S&P Global
Market Intelligence

Mercury General Corporation NYSE:MCY

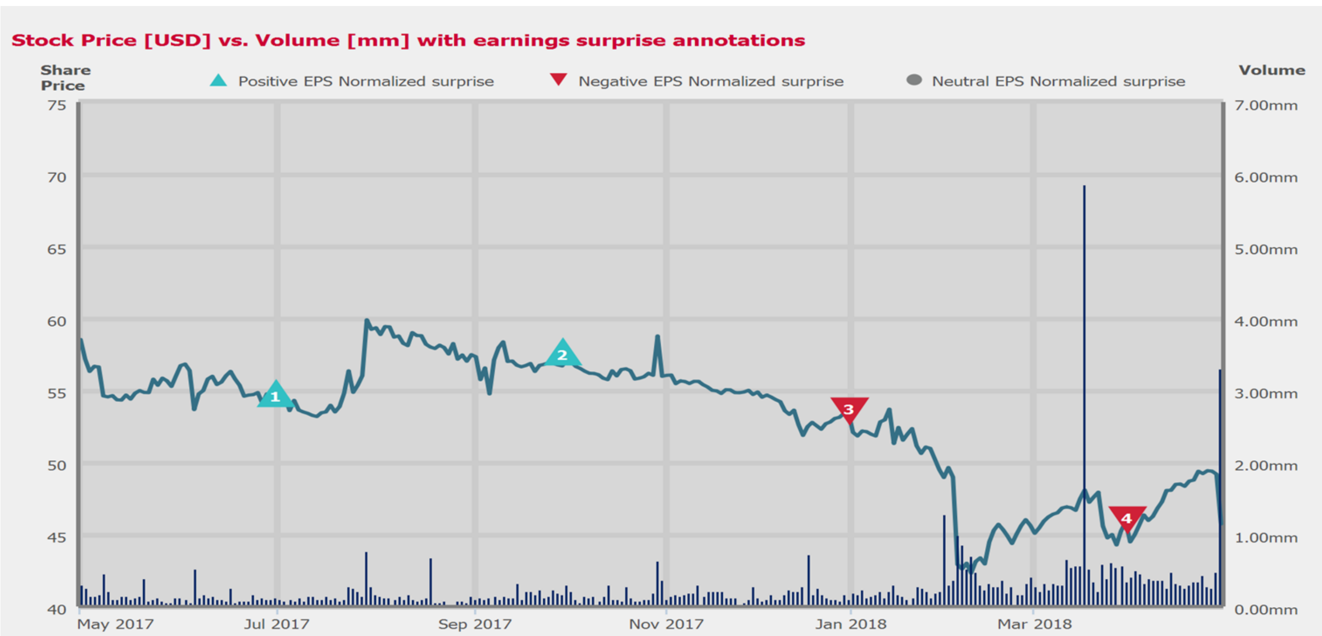
FQ2 2018 Earnings Call Transcripts

Monday, July 30, 2018 5:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2018-			-FQ3 2018-	-FY 2018-	-FY 2019-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.55	0.88	60.00	0.71	1.98	3.08
Revenue (mm)	-	-	-	-	3388.00	3489.00

Currency: USD
Consensus as of May-25-2018 5:04 AM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ2 2017	0.50	0.68	36.00 %
FQ3 2017	0.52	0.60	15.38 %
FQ4 2017	0.33	0.15	(54.55 %)
FQ1 2018	0.30	0.07	(76.67 %)

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Call Participants

EXECUTIVES

Christopher Wadewitz Graves
VP & Chief Investment Officer

Gabriel Tirador
President, CEO & Director

Robert Houlihan
VP & Chief Product Officer

Theodore Robert Stalick
Senior VP & CFO

Unknown Executive

ANALYSTS

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

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

Ronald David Bobman
Capital Returns Management, LLC

Presentation

Operator

Good morning. My name is Kelly, and I will be your conference operator today. At this time, I would like to welcome everyone to the Mercury General Second 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 risks and uncertainties, which cannot be predicted or quantified and which may cause future activities and results of operations to differ materially from those discussed here today.

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

Gabriel Tirador
President, CEO & Director

Thank you very much. I would like to welcome everyone to Mercury's second 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; and Robert Houlihan, Vice President and Chief Product Officer. On the phone is Chris Graves, Vice President and Chief Investment Officer.

