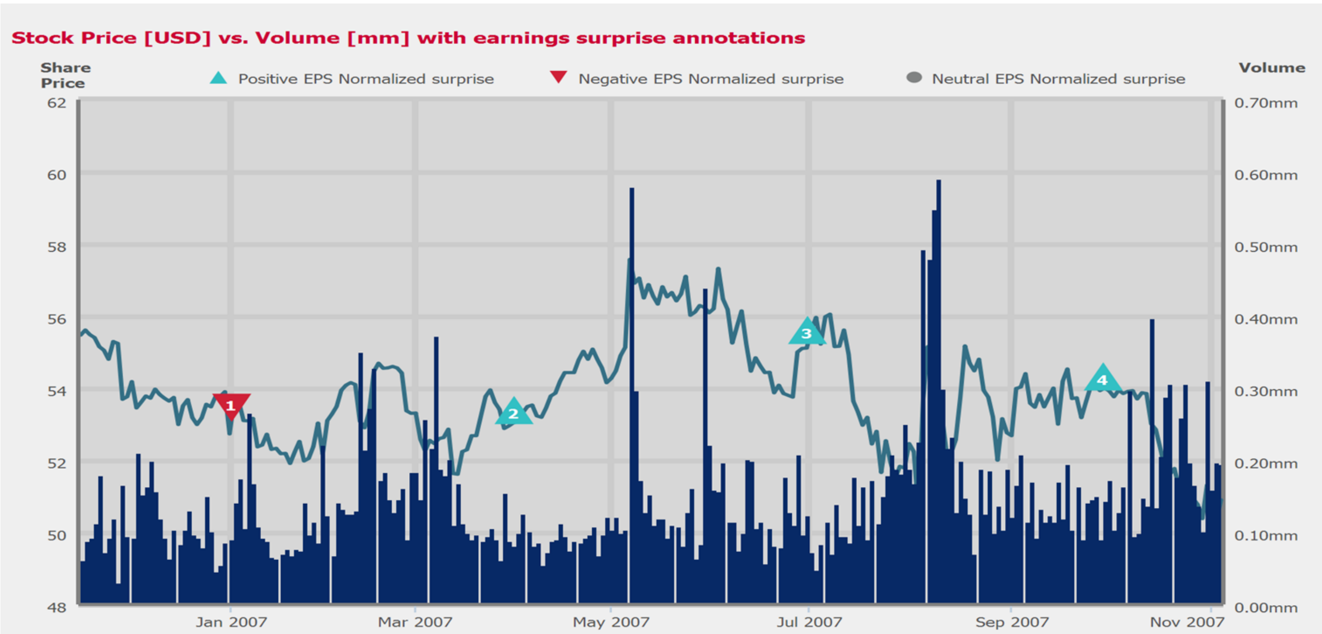
S&P Global
Market Intelligence

Mercury General Corporation NYSE:MCY
FQ4 2007 Earnings Call Transcripts
Monday, February 11, 2008 6:00 PM GMT
S&P Global Market Intelligence Estimates

	-FQ4 2007-			-FQ1 2008-	-FY 2007-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.82	0.96	▲17.07	1.04	4.22	4.37
Revenue	-	-	▲(3.73 %)	-	-	-
Revenue (mm)	727.02	699.90	-	782.40	3009.10	2982.02

Currency: USD
Consensus as of Feb-11-2008 3:34 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2006	1.17	0.89	▼1 (23.93 %)
FQ1 2007	1.05	1.11	▲2 5.71 %
FQ2 2007	1.09	1.15	▲3 5.50 %
FQ3 2007	1.12	1.13	▲4 0.89 %

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Call Participants

EXECUTIVES

Christopher Graves

Gabriel Tirador

Theodore R. Stalick

ANALYSTS

Alison Jacobowitz
Merrill Lynch

Charles Gates
Credit Suisse

Dan Farrell
Fox-Pitt Kelton

Meyer Shields
Stifel Nicolaus & Company

Richard Sbaschnig
Oppenheimer & Co.

