S&P Global
Market Intelligence

Mercury General Corporation NYSE:MCY

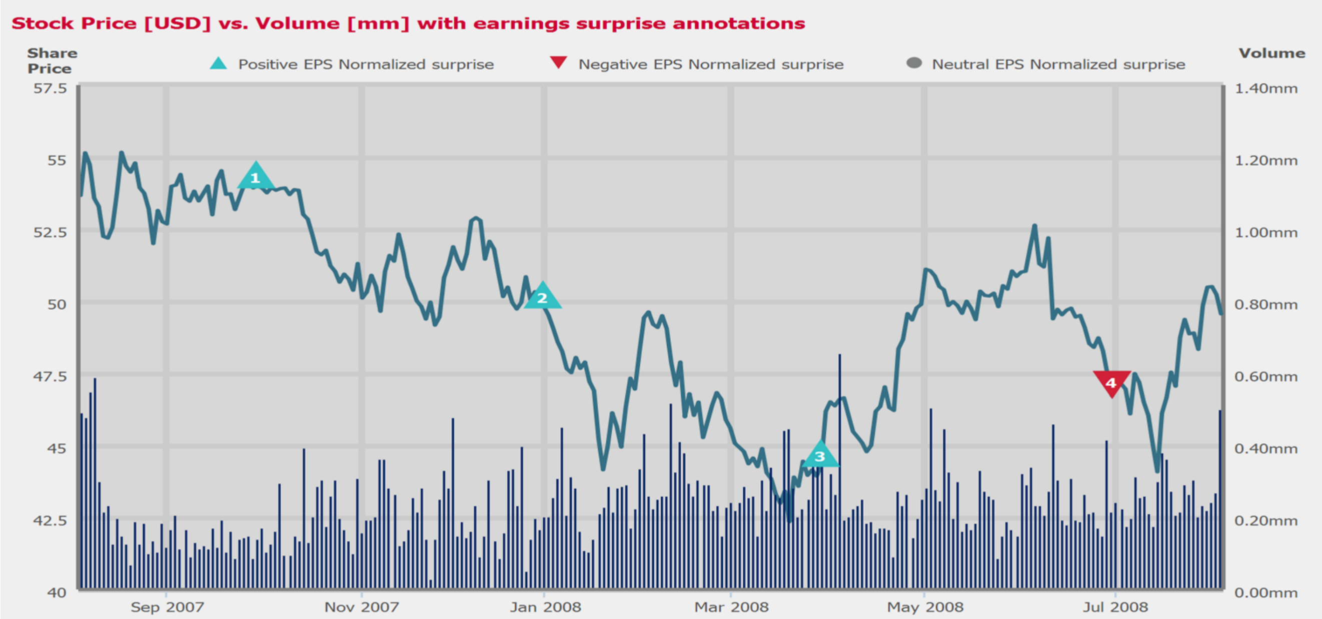
FQ3 2008 Earnings Call Transcripts

Monday, November 03, 2008 6:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2008-			-FQ4 2008-	-FY 2008-	-FY 2009-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.90	0.72	(20.00 %)	0.84	3.57	3.45
Revenue	-	-	(1.82 %)	-	-	-
Revenue (mm)	708.00	695.14	-	643.30	2771.95	2683.65

Currency: USD
Consensus as of Nov-03-2008 5:50 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2007	1.12	1.13	0.89 %
FQ4 2007	0.82	0.96	17.07 %
FQ1 2008	1.00	1.02	0.99 %
FQ2 2008	0.98	0.86	(12.24 %)

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Call Participants

EXECUTIVES

Christopher Graves

Gabriel Tirador

Theodore R. Stalick

ANALYSTS

Alison Jacobowitz
Merrill Lynch

Meyer Shields
Stifel Nicolaus & Co.

Presentation

Operator

Good afternoon. My name is Ashley, and I will be your conference operator today. At this time, I would like to welcome everyone to the Mercury General Third Quarter 2008 Results Conference Call.

All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [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 conference over to Mr. Gabriel Tirador. Sir, please go ahead.

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; Chris Graves, Chief Investment Officer; John Sutton, Senior, Vice President Customer Service; and Robert Houlihan, Vice President and Chief Product 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 take questions, we will make a few comments regarding the quarter. In California, our combined ratio increased from 91% in the third quarter of 2007 to 97.7% in the third quarter of 2008. There were many factors contributing to the increase in the combined ratio during the quarter, including higher severity in our auto line that was partially offset by reduction in frequency.

A higher homeowners' combined ratio, one large commercial property loss and approximately $9 million of adverse reserve development compared to $3 million in the third quarter of 2007.

In our California personal auto line, we recorded an overall increase in severity in the high single-digits during the quarter, which was partially offset by a reduction in frequency. In addition the approximately 2% rate reduction that went into effect in April of this year had a negative impact on combined ratio as about 65% of the earned premium during the third quarter was earned at the lower rate level.

In our California commercial auto line we recorded a net severity in high single-digits that was partially offset by reduction in frequency.

