S&P Capital IQ

CONTENTS

Mercury General Corporation NYSE:MCY

FQ1 2018 Earnings Call Transcripts

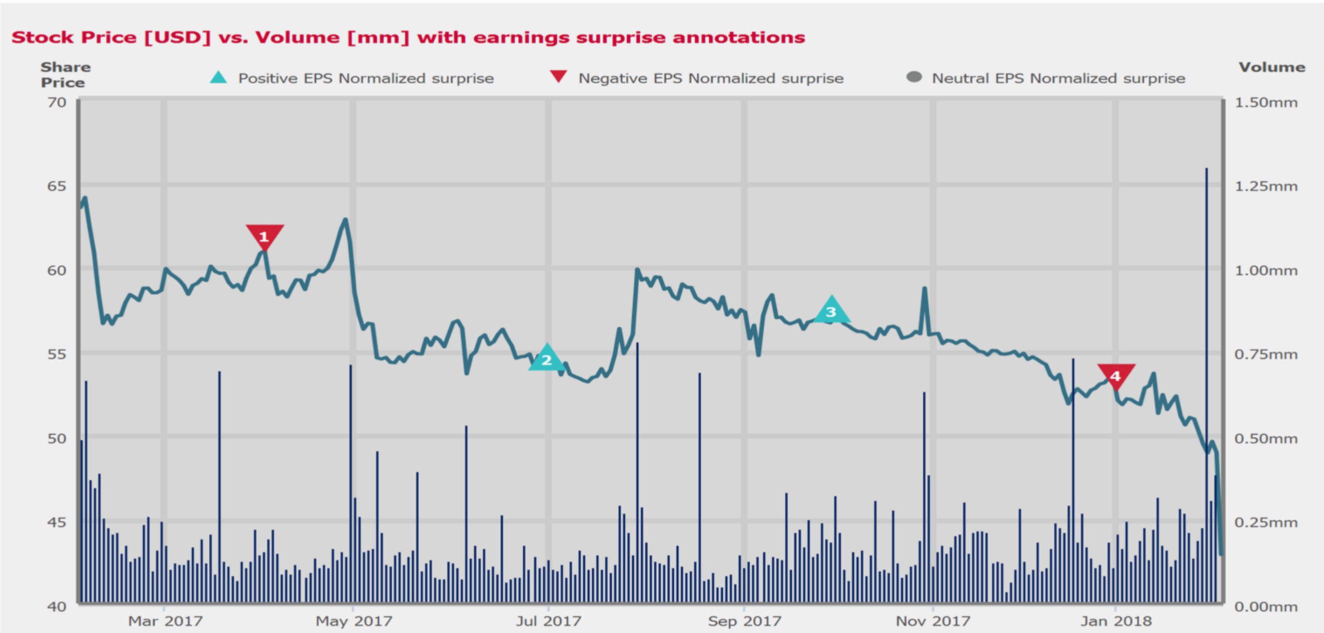
Monday, April 30, 2018 5:00 PM GMT

S&P Capital IQ Estimates

	-FQ1 2018-			-FQ2 2018-	-FY 2018-	-FY 2019-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.30	0.07	(76.67 %)	0.68	2.50	3.08
Revenue (mm)	-	-	-	-	3338.00	3449.00

Currency: USD

Consensus as of Feb-06-2018 8:43 PM GMT



	- EPS NORMALIZED -		
	CONSENSUS	ACTUAL	SURPRISE
FQ1 2017	0.54	0.20	(63.64 %)
FQ2 2017	0.50	0.68	36.00 %
FQ3 2017	0.52	0.60	15.38 %
FQ4 2017	0.33	0.15	(54.55 %)

Call Participants

EXECUTIVES

Gabriel Tirador
President, CEO & Director

Robert Houlihan
VP & Chief Product Officer

Theodore Robert Stalick
Senior VP & CFO

ANALYSTS

Carl-Harry Doirin
Raymond James & Associates, Inc., Research Division

Gary Kent Ransom
Dowling & Partners Securities, LLC

Sam Hoffman

Samir Khare
Capital Returns Management, LLC

Presentation

Operator

Good morning. My name is Amy, and I will be your conference operator today. At this time, I would like to welcome everyone to the Mercury General First 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 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
President, CEO & Director

Thank you very much. I would like to welcome everyone to Mercury's first 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 first quarter operating earnings were $0.07 per share compared to $0.20 per share in the first quarter of 2017. The deterioration in operating earnings was primarily due to an increase in unfavorable reserve development, partially offset by a reduction in catastrophe losses, lower policy acquisition costs and flat other operating expenses as compared to a 2.3% increase in earned premiums.