Before we take questions, we will make a few comments regarding the quarter. I am pleased to report our second quarter operating earnings were $0.88 per share compared to $0.68 per share in the second quarter of 2017. The improvement in operating earnings was primarily due to an improvement in the combined ratio, an increase in after-tax investment income and a lower corporate tax rate. The combined ratio was 96.9% in the second quarter of 2018 compared to 97.8% in the second quarter of 2017. The combined ratio in the quarter was aided by premium rate increases and lower catastrophe losses and negatively impacted by an increase in unfavorable reserve development, $4.7 million of reinsurance reinstatement premiums earned and a higher expense ratio. To improve our combined ratio, we have been increasing rates in most states. In California, a 5% personal auto rate increase in Mercury Insurance Company went into effect in March. A 6.9% personal auto rate increase for Mercury Insurance Company and California Automobile Insurance Company are pending approval with the California Department of Insurance. In addition, a 6.9% rate increase in our California homeowners line was filed in May. Personal auto and homeowners premiums in Mercury Insurance Company and California Automobile Insurance Company represent about 77% of our direct company-wide premiums earned.

Catastrophe losses were $2 million in the quarter compared to $10 million in the second quarter of 2017. $21 million of unfavorable reserve development in the quarter came primarily from our commercial lines of business and a reevaluation of ultimate loss adjustment expenses on our California personal auto line of business in light of increasing defense cost in an increasingly litigious environment. The expense ratio was 24.3% in the second quarter compared to 24% in the second quarter of 2017. The higher expense ratio was primarily due to an increase in advertising and possibly related accruals, partially offset by lower average commissions and cost efficiency savings. Advertising expense was $9 million in the quarter compared to $6 million in the second quarter of 2017. Excluding the impact of catastrophe losses, unfavorable reserve development and ceded reinstatement premiums earned, the combined ratio was 95.2% for the 6-month period ending June 30, 2018, compared to 97% for the 6-month period ending June 30, 2017.

After-tax investment income increased 11% to $31 million. The increase in after-tax investment income was primarily due to higher short-term interest rates, an increase in invested assets, a lower corporate tax rate and higher yields obtained on certain classes of investments. Company-wide private passenger auto new business applications submitted to the company increased approximately 20% in the quarter, and company-wide homeowners applications increased 14% in the quarter.

Lastly, the car -- wildfire in Northern California has been burning since last week. At last report, the fire has destroyed over 800 structures and is approximately 20% contained. As of this morning, 11 total loss claims, one partial loss claim, 16 evacuation claims and 2 renter claims have been reported to the company. Our catastrophe reinsurance treaty provides for $205 million of coverage in excess of our $10 million retention.
With that brief background, we will now take questions.

Question and Answer

Operator

[Operator Instructions] Your first question comes from the line of Greg Peters from Raymond James.

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

I had just a couple quick questions for you. First, around the pending 6.9% rate increases, is there -- have you outlined an expectation around timing on when the Insurance Commissioner might provide you the green light on that?

Gabriel Tirador
President, CEO & Director

Well, on the Cal Auto one, I believe that was filed sometime last September or so.

Unknown Executive

Mid-September.

Gabriel Tirador
President, CEO & Director

Mid-September. So that one is closer, I would say, to getting approved. The Mercury Insurance Company one, that was just filed in April, I believe. So that's a more recent one. So the Cal Auto, our expectation is to get approved within the next few months, would you say, Robert? Historically, at least.

Robert Houlihan
VP & Chief Product Officer

Yes, we've received questions and we've corresponded with the department. There's no outstanding issues, but we're still working through additional questions are coming in from the department. So we think there will be progress on that in the very near future.

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

Robert, is it true that these -- it seems like from the time you make the initial filing to the time there's resolution, one way or the other, it takes about a year. Is that an accurate read on it? Or am I missing something?

Robert Houlihan
VP & Chief Product Officer

That's accurate, although we kind of break it down as to whether there's an intervener in the process or not. And generally, if there's no intervener, it's been a shorter time -- a little bit shorter timeframe than that.

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

But the intervener only gets involved if the rate increase is in excess of 6.9%, correct?

Robert Houlihan
VP & Chief Product Officer

No. Interveners can be on any filing. The rule around the 6.9% is if the increase is above that amount and the intervener requests its hearing, they must be granted a hearing. If it's less than that, it's at the

Commissioner's discretion as to whether to grant a hearing. But there can still be interveners on filings below the 6.9% and below.

Gabriel Tirador
President, CEO & Director

No, we don't have one in the Cal Auto one, the 6.9%, that we don't have one on that, and we don't have one on the Mercury Insurance Company one...

Robert Houlihan
VP & Chief Product Officer

Correct.

Gabriel Tirador
President, CEO & Director

As well.