The third quarter of 2008 continued the trend of increasing severity in medical, labor and parts costs. For the nine months ended September 30th, 2008, we recorded an increase in California severity in the mid single-digits and a reduction in California frequency in the low single-digits.

Our California auto frequency has been positively impacted from what we believe was reduced driving as a result of higher fuel costs and the over all economic slowdown. However it is difficult to predict whether the reduction in frequency will continue for the next several quarters or driving levels will revert to previous levels as a result of declining fuel cost.

Our statutory combined ratio for our homeowners' line increased to 99% in the third quarter of 2008 from 80% in the third quarter of 2007. The deterioration in our homeowners' results was primarily due to a few large non-catastrophes related buyer loss and some negative reserve developments. We believe this quarter's homeowners' results was an anomaly and we do not expect our California homeowners' results, excluding any catastrophes to post such a high combined ratio in next quarter.

Lastly as I mentioned earlier, our California combined ratio was adversely affected by a large commercial fire loss during the quarter. The commercial fire loss was approximately $5 million and added about nine tenth of a point to the overall California combined ratio during the quarter as compared to prior year.

Our third quarter 2008 combined ratio of a 117.7% in our non California operations was significantly worse than a 105.5% combined ratio posted in the third quarter of 2007. The deterioration in the combined ratio during the quarter was primarily due to adverse development in New Jersey and increased losses and Texas related to Hurricane Ike.

The adverse development in our non California operations was $7 million, which was comprised of $13 million of adverse development for New Jersey, partially offset by $6 million of net positive development from other states. The development in New Jersey was primarily related to the reestimation of prior year's loss reserves for the PIP coverage. Losses from Hurricane Ike totaled $6 million during the quarter.

New Jersey continues to be the most difficult state to estimate our ultimate liabilities for the bodily injury and PIP coverages, due to the lack of historical data and a long-tail nature of these coverages. We will continue to monitor the results closely. However, until we obtain more operating history in New Jersey, estimating our ultimate losses will be challenging.

As we've discussed on previous calls, we are taking steps to improve our results in New Jersey. Our new territorial pricing changes went into effect on August 1st, 2008 and a new rating plan was filed recently with improved segmentation and a rate increase of about 5%.

In addition, we are tying [ph] our underwriting, are working with agents to improve results and have made changes to our claims processes for PIP and BI. The early indication is that the clean [ph] process changes are having a positive impact on our PIP cost for current accident year. However, data is too green to make any changes to our selection to the accident year. We believe we will turn the New Jersey operations around similar to what we did in Florida.

In Florida improved claims handling, pricing, underwriting and agent selection has improved our Florida results significantly. Our Florida combine ratio is now in the low to mid 90.

Our company wide expense ratio increased from 27.7% in third quarter of 2007 to 28.5% in third quarter of 2008. The increase was primarily due to an increase in technology related expenditures, the establishment of our new product management function and assessment for the New Jersey guarantee fund and the fact that fixed costs have not declined in proportion to the declines in premiums. To address the increase in expense ratio during the soft market, we are freezing new hiring except for certain positions.

We continue to aggressively make changes to our rating plans to improve our segmentation and overall pricing adequacy. During the third quarter, we implemented five rate changes and we expect to implement two additional rate changes in the fourth quarter of 2008.

Although the competitive environment remains intense, we continue to observe more filings for rate increases than rate reductions. The industry is experiencing a reduction of frequency but we believe the increase in severity more than offset the reduction of frequency. We believe we will continue to see an increased level of rate action taking by some of our competitors. However, we expect our growth rate for the next quarter to be negative in the mid to high single digit.

Earlier this month, we announced that we entered into a definitive agreement with Aon Corporation for the purchase of Auto Insurance Specialist Incorporated. AIS is a major producer of automobile insurance in the State of California and our largest independent broker producing over $400 million of direct premiums written, which represented 14% of the company's direct premiums written during 2007.

A few months ago, we were informed by AON of their desire to sell AIS as part of their strategy to focus on commercial lines. When we were informed by AON of their desire to sell AIS, we felt that it was important for us to consider that a significant portion of our California business is written by AIS. We concluded that it was in a company's and our agent's best interest for Mercury to acquire AIS.

Our intention is for AIS to continue to operate as an independent agency under the same management. We believe the purchase will be slightly accretive to earnings. Before we take your questions, Chris Graves, our Chief Investment Officer will provide information on our investments and Ted Stalick, our Chief Financial Officer will comment on our capital position, Chris?

Christopher Graves

Thank you, Gabe. Mercury's investment portfolio's market value was adversely impacted by numerous market events that transpired over the summer. As reported Mercury's realized loss for the quarter was $276 million. But half of that amount came from valuation changes to municipal bonds and the other half from declines in common stock.

At the start of 2008, Mercury adopted FASB 159 for the entire investment portfolio. Under FASB 159, Mercury recognized its market value changes as realized gains or losses on the income statement, regardless to whether the security is actually sold. The lion's share of the $276 million is truly unrealized, that is to say that Mercury still owns the positions that contributed to the accounting loss.

