S&P Capital IQ

CONTENTS

Mercury General Corporation NYSE:MCY

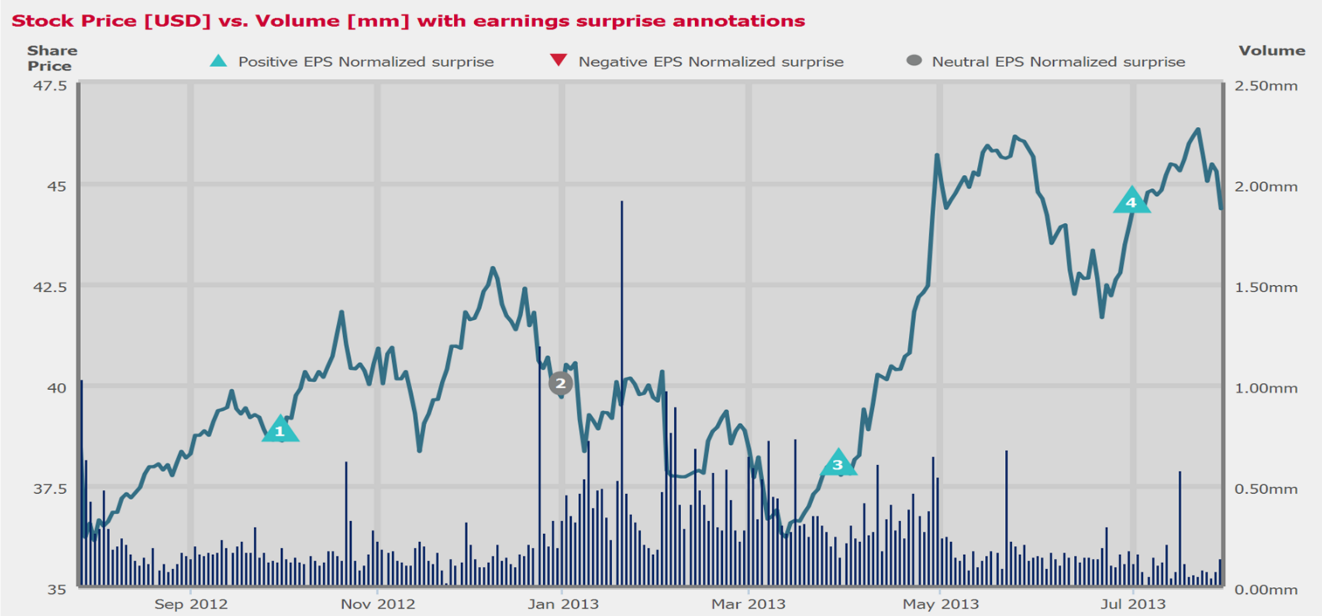
FQ3 2013 Earnings Call Transcripts

Monday, October 28, 2013 5:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2013-			-FQ4 2013-	-FY 2013-	-FY 2014-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.64	0.53	▼(17.19 %)	0.57	2.53	2.71
Revenue (mm)	672.24	704.90	▲4.86	670.60	2681.22	2744.11

Currency: USD
Consensus as of Oct-28-2013 1:32 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2012	0.56	0.62	▲1 10.71 %
FQ4 2012	0.23	(0.17)	NM
FQ1 2013	0.47	0.69	▲2 46.81 %
FQ2 2013	0.61	0.63	▲3 3.28 %

Call Participants

EXECUTIVES

Christopher Graves
Chief Investment Officer and Vice President

Gabriel Tirador
Chief Executive Officer, President and Director

Robert Houlihan
Chief Product Officer and Vice President

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

ANALYSTS

Alison Marnie Jacobowitz
BofA Merrill Lynch, Research Division

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

Presentation

Operator

Good afternoon. My name is Mackenzie, and I will be your conference operator today. At this time, I would like to welcome everyone to the Mercury General Quarterly 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 result 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
Chief Executive Officer, President and 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 Chief Financial Officer; Robert Houlihan, 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 results declined from $0.62 per share in the third quarter of 2012 to $0.53 per share in the third quarter of 2013. The decline was primarily due to lower after tax investment income and nonrecurring increases to tax contingency reserves.

After tax investment yields were 3.6% in the third quarter of 2013 compared to 3.8% in the third quarter of 2012, declining as a result of recent investments being made at lower market interest rates.

Nonrecurring increases to tax reserves were approximately $0.04 per share. The combined ratio excluding catastrophe losses was essentially the same in both the third quarter of 2013 and 2012. However, on a sequential basis, the combined ratio excluding catastrophe losses deteriorated from 96.8% in the second quarter of 2013 to 98.9% in the third quarter of 2013.

