S&P Global
Market Intelligence

Mercury General Corporation NYSE:MCY

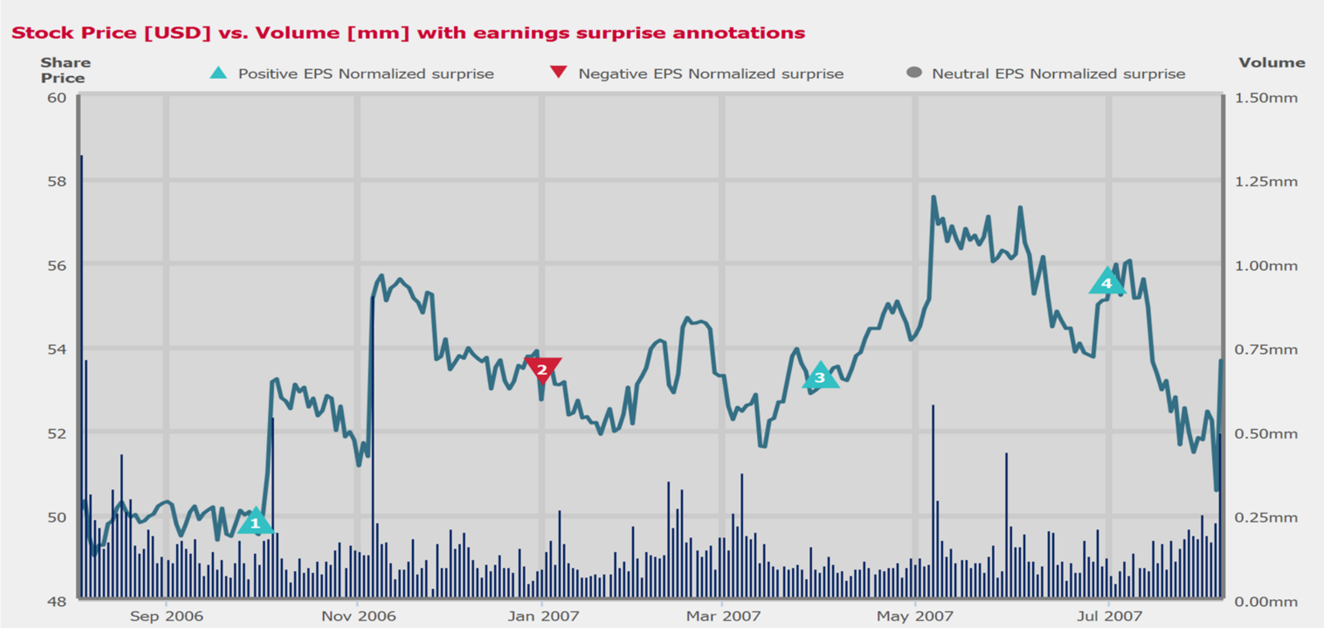
FQ3 2007 Earnings Call Transcripts

Monday, November 05, 2007 6:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2007-			-FQ4 2007-	-FY 2007-	-FY 2008-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.12	1.13	0.89	0.94	4.33	4.36
Revenue	-	-	(2.08 %)	-	-	-
Revenue (mm)	775.00	758.85	-	738.43	3034.40	3097.53

Currency: USD
Consensus as of Nov-05-2007 4:01 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2006	1.15	1.22	6.09 %
FQ4 2006	1.17	0.89	(23.93 %)
FQ1 2007	1.05	1.11	5.71 %
FQ2 2007	1.09	1.15	5.50 %

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George Joseph

Theodore R. Stalick

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Operator

Good afternoon. My name is Regina and I will be your conference operator today. At this time, I would like to welcome everyone to the Mercury General third quarter results 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.

Mr. Gabriel Tirador, you may begin your conference.

Gabriel Tirador

Thank you very much. I would like to welcome everyone to Mercury's third quarter conference call. I'm Gabe Tirador, President and CEO. In the room with me is 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, and Ron Deep, Vice President of the South East Region.

Before we open it up for questions, I would like to make a few comments regarding the quarter. In our California operations, our loss ratio increased from 61.7% in the third quarter of 2006 to 64.1% in the third quarter of 2007. The primary reason for the increase in the loss ratio was due to a small amount of adverse development recorded in the third quarter of 2007 on prior accident periods compared to positive developments recorded in the third quarter 2006.