While most of our investments declined with the market, we have two impairment... two prominent impairments. We took an impairment charge of $40 million for our positions in Lehman and Fannie Mae preferred stock. We do not own much in the way of other financial stocks.

In the quarter we experienced a drastic reversal in market direction from Q2 for both bonds and stock. Our common stocks after a strong second quarter weakened very quickly despite many holding announcing earnings exceeding estimates and having strong financial statements. Strong pressure in municipal bond also increased. Many levered tender option bond programs collapsed, and another levered players pushed many millions of bonds into the market.

Selling pressure from these two market segments was not unique just to them as most markets were experiencing much more supply than willing buyers. While the market freezed [ph] the investment portfolio, we've tried to manage risk through conservative asset allocation. 2.3 billion or 72% of the portfolio is in municipal bonds, that even after the downgrades of the monoline insurers have an average rating of AA3AA. $250 million or 8% of the portfolio is in short term cash and cash equivalents.

And now I'll turn over to Ted for discussion of our capital.

Theodore R. Stalick

Thank you, Chris. I'd like to make a few comments about our capital position. Mercury maintains a strong balance sheet, so that we are able to weather turbulent times without putting our operations at risk. We have resisted significantly levering up the company in the past to protect ourselves in difficult times just like this. So even with the recent valuation adjustments to our investment portfolio, Mercury's capital position remains very strong.

Operating leverage today is as low as it is been over the past five years. As September 30th, our underwriting leverage as measured by premiums to surplus is a very comfortable 1.7 to 1. And this compares to the past five years where it's ranged between 1.7 to 1 and 2 to 1.

Financial leverage is currently near historic lows at 8% debt-to-total capital and has ranged between 7% and 12% over the past ten years. With the planned $120 million of financing for the AIS transaction, financial leverage will go up to around 15% which is an amount that we feel comfortable with. In the future, we would not expect this ratio to go much higher.

There is nothing like having a strong balance sheet in times like this. We believe that our current capitalization is strong enough to allow us to observe more shocks, should they occur. It also allows us to begin to grow when the insurance markets start to harden and to continue to paying dividends to our shareholders. And now with all that background, we will now open it up open for questions.
Question And Answer

Question and Answer

Operator

[Operator Instructions]. Our first question comes from the line Meyer Shields from Stifel Nicolaus.

Meyer Shields
Stifel Nicolaus & Co.

Thanks, hi, everybody.

Gabriel Tirador

Hello.

Theodore R. Stalick

Hi.

Meyer Shields
Stifel Nicolaus & Co.

I guess one reporting question?

Gabriel Tirador

For?

Meyer Shields
Stifel Nicolaus & Co.

For the AIS business that can be shown directly [ph] broken out in terms of your recording?

Gabriel Tirador

We don't anticipate it being broken out as far we as reporting now.

Meyer Shields
Stifel Nicolaus & Co.

Okay. But will be, is it reasonable to assume that it will be in other revenues and other expenses... the revenue expense on it?

Theodore R. Stalick

Well the majority of that Meyer will be consolidated, 90% of the business that AIS currently produces is directly with Mercury. So the portion that they don't produce with Mercury will be broken out separately.

Meyer Shields
Stifel Nicolaus & Co.

Okay I got. With regard to California I guess, I think it went through the percentage of auto premiums in the quarter that were at lower rate levels, and I was wondering if you get same number for homeowners.

Theodore R. Stalick

For homeowners' it was negligible because the rate went into affect on 1-8-15 and at their annual policies.

Meyer Shields
Stifel Nicolaus & Co.

Okay so we look forward I understand that there are steps taken outside of California, but within California's I guess you've got sort of an increasing percentage of the book of business will earned at lower rate levels and that cost continued to rise on a net basis. Is there anything that you can do to offset that commodity [ph] ratio deterioration?

Theodore R. Stalick

Well a couple of things. One, in our homeowners' line, we're coming from a very low combined ratio and this quarter VCO was an anomaly. We're also obviously taking a look at making sure that our coverage A replacement cost for our insurers are adequate which also has an impact on the overall premium level in homeowners. In addition to that, we have filed as part of the territorial rate finds [ph] that were mandated a few months ago, a slight increase in our California auto business.

Operator

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

Alison Jacobowitz
Merrill Lynch

Sorry, if you've answered this or if it's somewhere. I didn't hear it of see it. I'm just wondering for the California. Did you quantify, I get the large loss, I get the adverse reserve development, did you quantify what happened in homeowners. I think you said there was some prior losses this quarter that pressured the margin a little bit?

Gabriel Tirador

Yes. I think we, in my prepared remarks Alison, we basically said that there is a 99% combined in the quarter compared about 80% a year ago or and that roughly I believe added to the California combined ratio, almost 2 points..

Alison Jacobowitz
Merrill Lynch

Alright, Okay, great, thank you, sorry.

Operator

[operator instructions]. And there are no further questions at this time

Gabriel Tirador

Okay, I would like to thank you everybody for joining us on this quarters call. And we look forward to speaking to everybody next quarter.

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