The combined ratio was 103.8% in the first quarter of 2018 compared to 103.1% in the first quarter of 2017. The combined ratio was negatively impacted by $43 million of unfavorable prior accident year reserve development, $9 million of catastrophe losses and $4.6 million of reinsurance reinstatement premiums earned.

The unfavorable reserve development in the quarter came primarily from the bodily injury line of coverage on our California auto lines of business. As we discussed on our fourth quarter conference call, the company uses historical loss development patterns for estimating ultimate losses.

Over the past few years, actual case reserve and paid loss development have tended to exceed the company's historical loss development patterns. Accordingly, at year-end 2017, the company factored this tendency into the company's ultimate loss selection.

During the first quarter of 2018, prior accident year losses developed beyond what was expected despite the fact that year-end 2017 we weighted more heavily to more recent years development factors into our loss selections. Increased utilization of medical services, including epidural injection and surgical procedures, along with an increase in alleged traumatic brain injuries and an aggressive plaintiffs' bar are contributing to the increase in California bodily injury severity.

As reported by Fast Track, in the fourth quarter of 2017, California private passenger automobile bodily injury severity increased by 10% for the industry, and the liability loss ratio has increased from 76.7% in 2014 to 91% in 2017.

Catastrophe losses of $9 million in the quarter were primarily due to winter storms and mudslides in California. This compares to $30 million of catastrophe losses in the first quarter of 2017, primarily due to severe rainstorms in California.

Excluding the impact of catastrophe losses, unfavorable reserve development and ceded reinstatement premiums earned, the combined ratio was 96.8% in the first quarter of 2018 compared to 98.8% in the first quarter of 2017.

The expense ratio was 25.5% in the first quarter compared to 26.3% in the first quarter of 2017. The lower expense ratio was primarily due to a decrease in acquisition costs primarily from lower average commissions and cost efficiency savings.

To help offset increase in loss trends, we have been increasing rates in most states. In California, a 5% personal auto rate increase in Mercury Insurance Company went into effect in March. In addition, a 6.9% rate increase from Mercury Insurance Company and California Automobile Insurance Company, are pending approval with the Department of Insurance.

Personal auto premiums in Mercury Insurance Company represents about half of our direct company-wide premiums earned, and California Automobile Insurance Company represents about 14% of our direct company-wide premiums earned.

Premiums written grew 6.1% in the quarter primarily due to an increase in policies written and higher average premiums per policy. Company-wide private passenger auto new business applications submitted to the company increased approximately 9.5% in the quarter as competitors continue to increase rate and tighten their underwriting. Company-wide homeowners applications increased 10% in the quarter.
With that brief background, we will now take questions.

Question and Answer

Operator

[Operator Instructions] Your first question today comes from the line of Carl Doirin of Raymond James.

Carl-Harry Doirin
Raymond James & Associates, Inc., Research Division

Just a couple of clarification here. Gabe, you've mentioned a 6 point -- rate increases pending for both Mercury and California Auto. For California Auto, is it that same 6.9% pending that was -- that you mentioned in the fourth quarter?

Gabriel Tirador
President, CEO & Director

Yes, that's the same one. I think that we filed that sometime in September of last year.

Theodore Robert Stalick
Senior VP & CFO

Yes, mid-September.

Gabriel Tirador
President, CEO & Director

Mid-September.

Carl-Harry Doirin
Raymond James & Associates, Inc., Research Division

And then of course, there was a 5% that went to effect in March for Mercury. What's the -- can you tell us what the rate increase was that was filed recently that's also pending?

Gabriel Tirador
President, CEO & Director

6.9%.

Carl-Harry Doirin
Raymond James & Associates, Inc., Research Division

Okay, okay. Same thing. All right. And of course, just, I guess, given the adverse user development in the quarter, I guess, my next question is, guess, how many rounds of rate increase do you think you need going forward, to sort of catch up with the loss trends?

Gabriel Tirador
President, CEO & Director

Robert, do you want to handle that question?

Robert Houlihan
VP & Chief Product Officer

Yes, I'll spend some time on that. Accident year basis, the results are better. I think the pending rate increase we project, will be enough to maintain an underwriting profit prospectively.

Gabriel Tirador
President, CEO & Director

Yes. We're writing at about -- company-wide, if you take away the development at about a 98.5% combined ratio, excluding the development. Severity is going up here in California for BI, as I mentioned earlier. Frequency is down a little bit. So a lot of it depends on the future, what happens with not only development, but also with -- just with overall trends in the market. So we think that from an accident year basis, as Robert alluded to, that if we don't have any further development and if trends stabilize that the rate increases that we have pending are going to be sufficient.

