S&P Global
Market Intelligence

Mercury General Corporation NYSE:MCY

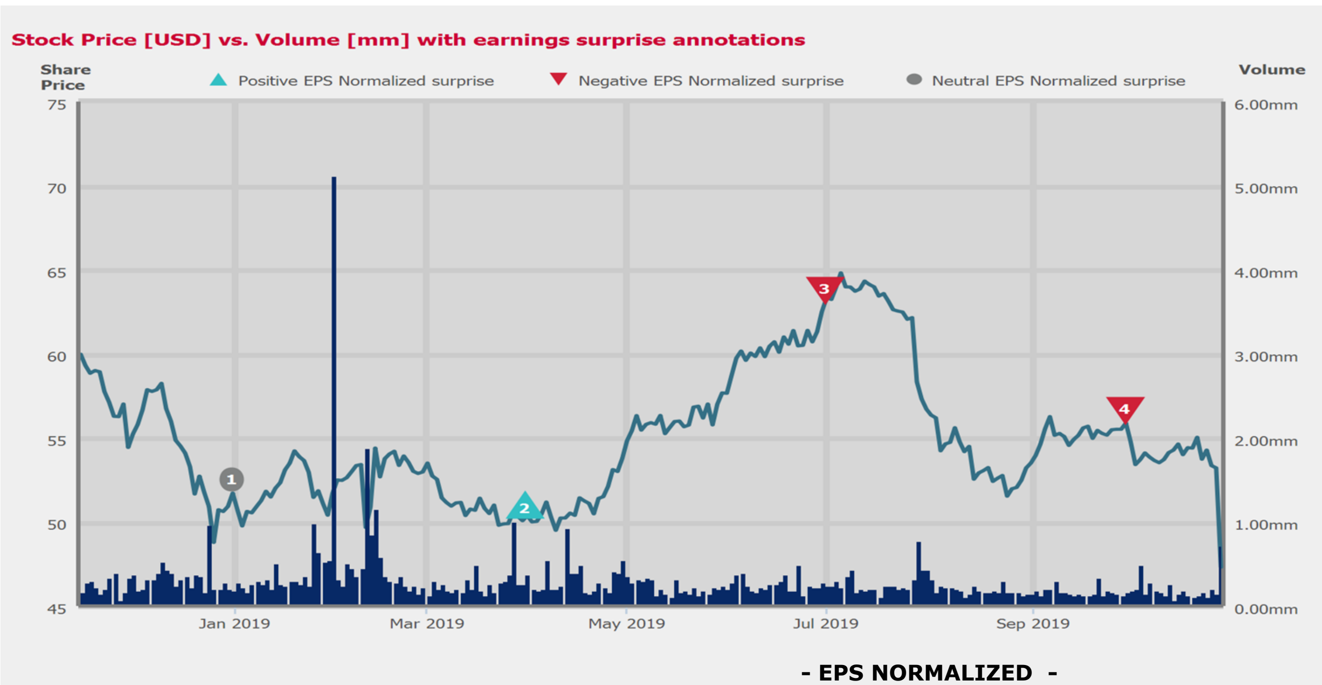
FQ3 2019 Earnings Call Transcripts

Monday, October 28, 2019 5:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2019-			-FQ4 2019-	-FY 2019-	-FY 2020-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.08	0.78	(27.78 %)	0.47	3.17	3.68
Revenue (mm)	968.71	983.06	1.48	910.15	3705.20	3899.97

Currency: USD
Consensus as of Oct-21-2019 6:36 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2018	0.46	(0.26)	NM
FQ1 2019	0.77	0.87	1 12.99 %
FQ2 2019	1.03	0.74	2 (28.16 %)
FQ3 2019	1.08	0.78	3 (27.78 %)

Table of Contents

Call Participants

EXECUTIVES

Christopher Wadewitz Graves
VP & Chief Investment Officer

Gabriel Tirador
President, CEO & Director

Jeff Schroeder
Chief Product Officer & VP

Theodore Robert Stalick
Senior VP & CFO

ANALYSTS

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Unknown Analyst

Presentation

Operator

Good morning, my name is Valerie, and I will be your conference operator today. At this time, I would like to welcome everyone to the Mercury General Third Quarter Conference Call. [Operator Instructions]

This conference call may contain comments and forward-looking statements based on current plans, expectations, events and financial and industry trends, which may affect Mercury General's future operating results and financial position.

Such statements involve risk and uncertainties, which cannot be predicted or quantified, and which may cause future activities and results of operations to differ materially from those discussed here today.