Unidentified Analyst

Presentation

Operator

Good afternoon. My name is Virginia, and I will be your conference operator today. At this time, I would like to welcome everyone to the Mercury General's Fourth Quarter Results Conference Call. All lines have been placed on mute to prevent any background noise. After the speaker's 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 fourth 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. On the phone, we have Bruce Norman, Senior Vice President of Marketing.

Before we open it up for questions, I would like to make a few comments regarding the quarter. During the fourth quarter, there is typically a seasonality impact on the California personal auto loss ratio, largely due to weather and usage. The fourth quarter of '07 was no exception. Consequently, our first quarter auto loss ratio deteriorated as compared to the third quarter of '07, but was somewhat comparable to the fourth quarter of '06.

Excluding the impact of the Southern California wildfires, our California operations produced a loss ratio of 67.9% in the fourth quarter of '07 compared to 66.4% in the fourth quarter of '06. This year-over-year increase in the loss ratio was primarily due to slightly higher auto frequency and severity recorded in the fourth quarter of '07, negative reserve development on prior accident years, and from the re-estimation of the current year loss ratio, all of which was partially offset by slightly higher average auto premiums. In addition to the higher loss ratio in our personal auto line, our homeowners loss ratio, excluding the impact of the Southern California wildfires, was up over the 2006 fourth quarter due to an increase in recorded severity. Our fourth quarter 2007 California expense ratio increased primarily as a result of various expense accrual reductions taken in the fourth quarter of '06, resulting in a lower than normal expense ratio in the fourth quarter of '06.

Our combined ratio was of 100.4% in our non-California operations improved significantly as compared to their 109.1% combined ratio in the fourth quarter of '06. Excluding our New Jersey results, our combined ratio in our non-California operations were 98% in the fourth quarter. The improvement in the combined ratio is largely attributable to positive developments recorded on prior accident periods, primarily in our Florida operations, as a result of our continued focus on operational improvements. Although we believe many of the operational improvements will begin to have a positive impact in our New Jersey operations, due to the long-tail nature of bodily injury and PIP in New Jersey, we've not yet recognized any of the benefits from our operational improvements in the current accident period.

In addition, as I have previously reported, we implemented a revenue neutral rate change in April, designed to improve possibility in New Jersey. This rate change had a negative impact on our new business submissions. In addition, we implemented another similar rate change effective in October of 2007. Although these rate changes where revenue neutral, we believe the rate changes will more accurately price our risks, which over time should lead to improved profitability and a more competitive product. In addition, the April rate change we implemented included a cap on the amount of increase any one policyholder received. As this cap is lifted over the next 6 to 12 months, our average premium should increase.

In California, we recently obtained approval from the California Department of Insurance on our auto filings. In our preferred company, which represents approximately 70% of our California personal auto business, our overall rates will be reduced by approximately 3.6% and the remaining 30% of our California personal auto business will receive a slight increase of 0.4%. Although we originally applied for a revenue neutral rate change in our preferred company and a 4% increase in our non-preferred business, we agreed to the adjusted rate changes due to the other changes included in our rate filing that we believe will make us more competitive. In addition, this new rate level gets us very close to full compliance with the new territorial rate regulations, and as required by the regulations we plan on making a filing by July of 2007 to make this fully compliant. The effective date of our new rate level is late April. We will continue to monitor our results closely and make any necessary future rate filings when we feel necessary.

The competitive environment remains intense. We continue to believe that growth would be very difficult to achieve over the next several quarters and most likely our premium's written growth will be negative. However, we do believe the market is beginning to change. As I mentioned in last quarter's conference call and as we predicted about a year ago, the margins of many of our competitors for the personal auto line are deteriorating as a result of previous rate reductions and increasing loss cost. In some cases, the margin deterioration has been significant. In addition, during the fourth quarter we observed more filings for rate increases than rate reductions. In our California market, one major carrier has filed for a 5% rate increase for a portion of their business. Consequently, we believe that over the next 12 months we will begin to see an increased level of rate action taken by some of our competitors.