Our loss ratio on California business on a year-to-date accident year basis, was 63.6% compared to 64.2% in 2006. On an accident year basis, we are recording severity increases in the low single digits and frequency as relatively flat. Offsetting the increase in severity is an increase in the average premium collected for policy.

In addition to the higher calendar year loss ratio in our auto personal line, our homeowners loss ratio in the third quarter was up over the 2006 third quarter due to an increase in recorded severity. Our California expense ratio increased from 26.5% in the third quarter of 2006 to 26.9% in the third quarter of 2007. The increase in the expense ratio was primarily attributed to an increase in advertising expenses and aging contingent commission.

Our combined ratio of 105.5% in our non-California operations in the quarter is still above our target. We continue to see improvements in some of our non-California operations as a result of our continued focus on operation improvements. However, New Jersey is the primary state that continues to exert a large negative effect on our non-California results. Excluding the New Jersey results, our combined ratio in our non-California operations was about 100% in the quarter.

As I previously reported, to improve our results in our New Jersey operations, we implemented a revenue neutral rate change in April designed to improve profitability. This rate change had a negative impact on our new business submissions. In addition, we recently implemented another similar rate change that became effective in October, 2007. Although these rate changes were 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 policy holder receives. As this cap is lifted over the next six to 12 months, our average premium should increase.

The competitive environment remains intense. We continue to believe that growth will be very difficult to achieve over the next several quarters and most likely our premiums written growth will be slightly negative. However, we do believe that the market is beginning to change.

As we previously predicted, as a result of rate reductions and increasing loss cost, the margins of many of our competitors for the personal auto line are deteriorating. In some cases, the margin deterioration has been significant. 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, and improving our technology. The development of our Mercury First front-end sales system is scheduled to be rolled out to our first date in the first quarter of 2008.

Lastly, in late October, the Southern California region was significantly affected by sweeping firestorms. Our catastrophe claims team has been working diligently to begin the process of helping our insurers in their time of need. Our current loss estimate related to the firestorms is between $20 million and $30 million. However, this amount is our current best estimate based on claims reported to date and claims that we anticipate will be reported in the future. Since the fires are very recent, many of the claims have yet to be reported and it is possible that our estimate will change as we receive more information in the future.

Now, with that brief background, I will now open it up for questions.

<TAG>Question-and-Answer Session</TAG>

Question and Answer

Operator

(Operator Instructions) Our first question comes from Charlie Gates of Credit Suisse.

<TAG>Charles Gates -

Credit Suisse</TAG>

I have a couple of questions. One, the $20 million to $30 million, that’s a pretax number?

Gabriel Tirador

Yes.

<TAG>Charles Gates -

Credit Suisse</TAG>

Okay. There was the first one. The second question; Gabe, I think you indicated that you saw some seeds of change with regard to personal auto insurance pricing. Could you elaborate on that please, sir?

Gabriel Tirador

Well, we are seeing more margin deterioration from our top competitors. In some instances, we are seeing in the neighborhood of five, six point changes year over year. We are seeing more increased rate action than we have in the past and we believe we’ll continue to see that because we believe that frequency is relatively flat, severity is going up and with many of our competitors taking rate reductions, all that’s done is squeeze the margins even further. So we are seeing some evidence of margin deterioration, some signs that competitors are actually starting to file for rate increases as well.

<TAG>Charles Gates -

Credit Suisse</TAG>

What do you trace the increased severity to?

Gabriel Tirador

I would have to say primarily in the bodily injury line, it would have to be medical costs. In the physical damage line, which we’ve seen increased severity for some time, we also -- you know, labor rates and the cost of materials to repair the cars has gone up as well.

<TAG>Charles Gates -

Credit Suisse</TAG>

My last question -- would you foresee that the business outside the state of California will continue to contract?

Gabriel Tirador

At least for the next several quarters, I would continue to expect that, Charlie.

<TAG>Charles Gates -

Credit Suisse</TAG>

Thank you.

Operator

Your next question comes from the line of Alison Jacobowitz with Merrill Lynch.