The deterioration was primarily driven by worse results on our California homeowners line of business. California homeowners experienced higher loss frequency during the quarter. That, coupled with the forced 5.5% rate reduction taken in May 2013 were the major reasons for the deterioration in our California homeowners results.

We continue to experience improvement in our underlying operating results outside of California. Excluding catastrophes, operations outside of California posted a combined ratio of under 100% for the third consecutive quarter.

Over the past few years, we have taken significant rate action in most of the states outside of California and the impact of those rate actions is having a positive impact on our results.

Premiums written grew by 2.9% in the current quarter. Our top line is expected to be under pressure going forward as new business, private passenger sales and retention levels outside of California have declined due to rate increases and the California market remains competitive.

The company continues to actively file for rate changes to improve our profitability. In July, we implemented a 6.9% rate increase in our nonstandard California company, which represents approximately 23% of our California private passenger auto business.

For our preferred company, which represents approximately 77% of our California personal auto premiums, a 6% rate increase request is currently being reviewed by the California Department of Insurance.

As we previously reported, our California homeowners rates were reduced by 5.5% in May of 2013 as a result of a decision made by an administrative law judge. We disagreed with the administrative law judge's decision and are challenging it in Superior Court. Among other things, the court is also being asked to make a ruling regarding our right to earn a fair rate of return. The case is currently expected to be heard in March of 2014.

In the meantime, we updated our homeowner data and filed for a rate increase in our homeowners line. Subsequently, we recently reached a stipulated agreement to increase our homeowners rates by 8.25%. However, the stipulated agreement must be approved by the administrative law judge and the insurance commissioner. We are currently awaiting a decision on the stipulated agreement.

As we move into the fourth quarter, we would like to remind you that our fourth quarter is typically the highest frequency quarter of the year due to weather and seasonal

driving.
With that brief background, we will now take questions.

Question and Answer

Operator

[Operator Instructions] Your first question comes from the line of Vincent DeAugustino with KBW.

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

I guess, the first one is, I'm just curious more recently how the California auto loss cost trend environment has been going, just kind of with your filings out there and how you feel?

Gabriel Tirador
Chief Executive Officer, President and Director

I'll have Ted take that question.

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

So in California, which is by far the largest state, our frequency is running in the very low single-digit increases and severity is in sort of low to mid single-digits. When we look at the first 9 months for this year compared to the first 9 months of last year, BI severity is rising at a somewhat higher rate than the physical damage severity. And as you recall, we took a 4% rate increase in California personal auto back in October of 2012, and then a 6.9% increase in Cal Auto in July of this year. So essentially, our rate increases are generally keeping up with the trend.

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

Okay. So one of the things that I noticed was that kind of in your preferred filing, you've come back to the department with some recent data that suggested that the indicated rate increase, if I'm reading it right, should be higher than 6%. But I guess in the spirit of getting it through sooner, you're kind of keeping the request at 6%. So my first question would be is that, it was just beyond clarification in the way I'm reading it. Should I read that as -- that you're actually should need a 16% rate increase? Or am I not thinking about that right? And then the second part of the question would be is, should we expect you to file another request pretty soon after the current one kind of get finalized?

Gabriel Tirador
Chief Executive Officer, President and Director

Well, I'm not sure, Vincent, with respect to the 16% rate increase. We did update the data, and the updated data did suggest that the 6% was very much needed. And we recently had a meeting with the department on Thursday with respect to this rate change. And I don't know, Robert, do you want to add anything to that? I'm not sure where the 16%...

Robert Houlihan
Chief Product Officer and Vice President

The indication in the filing, there's a minimum and maximum range the 6% was within that range, and that's what we're comfortable with at this point in time.

Gabriel Tirador
Chief Executive Officer, President and Director

Yes. Yes, Vincent, we're running in California auto, we're running at a combined ratio right around 100%. So if that helps you a little bit.

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

Okay, it does very much. And then just the 16.2% came from the amendment letter on 9/27 so I was just picking that up from the filing?

Gabriel Tirador
Chief Executive Officer, President and Director

That's the minimum and the maximum as far as the filing goes. I see, Vincent. Yes.

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

Okay, cool. All right. And so did -- I guess, just sticking on the topic of loss cost trends. One of the things we've talked about, it may even been as far as about a year ago, it was when the California auto parts regulations, the new ones were coming out. It was still a little too early to tell when we chatted then. So I was just curious if there's been any measurable impact now or I guess, since it's been on the shelf maybe a little bit longer. If you guys have any updated thoughts.

