S&P Capital IQ

CONTENTS

RLI Corp. NYSE:RLI

FQ4 2011 Earnings Call Transcripts

Thursday, January 26, 2012 4:00 PM GMT

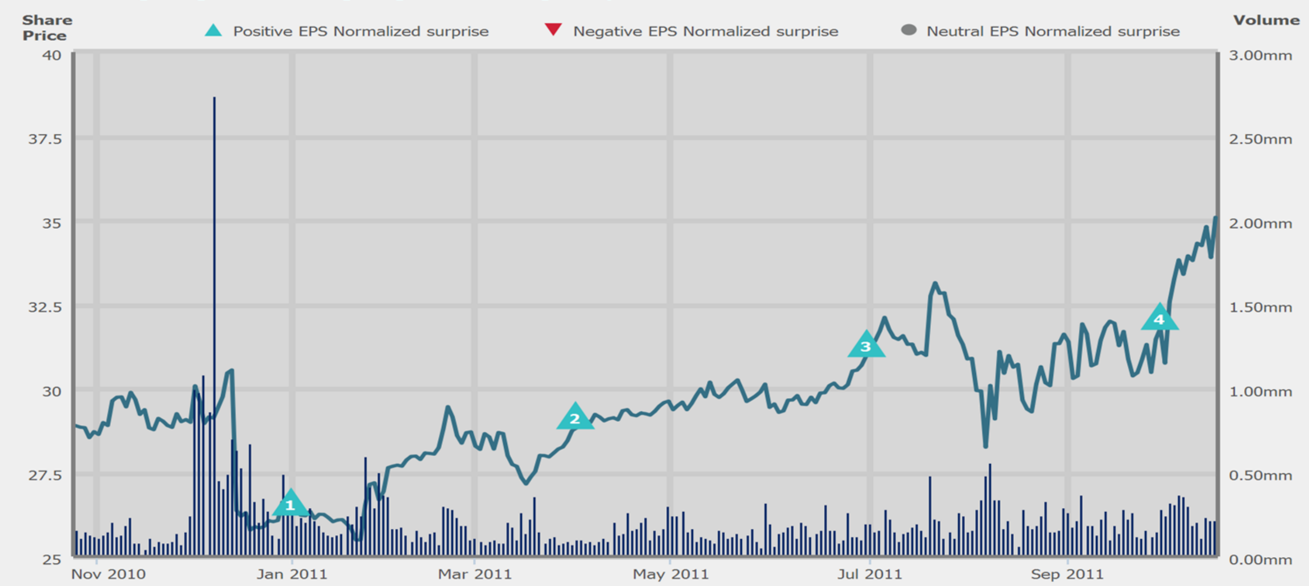
S&P Capital IQ Estimates

	-FQ4 2011-			-FQ1 2012-	-FY 2011-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.55	0.68	▲23.64	0.54	2.68	2.79
Revenue (mm)	153.42	163.96	▲6.87	155.85	593.55	619.17

Currency: USD

Consensus as of Jan-26-2012 2:11 PM GMT

Stock Price [USD] vs. Volume [mm] with earnings surprise annotations



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2010	0.49	0.83	▲1 69.39 %
FQ1 2011	0.46	0.56	▲2 21.74 %
FQ2 2011	0.53	0.96	▲3 81.13 %
FQ3 2011	0.49	0.62	▲4 26.53 %

Call Participants

EXECUTIVES

Aaron H. Jacoby
Vice President of Corporate Development

Jonathan E. Michael
Chairman and Chief Executive Officer

Michael J. Stone
Director

Thomas L. Brown
Chief Financial Officer and Senior Vice President

ANALYSTS

Adam Klauber
William Blair & Company L.L.C., Research Division

Court Dignan
Fidelity Investments

Douglas Robert Mewhirter
RBC Capital Markets, LLC, Research Division

Matthew John Carletti
JMP Securities LLC, Research Division

Randolph Binner
FBR Capital Markets & Co., Research Division

Vincent M. DeAugustino
Stifel, Nicolaus & Company, Incorporated, Research Division

Presentation

Operator

Good morning, and welcome, ladies and gentlemen, to the RLI Fourth Quarter Earnings Teleconference. At this time, I'd like to inform you that this conference is being recorded. [Operator Instructions]

Before we get started, let me remind everyone that through the course of today's teleconference, RLI management may make comments that reflect their intentions, beliefs and expectations for the future. As always, these forward-looking statements are subject to certain risk factors, which could cause actual results to differ materially. These risk factors are listed in the company's various SEC filings, including the annual Form 10-K, which should be reviewed carefully. The company has filed a Form 8-K with the Securities and Exchange Commission that contains the press release announcing fourth quarter results.