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

Okay. So the second question is just around the combined ratio. You obviously showed a nice improvement in the second quarter, congratulations. And with the 95.2%, I'm going to call it an underlying combined ratio, is it your expectation that, that 95.2% should hold through the balance of the year or should get better? Again, the 95.2%, as I understand it, excluded catastrophes, reserve development and reinsurance reinstatement premium, to clarify.

Gabriel Tirador
President, CEO & Director

I mean, I think it will depend on trends, really on what happens with loss trends and whether or not the rate increases that we have, that are still earning in, by the way, because the Mercury Insurance one went into effect -- I think the 6.9% went into effect in March. So we're going to still benefit from that going forward. It will depend on the trends, whether or not the trends have stabilized or will stabilize. The Fast Track numbers do indicate that the first quarter severity came down a little bit for -- Ted, you want to get that?

Theodore Robert Stalick
Senior VP & CFO

Yes, yes. The Fast Track BI for California came down to 5.6% in the quarter. And overall, paid severities or trended down for other coverages in the quarter. So that may be an indication that inflationary pressures are moderating somewhat in California.

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

So if they stabilize at these levels, the 95.2% could hold or get even better, right, if the rate increases continue to roll through earned premium?

Gabriel Tirador
President, CEO & Director

I mean, I guess, it's possible either way.

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

Yes. Right. I don't want to -- I'm not trying to put you in a box. Sorry about that.

Gabriel Tirador

President, CEO & Director

No, no. We don't like to forecast combined ratios or [indiscernible] earnings. We never have.

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

But what -- but you do have a combined ratio target for the company, correct?

Gabriel Tirador
President, CEO & Director

We do. And that's 95%. That's correct.

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

Is that 95% including, all-in, including catastrophes, prior period reserve development?

Gabriel Tirador
President, CEO & Director

Yes.

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

So the actual underlying combined ratio would be lower? The 95.2% on a -- if you were to apples-to-apples, should actually be below that because you're going to assume there's going to be some catastrophe losses in any given year. Is that...

Gabriel Tirador
President, CEO & Director

That's a reasonable assumption. That's our goal.

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

Okay. Okay. That something below 95% is your -- underlying is your goal?

Gabriel Tirador
President, CEO & Director

As you're defining it, yes. Correct. Yes.

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

Okay. Perfect. I don't mean to parse words here, but...

Gabriel Tirador
President, CEO & Director

Yes -- no. That's accurate. Well, our goal is to have a 95% combined ratio company-wide, all-in. That's our goal.

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

Got it. And then, I guess, and I know there's other people that are going to ask questions, so I'll just -- I'd like to ask Chris a question whenever I get a chance. And so it looks like the yield is up in the quarter. You did a real nice job of improvement in investment income. And I'm just curious if the current run rate is sustainable, or are there some puts and takes that might moderate as we work through the balance of the year?

Gabriel Tirador
President, CEO & Director

Chris, you want to handle that?

Christopher Wadewitz Graves
VP & Chief Investment Officer

Yes. Yes. Can you hear me okay?

Gabriel Tirador
President, CEO & Director

Yes.

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

Yes.

Christopher Wadewitz Graves
VP & Chief Investment Officer

Yes, okay. Good, good. I'm calling in on a cellphone. Yes, it's -- there's some give and take going on in the portfolio. For example, the -- on the municipal bonds, we still got some pretty nice book yields in the portfolio, and the current rates still aren't quite, in most cases, at levels that can be accretive as bonds roll off. But on the flip side, we've got short rates rising with the Fed. We've got the portfolio more sensitive to short rates through CLOs, bank loans and then the cash balances themselves. So with exactly those 3 together, it's about 10% of the portfolio, so that makes us pretty sensitive each time the Fed moves rates up. And then just the benefit...

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

Chris, did you say CLOs as part of that 10%?

Christopher Wadewitz Graves
VP & Chief Investment Officer

Yes. CLOs are, I think they're about 3% of the portfolio right now. And that's an increasing exposure that we're going to continue to build. And so with the benefit also of the company's, with this quarter's good results and everything, that also adds wind to my back. So I can't say, yes, this is a sustainable rate just yet, but I certainly feel good about the numbers that I'm turning in right now.

Operator

Your next question comes from the line of Ron Bobman from Capital Returns.

Ronald David Bobman
Capital Returns Management, LLC

I had 2 topics I wanted to ask you about. When you mentioned, Gabe, the adverse development, I think I heard you say -- I just wondered if you would repeat it and maybe expand on it a little bit, but you started out saying that there was an element that was the commercial book, but then you also referenced the personal auto. Could you correct me if I heard it wrong and maybe expand on it a little bit?