<TAG>Alison Jacobowitz -

Merrill Lynch</TAG>

Thanks. We have been hearing a couple of people lowering rates by big amounts in California -- Geico and Infinity -- because of all the regulation changes in compliance with that, and I'm just wondering if you're still seeing some of that, or what effect you expect that to have on the market?

And then also, if you could just update us on your own rating actions in California, any changes planned or going on?

Gabriel Tirador

I think here in California it's a little different situation, Alison, with respect to some of the rate actions taken by some of our competitors going down. I think Geico was one of the last companies that we've seen with a rather large reduction. And companies here in California have been, as you know, had to file for this new territorial regulations and they've taken I think the opportunity not to have a lot of dislocation in their books. And as a result of that, have taken some reductions.

But I don't think California is immune from any of the loss cost increases that we are generally seeing. Here in California for Mercury's standpoint, we have filed -- I think I mentioned it back in our previous conference call, we filed back in ’06. We’ve had recent discussions with the department over the past several weeks. We believe that over the next month or two, they will get back to us one way or another with respect to what their recommendation is going to be on our rate filing. So the situation in California is a little different than the rest of the country.

<TAG>Alison Jacobowitz -
Merrill Lynch</TAG>

But when you’re then talking about the seeds of change that Charlie so nicely phrased it, are you referring then more to markets outside of California?

Gabriel Tirador

It’s hard to exactly predict, Alison, the timing of this, as you know. We are seeing it -- obviously we are seeing the signs outside of California with respect to actual rate increases already occurring. We are not seeing too much of that yet in California.

<TAG>Alison Jacobowitz -
Merrill Lynch</TAG>

Okay, great. Thank you.

Operator

Your next question comes from the line of Joshua Shanker of Citigroup.

<TAG>Joshua Shanker -
Citigroup</TAG>

Following up on the same things that Charlie and Alison were interested in, I’m interested in finding out how your conversations with California regulators or even other states goes. Looking at the profitability of the industry, it is still quite high, even though I do here that there is some trend change in frequency and severity. When you go to ask for a rate increase to a regulator, how does the relationship between your profitability relate to your ability to get a rate increase approved?

Gabriel Tirador

I guess it would depend on each individual state, Joshua. It just depends on each individual state. A state like Illinois, obviously very easy to get a rate change. Here in California, with the new rate regulation, they are not really looking at how competitive you are.

I will state though that there are a lot of variances here in California that you can apply for with respect to a rate change, and in fact there is still a lot of uncertainty with respect to those variances. The Department of Insurance just issued a bulletin last week that they want additional information from both consumer groups and the companies with respect to how they are going to treat these variances, how are you going to file for these variances. So there is still a little bit of uncertainty with respect to the variances here in California.

But it just varies by state, Joshua. It's depending on the state.

<TAG>Joshua Shanker - Citigroup</TAG>

And here in New York, I've seen television commercials for Geico where they are announcing New Jersey rate decreases. Are you seeing in California local advertising announcing the rate decreases for Geico starting to hit the airwaves?

Gabriel Tirador

I have not seen any. I have not seen any announcing the rate reductions.

<TAG>Joshua Shanker - Citigroup</TAG>

Thank you.

Operator

Your next question comes from the line of Richard Sbaschnig of Oppenheimer.

<TAG>Richard Sbaschnig - Oppenheimer</TAG>

Just a quick follow-up on your rate regulation in California, it's been quite a while for that to get approved. I'm just curious what -- is the price level the main sticking point? What kind of rate reduction are regulators thinking about?

Gabriel Tirador

Well, we really don't have any sticking point at this point because they haven't really gotten back to us, so we have to wait and see what they come back and tell us.

George Joseph

I had a recent conversation with the rates regulators because our filings had been trending so long. And the problem was when the commissioner issued a regulation to change the territorial rate, the department was hit with roughly a thousand filings all within a short time, so that is one of the principal reasons they have been backed up, but understand they are beginning to get current.

<TAG>Richard Sbaschnig - Oppenheimer</TAG>

The other question I had is in the non-California business, you've been able to keep the loss ratio fairly steady, despite a substantial decline in the premium. I'm just curious I guess how have you been able to do that? What might be behind that steady expense ratio?