RLI management may make reference during the call to the operating earnings and earnings per share from operations, which are non-GAAP measures of financial results. RLI's operating earnings and earnings per share from operations consist of net earnings after the elimination after-tax realized investment gains or losses. RLI's management believes that this measure is useful in gauging core operating performances across reporting periods, but may not be comparable to other companies' definitions of operating earnings. The Form 8-K contains a reconciliation between operating earnings and net earnings. The Form 8-K and press release are available at the company's website at www.rlicorp.com.

I will now turn the conference over to RLI's Vice President, Corporate Development, Mr. Aaron Jacoby. Please go ahead, sir.

Aaron H. Jacoby
Vice President of Corporate Development

Thank you. Good morning, to everyone. Welcome to the ROI earnings teleconference for the fourth quarter of 2011. Joining me on today's call are Jon Michael, Chairman and CEO; Mike Stone, President and Chief Operating Officer; and Tom Brown, Vice President and Chief Financial Officer.

I'm going to give some brief opening comments on the quarter, then turn the call over to Mike to talk about our operations and market conditions. Then we will open the call to questions, and Jon will finish with some closing comments.

Operating income came in at $1.35 per share in the quarter and $5.58 for the year. Results for both periods were positively influenced by favorable development in prior year loss reserves, $11 million in the quarter and $92 million for the year, with our casualty segment being the primary driver.

The combined ratio for the quarter was 82%, which allowed us to finish the year with a 78% combined ratio. 2011 marked the 16th consecutive year that RLI has maintained a combined ratio below 100%. Perhaps an equally impressive figure is the 87% combined ratio RLI has averaged over those same 16 years.

Gross premium was up 12% in the quarter and 10% for the full year. This growth was driven by our acquisition of Contractors Bonding in April, as well as by organic growth in some of our newer product initiatives.

Within the investment portfolio, investment income was down 2.6% for the quarter, an improvement relative to the annual decline of 4.7%. As we've noted before, our ability to deliver superior underwriting results is particularly important in today's low interest rate environment.

On a total return basis, our investment portfolio performed admirably in the tough and volatile year. The portfolio returned 3.4% in the quarter and 7.3% for the year. Between the positive underwriting and investment returns in 2011, capital grew significantly, which allowed RLI to pay a $5 per share special dividend in December. Including this dividend, book value per share advanced 16% on the year. And over the last 6 years, ROI has returned over $700 million to shareholders in the form of dividends and share repurchases.

And with that, I will now turn the call over to Mike Stone. Mike?

Michael J. Stone
Director

Aaron, thank you, and good morning, everyone. A superior underwriting quarter and year. A testament to our underwriting expertise and discipline and a business model that rewards underwriting profits, I might add, in all markets and economic conditions. Again, a 78% combined ratio for the year when the industry is going to be north of 100%, we probably outperformed the industry by some 25% combined ratio points this year. A stellar performance.

We're particularly proud of being able to grow our premium by 12% in the quarter and 10% in the year while maintaining our underwriting performance. The market continues to improve, that is rates are moving in the right direction, but it's uneven, somewhat product-specific or geographic-driven by particular issues, for example, property wins, catastrophe wins due in some large part to the model change to reinsurance costs and to cap activity.

I continue to watch for movement from our Transportation division, a short-tail casualty line which should be an early indicator of true firming in the marketplace. My observation is somewhat mixed. Rates remained fairly flat, but we're seeing more opportunities in that space, which is hopefully a precursor to better rate activity. Frankly, without some real improvement in the economy, that is, exposure growth and the construction activity, we will continue to encounter difficulty growing organically.