We continue to focus on various strategic initiatives including standardizing our claims and underwriting processes, improving our pricing to improve segmentation, improving our technology, and enhancing our customer service levels. The development of our Mercury First front-end sales system is scheduled to be rolled out to our first state in the first quarter of 2008.

As we reported in our press release, our Board of Directors declared a quarterly dividend of $0.58, representing an 11.5% increase over the quarterly dividend amount paid in 2007. Since we first began paying dividends in 1985, we have continued to return capital to our shareholders by increasing our dividend every year. Over the past ten years, we have increased our dividend by an average of approximately 13% per year.

Before we open it up for questions, and in light of the recent turmoil in the financial markets, Chris Graves, our Chief Investment Officer, is going to provide some information on our investments. Chris?

Christopher Graves

Thank you, Gabe. In the last quarter call, in response to a question, I touched on our exposure to the bond insurers. Back then, it appeared we all recognized the bond insurers are facing problems from their CMO and CDO exposures. In the month since our November call, the situation has deteriorated with adverse rating actions against several insurers.

At market value, Mercury owns $2.45 billion in municipal bonds and 48.9% of our portfolio... municipal bond portfolio is insured. Municipal bonds are 69% of the total portfolio. The biggest risk to the portfolio in my opinion is from market value erosion as a result of ratings downgrades. Even so, I consider the risk tolerable since our underlying credits are good. Additionally, Mercury's municipal book yield are predominantly higher than the market and we ended year with $29 million in unrealized gains.

There's no doubt that the municipal bond market is under duress. I consider this a positive for Mercury since we are net buyers. There are many opportunities in the market to pick a book yield that didn't exist just a month ago. The average rating of our municipal bond portfolio with insurance is AA1 and AA +. Without the insurance it’s AA3, AA-, which gives the benefit of other credit enhancements. The pure underlying rating with no credit enhancement other than the issuer is A1, AA-. In addition, 6% or about $150 million of the portfolio is refunded without being re-rated AAA. Our exposure to bond insurers that are over 1% of Mercury's munis assets are as follows; Ambac, 9%, Fujix [ph] 7.2%, FSA 11.3%, MBIA 17%, and XLCA is 1.7%.

In summary, our municipal bond portfolio has strong underlying ratings. The strong underlying ratings reduce our exposure to market value declines as a result of potential rating downgrades to the bond insurers. In addition, most of our muni positions are purchased with the intent to hold to maturity, and credit market conditions have not changed that intent. Lastly, we view the credit market as a buying opportunity.

Gabe, back to you.

Gabriel Tirador

Thanks, Chris. Well, with that brief background on the fourth quarter, let's go ahead and open it up for questions.
Question and Answer

Question and Answer

Operator

[Operator Instructions]. Your first question will be from Charlie Gates of Credit Suisse.

Charles Gates
Credit Suisse

Hi. Good morning, guys.

Gabriel Tirador

Good morning, Charlie.

Charles Gates
Credit Suisse

Question for you. [inaudible] the changes in rates again that you put into place in the State of California?

Gabriel Tirador

Well, we were approved, Charlie, for a 3.6% rate reduction in our largest preferred company here in California, which represents approximately 70% of our business. The remaining 30% of our business in California is going to receive a slight increase on 0.4%.

Charles Gates
Credit Suisse

Okay. And that put makes you largely compliant with basically the regulatory structure in the state?

Gabriel Tirador

That is correct.

Charles Gates
Credit Suisse

Okay, that with my first question. My second question, I think that you, Gabe, opined that you saw… while the market remained tough that some companies are now electing to recognize that in raised rates. Could you elaborate on that?

Gabriel Tirador

Well, for example, here in California we've seen a 5% rate filing from progressive for their agency business. We've seen here insurance filed for over 6% I believe here, in California. And in various parts of the country, we've seen… we've all state raise rates in certain parts of the country and Safeco as well. So we are starting to see carriers actually filing for some rate increases.