Gabriel Tirador
President, CEO & Director

Yes, it was a combination of both commercial lines of business, loss side, and also, under personal auto, loss adjustment expenses. Basically, our defense costs are going up as we're defending more of these claims with bodily injury. And...

Ronald David Bobman
Capital Returns Management, LLC

Should we think of the $20 million being like half and half, commercial being half? And the defense costs element on personal auto, is that mainly in the ballpark?

Gabriel Tirador
President, CEO & Director

That's pretty close. That's pretty close.

Ronald David Bobman
Capital Returns Management, LLC

Okay. And then separate and apart from that, the app count growth was pretty significant on both auto and home. What's going on there? What's driving that?

Gabriel Tirador
President, CEO & Director

Well, I think it's a combination of factors. I think there's been rate increase activity going on in the market. And as a result of that, our close ratio has improved. In addition to that, there's been more quoting. So a combination of increased quoting activity and a close ratio improvement, as a result of, I believe, rate increases. Although it appeared to me, and Robert, I don't know, if you want to mention anything here, that the more -- the most recent month's rate increases, it looks like it started to slow down, the number of rate increases and the magnitude of rate increases. So...

Robert Houlihan
VP & Chief Product Officer

I would say the rate increases have induced more shopping. We've also shifted our advertising spend more towards California and we generated more business in California because of the shift in ad spend. So I think it's a combination of more shoppers from more rate increases and [indiscernible] and a slightly bigger ad spend in California, driving growth in our auto and homeowners in California.

Gabriel Tirador
President, CEO & Director

In our view, being competitive, I think the close ratio improved as well.

Robert Houlihan
VP & Chief Product Officer

Yes.

Ronald David Bobman
Capital Returns Management, LLC

Is the legal representation, back to my -- the sort of the adverse development and the LAE burden, is that geographically weighted? I mean, are you seeing it more in a certain part of the state, or not clear?

Gabriel Tirador
President, CEO & Director

Well, I think I mentioned last quarter, I've seen it throughout the whole state. But Southern California, I would say, is worse.

Operator

Your next question comes from the line of Christopher Campbell from KBW.

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

Just, I guess, my first question is the reserve additions. If I'm just looking at the last few quarters, you guys have had about $100 million in the last 3 quarters. So at what point do you decide that this California BI issue might be bigger and that you need to take maybe a larger reserve charge to kind of put it behind you once and for all?

Theodore Robert Stalick
Senior VP & CFO

Well, we essentially look to evaluate the reserves every quarter and we think our best estimate based on the data that we -- that's available and our view of what's going to happen in the future. And so what you're talking about is putting a bias into our estimate, biasing it higher or low. We don't bake bias into our reserve analysis. What we do, do is we have -- the company creates its own internal analysis and we have external actuaries create their own analysis independently and then we sort of compare those analysis. And typically, the differences are not significant, and we come up with our point estimate from that process. But as far as taking sort of a big math or a big charge to put it behind us, that's just not something that we do.

Gabriel Tirador
President, CEO & Director

I'd also like to point out that I think the last couple of years, the environment has changed. There's no question about it, especially here in California from a BI perspective. And the historical loss development factors that were chosen, they've been changing because of the environment changing. And I think once that stabilizes and those factors become more stable, the accuracy of reserves are going to be much more stable as well. So -- and I think we're getting closer to that. It's not an exact science, as you know, reserving, so that's -- we basically try to make our best estimate of the numbers. We use outside actuaries. We have internal actuaries, and we try to get to that best estimate. But there's no question that the change in the environment here in California has caused us to be off from historical trends.

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

Got it. And are your loss development factors, I mean, are they materially different if you look at that versus California and non-California?

Theodore Robert Stalick
Senior VP & CFO

I think the way you would look at it is that they are -- they're changing more as you progress through the triangle. Whereas if you look at some of the other states, and we have favorable development in more than half of our states outside of California, and those have very stable development patterns. California has had progressively increasing development patterns as you go across the triangle. And that's what Gabe was describing earlier, which makes it much more challenging to get ahead of the reserves.

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

Got it. That's very helpful. And I know -- and I was reading on the press release that you started introducing or reintroducing 12-month policies. So any difference, any changes you're doing in your pricing reserve loss picks to kind of factor in that you might not be able to reprice those as quickly? I mean, if, knock on wood, that you get the estimate, do you get like the first pass at that incorrect?

Robert Houlihan
VP & Chief Product Officer

Well, certainly, in the indication process, we consider how long the next rate level will be in effect, and that certainly affects that calculation, the higher percentage of annual policy. So in that respect, we take it into consideration.