Let's look at our segments. Casualty gross written premium, up 10% in the quarter, 4% in the year, largely due to our CBIC acquisition and our professional services group growth. Our rates overall basically fat -- not fat, flat. Some areas due to lost activity, for example, the general liability habitational risks where rates are moving north, but are really driven by significant loss activity in that space. And geographic issues in our commercial umbrella space, where New York contractors are allowing us to get some double-digit rate increase in that space as well. Again this quarter, this segment benefited from prior year's improvement. Much of our business is driven by construction activity from general liability for contractors to architects and engineers, and we need the economy to pick up to enable us to grow on that space.

Property continues to be a growth driver for us. Its pricing allows for reasonable returns in this space. We're up 10% in the quarter and 15% in the year, driven by RLI Re and our crop business, up some 90% and 30%, respectively, year-to-date. We did renew our reinsurance with our crop partner and continue to believe it's a good business long-term and provides a nice diversification for us. Rates in this space, as I indicated, catastrophe and wind is up some 15% year-to-date, DIC down and fire down some 8% to 3%, respectively. RMS 11 continues to drive rate in the cat win space. Overall, not as firm as you would expect given all the loss in this market segment.

Security, gross written payment, up 23% in the quarter, 21% year-to-date, driven by our acquisition of CBIC and modest growth in the RLI segments, except for construction contract surety, where we're actually down 11%.

Surety is performing well, with a combined ratio of 85% for the quarter, 75% to 78% in the year. Contract surety is coming under pressure due to very weak construction activity, placing a significant hardship on contractors and their sureties. We remain vigilant and exhibiting underwriting discipline. However, it's been a difficult part of the marketplace and market time for our contract surety. We'll continue to be vigilant here. Our CBI surety business continues to perform as expected, and we expect less volatility here, given the smaller size of the contractors and a lower net position in that business.

On 1/1, we renewed a couple of our rather large treaties. Our property pro-risk catastrophe treaty were renewed at rate increases of 5% to 7%. Casualty rates, as we renewed our large combined casualty treaty, were up some 2% to 3%, basically driven by some select spots of transportation and commercial umbrella and personal umbrella.

Overall, stellar quarter from an earnings perspective and year, while I am loath to sound political, we need a more robust economy. Without a more robust economy and exposure growth, we're going to have difficulty growing and difficulty driving our growth in the future.

However we adapt under all circumstances, as can be seen by how we have moved our segments from 70% casualty, 20% property and 10% surety to now, where we feel better opportunities to exist in other spaces, it's 46% casualty, 38% property and 16% surety. So again, a good quarter, good year and we look forward to 2012.

Aaron H. Jacoby
Vice President of Corporate Development
Great. Thanks, Mike. Operator, we can now open the call up for questions.

Question and Answer

Operator

[Operator Instructions] We'll take our first question from Randy Binner with FBR Capital Markets.

Randolph Binner
FBR Capital Markets & Co., Research Division

Just a couple of clarification questions on pricing and kind of market dynamics. I guess first in surety, you mentioned contract surety is lower. But on commercial surety, just interested to get your take on the market dynamic there and if there's maybe more top line production in that area.

Michael J. Stone
Director

We are up a bit in the quarter and for the year, single digit increase. That space has quite a bit of capacity, and we're fairly cautious at this stage. Usually at this stage of the surety market cycle, we start seeing commercial surety underwriters do unusual things. And we haven't seen that yet, which is good. But we're cautious here and wouldn't expect a whole lot of growth, but feel like we're in a good spot here.

Randolph Binner
FBR Capital Markets & Co., Research Division

I apologize if you break this down in the press release or somewhere else, but what's your rough breakdown in contract versus commercial?

Michael J. Stone
Director

Our contract versus -- again, we've got basically 4 areas of surety that we operate under. We have contract; we have what we call commercial surety, which is really account-driven miscellaneous surety; and we have a miscellaneous surety, which is transactional with small accounts; and then we have oil and gas. They're all pre-CBIC, roughly 25%. Little bit larger on the miscellaneous side. And with the addition of CBIC, our -- we'll increase our miscellaneous commercial business, that is the transaction business, and the contract business a bit. So the split will be more like 30-30, 20-20 going forward.

Randolph Binner
FBR Capital Markets & Co., Research Division

That's helpful. I mean, I guess, if contract is slow and commercial is crowded but not yet irrational, it seems like the outlook there would seem to me only get worse from a premium production perspective. Is that fair?