Charles Gates
Credit Suisse

Okay. Do you know what… this is my last question. Do you know whether the progressive rate increase has been approved yet?

Gabriel Tirador

No, I'm not aware of that. I highly doubt that has been approved because it just made public notice, I think it was either very late December or early January, Charlie. So I think the effective date that they proposed and they're filing, from what I recall, was somewhat… sometime in March.

Charles Gates

Credit Suisse

Okay. Thank you very much.

Gabriel Tirador

You're welcome.

Operator

Your next question will be from Meyer Shields of Stifel Nicolaus.

Meyer Shields
Stifel Nicolaus & Company

Thanks, good morning.

Gabriel Tirador

Good morning.

Meyer Shields
Stifel Nicolaus & Company

Have you taken any rate activity with regard to California homeowners?

Gabriel Tirador

No, we haven't.

Meyer Shields
Stifel Nicolaus & Company

Is it reasonable to expect continued I guess severity increases?

Gabriel Tirador

Well, we're actually taking a look at our homeowner filings right now. And we anticipate making a filing in homeowners probably by May 1, I believe is our target. Whether or not there will be an increase or decrease, I really can't tell you right now. Our actuaries are in the process of evaluating that line of business right now.

Meyer Shields
Stifel Nicolaus & Company

Okay. That's helpful. And when we look outside of California, I think last quarter you talk about expectations when that business will start being profitable. Is that timeline still intact?

Gabriel Tirador

Well, I believe, what I… we said about a year ago is that we felt that by fourth quarter of this year that we should start seeing some improvements in our operations outside of California because we are making a significant amount of operational improvements and in addition to that we are making various rate filings. Now, in the fourth quarter of this year, we did see quite a bit of positive improvement with the exception of New Jersey.

Now, as I mentioned earlier, one of the biggest issues that we've in New Jersey is that in the PIP and the BI line, they tend to be very long-tailed lines in New Jersey compared to any other state that we've seen elsewhere. So although we believe that some of the changes that we have made in New Jersey from an operational standpoint and from a rating standpoint are going to have a positive benefit, we have yet to record that in the results, in particular into BI or PIP, because it's going to take some time to see if the changes that we've made are going to have an impact.

Meyer Shields

Stifel Nicolaus & Company

Okay. Thank you.

Operator

Your next question will be from Alison Jacobowitz of Merrill Lynch.

Alison Jacobowitz
Merrill Lynch

Hi, thanks. Two questions, one, I missed the first like 10 seconds, so I don't know if you said it. I heard that there was some reserve re-estimation for the year in the fourth quarter. Did you quantify it... can you quantify it? I think it's on the press release, it was $20 million of strengthening, so what the addition was there? And then if you... can you just repeat the exposure to the bond insurers because it went by me too quick?

Gabriel Tirador

Hey, guys. Ted, why don't you go...

Theodore R. Stalick

On the reserves, in California, there is about $4 million of re-estimation for the current 2007 accident year.

Alison Jacobowitz
Merrill Lynch

So, that was in addition to the $20 million in the press release?

Theodore R. Stalick

Yes, the $20 million in total.

Alison Jacobowitz
Merrill Lynch

Yes. It was that part of the $20 million?

Theodore R. Stalick

No, in addition to it.

Alison Jacobowitz
Merrill Lynch

In addition, okay.

Gabriel Tirador

The $20 million was the year-to-date number.

Theodore R. Stalick

That's the year-to-date number.

Alison Jacobowitz
Merrill Lynch

All right. I read it quick. We had so much going this morning, I have to go back through it, but… okay, but it wasn't part of the $20 million?

Theodore R. Stalick

Correct.

Alison Jacobowitz
Merrill Lynch

Okay.

Christopher Graves

And else it on the bond insurers. Again this is bond insures that are over 1% of our muni assets, Ambac was 9%, Fujix 7.2%, FSA 11.3%, MBIA 17%, XLCA 1.7%.

