gabriel Tirador
Chief Executive Officer, President and Director

It's not -- at this point, it's immaterial with respect to the number of sales that we're getting from Google per week. It's really immaterial. It's something that we're watching and working with Google on. But right now, the sales, when you consider our weekly sales company-wide, it's a very small fraction.

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

That makes sense, that makes sense, okay. Just -- and just piggybacking on the production side, can you just remind us how your advertising and marketing program is going? I know there's been increased expense this year. Can you sort of lay the groundwork of what we should be thinking about in terms of not only the expense for the full year '15, but how it might look for 2016?

Gabriel Tirador
Chief Executive Officer, President and Director

Sure. I mean, I think based on the first 9 months of the year, we're recovering the vast majority of our advertising costs. In other words, our cost per sale is close to where it needs to be. And when we take a look at our advertising, we evaluate the effectiveness of our advertising. We take a look by comparing the lifetime acquisition costs that are built into our pricing through the actual acquisition costs. So we're very close to where we'd like to be. We're a little bit off. I think we're going to -- the budget this year was somewhere in the neighborhood of $48 million company-wide for advertising. I think we're going to come in a little less than that this year, maybe, I don't know, $45-ish million would be my best estimate at this time. And as we look forward into 2016, I think you're going to see similar amounts of advertising. Because we think that the economics are working for us -- in general for us right now. So when we evaluate the economics, we're pretty close to where we need to be, so we're going to continue to do it. So I anticipate that our budget next year for advertising is going to be similar. It might be a little lower, but it's going to be similar.

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

Okay. One other minor technical question. Just in the press release and the financials, there's a reconciliation of the operating measures. I noticed there is a big jump up in the change in the net unearned premium, quarter-over-quarter, but it's flat year-to-date. Is there something going on there? Or is it just a timing difference?

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

That's pretty much a timing difference. The third quarter -- we have seasonal -- seasonality to our premiums written. In the first and third quarters, we write more premium than in the second and fourth. So it's more of a seasonal with which, 6- and 12-month policies, you'll see fluctuations.

Operator

[Operator Instructions] Your next question is from Alison Jacobowitz of BMO Merrill Lynch (sic) [BofA Merrill Lynch].

Alison Marnie Jacobowitz
BofA Merrill Lynch, Research Division

Really answered most of my questions, but if I could just look at it -- well, first of all, on the claims frequency, if I can ask you to just maybe repeat a little what you said on the auto claims frequency inside of California. I believe you said it was flat quarter-over-quarter and severity was up in the low single digits. But if you could repeat that and if you could add any more color on what you're seeing in frequency. And then, as far as the expenses, just even taking a step back, if you look at the way the expense ratio was in the quarter and you've talked before about maybe a range. I don't think I heard you say it this time, how you're looking at your own expense ratio given everything you said about advertising and rate increases, et cetera, going forward.

Gabriel Tirador
Chief Executive Officer, President and Director

Okay. To answer the first part of your question, as I mentioned earlier, our frequency was relatively flat in the quarter in our auto line, year-over-year, in California auto, and our severity was up in the low single digits. Now year-to-date, our frequency is up year-over-year and it was up the most -- to my recollection, was in the first quarter, it was up the most. And then in the second and third quarter, it was relatively stable as compared to the first quarter. And year-over-year, as I mentioned, in the third quarter relatively flat with severity up. As far as the expense ratio, we ran at about a 26% expense ratio. On a year-to-date basis, we're running at about 27% year-to-date with the increased ad expense. Going forward, as far as the fourth quarter is concerned, first, the fourth quarter, our advertising spend goes down quite a bit. So I anticipate that the fourth quarter expense ratio to be 26-ish in the fourth quarter, 26% to 26.5%, maybe, let's call it. And then as far as next year, probably similar to what it's running this year.

Operator

You have no further questions at this time.

Gabriel Tirador
Chief Executive Officer, President and Director

Well, I'd like to thank everyone for joining us this quarter, and we look forward to speaking with you again next quarter. Thank you very much.

Operator
Ladies and gentlemen, this concludes today's conference call. You may now disconnect.