Gabriel Tirador

We've been reducing expenses as well, at the same time.

<TAG>Richard Sbaschnig - Oppenheimer</TAG>

I mean, where is it coming from? Is it coming from agent commissions or --

Gabriel Tirador

No, no, primarily salary related and advertising.

<TAG>Richard Sbaschnig - Oppenheimer</TAG>

Okay, thanks a lot.

Operator

Your next question comes from the line of Robert Rodriguez of First Pacific Advisors.

<TAG>Robert Rodriguez - First Pacific Advisors</TAG>

Yes, just a quick question on the, since it's so topical
today, on the asset quality of the investment portfolio as it relates to the
various levels there. Can you disclose or have you disclosed what proportion of
your investment portfolios would be in level one, two, or three presently?
Secondly would be your exposure to any of the CDO/sub-prime
issues that are going on today.

Christopher Graves

The overall portfolio, the portfolio, the average rating is
Double A by both services. We don't have any sub-prime exposure. We have about
$20 million in Alt-A, which are Triple A rated and have maintained their
rating. We don't have any CDOs.
Speaking of topical subjects on the area of municipal bond
insurance, we have, as you know, about $2.4 billion in municipal bonds and
there's various ways to slice and dice this kind of data, but just looking at
what's insured and giving credit towards other enhancements, such as FHA or
Jenny Mae, PSF, permanent school fund, other enhancements that are along with
the insurance, the underlying rating on the municipal bond portfolio -- the
total rating currently on just municipal bonds is Double A1, Double A-plus. If
you take off just the insurance, it drops down to Double A3, Double A-minus,
and there's a lot of other ways to cut through this data.
About 48% of the municipal bond portfolio is insured.
<TAG>Robert Rodriguez -
First Pacific Advisors</TAG>
Okay, that was going to be my next question, given the fact
that when you have bond insurers selling that between 20% and 35% a book, it
does raise a question as to the integrity and, shall we say, value of the
insurance that they are providing. Thank you very much.

Operator

Your next question comes from the line of Dan [Sorel] of
[inaudible].

Dan Sorel

Good afternoon. Just a couple of quick questions; the New
Jersey book, how large is that right now?

Gabriel Tirador

We've written close to about $90 million year-to-date so far.

Dan Sorel

Okay, and then just in terms of the decline in premium outside of California, is it across the board in a lot of states, or is it particular states like New Jersey that are driving the decline now?

Gabriel Tirador

We are seeing declines across the board but by far the biggest decline is New Jersey.

Dan Sorel

Okay, and then just last question, development in the quarter, it looks like it was about $2 million adverse, which isn't that big a number, but within that, any significant movements in any particular states, or any other color you can add to it?

Theodore R. Stalick

Most of the development is in California. Outside of California, there's some pluses and minuses that kind of netted out close to zero, but nothing significant.

Dan Sorel

Okay. Thanks, guys.

Operator

Your next question comes from the line of Meyer Shields of Stifel Nicolaus.

<TAG>Meyer Shields - Stifel Nicolaus</TAG>

Looking at the California policy count, it was actually down for the first time in a long time. I was hoping you could talk a little bit about what's --

George Joseph

It's hard to hear you. Can you speak up?

<TAG>Meyer Shields - Stifel Nicolaus</TAG>

Sorry. Is this better?

Gabriel Tirador

Yeah, that’s much better.

<TAG>Meyer Shields -

Stifel Nicolaus</TAG>

Okay, sorry, my microphone was messed up. Can you talk a little bit about what led to the declining policy count in California personal auto in the quarter? Because we haven’t seen this in quite a while.

Theodore R. Stalick

One thing that I would like to point out is we typically see the growth in the sequential change in policy growth from the June 30th quarter to the September 30th quarter is less than any other quarter during the year. And if you go back, we went back and looked at the last 15 years and it’s that same pattern. So it’s not unusual to see less of a rate of growth in the third quarter than you have previously in the year.

On top of that, we did have a slight decrease in the renewal ratio in the third quarter. So you kind of couple that with a seasonal phenomena and you see the decline in PIP count.

Gabriel Tirador

Our third quarter -- actually, our first quarter we had the highest amount of new business historically, and the first and third quarters have the largest amount of renewals. And as the year progresses, typically for us, the new business goes down quarter by quarter, the first quarter being the highest new business and the third quarter, the new business wasn’t quite enough to offset the decline in the renewal ratio.