Michael J. Stone
Director

You say for contract? I'm sorry.

Randolph Binner
FBR Capital Markets & Co., Research Division

Well, for -- yes, for just surety in general, contract and then commercial as well.

Michael J. Stone
Director

Again, I think it's not completely across-the-board that way. I wouldn't look at it with just a broad brush like that. Certainly, I think our oil and gas business is doing well, growing a bit. I think our commercial business will grow a little bit. I think our miscellaneous business will grow -- hopefully grow even more significantly, and our contract business will be under pressure for a bit. We've been through these cycles before. It's time to be careful certainly on the contract surety side, and we will be. But there is still -- I still hope and expect that 2012 will be a decent surety year.

Randolph Binner
FBR Capital Markets & Co., Research Division

That's helpful. And then just real quick on property. I think you mentioned that RMS 11 is driving rate higher, but not as much as you might think. Any quantification of kind of where rates come in there versus where it should be relative to the losses of the last couple of years?

Michael J. Stone
Director

Well, relative to losses of the last couple of years should be up quite a bit higher. But certainly, we haven't experienced that loss activity, but the industry has. It's actually wins for -- win rates for 2011 were up some 15%, driven more so in the second half as people started implementing RMS 11. Certainly, reinsurance renewals on 1/1 are up pretty well across the board and we experience a bit of uptick probably a little less than the industry. But certainly, reinsurers are starting to try to drive rate, and there has been quite a bit of loss activity in this space and not fully recognized is the Thailand floods recently amongst other large international catastrophe. The only thing you can say good about the property cat market is there wasn't a Florida event this year. I should say last year. I don't know about this year yet.

Operator

And we'll take our next question from Doug Mewhirter with RBC Capital Markets.

Douglas Robert Mewhirter
RBC Capital Markets, LLC, Research Division

I just have a general question about -- or a specific question about the reserve releases and any other comments that you might be able to make in addition. What -- I guess mostly came from casualty, what accident years roughly did it come from? And just where do you see the trends running in terms of loss costs? And any kind of leading indicators of those kind of trends, severity, frequency, et cetera, in casualty?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

It's Tom Brown. Thanks for the question. The casualty here, you'll be seeing in the release is primarily from 2006 through 2009, so the more recent accident years. We really don't like to comment much on what's going to happen in the future, too many variables.

Douglas Robert Mewhirter
RBC Capital Markets, LLC, Research Division

Okay. How about what kind of, I guess, current frequency and severity turns are you seeing then from casualty?

Michael J. Stone
Director

It's Mike Stone. I'll be happy to try to give you an answer. I think our frequency and severity turns are fairly benign, I think less than what we would've expected. Probably on the low single digits order of magnitude. I think that's one of the things that is continuing to keep rates more moderate than you would expect, given what's happened over the last 6 or 7 years for casualty rates and what's happening with the loss activity in the property space.

Operator

And we'll take our next question from Vincent DeAugustino with Stifel, Nicolaus.

Vincent M. DeAugustino
Stifel, Nicolaus & Company, Incorporated, Research Division

I know the saying goes if it's not broken, don't fix it, and RLI is clearly a well run operation. But I'm curious if there's anything on the radar in terms of new initiatives or potential acquisition areas, or any areas that you think can be improved. Basically just wondering if there's any new strategic goals on the horizon for 2012 or beyond.

Jonathan E. Michael
Chairman and Chief Executive Officer

Yes, Jon Michael here. Well, we had combined ratio of 78% and I think we have a lot of improvement to do from that. And in terms of acquisitions, we are constantly looking for new products, product extensions, acquisitions, of course, we don't have anything to announce. But we're constantly looking and we'll change just as we've changed in the past. But as much as we change, things remain the same. We've had 16 years of combined ratios under 100%.

Vincent M. DeAugustino
Stifel, Nicolaus & Company, Incorporated, Research Division

I guess just one other question. Looking at your equity portfolio performance after incorporating the 12% return, if my math is right, it looks like there is something in the neighborhood of maybe an $18 million net new fund addition. Is there maybe any incremental bullishness going on there, or am I just reading too much into it?

Aaron H. Jacoby
Vice President of Corporate Development

Vince, can you repeat the question, please?

