S&P Global
Market Intelligence

Selective Insurance Group, Inc. NasdaqGS:SIGI

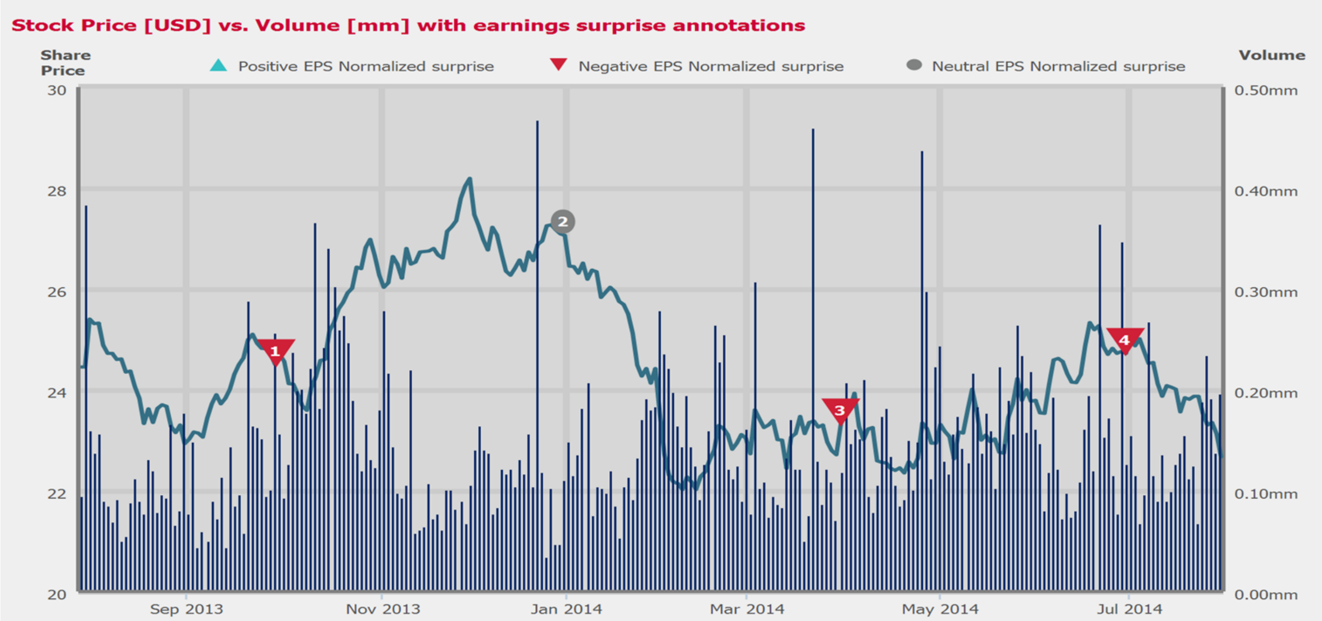
FQ3 2014 Earnings Call Transcripts

Thursday, October 30, 2014 12:30 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2014-			-FQ4 2014-	-FY 2014-	-FY 2015-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.51	0.76	▲49.02	0.64	1.80	2.26
Revenue (mm)	511.18	515.36	▲0.82	510.51	1965.55	2024.57

Currency: USD
Consensus as of Oct-30-2014 3:26 AM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ3 2013	0.44	0.42	(4.55 %)
FQ4 2013	0.45	0.45	0.00 %
FQ1 2014	0.33	0.23	(30.30 %)
FQ2 2014	0.49	0.46	(6.12 %)

Table of Contents

Call Participants

EXECUTIVES

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

Gregory Edward Murphy
Chairman & CEO

Jennifer Wilson DiBerardino
Former Sr. Vice President, Investor Relations & Treasurer

John Joseph Marchioni
President & COO

ANALYSTS

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Michael Zaremski

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Presentation

Operator

Good day everyone. Welcome Selective Insurance Group's Third Quarter 2014 Earnings Release Conference Call. At this time for opening remarks and introductions I would like to turn the call over to Senior Vice President, Investor Relations and Treasurer, Ms. Jennifer DiBerardino.