I would now like to turn the call over to Mr. Gabriel Tirador. Sir, please go ahead.

Gabriel Tirador
President, CEO & Director

Thank you very much. I would like to welcome everyone to Mercury's Third Quarter Conference Call. I'm Gabe Tirador, President and CEO.

In the room with me is Mr. George Joseph, Chairman; Ted Stalick, Senior Vice President and CFO; Jeff Schroeder, Vice President and Chief Product Officer; and Chris Graves, Vice President and Chief Investment Officer.

Before we take questions, we will make a few comments regarding the quarter. Our third quarter operating earnings were $0.78 per share compared to $1.11 per share in the third quarter of 2018.

The deterioration in operating earnings was primarily due to an increase in the combined ratio. The combined ratio was 98.6% in the third quarter of 2019 compared to 95.6% in the third quarter of 2018.

The deterioration in the combined ratio in the quarter was primarily from worst results in our private passenger auto business outside of California and our California commercial auto business, which together added 2.8 points to the company-wide combined ratio in the third quarter of 2019 compared to the third quarter of 2018.

For states outside of California, we posted a private passenger auto combined ratio of 101% in the third quarter of 2019 compared to 82% in the third quarter of 2018.

Those results include approximately $2 million of favorable prior year reserve development on $86 million of earned premium compared to $12 million of favorable prior year reserve development on $88 million of earned premium in the third quarter of 2018.

Our California Commercial Auto business posted a combined ratio of approximately 120% in the third quarter of 2019 compared to 90% in the third quarter of 2018. Those results include approximately $6 million of unfavorable prior year reserve development on $34 million of earned premium compared to $1 million of unfavorable prior year reserve development on $29 million of earned premium in the third quarter of 2018.

Our California private passenger auto combined ratio deteriorated slightly to approximately 97.6% in the third quarter of 2019 from 97.4% in the third quarter of 2018.

Overall, frequency was relatively flat and severity was up approximately 7% compared to the third quarter of 2018. Partially offsetting the year-over-year increase in loss severity in the quarter were recent rate increases. In California, a 6.9% personal auto rate increase for California Automobile Insurance Company was implemented in March 2019, and a 6.9% personal auto rate increase for Mercury Insurance company was implemented in May of 2019.

Collectively, these represent 2/3 of company-wide direct premiums earned. Approximately 81% of the California Automobile Insurance Company rate increase was earned during the quarter and about 53% of the Mercury Insurance Company rate increase was earned during the quarter.

Our third quarter 2019 California private passenger auto frequency and severity each increased by about 4% compared to the second quarter of 2019. The sequential increase in frequency of severity was the primary reason our California private passenger auto combined ratio deteriorated from approximately 96.7% in the second quarter of 2019 to 97.6% in the third quarter of 2019.

The sequential increase in frequency and severity in the quarter was partially offset by our recent rate increases. Our year-to-date accident year combined ratio for California personal auto is approximately 96.1%.

Our California homeowners combined ratio was 97.5% in the third quarter of 2019 compared to 101.2% in the third quarter of 2018. A 6.99% rate increase in our California homeowners line was approved by the California Department of Insurance and was implemented in August 2019.

We also recently filed for another 6.9% rate increase in our California homeowners line of business.

California homeowners premiums represent about 13% of direct company-wide premiums earned.

Company-wide, we recorded $1 million of favorable prior year reserve development in the quarter compared to $6 million of unfavorable reserve development in the third quarter of 2018.

Catastrophe losses, primarily from Hurricane Imelda in Texas, were $3 million in the quarter compared to $13 million in the third quarter of 2018, primarily from the Carr wildfire in Redding, California.

The expense ratio was 24.2% in the third quarter compared to 24% in the third quarter of 2018. The slightly higher expense ratio was primarily due to a $6 million increase in accrued expense related to our previously announced settlement with the California Department of Insurance, partially offset by a decrease in profitability related accruals, slightly lower acquisition cost and cost efficiency savings.

Premiums written grew 8.6% in the quarter, primarily due to higher average premiums per policy and an increase in homeowners policies written.

Several wildfires earlier in October and wildfires currently burning have caused damaged in California. At this time, it's too early to estimate our losses from these wildfires. Our catastrophe reinsurance treaty provides coverage for wildfire catastrophe losses in excess of Mercury's $40 million retention as a total wildfire limit of $508 million and allows for 1 full reinstatement.