Carl-Harry Doirin
Raymond James & Associates, Inc., Research Division

Okay, that's fair. And I guess, also -- you also mentioned plaintiffs' bar being more aggressive. Have you seen -- has it gotten progressively worse, meaning are you seeing it getting worse in 2017 as the months go by versus 2016?

Gabriel Tirador
President, CEO & Director

Yes. I would say that it probably started in '16. But yes, we saw an increase in '17. That is somewhat anecdotal, but we feel that '17 was worse. And in '18, that trend continued. As I mentioned earlier, the Fast Track saw the pretty big spike in PPA liability loss ratio. You have -- '13 ended at a 77; '14 ended at 77 about; and then you saw a big spike in '15; and then a really big spike in '16; and then it seems to be beveled off a little bit in '17. So really, from '14 to '17, there's been a big increase in trends in the industry.

Carl-Harry Doirin
Raymond James & Associates, Inc., Research Division

Okay. And then last question for me, can you talk about sort of your, I guess, growth in -- outside of California?

Gabriel Tirador
President, CEO & Director

Well, outside of California, we've had negative growth. We've been shoring up there the profitability. We posted a combined ratio in the high 90s, 98.5%, something like that, outside of California in the quarter. So as a result of that, the top line has suffered a little bit. The application count outside of California for private passenger auto was down about 20% or so. In California though, our app count, including our nonstandard writer workmen's auto, was up about -- almost 20%. It was up 19% in California, private passenger auto applications.

Operator

Your next question comes from the line of Gary Ransom of Dowling & Partners.

Gary Kent Ransom
Dowling & Partners Securities, LLC

I wanted to go more into the bodily injury trends. You mentioned certain types of injuries, and I'm not sure I understood the significance of the -- what you were saying about those severe injuries. Could you clarify what -- why are those new and why are those different?

Gabriel Tirador
President, CEO & Director

Well, epidural injections are really the -- one of the things that we're seeing a lot more often now and -- which is basically just an injection in the back between the epidural space in the back. And it used to be -- we didn't really see as many of these. And now many claims are being built up by the types of attorney. They're attorney-driven really medical procedures, in our view, in many cases. In many cases, people have had back injuries before the accident. So we're seeing more and more of these epidural injections in our claims that are coming in being driven by attorneys and trying to drive up the medical special so they can drive up the cost of the claim. Now we're doing a lot of things internally to try to combat that. Some of these, we're taking to trial. But nevertheless, when you have an increase in medical costs, an increase in medical procedures, it's going to impact severity. We're also seeing more surgical procedures in the back, people more willing to actually go ahead and have the back surgery. Another thing is traumatic brain injuries. We're seeing more of that where there's an accident and now they're alleging a concussion. They're not the same anymore, cognitive abilities have declined, things of that nature. So those 3 things, I think in sum is what we're seeing more of as compared to the past. And I think what's -- not only us, it's the industry, which is why, I think, that you're seeing or have seen the increase in severity going on in the industry here in California.

Gary Kent Ransom
Dowling & Partners Securities, LLC

So you think that's been filtering into what you were talking about in the severity for Fast Track as well?

Gabriel Tirador
President, CEO & Director

Yes, absolutely. And we've spoken to a lot of our counsel outside that handle our claims and handle claims for other carriers as well. And there's no question that this is impacting or has impacted the industry.

Gary Kent Ransom
Dowling & Partners Securities, LLC

I may not remember exactly right, but I kind of recall that collision was also up a lot in California in the last Fast Track data. I may not have that right, but it's -- have you seen any unusual trends on the auto repair side, call it?

Gabriel Tirador
President, CEO & Director

I mean, it's up a little bit. Not a lot. I'm looking at Fast Track here for PPA collation loss ratio. According to Fast Track, at the end of '13, it was 70%; at the end of '14, it's 71.6%; at the end of '15, 73%; at the end of '16, 75.8%; and end of '17, dipped down a little bit at 72.1%. Now that's loss ratio. That includes the rate increases. But we're seeing in the mid-single digits, had severity increases with frequency down a little bit.

Gary Kent Ransom
Dowling & Partners Securities, LLC

Okay. What do you think is the solution for the -- I mean, as we have -- plaintiffs' bar is pushing for all of this, is the answer just 6.9% every chance you get? Or is -- are there more things you can do on the claims management side, even maybe the underwriting side?

Gabriel Tirador
President, CEO & Director

I think it's all 3. I think there's things that we are doing and are going to continue to do on the claims side, better segmentation of our losses, which is something that we've been focused on the last couple of years. On the underwriting side, working with our agents and also taking rate. We're really attacking this problem, all 3 facets of the business. We're attacking it by trying to do things on the claims side, taking some of these cases to trial and on the underwriting side and then with some rates. So it's a combination of all 3 factors.