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

Okay. Great. And then I saw the, like the strong premium growth, part of that was the reintroduction of the 12-month policies. But are you seeing any benefit from the Access bankruptcy?

Gabriel Tirador
President, CEO & Director

Yes, we did. In our nonstandard auto company, Workmen's, there's significant growth there.

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

Okay. And then like -- so are you doing -- so is it coming in -- yes, like so what are the close rates on that versus like what that book looked like before the Access bankruptcy? Like are they up, are they down? And then kind of is there any indication that -- how much higher your prices are than Access' were?

Gabriel Tirador
President, CEO & Director

Based on some samples that we took, looking at their previous policy, substantially higher. Which could be the reason that they're no longer in business.

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

Right. Yes. Yes. I got it. So -- yes, there's been some other non-standard carriers that have been picking up business from that as well. And then just one final numbers one. Tax rate was a little lower. Is that just the more of that investment income versus underwriting income? Is that kind of a mix thing this quarter? Or anything special?

Theodore Robert Stalick
Senior VP & CFO

Well, if you look at our effective tax rate in 2018, now we're under the benefit of the lower federal tax rates, our investment income's effective tax rate is around 10% and underwriting income, other income and capital gains and losses are around 21%. So that's sort of how the math works out, and it just depends on the relative weight of those components of income.

Operator

[Operator Instructions] Your next question comes from the line of Greg Peters of Raymond James.

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

Actually, 2 follow-ups. First of all, on the unfavorable development in the auto, not the commercial auto, the auto side, you said most of it is skewing -- or a portion of it is skewing from Southern California. I know you're pretty thoughtful in how you segment your customers. And I'm curious if there's been any predisposition to one segment being more at risk for these reserve adjustments than another segment.

Gabriel Tirador
President, CEO & Director

We don't -- when we take a look at our reserves in total, we don't segment or calculate our total reserves based on segment. Pricing is a different matter. We know -- obviously, we do consider territory from a pricing standpoint. And that -- we take that into account. But when we take a look at our reserves and calculate our total reserves, we're not taking Southern California and calculating it -- a reserve for Southern California and one for Northern California. We take a look at the -- our whole book of business. First of all, you have more credibility, and second of all, from a pricing standpoint though, there's no question that we take territory into account.

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

Got it. And then I think you mentioned that there's favorable development outside of California. And I know that's been a business that hasn't been growing for you. And I'm curious now that you seemingly turned the corner around development, at least favorable development, I'm wondering if your growth profile is going to change for states outside of California.

Gabriel Tirador
President, CEO & Director

Actually, in this quarter outside of California, we actually saw a slight increase in our new business applications in private passenger auto. They grew about 2%, 2.3% outside of California. We've got a lot of initiatives going on trying to make it easier for our agents. We have new software that we're implementing in the next couple of weeks. We have improvements in segmentation that we've been working on, on the underwriting side as well. So we're hopeful that all the things that we're working on are going to improve not only the top line, but also our bottom line.

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

And are there -- would you like to call out any other states that are working, you're seeing some sense of optimism? Or you just like to leave it with that?

Gabriel Tirador
President, CEO & Director

I would just say that most of the states right now are well below 100, Ted? And some of our bigger states, Florida -- I mean, Texas, actually, I think grew a little bit. And Florida was down a little bit, is my recollection of the 2 biggest states. But overall, like I said, from an application count standpoint, which is something that we monitor, our application count this quarter was up slightly.

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

That's the first time in a while, correct?

Gabriel Tirador
President, CEO & Director

Yes, yes. I mean, because if you take a look at the year-to-date, application count, they're down like 10%.

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

Right. But I mean, going back over for an extended period of time, that's been the shrinking market for you, so do you feel like...

Gabriel Tirador
President, CEO & Director

Yes, yes. So it was a decent quarter. We're hopeful that -- we're hoping that we can continue that trend.

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

Yes. It sounds like you may have turned the corner there. The last question around advertising. You talked about moving around some of the pieces within the company. I'm wondering if the overall budget has changed for the full year and how it compares with the previous year.

Gabriel Tirador
President, CEO & Director

It's up slightly. I think our budget this year is up $2 million or $3 million, and we expect to spend around $40 million, Ted?

Theodore Robert Stalick
Senior VP & CFO

Yes.

Operator

And there are no further questions at this time.

Gabriel Tirador
President, CEO & Director

Well. Great. Thank you for joining us this quarter, and we look forward to talking to you in the third quarter. Thank you very much.

Operator
And this does conclude today's conference call. You may now disconnect.