Vincent M. DeAugustino
Stifel, Nicolaus & Company, Incorporated, Research Division

Sure. Looking at the equity portfolio performance after incorporating the 12% return from the quarter, it looks like, if my math is right, there should be about an $18 million net new fund addition to the equity side. Just curious if there was any incremental bullishness going on there.

Thomas L. Brown
Chief Financial Officer and Senior Vice President

I didn't catch the last piece, but yes, you're right. We have increased our position in equities by approximately 20% of the overall investment portfolio, a strong increase from 9/30 to 12/31 in prices and it also is due somewhat to a high dividend yield investment equities, which throws up a pretty good return. I didn't catch the last part of your question.

Vincent M. DeAugustino
Stifel, Nicolaus & Company, Incorporated, Research Division

No, that's perfect. And then if I may, just one follow-up from an earlier question on the casualty line reserve leases. Were there any adjustments to prior 2011 quarters, or is it just mostly the 2006 to 2009 accident years?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

This is Tom Brown. It really is some -- there is some release for full of 10 years. But again, as I said earlier, it's predominantly in the 2006 through 2009 accident years.

Operator

And we'll go next to Adam Klauber with William Blair.

Adam Klauber
William Blair & Company L.L.C., Research Division

Could you talk a bit about the competitive environment? Have we seen any pullback from the standard players?

Michael J. Stone
Director

It's Mike Stone. That's kind of bit of a mixed bag. We've seen a little bit of pullback in some areas. But by and large, they're still -- probably if we look at our competition, probably the toughest piece of our competition, biggest piece of our competition that we've seen over the last 5 or 6 years as the market has trended downward. We haven't seen a big pullback again, which would be a precursor of a real firming market, so we think the standard guys are still there. They haven't felt the pain quite yet. We're starting to feel a little of it but probably not enough of it to drive them completely out like what has happened in the past.

Adam Klauber
William Blair & Company L.L.C., Research Division

To the extent they're pulling back, is it more on the property than the casualty side?

Michael J. Stone
Director

Again, it depends on geography as much as anything. We see some of it on the property side certainly and in some areas I indicated like in the northeast on the casualty side.

Adam Klauber
William Blair & Company L.L.C., Research Division

Okay. And then as far as property premium -- sorry, gross premium written, it was lower in the fourth quarter than in the prior 3 quarters. Is that just more of a quarterly fluctuation, or did something change in the fourth quarter?

Michael J. Stone
Director

It's almost no crop premium in the fourth quarter. That's probably the reason that, if you look at quarter by quarter, that fourth quarter will be less.

Adam Klauber
William Blair & Company L.L.C., Research Division

But also that's why the growth is less because some of the growth over the last 2 quarters has been crop?

Michael J. Stone
Director

Yes.

Adam Klauber
William Blair & Company L.L.C., Research Division

Okay, that makes sense. And then finally on, when I look at casualty accident combined ratio, it's running around 104%, I think 105% for the last 2 years. How much rate do you think needs to be put in that book to get it back to your core profitability? And are you seeing any more discipline in the market that would let you get that rate?

Michael J. Stone
Director

I'll answer the second question first. We're not seeing as much discipline in the market as we would like. So we're seeing a fairly flat rate environment, which is good compared to what we've seen in the recent past when rates are declining, so flattening out of rates is a good thing. As I think I've said before, I don't think rates stay in spaces. They move one direction or the other. They don't stay flat forever. We've been bumping along what we think is the bottom for a while. What's going to be interesting is that they actually do turn up. Or as they have in the past, in the recent past when we think things were going to firm, they actually go down. I do think we're at an inflection point. We think we need 10% to 20% rate increase to get us to the margins where we think we ought to be on across-the-board basis in casualty.

Operator

And we'll take our next question from Court Dignan with Fidelity Investments.

Court Dignan
Fidelity Investments

I have a question on how we should be thinking about the balance sheet and premium leverage, given the sort of mix changes the company's had over the last couple of years, your organic growth expectations, as well as sort of retaining flexibility for prospective acquisitions, which has obviously played a role in the company's history. So I mean -- I don't know if it's too simplistic to think about it within the context of premium surplus, but I was wondering if you could just hit on that.