Jennifer Wilson DiBerardino
Former Sr. Vice President, Investor Relations & Treasurer

Thank you. Good morning, and welcome to Selective Insurance's third quarter 2014 conference call. This call is being simulcast on our website and a replay will be available through December 1, 2014. A supplemental investor package, which includes GAAP reconciliations of non-GAAP financial measures referred to on this call, is available on the Investors page of our website at www.selective.com.

Selective uses operating income, a non-GAAP measure, to analyze trends and operations. Operating income is net income excluding the after-tax impact of net realized investment gains or losses, as well as the after-tax results of discontinued operations. We believe that providing this non-GAAP measure makes it easier for investors to evaluate our insurance business.

As a reminder, some of the statements and projections that will be made during this call are forward-looking statements, as defined by the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not guarantees of future performance and are subject to risks and uncertainties. We refer you to Selective's Annual Report on Form 10-K and any subsequent Form 10-Qs filed with the U.S. Securities and Exchange Commission for a detailed discussion of these risks and uncertainties. Please note that Selective undertakes no obligation to update or revise any forward-looking statements.

Joining me today on the call are the following members of Selective's executive management team; Greg Murphy, CEO; John Marchioni, President and Chief Operating Officer; Dale Thatcher, CFO; and Ron Zaleski, Chief Actuary.

Now, I'll turn the call over to Dale to review the results.

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

Thanks, Jen and good morning. We are very pleased with third quarter results as our insurance operations posted an excellent quarter and investment results were in line with our expectations. Now 3 quarters through the year, our ex-CAT statutory combined ratio stands at a solid 91.8%.

Operating income per diluted share for the quarter was $0.76, up 81% from $0.42 per diluted share a year ago. Excluding the impact of favorable prior year category development and catastrophe losses, operating earnings per diluted share were 40% higher than the third quarter of 2013.

The third quarter statutory combined ratio was 91.5%, compared to 96.3% a year ago, and our underlying combined ratio excluding catastrophes and prior year casualty development improved by 2.4 points. A light quarter for weather led to catastrophe losses of only 1.2 points compared to 2.7 points in the prior year period. Favorable prior year casualty reserve development in the quarter was $8 million or 1.7 points compared to $3.5 million or 0.8 points a year ago.

As has been the case in recent quarters, general liability was the greatest contributor to the favorable development with $11 million or 2.4 points on the overall combined ratio. As you analyze our results this quarter, keep in mind that the elevated property losses from the first half of the year were substantially paid in the third quarter leading to a decline in reserves on a sequential quarter basis.

On overall basis statutory net premiums written were up 0.5% in the quarter with standard commercial lines flat. While our growth moderated compared to the second quarter, the sale of our Self-Insured Group announced in the first quarter of this year impacted production numbers as most of this business had third quarter renewal base. Excluding the $27 million in premiums written by this group in the third quarter of last year, standard commercial lines statutory net premiums written increased by 8% and overall premium increased by 6%.

In standard commercial lines we achieved quarterly renewal pure price increases of 5.3% while retention held steady at 83%. The standard commercial lines statutory combined ratio for the quarter was 90.9% compared to 95.6% a year ago, on an ex-CAT basis, results improved by 5 points.

Workers Compensation generated a combined ratio of 111.2%, a 7 point improvement over the same period of last year reflecting our continued efforts to improve the profitability of this challenging line. While there is still more work to do, we are pleased with our early successes and for the third consecutive quarter, there was no reserve development in the Workers Compensation line either favorable or unfavorable. All other standard commercial lines of business generated a strong profitability in the quarter.

Personal Lines net premiums written declined 2% in the quarter, as we continued the strategic nonrenewal of dwelling fire business and a reduction in monoline homeowners. As a result of these initiatives, retention decline to 81% from 86% in the third quarter of 2013. The statutory combined ratio of 88.9% including catastrophe losses of 2.2 points compared to the third quarter of 2013 when the statutory combined ratio was 97.6% including the 11.7 points of catastrophe losses.

Homeowners had a strong quarter with a statutory combined ratio of 86.8% and renewed pure pricing of a strong 9.8%. Year-to-date homeowners' profitability has been impacted by CAT and non-CAT weather with a statutory combined ratio of 110.8%, while renewal pure pricing achieved is 9.4%.