Alison Jacobowitz
Merrill Lynch

Thank you very much.

Gabriel Tirador

I think it's important, Alison, though for you to understand what the underlying writing is without insurance though, what is that Chris in...

Christopher Graves

A1 and AA minus.

Gabriel Tirador

Did you get that, Alison?

Alison Jacobowitz
Merrill Lynch

Yes. I thought that was with the insurance.

Christopher Graves

That was without. With the insurance is AA1, AA plus; without insurance, A1, AA minus.

Alison Jacobowitz
Merrill Lynch

Okay. Perfect, thank you.

Operator

Your next question will be from Richard Sbaschnig of Oppenheimer.

Richard Sbaschnig
Oppenheimer & Co.

Yes, hi. Just in terms of the non-California business, I guess the... have you seen any really rate improvement or rate changes by competitors in the State of New Jersey?

Gabriel Tirador

What do you mean by... I guess rate improvement?

Richard Sbaschnig
Oppenheimer & Co.

Well, I mean you are detailing progressive and some of these folks are out there raising rates in California. Have you seen anything like that at all in New Jersey yet?

Gabriel Tirador

No, I can't say that we have. In New Jersey, one of the reasons, we probably don't see it as quickly... here in California when they actually make the filing, and makes public notice.

Richard Sbaschnig
Oppenheimer & Co.

That's right.

Gabriel Tirador

And in New Jersey you don't know about it until it finally gets approved, and that could take several, several months and… if not longer. So that's one key difference between New Jersey and California where sometimes you don't have the information as quickly.

Richard Sbaschnig
Oppenheimer & Co.

Got it. And also, in terms of the schedule for the rollout of Mercury First, I guess... could you give us I guess a rough maybe next kind of two quarters what your schedule is for which states?

Gabriel Tirador

Yes. Roughly, New York is going to be our first state and that's scheduled to be out in late march. And subsequent to that, it's probably going to be Florida and subsequent to that California. The rest of the states we still haven't really determined it. But I will tell you this that we… our goal is to have Mercury First in all of our states… all 13 of our states by the end of this year.

Richard Sbaschnig
Oppenheimer & Co.

Thank you.

Operator

[Operator Instructions]. Your next question will be from Marc Serafin [ph] of Citadel Investment.

Unidentified Analyst

Good afternoon.

Gabriel Tirador

Hi, Marc.

Unidentified Analyst

Was the... were the equities the underlying driver of the lower investment yields in the quarter, or is there anything that's… you shuffled around that would...?

Gabriel Tirador

As far as investment income?

Unidentified Analyst

Yes.

Gabriel Tirador

Well, one thing that did occur in the quarter… we had... we ended up the year, Marc, with very good results in our equity portfolio. I believe our equity return was in the neighborhood of over 27%… maybe 30% compared to 5% in the Standard & Poor's. And so we... what we... I think we accrued something in the neighborhood of $2 million for investment managers' performance-related bonuses. So that had a slight impact in the quarter.

Unidentified Analyst

Okay. That's helpful.

Gabriel Tirador

Okay.

Unidentified Analyst

And then you had mentioned in your prepared remarks that the fourth quarter in California might have included some prior quarter re-estimation.

Theodore R. Stalick

Right, Marc.

Unidentified Analyst

Can you quantify that for us?

Theodore R. Stalick

We had... that's the approximately $4 million.

Unidentified Analyst

Okay. So then the $4 million in the fourth quarter would be another adjustment factor that you guys would look at for a seasonal run rate in the fourth quarter?

Theodore R. Stalick

Well, if you are trying to back into our accident quarter loss ratio...

Unidentified Analyst

And was that mostly severity?

Theodore R. Stalick

Then you would take that out of the $4 million.

Unidentified Analyst

Is that a severity issue?

Theodore R. Stalick

Yes.

Gabriel Tirador

The re-estimation is primarily severity, yes.

Unidentified Analyst

Got you. And then, one quick question was on, your definition of revenue neutral. Can you just explain that a little bit more for us?