Loss occurs for a wildfire event includes all losses within 150-mile radius and within a 10-day period. Both the radius point and a 10-day window are at the choice of Mercury.

Lastly, we generally expect a combined ratio for the fourth quarter, excluding catastrophes, to be higher than the rest of the year due to increased loss frequency and higher severity caused by seasonal dry wind weather. That said, it is hard to predict with certainty, whether the underlying combined ratio will be higher as there are many factors currently unknown or beyond our control.
With that brief background, we will now take questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from Greg Peters of Raymond James.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

I want to go to a couple of areas. First of all, on -- you talked about your catastrophe program for wildfires and you talked about the 1 reinstatement. Have you affected that 1 reinstatement yet or is that still outstanding?

Gabriel Tirador
President, CEO & Director

Still outstanding. We have not.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Okay. And then going to the auto results in California. With the 2 rate increases, one in Cal Auto and the other in Mercury Insurance, I'm surprised that you're still seeing erosion. I would have expected that the combined ratio would have started to improve, and I picked up your comments around frequency and severity.

Have you filed for another round of rate increases yet for those 2 businesses considering what's going on with frequency and severity? And more importantly, I know we've talked about your longer-term combined ratio targets. And I'm just curious, based on these trends, it doesn't look like it's a reasonable target at least in the near term. So couple of questions in there, maybe you can answer those.

Gabriel Tirador
President, CEO & Director

Yes. No. Thanks, Greg. Our quarterly results can be volatile. So we don't make rate decisions just based on just 1 quarter worth of data. Our year-to-date -- and if you take a look at private passenger auto in California -- our year-to-date -- accident year combined ratio -- is about 96%, and we do have some more rate to earn in. We evaluate our ratings every quarter. I will say this, I think it's likely that we're going to file for some rate in Cal Auto by year-end. So that's what we're looking at right now.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Okay. And then the outside California piece. It seems like that's been running at an elevated combined ratio for a while now. And I know you've been working hard to address the profitability challenges there. Where do you think you are in the process? Are you closer to getting it fixed? Farther away from getting it fixed? Can you give us a sense -- a time line on when the results might stop being a drag on your business?

Gabriel Tirador
President, CEO & Director

Well, I think if you take a look at our 2018 calendar year results outside of California, I think, we posted in the 93%, 94%. If you take a look at our 2018 accident year for outside of California, as of today, we're running like close to a 97%, 96% and change, combined ratio. So '18 results were actually pretty decent outside of California. This year, they've deteriorated a little bit. And Florida has been one of the reasons and we're trying to address Florida. So there's still, obviously, we're running at about 101% combined ratio outside of California, we want to get that lower. When you take a look at all our lines of business outside of California, I think, we were in about 99% combined ratio for the quarter. Definitely still some work to do. We have some various plans, class plans that we plan to implementing. Jeff, do you want to comment on anything we're doing with respect to that in some of these states?

Jeff Schroeder
Chief Product Officer & VP

Yes. In -- a number of these states we do have rate earning in or rate moving in, in the coming months here, certainly on the personal auto side. And on the commercial side, outside of California, we've got rate earning in, in the high single-digit range in each of the major products outside of California.

Gabriel Tirador
President, CEO & Director

We're also making some segmentation improvements. So I think we have -- we were scheduled to make a change in Florida in September, but that's been delayed because of -- we haven't received approval yet, but we're hopeful we get that in, in Florida in sometime, I believe, in November.

Jeff Schroeder
Chief Product Officer & VP

November or December.

Gabriel Tirador
President, CEO & Director

November or December. Okay.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

I guess the final question. The investment income results. The yield on a year-to-date basis is in line, it did pop up to 3.5% in the third quarter -- or last year. And so I'm just curious, what's causing the movement on a year-over-year basis for the quarter. And maybe you can -- I, obviously, there's downward pressure on yields now. Maybe you can give just give us an update and perspective on that. That's was -- that was my last question.

Theodore Robert Stalick
Senior VP & CFO

Yes. Sure. Well, right. You mentioned rates and that's obviously a big part of it. We've been -- throughout this year, once the yield curve flattened -- and I talked about this last quarter too -- we started reducing our duration, allowing more cash build -- money market rates are actually very competitive versus some of the offerings I'm seeing out there on bonds due 1 to 3 years. We also been making this year a much bigger shift towards taxables from tax exempt, since tax yield on taxables is more attractive, but you're still not getting that much.