In Personal Auto, the statutory combined ratio for the quarter 100.3% an improvement from the prior year period of 107.4%. Results also were improved on an ex-CAT basis with a 101.2% combined ratio compared to 105.9% last year. Personal Auto had $2 million of favorable prior year casualty reserve development, reflecting a continuation of positive reserving trends and renewal pure price was 3.8%. While we focus our homeowners strategy on rate and underwriting initiatives, we expect Personal Auto to continue its improvement through a combination of rate increases and aging of the book.

Net premiums written for our excess and surplus operation grew 11% in the quarter to $40 million with the statutory combined ratio of 102.9% including 1.4 points of catastrophe losses. Adverse prior year casualty reserve development of $4 million adds 11.1 points to the E&S combined ratio in the quarter. The unfavorable development has related to updated actuarial assumptions if the book matures and we gather more of our own experience. We remain confident in our path to profitability for this line.

Turning to our investment portfolio, after tax investment income in the quarter increased 5% from the year ago to $26 million. The year-to-date after tax yield on the portfolio remained flat compared to a year ago at 2.3% and investment assets increased 5% from year end to $4.8 billion. After tax new money yields of 2.14% in the quarter were slightly below our full year budget of 2.25% reflecting the backup in rates in the third quarter.

The overall pretax portfolio unrealized gain position increased from $79 million at year end 2013 to $115 million at the end of the third quarter. Also the pretax unrecognized gain position in the fixed income held-to-maturity portfolio was $18 million or $0.21 per share on an after tax basis. Our fixed income portfolio continues to highly rated at AA minus credit quality with the duration of 3.6 years including short-term investments.

Surplus and stockholders equity each entered the quarter at $1.3 billion and book value per share grew 9% from the year end to $22.45. Our premium to surplus ratio remained at 1.4 to 1. Benefitting from strong profitability in the quarter, our annualized operating ROE for the first 9 months of the year was 9.1% and total ROE was 11.1%, both in excess of our weighted average cost of capital of 8.8%.

Now I'll turn the call over to John Marchioni to review insurance operations.

John Joseph Marchioni
President & COO

Thanks, Dale. I'm very encouraged by our success in implementing the underwriting and claims initiatives that have resulted in our underlying profitability improvement. This is in spite of some headwinds we've experienced with price moderation, competition for new business opportunities, and continued low interest rates. The commercialized market is becoming increasingly competitive. We have successfully managed the delicate balance between rate retention over the past 4 years relying on sophisticated underwriting and pricing tools along with very strong agency relationships.

Moving forward, in addition to underwriting and claims improvements, we remained focused on achieving pure rate increases, an amount that meets or exceeds expected loss inflation trends. Our highest quality accounts in the first 9 months of the year we achieved pure rate of 5% and point of renewal retention of 89%. These accounts comprised 54% of our standard commercial lines renewal book. Our lower quality accounts we achieved pure rate of 12% and point-of-renewal retention of 74%. These accounts represent 8% of our standard commercial lines renewal book.

We have taken a number of actions to improve underwriting results over the past few years which are yielding positive results. We improved the hazard mix on our Workers Compensation book of business by focusing on lower hazard accounts. We have also targeted specific classes of business for re-underwriting. An example of this is a significant reduction in snow plowing exposure in the contractors book. Most importantly our underwriters are using the dynamic portfolio manager tool to target the lowest performing business for significant rate increases or reducing retention in order to improve the overall profitability of their individually managed books of business.

When taken altogether, these actions are having a positive effect on our underlying profitability. We are very encouraged by the positive claim trends emerging as a result of the enhancements we have made in our claims operations. The impact of these changes will take a while longer to manifest into results as more time is required to prune them out from an actuarial perspective. We believe the stability we are seeing in Workers Compensation reserves over the past 3 quarters is largely due to our claims initiatives.

While we are not ready to declare victory by any stretch, we feel good about the early signs of improvement in Workers Comp so far. The strategic case management unit employs a triage process which focuses on claims with the potential for high severity. After the claims are directed into the unit, seasoned specialists and expert medical resources walk the cases through the settlement. As a result we are seeing significant improvement in claim outcomes.

Excess and surplus lines statutory net premiums written grew 11% year-to-date to $107 million and achieved renewal pure price increases of 3.8%. Given the unfavorable casualty reserve development this quarter, we no longer expect E&S to be at the same relative profitability level as our standard operations for 2014.