<TAG>Meyer Shields -

Stifel Nicolaus</TAG>

Gabe, in your comments at the beginning of the call, you mentioned that you are getting higher average premium per policy in California. What’s driving that?

Gabriel Tirador

I think there’s quite a few things driving that. There’s the combination of symbol and model year drift. We no longer are using portable persistency and that had the impact of lowering average premiums in previous years, and as the book matured and those discounts increased, it had the impact of lowering the average premium. I think also a distribution shift to higher average premiums, as an example, we're a lot more competitive with the young drives and family risks today, which tend to have higher average premiums.

<TAG>Meyer Shields - Stifel Nicolaus</TAG>

Okay, that's very thorough. Also, with regard to the California fires, was there any material impediment to business production?

Gabriel Tirador

Well, obviously the homeowners production slowed a little bit during that period. Whenever we have fires like that, we have set moratoriums in place in certain areas, and you always see a little bit of a dip. People are not really worried about either homeowners or auto insurance during that week, so -- in certain segments, so you do see a little bit of a slowdown during that time.

<TAG>Meyer Shields - Stifel Nicolaus</TAG>

Fantastic. Thanks so much.

Operator

(Operator Instructions) Your next question comes from the line of Al [Corpesino] of [Meadow Investments].

<TAG>Al Corpesino - Meadow Investments</TAG>

Thanks very much. Actually, Josh asked my main question. I just wanted maybe just one follow-up though, which was to verify that the impact of catastrophes, both in California and the non-California operations, was de minimis this quarter?

Gabriel Tirador

In Q3?

<TAG>Al Corpesino - Meadow Investments</TAG>

Yeah.

Gabriel Tirador

Yes, that's correct.

<TAG>Al Corpesino - Meadow

Investments</TAG>

Okay. Thanks very much.

Operator

Your next question comes from the line of Richard Sbaschnig

of Oppenheimer and Company.

<TAG>Richard Sbaschnig -

Oppenheimer</TAG>

One thing I kind of noticed is the paid to incurred seems to

be running a little bit high year-to-date, relative to last year, despite some

of these reserve adjustments. I'm just wondering if you could maybe talk about

the dynamics there.

Theodore R. Stalick

Typically what happens as your growth slows down, your paid

to incurred starts to get close to being the same number. As you are growing,

you are setting up more reserves but you haven't paid them yet, so it's more of

a timing thing. Does that make sense?

<TAG>Richard Sbaschnig -

Oppenheimer</TAG>

No, absolutely. Also, I wonder, George, if you could share

us what your thoughts on kind of the recent up-tick in M&A activity and

what your outlook for maybe Mercury or the industry in general in terms of

where merger activity is headed.

George Joseph

Well, I think over the next three or four years, you are

going to see some more mergers in the insurance business because, at least from

Mercury's viewpoint, we are entering a new era. We need to develop priorities

that we had to pay a lot of attention to in the past, such as significantly

improved segmentation and a much better point of sales system, even continued

improvements in the back-end programs. These issues are [costs] and Mercury is

positioned to handle it. We have the wherewithal to do it and we are going to

do it. And over the next couple of years, you'll see we'll develop a much different Mercury from what you see today.

But for a number of companies, I don't think that's going to happen, and if it doesn't happen, I think you are going to see like you saw in Massachusetts. When the environment changes, it is going to result in the kind of merger that you saw with commerce, where they may feel that while they've been quite successful with the old environment, maybe it's much more questionable with the new environment. The new environment, they are different from the new environment we're talking about but it is a different environment.

So in summary, yes, I would expect to see more mergers and acquisitions over the next three or four years.

Operator

Your next question comes from the line of William Jones of [Now Gate] Investor.

<TAG>William Jones - Now Gate Investor</TAG>

Good morning. Could you give us an update on your next gen systems and how they are progressing?

Gabriel Tirador

Our next gen system has, which is our back-end systems for underwriting claims, billing, commissions, has been deployed to four of our states. California being one of them, and that was deployed back in May of this year. Our next three states are scheduled to be deployed in '08. I don't have a specific date for you right now.