So I'm somewhat optimistic now. We're seeing some cracks in interest rates, there's been some weakness here recently. There's certainly room for spreads to widen. So I'm, currently, actually in the process of repositioning some of our positions. And if the current rate trend picks up a little bit, we'll be in a good position to take advantage and get a little more yield. There's lots of new offerings coming out for things that have yield but trap you into a long-duration situation, which I think would be a mistake. So I'm trying to avoid that and just be patient and smart.

Operator

Our next question comes from Chris Campbell from KBW.

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

I guess first question, I'll just kind of follow-up on the core loss ratio question. I think, Gabe, in your script, when you opened up, you said about 280 bps of the year-over-year deterioration was private passenger auto outside of California and then California commercial auto. So there's -- core loss ratio was about 490 bps worse year-over-year. So where is the other 110 bps of deterioration coming from?

Gabriel Tirador
President, CEO & Director

You're talking about year-over-year?

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

Year-over-year, yes. That's correct.

Gabriel Tirador
President, CEO & Director

Yes. I mean California PPA, as I mentioned in my prepared remarks, deteriorated slightly as well year-over-year, but most of it is coming from what I mentioned earlier with respect to outside of California and commercial auto is 2.8 points. The combined ratio year-over-year was -- what was it last quarter, Ted?

Theodore Robert Stalick
Senior VP & CFO

For?

Gabriel Tirador
President, CEO & Director

For 2018 compared to 2019? So the difference between the two is 98.6 versus 95.6. So that's about 3 points. So 2.8 points of that is the business outside of California in commercial auto and then you got the rest from it, which is 0.2 point that's coming from our California private passenger auto. I think I said that was 97.6 compared to 97.4. There's your 0.2. You got the 2.8, and there's your 3 points.

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. Got it. Because I was like backing out the CAT loses and then the reserve development too, year-over-year. So if I do that, I have a 69.3% core loss ratio for you all in the third quarter of '18 and I've got 72 point -- I'm sorry, 74.2% this quarter. So that delta is...

Gabriel Tirador
President, CEO & Director

Okay. I see -- when I was talking about calendar year results, when I -- what I was comparing the difference. What businesses were guiding that, what was the change year-over-year that was driving the calendar year results deterioration. And that's what it is. It's the business outside of California, which by the way, in the third quarter of 2018 outside of California had a really, really good quarter, right? So had a 82% combined ratio compared to 101% this quarter. So I was comparing the calendar year results, what we actually recorded, with 2.8 points from a calendar year perspective, Chris.

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. Got it. And then -- so I guess what is the game plan to fix like outside of California? I mean where exactly are you seeing the problems like which states, which lines of businesses and coverages? And then kind of is it a rate -- I mean, is that a rate game or you just file rates and wait for those to earn in? And then like how soon should we be able to see the benefits of all your work outside of California?

Gabriel Tirador
President, CEO & Director

Well, as I mentioned earlier, I think in 2018 -- and we take a look at even as of today -- outside of California we were at a 98%, 97% combined ratio. It's deteriorated, and a lot of that deterioration has come from Florida and Georgia. And I think I mentioned that in our previous call. And we're taking steps -- Jeff talked about rate earning in. We have rate increases that are earning in. And in addition to that, we're improving -- trying to improve our segmentation. So we were where we needed to be in 2018, or very close to it. 2019, we deteriorated a little bit, we're taking some rate to address it and we're also trying to improve our segmentation.

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. Got it. That's very helpful. And I think you had mentioned a couple of like frequency and severity numbers in the intro script. So were you saying that -- just to confirm these numbers -- quarter-over-quarter, frequency and severity were in California auto-- or in California private passenger auto -- each of those were up 4%? Correct?

Gabriel Tirador
President, CEO & Director

No. Yes. I disclosed a couple of frequency and severity. One of them I disclosed year-over-year. Year-over-year, the frequency was relatively flat. And severity was up about 7% year-over-year. When you take a look at it compared with this -- what we recorded in the second quarter of '19 compared to the third quarter, that's the 4% each.

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. So got it. Yes. I saw those 2 numbers, I was just trying to confirm that.

Gabriel Tirador
President, CEO & Director

Yes. The year-over-year number and -- was basically flat frequency, 7% increase in overall severity. In BI severity recording really about 10% and BI severity is what we recorded in the quarter and in year-to-date for California PPA.

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

Got it. And do you have like smaller figures for the commercial auto book?

Gabriel Tirador
President, CEO & Director

I'm sorry. Say that again, Chris?