Gabriel Tirador
Chief Executive Officer, President and Director

That regulation, Vincent, went to effect on March 30, so it's been about, I guess, 6 months now. We've had a couple quarters with it, and at this point, I would still say it's difficult to estimate the impact as it works its way through the market. The potential is that there will be a reduction in the number of aftermarket parts used to repair vehicles and aftermarket parts are generally more cost-effective than original equipment manufactured parts. So it has the potential to increase our costs. Now I will say that most of the parts that we do use at Mercury are original equipment manufactured parts, and about half of the cost associated with repairing vehicles is labor. But we do use aftermarket parts in instances, so this regulation does have the potential to increase our cost, we're watching it closely. But at this point, we can't really say that it's having a measurable impact on our cost right now.

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

Okay, great. And then one last one. I noticed the fixed income duration ticked up a little. Is that just with call features and kind of where interest rates have been recently driving that?

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

Yes, Vincent. You're right, we are moving a little bit out just a couple of years perhaps on the yield to call, trying to find opportunities that are accretive to our current average book yields.

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

Okay. So it would both those impacts, some active management and then on new money and then just on the...

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

Yes.

Operator

[Operator Instructions] Your next question comes from the line of Alison Jacobowitz with Bank of America Merrill Lynch.

Alison Marnie Jacobowitz
BofA Merrill Lynch, Research Division

A couple of questions. I think in the past couple of years in the fourth quarter, we've seen some extra special dividends flow through and boost investment income. I was just wondering if that, if we'll see that going into next quarter. And then also, if you could talk about the overhead expenses due to that restructuring. We saw the charge. I was wondering how the expense ratio is -- or the overhead ratio is playing out in your view and how we should think about that given the restructuring?

Gabriel Tirador
Chief Executive Officer, President and Director

Okay. Yes.

Christopher Graves
Chief Investment Officer and Vice President

Alison, it's Chris. The special dividend, I'd love to see them, I doubt we get them. I mean, I think some of that had to do with trying to get ahead of the ObamaCare tax and there were other reasons in there too, so companies are just trying to maximize the yield returns to their investors. So I don't think we'll see as much of that again. I hope to see it, certainly. But we do, I mean, just as a -- I guess from a strategic perspective, we're not focused on that, but we're trying to find other yield opportunities out there and take advantage of them whenever we can. There's been quite a few hiccups in the market this year. I was out from this call at the second quarter, but the missile market saw some disruption, and we jumped in there and took advantage of those yield opportunities. So you may not see it, there's a onetime situation in the fourth quarter from companies, but we're constantly, actually, looking at the broad market trying to find opportunities.

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

And then your question on the expense, we did do the restructuring in Q1, and took about a $10 million charge. I'll just remind you that over half of the costs relate to claims adjusting, and we're expecting that our expense ratio will be kind of where it's been in the 27, maybe high 26 range going forward and we see some improvement on the LAE ratio since a lot of those cost flow through the loss adjustment expenses.

Gabriel Tirador
Chief Executive Officer, President and Director

And then I'll just add to that. The change that we made on -- in the hub consolidation earlier in the year along with some other cost-saving measures, we believe will improve our competitive position going forward as we incorporate some of those cost-saving measures into our pricing and something that we're taking a look at now with respect to our loss indications, our overall cost structure, that includes the cost-saving measures that we've done here at the beginning of the year. And we're also taking a look at other costs as well. So we plan on making some changes to our pricing and some of the states outside of California to incorporate some of these cost savings in the future.

Operator

Your next question comes from the line of Vincent DeAugustino with KBW.

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

Just one quick one. As far as the policy in force growth goes, from the homeowners side, the movement there has been kind of somewhat expected but I was a little surprised by the swing on the auto PIF. So I'm just curious if there's anything kind of moving around that would be interesting there. We're just curious any thoughts that you have.

Gabriel Tirador
Chief Executive Officer, President and Director

Well, the auto PIF in California is going a little bit, but outside of California, Vincent, we've had a decline as a result of the rate changes that we've made outside of California to improve our profitability. So that's basically what you're seeing is increase in California and a decline in PIF outside of California. And as I just mentioned, we're taking steps to potentially make some rate changes outside of California to improve our competitive position, so to help with the top line growth that includes some of the cost saving measures that we've implemented earlier in the year, and we plan on taking some further steps on cost as well. So it's really driven by outside of California right now.

Operator

There are no further questions at this time.

Gabriel Tirador
Chief Executive Officer, President and Director

Well, we'd like to thank everyone for joining us this quarter and we look forward to speaking to you again next year. Thank you.

Operator
This concludes today's conference call. You may now disconnect.