Gabriel Tirador

That just basically means that the… overall if every insured continue to be on the books for us and renewed and if we had, let's just say, $100 million in premium in-force that we will continue to have $100 million in premium, that overall some people's rates may go up, some people's rate may go down. But if everyone stayed with you...

Unidentified Analyst

Right.

Gabriel Tirador

You'd have the same amount of revenue. That's what’s typically referred to as a revenue neutral filing.

Unidentified Analyst

Okay. And then your comment about negative premiums should continue here maybe into the near future, was that a California-specific comment or was that company-wide?

Gabriel Tirador

That's company-wide, Marc.

Unidentified Analyst

Thanks.

Gabriel Tirador

Okay.

Operator

Your next question will be from Dan Farrell of Fox-Pitt Kelton.

Dan Farrell
Fox-Pitt Kelton

Hi, everyone. I just had some questions on your non-California business actually. Can you talk a little bit more about where you stand in all your efforts on improving the profitability there? We have obviously seen improvement from where we were. Over the past year you've obviously been putting through different re-pricing of the business and things like that. We are still seeing obviously some downward trend in those premiums. But where do you see everything ultimately settling out in terms of what type of combined ratio you would ultimately like to offer at that level? When should we see topline stabilize? If you could just sort of give sort of an overview and maybe hit some of the trends in some of the larger states?

Gabriel Tirador

Well, it's difficult to say when the topline will stabilize. As you know, it's a very competitive market today. I will say that our target is to achieve a 95% combined ratio in all of our states. And we're really focused on making changes in various states with respect to improving our segmentation. We have hired quite a bit more staff here internally to manage our products and actuarial staff as well. So we're focused on getting that done.

As far as the timing goes, excluding New Jersey like I mentioned earlier, we’re in a 98% on a calendar year result basis and we’re seeing tremendous improvement, for example, in our Florida operations. We've seen the severity in our BI because of some of the changes that we've made go down quite a bit. We do expect that in New Jersey based on the changes that we've made operationally and with the rate changes that were made… and in addition to that we're contemplating another rate change in New Jersey here in the next several months as we are in other states. One of the key factors though in n New Jersey, which is driving the combined above 100, as I mentioned earlier, has to do with BI and PIP and the fact that we don't feel comfortable at this point recording current accident losses with the expectation that the benefits that we believe are going to be derived to lower the loss ratio in that state. Now, as we gather more evidence with respect to these two coverage in New Jersey, we believe that we're going to lower that loss ratio.

Dan Farrell

Fox-Pitt Kelton

Okay. And do you have segmented pricing at all those non-California states now or there is still some that you're rolling out different versions of it?

Gabriel Tirador

We are still rolling out different versions of it and there's still improvement to be made. We are going to be making some rate changes here in Texas, Florida, New Jersey, as I mentioned before Georgia. So there is going to be continued changes with respect to improving our segmentation in those states.

Dan Farrell
Fox-Pitt Kelton

Okay. Thank you very much.

Gabriel Tirador

Thank you.

Operator

There is a follow-up from Richard Sbaschnig of Oppenheimer.

Richard Sbaschnig
Oppenheimer & Co.

Yes. I just want to get your take on what... any changes in the M&A outlook for personal auto insurers?

Gabriel Tirador

Well, I guess just from my perspective anytime you have a situation where companies are struggling to grow and are seeking to grow the topline, there is a potential I think for M&A activity. We've seen a little bit of that over the past year. Whether or not there will also be more it's hard to say, but this environment may lend itself to more M&A activity.

Richard Sbaschnig
Oppenheimer & Co.

Okay. Thank you very much.

Gabriel Tirador

You are welcome.

Operator

And at this time, there are no further questions.

Gabriel Tirador

Well, I would like to thank everybody for participating in the call today, and we look forward to talking to everybody next quarter. Thank you very much.

Operator
This concludes today's conference call. Thank you for your participation. You may now disconnect.