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

Yes. Do you have the similar frequency and severity trends for the commercial auto book in California as well?

Gabriel Tirador
President, CEO & Director

I don't have it handy. But they're probably comparable in commercial auto. The tort environment here has been very challenging. I think you've heard it from some other competitors as well, a very aggressive plaintiff's bar and what appears to me as more liberal juries is driving up the severity. And in commercial auto, it's more challenging because the limits are higher. The typical bodily injury limit for commercial auto is $1 million. So it makes decisions on settlement offers more difficult when you have that kind of limit.

Christopher Campbell

Keefe, Bruyette, & Woods, Inc., Research Division

Okay. Got it. And then just one last one. What accident years are you seeing the favorable development emerge from?

Theodore Robert Stalick
Senior VP & CFO

Well, we didn't have -- we reported, I think, $1 million of favorable. So there's a few things that are kind of going both ways on that. As Gabe mentioned, we had a little bit of adverse in commercial auto that was offset by some favorable and some of our other lines of business. But I think we're seeing that the last couple accident years are pretty stable as far as the ultimate picks.

Operator

Our next question comes from Jay Cohen of Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

As Chris pointed out, the accident year loss ratio in the third quarter -- well, on my model, looks like it jumped up quite a bit from the first half of the year, and maybe some seasonality. But was there any kind of current year catch-up in the third quarter, where you reassess the first half loss ratio?

Christopher Wadewitz Graves
VP & Chief Investment Officer

There was not. There's really not anything that was material, Jay.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Okay. So that's...

Christopher Wadewitz Graves
VP & Chief Investment Officer

And I think as Gabe mentioned, our third quarter California personal auto frequency was 4% higher than the second quarter and severity was 8% -- also 4% higher than the second quarter. So you have basically 8% higher in total than Q2, when you're looking at Q3.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

And is that partly seasonality? Does that happen every year or was this a little bit unusual?

Gabriel Tirador
President, CEO & Director

Yes. Second quarter tends to be our best quarter. I will say that, second quarter tends to be our best quarter. But this was a little surprising, I would say. When you have a 4% sequential increase in frequency and severity, that was a little surprising to us. But I mentioned earlier, Jay, quarterly results could be -- they can be volatile.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Right. Never read too much into one quarter, certainly.

Gabriel Tirador
President, CEO & Director

Yes.

Operator

[Operator Instructions] Our next question comes from Corey [indiscernible] of [Pequot].

Unknown Analyst

Yes. I have a question just in general about the severity trends. I noticed that when Travelers reported it, they talked about severity issues. You guys have seen these cycles before. I just wonder what -- how you would compare this cycle to previous cycles where we've had severity increases like we're seeing right now.

Gabriel Tirador
President, CEO & Director

Compared to previous cycles. I don't -- I've been doing this for some time. And from my perspective, I think, from just a tort environment, it's probably -- it's the most challenging that I've seen personally. There has to have been more challenging. But I view it as very aggressive. I see very aggressive plaintiff's bar, as I mentioned earlier, trying to drive up the cost complaints or settlements. So I kind of view this current environment as high severity BI environment. And I think in Fast Track, if I'm not mistaken, in California, I think for the second -- because Fast Track, they're delayed a quarter. And I believe with the high severity, quarter-over-quarter was up like 10%, something like that.

Theodore Robert Stalick
Senior VP & CFO

Almost double digits.

Gabriel Tirador
President, CEO & Director

It was double-digit. So Fast Track, quarter-over-quarter in the second quarter, for California, was up about 10%. That's just 1 quarter, you can't read a lot into it. We'll see what happens in the third quarter. Year-over-year, I think, it's up 5%, 6%. Whether or not these trends stabilize, we'll have to wait and see, we're trying to get ahead of it. As Ted mentioned, we really did not have much development -- really -- actually we had positive development, I believe, in California, in private passenger auto. In the quarter, we had a little bit of positive development from prior year. So we're trying to stay ahead of it. We pick some severity trends that, obviously, the most recent accident year is the most difficult to pick, right? Because it's not very -- it's very green. So we pick a pretty high severity pick of 10% for bodily injury increase cost in California, higher than would be indicated by Fast Track, but something that we just want to -- we want to make sure we stay ahead of.

Unknown Analyst

I haven't seen this is a long time either, anything like this.

Operator

I'm showing no further questions at this time.

Gabriel Tirador
President, CEO & Director

Okay. I'd like to thank everyone for joining us this quarter, we'll talk to you next quarter.

Operator
Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.