We have successfully converted to a single underwriting guide for the 2 books of business that we purchased in 2011 and they now benefit from that synergy. The automation enhancements undertaken after the acquisition of our E&S operations have been introduced in pilot and full roll out as expected by year end. We are working with our retail agents to drive more of their E&S opportunities to our Mesa wholesale agents where we still see significant opportunity to write additional premium.

One of the benefits of having an E&S operation is that based on market dynamics, segments that we are no longer comfortable writing in our standard commercial lines present opportunities for us in E&S. A good example of this is snow plowing. While we have curtailed this class of business in standard commercial lines we are writing it in E&S. We continue to feel very good about our E&S growth and profitability prospects moving forward.

Personal Lines core profitability improvement is on track despite the decline in net premiums written due to our strategic non-renewal of dwelling fire policies as well as targeted non-renewal actions on underperforming auto and home business. Personal Lines renewal pure price increased 6.8% in the quarter and 6.5% for the 9 months while retention is 81% year-to-date.

In order to improve the overall growth results of personal lines we will be rolling out several product changes in early 2015 which will include the introduction of Selective Edge. We believe that a significant portion of the population shops on overall value and service and not purely on price. The independent agent channel is best suited to attract and service this customer through the broad range of products and services they can provide. In order to win in this market we will work with our agents on targeted marketing campaigns to attract and retain this consultative buyer as well as offering a broad array of coverage options that this customer demands.

Now I will turn the call over to Greg Murphy.

Gregory Edward Murphy
Chairman & CEO

Thank you, John. The strong results for both the quarter and year-to-date reflects the hard work of our 2100 employees, 1100 retail agents, and 85 wholesale general agents to execute on our strategies in a more competitive market as result of a significant efforts over the past 3 year period we feel confident in our 2014 92 ex-CAT statutory combined ratio target. We presented this target and our strategies to achieve it in May 2012, and we have been tracking very closely to our expectations on all fronts: rate, loss inflation trends, underwriting actions, and claims initiatives.

While commercial lines renewal pure price pricing is under some industry wide pressure for the first 9 months of 2014, we have successfully achieved renewal pure price increases of 5.8%. For several years we have been achieving rate above loss inflation and at levels higher than the industry. While not every competitor discloses their renewal pure price changes on a quarterly basis, against the peers that do, we tend to be one of the top performing companies.

Our expectation for the full year 2014 is to obtain overall renewal pure price increases of approximately 5.5%. We are on track with our overall profitability goals and continue to make progress while monitoring the state of the industry for profitable growth opportunities. In 2015 we expect to generate new business growth from: one, the expansion of our distribution force and new products; two, increasing our share of volume from both retail and wholesale agents; and three, obtaining more E&S business from Selective's retail agents.

Another area of focus has been customer experience that promotes loyalty and best in class service. While service is the part of our culture since Selective's founding over the past several years, we have been implementing numerous customers experience initiatives including a roll out of a more user friendly bill, a mobile service app, and driving self-service through our online and mobile offerings. We are also tracking service levels through surveys that produce net promoter scores. We view this as an opportunity to increase retention and profitability.

In recognition of improving operating results and capital levels, the Board of Directors declared an 8% quarterly dividend increase to $0.14 per share effective December 1, 2014 to shareholders of record on November 14, 2014. As been our practice, we will release our 2015 expectations with the fourth quarter earnings in January. For 2014, our guidance is as follows: an ex-CAT statutory combined ratio of 92 which includes no additional prior year casualty development, 4 to 4.5 points of catastrophe losses for the year, after tax investment income of approximately $105 million, and weighted average shares of 57.4 million. Now I'll turn the call over to the operator for your questions.

Question and Answer

Operator

[Operator Instructions]. Our first question is from Vincent DeAugustino from KBW.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

So, just a couple of quick ones on the nice quarter here. So, John to your point on shifting the focus on the Workers Comp side to lower hazard business, I was just curious if you might get a call out some of the industries broadly I guess, I don't want to give away too much competitive information there but just where you have an increased appetite? And then secondly maybe for Dale, I am just thinking how you guys operate on the reserve side, I wouldn't expect your projected development patterns to immediately change there but conceptionally would you agree that there should be shorter tail segment of the Workers Comp business with quicker claims payment? And then kind of what the mix versus low hazard versus just maybe regular business going forward might be in a few years?