Gary Kent Ransom
Dowling & Partners Securities, LLC

When you try to get rate, is there any, call it, sympathy from the commissioner that these rate increases are becoming more necessary?

Gabriel Tirador
President, CEO & Director

I don't know if I...

Gary Kent Ransom
Dowling & Partners Securities, LLC

Or just business as usual? Yes, maybe that's the wrong word.

Gabriel Tirador
President, CEO & Director

But I -- we've been able to get our rate. Robert, do you want to comment on that?

Robert Houlihan
VP & Chief Product Officer

No. I think this part meant, look at the return on surplus formula and with more losses in the system higher trend that works its way through the formula, which makes it easier to justify rate increase.

Gabriel Tirador
President, CEO & Director

There's a lot -- for example, there's one major competitor here in California that recently was approved, something like a 6.5%. Actually, it has not yet been approved for 6.5% and they've already filed for another 6.9%. And it's a big -- and this is a big competitor.

Gary Kent Ransom
Dowling & Partners Securities, LLC

Yes. Has anyone -- does anyone brave the possibility of doing 7% or 10% or 12%? Or is that just too problematic?

Gabriel Tirador
President, CEO & Director

Well, I don't think -- unless you're way, way behind, I think that's probably too problematic. Robert, do you want to...

Robert Houlihan
VP & Chief Product Officer

No, of course -- no, if you file for more than 7% and intervene a request of rate hearing, it's no longer at the discretion of the commissioner once you go to rate hearing. And that process is so lengthy, it could potentially delay the rate increases so much that I think it's -- as Dave said, unless you're really far behind on rate, it doesn't make sense to step beyond the 7%.

Operator

[Operator Instructions] Your next question comes from the line of Samir Khare with Capital Returns Management.

Samir Khare
Capital Returns Management, LLC

A few questions centered around the prior year development. What accident years does this come from?

Theodore Robert Stalick
Senior VP & CFO

Yes, about half of it is from 2016, a little over half, about 1/3 of it is from '15, and the rest is spread across the other accident years.

Samir Khare
Capital Returns Management, LLC

Okay. And did discharge come from a full reserve review done in Q1 or an actual versus expected type exercise?

Theodore Robert Stalick
Senior VP & CFO

Well, we do actual versus expected. We also have our external actuaries and our internal actuaries do a full review quarterly.

Samir Khare
Capital Returns Management, LLC

Okay. The increase in plaintiffs' bar activity that you spoke of before, is that widespread in California or more confined to a specific region within California?

Gabriel Tirador
President, CEO & Director

I would say it's throughout the whole state. I've seen cases up north and down south, although I would say more so down in Southern California.

Samir Khare
Capital Returns Management, LLC

Okay. And then with the ability to get the rate increases that you submitted for, it sounds like a hard market exists in California auto. Would you characterize the current market as such?

Gabriel Tirador
President, CEO & Director

I mean, I would say so. I think there's a lot of rate activity going on. Results have deteriorated. Our app counts in California are up 19%, and we've taken a 5% rate increase recently in our biggest company. So we had -- there was one carrier that was put under, I guess, conservatorship by the Department of Insurance here in California. So that's just some increase in apps, I think, for the industry as well. So yes, I would characterize it as such right now.

Operator

And there are no further questions in queue at this time. I turn the call back to the presenter for any closing remarks. Sorry, we do have one more question in queue.

Gabriel Tirador
President, CEO & Director

Okay.

Operator

It's from the line of Sam Hoffman of Lincoln Square.

Sam Hoffman

And I miss the beginning of the call, so it may have been covered. But I wanted to know, have you guys seen any impact from the legalization of marijuana in California? Or do you anticipate any impact from that on frequencies?

Gabriel Tirador
President, CEO & Director

I can't say that we've seen any impact to date regarding the legalization of marijuana. Robert, do you have...

Robert Houlihan

VP & Chief Product Officer

No. I mean, most of the trends are more on the severity side than the frequency side, right, at this point in time. So I'm sure there are some cases but we haven't really seen a broad trend yet.

Gabriel Tirador
President, CEO & Director

Yes.

Sam Hoffman

Are you expecting that to take place? And have you looked to like Colorado as an example? Or do you feel confident that based on the first quarter that, at least in your state, that -- and in California, it's less of an issue?

Gabriel Tirador
President, CEO & Director

As Robert mentioned, it doesn't appear after the first quarter that it's had an impact. We'll have to monitor it. Whether or not the people that are buying it were just smoking it before illegally, I don't know. But we'll have to monitor.

Operator

And there are no further questions in queue. I turn the call back to the presenters for their closing remarks.

Gabriel Tirador
President, CEO & Director

Okay. I like to thank everyone for joining us this quarter and hope to bring you better results in the second quarter. Thank you.

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