Jonathan E. Michael
Chairman and Chief Executive Officer

Yes, this is Jon Michael. In terms of premium to surplus and how much leverage we can probably generate in terms of operating leverage and maintain ratings, we believe that, that number is probably starts to get taxed at around 1.3 or thereabouts, so we really do have a long way to go before we get to that kind of leverage. In terms of acquisitions that I've previously mentioned, we are constantly looking at new products, product extensions, acquisitions and the like, and that's -- last year, I think we did Contractors Bonding and Insurance Company. And we did other several product extensions. So we will continue to do that.

Court Dignan
Fidelity Investments

Is the environment for acquisitions better or worse than 6 months ago, 12 months ago, 24 months ago? No difference?

Jonathan E. Michael
Chairman and Chief Executive Officer

No difference, yes. I'd say, given where our stock's trading, we're in a better position than others. But I think what happens is that when you begin to look at acquisitions of the -- the expectation of the acquired is quite a bit different than what we're thinking that we ought to pay.

Court Dignan
Fidelity Investments

And then on the premium to surplus, 1.3x. The way you interpret that, I mean, is everything firing, all hands on deck, you operate at 1.3. But in more normal course, I mean, is 1x more a reasonable target? I'm just trying to make sure I, obviously, you know where you were at 0.5 a couple -- a year ago or so, that was obviously on the low end, but...

Jonathan E. Michael
Chairman and Chief Executive Officer

Yes. I think we can easily operate at 1.3. But what happens is the rating agencies won't allow you to go beyond that and maintain an A+ rating. And it depends on the products that you're writing.

Court Dignan

Fidelity Investments

And then last question I have was just on the investment portfolio. I think maybe 6 months ago, you guys were buying 7- to 10-year corporates plus I think adding some longer-dated GSE paper. Can you give us a sense for what you're looking at now and what generically, for the fixed income portfolio, you're getting for new money yield?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Yes, let me take this. It's Tom Brown. It's remained fairly consistent with the exception of our previous comment, we have shifted a little more into the equities, getting some better yield, different yield on the equities as opposed to the fixed income portfolio. We should also point out that we did have a press release earlier in the week that we just announced a new hiring of a CIO, Aaron Diefenthaler. Too early to comment on some of his thoughts and views on the portfolio going forward.

Court Dignan
Fidelity Investments

Can you give me a sense for the fixed income portfolio what you're getting for new money yield?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Offhand, I think it was 2.9%. I think, roughly 2.9%.

Operator

[Operator Instructions] And we'll take our next question from Matt Carletti with JMP Securities.

Matthew John Carletti
JMP Securities LLC, Research Division

Just a couple of questions on the crop book. One is, directionally, what do you expect on that book this year, the kind of growth flat or otherwise? And secondly, were there any material changes on the renewal in terms of conditions?

Michael J. Stone
Director

It's Mike Stone. Again, we continue to like the crop business. We expect -- obviously, premium is driven a bit by price commodity prices, so we would expect our crop premium probably be down a bit. We did renew the reinsurance partnership. So we would expect premium to be down a little bit in 2012, but it's yet to be determined with the pricing and the overall conditions in that market.

Matthew John Carletti
JMP Securities LLC, Research Division

In terms of the renewal, any material change to terms of conditions or the length of the renewal?

Michael J. Stone
Director

The renewals on an annual basis, and we went from a 6% quarter share to a 4% quarter share. And some of that was driven by them seeking better terms in 2011 crop year, if I got that right, being not as good as it was before. We felt like keeping our overall premium at around what we want it to be to begin with. And given the spike in prices, 4% gets us about where we want to be.

Operator

And we have no further questions in the queue. [Operator Instructions] Mr. Jacoby, we have no further questions in the queue at this time.

Aaron H. Jacoby
Vice President of Corporate Development

Great. Now I'd like to turn the call over to Jon Michael.

Jonathan E. Michael
Chairman and Chief Executive Officer

Thank you, and thank you for attending. I want to thank all of our 900 associates for another fantastic year. 78% combined ratio, our volume was up even without the acquisition of CBIC so we have had a terrific year and we look forward to delivering even better results next year. Thank you all for listening, and we will talk to you next quarter.

Operator
That does conclude today's conference. Thank you for your participation.