John Joseph Marchioni
President & COO

Alright, so I will start Vince and then Dale could jump in on the reserving side. With regard to appetite and success, I guess the first thing to point out would be as you know, where we have historically been in a heavier contractor market overall. That has come down in terms of mix over the last few years. That has been a concerted effort on our part. We continue to be a very strong contractor's market and a very probable contractor's market where we have really tried to diversify into other segments. In terms of the segments that when you think about lower hazard smaller Workers Comp industry verticals that we are talking about here, I would say you think about that heavily in the retail and the service type business segments which are generally thought based products and the ability to go out and write the Workers Comp on those competitively I would say is a big part of our expectation and strategies going forward.

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

And Vince on the reserve development side, I mean as you know with our book of business just in general terms being more small commercial it already tends to have a little bit shorter tail than the broad industry. And clearly a lower hazard comp book we would expect to have a somewhat shorter tail also but Workers Comp is the longest tail line that's out there. But -- so certainly we would expect to see some benefit from that but I can't say that it would be dramatic enough to make large modifications to our schedule patterns.

Gregory Edward Murphy
Chairman & CEO

And then finally Vince, we have a very specific internal targets, we don't talk about those externally in terms of shifting the mix and we really think about those on a policy account basis because as you would expect your higher severity classes carry higher average premiums. So you are really going to see this-- the shift ought to manifest itself in policy accounts first and foremost and then later on you are going to see it on a premium mix basis. We manage that internally, we hold our production folks accountable just moving those targets but we just haven't talked about those externally.

John Joseph Marchioni
President & COO

And business is great. And also just kind of dovetail on the whole comp question, obviously we had the conversations with you, we saw the comp claims handling down in Charlotte. We feel very confident and good about what we have done there. We had triage model in place now. We have got our strategic case management unit fully staffed now. And we are in the process of moving the balance of our inventory out of our 5 regional offices there. There is a small case remainder that needs to be pulled through that office. So we feel really good about how we are going to be handling comp going down the road, specifically around the specialties that we will be able to create on claim handling. And the level of focus that we will have now going forward is greatly increased as one centralized unit versus how it was handled previously as more or less by decentralized kind of units. So we really look forward to some fundamental improvement in our comp book going forward.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Okay, color there is actually really helpful and I actually do think the consolidation within Charlotte is right. So just want a sense -- so John, just on the Personal Lines product change so when I think about kind of some of the big, let's call it agency focused insurers, mainly you guys in Cincinnati and Hanover, you know, Hanover and Cincinnati both have recently had some new products come to market within the Personal Line space so I am wondering how much does your new Edge product look and feel similar to those?

John Joseph Marchioni
President & COO

Yes, so clearly when we designed product changes we are looking at the competitive set that we have in most of our agents. We certainly view our product in line in certain cases better than that. And honestly I would say if you were to survey our agency plan, they would tell you that our home products has historically been very, very good from a coverage perspective relative to the industry. And for us this is really trying to package up those coverage enhancements on both the home and the auto side in a way that is easier for agents to market that product to this customer base.

But we feel very good about how it is positioned in those, in the competitive set that we see typically.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Okay and sorry if I missed this, with other calls joining a little bit late but on maturity side did you guys happen to talk about the reserve action there or I can just grab the transcript afterwards maybe?

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

You mean excess and surplus as opposed to..

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

I am sorry, yes, sure, E&S sorry my bad.

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

Actually we had a $4 million adverse development there on the E&S. And I can't remember this as a young book and a small book. So we do expect some level of volatility as we gain experience and background with that. We do maintain our commitment to the profitability expectations that we have there, although we don't think that we will achieve the initial combined ratio that we thought we are going to get for this year, 2014. But we did think that our overall basis were in good shape and remember we did tend to react very quickly to any kind of adverse patterns in our reserves because we like to stay on top of that and maintain a very strong balance sheet.

Operator

Our next question is from Mark Dwelle of RBC Capital Markets.

Mark Alan Dwelle

RBC Capital Markets, LLC, Research Division

Yeah, this is kind of the quarter we have been watching for, for some time. So I don't want to pick on a negative but on the -- I guess when I think about the adverse development charge in the E&S unit, I guess what it implies to me is if the -- if you hadn't had that charge your run rate would have been in the mid-90s. Is that more of the level that we should think about going forward or is there a factor of mix or something else that might make that number lower than I would might otherwise guess?