And our Mercury First system, which is our front-end sales system that we believe is going to be a huge benefit to our agents, that is scheduled to be released in the first quarter of '08, with pretty rapid release dates for each subsequent state. So there is going to be a pretty quick release of this system throughout '08.

<TAG>William Jones - Now Gate Investor</TAG>

Is there any impact on the income statement for those development costs at the moment?

Theodore R. Stalick

On the development side, they are all capitalized as they get rolled into production. You have maintenance and depreciation costs, which are adding maybe 10 to 20 basis points to the expense ratio.

Gabriel Tirador

And we've been seeing that -- for example, next gen is already being expensed at this point, so you are already seeing those costs in the numbers.

<TAG>William Jones - Now Gate Investor</TAG>

And then lastly, are you still holding off expansion into other states, pending completion of the next gen system?

Gabriel Tirador

Well, we are holding off expansion for a couple of reasons -- technology, and we want to get our price segmentation structure in order, those couple of things, so I wouldn't anticipate any expansion really in '08 -- geographic expansion.

<TAG>William Jones - Now Gate Investor</TAG>

Thank you.

Operator

(Operator Instructions) Your next question comes from the line of Meyer Shields of Stifel Nicolaus.

<TAG>Meyer Shields - Stifel Nicolaus</TAG>

Thanks. Two quick follow-ups, if I can; we haven't talked about [inaudible] in a while, which I guess is good, but I was wondering, is there anything going on that we should know about or is it basically a closed issue?

Gabriel Tirador

What's going on there is we plan on going back to the court by the end of the year to vacate the injunction. We had an injunction earlier -- not an injunction, a hearing earlier this year to vacate the injunction and the court allowed a little bit more discovery on the plaintiff's side and we are in the process of that, and we are scheduled to go back. We don't have a firm date but we plan on going back to the court by the end of the year. I will say that the number of applications that we get from these brokers are minimal to our overall application. It's very minor.

<TAG>Meyer Shields - Stifel
Nicolaus</TAG>

Turning to New Jersey, if I can, we don't have the numbers but I'm trying to break out the New Jersey loss ratio or [inaudible] ratio trends versus the remainder of the non-California book. Is it safe to say that New Jersey is getting worse or has it been constant?

Gabriel Tirador

It's been pretty constantly bad. It hasn't really gotten worse. It's about a similar level that it has been. And really, as I mentioned before on previous conference calls, the big issue in New Jersey from our perspective is making the estimates for PIP and BI. For example, what we're doing is we are basing it on our 2004 year, which is our most developed year. But there is still quite a number of open claims in '04, believe it or not, with respect to BI and PIP, a significant number, more than any other state that I've ever seen that we're in business in.

So we use the '04 year to try to predict '05 and '06 and further years, and that's what we have been doing. But as you know, there's more uncertainty with respect to a state that has a longer tail like New Jersey does. I imagine that some of our other competitors are probably going to have to deal with that as well.

<TAG>Meyer Shields - Stifel
Nicolaus</TAG>

From your perspective though, it sound to me like you are pursing premium growth in New Jersey with the two revenue units you're filing. Am I reading that correctly?

Gabriel Tirador

Well, what we are pursuing is more -- what we found in taking a look at our rate level in New Jersey is that we had groups of risks that were very unprofitable, and we decided that we are going to raise those rates significantly. And as we do that, what should occur is we should either write them at a profit or they are going to go away, which is one of the reasons that we've seen this decline in business in New Jersey.

In other words, we are trying to improve our results through improved segmentation at this point, not an overall rate increase.

<TAG>Meyer Shields - Stifel Nicolaus</TAG>

Right, but if it's revenue neutral, that means that you are dropping rates elsewhere, which means I guess --

Gabriel Tirador

Yeah, and we should be dropping rates on those that deserve to be dropped.

<TAG>Meyer Shields - Stifel Nicolaus</TAG>

Okay, perfect. Thank you very much.

Operator

(Operator Instructions) There appear to be no further questions at this time.

Gabriel Tirador

Okay. Well, thank you for joining us this quarter and we'll talk to you next quarter. Thank you very much.

Operator

This concludes today's conference. Thank you for participating. You may now disconnect.