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

Mark, as we talked about from us even getting into the E&S business it was with the recognition that on a historic basis this area within the industry has tended to perform at 6 to 10 points better than the commercial line space. And it is our full expectation to be able to over time achieve that same level of performance. So I agree with your mathematical assessment that we would have been in the mid-90s with that and that's clearly what our goal is. We'll lay that out in more detail when we provide guidance for 2015 as to that's where we think that's going to perform next quarter.

John Joseph Marchioni
President & COO

And Mark just to add to that as we scale up more then we'll be able to see some of the expense ratio efficiencies. But I think you know the core of that expense ratios is pretty solidly based around commissions paid to the wholesale agency. So I think it's going to take us some time where we feel very comfortable about the quality of the book and what we are doing. We made a lot of fine tuning and we'll continue as we are pretty aggressive on dealing with issues that manifest themselves and just take a look at the comp how everybody was on that. And we feel very good about the comp and I think that's how we manage our organization overall.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay, kind of a little bit in that same vein then, you talked about some business that you were shifting sort of away from standard and towards E&S, can you talk about just in general how you're seeing business flows or is business still flowing in that direction or more generally are you seeing flows come out of the specialty area and towards the standard lines.

John Joseph Marchioni
President & COO

I don't think we are seeing a big shift. You know the one big segment that you did see move from standard to E&S over the last couple of years has been on the habitational side. That's not a place that we played in on the admitted market, with our admitted product but we certainly do on the E&S side. I would say that's kind of leveled off and I think on the upper end of E&S which is not where we really play on the brokerage side business, the larger accounts. I do think you are starting to see a little bit more of that migrate back to the admitted market. But I don't think you are seeing a big shift beyond those 2 areas at this point.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay, that's helpful and then the last question I had and maybe this is a question for anybody, Greg maybe, just in general on the mood of customers at this stage we've been raising rates for 4, 5 or 6 years in some cases. I know when I get that many rate increases I eventually kind of get tired of it. What are you sensing from your agencies and what are people telling you about how customers are, where their mood is at this stage of the cycle?

Gregory Edward Murphy
Chairman & CEO

I think you said it pretty well. There is a little fatigue out there and that's probably the best word to use. Our sense is that going forward I think what we need to do and we have been trying to manage this story is teasing out their customers. There should be some level of ongoing expectation of rate relative to loss inflation trends. And I think that's the way we like to talk about it and refer to it. I have heard many of our other competitors use that kind of language and I think that just reflects that we just can't start these wild cyclical swings where you're reducing rates substantially in some years and then trying to build back rate up over. But I will say that there is a number of companies that are going to be moving into the 2015 time period that still are going to require some fundamental improvement in their core underwriting results and if you haven't done the heavy lifting that we've done, it’s going to be very difficult out there.

Operator

[Operator Instructions] Next we have Mike Zaremski from Balyasny Asset Management.

Michael Zaremski

In regards to the investment income guidance, I was just curious markets have obviously been choppy so far this quarter, have you guys contemplated within that guidance the potential for weaker alternative returns?

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

Basically if you look at where we are through 9 months and kind of work through that, it is clear that our original guidance of $100 million was a little bit short of where we will ultimately be. That's why we have bumped into the $105 million. So we haven't included any dramatic expectations for material changes in any of the classes of investments that we are in.

Michael Zaremski

Got it. Okay. And then lastly on the E&S reserve additions, can you provide any color on actually what drove the additions, was it Casualty, Property, or a mix of both that will be helpful, thank you?

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

It was all Casualty development. Remember that book of business is 75% Casualty and 25% Property. And basically since that is brand new we bought it at the end of 2011, it was clearly the 2012 and 2013 actual years.

Gregory Edward Murphy
Chairman & CEO

And the only other thing I would add there from a casualty perspective it was -- we are at GL rate, there is no comp in that book, there is no commercial auto in that book, it is purely GL.

Operator

Thank you. There are no other questions in the queue at this time.

Gregory Edward Murphy
Chairman & CEO

Thank you. If you have any follow-up matters please contact Jennifer or Dale. Thank you very much for participating on the call.

Operator
Thank you. You may disconnect your lines at this time.